Debt-equity bias reduction allowance (DEBRA)

Feedback of CREFC Europe on the European Commission's 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

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We support initiatives to encourage productive and sustainable investment in the European economy, but we do not think the debt-equity bias is as real or pervasive as the Commission appears to believe, and while we express no opinion about the proposed allowance on new equity, we have serious concerns about the proposed limitation to interest deductions. In brief:

(1) A loan and an equity investment are very different things in commercial terms: a lender provides a (financial) service for a capped return (a finance charge), whereas an equity investor is an owner of the investee business (with rights to profit distributions). A great deal of productive and sustainable long-term funding for business takes the form of (low risk, low return) debt. This is certainly the case in the capital intensive context of the built environment and real estate. Where debt is genuine, commercially priced, third party debt, it is both reasonable and usual for tax relief to be available for that business cost. Distributions of profit on the other hand are just that - they are not a cost of the business.

(2) For many businesses (including SMEs), debt may be a more attractive source of additional capital than equity not because of its tax characteristics, but because it comes at a fixed cost. Borrowing allows equity capital to be leveraged to drive growth without loss of control, diluting ownership or giving up super-profits. Debt also offers attractive risk/returns to institutional (and other) investors, and real estate debt has the additional characteristic of an illiquidity premium that suits life companies, for example. There are likely to be unintended consequences from a heavy-handed legislative intervention designed to distort the market away from debt towards equity.

(3) For most non-financial businesses, "exceeding borrowing costs" will mean "borrowing costs", as they are unlikely to have material amounts of interest receipts. In effect, therefore, the directive proposes an arbitrary restriction on tax relief for financing costs, making debt (the cheapest form of capital because it is low risk/return compared to equity) more expensive. That will be a problem for businesses with existing and/or involuntarily high leverage.

(4) Real estate is a long-term, capital intensive industry, in which both income (rent under a lease) and outgoings (including financing costs on debt) are typically fixed for many years in advance and therefore predictable. That characteristic makes real estate attractive for institutional capital. Yet many existing arrangements, which may have been structured on the assumption of tax relief under existing rules, may come under pressure if interest relief is suddenly and arbitrarily to be denied for part of the debt from 1 January 2024 (which is less than 18 months away). Some form of grandfathering for existing arrangements should be considered, or commencement of the interest restriction significantly delayed.

(5) The proposed exclusion of "financial undertakings" gives rise to a familiar problem for the real estate industry, insofar as both (a) entities classified as "financial undertakings (e.g. AIFs) and (b) entities not so classified (e.g. listed or private companies and other vehicles) are routinely used to develop, own and manage real estate assets. Are the competition, market distortion and arbitrage risks for the real estate sector that result from this approach to scope understood, considered and justified?

We are not implacably opposed to the proposed measure. However, great caution is needed before introducing it at a time of involuntarily (GFC or pandemic-induced) high leverage, and its impact on existing arrangements could be damaging and counterproductive. If it is to be taken forward, a slower, more gradual implementation would be advisable.

The document uploaded with this response [*reproduced below*] sets out our views more comprehensively and in a little more detail.

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Feedback of CREFC Europe on the European Commission's 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

We are grateful for the opportunity to comment on this initiative. CREFC Europe is a trade association promoting a diversified, sustainable and successful real estate finance market in Europe that can support the real economy without threatening financial stability. Our membership includes a range of bank and non-bank lenders, intermediaries and advisory businesses, as well as real estate firms that use debt to finance their activities.

Our feedback largely builds on our responses to the DEBRA Roadmap and Full Consultation.

The "debt-equity bias"

As we have previously tried to explain, a loan and an equity investment are very different things in commercial terms: a lender provides a (financial) service for a priority but capped return (a finance charge), whereas an equity investor is an owner of the investee business (with rights to profit distributions, which are potentially unlimited, but also uncertain). Debt can improve the returns to equity owners (allowing their investment to go further, and with a limited and known impact on profits), but it adds risk (because the debt must be serviced, unlike profit distributions which can be reduced or stopped in challenging times). It is right, therefore, that the tax treatment of finance charges and equity distributions is different, provided of course that loans are not used as a vehicle for equity investment (and there is much national and EU legislation designed to prevent that).

