Advances in Economics, Business and Management Research, volume 133
3rd International Conference on Advances in Management Science and Engineering (IC-AMSE 2020)

Income Tax and Capital Structure of Multinational Corporations

Deqiang Deng[1,2] and Rui Shao[2,*]

[1]School of Accounting, Nanjing Audit University, No. 86 Yushan West Road, Nanjing, 211815, China

[2]School of Economics and Management, Nanjing University of Science and Technology, No. 200, Xiao Ling Wei, Nanjing, 210094, China

*Corresponding author

Keywords: ***multinational corporations, income tax, capital structure***

Abstract. With economic globalization and the deepening of international division of labor, multinational corporations have become an important part of the world economy. Different from the scope of business activities in which domestic enterprises are only distributed in one country, the scope of business activities of multinational corporations extends to a number of countries and regions. Therefore, the complex and diversified business activities environment and characteristics of it have caused a special impact decision system for the capital structure of multinational corporations. The operations of multinational companies are affected by exchange rates and national policies, and they have special risks and advantages. In particular, multinational companies face a complex tax environment. The income tax has an impact on the capital structure of multinational corporations. The theoretical basis of this effect includes MM theory and trade-off theory. The decision of capital structure is an important financial issue for multinational companies. This paper summarizes some conclusions and suggestions based on the literature on capital structure and tax burden of multinational corporations.

Introduction

As an important part of financial theory, capital structure theory not only relates to the decision-making of corporate capital structure, but also provides an important theoretical basis for the process of business management. Taxation is a macro-control method of the state to the market economy, which directly relates to the level of profit that the enterprise obtains in its operations.

The revised MM theory states that debt leverage can have an effect on the value of a company and the cost of capital. The trade-off theory adds the corporate income tax deductible income cost by relaxing the assumptions of the MM theory, and analyzes the optimal capital structure of the agency cost to maximize the value of the enterprise. Agency theory believes that equity financing will cause business managers and business owners to make different decisions.

Besides the tax, the non-tax factors affecting the company's capital structure in the development of companies mainly include company size, profitability, growth, asset mortgage value and non-debt tax shield.

Multinational Companies and Their Capital Structures

Transnational corporations refer to monopolistic enterprises that set up branches or subsidiaries around the world to engage in international production and business activities through foreign direct investment based on their own countries. Different from the scope of business activities in which domestic enterprises are only distributed in one country, the scope of business activities of multinational corporations extends to a number of countries and regions. Therefore, the complex and diversified business activities environment and characteristics of it have caused a special impact decision system for the capital structure of multinational corporations. As a result, they will be affected by political risks, exchange rate risks, international tax differences, international legal environment differences, and national cultural differences.

When multinational companies obtain their cash flows from incompletely related markets located in different countries and regions, the volatility of returns is reduced to varying degrees. And these are making up for the intrinsic benefits of internationalization.

In addition, the internationalization and specialized production of multinational corporations can effectively avoid the restrictions on economies of scale in the host country market. Multinational corporations have achieved economies of scale and effectively reduced their expected bankruptcy costs and liquidation costs.

The Impact of Income Tax on Financing and Capital Structure

The capital structure of an enterprise will be affected by the existence of taxation. There are two main results: First, the tax revenue effect, after the taxpayer pays the tax, the freely disposable funds become less; second, the substitution effect, In order to reduce taxes, taxpayers usually make reasonable financing decisions according to the corresponding tax policies of the country. Taxation will have a great impact on the financing decisions of enterprises. The interest generated by the enterprise through debt financing is regarded as the pre-tax deduction of the expenses incurred in the operation process. The dividends allocated by the enterprise to the shareholders must be paid after the enterprise income tax has been paid, and the enterprise cannot obtain the tax benefits. Due to the existence of taxation, the status of shareholders and creditor is unequal. From the perspective of personal income tax, due to the government's collection of personal income tax, the dividends received by the shareholders from the enterprise and the interest income earned by the creditors from the enterprise must be subject to personal income tax, so that the dividends paid by the enterprise to the shareholders and paid to the creditor is not equal to their actual income. If there is a difference in the tax rate between the income tax and the income tax of the dividend, then the shareholders and creditors will have different assessments of the value of the enterprise, and the required rate of return will be different [1].

