Multinationals' capital structures, thin capitalization rules, and corporate tax competition

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Executive Summary

Existing corporate tax systems permit the deduction of interest payments from the corporate tax base, whereas the equity returns to investors are not tax deductible. Corporations will thus trade-off this tax advantage of debt against its non-tax costs, where the latter arise primarily from an increased risk of financial distress and the resulting agency costs due to conflicting interests between debt and equity owners. As a consequence, higher corporate tax rates are expected to lead firms to adopt higher debt-equity ratios. Recent empirical studies provide evidence for this hypothesis for both nationally operating firms and, even more prominently, for multinational firms.

The close empirical link between corporate tax rates and multinational firms' financial policies, together with a rapid growth of financial transactions *within* multinational enterprises, has aroused concerns among policy-makers that multinationals use their internal debt policy in order to shift profits from high-tax to low-tax countries. Such concerns are supported by independent evidence that multinational firms seem to pay lower taxes, as a share of pre-tax profits, than domestically operating firms. In response to these developments, many countries have introduced thin capitalization rules, which limit the amount of interest payments to related entities that is deductible from the corporate tax base. As of today, the majority of OECD countries includes such constraints in their corporate tax codes, and several countries have introduced or tightened them during the last decade, e.g., Germany in 2008. On the other hand, the move to stricter rules is not universal. For example, Ireland and Spain have recently abolished thin capitalization restrictions completely for financial transactions between affiliates in EU member states.

In general, there are two conflicting considerations in the setting of thin capitalization rules. On the one hand, they have the potential to secure the domestic corporate tax base, particularly in high-tax countries, by limiting international profit-shifting via intra-company debt policies of multinationals. On the other hand, binding thin capitalization rules increase the effective tax rate from the perspective of highly mobile multinational firms and this may have a detrimental effect on foreign direct investment.

The aim of our paper is to investigate the consequences of these considerations for the optimal setting of thin capitalization rules from the perspective of countries engaged in international tax competition.

We set up a model where countries compete for internationally mobile firms through statutory tax rates and thin capitalization rules. For the case of identical countries we show that tax competition leads to inefficiently low tax rates and inefficiently lax thin capitalization rules. Hence in our model a coordinated tightening of thin capitalization rules, such as the specification of minimum standards, will benefit both countries. This is true even though the imposition of such standards will lead countries to reduce statutory tax rates in the competition for mobile capital. We also analyze asymmetries between countries and show that the country with the relatively larger number of domestically operating firms will choose the more lenient thin capitalization rules in the absence of coordination. If these differences are substantial, then a binding minimum standard for thin capitalization rules may reduce welfare in the country with the larger domestic tax base. This implies that the political implementation of this coordination measure may be difficult, even if there are overall welfare gains to be reaped. Moreover, any attempt to tighten existing thin capitalization rules must carefully distinguish between intra-firm financial transactions that are primarily driven by tax considerations, and those financial flows that serve a productive purpose within the firm.