Revue de Droit Fiscal n°18/2023

Oliver R. HOOR

PROPOSAL FOR A COUNCIL DIRECTIVE ON LAYING DOWN RULES ON A DEBT-EQUITY BIAS REDUCTION (DEBRA): A CRITICAL ANALYSIS

OLIVER R. HOOR[1]

TAX PARTNER (HEAD OF TRANSFER PRICING AND THE GERMAN DESK) WITH ATOZ TAX ADVISERS (TAXAND LUXEMBOURG)

I. INTRODUCTION

On 11 May 2022, the EU Commission released a Directive Proposal[2] on laying down rules on a debt-equity bias reduction allowance ("DEBRA") and on limiting the deductibility of interest for corporate income tax purposes (the "Proposal").

The Proposal is in line with the Commission Communication on Business Taxation for the 21st century, which singles out the pro debt bias of tax rules as a relevant issue to be tackled by European institutions. The purpose of the Proposal is to foster equity financing through an allowance on equity that would be deductible for corporate tax purposes. This measure would be complemented by an additional restriction placed on the deductibility of exceeding borrowing costs.

In terms of timing, the Proposal provides that member states shall adopt the Directive by 31 December 2023 at the latest and the provisions of the Proposal should apply as from 1 January 2024. However, this initial plan in terms of timing will most probably not become reality given that the examination of the Proposal at EU Council level has now been suspended due to the many interlinkages with other current EU corporate tax initiatives which the EU Council would like to put forward first. Therefore, the future of the Proposal is uncertain at this stage.

Still, because this Proposal might be brought back to the table in the future, this article considers the key commercial reasons for debt funding, provides a clear and concise overview of the Proposal, and analyses the various issues raised by the proposed DEBRA and interest limitation rule.

II. KEY COMMERCIAL REASONS FOR DEBT FUNDING

The DEBRA proposal aims to address the tax-induced debt/equity bias for companies in the EU. However, how a business finances its operations is an important business decision that depends on a range of factors. While the deductibility of interest expenses is one factor to be considered, the decision as to whether a company should be financed by equity or debt is generally not tax driven and there are a number of good commercial reasons why intra-group debt funding can be preferable to a contribution of equity. Evidently, a loan receivable is very different from a participation in a company.

On the one hand, debt is easier to create and provides much more flexibility in terms of cash repatriation (*i.e.* repayment of principal amount and payment of interest) than equity. The cost of debt is generally lower than that of equity. On the other hand, equity tends to be more formal and bureaucratic to issue and repay resulting in higher administrative costs for financing. Furthermore, dividend distributions are subject to limitations in terms of amount and timing and the repayment of capital is not a straight-forward exercise and may trigger additional tax costs.

In many circumstances, the split between equity and debt funding will be dictated by external aspects. While debt generally ranks *pari passu* with other creditors, equity always ranks below debt. Hence, the choice of equity or debt funding has a significant impact on the ranking between intra-group funding and external debt funding. In some countries, the decision regarding mix of debt and equity will be dictated by foreign exchange controls or other local regulatory constraints and in the absence of economic and political stability there may be a strong preference for

1. The author may be contacted at: oliver.hoor@atoz.lu and wishes to thank Samantha Schmitz (Chief Knowledge Officer) for her assistance regarding the review of this article.

2. Proposal for a Council Directive on laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes (COM/2022/216 final).

Toutes reproduction ou adaptation totale ou partielle, par quelque procédé que ce soit, est interdite. L'usage de cette ressource est autorisé uniquement pour l'utilisateur mentionné ci-dessous. Toute transmission à des tiers est formellement interdite.

Imprimé le 09/06/2023 par lisa.brand@atoz.lu

LEXNOW

debt funding (to ease future cash repatriation). Moreover, debt funding may be preferred when minority shareholders co-invest into a company in order to not change the dynamics of an investment. Additional equity funding may further be subject to shareholder approval.

A key consideration is that a group will seek external financing in the country where the capital market offers the best conditions. This is, however, not necessarily the country of investment and parent companies will often be able to raise external funding at lower rates than their subsidiaries. There are significant commercial benefits from a centralized treasury function managing a group's financing. Accordingly, it is legitimate to implement a central treasury function or finance companies. Last but not least, where access cash is moved around a group between entities without a direct shareholding relationship, there is reasonably no way to grant additional funding in the form of equity.

III. THE PROPOSAL

A. Opening comments

The Proposal includes rules concerning both an allowance on equity and a limitation on the deductibility of exceeding borrowing costs.