Companies can take advantage of tax shields. Tax shields can reduce corporate tax burdens. The benefits, in turn, affect the capital structure decisions of multinational companies. The tax shield can be divided into a debt tax shield and a non-debt tax shield. On the one hand, the company will consider the choice of debt financing, the generated interest and other financing expenses as a debt tax shield before tax deduction; on the other hand, the formation of a large amount of debt through debt financing will cause high risk to the enterprise, so there is a limit to the debt financing of the company. At this time, the non-debt tax shield that deducts the depreciation and amortization amount can also play a role in saving taxes, and even replace the role played by the debt tax shield in capital structure decision-making. The existence of debt tax shield encourages the company to carry out debt financing. In the decision-making of capital structure, enterprises need to weigh the mutual restriction relationship between debt tax shield and non-debt tax shield, and take into account the relationship between the two in tax planning [2].

Generally speaking, in the financing decision-making, the enterprise obtains the funds needed for its own business development mainly through equity and debt financing. Shareholders and creditors are asking for a certain amount of compensation while providing funds. Enterprises will take the enterprise income tax into consideration when making financing decisions, and tend to choose a low financing cost. Although debt financing can generate tax-deductible income, large-scale debt is risky. Enterprises must not only bear a large amount of funds due to repay principal and interest, but also bear the normal impact of the capital chain due to adverse factors. This affects the normal operation of the company and even leads to bankruptcy of the company, so it is impossible for the company to use 100% debt financing. According to the agency cost theory, when a listed company makes a financing decision, it needs to make a trade-off between financial leverage benefits and financial distress costs. With the increase of asset-liability ratio, financial risk and financial leverage income have a reverse trend.

The interest on debt has a tax-deductible effect. The interest income that is allowed to be deducted before tax and retained inside the enterprise can also increase the value of the enterprise. Meanwhile, with the large-scale debt financing, the financial risk of the company is also increased. The debt tax shield of multinational companies in making financing decisions is indeed an important factor to be considered, but it is necessary to find a balance.

Non-debt tax shields are the expenses other than debt interest, like depreciation. When the depreciation and amortization amount is larger, the amount of cost and expenses is also increased, and the non-debt tax shield leads to lower corporate income tax payment. Therefore, companies should choose their depreciation and amortization methods to maximize the use of non-debt tax shields.

The main components of the non-debt tax shield are depreciation and amortization. They are the behaviors that occur almost daily in the daily production and operation activities of enterprises. Therefore, enterprises use non-debt tax shields to save taxes and there are almost no costs and risks. Meanwhile, the non-debt tax shield formed by depreciation and amortization forms a non-cashing cost. It does not pay cash in actual operation. On the contrary, it will remain in the company.

The non-debt tax shield has a tax avoidance effect similar to that of the debt tax shield. Both can be deducted before tax and financed at a lower financing cost, but the two are different in tax law regulations and usage costs. The tax law strictly stipulates the standard for deduction of interest charges on borrowings. The rules for depreciation and amortization are not so strict. There is variability within the scope, there are a variety of methods, time limits to choose from, and the use is more relaxed. The debt tax shield is more flexible and convenient than the use of the non-debt tax shield.

From the perspective of the cost of use, if the enterprise uses the debt tax shield, it means that the company may have regular repayment of debt interest and principal during the operation process, and there is also the possibility of bankruptcy. The debt tax shield wants to obtain income. On the contrary, the use of the non-debt tax shield is based on the depreciation and amortization of the asset. In this way, the risks and costs it faces are greatly reduced.

If a company wants to take advantage of the the non-debt tax shield to decrease the corporate income tax and increase the net profit, this approach has great flexibility. Borrowing interest and related expenses arising from the use of debt by enterprises can be capitalized in the subsequent production and operation process. After being capitalized, they cannot be listed in the income statement, and cannot reduce the income tax paid by enterprises, but based on assets. Depreciation and amortization will occur after being put into production and operation, and deduction will be made in the form of depreciation. In this way, the original interest expense amount can be converted into depreciation deduction, and the debt tax shield can be turned into a non-debt tax shield. Non-debt tax shields are more flexible and less costly for companies, so business operators are more willing to use them. This tendency of business operators weakens the role of debt tax shields in enterprises, and these two types of tax shields can be transformed into each other.

