The Challenges of Redefining Corporate Tax Residence in a Competitive Global Market

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Introduction

Since the Revenue Act of 1918, the United States has determined a corporation's residence based on its place of incorporation.[1] A corporation is "domestic" if it is "created or organized in the United States or under the law of the United States or of any state."[2] A foreign corporation is one that is not "domestic."[3] There has been a spate of bills introduced in the US Congress that would change this longstanding rule.[4] The "International Tax Competitiveness

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[1] *See* David R. Tillinghast, *A Matter of Definition: Foreign and Domestic Taxpayers*, 2 INT'L TAX & BUS. LAW. 239, 252-53 (1984).

[2] *See* I.R.C. § 7701(a)(4) (2006) (defining "domestic" as applied to corporations and partnerships).

[3] I.R.C. § 7701(a)(5) (2006) (defining "foreign" as applied to corporations and partnerships)

[4] *See* International Tax Competitiveness Act of 2011, S.1373, 112th Cong. § 2(a) (2011); Stop Tax Haven Abuse Act, S. 1346, 112th Cong. § 102 (2011). Various versions of the Stop Tax Haven Abuse Act had previously been introduced in Congress. *See* 157 CONG. REC. S4518 (daily ed. July 12, 2011) (statement of Sen. Levin). The International Tax Competitiveness Act of 2011 was also introduced in the House of Representatives as H.R. 62; the Stop Tax Haven Abuse Act

Act" and the "Stop Tax Haven Abuse Act" would include a provision in the Internal Revenue Code ("Code"), Section 7701(p), which would treat what would otherwise be foreign corporations as domestic corporations for tax purposes if they were "managed and controlled" in the United States ("Proposal").[5] This Proposal would apply only to corporations that are either publicly traded on an established securities market, or to corporations with gross assets total $50 million or more.[6] Controlled foreign corporations ("CFC") with substantial assets that are

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is H.R. 2669. There has been more discussion on this particular Proposal in the Senate level; thus, this Paper will refer to the Senate bills.

[5] The text of the Proposal is as follows:

> (p) Certain Corporations Managed and Controlled in the United States Treated as Domestic for Income Tax-
> (1) In General - Notwithstanding subsection (a)(4), in the case of a corporation described in paragraph (2) if--
> (A) the corporation would not otherwise be treated as a domestic corporation for purposes of this title, but
> (B) the management and control of the corporation occurs, directly or indirectly, primarily within the United States, then, solely for purposes of chapter 1 (and any other provision of this title relating to chapter 1), the corporation shall be treated as a domestic corporation.

S. 1373 § 2(a); S. 1346 §103(a). The Proposal goes on to instruct Treasury to provide regulations regarding the definition of "managed and controlled," with special rules for corporations that primarily hold investment assets only. *See* S. 1373 § 2(a); S. 1346 §103(a).

[6] S. 1373 § 2(a); S. 1346 §103(a). US$50 million refers to valuation in the taxable year or the year before, directly or indirectly. "Reasonably expected to be less than $50 million" is also excluded. The Proposal does not suggest a method for valuation. The Internal Revenue Service ("IRS") may also waive the application of the Rule. *See* S. 1373 § 2(a); S. 1346 §103(a).

engaged in the active conduct of a US trade or business and are members of an affiliated group that has a domestic parent are exempted from this provision.[7]

One commentator has stated that "[n]othing is more fundamental under the federal income tax system than determining whether an individual is a domestic or foreign taxpayer."[8] US resident taxpayers are subject to taxation on their worldwide income.[9] Non-resident taxpayers, however, are taxed only on income that is either "fixed, determinable, annual, periodical", or effectively connected to the United States if they are engaged in a US trade or business.[10] Moreover, income earned by a foreign corporation is not taxed until it is remitted to the United States. Thus, it has been common practice for US multinationals to use foreign corporations when operating abroad in order to defer US tax on current operations.[11] To combat abusive use of foreign corporations, certain types of income earned by a CFC are included in the

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[7] S. 1373 § 2(a); S. 1346 §103(a). Cash or cash equivalents, or stocks in foreign corporations do not count as "substantial assets held for use" in a US trade or business.

[8] Tillinghast, *supra* note 1 at 239.

[9] I.R.C. §11.

[10] I.R.C. §§ 881-882.

[11] REUVEN S. AVI-YONAH, ET. AL, GLOBAL PERSPECTIVES ON INCOME TAXATION LAW 154 (Oxford University Press 2011). As an example, Google has reduced its effective tax rate to 2.4% (roughly $3.1 billion in lost US tax revenues) by moving profits through Bermuda and Ireland. Jesse Drucker, Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes, BLOOMBERG.COM (Oct. 21, 2010) *available at* http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html.

US parent's taxable income.[12] Enacting this Proposal, however, could undo the CFC regime and treat foreign subsidiaries that are not engaged in active trade or business as US corporations, thus taxing them currently on their worldwide income.[13] Corporations affected by this Proposal include foreign operations of multinationals that have key senior managers based in the United States, foreign entities acquired by US investors with US-based management, and US-managed start up businesses organized outside the United States.[14]

This Paper will argue that this Proposal in its current form is problematic, and is not the appropriate means by which to make inroads towards international tax competitiveness or stopping the abusive use of tax havens. Part I provides background on the current law on corporate residence and discusses the underlying policy rationale. Part II discusses three outstanding issues raised by this Proposal. The primary issue is that the "managed and

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[12] *See* I.R.C. §§ 951-965.

[13] *See* New York State Bar Association Tax Section, *Report on the Management and Control Provision of the "International Tax Competitiveness Act of 2011,"* 7 (Jan. 31, 2011) [hereinafter NYSBA Report] (discussing the issues surrounding changing the definition of corporate residence based on "management and control" and ultimately recommending that it be considered in connection with broad-based international tax reform in the future); *see also* Organization for International Investment, *Letter to Senate Finance Committee Leadership Re: Corporate Residency*, *available at* http://www.ofii.org/policy-issues/tax-federal-initiatives/243-corporate-residency-proposals.html [hereinafter OFII Letter] (expressing the organization's concerns, on behalf of numerous non-US multinationals, regarding the Proposal, and urging that it should be rejected).

[14] NYSBA Report, *supra* note 13, at 8.

controlled" standard must be adequately explained and defined. There are also a number of other issues implicated by this Proposal that must be resolved and more meaningfully addressed by Congress and Treasury. Part III will select the most appropriate definition of "management and control" and suggests that it would be better to wait and see how other tax reform proposals progress before enacting any one particular proposal.

I. Background

In order to properly evaluate the merits of this Proposal, it is best to place it in context. This Part explains the current law on corporate residence, and then provides an overview of the two "headlines" under which this Proposal was introduced in Congress: the issues of international tax competitiveness and stopping the abusive use of tax havens.

A. Corporate Residence: Place of Incorporation

Corporate residence in US tax law is determined by place of incorporation.[15] The earliest iteration of the place of incorporation rule was the Revenue Act of 1918, which referred only to entities "organized or created" in the United States.[16] The Bureau of Internal Revenue, now the Internal Revenue Service ("IRS"), subsequently clarified the meaning of the statute in OD 661, which states that a "corporation is a creature of the law and can exist only by virtue of the law which creates it.[17] Such a corporation must of necessity be domestic to the country under whose laws it is created."[18] The rule seems to suggest that an entity owes allegiance to state of

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[15] I.R.C. § 7701(a)(4).

[16] Tillinghast, *supra* note 1, at 252

[17] *Id.* (quoting OD 661). OD 661 was a response to an organization that filed articles of incorporation with the United States Court for China. *Id.*

[18] *Id.*

incorporation.[19] The words "under the law of" have since been added to the language of the place of incorporation rule, and are now codified in § 7701(a)(4).[20]

The "place of incorporation" test has survived previous challenges to its existence. Various proposals to change the place of incorporation test had been introduced in the early 2000's.[21] These proposals originally surfaced in response to corporate inversions. Corporate inversions are essentially transactions wherein current shareholders of a US company would exchange their shares for shares of a non-US entity, typically one in a low-tax jurisdiction.[22] The non-US entity would then become the parent company of the entire consolidated taxpaying group, even if headquarters and primary operations were still entirely based in the United

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[19] AVI-YONAH, ET. AL., *supra* note 11.

[20] Tillinghast, *supra* note 1, at 253.

[21] The current Proposal is not the first suggestion that place of incorporation be replaced, nor are S.1373 and S. 1346 even the first incarnations of this Proposal. Senator Levin had in fact raised the same Proposal in the previous session of Congress, although he now states that this year's version is a "stronger" one. *See* 157 CONG. REC. S4518 (daily ed. July 12, 2011) (statement of Sen. Levin). A similar proposal was also endorsed by the Joint Committee on Taxation in the early 2000's. *See* Reuven S. Avi-Yonah, *Beyond Territoriality and Deferral: The Promise of 'Managed and Controlled,'* 63 TAX NOTES INT'L 667, 667 (Aug. 29, 2011).

