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Allowance for Corporate Equity: The Latest Developments in European Union Law

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Abstract There are two ways of financing companies, namely equity financing and debt financing. These two ways of financing companies are relevant for tax law because the payment of interest arising from loan financing reduces the tax base of income tax, and the payment of dividends paid due to ownership of the company does not reduce the tax liability of the company. Therefore, over time, attempting to achieve neutrality in corporate financing was a challenging task. One of those ways is Allowance for Corporate Equity. In May 2022, the European Commission adopted a 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, the so-called DEBRA proposal, which seeks to reduce the tax base of corporate income tax arising from equity financing. Consequently, this paper will briefly discuss the Allowance for Corporate Equity, give an overview of the 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 and assess the European Commission proposal.

Keywords
allowance for corporate equity,
corporate income tax,
European Commission,
debt,
equity,
DEBRA

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1 Introduction

A company may be financed by debt or equity (Jelčić *et al.*, 2008: 353). The decision on the source of financing influences the taxation of the company. The general rule is that the interest on debt is deductible from the taxable income of the company, thus encouraging companies to finance their operations with debt rather than equity, especially in high-tax countries (Blouin *et al.*, 2014: 3). As loans between affiliated companies may become a means of tax avoidance, the countries have sought ways of limiting such loan financing, thus creating Thin Capitalisation rules and Earning Stripping Rules (Pribisalić, 2022: 2). Considering the fact that interest paid may be deducted from taxable income and dividends cannot, the issue of capital structure of companies has long been on the academics' and tax policy makers' agenda. The approaches in tax law are versatile and can be systematised using different criteria, so the distinction between neoclassical and neo-institutionalist approaches may be identified. In neo-institutionalist approaches, the Trade-Off Theory and The Pecking Order Theory of Capital Structure have been identified (Pribisalić, 2022: 67-69). The neoclassical approaches refer to the theory of Modigliani and Miller from 1958, which set the foundations for future investigations of the capital structure of companies. Their irrelevance theorem starts from an assumption of a frictionless capital market, and the results point out the irrelevance of the capital structure for the company value. However, taking into account the presence of taxes, they conclude that companies generally favour debt because the debt tax shield generated by the possibility of deducting interest paid on debt increases the company's value (Wamser, 2008: 4).

Kock and Gérard (2018: 1) propose an approach relating to the elimination of the debt bias by approximating the effective marginal tax rates for debt and equity. They identify the two opposing cases: the so-called Comprehensive Business Income Tax (CBIT), which includes the elimination of the tax deductibility of interest, and the Allowance for Corporate Equity (ACE).

In this paper, following the introductory remarks, the authors discuss the ACE as a model for achieving tax neutrality in corporate financing, its relationship with the CBIT, which also seeks to achieve tax neutrality in corporate financing, and briefly show how the ACE is implemented in the EU Member States in the third chapter. Also, a 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, which seeks to reduce the tax base of corporate income tax arising from equity financing (hereinafter: DEBRA) will be presented in the fourth chapter. The issue of its relationship with Article 4 of the 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 (hereinafter: ATAD) will be addressed, and finally, it will be concluded whether the newly proposed system in the European Union meets the expectations.

2 Allowance for Corporate Equity

Corporate income tax reform is high on the tax policy agenda. The Allowance for Corporate Equity (hereinafter: ACE) draws special attention as it has been occurring on tax reformers' agendas from time to time since the 1980s when its theoretical foundations were developed by Robin Boadway and Neil Bruce in 1984, and Ekkehard Wenger in 1983 (Klemm, 2006: 3). Historically, the ACE was originally introduced in the 1970s by the Meade Committee in their proposal of amendments to the UK tax system. Later on, the leading commentators Boadway and Bruce provided a theoretical framework of a corporate tax system that is neutral to investment financing decisions and suggested the introduction of an allowance for corporate capital (Kayis-Kumar, 2015: 323-324).

Boadway and Bruce discuss the two ways of levying a neutral corporate income tax. The first one is the imputed income method, which defines as its tax base the true economic profit of the company. In accordance with this method, the company's profit total income is reduced by total imputed costs, both capital and current. The deduction for capital costs equals the real cost of financing the replacement value of the capital stock (which includes both debt and equity costs) increased by true economic depreciation valued at historic prices adjusted for the rate of inflation. Another way of levying a neutral business tax is using the cash flow of the firm as the tax base, followed by allowing an immediate write-off of investment expenditures at the time they are undertaken. This method referred to as the cash flow method, does not permit any deductions for interest or depreciation (Boadway and Bruce, 1984: 231-232).

Kayis-Kumar *et al.* (2022: 5) explain a small but important change in the existing corporate tax system which occurs upon the introduction of the ACE. It provides for a notional deduction for the cost of equity finance. Importantly, the ACE remains revenue neutral and, at the same time, addresses two of the main economic distortions which occur in the current corporate tax system: investment decisions (whether to invest and how much to invest) and financing decisions (whether to finance corporate activity with debt or with equity) (Kayis-Kumar *et al.*, 2022: 5).

