The EU DEBRA proposal

An undesirable ACE up the EU Commission's sleeve

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Introduction

In most corporate tax systems, corporate debt is treated more favourably than equity. Interest payments on loans are generally tax deductible whereas the cost related to equity financing in the form of dividends paid, cannot be deducted against profits. The unequal treatment of debt and equity creates a bias towards debt financing. It is generally undisputed that high indebtedness of companies brings along with it certain economic distortions and an increased vulnerability in times of crisis and risk of insolvency.

On 11 May 2022, the European Commission presented a proposal for a harmonised EU wide debt-equity bias reduction allowance (the DEBRA proposal).[1] To eradicate the preferential treatment of debt, the DEBRA proposal lays down rules for an EU-wide allowance for corporate equity (ACE) combined with a new limitation of the deductibility of interest payments.

In this article, a number of points are raised showing that the DEBRA proposal in its current form is bad policy and should not be adopted. Suggestions are made for a revised DEBRA directive which is more fit to purpose, less prone to abuse and tax revenue drainage, and therefore altogether more in line with the EU's pending BEFIT initiative.[2]

Solving the great debt-equity distortion

For decades, tax policy theorists have debated the appropriateness of a solution to the corporate tax debt bias. On the one extreme, proponents of the 'allowance for corporate equity' (ACE) advocate for the introduction of a 'notional interest deduction' (NID), a fictional tax deduction calculated in function of a company's equity which mimics the deduction of a company's interest cost. On the other hand, proponents of the 'comprehensive business income tax' (CBIT) propose a system full non-deductibility of interest payments (NDI). In such a system, neither interest payments nor the return on equity paid from taxable corporate earnings gives rise to a deduction.

Both approaches solve the debt-bias but they come with fundamentally different properties. For one, the adoption of an ACE type system fundamentally narrows the corporate tax base because it grants an

[1] European Commission, *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*, *COM(2022) 216 Final* <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52022PC0216> [accessed 9 May 2023].

[2] European Commission, 'Business in Europe: Framework for Income Taxation (BEFIT)', *European Commission - Have Your Say*, 2023 <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13463-Business-in-Europe-Framework-for-Income-Taxation-BEFIT-_en> [accessed 9 May 2023].

additional tax deduction. This reduces tax revenues. CBIT type systems widen the tax base, thus increasing tax revenues. An asymmetric adoption of ACE systems by only a limited number of countries can furthermore induce new forms of tax planning which is not always easy to tackle with anti-abuse measures, thereby putting additional pressure on tax revenues. For these reasons, the Tax Justice Network's Corporate Tax Haven Index assesses countries based on the premise that the debt-equity bias should be addressed by (further) restricting interest deductibility, instead of granting companies an allowance for corporate equity (ACE).[3]

In the DEBRA proposal, the EU Commission proposes a mix of both a watered-down ACE and CBIT. On the one hand, companies will be allowed a NID for newly raised corporate equity only. This measure, also known as a 'soft ACE', contrasts to the system of a 'hard ACE' under which a NID is granted on both existing and new equity. The DEBRA's NID rate is based on the risk-free interest rate, increased with a 'risk premium' of 1 percentage point for large companies and 1.5 percentage point for SMEs. On the other hand, the existing rules in the ATAD that limit the deductibility of interest are tightened further. More specifically, the DEBRA provides that the deductibility of interest will generally be limited to 85 per cent of excess borrowing costs of a company. The DEBRA's new interest deduction limitation will operate in parallel with the interest limitation in the ATAD 1.[4] Under the ATAD 1, net interest expenses can only be deducted to a value of 30 per cent of a company's EBITDA with a safe haven of €3 million. In the DEBRA proposal it is suggested that the application of both rules is mutually exclusive: the more stringent interest limitation rule prevails.

A solution based on misguided modelling and selective analysis

The EU Commission's proposal is based on an assessment of five different policy options to remedy the tax-induced debt bias. These policy options are: 1) a 'hard ACE', 2) a 'soft ACE', 3) an allowance for corporate capital (ACC) which replaces the deduction of effectively paid interest by a notional deduction for both debt and (both old and new) equity, 4) the non-deductibility of interest payments (NDI) which would completely disallow the deductibility of interest, and 5) a combination of 'soft ACE' and partial limitation of interest deductibility (partial NDI).

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[3] Tax Justice Network, *Haven Indicator 7: Patent Boxes*, Corporate Tax Haven Index 2021 (2021) <https://cthi.taxjustice.net/cthi2021/HI-7.pdf> [accessed 9 May 2023].
[4] European Union, 'Council Directive (EU) 2016/1164 of 12 July 2016 Laying down Rules against Tax Avoidance Practices That Directly Affect the Functioning of the Internal Market', 2016 <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L1164&from=EN> [accessed 29 April 2019].

