NEWSLETTER

AMENDMENT OF THE THIN CAPITALISATION RULES AND PROPOSALS FOR DEBRA AND ATAD 3 DIRECTIVES

1. Amendment of the thin capitalisation rules

- The proposed amendment to the Income Tax Act (No. 595/2003 Coll., as amended) is planned to extend the thin capitalisation rules with effect from 1 January 2024.The tax deductibility of interest exepnses arising from contracts concluded after 31.12.2023 or amendments to older contracts will be tested in two steps under the proposed amendment.
- For the purposes of the first step test, the decisive factor will be the ratio of the amount of net interest expense to the tax base plus net interest expense adjusted for tax depreciation and amortisation of assets (tax EBITDA). The term net interest expense is defined as the difference between interest expense and interest income in the relevant taxable year, where interest expense is defined as expenses related to any debt instruments, whether related or third party, including those capitalised in the acquisition value of assets, and any related costs such as exchange rate differences, bank charges, etc. Interest expense in excess of 30% of the above-mentioned ratio will not be tax deductible.
- The new regulation also contains de minimis rules, i.e. the ratio of net interest expense to tax EBITDA does not need to be tested if the amount of the net interest expense does not exceed EUR 3m. At the same time, certain types of companies are exempted from such testing, e.g. banks, insurance and reinsurance companies as well as companies whose related parties are solely natural persons.
- Interest not included in the tax base under the above rules can be carried forward over the next five taxable periods. However, in the relevant taxable year, the carried forward interest can only be utilised up to 30% of the tax EBITDA while considering also the net interest expense for that period.
- If any interest is assessed as tax non-deductible in a given tax year based on the above introduced rules, there is no need to test it further. Otherwise, taxpayers will also test the tax deductibility of interest under the existing thin capitalisation rules, i.e. the limit on the tax deductibility of borrowing costs from related parties (not including interest capitalised in the acquisition value of assets) to 25% of profit or loss plus depreciation and interest expense (accounting EBITDA).
- To sum up, the proposed amendment extends the scope of the thin capitalisation rules to all debt instruments, to debt received from third parties as well as to interest capitalised in the acquisition value of assets.

2. Proposal for a Council Directive laying down rules on the Debt Equity Bias Reduction Allowance and limiting the deductibility of interest for corporation tax purposes ("DEBRA"))

- DEBRA's draft Directive includes:

  i. a favourable regime for equity financing in the form of a possible deduction of hypothetical interest on equity increases in taxation of all companies in EU Member States (except for specifically defined financial companies such as banks, insurance companies, etc.); and

ii. an additional rule limiting the tax deductibility of interest over and above the rules introduced under ATAD I.

- The amount of the deduction (i) is calculated by multiplying the base (the year-on-year increase in net equity) by the hypothetical interest rate (the risk-free rate at maturity of ten years plus a risk premium of 1%, or 1,5% in the case of small and medium-sized enterprises).
- This deduction will be granted for a period of up to 10 years (in case of insufficient tax base, it can be carried forward to subsequent years without any time limit) and its amount will be limited to a maximum of 30% of the company's EBITDA for each taxable period.
- At the same time, a number of anti-abuse measures will be laid down (e.g. exclusion of specific cases of equity increases in the context of the group's business activities or transactions under common control, special conditions for contributions in kind or investments in assets, etc.).
- The Directive will also limit the tax deductibility of interest (ii) to 85% of the net borrowing cost (the excess of interest paid over interest received). This rule will apply in parallel with the thin capitalisation rules (see point 1. above and the existing thin capitalisation rules).
- If the Directive is implemented together with the aforementioned Amendment, borrowing costs will be subject to three tests limiting its tax deductibility.
- Proposed date of effectiveness: from 1.1.2024, implementation date until 31.12.2023.

