On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

7 October 2021

Response to the European Commission's Consultation on Debt Equity Bias Reduction Allowance (DEBRA)

Current issues

To what extent do you agree or disagree with the following statements on the indebtedness of non-financial corporations in the EU?

Answer:

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Don't know
High levels of debt make enterprises more vulnerable to insolvency.			X			
High levels of debt make enterprises more profitable.			X			
High levels of debt are due to lack of other financing options.				X		
Debt levels of large non-financial enterprises are too high.						X
Debt levels of small and medium sized enterprises (SMEs) are too high.						X

How much do you agree or disagree with the following reasons for enterprises to finance their investments through debt rather than equity.

Enterprises use debt to finance investments …

Answer:

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Don't know
… to increase the return on equity.	X					

… because they have no or only limited access to equity financing.		X				
… because interest levels are low and thus debt financing is cheap.			X			
… to diversify risk.		X				
… to reduce their tax liabilities.					X	
… to avoid the dilution of voting rights of their main shareholders.		X				
… for other reasons (dialog box with free text will open)	X					

Please specify the other reasons. 500 character(s) maximum

Answer:

Another reason to use debt to finance investments is also to have more money in the company, and thereby increase the money at work and the ability to consummate bigger deals.

Do you have further points you would like to raise in relation to the indebtedness of the business sector in general or on the ratio of debt to equity specifically? 1000 character(s) maximum

Answer:

We would like to stress that debt and equity financing should not be seen as in conflict or mutually exclusive. From a company's perspective, the choice of equity and debt financing is not binary but rather complementary. There are various ways of setting up financing for especially small and innovative companies, and therefore it is crucial to get the tax deductions of costs related to financing right, in order to facilitate and support companies' access to capital.

Please find in the appendix attached a further outline of our considerations on the choice between equity and debt.

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Possible Solutions

Several Member States have introduced measures to limit the ratio of debt to equity by limiting the deductibility of interest payments. Other countries have introduced a tax allowance on equity to counter the debt-equity bias. This is often done by allowing the deduction of a notional interest rate on equity.

How much do you agree or disagree with the following statements about existing Member State measures to support equity financing?

National initiatives which tackle the tax debt-equity bias …

Answer:

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Don't know
… are preferable to an initiative at the EU level since they can be better targeted to the needs.				X		
… are creating difficulties for enterprises operating in the single market across countries.		X				
… are a form of tax competition among countries.			X			

The tax debt bias could be addressed via several possible policy options. When considering the options below, the respondent should assume that the overall impact on the tax costs for corporations and tax revenues for Member States will be neutral, even though the possible offsetting measures remain at the discretion of each Member State. As an example, the policy option to mitigate the debt equity bias could be combined with a change in the corporate tax rate to ensure that the global impact on tax revenues of Member States and on tax costs for corporations is neutral.

In your view, which option would be best suited to address the debt-equity bias? Please rank the options from 1 (most suited option) to 4 (least suited option).

Answer:

	1 (most suited option)	2	3	4 (least suited option)
Option 1: Disallow any financing costs as deductible expense.				X
Option 2: An allowance on equity that provides for the deductibility of a notional interest on all equity (maintaining the existing interest deductibility).	X			
Option 3: An allowance that provides for the deductibility of a notional interest on new equity (maintaining the existing interest deductibility).		X		

Option 4: An allowance on corporate financial capital (financial debt+equity) that would replace the tax deduction of interests.			X	
Option 5: other	X			

If other, please explain shortly which type of measure should be envisaged and how it should be designed? 1000 character(s) maximum

Answer:

We believe it is important that differences between the tax deductions of costs related to debt vs. equity financing are dealt with in a way that allows for more deductions – not fewer. Thus, we are happy to support the idea of introducing an equity allowance.

Please find in the appendix attached a further outline of the points, which we believe are important to take into account when designing such a system.

Following the European System of Accounts 2010, the working definition of equity is: "equity is a financial asset that is a claim on the residual value of a corporation, after all other claims have been met". Do you consider this definition useful or would you propose an alternative definition?
Please choose between: (only one option possible)

- **Definition useful**
- **Definition not useful, I would propose an alternative**

Answer:

Definition useful.

When a tax allowance for corporate equity is granted (as in policy options 2, 3 and 4), a notional interest rate needs to be determined. The notional interest rate will be determined based on a risk free market interest rate in order to take annual interest rates variations into account. In addition a risk premium can be added to the risk free rate for calculating the notional interest rate. How high do you think the notional interest rate should be?

The notional interest rate for an equity allowance should be:

Please choose between: (only one option possible)

- **equal to the risk free interest rate + 0.5%**
- **equal to the risk free interest rate + 1%**
- **equal to the risk free interest rate + 1.5%**
- **equal to the risk free interest rate + 2%**
- **equal to the risk free interest rate + 2.5%**
- **equal to the risk free interest rate + 3%**

- **higher**

Answer:

Higher.

Please explain your response and/or provide further comments. 500 character(s) maximum

Answer:

If the goal is indeed a more symmetric tax treatment between debt and equity, it is important to match the situation for debt funding when it comes to the notional interest rate for a potential equity allowance. Therefore, we believe that the rates proposed above are too low, and should be closer to the existing rates for costs related to debt. This would also reflect the higher risk taken on equity than on debt.

Please find in the appendix attached a further outline of the points, which we believe are important to take into account when designing such a system.

In view of better addressing financing issues for Small and Medium Enterprises (SMEs), do you think that a more generous notional interest rate should be granted to SMEs?

Please choose between: (only one option possible)

- **strongly agree**
- **agree**
- **neutral**
- **disagree**
- **strongly disagree**
- **don't know**

Answer:

Agree.

Please explain your response and/or provide further comments. 500 character(s) maximum

Answer:

We agree that the notional interest rate for SMEs should indeed be higher. However, we believe that this should not necessarily be a fixed ratio.

For a tax allowance for corporate equity (options 2, 3 and 4 above), do you agree that such a proposal should include robust rules to protect it against being used for aggressive tax planning?

Please choose between: (only one option possible)

- strongly agree
- agree
- neutral
- disagree
- strongly disagree
- don't know

Answer:

Strongly agree.

Please evaluate the following elements in terms of effectiveness to make an allowance for equity more resilient to tax avoidance by expressing you (dis-)agreement with the following statements.

In order to prevent abuse of an allowance for equity for aggressive tax planning purposes, it is necessary to …

Answer:

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Don't know
… add a general anti-abuse provision that would deny notional deduction for operations carried out without any substantial economic purpose or carried out with related parties and that have the main purpose of converting old equity into new equity with the aim of benefiting from the notional deduction.			X			
… exclude cascading through intra-group loans and loans involving associated enterprises;			X			
… exclude cash contributions and contributions in kind;				X		
… exclude capital increase subscribed by the company or one of its subsidiaries (own shares);					X	
… exclude intra-group transfer of participations;				X		
… prevent re-categorisation of old capital as new capital through liquidations and the creation of new companies;				X		
… exclude acquisitions of businesses held by associated enterprises				X		

… exclude assets not linked to the activity		X				
Other (please specify)						

Final remarks

You have the option to upload a brief document, such as a position paper in case you think additional background information is needed to better explain your position or to share information about data, studies, papers etc. that the European Commission could consider to prepare its initiative.

Please note that the uploaded document will be published alongside your response to the questionnaire, the latter being the essential input to this public consultation.

In case you have chosen in the section "About you" that your contribution shall remain anonymous, please make sure you remove any personal information (name, email) from the document and also from the document properties.

Contact

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About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

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