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Editorial

A Zebra or a Donkey? the European Commission's Proposal for a Debt-Equity Bias Reduction Allowance (DEBRA)

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1 Introduction

As part of its Communication on Business Taxation for the twenty-first Century,[1] the European Commission announced that it would propose a Debt-Equity Bias Reduction Allowance (DEBRA). On 11 May 2022 the European Commission has indeed presented a corresponding proposal for such a Directive (in the following referred to as the DEBRA Directive).[2] The Commission intends to create incentives for the re-equitization of companies which have become financially vulnerable because of the Coronavirus disease 2019 (COVID-19) crisis. The draft Directive would apply to all taxpayers that are subject to corporate income tax in one or more EU Member States, including EU permanent establishments of non-EU entities. Nevertheless, there is an exception regarding financial undertakings, which reflects the fact that some of these are subject to regulatory equity requirements already preventing under-equitization.

The draft Directive, however, is not all carrots – certainly, it does offer a carrot in the form of the promised allowance on corporate equity (ACE). Yet it also contains a sizeable stick in the form of a limitation on interest deductibility. Moreover, the carrot is only small: The draft proposes merely a soft or incremental ACE regime,[3] as it only considers newly issued equity. By contrast, a hard ACE would apply to the full stock of equity.[4] In addition, the allowance can become negative – when the equity injection is reversed, e.g., through a profit distribution or a capital decrease, the previously granted allowance on new corporate equity is recaptured.[5]

In the following, we will explain briefly the underlying aim of the measure by answering the questions why debt bias is harmful and what policy measures can address it (II.). We shall then proceed to analyse the two components contained in the draft DEBRA Directive – the allowance on new corporate equity (III.) and the limitation on interest deductibility (IV.). It will become apparent that the proposal still suffers from substantial[6] defects that would need to be remedied; in particular, this concerns the exact calculation of the DEBRA and the corresponding transition provision as well as the rules of transposition for the interest limitation rules. Moreover, in order to avoid undue limitations on Member States' tax sovereignty, a common approach and a sunset clause should be considered. A short summary with an outlook on heraldic animals for taxation in Europe concludes this editorial (V.).

2 Potential measures against the debt bias

Under the current pro-debt bias of tax rules, businesses can deduct interest attached to debt financing, but not the costs related to equity financing.[7] The tax rules thereby follow the legal concept, which is also taken up in accounting – interest is a cost of doing business, whereas equity returns reflect business income. Economically, this does not necessarily make much sense, as both payments represent a return on capital.

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1 European Commission, *Communication from the Commission to the European Parliament and the Council, Business Taxation for the 21st Century*, COM(2021) 251 final. On this *see* e.g., Axel Cordewener, *EU Budgetary Reform and Tax Harmonization: Becoming Brothers in Arms,* 31(2) EC Tax Rev. (2022).

2 *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.

3 This classification was developed by Shafik Hebous & Martin Ruf, *Evaluating the Effects of ACE Systems on Multinational Debt Financing and Investment,* 156 J. Pub. Econ. 131–149 (2017).

4 And at the same time apply the full tax rate to the deduction.

5 *See* Art. 4(3) of the proposed DEBRA Directive.

6 As well as the slight technical glitch that Art. 9 of the DEBRA Directive refers to its Art. 4(5) rather than Art. 4(4).

7 Ruud de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 33(4) Fiscal Stud. 489–512 (2012).

2.1 Why Is the Debt Bias Problematic?

The first problem of the debt bias lies in the revenue implications: to the extent interest payments are deductible, they can be used to reduce profits in high tax locations and raise profits in low tax jurisdictions. This reduction in scarce fiscal revenue increases welfare losses from taxation, as distortionary taxes need to be raised.

Moreover, the debt-equity bias has adverse equity implications. At the firm level, the set up costs for tax arbitraging structure mean that small and medium-sized enterprises (SMEs) are far less likely to profit from the bias than larger companies. Moreover, at the individual level, the bias again can be more easily used by high-income and high net wealth individuals than by individuals with lower income, implying a reduction in the effective progressivity of the income tax.

