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Firms' financial choices and thin capitalization rules under corporate tax competition

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ABSTRACT

Thin capitalization rules have become an important element in the corporate tax systems of developed countries. This paper sets up a model where national and multinational firms choose tax-efficient financial structures and countries compete for multinational firms through statutory tax rates and thin capitalization rules that limit the tax-deductibility of internal debt flows. In a symmetric tax competition equilibrium, each country chooses inefficiently low tax rates and inefficiently lax thin capitalization rules. We show that a coordinated tightening of thin capitalization rules benefits both countries, even though it intensifies competition via tax rates. When countries differ in size, the smaller country not only chooses the lower tax rate but also the more lenient thin capitalization rule.

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1. Introduction

Existing corporate tax systems permit deduction of interest payments from the tax base, whereas equity returns to investors are not tax-deductible. This asymmetric treatment of alternative means of financing investment offers firms a fundamental incentive to increase their reliance on debt finance. For multinational companies, this incentive is further strengthened by the opportunity to use internal debt as a means to shift profits from high-tax to low-tax countries. Recent empirical research provides conclusive evidence that international tax differentials affect multinationals' financial structure in a way that is consistent with overall tax minimization.[1] Moreover, while profit shifting within multinationals can occur through a variety of channels, there are clear empirical indications that the use of financial policies plays an important role in this process (Grubert, 2003; Mintz, 2004). For this reason, international debt is suspected to be a core factor behind empirical findings that multinational firms seem to pay substantially lower taxes, as a share of pre-tax profits, as compared to nationally operating firms.[2]

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[1] Desai et al. (2004) show for U.S.-based multinational firms that a 10% higher corporate tax rate in the host country of a foreign affiliate raises the debt-to-asset ratio of this affiliate by about 3–4%. Similar evidence is obtained for European multinationals by Egger et al. (2010a) and for German multinationals by Mintz and Weichenrieder (2010, Chapter 5) and Buettner et al. (2010). Huizinga et al. (2008) provide more general evidence that the capital structure of European multinationals is adapted in a tax-minimizing way to international differences in corporate tax systems and rates.

[2] For Europe, Egger et al. (2010b) have estimated, using econometric matching techniques, that the tax burden of an otherwise similar manufacturing plant is reduced by more than 50% when the parent firm is foreign-owned, rather than domestically owned. Hines (2007) finds related evidence that the effective tax payments of U.S. multinationals in their respective host countries have fallen more rapidly than the statutory tax rates in these countries.

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Table 1
Thin capitalization rules in 2005.

Country	Safe haven debt-to-equity ratio (1)	Debt in column (1) refers to (2)
Australia	3:1	Total debt
Belgium	7:1	Related party debt
Bulgaria	3:1	Total debt[a]
Canada	2:1	Related party debt
Croatia	4:1	Related party debt
Czech Republic	4:1	Related party debt
Denmark	4:1	Total debt
France	1.5:1	Related party debt
Germany	1.5:1	Related party debt
Hungary	3:1	Total debt[a]
Italy	4:1	Related party debt
Japan	3:1	Total debt
Latvia	4:1	Total debt[a]
Lithuania	4:1	Total debt
Luxembourg	5.7:1	Related party debt
Mexico	3:1	Total debt
Netherlands	3:1	Total debt
New Zealand	3:1	Total debt
Poland	3:1	Total debt
Portugal	2:1	Related party debt
Romania	3:1	Total debt[a]
Slovakia (2003)[b]	4:1	Related party debt
Slovenia	8:1	Related party debt
Spain	3:1[c]	Related party debt
South Korea	3:1	Related party debt
Switzerland	6:1	Total debt
Turkey	2:1	Related party debt
UK	1:1[d]	Total debt
USA	1.5:1	Total debt

Source: Buettner et al. (2009, Table 1).
[a] Debt in column (1) refers to total debt, but loans from financial institutions are not considered.
[b] Thin-capitalization rule was abolished in 2004.
[c] Since 2004 the thin-capitalization rule applies only to related party debt from outside the European Union.
[d] Since 2004 the UK applies anti-abuse rules employing an arm's length principle, but the safe haven debt-to-equity ratio is still used as a guideline.

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 tax base. Table 1 lists all countries that included such constraints in their corporate tax codes in 2005. The general way to enact thin capitalization provisions is to specify a *safe haven* debt-to-equity ratio, and to limit the deduction of the costs of debt once this critical threshold level is surpassed.[3]

On the other hand, the move to stricter thin capitalization rules is not universal. The United States, for example, which was one of the first countries to introduce an *earnings*' *stripping rule* in 1989, has introduced changes to its tax code in 1997 that facilitated the use of internal debt as a tax-saving instrument.[4] Ireland and, more recently, Spain have even abolished thin capitalization restrictions for loans from EU-based companies completely, in response to a 2002 ruling by the European Court of Justice that thin capitalization rules must be set up in a non-discriminatory way. In the case of Ireland, it is furthermore noteworthy that the relaxation of thin capitalization rules directly followed the forced termination of Ireland's split corporate tax rate, which had long been used as an instrument to provide preferential tax treatment to multinationals. This suggests that at least some countries might strategically use lax thin capitalization rules as a means to grant targeted tax relief to multinational firms.

These recent developments have led to an increasing awareness in the European Union of the potential inefficiencies that result from a decentralized setting of thin capitalization rules. In a communication, the European Commission (2007) has announced its willingness to take coordinated actions against 'wholly artificial arrangements' used to shift profits between establishments, and explicitly includes thin capitalization rules as a possible countermeasure at the EU level.

[3] Detailed descriptions of existing thin capitalization rules are given by Gouthière (2005) for most OECD countries, and by Dourado and de la Feria (2008) for the EU member states.

[4] The main element among these tax changes was so-called 'check-the-box' provisions which introduced *hybrid entities* that are considered as corporations by one country, but as unincorporated branches by another. These rules can be used by U.S. multinationals to circumvent existing rules for controlled foreign corporations (CFC rules), which disallow the deferral of passive business income, including interest payments, for the affiliates of U.S. corporations. See OECD (2007, Chapter 5).

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