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Effect of Thin Capitalization on Corporation Tax Compliance Among Multinational Corporations in Nairobi, Kenya

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Abstract

Over the past few decades, the contribution of corporate tax compliance to Kenya's total tax revenue has declined, posing challenges to the fiscal expectations of the Kenya Revenue Authority (KRA). Kenya Revenue Authority (KRA) has failed to reach fiscal expectations for corporate tax compliance despite numerous reorganization efforts aimed at doing so over the past few years. This study aimed to establish the effect of thin capitalization on corporation tax compliance among multinational corporations in Nairobi, Kenya. The theories that guided this study were: the Theory of Planned Behaviour and the Theory of International/Foreign Trade. The target population was made up of 218 multinational corporations in Nairobi, and a sample size of 141 respondents was determined by the Yamane formula. After response collection and tallying of the responses, 121 respondents correctly filled and submitted their questionnaires, indicating an 86% response rate. Questionnaires were used to collect primary data, and analysis included both descriptive and inferential statistics. The study found that thin capitalization had a negative and significant effect on corporation tax compliance ($\beta = -0.288$, $p = 0.012$). Based on the findings regarding the negative effect of thin capitalization on corporation tax compliance, policymakers should implement stricter debt-to-equity ratio limits and interest deduction caps in line with OECD recommendations. The current findings demonstrate that aggressive debt financing strategies significantly undermine tax compliance, suggesting the need for legislative reforms to close these loopholes. Future research should investigate the effects of corporate governance characteristics and organizational culture on corporate tax compliance.

Keywords: *Thin Capitalization, Corporation Tax Compliance, Multinational Corporation*

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1. Introduction

Taxes are a key source of funding for all governments to maintain progress. In fact, in an attempt to improve tax performance, governments all over the world have created and passed laws creating various tax heads, including income tax, excise duty, and VAT. One of the tax categories that governments utilize to generate money is corporate income tax. It is the tax that corporate taxpayers pay on their profits. States have chosen to treat company tax in two ways: globally and territorially (Siripurapu, 2021). While both domestic and overseas profits are liable to taxation under the worldwide approach, with tax credits provided to the foreign tax authority, only domestic profits are subject to taxation under the territorial approach (Siripurapu, 2021).

Corporate income tax refers to taxes paid on incomes generated by corporations that are tax residents in Kenya. Local companies are taxed at a standard rate of 30% of Profit Before Tax, while the tax rate for non-resident companies is pegged at 37.5%. The Income Tax Act, under section 2, defines a permanent establishment as a fixed business premise where a person carries on business and includes a building site and a construction project, which has existed for one hundred and eighty-three days (six months) or more. Corporate tax payable is determined after deducting all the allowable expenses, including interests, royalties, management, and professional service fees. All these expenses are easily utilized by the MNEs to manipulate the amount of tax payable to the government through the distortion of the transfer prices (KPMG, 2011).

Thin capitalization refers to a situation where a company is financed primarily through debt rather than equity, often as a strategy to reduce tax liability. This occurs when firms, particularly multinational corporations (MNCs), use excessive intercompany debt to shift profits to low-tax jurisdictions through interest deductions, thereby reducing taxable income in high-tax countries (OECD, 2021). Thin capitalization is a significant tax compliance issue, as it blurs the line between legitimate tax planning and aggressive tax avoidance. Governments implement thin capitalization rules (TCRs) to prevent tax base erosion by limiting the deductibility of interest expenses. These rules vary across jurisdictions but generally set a maximum debt-to-equity ratio or impose earnings-based interest deduction limits (Blouin, Huizinga, Laeven, & Nicodème, 2014).

Multinational companies play a significant role in the economies of countries. MNEs were established to supply countries lacking in capital with both physical and financial resources (Nsaku,2023). According to Hines (2021), MNEs are the global goliaths of modern times, responsible for large portions of world production, employment, investment, international trade, research, and innovation. Were (2013) found that many MNEs in Kenya began their operations as a means to provide foreign direct investment with increased activity during the post-colonial era. In some industry sectors, especially agriculture, manufacturing, transport, and finance, a strong MNE presence can be observed.