The amount of the allowance on equity would be deductible as a notional expense for corporate income tax purposes. DEBRA would, however, include a number of measures to avoid situations were the granting of the allowance is deemed undesirable (for example, avoiding a cascading effect in a chain of companies) and specific anti-abuse rules to tackle perceived situations of abuse.

B. Personal scope of application

The Proposal applies to taxpayers that are subject to corporate income tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country.

However, the Proposal does not apply to entities defined in the Proposal as financial undertakings. It is interesting to note that the definition of financial undertakings within the meaning of the Proposal is identical to the one included in the recent Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes ("ATAD 3", also referred to as Unshell Directive) and amending Directive 2011/16/EU (Directive on Administrative Cooperation, "DAC"). However, the definition of the Proposal is broader than the definition included in the Anti-Tax Avoidance Directive ("ATAD").

Financial undertakings which are out of the scope of both the allowance on equity and the interest limitation rules introduced by the Proposal are the following undertakings within the meaning of the various EU Directives and Regulations:

- Credit institutions;
- Investment firms;
- Alternative investment fund managers ("AIFM"), including managers of EUVECA, EUSEF and ELTIFs;
- Management Companies of Undertakings for collective investment in transferable securities ("UCITS");
- Insurance undertakings;
- Reinsurance undertakings;
- Institutions for occupational retirement provision;
- Pension institutions operating pension schemes which are considered to be social security as well as any legal entity set up for the purpose of investment of such schemes;
- Alternative investment funds ("AIF") managed by an AIFM;
- UCITS;
- Central counterparties;
- Central securities depositories;
- Insurance or reinsurance special purpose vehicles;
- Securitization special purpose entities;
- Insurance holding companies or mixed financial holding companies;
- Payment institutions;
- Electronic money institutions;
- Crowdfunding service providers; and
- Crypto-asset service providers.

C. An allowance on equity

1) General

The first measure provided under the Proposal is an allowance on equity which would be determined as follows:

Allowance on equity = Allowance Base * Notional Interest Rate ("NIR")

Accordingly, the allowance on equity corresponds to the allowance base multiplied by the applicable NIR.

Toutes reproduction ou adaptation totale ou partielle, par quelque procédé que ce soit, est interdite. L'usage de cette ressource est autorisé uniquement pour l'utilisateur mentionné ci-dessous. Toute transmission à des tiers est formellement interdite.
Imprimé le 09/06/2023 par lisa.brand@atoz.lu
LEXNOW

Revue de Droit Fiscal n°18/2023
Oliver R. HOOR

2) Computation of the allowance base

The allowance base is the difference between the net equity at the end of the current tax year and net equity at the end of the previous tax year. This means that the allowance on equity is granted only for the sum of equity increases in a specific year, not for the overall equity.

For the purposes of DEBRA, the terms equity and net equity are defined as follows:

- Equity is defined by reference to Directive 2013/34/EU (the "Accounting Directive") as the sum of paid-up capital, share premium account, revaluation reserve and reserves and profits or losses carried forward; and
- Net equity is then defined as the difference between the equity of a taxpayer and the sum of the tax value of its participation in the capital of associated enterprises and of its own shares. This ensures the avoidance of a cascade effect in a chain of companies which would arise if the tax value of the participations was considered.

3) Notional interest rate

The notional interest rate ("NIR") is calculated as follows:

NIR = risk free rate + risk premium

Hence, the relevant NIR consists of two components:

(i) the (currency-specific) 10-year risk-free interest rate (that is the risk-free interest rate for bonds with a term of 10 years as of 31 December of the preceding fiscal year), and

(ii) the risk premium.

The risk premium is generally set at 1.0%. However, in the case of small and medium-sized enterprises (SMEs), an increased premium of 1.5% would apply.

The risk premium is intended to take account of the risk premium paid by investors when raising capital and to mitigate the incentive for debt financing. The higher risk premium for SMEs reflects the higher risk premium when raising capital due to the higher inherent risk.

4) Allowance on equity

a. Allowance for a positive allowance base

The allowance on equity is to be determined by multiplying the basis for the allowance by the NIR. This allowance would be deductible for income corporate tax purposes and available for ten consecutive fiscal years from the year in which it arises.

The allowance on equity is deductible for 10 consecutive tax years, as long as it does not exceed 30% of the taxpayer's earnings before interest, taxation, depreciation and amortization ("EBITDA"). Should the allowance exceed 30% of the EBITDA, the exceeding amount may be carried forward for a maximum of five fiscal years.