We are pleased that the Commission has not proposed eliminating all deductibility for debt. However, it is disappointing and troubling that officials seem to find it difficult to accept that the premise that the tax system creates a bias against equity investment simply by treating debt differently is misconceived. Debt is treated differently because it is different. Tax treatment undoubtedly has some impact, but the (tax) tail does not, on the whole, wag the (commercial) dog.

We strongly support measures to encourage productive investment, whether through the deployment of (typically debt) capital seeking lower risk and returns, or through the deployment of (typically equity) capital seeking higher risk and returns. Some businesses may prefer to dilute their equity than to borrow. Other businesses prefer to borrow, leveraging their equity investment with some debt; and institutional investors may be attracted by the risk/return characteristics of lending to, rather than taking equity positions in, businesses. One approach is not inherently better than the other, for businesses or for investors – but they are different in commercial substance and effect.

Specific comment on Recital (1) – rationale

A great deal of productive and sustainable long-term funding for business takes the form of (low risk, low return) debt. It is both reasonable and usual for tax relief generally to be available for the cost of debt that is commercially priced and provided by an unconnected third party, because it is a cost of the business incurred in connection with inputs (loan capital) intended ultimately to drive higher profits. Far from minimising "unintended distortions", the proposed restriction of tax relief for so called "exceeding borrowing costs" is likely to create distortions.

Debt in the real estate economy

Levelling the tax playing field by giving tax relief (traditionally targeted at business costs) to distributions of profit may or may not be a good policy idea; but we oppose measures that arbitrarily restrict the tax deductibility of commercially priced, third party financing costs, especially if existing debt is affected. Such measures will increase the cost of capital (by increasing the cost of debt, which is generally the lowest cost capital) for businesses. That is a particular concern for sectors where substantial use of leverage is structural and widespread – like the capital intensive real estate and infrastructure markets.

Specific comment on Recital (7) and Article 6 – limitation to interest deduction

The specific mechanism based on the "exceeding borrowing costs" definition seems to us to be poorly designed. Using "interest paid minus interest received" may be a suitable approach in the context of financial businesses that receive significant amounts of interest (though we also understand why, having use that formulation, you chose to exclude financial undertakings). Given that "interest received" is generally likely to be relatively immaterial for most ordinary businesses, it would seem that effectively all the interest paid on genuine, commercially priced third party debt will be characterised as "exceeding borrowing costs" and thus as subject to a restriction on tax relief.

It strikes us as disingenuous and misleading to use language that implies some kind of "excess" when, in fact, the measure simply proposes to reduce the relief available for business borrowings by 15%. The fact that ATAD and a raft of national anti-avoidance provisions would not restrict the deductibility of such interest costs is irrelevant in this context – so relief will be denied where policymakers have not previously found a justification for restricting tax deductions.

As we wrote in our response to the European Commission's 2015 CMU Green Paper:

> *We suspect that too much prominence is being attributed to the deductibility of debt finance as a reason for its widespread use. In a commercial real estate context, and probably across other sectors of the economy, there are powerful commercial reasons for using debt finance, including:*
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> - ***Debt is vital to equity constrained investors.*** *Debt finance opens up investment opportunities that would otherwise not be possible because of the high cost of equity (which bears higher risks and therefore requires higher returns than debt). This helps to drive economic growth.*
>
> - ***Debt allows for greater risk diversification.*** *Borrowing money means you can afford to commit less equity to individual investments and can gain investment exposure to a greater range of investments. This reduces the vulnerability of portfolios and helps to smooth overall returns.*
>
> - ***Debt can be more flexible than equity.*** *Borrowing arrangements can also be tailored to reflect individual circumstances and can be periodically renegotiated. The greater accessibility and flexibility of debt allows funding to be provided to investment opportunities more quickly which ultimately facilitates quicker economic growth.*

While we disagree with the Commission's insistence that there is a "debt-equity bias", we accept that there is nothing sacred about the particular tax treatment of debt and equity to which we are accustomed. There is no 'neutral' tax environment for different forms of capital, just as there is no 'neutral' balance between equity and debt for businesses across the economy. However, the proposals are also problematic in another way.

