

**THIN CAPITALIZATION IMPACT ON LISTED MULTINATIONAL COMPANIES'
FINANCIAL PERFORMANCE IN NIGERIA?**

BY:

Ogbada, Eyong Ikwa, PhD, FCCA, MTMN

Email: eiogbada@gmail.com Phone: 08068175273

And

Okezie, Stella, PhD, ACA

Onunaka, Uzoamaka Faith

Department of Accounting, College of Management Sciences,

Michael Okpara University of Agriculture, Umudike,

Abia State, Nigeria

Abstract

Thin capitalization and financial performance of listed multinational companies in Nigeria was critically examined within a five year period (2017-2021) with an in-depth concentration. The study employed ex-post facto research design and a purposive or judgmental sampling technique to select eight (8) listed non-financial Multinational Companies from construction, food and beverages consisting of Unilever Nigeria Plc., UAC of Nigeria Plc., Cadbury Nigeria Plc., Guinness Nigeria Plc., Nestlé Nigeria Plc., Dangote Sugar Refineries Plc., Julius Berger Nigeria Plc. and PZ Cussons Nigeria Plc. While secondary data from the published financial annual reports of the eight (8) selected listed multinational companies in Nigeria were used. The study dependent variable was financial performance (return on assets) and independent variables were financial leverage and Effective Tax Rate. The control variable was firm size. The secondary data obtained were analyzed using multiple regression analysis. The result showed that financial leverage has a negative but significant effect on Return on Asset of listed multinational companies in Nigeria. The findings also revealed that Effective tax rate has a positive but insignificant impact on Return on Asset of listed multinational companies in Nigeria. Therefore the study recommends that a thin capitalization rule which will limit the debt-equity ratio, should be introduced in Nigeria as it helps prevent tax avoidance. The interest deductibility rules which was introduced in the Finance Act, 2019 limited interest deductibility to a specific benchmark of thirty percent (30%) of EBITDA. Hence, the Federal Inland Revenue should ensure that all multinationals comply with the Finance Act 2019 on the interest deductible from profit restriction. The study recommends that in order to improve performance, corporate managers are advised to reduce financial leverage. Multinationals should avoid over floating investment in affiliate with high leverage especially in a developing state in order to sustain it operations and maximize needed profit. The study also suggest that Managers of MNCs should engage in tax planning activities that will reduce the effective tax rate and improve overall financial performance as effective tax rate has a positive but insignificant effect.

Keywords: *Effective Tax Rate, Firm Size, Financial Leverage, Multinational Corporations, Thin Capitalization.*

INTRODUCTION

Background of the Study

A Company's capitalization method can significantly impact its reported profit for tax purposes. Tax laws typically allow a deduction for interest paid or payable in arriving at the taxable profit. The higher the level of debt in the company, vis-à-vis the interest it pays, the lower its taxable profit. Hence, debt is often a more efficient tax method of financing than equity. A deliberate effort to be highly leveraged is perceived to be a tax planning strategy by most Multinational Companies (MNCs) to minimize group tax liabilities. Thin capitalization is report as the situation where a company is financed through a relatively high level debts compared to equity (OECD, 2012). In the OECD thin capitalization legislation report, there are evidences where a subsidiary or branch of a MNC in one tax jurisdiction with lower tax rate will finance its subsidiary in another tax jurisdiction with higher tax rate through debt capital, since interest expenses on debt capital are deductible for tax purposes in most tax jurisdictions of the world, deductions of interest expenses on debts would likely cause a lower assessable profits and potentially reduce tax revenue. Thin capitalization is a tax planning policy carried out by a company having strategically evaluated the country's fiscal policy to suit its capital composition, activities which enabled them to finance their operations relatively with high level of debt against equity. As a finance strategy, multinational companies use thin capitalization to put together their investment portfolio abroad, with the overall objective of reducing tax returns in the subsidiaries tax jurisdiction.

Multinational Companies (MNCs) usually can structure their financing arrangements to take advantage of inter and intra company transfers, transfer pricing, movement of intellectual property rights, and exchange of loans between related companies. Beyond establishing a tax-efficient mixture of debt and equity in borrowing countries, MNCs can also influence the tax treatment of the lender that receives the interest. For instance, arrangements may be put in place to allow the interest to be received in a country that either does not tax the interest income or which taxes such income at a lower rate (Akabom & Ijabu, 2018). MNCs' additional incentives to use debt instead of equity financing are concerned with the deployment of internal (related-party) debt as a profit-shifting instrument by injecting equity financing into a foreign associate in a low tax jurisdiction. This affiliate then offers loans to associated enterprises within the MNC in countries having higher tax rates. The implication is low tax revenue for these countries and higher tax savings for the MNCs due to the deductibility of interest expenses (Fagbemi, Olaniyi & Ogudipe, 2019). Intra-company borrowing and lending is one of the common channels through which multinational companies (MNCs) shift profits between countries to minimize their overall tax liability. Indeed, MNCs

can finance investments in high-tax countries with debts to enjoy interest deductions there at a high corporate income tax (CIT) rate, while the interest received can be taxable in low-tax countries where intra-company loans are issued. Debt shifting thus reduces the total tax liabilities of the MNC group without affecting its overall debt exposure or bankruptcy risk. This study seeks to fill the gap by presenting empirical findings to examine the impact of thin capitalization on financial performance of multinational companies in Nigeria being the main objective of this study. While specifically the study is to:

1. Determine the impact of Financial leverage on Return on Asset of listed multinational companies in Nigeria
2. Examine the impact of effective tax rate on Return on Asset of listed multinational companies in Nigeria

The null hypothesis formulated and tested for the study are:

1. H_0 : Financial leverage has not significantly impacted Return on Asset of listed multinational companies in Nigeria.
2. H_0 : Effective tax rate has no significant impact on Return on Asset of listed multinational companies in Nigeria.

Review of Related Literature

Thin capitalization: Thin capitalization refers to the situation in which a company is financed through a relatively high level of debt compared to equity (OECD thin capitalization legislation report, 2012). A company is said to be operating with thin capitalization if the size of the paid-up capital is small or low compared with its debt capital or the size of its operation (Ibiloye, 2013). Thin capitalization refers to a situation whereby an enterprise employs more debt than equity to finance its business activity (highly geared). The effect of thin capitalization on taxation is that enterprises with high debt funding would enjoy tax reliefs on interest charges unlike dividend. This is because interest is tax deductible and paid before the profit of the borrowing company is determined, thereby making debt financing more attractive to associated companies because profit is shifted from one country to another for the purpose of tax avoidance (Gbonjubola, 2013).

According to Webber (as cited in Akabom & Ijabu, 2018), thin capitalization is viewed as the tactics adopted by multinational companies for usage of direct foreign investment in their capital structure. Thin capitalization brings about tax avoidance practice that affects the level of income tax that accrued to the government. From the perspective of firm's finance strategy, thin capitalization is a financial technique that multinational companies adopt to avoid tax on their investment portfolio abroad.

The level of debt in the capital mix of a company is a crucial managerial decision since it affects the shareholders' return and risk. On one hand, debt or loan as a finance source is considered cheaper than equity because the debt option improves dividend payable to shareholders. Apart from the dilution of earnings, there is also the question of ownership and control associated with the issue of shares (Aziz & Abbas, 2019; Gomis & Khatiwada, 2016; Iqbal & Usman, 2018). On the other hand, there is a problem of an increased cost of capital, reduction in firm value, and bankruptcy cost due to financial distress associated with high financial leverage. The general assumption on the link between financial leverage and financial distress or failure is that highly geared firms have a higher degree of risks because of the potential of default in effecting payment of interest expense leading to bankruptcy or liquidation. Thin capitalization is proxy by financial leverage. It is measured as a ratio of the firm's total long term debt to shareholders' equity.

Reasons for a Thinly Capitalized Company

A company may be thinly capitalized for some or all of the following reasons:

- i. It is carrying a greater quantity of interest-bearing debt than it could sustain on its own.
- ii. The interest charged is in excess of the commercial rate for the loan(s) which it is carrying.
- iii. The duration of the lending is greater than would be the case at arm's length.
- iv. Repayment or other terms are more disadvantageous than could be obtained in an arm's length arrangement

Features of Thin Capitalization

- a. Thin capitalization is where a company is heavily financed by debt as against equity capital.
- b. Where a company has higher proportion of debt to equity capital, the taxable profits of the company will be eroded by the interest expense.
- c. Where the debt is provided by a foreign parent company then more of the profits is repatriated out of the country.
- d. As a result of the high level of interest expenses, which erode the taxable profit of the company, it will, therefore, reduce the tax revenue due to the government.

According to OECD (2012), the manner in which a company is capitalized can have a significant effect on the amount of profit it reports, and thus the amount of tax it pays. For this reason, country tax administrations often introduce rules that places a limit on the amount of interest that can be deducted in calculating the measure of a company's profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive debt, and thus aim to protect a country's tax base. From a policy

perspective, failure to tackle excessive interest payments to associated enterprises gives MNCs an advantage over purely domestic businesses which are unable to gain such tax advantages.

Approaches of Thin capitalization rules

Thin capitalization rules typically operate by means of one of two approaches discussed below.

