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Is Incorporation Really Better Than Central Management and Control for Testing Corporate Residency? An Answer to Corporate Tax Evasion and Inversion

CHARLES EDWARD ANDREW LINCOLN IV*

INTRODUCTION

Central management and control is the best test for determining corporate residency because it is the test most likely to accurately reflect economic reality of a corporate entity.¹ The place where decisions are made that affect the core of the business, not where incorporation exists, *should* be the most important factor in the tax assessment process.² The two tests are the “incorporation test,” a legal test, and the “central management control test,” which is a substantive test.³ Many countries combine the two tests.⁴ An argument running through this essay is that the control and management test is more akin to economic reality.⁵

The determination of corporate residency is important, because the resident country can tax the company on its worldwide income—not just

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1. See Kara Baquizal, *The Challenges of Redefining Corporate Tax Residence in a Competitive Global Market*, 2012-SUM INSIDE BASIS 3, 9 (2012) (footnote omitted) (“‘The real business is carried on where the central management and control actually abides.’ In *De Beers Consolidated Mines Ltd. v. Howe*, Lord Loreburn articulated what is now the leading common law standard regarding corporate residence.”). In the European Union, the EU Merger Directive regulates issues pertaining to moving corporate residence and

[s]uch a transfer results in genuine economic integration in that Member State. Assuming that the head office is the ‘place of central management and control,’ such a transfer would also imply, under a tax treaty between the two Member States concerned, the transfer of tax residence. To borrow the terminology used by (the original EC Merger Directive and) the EU Merger Directive, it may be inferred that, in that situation, the transfer of the registered and head office of a national converting company (and, consequently, of the tax residence) would be motivated by ‘valid commercial reasons.’

Luca Cerioni, *Cross-Border Mobility of Companies in the European Union: Tax Competition and Increased Scope for the CCCTB Following Cartesio*, 64 BULL. INT’L. TAX’N. 636, 641 (2010).

2. See Baquizal, *supra* note 1, at 4-5.

3. See *id.*

4. See *id.*

5. See *infra* Part IV.

income within its borders.⁶ A jurisdiction with a particular tax system can become a magnet to attract income and business profits from other countries, unless a company is a permanent establishment in the other countries or subject to source state taxation, such as dividends or interests.⁷ The test for residency can be determined by the incorporation test or the central management and control test (or a derivative thereof).⁸

Having these various tests can lead to abuse, such as a jurisdiction that has only adopted the incorporation test and then has a 0% or low tax—this structure can draw worldwide income to a low tax jurisdiction.⁹ This would be considered abuse.¹⁰ These scenarios have prompted the enactment of anti-abuse rules.¹¹

I. BACKGROUND OF CENTRAL MANAGEMENT AND CONTROL FOR CORPORATE TAXATION

A. Basis of Corporate Taxation

In *Brushaber v. Union Pac. R.R. Co.*,¹² the Supreme Court of the United States held that, in relation to the Sixteenth Amendment of the United States Constitution, the “whole purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived.”¹³ Further, the Supreme Court of the United States gave additional insight into *Brushaber* in 1988 in *South Carolina v. Baker*¹⁴ when it stated the following in one of the footnotes:

The legislative history merely shows that the words “from whatever source derived” of the Sixteenth Amendment were not affirmatively intended to authorize Congress to tax state bond interest or to have any other effect on which incomes were subject to federal taxation, and that the sole purpose of the Sixteenth Amendment was to remove the apportionment requirement for whichever incomes were otherwise taxable.¹⁵

6. See Baquizal, *supra* note 1, at 3.

7. See *id.* at 5.

8. See *id.* at 4-5.

9. See *id.*

10. See *id.* at 7.

11. See Baquizal, *supra* note 1, at 12.

12. 240 U.S. 1 (1916).

13. *Brushaber*, 240 U.S. at 18 (In other words, the destination and disposition of profits and capital interests, the location of equity beneficiaries ought to be the most important factor in tax assessment process).

14. 485 U.S. 505 (1988).

15. *Baker*, 485 U.S. at 522 n.13.