The different policy options are assessed based on their quantifiable macroeconomic impacts like cost of capital, share of debt-financed total assets, investment, wages and GDP, as predicted by the CORTAX computable general equilibrium model. An additional qualitative assessment is made of the different policy options' impact on criteria like the enhancing of fairness of the tax system, 'competitiveness' of the EU economy, or reduction of the administrative and compliance burdens. Based on this assessment, the EU Commission concludes that the allowance on new equity ('soft ACE') with an interest limitation (option 5) is the preferred option.

Misguided modelling

The selection of option 5 ('soft ACE' and partial NDI) draws heavily on the findings of the CORTAX modelling. The option is predicted to slightly reduce the cost of capital, with only minor negative impact on wages, employment, or GDP. It is however the least effective option if the impact on the debt-equity financing divide is assessed. The option, however, is predicted to be revenue neutral: the revenue gain of the NDI component is predicted to offset the cost of the ACE component.

It should be noted that the CORTAX model, which in the past has regularly been used by the EU Commission to support corporate tax reform like the (abandoned) CCCTB and CCTB proposals[5], is not without flaws. The model is an input-output system that is strongly dependent on assumptions that simplify economic reality. Its findings are presented in the form of an equilibrium between the introduction of a policy option and revenue neutrality in the corporate tax. This revenue neutrality is achieved by decreasing or increasing the statutory corporate tax rate, to the extent predicted by the model. In this predicted equilibrium, the impact on parameters like economic growth, wages, jobs, and GDP is calculated.

However, the model employed overlooks the potential impact on public spending resulting from tax measures that effectively diminish revenues. Rather, it assumes that government budgets are maintained in balance through automatic increases in Corporate Income Tax (CIT) rates[6], or "by the government adjusting transfers to retirees". In other words, when evaluating the favorable outcomes, such as economic growth and increased employment, of a policy that reduces corporate tax revenues, the CORTAX model assumes that governments cut pensions to prevent

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[5] European Commission, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, 16 March 2011 <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011PC0121&from=EN> [accessed 26 February 2021].

[6] This compensation mechanism is discarded by the EC because model results show that CIT rates would need to be raised above 100% to make out for the revenue losses caused by the allowance, something that is acknowledged to be unrealistic.

budget deficits. Recent experiences in France show that the introduction of pension cuts is a volatile affair, the fall-out of which can affect political and economic stability and growth. The premise that countries will easily resort to pension cuts to fill holes in the corporate tax revenue budget is simply detached from reality and questionable policy advice in the context of growing inequalities. Other completely unrealistic assumptions are the underlying premises that all economic actors have full information, that markets reflect perfect prices, and that companies realising windfall profits will reinvest these gains in the economy rather than in personal wealth of the owners, possibly situated outside the EU.

As repeatedly noted by the EU Commission in the DEBRA proposal: the CORTAX results are only accurate in a scenario of economic growth. In the case of the introduction of ACE type measures, it is assumed that economic growth combined with the lower cost of capital or lower effective tax rates directly translate into increased investment, higher wages, and growing employment. In the current global reality, the scenario of perpetual economic growth is removed from reality. By the EU Commission's own admission, exogenous reasons like wars, pandemics and the climate crisis and associated droughts, simply make the results of the CORTAX modelling overly optimistic. Needless to say, these exogenous shocks are in full force these days[7].

Finally, one can seriously question whether the 'outputs' of the CORTAX input-output modelling – investment, growth of GDP – are appropriate benchmarks for corporate tax reform proposals. In the DEBRA proposal, the EU Commission notes that 'investment' and 'growth' are linked with the 'competitiveness' of the EU, with 'competitiveness' being both a prerequisite for investment and growth - as well as a result of it.

In the past the Tax Justice Network has repeatedly called out the 'competitiveness agenda' as an ill-founded guise for the mere slashing of taxes, ignoring the fact that in reality, the handing out of tax cuts affects the quality of public services, which in turn has a clear negative impact on economic performance.[8] Instead of focusing only on 'investment' and 'growth', the modelling should assess impact of corporate tax reform on benchmarks like equality, impact on distribution and concentration of wealth and income and other parameters that contribute to economic and political stability. An appropriate model should in any case reward

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[7] Lasse Boehm and Alex Wilson, *EU Energy Security and the War in Ukraine: From Sprint to Marathon* (21 February 2023) <https://www.europarl.europa.eu/thinktank/en/document/EPRS_BRI(2023)739362> [accessed 16 May 2023]; Joint Research Centre (JRC), *Drought in Europe*, GDO Analytical Report (August 2022) <https://edo.jrc.ec.europa.eu/documents/news/GDO-EDODroughtNews202208_Europe.pdf>; World Health Organization (WHO), 'WHO Coronavirus (COVID-19) Dashboard', 2023 <https://covid19.who.int> [accessed 16 May 2023].

[8] Nick Shaxson, 'The Competitiveness Files: Martin Wolf', *Tax Justice Network*, 2020 <https://taxjustice.net/2020/01/06/the-competitiveness-files-martin-wolf/> [accessed 9 May 2023].

policy reform that triggers sustainable growth built on economic and political stability rather than flash-in-the-pan growth based on tax-cuts.