Limiting the amount of debt on which deductible interest payments may be made:

Thin capitalization rules often operate by limiting, for the purposes of calculating taxable profit, the amount of debt that can give rise to deductible interest expenses. The interest on any amount of debt above that limit (excessive debt) will not be deductible for tax purposes. Countries take different approaches to determining the maximum amount of debt that can give rise to deductible interest payments, but there are generally two broad approaches:

- 1. The “Arm’s length” approach:** Under this approach, the maximum amount of allowable debt is the amount of debt that an independent lender would be willing to lend to the company i.e. the amount of debt that a borrower could borrow from an arm’s length lender. The arm’s length approach typically considers the specific attributes of the company in determining its borrowing capacity (that is, the amount of debt that company would be able to obtain from independent lenders). The arm’s length approach can also encompass a determination of the amount of debt that a borrower would have borrowed if the lender had been independent enterprise acting at arm’s length. An arm’s length approach requires the taxpayer company (and tax authority) to establish the amount of debt a third party lender would be willing to lend to it. This involves taking a view on the amount of debt that third party lenders, acting at arm’s length, would be willing to lend to the specific company in question, taking into account the specific attributes of that company. The approach can also take into consideration the amount the lender, acting at arm’s length, would be willing to borrow.
- 2. The “Ratio” approach:** Under this approach, the maximum amount of debt on which interest may be deducted for tax purposes is established by a pre-determined ratio, such as the ratio of debt to equity. The ratio or ratios used may or may not be intended to reflect an arm’s length position. In contrast, a ratio approach relies on an often inflexible standard embodied in a ratio. Ratio approaches determine the amount of deductible interest expense by reference to a specified ratio, such as the ratio of debt to equity. For example, the rules might allow interest payments on debt of up to two times the total amount of equity invested in the group affiliate. Any additional interest would not be deductible. Approaches differ among countries. For example, Kenya uses a debt to equity approach and employs a 3 to 1 ratio, while Ghana and Canada; for example, use a 2 to 1 debt to equity

ratio. In applying such ratios, some countries use only related-party debt in the equation, whereas others apply this approach using total debt as the basis. It might be expected that a ratio employing total debt as the basis would be lower than a ratio using only related party debt in the equation. Another type of ratio compares the debt to equity ratio (or other financial indicators) of the entity under consideration to the worldwide group debt (or other financial indicator) to worldwide equity to determine (for the purposes of the thin capitalization rules) if the group affiliate's debt level is excessive.

Countries adopt a number of approaches for applying ratio approaches. Some countries aim to determine ratios with the aim of approximating an arm's length position. Others determine ratios according to other criteria. Where ratios are determined according to arm's length criteria, some countries treat the specified ratios as equivalent to a safe harbour. Under this approach, taxpayers will have some certainty that interest that falls within the specified parameters will be considered to be acceptable. Interest that is in excess of the safe harbour may be challenged, however, and potentially disallowed, unless the taxpayer can show that the excess interest represents an arm's length amount.

Limiting amount of interest that may be deducted by reference to its ratio to another variable.

Some countries employ a ratio approach that focuses on the amount of interest paid or payable in relation to the amount of income out of which that interest is paid. This is sometimes referred to as an earnings stripping approach. The applicable ratio may be by reference, for example, to a ratio of the amount of interest to operating profit or a measure of cash flow (e.g. an interest to EBITDA ratio). Germany and Italy, for example, generally cap the deductibility of interest to 30% of EBITDA.

Provisions of Finance Act, 2019 on Thin Capitalization

Prior to the commencement of Finance Act, 2019, there are no thin capitalization rules in Nigeria. However, in practice, FIRS sometimes seeks to disallow interest deductions considered excessive, which in most cases usually done arbitrarily. The Finance Act, 2019 now introduces a specific benchmark of thirty percent (30%) of earnings before interest, taxes, depreciation and amortization (EBITDA) in a year as the limit for interest deduction on loans by a foreign 'connected person'. Where there is excess interest, such is considered as a disallowable deduction in that year. Any unclaimed interest as a result of the restriction can be claimed within 5 years, after which it is lost. The Act exempts Nigerian subsidiaries of foreign companies engaged in banking and insurance from this rule.

Multinational Companies: A multinational company (MNC) can be defined as an enterprise that engages in foreign direct investments (FDI) and which owns or, to a certain extent, controls value-added activities in several countries (Dunning & Lundan, 2008). Multinational Corporation (MNC) is also viewed as a

business entity with one or more foreign affiliates in which the parent company holds at least a 10 percent ownership stake (Foley, Hines & Wessel, 2021). Multinational companies entail the activities or operation of firms that are located in various countries through foreign direct investment. The idea of multinational companies operating in various countries has benefits in aspects of competitive advantage, cost leadership, market growth and tax benefit advantage. The activities of multinational company (MNC) vary in various countries through subsidiary and joint venture, as well as engage in foreign direct investments (FDI).

