

EFB Position Paper: Time for a Level Playing Field Between Debt and Equity



One of the important goals of the EU2020 Strategy and the Single Market Act is to improve access to finance for Small and Medium sized Enterprises (SMEs). In aiming for this goal all stakeholders need to consider that **access to finance is not only access to debt, but also access to equity.**

Access to Finance = Access to Debt + Access to Equity

$$A2F = A2D + A2E$$

Why Equity?

Equity finance is key to strong and sustainable business growth. For most companies it is the most important form of finance. It comes in two main forms, paid-in capital and retained earnings.

For external stakeholders, a sound equity base in a company is an indication of a long term commitment to the company by its owners. For financial institutions, a strong equity to assets ratio makes lending reasonably unproblematic even under Basel III. Without equity, access to debt is a challenge. A weak equity position raises concerns among external stakeholders, not least among banks. **Without equity, there is no other finance.**

Banks that offer debt finance typically require of their customers at least some amount of equity for every unit of debt provided. The stronger the equity base of a company, the better its ability to raise loans. Conversely, the weaker the equity position of a company, the less it is able to raise loans and the less it is able to invest in growth and job creation.

In the wake of the European debt crisis it is of paramount importance to strengthen the equity base of European companies. Equity is a prerequisite for all other finance. The need for equity finance will increase further as Basel III becomes the norm and forces banks to demand higher equity ratios from their customers than before.

In summary, the best way of securing access to finance is to promote equity finance.

The policy required to promote equity finance is very straightforward: it is to create a level playing field for all forms of finance. This can be done by establishing tax neutrality between equity and debt, for all types of business owners.

Family Business taxation

For family businesses, taxation has three dimensions: business, current owners and future owners, as follows:

- Firstly, profit generated in the business is taxed at the applicable corporate tax rate.
- Secondly, the profit distributed by the business to its owners is taxed at the owner level.
- Thirdly, when passed from one generation to another, the business assets are often taxed further.

In many cases this two-fold or even three-fold taxation causes the total tax burden of family businesses and their owners to be higher than the total tax burden of businesses held by other types of owners.

Taxation of equity vs. debt, the concept of the Total Efficient Tax Rate (TETR)

In most European countries the taxation of income from equity is harsher than the taxation of income from debt. This can be shown through a calculation of the so-called Total Efficient Tax Rate (TETR) of equity on the one hand and debt on the other hand. TETR takes into account taxation at both the level of the business and at the level of the owner. TETR on income from equity could be defined as follows:

TETR = Tax on corporate profits payable by the corporation + tax on dividend payable by the recipient of the dividend distributed from the corporate profits

The following calculation illustrates TETR on equity and TETR on debt in a situation, where profit is distributed either as dividend or as interest. The tax rates used in the example represent typical tax rates in Member States.

Corporate level

	Equity	Debt
Corporate profit before interest	100	100
Deductible interest on debt	n/a	100
Corporate profit before tax	100	0
Tax on profit at corporation level (25%)	25	0
Dividend payable	75	0

Owner level

	Equity	Debt
Dividend income/interest income	75	100
Tax on dividend (20%)/interest (20%)	15	20
Total amount of tax (business + owner)	40	20
TETR	40,0%	20,0%

OWNER



As the calculation of TETR shows in the example above, equity finance has a considerable tax disadvantage over debt finance. This makes it less interesting to finance a company through long term equity than through debt. Unfortunately high levels of indebtedness make enterprises more vulnerable to economic downturns.

What can be done to strengthen the equity ratios of businesses?

For the European Union to develop into an environment that is conducive to long term sustainable and responsible investment measures need to be taken to ensure that businesses are not so reliant on debt. As the review of the Small Business Act highlighted, 'high indebtedness has made many SMEs vulnerable to difficult financial market conditions'

But today, as illustrated above, most Member States have fiscal codes that create incentives for debt finance over equity finance. As a consequence, household savings typically flow into deposits and bonds and property, but rarely into company balance sheets in the form of paid-in equity. The result is low equity ratios in privately held businesses. A recent IMF study has also highlighted that, '**most tax systems today contain a "debt bias," offering a tax advantage for corporations to finance their investments by debt. This has grown increasingly hard to justify. One cannot compellingly argue for giving tax preferences to debt based on legal, administrative, or economic considerations. The evidence shows, rather, that debt bias creates significant inequities, complexities, and economic distortions. For instance, it has led to inefficiently high debt-to-equity ratios in corporations (Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, Ruud A. de Mooij, May 2011).**'

A simple remedy would be to implement a tax system that does not favour debt and other forms of investment over equity but creates a level playing field for all forms of savings and all types of owners. This would, firstly, encourage the flow of private and household savings to businesses and, secondly, encourage businesses to re-invest their retained earnings in the business. This would contribute to economic growth and employment in Europe.

There are several different ways in which this aim can be achieved, **helping businesses to strengthen their equity capital and reducing the current tax discrimination that favours debt over equity. One of them is called Allowance for Corporate Equity or ACE.**

Example: Allowance for Corporate Equity

Corporate level		
	Equity	Debt
Corporate profit before interest	100	100
Deductible interest on debt	100	100
Corporate profit before tax	0	0
Tax on profit at corporation level (25%)	0	0
Owner level		
	Equity	Debt
Dividend income/interest income	100	100
Tax on dividend (20%)/interest (20%)	20	20
Total amount of tax (business + owner)	20	20
TETR	20,0%	20,0%

As demonstrated above, the ACE system works such that the taxable income of a company is the Net Result less the cost of equity. The cost of equity is calculated as per a notional interest rate defined in the tax code. The result at company level is that a company's tax position does not automatically deteriorate when it uses equity finance rather than debt finance. At owner level the result is that the total efficient tax rate on dividend distribution is the same as on interest payments. This would reduce the cost of equity finance, lead to stronger capitalization of businesses with equity in the real economy and hence provide more capacity for long term investments and job creation. At the same time it would help to balance the structure of household savings by adding a stronger element of equity ownership as a complement to bank deposits, bonds and property.

Proposals

To increase equity: Member States should reduce The Total Efficient Tax Rate (TETR) of income from equity so that is no higher than the TETR of income from debt finance or property.

To avoid equity shrinking: Member States should abolish taxation that depletes equity.

Positive outcomes

- A larger proportion of aggregate savings in the economy would flow into company balance sheets in the form of equity. If company balance sheets were stronger on average, then the average classification of corporate loans would improve. If the average classification of corporate debt was better, then the solvency ratios of banks under Basel II and Basel III would improve without any need for additional support for the banking sector.
- A company with a strong equity position is independent. It will not be rocked by turmoil in the financial markets. It can take a profit hit without breaking loan covenants. It can deal with revaluations of goodwill or pension liabilities. It can make investments on very short notice when the opportunity arises. And, debt in the balance sheet of a well-capitalized company is not a strain on the solvency ratio of the banks that provide loans to it. Companies with stronger balance sheets means a more stable economy, feeding innovation, growth and job creation.
- In sum, it will lead to a world economy based on independent decisions on the use of equity in self-reliant companies in the real economy rather than on regulatory decisions on access to debt from government-supported financial institutions.

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European Family Businesses is a federation of 11 national family businesses associations. Our aim is to make political decision makers aware of the contribution of family businesses to society at large and to promote policies that are conducive to long term entrepreneurship. Our members represent turnover in excess of one trillion Euro, 9% of European GDP.