In conclusion, the quantitative modelling which led the EU Commission to opt for DEBRA as composed of a 'soft ACE' component and a limited NDI component, is unconvincing. More emphasis should be put on the assessment of the qualitative aspects of the policy options.

If the qualitative assessment of policy option impacts provided by the EU Commission is taken at face value, it is not the combined 'soft-ACE' with 'partial NDI' that prevails. Rather, the optimal policy option is option 4: full non-deduction of interest (NDI). This policy option does not only allow for the generation of tax revenue, it also most effectively reduces cross-border tax abuse opportunities and is the least burdensome option when it comes to administration and compliance costs.

Detractors will argue that the NDI solution will have a dramatic impact on investment and growth and on the 'international competitiveness' of the EU economy. These arguments are ill-conceived. First, the whole point of DEBRA regime is to create sustainable growth, as in, growth that is robust because it is financed by equity. If the DEBRA regime weeds out growth that is financed by extensive debt leveraging, then this is not necessarily a bad thing. Secondly, as to the impact on the international competitiveness of the EU economy, it should be noted that in a ceteris paribus scenario, the introduction of an NDI regime creates a significant increase in corporate tax revenues. Unlike the CORTAX model seems to suggest, these surpluses do not necessarily need to be compensated on the revenue side by lowering the statutory tax rates. The revenue surpluses could very well be used on the expenditure side by adopting measures that target sustainable growth and innovation, and as such, increase the EU's 'international competitiveness'.

Selectiveness in choice of policy options, assessment criteria and country practice

A second problem is the selectiveness of the EU Commission's choice of policy options. When it comes to assessing policy options that involve the limitation of interest deduction in particular, two scenarios are assessed: a full NDI, and a partial NDI which is combined with a 'soft ACE'. The option of a self-standing 'soft ACE' is also assessed.

For no good reason, the policy option of a standalone 'partial NDI' (logically mirroring the scenario of a standalone 'soft ACE') is not considered in the EU Commission's analysis. The EU Commission concludes that the two extreme options – a 'hard ACE' and the full NDI – are too expensive, and too detrimental to economic growth, respectively. A 'soft' ACE plus added partial NDI eventually prevails over a standalone 'soft ACE' as the combined measure does remedy the debt bias to some extent (but to a far lesser degree than a 'hard ACE') while the partial NDI component would reduce the fiscal burden of the measure. It is unclear why the policy option of a self-standing limited NDI was not tested.

It is clear that the option of a full NDI presents a significant change of traditional corporate tax policy. It is also obvious that this option generates extreme values in the CORTAX modelling which makes this option prone to – unfounded, as shown – criticism. For these reasons it is difficult to comprehend why the obvious alternative scenario of a self-standing partial NDI has not been tested. The CORTAX model could be used to test scenarios with increasing thresholds of non-deductibility of interest to identify the 'sweet spot' of a deduction limit (ie only X per cent of the total net interest cost is deductible) which addresses the debt bias, while safeguarding member states' corporate tax revenues without negatively impacting economic growth – even within the confines of the flawed CORTEX model and its assumptions, as discussed above.

It should be noted here that the ATAD 1 interest limitation rules employ a relative cap of deductible interest up to a value of 30 per cent of the company's EBITDA with a safe haven of €3 million. These thresholds are designed to combat abuse. In practice, the vast majority of EU companies are not affected by these rules and, as such, the ATAD's impact on the debt bias is limited. An additional cap in function of absolute net financing costs is needed to address the bias. But such a rule cannot be introduced without proper modelling of the impact of threshold variations, which is selectively kept out of the EU Commission's DEBRA modelling efforts.

As to the justification of the introduction of a 'soft ACE' component under DEBRA, the EU Commission corroborates its modelling results with the empirical experience of individual EU Member States that have adopted ACE-like measures in the past. The Belgian ACE experience is cited as a prime example of how an ACE has the potential to effectively remedy the debt bias. The Belgian experience is irrelevant, though, for two reasons. First, the studies referred to date from before 2018 when Belgium employed a 'hard ACE' system, and not a 'soft ACE' like DEBRA. Second, not mentioned is the fact that the positive effect of the Belgian hard ACE was achieved on the back of out-of-control spiralling revenue costs, with ACE losses at a certain point in time representing not less than 50 per cent of overall Belgian corporate income tax revenues and three times more than the initially budgeted cost of the measure.[9] The selective referral to the Belgian experience does not help confirm whether DEBRA's 'soft ACE' will result in any significant effect on the debt bias. Rather, the member states' experiences should serve as a cautionary tale: if an ACE comes along, watch the state's coffers, especially if the ACE is not matched with robust anti-avoidance rules.

