Attn Mr Gerassimos Thomas
Director General
DG TAXUD
European Commission
1049 Bruxelles
Belgium

29 July 2022

Dear Mr Thomas,

Subject: PwC response to the European Commission's request for feedback on the Debt-equity bias reduction allowance ('DEBRA') proposal for a Directive

PwC International Ltd (PwC), on behalf of the PwC network, welcomes the opportunity to respond to the request for feedback on the proposal for a Directive (Directive), by way of this letter[1].

Executive Summary of our key comments

The European Commission (EC) has set out several objectives for this proposal, and as a result the proposal contains different measures stimulating equity investment and discouraging debt financing, through a 'carrot and stick approach'. We express a concern regarding the cohesiveness between the proposed equity allowance and the proposed interest deduction limitation rule. The proposed interest deduction limitation rules seem to be predominantly designed to achieve budget neutrality on average for Member States, and less by tax policy principles.

According to the EC's legislative agenda, the consultation on BEFIT is expected in the third quarter of this year, to be followed by a legislative proposal in spring next year. Depending

[1] We also refer you to PwC's earlier submission on this issue "Debt Equity Bias Reduction Allowance ('DEBRA') proposal", submitted 7 October 2021, available via this link.

PricewaterhouseCoopers International Limited
1 Embankment Place
London WC2N 6RH
T: +44 (0)20 7583 5000 / F: +44 (0)20 7822 4652

on the policy objectives underlying a 'future-proof' corporate income tax system for the EU, an allowance for equity could be part of the design of BEFIT. In order to avoid uncertainty, (more) clarity at this stage on how DEBRA would fit in the future design of a new EU corporate income tax system, would be most welcome.

It is suggested to reconsider the outcomes of the interaction between the interest limitation restriction outlined in the Directive ('DEBRA ILR') and the existing Interest Limitation Rule provided for under Article 4 of the ATAD ('ATAD ILR'). We would recommend that the list of financial undertakings in DEBRA is aligned with the ATAD-equivalent list. Furthermore, the Directive should take account of the range of exemptions and carve outs that are applicable to taxpayers whose interest expenses are limited by the ATAD ILR.

PwC recommends the European Commission to issue guidance and provide clarification on how the Directive is linked with the OECD Pillar Two proposal and the proposed European Commission Pillar Two Directive ('Pillar Two Directive').

We would like to draw attention to areas where the Directive interacts with existing EU law provisions. We recommend that the European Commission evaluate the compatibility of the interest limitation rule set out in Article 6 of the Directive with Article 17 "right to property" and Article 20 "principle of equality" of the European Charter of fundamental rights ("EU Charter"). We suggest to give clarity with respect to the definition of "taxpayer" to be considered for the purposes of Article 6 of the Directive. There might be a potential breach of the freedom of establishment under Article 49 TFEU.

Finally, we refer to the annex for specific considerations.

With this letter we kindly invite you to take our observations into consideration. We stand ready to discuss the issues raised in this letter in more detail, if that would be helpful at any point - please do not hesitate to contact me or one of the individuals set out below.

Yours sincerely,

Stef van Weeghel
Global Tax Policy Leader
stef.van.weeghel@pwc.com
T: +31 (0) 887 926 763

PwC Contacts

Name	**Email Address**
Edwin Visser (Tax Policy)	edwin.visser@pwc.com
William Morris (Tax Policy)	william.h.morris@pwc.com
Phil Greenfield (Tax Policy)	philip.greenfield@pwc.com
Chloe O' Hara (Tax Policy)	chloe.ohara@pwc.com
Keetie van der Torren-Jakma (Tax Policy)	keetie.van.der.torren-jakma@pwc.com
Claudio Valz (EUDTG)	claudio.valz@pwc.com
Emmanuel Raingeard de la Bletière (EUDTG)	emmanuel.raingeard@pwcavocats.com
Jonathan Hare (EUDTG)	jonathan.hare@pwc.com
Guglielmo Ginevra (EUDTG)	guglielmo.ginevra@pwc.com
Rosalind Piggot (Fiscal Policy)	rosalind.piggot@pwc.com
Joanne Helen Theodorides (PwC Cyprus)	joanne.theodorides@pwc.com
Francisco José Ancede (PwC Portugal)	francisco.jose.ancede@pwc.com
David Ledure (PwC Belgium)	david.ledure@pwc.com
Pieter Deré (PwC Belgium)	pieter.dere@pwc.com
Mikołaj Kondej (PwC Poland)	mikolaj.kondej@pwc.com
Philip Ramstetter (PwC US)	philip.s.ramstetter@pwc.com
Audrey Azzopardi (PwC Malta)	audrey.azzopardi@pwc.com

