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# Defending Worldwide Taxation With A Shareholder-Based Definition Of Corporate Residence

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## Defending Worldwide Taxation With A Shareholder-Based Definition Of Corporate Residence\*

*J. Clifton Fleming, Jr., \*\* Robert J. Peroni\*\*\* & Stephen E. Shay\*\*\*\**

*This Article argues that a principled, efficient, and practical definition of corporate residence is necessary even if some form of corporate integration is adopted, and that such a definition is a key element in designing either a real worldwide or a territorial income tax system as well as a potential restraint on the inversion phenomenon. The Article proposes that the United States adopt a shareholder-based definition of corporate residence that is structured as follows:*

- 1. A foreign corporation is a U.S. tax resident for any year if fifty percent or more of its shares, determined by vote or value, was beneficially owned by U.S. residents on the last day of the immediately preceding year (or was the average ownership for the year by U.S. residents as determined by averaging U.S. resident ownership on the last day of each quarter of the preceding year). A foreign corporation presumptively satisfies this test if any class*

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\* Copyright © 2017 by J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay. All rights reserved. Thanks to those who commented on earlier drafts of this Article—Ellen Aprill, David Elkins, Jennifer Kowal, Omri Marian, Katie Pratt, Julie Roin, and Bret Wells; also to participants at a March 2016 BYU Law Review symposium on international tax policy, participants at an August 2016 tax meeting at the Southeastern Association of Law Schools' annual meeting, participants at a September 2016 tax colloquium presentation at Loyola Law School in Los Angeles, and participants at an October 2016 workshop at the Vienna University of Economics and Business in Vienna, Austria. The views expressed in this Article are those of the authors and do not reflect those of their universities, any organization for which any of the authors serves as an officer or renders pro bono services, or, in the case of Mr. Shay, any client.

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- of its shares is regularly traded in one or more U.S. public capital markets or is marketed to U.S. persons.*
2. *This presumption can be rebutted by the foreign corporation showing that U.S. resident beneficial ownership of its shares is below the fifty-percent threshold.*
  3. *The presumption can be overcome in the same way by the IRS if it encounters cases where a foreign corporation that is actually foreign-owned lists a class of shares on a U.S. exchange in order to achieve U.S. resident status for tax-avoidance reasons.*

*This proposed shareholder-ownership test, however, would be an alternate definition; a corporation would continue to be a U.S. tax resident if it were formed under the law of a U.S. jurisdiction. Finally, this Article examines the common objections to a shareholder-based definition of corporate residence and explains why those objections are unpersuasive.*

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## I. INTRODUCTION

### A. *The Unavoidable Challenge*

In the U.S. legal system, corporations are intangible fictional entities created by legal fiat to achieve various ends that are considered worthwhile.<sup>1</sup> But precisely because corporations are fictional, they do not *live* anywhere.<sup>2</sup> Thus, determining where a corporation resides is a much more difficult endeavor than determining the residence of a human being.

This difficult query cannot be dodged, however, and it has foundational significance. It is an accepted international norm that a country may tax a *resident* corporation on its worldwide income, though it may choose not to exercise the full extent of its taxing jurisdiction. In contrast, a foreign corporation may be taxed only on income with some nexus to the taxing country.<sup>3</sup> A worldwide taxation

1. A principal reason for the corporate fiction is to promote investments in corporations by creating a liability shield to protect investors from creditor claims that exceed the amounts invested, subject to a number of exceptions allowing the corporate liability shield to be pierced. Within the income tax, corporations serve as a single point for levying the tax that is much more convenient than pursuing individual shareholders.

2. See Michael J. Graetz, *The David R. Tillinghast Lecture—Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 320 (2001) [hereinafter Graetz, *Taxing International Income*] (“[I]n the case of corporations, the idea of residence is largely an effort to put flesh into fiction, to find economic and political substance in a world occupied by legal niceties.”); Adam H. Rosenzweig, *Source As a Solution to Residence*, 17 FLA. TAX. REV. 471, 479–80 (2015) (“The difficulty with defining residency for entities is that the most straightforward way to define residency—physical presence—is not available, simply because legal entities cannot be physically present in the same manner as individuals.”). Given this fact, as we understand it, Professor David Elkins, commenting on an earlier draft of this Article, took the position that the residence of corporations should be disregarded in determining whether and how to tax corporate income. Instead, in his view, it is the residence of the shareholders of the corporation that is the relevant factor in determining the proper tax treatment of corporate income. We look forward to reading his future paper on this topic.

3. 1 RESTATEMENT OF THE LAW (THIRD) FOREIGN RELATIONS LAW OF THE UNITED STATES § 412(1) (AM. LAW INST. 1987).

system, which the United States employs in form,<sup>4</sup> observes these norms by taxing resident corporations on the sum of their domestic-source and foreign-source incomes,<sup>5</sup> while taxing nonresident corporations only on U.S.-source income.<sup>6</sup> Thus, a worldwide system rests in part on its classification of a corporation as a resident as distinguished from a nonresident corporation.<sup>7</sup> The fictional nature of the corporate form makes this distinction inherently difficult to draw.

It does not seem likely that the United States can avoid this challenge by moving towards an explicit territorial or exemption system that would forgo U.S. taxation of foreign-source business income. This is so because the most viable current territorial proposals would adopt a form of U.S. final minimum tax on foreign income,<sup>8</sup> under which U.S. taxation of foreign income would still be heavier than the burden imposed by the tax laws of most other countries, and the benefit of avoiding U.S. income tax by eroding the U.S. tax base would remain.<sup>9</sup> Accordingly, a politically plausible U.S. territorial

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4. See generally J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L.J. 79 (2009) [hereinafter Fleming, Peroni & Shay, *Worse Than Exemption*] (explaining why the U.S. international income taxation system is a worldwide system in form but largely an incoherent and elective quasi-territorial system in substance).

5. See I.R.C. § 61(a) (2012).

6. See I.R.C. §§ 881, 882, 864(c)(2)–(3) (2012). However, certain limited categories of foreign-source income of a nonresident corporation that are closely connected with the conduct of a U.S. trade or business are subject to U.S. income tax. See I.R.C. § 864(c)(4) (2012).

7. In important places, the Internal Revenue Code uses the term “domestic corporation” to refer to a U.S. corporate resident and the term “foreign corporation” to refer to a nonresident corporation. See, e.g., I.R.C. §§ 881(a), 882(a), 7701(a)(4)–(5) (2012). For this purpose, a domestic corporation is defined as one that is “created or organized in the United States or under the law of the United States or of any State” and a foreign corporation is any other corporation. I.R.C. § 7701(a)(4)–(5) (2012). The District of Columbia is treated as a State and as geographically part of the United States for purposes of this definition. I.R.C. § 7701(a)(9)–(10) (2012). For convenience, we refer to domestic corporations as U.S. residents and foreign corporations as U.S. nonresidents throughout this Article.

8. Representative Camp’s tax reform proposal would have provided for a minimum tax on foreign income. See H.R. 1, 113th Cong., §§ 4201, 4211 (2014). The Obama Administration’s framework for corporate tax reform also includes a minimum tax on foreign income using a different base and tax rate. WHITE HOUSE & U.S. TREASURY DEP’T, THE PRESIDENT’S FRAMEWORK FOR BUSINESS TAX REFORM: AN UPDATE 24 (Apr. 2016), <https://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-An-Update-04-04-2016.pdf>.

9. See Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *Designing a 21<sup>st</sup> Century Corporate Tax—An Advance U.S. Minimum Tax on Foreign Income and Other Measures to Protect the Base*, 17 FLA. TAX REV. 669, 717–21 (2015) [hereinafter Shay, Fleming & Peroni, *Designing a 21<sup>st</sup> Century Corporate Tax*]. Professor Adam Rosenzweig has observed that the question at issue in defining corporate residence is whether a country wants to exercise its taxing

regime will not eliminate the unavoidable incentives under the current law for U.S. resident corporations to become nonresidents, nor will it eliminate the need for an effective U.S. response.<sup>10</sup>

A second, and possibly more important, reason why U.S. adoption of a territorial-based system would not eliminate the need to deal with the corporate residence conundrum is that conventional territorial regimes typically have a worldwide taxation component. Specifically, territorial countries often apply worldwide taxation to passive foreign income and tax haven business income received by their corporate residents.<sup>11</sup> Assuming that a U.S. territorial-based system would follow

power, including reporting and withholding obligations, over foreign-source income. Rosenzweig, *supra* note 2, at 481. Recent corporate inversion activity has illuminated the ability of a nonresident parent group to also earnings-strip the U.S. tax base. See Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *Treasury's Unfinished Work on Corporate Expatriations*, 150 TAX NOTES 933, 935 (2016) [hereinafter Shay, Fleming & Peroni, *Treasury's Unfinished Work*].

10. Professor Omri Marian has pointed out that the concept of corporate residence would have a critical role in a U.S. territorial regime because the operation of important source rules is controlled by residence, *see, e.g.*, I.R.C. §§ 861(a)(1)–(2), 865(a), (e) (2012), and these rules are unlikely to be changed. See Omri Marian, *The Function of Corporate Tax-Residence in Territorial Systems*, 18 CHAP. L. REV. 157, 159 (2014). While that is correct under current law, we have argued that source rules are “instruments for implementing source taxing jurisdiction and effecting residence country accommodation of source country taxation” and could be modified to suit the appropriate purpose. Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *The David R. Tillinghast Lecture—“What’s Source Got to Do with It?”—Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 83, 138–39, 147 (2002) [hereinafter Shay, Fleming & Peroni, *Source Rules*]. For this reason, we do not think classification of an entity as resident is fundamentally linked to determining the source of income.

One might ask whether the United States would adopt the U.S. House of Representatives Republican tax plan to replace the income tax on business income with a destination-based cash flow tax (*see* MAJORITY MEMBERS OF H. COMM. ON WAYS & MEANS, A BETTER WAY: OUR VISION FOR A CONFIDENT AMERICA, TAX REFORM TASK FORCE BLUEPRINT 24–29 (June 24, 2016), [http://abetterway.speaker.gov/\\_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf](http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf)), in which case the pressure on corporate residence would be reduced. The House Republican business tax proposal carries a very high revenue cost, would create significant winners and losers, and has no direct analog in the world today. In addition to being a radical change, there is no comparable U.S. Senate plan. For these reasons, we do not consider a destination-based cash flow tax as a replacement for the business income tax to be a likely alternative.

