Determining the Residence of Members of a Corporate Group

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KEYWORDS: TAX POLICY ■ RESIDENCY ■ CORPORATE INCOME TAXES ■ SHAREHOLDERS ■ CORPORATIONS ■ UNITARY TAXES

A "corporation" is a set of complex legal relationships that the law has sought to simplify by characterizing the corporation as a "person" in some important contexts. In contrast to a natural person, a corporation has no internal organizational principle or substance. In the terminology of the Aristotelian categories, it has no essence that defines its fundamental nature. To the contrary, it is a collection of accidental relationships that result from the activities conducted in the name of the corporation. Like a computer, it has a soul only through anthropomorphic metaphor.

That a corporation has no essence means that it is whatever the law says it is. For example, the law says that a corporation can enter into a contract with other corporations and with natural persons. As a result, it can enter into such contracts. In substance, a contract between a corporation and a natural person specifies a complex relationship between that natural person and the various stakeholders in the corporation. A contract between two corporations specifies the relationships among the stakeholders of both corporations. Some contract doctrines, such as "meeting of the minds," are inapplicable to corporations except by analogy. Sometimes the analogies are fruitful, and sometimes they are downright silly. The starting point of most such analogies is to treat a corporate contract like a contract with a hypothetical natural person who owns the assets held in the name of the corporation.

Treating a corporation as a person simplifies the statement of the relationships between persons dealing with the corporation and the stakeholders in the corporation. Those identical relationships could be specified, however, without resort to the metaphor of the corporation as a person. The stakeholders of businesses that operate as partnerships routinely enter into contracts and establish other business relationships without resort to a similar metaphor.

In many cases, the law says that a corporation will not be treated like a natural person. For example, corporations are not allowed to vote and are not called for jury duty. In many commercial contexts, the metaphor of corporation as person is

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so strained that the corporation is treated as a conduit rather than as a person. For example, under tort law, the owner-operators of a corporation may be unable to insulate themselves from liability for a tort simply because their wrongful act was performed in the name of a corporation.

When the law treats the stakeholders of a corporation as the owners of the assets held in the name of the corporation, it is sometimes said to have ignored the corporate existence. In fact, the law has simply declined to indulge the fiction that the corporation is a person. It is testament to the power of the corporation-as-person metaphor, however, that a focus on the substance of a set of relationships is commonly described as ignoring that substance.

Many countries, including Canada, treat a corporation as a person for purposes of taxation in at least some important cases. That is, the income that is attributed to a corporation under tax accounting rules is subject to taxation as if, in substance, that income were earned by the corporation. The general pattern, however, is to give special relief from the corporate tax in some cases. For example, many countries do not impose a tax on certain owner-operated businesses organized in corporate form. Countries almost always exempt corporations from tax on dividends received from a related corporation, in order to avoid what is referred to, metaphorically, as a double tax on corporate profits.

Under the international tax rules followed by Canada and most other countries, the tax treatment of a corporation depends on its status as a resident or a non-resident. A non-resident corporation is taxable only on that portion of its income that has a nexus with the taxing country. In contrast, a resident corporation is taxable, with perhaps some exceptions, on the income it earns from its worldwide operations, without reference to the nexus of its income to its country of residence.

To apply tax rules that depend for their operation on the residence of corporations, a tax system must devise rules for determining corporate residence. Robert Couzin has written a substantial and enlightening book, *Corporate Residence and International Taxation*, in which he examines Canada's rules for determining corporate residence.[1] Couzin states that the purpose of his book is "to discover what is meant by corporate residence, how and why the concept developed in the case law of the United Kingdom, and how it is used today in income tax conventions and in Canadian domestic income tax law."[2] A reasonable conclusion to be drawn from this fascinating book is that corporate residence, as currently understood, is not a coherent concept.

The basic problem that arises in ascertaining the residence of a corporation is that a corporation does not have a residence. An individual's residence, according to common parlance, is the place where that person lives and makes a home. A corporation does not live, does not have a home, and is not located anywhere. It can have a "residence," therefore, only if the law assigns it one.

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

2 Ibid., at ix.

Although individuals do reside in particular countries, their residence for tax purposes is usually assigned to them under the tax laws. In some cases, the assignment may have been made under bright-line rules that ignore many of the nuances of the residence concept. For example, the law may provide that an individual is resident in a country if he or she is physically present in the country for more than half of the taxable year. Even these bright-line rules, however, are based on real relationships between the individual and the country. Corporations do not have relationships with a country that are analogous to the relationships used to assign residence status to individuals. For example, a corporation has no physical attributes and therefore cannot be physically present in any country for even a day.

