FESE response to the Commission consultation on DEBRA

6th October 2021, Brussels

Questionnaire

1. Current issues

Q1. To what extent do you agree or disagree with the following statements on the indebtedness of non-financial corporations in the EU?

	strongly agree	agree	neutral	disagree	strongly disagree	don't know
High levels of debt make enterprises more vulnerable to insolvency.	☒	☐	☐	☐	☐	☐
High levels of debt make enterprises more profitable.	☐	☐	☐	☒	☐	☐
High levels of debt are due to lack of other financing options.	☐	☐	☐	☒	☐	☐
Debt levels of large non-financial enterprises are too high.	☐	☒	☐	☐	☐	☐
Debt levels of small and medium sized enterprises (SMEs) are too high.	☐	☒	☐	☐	☐	☐

Q2. In your view, how high is the proportion of debt compared to equity for non-financial corporations in your country?

☐ Not more than 25%

☐ 25% - 50%

☐ 50% - 75%

☐ 75% - 100%

☐ 100% - 125%

☐ 125% - 150%

☐ 150% - 200%

☐ More than 200%

Q3. In your view, how high <u>should</u> the proportion of debt compared to equity be for non-financial corporations in your country?

☐ Not more than 25%

☐ 25% - 50%

☐ 50% - 75%

☐ 75% - 100%

☐ 100% - 125%

☐ 125% - 150%

☐ 150% - 200%

☐ More than 200%

Q4. How much do you agree or disagree with the following reasons for enterprises to finance their investments through debt rather than equity.

Enterprises use debt to finance investments …

	strongly agree	agree	neutral	disagree	strongly disagree	don't know
… to increase the return on equity.	☐	☐	☒	☐	☐	☐
… because they have no or only limited access to equity financing.	☐	☐	☐	☒	☐	☐
… because interest levels are low and thus debt financing is cheap.	☐	☐	☐	☐	☐	☐
… to diversify risk.	☐	☐	☐	☐	☐	☐
… to reduce their tax liabilities.	☐	☒	☐	☐	☐	☐
… to avoid the dilution of voting rights of their main shareholders.	☐	☒	☐	☐	☐	☐
… for other reasons (dialog box with free text will open)	☐	☒	☐	☐	☐	☐

Please specify the other reasons: *(500 character(s) maximum)*

Taxation on public equity deters investment in companies listed in the EU. In respect to the debt-equity bias, interest payments on debt may be deducted from profits before they are taxed, whereas equity financing does not receive any form

of tax relief. EU Financial instruments (guarantees) are making debt even cheaper because enterprises have no collateral cost. With interest rate tax deduction and no collateral costs, debt financing is cheaper compared to equity.

Q5. Do you think that enterprises in the EU should be encouraged to use less debt financing and more equity financing?

☐ Strongly agree

☒ Agree

☐ Neutral

☐ Disagree

☐ Strongly disagree

☐ Don't know

Q6. Do you have further points you would like to raise in relation to the indebtedness of the business sector in general or on the ratio of debt to equity specifically? *(1000 character(s) maximum)*

Companies should be encouraged to consider strengthening their equity base as an alternative to debt financing. The CMU framework should incentivise companies to access financing opportunities available on capital markets and enable investors to invest in EU companies, including SMEs (i.e. market capitalisation < EUR 1 bn). A possibility is to consider lowering taxes on investors' public equity investments as well as to consider providing provisions to incentivise companies' listings on the EU's capital markets. In addition, the harmonisation of tax procedures could be considered. The issuance of equity is a credible funding alternative that avoids the risk of having to rely on credit financing as the only source. In addition, it could lower the risk of a high debt-to-equity ratio. Naturally, the optimal level of debt differs per economic sector and across economic cycles, and there are legitimate non-tax reasons (e.g. relating to capital costs) for companies to opt for debt financing.

