CHAPTER 7

Residence-Based Taxation: A History and Current Issues

Kiyoshi Nakayama and Victoria Perry

INTRODUCTION

As discussed in previous chapters, source-based taxation faces many difficulties: it is increasingly difficult—conceptually and practically—to allocate profits to where they originate (see Chapter 5). Multinational enterprises can take advantage of such ambiguities by shifting reported profits to jurisdictions with lower tax rates. Countries then face an incentive to compete for tax bases—both reported profits and real investment (see Chapter 6). This chapter turns to residence-based taxation—the other important historical concept for corporate income taxation—to assess the difficulties that have been encountered in its implementation.

While no country relies purely on residence-based taxation, it is still instructive to think through the impact of using a pure residence-based system of corporate taxation, rather than a source-based one. Such a shift in approach would transform the problems encountered by source taxation into different ones:

• **Definition:** Once a firm’s residence is determined, all problems of allocating profits to where they originate should disappear. However, determining a firm’s residence is difficult, too, and can be based on various criteria, such as ownership, place of management, and main location of production, each of which could give contradictory results.

• **Tax competition and tax avoidance:** Under residence-based taxation, firms would not face incentives to shift profits and countries would not be able to use the tax system to attract real investment from existing firms. Instead, firms would have an incentive to change their place of residence, while countries would try to attract corporate headquarters.

• **Double taxation risks:** Unless taxation is limited to the country of the corporate headquarters, a company could still face double taxation risks, as a subsidiary could be considered a resident both in the country of its own incorporation and of its corporate headquarters. Apart from creating the potential for double taxation, such a scenario reintroduces the need for using transfer prices to determine the profits of the subsidiary so that it can be taxed in the country where it is located.
Hence, even a pure residence-based system would still face major challenges. In practice, however, such a system does not exist; most systems have elements of both. It is therefore important to understand the practical effects of the interactions between the two systems. When both systems apply, corporations can still take advantage of low source-based taxation by moving activities or reported profits, but the benefits of investing in countries with lower tax rates are reduced by the additional payment liability at home under the residence base. These benefits are not eliminated, though, because residence-based taxes are often easy to reduce or avoid altogether, notably as in practice they typically apply to repatriated earnings only.

This chapter first looks at the history of residence-based taxation and at some data showing where it is most relevant today. It then turns to some of the difficulties encountered with residence-based taxation, such as avoidance through deferral and manipulation of the place of residence. Finally, it examines the need for and evolution of complicated anti-avoidance rules.

**HISTORICAL BACKGROUND AND CURRENT CONTEXT**

**History**

In the early twentieth century, residence of a corporation was more easily determined than it is now. The classic multinational corporation had a national identity—through a fixed and easily identified headquarters location that generally coincided with the residence of most shareholders—and that generally was the country where the entity was formed or incorporated. These factors are largely gone now. Despite the convenient legal fiction of their existence, corporations are not human beings who are born in a country, sleep in a generally identifiable place, and hold passports. As noted in Chapter 3, most of the criteria that might logically be used to determine corporate residence tend to point in different directions now. In the inimitable words of one author, “There’s a reason we call them multi-nationals” (Graetz 2001).

As discussed in Chapter 3, a corporation’s income might be imposed by the country where the corporation is resident or by the country “where the income is generated”—that is, at the “source.” Or some combination of the two could be used. In terms of national laws, nothing would prevent a country from laying claim to tax income on either or both of these bases. But striking a compromise between residence-based taxation and source-based taxation has been a principle

---

1 A third (at least) possibility would be for countries to impose taxes at the location where the corporation’s output is used or sold; this has never been done for corporate income tax, although it is common practice for consumption-type taxes (for example, VATs), but the implications of that possibility are now under active debate, as discussed in Chapter 13. Moreover, there are other possibilities—mentioned in Chapter 12—such as identifying the corporation with the residence of its ultimate owners—which have also never been used.
of prevention of double taxation since the development of the League of Nations Model Tax Convention.2

The long-standing internationally agreed architecture of the corporate tax system, beginning in the early twentieth century, assigned the primary right to tax business income to the source country, but overlay that with the notion that passive income—in the form of interest payments, dividends, and the like—would be taxable by the country of residence of the recipient corporation. This was to be laid out in bilateral treaties between individual countries. At the time it was believed that this approach to taxing active and passive income would be easier to identify and enforce.