1.1 Problem Statement

Corporate income tax is a vital source of revenue for most governments worldwide, as it funds essential public goods and services such as infrastructure, free education, and subsidized healthcare. However, for decades, the effectiveness of corporate income tax has been undermined by widespread tax evasion and avoidance by multinational enterprises (MNEs). These companies often shift profits to offshore jurisdictions with low tax rates and strict financial secrecy laws, thereby avoiding taxation in the countries where the income is generated (Beer et al., 2020).

In Kenya, this challenge has been particularly pronounced. Corporation tax contributes an average of 12% to government revenue, making it one of the largest sources of funding for the exchequer. Despite this, the Kenya Revenue Authority (KRA) has consistently fallen short of its corporation tax revenue targets. For the financial year 2023/2024, KRA collected Kshs. 464.2 billion against a target of Kshs. 526.56 billion (KRA, 2024). In the following year, 2024/2025, collections stood at Kshs. 304.83 billion against a target of Kshs. 321.08 billion (KRA, 2025). These persistent shortfalls not only raise concerns about the health of Kenya's business environment but also highlight possible weaknesses in tax compliance and enforcement.

A significant contributor to this problem is the behavior of MNEs. Due to their complex business structures and cross-border transactions, MNEs often engage in sophisticated tax avoidance strategies such as transfer pricing manipulation. Such practices reduce taxable income in Kenya and shift profits to parent companies abroad, leading to revenue losses and placing developing countries at an unfair tax disadvantage (Kurian, 2022). Given the critical role of corporation tax in financing Kenya's development agenda, the compliance of MNEs has become a focal point for KRA. Yet, despite heightened scrutiny, evidence suggests that tax avoidance by MNEs continues to erode revenue collections.

2. Literature Review

2.1 Theoretical Review

2.1.1 Theory of Planned Behaviour

Theory of Planned Behaviour (TPB) is an expansion of the earlier Theory of Reasoned Action (TRA), which incorporates behavioral intentions as significant motivators for predicting the actual behavior of humans, and it assumes that people have volitional control over their behavior (Ajzen & Fishbein, 1980). However, Ajzen argues that TRA is unable to explain non-volitional behavior because the occasional behavioral intention toward one behavior fails to predict actual behavior due to incomplete control, which occurs in relation to opportunities and resources, including time, money, information, and ability.

The Theory of Planned Behavior (TPB), advanced by Ajzen (1985), explains how attitudes, subjective norms, and perceived behavioral control shape managerial intentions and actual financing behavior. In thin capitalization, managers' attitudes are influenced by the expected tax savings from interest deductibility and the possibility of improving return on equity through leverage (Modigliani & Miller, 1963; Ng, 2013). Subjective norms also contribute, as firms often face pressure from shareholders seeking higher earnings per share, or from peer firms and industry benchmarks that normalize high debt-to-equity ratios (Kraus & Litzenberger, 1973; Kassem & Higson, 2020).

Likewise, perceived behavioral control, including access to credit markets, regulatory thresholds on debt-to-equity levels, and the firm's ability to sustain repayments, affects managerial confidence in implementing a thinly capitalized structure (Myers, 1984; Ajzen, 1985). Collectively, these three components of TPB highlight that thin capitalization is not simply a financial optimization strategy but also a behavior shaped by managerial perceptions, social influence, and institutional constraints. Thus, TPB offers a useful behavioral lens for understanding why managers in many multinational and domestic corporations deliberately pursue thin capitalization as a financing choice.

According to Ajzen (1985), TPB states that if people believe a proposed behavior could lead to positive results, they are more likely to carry it out. In addition, the central idea behind the theory of planned behaviour is that an individual's intent to engage in a particular action is the primary factor in determining whether or not that action takes place. Attitude, subjective norms, and subjective control all play a role in shaping intentions, as the theory proposes. The idea of planned behavior, in particular, attempts to clarify the manifestation of attitude. Taxpayer behavior can be predicted using a combination of subjective norms, subjective control, and subjective intentions.