It should be noted that the central management and control test, as laid out in *De Beers* (discussed below), is not directly related to the test used in the U.S. Tax Code.¹⁶ However, the 1853 British Income Tax Act (which appeared several decades prior to the enactment of the Sixteenth Amendment) taxed residents of the United Kingdom and the greater Empire, specifically South Africa,¹⁷ based on the source of the income and the residency of the income.¹⁸

B. *De Beers Case*

In *De Beers Consol. Mines, Ltd. v. Howe*,¹⁹ the King's Bench Division described De Beers Co. in the following manner:

[De Beers Co.] was incorporated and registered in South Africa. The office denominated its head office was in Kimberley in the Cape Colony, and it had an office in London. It owned extensive diamond mines in South Africa. The essential part of its business was the sale of the diamonds from its mines to a syndicate of diamond merchants of London under such conditions as to control the diamond trade of the world.²⁰

On the appeal from the King's Bench decision in *De Beers*, the House of Lords decided that the test for residency of a corporation would be "central management and control" of the business.²¹ The losing party, De Beers Co., argued that the company should be considered a resident where it is incorporated, but the court rejected the incorporation test.²² Perhaps the main factors that tipped the scale towards determining that De Beers Co. had residency in the UK were that the meetings in terms of the business's contracts were all in England, the London office controlled the negotiation and signing of contracts, and all majority vote matters were taken care of in London.²³

16. See *De Beers Consolidated Mines Ltd. v. Howe*, [1906] AC 455, 458 (HL) (appeal taken from Eng.); see also I.R.C. § 882 (West 2014).

17. See *De Beers Consolidated Mines Ltd. v. Howe*, [1905] 2 KB 612, 627 (appeal taken from Eng.) ("[T]his company does not exercise any trade within the United Kingdom. Its only source of profit in this kingdom is derived from entering into a contract once a year with a syndicate of diamond merchants in London.")

18. See *De Beers*, [1906] AC at 455, at 457-58 (HL) (describing Schedule D of the second section of the Income Tax Act of 1853); see also U.S. CONST. amend. XVI. The Sixteenth Amendment to the U.S. Constitution was enacted in 1913. *Id.*

19. *De Beers*, [1905] 2 KB at 612.

20. *Id.*

21. See ROBERT COUZIN, CORPORATE RESIDENCE AND INTERNATIONAL TAXATION 47 (2002).

22. See *De Beers*, [1906] AC 455, 458 (HL).

23. See COUZIN, *supra* note 21, at 46-47.

C. Reasoning in the *De Beers* Case

The reason the *De Beers* decision makes sense is because of the “economic substance” of the business and where the income was actually coming from.²⁴ Where agents make payments, negotiate contracts, and perform other acts of a similar nature is where business is occurring, not necessarily where it is sourced or mined from originally.²⁵ This is the essential message of the *Brushaber* holding²⁶—from the standpoint of the income tax, the origin of money is irrelevant compared to its ultimate destination or distribution, setting aside for the moment questions of money laundering and the possible criminal sources of income.²⁷

The House of Lords’ *De Beers* opinion does not make this explicit, but *De Beers* Co. was set up by English investors—under the direction of Cecil

24. When determining what exactly economic substance is, the U.S. Tax Court has stated:

Under the economic substance doctrine, a court may disregard a transaction for Federal income tax purposes if it finds that the taxpayer did not enter into the transaction for a valid business purpose but rather sought to claim tax benefits not contemplated by a reasonable application of the language and purpose of the Code or its regulations. The origins of the economic substance doctrine can be traced back to the Supreme Court’s decision in *Gregory v. Helvering*, 293 U.S. 465 (1935). In *Gregory*, the Court held that a reorganization complying with formal statutory requirements should be disregarded for tax purposes because the taxpayer’s creation and immediate liquidation of a corporation was an impermissible attempt to convert ordinary income into capital gain. The Court recognized the taxpayer’s right to minimize taxes through legal means but stated that ‘the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.’ The Supreme Court concluded that ‘The whole undertaking, though conducted according to the terms of [the statute], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else.’

Palm Canyon X Investments, LLC v. C.I.R., 98 T.C.M. (CCH) 574, 587(2009) (citations omitted).

25. In discussing what an agent is in the United States, the U.S. Tax Court has stated:

[A]n agent shall be considered regularly to exercise authority to negotiate and conclude contracts or regularly to fill orders on behalf of his foreign principal only if the authority is exercised, or the orders are filled, with some frequency over a continuous period of time. This determination shall be made on the basis of the facts and circumstances in each case, taking into account the nature of the business of the principal; but, in all cases, the frequency and continuity tests are to be applied conjunctively. Regularity shall not be evidenced by occasional or incidental activity. An agent shall not be considered regularly to negotiate and conclude contracts on behalf of its foreign principal if the agent’s authority to negotiate and conclude contracts is limited only to unusual cases or such authority must be separately secured by the agent from his principal with respect to each transaction effected.

See InverWorld, Inc. v. C.I.R., 71 T.C.M. (CCH) 3231, 3237-22 (1996).