[22] John S. Barry, *Corporate Inversions: An Introduction to the Issue and FAQ*, TAX FOUNDATION, *available at* http://www.taxfoundation.org/news/show/199.html (explaining corporate inversions).

States.[23] Instead of changing the rule on residence, however, IRC §7874 was introduced, which makes inversions difficult to accomplish.[24]

An advantage to the "place of incorporation" standard is that it requires no interpretation.[25] Formalistic tests like "place of incorporation" lower compliance costs, avoid litigation risks, and can be easily administered, especially in cases that involve complex chain of related corporations.[26] On the other hand, this standard can be easier to manipulate and may thwart other policy goals.[27] Thus, using a facts and circumstances-based test like "management and control" could provide a more accurate depiction of how a corporation operates and where it is really "resident." At the same time, it could also be inaccurate: a fully functioning Brazilian operation can have its Chief Financial Officer, for example, based in New York and still be deemed a US resident under "management and control." Facts and circumstances-based tests can introduce great uncertainty, which is something that taxpayers and the IRS should strive to avoid.

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[23] *See* Daniel Shaviro, *The Rising Tax-Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 384 (2011).

[24] The anti-inversion rules attach "adverse tax consequences," which include continued US resident status to such transactions. *See id.*

[25] *See* NYSBA Report, *supra* note 13, at 19.

[26] *Id.* ("Under current law, residency affects tax liability more fundamentally than other ambiguous rules. This will both add to the administrative burden of complying and enforcing the rule and likely cause its own economic distortions, as taxpayers adjust their behavior and location of operations.").

[27] AVI-YONAH, ET. AL., *supra* note 11, at 154. *See infra* Part I.B for a brief discussion on other policy goals underpinning this Proposal.

Civil law jurisdictions, such as Sweden and Italy, have taken the more formalistic view by considering the taxpayer's place of incorporation, place of legal registry, or the location of the taxpayer's legal office location or headquarters.[28] Japan also refers to the taxpayer's headquarters.[29] The Commonwealth countries, however, look to a substantive connection between the country and the taxpayer.[30] Most other countries, Germany and the Netherlands, for example, have taken a combination of these methods.[31] More recently, even the United Kingdom, which developed the "managed and controlled" test in the early twentieth century,[32] introduced a test based on formal incorporation in 1988 for companies incorporated in the United Kingdom.[33]

B. International Tax Policy Reform

In an "era of enhanced global economic interdependency," governments across the world are revisiting their international tax policies with a view to stay competitive with their peers.[34] At the same time, regulations must also encourage foreign investment, avoid double taxation, and

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[28] AVI-YONAH, ET. AL., *supra* note 11, at 153.

[29] *Id.*

[30] *See infra* Part II.A for a discussion on how Commonwealth countries define "managed and controlled."

[31] AVI-YONAH, ET. AL., *supra* note 11, at 153-54.

[32] *See infra* Part II.A for a discussion on English law on corporate residence.

[33] HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION, 434-35 (3d ed. 2010).

[34] Arthur J. Cockfield, *International Tax Competition: The Last Battleground of Globalization*, 63 TAX NOTES INT'L 867, 867 (Sept. 19, 2011).

prevent fiscal evasion.[35] Encouraging foreign investment in a competitive market is a difficult task, and is a very real concern for most countries. Australia, Canada, Germany, Italy, Sweden, and New Zealand have all discussed reforming their tax systems to encourage international investments, or at least, not drive them away.[36] The significance of attracting investment may, for better or worse, give taxpayers more bargaining power than the government.[37] Meanwhile, avoiding double taxation and preventing fiscal evasion are emphasized by difficulties in identifying which country has jurisdiction to tax income that has a connection to many countries.[38] Countries have long ago established a complex network of tax treaties to prevent double taxation and encourage positive trade relations across nations. Although tax treaties have

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[35] *See* Victor Uckmar, *Double Taxation Conventions*, 152, printed in INTERNATIONAL TAX LAW (Andrea Amatucci, ed.); *see also* Cockfield, *supra* note 34 (stating that other jurisdictions have been "reforming their tax systems so that they encourage . . . international investments).

[36] Cockfield, *supra* note 34.

[37] Take for example the case of when Ireland was contemplating raising its corporate tax rates at the height of the EU crisis last year. The American Chamber of Commerce in Ireland, driven by comments from executives at leading multinationals such as Microsoft, Hewlett Packard, and Intel, warned the Irish authorities that an increased tax rate could negatively affect the ability of Ireland to "win and retain investment." Thomas Biesheuvel, *Microsoft, Hewlett-Packard Warn Irelend on Tax, Telegraph Says*, BLOOMBERG.COM, *available at* http://www.bloomberg.com/news/2010-11-21/microsoft-hewlett-packard-warn-ireland-on-tax-telegraph-says.html (Nov. 21, 2010).

[38] Cockfield, *supra* note 34, at 868.

now become more important means to achieve those ends, they are not necessarily enough.[39] Congress is clearly aware of these goals and have presented the Proposal under the premises of both "international tax competitiveness" and "stop[ping] tax haven abuse."[40]

1. International Tax Competitiveness

"We must make sure our tax code does not encourage American businesses to relocate jobs overseas, and at the same time, the tax code must not put U.S. businesses at a disadvantage in foreign markets."[41] Moreover, the "[t]ax code should encourage economic growth and job creation.[42] Senate Finance Committee Chair Max Baucus' opening statements on a September 8, 2011 hearing on international tax issues succinctly explains the driving force behind the idea of "international tax competitiveness." At this hearing, practitioners and academics presented ideas on reforming US international tax law; redefining corporate residence was one suggestion.

There is not, however, a consensus on how the rules should be changed, nor is there a consensus on whether US multinationals are indeed at a competitive disadvantage because of the US tax system.[43] In his opening remarks to the September 8th hearing, Ranking Senate Finance Committee Member Sen. Orrin Hatch stated, "our international tax system discourages, and some would say penalizes, U.S. multinational corporations from repatriating foreign earnings by

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[39] Uckmar, *supra* note 35, at 149-50.

[40] *See* S. 1373 § 2(a); S. 1346 §103(a).

[41] Tax Reform Options International Issues: Hearing Before the S. Comm. on Finance, 112th Cong. (2011) (opening statement of Sen. Baucus, Chair, S. Comm. on Finance), *available at* http://finance.senate.gov/hearings/hearing/?id=85bf3d89-5056-a032-5289-d0bff7d57faa.

[42] *Id.*

[43] *See* NYSBA Report, *supra* note 13, at 15.

imposing a thirty-five percent residual US tax at the time of repatriation."[44] Nevertheless, it appears there is reason to believe that US multinationals are actually better off than multinationals based elsewhere, due to variations in tax provisions, if not tax rates.[45]

Another suggestion discussed at the September 8th hearing is to switch to a territorial tax system.[46] The United States is the lone holdout that claims to employ a worldwide, or residence-

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[44] Tax Reform Options International Issues: Hearing Before the S. Comm. on Finance, 112th Cong. (2011) (opening statement of Sen. Hatch, Member, S. Comm. on Finance); *see also* Tax Reform Options International Issues: Hearing Before the S. Comm. on Finance, 112th Cong. (2011) (statement of Phillip R. West, Partner at Steptoe & Johnson, LLP) ("Our tax code also appears to be a detriment in the global success of U.S. companies. Although there is no clear empirical evidence of the extent to which U.S.-based multinationals are at a competitive disadvantage as a result of the current U.S. international tax system, there is substantial anecdotal evidence.")

[45] *See generally* Jane G. Gravelle, *International Corporate Tax Rate Comparisons and Policy Implications*, Congressional Research Service Report (Mar. 31, 2011) (concluding that although the US statutory tax rate is higher than that of the rest of the world, the average effective tax rate is about the same, and could change depending upon which tax rates are being compared); David Kocieniewski, *U.S. Has High Business Tax Rates, Technically*, N.Y. TIMES, at A1 (May 3, 2011) (discussing the complexities of the US Tax Code and how companies have been able to lower their effective tax rates via tax planning).

[46] Kristen A. Parillo, *Panelists Describe the 'Right' Way for the US to do Territoriality*, TAX NOTES, 2011 TNT 198-3 (Oct. 13, 2011) (providing a summary of the issues discussed at the September 8th hearing on international tax issues before the Senate Committee on Finance).

based, system of taxation.[47] Other jurisdictions employ a territorial tax system, or at least a hybrid between the two, as deemed appropriate by that jurisdiction's legislative bodies. A territorial tax system is one that only taxes income earned within their borders. Other countries have shifted to the territorial tax system recently, or are at least seriously considering moving to a pure territorial tax system.[48] The United Kingdom and Japan are the most notable of those countries, and have moved to territorial tax systems partly in an effort to stay competitive.[49] It is no longer the case that only countries in greater need of foreign investment used such systems.[50]

Moving the United States to a territorial system of international taxation is not a new suggestion by any means, but it has been receiving more serious attention than usual.[51] Implementing this system, however, significantly undermines the value of residence status because all business income would be taxed similarly, regardless of the taxpayer's residence.[52]

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[47] Tax Reform Options International Issues: Hearing Before the S. Comm. on Finance, 112th Cong. (2011) (statement of Scott Naatjes, VP Tax/Gen. Tax Counsel to Cargill Inc.) ("The United States stands nearly alone in its taxation of worldwide income.").