Finally, the qualitative assessment of the retained policy options is also selective. For example, the options are tested on their impact on investment and growth, and international competitiveness, yet they are not tested on their impact on inequalities or negative spillovers on third

[9] Ernesto Zangari, *Addressing the Debt Bias: A Comparison between the Belgian and the Italian ACE Systems*, European Commission - Taxation Papers (2014) <https://taxation-customs.ec.europa.eu/system/files/2016-09/taxation_paper_44.pdf> [accessed 9 May 2023].

countries. As shown below, negative spillovers are an important aspect of ACE measures, but not of NDI measures. Furthermore, as also shown below, the assessment mentions the positive impact of the DEBRA proposal (soft ACE with partial NDI) on certain sustainable development goals. Negative impacts on other sustainable development goals or the fact that other policy options (like the full NDI) have a far wider positive impact on sustainable development goals is completely ignored.

Exclusion of financial undertakings: altering the problem to fit the solution

The DEBRA impact assessments note that one of the additional reasons to address the debt-bias is that excessive indebtedness in the corporate sector also translates into increased leverage of the financial sector with the potential to lead to financial instability. It is certainly the case that the debt-bias can potentially be a far greater concern in the financial sector than elsewhere in the economy due to externalities associated with systemic risk in the sector. For this reason, it is all the more surprising that the DEBRA proposal excludes the financial sector from its scope of application.

Also from a revenue perspective, the exclusion of the financial sector from a new regime to limit debt financing seems ill-conceived. The EU Commission notes that, at an EU-average corporate income tax rate of 26 per cent, a rough estimate of the costs of the existing deductibility of interest by companies across the EU amounts to €64 billion for non-financial corporations and €206 billion for financial corporations. Additionally, by its own admission, the EU Commission observes that the objective of the DEBRA is to address the debt-equity bias in the EU, and not only in certain sectors. As such, the use of sectoral exclusions or inclusions to the DEBRA regime is a policy that needs to be discarded. It is difficult to see why this conclusion has been applied so inconsistently when it comes to the financial sector.

The EU Commission justifies the financial sector exclusion by noting that financial companies are already subject to regulation on their capitalisation, which means that the issue of undercapitalisation is addressed in other (non-tax) ways. Furthermore, it is said that because financial institutions usually receive more interest than they pay, the interest deduction limitation component of DEBRA – which only applies to net interest paid – would not apply. The ACE deduction component of the DEBRA, however, would be applicable. As a result, non-financial companies would in a way finance the DEBRA ACE benefit granted to financial companies.

This reasoning is far from convincing. First, the argument that the debt-equity bias among financial undertakings is resolved by other measures does not hold. The recent spree of bank bailouts has shown that the safeguards implemented after the financial crisis were not always sufficient to prevent insolvency, and that systemic effects could result in turmoil across the globe.

De Mooij and Heckemeyer (2013) have shown furthermore that, regardless of capital requirements, the tax bias toward debt finance matters for both financial and non-financial institutions, and that the average bank is equally responsive to tax incentives to address the bias as an average non-bank.[10] Tellingly, in countries like Italy and Belgium, financial institutions were not excluded from the ACE system, despite (EU based) capital controls being enforced. Palan et al. (2018) have shown that more than other sectors, the financial sector is prone to engage in debt-equity arbitrage given the widespread access and use in the financial industry of hybrid financial products.[11] All these elements indicate that if there is one sector in which addressing the tax bias of debt is highly relevant, it is the financial sector.

The EU Commission's observation that applying the DEBRA regime as it is currently proposed to financial institutions would effectively mean granting those institutions a tax cut based on their equity stocks is technically correct. The conclusion drawn from the observation is wrong. Instead of excluding the financial sector from the DEBRA regime, the correct conclusion is that the DEBRA regime should be revised in such a way that can seamlessly apply across all sectors. As mentioned above, such revision should consist in abolishing the ACE component of DEBRA and instead devising an absolute limitation on interest deduction across the board for all companies in all sectors. This new limitation of interest deduction would then apply to all sectors alike, completely in line with the EU Commission's own conception of a 'good policy'. As mentioned above, none of the scenarios involving full or partial non-deduction of interest without ACE component were seriously considered in the EU Commission's DEBRA proposal analysis.

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[10] Ruud de Mooij and Jost Heckemeyer, *Taxation and Corporate Debt: Are Banks Any Different?*, IMF Working Paper (2013) <https://www.imf.org/external/pubs/ft/wp/2013/wp13221.pdf> [accessed 9 May 2023].

[11] Ronen Palan and Duncan Wigan, 'The Economy of Deferral and Displacement', in *Shadow Banking*, 2018, 181–96.

(Not so) robust anti-avoidance rules The DEBRA proposal is said to come with a set of 'robust anti-tax abuse measures'. The three specific anti-abuse rules (SAARs) included in the proposal are largely inspired by the EU Council's Code of Conduct Group for Business Taxation's review of the six individual EU member states NID regimes of 2019.[12]

The rules are not as robust as claimed to be. For instance, a first SAAR targets potential abusive increases in equity that result from the valuation of a contribution in kind of an asset necessary for the taxpayer's income generating activities. From the wording of the rule, however, it is unclear whether the provision also applies to subsequent revaluations of these asset. If not, the rule is prone to abuse. A more apt solution would be to exclude altogether from the DEBRA equity base any subsequent increases of capital through subsequent re-evaluation of assets.

