EBF_045750

EBF POSITION on the Proposal for a

COUNCIL DIRECTIVE

on laying down rules on a debt-equity bias reduction allowance and on limiting the

deductibility of interest for corporate income tax purposes

[26th July 2022]

Introduction

The EBF agrees with the over-arching principle of mitigating the tax induced debt-equity bias in corporate investment decisions to render financing more accessible to EU business and to promote the integration of national capital markets into a genuine single market. As expressed by the EBF by itself and also in the context of the Markets4Europe campaign which it founded and led prior to the creation of the CMU Action Plan, the European banking sector believes that promoting equity markets for companies seeking risk capital is in the interest of the EU's competitiveness and also in the long-term interest of the banks, which will stand to gain from greater equity market business as users of equity markets and also as providers of services to companies accessing equity markets.

We are aware that a proposal of this nature may have a net impact on fiscal revenue, which may be one of the considerations for Member States to take into account as they evaluate the different options to achieve the objective of the proposal, which is to promote equity issuance. At the same time, in our view, an EU regime aimed at this objective must also fulfil the following principles:

- It must reduce the tax bias in favour of corporate debt ***by making capital raising more attractive rather than by making corporate debt more costly for the borrowers;***
- It must treat ***all equity issuers in the same way***, without creating a different category of issuer; and
- It must foster ***a level playing field among issuers from different Member States***, in line with both the Banking Union and the Capital Markets Union.

Further reflection is necessary to ascertain the scope of the proposal, in particular to determine which type of equity should be included as well as the time period to apply the mechanism.

Our assessment of the Proposal

It is important to note that a total of six Member States have put in place a regime designed to incentivise capital raising. Unlike the Commission's proposal, these regimes have notably the following features in common:

- They rely on incentivising equity, rather than disincentivize debt, as a tool to address the bias;
- They do not exclude the financial sector from their scope of application.

European Banking Federation aisbl

Brussels / Avenue des Arts 56, 1000 Brussels, Belgium / +32 2 508 3711 / info@ebf.eu
Frankfurt / Weißfrauenstraße 12-16, 60311 Frankfurt, Germany
EU Transparency Register / ID number: 4722660838-23

In general, these regimes have been successful, and they can be expected to be even more useful during the recovery from the current downturn in the economic cycle.

Based on the considerations above, we are convinced that the proposal adopted by the Commission will have negative effects on the EU economy, as follows:

1) It will raise the cost of borrowing for corporates because of the limitation of the deductibility of interest.

We are aware that, from the start, the concept of removing the gap between the fiscal treatment of equity and loan financing was intended to be based on a dual approach, i.e., making equity attractive and at the same time reducing the attractiveness of loans.

Whatever the merits of such an approach before, we believe that in the current context, only the positive part – making equity more attractive – should be implemented, and the negative element – making interest less deductible – should not be maintained.

The reason is that, at a time of a downturn in the economic cycle as we are facing, with increasing interest rates, and a period in which billions of sustainability and digitalisation related investments must be made (not only but mostly) through bank loans, this increase in costs will put additional financial pressure on companies already heavily impacted by COVID-19, the War on Ukraine, supply chain disruptions and inflation. This could seriously suppress investments and therefore lead to less competitiveness, resilience and growth in the economy.

In this context, it is worth reminding that interest cost deduction is already limited by various instruments under EU and domestic laws, in particular the Anti-Tax Avoidance Directive. Therefore, any additional reduction on interest cost deductions would come as an additional burden on borrowers.

2) **It will make the equity raised by the financial sector, including banks, less attractive in the eyes of the investors because of the sector's exclusion from the scope.**

Banks are required to issue equity (in the form of issued capital and hybrid instruments) to maintain minimum levels of capital. They are also required to hold a certain proportion of their balance sheet in high quality liquid assets which can be turned to cash at short notice. Equity can be raised in local, regional and global equity markets; the economic terms of the issuance constitute one element of the attractiveness of an issue. The DEBRA proposal would effectively allow non-financial issuers of equity to receive an allowance while the financial sector issuers would not be eligible. As such, this proposal would deviate from some of the Member State programmes (such as that of Italy) which allow all issuers to draw a benefit.

Since similar regimes do not exist in all Member States, it is hard to extrapolate on the comparative disadvantage that would be created for financial sector institutions in the case of their exclusion. It is true that some of the banking sectors in the EU may not feel the need to apply for such allowances if they were to exist. Moreover, the economic effect of the allowance may not be a significant factor for some investors when they compare potential equity investments. However, on behalf of the EU banking sector as a whole, we do see a problem with an allowance that will be withheld from banks as issuers.

The cost of equity for banks has important implications for the transmission of monetary policy and for financial stability. While the financial sector is required by regulation to hold capital, this does not mean that their equity comes with no cost. On the contrary, this sector, the capital of which has a strong public value through supporting fiscal stability, competes with other sectors and issuers for a largely unified investor pool which may favour other issuers for whom DEBRA will provide better terms. Therefore, any disadvantage for the banks as issuers of equity will be reflected in the cost of their capital and their ability to finance the economy. European banks have been struggling with low profits for more than a decade, with banks' return on equity, falling short of their cost of capital, leading to significant difficulties in attracting investors. DEBRA as proposed would add to these difficulties.

