INVEST EUROPE

7 October 2021

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

Position paper on the European Commission's Consultation on Debt Equity Bias Reduction Allowance (DEBRA)

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors. Our members provide an essential source of funding for innovative businesses at key stages of their growth journey, taking a long-term approach to investing in privately-held companies, from start-ups to established firms. They inject not only capital but also dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

By way of background, in 2020 alone, private equity and venture capital funds invested over €88bn into 8,163 European companies, a large majority of which (85%) are SMEs. Private equity and venture capital funds thereby play a key role in connecting providers of capital from across the EU and beyond with companies in search of financing.

Invest Europe welcomes the European Commission's initiative to look into possible options to mitigate a potential debt-equity bias induced by taxation, and would like to share the following points, which we believe are important to take into account when designing such a system.

The choice between equity and debt

We endorse the efforts of the European Commission to promote equity financing, of which private equity and venture capital is a crucial element. Indeed, equity investments play a fundamental role in supporting future growth, innovation and transitions.

However, we would like to stress that this will not be achieved through changes to tax legislation that assume a binary choice between debt and equity. Debt and equity financing should not be seen as in conflict or mutually exclusive. From a company's perspective, the choice between equity and debt financing is very often not binary but rather complementary, for example in a private equity context. 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.

The optimal use of debt differs from company to company and depends on various factors like economic situation, sector or business plan. Hence, for each company, the most optimal and needs-tailored mix of equity and debt capital must be sought. As also alluded to in the consultation questionnaire, enterprises finance their investments through debt rather than equity for a variety of commercial reasons, and in no way solely because of tax reasons. For instance, equity has significant governance implications (e.g. as a result of dilution of voting rights, giving access to boards, etc.).

The choice is also often influenced by the fact that not all types of financing are available or preferrable at a given time, particularly so for smaller companies and start-ups. Debt is a fundamental part of a typical company's capital structure and is often used to finance day-to-day operations and essential business activities such as buying raw materials, making capital expenditures, building new facilities, paying salaries and financing asset acquisitions.

In the case of private equity and venture capital transactions, debt also plays an important part in the way companies are financed by private equity funds. Depending on the type of underlying asset, debt may either come from a third party (e.g. bank debt) and/or come from internal sources (e.g. shareholder debt).

Bank debt may be used for a number of reasons. Amongst others, it can
- help to finance the acquisition and development of businesses;
- provide a relatively cheap and stable form of capital; and
- increase the spending capacity of a fund and thereby the number and size of investments in the fund's portfolio by leveraging investor commitments.

Meanwhile, internal debt may be used to
- encourage greater investment in and development of new business lines and geographies;
- facilitate a quick and immediate investment in an asset;
- ease the repatriation of cash;
- provide certainty in an insolvency scenario; and
- create efficiencies which investors find attractive and therefore encourage them to invest further capital.

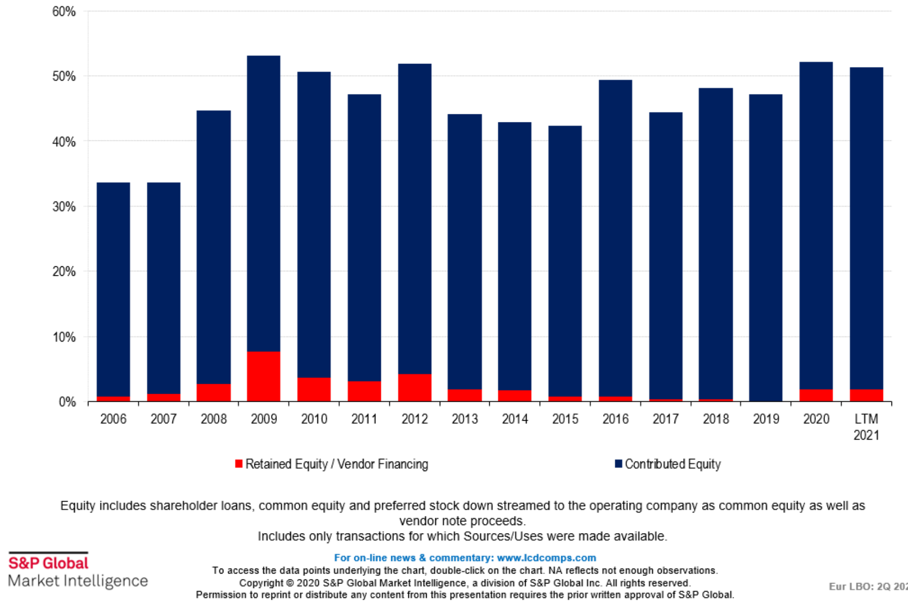
Thus, it is clear from the above that the reasons for using debt finance in a private equity and venture capital context are not all tax related.

Recent trends in the use of debt

Since the time of the financial crisis, both the breadth and volume of tax legislation aimed at restricting the amount of tax relief available on debt interest has increased in most countries. Notably in the past five years these restrictions have increased sharply and multinationally due to such measures as BEPS, ATAD and the general cap on interest tax relief to 30% of EBITDA.

If tax deductibility on debt interest were indeed one of the main factors driving decision making on financing structures, one would expect the level of debt financing to have decreased since the time of the crisis, and to have decreased sharply over the past five years, as restrictions to interest deductions have tightened. Yet, for example in the case of LBO transactions, as also shown in the S&P Global Market Intelligence's LCD European Leveraged Buyout Review, 2Q 2021 (see data on "Avg. Equity Contribution to Buyouts" below), debt levels across the EU have remained constant.

