A Tax Policy Perspective on Corporate Residence

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In the preface to *Corporate Residence and International Taxation*, Robert Couzin asserts that his book

> is not a tax policy text. The objective is not so lofty as to determine whether residence taxation of business corporations is a good or sensible thing, or even what meaning should be ascribed to corporate residence to make it as good and sensible as possible.[1]

That said, like any good tax commentator, Couzin cannot help talking, albeit briefly, about the tax policy issues. After a closely reasoned and comprehensive analysis of the Canadian rules and the treaty concept of corporate residence, which reveals several serious problems, Couzin adds a chapter in which he speculates about the tax policy aspects of the topic and how the existing problems might be fixed.[2] It is this final chapter of the book that stimulated my thinking and that I want to use as the springboard to express some thoughts about corporate residence.

It is necessary to make several preliminary points.

First, the concept of residence is a fundamental building block of the Canadian and most other developed tax systems, which students typically encounter early in their first tax courses. This initial study of residence is sometimes dangerous because we come to think we have a firm grasp of the concept. However, as Couzin's study demonstrates with respect to corporate residence, the concept is not a self-contained building block; its influence is pervasive and subtle, and we should not take it for granted.

Second, the concept of corporate residence is intimately connected with the fundamental proposition that a corporation is a taxable entity separate from its

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1 Robert Couzin, *Corporate Residence and International Taxation* (Amsterdam: International Bureau of Fiscal Documentation, 2002), viii.

2 Ibid., chapter 5, at 259-72.

shareholders.[3] It is only because corporations are separate taxable persons that it is necessary to determine their residence. Although the treatment of a corporation as a separate entity for income tax purposes may make sense in a domestic context, it makes little sense in the international context. A resident individual or corporation should not be able to avoid residence-country tax on foreign-source income by the simple expedient of having the income derived by a foreign corporation of which the resident owns all the shares. However, I suspect that in the early days of the income tax, the treatment of domestic corporations as separate taxable entities was extended to foreign corporations without much thought (just as the treatment of limited liability companies and the check-the-box rules in the United States were developed in the domestic context and extended to foreign entities without much thought).

The implications of the treatment of most foreign corporations as non-residents of Canada and as separate taxable entities are profound. Transfer-pricing rules, thin capitalization rules, controlled foreign corporation (CFC) rules, foreign investment fund (FIF) rules, rules for dividends from non-resident corporations, and other international tax rules are necessitated by these two fundamental concepts. On the other hand, it is difficult for me to understand how a system in which foreign corporations are treated as transparent would operate in practice. Each Canadian-resident shareholder would presumably be required to include in income its proportion of the income earned through the foreign corporation. A provision such as subsection 96(1) of the Income Tax Act[4] would be necessary to require the income of a foreign corporation to be computed in accordance with Canadian tax rules. However, a widely held foreign corporation with a few small Canadian shareholders could hardly be expected to comply with such a rule, and the Canadian shareholders would not have access to the information necessary to compute their share of the income. Accordingly, the treatment of foreign corporations as transparent would have to be restricted to foreign corporations that were controlled by Canadian residents or in which Canadian residents had a substantial interest. Other foreign corporations would have to be treated as separate entities, and then the issue of residence would have to be confronted.

Third, the death of corporate taxation has been greatly exaggerated. Obviously, if corporations are not taxed, corporate residence becomes largely redundant. However, the reality is that, despite all the pressures that should lead to their demise, corporate taxes not only remain an important component of government revenues, but have grown in relative importance in recent years. Simply waiting for the corporate tax to disappear is not a sensible response to the problems with our corporate residence rules.

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3 Ibid., at 10-18.

4 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

Fourth, it is important to keep in mind that the most important (though not the only) purpose of the concept of residence in our system is to distinguish between persons, including corporations, that are taxable on their worldwide income and those that are taxable only on their domestic-source income. Worldwide taxation is most commonly referred to as residence taxation or residence-based taxation. However, worldwide taxation need not hinge on residence in the ordinary or statutory sense; it may, and sometimes does, turn on other factors such as citizenship or place of incorporation. According to Robert Couzin, the basic problem in establishing corporate residence is "how to define a sensible connecting factor for the residence taxation of incorporated companies, and how to choose between potentially competing connecting factors."[5] I would describe the problem a little differently, in terms of the principal purpose of the concept of corporate residence: how to identify those corporations that should pay tax on their worldwide income. For many, probably even most, domestic corporations, the answer is relatively easy. A corporation that is created under and governed by the laws of Canada, that carries on business primarily in Canada, and whose shareholders, directors, and managers are residents of Canada, should clearly be taxable on its worldwide income (unless, as discussed subsequently, taxation of corporations on their worldwide income is abandoned). The determination of which individuals should be subject to worldwide taxation is similarly easy for most individuals. There are, of course, many corporations (and individuals) whose existence is not concentrated exclusively in a single country. Moreover, it is probably safe to say that the number of such corporations (and individuals) is growing as a result of the process of globalization. Nevertheless, in my view, a test that works well in most cases is usually a good one and, while it may need to be tweaked or supplemented, it should not be lightly abandoned.

