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EU AND INTERNATIONAL TAX POLICY

DEBRA: a crossroad between equity and debt

On May 11th, 2022, the European Commission presented the proposal for a Council Directive (the "**Directive**") laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes.

The ratio behind the Directive is that corporate tax rules encourage companies to raise financial resources through loans rather than equity with the deductibility of the financing costs of debt, albeit with certain limitations. No such a treatment is provided for equity injections.

The Directive on one side provides for a notional interest deduction on equity increases and on the other side a further limitation to the deduction of interest expenses on borrowings.

Subjective scope

The Directive applies to all taxpayers subject to corporate income tax in the EU, including permanent establishments in one or more Member State of entities resident for tax purposes in a third country.

Financial undertakings, such as credit institutions, investment firms, alternative investment fund managers, undertaking for collective investment in transferable securities management companies, insurance and re-insurance undertakings (and others listed in Article 3, paragraph 1, of the Directive), are expressly excluded from the scope of the Directive.

The Directive justifies such exclusion by stating that "*financial undertakings have special features and require a specific treatment. If the rules to address the tax related debt-equity bias were to apply to them, the economic burden of the measures would be unequally distributed at the expense of non-financial undertakings*".

Allowance on Equity

Article 4 of the Directive states that "*an allowance on equity shall be deductible, for 10 consecutive tax periods, from the taxable base of a taxpayer for corporate income tax purposes up to 30% of*

the taxpayer's earnings before interest, tax, depreciation and amortisation" ("**EBITDA**").
This allowance is computed based on the following formula.

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

where:

- the **Allowance Base** is equal to the difference between the net equity at the end of the tax year and the net equity at the end of the previous tax year (the year-on-year increase in net equity);
- the **Net equity** is the difference between (a) the equity of a taxpayer and (b) the sum of the tax value of its participations in the capital of associated enterprises[1] and of its own shares. The reason behind is that equity used to invest in associated enterprises may entitle the latter to the Allowance on Equity and is necessary to avoid multiple uses of the same equity increase;
- the **NIR** is equal to the (i) currency specific risk-free interest rate with a maturity of ten years with reference to the date of 31 December of the year preceding the relevant tax period plus (ii) a risk premium equal to 1%[2].

In case the Allowance on Equity is higher than the taxpayer's net taxable income in a tax year the excess of Allowance on Equity can be carried forward to the following tax periods, without time limits. The Allowance on Equity cannot exceed 30% of EBITDA for the corresponding tax year. The portion of the Allowance on Equity that exceeds 30% of EBITDA in a tax year can be carried forward for a maximum of five tax years pursuant to Article 4, paragraph 1 of the Directive.
By way of example, if a company having Net equity of 100 in t0, decides to increase in t1 its Net equity by 30, an Allowance on Equity will be deducted from its taxable base every year for ten tax years (until t10) determined by multiplying the increase of Net equity by the NIR relevant at December 31st of t0.

A. Net equity in t0	100
B. Net equity in t1	130
C. Increase of Net equity in t1 (B-A)	30
D. NIR (risk-free interest rate of 1%)	2%[3]
E. Allowance on Equity (C*D)	**0.6**

Such Allowance on Equity of 0.6 will be available for ten consecutive tax years from t1 until t10 included, provided that the Net Equity will not decrease.

The Negative Allowance on Equity

In case of decrease of the Net Equity in a tax year, an amount equal to the negative Allowance on Equity shall become taxable for ten consecutive tax years, up to the overall increase of Net equity for which such allowance has been obtained.
Following the previous example, if in t2 the company records a decrease in its Net Equity of 40, a negative Allowance on Equity becomes taxable for ten consecutive tax years from t2 until t11, up to the

[1] Pursuant to Article 3, no. 1 of the Directive, "associated enterprise" means a person, either legal or natural, who is related to another person in any of the following ways:
a. the person participates in the management of the other person by being in a position to exercise a significant influence over the other person;
b. the person participates in the control of the other person through a holding that exceeds 25 % of the voting rights;
c. the person participates in the capital of the other person through a right of ownership that, directly or indirectly, exceeds 25 % of the subscribed capital;
d. the person is entitled to 25 % or more of the profits of the other person.