According to Cnossen (2018: 822) the ACE is the only cash flow tax in practice today insofar as the ACE system taxes only pure profits as it provides for a deduction from conventionally computed profits, which equals the shareholders' funds (total equity capital of a corporation, including taxable profits net of Corporate Income Tax) multiplied by an appropriate nominal interest rate (which is determined by the government by taking into account a normal market rate of return on, *e.g.* medium-term government bonds). In reference to Devereux and Freeman, it should be considered that the lenders should get the same treatment as shareholders or members of the company, therefore, capital owners.

Devereux and Freeman (1991: 6-7) state that the value of the outstanding loan should be calculated and the same notional interest rate applied. They propose replacing the universal treatment of the deduction of actual interest with such a system. Otherwise, instead of buying shares, investors would have the incentive to lend to the company at excessively high-interest rates. However, the authors state that this approach shows a lack of understanding of the nature of the company. The company is owned by shareholders, and the shareholders are entitled to its assets and profits from the income after payment of all costs. These costs legitimately include the payment of interest to investors who have lent money to that company, and if a company wants to decrease its tax liability by paying an increased interest rate to lenders, it can only do so to the detriment of its shareholders. Another problem relates to affiliated companies, where shareholders and lenders are the same entities. Normally, interest payments do reflect the nominal financial cost of the company, so it would be unreasonable to replace the entire interest expense with a certain fixed tax expense. That expense could only be close to the actual interest expense (Devereux and Freeman, 1991: 6-7).

Klemm (2006: 4) clarifies that the ACE is designed to address the difference in the treatment of debt and equity and allow for a deduction of a notional interest rate on the firms' equity as well. Klemm defines the ACE or the notional return as "the product of the end of last year's equity stock (…) with a notional interest rate". He suggests defining the notional interest rate as "the risk-free nominal interest rate" due to the certainty of the tax advantages. It could be approximated by the rate of government bonds. Klemm explains that this description does not correspond to the theoretical tax described by Boadway and Bruce, which includes non-deductible interest and the calculation of the allowance as the interest cost of total assets. Klemm emphasises that total assets usually correspond to total debt and equity and concludes that the practical implementation is equivalent if the interest rate on debt paid is similar to the notional interest rate allowed on equity.

Klemm (2006: 4-5) goes on to describe the features of the ACE. The main ones, in case the right notional interest rate is chosen, ensure neutrality for financing choices, allowing firms to choose between debt and equity finance without an impact on the corporate tax. The ACE system is also neutral to investment. Marginal projects are not taxed, as the notional return of those projects matches the pre-tax profits exactly, and any investment that would be worthwhile in the absence of tax remains worthwhile when taxed. Another feature of the ACE system is the irrelevance of the method of tax depreciation as any increase in depreciation in early years reduces the stock of equity and hence the ACE in later years, which exactly offsets in net present value terms any benefit from earlier depreciation. Furthermore, the ACE is not influenced by inflation, and possible increases in monetary profits due to inflation will be offset by a higher notional return, as the notional interest rate will also be higher due to inflation. There is no need for indexation. This allows the ACE to achieve more than just equal treatment of debt and equity finance. All the listed features lead to the conclusion that the system is beneficial, leaving the question of why so few countries use it. This leads us to the challenges of the system, one being that because of the narrower tax base, a higher tax rate is needed to collect the same amount of revenue, which has negative consequences in the presence of tax competition for mobile economic rents. It is also questionable whether other countries will accept corporate tax payments under an ACE system as a basis for double tax relief (Klemm, 2006: 4-5).

Taking into regard how the deductible amount is determined, Kock and Gérard (2018: 2) state that Hebous and Ruf provide a broad categorisation of the existing ACE schemes into hard and soft ACE regimes. A hard ACE regime includes the full stock of equity and applies the full tax rate to the deduction. Examples of this approach may be found in Belgium or Croatia. Soft (or partial) ACE versions appear with various features. The so-called incremental schemes only consider newly issued equity, while the other schemes grant a deduction upon equity remuneration in the form of dividends (Brazil) or apply reduced tax rates on the deduction (the examples thereof are the first Italian and the Austrian ACE system) (Kock and Gérard, 2018: 2).

2.1 Advantages and disadvantages of the Allowance for Corporate Equity

The ACE system has many advantages; however, it has also often been disputed. The biggest advantage of an ACE is that it encourages investment by reducing the marginal effective tax rate for investment to zero while still taxing the existing capital and economic rents. The ACE, through a deduction for equity, enables a zero tax rate on marginal projects (and marginal firms). This feature is especially favourable in the post-pandemic economic environment, as it encourages investment. In case companies earn above the normal rate of return, the effective tax rate will increase with economic rent. If firms, which are making economic rents, may choose the location of the business, a lower corporate tax rate would attract more companies to such a country than an ACE would. Furthermore, the ACE system is not affected by the method of tax depreciation and inflation because accelerated depreciation for tax purposes reduces the book value of assets, decreasing the base for the calculation of the ACE. The present value of this reduction exactly offsets the benefits of accelerated depreciation. A similar effect may be identified for inflation, in which case an increase in profits caused by inflation is offset by a higher notional return. Another advantage of the ACE is that it allows for radical simplification of the depreciation schedule. It is also easy to introduce as it can be incorporated into the current system by simply adding a form of deduction. It allows for the simplification of complex depreciation provisions and eliminates complexity from decision-making about financing options (debt vs equity). The ACE would contribute to the tax system to achieve Capital Import and Capital Export Neutrality if it would be accompanied by the elimination of withholding taxes. The precondition for Capital Import Neutrality and Capital Export Neutrality is equalising the overall tax burden on investment, regardless of whether invested domestically or abroad (from the point of view of the overseas investor and the domestic investor). Expectedly, the capital investors will be inclined to the place where they receive the largest economic benefit. Complete neutrality remains unattainable as long as different international jurisdictions apply different tax rates. (Kayis-Kumar *et al.,* 2022: 8-10).