Conversely, should the deductible allowance be greater than the net taxable income in the relevant tax period, the exceeding amount of the allowance is to be carried forward into subsequent tax periods without limitation in time. Consequently, the allowance may not result in a tax loss.

b. Allowance for a negative allowance base

Should there be a net reduction in equity in a given fiscal year (that is the negative allowance base), an amount equal to the negative allowance on equity would become taxable for ten consecutive years if the taxpayer has deducted an allowance on equity in previous fiscal years in accordance with the provisions of the Proposal.

The negative allowance base must be multiplied with the NIR. The negative tax-free amount is to be treated as taxable income for ten consecutive years.

The Proposal does not clarify whether the allowance claims from the preceding fiscal years will lapse for the corresponding remaining term. However, it seems to make sense to consider that these will continue to be granted and the reduction in equity will be compensated by a negative (taxable) allowance of (maximum) the same amount. This should be clarified if the Proposal will finally be adopted.

The amount of negative (taxable) allowance would be limited to the overall increase of net equity in respect of which an allowance on equity has been obtained.

Nevertheless, the taxable allowance on equity (that is the negative allowance) would be waived if the taxpayer can prove that the reduction in equity is due to accounting losses in the very same fiscal year (resulting from the company's business activities) or a legal obligation to reduce the capital.

5) Anti-abuse rules

The Proposal provides for a number of anti-abuse rules that target (i) the multiplication of the allowance of equity

Toutes reproduction ou adaptation totale ou partielle, par quelque procédé que ce soit, est interdite. L'usage de cette ressource est autorisé uniquement pour l'utilisateur mentionné ci-dessous. Toute transmission à des tiers est formellement interdite.
Imprimé le 09/06/2023 par lisa.brand@atoz.lu
LEXNOW

in a group of companies, (ii) the potential overvaluation of assets and (iii) the recycling of equity into new equity through a corporate reorganization.

– **Excluding equity increases**

An increase in equity would be deemed abusive if it is the result of:

- The granting of loans between associated enterprises;
- An intra-group transfer of participations or of a business activity as a going concern; or
- A contribution in cash by a person that is resident in a jurisdiction that does not exchange information with the Member State in which the taxpayer seeks to deduct the allowance on equity.

In these circumstances, the amount of equity increase would not be taken into consideration for the purpose of the computation of the allowance base.

However, this anti-abuse rule would not apply if the taxpayer can provide valid economic reasons for the transaction and the latter does not lead to a double deduction of the defined allowance on equity.

– **Setting limitations on the valuation of assets**

Another anti-abuse rule aims to prevent the overvaluation of assets or the purchase of luxury goods for the purpose of increasing the base of the allowance.

This measure would exclude from the allowance base contributions in kind or investments in assets where the asset is not necessary for the performance of the taxpayer's income-generating activity.

If the asset consists of shares, it shall be taken into account at its book value. In case of other assets, the market value shall be recognised, unless a different value has been given by a certified external auditor.

– **Corporate reorganizations**

Finally, increases in equity resulting from the restructuring of a group are to be included in the tax base only to the extent that such restructuring does not result in the conversion of existing equity into new equity. Consequently, existing equity may not be recycled through a group reorganization.

– **General anti-abuse rule ("GAAR")**

The explanatory memorandum to the Proposal mentions that the GAAR under ATAD may still apply to abusive scenarios that are not otherwise captured by the specific anti-abuse rules provided under the Proposal.

D. Limitation on the deductibility of interest expenses

1) General

The Proposal does not only incentivise the increase of equity but also includes an additional limitation to the tax deductibility of exceeding borrowing costs which is meant to disincentivise debt funding.

2) Definition of exceeding borrowing costs

Regarding the definition of exceeding borrowing costs, reference is made to the definition provided in Article 4 (Interest Limitation Rules) of the Anti-Tax Avoidance Directive ("ATAD"). Thus, exceeding borrowing costs are "the excess of borrowing costs over interest income and other economically equivalent taxable revenues".

According to the interest limitation rules, the term borrowing costs is defined as "interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance as defined in national law, including, without being limited to,

- payments under profit participating loans,
- imputed interest on instruments such as convertible bonds and zero coupon bonds,
- amounts under alternative financing arrangements, such as Islamic finance,
- the finance cost element of finance lease payments,
- capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest,
- amounts measured by reference to a funding return under transfer pricing rules where applicable,
- notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings,
- certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance,
- guarantee fees for financing arrangements,
- arrangement fees and similar costs related to the borrowing of funds."

As far as interest income and other economically equivalent taxable revenues are concerned, ATAD does not provide for a clear definition of what is to be considered as "revenues which are economically equivalent to interest."