[2] The risk premium is set at 1.5% in the case of taxpayers qualifying as small or medium-sized enterprises (SMEs).
[3] If the taxpayer is not a SME, the risk premium is set at 1%. Otherwise, it is equal to 1.5%.

overall increase of Net equity for which such allowance has been obtained under this Directive (30).

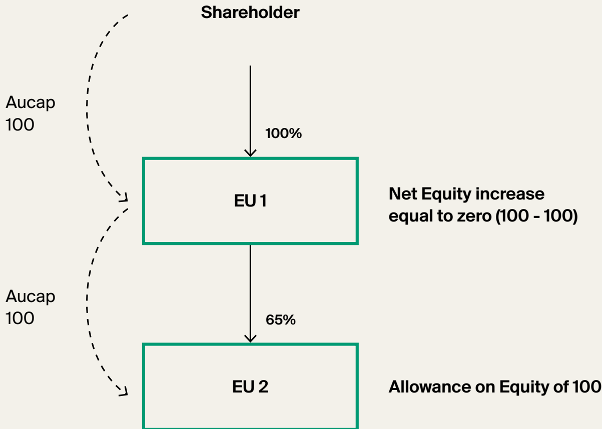
A. Net equity in t1	130
B. Net equity in t2	90
C. Decrease of Net equity in t2 (the lower of (B-A) and 30)	(30)
D. NIR (with a risk-free interest rate of 1%)	2%
E. Negative Allowance on Equity (C*D)	**(0.6)**

As a result, assuming that NIR is still 2%, from t2 to t10 the company will not benefit of any Allowance on Equity (0.6 – 0.6). In t11, the company will tax the negative Allowance on Equity for the amount of 0.6.
In any case, this recapture rule can be rebutted if the Net Equity decrease is the result of accounting losses or is due to a legal obligation to reduce capital. Applying such rebuttal to the previous example, the company could continue to benefit of the Allowance on Equity of 0.6 from t2 until t10 without recording a negative Allowance on Equity.
In the scenario with an increasing NIR of 2.5%, from t2 to t10 the company could have a net negative balance equal to 0.15 (0.6 – 0.75). In t11, the company could tax a Negative Allowance on Equity equal to 0.75.

	t0	t1	t2	t3	t4	t5	t6	t7	t8	t9	t10	t11
Allowance on Equity (t1 – t10)		0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	
Negative Allowance on Equity (t2 – t11)			-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75
Net Allowance on Equity		0.6	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.75

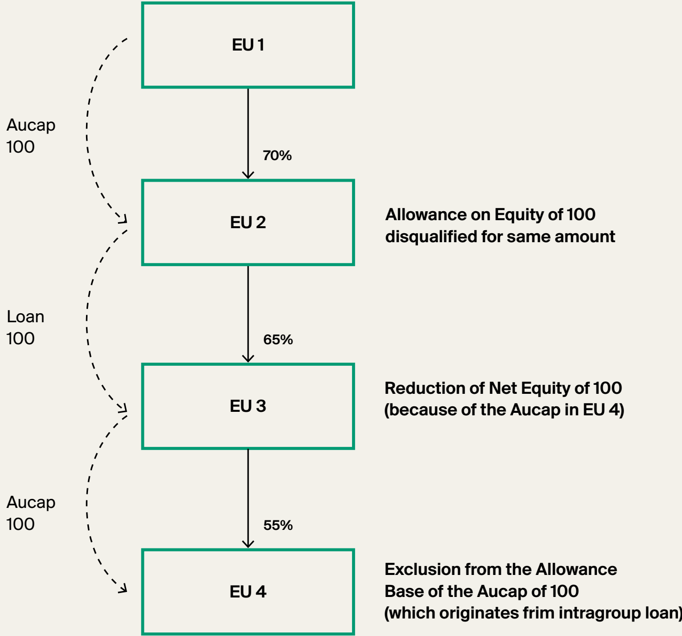
Anti-abuse measures

Robust **anti-abuse measures** are provided by Article 5 of the Directive ensuring that the rules on the deductibility of an allowance on equity are not used for unintended purposes such as the multiplication of the allowance within a group in the EU.
As general rule, capital increases along corporate chains push down the Allowance on Equity at the level of the receiving company with no multiplier effect. By way of example, if EU 1 receives a capital increase of 100 and uses such funds to capitalize for the same amount its wholly owned subsidiary EU 2, only the latter will be entitled to benefit from the Allowance on Equity.

