

## The Function of Corporate Tax-Residence in Territorial Systems

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### INTRODUCTION

Under the U.S. “worldwide” (or “residence-based”) tax system, corporations that are considered “domestic” for tax purposes are generally taxed on their worldwide income from whatever source derived.<sup>1</sup> Foreign corporations are taxed in the United States only to the extent they earn income that is sourced within the United States. The U.S. residence-based system is frequently contrasted with “territorial” (or “source-based”) systems, variants of which are adopted by most member countries of the Organization of Economic Cooperation and Development (OECD).<sup>2</sup> In a territorial system, income is only taxed if it is derived from sources within the geographical boundaries of a jurisdiction. This is generally true whether the income is earned by foreign or domestic taxpayers. Foreign-source income (meaning, income sourced outside the jurisdiction’s geographical boundaries) is generally exempt from tax.

In a previous article, I outlined a functional approach to corporate tax-residence determination in residence-based systems.<sup>3</sup> This Essay complements that article by explaining the

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<sup>1</sup> This rule is of course subject to multiple exceptions that enable U.S. domestic corporations to avoid current taxation on most foreign-sourced income. *See, e.g.*, Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 700 (2011) (describing the United States residence-based system as an “ersatz variant on territorial systems”); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 EMORY L.J. 79 (2009) (surveying the U.S. exception to residence-based taxation, concluding it does not function as a residence-based system). The starting point of the analysis, however, is that U.S. corporations’ worldwide income is subject to corporate tax in the United States.

<sup>2</sup> *See* Omri Marian, *Meaningless Comparisons: Corporate Tax Reform Discourse in the United States*, 32 VA. TAX REV. 133, 163–65 (2012) [hereinafter Marian, *Meaningless Comparisons*].

<sup>3</sup> Omri Marian, *Jurisdiction to Tax Corporations*, 54 B.C. L. REV. 1613 (2013) [hereinafter Marian, *Jurisdiction to Tax Corporations*].

functional importance of corporate tax-residence determination in territorial systems. I differentiate between “positive” and “negative” functionalities of corporate tax-residence in territorial systems. Under a positive approach, corporate tax-residence positively points to the source of income earned by the corporation. Thus, corporate taxes serve as a proxy to source taxation. While the positive function had historical merit, it is currently obsolete.<sup>4</sup>

Under a negative approach, corporate tax-residence is only relevant to the extent it prevents income from being sourced to a jurisdiction in which income could not have possibly been generated. As such, residence determination serves as an instrument to prevent income shifting and base erosion. I suggest that this is the correct role of residence determination in the current environment.<sup>5</sup>

More specifically, multinational corporations use multiple “income shifting” techniques to erode the tax base in jurisdictions in which income has economically been generated. Such techniques are aimed at manipulating the *source* of income for tax purposes by having income that has been generated in a high-tax jurisdiction reported as earned in a low-tax jurisdiction. Income shifting techniques necessitate the use of affiliate corporations resident in different jurisdictions. At least one of these corporations must be a tax resident in a low-tax jurisdiction, so income can be booked (i.e., shifted) to that foreign affiliate. Such foreign affiliates usually perform little or no real economic activity. Therefore, I suggest that residence determination in territorial systems should be constructed so as to make sure that such foreign affiliates are *not* respected as tax residents of jurisdictions where no real activity takes place.

The issue of residence determination in territorial systems is a timely one in the United States. In recent years, the idea to replace the U.S. residence-based system with a territorial one gained substantial traction. One recent example is a comprehensive tax reform draft suggested by David Camp, the Chairman of the House Committee on Ways and Means. Camp’s proposal adopts the territorial variant known as a “participation exemption” system.<sup>6</sup> Under a participation exemption system,

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<sup>4</sup> See discussion *infra* Part II.C.

<sup>5</sup> See discussion *infra* Part III.

<sup>6</sup> HOUSE COMM. ON WAYS & MEANS, 113TH CONG., TAX REFORM ACT OF 2014 DISCUSSION DRAFT SECTION-BY-SECTION SUMMARY tit. IV, available at [http://waysandmeans.house.gov/uploadedfiles/ways\\_and\\_means\\_section\\_by\\_section\\_summary\\_final\\_022614.pdf](http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf).

dividends paid by foreign subsidiaries of U.S. corporations, as well as capital gains from the disposition of foreign subsidiaries, and other foreign operations will be largely exempt from U.S. tax. A similar recent proposal has been brought forward by Michael Enzi, a member of the Senate Finance Committee.<sup>7</sup>

One common theme of these recent territorial-reform proposals is their complete ignorance of the issue of corporate tax-residence. While the reason for such ignorance is not explicit, it is possibly based on the assumption that in territorial systems—in which the question of jurisdiction is a question of source rather than residence—residence determination is meaningless.<sup>8</sup> This is wrong. The reason is that in many instances the source of income is keyed off the residence of a corporation. Income from dividends and interest payments is sourced to the residence of the paying corporation.<sup>9</sup> Capital gains from the sale of a corporate subsidiary's stock are sourced to the residence of the corporate seller.<sup>10</sup> There are other examples where source of income is directly linked to the residence of the taxpayer.<sup>11</sup> These source rules play an important role in intercompany payments that stand in the basis of income shifting techniques. Questions of source and residence are not really separate jurisdictional questions. Residence is used to manipulate source, and as such can be designed to prevent such manipulation.

Currently, the United States uses a formal test for corporate residence determination—the place of incorporation (POI). This test is notoriously easy to manipulate. All that one has to do in order to create a “foreign” affiliate in a tax haven is to incorporate one. Leaving this test intact under a territorial system may exacerbate the problem of income shifting.

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<sup>7</sup> United States Job Creation and International Tax Reform Act of 2012, S. 2091, 112th Cong. tit. I (2012).

<sup>8</sup> See Marian, *Jurisdiction to Tax Corporations*, *supra* note 3, at 1630.

<sup>9</sup> See Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 281 (2003) (“The basic rule sources the interest income to the country of the payor . . . . Most countries consider the residence of the payor as the country of source.” And “[a] powerful consensus also exists with respect to the source rules for dividends. They are sourced at the country of the dividends’ payor, which allows the source country to get the ‘first bite’ of taxation.”).

<sup>10</sup> HUGH J. AULT & BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 539 (3d ed. 2010) (“[M]ost countries generally accept the international treaty norm that capital gains on shares are taxable only in the residence country of the shareholder.”).

<sup>11</sup> For some additional examples in the U.S. context, see I.R.C. §§ 861–863 (2012) (source depends on residence in the context of guarantee fees, communications income, certain sales through fixed place of business, and more).

This Essay continues as follows: In Part I, I explain the functional approach to corporate tax-residence determination. In short, the functional approach requires that tax-residence models will be constructed so as to support the policy purpose for which corporations are taxed in the first place. In territorial systems, any corporate-tax construct (including residence) can only make sense if it operates to assure that income produced in a specific jurisdiction is taxed in that jurisdiction. In Part II, I explore the possible functionalities of residence determination in supporting territorial taxation, using the United States as a case study. Historically, tax-residence positively functioned as a proxy to the source of income. Today, however, such function can no longer stand. In Part III, I discuss an alternative instrumentality of residence determination in territorial systems. Residence can have a negative functionality, namely it can point to jurisdictions that are clearly *not* the source of income. As such, residence determination functions as an anti-income-shifting mechanism. One way to achieve such a function is to adopt tax-residence determination that is based on formulary apportionment that takes into account a corporation's contribution to the control group earnings (though there are other tests that may achieve similar results). I conclude with a call to consider corporate-residence determination in U.S. territorial reform proposals.

## I. THE FUNCTIONAL APPROACH TO CORPORATE TAX-RESIDENCE

### A. The Functional Approach in Residence-Based Systems

Corporate tax-residence, namely, the determination whether a corporation is "domestic" or "foreign" for tax purposes, is a foundational legal construct. The tax-residence heavily affects the tax liability of the corporation and its affiliates. Unfortunately, corporate tax-residence is meaningless as a normative construct. The reason is that corporations are not real beings; they are imaginary entities. Corporations are not, in and of themselves, the target of policy making.<sup>12</sup> Rather, corporations are instruments. Corporations are used by their individual interest holders (such as shareholders, creditors, managers, and employees) to achieve certain goals. In turn, corporations are

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<sup>12</sup> Daniel Shaviro, *The David R. Tillinghast Lecture: The Rising Tax Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 395 (2011) ("After all, corporations are not sentient beings, and cannot feel benefits or burdens. Thus, they are not directly of normative interest.").

targeted by policy makers to affect individuals who are involved with corporations.