[48] Cockfield, *supra* note 34.

[49] *Id.*

[50] Shaviro, *supra* note 23, at 378.

[51] "Political winds seem to be shifting in favor of moving to a territorial system." Parillo, *supra* note 46 (quoting J. Clifton Fleming and Robert J. Peroni). *See generally* Michael Beller, *Portman Legislation Would Shift U.S. To Territorial Corporate Tax System*, TAX NOTES, 2011 TNT 229-4 (Nov. 29, 2011) (reporting Sen. Rob Portman's intent to introduce legislation switching to a territorial tax system with a lower top corporate tax rate).

[52] NYSBA Report, *supra* note 13, at 16.

Moreover, it has been suggested that shifting to a territorial tax system is actually one way to respond to the problems caused by residence-related tax planning.[53] Thus, Congress must evaluate all of its options carefully; it would be unwise to pass bills in the current session that could be rendered moot soon after.

On October 26, 2011, Rep. Dave Camp, Chair of the House Ways and Means Committee, released a Discussion Draft on tax reform ("Camp Draft").[54] The Camp Draft would drop the highest corporate income tax rate to 25% (down from 35% currently), and would essentially adopt a territorial tax system by allowing for a 95% deduction on foreign-source dividends.[55] These suggestions, designed to be revenue neutral, have been met with both serious concerns and cautious optimism.[56] At the very least, the Camp Draft is meant to generate public comment, and become a starting point in meaningfully modifying the Code to at least be closer to the systems employed by other members of the Organisation for Economic Co-operation and Development

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[53] *See* Shaviro, *supra* note 23, at 413.

[54] *Ways and Means Chairman Camp Releases Discussion Draft for Corporate Rate Reduction, Territorial Tax System*, PricewaterhouseCoopers Washington National Tax Services Publication, Nov. 1, 2011 [hereinafter PwC Publication] (on file with the author) (summarizing the Discussion Draft released by Rep. Camp).

[55] *Id.*

[56] *See generally* Martin A. Sullivan, *Economic Analysis: The Layman's Guide to the Camp Territorial Tax Plan*, 133 TAX NOTES 655 (Nov. 7, 2011) (providing commentary on the Discussion Draft released by Rep. Camp that advocates for a territorial tax system).

("OECD").[57] There is, however, no set timeline for commentary, much less a timeline for this discussion to result in actual changes.[58]

2. "Stop Tax Havens"

With a "$100 billion yearly drain on the US treasury" that results from the use of offshore tax havens, one need not look far to identify the motivating factor behind heightened attention on overhauling the US tax code, or at least closing particularly egregious loopholes in the system.[59] This particular Proposal, however, does not seem to have been quantified at the time of this writing in terms of how much revenue it will generate. Nevertheless, the Proposal aims to minimize the use of foreign companies through which taxpayers redirect their income and reduce their US tax base.[60] Investment firms such as hedge funds in particular have earned heightened

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[57] *See* Marie Sapirie, *Territorial Proposal Still a Work in Progress, Panelists Say*, TAX NOTES TODAY, 2011 TNT 212-2 (Nov. 2, 2011); *see also* PwC Publication *supra* note 54.

[58] *See* Sapirie, *supra* note 57.

[59] *See* 157 CONG. REC. S4518 (daily ed. July 12, 2011) (statement of Sen. Levin) ("Over the years, we have learned a lot of the offshore tricks and have designed this bill to fight back by closing obnoxious offshore tax loopholes and strengthening offshore tax enforcement.").

[60] *See id.* ("This bill offers powerful new tools to combat those offshore and tax shelter abuses, raise revenues, and eliminate incentives to send U.S. profits and jobs offshore. Its provisions will hopefully be part of any deficit reduction package this year, but should be adopted in any event."); 157 CONG. REC. S4615 (daily ed. July 14, 2011) (statement of Sen. Rockefeller) ("[Sixty] Minutes aired a story on tax avoidance that centered on Zug, a town in Switzerland . . . [that] is home to nearly 30,000 corporations, many of which operate out of mailboxes. This is

attention from Congress. "Managed and controlled" is specifically defined differently for such firms in both bills.[61]

Corporate residence is not the only target, however. There are numerous other proposals on the table, all designed to "close loopholes" in the US international tax system. Examples include: currently taxing offshore intangibles, modifying earnings stripping regulations, and deferring interest expense deductions related to deferred income.[62] Each of these proposals, endorsed by President Barack Obama, could very well lead to greater tax revenues than changing the definition of corporate residence.[63]

The Stop Haven Tax Abuse Act itself is more comprehensive in scope than the International Tax Competitiveness Act. For example, the bill contains provisions that are directed towards taxpayers with financial accounts offshore, such as heightened reporting requirements.[64] The bill also takes aim at enhancing anti-money laundering regulations and the

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because the tax rates in Zug are low and companies can . . . avoid higher taxes in their home country.").

[61] Corporations that "primarily hold[] investment assets" are "managed and controlled" in the United States if the assets held are on behalf of investors and decisions on how to invest those assets are made in the United States. *See* S. 1373 § 2(a); S. 1346 §103(a). Issues attendant to this particular proposal are beyond the scope of this Paper.

[62] *See generally* Joint Committee on Taxation, *Description of Revenue Provisions Contained In The President's Fiscal Year 2012 Budget Proposal*, JCS-3-11 (June 14, 2011), *available at* http://www.jct.gov/publications.html?func=select&id=7.

[63] *See id.*

[64] S.1346, §§ 103, 201.

Foreign Account Tax Compliance Act.[65] It also has punitive elements as it goes after those who promote abusive tax shelters and assist in understating tax liabilities.[66] In view of these other proposals, perhaps corporate residence is just the tip of a bigger iceberg.

II. Issues Presented

Whether or not redefining corporate residence will deliver the goals above is a question best answered by first considering the issues raised by this Proposal. First, the guidance provided by the statute regarding what "management and control" means has led critics to argue that the language is improper for the United States to adopt. Second, the Proposal raises additional questions to do with the cost of avoiding this rule, the "active trade or business" exception, transition problems, and inconsistencies with some of the United States' existing tax treaties. All of these concerns must be resolved and reviewed in conjunction with other proposals being discussed in Congress. These issues are discussed below in that order.

A. Defining "Management and Control"

Properly defining "managed and controlled" poses a significant challenge for legislators and tax administrators. To date, the proposals presented by Congress seem to be borrowed from other existing definitions of "management and control" as employed in other jurisdictions. Specifically, the Proposal utilizes language from the US-Netherlands Tax Treaty ("Dutch Protocol") that focuses on "substantial presence."[67] Commentators have questioned the use of

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[65] *Id.* at §§ 201-206.

[66] *Id.* at §§ 301-302.

[67] *Compare* S. 1373 § 2(a); S. 1346 §103(a) *with* Convention Between the United States and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal

this language, and instead bring up the use of the traditional view of "managed and controlled" per English law.[68] Both of these tests are discussed below.

Further complicating the potential inconsistencies raised by such a facts-and-circumstances based test are trends in multinational business operations. It has become standard business practice to shift from top heavy management styles towards favoring regional business units and having decisions made at a lower level than at the parent company's boardrooms.[69] For example, a manager based in the United States may also be responsible for oversight functions in other countries close to the United States, such as Canadian or Latin American operations.[70] With this shift in empowering middle management, combined with corporations' penchants for cross-management functions and keeping up with the demands of an ever-changing global market, it will not be easy for the taxpayer and the IRS to arrive at the correct answer for an entity's tax residence.[71]

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evasion with Respect to Taxes on Income, art. 26(8)(e)(iii), Dec. 18, 1992, amended Mar. 8, 2004 [hereinafter "Dutch Protocol"].

[68] *See* NYSBA Report, *supra* note 13, at 10-11.

[69] *See* Matthew Collett, *Developing a New Test for Fiscal Residence for Companies*, 42 UNSW L. J. 622, 629 ("[H]eadquarters may become less important, as more and more [multinationals] move from hierarchical structures to different business models. For example, Rio Tinto claims that it now has largely autonomous business cent[er]s scattered around the world.")

[70] *See* OFII letter, *supra* note 13, at 3.