Apart from advantages, Kayis-Kumar *et al.* (2022: 10-11) discuss some of its drawbacks. The equity deductions allowed under the ACE are applied across all corporate structures. However, limiting the reform to corporate structures makes it possible to create distortions regarding organisational form as it may encourage individuals with businesses to incorporate rather than pay tax through the personal income tax system. Kayis-Kumar *et al.* go on to explain that the ACE does not provide a solution to problems associated with the arbitrary distinction in international taxation as equity-financed outbound investments are largely taxed abroad while debt-financed outbound investments are taxed at home, which is a part of a wider discussion on allocation of more taxing rights to source countries. Additionally, the ACE is not designed to solve existing problems with base erosion and profit shifting and may encourage profit-shifting to companies using the equity deduction for equity then provided to foreign branches. Kayis-Kumar *et al.* argue that introducing equal treatment of debt and equity could diminish concerns about thin capitalisation rules. They state that the incentive for Multinational Enterprises to use transfer pricing one way or another will continue until international taxation becomes fully integrated, as high headline corporate tax rates will be an incentive for such arrangements.

The ACE provides simple rules regarding the timing of expenses as well as an opportunity to eliminate targeted concessions. In those circumstances, the tax authorities will be able to dedicate resources otherwise spent on complexities and competing interpretations towards integrity issues like profit shifting. Although many challenges associated with cross-border flows related to an ACE do exist, many tax academics, such as Sørensen, continue to support the wider use of the ACE as its desirable properties prevail (Kayis-Kumar *et al.*, 2022: 10-11).

Another important economic argument, not necessarily in the best interest of a particular country having an implemented the ACE at a time of increasing globalisation, should be mentioned. The ACE focuses on taxing economic rents and hence narrows the tax base. Consequently, collecting the same revenues as in the classical corporate income tax system may only be achieved by the use of the above-average corporate income tax rate (Pribisalić, 2022: 77; Klemm, 2006: 3).

2.2 Comprehensive Business Income Tax and its difference in relation to the Allowance for Corporate Equity

The intention of introducing CBIT is to eliminate the favourable fiscal discrimination of debt-financed investment by abolishing the deduction for interest payments. The CBIT was proposed by the United States of America Treasury in 1992. In their proposal, the US treasury makes a distinction between the so-called CBIT entities and non-CBIT entities. Mostly, firms will be considered to be CBIT entities (only small firms will not), and they are not allowed to deduct the interest. The same rule is applicable to financial companies (including banks). In order to avoid double taxation of interest, the interest which the firms or banks received from other CBIT entities should be exempt or credited. The interest received from non-CBIT entities will be taxable, including interest from households or government bonds. Interest received from abroad will also be taxable, although an exemption or credit could be introduced if this interest comes from a CBIT entity (that would be the case if other countries introduced a CBIT). CBIT makes corporate income tax a broad-based tax on capital at the firm level, as all capital income will, in that case, be taxed at the source. The US treasury proposal pairs the CBIT with an abolition of personal taxes on capital, thus avoiding double taxation of some sorts of capital income, such as dividends and broadening the base to currently exempt types of capital income, such as that earned by institutional investors (de Mooij and Devereux, 2009: 18).

Some disadvantages of the CBIT include that it raises the cost of capital on debt-financed investments, which could lead to fewer investment projects being profitable and the decline of investment. The effect thereof would be opposite to the ACE. Corporate tax revenues would be raised by the broadening of the base under CBIT. In order to maintain the overall tax revenue, a lower corporate tax rate could be applied, which would reduce the cost of capital on equity-financed investments and could attract mobile economic rents or paper profits of Multinational Enterprises. The described effect is opposite from the ACE: CBIT would shift the tax burden away from rents towards the marginal investment return. In the case of mobile rents, credit constraints and multinational profit shifting would be important in connection to marginal investment decisions, which would make the CBIT attractive (de Mooij and Devereux, 2009: 18).

Sørensen summarises the effects of a revenue-neutral transition from a classical corporate tax system to the CBIT. For low-yielding companies which mostly rely on debt, the cost of capital could rise significantly. On the other hand, for high-yielding companies relying mainly on equity, the overall cost of capital would most likely be reduced (Sørensen, 2007: 212).

Another possible influence of CBIT may be the one on intracompany financial policies. If all countries adopted a CBIT system, Multinational Enterprises would no longer have an opportunity to shift profits through the adjustment of their intra-firm capital structure. However, in case only one single country has a CBIT in place, firms could be encouraged to discontinue financing investment in that country by debt (de Mooij and Devereux, 2009: 19).