Toutes reproduction ou adaptation totale ou partielle, par quelque procédé que ce soit, est interdite. L'usage de cette ressource est autorisé uniquement pour l'utilisateur mentionné ci-dessous. Toute transmission à des tiers est formellement interdite.
Imprimé le 09/06/2023 par lisa.brand@atoz.lu
LEXNOW

However, given that borrowing costs and interest income should be mirroring concepts, the latter should be interpreted in accordance with the broad definition of borrowing costs.

3) Mechanism of the rule

The measure in the Proposal would limit the deductibility of interest to 85% of the exceeding borrowing costs incurred during the relevant fiscal year. This limitation to the deductibility of (arm's length) interest would apply in addition to the interest limitation rules that already had to be implemented by EU Member States in accordance with ATAD.

The interest limitation rules of ATAD limit the deductibility of exceeding borrowing costs to 30% of the EBITDA. In addition, EU Member States were free to adopt a safe harbour of up to EUR 3 million (*i.e.* up to this amount exceeding borrowing costs are deductible without any limitation).

Thus, in practice, there would be a need for a certain coordination between the two rules. When the 85% amount is higher than the amount that would be deductible under the ATAD interest limitation rules, the taxpayer should only be entitled to deduct the lower of the two amounts in that fiscal year.

If the DEBRA limitation would result in an additional restriction with respect to the deductibility of exceeding borrowing costs (below the deductible amount of exceeding borrowing costs under the ATAD interest limitation rules), such expenses shall be carried forward (or back) in accordance with the interest limitation rules and might still be deducted in a future (or previous) fiscal period.

Hence, the deductibility of the exceeding borrowing costs may be restricted twofold, be it under the interest limitation rules (30% EBITDA limit) or under the proposed new interest limitation rule (85% of the exceeding borrowing costs).

Since the definition of financial undertakings under ATAD is not the same as the one under the Proposal (the Proposal excludes more entities than ATAD does), some undertakings (*e.g.* Securitization special purpose vehicles within the meaning of EU Regulation No. 2017/2402) would only be subject to the interest limitation rules under ATAD but not to the rule provided under the Proposal.

IV. CRITICAL REVIEW OF THE PROPOSAL

The proposed allowance on equity and the proposed limitation on the deductibility of exceeding borrowing costs entail a number of issues as analysed in this section.

A. Undermining the arm's length principle

The arm's length principle is the international transfer pricing standard that OECD member countries have agreed to be used for tax purposes by multinational groups and the tax administrations. When the pricing of controlled transactions does not adhere to the arm's length standard, the tax administrations may perform tax adjustments in order to restate arm's length conditions.

Both measures proposed under the Proposal undermine the arm's length principle. With respect to the allowance on equity, the risk premium of 1% (or 1.5% in the case of SMEs) contained in the Proposal seems to be disconnected from the market reality (even more considering the current environment of increasing interest rates).[3]

Here, it would be good to allow taxpayers to determine the arm's length NIR on a case-by-case basis to account for the individual company risk profile and include the current formula only as a safe harbour rule for those taxpayers that do not want to prepare a transfer pricing analysis in a given case.

The introduction of an additional rule to limit the deductibility of "arm's length" interest expenses would be problematic for many businesses. The amount of deductible interest expenses would often not be known until the annual accounts are prepared and the interest limitation rules under ATAD and the Proposal can be applied. This would create additional legal uncertainty and make it nearly impossible for businesses to plan ahead.