2. Possible Solutions

Several Member States have introduced measures to limit the ratio of debt to equity by limiting the deductibility of interest payments. Other countries have introduced a tax allowance on equity to counter the debt-equity bias. This is often done by allowing the deduction of a notional interest rate on equity.

Q7. How much do you agree or disagree with the following statements about existing Member State measures to support equity financing?

National initiatives which tackle the tax debt-equity bias …

	strongly agree	agree	neutral	disagree	strongly disagree	don't know

… are preferable to an initiative at the EU level since they can be better targeted to the needs.	☐	☐	☐	☒	☐	☐
… are creating difficulties for enterprises operating in the single market across countries.	☐	☒	☐	☐	☐	☐
… are a form of tax competition among countries.	☐	☒	☐	☐	☐	☐

Q8. How much do you agree or disagree with the following statements about an EU initiative to mitigate the debt-equity bias?

An EU-wide initiative which tackles the tax debt-equity bias …

	strongly agree	agree	neutral	disagree	strongly disagree	don't know
… would be a useful tool to support the recovery of companies from the COVID-19 crisis and incentivise investment through equity in the transition to a greener digitalised economy without creating distortions in the single market.	☐	☐	☐	☐	☐	☐
…would reduce tax competition among Member States.	☐	☐	☐	☐	☐	☐
…would be beneficial for enterprises operating in the single market across countries.	☐	☐	☐	☐	☐	☐
…is not necessary: the tax debt equity bias should be addressed at Member State level.	☐	☐	☐	☐	☐	☐
…is not necessary: there is no such thing as a tax debt-equity bias.	☐	☐	☐	☐	☐	☐

The tax debt bias could be addressed via several possible policy options. When considering the options below, the respondent should assume that the overall impact on the tax costs for corporations and tax revenues for Member States will be neutral, even though the possible offsetting measures remain at the discretion of each Member State. As an example, the policy option to mitigate the debt equity bias could be combined with a change in the corporate tax rate to ensure that the global impact on tax revenues of Member States and on tax costs for corporations is neutral.

Q9. In your view, which option would be best suited to address the debt-equity bias? Please rank the options from 1 (most suited option) to 4 (least suited option).

	1 (most suited option)	2	3	4 (least suited option)
Option 1: Disallow any financing costs as deductible expense.	☐	☐	☐	☒
Option 2: An allowance on equity that provides for the deductibility of a notional interest on all equity (maintaining the existing interest deductibility).	☐	☐	☒	☐
Option 3: An allowance that provides for the deductibility of a notional interest on new equity (maintaining the existing interest deductibility).	☐	☐	☒	☐
Option 4: An allowance on corporate financial capital (financial debt+equity) that would replace the tax deduction of interests.	☐	☒	☐	☐
Option 5: other	☒	☐	☐	☐

If other, please explain shortly which type of measure should be envisaged and how it should be designed? *(1000 character(s) maximum)*

FESE encourages policymakers to consider the different characteristics of public equity and debt markets when undertaking capital markets regulatory initiatives. Some of the fiscal arrangements currently in place act as a barrier to incentivise investors' participation in the EU's public capital markets. A review should not result in new fiscal barriers for debt financing but rather be aimed at removing and/or alleviating the existing burdens on public equity financing, creating a level playing field between these two sources. To orient more investor/investment flows towards listed equity instruments, regulatory disincentives that suppress investor demand, or the creation of new taxes specific to the trading/investment in public equities, should be avoided. This approach would strengthen the overall attractiveness of European public markets (see also final remarks).

Sweden is a successful example where a special tax treatment of savings in funds and equities has promoted investments.

Q10. Following the European System of Accounts 2010, the working definition of equity is: "equity is a financial asset that is a claim on the residual value of a corporation, after all other claims have been met". Do you consider this definition useful or would you propose an alternative definition?