Furthermore, the bias has adverse real world (i.e., non tax) implications as well: it can encourage companies to accumulate debts. The excess debt reduces firms' resilience and gives rise to the threat of insolvencies,[8] a danger that has been exacerbated by the COVID-19 pandemic. Beyond that, the bias with its subsidy in favour of debt may make marginal investment projects that would not be lucrative in the absence of taxation profitable, leading to a potentially sizeable distortion in allocation efficiency.[9]

2.2 Potential Countermeasures

Traditionally, there are three key possibilities for eliminating such a debt-equity bias[10]: levelling-down through an ACE, levelling up through limitations on interest deduction or some intermediate form through a combination of both approaches.[11]

2.2.1 Levelling-Down Through an ACE

A (partial) levelling-down of debt and equity taxation at the level of the corporation is achieved through an ACE.[12] Such an allowance, which is also frequently referred to as a notional interest deduction (NID), reduces the overall tax liability. The allowance is meant to reflect the economic cost of the use of capital, so that only the remainder – the economic rent – is subject to corporate taxation. The cost of the use of capital is equal to the cost of long-term, risk-free financing plus a (oftentimes stylized) risk-premium. As indicated above, one can distinguish between hard ACE regimes, which apply to the full equity stock, and soft or incremental ACE regimes, which are confined to parts of the equity, in particular to the increase in equity in a certain period.[13]

In the European Union, ACE schemes already exist in Belgium, Cyprus, Italy, Malta, Poland and Portugal.[14] These schemes have received the blessing by the Code of Conduct Group.[15] They vary significantly in their generosity. The most lavish scheme is in operation in Malta, which sets the rate at the current yield to maturity on Malta Government Stocks with a remaining term of twenty years plus a 5% premium.[16] The maximum deduction in any given year cannot exceed 90% of chargeable income. In Cyprus, the allowance on new corporate equity is calculated by adding a premium of 5% to the yield on ten-year Cyprus government bonds. The allowance is capped at 80% of the taxable profits of the company or permanent establishment,[17] yielding an effective tax rate as low as 2.5%. In Belgium, by contrast, the allowance for new equity is 0.34% for SMEs and 0.0% for others,[18] reflecting the negative risk-free interest rates. In Italy, the base is the net increase in equity in the company generated after 2010; the rate, which is calculated on an annual basis, has been 1.3% since 2019.[19] In Poland, the base is determined by the increase in qualifying equity. The rate equals the reference rate of the National Bank of Poland (as applicable on the last day of the preceding calendar year), plus one percentage point. The total amount of revenue earning costs deducted in the tax year resulting from NID regime may not be higher than the amount of PLN 250,000 (approx. EUR 55,000).[20] In Portugal, the notional rate of return is applicable to new capital contributions made by the shareholders or third party creditors or by retaining earnings for the purposes of the company's incorporation

8 Javier Bianchi, *Overborrowing and Systemic Externalities in the Business Cycle*, 101(7) Am. Econ. Rev. 3400–3426 (2011).

9 Serena Fatica, Thomas Hemmelgarn & Gaëtan Nicodème, *The Debt-Equity Tax Bias: Consequences and Solutions*, 52(1) Reflets et perspectives de la vie économique 5–18, at 9 (2013).

10 In addition, there also is the proposal for a Destination-Based Cash-Flow Tax (DBCFT), *see* e.g., Alan J. Auerbach et al., *International Tax Planning Under the Destination-Based Cash Flow Tax,* 70(4) Nat' Tax J. 783–802 (2017). More generally on reform option Devereux et al., *Taxing Profit in a Global Economy – A Report of the Oxford International Tax Group* (2021).

11 *See* e.g., Spengel et al., *Debt-equity Bias Should Be Addressed on National Rather Than on EU Level*, 7 ZEW policy briefs (2021).

12 The concept goes back to Robin Boadway & Neil Bruce, *A General Proposition on the Design of a Neutral Business Tax,* 24(2) J. Pub. Econ. 231–239 (1984) as well as Michael Devereux & Harold Freeman, *A General Neutral Profits Tax,* 12(3) Fiscal Stud. 1–15 (1991).