Taxation of corporate entities is not different. Corporate taxes are one of the most common forms of taxation around the world. But it is not the corporations that are burdened by such tax. Individuals are.<sup>13</sup> For example, shareholders may see a diminished net return on their investment as a result of the tax imposed at the corporate level. Alternatively, employees may bear the burden through decreased wages. Or, it may be the case that consumers are affected if corporate taxes are capitalized into the pricing of the corporate products and services.<sup>14</sup>

Given that corporations are nothing more than an instrumentality, I have suggested in a previous article that corporate tax-residence determination must also be instrumental to the policy of corporate taxation.<sup>15</sup> Namely, in formulating a model for corporate tax-residence determination, we must work through two steps. First, define the policy purposes for which we tax corporations. Specifically, we must identify the group (or groups) of individuals whom we wish to burden by taxing corporations. The second step is to adopt the tax-residence test that best supports the policy purpose we identified. A corporate tax-residence test (as well as any corporate-tax construct, in fact) is only successful if it assures that corporate taxes eventually burden the intended individuals.

In residence-based systems, such as the United States, the underlying assumption is that there is a group or groups of individuals, the income of whom we wish to tax on a worldwide basis. Corporate tax is just an instrument to reach at the pockets of these individuals. Depending on who these individuals are, we may adopt different tax-residence tests.<sup>16</sup> For example, if those individuals are shareholders, we may choose to determine the residence of corporations based on where the majority of shareholders reside. If we aim to burden the managers of corporations (in their capacity as managers), we might choose to

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<sup>13</sup> The question of who those individuals are is unresolved and subject to a lively academic debate. See Marian, *Meaningless Comparisons*, *supra* note 2, at 161–62.

<sup>14</sup> See WILLIAM M. GENTRY, OFFICE OF TAX ANALYSIS, U.S. DEPT OF THE TREASURY, OTA PAPER 101, A REVIEW OF THE EVIDENCE ON THE INCIDENCE OF THE CORPORATE INCOME TAX 1 (2007) (“[C]orporate tax could be borne by some combination of the shareholders of corporations, investors in all capital through a decrease in the overall return to capital, workers through a decrease in wages, and customers through increased output prices.”).

<sup>15</sup> Marian, *Jurisdiction to Tax Corporations*, *supra* note 3.

<sup>16</sup> For a discussion of possible groups of individuals who may be the normative targets of corporate tax policy, see *id.* at 1638–49.

subject corporations to tax in the jurisdiction in which the corporate headquarters is located.

### B. The Functional Approach in Territorial Systems

The assumption that corporate taxation is an instrument to tax the worldwide income of certain individuals cannot stand in territorial systems of taxation. The reason is that in territorial systems, a policy choice has already been made to only tax income sourced within the jurisdiction, regardless of the residency of the taxpayers earning such income. In our quest to determine the “correct” corporate-residence in territorial systems, we therefore must start with a positive assumption that territorial taxation is superior, as a policy matter, to worldwide taxation.<sup>17</sup>

Under a functional approach to territorial taxation, we could justify the taxation of corporate entities only to the extent it supports source-based taxation. Namely, that taxing a corporate entity somehow assures that income is subject to tax in the jurisdiction in which it has been created. This should be true regardless of the identity of the individuals involved with the corporation. This concludes the first step of the functional analysis of corporate tax-residence determination in territorial systems. In the next two parts, I address the second part of the analysis. Meaning, how different models of corporate tax-residence may functionally support source-based taxation.

## II. THE “POSITIVE FUNCTION” OF CORPORATE TAX-RESIDENCE

### A. Corporate-Residence as a Proxy for Source

The first obvious possible territorial instrumentality of corporate tax-residence is that residence of a corporation positively identifies the source of income. Under this approach, income earned by a corporation that is a tax-resident in jurisdiction X is assumed to be sourced in jurisdiction X. Similarly, payments made by a corporation resident in jurisdiction X (for example, dividend or interest payments) are assumed to be sourced in jurisdiction X. I refer to this function as the “positive function” of corporate tax-residence.

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<sup>17</sup> This is probably one of the most contested issues in international tax literature, and beyond the scope of this Essay; I assume that for whatever reason, policy makers have reached a conclusion that a territorial system of taxation is preferable. For a summary of arguments in the debate on territorial versus worldwide systems (as well as other tax methods), see JANE G. GRAVELLE, CONG. RESEARCH SERV., RL34115, REFORM OF U.S. INTERNATIONAL TAXATION: ALTERNATIVES 1 (2012).

The positive approach is very much apparent in the current system of international taxation. For example, practically all countries in the world source interest and dividend payments to the country of residence of the paying corporation.<sup>18</sup> The philosophical underpinning for this rule is that the payments should be sourced to the place where the economic activity supporting the payment is taking place.<sup>19</sup> Since it is the economic activity of the corporation that supports that payment, income should be sourced to the residence of the corporation. For this justification to make sense, however, we must add one additional logical link: we must assume that the economic activity of a corporation indeed takes place where the corporation resides for tax purposes.

Historically, this assumption seems to have had some traction. In 1923, the League of Nations commissioned a group of economists to study the taxation of cross-border transactions.<sup>20</sup> The resulting report proved to be an influential tax policy document.<sup>21</sup> The report explicitly linked residence of business entities and the source of income earned by such entities. For example, the report referred to the “seat and residence” of a business as one of the four elements of “economic allegiance,” which in turn is one of the possible bases upon which the imposition of tax may be justified.<sup>22</sup> The report acknowledged, however, the complexity associated with such an assumption. When discussing the source of dividends, for example, the report considered the “fact that the company may produce its goods in one State and sell them in another, or have its chief office in one State and yet secure most of its earnings from sales in other States.”<sup>23</sup> This may result in “multiplicity of the claims of origin” of the dividends.

Today, the positive view is sometimes used to explain the allocation of taxing jurisdictions on international income in the context of bilateral income tax treaties. Such treaties are

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<sup>18</sup> See generally Brauner, *supra* note 9; AULT & ARNOLD, *supra* note 10 and accompanying text.

<sup>19</sup> See, e.g., Richard Vann, *International Aspects of Income Tax*, in TAX LAW DESIGN AND DRAFTING II 718, 722 (Victor Thuronyi ed., 1996).

<sup>20</sup> Fin. Comm. Econ. & Fin. Comm'n, *Report on Double Taxation*, League of Nations Doc. E.F.S. 73 F. 19 (1923), available at <http://setis.library.usyd.edu.au/pubotbin/toccer-new?id=brulegi.sgml&images=acdp/gifs&data=/usr/ot&tag=law&part=1&division=div1> [hereinafter *Report on Double Taxation*].

<sup>21</sup> It is argued that a coherent international tax regime exists and that its principals have been developed by the 1923 document. See Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303 (1996).

<sup>22</sup> See *Report on Double Taxation*, *supra* note 20.

<sup>23</sup> *Id.*

instruments that determine how income from cross-border transactions is allocated between the two signatory countries. Most treaties are based on a model published by the OECD. Professor Richard Vann concludes that under the OECD model, corporate tax functions as a “source tax” for business activities.<sup>24</sup> As Vann explains, tax treaties regularly provide that business income earned in a contracting state through a “permanent establishment” of a foreign taxpayer is taxed at source (i.e., the jurisdiction where the foreign taxpayer’s permanent establishment is located).<sup>25</sup> Permanent establishment is usually a fixed place of business, which is not legally separate (for example, by way of incorporation) from the controlling foreign taxpayer.<sup>26</sup> Business income earned not through a permanent establishment is generally exempt from source taxation.