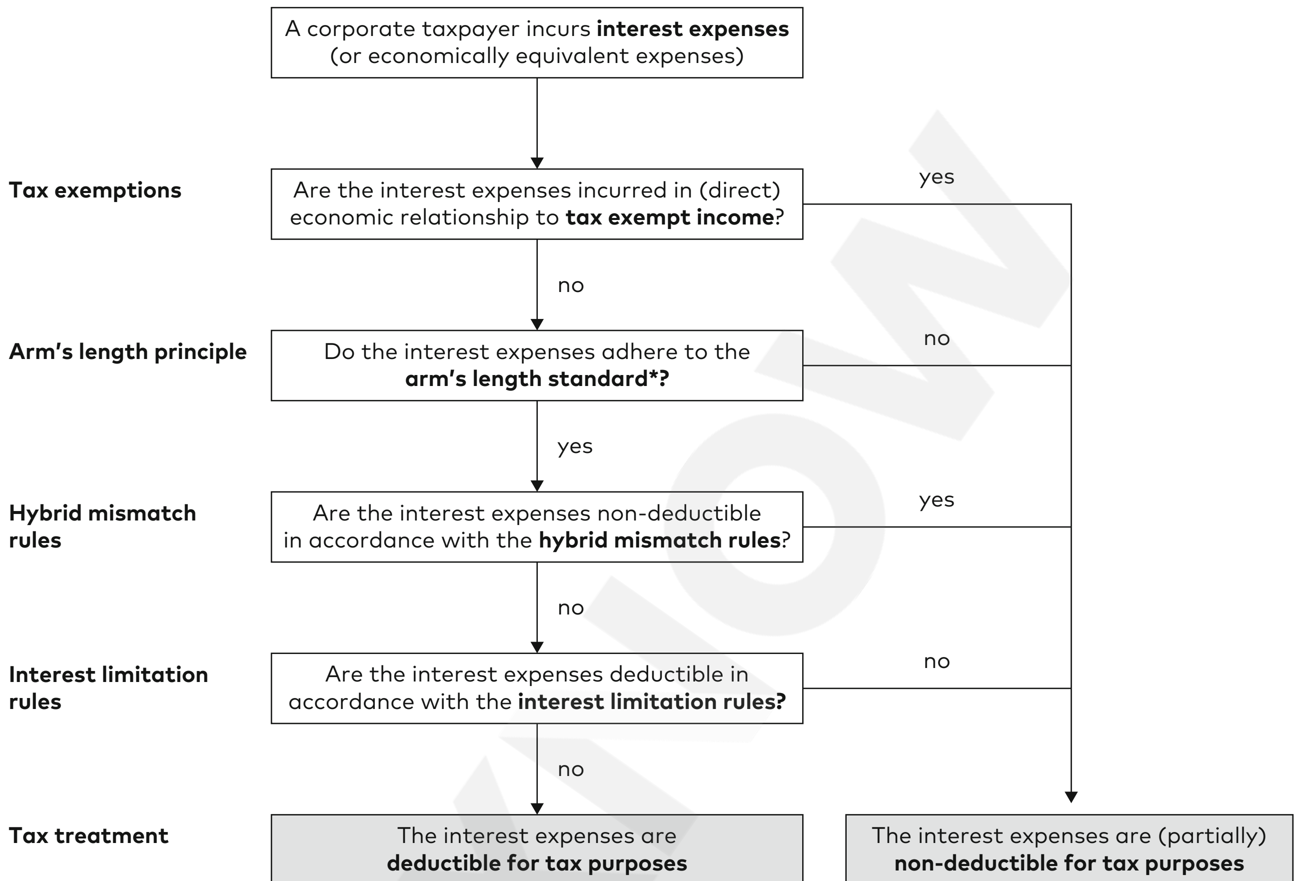
The determination as to whether or not interest expenses are deductible for tax purposes is already a multi-layer exercise that requires the analysis of:

- What are the assets financed by the debt and how is the income treated for tax purposes (interest expenses incurred in relation to tax exempt income is commonly not deductible for tax purposes);
- The arm's length nature of the interest charged under the debt instrument;
- The hybrid mismatch rules;
- The interest limitation rules.

3. See Opinion of the European Economic and Social Committee on the Debt-Equity Bias Reduction Allowance adopted on 26 October 2022.

Toutes reproduction ou adaptation totale ou partielle, par quelque procédé que ce soit, est interdite. L'usage de cette ressource est autorisé uniquement pour l'utilisateur mentionné ci-dessous. Toute transmission à des tiers est formellement interdite.
Imprimé le 09/06/2023 par lisa.brand@atoz.lu
LEXNOW

The following checklist reflects the sequence of steps to be followed through when analysing the deductibility of interest expenses for Luxembourg tax purposes:



* The non-deductibility in accordance with Article 56 LITL or Article 164 (3) LITL (hidden dividend distributions) is limited to excessive interest payments.

B. Risk of double taxation

When interest expenses are not deductible, double taxation will likely arise as the lender should be taxable on the corresponding income.

To deal with this obstacle, a carry-forward mechanism is proposed in regard to non-deductible interest (when the 85% of exceeding borrowing costs results in a lower amount of deductible interest expenses than the interest limitation rules) so as to mitigate the negative effect of not allowing the deduction of arm's length interest expenses.

Nonetheless, even such carry-forward would not eliminate the problem of double taxation as companies may for years or even never be able to use the amounts carried forward (resulting in an inclusion without deduction outcome).

C. Impact on business decision making and international trade

The proposed 85% limitation on the deductibility of exceeding borrowing costs may have a significant impact on business decisions as these increase the effective cost of capital for businesses. This may force multinational groups to raise the level of target return required on investments with the consequence that investments may be rejected that otherwise would have been approved.

