

**REFORMULATING CORPORATE RESIDENCE: A COHERENT
RESPONSE TO INTERNATIONAL TAX AVOIDANCE**

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ABSTRACT

REFORMULATING CORPORATE RESIDENCE: A COHERENT RESPONSE TO INTERNATIONAL TAX AVOIDANCE

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This thesis analyzes the concept of corporate residence, with particular reference to the law in the UK and Canada. It explores why corporate residence is relevant in tax policy, how corporate residence is understood in law, and how revenue authorities respond to the use and alleged ‘abuse’ of residence rules. Part I argues that the residence of taxpayers generally (individual or corporate) remains a relevant factor in international tax design, that taxation of corporations on the basis of residence has some justification, but that there is a disjunction between meaningful residence-based taxation and current definitions of corporate residence in domestic law and tax treaties. The formulations of residence based on incorporation, central management and control, and place of effective management, particularly as applied to multinational enterprises, are considered and are found to be deficient. Part II critically analyzes the major policy responses of the UK and Canadian governments to the exploitation of corporate residence. It argues that key legislative and administrative responses to international tax avoidance activities, for both outbound and inbound investment, are purportedly based on the acceptance of formal corporate residence yet undermine that concept in an effort to impose tax or refuse treaty relief based on where economic interests actually exist. The responses considered are the application of controlled foreign companies legislation to offshore subsidiaries, the invocation of treaty anti-abuse rules with respect to offshore intermediaries, and the use of overarching general anti-avoidance measures to challenge varied structures that rely on offshore entities. These haphazard anti-avoidance rules are overlaid with revenue authorities’ indignation at the motivations that underlie many corporate relocations. It is argued that a more coherent approach would be to focus on the objective reality or unreality of corporate establishment, by reformulating corporate residence in domestic law and tax treaties.

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LIST OF ABBREVIATIONS

LEGISLATION

CTA 2009	Corporation Tax Act 2009
ICTA 1988	Income and Corporation Taxes Act 1988
ITA 1985	Income Tax Act 1985 (Canada)
ITA 2007	Income Tax Act 2007
ITTOIA 2005	Income Tax (Trading and Other Income) Act 2005
TCGA 1992	Taxation of Chargeable Gains Act 1992
TIOPA 2010	Taxation (International and Other Provisions) Act 2010

CASE REPORTS AND JOURNALS

BIFD	Bulletin for International Fiscal Documentation
BIT	Bulletin for International Taxation
BTR	British Tax Review
CTJ	Canadian Tax Journal
DTC	Dominion Tax Cases (Canada)
STC	Simon's Tax Cases

OTHER ABBREVIATIONS

CEN	Capital export neutrality
CFC	Controlled foreign company
CIN	Capital import neutrality
CON	Capital ownership neutrality
CRA	Canada Revenue Agency
DTC	Double taxation convention
FAPI	Foreign accrual property income
FCA	Federal Court of Appeal (Canada)

FDI	Foreign direct investment
FPI	Foreign portfolio investment
GAAR	General anti-avoidance rule
HMRC	Her Majesty's Revenue and Customs
IFS	Institute for Fiscal Studies
IBFD	International Bureau of Fiscal Documentation
IFA	International Fiscal Association
IMF	International Monetary Fund
LOB	Limitation of benefits
LON	League of Nations
MNE	Multinational enterprise
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Co-operation
POEM	Place of effective management
TAAR	Targeted anti-avoidance rule
TCC	Tax Court of Canada
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development

CHAPTER 1

INTRODUCTION

1.1 WHY CORPORATE RESIDENCE?

Residence is both a term of substance and a term of art. In its substantial sense, residence conveys personal attachment to and participation in the social and economic life of a country. In its formal legal sense, residence is a tax planning tool that wealthy individuals and multinational enterprises (MNEs) may implement to avoid unpalatable tax burdens. The very term ‘tax residence’, while ostensibly neutral, evokes in the minds of many people thoughts of affluent athletes and entertainers absconding to Monaco or Switzerland, or sophisticated corporate groups creating ‘letterbox’ offices in Jersey, Bermuda, or the Cayman Islands.¹ Residence is unlike other tax planning tools – for example, a unit trust structure or a hybrid debt-equity instrument – in that its essence would seem to be social and economic attachment, and even political obligation, to a country. Yet the dominant conception of residence for income tax purposes in the UK, US, Canada, and various other jurisdictions, particularly in regard to corporations, requires little if any social and economic attachment to the purported home country. Corporate residence has been described as ‘ectopic’,² in that its legal meaning is dislocated from the commercial reality to which it relates. An unsurprising incident of this state of affairs is that revenue authorities in the UK, US, Canada, and elsewhere

¹ For example, the *Guardian* ran a series of articles in February 2009 titled ‘The Tax Gap’, available at <www.guardian.co.uk/business/series/tax-gap> (Tax Gap). The articles addressed various aspects of tax avoidance and government responses thereto, but the overwhelming theme was the use of ‘offshore’ jurisdictions to avoid UK corporate taxation. See in particular ‘Offshore – and out of reach to the Revenue’ (3 February 2009) <www.guardian.co.uk/business/2009/feb/03/offshore-tax-avoidance> and ‘Low-tax, low-cost flight to Dublin’ (10 February 2009) <www.guardian.co.uk/business/2009/feb/10/ireland-tax-gap-staff-levels>.

² J Prebble, ‘Ectopia, Tax Law and International Taxation’ [1997] BTR 383.

continually express concern about what they describe as the ‘exploitation’ or ‘abuse’ of corporate residence for tax avoidance purposes.

This thesis concerns the idea of corporate residence, with particular reference to the law in the UK and Canada. The thesis considers why corporate residence is relevant to taxation, how corporate residence is understood, and how British and Canadian revenue authorities respond to its use and its alleged abuse.

1.2 GLOBALIZATION, RELOCATION, AND TAX POLICY RESPONSES

1.2.1 Globalization and Corporate Mobility³

It is widely recognized that economic activity has become increasingly international since the early part of the last century. While the term ‘globalization’ is used in many contexts, in the area of public finance it can be seen as encompassing two related developments. First, it refers to the liberalization and integration of state economies themselves,⁴ through such things as elimination of foreign exchange controls and conclusion of investment treaties. Second, it describes the intense growth of business structures and methods that seek to harness the profit potential, and arbitrage opportunities, of international markets.⁵

Globalization in this latter sense involves the emergence of the truly multinational enterprise, whose scope of activity is such that it is difficult to regard the

³ For recent overviews see: MP Devereux, ‘Business Taxation in a Globalized World’ (2008) 24 *Oxford Rev of Economic Policy* 625; R Griffith, J Hines, and PB Sørensen, ‘International Capital Taxation’ in Institute for Fiscal Studies (ed), *Dimensions of Tax Design: The Mirrlees Review* (OUP, Oxford 2010) 914.

⁴ eg A Razin and J Slemrod, ‘Introduction’ in A Razin and J Slemrod (eds), *Taxation in the Global Economy* (Univ of Chicago Press, Chicago 1990) 1–2; V Tanzi, *Taxation in an Integrating World* (Brookings Institution, Washington DC 1995) xii–xiii.

⁵ eg Razin and Slemrod (n 4) 2–3; S Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (Weidenfeld & Nicolson, London 1992) ch 1.

enterprise as having one home country.⁶ Dunning and Lundan provide the following insight:

Most MNEs can be readily identified as originating from a single country. For example, ICI is easily identified as a British firm, Ford as a US firm, NEC as a Japanese firm, Volvo as a Swedish firm, Siemens as a German firm, Samsung as a Korean firm, and Nokia as a Finnish firm. Yet each of these MNEs has its shares quoted on a number of stock exchanges throughout the world, and the membership on their board of directors is multinational, while an increasing proportion of their value-added activity is undertaken outside their home countries. Increasingly, too, the (regional) head offices of MNEs are being relocated.⁷

The United Nations (UN) Department of Economic and Social Affairs observed almost 40 years ago that ‘[t]he dramatic growth of multinational corporations in the postwar period has been accompanied by unprecedented growth in the number of affiliates’.⁸

The UN Conference on Trade and Development (UNCTAD) observed more recently that the ‘universe’ of the largest MNEs expanded rapidly in the 1990s and the 2000s, slowing only during the global downturn of 1999–2001 and following the global financial crisis of 2008.⁹ It estimates that as of 2009 there were some 82,000 MNEs worldwide, operating 810,000 foreign affiliates and employing 77 million people.¹⁰ This

⁶ Tanzi (n 4) 2, 99; JH Dunning and SM Lundan, *Multinational Enterprises and the Global Economy* (2nd edn, Edward Elgar, Cheltenham 2008) 3–6.

⁷ Dunning and Lundan (n 6) 6. Ironically, Imperial Chemical Industries plc (ICI) is no longer British: it was acquired by the Dutch entity Akzo Nobel NV in 2008.

⁸ UN Department of Economic and Social Affairs, *Multinational Corporations in World Development* (Doc ST/ECA/190, UN, New York 1973) 8.

⁹ UNCTAD, *The Universe of the Largest Transnational Corporations* (Doc UNCTAD/ITE/IIA/2007/2, UN, New York and Geneva 2007) 1–2 <www.unctad.org/en/docs/iteiia20072_en.pdf>; UNCTAD, *World Investment Report 2009: Transnational Corporations, Agricultural Production and Development* (Doc UNCTAD/WIR/2009, UN, New York and Geneva 2009) 3–5 <www.unctad.org/Templates/Page.asp?intItemID=1485&lang=1>. The UN uses the term ‘transnational corporation’ to refer to a multinational enterprise. The author prefers the term *enterprise* because it conveys a group of affiliated corporations (a corporation is a single legal entity), and prefers the term *multinational* because it allows different corporations within the enterprise to have different nationalities (transnational suggests a corporation operating abroad through a branch).

¹⁰ UNCTAD 2009 (n 9) 17, 222–24. The actual number of affiliates is higher because some of the domestic data relied upon exclude certain entities; eg the Luxembourg figure excludes holding companies.

can be seen as a positive phenomenon to the extent that MNEs drive much foreign direct investment (FDI), which according to the UN serves to generate employment, raise productivity, transfer skills and technology, enhance exports, and generally contribute to the economic welfare of developing countries.¹¹

At the same time, it is notorious that economic globalization has far outpaced political globalization: there is a need for reform of bilateral arrangements and introduction of multilateral arrangements in a host of areas, not least in the area of taxation, to keep pace with economic change.¹² Yet even with the formation or enhancement of regional communities such as the European Union (EU) and the North American Free Trade Agreement, taxation remains largely sovereign, separated, and uncoordinated.¹³ This is not surprising given how critical public finance is to a country's unique identity and objectives. In the absence of political globalization and a concomitant evolution of multilateral tax arrangements, MNEs equipped with sophisticated tax advice engage in various self-help activities, sometimes described as tax avoidance, in order to minimize their global tax burdens. Very often this involves establishing foreign holding companies and subsidiaries, thereby enabling MNEs to route dividends, interest, royalties, and other payments into low tax states.

None of this is new. Public finance economists and tax lawyers have been suggesting for almost a century that enhanced international mobility of companies,

¹¹ See UNCTAD 2009 (n 9) and earlier World Investment Reports, especially UNCTAD, *World Investment Report 1992: Transnational Corporations as Engines of Growth* (Doc ST/CTC/130, UN, New York 1992) <www.unctad.org/Templates/Page.asp?intItemID=1485&lang=1>.

¹² N Serra, S Spiegel, and JE Stiglitz, 'Introduction' in N Serra and JE Stiglitz (eds), *The Washington Consensus Reconsidered: Towards a New Global Governance* (OUP, Oxford 2008) 6–7.

¹³ EU tax harmonization efforts are discussed in: S Bond, L Chennells, MP Devereux and others, *Corporate Tax Harmonisation in Europe: A Guide to the Debate* (Institute for Fiscal Studies, London 2000); M Lang, P Pistone, J Schuch and others (eds), *Common Consolidated Corporate Tax Base* (Linde, Vienna 2008).

capital, and profits would undermine the efficiency and equity of national tax systems in the absence of internationally coordinated responses.¹⁴ In the early 1990s, several years before internet communication and commerce became the worldwide norm, tax scholars observed that the international tax regime – if it could even be called a ‘regime’ – was in crisis.¹⁵ A common prediction in the 1980s and 1990s was that the almost limitless mobility of firms would fuel corporate tax competition, creating a ‘race to the bottom’ in corporate tax rates.¹⁶ It was sometimes questioned whether corporate taxes would survive in any small open economy.¹⁷ Those predictions have proven to be too bold: the corporate income tax survives in some form in most developed countries and continues to raise revenue.

1.2.1(a) Mobility of Affiliates and Headquarters

There is nonetheless ample evidence of firm mobility that inevitably creates downward pressure on tax rates and effective tax burdens. Various empirical studies illustrate the sensitivity of firm decisions, including corporate location decisions, to tax policies,¹⁸

¹⁴ eg ERA Seligman, *Essays in Taxation* (10th edn, MacMillan, New York 1925); H Wurzel, ‘Foreign Investment and Extraterritorial Taxation’ (1938) 38 *Columbia Law Rev* 809; SS Surrey, ‘Current Issues in the Taxation of Corporate Foreign Investment’ (1956) 56 *Columbia Law Rev* 815; PB Musgrave, ‘International Tax Base Division and the Multinational Corporation’ (1972) 27 *Public Finance* 394.

¹⁵ Razin and Slemrod (n 4) 2–3; Picciotto 1992 (n 5) 67–68.

¹⁶ eg GR Zodrow and P Mieszkowski, ‘Pigou, Tiebout, Property Taxation, and the Underprovision of Local Public Goods’ (1986) 19 *J of Urban Economics* 356; JD Wilson, ‘Theories of Tax Competition’ (1999) 52 *Nat’l Tax J* 269.

¹⁷ eg RH Gordon, ‘Can Capital Income Taxes Survive in Open Economies?’ (1992) 47 *The J of Finance* 1159; JM Mintz and D Chen, ‘Will the Corporate Income Tax Wither?’ in Canadian Tax Foundation (ed), *2000 World Tax Conference Report* (Canadian Tax Foundation, Toronto 2000) 45:1.