The Impact of Income Tax on Financing and Capital Structure of Multinationals

Taxation affects the multinational company's choice of financing methods, which in turn generates a tax effect. First, when a multinational company is financing, the corporate income tax will affect the company's capital structure. According to the international practice, when calculating the company's taxable income, the interest expense of the debt financing is allowed to be deducted before tax, and the profit distribution as dividends. However, it cannot be deducted. Secondly, the income tax on investors and the income tax on dividend income will change the capital structure of the company under financing. Finally, there are differences between shareholders' capital gains tax and dividend tax, which will affect the company's profit distribution policy.

Tax rates include nominal tax rates, marginal tax rates, and actual tax rates. The actual tax rate reflects the company's true tax burden level, which is the proportion of the taxable amount to the total income. It reflects the impact of various tax rate concessions and tax credit policies on the corporate income tax burden at the micro level, so as to provide empirical evidence. Therefore, the marginal tax rate is the best proxy variable for measuring the level of corporate tax benefits.

The tax rate includes nominal tax rate, marginal tax rate, and actual tax rate. The current state-of-the-art approach to estimating MTRs is developed by Graham [3], who builds upon the approach in Shevlin [4].

Suggestions

When financing, multinationals should weigh the impact of different countries and different political environments on tax burdens, and also consider the impact of financing channels and financing methods on corporate taxation. Multinational companies need to comprehensively consider the policies, interest rates and tax burdens of different countries, and make reasonable choices for financing locations, such as selecting countries with lower interest rates, more preferential tax policies and loose restrictions. Multinational companies can use the capital markets of developed countries for financing. If the capital market of the host country is not perfect, in order to avoid risks, multinational companies can also choose internal financing or through the financing of third countries and international financial institutions.

When the stock market overestimates the value of the company, multinational companies should adopt the financing method of issuing additional shares; if the stock market underestimates the value of the company, multinational companies should do more internal financing. When a multinational company become more competitive and their market positions are stable, they can appropriately increase their long-term debt and reduce the scale of equity financing accordingly, thereby reducing their capital costs.

Enterprises should pay attention to the proportion of internal profit retention, strengthen the ability of internal funds to accumulate, and at the same time update internal control measures, reasonably and effectively control various costs and expenses in the course of business operations, increase current profits, and improve the ability of enterprises to resist business risks.

While multinational corporations enjoy the convenience of multiple financing channels, they are also subject to the complicated and volatile fluctuations of the international economic and political environment. The exchange rate and interest rate of various countries are blurred. In the overseas financing of multinational corporations, debt risk mainly manifests in four types of exchange rate risk, interest rate risk, commercial risk and political risk. Based on the above analysis, multinational corporations not only need to choose favorable currencies when financing, but also should reasonably grasp the opportunity.

When multinational companies conduct financing activities, they have more choices and opportunities, although they encounter more operational risks. On the one hand, it is necessary to actively improve the financing channels of the domestic capital market. On the other hand, it should cooperate with multinational banks and financial institutions and organizations with high credit ratings in the host country to update new financing methods. Large enterprises directly issue international bonds overseas. For multinational companies, making full use of the international background can not only meet the company's capital needs, but also optimize the company's capital structure.

Multinational corporations should recruit and cultivate financial management talents, update the financing concept, and comprehensively strengthen the assessment and management of foreign exchange risks. With its own business risk status, it is familiar with and masters the financial structure and chooses the appropriate capital structure, actively explores financing channels, and pays attention to the arrangement of internal funds, and develops steadily and effectively [5].

In conclusion, corporate income tax has a significant impact on the capital structure of multinational corporations. Multinational corporations should use tax shields and optimize their capital structure. Multinational companies should choose appropriate financing locations and financing tools and improve risk management to maximize the value of the company.

References

[1] Yao Dan. The effect of income tax on the company's capital structure - Based on the analysis of Chinese listed companies. Master Thesis. Dongbei University of Finance and Economics, Dalian, China. 2017.

[2] Guo Xiaoge. Research on the influence of corporate income tax on capital structure on the different property rights. Master Thesis. Taiyuan University of Technology, Taiyuan, China. 2018.

[3] Graham, John R. Debt and the marginal tax rate. Journal of financial Economics 41.1 (1996): 41-73.

[4] Shevlin, Terry. Estimating corporate marginal tax rates with asymmetric tax treatment of gains and losses, Journal of the American Taxation Association. 12(1990):51-67.

[5] Tong Shunxin. Research on the Capital Structure of Multinational Enterprises and Its Optimization. Economic & Trade Update. 27(2017):41-44.