The final preliminary point is one that is often overlooked. To say that some corporations are subject to tax on their worldwide income and that the function of criteria such as residence and place of incorporation is to identify those corporations is somewhat misleading. It suggests that the distinction between corporations that are taxable on their worldwide income and those that are not (in our system, the distinction between resident and non-resident corporations) is of much greater significance than it really is. Non-resident corporations are generally taxable on any income derived from sources in Canada, and, more important, any Canadian-source business income derived by them is taxable generally in the same way as business income derived by resident corporations. Accordingly, the crucial difference between resident and non-resident corporations has to do with foreign-source income. However, resident corporations can establish non-resident subsidiary corporations to earn any foreign-source income.[6] If a Canadian-resident corporation

5 Supra note 1, at 22.

6 This result occurs because, as discussed above, a foreign corporation is a taxable entity separate from the Canadian parent and is not usually resident in Canada on the basis of either a central management and control or a place-of-incorporation test of corporate residence.

earns only Canadian-source income and its foreign subsidiaries earn exclusively foreign-source income, the imposition of Canadian tax on the worldwide income of resident corporations is not nearly as important as it would otherwise appear. This of course, is where CFC rules become relevant. CFC rules are essentially intended to prevent resident taxpayers from diverting domestic-source passive income to, or accumulating passive income in, a controlled non-resident corporation in order to defer or avoid current Canadian tax on the income.

In his final chapter, Robert Couzin poses a deceptively simple question: "What is the best test for corporate residence?"[7] Couzin finds both the place-of-incorporation and the central management and control tests vulnerable to manipulation by taxpayers. He suggests that consideration should be given to tests based on the location of executive (day-to-day) management of the corporation or the main business operations of the corporation. My initial reaction is to wonder why, even if these tests are better than the existing tests,[8] it is necessary to have a single test. Our current test is a combination of central management and control and place of incorporation. In principle, I have no difficulty adding other tests so that a corporation might be taxable on its worldwide income if

- it is incorporated in Canada,
- its central management and control are in Canada,
- the executive (day-to-day) control is exercised in Canada,
- the majority of the corporation's shareholders are resident in Canada,
- a substantial or controlling shareholder is resident in Canada, or
- the corporation has substantial business operations in Canada.

In practice, however, I suspect that such supplementary tests would have little positive impact on the Canadian tax net. As Couzin emphasizes,[9] in most of these situations, the corporation will also be resident in another country, and the tie-breaker rule in the treaty will often work in favour of the other country. In many cases, therefore, the treaty, in conjunction with subsection 250(5) of the Act, will effectively negate the addition of supplemental residence rules. If the tie-breaker rules do not resolve the dual-residence conflicts, unrelieved double taxation becomes

7 Supra note 1, at 260.

8 Superficially, it is not readily apparent why these tests are preferable to the existing tests. Executive management is probably as susceptible to manipulation as is central management and control. The executive management test provides less certainty than the place-of-incorporation test. The principal-place-of-business test is not susceptible to manipulation, and it has the virtue of establishing the residence of a corporation exclusively in one country. However, a principal-place-of-business test relies heavily on the facts in a particular case and is therefore uncertain in application. In my view, the type of test of corporate residence adopted by Canada is not as important as international consensus on a particular test.

9 Supra note 1, at 265-66.

a serious concern. Moreover, the addition of any supplementary tests of corporate residence has implications for the migration rules and for access to tax preferences.[10]

Consider, for example, a supplementary rule deeming corporations to be resident in Canada if they are controlled by a small group of shareholders resident in Canada.[11] The presence of shareholder "control" of a corporation in Canada appears to be a satisfactory connecting factor. Moreover, it is arguable that this type of control is a better test of corporate residence than the current central management and control test because it allows the Canadian tax authorities to look to the controlling shareholders to enforce the tax on the foreign corporation. Although a foreign incorporated company would be deemed to be resident in Canada and taxable on its worldwide income if its controlling shareholders were resident in Canada, the tax authorities might encounter difficulties in enforcing any tax liability against the foreign corporation unless it had assets in Canada. The controlling shareholders resident in Canada could be made liable for any Canadian tax assessed against the foreign corporation.