¹⁸ Most studies use US data, eg MP Devereux and R Griffith, ‘Taxes and the Location of Production: Evidence from a Panel of US Multinationals’ (1998) 68 *J of Public Economics* 335; H Grubert and J Mutti, ‘Do Taxes Influence Where US Corporations Invest?’ (2000) 53 *Nat’l Tax J* 825. For a survey of empirical research see R de Mooij and S Ederveen, ‘Corporate Tax Elasticities: a Reader’s Guide to Empirical Findings’ (2008) 24 *Oxford Rev of Economic Policy* 680. For a Canadian perspective see JM Mintz and M Smart, ‘Income Shifting, Investment, and Tax Competition: Theory and Evidence from Provincial Taxation in Canada’ (2004) 88 *J of Public Economics* 1149.

and recent survey evidence confirms that corporate income taxes and tax treaties are critical in parent companies' decisions regarding where to establish foreign affiliates.¹⁹

This view is borne out in the data regarding destinations and values of FDI. The UNCTAD reports mentioned above illustrate the extent to which MNEs operate via networks of foreign affiliates; high numbers of these affiliates are, unsurprisingly, located in 'tax havens'.²⁰ Country-specific studies by the US Government Accountability Office and the UK Trades Union Congress indicate that large financial institutions and other MNEs with headquarters in the US and UK have numerous subsidiaries established in tax havens.²¹ The latter report, which apparently was based on annual returns of the relevant institutions, claimed that Lloyds TSB, Royal Bank of Scotland, HSBC, and Barclays have between them 1,207 subsidiaries in tax havens, the two most popular destinations being the Cayman Islands and Jersey.

Of course, the bare number of corporations registered in a jurisdiction tells us little. Looking at the monetary value of FDI, the UNCTAD reports reveal massive inflows into haven states, particularly as a percentage of gross domestic product, although the figures do not link origin and destination countries.²² UK data on the stock of outbound direct investment shows that, as of 2009, the top 6 destinations were the US (24.5%), the Netherlands (15.0%), Luxembourg (12.2%), France (4.0%), Spain (3.2%),

¹⁹ UNCTAD, *Worldwide Survey of Foreign Affiliates* (Doc UNCTAD/WEB/ITE/IIA/2007/5, UN, Geneva 2007) <www.unctad.org/en/docs/webiteia20075_en.pdf>.

²⁰ UNCTAD 2009 (n 9) 222–24. The 'tax haven' characterization is discussed at text following n 29.

²¹ Government Accountability Office, *International Taxation: Large US Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions* (Doc GAO-09-157, Government Accountability Office, Washington DC 2008) <www.gao.gov/products/GAO-09-157> (2008 GAO Report); Trades Union Congress, 'UK Major Bank Subsidiaries in Tax Havens According to Their 2008 Annual Return Data' (2009) <www.tuc.org.uk/economy/tuc-15906-f0.cfm> (2009 TUC Report). Also see G Maffini, 'Tax Haven Activities and the Tax Liabilities of Multinational Groups' (2009) Oxford Univ Centre for Business Taxation Working Paper 09/25 <www.sbs.ox.ac.uk/centres/tax/papers/Pages/PaperWP0925.aspx>.

²² UNCTAD 2009 (n 9) 247–66.

and Canada (2.9%); other notable destinations included Ireland, Hong Kong, and the ‘UK offshore islands’.²³ Canadian data on the stock of outbound investment is even more striking: the top six destinations as of 2009 were the US (44.0%), the UK (11.0%), Barbados (6.9%), Ireland (3.8%), the Cayman Islands (3.3%), and Bermuda (3.1%).²⁴ The significance of tax havens in this list is not new. A 2005 study found that Canadian FDI into ‘offshore financial centres’ increased from \$11 billion in 1990 to \$88 billion in 2003, accounting for over 20 per cent of all Canadian FDI in 2003.²⁵ It is interesting that both the UK and Canadian statistics authorities caution readers that these data show immediate investments and that much FDI is ‘channelled’ through holding companies in intermediate jurisdictions before reaching its ‘ultimate’ destination. The implication is that such companies are mere conduits, having no meaningful independence.

The recent wave of threatened and actual emigrations of corporate headquarters from the US and the UK is confirmation that tax burdens influence not only the location of FDI by MNEs, but the ultimate ‘home’ of MNEs.²⁶ In the US this practice became known as the corporate inversion, describing the incorporation of a new parent company in a foreign state, often Bermuda, to hold the shares of the former American parent and

²³ Office for National Statistics, ‘Foreign Direct Investment: 2009’ (9 December 2010) <www.statistics.gov.uk/pdfdir/fdi1210.pdf>. The top three sources of inbound FDI were the US, the Netherlands, and France. For the US experience see RS Avi-Yonah, KA Clausing, and MC Durst, ‘Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split’ (2009) 9 *Florida Tax Rev* 497, 529–30.

²⁴ Statistics Canada, ‘Foreign Direct Investment: 2009’ (14 April 2010) <www.statcan.gc.ca/daily-quotidien/100414/dq100414a-eng.htm>, summarizing data from Statistics Canada, CANSIM: table 376-0051. The top three sources of inbound FDI were the US, the UK, and the Netherlands.

²⁵ F Lavoie, *Canadian Direct Investment in ‘Offshore Financial Centres’* (Catalogue No 11-621-MIE, Statistics Canada, Ottawa 2005).

²⁶ MA Desai and JR Hines, ‘Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions’ (2002) 55 *Nat’l Tax J* 409; J Voget, ‘Headquarter Relocations and International Taxation’ (2010) Oxford Univ Centre for Business Taxation Working Paper 10/08 <www.sbs.ox.ac.uk/centres/tax/papers/Pages/PaperWP1008.aspx> (also forthcoming in *J of Public Economics*). There has been less movement of corporate headquarters from Canada; the relocations that did occur between 1997 and 2007 tended to be acquisitions of Canadian companies by MNEs based in the US: Voget (ibid) 24–25.

its former subsidiaries. In 2008 there were several high profile examples of MNEs with British headquarters, including Shire Pharmaceuticals, United Business Media, and WPP Advertising Group, choosing to ‘leave’ the UK by way of a corporate reorganization that involved a new parent company incorporated in Jersey and ostensibly resident in Ireland.²⁷ American MNEs with significant intellectual property (IP) assets were, in the same time period, moving their European regional headquarters from the UK to Switzerland or Luxembourg. These ‘emigrations’ attracted wide media attention and seemed to confirm the view that a ‘radical overhaul’ of the UK tax regime was required in order for the UK to remain internationally competitive.²⁸ The tax policy changes enacted in the UK in 2008 and 2009, discussed below, were not enough for some MNEs, who announced more recently that they would be moving their tax residence from the UK to Switzerland.²⁹

1.2.1(b) Establishment in Tax Havens

It is often suggested in the literature that decisions with respect to ‘real’ FDI depend on a host of commercial factors, including the quality of local infrastructure, labour market, and legal system, and less so on tax, whereas FDI that involves the movement of assets and functions related to finance, IP, and other intra-group services is particularly sensitive to tax.³⁰ The typical concern is the use of tax havens for establishing special purpose vehicles, the insinuation being that these entities or their activities are somehow

²⁷ V Houlder, ‘Out of the door: tax treatment tempts businesses to relocate’ *Financial Times* (6 May 2008); F Clancy, ‘In Ireland, the Grass is Greener for Multinational Holding Companies’ 50 *Tax Notes Int’l* 759 (2 June 2008); J Cooklin, ‘Corporate Exodus: When Irish Eyes are Smiling’ [2008] *BTR* 613.

²⁸ Confederation of British Industry, *UK Business Tax: A Compelling Case for Change* (CBI, London 2008) <<http://taxreform.cbi.org.uk/>> 69.

²⁹ P Stafford, ‘Swiss tax rules lure McDonald’s from UK’ *Financial Times* (13 July 2009); R Jackson, ‘UK Supply Company Heads to Switzerland for Tax Purposes’ 60 *Tax Notes Int’l* 10 (4 October 2010).

³⁰ Tanzi (n 4) 80; J Slemrod, ‘Tax Havens, Tax Bargains and Tax Addresses: The Effect of Taxation on the Spatial Allocation of Capital’ in H Siebert (ed), *Reforming Capital Income Taxation* (JCB Mohr, Tübingen 1990) 23.

‘unreal’. Yet, as mentioned above, several corporate headquarters that fled the US or the UK recently were destined for countries – Bermuda, Ireland, Switzerland – that many would label as tax havens.

It is worth pausing to note that the categorization of a country as a ‘tax haven’ (or ‘offshore financial centre’) is subject to disagreement. Typically the term is applied to jurisdictions that offer favourable tax regimes for foreign investors, including low or zero corporate taxes, capital gains taxes, and withholding taxes. Levels of banking secrecy and information exchange may also be considered relevant. The publications of the Organisation for Economic Co-operation and Development (OECD) regarding harmful tax competition and exchange of tax information³¹ have tended to focus on the ‘offshore’ tax havens – ignoring OECD members Ireland, Luxembourg, and Switzerland – while other commentators³² prefer to include these and other ‘onshore’ jurisdictions in the list of tax havens.

However broadly the tax haven category is construed, these jurisdictions are central to various tax policy issues, including international tax competition among states, international tax evasion by individuals, and international tax avoidance by MNEs.³³ The traditional view of tax havens, adopted by northern governments, the OECD, the International Monetary Fund (IMF), certain non-governmental

³¹ OECD, *Harmful Tax Competition: an Emerging Global Issue* (OECD, Paris 1998); OECD, *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices* (OECD, Paris 2000); OECD, *Tax Co-operation: Towards a Level Playing Field – 2006 Assessment by the Global Forum on Taxation* (OECD, Paris 2006) and annual updates available at <www.oecd.org/ctp/http/cooperation>.

³² eg JR Hines and EM Rice, ‘Fiscal Paradise: Foreign Tax Havens and American Business’ (1994) 109 *Quarterly J of Economics* 149; H McCann, *Offshore Finance* (CUP, Cambridge 2006) ch 2; D Dharmapala and JR Hines, ‘Which Countries Become Tax Havens?’ (2009) Working Paper <<http://ssrn.com/abstract=952721>>.

³³ D Dharmapala, ‘What Problems and Opportunities are Created by Tax Havens?’ (2008) 24 *Oxford Rev of Economic Policy* 661, 661–62.

organizations, and many academic tax lawyers, is decidedly negative.³⁴ Havens are criticized for being ‘uncooperative’, for facilitating tax evasion by wealthy individuals, and for shifting a disproportionate fraction of the world’s corporate tax base away from both developed and developing countries.³⁵ An emerging contrarian view, adopted primarily by economists, is more positive: havens are praised for enhancing efficiency and mitigating tax competition among non-haven states.³⁶

The author’s own view of tax havens is neutral. A jurisdiction that we characterize as a haven should, like any other country, be free to set its own policies regarding tax levels and provision of public goods and services. Our criticism should be directed at structural features of domestic tax law and bilateral tax treaties which result in an international allocation of taxing rights that bears no resemblance to the locations of real economic interests.³⁷ A key structural feature is the concept of corporate residence, both for domestic law and treaty purposes. The question should not be: ‘Is locating a subsidiary in a tax haven, or relocating a parent company to a tax haven, a bad thing?’ The question should be: ‘Are we happy with the current legal rules regarding the meaning of location and relocation?’ In other words, do we believe that the establishment of an affiliate in Barbados, Jersey, or elsewhere, or the re-

³⁴ OECD 1998 (n 31); IMF, *Offshore Financial Centres: The Assessment Program – A Progress Report* (IMF, Washington DC 2005) <www.imf.org/external/np/pp/eng/2005/022505.htm>; Oxfam GB, *Tax Havens: Releasing the Hidden Billions for Poverty Eradication* (Oxfam Policy Paper, 2000); RS Avi-Yonah, ‘Globalization, Tax Competition and the Fiscal Crisis of the Welfare State’ (2000) 113 *Harvard Law Rev* 1573; S Picciotto, ‘Tackling Tax Havens and “Offshore” Finance’ (2007) *Transnational Institute Seminar on Money Laundering, Tax Evasion and Financial Regulation* <www.tni.org/archives/crime-docs/picciotto.pdf>.

³⁵ It is indisputable that a staggering amount of the world’s private wealth and corporate earnings are located – at least for fiscal purposes – in tax havens. Evidence regarding FDI is at text to nn 20–25. For estimates of foreign portfolio investment see: IMF (n 34); McCann (n 32).

³⁶ M Keen, ‘Preferential Regimes Can Make Tax Competition Less Harmful’ (2001) 54 *Nat’l Tax J* 757; MA Desai, CF Foley, and JR Hines, ‘The Demand for Tax Haven Operations’ (2006) 90 *J of Public Economics* 513; Q Hong and M Smart, ‘In Praise of Tax Havens: International Tax Planning and Foreign Direct Investment’ (2010) 54 *European Economic Rev* 82.

³⁷ Discussed further in chs 2 and 3.

establishment of a headquarters company in Bermuda, Ireland, or elsewhere, reflects commercial reality? If not, what is the proper response?

1.2.2 Legislative and Administrative Responses to Corporate Relocations

Movements of companies, capital, and profits away from traditionally high-tax states, whether to a pure tax haven or simply to a jurisdiction that offers a lighter tax burden, obviously threaten the original states' public finances. The standard policy response has not been to question whether these movements reflect commercial reality. The usual response has been to assume that the legality of corporate emigration is immutable, and to try to stem the outflow of corporate income through measures that, on the one hand, enhance the perceived competitiveness of the corporate tax system, and on the other, grasp at offshore corporate income via anti-avoidance rules and administrative censure.

1.2.2(a) The Legislative Response – Enhancing Competitiveness while Preventing Abuse

Recognizing that it is preferable to have a 'competitive' tax environment that raises some revenue rather than none,³⁸ jurisdictions around the world consistently reduced corporate tax rates in the period from 1982 through 2008.³⁹ Further rate reductions are planned in many countries, with a corresponding shift to higher levels of indirect tax. Initially the fiscal effects of rate reductions were mitigated by measures that broadened the corporate tax base, but that trend appears to have reached its limit.⁴⁰ The impetus from MNEs to have not only lower statutory rates, but more generous treatment of

³⁸ MP Devereux, B Lockwood, and M Redoano, 'Do Countries Compete over Corporate Tax Rates?' (2008) 92 J of Public Economics 1210.

³⁹ MP Devereux, R Griffith, and A Klemm, 'Corporate Income Tax Reforms and International Tax Competition' (2002) 35 Economic Policy 451; S Loretz, 'Corporate Taxation in the OECD in a Wider Context' (2008) 24 Oxford Rev of Economic Policy 639, 641–42. Nonetheless, corporate tax revenues have remained fairly stable: Loretz (ibid) 644–45; KA Clausing, 'Corporate Tax Revenues in OECD Countries' (2007) 14 Int'l Tax and Public Finance 115.

⁴⁰ Loretz (n 39) 645–47.

foreign branch profits and foreign affiliate dividends, has in fact resulted in a narrowing of the international scope of the corporate tax base in most developed countries other than the US.

