DEBT FINANCING COSTS FROM THE TAX LAW PERSPECTIVE: LEGACY TREATMENT VS. RECENT DEVELOPMENTS

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Abstract: *The paper explores the development of tax rules governing debt financing cost and analyses factors that have led to a rapid shift away from legacy treatments based on very general and somewhat soft limitations on tax deductions of excessive debt in recent years. The new concepts of excessive financing costs, hybrid instrument mismatches, minimum effective tax, misuse of shell entities, and debt-equity bias reduction are examined on the background of legacy concepts like thin capitalisation and transfer pricing.*

Keywords: *debt financing costs, thin capitalisation, excessive financing costs, debt-equity bias reduction allowance*

1. INTRODUCTION[1]

Tax law has historically treated debt financing as a legitimate source of finance to support and expand business activities. Consequently, costs incurred in debt financing have been allowed to be deducted from the corporate income tax base. However, over time, the deduction has become subject to limitations aimed at preventing companies from taking on an excessive level of debt as a substitute of capital, for which no deduction has traditionally been available. Too much debt not only weakens the financial stability of a business but also reduces income tax paid and therefore the tax revenues of public budgets.

The goal of this article is to explore the development of these limitations in the context of Czech tax law. The hypothesis is that the originally somewhat benevolent, almost *laissez-faire* approach of the legislator has ultimately developed into a very complex structure of specific limitations aimed at discouraging businesses from taking advantage of too much debt, and that the primary driver of these developments has been deeper international cooperation focusing more on level playing field rules than on the benefits of tax competition and country competitiveness, in particular among member states of the European Union (EU). This phenomenon is examined primarily using the research methods of deduction, induction, analysis and synthesis, mainly in the context of EU and Czech tax law frameworks.

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2. DEBT FINANCING

The temporary provision of funds to a business by a professional provider, namely a bank, has traditionally served to finance the activities of the business and its growth, be it scaling up production, investments into resources, or the development of new products. It is more advantageous for a business to seek debt financing instead of new capital, as the costs related to debt financing, in particular interest costs, are deductible from the business's corporate income tax base and thus offer the real benefit of having to pay fewer taxes. This is very different from the costs of capital. In a strict accounting sense, cost of capital cannot be deducted for tax purposes. Even in a wider sense, where dividends paid to the investors of the capital may be viewed as remuneration to the provider of the financing, no tax deduction for dividends paid has traditionally been available.

The differences in the treatment of debt and capital financing have historically created a bias that has led businesses to prioritise debt financing, further creating an incentive for groups of companies to fund their subsidiaries with intra-company loans instead of capital injections. With no limitation on the amount of the debt deduction, from the group financial management perspective, the headquarters of the group may be encouraged to leverage a group subsidiary with as much debt as possible, even if interest costs completely offset profit before interest. As a result, the income tax liability of the subsidiary may be significantly reduced or even eliminated. Within one country, this might be balanced out by a corresponding increase in taxable profit of the debt finance provider resulting from increased interest revenues. However, the provider may very well not be a taxpayer in the same country but based in a low or no tax jurisdiction, so on balance, a real and tangible financial advantage is gained. Already around the 1970s, several developed countries began to introduce rules limiting excessive interest deductions to protect their public budgets. This process significantly accelerated in the last few years, also due to an increased focus of the European Commission on the mitigation of tax inequalities and the harmonisation of a level playing field for income taxation.

3. LEGACY TREATMENT OF DEBT FINANCING COST

A very typical legacy treatment of debt financing costs has been to subject these only to the general deductibility test in relation to taxable income. In other words, if it could be demonstrated that the costs related to a business activity that generates or is expected to generate tax profits, the costs could be fully deducted.

This was the default treatment of debt financing costs in the completely new tax system in the newly created Czech Republic at the beginning of 1993. Section 24 (1) of the new Income Tax Act (ITA)[2] effective from 1 January 1993 established a general cost deductibility test that required proving (with the burden of proof resting with the taxpayer) that the costs were incurred to generate, ensure, and maintain taxable income. This very test has remained effective and unchanged to this day. If costs are demonstrably related to taxable income, they are deductible. The debt financing of assets or

[2] Section 24 (1) of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.

working capital or the on-lending of debt to another company usually fall within this category. Complications arise when the debt is used to finance assets that in turn generate income which is not fully taxed or taxed through different mechanics and possibly at a different and usually lower rate.