However, if the recognised expense of interest as a tax-deductible expense is refused, this would obviously violate the objective net principle, just as it violates the taxation of unrealised profit. It should additionally be emphasised that the unilateral introduction of CBIT would not be economically advisable or legally possible. In those circumstances, non-resident companies would be affected by this tax form because of the risk of lack of credit. Additionally, the existing double taxation agreements could be violated by limiting withholding tax deductions. Therefore, CBIT could only be introduced through extensive international coordination and harmonisation (Bohn, 2009: 14; Pribisalić, 2022: 72).

3 Allowance for Corporate Equity in the Member States of the European Union

Some EU Member States provide incentives for debt financing via the tax-deductibility of interest payments in their corporate tax systems. This system allows companies to deduct interests attached to debt financing; however, the costs related to equity financing, such as the payment of dividends, are not encompassed by this system. Six Member States of the European Union (hereinafter: Member States) (Belgium, Cyprus, Italy, Malta, Poland and Portugal) already have legislative measures in place with the aim of tackling the tax-induced debt-equity bias. The measures are not aligned in policy design; however, all of them provide for a tax allowance on equity (EC, 2021a: 1). This chapter will briefly present the ACE systems applied in these Member States.

3.1 Belgium

Belgian companies and Belgian branches of non-resident companies are entitled to deduct an interest expense regarding qualifying equity, known as the notional interest deduction (hereinafter: NID). The NID is calculated on the incrementally adjusted equity, which exceeds the average equity of the preceding five years. Qualifying equity is determined at the beginning of the tax period (for the current and five preceding tax periods). The system contains an anti-abuse measure – to prevent double tax benefits, certain items must be deducted from the equity. Furthermore, capital contributed by entities resident in jurisdictions not participating in the exchange of information should be deducted from the calculation basis of the NID unless a business purpose test is met. The NID is not allowed for subsidiaries when the direct or indirect parent financed the equity contribution with a loan. Equity allocated to foreign branches and foreign real estate qualifies for the NID, but this portion of the NID must be imputed first on that foreign-source income and only excess NID which relates to branches and real estate located in the EEA can be effectively used against Belgian taxable income. For the 2021 tax year, the NID rate is set at 0.092% (0.408% for small companies). The deduction may not be carried forward in the event of a loss (EY, 2021: 174-175). Carried forward NID (calculated before the 2019 tax year) is limited to EUR 1 million, increased by 70% of the taxable income in excess of EUR 1 million, meaning that 30% of the tax base in excess of EUR 1 million cannot be offset and is a minimum tax base (EY, 2021: 181).

3.2 Cyprus

Resident companies and non-resident companies with a permanent establishment in Cyprus are entitled to a NID amounting to up to 80% of their taxable income on new equity. Qualifying new equity includes share capital and share premium issued and settled on or after 1 January 2015 (Deloitte Cyprus, 2022: 2). The NID is deducted from the taxable income of the entity for the relevant tax year (subject to any restrictions) for the time period within the tax year during which the equity belongs to the entity and is used by that entity for its activities. The NID equals the "reference interest rate" multiplied by the "new capital"; however, the NID cannot be claimed on "old capital" (EY, 2021: 433).

3.3 Italy

In 2011, the Italian Government presented a reform that aims to balance the budget and stimulate company capitalisation through the use of the "*Aiuto alla Crescita Economica*" (Aid to Economic Growth) instrument, sharing the acronym as well as the features of the British ACE. Both systems provide for the allowance determined by applying an imputation (or notional) rate to the equity invested in the company (Panteghini *et al.*, 2012: 2).

The Italian NID or ACE provides Italian enterprises (including Italian branches of foreign businesses) with a possibility to claim a 1.3% deduction from taxable income corresponding to an assumed "notional return" on qualifying equity increases contributed after 2010. The legislation in place allows Italian resident companies the deduction from their net taxable income (after applying any tax loss carryforward) an amount which corresponds to a notional return on the increase in equity as compared to the equity at the end of the 2010 fiscal year. The described deduction may offset the annual taxable income, but it is not permitted to generate a loss, hence allowing the unused excess to be carried forward without time limitation. Qualifying equity increases include contributions in cash and the setting aside of profits to available reserves. Qualifying equity decreases relate to any assignments made to the shareholder (*e.g.* dividend distributions and repayment of capital reserves) and may also occur under specific anti-avoidance clauses, allowing clearance from anti-avoidance provisions if it can be demonstrated that there is no benefit duplication (EY, 2021: 868-869).

Law Decree no. 73/2021 (the so-called '*Sostegni Bis Decree*') brought about a measure whose purpose was to strengthen the ACE benefit for the tax period 2021 only. The existing rate of 1.3% was increased to 15% for the increase of net equity in 2021 up to EUR 5 million. The 15% rate applies to net equity increases that occurred in 2021 compared to those that existed at the end of 2020. Any capital increase exceeding EUR 5 million will benefit from the ordinary ACE regime (Pribisalić, 2022: 141).