However, foreign taxpayers may operate in the country of source not through permanent establishments, but rather through controlled subsidiaries that are respected as separate from their owners. Generally, holding the stock of a corporation does not give rise to a permanent establishment of a shareholder in the subsidiary’s jurisdiction. However, under the tax treaty network, such domestic subsidiaries are generally subject to tax jurisdiction in their country of residence. Thus, the taxation of domestic subsidiaries controlled by a foreign taxpayer “is in policy terms a source tax” on income of the controlling foreign taxpayer.<sup>27</sup> This equates the treatment of income earned by a foreign taxpayer operating through a permanent establishment with income earned through a subsidiary.

#### B. The Historical Success of the Positive Function in the United States

I now turn to the question of whether the positive approach has any merit in the context of international tax reform in the United States. The approach made historical sense. Namely, when the corporate tax-residence test was first formulated, it was reasonable to assume that the residence of a U.S. corporation positively pointed to the source of income earned by the corporation.

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<sup>24</sup> Richard Vann, “*Liable to Tax*” and *Company Residence Under Tax Treaties*, in *RESIDENCE OF COMPANIES UNDER TAX TREATIES AND EC LAW* 197, 199 (Guglielmo Maisto ed., 2009) [hereinafter *RESIDENCE OF COMPANIES*].

<sup>25</sup> OECD, COMM. ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL Art. 7 (2010), available at [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-oncapital-2010\\_9789264175181-en](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-oncapital-2010_9789264175181-en).

<sup>26</sup> *Id.* Art. 5.

<sup>27</sup> Vann, *supra* note 24, at 199–200.

Early U.S. corporate tax laws were justified as an instrument targeting either managers or shareholders. Such policy considerations were largely devoid, however, of international considerations. It was not until the third decade of the twentieth century that the U.S. worldwide, residence-based approach to international tax began to take shape.<sup>28</sup> However, as I explain below, late nineteenth to early twentieth century U.S. corporate taxes functionally operated as a source-based mechanism, and the residence test adopted back then made functional sense. That was the case whether the policy aim was shareholders or managers.

### 1. Why Did the United States Start to Tax Corporations?

The reasons for which Congress originally enacted corporate income tax laws are disputed. According to one reasoning, the first attempt by Congress to adopt a general tax on corporate profits—in the Tariff Act of 1894<sup>29</sup>—was influenced by real entity theory of the corporation prevalent at that time.<sup>30</sup> Real entity view of the corporation would theoretically support the taxation of corporations separately from their shareholders. As a historical explanation, however, entity theory is largely rejected by modern scholars,<sup>31</sup> with one commentator going as far as to note that “advances in the theory of corporate personality appear to have had only a modest influence, if any, on the taxation of the corporation.”<sup>32</sup>

Currently, accounts explaining the emergence of corporate taxation in the United States generally follow one of two main

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<sup>28</sup> Michael J. Graetz & Michael M. O’Hear, *The “Original Intent” of U.S. International Taxation*, 46 DUKE L.J. 1021, 1026 n.23 (1997) (referring to 1918–1928 as the “formative period” of U.S. international taxation); Reuven S. Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, 25 VA. TAX REV. 313, 317 (“The formative period of the U.S. international tax regime . . . was . . . the period between the two World Wars.”).

<sup>29</sup> The 1894 Act imposed a 2% tax on the net income of all “corporations, companies, or associations doing business for profits in the United States.” Tariff Act of 1894, ch. 349, § 32, 28 Stat. 509, 556. The Act was struck down as unconstitutional by the Supreme Court in *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429, *aff’d on reh’g*, 158 U.S. 601 (1895).

<sup>30</sup> See GEORGE K. YIN & DAVID J. SHAKOW, AM. LAW INST., FEDERAL INCOME TAX PROJECT, TAXATION OF PRIVATE BUSINESS ENTERPRISES: REPORTERS’ STUDY 36–40 (1999) (arguing for a connection between the development of real entity theories of corporations and taxation of corporations as separate entities).

<sup>31</sup> Reuven Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1209 (2004) (explaining the reasons for which real-entity view of corporate tax is “unpersuasive”); Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 466 (2001) [hereinafter Bank, *Entity Theory as Myth*].

<sup>32</sup> Bank, *Entity Theory as Myth*, *supra* note 31.

paths. According to one theory, corporate taxes as a real entity measure were first enacted in 1909, primarily as a regulatory device.<sup>33</sup> The tax reflected negative sentiment in Congress towards large-scale business entities<sup>34</sup> that accumulated substantial power towards the end of the nineteenth century. Influential corporate managers were identified as a source of abuse of power.<sup>35</sup> It has therefore been suggested that “the imposition of the corporate tax will enable the government, the shareholders and the public to obtain information that will serve as the basis for restricting such managerial abuses of power.”<sup>36</sup> Under this approach, the 1909 Act was an attempt to restrict managerial power.<sup>37</sup>

Under a second theory, “corporate income tax was originally adopted as a substitute or ‘proxy’ for taxing corporate shareholders directly,”<sup>38</sup> and the 1909 Act was simply part of a continuous attempt to tax shareholders’ wealth accumulated by doing business in corporate form.<sup>39</sup> Congress imposed taxes on companies in the transportation, banking, and insurance industries—all industries dominated by the corporate form of doing business—as early as 1864.<sup>40</sup> With the proliferation of general incorporation laws during the second half of the nineteenth century, corporations came to dominate most businesses, making the industry-specific approach inadequate.<sup>41</sup> The 1894 Act is seen as the first explicit federal attempt to systemically get at shareholders’ wealth through the taxation of corporations.<sup>42</sup> After the 1894 Act was struck down by the

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<sup>33</sup> Reuven Avi-Yonah, *Why Was the US Corporate Tax Enacted in 1909?*, in 2 STUDIES IN THE HISTORY OF TAX LAW 377 (John Tiley ed., 2007) [hereinafter Avi-Yonah, *Why Was the US Corporate Tax Enacted?*]; Avi-Yonah, *supra* note 31, at 1217–20; Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53 (1990).

<sup>34</sup> Ajay K. Mehrotra, *The Public Control of Corporate Power: Revisiting the 1909 U.S. Corporate Tax from a Comparative Perspective*, 11 THEORETICAL INQUIRIES L. 497, 510 (2010); see also Bank, *Entity Theory as Myth*, *supra* note 31, at 508–11.

<sup>35</sup> Avi-Yonah, *supra* note 31, at 1220 (citing President Taft’s Message to Congress, 44 CONG. REC. 3344 (1909)).

<sup>36</sup> Avi-Yonah, *Why Was the US Corporate Tax Enacted*, *supra* note 33, at 383.

<sup>37</sup> *Id.* at 382–87.

<sup>38</sup> Bank, *Entity Theory as Myth*, *supra* note 31, at 452; see also Steven A. Bank, *Entity Theory as a Myth in the US Corporate Excise Tax of 1909*, in 2 STUDIES IN THE HISTORY OF TAX LAW, *supra* note 33, at 393, 393 [hereinafter Bank, *US Corporate Excise Tax of 1909*].

<sup>39</sup> Bank, *US Corporate Excise Tax of 1909*, *supra* note 38, at 395.

<sup>40</sup> Bank, *Entity Theory as a Myth*, *supra* note 31, at 504–05.

<sup>41</sup> *Id.* at 505–08 (describing the dramatic increase in doing business through a corporate form toward the end of the nineteenth century).

<sup>42</sup> *Id.* at 462 (“The simultaneous income taxation of individuals and corporations was unprecedented at the federal level . . .”).

Supreme Court,<sup>43</sup> Congress reverted back to its industry-specific course of action in the War Revenue Act of 1898,<sup>44</sup> which imposed certain taxes on corporations engaged in the sugar and oil businesses. In its original version, the 1898 legislative proposals were broad enough to encompass all incorporated entities.<sup>45</sup> Congress ultimately rejected the idea in favor of taxation of two specific industries, sugar and oil.<sup>46</sup> However, “it was commonly understood that the object of the tax was two concerns—the Standard Oil Company and the American Sugar Refining Company.”<sup>47</sup> General taxation of all corporate entities was reintroduced in the 1909 Act, which was evidently tailored so as to withstand constitutional challenges, again as a mechanism to get at shareholders’ wealth.<sup>48</sup>

## 2. Place of Incorporation Test Functioned to Support Source-Based Taxation

Assuming any of the historical justifications for U.S. corporate taxation are plausible, did corporate tax-residence constructs support such purposes? Tax-residence of corporations was first explicitly defined in the War Revenue Act of 1917.<sup>49</sup> Section 200 of the 1917 Act defined a “domestic” corporation to be any corporation “created under the law of the United States, or of any State, Territory, or District thereof.”<sup>50</sup> This definition—using the place of incorporation (POI) as the sole determinant of corporate tax residency—survives almost unchanged to this day.<sup>51</sup> Curiously, the definition did not appear in the early version of the bill. Congressional records provide no explanation for the definition’s sudden appearance in the bill’s conference version.<sup>52</sup>

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<sup>43</sup> *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429, *aff’d on reh’g*, 158 U.S. 601 (1895).