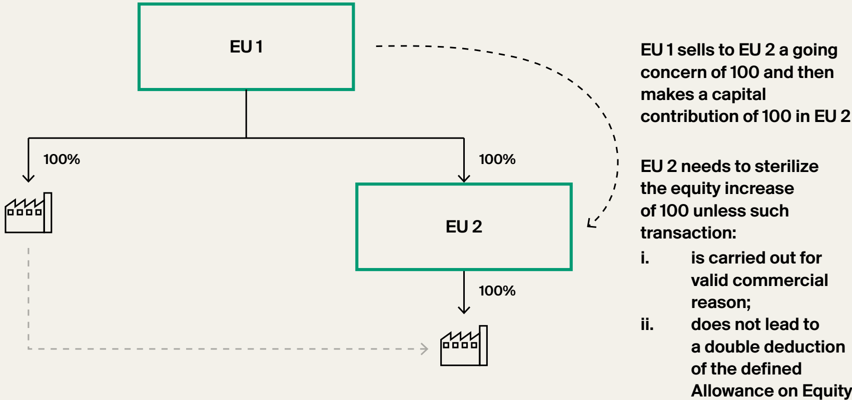


A first measure would target particular schemes put in place to circumvent the conditions on which an equity increase qualifies for an allowance under this Directive, thus excluding[4] from the Allowance Base the equity increases which are the result of:

a. loans granted between associated enterprises: an equity injection granted to a company (EU 2) could indeed be used by the latter to grant a loan to a related company (EU 3), which could in turn be used to inject equity in another related company (EU 4), and so forth;



b. a transfer between associated enterprises of participations or of business activities as going concerns: no further explanations is made by the Explanatory Memorandum but this could be due to the fact that the Directive is not intended to facilitate intercompany transactions which could in principle lead to a circular Net Equity increase.



c. a contribution in cash from a person resident for tax purposes in a jurisdiction that does not exchange information with the Member State in which the taxpayer seeks to deduct the allowance on equity: no further explanations is made by the Explanatory Memorandum but this could be due to the fact that the Directive is not intended to facilitate increases in Net equity deriving from cash contributions whose origin is unknown and that could lead to a multiplication of the Net Equity and of the Allowance on Equity.

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[4] These anti-abuse measures should not apply if the taxpayer provides sufficient evidence that the relevant transaction has been carried out for valid commercial reasons and does not lead to a double deduction of the defined allowance on equity.

Another measure aims to prevent the overvaluation of contributions in kind or investments in assets (e.g., luxury goods) which are not necessary for the performance of the taxpayer's income-generating activity in order to increase the Allowance Base. Contributions in kind are generally considered genuine and do not give rise to a decrease in the Allowance Base per se, unless the value of an asset exceeds reasonable professional needs and its market value. Thus, any part of the value of the asset contributed or recorded in the taxpayer's accounting books over its market value should be deducted from the base of the allowance.
A last measure targets the re-categorisation of old capital as new capital in the context of group reorganizations, which would otherwise qualify as an equity increase for the allowance (such re-categorisation could be achieved through the liquidation of a company and the incorporation of a new company). Therefore, such an increase can drive an increase in the base of the allowance on equity only to the extent that it does not result in converting into new equity the equity (or part thereof) that already existed in the group before the re-organisation.