3.4 Malta

The NID is optionally applied by companies or partnerships resident in Malta (also by non-resident companies or partnerships with a permanent establishment in Malta). The NID may only be claimed against profits to be allocated to the company's Foreign Income Account or Maltese Taxed Account or to profits that would have been so allocated in the case of undertakings other than companies (Eligible Profits). The NID is eligible to be claimed only if all shareholders or owners approve the claim of such deduction for the year of assessment. The NID that may be claimed during a year of assessment must not exceed an amount corresponding to 90% of the undertaking's Eligible Profits gross of the NID for the previous. Any excess NID may be carried forward indefinitely for deduction and deducted in the following years until it is absorbed. If an undertaking claims the NID, an amount equal to 110% of the profits relieved from the tax will be allocated to the undertaking's Final Tax. In accordance with the NID Rules, the amount claimed as the NID by the undertaking should allow an equal deemed interest income in a proportion corresponding to the proportion of the nominal value of the risk capital pertaining to each shareholder or partner. It is to be treated as interest for tax purposes, applying all provisions dealing with taxation of interest, apart from the investment income provisions (which provide for a 15% final tax). As a result, if the shareholder or partner is a tax resident outside of Malta, they are entitled to the non-resident exemption applicable to interest income. Such shareholders or partners which receive this deemed interest income are entitled to deduct against it any NID that they are eligible for, pursuant to their own risk capital (EY, 2021: 1100-1101).

3.5 Poland

Starting from 1 January 2019, a new NID mechanism is in place (applied from 2020), allowing the deduction from the taxable base of the hypothetical costs of obtaining external capital if the company receives funding in the form of additional payments to capital or retained profits. The maximum limit of NID is PLN 250,000 in a tax year (PWC, 2022b).

3.6 Portugal

Companies are entitled to a six-year period benefit from a NID of 7% on the amount of cash contributions or conversions of loans by shareholders to share capital, made on or after 1 January 2017, as well as conversions of payables to share capital, made on or after 1 January 2018. The maximum amount for the notional interest deduction is EUR 2 million (EY, 2021: 1439).

4 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 (DEBRA)

4.1 The need to regulate debt-equity bias

Recently, European tax policymakers have enhanced their efforts to make the business tax system in the EU fairer and more efficient. In this regard, a number of studies and documents have been made in order to provide a solid foundation for the new initiatives. Following the COVID-19 pandemic and the efforts for economic recovery, the milestone for the new wave of initiatives is the 2021 report Business Taxation for the 21st Century (EC, 2021b). The report refers to the many anti-tax avoidance and evasion measures as well as the OECD's BEPS project[1] and emphasises the importance of public revenues in supporting economic recovery. A "robust, efficient and fair tax framework" is set as a priority for the recovery, which is to be accompanied by the green and digital transition. Within one of the priorities entitled "Enabling fair and sustainable growth", the support of the development of Capital Markets Union is planned to be achieved by "removing tax barriers to cross-

[1] More information on OECD BEPS is available on https://www.oecd.org/tax/beps/ (6 July 2022)

border investment and addressing the debt bias in corporate taxation" (EC, 2021b: 2-3). The report goes on to establish that the current legislation on tax deduction of interest on debt is inclined to debt financing, allowing companies to deduct interest paid on debt without taking into account the costs of equity financing (*e.g.* the payment of dividends). The existing system encourages the financing of investments through debt and leaves equity as an unfavourable option for tax purposes. This leads to growing indebtedness, which may have negative consequences for the EU and may lead to high insolvency in some countries. "The debt bias penalises the financing of innovation through equity", the report claims. The issue has gained importance during the COVID-19 pandemic, as the companies' debts increased substantially. The report, therefore, mandates the Commission to prepare a proposal addressing the debt-equity bias in corporate taxation and to build the corresponding allowance system for equity financing, including the corresponding anti-abuse measures (EC, 2021b: 11).

Additionally, among many other goals directed at establishing Capital Markets Union, the Commission committed to 16 actions with the aim of supporting "a green, digital, inclusive and resilient economic recovery by making financing more accessible to European companies". This would make the EU attractive to individuals for saving and long-term investments and would enable the integration of national capital markets into a genuine single market (EC, 2020: 6-7). Action 4 addresses the debt bias in taxation in order to "remove undue fiscal incentives for debt financing" (EC, 2020: 8).

The recommendation to take measures regarding the debt-equity bias in corporate taxation, allowing for tax deductions on interest payments, while not providing the same treatment for equity financing "highlights the structural disadvantage facing companies that rely on equity financing, in particular, if they are young and small companies with poor access to credit", as referred to in the Report on the impact of national tax reforms on the EU economy (European Parliament, 2021). The Report warns that different systems of debt-equity bias have been introduced in some Member States (allowances for corporate equity) and that certain loopholes are being used by the MNEs to deduct national interests artificially. The proposed solution should allow the deduction of costs related to equity financing or the reduction of interest deductions. Therefore, a new set of legislation was expected from the EC to tackle those issues.

Currently, it is common for the European tax systems to allow for the deduction of interest payments on the debt in the calculation of the tax base of corporate income tax. Adversely, costs of equity financing (*e.g.* dividends) are not deductible. This asymmetric treatment of the two sources of corporate funding leads to a more favourable use of debt over equity for investment financing. Different measures regarding debt-equity bias for taxation purposes are in place in 6 EU Member States, namely Belgium, Portugal, Poland, Cyprus, Malta and Italy (EC, 2022: 1; EC, 2022: 5). The EC considers that ineffective regulation of tax-induced debt-equity bias will continue to provide insufficient incentives for equity financing over debt financing, and this will lead to tax planning, which distorts the distribution of investment and growth (EC, 2022: 1).