<sup>44</sup> War Revenue Act of 1898, ch. 448, 30 Stat. 448.

<sup>45</sup> See Bank, *US Corporate Excise Tax of 1909*, *supra* note 38, at 396–98 (discussing the original bill of the 1898 Act).

<sup>46</sup> The 1898 Act did not clearly define the corporations that were the subject of the tax. Rather, it defined the taxpayers subject to the tax by describing the business sectors in which they were engaged. Section 27 of the 1898 Act imposed the tax on “every person, firm, corporation, or company carrying on or doing the business of refining petroleum, or refining sugar.” 30 Stat. at 464.

<sup>47</sup> Bank, *US Corporate Excise Tax of 1909*, *supra* note 38, at 399.

<sup>48</sup> *Id.* at 400–01.

<sup>49</sup> War Revenue Act of 1917, ch. 63, § 200, 40 Stat. 300, 302.

<sup>50</sup> *Id.*

<sup>51</sup> Under current I.R.C. § 7701(a)(4), a domestic corporation is any corporation “created or organized in the United States or under the law of the United States or of any State.” I.R.C. § 7701(a)(4) (2012).

<sup>52</sup> The definition of “domestic” did not appear in early versions of the bill. See, e.g., H.R. REP. NO. 65-45 (1917). The first time the definition appeared in any formal version

However, the 1917 Act was merely a semantic change to an already functioning jurisdictional concept. Specifically, the same jurisdictional concepts had already been clearly established by the 1909 Act. Even though the 1909 Act did not explicitly define the terms “domestic” or “foreign” corporations, taxing jurisdiction applied, much like the 1917 Act, to

every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares . . . *organized under the laws of the United States or of any State or Territory of the United States* . . . [or] organized under the laws of any foreign country and engaged in business in any State or Territory of the United States.<sup>53</sup>

However, in the case of corporations organized under the laws of foreign countries, the tax applied to net income “from business transacted and capital invested within the United States.”<sup>54</sup>

Once again, the 1909 legislators left very little guidance, and certainly no explicit explanation, as to their adoption of the POI test.<sup>55</sup> One commentator, Rudolf Weber-Fas, expressed skepticism that any rationale for adopting the POI test in the United States existed at all,<sup>56</sup> and speculated that—given the minor role of international trade in U.S. economy at that time—international tax considerations have not been a source of “principal legislative concern.”<sup>57</sup> Weber-Fas concluded that it is likely Congress simply adopted the POI test because it was used by many states at the time.<sup>58</sup>

Indeed, during the nineteenth century, most states imposed various levies and property taxes on corporations “domiciled” or “resident” within the state’s territory.<sup>59</sup> Thus, Weber-Fas implicitly suggests at least one possible explanation for the adoption of POI at the federal level: path-dependence. But this

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was in the draft submitted to the Senate Committee on Finance on May 25, 1917. See STAFF OF S. COMM. ON FIN., 65TH CONG., ACT TO PROVIDE WAR REVENUE (1917). Congressional records do not reveal the background for this sudden appearance.

<sup>53</sup> Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 112 (emphasis added); see also William P. McClure & Herman B. Bouma, *The Taxation of Foreign Income from 1909 to 1989: How a Tilted Playing Field Developed*, 43 TAX NOTES 1379, 1381 (1989).

<sup>54</sup> § 38, 36 Stat. at 113.

<sup>55</sup> Rudolf Weber-Fas, *Corporate Residence Rules for International Tax Jurisdiction: A Study of American and German Law*, 5 HARV. J. ON LEGIS. 175, 215 (1968).

<sup>56</sup> *Id.* (“The existence of a clear rationale or of a conscious policy behind the adoption of [the POI] principle is doubtful . . .”).

<sup>57</sup> *Id.* at 216–17.

<sup>58</sup> *Id.* at 216.

<sup>59</sup> Mehrotra, *supra* note 34, at 511–17 (describing the adoption of corporate level taxes by multiple states during the nineteenth century).

path-dependence argument is significant, because at the state level, corporate tax-residence determination served as a source proxy.

Specifically, during much of the nineteenth century, states enjoyed territorial monopolies on corporate law.<sup>60</sup> Incorporation was not freely available. Rather, corporate charters were granted by special legislative acts of the states.<sup>61</sup> Consistent with such notion, “it was generally understood that a corporation’s legal standing reached only to the borders of the incorporating state” and that “a corporation existed only within the borders of the sovereign that created it.”<sup>62</sup> Consequently, it was accepted that a corporation, as a separate entity, “[could not] be taxed except by the State which created it,”<sup>63</sup> and that states could tax “foreign” corporations only on “[t]he privilege of acting” within the taxing state’s territory.<sup>64</sup>

This view of the corporation worked well with state-level corporate taxation during most of the nineteenth century. At the time, corporations had limited geographical reach. “Businesses transacted primarily in local product, labor, and capital markets, and rarely had operations out-of-state.”<sup>65</sup> State-level corporate taxation had even been justified, among other reasons, on administrative grounds, noting the advantage of the state over the federal government in taxing locally-operated businesses.<sup>66</sup>

It is not only the case the state-chartered businesses were locally operated by nature of their business;<sup>67</sup> many state laws also required it. “Corporations and legislatures expected—and legislatures sometimes mandated—that corporations would have significant operations in the incorporating state, that officers and directors would be residents of that state, and that shareholders’ and directors’ meetings would be held in the state.”<sup>68</sup> The

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<sup>60</sup> Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 46 (2006).

<sup>61</sup> *Id.* at 46–47; Mehrotra, *supra* note 34, at 515.

<sup>62</sup> Tung, *supra* note 60, at 54.

<sup>63</sup> JOSEPH HENRY BEALE, JR., *THE LAW OF FOREIGN CORPORATIONS AND TAXATION OF CORPORATIONS BOTH FOREIGN AND DOMESTIC* § 462, at 619 (1904).

<sup>64</sup> *Id.* § 462, at 620.

<sup>65</sup> Tung, *supra* note 60, at 46; see also Thomas R. Navin & Marian V. Sears, *The Rise of a Market for Industrial Securities, 1887-1902*, 29 BUS. HIST. REV. 105, 107 (1955) (noting that until 1880, the U.S. economy was “typified by small single-plant companies serving limited markets”).

<sup>66</sup> Mehrotra, *supra* note 34, at 516.

<sup>67</sup> Tung, *supra* note 60, at 56 (“[F]irms ordinarily incorporated in the state where their organizers resided and where their major operations were located.”) (emphasis added).

<sup>68</sup> *Id.* at 56–57.

functional result was a convergence of the place of residency of capital-owners, residency of managers, the place of incorporation, and the place where the corporation did business.

Under such a set of circumstances, it was perfectly sensible to view the place of residence of a company as the source of income earned by the company.<sup>69</sup> Consequently, payouts from a company of a state could have been assumed to be supported by income earned in that state.

This logic also extended to federal-level corporate taxes. Under the historical circumstances surrounding the crystallization of federal corporate taxation in the United States, the corporations that were the intended targets of corporate tax laws were incorporated in the United States and at the same time derived most of their income from U.S. sources.