11. See STAFF OF JOINT COMM. ON TAX’N, 112TH CONG., JCX-33-11, BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME 8 (2011) [hereinafter JOINT COMM., BACKGROUND AND ISSUES]; STAFF OF JOINT COMM. ON TAX’N, 109TH CONG., JCS-02-05, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 187, 190 (2005) [hereinafter JOINT COMM., OPTIONS TO IMPROVE]; U.S. TREASURY DEP’T, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21<sup>ST</sup> CENTURY 57, 59–60 (2007); HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 447–48 (3d ed. 2010); Edward D. Kleinbard, *Stateless Income*, 11 FLA.

this conventional pattern, the United States would have to address the issue of properly defining corporate residence in order to implement the worldwide taxation component of its territorial regime.

*B. The Defect of Current U.S. Law*

Under present U.S. federal income tax law, a corporation is a foreign resident if it was formed under foreign law and a U.S. resident if it was formed under the law of a U.S. jurisdiction.<sup>12</sup> Thus, residence is elective in the sense that because there are virtually no legal limitations on the power of relevant business decision makers to choose between formation in a U.S. or a foreign jurisdiction, U.S. law effectively gives those decision makers significant discretion in determining the residence of corporations engaged in international activities.<sup>13</sup>

The most prominent current issue that arises, in part, from the malleability of the U.S. corporate resident definition, is the inversion problem. Specifically, a U.S. resident corporation has considerable latitude to transform itself into a foreign resident by combining with a foreign corporation if, after the transaction, the former shareholders of the U.S. corporation own less than eighty percent of the surviving

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TAX REV. 699, 717 (2011) [hereinafter Kleinbard, *Stateless Income*]; Katrin Laschewski & Christian Laschewski, *The Impact of the International Tax System of the Home Country on the Location Decision of a Foreign Permanent Establishment: The Case of Germany*, WORLD TAX J., June 2015, at 171, 172–74 (2015); see also Shay, Fleming & Peroni, *Designing a 21<sup>st</sup> Century Corporate Tax*, *supra* note 9, at 685–86 (noting that all countries' international tax systems are hybrids that contain elements of both the worldwide and territorial approaches).

12. See *supra* note 7.

13. Studies have shown that despite the few legal limitations on the power to choose between foreign and U.S. incorporation, U.S. headquartered corporations that engage in international activities are, in fact, usually formed in a U.S. jurisdiction. See Eric J. Allen & Susan C. Morse, *Tax-Haven Incorporation for U.S.-Headquartered Firms: No Exodus Yet*, 66 NAT'L TAX J. 395, 406–09 (2013); Susan C. Morse, *Startup Ltd.: Tax Planning and Initial Incorporation Location*, 14 FLA. TAX REV. 319, 329–33 (2013) (discussing how U.S.-based startups are also generally incorporated in the United States); see also DANIEL N. SHAVIRO, *FIXING U.S. INTERNATIONAL TAXATION* 69–75 (2014) [hereinafter SHAVIRO, *FIXING*] (discussing non-tax factors that lead to U.S. incorporation); Susan C. Morse & Eric J. Allen, *Innovation and Taxation at Start-up Firms*, 69 TAX L. REV. 357, 360–61 (2016) (model suggesting tax planning, including using a pass-through entity, may not be cost effective for start-ups but more plausible after a start-up receives external financing). Nevertheless, it is clear that if the relevant decision makers determine that the tax benefits of foreign incorporation are sufficiently attractive, they have substantial freedom to elect foreign incorporation, particularly for foreign-headquartered subsidiaries.

foreign corporation.<sup>14</sup> As a result of this metamorphosis, a former U.S. corporation's future foreign-source income can avoid becoming subject to U.S. tax, and the surviving foreign corporation can pursue an earnings stripping strategy.<sup>15</sup> That is, the surviving foreign corporation can extract deductible interest, royalties, and service fee payments from its U.S. subsidiaries.<sup>16</sup> Because these payments are deductible, U.S. tax is avoided *pro tanto*.<sup>17</sup>

Inversions, however, are not the only problematic transactions that result from the manipulability of the U.S. corporate residence definition. For example, assume that USCorp, formed under the laws of Delaware, contemplates building a new factory to sell products to U.S. consumers. USCorp can employ an Irish subsidiary to build, own, and operate the factory, and then have that subsidiary sell its output to USCorp. Aggressive transfer pricing can then be used regarding the Irish subsidiary's sales to USCorp so that much of the profit from exploiting the U.S. market is income of the Irish

14. See I.R.C. §§ 7874(a)(2), 7874(b) (2012).

15. See generally J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework*, 93 N.C. L. REV. 673, 680–86 (2015) [hereinafter Fleming, Peroni & Shay, *Earnings Stripping*] (explaining and illustrating the earnings stripping problem).

16. *Id.* at 681 n.19 and accompanying text.

17. See generally *id.* at 680–87 (explaining and illustrating, again, the earnings stripping problem). Adoption of a U.S. territorial system would not eliminate the benefit of earnings stripping. Because the top U.S. corporate rate is, even after a reduction to, say 25 percent, likely to remain substantially above the top rate in reasonably stable tax havens (e.g., Bermuda, Ireland, and the United Kingdom), see JANE G. GRAVELLE, CONG. RESEARCH SERV., R41743, INTERNATIONAL CORPORATE TAX RATE COMPARISONS AND POLICY IMPLICATIONS 1, 16–18 (2014); MARK P. KEIGHTLEY & JEFFREY M. STUPAK, CONG. RESEARCH SERV., R44013, CORPORATE TAX BASE EROSION AND PROFITS SHIFTING (BEPS): AN EXAMINATION OF THE DATA 21 (2015), it would continue to be worthwhile from a tax minimization point of view to use deductible payments to move income from the U.S. tax base to related tax haven corporations even if the United States adopts a territorial regime. Indeed, adoption of a U.S. territorial system would increase the incentive to strip earnings out of the U.S. tax base. See Fleming, Peroni & Shay, *Earnings Stripping*, *supra* note 15, at 684. Thus, strengthened anti-earnings stripping rules are necessary, even if the United States goes territorial. As stated by Willard Taylor:

Inversions are not, and never were, solely about voting-with-your feet, or electing into, an exemption system of taxation for foreign business income. . . . A dollar earned in the United States is taxed at a 35 percent rate but if paid as interest to the new Irish parent is taxed at a 12.5 percent rate at most (and is not subject to withholding under the U.S.-Ireland treaty.) This has little to do with whether or not the United States adopts an exemption or territorial system . . . .

Willard B. Taylor, Letter to the Editor, *A Comment on Eric Solomon's Article on Corporate Inversions*, TAX NOTES, Oct. 1, 2012, at 105, 105.



subsidiary. Because the Irish subsidiary is a nonresident of the United States under current U.S. law, this foreign-source income will bear no U.S. tax until it is paid to USCorp in the form of dividends or until USCorp sells the Irish subsidiary's stock at a price that reflects its accumulated income.<sup>18</sup> The significant value of this deferral of U.S. tax is well-recognized.<sup>19</sup> Moreover, there is no guarantee that the Irish subsidiary will actually pay out a substantial amount of its profits as dividends or that its stock will be sold.

*C. Relevance to Worldwide vs. Territorial Taxation*

In short, the present U.S. definition of corporate residence makes it easy to transform what would otherwise be foreign active business income of U.S. corporations into foreign active business income that escapes a current U.S. tax. This fact has implications that go beyond the inversion phenomenon. To be specific, because foreign corporate residence, and corresponding freedom from U.S. tax with respect to foreign-source active business income are substantially elective, this might suggest that the only corporate income that the United States can feasibly tax is U.S.-source income. And, consequently, as the argument goes, the United States should accept this reality by abandoning efforts to employ worldwide taxation and, instead, adopt a territorial system under which U.S. taxing jurisdiction over foreign-source active business income would be formally surrendered.<sup>20</sup>

If this were the case, would a necessary implication also be that the United States should deviate from common practice by structuring its territorial regime so that passive and tax haven income are also

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18. See CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* 303 (4th ed. 2011) (describing the operation of the deferral principle).

19. See, e.g., Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 4, at 96–104 (discussing the value of the deferral principle); see also SHAVIRO, FIXING, *supra* note 13, at 55 (characterizing deferral as a “tax preference”); Patrick Driessen, *Would Territoriality Be a Tax Expenditure?*, 146 *TAX NOTES* 647, 649 (2015) (characterizing deferral as a “tax expenditure”). This deferral rule is sometimes called the “deferral privilege.” See, e.g., Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 4, at 85–87. The Subpart F (see I.R.C. §§ 951–965 (2012)) and passive foreign investment company (PFIC) (see I.R.C. §§ 1291–1298 (2012)) anti-deferral regimes of current U.S. tax law would not prevent deferral from applying in this fact scenario. See I.R.C. §§ 954(d)(1), 1297(d) (2012); Treas. Reg. § 1.954-3(a)(4) (2010).

20. See SHAVIRO, FIXING, *supra* note 13, at 66 (stating, but not endorsing, this argument).

exempted from U.S. tax instead of being subject to worldwide taxation?

The preceding two suggestions follow from the premise that there is no feasible definition of corporate residence that is less manipulable than the current U.S. definition. We reject that premise and the related suggestions.