26. *See Brushaber*, 240 U.S. at 18-19. Of course, the *Brushaber* case was decided almost a decade after *De Beers* was finally decided by the House of Lords. *Brushaber*, 240 U.S. at 1; *De Beers*, [1906] AC 455, 455 (HL).

27. *See Brushaber*, 240 U.S. at 18-19.

Rhodes, an Englishman²⁸—using English money to profit (at least primarily) English investors.²⁹ This is why the directors in London effectively had the last word on all significant corporate decisions.³⁰ If the governors and directors were really operating primarily in South Africa, De Beers Co.'s London directors should have effectively been subordinate to the Cape Town—or Kimberley—directors.³¹

The court could have probably asked various questions in relation to De Beers Co.'s business.³² Expenditures in South Africa most likely did not

28. Lucinda Saunders, *Rich and Rare Are the Gems They War: Holding De Beers Accountable for Trading Conflict Diamonds*, 24 *FORDHAM INT'L L.J.* 1402, 1407 n.20 (2000) (citations omitted); TOBIAS KRETSCHMER, *DE BEERS AND BEYOND: THE HISTORY OF THE INTERNATIONAL DIAMOND CARTEL I* (1998), <http://pages.stern.nyu.edu/~lcabral/teaching/debeers3.pdf>.

29. Saunders, *supra* note 28, at 1407-08; see KRETSCHMER, *supra* note 28, at 1.

30. This was also the case in the final House of Lords decision. *De Beers*, [1905] 2 KB at 614-16.

31. Control of the company was divided between "life governors" and "ordinary directors" and was managed through by-laws, which stated:

(1.) That the course of business respecting technical management of the company's work and operations at its mines, expenditure for wages, and such like, should be determined upon by the directors in Kimberley, who should however consult the directors in London on matters of exceptional importance: (2.) All other expenditure exceeding 25,000*l.* was to be determined upon by the majority of all the directors; but the directors in Kimberley with the sanction of the chairman might under special circumstances incur expenditure not exceeding at one time 50,000*l.* in addition. No further expenditure could be incurred unless the authority of the Kimberley directors was confirmed by the majority of all the directors: (3.) The policy of the board respecting the disposal of diamonds and other assets, the working or development of the mines and the output of diamonds, application of profits, and appointment of directors was to be determined by the majority of all the directors: (5.) Matters to be determined by the majority of all the directors were to be determined by resolution to be submitted to meetings of directors in Kimberley and London, and the decision was to be in accordance with the vote of the majority thus ascertained: (6.) Except as before provided the directors in Kimberley and the directors in London were to have equal and concurrent authority. The majority of the directors was always in London. Matters referred to in by-law 3 were always dealt with in London, and in all important matters under by-law 5 the majority voting had always been in London. No case had ever occurred where the directors in Kimberley had overruled the decision of the directors in London. Under powers conferred upon the directors generally, the directors in London had appointed four committees to control various departments of the company's business and report to them.

De Beers, [1905] 2 KB at 612-13. This being one of the potential alternate facts that could have could have changed the court's decision. *De Beers*, [1905] 2 KB at 623, 625.

32. Relevant questions could have included: Where does the weight of corporate wealth come to its (more-or-less final) resting place each year? Where are most of the warehousing activities, storage, and final dispositions of cash dividends (or capital, stock distributions) at the end of each year? Banking records could be compelled in any audit or review, and the law could compel disgorgement of improperly paid dividends (or distributions of any kind) if the money could be found, so the residences of the equity owners of stock may be more important than the directors. However, in the early twentieth century, as in later times, it can be assumed that these are, for the most part, overlapping categories—all managing directors are likely to be shareholders, they are normally elected by shareholders, and certainly their interests are closely aligned by principles of fiduciary duty with all of their shareholders. *De Beers*, [1905] 2 KB at 625-27.

show what the source of the wealth of the De Beers Co. mines was.³³ Incorporation in South Africa may have been a management convenience in an effort to make expenditures more efficient, given that most—if not all—of the mining activity was in South Africa, but it had nothing to do with the destiny of the diamonds extracted from the mines.³⁴

D. Elements of Central Management and Control and De Beers's Posterity

The *De Beers* rule for residency of a corporation was upheld almost half a century later in *Unit Construction Co. v. Bullock*,³⁵ which continued to apply the central control and management test.³⁶ However, the case further noted that this test for residency can be broken up into two elements: management and control.³⁷

Given this, Robert Couzin lays out three indicators for determining central management and control:

1. Strategic management – e.g. what a supervisory board does in a two-tier board system as in certain continental legal systems. Under UK law, strategic management is entrusted to the board of directors.
2. Actual or effective management, which is the implementation of strategic management – e.g. what a management board does in a two-tier board system. In the United Kingdom, this management is exercised by the highest-ranking corporate executives.
3. Junior and shop floor management – the immediate supervision of day-to-day operations.³⁸

The *De Beers* case was essentially the rule for corporate residency in *commonwealth* countries until 1988.³⁹ In 1988, the United Kingdom also added incorporation as a test for taxation in addition to the *De Beers* rule.⁴⁰

33. *Id.* at 625.