3.1 No-tax income

Although it can logically be derived from the general deductibility test that costs related to income which is not taxable are not deductible, a specific provision of Section 25 (1) i) of the ITA has nonetheless stated this explicitly (and consistently) since 1 January 1992.[3] One example are the borrowing costs of investments into government bonds, the income from which is tax exempt. No deduction for the financing costs of this investment is available because the resulting profit is also not taxable.[4]

The list of types of income exempt from tax changed over the years but was never too wide, and included, e.g., government bonds, mortgage bonds,[5] and bonds issued by Czech issuers outside of the Czech Republic.[6] The list was extended by the elimination of the taxation of dividends from qualified EU subsidiaries in 2004,[7] based on the implementation of the EU Parent-Subsidiary Directive.[8] Subsequently, a new provision of Section 25 (1) zk) of the ITA[9] correspondingly required all financing costs related to EU subsidiaries to be disallowed, and certain additional rules were enacted to mitigate any possible evasion. These included the rebuttable presumption that any debt undertaken by a Czech parent company within 6 months prior to the acquisition of shares in a EU-based subsidiary is always deemed to relate to the acquisition, thus rendering all financing costs non-tax deductible, unless proven otherwise.

3.2 Low-tax income

The provision of Section 25 (1) i) of the ITA includes not only a rule explicitly disallowing costs related to income which is not taxed, but also a rule which disallows costs related to income which is not taxed within the standard corporate income tax base, i.e., income which is not exempt from tax as such but is not taxed in the same way and usually not at the same rate as standard income.[10]

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[3] Section 25 (1) i) of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.

[4] This is a reflection of the *principle of symmetry of taxable revenues and deductible expenses.* The principle under which expenses related to income not taxed cannot be attributed to (combined with) expenses related to income taxed is outlined in Section 23 (5) of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.

[5] Income from mortgage bonds was exempt from tax until 31 December 2007, see Section 19 (1) l) of the Income Tax Act effective before 1st January 2008.

[6] Exemption was applied to interest income of tax non-residents defined in Section 17 (4) of Income Tax Act, No 586/1992 Sb., as amended.

[7] Provision of Section 19 (1) ze) of the Income Tax Act, No 586/1992 Sb., which came into effect on 1st May 2004.

[8] Council Directive 2011/96/EU of 30th November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states, L 345/8. In: *Official Journal of the European Union* [online]. 29. 12. 2011 [2023-04-25]. Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011L0096>.

[9] See Section 25 (1) zk) of the Income Tax Act, No. 586/1992 Sb., as subsequently amended, which came to effect on 1st May 2004.

[10] Provision 25 (1) i) of the Income Tax Act, No. 586/1992. Sb. refers since its original wording effective 1st January 1993 merely to income *"not included in the tax base"*.

This income includes income subject to a tax which is withheld at its source but then not again taxed in the hands of recipient. The withholding tax is considered the recipient's tax but is collected and transferred to the tax authorities by the payer. A typical example of such income are dividends from another Czech company. The paying company withholds the corporate income tax of the recipient when remitting the dividends. The dividend income is excluded from the corporate income tax computation at the level of the recipient as it already has been taxed, but at a rate lower that the standard corporate income tax rate (which is 19% at present, but it used to be significantly higher). The Czech approach was not to create a complex mechanism to pro-rata the deduction to reflect the lower income tax rate but instead to disallow the deduction completely.