2.1.2 Theory of International/Foreign Trade

International trade theory provides a useful framework for understanding corporate tax compliance in a globalized economy. The comparative advantage theory (Ricardo, 1817) suggests that countries specialize in certain goods or services, leading to increased cross-border operations by firms. However, when corporations operate internationally, they face multiple tax jurisdictions, which creates incentives for tax avoidance through profit shifting and transfer pricing (Cobham & Janský, 2018). The Heckscher–Ohlin model (Heckscher & Ohlin, 1933) emphasizes differences in factor endowments as drivers of trade, but these same differences extend to fiscal policies, including tax systems, leading multinational corporations to arbitrage across tax regimes.

The new trade theory (Krugman, 1979) highlights economies of scale and the dominance of multinational firms; such large players often exploit their global presence to engage in aggressive tax planning, undermining compliance (Gravelle, 2013). Similarly, Porter's diamond theory (Porter, 1990) shows that competitive advantage depends on national environments, yet disparities in regulatory strength and tax enforcement across countries enable corporations to selectively comply with tax laws where enforcement is weaker.

From a compliance perspective, international trade therefore complicates taxation because firms strategically use thin capitalization, intra-group transactions, and tax havens to minimize liabilities (Slemrod, 2019). This has led to the need for coordinated international frameworks such as the OECD's Base Erosion and Profit Shifting (BEPS) initiative, which seeks to align tax rules with the realities of globalization and trade integration (OECD, 2020). Consequently, international trade theory not only explains the movement of goods and capital but also highlights the compliance challenges governments face in ensuring fair taxation of cross-border corporate activities.

2.2.Empirical Review

2.2.1 Thin Capitalization

Firmansyah and Falbo (2020) researched manufacturing companies listed on the Indonesia Stock Exchange and showed that thin capitalization has a positive effect on tax avoidance. Contrary to the results of previous studies described above, research conducted by Haryanti, Amalia and Suprapti (2020) states that thin capitalization has no impact on tax avoidance. Haryanti et al. (2020) researched multinational companies listed on the Indonesia Stock Exchange.

Akabom and Ejabu (2018) on the effects of thin capitalization and international laws on the performance of multinational companies in Nigeria utilised ten samples drawn from 17 multinational companies quoted on the Nigerian stock exchange, and an ex-post facto design was adopted covering the period of 2012-2016, while the multiple regression technique was used for the analysis. The results indicate that thin capitalization is a revenue-stripping technique, but it affects the performance of multinational companies in Nigeria.

Fasita et al. (2022) in their study which investigate MNEs in Indonesia found that the composition of interest-bearing debt in a capital structure close to the debt threshold allowed in thin capitalization rules created an attractive incentive that can be deducted Thin capitalization uses countries with high tax rates to obtain tax incentives from the interest, while low tax rates are often used as fund by multinational companies by utilizing tax haven. Thin capitalization is a major trigger in multinational corporations' tax evasion attempts from taxable income, thus lowering corporate taxes.

2.2.2 Corporate Tax Compliance

Corporation tax compliance refers to the adherence of companies to tax laws and regulations imposed by governments. It includes timely filing of tax returns, accurate reporting of taxable income, and payment of the correct amount of tax. Tax compliance is a critical issue for governments, as non-compliance can lead to revenue loss, economic distortions, and enforcement costs (OECD, 2019). Corporation tax is levied on profits made by corporate taxpayers. Under section 3(2)(a)(i) of the Income Tax Act 1974, gains or profits from any business, for whatever period, are chargeable to tax. Corporation tax is imposed on resident and non-resident companies with permanent establishments in Kenya (PwC, 2021). In addition, under section 4 (a) of the Income Tax Act, the gains or profits of a resident-owned business that carries on its activities partly in Kenya and partly outside Kenya are deemed to have wholly accrued in or to have been derived from Kenya.