34. *Id.* at 612.

35. [1960] AC 351 (HL) (appeal taken from Eng.).

36. "If the *De Beers* case applies in such cases, it should apply here." *Unit Construction Co.*, [1960] AC 351, at 357 (HL) (footnote omitted).

37. *Id.* at 356.

38. COUZIN, *supra* note 21, at 58.

39. HUGH J. AULT ET AL., *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 435 (3d ed. 2010).

40. Corporation Tax Act 2009, c. 3, §§ 14-15 (Eng.).

II. THE OECD TEST FOR RESIDENCY

In the OECD Model Convention, Article 4(1) states that that a resident is a person (or entity) who is liable⁴¹ to taxation through the domestic laws of that country.⁴² In terms of residency for an individual, Article 4(2) states that if the domestic laws cannot lead to a conclusion, then a four-step analysis will commence.⁴³ The analysis starts where the permanent home is and then where personal and economic relations are closer (center of vital interests). It next looks to where the habitual abode is, and then the state in which the person is a national. If the question is still unsettled, the states will resolve the determination by mutual agreement.⁴⁴

III. COUNTER ARGUMENT TO CENTRAL MANAGEMENT AND CONTROL VIA STEF VAN WEEGHEL'S INCORPORATION TEST ARGUMENT FOR CORPORATE RESIDENCY

In a sense, central control and management is similar to effective management.⁴⁵ Indeed, the words seem to have similar connotations. For example, The Netherlands “gives great weight to the place of effective

41. The word “liable” is separate from the definition of subject to tax.

The primary definition of ‘liable’ in the Oxford English Dictionary (OED), derived from legal usage, refers to the circumstance in which a person is bound or obliged by law or equity, is ‘legally subject or amenable to’. One of the examples in the OED definition refers to categories of goods that are ‘liable to duties’. That would suggest a meaning more in the nature of actual than potential liability. The OED also, however, defines ‘liable’ as ‘exposed or subject to, or likely to suffer from (something prejudicial)’. Examples of the latter usage include expressions such as ‘liable to disturbance’ or, perhaps closer to the context of taxation, ‘lyable [sic] for all wilde [sic] beasts to come in and to devour her’.

COUZIN, *supra* note 21, at 106-07.

42. Org. for Econ. Co-operation & Dev. [OECD], *Model Tax Convention with Respect to Taxes on Income and on Capital: Condensed Version*, art. 4, para. 1 (2014).

43. *Id.*

44. *Id.*

45. Effective management and control is similar but can be different from central management and control:

There is a measure of similarity, notionally, between the place where ‘central management and control’ of a corporation is exercised and its ‘place of effective management’, although the two notions are not necessarily the same. The former is commonly seen to focus more directly, and possibly even exclusively, on legal governance considerations, while latter is seen to comport with a more operational test. In fact, however, taking account of the genesis of the central-management-and-control test and, particularly, the English corporate law context in which it which it [sic] developed, the two notions are probably more proximate, and more focused on business operations contrasted with corporate law procedure, than may be generally acknowledged.

management—that is, where the day-to-day management takes place.⁴⁶ This can take various shapes and forms, which are completely similar to central management and control: where the business directors and head office are located, etc.⁴⁷ The OECD Commentary on Article 4, Paragraph 3, Commentary at Paragraph 4 (known as the tie breaker rule) also says that the “place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made.”⁴⁸

At this point there seems to be a two-tiered analysis of management in common law countries: the decision level and the management level.⁴⁹ As a counter-argument to “central control and management”—but more specifically to effective management—Stef van Weeghel argues that:

there is an increasing tendency to omit the tie-breaker provision from the treaty and to leave the solution of cases of dual residence to the mutual agreement procedure. Both tendencies underscore the need to rethink the place of effective management as a useful criterion. A formal criterion, such as incorporation, while rejected by the Commentary, could be the answer⁵⁰

Van Weeghel presents three problems with the effective management test.⁵¹ First, there could be a “top holding company with an international board.”⁵² This international board would be composed of a diverse combination of nationals and foreign residents, whereby it would be difficult to determine where the effective management actually is.⁵³ Second, van Weeghel argues that a centrally managed multinational company may have difficulty ascertaining which country subsidiaries have central effective management.⁵⁴ Van Weeghel states that the challenge is “whether the operating subsidiaries have their effective management in the country of their stated residence or in fact all have their residence in the country of the parent company.”⁵⁵

46. AULT ET AL., *supra* note 39, at 436.

47. *Id.*

48. Org. for Econ. Co-operation and Dev., *Commentaries on the Articles of the Model Tax Convention: Condensed Version*, art. 4, para. 24 (2010).