13 Ernesto Zangari, *Addressing the Debt Bias: A Comparison Between the Belgian and the Italian ACE Systems*, 44 European Commission Taxation Papers (2014). Such an incremental allowance has in the meantime also been introduced in Belgium.

14 A further ACE scheme, which had been proposed by the French Senate has apparently been aborted.

15 *See* Guidance on notional interest deduction regimes by the Code of Conduct Group, Council of the European Union, *Malta's Notional Interest Deduction Regime (MT014)*, 14364/18 ADD 1 (2018).

16 European Commission, Commission Staff Working Document, *Impact Assessment Report Accompanying the Document Proposal for a Council Directive on Laying Down Rules on a Debt-Equity Bias Reduction and on Limiting the Deductibility of Interest for Corporate Income Tax Purposes*, SWD(2022) 145 final, at 102.

17 *Ibid.*

18 *Ibid.*

19 *Ibid.*

20 *Ibid.*

or increases of its share capital. The rate is 7% and the deduction is applicable for six years.[21]

2.2.2 *Levelling-Up: Limits to the Deductibility of Interest*

Conversely, the debt-equity bias may also be eliminated by levelling-up. Rather than extending the relief granted for interest payments to equity payments, interest could be made partially or fully non-deductible. When neither interest nor return on equity are deductible, the bias disappears, at least at the level of the company. This is indeed what the pure forms of comprehensive business income taxes (CBIT) seek to achieve by denying deductibility of interest. In a slightly lesser form, an (approximation to an) equal treatment can also be achieved through special instruments limiting deductibility of interest, such as thin capitalization rules[22] or interest limitation rules.

While comprehensive business income taxes are rare in practice, special instruments have been widely implemented. The most notable of these certainly are the interest limitation rules in Article 4 of the Anti-Tax Avoidance Directive (ATAD).[23] That provision limits the deductibility of interest payments from the tax base to 30%of the taxpayer's earnings before interest, tax, depreciation and amortization (EBITDA). Certain exemptions and escapes apply, for example for stand-alone entities and group-companies for which the ratio of its equity over its total assets is not significantly lower than the equivalent ratio of the group.

2.2.3 *Let's Meet in the Middle: Combination of Measures*

Finally, a combination of policy measures can also aim at reaching a kind of middle ground: by partially extending relief to equity and partially denying deductibility of interest payments, the bias could be reduced or even eliminated.[24] This approach is taken in the draft DEBRA Directive, which combines an allowance on new corporate equity with a further limitation on the deductibility of interest. It can be understood as a compromise, given that both the CBIT and the ACE are not fully convincing: The CBIT raises the cost of capital and thus hurts investment.[25] It becomes particular burdensome during periods of weak cash flow. On a macro-level, it can magnify business cycle contractions.[26] By contrast, the ACE would, in order to be fully neutral, require the transformation of the corporation tax into a personal consumption tax, which comprehensively exempts the normal return on capital.[27] Moreover, the ACE will generate less revenue than a conventional corporate income tax, so that either the rate would have to be increased or tax revenue would have to be found elsewhere.[28]

3 Component 1: The proposed DEBRA

The Commission proposal allows that increases in a taxpayer's equity can be deducted from the taxable base for corporate income tax purposes, similarly to what happens to debt. The deduction for new equity is permissible for ten consecutive tax periods after the increase in equity. This proposal, which largely follows the current Italian ACE rules,[29] applies to all taxpayers which are subject to corporate income tax in one or more Member States, with the exception of financial undertakings listed in Article 2 of the Directive. In the following, we will first look at the calculation of the allowance (1.) and limitations (2.) before we proceed to highlight the lack of adequate transitory provisions (3.) and discuss options for limit the scope of harmonization (4.).

3.1 Calculation of the Allowance

The DEBRA is calculated as the product of two factors: The *base of the allowance* is the difference between the level of net equity at the end of the tax period and the level of net equity at the end of the previous tax period. Equity is defined in Article 3(6) of the proposed DEBRA

21 *Ibid.*

22 On the empirical effects of such instruments *see* Ruud de Mooij & Shafik Hebous, *Curbing Corporate Debt Bias: Do Limitations to Interest Deductibility Work?,* 96 J. Banking & Fin. 368–378 (2018); Thiess Buettner et al., *The Impact of Thin-Capitalization Rules on the Capital Structure of Multinational Firms,* 96(11–12) J. Pub. Econ. 930–938 (2012).