Appendix

Analysis of the specific (technical) considerations for this Directive

Ability to avail of the allowance for equity investments

- We ask the Commission to clarify whether the intention is to harmonise the rules on equity allowances (and interest deductibility restrictions) across the various EU Member States, and remove the divergences in approach that currently exist.
- With the exception of Article 2 of this Directive, permanent establishments are not otherwise mentioned in the Directive. Perhaps this is to allow flexibility as to how equity is allocated between PEs and their Head Offices. It is not currently clear from the Directive how to determine the amount of equity in a permanent establishment, particularly where it is located in a non-EU country.
- How does the definition of EBITDA in this Directive compare to the ATAD, noting that the ATAD provides more details on how to establish EBITDA?
- If the allowance is greater than net taxable income, then the excess can be carried forward indefinitely, which we understand means the deduction could then be taken beyond the stated 10 year period. We understand that when carried forward amounts are deducted in a future tax year both caps apply i.e. cap of 30% EBITDA and cap of taxable income. There is an inconsistency between the Explanatory Memorandum and the text of the Directive. The former, refers to "unused allowance capacity, where the allowance on equity does not reach the aforementioned maximum amount", whereas the latter, refers to "the allowance on equity which exceeds 30% of EBITDA in a tax period".
- The Directive intends to support start-ups and scale-ups. The 30% EBITDA limitation may hamper this (i.e. only carried forward for 5 years, while such companies may have a longer time horizon to generate positive EBITDA).

Calculation of the equity allowance

Below are our comments with respect to the tax base on which the equity allowance would be calculated:

- The definition of 'equity' in the Directive includes "paid-up capital, share premium accounts, revaluation reserve and other reserves and profit or loss brought forward". We note that this definition may not align with existing equity allowance regimes already offered by some Member States. For example, the Cyprus Notional Interest Deduction ('NID') defines equity as the issued share capital and share premium from the issue of shares to the extent that these have been fully paid, thus not including revaluation reserve, other reserves nor profit or loss.

We ask the legislators to consider the following points:

a. Is it appropriate to allow such reserves to qualify as they relate to assets already invested in and would not align with debt financing where debt finances the cost of an asset?
b. What is the connection between the definition of equity and Directive 2013/34/EU (Accounting Directive) as the Directive proposal text itself does not refer to Directive 2013/34/EU (Accounting Directive) but rather only the Explanatory Memorandum. For example, for preference shares which are for financial statement purposes disclosed as a liability in the financial statements, would they be equity? We would ask the Commission to clarify that preference shares are viewed as either interest bearing or equity (with notional interest).
c. Is it possible to include in the tax base a capital contribution that does not relate to a specific identifiable asset, but rather to the provision of funding to day-to-day current expenses? Article 5(2) of this Directive does not clarify the point.

- The Directive does not specify what is the 'tax value' of a participation.

- The term 'relevant currency' is not defined under the Directive. The Explanatory Memorandum makes reference to 'the currency of the taxpayer'. We would like further clarity on what constitutes 'relevant currency' and whether it can include the legal currency in which the share capital is denominated or its financial reporting functional currency, etc.

- The 10-year risk free rate is determined by the implementing acts adopted pursuant to Article 77e(2) of Directive 2009/138/EC. As central banks are expected to tighten or relax monetary policy according to macroeconomic events, so too the risk-free rate will increase or decrease accordingly. We ask that the Commission consider the effects of negative interest-rates on the NIR and the allowance on equity and whether a floor is warranted, which prohibits the risk-free rate going below zero.