49. COUZIN, *supra* note 21, at 58.

50. Here, the place of incorporation can be seen as a counter argument to central management and control. Stef van Weeghel, *Chapter 10 Article 4(3) of the OECD Model Convention: An Inconvenient Truth*, in 5 *RESIDENCE OF COMPANIES UNDER TAX TREATIES AND EC LAW 307* (Guglielmo Maisto ed., 2009).

51. *Id.* at 305.

52. *Id.*

53. *Id.*

54. *Id.*

55. van Weeghel, *supra* note 50, at 305.

Third, van Weeghel states that the OECD has not resolved problems with holding companies and similar entities that may act as artificial companies where no actual effective control exists, but it is there as more of a formality.⁵⁶ In this case, actual effective control would be through the parent company.⁵⁷ Overall, the greatest advantage of incorporation as a test for residence is that it promotes predictability; the residency will always be known.⁵⁸ The United States uses this approach when corporate residency is used for determining taxation.⁵⁹

IV. COUNTERARGUMENT, SUPPORTING EFFECTIVE MANAGEMENT AND CONTROL, IN RESPONSE TO VAN WEEGHEL'S COUNTERARGUMENT, SUPPORTING THE INCORPORATION TEST FOR RESIDENCY

A counterargument to van Weeghel's arguments is that incorporation as the sole test for residency can sometimes be abused.⁶⁰ Even in the *De Beers* case itself, the court observed that a company may "escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad."⁶¹ One of the main reasons the analysis of *De Beers* makes sense is because the place of incorporation is not always where profits are earned or where decisions are made.⁶² It could merely be a piece of paper in a registry.⁶³ Van Weeghel's first two points concerning the diversity of the board and the "actual" management of multinationals can be classified into a single criterion of promoting efficiency.⁶⁴ Indeed, using the place of incorporation as the only test for residency provides the most efficient results.⁶⁵

56. *Id.*

57. *Id.*

58. "Place of incorporation as the test for residence-based corporate taxation presents some advantages, notably predictability." COUZIN, *supra* note 21, at 260.

59. "The United States currently uses a legal status test alone for entities, sometimes known as the place of incorporation rule." Adam H. Rosenzweig, *Source as a Solution to Residence*, 17 FLA. TAX REV. 471, 480 (2015). "Under existing U.S. income tax and corporate law, being a U.S. company generally means having incorporated in one of the fifty states (or the District of Columbia)." Daniel Shaviro, *The David R. Tillinghast Lecture: The Rising Tax-Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 397 (2010).

60. See *De Beers*, [1906] AC 455, at 458 (HL).

61. *Id.*; see COUZIN, *supra* note 21, at 260.

62. See *De Beers*, [1906] AC 455, at 458 (HL).

63. "Thus, at the turn of the twentieth century, the assumption of identity between the place of incorporation, source of income, and the residency of shareholders or managers seemed not at all obvious." Omri Marian, *The Function of Corporate Tax-Residence in Territorial Systems*, 18 CHAP. L. REV. 157, 172 (2014).

64. See van Weeghel, *supra* note 50, at 305.

65. See Omri Marian, *Jurisdiction to Tax Corporations*, 54 B.C. L. REV. 1613, 1620 (2013) [hereinafter Marian, *Jurisdiction to Tax Corporations*].

However, “if one accepts that the purpose of corporate taxation is to impose tax burdens on corporate shareholders,”⁶⁶ then shareholders—through directors—can retain profits without ever having to distribute the profits.⁶⁷ In response to this corporate retention of profits, a jurisdiction could enact laws to tax retained profits.⁶⁸ However, this is different from the place of incorporation tax; it is really effective management (or central management and control), which is what was argued previously.⁶⁹ Although efficiency would be the main goal, it is not necessarily the proper means of collecting revenue, because corporate directors could easily move around that goal.⁷⁰ Alternatively, if the goal is to avoid taxation, the shareholders—through the directors—could just incorporate in a new jurisdiction.⁷¹

A counterargument to van Weeghel’s third point indicates that proper anti-abuse rules would need to be put in place to counter-act artificial arrangements through GAARs or SAARs.⁷² Contrary to van Weeghel’s

66. *Id.* at 1623.