23 On these see Gianluigi Bizioli, *Taking EU Fundamental Freedoms Seriously: Does the Anti-Tax Avoidance Directive Take Precedence Over the Single Market?,* 26(3) EC Tax Rev. (2017); Ana Paula Dourado, *The Interest Limitation Rule in the Anti-Tax Avoidance Directive (ATAD) and the Net Taxation Principle*, 26(3) EC Tax Rev. 112–121 (2017); Caroline Heber, *The Interest Limitation Rule in the Light of European Constitutional Law,* 31(2) EC Tax Rev. 72–84 (2022); Pieter Van Os, *Interest Limitation Under the Adopted Anti-tax Avoidance Directive and Proportionality*, 25(4) EC Tax Rev. (2016). For a discussion of the constitutionality in Germany, which has developed the rule, *see* e.g., Roland Ismer, *Verfassungsrechtliche Rechtfertigung der Zinsschranke,* 96(17) Finanz-Rundschau Ertragsteuerrecht 777–784 (2014). The instrument has also been adopted under BEPS Action 4, cf. Emilio Cencerrado & María Teresa Soler Roch, *Limit Base Erosion via Interest Deduction and Others*, 43(1) Intertax 58–71 (2015).

24 *See also* Fatica et al., *supra* n. 9, at 14. A particular case of such middle ground would be an Allowance on Corporate Capital that would combine the properties of an ACE and a CBIT regime by allowing the deductibility of a single notional return on all capital, *see* Spengel et al., *supra* n. 11, at 3.

25 *See* International Monetary Fund, *Tax Policy, Leverage and Macroeconomic Stability*, IMF Policy Paper (2016), at 24.

26 *See ibid.*, at 23.

27 Sijbren Cnossen, *Corporation Taxes in the European Union: Slowly Moving Toward Comprehensive Business Income Taxation?,* 25.3 Int'l Tax & Pub. Fin. 808–840, at 834 (2018).

28 *Ibid.*, at 833. Doina Maria Radulsecu & Martin Stimmelmayr, *ACE v. CBIT: Which Is Better for Investment and Welfare*?, CESifo conference on the future of capital income taxation, Venice (2006) even find that corporate tax cannot be high enough to finance such a reform in a dynamic general equilibrium framework.

29 However, there are no rules in the draft Directive allowing transfers of unused ACE basis in the group.

Directive as the sum of the taxpayer's paid-up capital, share premium accounts, revaluation reserve and other reserves (which are defined in Article 3(8) of the Directive) and profit or loss brought forward. Thus, profits that are not distributed, but retained increase the allowance. In order to prevent cascading the allowance through participations, the tax value of participations in associated enterprises as well as its own shares are deducted from equity, yielding *net equity* as defined in Article 3(7) of the Directive.

The *notional interest rate* is independent of actual refinancing conditions for firms, which can be expected to be heterogenous.[30] The rate is calculated as the sum of the ten-year risk-free interest rate for the relevant currency[31] and a risk premium of 1% or, where the taxpayer is an SME, a risk premium of 1.5%. The higher risk premium for SMEs is mandatory for Member States so as to avoid selectivity concerns under State Aid rules. The Commission proposal also, given the existing differences in corporate tax rates among Member States, somewhat less convincingly argues that making the higher rates for SMEs mandatory is to ensure a level playing field for SMEs in the EU regardless of their place of residence. It is not clear what happens if the notional interest rate becomes negative (which, seeing the current inflation expectations is admittedly not as plausible as a year ago).