Specific comment on Recital (4) and Article 2 – scope

While we do not object to the proposed exclusion of financial undertakings from the scope of the proposed directive, we would point out that distortions are likely to arise in the context of (at least) real estate investment. Real estate is developed, owned and managed through a variety of vehicles, including AIFs and potentially securitisation special purpose entities, but also including listed property companies (including REITs or real estate investment trusts) private companies and joint ventures or other vehicles falling outside the scope of financial regulatory frameworks. In very broad terms, we would suggest that the exclusion from scope of financial undertakings would tend to apply to larger, lower-leveraged firms, while smaller, sometimes higher leveraged firms would still be in scope.

Has consideration been given to the implications for competition and markets of applying the financial/non-financial distinction in a way that slices through the real estate sector, leaving some market participants in scope and others out of scope? A similar question may arise in other contexts.

'Involuntarily' high leverage, financial stability and grandfathering

Interventions that significantly change the existing tax environment carry risks. Some businesses are more highly leveraged than others. That may be because of an investment strategy choice, or owing to the availability, cost and characteristics of different forms of capital at the relevant time, or because of the characteristics of the sector in which they are active (as mentioned above, higher leverage is common in the capital intensive real estate and infrastructure markets, for example).

Such higher leveraged businesses will obviously be most adversely affected by measures that increase their cost of capital by restricting the tax relief available in relation to their existing external borrowings. Measures with that effect should be approached with particular caution at a time when market stress and rising interest rates may render businesses with higher leverage more financially vulnerable as it is.[1]

The staff papers accompanying the proposal make numerous references to the relationship between high leverage and financial stability. It is undoubtedly the case that excessive leverage in a system can introduce instability (as we saw in the global financial crisis, for example). On the positive side, leverage can increase firepower, diversify investments, and amplify equity returns – but it does so by adding risk. Generally, leverage seems attractive when people feel optimistic (the debt will be repaid and the equity will enjoy super-profits), but optimism can become excessive exuberance, and leverage can change from smart to unwise when the cycle turns, the market crashes and the optimism evaporates.

The 2014 independent industry report A Vision for Real Estate Finance in the UK explored, in the aftermath of the GFC, how risks associated with the property cycle can best be addressed to ensure that credit is available to support the real economy without presenting unacceptable risks to financial stability. The report's analysis and recommendations (which did <u>not</u> include leverage caps or tax deductibility restrictions) are also relevant to the EU.

[1] They should also be approached with caution when – as is the case in the real estate sector – green transition and decarbonisation impose a substantial need for capital investment, at least partly via debt. We are not convinced by the EIB's assertion, quoted in the Commission staff's impact assessment report, that green investments are "likelier to be financed by risk-taking and risk-absorbing instruments such as equity". Lenders have a key role to play, and some (most notably Dutch banks using the CFP Green Buildings tool) have been showing how this can be done.

Two important points should be considered in this context:

(i) Is EU corporate debt high because businesses want high leverage and lenders are willing to provide it, or is it a legacy of different times when asset values, cash flow forecasts and prospects were better, a legacy that is still with us after those values, cash flows and prospects fell? We believe that to a considerable degree the latter is true[2], and the high leverage that can be observed is largely involuntary. Even if tax relief helped motivate that leverage, measures (such as new interest deductibility restrictions) that increase the cost of existing debt are likely to add stress to the system. That could make the transition to a lower leverage system traumatic.

    Neither borrowers nor their lenders will welcome a reduction in the net cash available to service existing debt which is higher than anyone anticipated because the macroeconomic environment has deteriorated. Does the Commission have evidence to suggest that equity capital will be available at lower cost to replace that debt? What will happen to businesses whose cash flows cannot sustain existing debt levels when tax deductibility is restricted, and which cannot refinance excessive debt with equity?

(ii) More specifically, how will a new measure affect existing arrangements that may not be susceptible to commercial amendment? In the real estate sector, many asset owners will have fixed their income through multi-year leases, while also having predictable outgoings under secured loan agreements. The cash flows, as well as interest or debt service coverage-related financial covenants in the loan documentation, will have been based on tax deductibility under pre-existing rules. An arbitrary restriction on tax relief may tip some such borrowers into covenant breaches (or even payment defaults).