The major objective of using foreign loan is to reduce or avoid the effect of tax returns on their subsidiaries, this is one of the strategies engaged by multinational companies to take advantage of the Nigeria tax system which does not have a thin capitalization rule that can limit the extent of debt in the capital structure of companies prior to the commencement of Finance Act, 2019.

Effective Tax Rate: The company income tax rate is of great concern to corporate managers because it is a major determinant of what country to invest. The company income tax rate of 30% in Nigeria is considered high when compared with the 25.32% average of OECD countries (Ezugwu and Akubu, 2014). Salaudeen (2017), argued that the applicable tax rate in making investment decisions should be the effective tax rate rather than the statutory tax rate. Therefore, the effective tax rate for a company is the average rate at which its pre-tax incomes are taxed. The effective tax rate is the average taxation rate for a corporation or individual. The effective tax rate reflects an individual or company's total tax burden.

Gearing /Leverage (Debt to Equity ratio): Gearing, also called leverage, measures the total long term debt of a company as a percentage of the equity capital in the company. Equity includes paid-up share capital, premium, reserves and retained earnings. Debt to Equity is the ratio of long term debt against total of paid-up share capital, premium, reserves and surplus in case of public sector or retained earnings. It indicates how an entity finance its business by either debt or equity. This is measured by dividing total debt by total equity. Equity may influence firm performance, since shareholders may not be entitled to dividends if company does not make profit in a particular accounting period. Company may as well decide to plug back the profit in the business in order to improve firm performance.

Firm Size: The size of a company can be measured through its total asset. The logarithm of total asset is known as firm size. The direction of the relationship between firms' size and thin capitalization cannot be predicted. This has received considerable attention in the literature and has provoked dynamic discuss. Some scholars documents that larger firms are more likely to exploit economies of scale and enjoy higher negotiation power over their clients and suppliers (Serrasqueiro and Nunes, 2008). In addition, they face

less difficulty in getting access to credit for investment, have broader pools of qualified human capital, and may achieve greater strategic diversification (Yang & Chen, 2009).

The Firm Size is the control variable for this study. Apart from the explanatory and predicting variables, the control variable has been used to control firm-specific features which can influence financial performance and leverage.

Financial performance: Performance can be evaluated using some financial and non-financial indicators to show to what extent an organization has been able to achieve a set objectives taking into consideration the resources deployed for that purpose (Enekwe, Agu & Eziedo, 2014). The Financial performance which this study examined reveals how well an organization used its financial resources and shows its financial health and fitness, as well as the results of the firm's work, operations, and policies. These results are presented in the form return on equity (ROE), return on assets (ROA), dividends per share (DPS), and earnings per share (EPS). ROE and ROA have been chosen as the dependent variables, and refers to how much profit firms earn based on their asset investments, and how effectively managers use investors' funds. Return on assets measures how efficiently a company can manage its assets to produce profits during a period. $ROA = \frac{\text{Profit before Tax}}{\text{Total assets}}$

$$\text{ROA} = \frac{\text{Profit before Tax}}{\text{Total assets}}$$

For the purpose of the study, three theories are used, each addressing the variables used in the study. The theories are; Tax planning theory, Political cost theory and Trade-off theory of Capital Structure. However, the study is anchored on Tax Planning Theory.

Tax Planning Theory: Tax planning theory is considered suitable for the study because it explores the derivable benefits resulting from a company's tax planning activities. For instance, Penno and Mark (2022), argues that tax authorities decides whether to change a taxpayer's deduction with a limited scope audit, and the taxpayer must balance the probability of a rejected deduction against the size of an aggressive claim. The theory is based on the assumption that corporate tax liability is a function of taxable income as against accounting income. The idea is to intensify activities that reduce taxable income but have no indirect relationship on accounting profit. The theory also recognized a positive association between firm tax planning activity and firm performance. Therefore, managers with profound knowledge of a country's tax laws benefit from tax savings by exploiting loopholes in tax laws.

Political Power Theory: Political power theory developed by Rasmus and Martin (2019), asserted that larger firms have economic and political power advantage over the small firms. Larger firms effectively utilize their economic and political power to lessen their tax liability being able to engage in aggressive

tax planning due to their broad resources. Furthermore, Rasmus and Martin (2019), noted that large firms are opportunistic in manipulating the political principles for the enhancement of their after tax returns.

Trade-off Theory of Capital Structure: Thin capitalization is supported by the trade-off theory of capital structure. This theory is one of the foremost theories in corporate finance which states that a company can determine how much debt and equity finance to use by balancing the costs and benefits (Kraus & Litzenberger, 1973). Trade-off theory of capital structure primarily implies offsetting the costs of debt against the benefits of debt. It states that there is a benefit to debt financing, that is, the tax benefits of interest expenses on debts and there is a cost of financing with debt, that is, costs of financial distress including bankruptcy costs of debt and non-bankruptcy costs. The marginal benefit of debt declines as debt increases, while the marginal cost increases as debt increases, so it is important that a company optimizes its overall value by ensuring trade-off when choosing how much debt and equity to use for financing.