The UK and Canada are enthusiastic participants in this worldwide trend. Consider first the movement to lower statutory rates. The UK had reduced its general corporate tax rate to 30 per cent by 1999; initially this was considered competitive among EU states but deeper cuts elsewhere impaired the UK's relative position.⁴¹ The UK responded by lowering the statutory rate to 28 per cent effective 2008. The current government, insisting that it is committed to corporate tax reform and competitiveness, has announced a further phase of reductions that would bring the rate to 24 per cent.⁴² In Canada, the combined federal and provincial corporate tax rate (for Ontario) had declined to 43.6 per cent as of 2000 and to 36.1 per cent as of 2007. There was a growing sentiment in the early 2000s that Canada was lagging other nations in various economic indicia, including net FDI, due in part to its lack of tax competitiveness.⁴³ These concerns prompted a series of tax rate reductions, and elimination of additional taxes, announced in the 2006 Budget and subsequent publications.⁴⁴ The combined federal and Ontario corporate tax rate reached 31 per cent in 2010 and the stated goal is to have a rate of 25 per cent in the near future. The federal government proclaimed that

⁴¹ Devereux et al 2002 (n 39); OECD, *Economic Surveys: United Kingdom – 2007* (OECD, Paris 2007) ch 5.

⁴² HM Treasury and HMRC, *Corporate Tax Reform: Delivering a More Competitive System* (HM Treasury, London, November 2010) <www.hm-treasury.gov.uk/corporate_tax_reform.htm> (Corporate Tax Reform) 9, 13.

⁴³ JM Mintz, *The 2006 Tax Competitiveness Report: Proposals for Pro-Growth Tax Reform* (CD Howe Institute, Toronto 2006); GR Zodrow, 'Policy Forum: Corporate Income Taxation in Canada' (2008) 56 CTJ 392, 393–94.

⁴⁴ Department of Finance, *The Budget Plan 2006* (Department of Finance, Ottawa 2006); Department of Finance, *2007 Economic Statement* (Department of Finance, Ottawa 2007).

this would give Canada the lowest statutory rate in the Group of Seven (G7) countries, but it seems the UK plans to do one better. Thus the competition continues.

While the headline rate of corporation tax may give an immediate flavour of a country's competitive position, it is not as important to MNEs as the composition of the corporate tax base, particularly the jurisdictional reach of the base. The well-publicized headquarters emigrations mentioned above served to confirm the significance of the jurisdictional scope of the tax system. Although it is sometimes claimed that these emigrations were prompted by excessive 'complexity' in the UK corporate tax system, it is apparent that the greatest source of concern was the broad and uncertain sweep of the UK regime for taxing 'foreign profits', including the profits of controlled foreign companies (CFCs).⁴⁵

The British and Canadian governments have come to accept that whether they pursue a 'worldwide' or 'territorial' approach to corporate taxation has a significant impact on the location decisions of MNEs. As the UK government observed in 2010:

... the Government needs to ensure that the way the tax system operates for UK headquartered multinationals does not inhibit commercial business practices or make them unattractive to international investment.

To be more competitive, the UK's corporate tax system should focus more on profits from UK activity in determining the tax base rather than attributing the worldwide income of a group to the UK. Moving towards a more territorial system in this way will better reflect the global reality of modern business and will allow businesses based here to be more competitive on the world stage supporting UK investment and jobs.⁴⁶

⁴⁵ Voget (n 26); Cooklin (n 27); J Freedman, G Loomer, and J Vella, 'Corporate Tax Risk and Tax Avoidance: New Approaches' [2009] BTR 74, 93–94.

⁴⁶ Corporate Tax Reform (n 42) 13. The reader may ask what is meant by the terms 'worldwide' and 'territorial'. No attempt will be made to define those terms here, as it is impossible to explain their meaning without extensive analysis. Deconstructing the concepts 'worldwide' and 'territorial', as well as the concept of 'foreign profits', is a focus of this thesis.

The major feature of the move to ‘a more territorial system’ was the dismantling of the tax credit regime in favour of exemption for most foreign dividends, proposed in 2007⁴⁷ and enacted in 2009.⁴⁸ The government also intends to modify the treatment of foreign branch profits, creating an optional exemption regime supported by anti-diversion rules.⁴⁹ In Canada the policy shift has been less dramatic, given that the legislation already features a participation exemption for foreign affiliate dividends where they are derived from business income earned in treaty countries, and provides generous exclusions from the CFC regime.⁵⁰ The federal government’s approach, announced in 2007, was to introduce certain ‘tax advantages’ for Canadian MNEs and to appoint an Advisory Panel to make recommendations for improving Canada’s international tax system generally.⁵¹ As yet there has been little discussion in Canada of exempting foreign branch profits. The nature and implications of the above changes are addressed in chapters two and three of the thesis. Without going into detail here, it is sufficient to say that the overwhelming theme of the legislative amendments and proposals in the UK and Canada is enhancing international competitiveness.

Some observers will maintain that these policy developments signal the demise of (residence-based) corporate taxation in the UK and Canada. In the author’s view that is an oversimplification, if not a complete error. There are at least two reasons for this. First, the UK and Canada continue to treat financing income and deductions as being

⁴⁷ HM Treasury and HMRC, *Taxation of Companies’ Foreign Profits: Discussion Document* (HM Treasury, London, June 2007) <www.hm-treasury.gov.uk/consult_foreign_profits.htm> ch 3.

⁴⁸ CTA 2009 pt 9A (ss 931A–931W), inserted by FA 2009 Sched 14.

⁴⁹ HM Treasury, *Foreign Branch Taxation: Discussion Document* (HM Treasury, London, July 2010) <www.hm-treasury.gov.uk/tax_foreign_branches.htm>; Corporate Tax Reform (n 42) 85–94.

⁵⁰ Known in Canada as the ‘foreign accrual property income’ (FAPI) regime.

⁵¹ Department of Finance, *The Budget Plan 2007* (Department of Finance, Ottawa 2007) 239–44; Advisory Panel on Canada’s System of International Taxation, *Final Report: Enhancing Canada’s International Tax Advantage* (Department of Finance, Ottawa 2008) <www.apcsit-gcrctfi.ca/index-eng.html> (Advisory Panel Report) ch 4.

within the exclusive competence of the residence state. Thus both countries' international tax systems involve a fundamental mismatch: returns on equity are taxed on a 'territorial' or 'source' basis, while the cost of debt is accounted for on a 'residence' basis.⁵² Proposals to limit interest deductibility in respect of foreign operations have been abandoned in both jurisdictions.⁵³ As of 2010, the UK Treasury and the Canadian Department of Finance continue to champion the foreign dividend exemption coupled with almost unlimited deductibility of interest. This position is indefensible from a tax policy perspective except to the extent that it enhances competitiveness. The second observation as to the continuing relevance of residence-based corporate taxation is the existence of CFC regimes in Canada and the UK, although the British government recognizes that reforming these rules 'is frequently identified by UK multinational businesses as the key priority needed to improve the UK's tax competitiveness'.⁵⁴ The nature, purpose, and application of CFC legislation is addressed in chapter five of the thesis. The important point here is that neither of these approaches is a feature of a 'territorial' system. They are features of a system that panders to international competitiveness concerns by narrowing the corporate tax base, while simultaneously attempting to limit 'abuse' of the system's generosity.

1.2.2(b) The Administrative Response – Condemning International Tax Avoidance

The above-described legislative developments, all occurring in the period from 2007 through 2010, are designed to make the UK or Canada an attractive location for internationally mobile firms, particularly the headquarters of MNEs. In each country the government perspective appears to be that, rather than having MNEs relocate their

⁵² Explained further in ch 2.

⁵³ Corporate Tax Reform (n 42) 13–14; Department of Finance, *Budget 2009* (Department of Finance, Ottawa 2009) 24, 162, 324–25.

⁵⁴ Corporate Tax Reform (n 42) 14, 25.

headquarters to Ireland, Switzerland, or some other low tax state, it is preferable to encourage them to remain resident in the UK or Canada, even if doing so requires the tax system to permit massive debt shifting into the home country and massive income shifting offshore.

It is ironic that, during the same time period that these competition-enhancing measures were introduced, revenue authorities in the UK and Canada have been raising the alarm about ‘aggressive’ or ‘abusive’ international tax avoidance conducted by MNEs. Of particular interest, both Her Majesty’s Revenue and Customs (HMRC) and the Canada Revenue Agency (CRA) have routinely drawn attention to avoidance involving the exploitation of entities resident in tax havens, whether used as ‘base companies’ to avoid tax in respect of outbound investment⁵⁵ or used as ‘conduits’ to avoid tax in respect of inbound investment.⁵⁶ HMRC and the CRA rarely dispute the existence or residence of these entities; instead they invoke specific anti-avoidance legislation or argue that the use of such entities is ‘aggressive’, in the sense of being contrary to Parliamentary intention.

It is useful to examine briefly the political context in which these responses have developed. That context includes vigorous efforts by the OECD and other organizations to identify and address ‘aggressive tax planning’ by corporations, combined with efforts of the same organizations to thwart international tax evasion by individuals, especially in the period following the global financial crisis of 2008.

⁵⁵ Discussed further in chs 5 and 7.

⁵⁶ Discussed further in chs 6 and 7.

The concept of ‘aggressive tax planning’ was a key theme of the OECD’s 2008 *Study into the Role of Tax Intermediaries*⁵⁷ (OECD Study) prepared on behalf of several revenue authorities. The OECD Study declared that aggressive tax planning comprises: (i) taking a tax position that is tenable but has unintended and unexpected tax revenue consequences; and (ii) taking a tax position that is favourable to the taxpayer without openly disclosing that there is uncertainty whether significant matters in the tax return accord with the law.⁵⁸ While the OECD Study dealt with aggressive tax planning generally, the specific issue of aggressive international tax planning continues to be a focus of the Joint International Tax Shelter Information Centre, the Seven Country Working Group on Tax Havens, and the Leeds Castle Group, each of which includes HMRC and the CRA.⁵⁹

It is notable that the work of these groups, as far as the author is aware, is largely focused on offshore tax evasion by individuals rather than tax avoidance by MNEs. The tendency of governments and revenue authorities to associate these distinct activities is unfortunate but not uncommon. The best examples of this practice are the policy statements issued in the wake of the 2008 financial crisis, which intimated that there was some connection between tax havens, tax evasion, tax avoidance, and the financial collapse. The G20 leaders’ Communiqué issued at the London 2009 Summit stated that, as one aspect of their commitment to strengthen financial regulation and supervision, countries would ‘take action against non-cooperative jurisdictions, including tax havens’.⁶⁰ The Communiqué referred to a report of the OECD Global Forum on

⁵⁷ OECD, *Study into the Role of Tax Intermediaries* (OECD, Paris 2008) <www.oecd.org/dataoecd/28/34/39882938.pdf>.

⁵⁸ *ibid* 10–11, 87.

⁵⁹ *ibid* 30–32.

⁶⁰ G20, ‘The Global Plan for Recovery and Reform’ (2 April 2009) <www.g20.org/pub_communiques.aspx>.

Transparency and Exchange of Information for Tax Purposes (Global Forum), assessing the progress of certain jurisdictions in implementing its ‘internationally agreed tax standard’.⁶¹ The essence of this standard, which has been in existence since 2000, is that jurisdictions agree to exchange tax information in order to counter suspected cases of tax evasion – it has nothing to do with either financial market regulation or tax avoidance. Nonetheless, publications issued by the Global Forum in 2008 through 2010 have routinely referred to tax evasion, tax avoidance, and the global financial crisis as though there is some intangible connection between them.⁶² Presumably the thinking of the G20 and OECD was that the recklessness of financial institutions such as Citigroup (in the US) and Royal Bank of Scotland (in the UK), whose losses threatened the integrity of global markets, often involved the use of structured investment vehicles that were located in tax havens. Thus it was appropriate to call for greater transparency and more coordinated regulation of those states’ financial sectors. Yet whatever the use of affiliates in tax havens may say about financial regulation avoidance, it is irrelevant to tax evasion,⁶³ although it may well be associated with tax avoidance.

More careful observers have questioned the wisdom of providing government ‘bailouts’ to certain banks when they were engaged in ‘aggressive international tax planning’ arranged by their structured finance departments. The 2008 GAO Report⁶⁴ and the 2009 TUC Report⁶⁵ are good examples. The authors of those reports did not

⁶¹ OECD, ‘A Progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard’ (2 April 2009) <www.oecd.org/ctp/http/cooperation>.

⁶² See most recently OECD, ‘The Global Forum on Transparency and Exchange of Information for Tax Purposes: a Background Information Brief’ (18 February 2011) <www.oecd.org/ctp/http/cooperation>.

⁶³ No one suggests that Citigroup, RBS or other financial institutions were engaging in tax evasion, although there are recent examples of wealthy clients of banks in Liechtenstein and Switzerland evading home country taxes: eg H Simonian, ‘Private banks face tax evasion clampdown’ *Financial Times* (8 May 2008); CRA, ‘Canada cracks down on unreported offshore account holders’ News Release (30 September 2010).

⁶⁴ (n 21).

⁶⁵ (n 21).

suggest that the identified banks were engaging in tax evasion, and conceded that some tax haven subsidiaries were undoubtedly providing financial services to their local populations. However, they sought to demonstrate the political and fiscal incoherence of socializing the losses of institutions that were shifting much of their taxable income into tax havens.⁶⁶ Similar sentiments had been expressed by Barack Obama during his 2008 presidential election campaign; he often stated that there is ‘a building in the Cayman Islands that supposedly houses 18,000 corporations,’ contending ‘[t]hat’s either the biggest building or the biggest tax scam in the world.’⁶⁷ In the UK, the issue of offshore tax avoidance had gained publicity in 2008, largely due to investigative reports by the *Guardian* newspaper highlighting the astonishing numbers of letterbox companies registered in low tax jurisdictions. Among other things, the series claimed that Zug, Switzerland is home to some ‘27,000 registered companies, one for every human resident’.⁶⁸

The indignation expressed by the US President and these other commentators is not related to criminal behaviour. Their indignation stems from the perception that the identified corporations are in no realistic sense participants in the economy of the Cayman Islands, Switzerland, or other offshore centre, being entirely controlled by domestic shareholders whose directives are executed by compliant offshore personnel. Yet none of the coordinated actions taken following the financial crisis, including the

⁶⁶ A Taylor and V Houlder, ‘Call to make bail-out banks list havens’ *Financial Times* (29 January 2009); R Jackson, ‘UK Banks’ Tax Haven Activity under Scrutiny’ 53 *Tax Notes Int* 1 498 (9 February 2009).

⁶⁷ eg B Obama, Campaign Speech, Indianapolis IN (23 October 2008). President Obama was referring to Uglan House, the main office of law firm Maples and Calder. Less than half of these entities had connections to the US: Government Accountability Office, *Cayman Islands: Business and Tax Advantages Attract US Persons and Enforcement Challenges Exist* (Doc GAO-08-778, Government Accountability Office, Washington DC 2008) <www.gao.gov/products/GAO-08-778>.