[71] *See id.*; *see also* Tillinghast, *supra* note 1, at 262-63. Corporations also tend to conduct board meetings in different locations, or have leadership comprised of professionals based all over the world as a result of having global operations.

1. Guidelines from Congress: the Dutch Treaty Standard

The Proposal calls for Treasury Regulations to identify cases wherein the management and control of a corporation would "occur[] primarily" in the United States.[72] The Proposal specifically provides the following general guidelines:

> (i) the management and control of a corporation shall be treated as occurring primarily within the United States if substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the corporation are located primarily within the United States, and
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> (ii) individuals who are not executive officers and senior management of the corporation (including individuals who are officers or employees of other corporations in the same chain of corporations as the corporation) shall be treated as executive officers and senior management if such individuals exercise the day-to-day responsibilities of the corporation described in clause (i).[73]

This language is essentially lifted from the 2004 Protocol amending the US-Netherlands Income Tax Treaty, which expounded upon the Limitation on Benefits article of the 1992 US-Netherlands treaty.[74] The Limitation on Benefits article of the Dutch Protocol extends treaty benefits to corporations that are publicly traded and having a substantial presence in the country in which it resides.[75] "Substantial presence" is established in two ways: either the corporation is traded on an established national exchange, or if the "primary place of management and control"

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[72] S. 1373 § 2(a); S. 1346 §103(a).

[73] S. 1373 § 2(a); S. 1346 §103(a). In the case of investment funds and similar businesses, the relevant test is the location wherein decisions on how to invest the assets are made. This specific rule and attendant issues are beyond the scope of this Paper.

[74] *Compare* S. 1373 § 2(a); S. 1346 §103(a) *with* Dutch Protocol, *supra* note 67.

[75] Dutch Protocol, *supra* note 67, art. 26 (emphasis added).

is in that State.[76] This particular language might be appealing to Congress because it has been described as a "robust" standard,[77] one that typically requires "more of a real presence" in a particular state than mere incorporation.[78]

Determining "primary place of management and control" requires a comparison of the degree to which day-to-day responsibilities are carried out in one state relative to another.[79] In this analysis, the Dutch Protocol also considers where staff conducts the day-to-day activities

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[76] *Id.*

[77] *See* NYSBA Report, *supra* note 13, at 10.

[78] Shaviro, *supra* note 23, at 405-06.

[79] *See* Dutch Protocol, *supra* note 67, art. 26(8)(e)(iii) ("[T]he company's primary place of management and control will be in the State of which it is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in that State than in any other state and the staffs conduct more of the day-to-day activities necessary for preparing and making those decisions in that State than in any other state.") (emphasis added); *see also* Dep't of Treasury, Technical Explanation of the Protocol Signed at Washington on Mar. 8, 2004, Amending the Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed at Washington on Dec. 18, 1992, at 23 [hereinafter Technical Explanation], *available at* http:// www.treasury.gov/press/releases/reports/tenether04.pdf (providing guidance on the US-Netherlands Tax Treaty)

necessary to carry out the decisions made by management regarding strategy and financing.[80] The Technical Explanation accompanying the Protocol notes, however, that the analysis will only involve the board of directors in most cases.[81] An example provided in the Technical Explanation illustrates how it is unnecessary to look beyond this board of directors in the case of a Dutch multinational with many regional holding companies when the Dutch board exercises much oversight over the global business.[82]

Despite the focus on the board of directors, however, the Technical Explanation also specifically notes that the location of board meetings is not the "primary place of management and control."[83] Moreover, the "place of effective management" test used in the OECD Model Convention's provisions on residence is explicitly distinguished.[84] This distinction is one of the criticisms against this proposed standard: the language in the Proposal is not derived from residence rules.[85] The language used to determine "substantial presence" is designed to determine which taxpayers can take advantage of treaty benefits, and already presumes residence by virtue of the "publicly traded" requirement.[86] The OECD Model Convention, upon which most income tax treaties are based, does not have the language in the Dutch Protocol.

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[80] *See* Dutch Protocol, *supra* note 67, art. 26(8)(e)(iii).

[81] *See* Technical Explanation, *supra* note 79, at 23.

[82] *Id.*

[83] *Id.*

[84] *Id.*

[85] *See* OFII Letter, *supra* note13, at 6-7.

[86] Dutch Protocol, *supra* note 67, art. 26.

The OECD Model Convention refers to the corporation's "place of effective management" as the tie-breaker for potential dual residence issues.[87] The 2010 OECD Commentary defines "place of effective management" as where "key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made."[88] Not all jurisdictions have chosen to use this tiebreaker, however.[89] Although the OECD decided against the use of formal rules referring to where an entity is organized, some countries still chose to have place of incorporation as a tiebreaker.[90] The US-Netherlands Tax

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[87] OECD Model Tax Convention art. 4 (3) ("Where by reason of [a person being liable to tax in a Contracting State under the laws of that State] a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated."). The OECD Commentary acknowledges that preference must be established because certain countries place importance to either registration or place of effective management. ORG. FOR ECON. COOPERATION & DEV., COMMENTARY ON THE ARTICLES OF THE 2010 OECD MODEL INCOME AND ON CAPITAL TAX CONVENTION 88 [hereinafter 2010 OECD MODEL COMMENTARY].

[88] 2010 OECD MODEL COMMENTARY, *supra* note 87, at 88-89.

[89] Various countries have opined on the OECD's model rules on residence. Italy is of the view that the location of the "main and substantial activity" of the entity is relevant. Japan and Korea reserved the right to use "head or main office" rather than "place of effective management" wherever such language exists. *Id.* at 89-90.

[90] *Id.* ("It would not be an adequate solution to attach importance to a purely formal criterion like registration."). Canada reserved the right to use place of incorporation as a tiebreaker. Emerging economies not yet in the OECD have indicated their preference for "place of incorporation" as

Treaty of 1992 itself requires that dual residence be resolved by mutual agreement between the competent authorities, considering the corporation's "place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors."[91] This language also appears in the Commentary to the 2010 Model Convention for countries who prefer such a case-by-case analysis.[92] The OECD recognizes that a case-by-case approach may be useful for companies that use "new communication technologies" in their management decision-making processes.[93]

In the absence of further guidance from the OECD, or examples based on cases implicating the limitation on benefits provisions of the Dutch Treaty, the language suggested by Congress invites further confusion. "Substantial" decision-making would need to be defined. Moreover, it would be difficult to quantify the amount of decision-making made in a company; a

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either a rule on residence or as a tie breaker. This includes Indonesia, Russia, Thailand, Vietnam, and eastern European nations. *See* 2010 Update to the OECD Model Tax Convention, *available at* http://www.oecd.org/document/32/0,3746,en_2649_33747_45689952_1_1_1_1,00.html.

[91] The Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed Dec. 18, 1992, art. 4(3).

[92] 2010 OECD MODEL COMMENTARY, *supra* note 87, at 89. The OECD lists the following as examples of factors relevant to the competent authorities' evaluation: location of board meetings, where the Chief Executive Officer and other senior management carry on their executives, location of headquarters, which countries' laws govern the legal status of the person, where its accounting records are kept. *Id.*

[93] *Id.*

second hurdle is identifying an amount that is "substantial." "Substantial" could mean fifty one percent, or seventy five percent, or in the case of having various decisions made in various locations, perhaps simply settling on wherever the most decisions are made in that range of various locations. A simple majority may not be substantial; however, it could reflect the way businesses operate.[94] As staff and directors are already typically in different locations, so too could a company's finance, strategy, and operations departments be scattered across the globe. Congress' version, however, does not invite the taxpayer to compare activities in State A versus State B, although it is possible that future Treasury Regulations might do the same.[95]

2. The *De Beers* Standard from English Common Law

"The real business is carried on where the central management and control actually abides."[96] In *De Beers Consolidated Mines Ltd. v. Howe,* Lord Loreburn articulated what is now the leading common law standard regarding corporate residence. This test has been followed by English and other common law countries' courts, and also appears in Her Majesty's Revenue & Customs International Tax Handbook.[97] Since the 1980's, however, the United Kingdom refers

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[94] "A Bermuda-incorporated, Paris-headquartered firm, listed on the NYSE with U.S. Style investor protections and disclosure rules, a CIO in Bangalore, a CFO in Brussels and a COO in Beijing may not sound nearly so fanciful in the near future." Mihir A. Desai, *The Decentering of the Global Firm*, Working Paper 09-054 Harvard Business School, *available at* http://ssrn.com/abstract=1279535

[95] *Compare* S. 1373 § 2(a); S. 1346 §103(a) *with* Technical Explanation, *supra* note 86.

[96] De Beers Consolidated Mines Ltd v. Howe, [1906] A.C. 455 (H.L.) (Eng.).

[97] *See Company residence: the case law rule - central management and control,* HER MAJESTY'S REVENUE & CUSTOMS, *available at*

to place of incorporation to establish residence as well.[98] Companies incorporated in the United Kingdom are per se resident in the United Kingdom, but foreign corporations may be UK companies if they are managed and controlled in the United Kingdom.