With respect to worldwide taxation, we have argued in prior work<sup>21</sup> that the United States unilaterally<sup>22</sup> should adopt a real worldwide system for taxing the foreign income of U.S. multinational enterprises (MNEs).<sup>23</sup> Under such a system, the foreign-source and U.S.-source income of a U.S. parent corporation and all of its domestic and controlled foreign subsidiaries would be aggregated and subjected to a current, nondeferred U.S. income tax. There would be a credit for foreign income tax payments, subject to the U.S. foreign

21. See, e.g., 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. 1, 8, 18–20 (2014) [hereinafter Fleming, Peroni & Shay, *Lipstick*]; J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, *Perspectives on the Worldwide vs. Territorial Taxation Debate*, 125 TAX NOTES 1079, 1081–82 (2009) [hereinafter Fleming, Peroni & Shay, *Perspectives*]; Robert J. Peroni, J. Clifton Fleming, Jr., & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Income Tax on Foreign Source Income*, 52 SMU L. REV. 455, 458 (1999) [hereinafter Peroni, Fleming & Shay, *Getting Serious*]; see also Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 989–94 (1997) (recommending that the United States strengthen its worldwide system and proposing a pass-through system for taxing U.S. persons' foreign-source income earned through a foreign corporation).

22. Multilateral harmonization of income tax laws would make a significant contribution towards resolving the problems of international income taxation. However, we do not anticipate major steps towards harmonization within the foreseeable future. Indeed, we agree with Professor Michael Graetz's view that "international tax competition dominates international tax law making. . . . [D]isparities in different countries' circumstances and interests make ongoing inter-nation competition far more likely than substantially more robust international cooperation—at least for the foreseeable future." MICHAEL J. GRAETZ, *FOLLOW THE MONEY: ESSAYS ON INTERNATIONAL TAXATION* xix (2016). Consequently, we see the need for the United States to develop unilateral reforms to its international income taxation system, including a reformed definition of U.S. corporate residence.

23. The most basic MNEs are parent/subsidiary structures or pairs of corporations whose stock is owned by the same party or parties (i.e., the brother/sister structure). There are virtually endless combinations and permutations of these basic patterns. For purposes of this Article, an MNE is a parent/subsidiary group of corporations that functions as an economic unit, with at least one member being engaged in business activity outside the country in which the MNE parent is a resident for tax purposes.

tax credit limitation.<sup>24</sup> However, under a real worldwide system, foreign tax imposed by high-tax foreign countries in excess of U.S. tax would not be cross-credited against the U.S. residual tax<sup>25</sup> on income earned in low-tax foreign countries. Therefore, the foreign tax credit limitation of current law would need to be modified to significantly reduce cross-crediting. This approach would greatly lessen present law's distortive incentive to choose low-tax foreign countries as locations for business or investment activity.<sup>26</sup> It would also end the so-called "lockout effect" of current law,<sup>27</sup> align U.S. international income taxation more closely with the ability-to-pay principle that underlies the choice of income as the primary U.S. federal tax base,<sup>28</sup> and allow the United States to collect a residual tax on income earned by U.S. MNEs in low-tax foreign countries. However, in order to function properly, a real worldwide system needs a robust and non-elective definition of corporate residence. Thus, a major objective of this Article is to bolster the case for real worldwide taxation by proposing the required definition.

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24. See generally I.R.C. § 904 (2012) (specifying the core rules of the foreign tax credit limitation). For a comprehensive discussion of the foreign tax credit limitation, see J. KUNTZ & R. PERONI, U.S. INTERNATIONAL TAXATION ¶ B4.16 (Westlaw 2016) (ebook).

25. A residual tax is the U.S. income tax liability that exceeds any allowable credit for foreign income tax payments on foreign-source income. See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 18, at 307.

26. See CONG. BUDGET OFFICE, OPTIONS FOR TAXING U.S. MULTINATIONAL CORPORATIONS 20 (2013) [hereinafter CBO, OPTIONS]; STAFF OF JOINT COMM. ON TAXATION, JCX-42-11, PRESENT LAW AND ISSUES IN U.S. TAXATION OF CROSS-BORDER INCOME 103 (2011) [hereinafter JOINT COMM., CROSS-BORDER INCOME]; Fleming, Peroni & Shay, *Perspectives*, *supra* note 21, at 1084–85.

27. See CBO, OPTIONS, *supra* note 26, at 20; JOINT COMM., CROSS-BORDER INCOME, *supra* note 26, at 103; J. Clifton Fleming Jr. & Robert J. Peroni, *Eviscerating the Foreign Tax Credit Limitations and Cutting the Repatriation Tax – What's ETI Repeal Got to Do with It?*, 104 TAX NOTES 1393, 1406, 1414 (2004). One of us has defined "lockout" as "the phenomenon of U.S. multinational enterprises retaining low-taxed foreign earnings in foreign subsidiaries to benefit from deferral of U.S. taxation." Stephen E. Shay, *The Truthiness of 'Lockout': A Review of What We Know*, 146 TAX NOTES 1393, 1393 (2015).

28. See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 306–27 (2001) [hereinafter Fleming, Peroni & Shay, *Fairness*] (discussing in detail the relationship between worldwide taxation and the ability-to-pay concept); Fleming, Peroni & Shay, *Perspectives*, *supra* note 21, at 1091–01; see also AJAY K. MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE 8–15 (2013) (tracing the rise of the ability-to-pay concept as a fundamental pillar of taxation in the United States).

### D. Inversions

Developing a sensible and less manipulable definition of corporate residence can also be a critical element in dealing with inversions. For example, in the typical corporate inversion scenario, the corporate headquarters of the departing U.S. corporation remains in the United States.<sup>29</sup> Thus, if the United States were to adopt headquarters location as an alternative definition of corporate residence (i.e., a corporation would be a U.S. resident if it either was formed under the law of a U.S. jurisdiction or was headquartered in the United States), many inversions might be deterred. This approach has been previously suggested<sup>30</sup> but, as explained below,<sup>31</sup> we ultimately conclude that there is a better pathway to the same end.

### E. Corporate Integration

Recently, corporate tax reform plans that propose integrating the separate corporate-level and investor-level taxes on corporate income into a unified regime that achieves single taxation of corporate income have been touted as partial or total cures for the inversion problem.<sup>32</sup> None of these plans, however, would obviate the need for a reformed corporate residence definition.

The first reason for this conclusion is that integration plans generally do not apply to income earned by foreign corporations.<sup>33</sup>

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29. For descriptions of various inversion transactions, see Bret Wells, *Cant and the Inconvenient Truth About Corporate Inversions*, 136 TAX NOTES 429, 430–36 (2012) [hereinafter Wells, *Inconvenient Truth*].

30. See e.g., JOINT COMM., OPTIONS TO IMPROVE, *supra* note 11, at 179–80; see also Omri Marian, *Jurisdiction to Tax Corporations*, 54 B.C. L. REV. 1613, 1643–47 (2013) [hereinafter Marian, *Jurisdiction*].

31. See *infra* Part III.

32. See Reuven S. Avi-Yonah, David Burton, Curtis Dubay, David S. Miller, Steven T. Miller, Stuart L. Rosow, Eric Toder, Alan D. Viard & Richard A. Westin, *Is Corporate Integration a Good Idea?*, 151 TAX NOTES 1697, 1698–99 (2016) (Reuven S. Avi-Yonah, David Burton, and Curtis Dubay describing and analyzing the desirability of, and methods for achieving, corporate integration); Kat Lucero, *Hatch Calls Regs Counterproductive*, 151 TAX NOTES 157, 157 (2016).

33. See U.S. TREASURY DEP'T, REPORT OF THE DEPARTMENT OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 17, 37, 48, 95 (1992) [hereinafter U.S. TREAS. DEP'T, INTEGRATION REPORT]; STAFF OF JOINT COMM. ON TAX'N, JCX-44-16, OVERVIEW OF APPROACHES TO CORPORATE INTEGRATION 37 (2016) [hereinafter JOINT COMM., INTEGRATION].

Thus, they rely on a classification that distinguishes foreign corporations from U.S. resident corporations.

More importantly, feasible integration schemes actually impose some degree of corporate-level taxation on the worldwide incomes of U.S. corporations unless implementation of integration is coupled with adoption of a territorial system.<sup>34</sup> Without territoriality, these plans perpetuate the incentives for U.S. corporations to invert into low-taxed foreign corporations or to put their new activities into low-taxed foreign subsidiaries in order to escape U.S. tax on foreign-source income and achieve other inversion benefits.<sup>35</sup> Thus, unless the United States were to enact a territorial system (and we recommend against doing so), a robust definition of U.S. corporate residence would be necessary even if the United States were to adopt a corporate integration plan.

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34. An integration system that imposes a corporate-level tax and then relieves dividends from taxation obviously imposes a corporate level-tax on the worldwide income of U.S. resident corporations unless a territorial system, which exempts foreign active business income, is adopted. *See generally* U.S. TREAS. DEP'T, INTEGRATION REPORT, *supra* note 33, at 17, 39–41 (describing how a corporation's foreign-source income would be treated under a corporate integration system that relieves dividends from taxation); Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 4, at 82 (explaining that a territorial regime does not tax foreign business income). Integration systems that impose a corporate-level tax but that give U.S. resident corporations a deduction for dividend payments or that allow U.S. shareholders a credit for corporate tax payments related to corporate income distributions effectively apply a corporate-level tax to undistributed worldwide income, assuming no territorial system. *See id.* at 95; JOINT COMM., INTEGRATION, *supra* note 33, at 34; *see also* John D. McDonald, *A Taxing History—Why U.S. Corporate Tax Policy Needs to Come Full Circle and Once Again Reflect the Reality of the Individual as Taxpayer*, 94 TAXES 93, 97 (2016) (“[I]ntegration alone is not sufficient. If the United States continues to impose tax on corporations, corporate managers will continue to have an incentive to erode the U.S. tax base and re-domicile to more favorable tax jurisdictions.”).

35. For an explanation of the various forms of inversions and their tax advantages under current U.S. law, see DONALD J. MARPLES & JANE G. GRAVELLE, CONG. RESEARCH SERV., R43568, CORPORATE EXPATRIATION, INVERSIONS, AND MERGERS: TAX ISSUES 3–5, 10–11 (2016); DAVID L. BRUMBAUGH, CONG. RESEARCH SERV., RL31444, FIRMS THAT INCORPORATE ABROAD FOR TAX PURPOSES: CORPORATE “INVERSIONS” AND “EXPATRIATION” 3–4 (updated 2007); Steven H. Goldman, *Corporate Expatriation: A Case Analysis*, 9 FLA. TAX REV. 71, 73–76 (2008); Shay, Fleming & Peroni, *Treasury's Unfinished Work*, *supra* note 9, at 935; Eric Solomon, *Corporate Inversions: A Symptom of Larger Tax System Problems*, 136 TAX NOTES 1449 (2012); Steven M. Surdell, *Inversions 2014—Self Help International Tax Reform for U.S. Multinationals?*, 92 TAXES 63 (2014); Wells, *Inconvenient Truth*, *supra* note 29, at 430–36; Bret Wells, *What Corporate Inversions Teach About International Tax Reform*, 127 TAX NOTES 1345, 1349–51 (2010).