⁶⁸ Tax Gap (n 1). These reports gained wider attention that prompted some corporate groups to defend their practices. Notably, the *Guardian* was forced to withdraw – and apologize for – a report alleging that UK retailer Tesco had created elaborate offshore structures to avoid ‘up to £1 billion’ in UK corporate taxes: KA Parillo, ‘Guardian Revises Tax Avoidance Accusations Against Tesco’ 50 *Tax Notes Int* 1 472 (12 May 2008).

global expansion of information sharing through Tax Information Exchange Agreements (TIEAs), responds to that concern. If anything, these developments give further legitimacy to zero-tax states including Bermuda, the Cayman Islands, and Jersey, to the extent that they have implemented the OECD's internationally agreed tax standard and thus assisted in the prevention of illegal activity.⁶⁹

This brings us back to the concerns of HMRC and the CRA with respect to corporate mobility and international tax avoidance. These concerns are not new, but there is a perception that HMRC and the CRA have become increasingly strident in challenging international tax planning in recent years.⁷⁰ Moreover, both authorities have used the 2008 financial crisis as a convenient nucleus to propel their concerns about the use of tax havens for offshore evasion and avoidance.

Consider first the response in the UK. The former Prime Minister, in urging British crown dependencies and overseas territories to implement fully the OECD exchange of information standards, also suggested that the OECD's focus should move beyond tax evasion, seeking to create new international standards for the control of offshore tax avoidance.⁷¹ Representatives of HMRC, who were instrumental in the development of the OECD Study, would appear to agree that such standards are desirable. As part of its ongoing project to improve relationships with large businesses

⁶⁹ See Picciotto 2007 (n 34).

⁷⁰ eg Cooklin (n 27); Freedman et al (n 45) 92–97; R Jackson, 'CRA Ramping Up Risk Assessment to Ensure Tax Compliance' 54 *Tax Notes Int'l* 1006 (22 June 2009).

⁷¹ R Jackson, 'Brown Pushes UK Tax Havens on OECD Standards' 54 *Tax Notes Int'l* 180 (20 April 2009). The Treasury commissioned an independent review of British crown dependencies and overseas territories. The conclusions of this review concern the constitutional relationship of such jurisdictions with the UK, the financial importance of such jurisdictions, and the need to implement measures to prevent tax evasion in such jurisdictions; the report does not address tax avoidance: M Foot, *Final Report of the Independent Review of British Offshore Financial Centres* (HM Treasury, London 2009) <www.hm-treasury.gov.uk/indreview_brit_offshore_fin_centres.htm>.

through, among other measures, the conducting of risk assessments,⁷² HMRC produced a manual on the Tax Compliance Risk Management Process.⁷³ That manual lists seven assessment indicators, including ‘complexity’, ‘governance’, and ‘boundary’ issues. Under the ‘boundary’ assessment indicator, which comprises issues related to international structuring, it is suggested that the highest level of risk (‘major risk’) exists in the case of a UK based enterprise ‘using offshore entities’ or having ‘extensive involvement with tax havens’.⁷⁴ In the author’s view it is not a coincidence that the heading ‘boundary’ echoes HMRC’s term ‘boundary of the law’, meaning the threshold beyond which tax planning is considered to become aggressive or unacceptable.⁷⁵ That which is international is presumed to be aggressive.

Much the same idea was expressed in the Code of Practice for banks adopted in 2009,⁷⁶ a voluntary statement of principles on bank governance, openness, and tax planning.⁷⁷ The Code of Practice and related commentary stipulate that, in arranging their tax planning, banks should comply not only with the ‘letter of the law’ but with the ‘spirit of the law’.⁷⁸ The initial consultation document reiterated the definition of aggressive tax planning from the OECD Study; it stated that one ‘signpost’ or example

⁷² HMRC, *Review of Links with Large Business* (HMRC, London 2006); HMRC, *Making a Difference: Delivering the Review of Links with Large Business* (HMRC, London 2007) (Delivery Plan); HMRC, *HMRC Approach to Compliance Risk Management for Large Business* (HMRC, London 2007). These documents are available at <www.hmrc.gov.uk/large-business/review-2007.htm>.

⁷³ HMRC, *Tax Compliance Risk Management Process Manual* (HMRC, London 2009) <www.hmrc.gov.uk/manuals/tcrmanual/index.htm>.

⁷⁴ *ibid*, annex B.

⁷⁵ Delivery Plan (n 72) 3.3.

⁷⁶ HMRC, *A Code of Practice on Taxation for Banks: Consultation Document* (HMRC, London, June 2009) <www.hmrc.gov.uk/consultations/index.htm> (COP 2009a); HMRC, *A Code of Practice on Taxation for Banks: Consultation Response Document* (HMRC, London, December 2009) <www.hmrc.gov.uk/pbr2009/supplementary.htm> (COP 2009b).

⁷⁷ By December 2010 the UK’s fifteen largest banks had agreed to comply: KA Parillo, ‘Largest Banks Sign UK Tax Code of Practice’ 60 *Tax Notes Int* 1 844 (13 December 2010).

⁷⁸ COP 2009a (n 76) 5, 6, 15; COP 2009b (n 76) 4, 20.

of such planning is a transaction where income, gains, expenditure or losses ‘are not proportionate to the economic activity taking place or the value added in the UK’, which may involve ‘the transfer of ownership of an income stream from a company in the UK to an associated offshore vehicle in a low-tax or no-tax jurisdiction’.⁷⁹ Most recently, the HMRC Business Plan for 2011 through 2015 indicates that £900 million is being invested to tackle tax avoidance and evasion, including ‘specific action to tackle off-shore avoidance and evasion’.⁸⁰

The CRA take a similar approach, suggesting that the use of tax haven affiliates is ‘aggressive’ and intimating that such behaviour is – in some undefined way – associated with offshore tax evasion. In 2005 the CRA announced that they were establishing eleven ‘Aggressive International Tax Planning’ (AITP) Centres of Expertise across Canada. The stated purpose of this initiative was ‘to strengthen and enhance ... audit and collection programs to counter international tax avoidance and evasion and aggressive international tax planning’.⁸¹ A particular concern was said to be the ‘abuse’ of tax havens. In 2007 the CRA stated publicly that there were about 50 projects underway pursuant to this initiative, looking at issues including residence, tax shelters, financial arrangements, and ‘tax treaty abuses’.⁸² More recently, the directors of the CRA International and Large Business Directorate and the CRA Competent

⁷⁹ COP 2009a (n 76) 10, 17.

⁸⁰ HMRC, *Business Plan 2011–2015* (HMRC, London, November 2010) <www.number10.gov.uk/wp-content/uploads/HMRC-Business-Plan1.pdf> 2, 4.

⁸¹ CRA, ‘Aggressive International Tax Planning Centres of Expertise’ Fact Sheet (August 2005) <www.cra-arc.gc.ca/nwsrm/fctshts/2005/m08/050823-eng.html>.

⁸² CRA, Comments from Canadian Life & Health Insurance Association Roundtable (May 2007).

Authority Services Division stated that, aside from transfer pricing, the CRA is particularly vigilant with respect to ‘the improper use of tax havens’.⁸³

The CRA, like HMRC and the authors of the OECD Study, are careful to point out that aggressive tax planning is not equivalent to tax evasion. A recent CRA Guide regarding the ‘risk’ of using tax havens explains that aggressive tax planning has the objective of obtaining benefits ‘that were never intended under the normal application of the tax laws’ but does not cross the line to evasion.⁸⁴ This Guide, along with other statements made and publications issued by the CRA in 2007 through 2010, continue to warn taxpayers about the CRA’s domestic and international efforts to obtain and share information in order to thwart offshore tax evasion. Somewhat perplexing is the CRA’s routine inclusion of references to ‘aggressive’ tax planning involving tax havens, as though this issue is somehow connected to criminal behaviour and will somehow be addressed through Canada’s growing network of TIEAs.⁸⁵ In any event, there is little doubt that significant resources will continue to be directed towards tackling international avoidance and evasion in upcoming years.

1.2.2(c) Rationalizing the Legislative and Administrative Responses

This brief discussion has sought to demonstrate that, in the face of globalization and corporate mobility, recent tax policy changes in the UK and Canada have attempted to reduce corporate flight through: (i) measures that enhance the competitiveness of the

⁸³ Jackson 2009 (n 70). The CRA Commissioner has highlighted similar issues in the past, suggesting that ‘treaty shopping’ and the use of ‘tax havens to avoid paying taxes’ constitutes non-compliance: A Nymark, ‘Strategic Priorities for the CCRA’ in Canadian Tax Foundation (ed), *2003 Conference Report* (Canadian Tax Foundation, Toronto 2004) 6:1, 6:3.

⁸⁴ CRA, *Guide RC4507: Using Tax Havens to Avoid Paying Taxes – Worth the Risk?* (CRA, Ottawa 2009) <www.cra-arc.gc.ca/E/pub/tg/rc4507/README.html>.

⁸⁵ LM Nadal, ‘Tax Cuts Part of Long-Term Economic Plan, Flaherty Says’ 46 *Tax Notes Int* 1 887 (28 May 2007); CRA, ‘Combating the abusive use of tax havens: Minister Blackburn to meet with his international counterparts’ News Release (5 January 2010).

corporate tax system, thus encouraging MNEs to remain ‘resident’ in these countries; and (ii) anti-avoidance measures including CFC rules, thus drawing ‘foreign’ income back into the domestic tax net. Revenue authorities, whose role is to administer the tax legislation, are quite properly focused on taxpayer compliance with the rules, including application of anti-avoidance rules. Yet HMRC and the CRA are also challenging international tax planning that skirts these rules, and doing so with great zeal. It is ironic that one form of international tax planning that remains unchallenged is perhaps the most aggressive, most tax-efficient, and most threatening to public finances: total emigration of a corporate group.

1.3 CORE ARGUMENTS OF THESIS

1.3.1 What this Thesis Concerns

As stated at the outset, this thesis concerns the nature of the corporate residence concept: why residence is relevant to taxation, what it means, and how revenue authorities respond to its use and its alleged abuse. The thesis focuses on current international tax rules in the UK and Canada, examining how these rules are interpreted and sometimes amplified by the respective tax administrations in the face of international tax avoidance.

The first theme is the relevance of corporate residence to tax policy. There is a current tendency among tax scholars to regard residence-based taxation as quaint, old-fashioned, and of diminishing relevance.⁸⁶ Yet in all of the tax policy developments discussed above, the concept of corporate statehood – that is, residence – is pervasive and pivotal. Companies threaten to *emigrate*. Some actually do. Companies demand

⁸⁶ As discussed in ch 2.

exemption of *foreign* dividends. The government capitulates. Companies want controlled *foreign* companies to be excused from tax. The government refuses. Companies *establish* affiliates in tax havens. The revenue administration treats that as aggression or abuse. While one can tenably argue that reliance on corporate residence as a basis for taxation should be reduced when redesigning international tax rules, the idea that residence is unimportant to current tax policy is plainly wrong.

The second and third themes – what residence means and how revenue authorities respond to its exploitation – are closely connected. The above discussion has pointed to various references by governments, tax administrations, media, and other commentators to the establishment of affiliated corporations in foreign jurisdictions, especially tax havens. Almost invariably there is some insinuation that tax haven entities are ‘unreal’ or lack substance, consisting of little more than a letterbox in a law office in Barbados, Bermuda, Ireland, Jersey, Switzerland, or other low tax jurisdiction. But what is the ‘unreality’ that the observer has in mind? More importantly, what is the reality with which this unreality is being contrasted?

In the author’s view, the reality is a corporation composed of human beings applying their collective intellectual endeavours in a particular geographic location. While a MNE may include various entities that serve limited functions within the enterprise, it is a myth that such functions can be achieved without the intellectual endeavours of people. The argument is often made that affiliates performing financing, IP management, insurance, or other intra-firm services can do so adequately without extensive (or any) contribution from directors, officers, or employees in the affiliate’s state of residence. What this means is that the necessary intellectual endeavours occur somewhere else. The unreality is a box drawn on a piece of paper, perhaps connected to various other boxes, with the name ‘Bermuda Co’ or ‘Swiss Co’ written inside it as

though the very act of drawing the box creates national attachment. The current meaning of corporate residence in the UK and Canada, being based on the formality of incorporation or acts of central management and control, seems to require very little beyond this drafting exercise. The vacuity of the corporate residence concept is thus central to much, if not most, international tax planning.

It is nonetheless important to accept the possibility of a foreign corporation being a 'real' resident of the intended residence state, even if its location is driven by tax. Protectionist concerns should not enter into the analysis of where economic interests exist. It is clear that modern MNEs operate through extensive networks of foreign affiliates, including special purpose vehicles that may serve valuable functions. There may be good commercial and tax reasons for an enterprise to segregate particular functions into particular entities and to locate those entities in low tax jurisdictions or, indeed, to move its corporate headquarters to a low tax jurisdiction. The question in either case should be whether the affiliate or parent company has been meaningfully established in the ostensible state of residence. That the location or relocation was motivated primarily or entirely by tax is, in the author's view, irrelevant. What is relevant is whether the entity is actually established there. Unfortunately, because the accepted meaning of corporate residence is vacuous, revenue authorities have tended to challenge the exploitation of residence by making nebulous associations with offshore tax evasion and by emphasizing the tax purpose of a foreign corporation's existence.

In sum, it is the author's view that the interpretation and application of various international tax rules reveal the administration's discontent with the legal architecture of corporate identity and corporate residence, and are tantamount to reconfiguring those concepts without legal authority. The author's intent is not so much to advocate creating some new, expansive formulation of corporate residence. It is to advocate bringing the

stated law into line with the current practice of revenue authorities with respect to corporate residence issues. This is very much a rule of law concern – the law should be capable of guiding behaviour. If we wish to tax the income of resident entities or enterprises on the basis of an understanding of corporate residence that reflects economic substance (and there is good reason to wish that), it is consistent with the rule of law to have that understanding of residence expressed in the law. It is contrary to the rule of law to have that understanding of residence revealed only through the discretionary application of anti-avoidance rules or principles to particular taxpayers. Formulating a meaningful definition of corporate residence would further two goals: (i) limit the erosion of the tax base that occurs through use of companies lacking bona fide establishment in their purported jurisdictions; and (ii) provide relatively transparent rules which corporate taxpayers can rely upon to know that ‘resident’ means resident.

The nature and function of residence-based corporate taxation are relevant to almost all jurisdictions, but this discussion focuses on the experience in the UK and Canada. These two countries have a shared legal tradition with respect to the understanding of corporate identity and residence, similar statutory definitions of corporate residence, shared historical adherence to a US-style foreign tax credit system that has yielded to dividend exemption, broadly comparable CFC regimes, and two of the largest bilateral treaty networks in the world. Some comparative references are made to the experience in the US, Commonwealth countries other than Canada, and certain EU states, but for the sake of brevity the law of those jurisdictions is not addressed in any detail.