Corporation tax compliance in Kenya involves the correct computation of annual tax based on the corporation's income for the year, filing of the information required by tax laws, and payment of the due. In Kenya, the corporate income tax is levied on the net income or profits and capital gains of an enterprise. The tax is charged at the rate of 30% for resident companies, while non-resident companies are charged 37.5%.

Corporations employ different strategies in managing tax compliance, ranging from full compliance to aggressive tax planning. Tax avoidance, which involves legal strategies to minimize tax liability, is a common practice, while tax evasion, the illegal act of underreporting income or inflating expenses, is punishable by law (OECD, 2021). Many firms engage in corporate social responsibility (CSR) tax compliance, where they view tax payments as part of their societal obligations (Lanis & Richardson, 2012). Corporate tax compliance is a multidimensional issue influenced by economic, regulatory, and behavioral factors. Governments and policymakers must balance enforcement with incentives to encourage voluntary compliance while deterring tax evasion and aggressive avoidance strategies.

2.3 Conceptual Framework

According to Mugenda (2008), a conceptual framework is a concise description of the phenomenon under study, accompanied by a graphical description of the major variables of the study. The independent variable of the study was Thin Capitalization, measured by Debt and Equity and Regulatory Awareness. Corporation tax compliance was measured by Timely payment of taxes and Accurate Declaration. As indicated in Figure 1.

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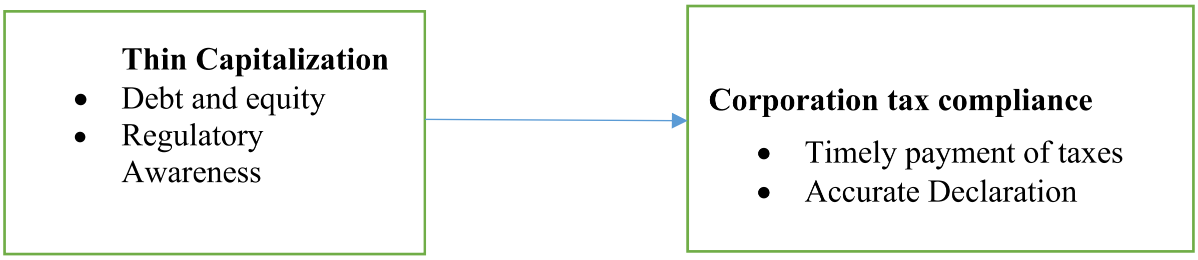

Independent Variable **Dependent Variable**

Figure 1: Conceptual Framework

3. Methodology

According to Creswell (2017), research design involves deliberately selecting and applying suitable research methods, sampling techniques, data gathering tools, and data examination approaches to address a specific research problem. The study used an explanatory research design. According to Cooper and Schindler (2000), the study population comprises individuals, households, or organizations with similar characteristics about which a researcher wants to make inferences. A target population is a certain group of the population that shares similar characteristics and is identified as the intended audience for a product, advertising, or research. It is a portion of the whole universe of people selected as the objective audience (Cooper & Schindler, 2014). The target population of the study was 218 multinational corporations in Nairobi (BRS,2024). The study's intended sample size was 141 respondents, as shown in the response rate Table 1. Following response collecting and tallying, 121 respondents completed and submitted their questionnaires, representing an 86% response rate and a 14% non-response rate.

Table 1: Response Rate

	Number	%
Response Rate	121	86.0
Non-Response Rate	20	14.0
Targeted Sample	141	

Reliability Test

Reliability is the degree to which an instrument yields the same results each time it is put into measurement under constant conditions (Saunders et al., 2009). To determine reliability, an internal measure of consistency called the Cronbach Alpha was used. According to Bain (2017), values of Cronbach's Alpha coefficients above 0.7 show that the instrument is reliable. In Table 2, all constructs meet the 0.7 threshold for reliability. Corporation tax compliance (.755) and Thin capitalization (.947). These alpha values imply that the items within each construct are well-aligned and contribute meaningfully to the measurement of complex tax compliance behaviors. The consistency across constructs enhances the credibility of the pilot study and affirms the robustness of the questionnaire design.