Arguably, deeming foreign corporations controlled by Canadian residents to be resident corporations would render the foreign accrual property income (FAPI) rules unnecessary.[12] Instead of taxing the Canadian shareholders of a controlled foreign affiliate on their pro rata share of its FAPI, they would be liable for their pro rata share of the foreign corporation's Canadian tax on its worldwide income.

One of the principal arguments against deeming CFCs to be resident in Canada is that our broad network of tax treaties would preclude us from taxing on this basis. Typically, a foreign corporation controlled by residents of Canada will be resident in the foreign country under whose laws it is established. The tie-breaker rule in the treaty would typically attribute residence to the other country.[13] In the absence of a specific tie-breaker rule, it seems unlikely that the competent authority of the other country would be willing to give up its residence in favour of Canada.

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10 Some tax preferences (for example, the small business deduction) are restricted to corporations resident in Canada. Accordingly, expanding the net of corporations resident in Canada would have the effect of providing these tax preferences to a larger population of corporations, subject to subsection 250(5).

11 This residence rule could be similar to the definition of a controlled foreign affiliate in subsection 95(1) of the Act.

12 Also, the foreign affiliate rules for dividends received by Canadian corporations from foreign corporations would be necessary only for non-controlled foreign corporations.

13 Article 4(3) of the Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, 2003), uses the place of effective management as the tie-breaker test. Canadian treaties typically use nationality, place of creation, or place of incorporation as the tie-breaker rule for dual-resident corporations. Several treaties leave the issue to the competent authorities to resolve. I am unaware of any treaty tie-breaker rule based on the residence of controlling shareholders.

In contrast, Canada and several other countries have been able to enact CFC rules without any conflict with their tax treaty networks.[14]

Moreover, there is no reason to suppose that, even in the absence of tax treaties, making CFCs residents of Canada would be acceptable to the government or to multinational corporations. Under the current system, Canadian residents are not taxable on the foreign-source active business income earned by foreign corporations that they control. If CFCs were deemed to be resident in Canada, it seems likely that exemptions would be introduced for CFCs resident in high-tax countries or engaged primarily in genuine business activities, similar to the exemptions under the FAPI rules. The fact that no country has adopted a deemed residence approach for CFCs rather than CFC rules is a strong indication that the deemed residence approach is unacceptable internationally.

In my view, serious consideration should be given to repealing the central management and control test of corporate residence. That test is subject to manipulation by taxpayers from one year to another. (In contrast, the place-of-incorporation test is subject to manipulation only once, when the corporation is created.) Because of the intensely factual nature of the test and control of the essential information by taxpayers, the tax authorities are in a no-win situation. If it is beneficial for a corporation to be resident in Canada, the necessary information can be marshalled to show that the required decision-making activities took place in Canada. If it is disadvantageous for a corporation to be resident in Canada, the tax authorities have enormous difficulty collecting the necessary information to prove the case. I am not aware of any recent situations where the Canada Customs and Revenue Agency has successfully asserted residence on the basis of central management and control. Therefore, the effect of repealing the test would be simply to remove a tax-planning device. The only caveat I have is that the central management and control test may have some prophylactic benefit with respect to transactions such as the US corporate inversions.[15] On the other hand, such problems might be dealt with by the application of the general anti-avoidance rule or specific anti-avoidance rules.

The problem of developing a satisfactory test of corporate residence has led some commentators to despair and call for the adoption of territorial systems, at least for business income.[16] Couzin finds this possibility worthy of serious consideration. I am

14 France is the only country whose courts have held that the CFC rules conflict with and are overridden by its tax treaties. (*Re Société Schneider Electric Appeal no. 232 276* (France: Conseil d'État 2002) 4 *International Tax Law Reports* 1077.) A Finnish court has held otherwise. (*Re A Oyj Abp KHO: 2002:26* (Finland Supreme Administrative Court) 4 *International Tax Law Reports* 1009.) The commentary on the OECD model convention has recently been revised to make it clear that CFC rules do not conflict with tax treaties. See paragraph 26 of the commentary on article 1.

15 These inversions involve widely owned US multinational corporations becoming subsidiaries of widely owned foreign corporations, usually based in tax havens, in order to avoid the US CFC rules. The head office of the corporation and its management remain in the United States.

