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WORKING PAPER

An Investigation of the Effect of the Notional Interest Deduction on the Capital Structure of Belgian SMEs *

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An Investigation of the Effect of the Notional Interest Deduction on the Capital Structure of Belgian SMEs^{}**

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Abstract

In 2005, the Belgian government introduced a radically new measure into the corporate tax system: the so-called notional interest deduction. This tax invention allows Belgian companies to deduct a fictitious interest cost on equity from their tax base and directly tackles the classical tax discrimination between equity and debt financing, which characterizes the tax system of most countries. This paper investigates whether the capital structure of Belgian small and medium sized enterprises (SMEs) reflects the cross-sectional variation in tax incentives induced by the notional interest deduction, three year after its introduction. To measure the tax incentives of the notional interest deduction we incorporate the notional interest deduction into a simulation procedure of marginal tax rates. For our sample of SMEs, we find that, due to the notional interest deduction, the simulated marginal tax rates declined from 29% to 2.9%. Consistent with the trade-off theory on capital structure, our regression analysis reveals that the explanatory power of the debt rates of Belgian SMEs on marginal tax rates is higher if the marginal tax rates take the notional interest deduction into account. We interpret this as evidence consistent with a debt policy of Belgian SMEs that takes into account the tax incentives of the notional interest deduction.

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