The source country of payment of passive income, nonetheless, typically imposes a withholding tax on such payments made to recipients abroad. There are then two basic mechanisms to effectuate the avoidance of double taxation and to allocate the tax base between the source country and the country of residence of the company.3 First, most countries unilaterally provide in domestic law for the grant of a tax credit against tax paid to the source country by resident corporations on income that has been taxed by the source country. These credits are often country specific and nonrefundable; thus if the source tax exceeds the residence-based tax, there is no refund.4 Second, the elaborate network of bilateral treaties typically also provides for such tax credits, but at the same time stipulates that the source country will reduce its withholding taxes on interest and dividends paid to recipients resident in the treaty partner country thereby allocating a greater share of the tax to the residence country.

Although historically details of systems and anti-avoidance legislation have differed among countries, the most common approach involved immediately taxing profits at the source, while also levying residence-based taxes on worldwide profits. But foreign profits were typically taxed by the residence country only at the time of repatriation, and a credit for foreign tax paid was then allowed. Since the 1980s, however, there has been a strong shift toward territorial systems, in which foreign active business profits are exempt, unless captured by some anti-avoidance provision (see Chapter 3, Box 3.1).

The Role of Foreign Profits Today

As discussed in Chapter 4, the role of multinational enterprises has vastly increased in economic significance since the early twentieth century. For the present discussion about the relevance of residence-based taxation, the

---

2 Source was an even more intuitive concept than residence, essentially referring to the geographic location of production. But now even that concept has become muddy.

3 For a detailed discussion of determining the source of income and its allocation, including the concept of permanent establishment, see Chapters 3 and 8.

4 A common way to overcome this limitation is to mix income from high- and low-tax jurisdictions by having a holding company in a country that does not levy residence-based taxes.

5 See Chapter 8 for a discussion of tax treaties.
crucial question is the importance of profits these entities earn outside their home country.

It should also be noted that the number of capital-exporting countries is increasing (Figure 7.1). This indicates that residence-based taxation is no longer an issue for advanced countries only. Companies in emerging economies have increased outbound investment considerably in recent years. Even if most emerging economies are still capital-importing countries on a net basis, they may also host capital-exporting firms, and hence securing proper residence-based taxation is becoming a key tax policy objective.

**CHALLENGES OF RESIDENCE-BASED TAXATION**

**Avoidance through Deferral**

Enforcing taxes on the foreign operations of resident companies is difficult, as the tax authority does not have access to foreign subsidiaries. For firms, compliance is also costly, as they would have to calculate their tax base both under local tax laws to satisfy their source-based liability and then again under their home country’s rules to determine any residual residence-based tax. But very few countries attempt to tax foreign earnings immediately—Brazil being one example. A common simplification in worldwide tax systems is that foreign earnings of an overseas subsidiary of the resident company are not taxed until repatriated to their parent company (the resident company), a feature commonly called deferral. This

![Figure 7.1. Share of Capital-Exporting Countries (Percent)](chart.png)
was in recent years a particularly notable issue for Japan and the United States—both of which had the highest rates of corporate income taxation among the OECD (until 2014 in Japan and 2017 in the United States)—since where the statutory corporate income tax rate of a country in which a company is resident is higher than that of countries in which subsidiaries of the resident company are located, it would incentivize deferral of repatriation and thus the payment of tax on income in lower-tax jurisdictions. The resident company avoids being taxed on its foreign earnings by not distributing dividends from its overseas subsidiary to the parent company. If the foreign business is growing, this can easily be done by reinvesting all profits, but even in a mature business it can be achieved through various arrangements. In a simple example, a US-resident parent company would establish a subsidiary holding company in a low-tax jurisdiction, which in turn would own an operating subsidiary in a third country. Income would be stripped from the operating company into the holding company, by using some combination of interest payments, royalties, and dividends—which would be subject to minimal taxation in the intermediary country. Unless repatriated to the residence of the parent company—in this example, the United States—substantial taxation could be deferred essentially indefinitely.