3. Proposal for a Council Directive laying down rules to circumvent the misuse of so-called “shell entities” and amending Directive 2011/16/EU (the "ATAD 3" or "Directive")

- The purpose of the draft Directive is to identify companies that may constitute companies without economic substance established or incorporated for the sole purpose of obtaining a tax advantage; and the consequent taxation of the income of such companies in the country of the shareholder meeting the minimum economic substance requirements. At the same time, companies without economic substance may be denied the benefits of the double taxation treaties, of the EU Interest and Royalties Directive and ofthe Parent-Subsidiary Directive.
- As a first step, it will be necessary to examine whether the Company in question falls within the scope of the Directive on the basis of the non-/fulfillment of three entry criteria:

  i. if the three entry criteria are not met, no further action will be necessary, but

  ii. if the three entry criteria are met, the Company will be subject to reporting obligations and potential tax consequences (see below).

- 3 The entry criteria are as follows and are tested cumulatively over the <u>two preceding tax years:</u>

  i. More than 80% of the revenue generated by the Company is relevant income (this is mainly passive income such as dividends, interest, royalties, etc.),

  ii. The Company is engaged in cross-border activities as follows:

     - more than 55% of the book value of the assets (immovable property and movable property over EUR 1 million - e.g. yacht, excluding securities, shares and cash) is located outside the Company's Member State of tax residence,

     - at least 65 % of the relevant income is derived or paid through cross-border transactions, and

     - the criterion is also met if the Company does not actually receive income under (i) but holds assets (immovable property, movable property of over EUR 1 million, financial investments from which dividends/revenue from transfer of shares are generated) capable of generating relevant income and these assets account for more than 75% of the total book value of the Company's assets,

  iii. The Company has outsourced the execution of day-to-day activities and decision making activities to a company that is not an affiliated company in the same state as the Company.

- If the three entry criteria are met, the Company is considered to be at risk and will be required to (among others) provide the following information (minimum economic substance indicators) in its tax return and attach relevant evidence:

  - Existence of own premises, at least one bank account in the EU, details of tax residency and qualifications of management (directors) and employees (one director and the majority of full-time employees must be tax resident in the same country as the company) and other details:

- If the company fails to prove the existence of minimum economic substance, the tax consequences are as follows:

  i. The existence of the Company will be disregarded for tax purposes, i.e.

     - A shareholder of the Company (a resident of an EU Member State) will be liable to tax the relevant income (e.g. dividends) as if it had arisen directly at the level of the shareholder.

     - The entity paying relevant income to the Company will be taxed as if it were paying the income directly to a shareholder of the Company.

     - However, the tax paid to the Company will be creditable by the shareholder of the Company.

  ii. The Member State of tax residence will not issue a tax residence certificate to the Company (for the purposes of applying double taxation treaties and EU Directives).

Penalties: min. 2.5% of the Company's turnover p.a. for failure to comply with the reporting obligation (mentioning the minimum economic substance criteria in its tax return).

Exceptions: outside the scope of the Directive are e.g. regulated companies (banks, insurance companies, etc.), companies with at least 5 full-time employees.

Proposed date of effectiveness: from 1.1.2025 (implementation date by 30.6.2022), however, the required criteria will have to be tested two years retrospectively, i.e. from 1.1.2023.

We will inform you about further steps and changes in the legislative process. If you would like to learn more about a certain topic, or if you have additional questions about the information provided, do not hesitate to contact the authors of the article.

Authors

HANA HLAVÁČKOVÁ
TAX MANAGER
Direct +421 2 5710 6648
Mobile +421 911 665 322
hlavackova@bdoslovakia.com

JANA DEVEROVÁ
TAX MANAGER
Direct +421 2 5710 6647
Mobile +421 911 934 927
deverova@bdoslovakia.com

OUR OFFICES

BRATISLAVA

BDO Tax, spol. s r.o.
Pribinova 10, 811 09 Bratislava,
Slovak Republic

KOŠICE

BDO Tax, spol. s r.o.
DUETT Business Residence 3B,
Námestie osloboditeľov 3B,
040 01 Košice, Slovak Republic

IČO: 46 396 381
DIČ: SK 7020 000 031
BDO Tax, spol. s r.o. is registered with the Companies Register of the District Court Bratislava I