Specifically, during the late nineteenth century, U.S. businesses were overwhelmingly focused on U.S. local markets, which provided a “continental size” consumer base for their products.<sup>70</sup> The economic opportunities of scale could all be exploited with no need to look to foreign markets. American companies thus tended to invest in their own backyard,<sup>71</sup> and the

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<sup>69</sup> Interestingly, state-level corporate taxes had territorial effects similar to the ones experienced by civil law countries in mainland Europe. In Continental Europe of the nineteenth century, foreign companies were generally not recognized, nor allowed, to operate within a jurisdiction unless a treaty so provided. By the late nineteenth century, most mainland European jurisdictions had laws under which domestic companies were legally recognized only if they had their main economic activity within the jurisdiction of residence. The purpose of these sets of laws was to prevent shareholders from operating in their own jurisdiction through a foreign company, and by doing so, to avoid the reach of local corporate law. Similarly, these rules prevented shareholders from operating in a foreign jurisdiction through a domestic company, thus avoiding the foreign jurisdiction's corporate law. The result of these incorporation rules was that companies were only recognized and allowed to operate in the countries where their real activity took place, which later became known as the “real seat” or “central administration” principle. Considering the cost and speed of travel and communications at that time, it followed that management were placed in the same jurisdiction where operations were conducted. This “real seat” test has been carried into tax law, as most continental jurisdictions originally determined the tax-residence of corporations based on the “real seat” test. Many still do. See John F. Avery Jones, *Corporate Residence in Common Law: The Origins and Current Issues*, in RESIDENCE OF COMPANIES, *supra* note 24, at 121, 132–33.

<sup>70</sup> MANSEL G. BLACKFORD, *THE RISE OF MODERN BUSINESS: GREAT BRITAIN, THE UNITED STATES, GERMANY, JAPAN & CHINA* 87 (3d ed., 2008).

<sup>71</sup> JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, *THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA* 164 (2003); LANCE E. DAVIS & ROBERT J. CULL, *INTERNATIONAL CAPITAL MARKETS AND AMERICAN ECONOMIC GROWTH, 1820–1914*, at 79–91 (1994) (discussing the insignificance of foreign investment by U.S. investors between 1797 and 1896).

United States only played a minor role in global trade.<sup>72</sup> While U.S. exports steadily increased during the nineteenth century, the United States remained a net-capital importer until the end of the century.<sup>73</sup> Even amid positive inflow of investment, up until the early nineteenth century (when the 1909 Act became functional), foreign investment in the United States did not play a significant role in U.S. economic growth.<sup>74</sup> Thus, it would seem plausible to argue that jurisdiction to tax corporations could have acted as a functional equivalent of territorial taxation.

The corporations at issue were for the most part state-chartered corporations, which meant that their owners and managers were most probably U.S. residents (by virtue of being residents in the charter state), and that they operated primarily within the United States. Control patterns at the time also supported the localized view of the corporations. “As the 19th century was drawing to a close, family control of industrial enterprises was the norm in the United States and there were only very rare examples of companies with widely dispersed shareholdings and well-developed managerial hierarchies.”<sup>75</sup> Thus, the assumption of identity between POI, residency of managers, residency of shareholders, and the place of activity obviously worked for the federal level just as it worked at the state level.

However, during the second half of the nineteenth century, an increasing number of states neglected the model of state-chartered corporations in favor of general incorporation laws.<sup>76</sup> Local business entrepreneurs were quick to take advantage of the liberalization of corporate laws, and “by 1904 corporations accounted for three-quarters of the United States’ industrial outputs.”<sup>77</sup> Between the 1890s and the early 1900s, the U.S. economy underwent an unprecedented wave of consolidations, resulting in the separation of management from

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<sup>72</sup> Robert E. Lipsey, *U.S. Foreign Trade and the Balance of Payments, 1800-1913*, at 5 (Nat’l Bureau of Econ. Research, Working Paper No. 4710, 1994), available at <http://www.nber.org/papers/w4710.pdf>.

<sup>73</sup> *Id.* at 10.

<sup>74</sup> DAVIS & CULL, *supra* note 71, at 111.

<sup>75</sup> Brian R. Cheffins, *Investor Sentiment and Antitrust Law as Determinants of Corporate Ownership Structure: The Great Merger Wave of 1897 to 1903*, at 4 (Dec. 15, 2002) (unpublished manuscript) (on file with *Chapman Law Review*), available at <http://escholarship.org/uc/item/2x90s8bc#page-1>.

<sup>76</sup> See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 135–37 (1932) (describing the erosion of centralized ownership structure parallel to adoption of general corporate laws in multiple states).

<sup>77</sup> BLACKFORD, *supra* note 70.

control.<sup>78</sup> This period saw the institutionalization of managerial capitalism, namely the rise of professional, hierarchical salaried management at the expense of personal management by owners.<sup>79</sup> Thus, at the turn of the twentieth century, the assumption of identity between the place of incorporation, source of income, and the residency of shareholders or managers seemed not at all obvious.

Nonetheless, a functional argument for POI had merit even under the newly developed socio-economic environment of the early twentieth century. The wave of consolidations engulfing the United States starting in the 1890s indeed changed the ownership structures of U.S. corporations. However, it apparently did not change the national identity of the corporations' owners and managers, nor did it change the geographical source of the corporations' income. The consolidation movement was horizontal in nature. It was characterized by the amalgamation of multiple small and medium businesses in the same industry into trusts, and later into holding companies.<sup>80</sup> Owners of the "old" family businesses ceded management rights to some form of central management, but did not relinquish their ownership.<sup>81</sup> The result was the diffusion of ownership, but the centralization of management.<sup>82</sup> Thus, the transformation was from a situation in which many U.S. individuals owned and managed many U.S. incorporated corporations, to a situation in which many U.S. individuals owned or managed few U.S. incorporated corporations that earned income in the United States. To the extent that the true targets of corporate taxes were those individuals' income, POI still made sense.

Interestingly, the classes of owners and managers targeted by early corporate taxes never remained in the abstract. Individuals were, at times, identified by name. For example, in 1889, Thomas G. Shearman published an article titled *The Owners of the United States*.<sup>83</sup> The article was one of the earliest

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78 PAUL FRENTROP, A HISTORY OF CORPORATE GOVERNANCE: 1602–2002, at 192–94 (2002); Navin & Sears, *supra* note 65; Cheffins, *supra* note 75, at 6–10.

79 Mehrotra, *supra* note 34, at 524.

80 For a description of the U.S. horizontal consolidation movement at the end of the nineteenth century see, e.g., FRENTROP, *supra* note 78, at 192–94; Navin & Sears, *supra* note 65; Cheffins, *supra* note 75, at 12 ("One key constituency which remained when a turn-of-the-century merger had been concluded was composed of the owners of the formerly autonomous firms encompassed within the consolidation. This was because of the merger package typically offered to incumbents with an industry.").

81 FRENTROP, *supra* note 78, at 193.

82 Cheffins, *supra* note 75, at 10–11.

83 Thomas G. Shearman, *The Owners of the United States*, 8 FORUM 262 (1898).

attempts to measure income distribution within the United States. Shearman found that “40,000 persons own[ed] over one half of the wealth of the United States, while one seventieth part of the people own[ed] over two thirds of the wealth.”<sup>84</sup> Even more significant was Shearman’s conclusion that while the top echelon of wealthy Americans greatly benefited from the indirect effects of taxation, they carried little of the tax burden.<sup>85</sup> Shearman’s article turned out to be highly influential.<sup>86</sup>

Shearman supported his conclusions not by numbers alone, but also, for lack of a better description, by “name calling.” Shearman identified by name many of the wealthiest Americans avoiding the tax burden, putting faces on the abstract notion of “rich Americans.” He spelled out names such as Astor, Vanderbilt, Rockefeller, and many more as specific examples.<sup>87</sup> “Name calling” was common in floor debates, both in the context of the 1894 Act and of the 1909 Act. Wealth distribution played a major role in these debates, and elected officials frequently named the intended targets of corporate taxes.<sup>88</sup> These wealthy individuals were understood to be the intended target of the Acts.

Significantly, these identified individuals held most of their wealth in corporations incorporated in the United States. These corporations, in turn, earned much (if not all) of their income from U.S. operations.<sup>89</sup> Standard Oil and the American Sugar

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<sup>84</sup> *Id.* at 271.

<sup>85</sup> *Id.* at 272.