- Given the different risks of conducting business in different EU Member States, perhaps the proposal should allow each Member State more flexibility on the level of the premium (assuming that the proposal is harmonising).

- Can the Commission clarify what is an "accounting loss"? For example, could a loss arising from a revaluation (i.e. a revaluation loss) satisfy this exception?

- In terms of calculating a negative equity allowance, what type of legal obligation is the Directive referring to? Some illustrative examples would be helpful.

- Concerning Article 4(4) of the Directive, could the reference to 'Union currency' be restrictive given that under Article 4(2), the Directive makes reference to 'relevant currency', which we understand could include currencies of third countries too? With the greater adoption of the Euro within EU Member States, does the requirement for at least three Union currencies become too restrictive? Regarding Article 4(4)(b) of this Directive we highlight that there is typically a delay when GDP figures are issued, which may cause inefficiencies in this approach.

- Regarding Article 5(2) of this Directive, which "book value" is being referred to here: tax, accounting carrying value, etc? Is the "different value" that has been given by the certified external auditor still aiming to achieve "market value" or some other value? Does this paragraph refer to the value at time of acquisition of the asset or is it an ongoing test of the value of the asset?

- Regarding Article 5(3), it would be helpful to understand what is meant here by a "reorganisation". Is the "group" referring only to the existing presence of the group within the EU, or is it looking more globally? For example, equity may already be in a third country parent location, after which there is a reorganisation to an EU Member State of the group's business. Would this potentially fall within the scope of this rule?

- An amount shall become taxable if, after having obtained an allowance on equity, the base of the allowance on equity is negative "in a tax period". For how long is the controlling period? And will it be counted based on the year in which the capital increase took place or the subsequent 10 years of deduction? In the latter case, can not a company that makes an equity increase in a given year (N) be able to reduce its equity up to N+20?

- How should the "negative allowance" be covered, in case the company is meant to cease to exist?

<u>Restriction on ability to deduct exceeding borrowing costs</u>

- A permanent disallowance of 15% of exceeding borrowing costs is quite penal from the point of view of investees and is not in keeping with the typical policy of allowing taxpayers to carry tax attributes, losses or unused allowances with them to future tax years.

- The introduction of this further restriction on the ability of an undertaking to deduct exceeding borrowing costs is presumably to dissuade investors from providing further debt financing, or at least to the same degree as currently exists. However, the interest limitation element of the proposal applies in such a way that it does not distinguish between new and existing debt financing. Accordingly, businesses who have taken on debt financing already will be penalised for this decision to the extent that they have exceeding borrowing costs greater than 85% of the otherwise deductible interest expense. We do not believe that punishing investees for their previous financing decisions is a good approach to take.

- We note that individual Member States will have individual interest limitation rules/thin cap rules that result in non-deductible interest expenses already. Layering this DEBRA restriction on top of existing rules will create further complexity and administrative burdens for businesses.

- Some businesses became more highly-leveraged during the COVID-19 pandemic. Not all businesses will remain solvent, particularly given the uncertain economic circumstances we now face. However, this is for a variety of reasons and is likely to be contained amongst a small number of players. Looking at the bigger picture, a recent report, also published by the European Commission, suggests that private debt levels "*are easing as the economy rebounds from the crisis*".[2] We therefore suggest the Council to consider whether the risk of insolvency of a small number of players justifies the limitation of interest deductibility contained in the Directive.

- The Directive intends to support start-ups and scale-ups. Start-ups with no substantial EBITDA create tax assets under the ATAD ILR, while this will largely result in a permanent difference under the DEBRA ILR. Likewise, the Directive intends to support small and medium sized enterprises by allowing a higher equity allowance. However, while such enterprises are typically not affected by the ATAD ILR due to the de minimis rule up to EUR 3m, they will be directly negatively affected by the DEBRA ILR in the absence of any de minimis.

Meaning of taxpayer

The Directive does not seem to specify whether the term "taxpayer", for the purposes of the Directive, shall be interpreted as a "standalone taxpayer" or whether it can be considered at a group level, including for the intertemporal rule, and it would therefore be helpful to have this clarified. Noting that the ATAD at Article 4(1) refers to the option for Member States to treat as a taxpayer:

> *"(a) an entity which is permitted or required to apply the rules on behalf of a group, as defined according to national tax law;*
>
> *(b) an entity in a group, as defined according to national tax law, which does not consolidate the results of its members for tax purposes.*

In such circumstances, exceeding borrowing costs and the EBITDA may be calculated at the level of the group and comprise the results of all its members."

