Unprofitable subsidiaries becoming new tax haven for multinational corporations

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Multinational corporations are moving income from their profitable, high-tax subsidiaries into unprofitable ones to save money on taxes, a University of Waterloo study has found.

The study's findings shed light on a tax planning strategy that is not currently focused on by governments, which tend to focus their efforts on firms who move their money from countries with higher taxes to lower tax-rate countries to save.

"Governments expend considerable effort to prevent their tax bases from being eroded by companies moving their money offshore," said Ken Klassen, the study's author and an accounting and finance professor at Waterloo. "This insight could help tax authorities better target their efforts,".

Using theoretical models, the researchers examined income shifting by multinational firms and data from nearly 60,000 subsidiaries from 2003 to 2012 in Europe.

They found that firms that are in a country with a high tax rate are saving a significant amount of money by moving income to their unprofitable subsidiaries. The unprofitable subsidiaries are taxed at a lower rate than those that have higher profit margins.

The trend, said Klassen, is not unlike what he's seeing in research focusing on Canadian and American companies.

"Analysts may not consider that a Canadian multinational would want to shift income into the U.S., where the tax rate is higher," said Klassen. "These findings show us that North American companies can actually save a significant amount of money if they move income to an unprofitable affiliate in another jurisdiction.

"Determining if foreign affiliates are experiencing losses could benefit organizations such as the Canada Revenue Agency (CRA) in deciding which transactions to scrutinize."

While changing income earning patterns to use the losses runs the risk of drawing attention from taxing authorities such as the CRA, said Klassen, the savings seem to outweigh the potential negatives for many.

If the subsidiary does become profitable again, however, the extra income would be taxed at a higher rate.

The study was recently published in *The Accounting Review*.

Provided by University of Waterloo

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