The Parental Debt Puzzle - Multinational Companies and Parental Debt Utilization in an International Tax Setting

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Multinational companies largely endow their subsidiaries with parental debt although this decision often appears sub-optimal based on standard theory for tax-efficient capital structures. Recent research suggests that parental debt replaces external debt in affiliates of multinational companies whenever it is cheaper to centrally borrow external capital on headquarters level and to route it to the subsidiaries in terms of parental debt. Data for Norwegian multinationals partly confirms this hypothesis, but the empirical analysis also indicates that particularly smaller multinational networks, in some settings, utilize parental debt to replace equity in high-taxed affiliates' and, hence, engage in so-called internal debt-shifting.

Recently, tax avoidance by large multinational companies has called a great deal of attention in media and politics. It turned out that world-famous companies such as Amazon, Apple, Google and Starbucks have been paying almost no corporate income taxes in countries that they gain tremendous revenue in and at the same time benefit from public infrastructure. Although these companies have been utilizing tax avoidance strategies that are largely legal, this contrast has originated public outrage and the feeling of social injustice. Two main tax avoidance strategies that a lot of multinationals have in place are abusive transfer pricing and debt shifting.

I have dipped into this interesting area of conflict and examined multinationals firms' debt shifting strategies with a particular focus on the role of parental debt (i.e. internal loans from the parent company). Multinational companies seek to exploit tax rate differences between tax jurisdictions that their affiliates operate in by utilizing external and internal loans in a way that overall maximizes tax deductions on interest expenses. A given interest expense in a high-taxed affiliate allows for larger tax savings than the same amount in a low-taxed country. Following this mechanism, in theory, a tax-efficient optimal capital structure can be derived for multinational companies. According to theory, all internal loans within the multinational network should be lent out by the lowest-taxed affiliate in order to maximize tax savings.

Consequently, multinationals using parental debt forego certain tax savings from a tax theory point of view if the parent firm is not the lowest-taxed unit. However, real world multinational capital structures draw a different picture and show that multinationals largely utilize parental debt. Previous studies have revealed that affiliates of German and U.S. multinationals have featured significant parental debt-to-total asset ratios in the past. My analysis shows that 33% of all covered Norwegian multinationals utilized parental debt between 1994 and 2004. The average net parental debt to-total asset ratio among these companies was 7.8%. This contradiction between capital structure theory and reality constitutes what I call the parental debt puzzle. Why do multinationals largely endow their subsidiaries with parental debt although it appears to be value disruptive from a tax-efficient capital structure theory perspective? And how can parental debt be incorporated in a debt shifting model?

Recent research suggests that parental debt is utilized in order to replace external debt in multinationals’ affiliates whenever it is cheaper to centrally borrow external capital on parent level and to route it to the affiliates in terms of parental debt. That way, parental debt circumvents an adverse institutional environment in the country of the affiliate or unfavourable affiliate characteristics that may lead to expensive local external capital. Additionally, the multinational network benefits from corporate centre advantages resulting from centralized borrowing and can utilize parental debt as commitment device in order to mitigate adverse affiliate characteristics and make local external debt affordable. A model of debt shifting incorporates parental debt as commitment device and argues that it is not part of the internal debt shifting mechanism.

My empirical analysis confirms the hypotheses that parental debt circumvents capital market inefficiencies (as it rises with weaker creditor rights), and that it is backed by external debt and, therefore, subject to the standard tax shield and the external debt shifting mechanism (as it increases in the statutory tax rate of the affiliate). However, there is also some indication that, in certain settings, parental debt is used for internal debt shifting purposes as well. In these cases, parental debt replaces equity in high-taxed affiliates. Particularly smaller multinationals with moderate financial expertise may have incentives to abstain from setting up an internal bank and, instead, to conduct internal debt-shifting by means of the parent unit.