As EBITDA and exceeding borrowing costs are relevant for the Directive too, could these be calculated at the level of the group as opposed to an entity level for total consistency and alignment (and therefore more simplicity) with ATAD Article 4.

EU law considerations

[2] 2022 European Semester - Spring Package, p14. Available via this link.

We would like to draw attention to the following areas where the Directive interacts with existing EU law provisions, and in which areas the Directive might be improved .

Absence of evaluations by the European Commission on the compatibility of the interest limitation rule set out in Article 6 of the Directive with Article 17 "right to property" and Article 20 "principle of equality" of the European Charter of fundamental rights ("EU Charter"):

- The interest limitation rule set out in Article 6 of the Directive introduces for EU corporations a permanent disallowance of some exceeding borrowing costs. The impossibility to carry forward or carry back the excessive borrowing costs (except for the case outlined in the second part of paragraph 1 of Article 6 of the Directive) can be considered to have confiscatory effects for EU corporations pursuant to Article 17 of the EU Charter and a serious breach of the principle of ability to pay derived from the principle of equality enshrined in Article 20 of the EU Charter, and as interpreted by the Constitutions of many EU Member States.

Lack of clarity with respect to the definition of "taxpayer" to be considered for the purposes of Article 6 of the Directive. Potential breach of the freedom of establishment under Article 49 TFEU:

- The Directive does not seem to specify whether the term "taxpayer" for the purposes of the interest limitation rule set out in Article 6 shall always be interpreted as a "standalone taxpayer" or whether instead it can be considered at a group level (similarly to the ATAD Directive). Assuming that the term "taxpayer" can be interpreted also at the level of the "group" and that the exceeding borrowing costs will be calculated within the companies belonging to the same group but resident in the same jurisdiction, this circumstance could lead to a breach of the freedom of establishment under Article 49 TFEU to the extent that the interest revenues and borrowing costs of other EU companies belonging to the same group - but resident in a different Member State - are excluded from the computation of the exceeding borrowing costs at the domestic group level.

Interaction with ATAD ILR rules

In addition to the points raised above in relation to the restriction on the deductibility of exceeding borrowing costs, we also wish to raise a number of concerns regarding the interaction between the restriction outlined in the Directive ('DEBRA ILR') and the existing Interest Limitation Rule provided for under Article 4 of the ATAD ('ATAD ILR'):

- While the DEBRA ILR provides that interest expenses not permanently disallowed (i.e. 85% of exceeding borrowing costs) can continue to be deductible subject to the ATAD ILR, and an example of how this might apply is provided for in the Directive, there nonetheless appears to be a general lack of guidance as to how the two measures should interact.

- The DEBRA scoping rules exclude certain financial undertakings, as set out in Article 2 of the Directive, from the provisions of the proposal. The list of financial undertakings in DEBRA differs from Article 2(5) of the ATAD-equivalent list. The variation in itself is not an issue, and we appreciate that the range of businesses carrying out financial service activities in the intervening 6 years since ATAD was published has increased to account for new activities such as peer to peer lending and crypto asset services. However, this results in a situation where some financial undertakings, such as crowdfunding service providers, crypto-asset service providers and electronic money institutions are subject to the ATAD ILR, but cannot avail of the DEBRA equity allowance. The Directive does not take account of the range of exemptions and carve outs that are applicable to taxpayers whose interest expenses are limited by the ATAD ILR:

    - There is no provision in the DEBRA ILR to grandfather existing or legacy debt financing, whereas the ATAD ILR provided that loans concluded before 17 June 2016, which had not been modified since then, could be regarded as legacy debt, and an exclusion from the ATAD ILR would apply to interest on these loans.

    - Under the ATAD ILR, a taxpayer may fully deduct exceeding borrowing costs to the extent the taxpayer is a standalone entity. No such provision is made with regards to the DEBRA ILR.