Empirical Review

Osamor (2022), examined the effects of thin capitalization on return on invested capital of multinational and non-multinational firms. Secondary data was obtained from the annual reports of the firms from 2006 to 2020. Thin capitalization was proxy with debt-to-equity ratio, firms' financial performance was proxy with return on invested capital, while tax burden and firms' size were used as control variables. Data was analyzed using descriptive statistic, unit root test, co-integration and panel data regression. The findings of this study concluded that thin capitalization had effects on firms' financial performance in both multinational and non-multinational firm in Nigeria. Hence, it was recommended that Nigeria government should introduce thin capitalization rules and other forms of tax avoidance strategies need to be properly checked from both multinational and non-multinational firms to ensure that effective tax rate is paid.

Otuya and Omoye (2021), investigated the thin capitalization and performance of MNCs in Nigeria for the period 2014 to 2018. The study deployed descriptive, correlation and regression analyses as data analytical techniques. The findings indicated that thin capitalization, interest expenses rate, effective tax rate, and capital intensity have a positive but insignificant association with MNCs financial performance. The study further revealed that managerial efficiency has a negative but insignificant association with financial performance. The study concludes that thin capitalization practices enhance the financial performance of multinational companies in Nigeria and recommends that tax authorities initiate tax reforms aimed at reducing the statutory corporate tax rate.

Udeh and Eze (2021), examined the impact of corporate tax evasion on the operating cash flow performance of manufacturing enterprises in Nigeria. The population of the study, which used an Ex Post Facto research design, was made up of listed manufacturing companies in Nigeria. Utilizing both descriptive and inferential statistical methods, the financial statement data were examined. The multiple regression method was used to assess the hypotheses, specifically the Random-GLS estimation method based on the outcomes of the Hausman Specification test. According to the empirical findings, the effective tax rate had a negligible beneficial impact on operating cash flows but a considerable positive impact on investing cash flows.

John and Stephanie (2021), examined the interactive effect of tax planning and corporate governance on the financial performance of 50 non-financial quoted companies in Nigeria between 2017 and 2018. A system GMM was employed to estimate the dynamic models, and results show that ownership structure (OS) and capital intensity (CI) exerted a significant and positive impact on the returns on assets. This implies that OS plays a significant role to ensure that CI triggers an increase in the return on assets of the quoted Nigerian companies. However, board diversity and thin capitalization wielded a significant and negative influence on return on assets. This study thus recommends that companies should put in place a strong corporate governance mechanism that will monitor, check and balance tax planning activities and strategies adopted by the management of quoted companies in Nigeria.

Umeh, Okegbe and Ezejiofor (2020), examined the impact of tax preparation on business value in listed consumer products manufacturing firms in Nigeria. The study employed ex-post facto research design. From the population of all the non-financial companies quoted on the Nigeria Stock Exchange, a sample size of 21 firms was chosen based on the availability of the financial statements of the selected firms. The study discovered that the Effective Tax Rate (ETR) has a statistically significant negative impact on firm value. The study also discovered that book tax difference (BTD), though not statistically significant, had a beneficial impact on business value.

Okesola (2018), examined the effects of thin capitalization rules on tax revenue by using the Latvian economy as a case study. Taxes on corporate profits, gross fixed capital formation annual percentage growth, short-term interest rates on loans in the Euro Area (EA) and adjusted net national income percentage growth data for the period of 2000 to 2016 were obtained from the Organization for Economic Cooperation and Development (OECD) and the World Bank database. A multiple regression model was adopted and the results showed that the thin capitalization policy is statistically insignificant to tax revenue in Latvia.

Akabom and Ijabu (2018), examined the effect of thin capitalization and international laws on performance of multinational companies in Nigeria covering the period of 2012-2016. The analysis technique used was the multiple regressions. Research results indicated that thin capitalization is revenue stripping techniques but it affects performance of multinational companies in Nigeria. The study therefore recommended among others that Government should design a framework that will limit debt-to-equity ratio of multinational companies operating in Nigeria, since it has become imperative that companies used high leverage to generate and shift earnings without having carefully managed the accompany problems of financial distress.

Ramadhan and Riandoko (2017), investigated the effect of thin capitalization rule implementation on corporate capital structure (debt and equity) in a sample of 76 publicity-listed Indonesian firms for 2015 and 2016. This study used leverage data in 2015 (before the implementation) and 2016 (after the implementation). The data was separated with the leverage above 4:1 and below 4:1. Paired sample t-test was used for analysis. The findings showed that the thin capitalization rule significantly affected corporate capital but did not significantly affect corporate debt in both samples.