1.3.2 What this Thesis Does not Concern

As Richard Vann has recently observed, much of the literature regarding international tax law and policy can be divided into two categories: that written by tax practitioners and administrators, focusing on the detailed rules and what results they produce (for better or for worse); and that written by public finance economists, often arguing that taxation of international corporate income is doomed and that radical changes are required. He goes on to say that '[a]n important role for legal academics is to investigate how policy prescriptions can be made operational'.⁸⁷ This thesis is in that vein. The central aims are to demonstrate how current formulations of corporate residence are flawed and to suggest policy prescriptions as to how the concept can be improved, reducing opportunities for international avoidance without resorting to impossible arguments about what activities are 'unacceptable' or 'abusive'.

As such, this is not a pure policy discussion that proceeds on the basis that one can dispense with, or at least overcome, concerns related to national sovereignty and differing domestic legal traditions. Nor is it a wide-ranging assessment of all features of the international tax system. The thesis focuses on certain international tax rules in the UK and Canada that impact on corporate residence, analyzing how these rules are applied in response to international tax avoidance activities.

Nor is this work intended to be an exhaustive description of the taxation of inbound and outbound investment according to UK domestic law, Canadian domestic law, and bilateral tax treaties. This thesis does not purport to describe in microscopic detail the mechanics of the foreign tax credit, the foreign dividend exemption, the CFC

⁸⁷ RJ Vann, 'Taxing International Business Income: Hard-boiled Wonderland and the End of the World' (2010) 2 World Tax J 291, 292.

attribution rules, or other specific anti-avoidance rules relevant to international transactions. In all cases the author has attempted to explain these provisions with detail sufficient to elucidate how their operation is a function of corporate residence, among other key elements. The intricacies of these rules have been described admirably elsewhere and references are provided to such sources. Repeating those descriptions here would risk obscuring the paramount argument of the thesis.

Finally, this thesis does not deal with the field of international transfer pricing.⁸⁸ Any feasible reconfiguration of the corporate residence concept will allow scope for MNEs to remain ‘multinational’ in that they will continue to have truly foreign operations. This means that a great deal of transnational income flows would still occur within firms. One might predict that, where an offshore financing affiliate, IP affiliate, captive insurer or the like is substantially established in its state of residence, it would be somewhat less likely to accept artificial transfer prices dictated by a controlling shareholder, yet the risk of having transfer prices divorced from market reality would remain. Determining whether the parties to a transaction are in fact resident in different countries remains a crucial first step.

1.4 OUTLINE OF THESIS

1.4.1 Outline of Part I

Part I of the thesis, comprising chapters two, three and four, is a largely theoretical discussion of the nature and scope of residence-based taxation. It argues that the residence of taxpayers generally (whether individual or corporate) remains a relevant

⁸⁸ See Int’l Fiscal Association (ed), *Transfer Pricing and Intangibles*, Cahiers de Droit Fiscal International vol 92a (IFA, Kyoto 2007); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD, Paris 2010); Avi-Yonah et al 2009 (n 23); Vann 2010 (n 87).

factor in tax design, that taxation of corporations on the basis of their residence continues to have some justification, but that there is currently a disjunction between meaningful residence-based taxation and actual formulations of corporate residence.

Chapter two explains that economic globalization has been accompanied by a growing body of scholarship that challenges the principles upon which international tax jurisdiction is based. Focusing on the concepts of tax equity and ‘economic allegiance’, the connecting factors of residence and source are situated in their historical and constitutional context. The chapter highlights the longstanding international consensus on the allocation of tax jurisdiction among home and host states, a consensus that seems to endure despite the development of regional communities such as the EU. It is argued that rules which ascribe jurisdiction based on residence and source are not consistent with any single policy framework, because residence and source are merely terms that suggest some economic nexus with a state. Applying criteria that are commonly used to evaluate tax policy – equity and efficiency – it is shown that residence, if properly understood as the home economic interest, continues to be theoretically and practically justified as a basis for taxation.

Building upon this theoretical foundation, chapter three considers the jurisdictional principle of residence in the specific and more difficult context of MNEs. If a state wishes to tax corporations on a residence basis then it is sensible to have some policy reason for taxing corporations at all, and to have some idea how the hallmarks of residence are related (or not) to that policy rationale. This chapter reviews the rival ‘theories of the corporation’ and argues that, although entity theory is the traditional underpinning for corporate taxation, one can justify a corporate tax given any such theory. The most convincing justification is that corporate taxes serve an essential withholding function, although there may also be a benefits rationale. It is argued that

these justifications are apposite to both home and host state taxation, which has important implications for the policy choice between ‘credit’ and ‘exemption’ systems.

The justifications studied in chapter three are viable when corporate residence is understood as a special form of source, that is, as a substantial economic interest in the home state. Unfortunately, neither of the principal tests of corporate residence employed in the UK and Canada – incorporation or central management and control – is a satisfactory gauge of the home economic interest. Chapter four argues that the incorporation test is a *de jure* standard that bears no relation to economic activity, while the central management and control test is little better because it constitutes a ‘highest functions’ paradigm that is easily manipulated. Particular attention is given to *Wood v Holden*⁸⁹ and its ramifications. Although the treaty concept of place of effective management has promise in that it could denote ‘real’ and ‘substantive’ management, to date that interpretation has been eschewed by higher courts and its importation into domestic law has been resisted by business. Recent UK and Canadian cases on the residence of trusts are noted because they illustrate a contrasting, and perhaps preferable, approach to residence.

1.4.2 Outline of Part II

Part II of the thesis, comprising chapters five, six and seven, critically analyzes the major policy responses of the UK and Canadian governments to the exploitation of corporate residence. It argues that key legislative and administrative responses to the international avoidance of tax by MNEs, for both outbound and inbound investment, are purportedly based on the acceptance of formal corporate residence yet undermine that concept in an effort to tax the income of the ‘real business’.

⁸⁹ [2005] STC 789 (Ch), *aff’d* [2006] STC 443 (CA).

Chapter five deals with the most visible attack on foreign corporate residence, namely, a state's CFC regime. The essence of CFC legislation is that certain passive or mobile income of foreign subsidiaries is attributed to domestic shareholders. Although such legislation may be necessary, it is questionable whether the current rules in the UK and Canada are correctly targeted. This chapter examines the history and context of CFC legislation in the UK and Canada, demonstrating how the rules have become more focused on 'abuse' of foreign dividend exemptions. Indeed, the apparent consensus regarding the legitimacy of CFC regimes exists only to the extent that they target 'abusive' or 'wholly artificial' structures, illustrated by the decisions in *Cadbury Schweppes*⁹⁰ and *Vodafone 2*.⁹¹ The chapter goes on to argue that the UK and Canadian rules remain flawed both in their design and in their application: the first flaw stems from the imprecise definitions of 'exempt activity' and 'active business'; the second consists in the overzealous application of avoidance 'motive tests' in order to disregard the effectiveness of foreign subsidiaries. This approach tends to conflate concerns about artificial corporate establishment or activity (the objective component) with concerns about tax purposes or tax motives (the subjective component). It is argued that UK and Canadian legislation should seek to better identify what income *is* earned in the home state and what income *is* earned in foreign states, and to tax the home interest accordingly.

In chapter six the consideration turns from outbound investment to inbound investment, revealing the incoherence of current policy responses to tax treaty 'abuse'. This chapter briefly reviews the nature of bilateral tax treaties, which serve to allocate fiscal jurisdiction and reduce the burden of double taxation. International organizations

⁹⁰ Case C-196/04 *Cadbury Schweppes plc and anor v IRC* [2006] STC 1908 (ECJ).

⁹¹ *Vodafone 2 v Revenue and Customs Commissioners (No 2)* [2008] STC (SCD) 55, rev'd [2008] EWHC 1569, [2008] STC 2391 (Ch), rev'd [2009] EWCA Civ 446, [2009] STC 1480 (CA).

and various states have identified ‘treaty shopping’ as a concern, but not all states have a uniform view of what constitutes abuse of the treaty relationship. HMRC or the CRA may challenge alleged treaty abuse by seeking amplified interpretations of terms in the relevant treaty, particularly the term ‘beneficial ownership’, as in *Prévost Car*,⁹² or by invoking broader anti-abuse principles or rules, as in *MIL Investments*.⁹³ It is argued that these approaches, much like the application of CFC legislation, tend to conflate concerns about artificial corporate establishment or activity (the objective component) with tax purposes or tax motives (the subjective component). A more coherent response to treaty conduit arrangements viewed by government as undesirable would be to identify by statute and treaty those circumstances in which a purported intermediary lacks independent establishment in the treaty state.

Beyond the specific anti-avoidance approaches discussed in the previous two chapters, tax authorities who view a given international tax structure as unacceptable may invoke overarching countermeasures in the form of general anti-avoidance rules (GAARs) or similar interpretive principles. Chapter seven considers the arguments that have been made by revenue authorities in this context, with respect to both outbound and inbound investment. The chapter first reviews the prevailing anti-avoidance approaches in the UK and Canada; it then scrutinizes key cases where HMRC or the CRA have invoked anti-avoidance measures in order to challenge international arrangements that they deemed unacceptable, particularly those involving tax haven companies. Allegations that a foreign entity was a ‘sham’, that transactions involving a foreign entity were abusive under domestic law, or that such transactions were an abuse

⁹² *Prévost Car Inc v The Queen* 2008 TCC 231, aff’d 2009 FCA 57.

⁹³ *MIL (Investments) SA v The Queen* 2006 TCC 460, aff’d 2007 FCA 236.

of a tax treaty, are discussed. The submissions and decisions in *Furniss v Dawson*⁹⁴ and *MIL Investments*,⁹⁵ among other cases, are examined. It is explained that corporate residence issues are often implicated, although rarely addressed, in such tax avoidance litigation. Where one properly concedes that the avoidance purpose of a MNE in implementing an international tax structure is largely irrelevant, the distinction between ‘acceptable’ / ‘deserving’ structures and ‘unacceptable’ / ‘undeserving’ structures often reduces to the distinction between real economic establishment abroad and formal residence abroad.

1.4.3 Conclusion

The thesis concludes in chapter eight by considering the themes of the policy responses addressed in Part II and judging them against the rationales for residence-based taxation discussed in Part I. The unifying flaw in these policy responses is that, while each is premised on acceptance of corporate residence (and corporate personality) in their formal legal sense, each undermines those concepts in an effort to impose tax or refuse treaty relief based on where substantial economic interests actually exist. The ‘ectopia’ between residence as a term of art and residence as a term of substance is at the root of all of this. Unfortunately, rather than attempting to reconcile this disparity through legislative improvement of corporate residence formulations, the UK and Canadian governments continue to rely on haphazard anti-avoidance rules and, augmenting this, revenue authorities’ indignation at tax-motivated corporate relocations. A more coherent approach would be to focus on the objective reality or unreality of corporate establishment, ignoring the purposes or motives for such establishment. Although it would not resolve all difficulties, a salutary approach would be to redefine corporate

⁹⁴ [1982] STC 267 (Ch), aff’d [1983] STC 549 (CA), rev’d [1984] AC 474 (HL).

⁹⁵ (n 93).

residence – both in domestic law and tax treaties – such that it better reflected the government’s views of economic reality. The incorporation test would be abandoned and the central management and control test might be replaced with a cumulative list of relevant factors. The test itself is important, but so is the government’s willingness to abide by it.

The thesis deals predominantly with UK and Canadian tax policy and law in the period 2005 through 2010. It takes account of legal developments up to 31 January 2011.

PART I

CHAPTER 2

THE IMPORTANCE OF RESIDENCE IN TAX DESIGN

2.1 INTRODUCTION

2.1.1 Globalization and Optimal Tax Principles

The ongoing process of economic liberalization and integration has been accompanied by a policy debate regarding the most appropriate principles for assigning income tax jurisdiction. The optimal structure of taxes on international profits, especially corporate profits, has been studied by economists and lawyers for nearly half a century. In particular, the last twenty years have seen a growing body of scholarship that challenges the traditional legal principles¹ upon which tax jurisdiction is based – ‘residence’ and ‘source’.

Recent literature in both economics and law has suggested some reconfiguration of the residence and source principles, often in favour of greater source-based taxation, or has advocated abandonment of these principles in favour of a radically new international system. In the public finance literature, two of the most influential articles are by Devereux² and by Desai and Hines,³ arguing against the traditional adherence to capital export neutrality and its prescription of residence-based taxation. Among legal scholars, Vogel vigorously asserted that the prevailing system of residence-based

¹ This thesis deals primarily with the legal understanding of the residence and source principles rather than the economic understanding thereof. This distinction is addressed at text to nn 10–11.

² MP Devereux, ‘Capital Export Neutrality, Capital Import Neutrality, Capital Ownership Neutrality and All That’ (1990) Institute for Fiscal Studies (unpublished); also see MP Devereux, ‘Issues in the Taxation of Income from Foreign Portfolio and Direct Investment’ in S Cnossen (ed), *Taxing Capital Income in the European Union* (OUP, Oxford 2000) 110.

³ MA Desai and JR Hines, ‘Evaluating International Tax Reform’ (2003) 56 Nat’l Tax J 487.

taxation with foreign tax credits was inequitable and adverse to ‘economic reason’.⁴ Graetz denounced the existing system of international taxation as being founded upon ‘inadequate principles, outdated concepts, and unsatisfactory policies’.⁵ More recently, the general reporters for the 2005 congress of the International Fiscal Association (IFA) criticized the ‘immobilism’ of the prevailing international tax regime, which in their view exhibits an unacceptable bias towards developed countries.⁶ Other scholars including Schön⁷ and Vann⁸ have sought to move beyond this debate, contending that it has become largely irrelevant. These are only examples of the pattern of academic discontent with the role of residence in international tax design.

2.1.2 The Continuing Relevance of Residence

Against this backdrop of dissatisfaction, it would be imprudent to embark on a detailed analysis of the concept of corporate residence and its tax policy consequences without first examining the justifications for residence-based taxation. It would be easy to point to the evidence of foreign affiliate and headquarters relocations mentioned in the introductory chapter, as well as government reactions against the ‘abuse’ of corporate residence discussed in Part II of this thesis, in order to conclude as a practical matter that corporate residence is a real and potent consideration. Yet this would not answer the normative inquiry about the relevance of residence. The purpose of this chapter is to

⁴ K Vogel, ‘The Search for Compatible Tax Systems’ in H Stein (ed), *Tax Policy in the Twenty-First Century* (John Wiley & Sons, New York 1988) (Vogel 1988a) 85–86; K Vogel, ‘Worldwide vs Source Taxation of Income – A Review and Re-Evaluation of Arguments (Part I)’ (1988) 8–9 *Intertax* 216, ‘(Part II)’ 10 *Intertax* 310, and ‘(Part III)’ (1988) 11 *Intertax* 393 (collectively, Vogel 1988b).