*F. The Way Forward*

Consequently, a principled, efficient, and practical definition of corporate residence is required even if some form of corporate integration is adopted. More importantly, such a definition is a key element in designing either a real worldwide or a territorial income tax system and is also a potential restraint on the inversion phenomenon. Professor Omri Marian has recently published an extensive analysis and evaluation of the alternative approaches for defining corporate residence.<sup>36</sup> In this Article, we take a somewhat different approach from Professor Marian, although we view his work and this Article as mutually supportive overall. We focus on developing a robust U.S. concept of corporate residence that is based on the premise that the U.S. corporate income tax serves principally as a device to limit rate gaming and deferral by indirectly imposing a current tax on shareholders.

Specifically, we will argue that the best remedy for the current inversion problems created by the U.S. definition of corporate residence, and the best approach to strengthening the case for a U.S. system of real worldwide taxation, is to amend the U.S. definition of corporate residence. Under our proposed amendment, a corporation is a U.S. resident for income tax purposes if it was formed under the laws of a U.S. jurisdiction, or at least fifty percent of its shares, by vote or value, is owned by U.S. residents. This approach would reduce the manipulability of the current U.S. definition and counter the argument that real worldwide taxation is unattainable because there is no feasible, non-elective definition of corporate residence. This approach would also prevent U.S. corporations from successfully inverting by merging into smaller foreign corporations. This is because the surviving corporation, being substantially owned by U.S. residents, would itself be a U.S. resident. Thus, both its foreign-source income and its earnings stripping receipts would remain in the U.S. tax base. Our proposal would also deal with situations where a U.S. corporation uses a low-taxed foreign subsidiary to manufacture goods

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36. See generally Marian, *Jurisdiction*, *supra* note 30. Professor Marian proposes a definition that would treat a corporation as a U.S. resident if either (1) it is managed or controlled from the United States, or (2) its securities are listed on a U.S. exchange or it is controlled by a corporation, the securities of which are listed on a U.S. exchange. *Id.* at 1618. Although we prefer our own approach to determining corporate residency set forth in this Article, we believe that Professor Marian's approach would be a considerable improvement over existing U.S. tax law.

for sale into the U.S. market. Because a U.S. parent would own the foreign subsidiary, it would be a U.S. resident and all income shifted to it would be part of the U.S. tax base.

Finally, our proposal has a simplification benefit. This is because all foreign corporations controlled by U.S. residents would themselves be U.S. residents subject to current worldwide taxation. Thus, if comprehensive stock ownership attribution rules were employed for purposes of defining control, there would be no need for Subpart F. Moreover, there would be a great reduction in the population of foreign corporations to which measures for abolishing deferral would have to apply. It would be possible to de-link the residence classification of a parent corporation from its wholly owned subsidiaries where the earnings of a foreign subsidiary corporation would, as under current law, eventually be taxed by the United States. While our preference would be to extend the residence classification to subsidiaries, the proposal retains its importance even if it only were applied to the parent corporation of a controlled group.

Our proposal would not, however, address foreign corporations that pursue earnings stripping benefits by acquiring smaller U.S. corporations. That problem would have to be dealt with through legislation that specifically attacks earnings stripping. We have made relevant suggestions in our earlier work.<sup>37</sup>

Although the details of our proposal differ from Professor Marian's,<sup>38</sup> we agree with him on a very important basic point: it is feasible to construct a coherent and non-elective definition of corporate residence.

## II. WHY A SHAREHOLDER-BASED DEFINITION?

### *A. Why a Corporate Income Tax?*

As indicated in the introduction, we advocate a shareholder-based residence approach as a supplement to place-of-incorporation as the U.S. definition of corporate residence. To explain our choice, we must begin by investigating the reasons for a corporate income tax.

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37. See Fleming, Peroni & Shay, *Earnings Stripping*, *supra* note 15, at 723–37.

38. See *supra* note 36.

The corporate income tax originated in the progressive era as a device to impose a measure of public control on corporate behavior.<sup>39</sup> The rationale was that because corporate income tax returns were public documents under this early regime, corporate operations would attract governmental and public scrutiny, which would facilitate regulation of corporate behavior.<sup>40</sup> This justification vanished, however, when corporate opposition resulted in repeal of the requirement for public disclosure of returns.<sup>41</sup>

Nevertheless, the corporate income tax, minus return disclosure, has been rationalized in modern times as a device to regulate corporate behavior.<sup>42</sup> The thought is that by limiting the buildup of wealth within corporations and providing positive incentives through tax expenditures and disincentives through denial of deductions and credits, the tax system can shape corporate behavior.<sup>43</sup> The large net worths and cash holdings of U.S. corporations, however, indicate that the corporate income tax has not been a meaningful restraint on accumulations of corporate wealth.<sup>44</sup> And, while the corporate income tax has undeniably affected corporate decisions regarding the location and composition of business activity,<sup>45</sup> its role has been limited outside of the business domain. In addition, it has had little or no effect on closely related issues such as restraining executive compensation.<sup>46</sup>

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39. See Marjorie Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 53–57 (1990).

40. See *id.* at 133–35.

41. See Jane G. Gravelle, *The Corporate Income Tax: A Persistent Challenge*, 11 FLA. TAX REV. 73, 81 (2011).

42. See Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1246–49 (2004); see also Reuven S. Avi-Yonah, Letter to the Editor, *Tax Reform in the (Multi) National Interest*, 124 TAX NOTES 389 (2009) (justifying the corporate income tax as a charge for the burdens placed on society by corporate activities). This is an alternative way to describe both a penalty tax and a benefits tax.

43. See STAFF OF JOINT COMM. ON TAXATION, JCX-47-15, ECONOMIC GROWTH AND TAX POLICY 15–17 (2015) (describing the impact of tax provisions on corporate investment decisions).

44. See Adam Davidson, *Why Are Corporations Hoarding Trillions?*, N.Y. TIMES MAG. (Jan. 20, 2016), [www.nytimes.com/2016/01/24/magazine/why-are-corporations-hoarding-trillions.html](http://www.nytimes.com/2016/01/24/magazine/why-are-corporations-hoarding-trillions.html).

45. See, e.g., CBO, OPTIONS, *supra* note 26, at 12.

46. For example, studies suggest that the \$1 million deductibility cap in Section 162(m) of the Code has had little effect on overall executive compensation levels or compensation growth rates at corporate taxpayers subject to the cap. See, e.g., Nancy L. Rose & Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code to Influence CEO Compensation* (Nat'l



Moreover, the corporate income tax has played little, if any, role in causing corporations to significantly address the most pressing social and environmental problems of the United States.<sup>47</sup> At best, the limited role of the corporate income tax in relation to corporate social behavior is not a persuasive justification for a thirty-five percent tax on corporate income.

Various benefit rationales have also been advanced in support of the U.S. corporate income tax.<sup>48</sup> The principal problem with those rationales, however, is that there is no obvious linkage between the tax a U.S. resident corporation pays to the U.S. Treasury and the government benefits enjoyed by that corporation.<sup>49</sup> With respect to the benefits of operating in the legal form of a corporation, those advantages, including limited liability, are largely available to limited liability companies and other forms of unincorporated business enterprise, such as the limited liability partnership, without payment of entity-level tax.<sup>50</sup> Benefits rationales are simply inadequate to justify

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Bureau of Econ. Research, Working Paper No. 7842, 2000), <http://www.nber.org/papers/w7842.pdf>.

47. We would identify, *inter alia*, curbing race, gender, and other forms of discrimination, protecting the environment, addressing America's decaying infrastructure, increasing the achievements of American students in comparison to those of other countries, and reducing American poverty as problems largely or completely unaddressed by the U.S. corporate income tax.

48. *See, e.g.*, Reporters' Study, *Taxation of Private Business Enterprises*, AM. LAW INST., 49, 51–54 (1999) [hereinafter ALI, PRIVATE ENTERPRISES] (acknowledging the argument that a separate corporate tax is justified as a charge for the benefit of limited shareholder liability, but finding the argument unpersuasive); Calvin H. Johnson, *Replace the Corporate Tax with a Market Capitalization Tax*, 117 TAX NOTES 1082 (2007) (arguing that a separate corporate tax for publicly traded corporations is justified as a tax on the liquidity benefit of access to public securities markets); Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 994 (1988–89) (earlier work taking a similar position).

49. *See, e.g.*, ALI, PRIVATE ENTERPRISES, *supra*, note 48, at 60 (“[T]here is no indication that the amount of the tax properly reflects the value of the benefit.”); Harry Grubert & Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, 66 NAT'L TAX J. 671, 707 (2013) (“The corporate tax is not generally characterized as a benefit tax.”); Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tensions Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475 (2005) (expressing doubts that the benefits of incorporating in the United States justify the worldwide taxation of corporate income).

50. *See* Marian, *Jurisdiction*, *supra* note 30, at 1659 (“[I]t probably makes little sense to argue that the current purpose of corporate taxes in the United States is to tax the benefits of incorporation. Under the ‘check the box’ regulations, the U.S. is explicitly willing to grant such benefits without charging anything for them.”). The “check-the-box” entity classification regulations in Treas. Reg. §§ 301.7701(2)–(3) (2016) largely make corporate status elective for

the modern U.S. corporate income tax with respect to U.S. resident corporations.<sup>51</sup>

The U.S. corporate income tax has also been justified as a tax on economic rents earned by businesses operating in corporate form.<sup>52</sup> This rationale fails, however, because “the corporate income tax as currently applied is not a tax on pure profits or economic rents.”<sup>53</sup>

Finally, it has been observed that the U.S. corporate income tax enjoys the virtue of convenience—it is easier to collect tax on corporate income at the entity level instead of pursuing the shareholders.<sup>54</sup> This rationale, however, is a tacit admission that the corporate income tax is actually a tax on shareholders. We agree with that characterization.