A second SAAR targets potential abusive increases in equity that result from converting 'old' equity into 'new' equity as the result of a company reorganization. It is unclear whether 'old' equity includes only equity registered on the liability side of company's balance sheet or also equity representing unexpressed gains on the asset's side. If unexpressed gains are also able to be turned into 'new' equity, the total revenue cost of DEBRA's ACE might be much higher than anticipated.

Finally, a third SAAR prevents inclusion in the DEBRA equity base any equity increases as the result of, inter alia, loans between associated enterprises. This rule aims at preventing cascading the DEBRA through participations to multiply the allowance deduction. The rule does not prevent 'double dipping' by which a company that received a capital injection from an unrelated party on which it deducts the DEBRA, uses the funds to grant a loan to an associated company that can deduct the interest. Similarly, the rule also does not prevent a company from taking out a loan from a third party and using the funds to inject equity in a subsidiary which deducts the DEBRA. All of this makes DEBRA vulnerable to tax planning. In its 2019 Code of Conduct Group for Business Taxation's NID regime review, a rule targeting 'double-dipping structures combining interest deductibility and deductions under the NID' was expressly identified as a tool to make the regime less vulnerable for tax planning. A comprehensive tool to prevent double-dipping structures is altogether missing from the DEBRA proposal.

In the proposed preamble to the DEBRA Directive, it is noted that general anti-abuse rule (GAAR) in Article 6 of the ATAD Directive (EU/2016/1164) applies against abusive acts which are not covered by the DEBRA SAARs. Not only is the ATAD GAAR notoriously difficult to apply in practice, but resorting to coexisting anti-abuse frameworks with different scopes and

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[12] Council of the European Union, *Annex 2. Guidance on Notional Interest Deduction Regimes, Code of Conduct Group (Business Taxation) Report to the Council* (Brussels, Belgium, 25 November 2019) <https://data.consilium.europa.eu/doc/document/ST-14114-2019-INIT/en/pdf> [accessed 9 May 2023].

purposes to fill loopholes is a clear sign of the complexification of the tax systems. Furthermore, in case of 'double dipping' involving third countries, it is unlikely that EU member states will call on the ATAD GAAR to claim that multinational enterprises are violating the object and purpose of the DEBRA directive when they swap debt financing for equity financing (with DEBRA deductions) in EU group companies while concentrating debt financing (with interest deductions) in group companies in third countries. After all, such restructuring does increase the equity position of the European companies involved, and does so with little to no negative tax revenue impact in EU countries. The DEBRA Directive does not have as its 'object or purpose' that the application of DEBRA should be void of negative spillovers on third countries. In other words, an open invitation seems to be extended by DEBRA to multinational enterprises for the restructuring of their global corporate affairs for the purpose of increasing the EU group companies' equity position, while risking exacerbating international inequalities. Whether these restructurings (and in particular the double-dip restructurings) are acceptable under the GAAR provisions in third countries, is another pertinent question.

The fact that third countries might altogether not be pleased with the introduction of DEBRA is not merely a theoretical observation. Since 2016, the US Model Income Tax Treaty[13] contains a specific provision in its article 11 on 'interests' which provides that interest paid to a related party lender shall be excluded from the benefit of zero withholding tax under the tax treaty if the lender has benefitted from "notional deductions with respect to amounts that the Contracting State of which the beneficial owner is resident treats as equity." So far, the only US tax treaty in which this clause is inserted is the new treaty with Croatia, an EU member state. The treaty was signed in December 2022, six months after the EU Commission presented its DEBRA proposal. Under the new treaty, a Croatian parent company that benefits from DEBRA and which grants a loan to its US subsidiary will be taxed on the interest at the US domestic law rate of 30 per cent instead of the zero-rate granted under the tax treaty.[14] Croatia will most certainly not be the last EU member state that is made to pay for DEBRA in a bilateral context with the US. In a way, this US tax treaty rule is nothing more than a SAAR adopted in reaction to DEBRA.

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[13] United States Department of the Treasury, *United States Model Income Tax Convention*, 2016 <https://home.treasury.gov/system/files/131/Treaty-US-Model-2016_1.pdf> [accessed 9 May 2023].

[14] United States and Republic of Croatia, *Convention Between The Government Of The United States Of America And The Government Of The Republic Of Croatia For The Avoidance Of Double Taxation And The Prevention Of Tax Evasion With Respect To Taxes On Income*, 2022 <https://home.treasury.gov/system/files/131/Treaty-Croatia-12-7-2022.pdf> [accessed 9 May 2023].