As a result, tax revenue raised in the residence country on foreign profits is typically quite low, while the administrative and compliance costs are quite high, which could be one of the reasons behind the move from worldwide to territorial systems. Perhaps most important, though, has been the consideration of tax competition over corporate headquarters. Among advanced economies that relatively recently shifted to the territorial system, the United Kingdom, which adopted the territorial system in 2009, was indeed concerned with UK companies’ competitiveness. And the shift to a territorial system does not appear to have affected corporate tax revenues much (Table 7.1). Japan, which also adopted the participation exemption system in 2009, was concerned with the accumulation of foreign earnings that had not been repatriated to Japan—the so-called lockout effect. For the United States (Box 7.1), there was indeed a notable increase in repatriations following the shift toward territoriality. It should be noted, though, that these repatriations, while relevant for tax purposes, do not necessarily imply any actual flows. Even when funds were kept abroad, there were various means by which they could effectively already be invested in US assets (for example, US Treasuries), while technically held by a foreign subsidiary.

---

6 Markle (2010) indicated steep compliance costs and ineffective anti-avoidance measures under the worldwide system as motivations for the reform.

7 Japan’s Ministry of Economy, Trade, and Industry survey noted that accumulated foreign earnings in 2008 reached ¥19.6 trillion ($189 billion; ¥19.6 trillion was equivalent to 196 percent of Japan’s corporate income tax revenue in 2008).
Box 7.1. Deferred Profits and the US Tax Cuts and Jobs Act of 2017—Transition Tax and Impact

Under prior law, the possibility of deferral, likely combined with the expectation of a future reduction in the tax rate applied to repatriations, resulted in US multinationals building up a substantial stock of unrepatriated earnings (in the order of $2.6 trillion by 2017). Without the expectation of such a future reduction in applicable tax, if unrepatriated funds had simply accumulated at the investor’s minimum required pretax return, deferral would not have changed the present value of taxes due—and thus presumably would have been much less attractive. The expectation of a future likely reduction in tax on repatriations may have been stoked by the previous experience of a temporarily reduced rate on repatriations (for example, as part of the Homeland Investment Act of 2004) and widespread discussion at the time of the potential move to a territorial-based system—which by definition would have removed taxation on repatriation to the United States. As a transition measure associated with the move to territoriality, the Tax Cuts and Jobs Act imposed a onetime tax on the deemed repatriation of that income (no actual repatriation was needed; this was an accounting calculation). Justifying expectations of a reduced applicable rate, the rate attached, for corporate owners, was 15.5 percent for funds that were held in cash or cash-equivalent assets and 8 percent for the remainder (presumably reinvested earnings). The tax due was further reduced in present value by its payment being extended over eight years.

US-registered multinational corporations brought into tax $396.3 billion in deferred earnings from foreign affiliates in 2019. This was 53.4 percent less than in 2018, when $850.9 billion was repatriated following the introduction of the Tax Cuts and Jobs Act. But the 2019 total was still more than twice the average annual amount over the decade preceding the 2017 act, which generally eliminated taxes on future repatriated earnings. More than half of the dividends in 2019 came from affiliates in three countries: Ireland, at $85.8 billion; the Netherlands, $74.3 billion; and Bermuda, $67.9 billion. In terms of industry sectors, US multinationals in chemical manufacturing, at $99.6 billion, and computers and electronic products manufacturing, at $92.5 billion, were the largest.

Sources: Bureau of Economic Analysis (2020); and Chalk, Keen, and Perry (2018).

TABLE 7.1.