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☐ Definition useful

☒ Definition not useful, I would propose an alternative

What alternative definition of 'equity' would you suggest? Ideally explain your proposal. *(1500 character(s) maximum)*

Corporate equity is a financial instrument representing many benefits given by a corporate and that can be issued to investors. These benefits include possible dividend rights and a claim on the value of a corporation after all other claims have been met. Equity instruments are traded on secondary markets and their value varies depending on the performance of the corporate issuing them and offer/demand for such instruments.

Q11. When a tax allowance for corporate equity is granted (as in policy options 2, 3 and 4), a notional interest rate needs to be determined. The notional interest rate will be determined based on a risk free market interest rate in order to take annual interest rates variations into account. In addition a risk premium can be added to the risk free rate for calculating the notional interest rate. How high do you think the notional interest rate should be?

The notional interest rate for an equity allowance should be:

☐ equal to the risk free interest rate + 0.5%

☐ equal to the risk free interest rate + 1%

☐ equal to the risk free interest rate + 1.5%

☐ equal to the risk free interest rate + 2%

☐ equal to the risk free interest rate + 2.5%

☐ equal to the risk free interest rate + 3%

☐ higher

What notional interest rate would you suggest? *(50 character(s) maximum)*

Please explain your response and/or provide further comments. *(500 character(s) maximum)*

Q12. In view of better addressing financing issues for Small and Medium Enterprises (SMEs), do you think that a more generous notional interest rate should be granted to SMEs?

☐ Strongly agree

☒ Agree

☐ Neutral

☐ Disagree

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☐ Strongly disagree

☐ Don't know

Please explain your response and/or provide further comments. *(500 character(s) maximum)*

Recognising that SME companies may represent higher risk levels, tax incentives for long-term investors in SMEs specifically could also be considered for incentivising long-term investments. The Commission should conduct a study on tax incentives for SMEs, specifically when they are seeking debt or equity financing. This should include an overview of existing incentive practices in the EU, assessing various national regimes, and identification of best practices to adapt on a pan-European level.

Q13. How much higher do you think the notional interest rate should be for SME compared to the notional interest rate applied to larger enterprises?

☐ +0.5 percentage points

☐ +1 percentage points

☐ +1.5 percentage points

☐ +2 percentage points

☐ +2.5 percentage points

☐ +3 percentage points

☐ higher

How much higher do you think the notional interest rate for SMEs should be compared to larger companies? *(100 character(s) maximum)*

Q14. For a tax allowance for corporate equity (options 2, 3 and 4 above), do you agree that such a proposal should include robust rules to protect it against being used for aggressive tax planning?

☐ Strongly agree

☒ Agree

☐ Neutral

☐ Disagree

☐ Strongly disagree

☐ Don't know

You indicate that you disagree with rules against aggressive tax planning. Could you please explain? *(1000 character(s) maximum)*

Q15. Please evaluate the following elements in terms of effectiveness to make an allowance for equity more resilient to tax avoidance by expressing your (dis-) agreement with the following statements.

In order to prevent abuse of an allowance for equity for aggressive tax planning purposes, it is necessary to…

	strongly agree	agree	neutral	disagree	strongly disagree	don't know
… add a general anti-abuse provision that would deny notional deduction for operations carried out without any substantial economic purpose or carried out with related parties and that have the main purpose of converting old equity into new equity with the aim of benefiting from the notional deduction.	☐	☐	☐	☐	☐	☐
… exclude cascading through intra- group loans and loans involving associated enterprises;	☐	☐	☐	☐	☐	☐
… exclude cash contributions and contributions in kind;	☐	☐	☐	☐	☐	☐
… exclude capital increase subscribed by the company or one of its subsidiaries (own shares);	☐	☐	☐	☐	☐	☐
… exclude intra-group transfer of participations;	☐	☐	☐	☐	☐	☐
… prevent re-categorisation of old capital as new capital through liquidations and the creation of new companies;	☐	☐	☐	☐	☐	☐
… exclude acquisitions of businesses held by associated enterprises	☐	☐	☐	☐	☐	☐
… exclude assets not linked to the activity	☐	☐	☐	☐	☐	☐

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Other (please specify)	☐	☐	☐	☐	☐	☐

Please explain which anti-abuse provision you would include in the proposal to make the EU level equity remuneration allowance more resilient to tax avoidance. *(1000 character(s) maximum)*

3. Final remarks

Option to upload a brief document, such as a position paper in case you think additional background information is needed to better explain your position or to share information about data, studies, papers etc. that the European Commission could consider to prepare its initiative.