In earlier work,<sup>55</sup> we concluded that the principle of ability-to-pay<sup>56</sup> provides the primary justification for the income tax on individuals<sup>57</sup> and that the U.S. individual income tax is, in fact, based on the ability-to-pay principle.<sup>58</sup> We then explained that without a tax on C corporation<sup>59</sup> income at a rate that is substantial in comparison to individual tax rates, individuals with capital to invest in corporate shares could undermine the ability-to-pay principle by earning income through C corporations that bears less tax than the tax borne by others

federal income tax purposes, even for forms of business enterprises that possess significant nontax corporate attributes, such as limited liability and centralized management.

51. We have argued that U.S. source taxation of nonresident corporations is justifiable on the basis of a benefits rationale, *see* Shay, Fleming & Peroni, *Source Rules*, *supra* note 10, at 88–106, but that is a quite different situation from that of a U.S. resident corporation.

52. *See* MARK P. KEIGHTLY & MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R42726, THE CORPORATE INCOME TAX SYSTEM: OVERVIEW AND OPTIONS FOR REFORM 15 (2014).

53. *Id.*

54. *See* ALI PRIVATE ENTERPRISES, *supra* note 48, at 76; McDonald, *supra* note 34, at 127–28.

55. *See generally* Fleming, Peroni & Shay, *Fairness*, *supra* note 28 (discussing the application of the ability-to-pay principle to international income taxation).

56. In this Article, we define the ability-to-pay principle as a norm dictating that a taxpayer with a larger net income in a particular year should pay more income tax for that year than is paid by a taxpayer with a smaller net income for the same year and, at politically agreed levels, proportionately more tax. For a discussion of nuances of this norm, *see* Fleming, Peroni & Shay, *Fairness*, *supra* note 28, at 301 n.1.

57. *See id.* at 301–02.

58. *See id.* at 302.

59. For purposes of this Article, a C corporation is an incorporated entity that pays a corporate tax under I.R.C. § 11 (2012). However, we exclude for this purpose entities subject to defacto pass-through treatment such as regulated investment companies and real estate investment trusts.

who have the same or less ability to pay. They could do this by taking advantage of deferral of tax on corporate income until dividends are paid or shares are sold<sup>60</sup> at the cost of a comparatively low corporate tax, or at no cost at all if the corporate income tax does not exist.<sup>61</sup> A substantial tax on C corporation income is a limitation on this strategy if corporate income tax is a meaningful burden on shareholders.<sup>62</sup>

Although the incidence of the corporate income tax is a long-running controversy,<sup>63</sup> recent work concludes that most of the burden

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60. See J.D.R. ADAMS & J. WHALLEY, *THE INTERNATIONAL TAXATION OF MULTINATIONAL ENTERPRISES IN DEVELOPED COUNTRIES* 8 (1977) (explaining that a justification for corporation taxes is that otherwise company profits would escape taxation if the income was not distributed to shareholders); KEIGHTLY & SHERLOCK, *supra* note 52, at 15 (noting that corporations would be incentivized to retain earnings in order to avoid taxes if not for a corporate income tax); U.S. TREASURY DEP'T, *INTEGRATION REPORT*, *supra* note 33, at 95 (explaining that under the imputation credit corporate integration system, shareholders will not be required to pay additional tax on distributions of corporate earnings that have already been taxed under the corporate tax); Reuven S. Avi-Yonah & Amir C. Chenchinski, *The Case for Dividend Deduction*, 65 *TAX LAW.* 3, 7 (2011) (explaining that one argument in favor of the corporate tax is that without it, owners would be able to defer the tax, which would effectively reduce their tax rate); Daniel I. Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 *TAX NOTES*, 641, 641–42 (2010) (explaining that without a corporate tax, the top marginal rate would be the highest individual rate); Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 *TAX L. REV.* 99, 138–39, 159–60 (2011) [hereinafter Kleinbard, *Lessons*] (arguing that the corporate income tax is a substitute taxation by which the owners are taxed on a current basis by taxing the entity); Rosenzweig, *supra* note 2, at 478–79; see also David A. Weisbach, *The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax*, 60 *TAX L. REV.* 215, 217 (2007) (“If we imposed only an individual-level income tax with the realization requirement, individuals could park assets in shell corporations and avoid taxes on capital income. Firm-level taxes, whether collected at the firm level or calculated at the firm level and passed through to owners, can be seen as a necessary back-up to individual-level income taxes that rely on realization.”).

61. See JANE G. GRAVELLE & THOMAS L. HUNGERFORD, *CONG. RESEARCH SERV.*, RL34229, *CORPORATE TAX REFORM: ISSUES FOR CONGRESS* 4–5 (2012) (explaining that without a high corporate tax rate, individuals may obtain a lower tax rate by using the corporation as a tax shelter).

62. See Fleming, Peroni & Shay, *Fairness*, *supra*, note 28, at 320–21. In earlier work, we stated that the corporate income tax “cannot be explained on ability-to-pay grounds because liability under the corporate-level tax is calibrated to the taxable income of the corporation and bears no necessary relationship to the respective abilities to pay of any individuals.” *Id.* at 319. This language is inartful and creates a misimpression. By it we meant that the corporate income tax is not directly based on the ability-to-pay of either the corporation or the shareholders. Instead, as explained in this Article, our view is that the corporate income tax serves as a defense against attempts to undermine the ability-to-pay principle and, therefore, is justified by that principle.

63. For an early discussion of this controversy, see William A. Klein, *The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics*, 1965 *WISC. L. REV.* 576.

of this tax falls on owners of capital, including shareholders.<sup>64</sup> Thus, a substantial corporate income tax serves as a restraint on use of the C corporation to undermine the ability-to-pay principle. To be sure, it is a crude restraint in that its primary incidence falls on capital generally,<sup>65</sup> not just on shareholders, and its rates are not calibrated to either the rates of individual shareholders or the length of time the individual tax on dividends or gains from share sales is deferred.<sup>66</sup> Nevertheless, there is nothing better and so the corporate income tax serves as a second best limitation on the capacity of investors to minimize the effects of the ability-to-pay principle by strategically employing C corporations.

The preceding analysis, however, must be re-examined in light of recent work showing that approximately seventy-five percent of U.S. C corporation equity is owned by tax-exempt shareholders that

64. See CONG. BUDGET OFFICE, *THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES*, 2013, at 26 (2016) (“CBO allocated 75 percent of corporate income taxes to owners of capital in proportion to their income from interest, dividends, rents, and adjusted capital gains . . . . CBO allocated the remaining 25 percent of corporate income taxes to workers in proportion to their labor income.”); STAFF OF JOINT COMM. ON TAXATION, JCX-14-13, *MODELING THE DISTRIBUTION OF TAXES ON BUSINESS INCOME* 30 (2013) (Joint Committee Staff regards owners of capital as bearing 100 percent of the corporate income tax burden in the short run and 75 percent of corporate income taxes in the long run with the remainder not distributed to domestic and foreign owners of capital being borne by labor); GRAVELLE & HUNGERFORD, *supra* note 61, at 29 (“[I]t appears that most of the burden of the corporate tax falls on capital (and were debt considered, it is possible that labor benefits from the tax.)”); JIM NUNNS, URBAN INST. AND URBAN-BROOKINGS TAX POLICY CTR., *HOW TPC DISTRIBUTES THE CORPORATE INCOME TAX* 10 (2012) (“TPC’s updated long-run incidence assumptions for the corporate income tax are that 60 percent . . . falls on supernormal returns, 20 percent on labor income, and 20 percent on the normal return to all capital. . . . We assume the burden on supernormal returns falls only on shareholders . . . .”); Julie Anne Cronin, Emily Y. Lin, Laura Power & Michael Cooper, *Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology*, 66 NAT’L TAX J. 239, 239–40 (2013) (U.S. Treasury Department’s Office of Tax Analysis assumes that 82 percent of the corporate income tax is borne by capital income and 18 percent is borne by labor); Jennifer Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis*, 66 NAT’L TAX J. 185, 211 (2013) (describing an approach that treats over 90 percent of the corporate tax burden as borne by domestic capital); Li Liu & Rosanne Altshuler, *Measuring the Burden of the Corporate Income Tax Under Imperfect Competition*, 66 NAT’L TAX J. 215, 233 (2013) (“The average labor share of the corporate tax burden is around 60–80 percent.”). *But see* Kimberly A. Clausing, *Who Pays the Corporate Tax in a Global Economy?*, 66 NAT’L TAX J. 151, 180 (2013) (“[T]here is very little robust evidence linking corporate tax rates and wages.”).

65. See authorities cited in *supra* note 64.

66. See Fleming, Peroni & Shay, *Fairness*, *supra* note 28, at 319 n.46.

do not pay tax on dividend income or gains from stock sales.<sup>67</sup> Thus, with respect to these shareholders, the corporate income tax cannot be rationalized as a measure that prevents investors from minimizing their shareholder-level tax liability.

Nevertheless, we conclude that even as to the portion of the corporate income tax that is borne by tax-exempt shareholders, the tax is effectively an indirect levy on those shareholders. Our analysis runs this way: there is no normative right to income tax exemption for charities, other non-profits, and retirement plans.<sup>68</sup> Tax relief granted to those entities is thus a subsidy provided to achieve various ends.<sup>69</sup> Given the absence of a norm, Congress is free to decide the degree of subsidy that it is willing to provide to exempt entities. Its decision is that tax-exempt entities are not wholly tax-exempt. They generally are excused from federal income tax on their unlevered dividends and gains from share sales,<sup>70</sup> but they must bear tax on unrelated business taxable income as well as corporate-level tax on the income that is earned through their corporate equity investments<sup>71</sup> (except to the extent that the corporate income tax is shifted to other forms of capital and to labor).<sup>72</sup> Thus, the corporate income tax turns out to be a burden even on tax-exempt shareholders, although not for reasons directly related to ability-to-pay.<sup>73</sup>

Of course, this analysis heightens the incongruous treatment of interest received on corporate debt held by tax-exempt entities. In general, this interest is deductible<sup>74</sup> by the corporate payors. Thus, it

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67. See Steven M. Rosenthal & Lydia S. Austin, *The Dwindling Taxable Share of U.S. Corporate Stock*, 151 TAX NOTES 923, 930 (2016).