Trends in Corporate Income Tax Rates and Revenue per GDP in the United Kingdom and Japan, including Local Taxes

(Percent)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kingdom</td>
<td>Rate</td>
<td>30.0</td>
<td>28.0</td>
<td>28.0</td>
<td>28.0</td>
<td>26.0</td>
<td>24.0</td>
<td>23.0</td>
<td>21.0</td>
<td>20.0</td>
<td>20.0</td>
</tr>
<tr>
<td>Revenue</td>
<td>3.3</td>
<td>2.9</td>
<td>2.6</td>
<td>2.9</td>
<td>2.8</td>
<td>2.7</td>
<td>2.6</td>
<td>2.5</td>
<td>2.4</td>
<td>2.7</td>
<td>2.8</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax Rate</td>
<td>39.5</td>
<td>39.5</td>
<td>39.5</td>
<td>39.5</td>
<td>39.5</td>
<td>37.0</td>
<td>37.0</td>
<td>34.6</td>
<td>32.1</td>
<td>30.0</td>
<td>30.0</td>
</tr>
<tr>
<td>Revenue</td>
<td>4.6</td>
<td>3.7</td>
<td>2.5</td>
<td>3.1</td>
<td>3.2</td>
<td>3.5</td>
<td>3.8</td>
<td>3.9</td>
<td>3.8</td>
<td>3.7</td>
<td>3.7</td>
</tr>
</tbody>
</table>

Sources: IMF World Revenue Longitudinal Data; OECD Corporate Tax Statistics; Japanese Legislation.
Manipulation of Place of Residence

As noted in Chapter 3 (see examples in Table 3.1), residence criteria for corporations differ across countries, although there are two main approaches: a formal legal connection to the jurisdiction (place of incorporation or registration in the commercial register) or an economic connection (place of effective management, substantial ownership and control, or location of board of directors’ meetings). A combination of these two approaches is also used.

Predictably, the discrepancies in corporate residence rules have become a fertile ground for tax avoidance and minimization schemes. Avoidance schemes can go beyond changing residence from a high- to a low-tax jurisdiction but can even lead to no significant tax accruing to any state (see Box 7.2 for one example). The late Ed Kleinbard coined the term “stateless income” to describe the results of international tax planning by US-headquartered multinational enterprises that were able to take advantage of, among other things, such lacunae in the international system for defining corporate domicile (residence): “By ‘stateless income,’ I mean income derived by a multinational group from business activities in a country other than the domicile (however defined) of the group’s ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customers or the factors of production through which the income was derived, and is not the domicile of the group’s parent company” (Kleinbard 2011).

One way that some multinational enterprises avoid taxation in high-tax jurisdictions is by shifting the fiscal domicile of the parent company using an approach known as inversion. A corporate inversion is a scheme that makes a resident company into a foreign company by means of a merger with a foreign company—often smaller than the resident company—or into a subsidiary of a foreign company that the resident company created. This all occurs without

Box 7.2. Manipulation of Irish Residency: An Example

The so-called “Double Irish” structure offers a simple example of how residency laws can be manipulated. Under this formerly available structure, one Irish subsidiary (IRL1) would be an Irish-registered company selling products to non-US locations from Ireland. A second Irish subsidiary (IRL2) would hold intangible assets and charge the IRL1 royalties, thereby shifting most profits to IRL2. IRL2 would be registered in Ireland but managed and controlled from a low- or no-tax jurisdiction. The Irish tax code considered IRL2 to be a resident of the low-tax jurisdiction (based upon the Irish “managed and controlled” test), but the US tax code considered IRL2 to be an Irish company (based on the place of incorporation or registration test). Neither jurisdiction therefore taxed the income of IRL2, as neither viewed it as legally resident within its jurisdiction. In 2015 Ireland closed this avenue of tax minimization by changing the definition of tax residence to include not only entities that are effectively managed in Ireland but also those incorporated there. However, structures already in place were grandfathered until 2020. For more than a decade, Google enjoyed an effective tax rate in the single digits on its non-US profits by using a subsidiary in the Netherlands to shift revenue from royalties earned outside the United States to Google Ireland Holdings, an affiliate based in Bermuda and not deemed resident in either the United States or Ireland.
changing shareholders, business operations, or place of effective management. Multinationals based in a country with a worldwide tax system can lower their tax by inverting into a lower-tax jurisdiction with a territorial system. This goes beyond the tax saving of not having to pay any more residence-based taxes on existing deferred worldwide profits in the original residence jurisdiction, but also includes further gains from generating profits through increased operations abroad after the inversion.8

As the United States maintained a worldwide tax system in combination with one of the highest tax rates until 2017, corporate inversions of US companies became rampant. From 1982 to 2017 more than 60 US companies were reincorporated in lower-tax countries (CBO 2017). Popular destinations for inversions included Ireland and Bermuda.