⁵ MJ Graetz, ‘The David R Tillinghast Lecture – Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies’ (2001) 54 *Tax Law Rev* 261.

⁶ A Schindel and A Atchabahian, ‘General Report’ in Int’l Fiscal Association (ed), *Source and Residence: New Configuration of Their Principles*, Cahiers de Droit Fiscal International vol 90a (IFA, Buenos Aires 2005) (IFA 2005 Congress) 21.

⁷ W Schön, ‘International Tax Coordination for a Second-Best World (Part I)’ (2009) 1 *World Tax J* 67.

⁸ RJ Vann, ‘Taxing International Business Income: Hard-boiled Wonderland and the End of the World’ (2010) 2 *World Tax J* 291.

highlight the basic features of the international tax system, including the allocation of at least some taxing rights to the state of residence of the investor, and to argue that such allocation continues to have merit in globalized economies. Applying criteria that are commonly used to evaluate tax policy – equity and efficiency/neutrality – it is shown that residence, *if properly understood*, remains a legitimate basis for tax jurisdiction.

This is not to say that what is typically referred to as ‘source’ taxation is irrelevant or that recent calls for enhanced source taxation are misplaced. An ideal international tax system would: (i) seek to align income tax jurisdiction with the location or locations of substantial economic interests; and (ii) recognize that such interests result from a variety of human endeavours,⁹ often taking place across multiple states – including the home state. Insofar as ‘residence’ and ‘source’ are proxies for the location of substantial economic interests resulting from human endeavours, each represents a legitimate nexus upon which to base a state’s tax jurisdiction. The challenge for globalized economies is to reinvigorate the concept of residence so that it remains economically meaningful, rather than minimizing or abandoning residence as a basis for taxation.

2.1.3 Disentangling Legal and Economic Terminology

A thorough analysis of tax policy principles should be guided by both legal and economic concepts; unfortunately this tends to give rise to conflicts of terminology. This thesis deals primarily with the legal understanding of the residence and source principles. The terminology of international tax law sees residence-based taxation as taxation *in* a particular jurisdiction (the ‘home’ state), whether the taxpayer is an

⁹ Kemmeren’s ‘principle of origin’, which is based on the proposition that all income originates where human beings engage in intellectual activity, is discussed at text to n 85. See EC Kemmeren, ‘Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach’ (2006) 60 BIFD 430.

individual, partnership, trust, corporation, or other entity, and characterizes source-based taxation as taxation *in* a foreign jurisdiction (the ‘host’ state), again regardless of the taxpayer’s natural or legal identity.¹⁰ This is quite different from the economic understanding of residence and source. In the economics literature, the idea of residence taxation is associated with the taxation *of* human beings (in their home state), while the concept of source taxation conveys taxation *of* income from capital, including capital organized in the corporate form (wherever in the world the capital is located). Economists thus refer to corporate taxation by any jurisdiction/state as ‘source-based taxation of capital income’.¹¹ Any mixture of these divergent terminologies leads to a lack of clarity in normative claims about tax policy, particularly when one is dealing with taxation of corporations.

To avoid ambiguity, the arguments in this chapter are based on the following assumptions. First, the legal terminology of residence and source is employed throughout, corresponding broadly to taxation in home and host states.¹² Second, the analysis disregards – for now – the various forms of business organization through which income may be earned, be that a proprietorship, partnership, trust, corporation, or other organization. This abstraction permits isolation of the key issue: allocation of taxing rights among states according to the location(s) of income-generating activity. The complexities of corporate taxation, including taxation of multinational corporate groups, are mentioned but not explored. Chapter 3 considers the application of the

¹⁰ eg R Rohatgi, *Basic International Taxation* (2nd edn, Richmond Law & Tax, Richmond 2005) 13–15; A Miller and L Oats, *Principles of International Taxation* (Tottel Publishing, Haywards Heath 2006) 20–21.

¹¹ eg S Bond, L Chennels, MP Devereux and others, *Corporate Tax Harmonisation in Europe: A Guide to the Debate* (IFS, London 2000) 20–21; DJS Breen, ‘Here or There? The Source and Residence Principles of International Taxation’ in RM Bird and JM Mintz (eds), *Taxation to 2000 and Beyond* (Canadian Tax Foundation, Toronto 1992) 307–08; GR Zodrow, ‘Capital Mobility and Source-Based Taxation of Capital Income in Small Open Economies’ (2006) 13 *Int’l Tax and Public Finance* 269.

¹² Thus the term ‘source’ means geographical source. In the UK and Canada the term is often used to refer to a type of income; that is not the usage here.

jurisdictional principle of residence in the specific and more difficult context of corporate taxpayers.

2.2 TAX PRINCIPLES AND THE INTERNATIONAL TAX ‘SYSTEM’

2.2.1 The Right to Tax

As a matter of public international law, each country has the sovereign right to legislate within its jurisdiction. International tax law is part of public international law because it concerns the mutual rights of sovereign states.¹³ The terms ‘right to tax’, ‘tax sovereignty’ and ‘tax jurisdiction’ are largely equivalent: each denotes the scope within which the fiscal power of the state can be legitimately exercised.¹⁴ In the author’s view, the importance of tax sovereignty cannot be over-emphasized; each country is politically independent and directs its primary attention to creating and enforcing its own laws, despite harmonization efforts within regional communities including the European Union (EU).¹⁵

Tax sovereignty or jurisdiction is said to comprise both a right to legislate and a right to enforce.¹⁶ There is a difference of academic opinion regarding the power of states to legislate extraterritorially when there is no right to enforcement. One school of thought maintains that a state’s right to tax is in principle unlimited: a state may enact legislation taxing the income or assets of persons having no connection to the country,

¹³ AH Qureshi (ed), *The Public International Law of Taxation: Texts, Cases and Materials* (Graham & Trotman, London 1994) 1–9; RS Avi-Yonah, ‘International Tax as International Law’ (2004) 57 *Tax Law Rev* 483, 484–91.

¹⁴ The terms may not be exactly synonymous. Martha has argued that jurisdiction is one attribute of sovereignty: RSJ Martha, *The Jurisdiction to Tax in International Law* (Kluwer, Deventer 1989) 12–18.

¹⁵ M Stewart, ‘Commentary’ (on O Ruding, ‘Tax Harmonization in Europe’) (2000) 54 *Tax Law Rev* 111, 123–25; DR Ring, ‘One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage’ (2002–03) 44 *Boston College Law Rev* 79, 128–31.

¹⁶ Qureshi 1994 (n 13) 3, 22; S Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (Weidenfeld & Nicolson, London 1992) 307–08.

whether or not such a law could be enforced as a practical matter.¹⁷ In the UK and Canada, this view of tax jurisdiction is buttressed by the constitutional argument that extraterritorial lawmaking of any nature is within the competence of Parliament.¹⁸ The other school asserts that tax jurisdiction is constrained by the requirement of a ‘legally relevant connection’ between a state and a taxpayer.¹⁹ According to this view, purporting to tax the foreign income or assets of bona fide non-residents is not only impractical, but contrary to international law.

While this matter remains contentious, both schools of thought accept that a state has the right to tax where there exist legally relevant ‘connecting factors’ with that state. The generally accepted connecting factors, and thus the accepted bases for tax jurisdiction, might be broadly divided into nationality and territoriality. The term ‘nationality’ is used here in a larger sense than citizenship; it would encompass all factors that link a taxpayer personally to a particular nation, including citizenship (or incorporation), domicile, and residence. These factors have been styled ‘subjective’ connections because they concern the subject upon whom liability is imposed, be that a human being, corporation, or other entity.²⁰ Territoriality, on the other hand, comprises factors that link a taxpayer’s economic interests or activities with the geographic territory of a sovereign state. These factors have been styled ‘objective’ connections

¹⁷ eg A Knechtle, *Basic Problems in International Fiscal Law* (Kluwer, The Netherlands 1979) 37, 41; AH Qureshi, ‘The Freedom of a State to Legislate in Fiscal Matters under General International Law’ (1987) 41 BIFD 14; HD Rosenbloom, ‘International Tax Arbitrage and the “International Tax System”’ (2000) 53 Tax Law Rev 137.

¹⁸ S de Smith and R Brazier, *Constitutional and Administrative Law* (8th edn, Penguin, London 1998) 78–79; P Hogg, *Constitutional Law of Canada* (5th edn, Carswell, Toronto 1997) [13.1]–[13.2].

¹⁹ eg AR Albrecht, ‘The Taxation of Aliens under International Law’ (1952) 29 *British Yearbook of Int’l Law* 145, 152–53; Avi-Yonah 2004 (n 13). For further discussion see Qureshi 1994 (n 13) 22–125.

²⁰ IFA 2005 Congress (n 6) 30.

because they relate to the object of taxation.²¹ It is common in tax policy literature to group all territorial factors under the heading of ‘source’.

The decision to rely on one connecting factor does not preclude reliance on others; virtually all states assert both national jurisdiction, taxing the worldwide income of persons who are residents or citizens of the state, as well as territorial jurisdiction, taxing local income derived by non-resident persons. Worldwide taxation of residents or citizens has traditionally been justified based on the ‘ability to pay’ formulation of tax equity and the economic principle of capital export neutrality (CEN).²² Territorial taxation of non-residents has traditionally been premised on the ‘benefit theory’ configuration of tax equity and the economic principle of capital import neutrality (CIN).²³ The obvious problem of double taxation which stems from these overlapping assertions of jurisdiction is ameliorated by unilateral legislative relief and by reciprocal treaty concessions, as discussed in more detail below. Whether or not one agrees that these jurisdictional bases amount to principles of international law, it is reasonable to treat source and residence, if not citizenship, as customary norms.²⁴

2.2.2 The International Tax Consensus

The primary concern in international taxation is the resolution of competing jurisdictional claims between states of ‘residence’ and ‘source’. An associated concern is the appropriate division of taxing rights among multiple ‘source’ states, although, as argued here, these ostensibly separate concerns should be seen as the same issue.

²¹ IFA 2005 Congress (n 6) 29.

²² Discussed at text to nn 88–93 and 114–116.

²³ Discussed at text to nn 99–104 and 120–123.

²⁴ NH Kaufman, ‘Fairness and the Taxation of International Income’ (1998) 29 *Law and Policy in Int’l Business* 145; RS Avi-Yonah, ‘Tax Competition, Tax Arbitrage and the International Tax Regime’ (2007) 61 *BIFD* 130, 132–33.

Allocations of tax jurisdiction between states have been achieved through a combination of unilateral statutory measures and bilateral tax agreements, producing an international regime that has remained remarkably unchanged for eight decades. Despite each state's desire for fiscal sovereignty, there exists a resilient international consensus on the allocation of taxing rights – a regime which Avi-Yonah has described as a 'flawed miracle'.²⁵

There are certain key principles which animate this international tax consensus. The development and application of these principles, first by the League of Nations (LON) and later by the Organisation for European Economic Co-operation (OEEC) and its successor, the Organisation for Economic Co-operation and Development (OECD), has resulted in a pragmatic yet imperfect division of taxing rights. In contrast to much of the literature regarding international tax policy, the author is not particularly concerned with defending or attacking the prevailing tax consensus at large. It is nonetheless necessary to discuss the evolution and current allocation of international taxing rights because it is these features that have prompted much of the criticism of so-called 'residence-based' taxation.

2.2.2(a) *Economic Allegiance: The Work of the League of Nations*

Before examining the features of the current international tax regime, it is helpful to revisit the early work of the LON with respect to the alleviation of international double taxation. This work demonstrates that the underpinnings for what we now call 'residence taxation' and 'source taxation' are reflected in the broader principle of 'economic allegiance' (or economic interest). Exploring the concept of economic

²⁵ RS Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification' (1996) 74 Texas Law Rev 1301, 1303.

allegiance helps clarify that residence was intended to denote an important economic nexus, not merely a political attachment begetting an obligation to pay tax on one's worldwide income.

In 1921 the Financial Committee of the LON appointed a group of experts to investigate the economic consequences of double taxation and to propose principles to guide international agreements for the resolution thereof. The experts completed their report (Economists' Report) in 1923;²⁶ that report and a subsequent document²⁷ formed the basis for the 1927 report on double taxation and tax evasion.²⁸ The Economists' Report, which in large part reflects the philosophy of its American contributor Ernest Seligman,²⁹ is a fascinating document which had a profound influence on the international tax system. Undoubtedly the most important aspect of that report is the discussion of general principles governing 'international competence in taxation'.

Under that heading the authors considered four different principles upon which income tax liability might be based. They criticized political allegiance stemming from nationality/citizenship as a basis because of the often tenuous connection between a non-resident and the mother country; they concluded that political allegiance was 'clearly insufficient' as a theoretical basis for individual fiscal obligation.³⁰ Temporary

²⁶ Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, *Report on Double Taxation Submitted to the Financial Committee of the League of Nations* (Doc EFS73.F19, LON, Geneva 1923). This and other LON and OEEC reports are available at <<http://setis.library.usyd.edu.au/oztexts/parsons.html>>.

²⁷ LON, Technical Experts to the Financial Committee, *Double Taxation and Tax Evasion Report and Resolutions submitted by the Technical Experts to the Financial Committee* (Doc F.212, LON, Geneva 1925).

²⁸ LON, Committee of Technical Experts on Double Taxation and Tax Evasion, *Report of the Committee of Technical Experts on Double Taxation and Tax Evasion* (Doc G216.M85, LON, Geneva 1927). For a detailed review of the early work of the LON see Picciotto (n 16) ch 2 or MJ Graetz and MM O'Hear, 'The "Original Intent" of US International Taxation' (1997) 46 *Duke Law J* 1021, 1066–89.

²⁹ See ERA Seligman, *Essays in Taxation* (10th edn, MacMillan, New York 1925), particularly ch 4, 'Double Taxation'.

³⁰ Economists' Report (n 26) 19.

residence was similarly held to be an inadmissible test. They found that a third principle – domicile or permanent residence – is far more defensible because it approaches the idea of economic obligation to the home state; the authors asserted that any person with a substantial residential connection to a place ‘ought undoubtedly to contribute to its expenses’.³¹ They conceded that domicile or residence could not be the sole consideration, however, as the principle of location or origin of wealth is also legitimate. The twin principles of domicile/residence and location/origin were brought together in the following important passage:

Practically, therefore, apart from the question of nationality, which still plays a minor role, the choice lies between the principle of domicile and that of location or origin. Taking the field of taxation as a whole, the reason why tax authorities waver between these two principles is that each may be considered as a part of the still broader principle of economic interest or *economic allegiance*, as against the original doctrine of political allegiance. A part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority. The ideal solution is that the individual’s whole faculty should be taxed, but that it should be taxed only once, and that the liability should be divided among the tax districts according to his relative interests in each.³²

One can identify three broad principles or norms integrated in this passage, each of which informs the current international tax system. The first and most fundamental of these is that any modern theory of income tax jurisdiction must be based on economic allegiance / economic interest, rather than political allegiance or obligation. The second and third principles are closely related. The second principle – ‘that it should be taxed only once’ – implies that double taxation should be avoided by allowing only one state to tax a given amount of income, while the third principle – ‘that the liability should be

³¹ Economists’ Report (n 26) 19.