In *De Beers*, the House of Lords had to determine whether De Beers Consolidated Mines, Ltd., the leading purveyor of diamonds mined in Kimberley, South Africa, would be taxed as a resident in the United Kingdom.[99] Residents of the United Kingdom were to pay taxes on profits or gains acquired "whether situate in the United Kingdom or elsewhere."[100] In coming to its decision, the Court explicitly refused to accept the company's position that a company "resides where it is registered, and nowhere else."[101] Moreover, for any such case calling into question a corporation's tax residence, it must be done "upon a scrutiny of the course of business and trading."[102]

De Beers Consolidated Mines, Ltd. is registered in South Africa, and is headquartered formally at Kimberley.[103] General meetings had always been held in South Africa, and is where profits originate.[104] A few directors and "life governors" of the company also reside in South

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http://www.hmrc.gov.uk/manuals/intmanual/intm120060.htm. Examples of case law appear in the following discussion.

[98] *See id.*

[99] *De Beers*, at 456.

[100] *De Beers*, at 458 (citing the second section of the Income Tax Act, 1853, Sched. D).

[101] *Id.*

[102] *Id.*

[103] *Id.*

[104] *Id.* at 459.

Africa, with board meetings held in both Kimberley and in London.[105] What ultimately swayed the Court, however, was the fact that majority of the directors lived in England, and it was the directors' meetings in London where "the real control" is exercised in "practically all" of the company's important business.[106] Contracts were negotiated out of London, and London controlled expenditures, appointment of directors, company wide policies pertaining to diamonds and assets.[107] London controlled everything but routine expenses related to mining operations.[108] With these conclusions of fact, the Court ruled that the company was resident in the United Kingdom for tax purposes.[109]

De Beers instructs to look to the board of directors, and consider where "high level" decision-making occurs. The taxpayer had active businesses in South Africa and also had directors there; nevertheless, the Court focused on the majority of the board of directors' activities. This focus on the board, which may be in the form of passive oversight, has led to *De Beers* being characterized as a less "robust" standard for "management and control" relative to the Dutch standard.[110]

Later English Courts have been reluctant to stray from De Beers. De Beers has been upheld even in circumstances wherein the taxpayer probably thought they had successfully sidestepped the rule. Recently, in *Laerstate BV v. Commissioners*, a Dutch Company owned by a

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[105] *Id.*

[106] *Id.*

[107] *Id.*

[108] *Id.*

[109] *Id.*

[110] *See* NYSBA Report, *supra* note 13, at 10.

UK non-resident was still deemed a resident of the United Kingdom.[111] The principal shareholder of the company was a UK citizen, and it was he who exercised de facto control of the company.[112] The House of Lords has also ignored boards of directors of subsidiaries and focused entirely on the parent company's board. In *Unit Construction Co Ltd v. Bullock*, the House of Lords held that it is appropriate to look at facts beyond what was formally done when the board of directors of a particular company "do not and cannot exercise their powers."[113] A question of de jure versus de facto management, *Unit Construction* deals with local directors of an English firm's Kenyan subsidiary that never functioned as a board of directors.[114] This was inconsistent with the articles of association, which gave the local board managerial power and did not consider meetings held in the United Kingdom to be valid.[115]

Invoking Lord Loreburn, Lord Radcliffe looked to the subsidiary's head office and held that the Kenyan subsidiary, although not incorporated in the United Kingdom, to be resident in the United Kingdom.[116] In his speech, Lord Radcliffe also recognized the burden of having to collect evidence pertaining to subsidiaries' operations.[117] Nevertheless, he maintains that residence is a question of fact and the appropriate inquiry must be conducted. Otherwise, an

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[111] Laerstate BV v. Commissioners, [2009] UKFTT 209 (TC) (Eng.) (emphasis added)

[112] *Id.*

[113] Unit Construction Co. Ltd. v. Bullock, [1960] A.C. 351 (Eng.).

[114] *Id.*

[115] *Id.*

[116] *Id.* at 371.

[117] *Id.*

alternative would depend too much on the "measure of candor and responsibility" shown by the taxpayer and their advisers.[118]

UK law has influenced other common law jurisdictions pursuant to *De Beers*, such as Canada and Australia. Canadian corporate residence is not explicitly defined in the Canadian Income Tax Act, and refers to De Beers principles.[119] A corporation need not be incorporated in Canada to be resident in Canada, although incorporation in Canada will nevertheless make a corporation resident in Canada per the "deemed residency" provisions of the Income Tax Act.[120] The "deemed residency" provisions of the Income Tax Act treats what would be a non-resident corporation under common law as a resident corporation if it were incorporated in Canada, or is grandfathered in around 1965.[121] Canada has taken *De Beers* further as it applies to residencies of trusts as well.[122] Moreover, the Supreme Court of Canada has also extended *De Beers* to non-

[118] *Id.*

[119] The Canada Revenue Agency's guidelines explicitly draw from "common law principles" of british courts. *Residency of a Corporation*, CANADA REVENUE AGENCY, *available at* http://www.cra-arc.gc.ca/tx/nnrsdnts/bsnss/bs-rs-eng.html. *See generally* Revenue Canada Interpretation Bulletin IT-391R, *available at* http://www.cra-arc.gc.ca/E/pub/tp/it391r/it391r-e.txt.

[120] *See, e.g.*, Saipem UK Limited v. The Queen, 2011 TCC 25 (CanLII), *available at* http://canlii.ca/s/16gev.

[121] Income Tax Act, R.S.C. 1985, c.1 § 250(4) (Can.)

[122] *See* St. Michael Trust Corp. v. Canada, 2010 FCA 309 (CanLII), *available at* http://canlii.ca/s/15z7j ("By analogy from De Beers . . . the task is to determine where a trust

tax cases, having used *De Beers* in resolving a matter of residency with regard to bills of exchange.[123]

Generally, Canadian authorities look to "independent decision making," that is, the location of topmost decision makers. For example, in *R.A. Hewitt & Sons Ltd. v. The Queen*, the Tax Court of Canada looked at a number of factors in determining the residency of a Bahamian subsidiary of an Ontario-based corporation with farming operations in the Bahamas.[124] Such factors included: the residency of the directors of the subsidiary, where the corporate seal and record book was kept, location of board meetings, and where management decisions were made.[125] The subsidiary in question had a Bahamian bank account, but even though Bahamian checks were used to pay for purchases, orders were made in Ontario and the cheques were signed in Ontario and later mailed to the Bahamas.[126] The Tax Court had no difficulty in finding that the corporation was resident in Canada.

'keeps house and does business,' i.e., where the powers and discretions of the trustee are really being exercised.").

[123] *See* Canada Life v. Canadian Imperial Bank of Commerce, 1979 CanLII 41 (SCC), [1979] 2 SCR 669, *available at* http://canlii.ca/s/wdgl.

[124] R.A. Hewitt & Sons Ltd. v. The Queen, 2000 CanLII 532 (TCC), *available at* http://canlii.ca/s/ntgk.

[125] *Id.*

[126] *Id.*

Another example is *1143132 Ontario Ltd. v. The Queen*, where the Tax Court emphasized the board of directors as a primary factor in determining residency.[127] The Tax Court referred to the residency of the board of directors, and to a lesser extent, the place of incorporation. Most strikingly, though, the Tax Court noted in paragraph 36 of the opinion that they would have preferred more facts but is making the most of what was presented in the proceedings.[128] Moreover, the onus was on the taxpayer to provide whatever evidence it would like to establish residency.[129] This is exactly the type of inconsistency that would inevitably result from employing a facts-and-circumstances based test.

Australia also utilizes a "management and control" test, which is codified in § 6 (1) (b) of the the Income Tax Assessment Act of 1936.[130] Per Australian law, a company is resident if it is either incorporated in Australia, or carries on business and has its "central management and

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[127] *See* 1143132 Ontario Limited v. The Queen, 2009 TCC 477 (CanLII), *available at* http://canlii.ca/s/124rg ("It is well accepted that it is the role of directors to manage a corporation and, in the absence of any evidence to the contrary, I must proceed on the basis that it was the directors who managed the company.").

[128] *Id.* ("While one might like to have more facts, on the facts before me I can only infer that the central management and control of [corporation] was outside of Canada and that, as a result, [it] was a non-resident.").

[129] *Id.* ("If there were evidence to show that the central management and control was in Canada, the Appellant, who was the sole owner of [subsidiary], was well placed to bring forward any such evidence. It chose not to do so.")