**ANTI-AVOIDANCE RULES**

**Early Efforts: The Development of Controlled Foreign Corporation Rules**

To counter tax deferral under worldwide tax systems (or to bring some income into the tax net under territorial systems) an increasing number of countries have adopted controlled foreign corporation (CFC) rules that tax immediately the undistributed income of overseas subsidiaries of a resident company as income of the resident company, dependent on its share of ownership of the subsidiary as well as some other conditions. The first use of CFC rules was in the United States. The original—and current—US CFC rules (known as Subpart F rules), introduced in 1962, did not apply to all undistributed income of the overseas subsidiary, however, but only to certain categories of undistributed foreign-source income considered as passive, such as interest, dividends, rents, and royalties, and that had been subject to zero or low foreign tax rates. The original rules defined a CFC as a company that is more than 50 percent, by vote or value, owned by a US parent company or certain other US shareholders. This definition, however, proved susceptible to manipulation (Durst 2019, 42), and many changes were made to the rules.

Among the main changes introduced over the years, two exceptions, the active financing exception and look-through rules, are regarded as major factors weakening the effectiveness of the US CFC rules (Americans for Tax Fairness 2015a, 2015b). The active financing exception allows a US company to avoid the application of CFC rules on undistributed income of a CFC that is predominantly engaged in the active conduct of a banking or similar business and that conducts substantial activity with respect to such business. The CFC look-through rules

---

8 If a country’s tax law defines a resident company as one that has a place of effective management, changing a country of incorporation alone would not change the fiscal domicile. However, if the definition of a resident company is based on a place of incorporation—as in the United States—or location of a head office, a resident company can quite easily change its fiscal domicile.
allow a US company to avoid the application of CFC rules if passive income is paid to a CFC by a related CFC and that income can be traced to the active income of the payer CFC. In addition, the 1997 Treasury regulation that aimed to simplify the process of qualifying business entities as partnerships or other forms of pass-through entities for tax purposes (“check-the-box rules”) undermined the operation of the CFC rules. The check-the-box rules allow US-based multinational enterprises to treat their second-tier operating subsidiaries owned by holding companies (first-tier subsidiaries of the US-based multinational enterprises in zero- or low-tax jurisdictions) not as separate companies but as unincorporated branches of the holding companies. This means payments of interest, royalties, and other kinds of passive income made by the operating companies to their parent holding companies are not legally payments, as technically they are made within a single entity. Thus, the parent holding companies in zero- or low-tax jurisdictions that are subsidiaries of US-based multinational enterprises are not treated as receiving CFC income (Durst 2019, 43). It was estimated even a decade ago that these features within the CFC rules cost the US Treasury $90 billion per year (Clausing 2011). The accumulated undistributed profit of US-based multinational enterprises reached $2.6 trillion in 2015 (Phillips and others 2017).

After the introduction of the CFC rules by the United States, other OECD member countries also introduced such rules; currently 49 countries have CFC rules (OECD 2020). CFC rules in these countries are broadly similar in function to the US rules, but the design varies by country. For example, the level of the corporate income tax rate in the country of the CFC, generally a condition to apply CFC rules, ranges from 10 percent to 75 percent of the rate in the residence country. Ten countries apply CFC rules only to passive income, while the rest apply the rules to all income.

In member countries of the European Economic Area, CFC rules now generally apply only to operations located outside the European Economic Area. The European Court of Justice ruled in 2006 that the then-existing UK CFC rules should not apply to CFCs in Ireland controlled by the UK parent company unless the Irish subsidiaries were wholly artificial arrangements. This European Court of Justice ruling was interpreted as not allowing European Economic Area countries to apply CFC rules where the subsidiary in question is an actual establishment intended to carry on genuine economic activities in the European Economic Area member state, regardless of the existence of tax motives for the establishment of the arrangements.

