The Author's Response

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I am flattered that three distinguished observers of the fiscal scene should find in my book on corporate residence a stimulus for broad reflections on tax policy, far broader than the modest scope of my own work. This modesty is not feigned. I confess to the conceit that I may have added something to the study of corporate residence. But I do not claim to have travelled any noticeable distance down the royal road of international tax theory. My final chapter gingerly touched upon the subject. It may surprise my friends how daunting I found its writing and with what trepidation I released it to the publisher.

These three papers are far above the madding crowd of cases, treaty provisions, and statutory jargon that filled my own effort. Brian Arnold ends his note with a paraphrase of Voltaire's famous "If God did not exist, it would be necessary to invent Him," thereby elevating corporate residence to divine status.[1] Michael McIntyre opens his with a philosophical, or theological, proposition: that the corporation has

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1 For the historically minded, the citation "Si dieu n'existait pas, il faudrait l'inventer" is from a 1768 verse epistle attacking a violently atheistic text entitled "Les Trois Imposteurs." Voltaire, "Epitre à l'auteur du livre des Trois Imposteurs," in Louis Morand, ed., *Oeuvres complètes de Voltaire* (Paris: Garnier, 1877-85), tome 10, 402-5. I hope that Brian Arnold did not consult the original and therefore did not intend to apply to me Voltaire's opening epithet in that work: "Insipide écrivain"! Nor, notwithstanding Arnold's defence of the concept, do I suppose he intended to apply to corporate residence Voltaire's paean to the sacred bond of society: "le premier fondement de la sainte équité, le frein du scélérat, l'espérance du juste."

no organizational principle, essence, or soul.[2] He closes with a call to arms reminiscent of Karl Marx, but with governments standing in the place of the workers.[3] Scott Wilkie sticks with taxation, but his dialectic of source and residence is of Hegelian intensity.

Roasting aside, these remarks by Wilkie, McIntyre, and Arnold amply and ably illustrate some of the directions a debate on the international taxation of corporations might take. Obviously, these authors have merely hinted at what they have to say about the topic. I will similarly limit myself to a few brief observations on some directions implied by them, or perhaps inferred by me.

THE CORPORATE ARTIFICE

The personification of the corporation was part of the background to the judicial establishment of both a concept of and test for corporate residence. McIntyre observes more generally that the relationships among stakeholders of corporations—and, I would add, others who deal with the corporation and its stakeholders—are entirely dependent on positive law. Corporate personality has had an important and positive impact on the development of trade and commerce and has thereby contributed to the welfare of individuals. But the incorporated company is still a creature of the law, rather than a natural fact, and it is appropriate to ask, rather than assume, how taxation should apply to these presumptive beings.

One answer might be that the determination of tax liability should depend purely upon an assessment of economic or commercial relations among natural persons. Even this would not exclude legal rules and fictions, including corporations. The economic and commercial relations themselves depend upon legal rights, obligations, and relationships. Tax is an ancillary legal regime. Canadian courts are notably respectful of "legal substance," and that includes the legal existence of corporations.

I hasten to add that the acceptance of non-tax legal facts does not tie the hands of the tax courts. There is a legitimate debate as to how much liberty courts should take in applying the words of the tax statute to the legal substance of transactions, but I cannot see how (or why) legal relations, including those consequential to the incorporation of a company, could (should) be jettisoned. If the Duke's contract with his gardener[4] is respected in determining the legal rights and obligations of the parties, I believe it should be respected for tax purposes. As Mr. Justice Linden observed, "[i]n tax law, form matters."[5] However, legal results can be respected

2 McIntyre refers to Aristotle, but it could be Aquinas. His denial of anthropomorphic essence to the corporation is not unflinching, for he later attributes to the multinational enterprise an "androgynous nature."

3 I refer, of course, to the well-worn finale of *The Communist Manifesto* (1888): "The proletarians have nothing to lose but their chains. They have a world to win. Workers of all countries unite."