67. Consider the following explanation:

Assume that Jurisdiction C (“C”) does not impose corporate income tax, but does impose income tax on individuals. To avoid individual income taxes, residents of C regularly operate their businesses through closely held corporations. Instead of distributing the profits earned by their corporations—which would result in the imposition of individual income tax—C’s residents retain their profits at the corporate level, where they remain untaxed.

Id. at 1623-24.

68. *Id.* at 1624.

69. *Id.* at 1621, 1625.

70. Marian noted that:

This result makes C’s corporate tax-residence test meaningless, specifically because it is based on the normative justification of efficiency, and particularly because efficiency is achieved. By adopting the most efficient model, C avoided behavioral distortions, but completely defeated the purposes for which C enacted corporate tax in the first place. C’s residents can still avoid tax on retained profits.

Marian, *Jurisdiction to Tax Corporations*, *supra* note 65, at 1624.

71. See *id.* at 1629 & n.63; *Episode 390: We Set up an Offshore Company in a Tax Haven*, NPR (July 27, 2012, 6:04 PM), <http://www.npr.org/blogs/money/2012/07/27/157499893/episode-39ft-we-set-up-an-offshore-company-in-a-tax-haven> (illustrating the ease in which one could set up offshore companies by describing how simple it was for NPR staff to call to set up wholly owned corporations in tax havens).

72. See van Weeghel, *supra* note 50, at 305. As a general definition, “[A]n anti-abuse rule is a rule designed to prevent a taxpayer from achieving a result which is inconsistent with a dominant policy of the law by altering the tax consequences which would otherwise have flowed from a transaction, to others more consistent with that policy.” Frank V. Battle, Jr., *The Appropriateness of Anti-Abuse Rules in the U.S. Income Tax Systems*, 48 TAX LAW. 801, 802 (1995); see Jose Manuel Calderón, *The Spanish Transfer Pricing Regime and the OECD/G20 Base Erosion and Profit Shifting Project*, 70 BULL. INT’L. TAX’N 430, 430 (2016) (“[T]he application of the general anti-abuse rules (GAAR), *fraus legis* (abuse of law), anti-sham transactions and recharacterization provisions, as well as the inversion of the burden of proof with regard to the reality and economic rationality of any structure were the primary mechanisms

promotion of incorporation as the best and most efficient test for corporate residency, anti-avoidance rules can frequently “deter legitimate business transactions.”⁷³ Often, anti-avoidance rules do not even stop artificial arrangements from occurring.⁷⁴

V. GENERAL REMARK ON THE GENERAL PROBLEMS WITH INCORPORATION AND CORPORATE INVERSIONS

Corporate inversion is generally only possible with an incorporation test, such as the one used in the United States.⁷⁵ It has also been found to be more difficult to conduct a corporate inversion with the management and control test.⁷⁶ Van Weeghel’s third point for setting up anti-abuse rules

for the tax regularization and the reassessment of inbound transactions.”); Genevieve Loutinsky, *Gladwellian Taxation: Detering Tax Abuse Through General Anti-Avoidance Rules*, 12 HOUS. BUS. & TAX L. J. 82, 85 (2012) (footnotes omitted) (“SAARs are targeted at narrow, ‘specific areas where abuse has been previously identified or revenue leakage is suspected. Often, SAARs are tied to or inserted into a specific section of a nation’s revenue code. However, SAAR’s weakness is its specificity. Additionally, the SAAR is further abated by the fact that it is easily avoided and incorporated into new avoidance activities. In contrast, GAAR’s strength is its applicability to particular sections or even the entire revenue code. Its broad language has resulted in its labeling as essentially the ‘carpet bomb’ to a SAAR’s ‘smart bomb.’”).

73. “The principal argument against anti-abuse rules is that they will deter legitimate business transactions.” Battle, *supra* note 72, at 806.

74. As illustrated by the following example, anti-avoidance rules can often be circumvented through complicated tax codes and tax planning techniques:

Consider another example. Corporation *C* has a large built-in loss in its operating assets. It transfers all of its assets to a partnership—the other assets of which consist of traded securities. Now assume that *C* sells its partnership interest to either one of the other partners or to a third party. No section 754 election is made. Do the remaining partners obtain the benefit of the built-in loss in the assets received from *C*, even though they could not have realized those benefits had they purchased the stock of *C*? Simply applying the mechanical rules of Subchapter K produces the duplicated loss. Example 10 of the anti-abuse regulations seems close to this case. However, the facts of example 10 suggest a contrived transaction—something different from what appears on the surface. Family members form the partnership, and there is at least a suggestion that changes in values of property over time will not be taken into account by the parties in allocating income and loss. Will this example stop transactions such as that posed here? One wonders.