<sup>86</sup> Shearman was invited to testify at the Ways and Means tax subcommittee when potential changes to tax law had begun to be discussed in 1893. STEVEN S. WEISMAN, *THE GREAT TAX WARS: LINCOLN TO WILSON—THE FIERCE BATTLES OVER MONEY AND POWER THAT TRANSFORMED THE NATION* 124 (2002).

<sup>87</sup> Shearman, *supra* note 83, at 265.

<sup>88</sup> In the context of the 1894 Act, see, e.g., WEISMAN, *supra* note 86, at 137 (referring to Benton McMillin, the chairman of the Ways and Means Subcommittee on Taxation and one of the original drafters of the 1894 bill, who argued that empires fell due to wealth concentration, noting that “the Emperor of Russia, the Sultan of Turkey, the Emperor of Austria, the Emperor of Germany, the King of Italy, Queen Victoria and others who . . . were worth less than the Rothschilds, Rockefellers, Vanderbilts and others in the United States”); see *id.* at 144 (noting that Senator William Allen of Nebraska, who “[i]n defending the tax . . . asserted that 9 percent of the families in America owned 71 percent of the wealth. In New York alone, he declared . . . there were 119 millionaires! He rattled off their names: Vanderbilt, Whitney, Rockefeller and so on . . .”). In the context of the 1909 Act, see *id.* at 219 (quoting Representative Cordell Hull as complaining about the “infamous system of class legislation’ that burdened the average person while ‘virtually exempting the Carnegies, the Vanderbilts, the Morgans, and the Rockefellers, with their aggregated billions of hoarded wealth”).

<sup>89</sup> The source of wealth of these corporations has also been part of the political debate. Corporations were regarded as a “class of our citizens who own and control a very large and increasing part of the property of the country; who enjoy certain public franchises of very substantial character.” STEVEN A. BANK, *FROM SWORD TO SHIELD: THE*

Refinery Company, the intended targets of the 1898 Act,<sup>90</sup> were both perfect examples. Standard Oil was incorporated by John Davison Rockefeller in 1870 in Ohio.<sup>91</sup> The American Sugar Refining Company, substantially owned and managed by Henry Osborne Havemeyer, was incorporated in 1891 in New Jersey.<sup>92</sup> Other examples of companies owned or managed by individuals who were identified in tax reform debate included the Vanderbilts' railroad empire, which was composed of several state-chartered corporations incorporated during the nineteenth century,<sup>93</sup> as was the Goulds' railroad conglomerate.<sup>94</sup> The Astors' fur trading empire was operated, among others, via the American Fur Company, incorporated in New York in 1808.<sup>95</sup>

To summarize, from a jurisdictional point of view, it does not matter if one prefers the regulatory argument or wealth distribution argument to explain the corporate tax acts of the late nineteenth and the early twentieth centuries in the United States. The intended targets of the corporate tax acts were named. These individuals held their fortune by virtue of their ownership or control of corporations that were incorporated and operated in the United States. Under such circumstances, the POI model effectively operated to tax income earned by such individuals from their U.S.-based operations.

### C. The Modern Failure of the Positive Function in the United States

Thus far I have shown that in the historical context surrounding the adoption of corporate taxation in the United

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TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT 46–47 (2010) (citing William L. Wilson, *The Income Tax on Corporations*, 158 N. AM. L. REV. 1).

<sup>90</sup> See *supra* text accompanying notes 44–47.

<sup>91</sup> 7 DICTIONARY OF AMERICAN HISTORY, 520–21 (Stanley I. Kutler ed., 3d ed. 2003).

<sup>92</sup> See WM. SULZER, AMERICAN SUGAR REFINING COMPANY 9 (1904), available at <http://ia700409.us.archive.org/27/items/cu31924103062851/cu31924103062851.pdf>.

<sup>93</sup> For example, Vanderbilt is well known for his involvement within the New York & Erie Railroad. See EDWARD J. RENEHAN JR., COMMODORE: THE LIFE OF CORNELIUS VANDERBILT 243 (2007). The New York & Erie Railroad was incorporated under a state act of New York. See *Erie Ry. Co. v. Pennsylvania*, 88 U.S. 492, 493 (“The Erie Railroad Company was chartered by an act of the legislature of the State of New York, April 24th, 1832, with power to construct a railroad from the city of New York to Lake Erie, through the southern tier of counties of the State of New York.”).

<sup>94</sup> For example, in 1860 Jay Gould purchased the controlling interest in the Rutland & Washington Railroad Company and became its president. See 7 THE NATIONAL CYCLOPÆDIA OF AMERICAN BIOGRAPHY, JAMES T. WHITE COMPANY 218 (1899). The Rutland & Washington Railroad Company was chartered under an act of the state of Vermont in 1847. See 1 THE RAILROAD LAWS AND CHARTERS OF THE UNITED STATES 844 (W.P. Gregg & Benjamin Pond eds., 1851).

<sup>95</sup> STATE OF N.Y., AN ACT TO INCORPORATE THE AMERICAN FUR COMPANY, ch. CXL (1835) (passed April 6, 1808).

States, the POI test for tax-residence determination operated as a source-based tax instrument. This is a functional rather than a historical argument. Namely, I do not suggest that the original drafters of U.S. corporate tax law have purposely so designed the tax-residence test. This would necessitate full-blown historical research, well beyond the scope of a symposium piece. However, the functional argument demonstrates that the adopted residence test (POI) supported source taxation, and that in turn, source-based taxation supported the historical purposes for which the United States adopted corporate taxes.

The consideration of current territorial reform proposals thus begs two questions: First, will a POI test support source taxation under current economic conditions? Namely, if a corporation is incorporated in the United States, does POI positively point to the United States as the source of income (and if a corporation is incorporated elsewhere, does this suggest that the source of income is not the United States)? Second, if the answer is in the negative, is there any other corporate tax-residence test that might positively point to the source of income earned and distributed by a corporation?

It is clear that the answer to the first question is in the negative. Today, unlike the early twentieth century, the United States takes a leading role in the global economy.<sup>96</sup> U.S.-incorporated corporations can freely operate around the world and earn foreign-source income. The assumption that such corporations accumulate all of their wealth from domestic operations is no longer viable. Conversely, there is ample evidence that U.S.-incorporated corporations accumulate most of their profits not directly, but in affiliates incorporated in low-to-no tax jurisdictions (where no economic activity takes place).<sup>97</sup> It is easy and practically costless to incorporate a subsidiary in a tax haven, thereby avoiding U.S. taxing jurisdiction altogether. Meaning, foreign incorporation does not mean that income is *not* sourced to the United States. POI is dysfunctional to the extent we expect it to point to the source of income.

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<sup>96</sup> As of December 2013, “[t]he United States is the largest investor abroad and the largest recipient of direct investment in the world.” JAMES K. JACKSON, CONG. RESEARCH SERV., RS21118, U.S. DIRECT INVESTMENT ABROAD: TRENDS AND CURRENT ISSUES (2013).

<sup>97</sup> See DONALD J. MARPLES & JANE G. GRAVELLE, CONG. RESEARCH SERV., R40178, TAX CUTS ON REPATRIATION EARNINGS AS ECONOMIC STIMULUS: AN ECONOMIC ANALYSIS (2011); see also STAFF OF PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, 112TH CONG., REP. ON REPATRIATING OFFSHORE FUNDS: 2004 TAX WINDFALL FOR SELECT MULTATIONALS (Comm. Print 2011).

Answering the second question—whether any tax-residence test other than POI can positively point to the source of income of a corporation—is more complex. The United States’s formal POI test is frequently contrasted with more substantive corporate tax-residence tests used by other jurisdictions. Substantive tests inquire into various “connecting factors” that define “the link between a company and the national territory of the State who wants to exercise its jurisdiction to tax that company . . . .”<sup>98</sup> Such tests may include, among others, the central management and control (CMC) test;<sup>99</sup> the place of effective management (POEM);<sup>100</sup> the place where main economic activity is carried on;<sup>101</sup> or the place of residence of shareholders.<sup>102</sup> An argument can be made that a substantive residence test can theoretically point to the source of income. The logic is that substantive tests point to the jurisdiction of the corporation’s real economic attributes, where income is presumably generated.