4 *Inland Revenue Commissioners v. Westminster (Duke)*, [1935] AC 1 (HL).

5 *The Queen v. Friedberg*, 92 DTC 6031, at 6032 (FCA). Ironically, the learned justice invoked "form" against, rather than for, the benefit of the taxpayer.

without eliminating the possibility for judgment as to the appropriate tax consequences. Courts may decide that a particular legal obligation or transaction is not of the type intended to be referenced by the legislator in some particular statutory provision.[6]

Corporations "exist" in the same sense that contracts, trusts, partnerships, and torts exist. All are relevant to the assessment of tax liability. Tax legislation can expressly treat corporations as if they were transparent, but by this very act, it concedes their legal existence. The policy challenge is how to integrate an acceptance of the useful and comfortable fiction of corporate personality into the fiscal regulatory regime while maintaining the integrity of the underlying objectives of that regime.

National tax policy today is somewhat ad hoc in this regard, although I intend no pejorative connotation. This may be a case where pragmatism trumps philosophy. Internationally, controlled foreign corporation (CFC) and foreign investment fund (FIF) rules circumvent the corporate entity without ignoring it. Partnership elections, check-the-box in the United States, and regimes governing collective investment vehicles are among the many ways in which tax systems render transparent that which is legally opaque. In a sense, a proper exemption system applicable to both foreign affiliates and branches effectively ignores the corporate existence of the subsidiaries. Pragmatic solutions should be adopted in a proper theoretical context. Until we understand what are the proper implications of corporate personality for taxation, we cannot know whether solutions are necessary and judge whether they are appropriate.

BUSINESS INCOME AND INVESTMENT INCOME

I am wary of schedular approaches to income taxation. Categories of profit are too permeable, one type of income too easily transmogrified into another. Nevertheless, there does seem to be a distinction between business profits and passive, investment income, however imprecise it may be at the margins, that is pertinent to the discussion of corporate residence, and corporate taxation generally.

As Arnold observes, the Canadian system for the taxation of business profits is, in large measure, territorial.[7] Many states, about half the OECD members, adopt an

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6 This could be a conceptual justification for the doctrine expressed in *W.T. Ramsay v. Inland Revenue Commissioners*, [1982] AC 300 (HL). A narrower form of this proposition was presented as guideline 3(b) in the Supreme Court of Canada judgment in *Stubart Investments Limited v. The Queen*, 84 DTC 6305, at 6324.

7 Many exemption systems carry the logic to its proper conclusion and extend the exemption to foreign branch profits. The Canadian system does not go that far, except for multinational life insurers. As well, our exempt and taxable surplus rules do not extend territoriality to business profits earned in a non-treaty country and subjected to tax at less than the Canadian rate. The interaction of the exemption of foreign business income with paragraph 95(2)(a) of the Income Tax Act (RSC 1985, c. 1 (5th Supp.), as amended) may serve effectively to expand the scope of exemption to low-taxed foreign active business income. One can argue over whether this is an appropriate or

overtly territorial approach. In this circumstance, corporate residence becomes irrelevant for this class of income. Business profits are instead subjected to tax on a source basis or, to bury the source-residence distinction altogether, they are taxed where they are earned. Credit systems do not accept the proposition in the same form (a difference that explains why some of McIntyre's comments do not ring entirely true to a Canadian ear), but with averaging, check-the-box planning, and indefinite deferral, the result may be similar.[8] The longstanding and unproductive debate between the capital import and capital export neutralists may be moot, or at least needs to be put into practical perspective.

While the territorial principle may be relatively widely accepted, or at least tolerated, for business income,[9] investment income is a horse of a different colour. The developing international norm is that capital income should be subject to tax in the place where the individual who is enriched by it resides rather than in, or solely in, the place where it arises. Tax systems are not so quick to recognize exemption or territoriality in this case.[10] CFC and FIF rules proliferate precisely to reverse any potential territorial effect.