Apart from the negative impact on global growth and employment opportunities, the ultimate long-term effect of this would be increased costs being passed onto consumers and reduced earnings realized by the shareholders.

Toutes reproduction ou adaptation totale ou partielle, par quelque procédé que ce soit, est interdite. L'usage de cette ressource est autorisé uniquement pour l'utilisateur mentionné ci-dessous. Toute transmission à des tiers est formellement interdite.

Imprimé le 09/06/2023 par lisa.brand@atoz.lu

LEXNOW

These concerns are shared by the European Economic and Social Committee ("EESC") that state in their opinion that "The EESC is concerned that the Commission proposal could make SMEs and micro-businesses, the backbone of the European economy, financially weaker. Such companies do not have easy access to capital markets and, therefore, limiting the deductibility of their interest costs could hamper investment, growth and job creation across Europe."[4]

The EESC further "fears that not allowing deduction for legitimate costs of doing business in the form of interest charges might put European companies at a competitive disadvantage compared to businesses in other major trading blocs. Such adverse outcomes are even more likely in the current economic situation with interest rate increases."

The EESC considers that "in the current economic scenario, which is characterized by the double adverse influence of sustained inflation coupled with rising interest rates implemented by central to keep inflation under control. Debt levels have furthermore increased in many businesses during the so-called pandemic. A limitation on tax deductibility could indeed make debts weighing on small and micro-companies more difficult to manage."

The EESC "points out that a substantial reduction of deductibility for debt-financing could trigger unintended consequences on SMEs, ..., such as a weakened sustainability of corporate debts, layoffs and overall loss of financial stability across the internal market."

D. Excessive complexity

The Proposal entails a lot of unnecessary complexity. With respect to the allowance of equity the following factors contribute to complexity:

- The determination of the allowance base;
- The tracing of the allowance base over ten consecutive years;
- The recapture of a potential allowance for a negative allowance base for ten consecutive years;
- The carry forward of (i) unused allowance and (ii) allowance exceeding the maximum amount corresponding to 30% of the company's EBITDA;
- The (non-)application of several specific anti-abuse rules and the GAAR.

In light of all this complexity, the allowance on equity should at the very least be optional, ideally upon each individual increase of equity (rather than a choice for all future equity increases).

Regarding the proposed interest limitation rule, the interaction with the interest limitation rules (provided under ATAD) may raise intricate issues.

Additional complexity derives from the interaction with other initiatives at global and EU level such as Pillar 2 (global minimum tax) and "Business in Europe: Framework for Income Taxation" ("BEFIT"), an initiative that aims to introduce a new framework for EU corporate taxation.

The EESC recommends "limiting compliance costs for the European enterprises interested in benefiting from the new allowance on equity by achieving a sufficient level of legal certainty and predictability of the new rules in order to prevent uncertainties and interpretative issues, possibly resulting in extended negotiations or even litigations between tax authorities and companies."[5]

E. Allowance on equity and the participation exemption regime

One specific question regarding the Proposal is linked to the tax treatment of the allowance on equity at the level of the investors.

The EU Parent-Subsidiary Directive provides for a specific anti-abuse rule that would deny the application of the participation exemption regime in case of deductible dividend payments. Here, the Proposal should clarify that the participation exemption regime will apply regardless of a notional deduction at the level of the company.

Another concern is related to the potential application of the hybrid mismatch rules provided under ATAD 2. Here, the Proposal should clarify that the notional deduction is not classified as a hybrid payment that gives rise to a mismatch outcome (deduction without inclusion) which may trigger the application of the hybrid mismatch rule.

F. Questionable legal basis for the Proposal

The purported legal basis of the DEBRA initiative is Article 115 of the Treaty on the Functioning of the EU ("TFEU") which stipulates that legal measures under that article shall be vested the legal form of a Directive. However, the EU's competences are governed and limited by the principles of subsidiarity and proportionality if the Directive is imperative for the functioning of the internal market.

4. See Opinion of the European Economic and Social Committee on the Debt-Equity Bias Reduction Allowance adopted on 26 October 2022.

5. See Opinion of the European Economic and Social Committee on the Debt-Equity Bias Reduction Allowance adopted on 26 October 2022.

Toutes reproduction ou adaptation totale ou partielle, par quelque procédé que ce soit, est interdite. L'usage de cette ressource est autorisé uniquement pour l'utilisateur mentionné ci-dessous. Toute transmission à des tiers est formellement interdite.
Imprimé le 09/06/2023 par lisa.brand@atoz.lu
LEXNOW

1) The principle of subsidiarity

The general aim of the principle of subsidiarity is to guarantee a degree of independence for a lower authority in relation to a higher body or for a local authority in relation to central government. It therefore involves the sharing of powers between several levels of authority, a principle which forms the institutional basis for federal states.