Income not included in the standard corporate income tax base at present also includes dividends from non-Czech companies. These may also be subject to tax withholding at the source on behalf the Czech recipient, but unlike in the case of Czech payers, this tax is transferred to the tax authorities of the state of the payer. The Czech tax authorities require that these dividends be taxed by the recipient in the Czech Republic within a separate income tax base[11] at the rate of 15%[12] disregarding the tax suffered abroad, although it subsequently allows a credit of the foreign tax already paid against the Czech tax due from such income. The procedure is governed by a mechanism provided by the applicable double tax treaty between the Czech Republic and the state of the payer of the dividends.[13] In the end, the amount of tax collected from this income depends on the provisions of the particular double tax treaty and the rate applied by the foreign payer, and may ultimately be significantly lower than if it had been taxed by the standard corporate income tax rate. For this reason, no deduction is allowed for financing costs related to foreign dividend income taxed within a separate income tax base outside of the standard corporate income tax base.[14]

3.3 Thin capitalisation rules

Already in the first Income Tax Act after the introduction of a completely new tax system in 1993,[15] the law anticipated the possible excessive loading up of Czech companies with debt, which could significantly reduce their income tax base and affect the tax revenues of Czech public budgets. A provision in Section 25 (1) w)[16] disallowed the deduction of financing costs exceeding a certain multiple of a company's equity. This provision became

[11] Section 20 (b) of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.
[12] Section 21 (4) of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.
[13] A list of existing double tax treaties entered into by the Czech Republic can be found in a summary document published by the Czech Ministry of Finance on its official website. Agreements for the elimination of double taxation with respect to taxes on income or with respect to taxes on income and on capital in force. In: *Ministry of Finance of the Czech Republic* [online]. [2023-04-22]. Available at: <https://www.mfcr.cz/cs/legislativa/dvoji-zdaneni/prehled-platnych-smluv>.
[14] Section 25 (1) i) of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.
[15] The first thin capitalisation rules were part of the original Income Tax Act, No. 586/1992 Sb., already from its first day on 1st January 1993, even though limited to loans provided by foreign creditors only (and not limited to related parties). This provision was amended on 1st June 1993 by Act No. 157/1993 Sb., which also deferred the first application of all thin capitalisation rules to the 1994 tax year.
[16] Section 25 (1) w) of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.

known as the thin capitalisation rule because it affected companies which were, suspectedly on purpose, only thinly capitalised by their shareholders, with additional funds needed for business operations supplied in the form of debt from (or caused by) the same shareholders instead of additional capital. The presumption was that the main motive of the preference of debt over capital in these situations was to gain a tax benefit at the expense of Czech tax revenues.

The Czech thin capitalisation rules were based on a model pioneered by several developed countries in the decades prior, especially Canada, Australia, the Unites States, and France.[17] However, after the first pioneering years,[18] the impact of the rules was limited to debt provided by related party providers, and even the definition of the related party was somewhat narrow – e.g., for years, related parties included parent but not sister companies.[19] If the parent company within a group caused another subsidiary to provide a loan to the Czech subsidiary of this parent company instead of providing it directly, it was not affected by the thin capitalisation rules.

At the beginning, the multiple of a company's equity set out by the thin capitalisation rules differed for banks (6) and non-banking taxpayers (4). The rule operated in a way that the financing costs related to the part of a related party debt which exceeded quadruple equity in the given year were not deductible from the corporate income tax base in that year.

The thin capitalisation rules were repeatedly modified over the years to deal with possible loopholes, e.g., the absence of affiliated companies in the definition of related parties, but the rules conceptually operated without dramatic changes for more than a quarter of a century.

3.4 Transfer pricing rules

The final legacy rule that originates back to the beginning of the new Czech tax system in 1993 is the anti-abuse rule requiring that all transactions among related parties to be undertaken at arm's length level for tax purposes. A provision of Section 23 (7) of the Income Tax Act allows the tax authorities to adjust the corporate income tax base if the transfer price between related parties differs from one which would have been entered into between unrelated parties. The law provided a wide definition of related parties and included not only those connected via capital but also via personnel (e.g., through the participation of the same individuals in the management of both companies).[20]

Prior to 2008, the law explicitly stated that for debt financing among related parties, a rate equal to 140% of the discount rate of the Czech National Bank[21] is to be considered

[17] PILTZ, D. J. International aspects of thin capitalization: General Report. *Cahiers de droit fiscal international.* 1996, Vol. LXXXlb, No. II, p. 100.

[18] The Czech thin capitalisation rules included certain non-related party loans until the end of 1997. Amendment to the Income Tax Act No. 168/1998 Sb. abolished all thin capitalisation restrictions regarding non-related party loans effective 1st January 1998.