Hence, on 11 May 2022, the EC published the proposal of a directive containing rules for the deductibility for tax purposes of notional interest on increases of equity and limiting the tax deductibility of exceeding borrowing costs (EC, 2022: 1), colloquially referred to by its abbreviation as the DEBRA (Debt-Equity Bias Reduction Allowance) proposal. The proposal should provide equal income tax treatment for equity and debt financing for companies operating in the EU. The legal base for the proposal is Article 115 of the TFEU, authorising the Council to issue unanimously, upon consulting the European Parliament and the Economic and Social Committee, directives with the aim of harmonising Member States' legislations which directly affect the establishment or functioning of the internal market. This legal basis is used for all EU legislation relating to direct taxation. As stated in the DEBRA proposal explanatory memorandum, the proposal complies with the principles of subsidiarity and proportionality. The absence of appropriate EU rules, accompanied by the existing measures in some EU Member States, may result in internal market functioning distortions and affect investment location. Therefore, a single EU rule would bring legal certainty and improve competition in the single market by providing all businesses with similar incentives for financing. It is also stated that the proposed measures represent the minimum necessary level of protection for the internal market and for achieving the objectives (EC, 2022: 3).

In the process of drafting the proposal, stakeholder consultations and the impact assessment were conducted. The conclusion was that the expected economic impact would be positive and that the measures should favour higher equity ratios and hence reduce insolvency risks (EC, 2022: 4-6).

4.2 The DEBRA proposal provisions

The personal scope of the DEBRA proposal, as set out in Article 2, encompasses taxpayers 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, except for financial undertakings. The inclusion of financial undertakings in the scope of the proposal would lead to unequal distribution of the economic burden of the measure at the expense of non-financial undertakings (EC, 2022: 7).

Rajathurai *et al.* (2022) explain that the reason for excluding financial undertakings is their regulatory capital requirement, which prevents them from being under-capitalised; however, due to the broad definition, some entities are not subject to such requirements. An alternative explanation is that such entities would not feel the effects of interest deduction limitation and that it would not be fair for them to have the advantage of equity allowance if they did not bear the economic burden of the DEBRA proposal.

The proposal includes two independent measures: allowance on equity (Article 4), accompanied by anti-abuse rules (Article 5), and limitation to interest deduction (Article 6). As per Article 11, after the adoption, the DEBRA should be transposed into Member States' national legislation by 31 December 2023, and the provisions should be in application from 1 January 2024. The Member States already applying the rule on allowance on equity may apply a "grandfathering" clause, providing the taxpayers already using the benefit to continue using it for up to 10 years (EC, 2022: 10).

In order to provide the EC with sufficient information about the DEBRA implementation, the proposal contains the rules on monitoring and reporting, which should be performed yearly. This should allow appropriate evaluation of the DEBRA implementation (Articles 7 and 8 of the DEBRA proposal).

4.2.1 Allowance on equity

An allowance on equity, as set out by Article 4 Paragraph 1 of the DEBRA proposal (EC, 2022: 19), is deductible, for ten 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). In case of a higher deductible allowance on equity than the taxpayer's net taxable income in a tax period, the taxpayer may carry forward the excess allowance on equity to the following periods without time limitation. Also, for a maximum of 5 tax periods, the taxpayers may carry forward the part of the allowance on equity which exceeds 30% of EBITDA in a tax period.

The base of the allowance on equity, in accordance with Article 4 Paragraph 2, is the difference between the level of net equity at the end of the tax period and the level of net equity at the end of the previous tax period, taking into account the anti-abuse rules. The allowance on equity is equal to the base of the allowance multiplied by the 10-year risk-free interest rate for the relevant currency and increased by a risk premium of 1% or if the taxpayer is an SME, a risk premium of 1.5% (notional interest base[2]), which is the reflection of higher costs of financing for SMEs. As explained in the DEBRA proposal (EC, 2022: 8), by using this approach, the measure has an impact and is simple to implement at the same time and does not harm Member States' budgets. It also ensures that the specific circumstances of different businesses are considered.

Shortly, in accordance with the DEBRA proposal (EC, 2020: 7-8), the calculation is performed as follows:

Allowance Base = net equity at the end of the tax period - net equity at the end of the previous tax period

Allowance on equity = Allowance Base x Notional Interest Tate (NIR)

NIR = Risk-Free Rate + Risk Premium (1% or 1.5% for SMEs)[3]

[2] The notional interest rate has two components: the risk-free interest rate and a risk premium. The risk-free interest rate is the risk-free interest rate with a maturity of ten years, in which the allowance is claimed for the currency of the taxpayer (Solvency II). The risk premium is 1%, accounting for the risk premium that investors actually pay and better mitigates the bias. The risk premium is 1.5% for SME taxpayers, reflecting the higher risk premium they incur to obtain financing (EC 2022, 8).

[3] Formulas as in EC (2022: 7-8).

The DEBRA proposal (EC, 2022: 8-9) goes on to explain that the allowance is granted for ten years (approximate maturity of most debt) while controlling the overall budgetary cost of the allowance on equity. In case an increase in a taxpayer's equity qualifies for an allowance on equity, the relevant allowance is deductible in the year it was incurred (TY) and in the next successive nine years (TY+9). If in the following year (TY+1), a new increase in a taxpayer's equity also qualifies for an allowance on equity, the new allowance on equity will also be deductible for the tax year in which it incurred and the following nine years since its incurrence (until TY+10).