[130] Income Tax Assessment Act of Australia, § 6(1)(b).

control" in Australia.[131] Similar to the United Kingdom and Canada, "management and control" refers to where highest-level decision-making occurs regarding business strategy.[132] These decisions are those that set the company's goals and direction, and evaluate performance based on benchmarks and market risks and opportunities.[133] In *Koitaki Para Rubber Estates Ltd. v. Federal Commissioner of Taxation*, the High Court of Australia held true to the De Beers standard as it held that a company that owns rubber plantations in Papua New Guinea is resident in Australia because the "corporate acts" of the company where done in Sydney.[134] Their board of directors and majority of their shareholders reside in Sydney.[135] The company's comprehensive production operations in Papua are merely auxiliary, under the supervision, direction, and control of the Sydney office.[136] In Australia, the company has "its life and being."[137]

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[131] *Id.*

[132] *See* Koitaki Para Rubber Estates Ltd. v. Fed. Comm'r of Taxation (1941) 64 CLR 241, 244 (Austl.) (citing *De Beers Consolidated Mines v. Howe); see also* Taxation Ruling 2004/15: Residence of Companies not incorporated in Australia, AUSTRALIAN TAXATION OFFICE, *available at* http://law.ato.gov.au/atolaw/view.htm?locid=%27TXR/TR200415/NAT/ATO/fpF11%27&PiT=99991231235958#fpF11 [hereinafter ATO Ruling]

[133] *See* ATO Ruling, *supra* note 132.

[134] *Koitaki*, 64 CLR at 244.

[135] *Id.*

[136] *Id.*

[137] *Id.*

The Australian Taxation Office's Taxation Ruling 2004/15 is quite comprehensive and could be a good model for the IRS when it writes its own Regulations, instead of following the Dutch Treaty.[138] This Ruling succinctly summarizes issues relevant to "management and control," and provides good examples that lend insight into the approach of the Australian Taxation Office. The relevant actors at issue are those who are actually making decisions, not just those who have he right to do so.[139] Although a prima facie indicator for high-level decision-making is the location of the board of directors, it is possible that the board is not actually the highest-level decision maker.[140] The Australian authorities would also look for facts that indicate that a meeting was held in a particular place for no business reason.[141] Moreover, in the case of electronic meetings, the relevant locations would be those of the participants in the meeting, not the location of the equipment.[142] It has been suggested, however, that although the Ruling has provided more insight on "management and control," it has not done enough by way of clarifying the operation of the test.[143] Given that the test turns on the facts and circumstances of each test, it will generally be difficult to explain how the test applies with certainty.[144]

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[138] *See* ATO Ruling, *supra* note 132.

[139] *See id.*

[140] *See id.*

[141] *See id.*

[142] *See id.*

[143] Michael Dirkis, *Still a Problem Child: Central Management and Control after RITA*, 15 REVENUE L. J. 126, 139 (2005).

[144] *Id.* ("[G]iven the fact and circumstance nature of the test, TR 2004/15 was never going to do anything other than restate the law. Operational clarity was never going to be achievable.")

An issue left unresolved, however, is how to handle companies that have multiple, or even changing, residencies.[145] Australia, Canada, and the United Kingdom recognize that a company might have divided management and control, whereupon the *De Beers* test cannot be determinative.[146] This is where the resident tiebreaker rules in tax treaties may be useful.[147] As discussed above, the Contracting States may choose their own tiebreaker.[148] The Canada-UK tax treaty requires mutual agreement by competent authorities.[149] The Canada-Australia tax treaty

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[145] *See Divided or Multiple Residence*, HER MAJESTY'S REVENUE & CUSTOMS, *available at* http://www.hmrc.gov.uk/manuals/intmanual/intm120060.htm (last visited Dec. 1, 2011).

[146] In *Swedish Central Railway Co. Ltd. v. Thompson*, the House of Lords established that it is possible for a company to reside in more than one place. Swedish Central Railway Co. Ltd. v. Thompson, [1925] A.C. 495, 501 (H.L.) ("[M]anagement and control of a company may be divided, and it may 'keep house and do business' in more than one place; and, if so, it may have more than one residence."). The case has been cited in other Commonwealth countries, including Canada and Australia. *See, e.g.*, Koitaki Para Rubber Estates Ltd. v. Fed. Comm'r of Taxation (1941) 64 CLR 241, 244 (Austl.).

[147] In *Unit Construction Co. Ltd. v. Bullock*, Lord Radcliffe explicitly stated that the court does not resolve competing claims between jurisdictions. Unit Construction Co. Ltd. v. Bullock [1960] A.C. 351, 368 ("For any one taxing authority the relevant question is whether the company is resident within the area of its jurisdiction or non-resident: it is not required to ascertain positively whether or not the company is also resident within another jurisdiction.")

[148] *See supra* notes 87-93 and accompanying text (explaining the OECD Model Convention).

[149] Convention Between the Government of Canada and the Government of the United Kingdom of Great Britain and Northern Ireland For the Avoidance of Double Taxation and the Prevention

utilizes place of incorporation as a tiebreaker; or place of effective management if the company is incorporated or organized in neither country.[150] The UK-Australia tax treaty looks to place of effective management.[151] These treaties generally adhere to a common understanding of "place of effective management." Moreover, the Commonwealth countries have at least developed a significant amount of similar material on the issue of what constitutes "management and control," and such guidance would possibly provide a measure of international consistency in resolving the question of corporate residence.

B. Additional Considerations

Using the "managed and controlled" standard is expected to make it difficult for taxpayers to use foreign (shell) companies to hold assets and escape US taxation.[152] Proponents of this Proposal suggest that enacting this legislation now is a necessary step to reforming the US international tax system, due in part to the fact that discussions on territoriality and deferral mechanisms would require a wider scale of reform that the United States might not be willing to

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of Fiscal Evasion With Respect to Taxes on Income and Capital Gains, signed Sept. 8, 1978, art. 4(3).

[150] Convention between the Government of Australia and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains, art 4(4), [1981] ATS 14.

[151] Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains, art 4(4), [2003] ATS 22.

[152] *See* Avi-Yonah, *supra* note 21, at 668.

wait for.[153] As it is, the Stop Tax Haven Abuse Act was intended to be part of a deficit reduction package.[154] Congress, however, has since decided to address tax reform separately from deficit reduction, suggesting that it is more prudent to carefully examine the US tax system in bigger pieces rather than on an ad hoc basis.[155]

1. Cost of Avoiding this Rule

This Proposal is not perfect, and its proponents acknowledge its limitations.[156] The Proposal is meant to increase the costs of escaping US residence: corporations would have to relocate executives outside the United States for those corporations to be non-US resident.[157] Nevertheless, there will still be situations wherein the tax benefit is so great that the corporation would move its executives abroad, with additional compensation and benefits if necessary.[158]

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[153] *Id.* ("The debate between opponents and proponents of deferral and territoriality seems unlikely to produce real reform soon. But if we adopted the managed and controlled test, it would become much more difficult for U.S. Multinationals to avoid subpart F merely by creating shell companies overseas and using one of the myriad loopholes in the existing rules.").

[154] 157 CONG. REC. S4518 (daily ed. July 12, 2011) (statement of Sen. Levin) ("Its provisions will hopefully be part of any deficit reduction package this year, but should be adopted in any event.").

[155] *See* John D. McKinnon, *Deficit Deal Might Delay Tax Overhaul*, WALL ST. J., A5 (Nov. 15, 2011).

[156] *See, e.g.*, Avi-Yonah, *supra* note 21, at 668 ("No loophole closer is ever perfect.").

[157] *See* NYSBA Report, *supra* note 13, at 20; *see also* Avi-Yonah, *supra* note 21, at 668 ("Moving people is harder than creating corporate shells.").

[158] Avi-Yonah, *supra* note 21, at 668.

This decision is contingent upon the prevailing tax rate, and the scope of relocations necessary. The amount of tax savings may be at the current top rate of thirty-five percent, or, considering other proposals, it may be at twenty-eight or twenty-five percent.[159] The scope of such relocations would depend on how "managed and controlled" is defined. Under *De Beers*, only the board of directors of each corporation would have to be relocated, or they would at least have to conduct their meetings in a low-tax jurisdiction. Under the language of the Dutch Protocol, however, corporations might have to scatter their management and staff across multiple countries, for example, so as to fall on the other side of the rule. Multinationals, particularly those with non-US parent companies, have threatened to exercise either option should this Proposal be enacted.[160]

2. Active Trade or Business Exception

Commentators have also identified outstanding questions associated with the Proposal's exception for CFC's that are part of multinational groups with a US parent company with sufficient assets used for an active trade or business.[161] First, the Proposal does not specify if the US parent must directly conduct the US active business; stock ownership could be sufficient.[162] Second, the exception does not require the application of rule in the Proposal to the parent

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[159] The Camp Draft released in November 2011 considers a 25% rate for the maximum corporate income tax rate in conjunction with other provisions. *See* PwC Publication, *supra* note 54.

[160] *See* OFII Letter, *supra* note 13, at 2-3.