Yetty, Eka and Eneng (2016), examined the effect of thin capitalization on tax avoidance. The population of their study was limited to manufacturing firms listed on Indonesian Stock exchange for period 2010-2014. The study made use of secondary data such as Annual Report Financial Statements that are published during the observation year. The multiple linear regression equation was used. It was discovered that Leverage does not have a significant effect on tax avoidance.

Saratu (2015), investigated the impact of competition on tax avoidance activities among Nigerian Deposit Money Banks. They made use of data obtained from the financial statement of 15 banks operating on the Nigerian Stock Exchange for a period of 10 years. It was noted that competition has a positive and insignificant impact on tax avoidance. The findings suggested that while effective tax rate and managerial efficiency are negatively related, effective tax rate and non-performing loans showed a positive and insignificant relationship. It was further recommended that the environment in the banking sector should be further enhanced through favorable banking policies to encourage competition among the banks and by doing this tax revenue will increase for the government and this increase in revenue would help the Federal Government undertake more economic infrastructural developments.

Manawaduge, Zoysa, Chowdhury and Chandarakumara (2011), analysed the impact of capital structure on firm performance in the context of an emerging market—Sri Lanka. The study applies both pooled and panel data regression models for a sample of 155 Sri Lankan-listed firms. The results demonstrate that

most of the Sri Lankan firms finance their operations with short-term debt capital as against the long-term debt capital and provide strong evidence that the firm performance is negatively affected by the use of debt capital. The study also finds a significant negative relationship between tangibility and performance indicating inefficient utilization of non-current assets. The negative performance implications associated with over-utilization of short-term debts and the under-utilization non-current assets provide corporate managers with useful policy direction.

Methodology

Research Design: The study employed the ex-post facto research design. The justification for adopting this design is that requisite data were not manipulated but sourced from secondary materials with a view to accessing extensive information and obtaining good knowledge about the study.

Population of the study: The population of the study comprises of non-financial multinational companies listed on floor of the Nigeria Stock Exchange as at 31st December, 2021.

Sample and sampling technique: This study employed a purposive or judgmental sampling technique to select eight (8) listed Multinational Companies from construction, food and beverages consisting of Unilever Nigeria Plc., UAC of Nigeria Plc., Cadbury Nigeria Plc., Guinness Nigeria Plc., Nestlé Nigeria Plc., Dangote Sugar Refineries Plc., Julius Berger Nigeria Plc. and PZ Cussons Nigeria Plc. for the period 2017 to 2021 making a total of 40 year-end observations. These companies were used because they reported their financial transaction based on International financial reporting standard, and disclosed well appropriately information needed for the computation of all variables in the study.

Source of Data Collection: The study made use of secondary data. Data were generated from the audited annual reports of our sampled companies for the years 2017 to 2021.

Model Specification: In estimating the model, descriptive statistics was used to determine the normality of the data. The data collected were analyzed using multiple regression to establish the relationship between the independent and dependent variables.

The model built for the purpose of analysis for this study is as follows;

$$ROA = \beta_0 + \beta_1 LEV_{it} + \beta_2 EFFTAX_{it} + \beta_3 FS_{it} + \mu_{it} \text{-----}(1)$$

Where:

ROA= Return on Asset; LEV = Financial Leverage; EFFTAX = Effective Tax Rate; FS = Firm Size;

β_0 = Constant; β_1 - β_3 = Regression Parameters; μ = Error term; i = sampled companies;

t = time dimension

Measurement of Variables: The variables of the study are measures as described in the table below:

Table 1 Operationalization of Variables

Variables	Measurement	Abbreviations
DEPENDENT VARIABLE (Financial Performance)		
Return on Asset	Profit before Tax / Total Asset	ROA
INDEPENDENT VARIABLES (Thin Capitalization)		
Financial Leverage	Long-term debt / Shareholders' Fund	LEV
Effective Tax Rate	Income tax Paid / Profit before Tax	EFFTAX
CONTROL VARIABLE		
Firm Size	Natural Log of Total Assets	FS

Source: Authors compilation 2023

Data Presentation and Analysis

Data Presentation: The analysis of the data collected in terms of the statistical characterization and econometric evaluation is presented here. Preliminary estimation such as the descriptive statistics are discussed. Thereafter, multivariate regression estimation is conducted and interpreted. These provide the necessary apparatus with which to test the hypotheses formulated in the study. The results are presented and interpreted below.

