EU Directive Proposal for notional interest deduction on new equity capital and limitation of the deductibility of interest

On May 11, 2022, the European Commission released a draft Directive to eliminate the imbalance in the tax treatment of equity and debt financing (DEBRA „Debt-Equity Bias Reduction Allowance). The proposed Directive is intended to affect all taxable corporate entities from 2024 that are resident in a Member State of the European Union and subject to corporate income tax.

CONTENT OF THE PLANNED REGULATIONS

The draft Directive „DEBRA“ treats for a notional tax deduction of operating expense for allowance on new equity into the company.

The starting point for the deduction of notional interest on equity (also known as the allowance) is the difference between the equity on the balance sheet date of the past fiscal year and that of the previous fiscal year. The increase in net equity calculated in this way earns notional interest at a fixed interest rate for tax purposes, with the fixed interest rate calculated by a 10-year risk-free interest rate plus a risk premium of 1 % (1.5 % for small and medium-sized enterprises).

The deduction for new equity is allowed for 10 consecutive tax years after the allowance on equity. The deductibility of the deduction for equity is capped at 30 % of EBITDA. Taxpayers who are affected by this cap may carry forward the equity deduction portion, which exceeds the 30 % of EBITDA in any one tax period for a maximum of five tax years.

The proposed Directive also contains several specific anti-abuse measures. These relate especially to a cascading of the deduction within a group, which would allow its multiple use for a single capital increase. Other considerable situations arise from increases in equity resulting from contributions in kind or investments in assets, as well as from converting old capital into new equity.

OTHER LIMITATIONS ON INTEREST DEDUCTION

However, in addition to the positive promotion of allowance on equity, the Directive also has a „flip side“ of the coin. In the future, the tax deductibility of financing expenses, interest income (net interest) will only be possible up to 85%, irrespective of and prior to the application of existing regulations. This means that 15% of the net interest will no longer be allowed as a tax deduction. This non-deductibility is final, to this extent that there is no carryforward or carryback of non-deductible interest.

It should be noted that in Germany the existing regulations, e.g., on the interest barrier (Section 4h of the German Income Tax Act) or trade tax add backs pursuant to Section 8 No. 1 of the German Trade Tax Act (GewStG) also apply alongside the application of the DEBRA regulations.

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www.bdo.de

CONTACT

BDO AG
Wirtschaftsprüfungsgesellschaft

GORAN PERANOVIC
Certified Tax Advisor, Partner,
International Tax Services &
Transfer Pricing
Phone: +49 201 87215 – 172
goran.peranovic@bdo.de

CHRISTIAN FISCHER
Certified Tax Advisor, Partner,
Tax & Legal
Phone: +49 461 9090-193
christian.fischer@bdo.de

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WHAT'S NEXT?

At present – according to the current knowledge - the negotiations between the member states on the proposal are on the agenda. If all 27 member states agree to adopt this Directive, the Member States shall transpose the Directive into their national laws by December 31, 2023 for the rules to come into effect as of January 1, 2024.

RECOMMENDATION FOR ACTION

Implementation of the EU Commission's draft Directive is likely to have significant effects regarding existing and planned financing structures for companies, as in particular the further restricted tax deductibility of interest expenses is likely to lead to considerable additional tax burdens. Conversely, the timing of allowance on equity to achieve the deduction on equity should be closely examined. The current draft Directive creates the tax incentive to reduce equity as much as possible before the new rule takes effect, in order to make a corresponding increase after the rule takes effect. Therefore, not only the development on the further progress of the Directive must be closely monitored, but also restructuring with regard to existing financing structures have to be examined.

The BDO AG team will be happy to assist you with our comprehensive expertise. Please feel free to contact us.