The DEBRA can be deducted in the relevant year as well as in the nine subsequent years. The Commission argues that this approximates the maturity of most debt, while keeping the overall budgetary cost of the allowance on equity under control.[32] An increase in a taxpayer's equity thus gives rise to an allowance that can be deducted in the year it was incurred and in the successive nine years. Where the deductible allowance on equity in any of these years is higher than the taxpayer's net taxable income in a tax period, the taxpayer may carry forward the excess of allowance on equity to the following periods.[33] This carry-forward applies without time limitation. Regarding the intertemporal dimension of the DEBRA, it is not clear what circumstances are to be decisive: those of the original year when the allowance on equity was first granted or those of the fiscal year when the deduction is to be made. Thus, when the risk-free interest rate changes, is the initial rate to be grandfathered or is there an updating to the new rate? In a similar vein: what happens, if a company is a SME when it makes the equity increase, but ceases to be so in subsequent years? The wording does not really answer the questions and neither is there a clear purposive argument.

However, in reality, the picture will often become even more complicated: in the year following the first change in equity, the taxpayers generally not only need to consider the allowance stemming from the previous period. Rather, net equity can be expected to change (if only because of any undistributed profit of that year), setting in motion another allowance running for ten years. Moreover, there also is a recapture where equity is withdrawn: If the allowance base for a subsequent year under the rules of the proposed DEBRA Directive is negative and the taxpayer has already benefitted from an allowance on equity a proportionate amount will become taxable for ten consecutive tax periods and up to the total increase of net equity for which such allowance has been obtained.[34] The taxpayer may, however, demonstrate that the reduction in equity is due to accounting losses incurred during the tax period or due to a legal obligation to reduce capital. This rule appears somewhat problematic: One may wonder whether this asymmetry between losses and profits does not create undesired tax-planning opportunities: losses do not reduce the allowance, while profits increase it – a business that oscillates between losses and profits will then benefit from an allowance representing the sum of positive profits.

The Commission gives the example of a company with equity of 100 which decides to increase its equity in year t by twenty (base of the allowance). Then an allowance of twenty times the notional interest rate (risk free interest rate plus one percent, or where the company is a SME 1.5%) will be deducted from its taxable base every year for ten years (until t+9). Assuming that the risk-free interest is 0 and that the company is not a SME, the allowance on equity is 0.2. Taking into account the above complexities, further dimensions should be added to the example: in t+1 the company makes a profit of 10; it retains the profit, so that a further allowance on equity is granted in the amount of 10*0.01=0.1 In year t+2, the company makes a loss of ten, which has no impact on the allowance. In t+3, the company makes a capital reduction of twenty, so that a negative allowance on equity of – 0.2 applies. The necessary calculations can be represented in the following table:

The result appears somewhat odd – a company that has made no overall profits and that has reduced its capital by the same amount as it has increased it in a previous period, still gets an overall allowance on equity of 1.0. The effect, of course, is entirely due to the fact that profits are taken into account, but losses are not.

30 On this point *see* Stephen R. Bond & Michael Devereux, *Generalised R-based and S-based Taxes Under Uncertainty,* 87(5–6) J. Pub. Econ. 1291–1311 (2003). This implies that economic rents of larger, less risky, firms are exempted from taxation, while more risky firms are taxed beyond the pure rent.

31 Evaluated on the 31 Dec. of the year preceding the relevant tax period, Art. 4(2) of the proposed DEBRA Directive.

32 European Commission, *supra* n. 2, at 8.

33 Article 4(1) of the draft DEBRA Directive.

34 Article 4(3) of the draft DEBRA Directive.

Table 1: Example for Calculation of DEBRA

Time	*T*	*t+1*	*t+2*	*t+3*	*t+4*	*t+5*	*t+6*	*t+7*	*t+8*	*t+9*	*t+10*	*t+11*	*t+12*
Allowance t	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0	0	0
Allowance t+1 (Profit)		0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0	0
Allowance t+2 (Loss)			0	0	0	0	0	0	0	0	0	0	0
Allowance t+3 (Capital Reduction)				-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Total	0.2	0.3	0.3	0.3	0.1	0.1	0.1	0.1	0.1	-0.1	-0.1	-0.2	-0.2

3.2 Limitations to the Allowance

There are two kinds of allowances: on the one hand, the allowance on equity is confined to a maximum of 30% of EBITDA. On the other hand, the Directive contains anti-allowance provisions.