[19] Until Amendment No. 438/2003 Sb., effective 1st January 2004.

[20] Section 23 (7) a), b) of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.

[21] The discount rates are published by the Czech National Bank on its official website. In: *Czech National Bank* [online]. [2023-04-24]. Available at: <https://www.cnb.cz/cs/casto-kladene-dotazy/Jak-se-vyvijela-diskontni-sazba-CNB/>.

the arm‘s length rate.[22] Due to its wording, such a rate was not a rebuttable presumption or safe harbour but instead an arbitrary rate to be used by all taxpayers.[23] This rate was often below the market rate and did not allow for the factoring of risk or any collateral quality considerations. This provision was abolished at the end of 2007[24] and from 2008, interest rates are subject to the same general arm‘s length test as any other price.

The transfer pricing rule operated separately from the thin capitalisation rules, which also applied only to related parties, albeit with a separate (but not identical) definition of related parties. From 1 January 2004, both rules use the same definition of related parties.[25] The main difference between the two rules is that the thin capitalisation rule only tests the ratio of related party debt to equity (and excludes the financing costs on the excess debt as compared to the equity level), not the costs of individual financing arrangements to their arm‘s length costs.[26] That is exactly what the transfer pricing rule is designed to deal with, as it may lead to disallowing part of the costs of debt financing even if the tax payer is not thinly capitalised.

3.5 End of legacy

The structure of the tax rules related to debt financing set out in 1993 served as a cornerstone for the protection of Czech tax revenues from erosion by investors loading up Czech companies with excessive debt. Even as far as at the end of the 2010s, the system still operated on the general deductibility test of the relationship of financing costs to taxable income, the disallowance of costs related to no-tax or low-tax income, and the exclusion of costs related to excessive debt from related parties, either in relation to a company’s capital situation (thin capitalisation) or arm‘s length rates (transfer pricing).

4. RECENT DEVELOPMENTS

Most of the subsequent developments in the approaches to debt financing costs have ultimately come because of the effort of developed economies on the platform of the Organisation for Economic Cooperation and Development (OECD) and later of the European Commission.

Discussions within OECD working groups in the early 2010s regarding the erosion of profits eventually led to the preparation of the Action Plan to Combat Base Erosion and Profit Shifting[27] in 2013. The European Commission picked up on the key conclusions of

[22] Section 23 (7) of the Income Tax Act, No. 586/1992 Sb., as subsequently amended, in the wording effective before 1st January 2008.
[23] The potential use of a rate lower than 140% of the discount rate of the Czech National Bank by a Czech debtor on a loan from a foreign creditor was not sanctioned though, as it did not erode the tax base of the debtor and thus did not endanger Czech tax revenues.
[24] By Income Tax Act Amendment No. 261/2007 Sb.
[25] Based on Income Tax Act Amendment No. 438/2003 Sb.
[26] Under a later amendment, the transfer pricing rule cannot be applied to debt financing where the interest level is below the market rate and the debt provider is not a Czech tax resident. That eliminates the need for the tax authorities to adjust the costs up if these are too low and thus ultimately reduce the corporate income tax collected. See Section 23 (7) of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.
[27] Addressing Base Erosion and Profit Shifting, OECD Publishing 2013. In: *OECD* [online]. 2013 [2023-04-12]. Available at: <https://read.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#page1>.

the Base Erosion and Profit Shifting (BEPS) initiative, which resulted in the introduction of *Anti-Tax Avoidance Directive* (ATAD)[28] in 2016. Combating the erosion of taxable profits (and thus the public budgets of EU member states) in debt financing included the introduction of an additional test aimed to prevent gaining a tax advantage through excessive debt leverage even from non-related parties. Furthermore, it included sophisticated rules tying the tax treatment of financing costs to the tax treatment of corresponding financing revenues by the counterparty to the debt financing arrangement in another country to be able to deal with the different treatment of hybrid financial instruments by individual countries and its undesired consequences. The Czech Republic implemented the ATAD rules in 2019, with the rules governing excessive financing costs[29] coming into effect in tax periods starting on or after 1 April 2019, i.e., in the tax period starting on 1 January 2020 for most taxpayers using the normal calendar year as their tax year. The hybrid instrument mismatch rules[30] came into effect on 1st January 2020.