These observations challenge whether corporate residence should ever be relevant to the question of where income is taxed. In the case of business profits, the territorial principle suggests it should not. In the case of investment income, liability should be concentrated in the state of residence of the owner, recognizing the possibility that jurisdiction to tax may be shared with the source state. If all corporations were owned by individuals residing in the state of corporate residence, then corporate residence-based taxation might be a proxy for individual taxation of investment income. However, this is not the case. The state of corporate residence collects tax on the foreign-source income of foreign shareholders. Such collective punishment is not conducive to efficient markets.[11]

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inappropriate result, but it does mean that, in practice, the Canadian exemption system may amount in most real life situations to a territorial system with respect to business profits.

8 Absent any requirement to repatriate earnings, and with accounting policies that permit parent corporations not to treat the tax cost of repatriation as a current expense, some multinational enterprises based in credit countries may defer the reckoning indefinitely. This, together with the ability to mix high-taxed and low-taxed profits and other planning techniques, reduces the distinction between credit and exemption systems—reduces, but does not eliminate. The parent corporation may need the cash accumulated abroad, and there are limits on the ability to utilize foreign tax credits, particularly in a system as complex as the US system.

9 Although it is not without critics. They complain about owners of capital escaping or deferring taxation on business profits and tend to reside in states where such capitalists are prevalent. One hears this grievance rather less often in developing economies.

10 I mean to distinguish between capital income that constitutes business profits, such as the earnings of a financial institution, and the direct or indirect investments of individuals. Tax treaties do not always do a very good job of making this distinction.

11 The problem was expressly remarked as long ago as the judgments in *Calcutta Jute Mills Company Limited v. Nicholson (Surveyor of Taxes)* (1876), 1 TC 83 (Eng. Ex. Ct.) and *Cesena Sulphur Company Limited v. Nicholson (Surveyor of Taxes)* (1876), 1 TC 88, at 102 (Eng. Ex. Ct.). Capital markets and collective investment vehicles have not got any simpler since.

Corporate residence is at best a clumsy instrument. I am prepared to be convinced that there is no better system to achieve efficient taxation of global business profits and prevent avoidance of home-country tax on investment income earned by individuals. However, this proposition merits being proved, rather than assumed.

WHERE ARE BUSINESS PROFITS EARNED?

The territorial approach to taxing business income does not eliminate the vexing question of where profits are earned. On the contrary, as Wilkie notes, it brings that question to the fore. I have never been completely convinced that business profits are susceptible of geographical location on a principled basis. If they are, is this purely a question of fact (economics)? How are legal rights, obligations, and relationships relevant?

This issue is not specifically tied to corporate residence and arises however one chooses to impose tax on business profits. However, the solutions have been linked. The current paradigm for allocating taxing jurisdiction over business profits is to respect corporate entities, and their residence (however determined), and then distribute the global group profits through transfer-pricing methodology based on the arm's-length standard. The residence state retains residual taxing powers, which it normally relinquishes, in whole or in part, through exemption or foreign tax credit rules.

For individuals, the localization of profits is largely distinct from the localization of residence. In the case of corporations, "central management and control" is simultaneously a test for residence and a function generative of profits. This is because corporations do not actually reside anywhere, and their vital signs are commercial, not physiological. Thus, the indicia of residence become additional fodder in the battle among taxing jurisdictions to attract the allocation of business profits.

McIntyre proposes two solutions to what he sees as an unworkable system of taxation based on corporate residence. The first is worldwide formulary apportionment. This expression seems to conceal what I see as the fundamental issue. Transfer pricing, as well as allocation of income to a permanent establishment, already includes a "worldwide" element. Multinational enterprises carrying on business through branches and subsidiaries around the world do, in effect, "apportion" their global profits. They do so, for example, by applying the arm's-length standard to functions said to be performed or undertaken in various locations and by identified entities.