Our recommendations

In light of the objectives of the proposal and the principle of fostering growth in competitive, unified market, **we recommend that the proposal be changed as follows:**

- **To remove the limitation on the interest deductibility**. Taking into account the fact that interest deductibility is already limited and that the economic cycle is changing, the proposal would be modified not to include any further restrictions on these deductions, thereby sparing a major new source of cost for the companies at a time when they need to make investments that are vital for the EU economy; and
- **To include the financial sector in the scope of the fiscal allowances or at least to allow Member States to do so if they so wish.** Taking into account the importance of treating equity issuers in the same way and in particular the importance of banks' regulatory equity for the rest of the economy, we recommend either including the financial sector in the scope or at least allowing those Member States that wish to offer a broader (and in our view more balanced) version of DEBRA to do so (e.g. "Member States may maintain or adopt allowance on equity measures for corporate income tax purposes for financial undertaking under national law.") This would ensure continuity in those countries where the local regime has been successful, considering the peculiarities of the individual Member States and avoiding a one-size-fits-all solution.

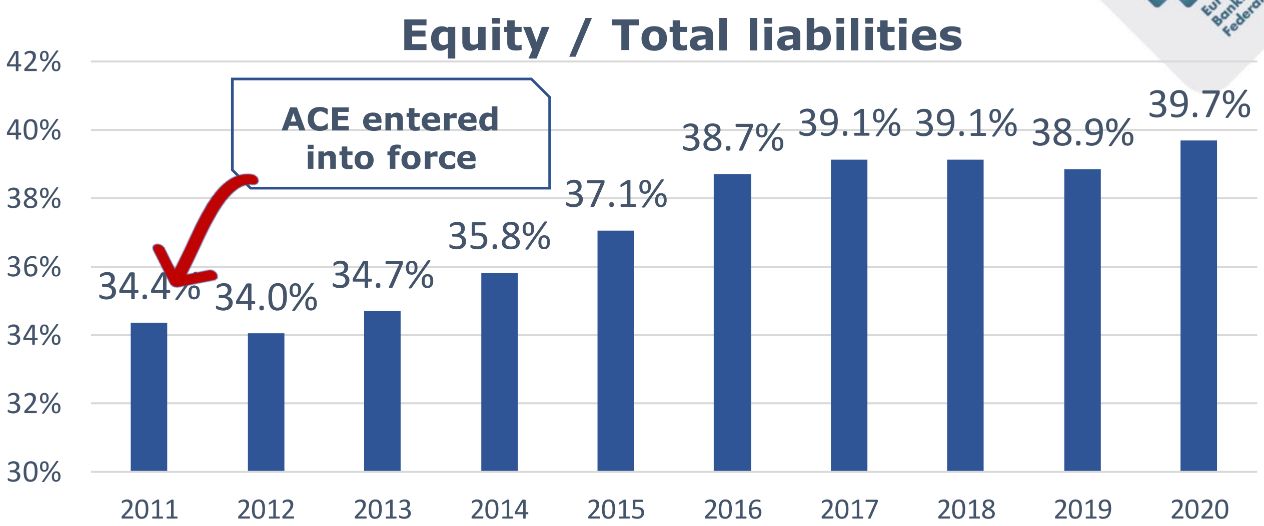
Conclusion: A Balanced and Focused DEBRA

We believe that the best way forward would be to set same conditions for all issuers anywhere in the EU, **making equity more attractive without making debt less attractive.** In the very least, the proposal should be modified to delete the additional restrictions on the interest rate deductibility, which would have negative consequences for companies that need to borrow. Moreover, we see value in either including the financial sector in the scope of companies that will benefit from the allowance or at least in allowing Member States to do so based on their own circumstances.

As one example, in Italy the so-called ACE - *Allowance for Corporate Equity* has worked well in the last years to support the recapitalization of enterprises, including banks.

The role of ACE will be even more important after the pandemic when companies need to rebalance the financial structure after the strong injections of liquidity via (guaranteed) loans.

The stimulus to capitalization worked well with a significant increase in the Equity / Total Liabilities ratio (see graph below).



Source: *Mediobanca Report (2021) on the cumulative data of 2140 industrial and tertiary companies mainly of large and medium size*

About EBF

The European Banking Federation is the voice of the European banking sector, bringing together national banking associations from across Europe. The federation is committed to a thriving European economy that is underpinned by a stable, secure, and inclusive financial ecosystem, and to a flourishing society where financing is available to fund the dreams of citizens, businesses and innovators everywhere.

www.ebf.eu @EBFeu

For more information contact:

Roger Kaiser
Senior Policy Adviser

r.kaiser@ebf.eu

Florin Theodorescu
Tax & Compliance Trainee

f.theodorescu@ebf.eu

+32 2 508 37 32