Descriptive Statistics: The descriptive statistics for both the dependent and independent variables are presented in table below

Table 4.1

	ROA	LEV	EFFTAX	FS
Mean	0.077806	1.547701	0.283769	8.043174
Median	0.039431	0.210280	0.306055	8.139430
Maximum	0.368073	10.66089	1.283526	8.657849
Minimum	-0.118447	0.000619	-0.263332	7.439775
Std. Dev.	0.117319	3.257030	0.278228	0.346667
Skewness	0.923872	2.141397	0.730140	-0.248954
Kurtosis	3.452944	5.840531	6.148627	1.898745
Jarque-Bera	6.032194	44.01823	20.07712	2.434456
Probability	0.048992	0.000000	0.000044	0.296050
Observations	40	40	40	40

Source: E-View Output generation

Table 4.1 presents the descriptive statistics of all the variables. N represents the number of observations and therefore the number of observations for the study is 40. Return on asset (ROA) has a mean of 0.077806 with a standard deviation of 0.117319. Also, ROA showed a maximum and minimum value of

0.368073 and -0.118447. The result also reveals that Financial leverage (LEV) reflects a mean of 1.547701 with a standard deviation of 3.257030. LEV also revealed a maximum value of 10.66089 and a minimum value of 0.000619. The Table also illustrate that Effective Tax Rate (EFFTAX) has a mean of 0.283769 with a standard deviation of 0.278228. EFFTAX reveals a maximum value of 1.283526 and a minimum value of -0.263332. Firm Size (FS) revealed a mean of 8.043174 with a standard deviation of 0.346667. Also, FS shows a maximum and minimum values of 8.657849 and 7.439775 respectively.

Normality of the variable was examined using the skewness, kurtosis, Jarques-Bera and probability statistics. According to Kline (2011), the univariate normality of variables can be assumed if the skewness statistic is within the interval (-3.0, 3.0) The data set for all the variables reveal skewness statistic values that are between the range of approximately -3 and +3. Which means that all the data values are within the accepted skewness range for normality.

Correlation Analysis: The correlation coefficient matrix is used to identify the direction and strength of the relationship between thin capitalization and financial performance as well as the control variable. However, the emphasis is on the relationship between the dependent variable and the independent variables as well as the control variable.

Table 4.2

	ROA	LEV	EFFTAX	FS
ROA	1.000000			
LEV	-0.116825	1.000000		
EFFTAX	0.229660	0.113767	1.000000	
FS	0.331568	0.529307	0.054920	1.000000

Source: E-View Output generation

Table 4.2 displays the correlation coefficient between thin capitalization and financial performance of the selected listed multinational companies in Nigeria. The statistics shows that ROA has a negative relationship with LEV ($r = -0.116825$). The negative association suggests that that the higher the value incurred by the entity in the debt to equity, the lower the propensity of the financial performance. However, ROA has a positive relationship with EFFTAX ($r = 0.229660$) and FS ($r = 0.331568$).

The correlation also shows that LEV has a positive relationship with EFFTAX ($r = 0.113767$), and FS ($r = 0.529307$). However, EFFTAX has a positive association with FS ($r = 0.054920$).

Multiple Regression Analysis: The regression results of the panel data estimation are shown in Table 4.3

Table 4.3

Dependent Variable: ROA

Method: Least Squares
Date: 06/06/23 Time: 11:13
Sample: 1 40
Included observations: 40

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1.420335	0.446467	-3.181275	0.0030
LEV	-0.015684	0.005993	-2.617105	0.0129
EFFTAX	0.105029	0.059610	1.761933	0.0866
FS	0.185575	0.056022	3.312508	0.0021
R-squared	0.289888	Mean dependent var		0.077806
Adjusted R-squared	0.230712	S.D. dependent var		0.117319
S.E. of regression	0.102900	Akaike info criterion		-1.615484
Sum squared resid	0.381181	Schwarz criterion		-1.446596
Log likelihood	36.30968	Hannan-Quinn criter.		-1.554419
F-statistic	4.898739	Durbin-Watson stat		0.934230
Prob(F-statistic)	0.005885			

Source: E-View Output generation

Table 4.3 presents the results of multiple regression analysis for thin capitalization and financial performance of listed multinational companies in Nigeria. The output of the regression model unveils that the coefficient of the constant (C) is -1.420335, which implies that if all other variable is held constant all thing being equal, criterion variable is expected to be decreased on the average by about 1.420335 units. For model fitness, the R squared value is used to establish the level of overall fluctuation the study independent variables (LEV, EFFTAX and FS) can collectively cause ROA as the dependent variable to change. The R squared value of 0.289888 shows that LEV, EFFTAX and FS cause ROA to fluctuate at approximately 28.9888%; this means that 71.0112% fluctuation of the ROA is caused by other factors not considered in this study. The R² adjusted value of approximately 0.230712 shows that, there will be a 0.059176 (0.289888 – 0.230712) variation from the sampled result of R square if the other omitted factors are considered will bring about either 5.9176% increase or decrease in the level of fluctuation LEV, EFFTAX and FS can cause ROA to change.

