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DEBRA Directive

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On 11 May 2022, the European Commission published the proposal for the so-called "DEBRA", i.e. directive on laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes ("Proposal").

What is the Objective of the Proposal? Encouraging companies to finance their investments through equity by reducing tax treatment difference between equity vs debt funding.

Who is concerned? All taxpayers that are subject to corporate tax in one or more Member States (e.g. an EU resident corporate taxpayer and permanent establishment of a 3rd country), except for financial undertakings (e.g. AIF, AIFM, UCITS, securitisation special purpose entity, as defined in Article 2, point (2), of Regulation (EU) No 2017/2402)

When the rules are expected to apply? From 1 January 2024

What? The Proposal introduces two measures:

1. 1 An equity allowance

    - The equity allowance is granted in the form of a deduction for tax purposes of notional interest for 10 years and determined as follows:

1. **Allowance Base X Notional Interest Rate (NIR)**

    1. Allowance Base = the difference between equity at the end of the tax year and equity at the end of the previous tax year that is the year-on-year increase in equity
    2. NIIR = Risk Free Rate + 1% (or 1.5% for SMEs)

3. The risk-free interest rate is the risk-free interest rate with a maturity of ten years, as laid down in the implementing acts to Article 77e(2) of Directive 2009/138/EC (the so-called Solvency II Directive)
4. Equity includes paid-up capital, share premium account, revaluation reserve and reserves;

- The deductibility of the allowance is limited to a maximum of 30% of the taxpayer's EBITDA (earnings before interest, tax, depreciation and amortization);
- The part of the allowance on equity that would not be deducted in a tax year due to insufficient taxable profit could be carried forward without time limitation;
- Unused allowance capacity could be carried forward for a maximum period of five years;
- In case the Allowance Base becomes negative (i.e. a reduction of equity), an amount equal to the negative allowance on equity will become taxable for the subsequent 10 consecutive tax periods unless the equity reduction can be justified by accounting losses or a legal obligation to reduce the capital;
- The equity allowance is subject to 3 anti-abuse measures :

1. (i) equity increases that originate from (a) intra-group loans, (b) intra-group transfers of participations or existing business activities and (c) cash contributions under certain conditions are excluded from the Allowance Base;
2. (II) for contributions in kind or investments in assets, the Allowance Base will be decreased by the difference between the taxpayer's accounting books and the assets' market value;
3. (iii) where an increase in equity is the result of a reorganisation of a group, that increase shall only be taken into account for the calculation of the Allowance Base 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.

1. 2. Interest deduction limitation rule (" **DEBRA IDLR**")

- Interest deductibility is limited to 85% of exceeding borrowing costs;
- Interest deduction limitation rule of Directive (EU) 2016/1164 (" **ATAD1 IDLR**") and DEBRA IDLR should apply in parallel;
- If the result of applying ATAD1 IDLR is a lower deductible amount, the taxpayer will be entitled to carry the difference forward or back in accordance with ATAD1 IDLR
- Ex: if company A has exceeding borrowing costs of 100 and has a non-deductible amount of 15 under the DEBRA IDLR and 70 under ATAD1 IDLR, the difference i.e. 55 is carried forward or back in accordance with ATAD1 IDLR.

What's next? Based on the directive proposal, Member States shall implement the directive by 31 December 2023 at the latest.

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