The level of taxation in the investment or trading of shares of a company is a component of the debt-equity structural bias.

We encourage EU policymakers to consider the different characteristics of public equity and debt markets when undertaking capital markets regulatory initiatives. A review of fiscal arrangements should not result in the creation of new fiscal barriers for debt financing, but should rather be aimed at removing and/or alleviating the burdens on equity financing to create a level playing field. New or existing tax and regulatory disincentives that suppress investor demand should be avoided.

An EU-wide approach would reduce tax competition and fragmentation, establishing a common approach. Six EU countries (Belgium, Cyprus, Italy, Malta, Poland, and Portugal) have already introduced national rules to mitigate the bias. However, we recognise that the decision to issue equity or debt is not solely tax-driven as other economic and strategic factors also play a role.

FESE wishes to stress that initiatives aimed at eliminating the debt-equity bias should not impose new barriers to debt instruments; rather, new policies should result in investors paying lower taxes on their equity investments, incentivising the provision of equity capital as an alternative source of funding. It is worth mentioning that both debt and equity instruments will be instrumental to help to transition towards a more sustainable economy. For instance, "use of proceeds" debt instruments provide the transparency and assurance that investors' money will be used to support dedicated sustainable projects with actual impacts.

These new policies could be undertaken by the Commission's targeted revision of the Guidelines on State aid to promote risk finance investments (the "Risk Finance Guidelines"), with the aim at facilitating access to finance by SMEs and medium capitalisation companies. As they currently stand, EU risk finance policies are based on the assumption that "companies listed on the official list of a stock exchange or a regulated market cannot be supported through risk finance aid, since the fact that they are listed demonstrates their ability to attract private financing" (Commission Communication 2014/C19/04). This assumption should be challenged in order to allow new policies to support SME listings on public markets at the national level, notably in the context of the new CMU Action Plan which aims to alleviate listing constraints and encourage investor participation in SMEs.

FESE believes that the Commission should implement recommendation 11 of the Technical Stakeholder Expert Group (TESG) on SME Growth Markets, in which the Commission should

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consider enabling Member States to support SMEs facing difficulties in gaining access to capital markets. More specifically by:

- Having companies with a market capitalisation of €1 billion (i.e. Small Medium Capitalisation Companies), become beneficiaries of the Risk Finance Guideline, to allow such companies to benefit from tax incentives that would be compatible with State Aid rules.
- Amending Article 24(2) of the General Block Exemption Regulation (GBER) to clarify that aid for scouting costs can be extended to support SME investment research in unlisted SMEs.
- Clarifying that studies (commissioned and funded by the Commission) proving the existing public equity capital market failure in the EU may be used by Member States to prove such failure in the clearance procedure.

In addition, FESE believes that the Commission:

- Could consider encouraging Member States to introduce tax benefits to stimulate investors' participation in SMEs listed in their jurisdictions. For example, we believe that SME market segments could be relieved of dividend tax for investors investing in listed SMEs.
- Could encourage SMEs to create and promote SME dedicated investment vehicles, incentivising individual investors to pursue either an active or passive investment strategy on capital markets. This can be done by introducing tax incentives that have proven to be effective in the past (e.g. in France with the creation of the PEA-PME investment vehicle).
- Could consider encouraging Member States to stimulate the SME market segment by using government-funded repayable loans to cover SMEs' IPO expenses, repayable by the SME after it has raised funding on the public markets. This would help SMEs cover pre-IPO costs for roadshows and advisory services (audit, equity, communication, etc..).