68. See Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283, 286 (2011).

69. See *id.* at 301–02 (“[A] normal income tax generally would impose a tax burden on investment income. Thus, failure to tax such income earned by a charity represents a subsidy.”).

70. See I.R.C. § 501(a), (c) (2012).

71. See I.R.C. § 11 (2012).

72. See authorities cited in *supra* note 64. The issue of whether the existence and scope of the tax subsidy accorded tax-exempt organizations is appropriate is an important and large topic that is outside the scope of this Article.

73. See STAFF OF JOINT COMM. ON TAX’N, JCX-26-05, TESTIMONY OF GEORGE K. YIN, CHIEF OF STAFF OF THE JOINT COMMITTEE ON TAXATION AT A HEARING OF THE HOUSE COMMITTEE ON WAYS AND MEANS ON “AN OVERVIEW OF THE TAX-EXEMPT SECTOR” 2–4 (2005) (discussing the reasons for tax exemptions).

74. The general deduction provision for interest expense is I.R.C. § 163(a) (2012). The exceptions are I.R.C. § 163(f), (h), (i), (j), (l) (2012).

does not directly bear the corporate-level income tax;<sup>75</sup> it bears that tax only to the extent that there is shifting from corporate equity investments to debt capital.<sup>76</sup> There does not appear to be much of a shift, however, because the Congressional Research Service has found that “[t]he aggregate tax burden on debt is slightly negative, while equity is taxed at close to 40%.”<sup>77</sup> Assuming that is the case, corporate debt investments by tax-exempt entities bear less of a corporate income tax burden than the corporate equity investments of those entities. If that is true, however, it is equally true with respect to the corporate debt investments and corporate equity investments of taxable investors and it does nothing more than illustrate the longstanding inconsistent tax treatment of corporate debt and corporate equity.<sup>78</sup> This is an incongruity that seems unlikely to be eliminated in the near term and that requires remediation that is clearly outside the scope of this Article.

For purposes of this Article, we conclude that the best rationale for a substantial tax on corporate income is that it is a tool (1) to crudely interdict efforts by taxable equity investors to undermine the ability-to-pay principle<sup>79</sup> and (2) to limit the degree of subsidy provided to tax-exempt equity investors. With respect to both types of investors, therefore, the target of the corporate income tax is a corporation’s shareholders.

### *B. A Shareholder Tax Leads to a Shareholder-Based Residence Definition*

The above discussion concludes that direct or indirect shareholders are the ultimate targets of the U.S. tax on corporate income. For that reason, the task of properly defining corporate residence should focus on constructing a definition that reflects the

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75. See GRAVELLE & HUNGERFORD, *supra* note 61, at 33 (“[A]t the firm level, equity is subject to a tax rate of around 30% while debt is subsidized at about the same level (a negative 32% tax rate).”). We exclude interest from a controlled entity taxable under I.R.C. § 512(b)(13) (2012).

76. See authorities cited in *supra* note 64.

77. See GRAVELLE & HUNGERFORD, *supra* note 61, at 32.

78. See *id.* at 32–33.

79. See *id.* at 4 (“As long as taxes on individual income are imposed, a significant corporate income tax is likely to be necessary to forestall use of the corporation as a tax shelter.”).

centrality of shareholder residence. This is not a radical idea. The United States has already moved toward a shareholder-based corporate residence definition by adopting Section 7874. This section provides that if the foreign surviving corporation in an inversion is at least eighty percent owned (based on either the vote or value of its stock) by former shareholders of the inverted U.S. corporation, then the foreign corporation will be considered a U.S. resident.<sup>80</sup>

The conclusion that the United States should adopt a shareholder-based definition of corporate residence means that there must be rules defining the residence of shareholders. Determining the precise contour of those rules is a large, independent topic that is outside the scope of this Article,<sup>81</sup> and so we do not undertake to craft those rules in this work. Instead, we limit ourselves to observing that in present law there are useful starting points in Section 7701(b) with respect to individual shareholders, Section 7701(a)(4) and (a)(5) with respect to incorporated tax-exempt organizations, and Section 7701(a)(30)(E) and (a)(31)(B) with respect to tax-exempt trusts.

### III. A SHAREHOLDER-BASED DEFINITION IS FEASIBLE

#### *A. The Frequent Trading Objection*

A shareholder-based definition of corporate residence is clearly feasible with respect to closely held corporations because information regarding shareholder identity and residence will usually be readily available. Some commentators, however, argue that because ownership of the shares of publicly traded corporations changes frequently, shareholder residence is unworkable as a test for the tax residence of publicly held entities.<sup>82</sup> While this argument would have some traction if the object were to accurately attribute corporate income to various shareholders, that is not the goal with respect to determining corporate residence. To illustrate, we recommend that the United States adopt a rule that treats a corporation as a U.S.

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80. I.R.C. § 7874(b) (2012).

81. For example, there is a significant body of literature dealing with whether individuals who are U.S. citizens but who have no physical presence in the United States should be treated as U.S. residents for income tax purposes. *See, e.g.*, Michael Kirsch, *Revisiting the Tax Treatment of Citizens Abroad: Reconciling Principle and Practice*, 16 FLA. TAX REV. 117 (2014); Ruth Mason, *Citizenship Taxation*, 89 S. CAL. L. REV. 169 (2016).

82. *See* GRAETZ, *supra* note 22, at 140; Graetz, *Taxing International Income*, *supra* note 2, at 323; Daniel Shaviro, *The David R. Tillinghast Lecture: The Rising Tax-Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 415 (2010).

resident for any year if on the last day of the preceding year, fifty percent or more of its shares (determined by vote or value) is owned by U.S. residents. Under this rule, frequent share trading during the year would be irrelevant because the rule would operate on the basis of a *snapshot* taken at the end of the immediately preceding year. If such a rule were judged vulnerable to year-end gaming, then it could be modified to operate on the basis of the average of the snapshots taken on the last day of each quarter during the preceding year. In any event, frequent share trading would not hamper the rule's operation. Moreover, this *snapshot* approach would be feasible because we would be determining the aggregate extent to which foreign corporations' equity is U.S. owned, not the shares of their incomes that should be attributed to specific shareholders (an admittedly more difficult task).

Because the shares of U.S. corporations are predominantly in the hands of U.S. residents,<sup>83</sup> it is unlikely that share trading would cause a corporation to frequently change from resident to nonresident, and vice versa, on account of the corporation often finding itself on different sides of the fifty-percent line proposed above. If that were a concern, however, averaging share ownership snapshots over a three- or five-year period for purposes of applying the proposed fifty-percent test could ameliorate the risk.

### B. The Intermediary Objection

It might be suggested that the preceding proposal is meaningless because the use of multiple layers of intermediaries will make it impossible to know who owns shares in many cases.<sup>84</sup> We have two responses to this objection. First, our proposal does not require knowledge of the separate identities of shareowners. Instead, it requires knowledge of an aggregate—i.e., whether U.S. residents, who need not be specifically identified, own fifty percent or more of

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83. A recent study found that foreign residents owned \$5,543 trillion (24.3%) of the \$22,812 trillion U.S. C corporation stock outstanding at the end of 2015. See Rosenthal & Austin, *supra* note 67, at 927. However, by using a definition of U.S. corporate equity that was broader than C corporation stock, the Joint Committee Staff calculated that foreign investors held only 17.4% of U.S. corporate equities at the close of 2015. See JOINT COMM., INTEGRATION, *supra* note 33, at 15. For a description of uncertainties in the data, see Chris William Sanchirico, *As American as Apple Inc.: International Tax and Ownership Nationality*, 68 TAX L. REV. 207 (2015).

84. See, e.g., GRAETZ, *supra* note 22, at 140 (noting that assessing the “true” residence of a corporation is seemingly impractical with regard to multi-tiered multinationals).



the vote or value of a corporation's shares. If there is sufficient information to allow a determination that this aggregate benchmark is satisfied with respect to a particular corporation, then that corporation is a U.S. tax resident even if complex tiers of shareholding obscure ownership of the remainder of its stock. This should reduce the size of the problem presented by layers of intermediary owners.

Our second, and perhaps more important, response to the intermediary ownership objection is that we now live in a post-FATCA<sup>85</sup> world. It is not a large step from that world to one in which publicly traded corporations are required to know the extent to which their shares are beneficially owned by U.S. residents. FATCA itself generally provides that corporations, whether U.S. or foreign, that pay U.S.-source dividends to foreign financial institutions must confirm that the foreign financial institution has complied with due diligence requirements to identify the U.S. beneficial owners of accounts and certain investment entities holding the shares or withhold a thirty-percent tax and remit it to the Internal Revenue Service (IRS).<sup>86</sup>

In addition, the Fourth Anti-Money Laundering Directive of the European Union (EU) requires that each EU member state direct its domestic corporations to maintain accurate, current information regarding beneficial ownership of their shares and to make it available to governmental authorities.<sup>87</sup> Moreover, Norway has adopted legislation establishing a public registry of corporate ownership information.<sup>88</sup> We submit that the United States is operating in a world where a snapshot of aggregate U.S. share ownership, even when layers of intermediaries and frequent trading are involved, is, or soon can be, knowable.<sup>89</sup>

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85. FATCA refers to the Foreign Account Tax Compliance Act, Pub. L. No. 111-147, §§ 501, 511, 124 Stat. 71, 109-110 (2010). The salient provisions of FATCA are in I.R.C. §§ 1471-1474, 6038D (2012). For a detailed discussion of these provisions, see KUNTZ & PERONI, *supra* note 24, at ¶¶ B1.08[6][A], C2.10.

86. See GUSTAFSON, PERONI & PUGH, *supra* note 18, at 276-77.

87. See Roman Seer, *The European AEOI: Risks and Opportunities of Anti-Money Laundering Acts*, in 13 NEW EXCHANGE OF INFORMATION VERSUS TAX SOLUTIONS OF EQUIVALENT EFFECT 57, 73 (Giuseppe Marino ed., EATLP Int'l Tax Series 2015).