When applied in the context of the EU, the principle of subsidiarity serves to regulate the exercise of the Union's non-exclusive powers. It rules out Union intervention when an issue can be dealt with effectively by Member States themselves at central, regional or local level. The Union is justified in exercising its powers only when Member States are unable to achieve the objectives of a proposed action satisfactorily and added value can be provided if the action is carried out at Union level.

Here, the EU Commission claims that "This proposal complies with the principle of subsidiarity. The nature of the subject requires a common initiative across the internal market. The rules of this Directive aim to tackle the debt-equity bias in the EU corporate sector from a tax perspective and provide a common framework to be implemented into Member States' national laws in a coordinated manner. Such aims cannot be achieved in a satisfactory manner through action undertaken by each Member State while acting on its own".

The EU Commission considers that "The complete lack of relevant tax debt bias mitigating measures in 21 Member States along with the existence of significantly different measures in another 6 Member States may create distortions to the function of the internal market and can affect the location of investment in a significant manner. ... An EU-wide initiative in the form of a binding legislative proposal is therefore necessary to address in a coordinated and effective manner a problem that is common across the EU. An EU initiative would prevent potential loopholes between diverging national initiatives and would ensure that location of business and investment are not adversely impacted."

2) The principle of proportionality

The envisaged measure further must comply with the principle of proportionality. Accordingly, a measure must not go beyond what is required to ensure the minimum necessary level of protection for the internal market.

In this regard, the EU Commission states that "The Directive lays down rules to provide, across the EU and for all EU taxpayers, for the deductibility of an allowance on equity financing costs complemented by a rule to limit the deductibility of interest on debt financing instruments. The Directive also ensures the sustainability of the measures for Member States' budgets by virtue of a general rule that limits the deductibility of financing costs from taxpayers' taxable base. By setting a common EU-wide framework, the Directive allows legal certainty across the single market and the reduction of compliance costs for taxpayers."

On this basis, the EU Commission concludes that "Thus, the Directive ensures only the essential degree of coordination within the Union for the purpose of materializing its aims. In this light, the proposal does not go beyond what is necessary to achieve its objectives and is therefore compliant with the principle of proportionality."

3) Assessment

The EU Commission only has a legal basis in Article 115 of the TFEU to the extent (i) the Draft Directive is imperative for the functioning of the internal market and (ii) adheres to the principles of subsidiarity and proportionality.

As regards the need of the Proposal for the functioning of the internal market, the EU Commission claims that the lack of relevant debt bias mitigating measures in 21 member states along with the existence of significantly different measures in another 6 member states create distortions to the function of the internal market.

However, member states are free to introduce different tax rules and set incentives for investments in their territory. This is consistent with the EU member states' sovereignty in tax matters and the fundament of a healthy tax competition between countries. Hence, it is difficult to make the case that the Proposal is imperative for the functioning of the internal market. On this basis, the Commission should in the author's view have no authority to intervene.

While the introduction of an allowance on equity would be positive, the EU Commission should not force Member States to do so. Instead, it would be consistent with the principle of subsidiarity and proportionality to develop model rules that might be adopted (potentially in an amended form) by those EU Member States that would like to create incentives for additional equity funding.

The proposed limitation on the deductibility of interest payments would be even more problematic as it would harm businesses operating in the EU at a time when the economic situation is not exactly prosperous. There is definitely no need for the functioning of the internal market to impose a limitation on the deductibility of interest

Toutes reproduction ou adaptation totale ou partielle, par quelque procédé que ce soit, est interdite. L'usage de cette ressource est autorisé uniquement pour l'utilisateur mentionné ci-dessous. Toute transmission à des tiers est formellement interdite.
Imprimé le 09/06/2023 par lisa.brand@atoz.lu
LEXNOW

Revue de Droit Fiscal n°18/2023
Oliver R. HOOR

expenses in addition to the arm's length standard, the interest limitation rules (ATAD) and the hybrid mismatch rules. It is merely a budgetary measure to balance the expected decrease in tax revenues due to the proposed allowance on equity.

4) Considering the position of the Swedish Parliament

On 22 June 2022, the Swedish Parliament (*Riksdag)* released a reasoned opinion[6] on the application of the Principles of Subsidiarity and Proportionality and concluded that the Proposal conflicts with the principle of subsidiarity.

While the Riksdag supports the objective of promoting a well-functioning single market through positive measures, it considers that "there is reason to question the need for a common EU regulatory framework to reduce the distortion that the Commission considers exists in connection with financing of companies with debt rather than equity."