    - Unlike the ATAD ILR there is no de minimis threshold applicable for interest restricted under the DEBRA ILR. The de minimis threshold, which many Member States have allowed in their domestic implementation, usually up to €3 million, is an important device for SMEs, start-ups and scale-ups and reduces the compliance burden of applying the ATAD ILR in full.

    - The DEBRA ILR does not provide for an exemption for interest related to debt financing of EU long-term infrastructure projects (LTIP). This exemption is available under the ATAD ILR and demonstrates the importance of investing in key infrastructure projects within the EU.

  In all of the above examples, interest expenses may be permanently disallowed under the DEBRA ILR, even though there is no restriction on deducting such expenses under the ATAD ILR.

- In addition to the above, we also note that the DEBRA ILR does not take account of the carve outs provided in the ATAD ILR relating to the equity ratio rule and group ratio rule:

    - Some businesses will avail of the equity ratio rule such that they can deduct all exceeding borrowing costs under ATAD ILR, even to the extent that they exceed 30% of EBITDA. This will not be permissible under the DEBRA ILR.

    - Other businesses will be able to use the group ratio rule to increase their deductible exceeding borrowing costs to an amount greater than 30% of EBITDA. There is no such provision provided for in the DEBRA ILR.

In both instances, businesses will suffer a very penal permanent disallowance of interest expenses under the DEBRA ILR, and this will be much more impactful than the restrictions they currently face under the ATAD ILR.

Interaction with ATAD2

- In our view, it may be worthwhile to clarify how DEBRA interacts with the financial instrument rule of ATAD2. Based on Article 1 Section 2 Point (a) of the ATAD2, a financial instrument rule is applicable to the payments under a financial instrument[3]. The allowance under DEBRA does not seem to be connected with any payment and therefore we would not expect it to remain a hybrid mismatch. This is further supported by the Action 2 OECD report under which *rules that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to make a payment, such as regimes that grant deemed interest deductions for equity capital, are economically closer to a tax exemption or similar taxpayer specific* concessions and do not produce a mismatch in tax outcomes in the sense contemplated by Action 2[4].

- Irrespective of the above it would clearly remain against the aims of DEBRA if ATAD2 rules, which are aimed at anti abuse, would interact with the rules set in the Commission proposal. Nonetheless, country specific implementation of anti-hybrid rules may differ (e.g. the Polish law does not explicitly limit the scope of hybrid rules to payments) and therefore it may be worth stipulating explicitly that the allowance should not be considered as leading to deduction/ non-inclusion under financial instrument rules.

- Concerning Article 5(1), there is reference to the denial of a double deduction:

    - Is that only as regards double deductions of DEBRA? Noting the ATAD2 anti-hybrid rules deny double deductions globally, so what about similar regimes outside of the EU? ATAD2 has coordination rules as regards which party should deny the deduction. Will there be similar rules here?

    - What about "dual income" in the example in the explanatory memorandum? As an example, taxpayers A and C both have taxable income (A: interest income, C: trading income). Should there be denial of double deduction in such cases compared with ATAD2 where dual inclusion income means that there is no DD denial.

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[3] Which is understood as any instrument to the extent that it gives rise to a financing or equity return that is taxed under the rules for taxing debt, equity or derivatives under the laws of either the payee or payer jurisdictions and includes a hybrid transfer.

[4] OECD, *Action 2: 2015 Final Report: Neutralising the Effects of Hybrid Mismatch Arrangements*, p. 17.

Interaction with Pillar Two rules

The Directive will need to coordinate with the OECD Pillar Two proposal and the proposed European Commission Pillar Two Directive ('Pillar Two Directive'). In the absence of such coordination, EU companies falling within the scope of the Pillar Two rules who stand to benefit from DEBRA may suffer, among others, the following disadvantages which clash with the intended outcome of the Directive:

Utilising the equity allowance

- The allowance on equity under Article 4 of the Directive will not be taken into account for the purposes of the GloBE Income calculation (due to the fact that it is a tax fiction, and is unlikely to be recognised as an expense in the Profit and Loss Account of a constituent entity). Utilising the DEBRA equity allowance (ignoring any equivalent restriction in interest deductibility for comparative purposes) will result in a lower tax liability for the constituent entity, and therefore will result in lower covered taxes when it comes to calculating the entity's effective tax rate. Accordingly, a constituent entity can end up with an increased Pillar Two top-up tax liability from having benefited from the allowance on equity incentive.