88. See Sophie Haggerty, *Norway Latest Country to Adopt Public Registry of Beneficial Ownership*, GLOBAL FIN. INTEGRITY (June 15, 2015), <http://www.gfintegrity.org/norway-latest-country-to-adopt-public-registry-of-beneficial-ownership/>.

89. Professor Chris Sanchirico has argued that neither Treasury data nor federal securities law disclosures presently allow the U.S. ownership of large multinational corporations to be determined. See Sanchirico, *supra* note 83. His analysis, however, does not take into account the FATCA and EU developments described in the text at *supra* notes 85-89.

This proposition raises an interesting question. If we are moving to a world where it is possible to know whether a foreign-incorporated entity is fifty percent or more owned by U.S. residents, can we then determine the precise percentage of U.S. resident ownership and limit U.S. taxation of a foreign-incorporated entity's foreign income to that percentage? Our response is that it is much easier to determine that a foreign-incorporated entity is at least fifty percent owned by U.S. residents than it is to determine the precise percentage of U.S. ownership. Consequently, we are not presently prepared to recommend that the percentage of a foreign-incorporated entity's foreign income that is subject to U.S. taxation should be defined by the percentage of the entity's equity that is owned by U.S. residents. As tax enforcement progresses, however, this step may become feasible.<sup>90</sup>

### *C. The Related Party Objection*

As for the problem of determining beneficial ownership when stock is held by related parties, the United States has shown those difficulties can be dealt with through indirect and constructive stock ownership rules. Crafting the details of these rules is a task for another article. Here we limit ourselves to observing that the existing rules in Section 958 have proven workable and generally effective in the international context.<sup>91</sup>

We recognize that derivatives that draw their value from shares of a particular corporation's stock<sup>92</sup> can potentially be used to circumvent indirect and constructive stock ownership provisions. The development of rules to deal with derivatives is, however, a large undertaking<sup>93</sup> that is outside the scope of this Article. Consequently,

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90. We thank both Professor David Elkins and Ricardo Augusto Gil Reis Rodrigues of the Doctor of International Business Taxation Program at the Vienna University of Economics and Business for calling this point to our attention.

91. See I.R.C. § 958 (2012). For a comprehensive discussion of these rules, see KUNTZ & PERONI, *supra* 24, at ¶ B3.

92. For a description of such derivatives, see STAFF OF JOINT COMM. ON TAXATION, JCX-56-11, PRESENT LAW AND ISSUES RELATED TO THE TAXATION OF FINANCIAL INSTRUMENTS AND PRODUCTS 1-2 (2011).

93. See *generally id.* (providing a lengthy study of the issues presented by derivatives). U.S. courts have experience examining the substance of derivative contracts to determine ownership for tax purposes. For a recent court decision involving a failed attempt by the taxpayer to use derivatives to obtain an inappropriate tax result, see *Anschutz v. Commissioner*, 135 T.C. 78 (2010), *aff'd*, 664 F.3d 313 (10th Cir. 2011) (Tax Court rejecting attempted use of derivatives

we do not address issues raised by derivatives except to say that derivatives conferring the essential economic benefits of stock ownership on U.S. resident derivative holders would be treated as stock owned by U.S. residents for purposes of our proposal.

*D. A Public Trading-Based Presumption*

Taxpayers have fertile imaginations when it comes to creating arrangements that are difficult for the IRS to analyze and understand. Thus, our proposed shareholder-based residency test may turn out to be difficult for the IRS to administer. An effective response would be to recognize that if a corporation's shares are traded in U.S. securities markets, those shares are most likely marketed to and primarily held by U.S. residents.<sup>94</sup> Consequently, we suggest that our proposed shareholder-based residency definition be strengthened by a rebuttable presumption that a foreign corporation is a U.S. tax resident if any class of its shares is regularly traded in one or more U.S. public capital markets or is marketed to U.S. persons.<sup>95</sup>

This approach may seem problematic because it might create a bias against listing companies in the United States.<sup>96</sup> In the worst case scenario, as the argument goes, former U.S. corporations and historic foreign corporations might de-list their shares in the United States and list them on foreign stock exchanges, such as in London, Frankfurt, and Paris.<sup>97</sup> However, since substantial share ownership of a corporation by U.S. residents would alone be sufficient to make the corporation a U.S. tax resident under our proposal, a corporation that seeks U.S. investors would usually wind up in U.S. resident status, even if it listed its shares outside the United States. Thus, a corporation typically would lose little by a U.S. listing and a corporate residency test based on trading in U.S. capital markets should not be a significant barrier to U.S. listings. With respect to this proposed presumption, it

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to monetize shares while avoiding ten-year Section 1374 built-in gains tax by postponing formal transfer of shares).

94. Marian, *Jurisdiction*, *supra* note 30, at 1663.

95. *See id.* at 1663–64. Shares would be presumed to be marketed to U.S. persons if disclosure documents discussed the consequences of classification of the foreign corporation as a controlled foreign corporation or a PFIC.

96. *See* Am. Bar Ass'n Tax Sec. Task Force on Int'l Reform, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 753 (Spring 2006) [hereinafter *ABA Tax Section Task Force Report*]; Marian, *Jurisdiction*, *supra* note 30, at 1647.

97. *See ABA Tax Section Report*, *supra* note 96, at 753.

is useful to note that for purposes of determining whether transferors of U.S. corporate stock to a foreign corporation are U.S. persons, the Section 367 regulations adopt a presumption that persons transferring stock of a domestic corporation are U.S. persons.<sup>98</sup> The presumption is rebutted if the contrary is shown through ownership statements from transferors.<sup>99</sup>

Finally, we should note that we view this proposed presumption as a transition rule of sorts that eventually will be deleted from the classification structure that we hope will be enacted into law. In our view, once shareholder beneficial ownership information is required to be available and foreign corporations are in a position to more readily determine the identity of their shareholders, this public trading presumption will no longer be necessary and could be eliminated.

#### *E. Alternate Tests*

For the reasons discussed above, we propose that the United States adopt a shareholder-based definition of corporate residence that is structured as follows:

A foreign corporation is a U.S. tax resident for any year if fifty percent or more of its shares, determined by vote or value, was beneficially owned by U.S. residents on the last day of the immediately preceding year (or was the average ownership for the year by U.S. residents as determined by averaging U.S. resident ownership on the last day of each quarter of the preceding year). A foreign corporation presumptively satisfies this threshold if any class of its shares is regularly traded in one or more U.S. public capital markets or marketed to U.S. persons.

A foreign corporation can rebut this presumption by showing that U.S. resident beneficial ownership of its shares is below the fifty-percent threshold. The IRS can overcome the presumption in the same way if it encounters cases where a corporation that is actually foreign-owned lists a class of shares on a U.S. exchange in order to achieve U.S. resident status for tax-avoidance reasons.

The proposed shareholder-ownership test would, however, be an alternate definition. A corporation would continue to be a U.S. tax

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98. See Treas. Reg. § 1.367(a)-3(c)(2) (2015).

99. See Treas. Reg. § 1.367(a)-3(c)(7) (2015).

resident if it were formed under the law of a U.S. jurisdiction.<sup>100</sup> This approach has a convenience justification because it will eliminate the need to inquire into stock ownership in many cases. But, that raises the question of whether it is hypocritical for us to propose continuation of the U.S. place-of-incorporation definition of corporate residence after having gone to such lengths to argue that a shareholder-based definition is the proper approach in principle.

We believe that continued use of the place-of-incorporation approach is appropriate because that definition is a decent proxy for U.S. share ownership. This is because the shares of U.S. corporations are, on average, predominantly owned by U.S. residents.<sup>101</sup> This fact is not surprising in light of the well-recognized “home bias” in portfolio investments, which is demonstrated by the fact that investors hold a larger share of local equities in their portfolios than would be predicted by theories regarding the benefits of international investment diversification.<sup>102</sup> Thus, the place-of-incorporation definition of corporate residence is an acceptable rough justice rule,<sup>103</sup> even though a theoretically pure definition would be based exclusively on stock ownership.

If one were seriously concerned about outliers that fall beyond the reasonable scope of average cases, one could make the place-of-incorporation definition rebuttable by U.S. corporations that demonstrate U.S. resident beneficial ownership of their shares is below the fifty-percent benchmark. If such an approach were taken, the IRS should also be able to overcome this presumption on the same basis

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100. A corporation, however, should not be characterized as a nonresident solely because it is formed under foreign law. Doing so would create the problematic result of corporations escaping U.S. resident status by means of foreign incorporation even when owned by U.S. residents.

101. See generally JOINT COMM., INTEGRATION, *supra* note 33, at 15 (discussing the share of U.S. corporations owned by foreign investors); Rosenthal & Austin, *supra* note 67, at 927 (analyzing the various different holders of stock in taxable accounts); Sanchirico, *supra* note 83 (discussing uncertainties in stock ownership data).

102. See STAFF OF JOINT COMM. ON TAX’N, JCX-51-15, PRESENT LAW AND SELECTED POLICY ISSUES IN THE U.S. TAXATION OF CROSS-BORDER INCOME 35–36 (2015); Roger H. Gordon & James R. Hines, Jr., International Taxation 37 (Jan. 2002) (unpublished manuscript), [www.bus.umich.edu/otpr/WP2002-2paper.pdf](http://www.bus.umich.edu/otpr/WP2002-2paper.pdf); see also Lars Hornuf & Matthias Schmitt, *Does a Local Bias Exist in Equity Crowdfunding? The Impact of Investor Types and Portal Design* 23–24 (Max Planck Inst. for Innovation & Competition, Research Paper No. 16-07, 2016), <http://ssrn.com/abstract=2801170> (finding a general local bias within Germany with respect to equity crowdfunding investments).