---

9 Some OECD member countries without any formal CFC rules have other anti–base erosion rules that aim to achieve the same goal as CFC rules.
10 Some countries use nominal (statutory) corporate income tax rates.
11 The European Economic Area includes the 26 EU countries as well as Iceland, Liechtenstein, and Norway, which allows these three countries to be part of the EU’s single market.
Recent Approaches to Strengthening Residence Taxation

Improve CFC Rules

The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, launched in 2013, aimed to close gaps in international tax rules that allowed corporate tax bases to be eroded or artificially shifted to low- or no-tax jurisdictions. The guiding principle was to “ensure that profits are taxed where economic activities take place and value is created.” (OECD 2015a, p. 4) To this end, the project addressed 15 problematic areas, with the final BEPS package of 2015—endorsed by G20 leaders—including four minimum standards. Among the 15 Actions, Action 3 (Designing Effective Controlled Foreign Company Rules), and Action 2 (Neutralizing the Effects of Hybrid Mismatch Arrangements), are particularly relevant to residence-based taxation issues.

The BEPS final report on Action 3 provided recommendations intended to ensure effective CFC rules, in the form of six building blocks. The OECD was not able to turn the Action 3 recommendations into minimum standards, but only recommendations, due to the lack of consensus; it explained that a one-size-fits-all approach to CFC rules might not be viable. The executive summary of the BEPS Report on Action 3 stated: “Because each country prioritises policy objectives differently, the recommendations provide flexibility to implement CFC rules that combat BEPS in a manner consistent with the policy objectives of the overall tax system and the international legal obligations of the country concerned. In particular, this report recognises that the recommendations must be sufficiently adaptable to comply with EU law, and it sets out possible design options that could be implemented by EU Member States” (OECD 2015b, p. 10).

The report acknowledged the need for “striking a balance between taxing foreign income and maintaining competitiveness” (OECD 2015b, p. 15) but also suggested that making all capital-exporting countries adopt similar CFC rules could mitigate the competitiveness concern.

Against that background, the BEPS Action 3 report set out recommendations for “jurisdictions that choose to implement them” (OECD 2015b, p. 9) for the design of effective CFC rules to prevent shifting income into foreign subsidiaries (Box 7.3).

The OECD reported that by mid-2019 almost 50 OECD/G20 Inclusive Framework countries had enacted CFC rules, with European Union member states all having CFC rules in effect since the beginning of 2019 following the adoption of Council Directive (EU) 2016/1164 (see next paragraph). This is clearly a step forward in protecting residence-based taxation—but it is not entirely clear that all choices made under these guidelines will, in fact, lead to

---

13 Some earnings stripping techniques, which can be used to move income from source to residence countries, were also addressed—interest payments (Action 4) and general transfer pricing manipulation (Actions 8–10). However, certain important base erosion payments such as cross-border service or management fees that are used to strip income from source countries and locate them in low-tax residence countries were explicitly not addressed in the BEPS Project.
effective taxation of the income of foreign subsidiaries—in light of the referenced policy choices and priorities of various countries who may wish to compete for the headquarters of multinationals, or even for intermediate holding companies.

Subsequent to introduction of BEPS Action 3, the European Union, addressing the use of CFC rules in the European Union, took a firmer line, requiring all European Union members to adopt certain CFC rules in their national laws by January 1, 2019, in the European Union Anti-Tax Avoidance Directive. CFC rules under Anti-Tax Avoidance Directive requirements will be triggered if the actual corporate tax paid by a subsidiary or a permanent establishment is lower than the difference between the tax that would have been paid on the same profits in the European Union member state of the parent company and the corporate tax actually paid in the source state. CFC income that will be included as income of the parent company constitutes: (1) certain predefined categories of nondistributed (passive) income of CFCs (for example, interest, royalties, dividends)—however,

---

**Box 7.3. The OECD Report on BEPS Action 3**

The OECD report’s summary of the building blocks is as follows:

- **Definition of a CFC** – CFC rules generally apply to foreign companies that are controlled by shareholders in the parent jurisdiction. The report sets out recommendations on how to determine when shareholders have sufficient influence over a foreign company for that company to be a CFC. It also provides recommendations on how non-corporate entities and their income should be brought within CFC rules.