DEBRA and the SDGs: beggar-thy-third-country

The fact that the DEBRA proposal is oblivious to negative spillover effects in third countries raises other more fundamental issues. The EU Commission states that by mitigating the debt-equity bias, DEBRA may contribute directly to achieving the United Nations' Sustainable Development Goals (SDGs), and in particular SDG 8 ('*Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all*') and SDG 9 ('*Build resilient infrastructure, promote inclusive and sustainable industrialisation and foster innovation*').[15]

This prediction, of course, is based on theoretical assumptions and the findings of the CORTAX modelling of the DEBRA proposal – a model which is an inherently flawed. The fulfilment of SDG 9 in particular assumes that windfall gains from the DEBRA allowance will result in higher investment in innovative companies. By the same logic, the EU would be more effective in achieving the development goals by simply eliminating all its corporate taxes, or by having all countries introduce an extensive patent box regime,[16] both of which are generally seen as outdated and untenable policy propositions rooted in the Laffer curve fallacy.[17] This 'indirect' effect on SDG 9 does not seem the most efficient way to foster innovation. As explained below, much better alternatives exist to promote innovation directly rather than to rely on tax-cuts with uncertain indirect benefits.[18]

More certain than the indirect benefit is the fact that the ACE component of DEBRA will allow the tax bills of multinational companies to shrink. In aggregate, this will reduce EU member states' governments revenues and thereby their ability to provide public services for the realisation of sustainable development goals, and not just SDG 8 and 9. The lack of robust anti-avoidance rules risks exacerbating the revenue cost of DEBRA's ACE component to such an extent that it will not be compensated by DEBRA's additional interest deduction limitations. In such case, the introduction of DEBRA will necessarily cause a regressive shift in the income tax burden to other segments of society, like labour

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[15] United Nations, 'Resolution Adopted by the General Assembly on 25 September 2015: Transforming Our World: The 2030 Agenda for Sustainable Development (A/RES/70/1)' <https://www.un.org/en/development/desa/population/migration/generalassembly/docs/globalcompact/A_RES_70_1_E.pdf> [accessed 9 May 2023].

[16] Tax Justice Network, *Haven Indicator 7: Patent Boxes*.

[17] John Christensen, 'President Trump Visits La-La-Laffer Land', *Tax Justice Network*, 2017 <https://taxjustice.net/2017/04/27/president-trump-visits-la-la-laffer-land/> [accessed 9 May 2023].

[18] Markus Meinzer, Markus and others, *Comparing Tax Incentives across Jurisdictions: A Pilot Study*, 2019, 43 <https://www.taxjustice.net/wp-content/uploads/2018/12/Comparing-tax-incentives-across-jurisdictions_Tax-Justice-Network_2019.pdf> [accessed 3 July 2019].

and less mobile businesses, or to consumption taxes/VAT. This outcome is less than acceptable for the individual taxpayer in the EU.

If the achievement of SDGs 8 and 9 were genuinely an objective in the design of DEBRA, the obvious choice would be to adopt a regime of full non-deduction of interest (NDI) charges. In the Tax Justice Network's Corporate Tax Haven Index, full non-deduction of interest on related party debt is assessed as the optimal policy to protect the domestic tax base,[19] and thereby contribute to the achievement of SDGs 8 and 9.

As indicated in the CORTAX modelling, such approach would significantly increase the corporate tax base. Budget neutrality could be achieved by using the excess tax revenue to finance reductions in the tax on labour income or VAT, or to finance incentives for the promotion of employment or innovative entrepreneurship. Budget neutrality might altogether not even be a necessary goal to attain. Revenue surpluses from solving the debt-equity bias through an NDI regime could for instance be used to finance direct expenditures in the building of resilient infrastructure and sustainable industrialisation, all in line with SDG 8 and 9, or to finance the green transition.

Furthermore, a full NDI regime would especially target those corporate sectors that are currently heavily overly reliant on debt funding. As shown by Cojoianu *et. al.* (2021), the fossil fuel industry is such an industry.[20] DEBRA conceived as an NDI would directly affect the cost of capital for those businesses. This would not only stimulate the development and use of affordable clean energy (SDG 7), but it would also make DEBRA an important climate action measure (SDG 13).

From the sustainable development goals perspective of third countries the introduction of DEBRA is problematic. In light of double-dipping structures and the lack of a comprehensive anti-abuse tool to fight these structures, there is a great risk that DEBRA net contribution to the sustainable development goals is a negative one. The contribution is negative if the underlying increase in capital in an EU company is contingent to an increase in debt financing by a related company in a third country, especially if this third country is a lower-income country. This is not a mere theoretical consideration. Large multinationals tend to raise third party debt centrally and they can cite genuine economic purposes for doing so (excluding the application of the GAAR), like improved access to global capital markets and the increased bargaining power with lenders. Sophisticated group treasury functions are often adopted to manage the financial position of the group. DEBRA incentivises multinationals to assign a group's treasury function to an EU entity. To benefit from the 'double dip', the EU treasury entity would then

[19] Tax Justice Network, *Haven Indicator 15: Deduction Limitation for Interest*, Corporate Tax Haven Index 2021 (2021) <https://cthi.taxjustice.net/cthi2021/HI-15.pdf> [accessed 9 May 2023].
[20] Theodor F Cojoianu and others, 'Does the Fossil Fuel Divestment Movement Impact New Oil and Gas Fundraising?', *Journal of Economic Geography*, 21/1 (2021), 141–64.

grant loans to other group entities, including those subsidiaries in third countries. In such a scenario, an increased equity of EU companies is contingent to a higher exposure to debt financing in third country companies. Third countries could counter DEBRA's appeal to EU-centric tax restructuring by introducing similar or more advantageous ACE measures. This race to the bottom would lead to a global erosion of corporate tax revenues.