The Canadian rules for corporate residence were derived, in significant part, from decisions of the courts of the United Kingdom. The seminal UK case, discussed in detail by Couzin, is *De Beers*.[3] In that case, the court stated that it would determine corporate residence as nearly as possible by analogy to an individual. "A Company," the court stated, "cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see whether it really keeps house and does business."[4]

As Couzin notes, a corporation cannot keep house, notwithstanding the claim to the contrary made in *De Beers*. Presumably the court used the phrase "keeps house" metaphorically. The metaphor, nevertheless, is ill conceived. One might speculate where an individual would be keeping house if it engaged in the activities being conducted in the name of the corporation. That location, however, is indeterminate unless various arbitrary assumptions are made about the likes, dislikes, and family relationships of the hypothetical individual. Asking where a corporation "keeps house" is like asking whether a corporation would be a carnivore if it happened to be an animal.

Determining where a corporation "does business" is similarly problematic. People have become accustomed over the past hundred years to think of corporations as engaging in business. Corporations, however, cannot engage in business, except metaphorically. The business of a corporation is actually conducted by the employees, agents, and other representatives who engage in business activities in the name of the corporation. A corporation engages in business in much the same way that the owner of a baseball team plays baseball.

More fundamentally, the residence of an individual is not determined by where he or she engages in business—location of business activities is an issue for source jurisdiction, not residence jurisdiction. If the residence of a corporation is to be determined, as the *De Beers* court argued, by analogy to the residence of individuals, then the place where a corporation metaphorically engages in business is an irrelevancy.

In the end, the *De Beers* court pronounced that the residence of a corporation is the place where "the central management and control actually abides."[5] This

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

4 Ibid., at 212-13.

5 Ibid., at 213.

place-of-management test owes nothing to an analogy to the way the residence of individuals is determined. Indeed, as Couzin notes, individuals, in general, do not have a place of management.[6] Although this test may be linked to snippets of language from prior UK cases, it appears to be a judicial fabrication. In adopting that test, the *De Beers* court apparently was attempting to prevent the easy manipulation that everyone understood to be possible under the place-of-incorporation test, which was the test urged on the court by the taxpayer.

If the *De Beers* court was attempting to fashion a corporate residence test that was not subject to easy manipulation by taxpayers, it failed utterly. Corporate taxpayers subject to the place-of-management test are given, in effect, the right to elect their country of residence by performing in that country certain ceremonial events, such as the meeting of the board of directors. Indeed, tax planners seeking to manipulate the residence of a corporation to minimize taxes typically prefer the place-of-management test over the place-of-incorporation test, owing to the ease of changing corporate residence without tax consequences under the former test.

What has drained any conceivable substance out of both the place-of-management test and the place-of-incorporation test is the ability of a corporation to avoid residence taxation on its foreign earnings by establishing foreign subsidiaries and earning its foreign profits through those subsidiaries. In principle, that option was available to corporations even at the time of the *De Beers* case. As a practical matter, however, most multinational companies operated abroad through branches until after the Second World War. Today, multinational companies typically have hundreds, even thousands, of foreign affiliates. Subject only to the modest limitations imposed by anti-avoidance rules, such as Canada's foreign accrual property income rules and the US subpart F rules, a modern multinational enterprise is able to exploit its androgynous nature to make corporate residence ineffective.

As discussed above, corporations do not have a residence, as that term is generally understood. It should be no great surprise, therefore, that countries have huge difficulties taxing corporations on the basis of their residence. There are two routes that a country can follow to solve the problem of determining corporate residence. One is to establish a practical system of taxing corporations that does not depend on their residence. The second is to define corporate residence in terms of the function that residence taxation is intended to serve in a corporate income tax.

Some of the American states, most importantly California, have developed a practical and effective system of taxing corporations that operates without reference to the residence of a corporation. That system is worldwide combined reporting with formulary apportionment. It can be adapted, with only minor adjustments, by nation-states.[7] Under that system, each taxing jurisdiction imposes its tax on an

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6 Supra note 1, at 43.

7 See Michael J. McIntyre, "The Use of Combined Reporting by Nation-States," in Brian J. Arnold, Jacques Sasseville, and Eric M. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties* (Toronto: Canadian Tax Foundation, forthcoming).

apportioned share of the aggregate income of the entire corporate enterprise. No income is apportioned to a tax haven country unless meaningful economic activity is conducted in that country. For example, income from the production and sale of goods is apportioned between the place of production and the place of sale, with no income being apportioned to a jurisdiction simply because intangible assets are being held by a holding company that is resident in that country. In effect, a corporate group is treated as a single corporation operating through branches, and each country taxes its share of the total income fairly attributable to the branches located within its borders.

The second route, defining corporate residence functionally, requires some analysis of the functions that residence taxation is intended to serve. In the context of an individual income tax, the main purpose of residence taxation is to tax individuals on their total income, without reference to the source. By taxing its residents without regard to the source of their income, a country bases its tax on ability to pay and avoids creating inefficient tax incentives for foreign investment.

