A U.S. Perspective on the Future of Corporate Residence

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Looking behind a legal fiction

Corporations are legal entities, not people, so they don't actually reside anywhere. The concept of tax residence is a legal fiction.

This doesn't mean it's useless, or that anything goes. E.g., eyebrows might be raised if Poland classified global Domino's as a Polish corporation.

But it does mean that the legal fiction's purposes are critical to assessing how one should define corporate residence as a tax concept.

Why does corporate residence matter?

Corporate residence matters under treaties, & may affect how domestic source income is taxed.

But its main relevance is permitting a country that classifies Corp X as a resident to tax what it classifies as X's "foreign source income" (FSI).

So a key functional question is: Why would a given country want to tax a given company's FSI?

Reasons for taxing FSI

Not mainly due to the Monty Python tax principle ("To boost the British economy, I'd tax all foreigners living abroad").

Rather, 2 main reasons, 1 pertaining to resident individuals & 1 to domestic business activity.

Individuals: An income tax rationalized on "ability to pay" grounds must include the FSI they earn.

Corporate income tax backstops the individual income tax.

Domestic business activity: Here the issue is base erosion. Taxing FSI can help to deter or defeat profit-shifting by companies that are classified as residents.

How CFC rules can affect profit-shifting

CFC rules' effect on profit-shifting reflects their particular structure – not just the irrelevance of source (FTC limits aside) under a WW tax.

CFC rules typically reach passive income &/or low-tax income (which often overlap).

Taxing passive income can defeat the use of intra-group debt to aid profit-shifting.

Taxing low-tax income reduces the tax benefit from profit-shifting to that between the domestic rate & non-haven foreign rates.

It also may reflect skepticism that profits were actually earned in haven jurisdictions (raising the possibility that they were actually earned at home).

Keeping CFC rules in one's toolkit

While CFC rules expand a country's toolkit for addressing profit-shifting, they can only apply to companies it classifies as residents.

This creates a tradeoff: greater efficacy re. the companies affected, vs. distinctively offering an out to nonresidents.

Given the ubiquity of CFC rules amongst countries with "territorial" tax systems, it's clear that the tool is deemed valuable even though this tradeoff limits its optimal use.

Downside of over-relying on CFC rules

The U.S. may overuse CFC rules relative to other anti-profit-shifting tools (such as anti-earnings-stripping, transfer pricing enforcement).

This is the #2 reason for the recent wave of U.S. corporate inversions (Reason #1 is deferral/"trapped earnings").

But even without relative over-use of CFC rules, they can motivate tax planning to avoid resident status.

With this in mind, let's turn briefly to how resident companies are (and can be) defined.

Defining corporate residence

The U.S. uses a place of incorporation rule; other countries typically use “real seat” approaches (HQ, location of employees/assets, etc.).

Both approaches are at risk of facing declining efficacy.

Place of incorporation rules have been undermined by the rise of cross-border shareholding and global financial integration generally.

Real seat approaches undermined by rising mobility, falling transport & communication costs, & the rise of “decentered” global firms.

Hence the problem that I call “rising corporate residence electivity.”

Approach # 1 to rising corporate residence electivity

One approach is to make corporate residence standards tougher.

This could simply involve applying a disjunctive standard (e.g., domestically incorporated OR domestic HQ).

It also could involve devising new corporate residence standards.

E.g., Fleming-Peroni-Shay (2016) urge extending U.S. corporate resident status to companies > owned 50% by U.S. residents.

This inquiry sounds challenging! (And requires look-through rules.) But F-P-S claim that FATCA makes it more feasible than previously.

Dual residence & nowhere-residence

F-P-S also propose extending U.S. resident status to companies whose stock is traded/listed/marketed in the U.S.

They concede that this might lead to an increase in (unintentional) dual-resident companies.

Dual residence & nowhere-residence (a la Apple Operations Int'l) are already well-known issues in international tax.

The U.S. & U.K. have long had rules addressing dual residence. Might countries' residence rules increasingly address nowhere residence? (Cf. the BEPS response to hybridity in other dimensions.)

Approach # 2 to rising corporate residence electivity

An alternative to strengthening corporate residence rules would be to reduce their importance.

E.g., by reducing corporate income taxes, &/or anti-profit-shifting efforts, &/or such efforts’ degree of reliance on CFC rules.

Complementary responses to profit-shifting efforts might include, not just the usual suspects, but the replacement of transfer pricing by formulary apportionment.

Could also consider relying more on the owner level to tax corporate income, as in Toder-Viard 2016 & Grubert-Altshuler 2016.

What to expect

Yogi Berra: “It’s tough to make predictions, especially about the future.” That said, however:

--Neither residence rules, nor corporate taxes generally, strike me as inherently past the point of feasibility & repair.

--The demise of corporate income taxation, predicted by economists for decades, has consistently lagged behind such forecasts.

--But insofar as its future depends on politics, rather than economics or technical feasibility, I’m skeptical (speaking for the U.S. at least) that much will be done to save it.