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<sup>98</sup> See Peter Behrens, *General Principles of Residence of Companies*, in RESIDENCE OF COMPANIES, *supra* note 24, at 3, 26–27; see also Pasquale Pistone, *EC Law and Tax Residence of Companies*, in RESIDENCE OF COMPANIES, *supra* note 24, at 183, 184–85.

<sup>99</sup> The CMC test is used by all commonwealth jurisdictions, and widely adopted throughout the world. Under this test, “a company resides for purposes of income tax where its real business is carried on[,] . . . and the real business is carried on where the central management and control actually abides.” *De Beers Consolidated Mines, Ltd. v. Howe*, [1906] 5 A.C. 455 (H.L.) 458. For an excellent discussion on the adoption of the managed and controlled tests by Commonwealth jurisdictions, see ROBERT COUZIN, *CORPORATE RESIDENCE AND INTERNATIONAL TAXATION* 22 (2002); see also AULT & ARNOLD, *supra* note 10, at 435 (noting that Commonwealth jurisdictions traditionally adhered to the CMC test).

<sup>100</sup> This test is adopted by most civil law jurisdictions, and is the test prescribed by the OECD model, which it defines as “the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made.” OECD COMMITTEE ON FISCAL AFFAIRS, *MODEL TAX CONVENTION ON INCOME AND ON CAPITAL: CONDENSED VERSION 77* (2008). In most cases POEM is one and the same as CMC. See HM REVENUE & CUSTOMS, *INTM120210—COMPANY RESIDENCE: GUIDANCE ORIGINALLY PUBLISHED IN THE INTERNATIONAL TAX HANDBOOK*, at ITH348 (2010), available at <http://www.hmrc.gov.uk/manuals/intmanual/intm120210.htm#IDA1ORZF> (explaining the apparent differences between CMC and POEM and concluding that “it is not that easy to divorce effective management from central management and control and in the vast majority of cases they will be located in the same place”). For a description of different factual tests adopted by civil law jurisdictions, see Luc De Broe, *Corporate Tax Residence in Civil Law Jurisdictions*, in RESIDENCE OF COMPANIES, *supra* note 24, at 95.

<sup>101</sup> In Italy, a corporation will be considered “domestic” for tax purposes if, among satisfaction of other criteria, its main business purpose is in Italy for the greater part of the financial year. See, e.g., CARLO GALLI, *INT’L BUREAU OF FISCAL DOCUMENTATION, CORPORATE TAXATION—ITALY* 26 (2013).

<sup>102</sup> Countries using some variation of the residence-of-shareholders test include, for example, Australia and Italy. See Michael Dirkis, *Australia*, in RESIDENCE OF COMPANIES, *supra* note 24, at 311, 324–29 (discussing the ownership-presumption model adopted in Australia); see also Mario Tenore, *Italy*, in RESIDENCE OF COMPANIES, *supra* note 24, at 519, 540–44 (discussing the ownership-presumption model adopted by Italy).

Unfortunately, due to the nature of income and operations of multinational corporations, this argument is unconvincing. A single corporation can operate in multiple jurisdictions. Multiple different activities (such as research, manufacturing, advisement, sales, and so on) can each take place in a different jurisdiction (or each in multiple jurisdictions), notwithstanding all are aimed at generating the same stream of income. Under such circumstances, few streams of income can be said to have identifiable sources, and therefore no residence test can be said to point to the source of the income of a corporation. The production of income is no longer bound by physical proximities that converge around a single factor (or even around multiple factors with clear locational attributes). In short, “[t]here is no unifying normative concept that justifies treating income as derived in one jurisdiction rather than another.”<sup>103</sup>

This does not mean that corporate tax-residence has no function in supporting source-based taxation. To the contrary, tax-residence still plays a major part in sourcing income, but we must rethink the instrumentality of residence determination in such context. I address this issue in the next Part.

### III. THE “NEGATIVE” FUNCTION OF CORPORATE TAX-RESIDENCE

#### A. Corporate Tax-Residence and Income Shifting

In order to understand what might be the territorial instrumentality of corporate tax-residence determination, we must make a preliminary assumption, that income indeed has a source, or sources (notwithstanding we may have difficulty identifying such sources). Once this threshold is cleared, we must question what role (if any) corporate tax-residence could play in supporting source taxation in an environment where the positive identification of sources is almost impossible.

The positive difficulty with source-based taxation materializes in the problem of income shifting. Income shifting is a generic name for any technique by which a multinational group is able to have income that is economically generated in one jurisdiction, reported for tax purposes in another jurisdiction. For example, a patent could be completely developed in the labs of a corporation residing in a tax jurisdiction. It is very easy,

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<sup>103</sup> Marian, *Jurisdiction to Tax Corporations*, *supra* note 3, at 1631; Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 143 (2011) (“[T]he global tax norms that define the geographic source of income or expense are largely artificial constructs, difficult to administer and often devoid of any conceptual foundation.”) [hereinafter Kleinbard, *The Lessons of Stateless Income*].

however, to have the patent legally owned by an affiliate that resides in a tax haven. Thus, all royalties are paid to the tax haven corporation where income is booked, notwithstanding that all research activity took place in the parent's jurisdiction, and that the affiliate did not meaningfully participate in the activity. Professor Edward Kleinbard famously coined the phrase "stateless income" to describe the resulting tax consequences. He defines stateless income as "the movement of taxable income within a multinational group from high-tax to low-tax source countries *without* shifting the location of externally-supplied capital or activities involving third parties."<sup>104</sup>

Income shifting techniques have received much attention in recent tax reform discourse in the United States<sup>105</sup> and are the focus of a major project undertaken by the OECD.<sup>106</sup> To date, most mechanisms that have been put in place to address income shifting have, in one way or another, focused on making sure that income that is being "shifted" is "resourced" to its "true" origin.<sup>107</sup> For example, intercompany pricing measures focus on making sure that intercompany dealings are priced at arm's-length, so profits are not booked with foreign affiliates in tax havens. "Anti-stripping" mechanisms are intended to assure that income is not "stripped" from the source jurisdiction through deductible payments to a foreign affiliate. Controlled Foreign Corporation (CFC) regimes make income that is nominally earned by foreign affiliates taxed to the parent unless the foreign affiliate is substantively engaged in an active trade or business in the foreign jurisdiction.

Importantly for our purposes, any income shifting technique depends on the existence of both "domestic" and "foreign" affiliate corporations. Corporate tax-residence is thus an integral part to any income shifting technique, and as such can be a significant instrument in preventing it.

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<sup>104</sup> Kleinbard, *supra* note 1, at 702.

<sup>105</sup> See Omri Marian, *Meaningful Corporate Tax Residence*, 140 TAX NOTES 470, 470–71 (2013).

<sup>106</sup> For a discussion on the BEPS OECD project, see Yariv Brauner, *What the BEPS?*, FLA. TAX REV. (forthcoming 2014), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2408034](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2408034).

<sup>107</sup> Kleinbard, *The Lessons of Stateless Income*, *supra* note 103, at 140–51 (discussing common anti-income-shifting mechanisms).

### B. The Negative Function Explained: Formalism as a Proxy for Non-Source

While corporate tax-residence cannot positively point to the source of income, it can identify the jurisdictions in which income is definitely *not* generated. Since income shifting heavily depends on corporate tax-residence determination, the idea would be to design the residence test in a manner that would not allow income to be reported in a jurisdiction where a corporation has no real economic attributes. I refer to this approach as the “negative function” of corporate tax-residence.

A stylized example will help to demonstrate this “negative function.” Assume a world of three jurisdictions: Fredonia, Sylvania, and Florin. Both Fredonia and Sylvania are developed, high-tax jurisdictions. Florin is a tax haven. The GCH Group is a global leader in the designing and manufacturing of widgets. GCH’s headquarters as well as its research facilities are found in Fredonia, and are operating through a publically traded corporation, FredoniaCo. Each widget designed by FredoniaCo is IP protected, but the IP is owned by a GCH subsidiary resident in Florin, FlorinCo. FlorinCo has no employees. Two other GCH subsidiaries, FreCo and SylCo are residents in Fredonia and Sylvania, respectively. They both pay FlorinCo royalties for the right to manufacture the IP-protected widgets in their respective jurisdictions. FreCo and SylCo then sell the widgets in Fredonia and Sylvania, respectively, at a substantial markup over the cost of production. The deductible royalty to FlorinCo is set to match the gain from selling the widgets. In such a manner, all income is booked to FlorinCo (i.e., the royalties income), in spite of the fact that there is no economic activity in Florin. No income is booked to either Sylvania or Fredonia—due to the deductible royalties—in spite of the fact that both Sylvania and Fredonia are jurisdictions where real economic activity takes place.