- **CFC exemptions and threshold requirements** – Existing CFC rules often only apply after the application of provisions such as tax rate exemptions, anti-avoidance requirements, and de minimis thresholds. The report recommends that CFC rules only apply to controlled foreign companies that are subject to effective tax rates that are meaningfully lower than those applied in the parent jurisdiction.

- **Definition of income** – Although some countries’ existing CFC rules treat all the income of a CFC as “CFC income” that is attributed to shareholders in the parent jurisdiction, many CFC rules only apply to certain types of income. The report recommends that CFC rules include a definition of CFC income, and it sets out a non-exhaustive list of approaches or combination of approaches that CFC rules could use for such a definition.

- **Computation of income** – The report recommends that CFC rules use the rules of the parent jurisdiction to compute the CFC income to be attributed to shareholders. It also recommends that CFC losses should only be offset against the profits of the same CFC or other CFCs in the same jurisdiction.

- **Attribution of income** – The report recommends that, when possible, the attribution threshold should be tied to the control threshold and that the amount of income to be attributed should be calculated by reference to the proportionate ownership or influence.

- **Prevention and elimination of double taxation** – One of the fundamental policy issues to consider when designing effective CFC rules is how to ensure that these rules do not lead to double taxation. The report therefore emphasises the importance of both preventing and eliminating double taxation, and it recommends, for example, that jurisdictions with CFC rules allow a credit for foreign taxes actually paid, including any tax assessed on intermediate parent companies under a CFC regime.

CFC rules will not apply if the CFC is undertaking a substantive economic activity supported by staff, equipment, assets, and premises, as evidenced by relevant facts and circumstances (as mandated by Cadbury Schweppes); or (2) the nondistributed income of CFCs arises from “non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage.” The member state can opt to adopt either option (1) or option (2). Both options in essence utilize tests that must be decided by facts and circumstances. Without uniform and detailed interpretation guidance, these CFC rules would seem to be subject to the discretion of the tax administration of each European Union member state.

**Anti-inversion Rules**

The US Treasury in April 2016 issued temporary and proposed regulations aimed at removing the tax benefits of inversion transactions, following on from initial measures introduced in 2014. The regulations were finalized in 2018. While the simple technique of incorporating a subsidiary in a foreign jurisdiction and having it acquire its resident parent no longer worked even before 2014, another technique, redomiciling, accomplished by merging a domestic company with a foreign-based company under certain conditions, would serve the purpose as long as, most notably, the original foreign company contributed at least 20 percent of the shares of the newly merged company. The 2014 Treasury regulations were designed to make it more difficult for newly merged companies to repatriate earnings accrued before the merger tax-free, as well as to avoid the 20 percent ownership requirement. In 2016, Treasury issued additional regulations that treated some debt transactions between related parties as equity instead of debt; this was to deter foreign-based companies from practicing income stripping, particularly in this context.

Still, inversions and avoidance of tax on deferred income still posed a problem, even though the very large rate reduction in the Tax Cuts and Jobs Act of 2017, and the shift toward territorial taxation, should have mitigated the incentives to engage in inversions. Nonetheless, as discussed in Chapter 12, the origination of much intellectual property and the location of large residual profits in the United States indicated that such incentives could well remain, and the Tax Cuts and Jobs Act therefore took additional measures against them. The transition tax rate on inverted firms’ existing overseas assets was set at the full pre–Tax Cuts and Jobs Act rate of 35 percent instead of the reduced rates of 8 and 15.5 percent for other firms’ assets. Under this legislation, dividends received from newly inverted firms are now taxable as ordinary income instead of at the reduced rates generally applied to qualified dividends and capital gains. If at least 80 percent of an inverted (new foreign parent) company’s stock is held by former shareholders of the US company, the company is treated as a domestic corporation for US tax purposes.