1) The allowance on equity is limited to 30% of the taxpayer's EBITDA. Where taxpayers are capped by this rule, they can carry forward, for a maximum of five tax periods, the part of the allowance on equity which exceeds 30% of EBITDA in a tax period. The Commission justifies this restriction with the need to prevent tax abuse. The prevention of abuse is a general principle of law.[35] Nevertheless, such reasoning would certainly not have been sufficient for Member States, making once again apparent that the Commission applies far stricter standards for the justification of Member States' measures.
2) The Directive also contains a number of specific anti-abuse rules (SAARs),[36] in particular addressing cascading schemes that would allow multiple usage of the ACE for a single equity injection. Further situations that need to be addressed arise from equity increases originating from contributions in kind or investments in assets and the re-categorization of old capital as new capital.

3.3 Surprising Lack of Transitory Provisions

Finally, it should be noted that the fact that the allowance on equity is incremental requires (more) elaborate transitory provisions: the incentives for companies are to reduce the equity before the entry into force as far as possible. In order to minimize equity, dividends would be put forward in time, whereas equity contributions would be delayed. This recommendation clearly runs counter to what the Directive seeks to achieve. Obviously, this problem could be circumvented by opting for a hard ACE. If, however, the allowance on equity were to remain incremental, there would need to be transitory provisions, e.g., by bringing forward the relevant point in time for assessing the starting equity.

3.4 3Member States' Tax Sovereignty: Common Approach and Sunset Clause

The variance in the schemes at European level may distort the internal market and be the actual reason for intervention at the European level.[37] Yet this does not necessarily imply that the adoption of an ACE should be mandatory for Member States. It would instead be sufficient to implement a common approach, under which Member States could choose whether or not to introduce an ACE, but once they had taken that decision they could have to obey the rules set out in the DEBRA Directive. Moreover, a sunset-clause should be considered: both the adoption and subsequent amendments to the DEBRA Directive would require a unanimous vote in the Council. Given that the vast majority of Member States has not yet introduced an ACE, it seems premature to fix such a relatively novel instrument pretty much ad calendas graecas. Instead, the directive should initially be in force for a limited time span of say five or ten years. At the end of that time span, a decision on the extension could then be taken.[38]

[35] *See* e.g., Ismer, Roland, *Abuse of Law as a General Principle of European Union (Tax) Law,* in *A Guide to the Anti-Tax Avoidance Directive* 66–85 (Werner Haslehner, Katerina Pantazatou, Georg Kofler & Alexander Rust eds 2020).
[36] Article 5 of the draft DEBRA Directive.
[37] Skeptical on the need for European intervention to address the debt-equity bias Spengel et al., *supra* n. 11, at 4.
[38] Wolfgang Schön, *Facilitating Entry by Facilitating Exit: New Paths in EU Tax Legislation*, 46 Intertax 339 (2018).

4 Component 2: Limitation to interest deduction

As second component, the proposed DEBRA Directive would restrict the interest deduction, beyond the limitations already provided by Article 4 of the ATAD. The tax deductibility would be limited to 85% of exceeding borrowing costs (i.e., interest paid minus interest received). This proportional limit means that irrespective of EBITDA, 15% of interest expenses would become non-deductible. In contrast to the rules under the ATAD, the non-deductibility would be final – there would not be a carry-forward or – back of non-deductible interest.

The limitations under the proposed DEBRA Directive and the ATAD would apply in parallel. Thus, the limitation under the DEBRA Directive would become final. Any further-reaching limitation under the ATAD could then be carried forward or backward. The proposal gives the following example: a company A with exceeding borrowing costs of 100 would face the limit of the deductibility to 85% of 100 = 85 and thus renders a non-deductible amount of fifteen. If the deductible amount under the ATAD were lower (say 80 and consequently the non-deductible higher, i.e., 20), the additional non-deductible amount (i.e., 85–80=5) would be carried forward or back in accordance with the conditions of Article 4 of the ATAD.