4.1 Excessive financing costs

The new rule regarding excessive financing costs requires that financing costs exceeding 30% of a company's earnings before interest, taxes, depreciation and amortisation (EBITDA)[31] be not deductible. For this purpose, financing costs are treated on a net basis as the difference between financing costs and financing revenues, i.e., revenues from the provision of debt financing (or its on-lending). The rule covers not only debt financing from related parties but any loans, notwithstanding these being used to generate perfectly taxable income, which represents a radical shift from the historical approach to financing costs. Nevertheless, all previously existing restrictions including thin capitalisation remain in place and are applied concurrently.

The rule governing excessive financing costs does not apply to financial institutions. The ITA also provides a *de minimis* clause exempting financial costs not exceeding CZK 80 million from the test.[32] Costs made non-deductible as excessive can be carried forward to the following tax periods and deducted there if the capacity for deduction has not been exhausted in that period.

4.2 Hybrid instrument mismatches

A hybrid mismatch refers to a mismatch in the tax treatment of a financial instrument or entity between two or more jurisdictions. This situation is not unusual as international

[28] Council Directive (EU) 2016/1164 of 12th July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, dated July 2016, L193/1, also known as the Anti-Tax Avoidance Directive or ATAD. In: *Official Journal of the European Union* [online]. 12. 7. 2016 [2023-04-18]. Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32016L1164&from=cs>. This directive was subsequently amended by Council Directive (EU) 2017/952 of 29 May 2017, L144/1. In: *Official Journal of the European Union* [online]. 29. 5. 2017 [2023-04-18]. Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32017L0952&qid=1656842723272&from=EN>.
[29] Section 23e and 23f of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.
[30] Section 23h of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.
[31] The law provides specific mechanics for the calculation of tax-relevant EBITDA for the purposes of the excessive financing costs test, including only taxable revenues and tax deductible expenses.
[32] Section 23e (1) b) of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.

trade happens among countries with significant differences in tax laws, even within the European Union, where most income tax laws still remain unharmonised. One example may be debt instruments that are treated as debt in the issuing country based on their legal form but as equity in the investor's country because, from their perspective, the instrument may be substantively lacking key debt features such as the unconditional commitment to repay or a time-limited repayment period. As a result, the first country may provide the full deduction of the instrument's financing costs, while the second will exempt the corresponding income from taxation as dividends, based on their local dividend exemption rule.

Another example may be the qualification of an entity as a corporation fully liable to corporate income tax in one country, with it then being treated as a tax-transparent entity in another country under their own tax laws. Transparent entities are often not subject to income tax, and their profits are only taxed in the hands of their investors. The status of a tax-transparent entity may then result from one country's independent qualification of the entity's substantive features or the choice of its investors in other countries.

The ATAD requires the neutralisation of the effects of hybrid mismatch arrangements such as double deductions, when one amount reduces the tax base in more than one jurisdiction, or deductions without inclusion, when the tax base is reduced in one jurisdiction without the same amount being included in the tax base in another jurisdiction.

A double cost deduction in both the source and the recipient country is neutralised through the denial of a deduction in the recipient country. If the deduction is not denied in the recipient country, e.g., because the recipient is from a jurisdiction outside the EU, the deduction is denied in the source country. If costs are deducted in the source country without the corresponding income being taxed in the recipient country, the deduction in the source country is denied. If the deduction is not denied in the source country, because, e.g., the payer is outside the EU, the recipient must tax the corresponding income.

5. EXPECTED DEVELOPMENTS

Comparable to excessive financing cost and hybrid instrument mismatch rules, several other measures which might affect the tax regime of debt financing in the future come from the European Commission's effort to further address aggressive tax planning by multinational corporations and provide a level playing field for businesses in the single EU market.

5.1 Minimum effective tax rate

The minimum effective tax rate is a key feature of Pillar 2 of the BEPS 2.0 project undertaken by the OECD aiming to develop a comprehensive and coordinated framework for addressing the tax challenges of a digitalised economy. The goal is to prevent the shifting of profits to low-tax jurisdictions and to ensure that companies pay their fair share of taxes.