Id. (footnotes omitted).

75. See Douglas Chiu, Note, *Inversion Subversion: Corporate Inversions and the New Federal Laws Against Them*, 20 FORDHAM J. CORP. & FIN. L. 717, 730-31 (2015). The definition of corporate inversion is as follows: “Corporate inversions are the act of American corporations legally redomiciling [sic] to a foreign jurisdiction to lessen their corporate tax burden. While the practice has waxed and waned over the past decades, inversions were on the upswing in 2014, with several of America’s leading corporations at various stages of inverting.” *Id.* at 717.

76. See *id.* at 725. New acts proposed by Congress show that a form of the management and control test are key to ending corporate inversions by changing the

[T]hreshold for surrogate foreign corporations [which] would lower the threshold of stock ownership by legacy shareholders from 60 percent to 50 percent. Further, the Act would lower the general threshold of I.R.C. § 7874(b) from eighty percent to sixty percent. The Act also includes limitations on American management and control of the new foreign

would presumably be a counter argument against the problems that have been created with corporate inversions.⁷⁷ However, the United States has spent years trying to develop anti-abuse rules for corporate inversions while corporations have continued to find ways around these rules.⁷⁸ One such rule is the controlled foreign legislation rule with an 80% rule for determining whether the foreign incorporated company will be recognized as a United States company.⁷⁹ If such a company has conducted a corporate inversion and meets the controlled foreign company status, it will be taxed in the United States as a resident of the country and as a domestic corporation.⁸⁰ In addition, there is a 60% test of stock ownership for determining whether the corporation can claim tax benefits in the United States for at least ten years.⁸¹

Under I.R.C. Section 7874,⁸² there are two types of corporate inversions (the 60% and 80% inversions), but there are also three criteria to examine

corporation if, 'the management and control of the expanded affiliated group . . . occurs, directly or indirectly, primarily within the United States, and such expanded affiliated group has significant domestic business activities,' then the foreign corporation would be considered an inverted domestic corporation.

Id. at 732 (alteration in original) (footnotes omitted).

77. See generally van Weeghel, *supra* note 50.

78. See Chiu, *supra* note 75, at 721. Indeed, there is an extensive legislative history and push to end corporate loopholes for avoiding taxation. See generally *id.* "Historically, both expatriated corporations and the federal government have played a cat-and-mouse game in which the government passes legislation intended to respond to and suppress each corporate inversion. In response, corporations have developed different forms of inversions to get through loopholes in the law." *Id.* at 726.

79. See *id.* at 733, 736. The rules for foreign controlled corporations are summarized as follows:

Even if the nullification argument applied on these facts, it would fail nonetheless. There are several provisions in the Code that test control using vote and value thresholds of 50% or 80%. If a stockholder's election of an independent director was not attributed to its voting power, then corporations could structure their boards so that the voting thresholds would never be reached, as in the proposed scenario in *Hermes Consol.*, and the parties would have to rely solely on the value test. Thus, the voting power test could be easily manipulated and rendered unnecessary. In addition, the requirement for an independent director is ubiquitous. All stock exchanges require independent directors as members of the board and the audit committee. Therefore, all publicly traded companies would be subject to control tests that discounted votes for independent directors, thereby distorting voting power percentage.

Fish v. C.I.R., 106 T.C.M. (CCH) 608, 614 n.27 (2013).

80. See Chiu, *supra* note 75, at 728. "In an 80% inversion, the transferee foreign corporation is treated as a domestic corporation for all purposes of the Code and for all U.S. treaty obligations." D. Kevin Dolan et al., *What's Wrong with the New Anti-Inversion Rules?*, 16 J. INT'L TAX'N 52, 60 (2005).

81. See Chiu, *supra* note 75, at 728. "With regard to an expatriated entity involved in a 60% inversion, for the ten years following the final acquisition of properties for purposes of the Acquisition Test, the entity cannot use any tax attributes (e.g., deductions, losses, or credits) to offset any inversion gain." Dolan et al., *supra* note 80, at 61.

