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DEBRA, you are so beautiful

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‘You are so beautiful’ was a famous song from Joe Cocker. When DEBRA (the draft Debt-Equity Bias Reduction Allowance-directive) arrived many tax lawyers responded very positively. At last, a directive which offers enterprises something positive instead of taking away benefits. The question is, however, will this new baby grow up to be a very beautiful person or will she remain known as an ugly example of European legislation which should have been rejected years ago. What is it about? The European Commission is proposing a directive that will allow companies throughout the European Union to take a notional interest deduction on their equity. Who wouldn’t want that? From many updates from the various tax law firms and big four, I read that DEBRA is received with a lot of warmth. The European Commission is bringing something instead of further tightening the rules for companies. But read carefully what is proposed and think about the consequences! In any case, I can reveal already that it does not make me happy.

‘You are so beautiful’. But how beautiful is she? She looks like a very well looking newborn with a lot of benefits for companies but unfortunately this stands in no relation to the real content of this directive. This good-looking baby already seems to have a very unfriendly character. First of all, companies are given the right to claim a capital allowance (notional interest deduction) on their equity that is dependent on a risk-free return and a premium of 1% for multinationals and 1.5% for SMEs. This is so beautiful, isn’t it? However, in addition, the interest deduction within the European Union will be further restricted to 85%. Since ATAD already provided us with an interest deduction limitation, our DEBRA has a special concurrence measure with the earnings tripping rules from art.4 of the Anti-Tax Avoidance Directive (EU 2016/1164, art.4). Under article 4 ATAD the non-deductible interest may still be carried back or forward; after the introduction of DEBRA, this this will only apply insofar as the general interest deduction limitation of 85% is also met. As a result of the combination between Article 4 ATAD and DEBRA, the carry forward interest compensation scheme is significantly restricted. And, if I read the proposal correctly, the latter also applies to SMEs. After all, we should first apply DEBRA (the 85% standard) and then Article 4 ATAD. And where article 4 ATAD is lower than DEBRA, the difference may still be carried forward. But this means that any interest deduction is limited to 85%. For SMEs, with less interest to be paid than € 3m, this threshold won’t help them anymore. 85% is the maximum.

Why these new rules? The argumentation is, to say the least, quite vague. Reference is made to Covid and to a green economy. And I surely understand that after the COVID19 pandemic, governments are concerned about the companies that got into trouble because they had high interest costs due to (too) low solvency. But does it help to then further limit interest deductions? As if it is a choice for most companies to work with debt! Forgive me, but I then see some overzealous civil servant (him/her) in a grey Brussels building thinking about how we can effectively tackle certain problems suggested by politicians. He/she has succeeded, but with an approach that is totally detached from reality. All this does is to ensure that many more companies are wiped out in the years to come. This really cannot be the intention.

As said, these DEBRA provisions are very sharply justified. All kinds of arguments are used for them, and that is when it really starts to hurt me. The first argument is that COVID19 has taught us that we must be careful when financing companies with loan capital. We saw the solution and the consequences above. There will be many more bankruptcies in SMEs if DEBRA makes it to the finish line. The second argument is that, because the states will gain in terms of budget, this measure will help to further develop Europe's green climate agenda. And I really do not understand that. I do not like instrumentalization at all. In fact, I think it is principally wrong that corporation tax should be used in a general sense for any specific purpose.

But there is more that I do not like. What about the essential subsidiarity test? The proposal for a directive contains it, but I cannot understand from the arguments put forward what these have to do with subsidiarity. After all, if the Member States want to raise extra money, they can also adjust the rules in their own countries. And the fallacy that a further standardisation of interest deductions will 'boost' competition within the EU, as it really says, is one that shows a great deal of naivety. Or perhaps there is a double agenda. And the idea is that when the European Union embraces DEBRA, the next step to BEFIT (a less sexy name, but the successor to the previously proposed CCCTB) will be a simple one. Member States will simply follow.