So far, more than 130 countries have agreed to the Pillar 2 framework, including all OECD and G20 countries. The global minimum effective tax rate, set at 15% in October 2021 by the countries participating in the project, is the minimum tax rate that companies are required to pay on their profits, regardless of where those profits are earned. If a company's effective tax rate falls below this level in a particular jurisdiction, that company would be required to pay additional taxes to bring their effective tax rate up to the minimum level.

The European Union decided to mandate the results of the Pillar 2 project as a directive, with the aim to have it apply to all EU-based companies which are part of groups with consolidated revenues of EUR 750 million or more. Subsequently, *Directive on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union* was enacted on 14 December 2022.[33] It is scheduled to be implemented by EU member states during 2023 and applied in the tax periods beginning from 31 December 2023.

The directive introduces two interconnected rules that should assure the required minimum level of taxation, i.e., the income inclusion rule (IIR) and the undertaxed profit rule (UTPR), and authorises tax authorities to collect supplemental income tax from all effectively undertaxed companies in their territory.

The minimum effective tax rule will affect the deductibility of debt financing costs indirectly but significantly in many business sectors, including those operating with significant debt financing whose cost represent a considerable deduction for corporate income tax purposes. It is expected that approx. 3,500 companies in the Czech Republic will be affected by the new rule. Even if their effective tax rate is currently higher than 15%,[34] they may still be ultimately affected due to the complex method of calculation of the effective tax rate with several required adjustments to the standard corporate income tax base. Particularly tangible effects are expected for companies using investment incentives and grants or deductions for research and development costs.

5.2 Misuse of shell entities

Another set of rules in the making that may have an indirect effect on the tax treatment of debt financing costs relate to the tax position of entities interposed in a group or transaction structure for tax purposes but without sufficient economic substance. These 'shell' entities have no or negligible economic activity or physical presence and mainly serve to achieve tax planning benefits such as a not otherwise achievable reduction in the overall tax burden of the group or transaction.

One example could be a holding company set up in one country to hold shares of a trading company in another country, where shareholders are based in that other country and effectively control the holding company from there. Another example could be an entity set up to manage intellectual property or provide group financing. Such companies usually have no employees of their own and are administered by professional administrators. The main purpose of their existence is achieving certain tax benefits (besides

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[33] Council Directive (EU) 2022/2523 of 14th December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, dated 14th December 2022, L328/1. In: *Official Journal of the European Union* [online]. 14. 12. 2022 [2023-04-20]. Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32022L2523&from=EN>.

[34] The nominal corporate income tax rate in the Czech Republic in 2023 is 19%, see Section 21 of the Income Tax Act, No. 586/1992 Sb., as subsequently amended.

possibly also obscuring the overall ownership structure and hiding assets). These benefits might include the tax-free distribution of profits to or for the benefit of the ultimate shareholders, or a reduction of the overall group or transaction tax burden through loading up the trading companies in the other country with tax deductible debt financing costs or intellectual property royalty costs, whose profits then are subject to no or low tax at the level of the holding company.

The European Commission has noted that shell entities established in one member state have the potential to significantly erode the tax base of a company in another member state and thus distort the functioning of the common market. During the consultation procedure undertaken by the commission in 2021, one particular observation related to the debt financing cost structure, stating that a financial holding entity established to collect payments from that financial activities of that entity in another member state could take advantage of the exemptions from withholding taxes under the Interest and Royalty Directive[35] and then pass on this income to an associated entity in a low tax third country jurisdiction, thereby exploiting favourable tax treaties or even the domestic tax law of a specific member state.[36]

To battle the widespread abuse of shell entities, the European Commission in December 2021 proposed *Directive that lays down rules to prevent the misuse of shell entities for tax purposes.*[37] While the directive was originally scheduled to be implemented by the member states by June 2023 and come into effect on 1 January 2024, the legislative process has not been completed yet and the implementation schedule is expected to be delayed.

Apart from the creation of a reporting framework for qualified shell entities and the exchange of information among tax authorities of the member states, the main requirement of the directive is that the member state of the shell entity's shareholder tax the income of such entity as if it had directly accrued to that shareholder. The other member states are required to disregard otherwise formally applicable double tax treaties that would provide for the elimination of double taxation. The directive also provides a comprehensive mechanism for the identification of potentially harmful entities.

