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EACB Comments on the European Commission's public consultation on the Debt-Equity Bias Reduction Allowance (DEBRA)

The members of the EACB gladly take the opportunity to comment on the European Commission's public consultation on the Debt-Equity Bias Reduction Allowance (DEBRA).

Background and general remarks

Companies can finance themselves either through debt or equity. However, the return on these types of financing is taxed differently. Traditional corporate tax systems allow tax deductions for interest on debt, but not for equity costs. This leads to an effective tax advantage of debt financing over equity financing – the so-called debt bias. This tax preference for debt gives companies an incentive to finance themselves by borrowing, which in turn reduces the equity ratio and can have a negative impact on macroeconomic stability in the long term.

In principle, there are two ways to counteract this debt bias: one can either limit the tax deductibility of interest on debt or introduce the tax deductibility of notional interest on equity. Limiting the tax deductibility of debt interest would lead to new distortions, as interest income is usually fully taxed. The tax deductibility of notional equity interest, on the other hand, retains the full deduction for debt interest, but adds a similar deduction for ordinary equity return. This neutralizes the debt bias.

The IMF estimates that the debt bias increases the leverage ratio of companies by an average of 7 percent of total assets (financial institutions are included). In this context, the notional return on equity is shown to be an effective measure for strengthening the equity ratio of companies. In Belgium, for example, the notional return on equity led to an increase in the equity ratio by an average of 10 percentage points.

EACB position

Leverage generally refers to using debt capital as a source of financing of an investment with the view to expand a firm's asset base and generate greater returns on venture capital. Thus, it is an investment strategy that uses borrowed money, especially various financial instruments or borrowed capital, to increase the potential return on an investment. Companies borrow primarily because of this leverage, rather than because of the tax benefit of interest deductions. Thus, in our view, a proposal to create DEBRA should only affect situations where more debt capital is used than is prudently justified.

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Furthermore, a bank is to be seen differently from a non-financial corporation. In the banking industry, regulators play a much more important role regarding amount of capital than fiscal considerations. Moreover, unlike non-financial companies, it will generally be the case that interest income exceeds interest expense in the banking industry. That could be one reason why there should be a carve-out for banks on the new rules.

Should a carve-out not be granted, it becomes relevant which of the methods to reduce the debt-equity bias would be introduced. There are two main approaches proposed in the Inception Impact Assessment: 1) disallowing the interest payments' deductibility and 2) a notional interest deduction allowance, with different options for the latter.

As presented in the 2016's CCCTB impact assessment, a specific issue may arise with the application of the full non-deductibility of interest in the financial sector: "Applying the full non-deductibility of interest paid to the financial sector would represent a disproportionate financial cost for the sector, unless by symmetry the interest received would be exempted." This would be especially the case if interest rates rise and margins remain approximately the same. The tax burden would then quickly exceed the margin a bank makes. We therefore disagree with using option (1), "disallowing the deductibility of interest payments", to eliminate an unequal treatment of debt over equity financing.

We also do not support the introduction of option (4), "an allowance on corporate financial capital (financial debt + equity)" that would replace the tax deduction of interest, which would possibly have the same issue as the option (1), albeit somewhat weaker (depending on what the amount of the replacement deduction will be and how it moves with the increase in funding rates).

As for the options (2), "an allowance for a notional interest deduction on all corporate equity", and (3), "an allowance for a notional interest deduction on new corporate equity", they do not immediately lead to issues at first sight, as companies get a benefit in the form of an additional deduction. However, based on the results of the 2016's CCCTB impact assessment and the CORTAX model simulations, these approaches were estimated to significantly decrease total tax revenues. Therefore, in order to achieve budget neutrality, the offsetting corporate income tax rate increases at the Member States' level would be introduced. Taking this into account, the EACB believes that it is highly questionable whether there would also be a carve-out of a higher corporate income tax rate. It may well be that a sector with high equity will have an advantage, and another sector with lower equity – a disadvantage, with banks rather being in the latter category. In this case, the EACB would prefer not having a carve-out but rather support the approach introducing an allowance for a notional return on equity, because then the increase in the CIT rate would be mitigated.

Design of a notional return on equity

The tax deductibility of notional equity interest can be structured in different ways, with the notional interest rate and the tax base being the two most important elements. The notional

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interest rate is often based on the average interest rate for corporate or government bonds of a country and can be supplemented by a risk premium.

For example, some countries are guided by the yields on government bonds (Belgium, Italy, Cyprus). As a rule, these are supposed to correspond to the risk-free interest rate. Other countries orient themselves directly to the interest rate on debt capital (e.g. bank loans, which is intended to ensure more neutral incentives between equity and debt financing.

The basis of assessment is a company's equity capitalization. It can either comprise all of a company's equity (total existing equity) or be limited to the increase in equity compared with a base year (new equity).

Notional return on equity is a relatively new trend. In Europe Italy, Malta, Poland, Portugal and Cyprus have already introduced the notional return on equity. While notional interest rates vary widely from country to country, most countries have opted for the incremental system (new equity as the basis for assessment).

Conclusion

Notional return on equity is not a short-term measure that can offset the economic losses of the current crisis. However, experience from other countries shows that notional return on equity can be a useful long-term measure that can strengthen the investment environment and improve financial stability.

Better capital adequacy strengthens the resilience of firms because it can cushion more severe revenue declines over a longer period of time. Overall, a notional return on equity has a correspondingly positive impact on the economy.

The tax advantage of debt capital is inherent in traditional tax systems but can be greatly mitigated. There exist alternative methods for putting equity financing on an equal footing with debt financing of investments. Depending on how it is structured, this can be reduced or eliminated by making equity capital deductible for interest purposes, thus stimulating the formation of equity capital in companies.

Finally, should options (1) – disallowing the deductibility of interest payments – or (4) – introducing an allowance on corporate debt and equity – be considered, we would strongly support a carve-out for credit institutions.

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