16 See, for example, Michael J. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies" (2001) vol. 54, no. 3 *Tax Law Review* 261-336.

very skeptical. Given the huge inroad on worldwide taxation caused by the easy access to foreign corporations, the current Canadian system is largely territorial with respect to active business income. The concept of residence would still be necessary with respect to passive income. Thus, not much would be accomplished as far as corporate residence is concerned. The proposals to adopt a territorial system, even just for active business income, raise the much more difficult questions of whether low-taxed foreign-source business income should be exempt from Canadian tax when repatriated, and whether expenses—in particular, interest—associated with such exempt foreign-source income, should be deductible. In addition, the adoption of a territorial system would require robust geographical source rules to determine what revenue and expenses are related to Canada and are therefore to be taken into account. Some existing source rules are based on residence. For example, dividends, interest, and occasionally royalties are considered to be sourced in the country in which the payer is resident.[17] Therefore, even if a territorial system of taxation were to be adopted, it would still be necessary to have rules for corporate residence.

Couzin also argues that the corporate/shareholder taxation regime affects the continuing viability of the concept of corporate residence.[18] He argues that the lack of integration of corporate and shareholder-level taxes results in windfall profits for governments and that these profits are tied to the retention of corporate residence. He states that business income is "often taxed more heavily to resident individuals if it is earned through a resident corporation than through a foreign corporation or by means of a fiscally transparent intermediary, such as a partnership."[19]

Couzin's comments about corporate residence and corporate/shareholder taxation regimes are frustratingly brief. Admittedly, the latter subject could occupy an entire book by itself. It is especially complicated in the international context, involving the method for relieving international double taxation, the taxation of capital gains from dispositions of shares, the distinction between portfolio and direct investments, interest deductibility, hybrid entities, and the distinction between debt and equity.[20] However, the central relevance of corporate residence to the issue is not immediately apparent to me. Under various types of corporate/shareholder tax regimes, the consequences of a shareholder's investing in a resident or a foreign corporation can be significantly different (as in a full imputation system limited to resident corporations) or largely the same (as in a classical system or in an imputation system that recognizes foreign and domestic taxes). The point is that distinguishing between resident and non-resident corporations does not preclude a

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17 See Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003), 87, 143-44, and 147.

18 Supra note 1, at 270-72.

19 Ibid., at 270.

20 See, generally, Richard J. Vann, "General Report," in International Fiscal Association, *Trends in Company/Shareholder Taxation: Single or Double Taxation?* Cahiers de droit fiscal international, vol. 88a (The Hague: Kluwer Law International, 2003), 21-70, at 43-70.

country from implementing a policy of neutrality for investments in resident and non-resident corporations. For example, a country might provide relief with respect to shareholders' dividends without regard to the corporate tax paid by either a resident or a foreign corporation. Such a policy would also necessitate the exemption of dividends received by resident corporations from foreign corporations. In such a system, a resident individual would be indifferent about investing in a resident or a foreign corporation from a tax perspective. At the same time, that country could maintain rigorous CFC and FIF rules to restrict the benefits of its corporate/shareholder regime to active business income.

One significant policy issue not mentioned in Couzin's discussion of the future of the concept of corporate residence is non-discrimination. Article 24 of the OECD model convention prohibits discrimination by one state against nationals of the other state. It does not, however, apply to discrimination on the basis of residence, which, as noted earlier, is the fundamental concept used to differentiate between worldwide and source taxation. This result is especially ironic with respect to corporations because of the close correlation between nationality and residence. The absence of any international consensus about non-discrimination permits countries to provide tax incentives for domestic investment and activities and to implement headquarters and holding company regimes targeted for non-residents.

In conclusion, the concept of corporate residence is essential for any worldwide income tax system and for bilateral tax treaties. Although corporate residence is subject to manipulation by taxpayers, it has served, and continues to serve, reasonably well on balance. It has allowed governments to implement policies that effectively reduce the concept of corporate residence to a residual role. The ability to earn income through a non-resident corporation means that the worldwide taxation of resident corporations amounts, in practical terms (at least with respect to active business income), to the taxation of domestic-source income only. Many countries find this result unacceptable in respect of passive income, and they have adopted CFC and FIF rules to counteract it. The concept of corporate residence in domestic law and in tax treaties did not preclude countries from adopting rules to protect their tax base. I also remain skeptical about any move to abandon worldwide taxation of resident corporations in favour of a territorial system. Even in exclusively territorial tax systems, a concept of corporate residence is probably necessary for source rules. In short, if we did not have a concept of corporate residence, we would have to invent one.