If, after obtaining an allowance on equity, the base of the allowance on equity is negative in a tax period (decrease of equity), an amount equal to the negative allowance on equity is taxable for ten consecutive tax periods, up to the overall increase of net equity for which such allowance has been obtained, unless the taxpayer provides sufficient evidence that the reason for the negative allowance on equity is accounting losses incurred during the tax period or a legal obligation to reduce capital (Article 4 Paragraph 3 of the DEBRA proposal) (EC, 2022: 19).

4.2.2 Anti-abuse rules

The DEBRA proposal contains a set of anti-abuse rules in Article 5, which are intended to prevent abuse schemes, such as cascading the allowance within the group (EC, 2022: 9). Therefore, in accordance with Article 5, Member State must exclude from the tax base of the allowance capital increases deriving from:

a) granting loans between associated enterprises (intra-group loans);
b) a transfer between associated enterprises of participations or of business activity as a going concern (intra-group transfers);
c) cash contribution from a person resident for tax purposes in a jurisdiction not exchanging information with the Member State in which the taxpayer seeks to deduct the allowance on equity.

The exception of this provision relates to the taxpayers who provide 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.

The second anti-abuse measure relates to the increase in equity resulting from a contribution in kind or investment in an asset. The value of the asset will be taken into account for the calculation of the base of the allowance only if the asset is necessary for the performance of the taxpayer's income-generating activity. Shares will be taken into account at their book value, and other assets will, as a rule, be taken into account at their market value.

Finally, the increase in equity which resulted from a reorganisation of a group (*e.g.* windings-up and creation of start-ups), regarded as re-labelling of old capital as new capital (relating to equity which already existed in the group before reorganisation) should be excluded (Gianni and Origoni, 2022).

4.2.3 Limitation to interest deduction

The rule on limitation to interest deduction, set out in Article 6 of the DEBRA proposal, relates to the debt and provides for a limitation to the tax deductibility of debt interest payments. The taxpayer is allowed to deduct from its taxable base for corporate income tax purposes exceeding borrowing costs (interest paid reduced by the interest received) up to 85% of such costs incurred during the tax period. This provision enables addressing the debt-equity bias from the equity and debt side at the same time, providing efficiency and protection of Member States' public finance (EC, 2022: 10).

The rule of the DEBRA proposal interferes with Article 4 of the ATAD[4] rule – the taxpayer should apply the DEBRA Article 6 rule as a first step and afterwards calculate the limitation of the ATAD. If the amount is higher than the amount determined by Article 4 of the ATAD, the taxpayer is entitled to deduct only the lower of the two amounts in the tax period. The difference between the two amounts may be carried forward or back in accordance with Article 4 of the ATAD.

[4] The ATAD was adopted in 2016 with the aim of providing a set of rules for the implementation of anti-tax avoidance measures by the Member States. The adoption of the ATAD was the EU's response to some of the BEPS actions. Among five measures, the ATAD contains rules on interest limitation. The two directives have different objectives, so both measures may be applied simultaneously.

Valério (2022: 2) emphasises that the ATAD only sets out a minimum standard for the interest limitation rule, allowing Member States to prescribe decreased ratio, and place time limits or restrictions on the amount of unrelieved borrowing cost that may be carried forward or back. The DEBRA proposal, Valério states, seems to have done the work for the Member States in that regard. Rajathurai *et al.* (2022) are concerned that the parallel application of the DEBRA and the ATAD rules, from a compliance perspective, adds complexity to tax computations – the taxpayers will have to calculate deductibility of exceeding borrowing costs under the DEBRA as well as limitations on deductibility of interest under the ATAD and apply the highest limitation.

Another important observation by PWC Cyprus (2022: 3) discusses the position of financial undertakings, which are excluded from the DEBRA proposal. They warn that the list of financial undertakings from Article 2 of the DEBRA proposal is more expansive than the list of financial undertakings from Article 2(5) of the ATAD, leading to the conclusion that some businesses may be excluded from the scope of the DEBRA, but not from the scope of the ATAD interest limitation rule. This may result in those entities being subject to a limitation of deductible interest under ATAD, however, at the same time, not benefiting from DEBRA's allowance on equity.

Valério (2022: 2) goes on to connect the DEBRA proposal with the proposal for the Minimum Taxation Directive, based on the GloBE ruled of the OECD's BEPS Project Pillar Two – the existence of a tax allowance (as set out by the DEBRA) should lower the effective tax rate of groups operating in the EU. To conclude, Valério questions the need to harmonise this specific matter and does not consider that this was a pressing issue to regulate, while she confirms that the proposal is in line with the fairness agenda and attraction of investment capital to the EU.

Rajathurai *et al.* (2022) discuss the interaction of the DEBRA rules with the OECD's Pillar Two rules on the global minimum tax rate. The DEBRA provides for a notional deduction which may reduce the effective tax rate for taxpayers using the new equity allowance. This may reduce the effective tax rate below 15 per cent in jurisdictions where the nominal tax rate exceeds 15 per cent.