The effect of the directive's rules on debt financing structures may include the elimination of tax rate arbitrages related to the deduction of financing costs in one country and the taxation of the corresponding financial revenue in another country. An example would be Czech investors loading up their Czech trading company with debt provided by a Cy-

[35] Council Directive 2003/49/EC of 3rd June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different member states. L-157. In: *Official Journal of the European Union* [online]. 3. 6. 2003 [2023-04-21]. Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32003L0049&from=FI>.

[36] Section 5, page 8 ("Detailed explanation of the specific provisions of the proposal") of the Explanatory Memorandum to Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU. In: *European* Commission [online]. 22. 12. 2021 [2023-04-21]. Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021PC0565&from=EN>.

[37] Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU, dated 22 December 2021, 2021/0434 (CNS). In: *European Commission* [online]. 22. 12. 2021 [2023-04-24]. Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021PC0565&from=EN>.

priot shell financing company funded by capital investment from the very same Czech investors. As a result of the operation of the directive, the interest income from the Czech company would be taxed as the Czech investors' direct income, thus neutralising the tax benefits of the overall structure.

5.3 Debt-equity bias reduction

The final set of rules affecting debt financing comes again as the European Commission's response to the prevailing differences in the overall tax treatment of debt and capital. Debt financing costs are generally tax deductible, with some restrictions as discussed above. In contrast, the cost of capital is not tax deductible, mainly because normally such cost is not incurred, at least not in the accounting sense. However, economically it does exist, as no investor would choose to provide capital for free. The remuneration for the provision of capital is a dividend, but it is not accounted for as cost and does typically not enter corporate income tax calculations.

The difference in the tax treatment incentivises the use of debt before capital (equity) in funding scenarios, and this incentive has real and tangible economic value. This leads not only to the erosion of tax bases and thus a reduction of public revenues, but also to the undercapitalisation of the business environment, thus reducing its resilience in times of economic turbulence.

Several countries[38] have attempted to solve the debt equity bias issue by introducing a special allowance for the virtual cost of capital. The European Commission build on this experience when proposing a harmonised solution in a directive in 2022, *Debt-Equity Bias Reduction Allowance Directive* (DEBRA).[39]

Under the DEBRA proposal, companies would be allowed to deduct a notional interest allowance based on an increase in net equity during the tax year. Net equity is calculated as the difference between a company's equity and the total tax value of its participations in the capital of associated companies (and its own shares). The calculated increase in net equity is then multiplied by a reference interest rate based on the ten-year risk-free interest rate for a particular currency increased by a risk premium of 1% or 1.5% for small and medium-sized companies. Under the proposal, the resulting notional interest could be deducted in the year of the increase in the company's equity and in the following nine tax years, but would be subject to a cap at a level of 30% of the company's earnings before interest, taxation, and depreciation allowance (EBITDA).

However, the effect of the new deduction allowance would at the same time be somewhat compensated by additional of debt financing cost restrictions. The deduction would be limited to the lower of 85% of the excessive financing costs, i.e., the difference between

[38] Namely Belgium in 2006, Portugal in 2008, Italy in 2011, Cyprus in 2015, Malta in 2018, and Poland in 2019. See FLAMANT, E., GODAR, S., RICHARD, G. New Forms of Tax Competition in the European Union: an Empirical Investigation. *EU Tax Observatory.* 2021, No. 3, pp. 28–29 [2023-04-28]. Available at: <https://www.taxobservatory.eu/wp-content/uploads/2021/11/EU-Tax-Observatory-Report-3-Tax-Competition-November-2021.pdf>.

[39] 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. Dated 11th May 2022, 2022/0154 (CNS). In: *European Commission* [online]. 11. 5. 2022 [2023-04-28]. Available at: <https://ec.europa.eu/taxation_customs/system/files/2022-05/COM_2022_216_1_EN_ACT_part1_v6.pdf>.

the financing costs and financing revenues as defined by the ATAD rules, and the limit calculated based on the ATAD rules.[40]

Effectively, as the price to be paid for the ability to claim the notional interest allowance on capital, the companies could end up losing 15% of the present debt financing deduction, which could represent a significant additional tax burden for debt-intensive trading or investment operations.