Limitation to Interest Deduction

On the debt side, the deductibility of the allowance on equity is accompanied by a limitation to the tax deductibility of debt-related interest payments under Article 6 of the Directive.
In particular, a proportional restriction will limit the deductibility of interest expenses incurred during the tax year to 85% of exceeding borrowing costs (i.e., excess of interest expenses minus interest income).
Given that interest limitation rules already apply in the EU pursuant to Article 4 of the ATAD[5], the taxpayer will first apply the rule of Article 6 of this proposed Directive (i.e., deductibility of exceeding passive interests for 85%) and then calculate the limitation applicable under Article 4 of the ATAD (i.e., deductibility of exceeding passive interests up to 30% of EBITDA relevant for tax purposes). In any case, the taxpayer will be entitled to deduct only the lower of the two amounts in the tax year carrying the difference forward or back by Article 4 of ATAD.
By way of example, if a company has exceeding borrowing costs of 100, it should:

i. first, apply the 85% deductibility limit to such exceeding borrowing costs (100 * 85% = 85) under Article 6 of the Directive, and thus determine a non-deductible amount of 15;
ii. then, compute the amount of the remaining 85 that would be deductible under Article 4 of the ATAD (i.e., cap equal to 30% of EBITDA).

If, for instance, the company's EBITDA is 300, and 30% of its EBITDA is 90, the deductible amount of exceeding interest expenses is 85 (and the non-deductible amount is only 15).
Conversely, if its EBITDA is 266, and 30% of EBITDA is 80, only the lower amount of 80 is deductible, and the excess of 5 (i.e. 85 - 80 = 5) would then be available for the carry forward or back under the conditions of Article 4 of ATAD, as transposed in national law.

Open points on Debra

i. Associated enterprises

It is not specified whether the definition of "associated enterprises" provided by Article 3, no. 1 of the Directive, refers to EU associated enterprises only or includes also the ones which are resident outside EU. The inclusion of non-EU associated enterprises in such definition would have a negative effect by penalising capital contributions injected to non-EU associated subsidiaries which conversely are not eligible for Allowance on Equity. Nevertheless, such negative effect would be eliminated if non-EU associated enterprises contributed capital to their EU permanent establish-

[5] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (OJ L 193, 19.7.2016, p. 1).

ments, which, on the contrary, can benefit from the Allowance on Equity.

ii. Tax value of participations in associated enterprises

The amount of Net Equity must be decreased by the tax value of taxpayer's participation in the capital of associated enterprises (see point (i) above as to whether non-EU enterprises should also be included). Such provision may nevertheless have inconsistent effects by penalising (i) capital contributions injected to associated subsidiaries prior to the entry into force of DEBRA and (ii) acquisitions of controlling interests from non-group entities. In the event that a participated enterprise becomes an associated enterprise, the tax value of such participation will have to be decreased from the amount of Net Equity of the parent company. Conversely, if an associated enterprise becomes a non-associated enterprise, then the tax value of such participation will no longer have to be sterilised and the parent company could presumably realise an increase in Net Equity.

iii. Own shares

It is provided that the amount of Net Equity, which is the result of the difference between the equity of a taxpayer and the sum of the tax value of the taxpayer's participation in the capital of associated enterprises and the taxpayer's own shares, must be decreased by any amount of own shares purchased and held by the taxpayer. Nevertheless, the negative reserves of own shares should already be included in the definition of "equity" relevant for the calculation of Net Equity increases pursuant to Article 3, paragraph 1, no. 7, of the Directive. This should be therefore sufficient per se to neutralise the reserve of own shares from the calculation of such Net Equity increases.

iv. NIR and calendar year

It is provided that NIR is made of two components: a fixed rate and a variable rate with reference to the date of 31 December of the year preceding the relevant tax period. In case of taxpayers with tax period that does not coincide with the calendar year, would such date still be relevant or should those taxpayers consider the date on which their tax year ends?

v. NIR and Eurozone

In the Eurozone, the NIR is the same among the various Member States adopting the Euro currency, since the risk-free rate does not vary depending on the State where the company is established but is instead linked to the specific currency of the taxpayer. The NIR calculated by the Member States may therefore vary between the EU-countries in the Euro Area and the ones adopting other currencies (e.g., Poland, Denmark, Sweden, Bulgaria, Check Republic, ...).