- There is an asymmetry on the implications of DEBRA on Pillar Two, as entities in countries with higher taxation regimes may benefit from DEBRA without giving rise to any Pillar Two considerations, while entities in countries with taxation regimes closer to 15% may get a reduced benefit, if any, from DEBRA's allowance on equity.

- Constituent entities located in Member States with lower statutory tax rates will be particularly impacted given that, to the extent they utilise the DEBRA equity allowance to reduce their effective tax rate, they may need to pay over additional top-up taxes, making those countries comparatively less competitive from a tax perspective. Countries with higher statutory tax rates (and presumably knock-on higher effective tax rates for constituent entities) will achieve a reduction in the effective tax rate through the covered tax numerator, and this may bring the effective tax rate down and closer to 15%, thereby making the higher tax rate Member State more attractive.

Applying the DEBRA ILR

- In calculating the GloBE income or loss of a constituent entity, there is no ability to adjust the interest expense deducted in the financial accounts to what has been deducted for tax purposes locally. Accordingly, where a constituent entity suffers the DEBRA ILR such that 15% of the exceeding borrowing costs are disallowed in calculating the local taxable profits, it will have a higher local tax liability. This will translate into a higher covered tax amount relative to the GloBE income, creating an increased effective tax rate. This is likely to be regarded as a positive outcome for constituent entities with lower effective tax rates, but negative from the perspective of constituent entities already located in high tax jurisdictions, with (already) high effective tax rates.

The Council is recommended to mandate the EC to discuss with the Inclusive Framework how a deduction for equity allowances could be taken into account in calculating the GloBE income. In order to avoid uncertainty in application and interpretation, guidance in the implementation framework might not be sufficient.

Intertemporal rule

According to the intertemporal rule proposed in Article 11(2):

"Member States may defer the application of the provisions of this Directive to taxpayers that on [1 January 2024] benefit from an allowance on equity under national law for a period up to 10 years and in no case for a period longer than the duration of the benefit under national law."

In our view, this wording may lead to certain doubts which may be worthwhile clarifying:

(1) Firstly, whether the deferral is meant to be applicable to the taxpayer who is actually benefiting from the local allowance or also to one who is entitled to it but did not decide to utilise it.

(2) Secondly, whether the term "*in no case for a period longer than the duration of the benefit under national law"* should be understood as referring to (a) the expiry date of national regulations providing for allowance or (b) to the period in which allowance already granted expires. In the second case the question arises as to what will be the deferral period if, during the period in which the business benefits from the allowance under national legislation, further allowance is granted e.g. is such further allowance meant to prolong the original deferral?

Taking into account the above doubts, we ask the Commission to consider whether the deferral should be indeed applied to "taxpayers" benefiting from an allowance or alternatively if it would be better to apply it to "net equity increases" that are typically the base for the calculation of an allowance under national law.

The requirement to "benefit" should also mean that taxpayers with eligible equity should qualify for deferral even in cases where the national rules preclude a deduction for an allowance on equity at that time due to specific limitations imposed by national rules. For example, in some Member States with an equity allowance, the allowance on equity is restricted to 80% of relevant profit. On 1 January 2024 a taxpayer with eligible equity may not obtain a deduction due to losses (rather than profit) at that point in time, the taxpayer should also qualify for deferral should the Member State opt for Article 11(2) in its transposition.

How would this work in terms of groups, given that the ATAD ILR is on a group basis in many countries (not fiscal consolidation, but local group as defined in national law primarily for group loss relief purposes). For example, Taxpayer A, based in Cyprus on 1 January 2024 benefits from the Cyprus NID. Later, in 2026, Taxpayer A establishes Taxpayer B as its 100% subsidiary. Since A and B are in a group, and the interest limitation rule under the ATAD works on a group basis, how would this Directive's interest limitation rule apply to such a case?