³² Economists’ Report (n 26) 20 [emphasis in original]; cf Seligman (n 29) 112–13. The concept of allocating taxing rights based on economic allegiance was derived from German author Georg von Schanz: see Vogel 1988b (n 4) 219–20.

divided among the tax districts according to his relative interests in each’ – implies that the primary taxing right should be allocated to the state believed to have the stronger connection to that income.³³

One manifestation of the economic allegiance / economic interest principle as expressed above is that, where a person resides in one state and carries on some business in another, the theoretical justification for having a portion of the person’s ‘faculty’ taxed in the home state is not bare political obligation but rather the economic interest inherent in residing. The Economists’ Report focused on taxation of individuals, yet the views would be equally applicable to a corporation carrying on business through a foreign branch *if* the residence of a corporation denotes some economic interest rather than bare legal attachment. This approach is consistent with later LON publications where it was submitted that states should agree to treat the fiscal domicile of corporate entities as the place where the ‘real centre of management and control’ is located – that is, a place where real activity occurs.³⁴

The remainder of the Economists’ Report expounded on the principles of economic allegiance, single taxation, and tax allocation, proposing allocations of taxing rights between home and host states for given types of income based on where the economic interest would be stronger. The authors sought to gauge the strength of economic interests based on where wealth is produced, where it is possessed, and where it is consumed or otherwise enjoyed.³⁵ They distinguished the economic location or origin of wealth, which was said to be where wealth is produced, from the physical situs

³³ Avi-Yonah has described the current versions of these principles as the ‘single tax principle’ and the ‘benefits principle’: Avi-Yonah 2007 (n 24) 133–35.

³⁴ LON 1925 (n 27) 21, 34. Formulations of corporate residence in domestic law and tax treaties are discussed in ch 4.

³⁵ Economists’ Report (n 26) 22–23.

of wealth.³⁶ However, it was nowhere suggested that the origin of wealth must occur somewhere other than the place of possession and consumption. The two may overlap, with the extent of that overlap depending on the type of income. The authors gave the example of a trade carried on within state A, the profits of which accrue to securities located in state B, where the entire intellectual control and direction are found in state C, and where the owner of the income-producing assets is located in state D.³⁷ In such a situation, can one really identify a sole economic origin of the income? The authors recognized this difficulty but attempted to make reasonable allocations of income types between home and host countries, generally in accordance with economic interest.

2.2.2(b) *Single Taxation: Providing Relief Unilaterally*

The ‘single tax’ principle espoused in the Economists’ Report implies that double taxation should be avoided by allowing only one state to tax a given amount of income. In general, states have accepted that taxing residents’ income from foreign sources would lead to undesirable double taxation in the likely event that the host state asserted its taxing right.³⁸ States, in their capacity as residence jurisdictions, have for the most part acted unilaterally to mitigate the burden of foreign taxes.

It has long been recognized that unilateral relief of double taxation can be achieved by the residence state in essentially three ways: (i) allowing a deduction for foreign taxes in determining taxable income; (ii) crediting foreign taxes against domestic tax liability; or (iii) exempting foreign income where it has been subject to tax

³⁶ Economists’ Report (n 26) 23–25.

³⁷ Economists’ Report (n 26) 20.

³⁸ Early LON publications referred to double taxation as ‘evil’: eg Economists’ Report (n 26) 2, 9–10; LON 1925 (n 27) 5, 11.

abroad.³⁹ Until the 1940s it was common to allow only a deduction for foreign taxes, in effect treating such taxes as a cost of doing business internationally. In 1918 the US had taken the unilateral and rather generous decision to enact the foreign tax credit provisions. This allowed American corporations to reduce their US tax obligation commensurate with foreign taxes paid, although taxes in excess of the equivalent US tax burden were not credited.⁴⁰ The foreign tax credit system still prevails in the US, applicable to both foreign branch income and foreign dividends.⁴¹ Canada enacted a unilateral foreign tax credit shortly after the US (in 1919), applicable only to income taxes paid within the British Empire or paid to other states that granted a reciprocal credit for Canadian taxes – mainly the US.⁴² The UK originally allowed a credit only for taxes paid within the British Empire, limited to 50 per cent of the British tax.⁴³ Canada and the UK expanded their foreign tax credit provisions to apply to taxes paid in all countries by 1944 and 1945, respectively.⁴⁴ The UK and Canada now employ a mixture of credit and exemption methods depending on the identity of the taxpayer and the nature of the income.

Where the British or Canadian taxpayer is an individual earning foreign-source income, or a corporation earning foreign profits through a branch, a US-style system of worldwide taxation with foreign tax credits applies. Both countries provide this relief unilaterally, meaning that a tax treaty need not exist between the residence state and the

³⁹ LON 1925 (n 27) 10–11; PB Richman (now Musgrave), *Taxation of Foreign Investment Income: An Economic Analysis* (Johns Hopkins Press, Baltimore 1963) 29–33; RJ Vann, 'International Aspects of Income Tax' in V Thuronyi (ed), *Tax Law Design and Drafting* (IMF, Washington DC 1998) 756–59.

⁴⁰ Picciotto (n 16) 12–14; Graetz and O'Hear (n 28) 1045.

⁴¹ DN Shaviro, *Decoding the US Corporate Tax* (Urban Institute Press, Washington DC 2009) ch 7.

⁴² BJ Arnold, 'The Canadian International Tax System: Review and Reform' (1995) 43 CTJ 1792, 1794.

⁴³ Picciotto (n 16) 39–41; Graetz and O'Hear (n 28) 1046, 1071–72.

⁴⁴ Arnold 1995 (n 42) 1795; Picciotto (n 16) 39–41.

relevant foreign state.⁴⁵ In both jurisdictions foreign tax credits are limited to the domestic tax attributable to the relevant foreign income.⁴⁶ Thus, depending on the foreign tax burden, the applicable tax credit can range anywhere from zero to the entire amount of domestic tax otherwise payable on the foreign income.

The form of unilateral tax relief applicable to multinational enterprises (MNEs) based in the UK or Canada is quite different. The difference in treatment is not based on economic principles – it follows from the fundamental legal distinction between a foreign branch, which is considered an indivisible part of the resident company, and a foreign subsidiary, which is generally considered to have legal personality independent of its parent.⁴⁷ Until very recently, the UK provided unilateral relief for withholding taxes on foreign dividends and for underlying tax on foreign corporate profits where, generally, the dividends were paid to a UK resident company by a foreign company in which the UK company held a participating interest.⁴⁸ This position changed fundamentally in 2009, when the tax credit regime was dismantled in favour of exemption for most foreign dividends received by UK resident companies.⁴⁹ Canada has a much longer history of exempting foreign dividends received by Canadian corporations: an exemption has existed in some form since 1938 and was consistently expanded from that time until the 1972 tax reform.⁵⁰ Under current legislation, dividends distributed by a ‘foreign affiliate’ to a Canadian corporation are governed by

⁴⁵ ICTA 1988 s 790(1)–(5), rewritten to TIOPA 2010 ss 9, 18; ITA 1985 ss 126(1)(a), 126(2)(a).

⁴⁶ ICTA 1988 ss 796, 797, rewritten to TIOPA 2010 ss 36–42; ITA 1985 ss 126(1)(b), 126(2)(b), 126(2.1).

⁴⁷ The history and influence of corporate personality and corporate residence are addressed in chs 3–4. The attribution of income from controlled foreign companies (CFCs) is examined in ch 5.

⁴⁸ ICTA 1988 s 790(6)–(10), rewritten to TIOPA 2010 ss 12–16.

⁴⁹ CTA 2009 pt 9A (ss 931A–931W), inserted by FA 2009 Sched 14. The government also intends to permit exemption of some foreign branch profits: HM Treasury, *Foreign Branch Taxation: Discussion Document* (HM Treasury, London 2010) <www.hm-treasury.gov.uk/tax_foreign_branches.htm>.

⁵⁰ Arnold 1995 (n 42) 1794–97.

one of two systems: exemption or indirect credit, as explained further in chapter 3. Briefly, where dividends are paid from an affiliate's 'exempt surplus' – mainly active business income earned by an affiliate in a country with which Canada has a tax treaty – then exemption applies.⁵¹ Where dividends are paid from an affiliate's 'taxable surplus' – including business income earned in a non-treaty country and passive income – Canadian tax is payable with what is effectively a credit for any withholding taxes and any underlying foreign taxes paid by the affiliate.⁵² In either case single taxation is achieved.

2.2.2(c) *Single Taxation: Providing Relief by Treaty*

Domestic rules for crediting or exempting foreign-source income are, as a practical matter, of primary importance to taxpayers. Yet the consensus which exists in international taxation is reflected more fully in the global network of double taxation conventions (DTCs or treaties) that codify or in some cases extend unilateral decisions to forgo domestic tax jurisdiction.

Although there are various flaws in the current tax treaty system, the very existence of this network should be seen as a success for the LON, OEEC, and now the OECD. Standards that the LON thought to be useful for guiding international agreements were reflected in draft model DTCs first published in 1927 and 1928.⁵³ These drafts evolved, through their use by states and through refinements proposed by the LON Fiscal Committee, into model tax conventions signed at Mexico (1943) and

⁵¹ ITA 1985 ss 90, 113(1)(a).

⁵² ITA 1985 ss 90, 113(1)(b)–(c).

⁵³ LON 1927 (n 28); LON, *Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion* (Doc C562.M178.1928.II, LON, Geneva 1928).

London (1946).⁵⁴ The structure and principles of these early model DTCs carried through into the OECD Model Tax Convention, advanced in draft form in 1963 and revised periodically thereafter.⁵⁵ A variation of this model intended to be more appropriate for developing states was later proposed by the United Nations (UN).⁵⁶

It has been estimated that there are over 2,500 DTCs in existence, with the OECD Model being the most widely applied.⁵⁷ Global dissemination of the OECD Model persists despite the fact that it was ‘structured in light of the economic environment of the first half of the 20th century’.⁵⁸ While the OECD Model, UN Model, and related commentary are occasionally revised to deal with current concerns, none has undergone radical revision since its inception. Vann correctly observes that ‘the failure to adopt any new approach to international tax after the Second World War’, as compared to trade agreements and monetary regulation, meant that the regime adopted in the 1920s ‘continued by default’.⁵⁹ Accordingly, modern treaties based on the OECD Model and the UN Model reflect bilateral jurisdictional decisions made decades earlier.

⁵⁴ LON Fiscal Committee, *Model Bilateral Convention for the Prevention of the Double Taxation of Income* (LON, Mexico 1943) (Mexico Draft); LON Fiscal Committee, *Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property* (LON, London 1946) (London Draft); included as appendices in LON Fiscal Committee, *London and Mexico Model Tax Conventions – Commentary and Text* (Doc C88.M88.1946.IIA, LON, Geneva 1946).

⁵⁵ See most recently OECD, *Model Tax Convention on Income and on Capital* (OECD, Paris 2010) <www.oecd.org/ctp/tt/mtc> (OECD Model).

⁵⁶ UN Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (UN, Geneva 2001) (UN Model). A revised UN Model is planned for 2011.

⁵⁷ BJ Arnold, J Sasseville, and EM Zolt, ‘Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century’ (2002) 56 BIFD 233, cited in IFA 2005 Congress (n 6) 26.

⁵⁸ IFA 2005 Congress (n 6) 25.

⁵⁹ RJ Vann, ‘A Model Tax Treaty for the Asian-Pacific Region?’ (1991) 45 BIFD 99, 103. For similar views see Graetz (n 5) 262–63; Picciotto (n 16) 61–63.

For the purpose of the present discussion, two basic features of the OECD Model and UN Model deserve attention. The first is that the benefits of treaties based on either model are extended only to persons who are ‘residents’ of one or both of the Contracting States,⁶⁰ as discussed further in chapter 4. The second feature is that each model contemplates relief of double taxation by the residence country through either the exemption method or the credit method.⁶¹ There is a good argument that, with respect to outbound investment, DTCs achieve little beyond that which is already achieved through unilateral relieving measures,⁶² although that argument has less force with respect to a country like Canada that grants exemption over credit treatment based on the existence of a tax treaty with the foreign state. In any event, the primary beneficiaries of DTCs are the residents of treaty partner states, who are able to obtain reduced (or eliminated) host country taxes on passive income and capital gains by virtue of the applicable treaty.⁶³

2.2.2(d) *Tax Allocation: Treatment of Active and Passive Income*

In theory, the credit and exemption approaches are very different ways of implementing the single tax principle, whether achieved unilaterally or by treaty. What single taxation means in practice depends on the interaction of the chosen approach with the next principle identified by the LON and other commentators: tax allocation.

⁶⁰ OECD Model (n 55) Arts 1, 4; UN Model (n 56) Arts 1, 4. The UK legislation confirms this requirement in ICTA 1988 s 794, rewritten to TIOPA 2010 s 26. In the Canadian legislation the requirement exists but is not stated separately.

⁶¹ OECD Model (n 55) Arts 23A, 23B; UN Model (n 56) Arts 23A, 23B. Again, the UK legislation is more specific than the Canadian legislation in confirming this relief: ICTA 1988 s 788, rewritten to TIOPA 2010 ss 2, 6, 18.

⁶² T Dagan, ‘The Tax Treaties Myth’ (2000) 32 New York Univ J of Int’l Law and Politics 939; cf JF Avery Jones, ‘The David R Tillinghast Lecture – Are Tax Treaties Necessary?’ (1999) 53 Tax Law Rev 1.

⁶³ This leads to the problem of treaty shopping, discussed in ch 6.