[161] *See* S. 1373 § 2(a); S. 1346 §103(a). "Sufficient business assets" excludes cash and stock of foreign subsidiaries. S. 1373 § 2(a); S. 1346 §103(a). *See generally* NYSBA Report, *supra* note 13, at 24 (listing outstanding questions regarding the trade or business exception).

[162] NYSBA Report, *supra* note 13, at 24.

corporation: the parent corporation must be a US-organized corporation.[163] Third, the exception is limited to foreign-organized corporations part of a US affiliated group. Thus, CFC's held through partnerships would not be covered by the exception, nor would CFC's below a US consolidated group but ultimately owned by a foreign parent.[164] NYSBA Practitioners suggest that this is an oversight, or perhaps a drafting error.[165]

Additionally, this exception could exacerbate the lock-out problem that the Camp Draft hopes to fix, as it could encourage US multinationals to reroute their earnings to these CFC's.[166] A territorial tax system would ameliorate this problem, but until that happens, Congress could be encouraging investment elsewhere, causing billions of tax dollars to be trapped abroad. US multinationals currently have more than $10 trillion invested abroad, at least $1 trillion of which are foreign earnings.[167] Perhaps a rule that would facilitate the repatriation of those earnings,[168] in addition to a territorial system, could yield a significant amount of tax dollars that could be worth more than redefining corporate residence.

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[163] *See* NYSBA Report, *supra* note 13, at 24.

[164] *Id.*

[165] *Id.*

[166] The lock-out effect occurs when foreign earnings are trapped abroad because repatriating them to the United States would trigger US taxes at 35% (subject to considerations related to Subpart F).

[167] *See* Shaviro, *supra* note 23, at 380.

[168] *See* David Kocieniewski, *Companies Push For a Tax Break On Foreign Cash*, N.Y. TIMES, A1 (explaining how US multinationals are appealing to the US government for a reduced rate for repatriating their foreign earnings).

3. Transition Problems

Like any tax reform proposal, managing transitions can be challenging.[169] This Proposal expects to have the "managed and controlled" rule in effect two years after the date of enactment.[170] In two years, a taxpayer could restructure their tax planning and introduce contingency plans that could undermine the goals of this Proposal. In evaluating this Proposal, Congress or Treasury should also articulate specific rules governing the transition. Also, any changes in residency of a corporation by virtue of this Proposal could qualify as a reorganization under Section 368(a)(1)(F).[171] An F-reorganization would implicate importing gains or losses under Section 362 and will need to be reviewed.[172] This could cause significant tax costs if the management and control test is misapplied to the taxpayer.[173]

4. Dual Residence and Treaty Benefits

Enacting this Proposal could also cause corporations to be dual residents, occasionally at risk of losing treaty benefits. A taxpayer could be organized in State A, and "managed and controlled" in the United States. As discussed in further detail in Section A of this Part, each tax treaty has its own particular tiebreaker rule, depending upon the preferences of the Contracting

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[169] *See generally* Shaviro, *supra* note 23; Parillo, *supra* note 46.

[170] S. 1373 § 2(a); S. 1346 §103(a).

[171] *See* I.R.C. §368(a)(1)(F) ("[T]he term 'reorganization' means . . . a mere change in identity, form, or place of organization of one corporation, however effected."); *see also* NYSBA Report, *supra* note 13, at 24.

[172] *See* NYSBA Report, *supra* note 13, at 24-25.

[173] *See id.*

States.[174] Twenty-five US tax treaties use place of incorporation as a tiebreaker,[175] whereas other treaties look to "competent authorities" to agree on the appropriate residence.[176] In the latter case, should there be no agreement by the competent authorities, a taxpayer would be denied treaty benefits.[177] Without treaty benefits, the taxpayer would be subject to double taxation of income, and this would be primarily because of a unilateral change in US law. Commentators suggest that this is an unreasonable burden upon affected taxpayers, one that would encourage multinationals to relocate their operations outside the United States so as not to risk losing treaty benefits.[178] Therefore, in addition to the other outstanding questions presented above, Congress and Treasury must also consider adjustments that might be necessary for affected US tax treaties.[179]

III. Recommendations

For better or worse, this Proposal at least makes a contribution towards the ongoing debate regarding US international tax reform. This Proposal was submitted under two different

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[174] *See supra* notes 87-93 and accompanying text (describing the OECD Model Convention and how some Contracting States have opted to deviate from that model).

[175] The affected countries are: Austria, Bangladesh, Barbados, Canada, Cyprus, Czech Republic, Egypt, Greece, Hungary, Indonesia, Korea, Malta, Morocco, Norway, Pakistan, Philippines, Poland, Romania, Slovakia, Slovenia, South Africa, Sri Lanka, Sweden, Trinidad and Tobago, and Turkey. OFII Letter, *supra* note 13, at 4, n. 6.

[176] *See, e.g.*, Dutch Protocol, *supra* note 67, art. 26.

[177] *Id.*

[178] *See* OFII Letter, *supra* note 13, at 5.

[179] *See id.* at 4.

headings: under “international tax competitiveness” and “stop[ping] tax haven abuse.” Thus, Congress clearly has twin goals in mind, and must balance both. This Paper argues first that using the common law definition of “managed and controlled” is more appropriate for Congress’ purposes rather than the language from the Dutch Proposal. This Paper also cautions, however, that while this Proposal is theoretically beneficial, it is only a temporary solution to a bigger problem. It would be more sensible to wait and discuss this Proposal in conjunction with other propositions in order to properly achieve what Congress wants.

A. Common Law Should Prevail

The English understanding of “managed and controlled” as articulated in *De Beers* and replicated in other countries is a better standard than the Dutch Protocol for three reasons. One, it places the United States in line with other industrialized nations using the same standard.[180] Two, because of its history, there are many more guidelines and precedents available to aid in interpreting the standard.[181] Finally, *De Beers* lends itself well as a rule on corporate residence per se, rather than “borrowing” from other aspects of tax law.

Australia, Canada, and the United Kingdom, which are some of the United States’ valuable trade partners, all utilize the *De Beers* standard of corporate residence. These three countries offer good comparisons, as they are all advanced nations with corporate tax rates that

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[180] *See supra* notes 30-32 and accompanying text (surveying corporate residence standards used in other countries).

[181] *See supra* Part II.A.2 (discussing the history of the common law standard and its many interpretations in Australia, Canada, and the United Kingdom).

are fairly comparable to those of the United States.[182] As Congress hopes to prevent US taxpayers from being faced with disadvantages caused by tax regulations, then it should follow that a good way to achieve parity with other countries is to place US tax law in line with other industrialized nations. Achieving some parity with countries that can be considered the United States' "peers" can be accomplished by the use of the *De Beers* standard of corporate residence for corporations that are not organized in the United States. Although taxation worldwide will probably never be at a level playing field, perhaps aligning policies with countries of similar interests is one way to minimize tax arbitrage opportunities. Doing so would limit a taxpayer's ability to take advantage of favorable residence rules that allows the taxpayer to avail themselves of favorable tax rules via the use of sophisticated tax structures.[183] Combined with the investor rule specifically provided for offshore investment funds, using the *De Beers* standard for all other corporations' residence should staunch the flow of US tax dollars heading away from the United States.

A significant advantage to using *De Beers* rather than any other standard is that *De Beers* and its vast progeny offers much needed guidance that would be valuable for Congress,

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[182] The highest marginal tax rates of these countries are: 30% for Australia, 34% for Canada, 28% for the United Kingdom, and 35% for the United States. *See* Tax Rates Around the World, TAX RATES CC, *available at* http://www.taxrates.cc/ (listing worldwide corporate and individual income tax rates). For a more thorough analysis of how corporate tax rates compare acorss countries, see Gravelle, *supra* note 45.

[183] *See supra* notes 11-13 and accompanying text (describing international tax planning structures).

Treasury, and taxpayers on how such a rule would be implemented.[184] For the purposes of "management and control," one need only look at one level of management: the board of directors, top-level management.[185] Per *De Beers* and *Unit Construction*, the relevant board is that of the parent company. For example, a CFC may be incorporated in the Netherlands with its own board of directors, but since its parent corporation is based in the United States, then it would be a US resident. As a US resident, it would be taxable on its worldwide income in the United States, subject to the active trade or business exception. This interpretation of "management and control" is particularly helpful to the IRS if its goal is to prevent multinationals from creating a complex chain of foreign corporations, each of which has a board of directors that are most probably comprised of in-house counsel and tax directors. Moreover, this standard certainly requires more of the taxpayer in that the taxpayer is no longer able to create multiple holding companies by the simple expedient of incorporating in their low-tax jurisdiction of choice.

One difficulty with the *De Beers* standard, however, is that it is not particularly difficult to have board meetings in various locations, have boards meet remotely, or have boards comprised of individuals based in different locations. The scope and number of such meetings may also factor into the determination of residence; perhaps one board meeting held in the United States is sufficient to establish US residence. Questions similar to this, however, could be resolved by providing examples and explanations in forthcoming Treasury Regulations. The

[184] *See supra* Part II.A.2 (discussing the history of the common law standard and its many interpretations in Australia, Canada, and the United Kingdom).