But a pure subsidiarity test ensures that a measure will only be taken at European Union level if it leads to the intended results being achieved more effectively than if the Member States took it up themselves. More money for an energy transition can simply be achieved by Member States themselves. We do not need the European Commission for that. The fallacy that this measure will increase competition in the internal market requires no further explanation. That is sheer nonsense. It may provide more clarity for business but, as a former European Commissioner once said, 'tax competition is good for business because then there is a choice'. Whatever we think about that, further standardisation does nothing for business.

Of course, I could be accused of only talking about the interest deduction limitation and not about the capital deduction. In other words, as a tax professor and an international tax litigator, I am only concerned about the minus and not the plus, because this might be supporting my business. As far as I am concerned, this directive will disappear in its entirety into some dusty Brussels archive. I foresee major problems in its implementation alone. An increase in equity leads to a deduction that can be taken for ten years. An increase in a subsequent year opens a new ten-year period. And if we are dealing with a decrease in equity even though the club is profitable, we get the same exercise but then an amount has to be added to the profit for ten years. So, after ten years you have ten tranches of pluses and minuses to keep track of. I really do not understand who could dream up such a thing. As far as I am concerned, we will soon forget about it. Almost all companies are financed with both equity and debt, and they have no interest in a complicated capital deduction financed by an equally complicated interest deduction restriction. So, I fully accept that one consequence, forget also the notional interest deduction.

DEBRA came and impressed many. But as they often say in my country: a nice face is very interesting, but a nice character is key, look before you leap. We do not need DEBRA, neither this notional interest deduction, nor this second interest deduction limitation. Member States, reject this proposal without going into any discussion. This directive suits no country and no company. It just helps the European Commission to lower the threshold to get BEFIT being accepted.

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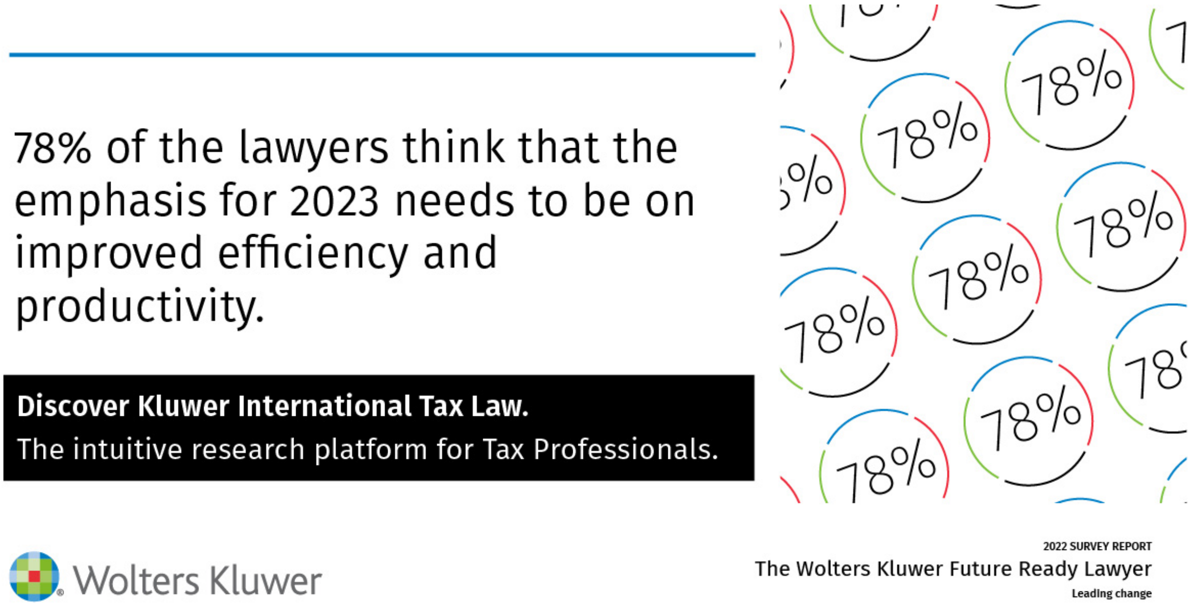

This entry was posted on Monday, June 20th, 2022 at 3:27 pm and is filed under ATAD, DEBRA, European Commission

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