    We consider that grandfathering provisions should exempt existing arrangements from the new deductibility restriction, or the new measure is likely to increase corporate financial fragility and may threaten financial stability. A material adverse tax change with less than 18 months' notice should be avoided.

Specific comment on Article 11 – Transposition (commencement provisions and grandfathering)

The Commission has provided for grandfathering where a member state already has national provisions for an allowance on equity. It should also provide for grandfathering in relation to existing loans and financing costs of borrowers. In the real estate context, assets are likely to be held for several years (this is a long-term investment asset class), with leases generating predictable income and borrowings requiring predictable debt service payments. Business models may well be relying on tax deductibility of third party debt to make those predictable cash flows add up. Businesses may be unable to make necessary adjustments before the proposed commencement date of 1 January 2024, less than 18 months away. It would be unfortunate for a measure intended to promote productive and sustainable investment to introduce a new source of financial fragility for businesses already facing rising inflation and energy costs and an uncertain growth outlook.

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[2] We interpret the ECB's November 2020 finding (cited in the Commission staff's impact assessment report) that "the deterioration in NFC financial health was largely driven by a drop in sales, lower actual and expected profitability, and an increase in leverage and indebtedness" as suggesting precisely this. Leverage did not increase (certainly did not only increase) because NFCs decided to borrow more in challenging times (although many governments encouraged that to get them through the pandemic). Leverage increased because asset values, revenues and profitability fell (the "pandemic has resulted in high debt levels", as the report notes). The same phenomenon is seen with real estate loan-to-value (**LTV**) ratios. LTVs rise if borrowers and lenders choose to borrow/lend more (the numerator L increases); but they tend to reach dangerous levels when values fall (the denominator V shrinks) – see A Vision for Real Estate Finance in the UK.

For existing businesses with external debt that is rendered more expensive by this proposal, replacing that debt with new equity is likely to be more expensive notwithstanding the new allowance, because equity investors require a higher return to compensate them for the greater risk they take, compared to lenders. A proposal that purports to remove a bias seems likely, instead, to increase both financial fragility and the cost of capital for many businesses.

This is not to express total hostility to the proposed measure. However, great caution is needed before introducing it at a time of involuntarily (GFC or pandemic-induced) high leverage, and its impact on existing arrangements, could be damaging and counterproductive. If the measure is to reduce financial fragility at the level of individual businesses and enhance financial stability, a slower, more gradual implementation would be advisable.

As we wrote in our CMU Green Paper response in 2015 (still relevant because of the pandemic):

> *Restricting the deductibility of debt would pose an enormous transitional challenge for all businesses and over the longer term would disadvantage those industries that – by virtue of being inherently capital intensive or higher risk – are structurally reliant to a greater extent on debt finance. That would include infrastructure and commercial real estate, and may well also include many up-and-coming SMEs. Accordingly, any proposals to change the tax treatment of debt finance need to be carefully thought out, the reasons for effecting the changes must be clear and it must be reasonably certain that the desired outcome could not be achieved through other means.*

In summary

- we consider that arbitrarily restricting the tax deductibility of interest paid to an unrelated third party lender for credit provided on commercial terms would be damaging for European businesses, markets and the economy, reducing investment and raising the cost of capital generally, introducing new distortions to the market, and (in the absence of grandfathering provisions to protect existing arrangements) needlessly increasing the financial fragility of businesses with (largely involuntarily) high existing levels of leverage;

- there are already extensive rules at national, EU and international level to combat excessive and tax-driven use of debt, and no evidence has been provided to suggest that these are inadequate (indeed, the use of the word “exceeding” in the phrase “exceeding borrowing costs” is disingenuous and misleading, because it implies something excessive even though the restriction in fact simply applies to borrowing costs); and

- we have no opinion on the proposed introduction of an allowance for equity investment, although we remain doubtful whether the cost of such a measure can be justified by its likely economic benefits. It is unfortunate that the need to address that (in our view, speculative) cost is the only justification for the proposed limitation on interest deductibility.

If you have any questions or would like to discuss our submissions, please contact Peter Cosmetatos, chief executive of CREFC Europe (+44 7931 588451 or pcosmetatos@crefceurope.org) in the first instance.