POSITION PAPER

Comments on Debt Equity Bias Reduction Allowance (DEBRA)

General comments and background

SMEunited has complained for many years that the existing debt-equity bias is one of the reasons, why SMEs rely too much on debt finance (interest rates are deductible) and show low rates of equity in their balance sheets (costs for equity like dividends are not deductible).

SMEunited asked in several policy papers for a better tax treatment of equity finance to reduce the bias. Therefore, we welcomed the announcement of DEBRA in the Communication on "Business taxation for the 21st Century" of the European Commission last year.

The aim of Commission proposal for DEBRA is to foster the development of EU Capital Markets Union by granting companies incentives to use equity, rather than debt, to finance their activities.

It stipulates that increases in a taxpayer's equity from one tax year to the next should be deductible from its taxable base, similarly to what happens to debt. Moreover, SMEs would benefit from a higher notional interest rate under the proposed rules. On the debt end, the proposal introduces a reduction of debt interest deductibility by 15%.

The current proposal for a Council Directive suggests a tax allowance for 10 years of an equity increases (Article 4). The allowance should be the "Risk Free Interest rate for 10 years plus a risk premium of 1% (1.5% for SMEs).

Furthermore, in order to reduce the impact on tax revenues and to tackle the bias from both side, the proposal includes a limitation of interest rate deduction for debt finance (Article 6). Only 85% of borrowing costs should be deductible.

Finally, SMEunited regrets that only incorporated companies can benefit from such an allowance. The majority of SMEs – mainly micro enterprises – which are organised in a different legal form are financing their investments with taxed profits and loans are not covered by the proposed instrument. Therefore, SMEunited invites national governments to support investments in such companies with similar instruments like untaxed reserves.

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Specific comments on the proposal for DEBRA

1. SMEunited welcomes an introduction of a Debt Equity Bias Reduction Allowance

A reduction allowance seems to be an effective instrument to increase the attractivity of equity finance for companies and can contribute to reduce the debt-equity bias existing on many Member States of the European Union.

2. Limiting the reduction allowance to capital increases

The proposal to stipulate a reduction allowance for capital increases goes in the right direction. However, the debt-equity bias exists also for existing equity and may justify an allowance for all equity in the balance sheet. This is especially the case, if the allowance does not include the full costs of equity, but only the cost equivalent of debts. **Therefore, SMEunited invites legislators to assess the possibility to stipulate the allowance for all equity.**

3. Limiting the reduction allowance to 10 year

The proposal limits the reduction allowance for additional capital to 10 year if the injection, which is shorter than many commercial investment loans. **Therefore, SMEunited recommends to extend the period for the reduction allowance to 15 years.**

4. Higher notional interest rate for SMEs

The fact that on average SMEs have to pay higher interest rates for loans, justifies the provision of higher notional interest rates for SMEs. **Therefore, SMEunited welcomes the suggested premium of 0.5% for SMEs, when calculation the notional interest rate the allowance.**

5. Reduction of the interest rate deduction of loans

Interest rates are costs for companies and especially in crisis times, where a large number of SMEs suffer from high debt rates, a reduction of the deductibility of interest rates form loans would create significant additional costs. Such extra costs are highly counterproductive, because SMEs will not be able to compensate this costs, even by increasing their share of equity. **Therefore, SMEunited fully rejects a reduction of interest rate deduction to 85%.**

6. Council directive as legal base for DEBRA

The European Commission proposes to implement DEBRA with a council directive, which requires unanimity by Finance Ministers. The fact that each single national government could provide already now such an allowance at national level, but has not done it, may hint to the difficulties ahead to achieve the support of all Finance Ministers. **Therefore, SMEunited invites the European Commission and the European Parliament to support publicly the necessity for such an allowance, which is especially relevant in times when many SMEs have solvency issues and should strengthen their capital base.**

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