The purposes of the corporate tax are similar. The corporate tax is a tax on the income that shareholders have derived through their ownership interests in corporations. By taxing shareholders indirectly on the total income they have earned through those ownership interests, without regard for its source, the corporate tax promotes fairness and efficiency. Fairness is achieved by eliminating artificial distinctions in the measurement of ability to pay based on the source of income. Efficiency is achieved by removing an unwarranted tax incentive for foreign investment. In addition, residence taxation of corporations reduces the opportunities for tax evasion that are endemic in a source-based tax.[8]

To be successful in imposing and collecting a residence tax on corporations, a country must define "residence" in a way that is not easily avoided. If corporations are free to elect not to be taxed as residents, they will make that election. As currently constituted, the place-of-management test and the place-of-incorporation test are elective to a substantial degree. As a result, the residence tax on corporations is largely elective in tax jurisdictions that employ either or both of those tests.

The place-of-incorporation test is flawed beyond repair. The place-of-management test, however, can be reconstituted to serve the purposes of corporate residence taxation. To reconstitute that test, two critical changes are needed.

First, place of management must be defined in terms of links that are important to a corporation and are difficult to move offshore. It cannot turn on ceremonial events, such as the place where the annual shareholders meeting is held. Second, the residence of a corporation needs to be defined uniformly for all of the members of a corporate group engaging in a common enterprise. That is, the subsidiaries of a corporation generally should take the residence of their parent corporation.

The development of a legal standard for corporate residence that depends on meaningful links between a particular corporation and a particular country is not

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8 See Michael J. McIntyre, "How the United States Should Respond to the ETI Dilemma" (2002) vol. 26, no. 7 *Tax Notes International* 865-72, reprinted in (2002) vol. 95, no. 8 *Tax Notes* 1251-55.

terribly difficult. All that is needed is to embody in legal language what everyone already knows. Everyone knows, for example, that IBM is an American company, that Chrysler used to be an American company and is now part of a German company, that Barclays is a UK company, that Sony is a Japanese company, and that CIBC is a Canadian company. Although multinational companies, by definition, have links with multiple countries, they usually are linked most closely to one country through a cluster of attributes.

A legal standard for defining residence would focus on meaningful links that a corporation could not surrender without significant dislocations. A list of such links would include the place where the chief operating officers actually work,[9] the place where the stock of the corporation is actively traded on an organized stock exchange, the place where the controlling shareholders reside, and the place where the corporation began its rise to international prominence. The definition of corporate residence, like the definition of individual residence, should depend on relationships that vary in importance from case to case. To prevent overlapping residence taxation, some tie-breaker rules need to be developed. The details of the definition are not critical. What is critical is a rediscovery of the seriousness of purpose that informed the *De Beers* court.

No attempt at infusing content into the place-of-management test will succeed unless all of the members of a corporate group have the same residence. Otherwise multinational enterprises will defer residence jurisdiction by earning their foreign profits in corporations that have acquired residence status in tax haven countries. Just as an individual cannot have one arm resident in one country and the other arm resident somewhere else, a business enterprise organized in corporate form should have only one country of residence. In effect, the residence rule currently applicable to an enterprise that operates through a single corporation with a series of branches would be extended to enterprises that operate through controlled affiliates.

The residence of a corporate group should not be determined simply by reference to the characteristic of the parent corporation. A rule that automatically assigned to subsidiaries the residence of their parent would invite various types of inversion transactions in which the traditional parent would become a subsidiary of a holding company located in a tax haven country. The proper rule is to look at the cluster of attributes of the enterprise as a whole and assign residence to all corporate members of that enterprise on the basis of those attributes.

The effect of a reformed residence rule would be to extend residence taxation to foreign income earned through what are now characterized as foreign corporations. The so-called deferral privilege would be repealed. As many commentators have noted, the deferral privilege, which results in asymmetrical treatment of foreign

9 Reuven S. Avi-Yonah, "For Haven's Sake: Reflections on Inversion Transactions" (2002) vol. 27, no. 2 *Tax Notes International* 225-31, at 228-30 (proposing that "residence" of a multinational corporation be defined as the place where the principal officers of a corporation manage the corporation's business on a daily basis).

and domestic earnings, is responsible for much of the complexity, inefficiency, and unfairness of international tax regimes around the world.

As suggested above, there are two general solutions to the current imbroglio. One solution is to eliminate the need for determining the corporate residence by adopting a worldwide combined reporting system. The other solution is to define corporate residence uniformly for all members of the corporate group. These two solutions differ radically in their implications for tax policy. Each would introduce its own set of complications. The two solutions are united, however, in one important respect: they impose a corporate income tax based on the aggregate income derived by all members of a corporate group without regard for the formal structure of that group.

In exploring the concept of corporate residence, Couzin has addressed issues of importance not only to Canadian tax specialists but to anyone concerned about the incoherence of international tax regimes around the world. Corporate residence has been a key concept in defining a country's tax jurisdiction. Yet corporations generally are free to elect whatever residence status best serves their tax-planning agenda. Perhaps the time has come for Canada and other responsible governments to regain the sovereign powers they have ceded to multinational enterprises by establishing for themselves the jurisdictional reach of their corporate tax.