The DEBRA Directive was scheduled to be implemented during 2023 and to come into force on 1 January 2024. However, the European Commission has recently announced a suspension of the legislative process.[41] Nonetheless, the commission has also stated that the DEBRA proposal will still be considered for inclusion within the new *Business in Europe: Framework for Income Taxation* (BEFIT) initiative, which will aim to provide a single corporate income rulebook for companies in the European Union.[42]

6. CONCLUSION

Czech tax laws have had a very pragmatic grip over debt financing costs since the inception of the new tax system on 1 January 2023, and the tax authorities have been able to apply this legacy treatment for more than 26 years with only some minor tweaks. The foundation for their approach has been the general tax deductibility test in relation to fully taxable income, supported by four negative pillars restricting deductions in specific cases: no-tax income, low-tax income, thin capitalisation, and transfer pricing.

This conveniently simple but somewhat benevolent system has been affected by the growing effort of global economies to limit the erosion of corporate income tax bases by sophisticated cross-border tax planning, including debt financing which shifts corporate profits from the countries where business activities take place to low tax countries and thus reduce their country tax revenues. The European Commission has become very active in this field, deciding to take part in the combat for the very same reasons.[43]

However, the European Commission has also aimed to secure a level playing field in the single EU market, where corporate income taxes have historically and deliberately been kept largely unharmonised and thus conducive to tax competition among the EU countries themselves. And as with DEBRA proposal, the effect of too much incentivisation

[40] See section 4, and specifically 4.1.

[41] Draft Ecofin Report to the European Council on tax issues, item 17, 14905/22. In: *Council of the European Union* [online]. 25. 11. 2022 [2023-04-28]. Available at: <https://data.consilium.europa.eu/doc/document/ST-14905-2022-INIT/en/pdf>. For the whole legislative process of DEBRA, also Briefing on EU Legislation in Progress, PE 733.678 – March 2023. In: *European Parliamentary Research Service* [online]. [2023-04-30]. Available at: <https://www.europarl.europa.eu/RegData/etudes/BRIE/2022/733678/EPRS_BRI(2022)733678_EN.pdf >.

[42] The *Business in Europe: Framework for Income Taxation (BEFIT)* proposal has been published on the official website of the European Commission. In: *European Commission* [online]. [2023-04-28]. Available at: <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13463-Business-in-Europe-Framework-for-Income-Taxation-BEFIT-_en>.

[43] The media at times inform about a surprisingly low level of taxes paid by even the most successful international businesses with large operations in the European Union. One of the examples is an article *Amazon had sales income of €44bn in Europe in 2020 but paid no corporation tax* in the U.K. newspaper The Guardian, dated 4th May 2021. In: *The Guardian* [online]. [2023-04-30]. Available at: <https://www.theguardian.com/technology/2021/may/04/amazon-sales-income-europe-corporation-tax-luxembourg>.

of debt financing over capital may in the long-term result in the relative undercapitalisation of EU businesses, which might eventually represent a significant economic and social risk in terms of resilience in times of crises or turbulences in the global economy. These factors ultimately present the main driver for a relatively fast and deep overhaul of the originally somewhat soft-touch legacy structure of debt financing cost rules in the Czech Republic.

Overview of the development of tax rules governing debt financing costs in the Czech Republic

Year	Rule	Czech Income Tax Act	Conceptual origin
1993	No-tax income rules	25 (1) i)	1993 New Czech Tax System
1993	Low-tax income rules	25 (1) i)	1993 New Czech Tax System
1993	Thin capitalisation	25 (1) w)	1993 New Czech Tax System
1993	Transfer pricing	23 (7)	1993 New Czech Tax System
2019	Excessive financing costs	23e and 23f	ATAD 1
2020	Hybrid mismatches	23h	ATAD 1, ATAD 2
2024	Minimum effective tax		PILLAR 2
2024	Misuse of shell entities		ATAD 3
2024	Notional interest deduction, reduction of interest allowance		DEBRA/BEFIT