The beta coefficient for LEV shows a negative value of -0.015684, which implies that financial leverage has an inverse relationship with level of financial performance. This suggests a one percent increase in LEV will cause a -0.015684 percent decrease in ROA though it is statistically significant with a p-value of 0.0129 at 5% level of significance. The result further shows a positive beta coefficient value of 0.105029 for EFFTAX but statistically insignificant with a p-value of 0.0866 at 5 percent level of significance. The beta coefficient of the control variable FS is observed to be positive with a value of 0.185575 and

statistically significant with a p-value of 0.0021 at 5 percent level of significance. This suggests that a unit increase in FS will increase ROA by 0.185575 units.

The F-statistics and its probability show that the regression equation is well-formulated explaining that the relationship between the variables combined is statistically significant. The Fisher statistic reveals a value of 4.898739 with a probability value of 0.005885 which prove that the overall model is statistically significant and that thin capitalization has a significant effect on financial performance of listed multinational companies in Nigeria.

Test of Hypotheses: In accepting or rejecting our null hypothesis the p-values of the t-statistic were used. The study adopted 5% level of significance. As p-values in excess of 5% were considered not significant.

H₀: Financial leverage has no significant effect on Return on Asset of listed multinational companies in Nigeria.

The t-statistics value of LEV is -2.617105 with the probability value of 0.0129, indicates a negative relationship but statistically significant at 5% level of significance. This implies that the null hypothesis should be rejected while the alternate hypothesis accepted.

H₀: Effective tax rate has no significant impact on Return on Asset of listed multinational companies in Nigeria.

The t-statistics value of EFFTAX is 1.761933 with the probability value of 0.0866, shows a positive association but not statistically significant at 5% level of significance. The result which indicates a P-value (0.0866 > 0.05), gives enough evidence to accept the null hypothesis and reject the alternate hypothesis.

Conclusion and Recommendations

Findings: The study examined the effect of thin capitalization on financial performance of listed Multinational companies in Nigeria. In light of the test being carried out, the following are the findings to the study:

1. Financial leverage has a negative but significant effect on Return on Asset of listed multinational companies in Nigeria.
2. Effective tax rate has a positive but insignificant impact on Return on Asset of listed multinational companies in Nigeria.

Conclusion: The study examined the effect of thin capitalization on financial performance of listed Multinational companies in Nigeria. As a result of the discussion and analysis, the study shows that there is a negative and significant relationship between financial leverage (LEV) and financial performance (ROA) and that ROA reduced as LEV increases. Therefore, the accumulation of debt capital in the capital

structure inversely affect the performance of these MNCs. It therefore implies that one unit increase in LEV tends to decrease the Return on assets and vice versa. However, the more the debts incorporate in the capital structure, the less the financial performance and vice versa. The results of the study indicated that financial leverage has a negative but significant impact on financial performance. The finding is consistent with the study of Manawaduge, Zoysa, Chowdhury & Chandarakumara (2011).

The study also revealed that Effective Tax Rate (EFFTAX) have a positive and insignificant effect on financial performance (ROA). This is in line with the works of Saratu (2015) and Otuya & Omoye (2021). Therefore, the study concludes that thin capitalization have a significant effect on financial performance of listed multinational companies in Nigeria.

Recommendations: The following recommendations are made which are consistent with the findings and the conclusion of the study:

1. A thin capitalization rule, which will limit the debt-equity ratio, should be introduced in Nigeria to curb tax avoidance. The interest deductibility rules which was introduced in the Finance Act, 2019 limited interest deductibility to a specific benchmark of thirty percent (30%) of earnings before interest, taxes, depreciation and amortization (EBITDA) in a year as the limit for interest deduction on loans by a foreign 'connected person'. Where there is excess interest, such is considered as a disallowable deduction in that year. Any unclaimed interest as a result of the restriction can be claimed within 5 years, after which it is lost. This new law will serve as an alternative to TCRs in order to reduce the amount of interest that can be charged against a company's profit in a particular period. However, Federal Inland Revenue should ensure that all multinationals comply with the Finance Act 2019 on the interest deductible from profit restrictions.
2. To improve performance, corporate managers are advised to reduce financial leverage. This offers substantial evidence that using debt capital as opposed to equity capital has a detrimental impact on the performance of listed multinational companies in Nigeria. Multinational companies should be mindful of excessive use of debt as leverage has a negative significant effect on their performance. Multinationals should avoid over floating investment in affiliate with high leverage especially in a developing state in order to sustain its operations and maximized desired profits.
3. Also, that Managers of MNCs should engage in tax planning activities that will reduce the effective tax rate and improve overall financial performance as effective tax rate has a positive but insignificant effect.

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