82. I.R.C. § 7874 (Westlaw through Pub. L. No. 114-329). The rules are relating to expatriated entities and their foreign parents. See generally *id.*

when determining corporate inversions: the Acquisition Test, Stock Ownership Test, and Business Activities Test.⁸³ The Acquisition Test criterion determines whether “a foreign corporation (‘transferee foreign corporation’) must make a direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation.”⁸⁴ The Stock Ownership Test criterion determines that “[a]fter the transferee foreign corporation’s acquisition, former shareholders of the domestic corporation must own at least 60% (or 80%) of the aggregate vote or value in the transferee foreign corporation’s stock.”⁸⁵ Moreover, the “former shareholders must have acquired their interests in the transferee foreign corporation ‘by reason of holding stock in the domestic corporation.’”⁸⁶

The last criterion, the Business Activities Test, states “that after the transferee foreign corporation’s acquisition, the expanded affiliated group (discussed above) that includes the transferee foreign corporation must not have ‘substantial business activities’ in the jurisdiction in which the transferee foreign corporation is created or organized as compared with the expanded affiliated group’s worldwide business activities.”⁸⁷ The three tests are used to determine whether any transaction has conducted a corporate inversion.⁸⁸

Overall, the corporate inversion matrix has proven to be complicated, because it is a less effective method as a matter of policy to end the problems with corporate inversions.⁸⁹ If the policy is to avoid corporate inversion and to avoid tax evasion, then the United States—and other

83. I.R.C. §§ 7874(a)(2)(B)(ii)(I)-(II) (Westlaw through Pub. L. No. 114-329); I.R.C. § 7874(a)(2)(B)(iii) (Westlaw through Pub. L. No. 114-329).

84. Dolan et al., *supra* note 80, at 54.

The ‘direct or indirect’ acquisition language clearly contemplates the acquisition of either the stock or assets of a domestic corporation. In addition, the ‘indirect’ language would appear broad enough to apply to a triangular reorganization in which a domestic acquiring corporation acquires the stock or assets of a domestic target in exchange for the stock of a foreign corporation that controls the domestic acquiror.

Id.

85. *Id.* at 55. “The provision looks to all ‘former shareholders’ in the domestic corporation regardless of whether they are domestic or foreign persons.” *Id.*

86. *Id.*

87. Dolan et al., *supra* note 80, at 58-59; *see also* I.R.C. § 7874. In summing up the two tests for eighty percent and sixty percent, Dolan writes, “There are 80% percent inversions and 60% percent inversions, with the percentages measuring continuity of shareholder interest. The three criteria are the ‘Acquisition Test,’ ‘Stock Ownership Test,’ and ‘Business Activities Test.’ The three tests are applied taking into account any plan or series of related transactions.” Dolan et al., *supra* note 80, at 54.

88. *Id.* at 54.

89. *Id.* at 61 (“Whatever the policy merits of curbing inversion transactions, the legislation is a poor tool in carrying out that policy.”).

countries using solely the incorporation method as a test for residency—should adopt the central management and control test.⁹⁰

VI. GENERAL PROBLEMS WITH INCORPORATION AND EFFECTIVE MANAGEMENT

With both types of tests, tax planning can yield a variation in where the tax is being assessed.⁹¹ Such a scenario includes treaty shopping and setting up conduit companies such as those in The Netherlands.⁹² However, the United States and other countries can set up limitations of benefits (L.O.B.) clauses to combat the abuse of conduits in places such as The Netherlands, which has low withholding tax rates.⁹³ In response to this, a corporation could adopt a business structure that would utilize banks that are well-established in countries—such as The Netherlands—leaving the U.S. and other countries to examine where the beneficial owners are operating and if they are really of the original country.⁹⁴

CONCLUSION

Overall, *De Beers's* central management and control seems to provide the best formulation as a single test to determine corporate residency.⁹⁵ However, from a policy point of view, in terms of raising revenue, a study should be conducted examining separate jurisdictions that apply different approaches. This would allow countries to see which ones are the most efficient, and which ones collect the most revenue. Depending on the government's policy, a jurisdiction could use this statistical data to examine which method is the most beneficial.

If raising the most amount of revenue is possible, then the standard that generates the most would be ideal. However, if the most efficient method is favored, the one that is determined to be most efficient should control. Yet this would fall into a greater matrix, because the jurisdictions may have other tax rules or an economic infrastructure that make a jurisdiction favorable for investments or like transactions. Ultimately, there can be other complications and factors to consider, such as whether to use a territorial system such as that of France for corporations.⁹⁶

90. See Marian, *Jurisdiction to Tax Corporations*, *supra* note 65, at 1643.

91. See generally Baquizal, *supra* note 1.

92. See *id.* at 15.

93. See *id.* at 14-15.

94. See generally *id.*

95. See *id.* at 14.

96. See AULT ET AL., *supra* note 39, at 436.