THE EUROPEAN ASSOCIATION OF CORPORATE TREASURERS

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# Response to the European Commission's feedback collection on the DEBRA Proposal

The European Association of Corporate Treasurers (EACT) welcomes the European Commission proposal for a Debt-Equity Bias Reduction Allowance (DEBRA), notably the implementation of a harmonised notional interest deduction regime for EU companies.

EACT represent the entire European economy and brings together 14 000 corporate treasury professionals active in 22 countries and working for around 6 500 individual non-financial companies.

Nevertheless, EACT anticipates that, for the reasons discussed below, the proposed directive may not result in increased equity funding as opposed to debt funding by EU companies. Rather, it risks increasing funding costs. In this context, EACT believes that the debt-equity bias should be addressed by making equity more attractive, as opposed to making other financing options more expensive.

First, EACT notes that the scope of the proposal is very broad, as it applies indifferently to most EU companies. Yet their profiles are very different, with large companies primarily relying on financial markets to finance their activities. On the other hand, for small, medium and family-owned businesses (SMEs) debt is often the only reasonable option to finance growth. As a result, EACT expects that the two measures provided by the Directive risk being unevenly applied across EU companies, depending on their profiles.

In addition, for many large companies, the proposed directive would likely result in increased cost of debt. Indeed, the deductibility of interest would be limited to 85% for all taxpayers while the notional interest measure would generally not be applicable given the limitation related to "*the tax value of its participation in the capital of associated enterprises and the value of its own shares*", as well as the necessity to distribute dividends, which is a market requirement for shareholders and investors.

Similarly, the proposed directive risks resulting in increased financing costs also for SMEs. Indeed, given their size, SMEs face serious challenges in accessing financial markets or private equity funding, while remaining heavily reliant on debt funding. Also, the implementation of some of the proposed rules, notably the determination of excess interest and the notional interest, would be particularly burdensome for SMEs whose resources are limited.

While EACT recognises that the notional interest rate insufficiently encourages EU companies to finance their development through equity instead of debt, this measure could be improved by applying a similar debt-equity tax treatment, notably considering:

- The application of a more attractive notional interest rate, for instance by incrementing the 10-year interest by a fair-market equity risk premium significantly higher than 1 or 1.5%.
- Allowing the deduction of notional interest during the full allowance period, except in the case of tax avoidance, with a view to providing certainty to EU companies.

Second, EACT warns about possible counterproductive collateral effects, which assume greater importance given the current economic stress.

Indeed, in a globalised capital market, limitations to the interest deduction risk is likely to prove detrimental to the growth of EU businesses by hampering their capacity to generate net income and accumulate retained earnings.

Also, EACT considers that the lower profitability that could result from the directive would negatively impact the EU's international economic attractiveness. As a result, investors currently operating in the EU could be encouraged to relocate part of their funding activities in non-EU countries.

Overall, EACT argues that in its current design the proposed directive risks having a detrimental impact on the competitiveness of EU businesses, while not being sufficiently effective in encouraging EU businesses to opt for equity instead of debt financing. If the European Commission still considers that the gap between debt and equity tax treatment must be narrowed, EACT would recommend the implementation of a truly equivalent regime between debt interest and notional interest.