vi. Negative Allowance on Equity

After having obtained an Allowance on Equity, in the case of a decrease in the Net equity in a tax period, it is provided for a "recapture rule": a negative Allowance on Equity should become taxable for ten consecutive tax periods and be calculated by taking into account the NIR with reference to 31st December of the year preceding the relevant tax year. However, the NIR may change every single year and the Directive does not seem to take into consideration the facilitating/penalising effects for the taxpayer that respectively a decreasing/increasing NIR over time may have. By way of example, in the scenario with a decreasing NIR, if a taxpayer enjoys the Allowance on Equity with a 4% NIR and is then required to tax the decrease in Net Equity with a 2% NIR, the taxpayer should still be able to benefit from the Allowance on Equity for the positive difference calculated by applying the two different notional interest rates. The positive effect for the taxpayer is that the taxable income arising from a decrease in Net Equity is less the Allowance calculated on the increase in Net Equity. Instead, in the scenario with an increasing NIR, the taxpayer would have to consider a

taxable income due to the decrease in Net Equity greater than the Allowance on Equity calculated on the increase in Net Equity.

vii. Interest limitation rule

Under the interest limitation rule pursuant to Article 6 of the Directive, in a given tax year, if the taxpayer has interest income but no interest expenses, the interest income could not be carried forward in the following tax years by the taxpayer. It would also not be allowed to carry forward the 15% non-deductible portion calculated by applying Article 6 of the Directive in case of an excess of interest income in the following fiscal years.

viii. 30% EBITDA limit

Article 4, para. 1 of the Directive, provides that "*the taxpayer may carry forward, for a maximum of 5 tax periods, the part of the allowance on equity which exceeds 30% of EBITDA in a tax period*". According to what is set forth in the Explanatory Memorandum (pg. 9), instead, "*the taxpayer will be able to carry forward, for a period of maximum five years, unused allowance capacity, where the allowance on equity does not reach the aforementioned maximum amount*". There is therefore a clear difference between what is provided by Article 4 of the Directive and the Explanatory Memorandum concerning the object of the carry-forward for a maximum of five tax years (the excess of the Allowance on Equity over the 30% of the taxpayer's EBITDA vs the ceiling of 30% of the unused EBITDA).
Moreover, the relationship between (i) 30% of EBITDA provided by Article 4 of the Directive for the deductibility of the Allowance on Equity and (ii) 30% of EBITDA under Article 4 of ATAD for the deductibility of exceeding interest expenses is not regulated by the Directive. Would the 30% cap be used twice (once for the deduction of the Allowance on Equity and once for interest deduction)? If the answer is negative, would the taxpayer have the choice to use the cap against one or the other at its own discretion?

ix. Valuation reserves

No reference is made in the Directive to the treatment of valuation items (e.g., participations and revaluation of trademarks and intangibles) among the possible circumvention transactions that could be carried out for the purpose of increasing the Allowance Base.
By way of example, assuming that the tax value of the participation in associated enterprises remains constant over time, the valuation of equity investments using the fair-value method with allocation of profits to equity would lead either to an increase or to a decrease of the Allowance Base. However, in order to avoid the duplication of the Allowance on Equity, such variation should be reasonably sterilized.

x. Fiscal unit or tax consolidation group

It is not specified whether the Allowance on Equity and the interest limitation rule pursuant to Article 6 of the Directive apply either on the fiscal unit or on its tax consolidation group, although to date such rules appear to apply only on a stand-alone basis.

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xii. Pillar 2

It should be taken into consideration how the provisions of the Directive coordinate with the rules introduced by Pillar 2 (Global Minimum Tax): without amendments to the latter rules, the allowance on equity will probably lower the effective tax rate (ETR) of groups operating in EU jurisdictions and thus it should be included in the qualified tax incentives.

Main differences between Debra and the Italian "ACE" Regime

Italian taxpayers can already benefit from deductions for equity contributions according to the Italian tax regime called "aid to economic growth" ("**ACE**"). Since 2011 Italy has indeed introduced the ACE tax regime[6], which provides for the deduction from the corporate taxable base of a notional yield on the net (qualifying) equity increases that an Italian resident company has recorded after December 31st, 2010.
The yield is computed by applying a defined rate, currently equal to 1.3%[7], to the increase of a company's net equity as compared to its accounting net equity on December 31st, 2010.
In particular, the net (qualifying) equity increases derive from:

i. cash equity contributions;
ii. waiver of shareholders' financial receivables;
iii. undistributed profits,

and must be netted of the decreases triggered by distributions or assignments to the shareholders. Within ten years after the entry into force of the Directive (2024), Italy will have to adapt its domestic provisions according to those of the Directive, which in some respects are less favourable to taxpayers. The main differences are as follows:

1. the Directive excludes financial undertakings from the list of beneficiaries, unlike the ACE regime. As of 2019, the Italian Ministry of Finance has recorded that over 326,000 companies have benefitted from ACE for a deduction of approx. Euro 18,4 billion, most of which are from the financial and insurance sector (37%). As a consequence, if adopted in the Italian law, Article 2 of the Directive would result in the non-deduction by financial undertakings of an important tax benefit. Furthermore, the exclusion of financial undertakings from the application of the Directive implies that the further limitation concerning the non-deductibility at 15% of the exceeding interest expenses provided by Article 6 does not apply either. Therefore, at Italian level, if no changes were made in the adoption of the Directive, the non-deductibility at 4% of exceeding interest expenses provided by Article 96 of the Presidential Decree no. 917/1986 should remain for financial undertakings;
2. DEBRA seems also to exclude from its scope individual entrepreneurs and commercial partnerships, which are currently eligible for ACE. Nevertheless, such exclusions could in principle have a distorting effect on the choice of legal form under which to operate;
3. the Directive provides for the deductibility of the allowance for ten consecutive years with a cap of 30% of the taxpayer's EBITDA for each tax year, while the ACE tax regime imposes no time limits for use of the benefit and provides for deductibility of the allowance up to the total net taxable income of the taxpayer;
4. the allowance provided by the Directive is calculated as a year-on-year increase in net equity and does not provide for the computation of past capital stock which however may be relevant for the Italian ACE tax regime. From the date of entry into force of the Directive, the past

[6] For the sake of completeness, the ACE tax regime has been temporarily repealed by Budget Law 2019 and reintroduced by Budget Law 2020.
[7] The notional interest rate is equal to 1.3% starting from 2019, while the rates for previous years ranged between 1.6% and 4.75%. It was also provided that increases occurred only in 2021 could benefit from an enhanced notional interest rate of 15%, albeit with a limit of Euro 5 million of eligible increases.

capital stock taken into account to calculate the ACE benefit would therefore be lost, unless special rules are introduced;

5. the ACE basis does not include increases in valuation reserves such as the reserve for unrealised foreign exchange gains, the fair value reserve for derivatives, the revaluation reserve, the first-time IAS adoption reserves and the fair value reserve for equity investments. Such reserves become instead relevant in the calculation of the Allowance on Equity pursuant to Article 3, paragraph 8 of the Directive;
6. for ACE purposes, the net equity is not reduced by the value of the participation in associated enterprises but only by the value of equity increases in such enterprises; only the latter, indeed, may cause a duplication of benefits;
7. the ACE basis does not include contributions in kind;
8. the Directive introduces a further limiting rule for the deduction of exceeding interest costs in addition to the provision of Article 4 of ATAD (i.e., deductibility of exceeding passive interests up to 30% of EBITDA relevant for tax purposes), which leads by default to the non-deductibility of exceeding interest expenses of a fixed 15%. The *ratio* of this rule is to further incentivise companies to use venture capital rather than bank debt. As of today, the ACE regime is not accompanied by any further limitation and therefore the taxpayer is still free to structure the company's sources of debt-capital financing as it wishes.

Next Steps

The Directive will be discussed by the 27 EU Member States and once unanimity is achieved, it will be published in the *Official Journal of the European Union*.
At this stage, it is provided that the Member States should bring the provisions of the Directive into force by December 31st, 2023, and apply them as of January 1st, 2024.
Member States that have rules in place providing for an allowance on equity increases, such as Italy and the five ones mentioned in the introduction, may defer the application of the provisions of this Directive for a period up to ten years.
Nevertheless, for those EU legislations which provides for a similar benefit on equity increases for a limited period of time (this is not the case of Italy), the application of the Directive may not be deferred for a period longer than the duration of the benefit under national law.

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