Assume that at some point FlorinCo makes payments (for example, in the form of dividends) to Sylvania or Fredonia. If Fredonia and Sylvania are both territorial jurisdictions, such payments will not result in income recognition in those jurisdictions, since the payments will be foreign-sourced. That is the case because payments of dividends and interest are generally sourced to the residence of the payor, which in this case is Florin.

Traditional anti-shifting mechanism will focus the efforts on resourcing the income from Florin to Sylvania or Fredonia (for example, by adjusting the dollar value of the royalties, thereby reducing deductions to FreCo and SylCo). My suggestion would

be to support these mechanisms by a residency construct that assures that FlorinCo is not considered a resident in Florin, where it has no economic attributes. Under such circumstances, no income will be sourced to Florin (since FlorinCo will be resident in a place other than Florin), and income shifting is prevented.

Importantly, the function of such residence determination is strictly negative. It does not positively point to the source of income as being in Fredonia or Sylvania, even though these are the only two available alternatives if Florin is ruled out. But where the “real residence” is, is irrelevant in this context. Negative residency construction simply prevents “false-residency.” Income will thus be sourced to a jurisdiction where some economic attributes exist (regardless if income was indeed produced in that jurisdiction), and *not* where income could not have possibly been produced.

Obviously, the negative function of corporate tax-residence demands that tax-residence be determined based on substantive connecting factors of the corporation to a jurisdiction. A formal residency determination such as POI would make it very easy (as is the case today under U.S. law) to incorporate pocketbook entities in tax havens, and book income to such entities. In a sense, “formal” residency attributes serve as a proxy to “non-source.”

### C. The Negative Function in Practice: Formulary Apportionment as a Tax-Residence Test

The last part of the functional puzzle is to determine how to construct a substantive corporate tax-residence test that can properly function to prevent income shifting.

It has previously been argued that corporate tax-residence is largely elective, in the sense that the taxpayer can arrange their affairs in a way that corporations reside for tax purposes in a jurisdiction of their choosing.<sup>108</sup> As a factual matter such argument is probably correct, and presents challenges to the functional project. However, arranging residence in one jurisdiction rather than another is not costless. Residence electivity is a matter of degree.<sup>109</sup> This largely solves the problem for our purposes. The sole requirement of a “negative” tax-residence construction in a territorial system is that it

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<sup>108</sup> Shaviro, *supra* note 12, at 381–85.

<sup>109</sup> *Id.* at 384.

decreases the electivity of tax-residence of a corporation to an extent that a corporation could not be resident where it has no (or very little) economic attributes. There is no need to identify “real” residency. In other words, the idea would be to increase the costs of residence election.

Increasing the cost of residence electivity means that tax-residence of corporations should not be determined by a single “substantive” factor (for example, the place of management). A single factor test will be rather easy to manipulate. For example, many jurisdictions use the place of central management and control (CMC) as the tax-residence test for corporations. It used to be the case that the place of CMC was presumed to be the place where board meetings are held.<sup>110</sup> This test is easy to manipulate by having the board meetings conducted in a tax haven. Effectively, it makes the CMC test a formal one. In other words, single factor tests may be too elective.

Obviously, an alternative would be to use multiplicity of factors, such as CMC, the place where the economic activity takes place, and so on. The problem with such an approach is that it is difficult to administer. In today’s world, a corporation may have its management, assets, and operations spread across the globe. Deciding a single location for residence under such circumstances is administratively challenging (which factors should take precedent?) and largely meaningless.

Nonetheless, our aim is not to “discover” the “true” residency of a corporation. It would therefore be satisfactory to combine the “multiplicity of factors” approach with an administratively feasible approach that is less than accurate. Luckily, such an approach has already been suggested and heavily discussed in other contexts: the formulary apportionment approach.

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<sup>110</sup> In the past, where the board met was seen as the decisive factor for purposes of making a determination as to the place of management, as expressed in the previous version of the OECD tax-treaty model. See OECD COMM. ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 81 (2005) (“The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined.”). However, in July of 2008, the OECD neglected the “place of board meeting” presumption, and adopted a much more nuanced (and less clear) test to determine the place of management: the decision is based on “facts and circumstances.” See OECD COMM. ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 77 (2008) (“All relevant facts and circumstances must be examined to determine the place of effective management.”).

Formulary apportionment has been proposed as an alternative to the territorial versus global taxation debate.<sup>111</sup> Specifically, formulary apportionment is a method used to allocate taxing jurisdiction from multijurisdictional activity by taking into account the relative weights (therefore “formulary”) of various economic attributes such as payroll, assets, and sales in various jurisdictions. “Under a formulary profit split, tax liabilities would reflect the economic reality of globally integrated businesses, and they would not vary among businesses based on their relative abilities to shift the ownership of intangible property.”<sup>112</sup>

The formulary apportionment approach is by no means uncontested.<sup>113</sup> Many doubt that such an approach can be applied as a unilateral measure, question which economic “attributes” should be taken into account in the formula, and doubt the extent to which such attributes are immune to taxpayers’ manipulation. But for our purpose, it does not really matter. We do not seek a “correct” result. All we need it to determine is that a corporation is *not* resident somewhere.

If a formula that takes into account number of employees, tangible assets, and sales figures is used to determine the residency of a corporation, a corporation will have very little chance to end up a resident in a jurisdiction where it has no economic activity. Of course, in order to make sense, the formula must not be calculated on a per-corporation basis. In such a case, a single employee in a small office may constitute all of the economic attributes of a corporation incorporated in a tax haven, which would defeat the purposes of the test. Rather, the measurement must be proportional to the entire control group. For example, a corporation would not be able to claim residency in a jurisdiction unless it meets certain formulary thresholds in that jurisdiction, compared to the group’s aggregate attributes.

It is likely that a corporation will end up a resident in a jurisdiction where it has some real infrastructure, which in turn implies that the jurisdiction is not a tax haven. As such, there is

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<sup>111</sup> Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 498 (2009).

<sup>112</sup> *Id.* at 507.

<sup>113</sup> For more skeptical views of formulary apportionment see, e.g., Julie Roin, *Can the Income Tax be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169 (2008), and see also J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?*, 36 MICH. J. INT’L L. (forthcoming 2014).

no “foreign corporation” resident in a tax haven, to which income can be shifted.

#### CONCLUSION

Corporate tax-residence plays an important role in territorial tax systems. Poorly constructed corporate tax-residence tests may be detrimental to source taxation. Conversely, properly constructed corporate tax-residence models can support source taxation by preventing income shifting. In turn, this purpose can be achieved by increasing the cost of electing tax-residence that is detached from real economic considerations. I have suggested one way to do so—formulary apportionment—but other cost-increasing mechanisms may achieve similar results. Of course, the nuts and bolts of each residence reform will have to be worked out, a task well beyond the scope of a symposium piece.

Increasing the cost of residence electivity may draw critique, as it may make the U.S. tax system less competitive. To the extent one truly believes in territorial taxation, such critique cannot stand. If an instrument is designed to support taxation of income in its true source, it makes little sense to argue against it. It makes little sense to support source taxation as an ideological matter and at the same time advocate competitiveness by allowing taxpayers to strip income away from the jurisdiction of source. Competitiveness must be addressed by other means, such as reducing corporate tax rates.

Recent international tax reform proposals in the United States seem to embrace the idea of territorial taxation. Unfortunately, such proposals, in their focus on source taxation, largely lose sight of the relevance of tax-residence determination to territorial taxation. Residence determination plays an important role in sourcing income, and is the linchpin for income-shifting mechanisms that operate against source-based taxation. This conclusion is particularly important to the United States, where the cost of tax-residence electivity is practically zero. It is therefore prudent, if not necessary, that any territorial reform proposal in the United States considers the tax-residence of corporations.