The proposed new rules would amount to a major paradigm change: they would be independent of EBITDA. Moreover, the ATAD rules are based on the premise of temporal non-deductibility, which can be recovered once a sufficient EBITDA is reached in later periods. Hence, they are based on the premise that new equity can be found and injected. By contrast, the limitation under the new rules would be final. They would thus raise financing costs for businesses operating with debt. This would be even more true for taxpayers who have used an escape from Article 4 ATAD, e.g., by making use of the stand-alone-escape carve out or the group ratio rule to increase the deductibility of interest beyond 30% of EBITDA. As a consequence, fundamental rights concerns that have already been raised against Article 4 ATAD, would become even more pressing under the proposed new rule. This is particularly true in a situation where new equity is not available. Finally, it should be noted that there is an inherent tension to the professed aim of the Directive which seeks to prevent insolvencies of businesses that were put under strain by the pandemic – as the new rules apply also to old debt, businesses which have accumulated large debts over the pandemic would be hit hardest. In the worst case, the new rule could even push such firms over the brink of insolvency.

Moreover, the transposition provisions in Article 12 of the DEBRA Directive are somewhat puzzling: paragraph 2 allows Member States to 'defer the application of the provisions of this Directive to taxpayers that on [1 January 2024] benefit from an allowance on equity under national law for a period up to ten years and in no case for a period longer than the duration of the benefit under national law'. This rule may be understandable as a grandfathering for existing allowance on equity schemes, while at the same time preventing double benefits to taxpayers. But why would the existence of an allowance on equity in a Member State prevent it from applying the new limitations on interest deduction? It is also simply incompatible with the envisaged common approach to mitigating the debt bias. The transitory provision should therefore be limited to the articles in the Directive on the allowance on equity.

5 Conclusion

The tax-world seems to be spinning ever faster: major transformative proposals, such as the revision of the energy taxation directive and the proposals for implementation of the OECD's Pillar 2, are churned out by the Commission almost every quarter. The implementation period for the proposed DEBRA Directive also displays a certain short-windedness – the proposal tentatively envisages an application of the new rules as early as 1 January 2024.

The proposed DEBRA Directive will consist of two measures: it combines the introduction of an allowance for new corporate equity with further limitations on the deductibility of interest. As demonstrated, the proposal still suffers from defects that need to be remedied; in particular, this concerns the exact calculation of the DEBRA and the corresponding transition provision as well as the rules of transposition for the interest limitation rules, the need for a common approach and a sunset clause. Seen from a wider angle, the Directive will, if adopted, further hybridize the tax treatment of the returns on capital: initially, there had been a clear principle – interest expenses on debt were deductible whereas payments on equity instruments were not. A first departure from this principle came with the limitations to interest deductibility. Allowances for corporate equity, which are also referred to as notional interest deductions, have also been introduced in some Member States. The DEBRA proposal marks a further step in this direction – the formerly distinct treatment of expenses on deductible debt on the one hand and non-deductible return on equity on the other hand converges towards some kind of a partial deductibility (which needs to be borne in mind when taxing the recipient of the payments).[39] This, in turn, may well be

[39] See e.g., the situation in the US, where shareholders of companies that benefited from the notional interest regimes may not be eligible for a full 'dividends received deduction', resulting in partial taxation of the dividend under IRC s. 245A(e) in the US. Conversely, the limitations on interest deductibility would need to be reflected when taxing the creditor so as to avoid double taxation.

understood as a reaction to increasing hybridization in economic reality, which blurs the lines between equity and debt and makes them less distinguishable.[40]

Against this background, the acronym DEBRA seems to fit remarkably well: a debra is a *zebroid.* Just as the mating of a horse and zebra yields a hebra, a debra is the offspring of the cross between a between a donkey and a zebra. It has black and white striped legs and a blurry grey body. Though still a rare animal, the debra may in the future well take the place of the 2022 ifa Berlin teddy bear and become the heraldic animal of the dawning new tax age. Its beauty may, however, very much be in the eye of the beholder.

[40] *See* Wolfgang Schön et al., *Debt and Equity: What's the Difference? A Comparative View*, 09–09 Max Planck Institute for Intellectual Property, Competition & Tax Law Research Paper.