Regardless of any positive impact on the sustainable development goals in a purely European context, such spillovers in third countries are completely at odds with the Addis Ababa Action Agenda[21] on the implementation of the goals. The Addis Agenda emphasises (para. 46) the importance of greenfield foreign direct investment – in contrast to debt financing – for sustainable development. It is clear that debt financing of local group companies and the related interest deduction against taxable profits in developing countries stifles those countries' potential to strengthen domestic resource mobilisation, as targeted under SDG 17.1.[22]

The same is true of third countries being forced to grant similar ACE measures to compete with DEBRA. The Addis Agenda furthermore stresses that international tax cooperation should be universal in approach (para. 28). The EU cannot and should not be blind to possible spillover effects of its regional tax initiatives, while at the same time claiming it is furthering the sustainable development goals. As a matter of fact, the European Commission should be reminded that under article 208 of the Treaty on the Functioning of the European Union, the EU has accepted, as part of its external development cooperation policy, to comply with the commitments approved in the context of the United Nations, like the UN's sustainable development goals. To the extent that DEBRA furthers certain sustainable development goals within the EU while creating negative spillover effects on the sustainable development efforts in third countries, the proposal is inappropriate and illegal.

Unspoken clash with the Minimum Tax Directive

Not a word is mentioned in the DEBRA proposal documents on the possible interaction with the EU's Minimum Tax Directive, first proposed

[21] Addis Tax Initiative, *Financing for Development Conference: The Addis Tax Initiative - Declaration*, 2015 <https://www.addistaxinitiative.net/sites/default/files/resources/ATI-Declaration-EN.pdf>.

[22] United Nations, 'Resolution Adopted by the General Assembly on 25 September 2015: Transforming Our World: The 2030 Agenda for Sustainable Development (A/RES/70/1)'.

in December 2021 and which implements the OECD/IF's Pillar Two Global Anti-Base Erosion (GloBE) rules.[23]

The introduction of any type of ACE measure like DEBRA is essentially a measure that narrows the corporate tax base by allowing a notional deduction, while at the same time leaving the income reported for accounting purposes untouched because the ACE is not an actual expense. Under the GloBE rules, undertaxed GloBE income is calculated by reference to the effective tax rate on financial accounting income. As such, the application of DEBRA's NID will result in a reduction of the jurisdictional effective tax rate (ETR).[24] If the final effective tax rate is reduced below 15 per cent, the DEBRA gives rise to a top-up tax. This is not an unlikely scenario as some member states employ a headline corporate tax rate that is close to 15 per cent and even for member states with higher headline rates, the combination of DEBRA and base-reducing tax incentives might reduce the effective tax rate below 15 per cent. As a result, in theory different (and potentially non-EU) countries would collect the top-up tax generated by application of the GloBE's income inclusion rule and undertaxed payments rule, respectively. Most likely, however, it will be the EU member state's own qualified domestic minimum top-up tax or equivalent measure, that will soak up any undertaxed profits generated by the DEBRA allowance.

None of the potential effects of an overlap of DEBRA and the Minimum Tax Directive is investigated in the EU Commission's DEBRA impact analysis. Such analysis is relevant though, as a collision between the two instruments risks robbing Peter to pay Paul. An overlap with the application of the Minimum Tax Directive will negate DEBRA's impact on the debt bias, while increasing both compliance costs for taxpayers and administrative burden for tax authorities. This, in turn, is completely at odds with the EU Commission's own BEFIT strategy for a comprehensive solution for business taxation in the EU which strives for reduced compliance costs and coherent corporate tax rules.

The general consensus is that it is large multinationals that are most prone to use ACE measures as a tax-planning device, and that one can expect a potential reduction of effectiveness of DEBRA in the case of companies that are part of multinationals that fall within the scope of the minimum tax. One sensible way forward then is to exclude these large multinationals altogether from the ACE component of DEBRA, while maintaining the proposed interest deduction limitation. While such special treatment would mitigate against one problematic aspect of

[23] European Union, *Council Directive (EU) 2022/2523 of 14 December 2022 on Ensuring a Global Minimum Level of Taxation for Multinational Enterprise Groups and Large-Scale Domestic Groups in the Union*, *L 328/1*, 2022 <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52022PC0216> [accessed 9 May 2023].
[24] Dieter Bettens, 'Article: The DEBRA Directive and Its Interplay With Pillar 2', *Intertax*, 50/12 (2022) <https://kluwerlawonline.com/api/Product/CitationPDFURL?file=Journals\TAXI\TAXI2022097.pdf> [accessed 9 May 2023].

interactions between the minimum tax and DEBRA, it also exacerbates complexity and raises questions around equal treatment.