[185] *See supra* note 106 and accompanying text (illustrating the focus on a company's board of directions).

Australian regulations in Taxation Ruling 2004/15 is quite comprehensive and would be immensely helpful to the IRS as it provides regulations and helpful examples to the taxpayer in determining what scenarios may constitute "managed and controlled" in or out of the United States.[186]

The absence of interpretative guidance in the context of corporate residence combined with the seemingly more comprehensive review required by the Dutch Protocol prove the language in the Proposal to be quite the unworkable standard. The Dutch Protocol asks too much of the taxpayer in that it considers day-to-day operations further down the corporation's organizational chart, with no clear end in sight as to where the analysis stops.[187] The costs of complying with this rule could substantially increase as immaculate records will have to be kept detailing what decisions are covered and who made a particular decision, where those decisions are made, what area of the business is affected by the decision, and maybe even what dollar value is at stake with that particular decision.[188] Should there be a dollar threshold to determine if a particularly "expensive" decision could sway that corporation's residence? Moreover, as record keeping is increasingly outsourced, it could be difficult to access any such records if the issue of residence is litigated, or if the IRS audits the taxpayer.

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[186] *See supra* notes 138-142 and accompanying text (providing examples of scenarios envisioned by the Australian Taxing Office that affect a company's residency status).

[187] *See supra* notes 79-80 and accompanying text (describing the analysis under the Dutch Protocol).

[188] *See supra* note 26 and accompanying text (referring to compliance costs); *supra* note 92 (listing record keeping as a possible factor in determining the location of effective management).

The analysis required by the Dutch Protocol significantly increases the risk, and any attendant costs, of litigating the question of corporate residence. This particular rule could be very inconsistently applied, depending upon how the IRS views a particular taxpayer's structure, or how courts would review the facts. Residence could very well turn on how well a corporation presents its "good" and "bad" facts to the trier of fact. As new industries or industry norms develop, so too could the residence of a particular entity change, based on the capability of the judiciary to evaluate business practices. These seem to be unnecessary burdens imposed upon multinationals that choose to engage in worldwide commerce. This is particularly true for companies organized abroad years ago, with no hidden tax-motivated agendas.[189]

Finally, another problem with the Dutch Protocol is that it is a rule designed to determine if the taxpayer can qualify for treaty benefits. It is a test that taxpayers would like to meet so that they can qualify for reduced tax rates and avoid double taxation.[190] US residence, however, is not something that a taxpayer necessarily wants due to the worldwide tax system.[191] Corporations would do well to comply with the Dutch Protocol to qualify for treaty benefits, but corporations might choose otherwise to escape US tax residency. The incentives to comply with the rules are different; the interpretation of the language provided could be different as well.

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[189] *See supra* note 14 and accompanying text (listing affected corporations).

[190] *See supra* note 75 and accompanying text (describing the limitation on benefits article of the Dutch Protocol).

[191] *See* Shaviro, *supra* note 23, at 379 ("A mere election to pay more tax, by gratuitously subjecting oneself to the U.S. worldwide system (such as it is), would make too little sense even to matter.")

A corporation might decide to avail themselves of treaty benefits by being a Dutch corporation rather than a US corporation, and thus conduct its investments through the Netherlands rather than the United States, at a possible loss to the United States' foreign investments.[192] In combination with the active trade or business exception provided for in the Proposal, there is much incentive to operate outside the United States and trap foreign earnings elsewhere.[193] Highly skilled foreigners are available to perform whatever duties need doing abroad if US-based management does not want to relocate. Moreover, relocating to the Netherlands might not even be an unthinkable proposition for some people.

The Dutch Protocol standard that has yet to be tested in the context of corporate residence. The example provided in the Technical Explanation also suggests that even a vast network of subsidiaries under a parent corporation is eligible for treaty benefits simply because their board of directors is based in the Netherlands.[194] The Technical Explanation outright states that it will be indeed a rare case wherein the analysis for qualifying for treaty benefits will need to go past the board of directors. This interpretation is strikingly similar to the *De Beers* standard. Thus, instead of stretching the Dutch Protocol's Limitations on Benefits principles, it would be easier to introduce *De Beers*-based rules outright, which would also provide access to a network of resources surrounding the interpretation and implementation of the rule.

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[192] *See supra* notes 34-36 and accompanying text (describing the importance of attracting and retaining foreign investment).

[193] *See supra* Part II.B.3 (discussing the active trade or business exception provided in the Proposal and the incentive to trap foreign earnings abroad).

[194] *See supra* notes 81-82 and accompanying text (discussing the example provided in the Technical Explanation).

B. Good Things Happen to Those Who Wait?

For various reasons, tax reform has been incredibly popular of late. Optimists would argue that real tax reform is coming, and although it will not happen overnight, there appears to be reason to believe that changes will come to the Code.[195] What those exact changes are, and when those changes can be expected, is a difficult prediction to make. Nevertheless, waiting for more comprehensive and systematic reform of the system would be a better way to keep the United States competitive in the realm of international tax and prevent the abuse of tax havens, rather than introducing stopgap measures that are only temporarily patching leaks in the system. Such measures are particularly unwise if they require specific transitional rules, could cause irreversible "damage," and may involve renegotiating provisions that were deliberately selected in tax treaties with trading partners.[196]

The Proposal seems to have already taken a back seat to other measures. Both bills espousing the Proposal are in committee as of December 2011, with no major activity since their introduction. Although the Senate Finance Committee heard testimony on the broader matter of reforming the US International Tax System back in September, it does not appear as though anything came out of that, necessarily.[197] The Committee has since held a number of other

[195] *See supra* notes 54-58, 62-66 and accompanying text (discussing other options being discussed in Congress).

[196] *See supra* notes 171-173 and accompanying text (describing the possibility of an F reorganization under IRC §368); Part II.B.4 (discussing the effects of corporate residence on treaty benefits).

[197] *See supra* notes 41-44 and accompanying text (recounting testimony presented at the Senate Finance Committee's September 8, 2011 hearing on international tax reform).

hearings covering other aspects of tax reform, such as charitable giving limitations, and other tax incentives available in the Code.[198] Furthermore, focus appears to have shifted to seriously considering a territorial taxation system.[199] If all business income were treated the same, corporate residence would be irrelevant: for as long as business income is earned in the United States, it will be taxable in the United States.[200] What it means for income to be "earned" in the United States is an entirely different and significant issue that implicates revisiting the United States' current rules regarding the source of income.

Thus, international tax reform is best discussed and acted upon as a whole, rather than in separate pieces. Moreover, this particular Proposal is limited in scope, as it only affects corporations. The use of disregarded entities, such as foreign equivalents to the US limited liability company, may still offer opportunities to engage in tax arbitrage. Disregarded entities are increasingly popular in tax planning,[201] and perhaps multinationals can find ways around a different definition of corporate residence by employing disregarded entities, or "tax nothings" even more.

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[198] *See* Senate Finance Committee Hearing Schedule, *available at* http://finance.senate.gov/hearings/ (last visited Dec. 2, 2011).

[199] *See supra* notes 54-58 and accompanying text (describing Congressional efforts that suggest moving to a territorial tax system).

[200] *See supra* notes 52-53 and accompanying text (describing territorial tax systems).

[201] *See* Cynthia Ram Sweitzer, *Analyzing Subpart F in Light of Check-the-Box*, 20 AKRON TAX J. 1, 8 (2005) ("The [check-the-box] regime has paved the way for creative tax avoidance planning options.").

Reforming the complex US tax system with an eye to close existing "leaks" in the system is certainly one way to approach limiting tax arbitrage opportunities. The problem with this approach, however, is that it leaves the US tax law always a step behind. A forward-looking approach that focuses on policies and rules that are more sustainable in the long run should be much preferred. Granted, it is difficult to call for comprehensive tax reform in challenging economic times. Nevertheless, stopgap measures like this Proposal, which has failed before, cause transitory problems and uncertainty that probably will not lead to appreciable and positive benefits that further Congress' goals of remaining competitive in an increasingly globalized marketplace.

Conclusion

Congress is faced with the daunting task of increasing tax revenues while still keeping the US markets competitive via tax regulation. Redefining the concept of corporate residence for tax purposes, although a fair suggestion, has yet to be properly discussed and raises other questions in need of resolution before this can proceed as a viable measure. The current Proposal does not use an appropriate alternative standard for corporate residence, and could be rendered moot by other ideas on the proverbial table. Tax reform is not an easy process; it generally accepted to be arduous and protracted. Nevertheless, there are reasons to believe that perhaps the tides have turned such that reform at least on the international tax front is on the horizon, rendering stopgap measures, which are themselves politically difficult to achieve, unnecessary in the long run.