The Riksdag that "the fundamental principle of tax sovereignty for the member states must be safeguarded in the case of direct taxation and it falls within the national competence of each member state to safeguard welfare by levying and using tax revenues in an appropriate way." (…) "It is important that the benefits of tax rules in this area are weighed against the restriction of member states' opportunities to introduce and retain their own national tax rules that involves. In the opinion of the Riksdag, the member states are better equipped to assess and have an overview of how corporate taxation should be formulated in order to achieve political and economic objectives. The Riksdag does not consider that the advantages of the proposal outweigh the disadvantages associated with restriction of national powers that the proposal involves."

The Riksdag considers that "the extent of the distortion between equity and debt may be questioned, as well as the need for further regulation in this area. In summary, the Riksdag considers that the Commission has not shown that a directive is necessary to achieve the objectives. Nor does the Riksdag consider that the Commission has provided sufficient justification to show that the proposal does not go beyond what is necessary to achieve the set objectives. In the light of the above, the Riksdag considers that the Commission's proposal cannot be considered to be compliant with the principle of subsidiarity."

This assessment is consistent with the author's views. The question arises whether other governments will also voice their concerns regarding the overreach of the EU Commission in the field of direct taxation.

G. Constitutional issues

The proposed interest limitation rule may further raise concerns from a constitutional perspective in several EU member states. Considering the example of Luxembourg, while the Constitution gives broad discretionary powers to legislators in the realm of tax law, the general principle of equality provided in article 10*bis* (1) of the Luxembourg Constitution places limits to this discretionary leeway. Similar provisions are included in the constitutions of other EU member states.

This principle requires legislators to treat similarly those situations that are substantially alike and treat differently those situations that are substantially different. The structure of the tax system is required to consider the ability-to-pay principle and the consistency requirement.

In the area of income tax law, the financial ability to pay is assessed based on the objective net principle. According to this principle, only the net income (that is the income after deduction of (business expenses) should be subject to income taxation. Thus, limiting the deductibility of borrowing costs incurred by Luxembourg companies might be a violation of the legislator's fundamental, systematic obligation to apply the objective net principle.

The question arises whether the violation of the objective net principle could be justified, for example, based on the purpose of controlling economic policy, the coverage of the state's financing needs or the fight against abuse. However, in the author's view it seems doubtful that there is a valid justification for the violation of the objective net principle.

The same kind of constitutional concerns have been raised in other EU member states. Back in 2015, a decision of the German Federal Fiscal Court raised serious doubts that the German interest barrier rules (which have been the blue print of the interest limitation rules in ATAD) are constitutional.[7] The case has been referred to the German Constitutional Court that still needs to deliver its decision. However, even if the Constitutional Court would confirm the decision of the German Federal Fiscal Court, the hierarchy of the Constitution and EU Law (ATAD, etc.) is not self-evident.

6. See https://secure.ipex.eu/IPEXL-WEB/document/COM-2022-216/serik.

7. German Federal Tax Court, Decision I R 20/15 of 14 October 2015.

Toutes reproduction ou adaptation totale ou partielle, par quelque procédé que ce soit, est interdite. L'usage de cette ressource est autorisé uniquement pour l'utilisateur mentionné ci-dessous. Toute transmission à des tiers est formellement interdite.
Imprimé le 09/06/2023 par lisa.brand@atoz.lu
LEXNOW

V. CONCLUSION

The Proposal provides for an allowance on equity and a limitation on the deductibility of exceeding borrowing costs. While the encouragement towards equity funding is a good idea, this objective should be pursued by tax allowances on equity without further penalising the deductibility of interest on debt. Considering the complexity of the proposed rules (combined with a low NIR), it would also make sense to allow companies to opt out.

The Proposal has many interlinkages with other current initiatives in the field of direct taxation including, in particular, the BEFIT initiative (aiming at the implementation of an EU corporate tax system) and Pillar 2 (aiming at the implementation of global minimum taxation).

This has been acknowledged by the Council in its report to the European Council on tax issues. Therefore, the examination of the Proposal has been suspended and, if appropriate, it would be reassessed within a broader context only after other proposals in the area of corporate income taxation announced by the Commission have been put forward.

Toutes reproduction ou adaptation totale ou partielle, par quelque procédé que ce soit, est interdite. L'usage de cette ressource est autorisé uniquement pour l'utilisateur mentionné ci-dessous. Toute transmission à des tiers est formellement interdite.
Imprimé le 09/06/2023 par lisa.brand@atoz.lu
LEXNOW