4.3 Evaluation of the DEBRA proposal

Van den Hurk (2022) comments that the business community welcomed the DEBRA proposal as it provides many benefits for companies. However, a thorough analysis reveals some unfriendly elements. Referring to the previously existing provisions on interest deduction in the ATAD, van den Hurk finds that after the introduction of the DEBRA, the carrying back or forward of non-deductible interest will only be possible in accordance with the interest deduction limitation of 85% rule, which will lead to restriction of the carrying forward interest compensation scheme. This rule was introduced with reference to the COVID-19 pandemic and the green economy; however, van den Hurk criticises the proposal by suggesting that limiting the interest deductions will have an opposing effect on the economy of highly indebted companies, leading to a high number of bankruptcies, especially in SMEs. Additionally, the essential subsidiarity test is also criticised, especially the explanation on boosting the EU competition, as well as the complicated implementation side, obliging companies to complex accounting. Van den Hurk finds that collecting more money for a green transition does not justify the DEBRA proposal and that the adoption thereof may only be "setting the scene" for the adoption of the BEFIT (see further in text).

Kelly (2022) finds that the DEBRA proposal was welcomed by the funds industry; however, he finds some "bad surprises" the companies might face. He marks that the lack of distinction between internal and external intercompany financing might be an issue. Additionally, Kelly finds that the rules do not consider financing decisions which are impacted by macroeconomic aspects, such as interest rates, nor the stage in an investment cycle (early-stage investments have different equity/debt structure than mature businesses) rather than tax avoidance. The proposal also affects financing linked to environmental, social and governance (ESG) criteria.

4.4 Future developments

In May 2021, the EC published the Communication Business Taxation for the 21st Century, which dealt with guidance to achieve a fair and sustainable business environment and EU tax system. Besides introducing the DEBRA mechanism, the Communication announced the new framework for business taxation BEFIT, which follows the OECD's Pillar 1 and Pillar 2 proposals (PWC, 2022a). Another tax-related proposal refers to the Unshell Directive draft (also known as ATAD 3), *i.e.* setting the transparency rules for the use of shell entities, making them more detectable by the tax authorities (EC Taxation and Customs, 2022).

The BEFIT (Business in Europe: Framework for Income Taxation) is expected to be presented by 2023, and it will represent a new framework for business taxation in the EU. The aim is to reduce administrative burdens by removing tax obstacles and creating a more business-friendly environment in the Single Market. The BEFIT should provide a single corporate tax rulebook for the EU, leading to a fairer allocation of taxing rights between Member States. Reducing administrative burden and compliance costs, preventing tax avoidance and supporting investments should strengthen the Single Market. The BEFIT will be a replacement for the 2016 proposal of the Common Consolidated Corporate Tax Base (EC, 2021c).

5 Conclusion

The paper provides a theoretical background on the fiscal instrument allowance for corporate equity as well as an overview of a recent European Commission proposal. So far, the efforts have been directed at providing a favourable tax treatment for the financing of companies through loans, creating a bias towards debt financing in comparison to equity-source financing. Hence, the paper discusses some theoretical approaches and provides a comparative analysis of the EU Member States applying the ACE. However, recently, tax policymakers have introduced a new topic on the agenda with the aim of providing more fair and efficient tax systems. The most recent EU proposal relates to the introduction of a directive on a specific aspect of corporate taxation, namely the allowance system, encouraging equity financing, including a set of anti-abuse measures.

As a rule, tax systems provide an allowance for the interest paid on loans as a source for company financing. This tax advantage encourages companies to choose debt financing over equity financing, as they have no incentives for the use of equity financing. The paper provides an overview of the leading theories explaining the neoclassical and neo-institutionalist approaches. The authors also discuss the current measures in force in six EU Member States, which provide an allowance for corporate equity.

The paper goes on to discuss the post-COVID-19 measures proposed on the EU level. Corporate income taxation is at the centre of attention, aiming to set a favourable scene for economic recovery through tax measures. A recent proposal is directed at reducing the debt-equity bias allowance and limiting the deductibility of interest for corporate income taxation.

Interests paid on loans represent the company's expense, and the companies are entitled to deduct such expenses from the tax base when calculating their income. Paying excessive interest on a loan, especially when a debtor is an affiliated company, can reduce the tax base and lead to shifting profits to countries with a lower tax burden. The proof of burden that the companies engage in tax avoidance is on the tax authorities, which should tax the companies appropriately by denying the use of such an allowance. Providing companies with the relief for financing their operations with equity capital has the aim of preventing the reduction of taxable income and, consequently, tax liability, as well as encouraging higher capitalisation of companies. However, it should also be taken into account that the equity belongs to the company and its owners, so investing equity into companies increases their economic strength. The question arises, concerning the principle of fairness in taxation, whether prescribing the possibility of an allowance for equity will help avoid base erosion and tax payments. Furthermore, taking into account that the ACE reduces the taxable income, it should be evaluated how high corporate income tax rate will enable collecting equal tax revenues, *i.e.* whether the Member States will need to introduce new taxes or adjust the existing ones. Another issue to be examined is whether companies, which have less equity to finance their assets and operations due to investments or less business, will be taxed more, even though their economic strength is weaker than companies financed with equity.

It remains to be seen whether the EU will adopt the DEBRA proposal. Upon the implementation of these provisions in the Member States' national legislation, all the issues discussed in this paper will be open to discussion and evaluation.

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