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Table 2: Test of Reliability of Questionnaire

Factor	Number of Items	Cronbach's Alpha score	Conclusion
Corporation tax compliance	5	0.755	Reliable
Thin capitalization	4	0.947	Reliable

Cooper and Schindler (2006) argue that data analysis involves data editing and reducing the data size to a manageable size, then coming up with summaries as well as getting patterns and application of statistical techniques. Data collected was edited, cleaned, and coded for completeness. Descriptive and inferential statistics were employed for analysis of the cleaned data.

4. Results and Discussion

4.1 Descriptive Analysis

4.1.1 Descriptive statistics for Thin capitalization

Table 3: The descriptive statistics reveal important patterns in multinational corporations' compliance with thin capitalization regulations, on table 3. For our company is aware of the applicable thin capitalization rules in its jurisdiction, respondents showed strong agreement (M = 3.98, SD = 0.846), where the relatively small standard deviation indicates most responses clustered closely around the mean, suggesting consensus among participants. Our company prepares annual reports on thin capitalization compliance, showing similar agreement levels (M = 3.93, SD = 0.798), with the slightly smaller standard deviation compared to awareness, suggesting even greater consistency in responses. Our company has taken measures to restructure its debt to comply with thin capitalization rules; mean agreement was marginally lower but still strong (M = 3.92, SD = 0.791), with the smallest standard deviation across all items, implying particularly consistent responses about restructuring activities. our company discloses related-party loans in its financial statements, receiving the highest agreement (M = 4.08, SD = 0.881). While the standard deviation was largest for this item, it remained below 1.0, indicating reasonably clustered responses. The overall mean of 3.98 across all items, with standard deviations consistently below 1.0, indicates strong organizational compliance with thin capitalization regulations while acknowledging some variability in implementation practices.

Table 3: Thin Capitalization

	N	Mean Statistic	Std. Deviation
Our company is aware of the applicable thin capitalization rules in its jurisdiction	121	3.98	.846
Our company prepares annual reports on thin capitalization compliance.		3.93	.798
Our company has taken measures to restructure its debt to comply with thin capitalization rules.		3.92	.791
Our company discloses related-party loans in its financial statements.		4.08	.881
Mean		3.98	

4.1.2 Descriptive statistics for Corporation Tax Compliance

Table 4: The descriptive statistics for corporation tax compliance (Table 4.9) indicate generally high agreement with the statements. The statement, "The company files its return on income by the prescribed date," had a mean of 4.02 (SD = 0.713), suggesting strong agreement with minimal variability. Similarly, "The company pays tax dues by the prescribed date" had a mean of 4.01 (SD = 0.713), showing agreement with the statement with moderate variability in responses. The statement, "The company makes timely and accurate tax declaration," had a slightly higher mean of 4.03 indicating agreement with the statement, with low variability in responses (SD = 0.718)."The company pays fines and penalties for overdue taxes" had a lower mean of 3.85 (SD = 0.543), showing moderate agreement, and low variability in responses. In contrast, "The company cooperates with KRA officers in conducting audits by providing all the necessary records" had the lowest mean (3.60, SD = 0.613), showing moderate agreement with low variability, The overall mean of 3.90 suggests that, on average, respondents agreed with the statements regarding corporation tax compliance, though with some variability in perceptions, particularly concerning audit cooperation and penalty payments.