This demonstrates that tax deductibility on interest is not a key factor in determining financing structures. Rather, there are many non-tax factors which influence the mix of debt and/or equity financing to be used, such as those outlined above.



Source: LCD, an offering of S&P Global Market Intelligence

Finally, to provide further examples from our industry, please find in the Annex a randomly selected sample of the most recently closed European deals of a small selection of our members. These examples also show that there is indeed no connection between the percentage of debt interest deductible and the amount of debt vs. equity there is in each of the deals, and thus that interest deductibility is not the driver in the decision on choice of financing.

The right way to tackle a tax induced debt-equity bias?

We understand the aim to reduce a tax induced debt-equity imbalance, even further than it has already been reduced, but it is important that this issue is dealt with in a way that is helpful and not detrimental to the access of diversified sources of financing for companies, keeping in mind the already existing measures restricting interest deductibility. Therefore, any differences between the tax deductions of costs related to debt vs. equity financing should be dealt with in a way that allows for more deductions – not fewer.

As also acknowledged in the impact assessment of the 2016 CCCTB proposal[1], the expected economic benefits of introducing an equity allowance are overall positive and should lead to moderate increases in investment, employment and growth. On the other hand, while disallowing tax deduction of interest on debt might be efficient in eliminating the bias, it is in the same impact assessment acknowledged that it would have negative effects on growth and employment due to depressed investment, an analysis we share.

A limitation on the deductibility of interest expense could result in an increase in the cost of debt financing. Any increase in the cost of financing for companies throughout the EU will result in the EU becoming a more

[1] SWD(2016) 341 final

expensive location in which to do business. This could have important competitiveness implications vis-à-vis other, non-EU, territories. Furthermore, by making debt financing more expensive, it does not follow that affordable equity will automatically become available to fill that financing gap.

Disallowing the deductibility of interest payments would especially penalize enterprises that lack easy access to equity and have instead to rely on debt financing to create jobs or invest in equipment. Small and innovative companies would probably be disproportionately impacted because they often rely on debt financing to fund growth initiatives. It would also create a tax bias because interest income is generally taxable in the hands of its recipient.

We thus strongly encourage the maintenance of the full deductibility of interest on business debt (subject of course to the various existing interest deduction limitations) as it exists under current law in most countries.

Should the European Commission decide to propose additional measures to mitigate a tax induced debt-equity bias, we would therefore support the idea of introducing an equity allowance. However, as the source of funding is international, it is important that these allowances are implemented into a generally equity-friendly tax environment improving in- and outflows of equity.

It is important to have a simple framework, which is comparable to the framework on debt. Therefore, the deduction in the investee business for the equity introduced by shareholders should be comparable to what happens in a situation of debt financing.

Furthermore, the new equity from shareholders should be subject to tax deductions in the ultimate jurisdiction where the investee company is established.

Finally, if the goal is 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 for deductions of costs related to equity proposed in the European Commission consultation questionnaire are too low, and should be closer to the existing rates for costs related to debt.

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<u>Annex - Sample of most recently closed European deals</u>

Total financing	Equity	Shareholders' debt	Bank debt	Interest rates range	% of debt interest deductible (4 years)
100%	100%	0%	0%	n/a	n/a
100%	28%	0%	72%	E+5% - E+6.5%	87%
100%	37%	0%	63%	E+4.25% - E+7.00%	36%
100%	54%	0%	46%	E+4.75%	100%
100%	100%	0%	0%	n/a	n/a
100%	45%	0%	55%	E+3.75% - L+8.25%	92%
100%	50%	0%	50%	E+4.50% - L+8.50%	20%
100%	62%	0%	38%	E/L+4% - E/L+6%	35-45%
100%	41%	0%	59%	E/L+3% - E/L+5%	100%
100%	34%	0%	66%	E+4.00% - E+5.25%	50%
100%	41%	0%	59%	L/E+3% - L/E+6.5%	100%
100%	40%	0%	60%	E+3.50% - E+4.75%	30%
100%	27%	16%	57%	E/L+5% - E/L+6%	100%
100%	36%	0%	64%	E/L+3.5% - E/L+8.5%	100%
100%	47%	3%	50%	E/L+3% - E/L+7%	70-80%
100%	39%	0%	61%	E+3% - E/L+7%	88%
100%	29%	0%	71%	E+4.25%	94%
100%	52%	0%	48%	L+7.25%	100%
100%	100%	0%	0%	n/a	n/a
100%	52%	0%	48%	E/L+5% - E/L+6%	100%
100%	49%	0%	52%	E+4.25% - E+8.25%	100%
100%	10%	22%	68%	E/L+4.5%	33%
100%	52%	0%	48%	E+3.75% - E+9.25%	79%
100%	100%	0%	0%	n/a	n/a
100%	100%	0%	0%	n/a	n/a
100%	28%	0%	72%	E/L+4% - E/L+9%	70-80%
100%	31%	0%	69%	E/L+6% - E/L+8%	70-80%
100%	56%	0%	44%	E+4.00%	64%
100%	52%	0%	48%	E+3.25% / L+3.50%	92%
100%	61%	0%	39%	E/L+3.50% - E/L+7.50%	30%

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.

About Invest Europe

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Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

For more information please visit www.investeurope.eu.