**Hybrid Entities**

Action 2 of the BEPS Report (OECD 2105c), *Neutralising the Effects of Hybrid Mismatch Arrangements*, is, like Action 3, a set of recommendations only, not
constituting minimum standards. Nonetheless, it is extremely complex (running to over 450 pages), and in the main addresses payments and instruments that may give rise to double deductions or exclusions from taxation. Chapter 7 of that report, though (the “Dual Resident Payer Rule”), explicitly identifies such double benefits in the context of dual-resident (related) entities—precisely arising in many cases because of the lacunae and overlaps in the definitions of residency used by a set of countries involved in such transactions. These problems had been identified earlier by the OECD (2012) and others and had caused increasing concern in regard to tax base erosion. To delve into the minutiae of these sophisticated tax planning arrangements, as addressed in the report on Action 2, is beyond the scope of this chapter. But the report itself provides examples of how these schemes work and how the recommendations of the Action 2 report could help to address the problem. Again, however, the main lesson is the extreme manipulability of the residence-based taxation concept in the world of modern economies and of modern tax planning.

Again, too, the European Union Anti-Tax Avoidance Directive addresses the issue of hybrid transactions in a more definitive way, mandatory for European Union and European Economic Area countries. Anti-Tax Avoidance Directive 1 was extended by Anti-Tax Avoidance Directive 2 (2017) to cover more arrangements (for example, permanent establishments of member countries, and related parties in non–European Union or non–European Economic Area countries). Notably for purposes of this chapter, among numerous transactions and arrangements covered for which double deductions, exclusions from tax, and the like could arise, Anti-Tax Avoidance Directive antihybrid provisions explicitly cover, for example, “payment[s] made by a dual resident taxpayer that is deducted under the laws of both jurisdictions where the taxpayer is resident“ (Deloitte 2020, p. 2).

**Exit Taxes**

While many countries, including the United States, have a departure tax for individuals who cease to be tax resident, departure taxes for companies were relatively few before the European Union Anti-Tax Avoidance Directive was issued. The European Union Anti-Tax Avoidance Directive required European Union member states to introduce an exit tax by December 31, 2019. The exit tax enables a country of which a taxpayer was a resident to tax the economic value of any unrealized capital gains generated within that country until the time of exit. The tax will apply when a taxpayer transfers one or more of the following: (1) assets from its head office to a foreign permanent establishment; (2) assets from a permanent establishment in a member state to a foreign head office or permanent establishment; (3) its tax residence to another country; or (4) business carried on by a permanent establishment in a member state to another country. Where the transfer takes place within the European Union or the European Economic Area, a taxpayer can opt to defer payment of the exit tax for five years.
Canada also has a departure tax for companies that cease to be a resident of Canada. When a company stops being a tax resident of Canada, the company will be considered to have disposed of all its property on the day its residency ceased. The 25 percent departure tax will also apply to the amount by which the fair market value of a company’s assets exceeds the total of its liabilities and the paid-up capital of its stock. Thus, the tax is imposed on the retained earnings and the unrealized gains that would have been subject to the Canadian tax if the company paid dividends as a resident. In contrast to the European Union’s exit tax, the Canadian departure tax does not allow a taxpayer to defer this payment.

CONCLUSION

While at first sight residence-based taxation may address some of the shortfalls of source-based taxation, namely tax competition through tax rates in source countries and the need for complicated profit allocations among different source countries, a second look confirms that residence-based taxation also faces various difficulties. Still, it does provide some protection from tax avoidance, and despite the trend toward territorial taxation, residence-based elements remain in most tax systems, at least in the anti-avoidance legislation.

Some progress has been made since 2015 in closing opportunities for tax minimization using corporate residence. However, the fundamentals of the system have not been changed, and further changes are needed. Chapter 12 continues the discussion of residence-based taxation, looking at possible further-reaching approaches for reform.

REFERENCES


15 While Canada adopts central management and control as one of several criteria to decide the residency of a company, the Income Tax Act deems a company incorporated in Canada as a resident of Canada. Thus, even if its central management and control is moved outside of Canada, the company remains a resident of Canada.
17 If the Canadian company became a resident of a country with which Canada has a tax treaty, a 25 percent rate will be reduced to that which would be applied to a dividend paid to a parent corporation resident in that treaty partner country (Article 219(3) of the Income Tax Act).