Table 4: Corporation Tax Compliance

	N	Mean Statistic	Std. Deviation
The company files its return on income by the prescribed date	121	4.02	.713
The company pays tax dues by the prescribed date.		4.01	.713
The company makes timely and accurate tax declarations.		4.03	.718
The company pays fines and penalties for overdue taxes.		3.85	.543
The company cooperates with KRA officers in conducting audits by providing all the necessary records.		3.60	.613
Mean		3.90	

4.2 Correlation Analysis

The correlation analysis was utilized to determine the relationships between thin capitalization and corporate tax compliance. Table 5 reveals significant correlations between corporation tax compliance and its predictors. A negative and significant correlation exists between thin capitalization and corporation tax compliance ($r = –.670$, $p = .000 < 0.05$), suggesting that aggressive debt structuring may undermine compliance.

Table 5: Correlation Statistics

	Corporation tax compliance	Thin capitalization
Corporation tax compliance	1	-0.670**
Thin capitalization	-0.670**	1
Sig.	0.000	

**. Correlation is significant at the 0.05 level (2-tailed).

4.3 Regression Analysis

The regression analysis was conducted to determine the effects of thin capitalization on corporation tax compliance. Table 6 showed that thin capitalization had a positive correlation with corporation tax compliance up to 67% (R= 0.670). The results reveal that thin capitalization caused a variation of 44.8% or (R^2=0.448 and adjusted R^2 =0.442) on corporation tax compliance.

Table 1: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.670[a]	0.448	.442	.45780

a. Predictors: (Constant), Thin capitalization _mean

Table 7 showed that there was an F statistic of 377.206 and a p-value of 0.000<0.05, which indicates that the model was significant in explaining the variance caused by corporation tax compliance.

Table 7: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	56.581	1	56.581	377.206	.000[b]
	Residual	17.891	119	.150		
	Total	74.472	120			

a. Dependent Variable: corporation tax compliance
b. Predictors: (Constant), Thin capitalization

Table 8 showed unit change in thin capitalization causes a -0.288 decline in corporation tax compliance (β = -0.288, p = 0.012). Suggesting that firms leveraging excessive debt financing may exploit interest deductions to reduce taxable income. The hypothesis was rejected.

Table 8: Regression Coefficient analysis

Variable	Standardized β	Std. Error	Unstandardized β	t-statistic	Prob.
constant	6.044	0.297		20.350	0.000
Thin capitalization	-0.288	0.113	223	-2.549	0.012

4.4 Discussion of the Findings

The study sought to establish the effect of thin capitalization on corporation tax compliance among multinational corporations in Nairobi, Kenya. The correlation matrix found that there was a negative and significant correlation between thin capitalization and corporation tax compliance (r = –.670, p = .000 < 0.05), suggesting that aggressive debt structuring may undermine compliance. The regression analysis found that thin capitalization had a negative and significant effect on corporation tax compliance (β = –0.288, p = 0.012), suggesting that firms leveraging excessive debt financing may exploit interest deductions to reduce taxable income. This finding aligns with Suryaningprang et al. (2022), who observed that thin capitalization is a prevalent tax avoidance strategy among multinational firms, often used to shift profits and minimize tax liabilities.

5. Conclusion

The study's first objective was to establish the effect of thin capitalization on corporation tax compliance among multinational corporations in Nairobi, Kenya. The study concludes that thin capitalization has a significant negative effect on corporation tax compliance, as firms exploit excessive debt financing to reduce taxable income through interest deductions. This finding contributes to the field by empirically demonstrating how aggressive capital structuring undermines tax compliance, particularly in emerging markets where regulatory gaps persist. The study adds to the discourse on tax avoidance by highlighting the need for stricter thin capitalization rules and debt-to-equity ratio regulations to curb profit-shifting incentives.

6. Recommendations

Based on the findings regarding the negative effect of thin capitalization on corporation tax compliance, policymakers should implement stricter debt-to-equity ratio limits and interest deduction caps in line with OECD recommendations. The current findings demonstrate that aggressive debt financing strategies significantly undermine tax compliance, suggesting the need for legislative reforms to close these loopholes. Future research should investigate the effects of corporate governance characteristics and organizational culture on corporate tax compliance.

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