FIEC is the European Construction Industry Federation, which through its 32 national member associations in 27 countries (24 EU countries, Norway, Switzerland, and Ukraine) represents construction companies of all sizes, i.e., small, and medium-sized enterprises and "global players", carrying out all forms of building and civil engineering activities.

FIEC Position on the Proposal for a Council Directive on Rules on a Debt-Equity Bias Reduction Allowance (DEBRA)

FIEC position

27/02/2023

KEY MESSAGES

1. The proposed interest deduction limitation rule significantly impacts the cost of financing for contractors and should be deleted.
2. The proposed measure on notional interest allowance on changes in the company's equity level has several potential shortcomings.

Introductory remarks

On 11 May 2022, the European Commission published a legislative proposal aimed at tackling the tax induced debt-equity bias (DEBRA). The overall aim of the proposal is to create a level playing field for debt and equity by encouraging companies to finance their investment through equity contributions rather than through debt financing.

While FIEC welcomes the objectives of the Commission's proposal, it warns that <u>the proposed provisions could have several counterproductive effects, especially with respect to the financing of companies and of infrastructure projects</u>. This is even more concerning in a context of inflation, rapidly increasing interest rates and the risk of significant disruptions to the economy caused by geopolitical events.

1 Consequences of limiting the deductibility of additional borrowing costs.

The DEBRA Proposal lays down rules to limit the tax deductibility of borrowing costs to 85 %[1]. Currently, some Member States have applied a ceiling below which the full deductibility of interest is not questioned. Moreover, the ATAD directive[2] allows Member States to exclude exceeding borrowing costs related to loans to finance long-term infrastructure projects.

The **new interest deduction limitation rule could have a significant impact on many companies in Europe, in particular on Small and medium-sized enterprises (SMEs) and**

[1] DEBRA Proposal, Art. 6

[2] ATAD 1, Art. 4(1) – "Exceeding borrowing costs shall be deductible in the tax period in which they are incurred only up to 30 percent of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA)."

microenterprises. These companies – which comprise roughly 95% of the construction sector[3] – are already experiencing cash flow problems due to current economic conditions. In addition, SMEs and microenterprises typically don't have the capacity change to choose between equity and debt, making it impossible to apply the proposed rules uniformly to all companies regardless of size.

For the construction sector specifically, the proposed interest deduction limitation rule will have a significant impact on the cost of financing for EU contractors. The sector, by the nature of its activities (real estate and infrastructure projects, etc.), has frequent and necessary recourse to debt. Therefore, the tightening of the deduction of financial charges will hamper the activities of the construction sector – indispensable towards achieving the energy and ecological transition – while also increasing production costs. As such, the proposed rules appear to be counterproductive.

On the specific issue of infrastructure financing by Member States, exceeding borrowing costs incurred on loans to fund long-term infrastructure projects should at least benefit from an exclusion clause, as already provided for in the ATAD 1 Directive.[4]

For the aforementioned reasons, **FIEC calls for the <u>deletion</u> of this provision aimed at reinforcing the limitation of the deductibility of financial charges in favour of the existing rules**.

2

Consequences of strengthening the use of equity capital

The DEBRA proposal also includes a separate measure on notional interest allowance on changes in the company's equity level.[5] The proposed allowance on equity would be calculated based on the difference between net equity at the end of the current and previous tax years, multiplied by a notional interest rate calculated over a 10-year period.

While FIEC welcomes the creation of a tax advantage for increasing equity capital, it wishes to highlight some potential shortcomings of the new measure:

1. The proposed tax system, its duration, and the rate of the risk premium (1.5% for SMEs or 1% for non-SMEs)[6] are low, regarding the current inflation, and rigid. More flexibility should be introduced.
2. The current rise in interest rates tends to reduce the liquidity of investors. As such, they will have to resort more to borrowing as they cannot be financed solely by equity capital.
3. The aim of increasing the use of equity capital can also have an impact on both corporate governance, with the potential introduction of new stakeholders, and business transfers – especially problematic for SMEs – which are in general financed through debts.

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[3] FIEC Statistical Report (2022)

[4] ATAD 1, Art 4 (4) - "Member States may exclude from the scope of paragraph 1 exceeding borrowing costs incurred on: b) loans used to fund a long-term public infrastructure project where the project operator, borrowing costs, assets and income are all in the Union".

[5] DEBRA Proposal, Art. 4

[6] DEBRA Proposal, Art. 4(2)