This suggests that the nub of the problem is not a requirement for global allocation, but rather the manner in which it is accomplished. The word "formulary" suggests an algorithm to replace the arm's-length standard. The problem is devising a formula that is sufficiently sophisticated and accurate, and relatively widely accepted. Those used within multijurisdictional states, such as Canada and the United States, are not particularly enticing.[12]

12 I like to tell a true story of a Canadian corporation that was losing money at its Quebec operation because of high labour costs. Paradoxically, as these wages increased, so did both its losses in Quebec and its Quebec provincial tax liability.

The OECD appears to be heading in the opposite direction, seeking to adapt the arm's-length standard used in transfer pricing between legal entities to the attribution of profits to a permanent establishment. This matter is discussed and elaborated upon by Wilkie.

The challenge here is to conceive of an approach to allocation that avoids the perceived pitfalls of both methods. The functional concept seems intuitively correct, and perhaps the difficulties with it lie in its application, the recognition of some functions but not others, and the anomalies that sometimes arise from the arm's-length metaphor.

Any change to the current system will be strongly resisted. We are heavily invested in and wedded to our system of taxing corporations separately and applying arm's-length transfer-pricing principles to locate the income. Like most practitioners, I instinctively recoil at the complexity of the transition from the current paradigm, but it is a mistake to be dismissive of alternatives. Paradigms do shift, and such movement is sometimes necessary for progress.

THE TEST FOR CORPORATE RESIDENCE

McIntyre's second solution to the corporate residence problem is to come up with a better test. The *De Beers* rule[13] was crafted to reconcile corporate personality with a taxing statute that demanded that persons be assigned a residence and also distinguished the taxation of residents from the taxation of non-residents carrying on business locally. The resulting judicial formula does not represent a principled policy decision as to where the worldwide income of a corporation should be taxed. The court in *De Beers* also expressed concern about the opportunity for tax avoidance presented by a strictly legal test based on place of incorporation. The court got that one right, although it took the US "inversion" to bring the problem home to some observers. It has been known for some time that the central management and control factual test also contains an elective element, at least in some circumstances. It is for this reason that several jurisdictions, including Canada, added a place-of-incorporation alternative.

McIntyre's suggested fix is to focus on more meaningful geographical links than the place where the directors meet: where the chief operating officers actually work, where the stock is traded, where the controlling shareholders reside, and "where the corporation began its rise to international prominence."[14] Arnold's wish list is place of incorporation, central management and control, executive or day-to-day control, residence of shareholders, or place of substantial business operations. Some of the items in these lists reflect a longstanding debate, which I discussed in my

13 *De Beers Consolidated Mines, Ltd. v. Howe* (1906), 5 TC 198 (HL).

14 I cannot resist pointing out that many a taxable multinational enterprise never rises to international prominence. Few private investment companies or mutual funds would make that grade.

text, about moving the focus of control down from the "pinnacle," the directors, to the executive managers. It has never been clear to me why this debate died out.

Both lists refer to share ownership, McIntyre adding the place where shares are traded. This brings us full circle to the question of who is taxed on what. If corporate residence taxation is a surrogate for shareholder taxation, especially in respect of passive income, then the temptation of using significant or majority ownership as the test for residence is understandable; however, the conceptual basis of the test is questionable, since it entails the taxation of foreigners on foreign income. If such a test of corporate residence were merely a shortcut to taxing the resident shareholders, then I suppose there should be full imputation of corporate tax payments for the benefit of the non-residents, a kind of reverse discrimination. Mixing share ownership with corporate residence seems to compound two different policy issues.

A FINAL THOUGHT

If corporate residence worked in practice to achieve desirable tax policy objectives, I would be loath to challenge its theoretical foundation. Much as I enjoy the intellectual stimulation of a good argument, the most important criterion for judging a tax system is whether it delivers the goods efficiently and fairly. I am reminded of the economist's musing: "I know it works in practice, but does it work in theory?"

My question is whether corporate residence as we know it today works either in theory or in practice.