103. See Marian, *Jurisdiction*, *supra* note 30, at 1652; see also Kleinbard, *Lessons*, *supra* note 60, at 159–60.

in order to deal with cases where a foreign-owned corporation is formed under U.S. law for tax-avoidance reasons. On balance, however, we reject this exception to the place-of-incorporation definition on grounds of administrative complexity. The possibility to rebut U.S. residence in the event of more-than-fifty-percent foreign ownership would, among other effects, (i) require each corporate taxpayer to consider the option; (ii) require appropriately strengthened tax rules for the transition from a domestic to a foreign corporation; and (iii) potentially provide a windfall gain to shareholders in predominantly foreign-owned U.S. corporations who acquired their shares at prices reflecting the burden of U.S. tax residence. Moreover, U.S. incorporation does not happen unless it is affirmatively chosen. Thus, in our view, there are relatively few outliers who would be harmed by the place-of-incorporation definition.

#### F. Other Proxies

In Section III.E of this Article,<sup>104</sup> we advocated using U.S. incorporation as an alternate U.S. residency test because U.S. incorporation seems to be an effective proxy for substantial U.S. share ownership. In this Section, we examine additional possible proxies.

The Staff of the Joint Committee on Taxation has recommended that a publicly traded foreign-incorporated entity be treated as a U.S. tax resident if its headquarters are located in the United States.<sup>105</sup> In a similar vein, Professor George Yin has proposed treating a foreign corporation as a U.S. tax resident if its principal customer base is in the United States.<sup>106</sup> Finally, Professor Adam Rosenzweig has proposed completely eliminating the present place-of-incorporation test and characterizing both U.S.-incorporated and foreign-incorporated entities as U.S. tax residents if (1) fifty percent or more of the gross income of a corporation for a year is U.S.-source, or (2) at least half of the average percentage of assets held by the corporation during the year produces U.S.-source income or is held for production of U.S.-source income.<sup>107</sup>

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104. See *supra* text accompanying notes 100–102.

105. See JOINT COMM., OPTIONS TO IMPROVE, *supra* note 11, at 179–80; Marian, *Jurisdiction*, *supra* note 30, at 1643–47.

106. See George K. Yin, Letter to the Editor, *Stopping Corporate Inversions Sensibly and Legally*, 144 TAX NOTES 1087, 1087–88 (2014).

107. Rosenzweig, *supra* note 2, at 507.

In this Article, we have argued that U.S. corporate tax residency should be linked to the residence of the owners of a significant block of the corporation's shares. It seems to us that because of the stock ownership data and home country bias referred to in Section III.E,<sup>108</sup> a corporation that satisfies any of the three immediately preceding residency definitions likely would have a substantial block of its shares in the hands of U.S. residents. Thus, these tests would be substantially consistent with our shareholder-residence approach. Nevertheless, it would be appropriate to allow foreign corporations to escape the preceding tests by proving that ownership of their shares by U.S. residents does not actually satisfy the fifty-percent benchmark described in Section III.A.

More importantly, even in the corporate inversion context, each of the three preceding tests is likely to have undesirable behavioral effects. The headquarters test will obviously deter corporations from maintaining their headquarters in the United States. Indeed, there is an adequate number of tax-advantaged foreign locations where U.S. managers can be stationed without their having to learn another language or sacrifice lifestyle comforts (e.g., Dublin, London, or Singapore).<sup>109</sup>

Likewise, Professor Yin's customer base test would have an adverse behavioral element. It would encourage corporations to limit the sales they make to U.S. buyers. We recognize that the attractiveness of the U.S. market would overcome this effect in most cases, but given the fact that our shareholder residence-based test would be an effective tool against manipulation of corporate residency, we see no reason to incur the behavioral risk inherent in Professor Yin's test, even if the risk is small. We have a similar reservation with respect to Professor Rosenzweig's proposed test because it would encourage corporations to limit their U.S.-source income and their U.S.-based production assets.

An alternative approach would be to treat a foreign-incorporated entity for tax purposes in the same manner as an individual and analogize the determination of corporate residence to the determination of whether a foreign individual is a resident of the United States. Although we reject this approach, it is worth the

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108. See *supra* text accompanying notes 101–103.

109. See generally Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169, 188–89 (2008). But see Marian, *Jurisdiction*, *supra* note 30, at 1645–46 (arguing the contrary).

following brief exploration. Foreign individuals are classified as residents for U.S. federal income tax purposes if they are accorded permanent resident (i.e., *green card*) status for immigration purposes or if they maintain a substantial presence in the United States (which generally is measured by days of physical presence in the United States).<sup>110</sup>

To maintain this analogy with an individual, a foreign-incorporated entity could be considered a U.S. tax resident if it maintained a substantial presence in the United States.<sup>111</sup> One way to measure substantial presence would be if more than fifty percent of its operating assets were located in the United States for more than 183 days in a year.<sup>112</sup> This substantial presence approach would provide a fully adequate basis for the United States to assert jurisdiction to tax a foreign corporation's worldwide income.<sup>113</sup> Although this approach is similar to the assets prong of Professor Rosenzweig's proposal, it would not use the income prong. We do not agree with looking to the amount of U.S.-source income as a residence test because, as recognized by Professor Rosenzweig, it closely aligns with a formula apportionment-like exemption of foreign income. We do not view this as a positive feature for a corporation predominantly owned by U.S. persons, because it defeats the underlying ability-to-pay objective of an income-based tax system.

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110. See I.R.C. § 7701(b)(1)(A) (2012).

111. This analogy of an entity to an individual is incomplete, for among other reasons, because it does not take into account the incidence of the corporate income tax.

112. The same-country dividends and interest exception to the definition of Subpart F foreign personal holding company income includes a requirement that the controlled foreign corporation have "a substantial part of its assets used in its trade or business located in such . . . country." I.R.C. § 954(c)(3)(A)(i) (2012). The regulations apply a 50 percent substantial assets test for this purpose and provide rules for identifying the location of tangible and intangible assets. Treas. Reg. § 4.954-2(b)(3)(iv)–(xi) (2016) (providing rules for valuing and determining the location of tangible and intangible assets of a controlled foreign corporation). For a detailed discussion of the same-country dividends and interest exception, see KUNTZ & PERONI, *supra* note 24, at ¶ B3.05[2][k1].

113. If this suggestion were adopted, it would be possible to employ the PFIC 25 percent stock ownership look-through rule to test the assets of a foreign holding company. But what if there was a non-U.S. parent holding company with both a U.S. subsidiary and a non-U.S. subsidiary, and the U.S. subsidiary held just over 50 percent of the group's total assets? Could the United States rely on jurisdiction over the U.S. subsidiary to assert jurisdiction to tax the worldwide income of the rest of the group? Based on existing law, the answer is affirmative and it likely is possible to obtain the relevant information. See, e.g., I.R.C. § 6038A (2012). However, collection may have to rely on jurisdiction over the U.S. assets.



More broadly, we do agree with Professors Rosenzweig and Yin that it is possible, and in the right case appropriate, to de-emphasize theory and adopt an instrumental, anti-tax avoidance approach to defining corporate residence. Nevertheless, an entity-level test that is not based on shareholder residence and that is not effectively elective will always be over- and under-inclusive in relation to our preferred shareholder residence criterion. It will be over-inclusive to the extent that it taxes foreign income of a predominantly foreign-owned corporation. It will be under-inclusive to the extent it fails to tax foreign income of a corporation predominantly owned by U.S. persons.<sup>114</sup> In addition, entity-level classification based on U.S. location of assets and activities is substantially equivalent to adopting a de facto formulary exemption system. We have explained our objections to such a system in earlier work.<sup>115</sup>

In the end, we conclude that our shareholder-based residence test, supplemented with the existing place-of-incorporation test, provides the best approach.

#### *G. The Dual Residence Problem*

Our proposed use of multiple corporate residence definitions would, of course, increase the number of corporations that are treated as dual residents with respect to the U.S. international income taxation system. However, several other countries with large economies employ multiple corporate residency tests without encountering unmanageable difficulties.<sup>116</sup> The same would likely be true with respect to the United States. Thus, we do not see this concern as a significant barrier to adopting our multi-part approach to defining corporate residence.

### IV. CONCLUSION

With respect to taxable shareholders, an unintegrated tax on corporate earnings, set at a relatively high rate, is best justified as a crude tax on those shareholders that prevents them from gaming the differences between individual and corporate tax rates and blocks

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114. Professor Rosenzweig points out other over- and under-inclusive features of his test as well. Rosenzweig, *supra* note 2, at 479. In the text following *supra* note 109, we also have noted behavioral problems regarding Professor Rosenzweig's test.

115. See generally Fleming, Peroni & Shay, *Lipstick*, *supra* note 21 (discussing the problems with a formulary apportionment system).

116. See AULT & ARNOLD, *supra* note 11, at 434–36.

corporations from being used as egregious tax deferral devices. With respect to tax-exempt shareholders, the corporate tax carries out the congressional policy of applying one level of tax to the corporate equity investments of those shareholders. These points lead to the further conclusion that the definition of corporate residence that is employed in the U.S. income tax should be based on shareholder residence because shareholders are the ultimate targets of the corporate income tax.

We have argued that the best way to accomplish this end is to take a multi-part approach that first defines a corporation as a U.S. resident if it is incorporated in a U.S. jurisdiction. This is justifiable because the data shows that, on average, such corporations are predominately owned by U.S. residents. In addition, we have argued that a foreign-incorporated entity should be treated as a U.S. resident if on a *snapshot* date or dates, at least fifty percent of its shares, by vote or value, is owned by U.S. residents. We have also argued for bolstering this alternative definition of corporate residence with a rebuttable presumption that foreign-incorporated entities are U.S. residents if at least one class of their shares is regularly traded in one or more U.S. capital markets or is marketed to U.S. persons. This presumption derives from the insight that if a corporation markets its shares to U.S. investors, the shares are likely to be primarily held by U.S. residents—a conclusion that is supported by the well-recognized *home bias* of investors. A foreign corporation could, however, rebut this presumption by demonstrating that U.S. residents own less than fifty percent of both the vote and value of its shares.

This multi-part approach to defining corporate residence would remove the principal tax advantages of inversion transactions in which a U.S. corporation merges into a smaller foreign corporation. This is so because the surviving foreign corporation would be treated as a U.S. tax resident under our proposal. More importantly, our approach would bolster the case for real worldwide taxation by making corporate tax residence a largely non-elective matter.