Thin Capitalization Rules and Multinational Firm Capital Structure

Jennifer Blouin  
(Wharton, University of Pennsylvania)

Harry Huizinga  
(Tilburg University and CEPR)

Luc Laeven  
(International Monetary Fund and CEPR)

Gaëtan Nicodème  
(European Commission, ULB, CESifo and CEPR)

Abstract: This paper examines the impact of thin capitalization rules that limit the tax deductibility of interest on the capital structure of the foreign affiliates of US multinationals. We construct a new data set on thin capitalization rules in 54 countries for the period 1982-2004. Using confidential data on the (internal) leverage of foreign affiliates of US multinationals, we find that thin capitalization rules affect multinational firm capital structure in a significant way. Specifically, restrictions on an affiliate’s ratio of overall debt to assets reduce this ratio on average by 1.9%, while restrictions on the ratio of an affiliate’s borrowing from the parent company to its equity reduce this ratio by 5.7%. Also, restrictions on borrowing from the parent reduce the overall debt to assets ratio of the affiliate by 3.5%, which shows that rules targeting internal debt have an indirect effect on the overall indebtedness of affiliate firms. Thin capitalization rules mitigate the traditional effect of corporate taxation on affiliate debt, while their impact on affiliate leverage is higher if their enforcement is automatic rather than discretionary. Finally, we exploit variation over time in thin capitalization rules to show that the first year impact of new capitalization rules on affiliate leverage is significant albeit less than its long-term effect. Overall, our results show than thin capitalization rules, which thus far have been understudied, have a substantial effect on capital structure within multinational firms.