Start-ups and young innovative companies

In its analysis, the EU Commission singles out a particular type of business for which DEBRA and its ACE component is especially relevant, namely start-ups and small innovative companies. Unlike multinationals and most small and medium enterprises, start-ups and small innovative companies struggle to gain access to capital markets. As such, these types of companies rely heavily on bank loans, yet financial institutions perceive them as high risk which increases the loan cost. At the same time, lack of access to other sources of financing makes start-ups extra vulnerable to external shocks. It cannot be disputed that a more streamlined access to venture capital is a sound policy objective to stimulate innovation and entrepreneurship in the EU.

However, it is highly doubtful whether the DEBRA and its ACE component are suitable instruments to achieve this objective. Start-ups and young innovative companies tend to be loss-making, both in the start-up phase and in the scaling-up phase. As such, these companies cannot immediately benefit from DEBRA's equity allowance as there are no profits against which to set off the allowance. The same is true for interest charges. In a sense, start-ups are immune to a tax-induced debt bias.

Innovative entrepreneurship is important in the EU. However, rather than adopting DEBRA, an isolated measure with questionable effectiveness, a comprehensive framework of start-up tax measures should be considered under the SME Relief Package[25] proposed by the EU Commission in September 2022. It is comprised of, inter alia, the BEFIT initiative[26] and the InvestEU initiative[27] to help small and medium enterprises access equity. Despite the global prevalence of tax incentives, empirical evidence finds that they play a limited role in influencing investor decisions while they often lead to revenue losses. As such, it is in any case essential for the EU to consider non-tax factors to strengthen the region's innovation investment attractiveness. As such, rather than a blunt tax cut in the form of DEBRA, increased budget for innovation

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[25] European Commission, 'A "Relief Package" for SMEs', *European Commission* <https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_22_5653> [accessed 9 May 2023].
[26] European Commission, 'Business in Europe: Framework for Income Taxation (BEFIT)'.
[27] European Commission, 'InvestEU' <https://investeu.europa.eu/about-investeu_en> [accessed 9 May 2023].

under the NextGenerationEU strategy[28] is arguably a much more effective way of stimulating innovative entrepreneurship within the EU.

Concluding observations: towards an A-less DEBRA

The EU Commission's DEBRA proposal in its current state is problematic for a variety of reasons and should be rejected.

The impact assessment which underlies it is based on inappropriate modelling. The policy analysis is highly selective with regard to the policy options available, qualitative criteria for assessment and the references to member states' prior experiences with the ACE. The selectiveness masks the fact that a full rejection of interest deduction across the board is the more desirable policy option if considered from all relevant angles. The assessment omits any analysis of a second-best (but probably politically more realistic alternative) of a self-standing absolute interest deduction limit. A limited NDI would provide a solution that - unlike the ACE based proposals - is not prone to abuse, while allowing member states to raise additional corporate tax revenues in a responsible way.

The DEBRA proposal's exclusion of the financial sector is ill-conceived. Banks are not different than ordinary companies when it comes to the effects of the debt bias. The aggregate revenue cost of interest deductions by banks far exceeds those of ordinary companies. The exclusion is justified in the proposal by suggesting that banks would effectively benefit from DEBRA's ACE component while not being burdened by the interest reduction limit. An alternative DEBRA regime should be conceived which avoids altering the problem to fit the solution, like an 'A'-less DEBRA, ie a regime composed of a self-standing NDI measure without an ACE component. A regime that would tackle the debt-equity bias but without handing out tax cuts through the granting of an allowance.

While the current DEBRA proposal is presented as a budget neutral measure, such neutrality depends highly on assumptions about its causal effects on increased future growth and the robustness of its anti-abuse measures. However, there is hardly any robust evidence suggesting that profit-based tax cuts lead to higher growth. In addition, given the current geopolitical, climate crises and macro-economic volatility, steady future growth is unlikely.

Also, the robustness of the proposed anti-abuse rules to tackle abuse of the ACE component is questionable. Certain types of double-dipping

[28] European Commission, 'The EU's 2021-2027 Long-Term Budget and NextGenerationEU : Facts and Figures', 2021 <https://data.europa.eu/doi/10.2761/808559> [accessed 9 May 2023].

structures are not caught by the proposed SAARs, and this will undoubtedly trigger aggressive tax planning by large multinationals and the scheming will not stop at the EU border. DEBRA's impact on increasing EU group companies' equity positions might very well result in increased debt funding in third countries. Such negative spillovers completely undermine the EU Commission's claim that DEBRA furthers the sustainable development goals within the EU. The EU Minimum Tax Directive will most likely neutralise some of DEBRAs alleged potential to solve the debt bias in the biggest multinationals, which is yet another strong reason to reconsider the application of DEBRAs ACE component, at least to large multinationals.

For start-up companies, a group expressly singled out by the EU Commission as a target group for DEBRA, the measure is of little direct and immediate benefit. Rather, the EU Commission should consider a comprehensive tax regime for start-ups under the SME Relief Package and BEFIT initiatives.

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