The ideal approach would be to allocate taxpayers' aggregate economic interests across jurisdictions according to where wealth is produced, possessed, and consumed, as urged in the Economists' Report. However, pragmatic decisions made in the last eighty years have produced the somewhat blunt result that income from foreign portfolio investment (FPI) is taxed on a so-called 'residence' basis while income from foreign direct investment (FDI) is taxed on a so-called 'source' basis.⁶⁴ This means that the investor's home jurisdiction has been assigned the primary right to tax most derivative or passive income, notably dividends, interest, royalties, and most capital gains, usually with a tax credit for any foreign withholding taxes that might apply. The host jurisdiction has enjoyed the primary right to tax active business income, either where the taxpayer's presence in the host state meets the permanent establishment threshold,⁶⁵ or where the 'host' jurisdiction has become a 'home' jurisdiction through the establishment of a foreign affiliate in that state. These observations are, of course, made at a high level of generalization. Many countries do retain a right to tax dividends and interest at source, but will limit such withholding taxes to a nominal level where the recipient is resident in a DTC partner state.⁶⁶ Further, model DTCs have consistently recognized the host country's right to tax rental income arising from real property located within its territory and capital gains arising from dispositions of such property.⁶⁷

The most difficult policy questions concern the appropriate allocation of jurisdiction over active business income earned by MNEs and dividends distributed

⁶⁴ Avi-Yonah 1996 (n 25) 1305–10; Avi-Yonah 2007 (n 24) 133–35.

⁶⁵ OECD Model (n 55) Arts 5, 7.

⁶⁶ OECD Model (n 55) Arts 10 [2], 11 [2]. For EU Member States, withholding taxes on inter-company dividends and interest may be limited further by Council Directive 90/435/EEC (23 July 1990) (Parent–Subsidiary Directive), Council Directive 2003/49/EC (3 June 2003) (Interest and Royalties Directive), and Council Directive 2003/48/EC (3 June 2003) (Savings Directive). The limitation of withholding taxes is discussed further in ch 6.

⁶⁷ OECD Model (n 55) Arts 6, 13 [1].

from such income.⁶⁸ As mentioned above, the approach taken in the UK and Canada is inconsistent. Where a resident entity earns foreign business profits through a branch, the profits are included in domestic income but a credit is allowed for any foreign taxes, up to the equivalent amount of domestic tax on such profits. Where a resident company establishes a foreign affiliate, even a wholly-owned affiliate, the income earned by such a company is not taxed in the parent company's state on a current basis – a phenomenon often described as 'deferral' because any tax that might be paid to the home state, assuming the credit system applies, is deferred until the foreign affiliate pays dividends.⁶⁹ If and when dividends are distributed by such a company to the UK or Canadian parent, under current legislation those dividends will usually be exempt from further taxation. Moreover, there was a de facto exemption even under the prior UK credit regime, and there still is under the Canadian credit regime applicable to dividends from non-treaty countries. This is because corporate groups with affiliates in low tax jurisdictions simply do not repatriate dividends unless and until they have generated sufficient credits to offset any domestic tax payable, whether through dividend pooling or other strategies.⁷⁰ This means that whether a 'deferral with credit' regime or an exemption regime applies to MNEs makes little difference to the actual allocation of tax revenues across states. Accordingly, where the subject of taxation is a multinational group (not an individual or single entity earning foreign branch income) it is rather

⁶⁸ Discussed further in ch 3.

⁶⁹ eg Musgrave 1963 (n 39) 24–25; Picciotto (n 16) ch 5; BJ Arnold, *Reforming Canada's International Tax System: Toward Coherence and Simplicity* (Canadian Tax Foundation, Toronto 2009) 40, 143.

⁷⁰ Various authors have made this observation, eg MA Desai, CF Foley, and JR Hines, 'Repatriation Taxes and Dividend Distributions' (2001) 54 Nat'l Tax J 829; HM Treasury and HMRC, *Taxation of Companies' Foreign Profits: Discussion Document* (HM Treasury, London, June 2007) <www.hm-treasury.gov.uk/consult_foreign_profits.htm> 10, 13; Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Department of Finance, Ottawa 2008) <www.apcsit-gcrefi.ca/index-eng.html> [4.28]–[4.32].

misleading to describe ‘residence’ taxation as involving ‘worldwide’ taxation. In theory the foreign profits may be taxable at home; in practice they are not taxed.

2.3 ASSESSING THE JUSTIFICATIONS FOR RESIDENCE TAXATION

2.3.1 Residence and Source as Guidelines

2.3.1(a) Absence of Single Unifying Framework

It is fashionable to question the justifications for the international consensus described above, in particular the normative basis for exclusive allocations of passive and active income types to home and host countries.⁷¹ Tenable arguments have been made that the consensus is largely justified or that it is terribly flawed.⁷² It is difficult to reconcile these arguments because each seems to begin with its own unique assumptions about the importance of interpersonal versus international equity, national versus global efficiency, and other metrics. Arguments in favour of existing or alternative allocations of tax jurisdiction inevitably reflect a particular world-view, prompting Musgrave to observe in the context of EU corporate taxation that there is no ‘objective, single answer to the question of how company profits should be divided in a multijurisdictional setting’.⁷³ Similarly, Ault and Bradford argue that various theoretical starting points for

⁷¹ eg IFA 2005 Congress (n 6) 57; M Lang, P Pistone, J Schuch and others (eds), *Source versus Residence: Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives* (Kluwer, Alphen aan den Rijn, the Netherlands 2008).

⁷² Compare Avi-Yonah 1996 (n 25) 1310–16 (arguing that the current consensus is largely justified); CI Kingson, ‘The Coherence of International Taxation’ (1981) 81 *Columbia Law Rev* 1151 (arguing that source rules combined with generous foreign tax credits lead to predatory ‘overtaxation’ by host states); K Vogel, ‘Which Method Should the European Community Adopt for the Avoidance of Double Taxation?’ (2002) 56 *BIFD* 4 (arguing that the current system discriminates against developing states and amounts to ‘fiscal imperialism’).

⁷³ PB Musgrave, ‘Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union’ in Cnossen (n 2) 59. For earlier discussion see PB Musgrave, ‘International Tax Base Division and the Multinational Corporation’ (1972) 27 *Public Finance* 394.

the analysis of international tax policy can lead to quite different results; they conclude that current rules are complex and inconsistent with any single unifying framework.⁷⁴

The fact is that any allocation of a taxpayer's income among the states in which he, she or it has some economic interest will entail a degree of arbitrariness. Determining the separate geographic components of the total economic interest that generated some amount of income – in other words, the contributing sources – is incredibly difficult. It has been argued that traditional models of comprehensive income are 'not susceptible to characterization as to source at all' and that any operational rules which purport to assign income to a geographic location are necessarily arbitrary.⁷⁵ The LON group of experts recognized this difficulty in 1923, stating that 'modern income is such a composite product and such a complex conception that even theoretically it is not easy to assign in a quantitative sense the proportions of allegiance of the different countries interested'.⁷⁶ Undaunted, they proposed assignments of income based on what they saw as the preponderant economic interest, focusing not so much on 'source' and 'residence' as on the locations where wealth is produced, possessed, and consumed.

It may well be that, in the later work of the OEEC and OECD, pragmatism and political power influenced the allocation of taxing rights such that the interests of capital-exporting countries were unduly favoured over the interests of capital-importing countries. This is evident in the case of income from international shipping and aircraft operations, for which exclusive jurisdiction has always been allocated to the state in which the 'real centre of management' or 'place of effective management' of the

⁷⁴ HJ Ault and DF Bradford, 'Taxing International Income: An Analysis of the US System and Its Economic Premises' in A Razin and J Slemrod (eds), *Taxation in the Global Economy* (Univ of Chicago Press, Chicago 1990) 42.

⁷⁵ *ibid* 31; cf Vogel 1988b (n 4) 223.

⁷⁶ Economists' Report (n 26) 27.

enterprise is situated.⁷⁷ One could also point to interest income, for which primary jurisdiction is allocated to the creditor's state of residence, with the debtor's state being allowed to levy only a minimal withholding tax.⁷⁸ Indeed, various states including the US, the UK, and now Canada simply gave up trying to tax interest paid to foreign investors in respect of their inbound investments, resulting in interest income being allocated exclusively to the residence state as much as international shipping income. These jurisdictional decisions were not made based on the belief that the *entire* economic interest in transportation income or in interest income exists in the state of the enterprise owner or capital owner; they were based on the belief that *some* economic interest existed there and that pragmatic or political concerns mandated an exclusive allocation. Even where decisions were made to allocate substantial tax jurisdiction to the so-called 'source' state, domestic legal rules and treaty principles used to determine whether a source exists in the relevant state (including the permanent establishment concept) have proven inflexible and artificial,⁷⁹ which again may result in default allocation to the so-called 'residence' state. Jurisdictional outcomes like this have led some to argue that all 'residence' taxation is unprincipled and unfair.

⁷⁷ OECD Model (n 55) Art 8[1]. This allocation was decided upon largely for pragmatic reasons: LON 1946 (n 54) 22. For discussion see G Maisto, 'Shipping, Inland Waterways Transport and Air Transport (Article 8 OECD Model Convention)' in Lang et al 2008 (n 71) 21.

⁷⁸ OECD Model (n 55) Art 11. The LON confessed that there were valid arguments in favour of allocating jurisdiction over interest to both the creditor's state and the debtor's state: Economists' Report (n 26) 38. The Mexico Draft proposed that income from 'movable capital' should be taxable only in the state 'where such capital is invested': Mexico Draft (n 54) Art 9. The London Draft proposed that interest should be taxable principally in the creditor's state of residence, with the debtor's state being entitled to levy a mutually agreed withholding tax: London Draft (n 54) Art 9. It goes without saying that the London Draft prevailed. For discussion see R Danon, 'Interest (Article 11 OECD Model Convention)' in Lang et al 2008 (n 71) 81.

⁷⁹ For discussion of source rules see: Vogel 1988b (n 4); JF Avery Jones, 'Tax Treaty Problems Relating to Source' [1998] BTR 222; SE Shay, JC Fleming Jr and RJ Peroni, 'The David R Tillinghast Lecture – What's Source Got to Do With It? Source Rules and US International Taxation' (2002) 56 Tax Law Rev 81. A recent example of the difficulty of applying source rules to complex international transactions is *Bayfine UK Products and anor v HMRC* [2009] STC (SCD) 43, rev'd [2010] STC 1379 (Ch).

2.3.1(b) *Residence as the 'Home Source'*

What plagues much of the debate about international tax policy is the implicit assumption that 'source' and 'residence' represent two distinct locations, with all wealth being produced in the former and being possessed (and possibly consumed) in the latter,⁸⁰ combined with the implicit or expressed assumption that legal residence is meaningless. The first assumption is often a false dichotomy and the latter assumption is often wrong. First, a good deal of the production, possession, and consumption of wealth may occur in the home state, such that residence might be equated with 'home economic interest' or 'home source'. Second, outside of the US – where residence can be based on citizenship or incorporation without further connections – residence may well denote a substantial presence in a state.

Taking a trivial case, it is clear that where an enterprise is owned, managed, and controlled in State A and carries on profit-generating activities exclusively in State A, the connecting factors of residence and source merge. The more complex situation is where an enterprise is owned, managed, and controlled in State A and carries on profit-generating activities in a variety of countries, with each activity contributing synergistically to the earning of income.⁸¹ The territorial 'sources' of such income may include State B, where a physical plant and workers are located, State C, where relevant technology, processes or methods are developed, and States D through Z, where the taxpayer's products are marketed and sold. Yet this list of 'sources' would almost certainly be incomplete if it did not include State A itself, where much of the strategy,

⁸⁰ eg Kingson (n 72) 1152–68 (dividing the world into source countries – where income is 'earned' – and residence countries – where income is 'owned'); Avi-Yonah 1996 (n 25) 1305–06 (stating that income originates in source countries and is received and consumed in residence countries); Kemmeren (n 9) 434 (stating that residing denotes consumption, not production, of income).

⁸¹ The even more complex situation is where the enterprise is a corporation that is managed and controlled in State A but is owned predominantly or exclusively by foreign shareholders. This situation is addressed in ch 3.

organization, and intellectual control will take place. The LON group of experts described these functions as ‘the whole apparatus for producing the income that is non-physical, namely; the brains and control and direction, without which the physical adjuncts would be sterile and ineffective’.⁸² With respect to State A, the connecting factors of residence and source again merge together.

It is therefore preferable to adopt the perspective that residence and source are not freestanding normative principles – they are merely guidelines to help assign tax jurisdiction based on some economic nexus.⁸³ The concepts overlap and might even be seen as interchangeable: Vogel argued that it is preferable to speak of the state of residence and the state(s) of non-residence.⁸⁴ Labelling one country as the ‘state of source’ or as the place where income ‘arises’ should be recognized as an ex ante decision rather than an economic conclusion. It is more appropriate to describe the so-called ‘state of source’ as the host state and to describe the ‘state of residence’ as the home state. A given item of income may arise from multiple economic sources, some occurring in the home state and some occurring in one or more host states. This should be true even if one ignores capital as a source in itself and maintains, like Kemmeren, that all income originates from the intellectual endeavours of human beings.⁸⁵ It is implausible to assume that an enterprise earning income in a foreign state does so without the contribution of at least some intellectual endeavour in the home state. Indeed, much of the overall strategy, organization, and coordination involved in an international business may be more readily attributed to the home state of the proprietor

⁸² Economists’ Report (n 26) 20.

⁸³ RM Bird and JS Wilkie, ‘Source- vs Residence-based Taxation in the European Union: The Wrong Question?’ in Cnossen (n 2) 91–98.

⁸⁴ K Vogel, “‘State of Residence’ may as well be “‘State of Source’” – There is no Contradiction’ (2005) 59 BIFD 42.

⁸⁵ Kemmeren (n 9) 434.

or parent company than to any one host state, such that the home source may constitute a residual but substantial economic interest. It may even be possible that there are multiple ‘home sources’ in the case of a globally integrated firm.⁸⁶ The main exception will be where the purported home state is merely a ceremonial home: a place of citizenship or incorporation only. Leaving that exception aside for now, one becomes sceptical of arguments in favour of ‘exclusive residence’ taxation or ‘exclusive source’ taxation, because surely they ignore important elements of economic interest.

2.3.2 Assessing the Justifications for ‘Home Source’ Taxation

Taking this perspective on the meaning of residence obviously affects how one assesses the equity and efficiency justifications for residence-based taxation. The author’s view is that the justifications for residence taxation should be advanced on the basis that residence is a proxy for the home source, being one element of the ‘still broader principle of economic interest’,⁸⁷ and not on the basis that residence demands ‘worldwide’ taxation. To the extent that equity and efficiency arguments for or against residence taxation are based upon seeking some conformity of taxing rights with economic interests, those arguments are convincing. To the extent that such arguments are based on protectionist concerns of governments, on assumed political obligations, or on competitiveness concerns of MNEs, they are less convincing. Less convincing does not mean irrelevant, however: concerns about state sovereignty and national self-interest may tip the scales in favour of greater home source taxation even if the equity and efficiency indications are ambiguous.

⁸⁶ MA Desai, ‘The Decentering of the Global Firm’ (2009) 32 *The World Economy* 1271. This obviously has implications for identifying the state(s) of corporate residence, as discussed in ch 4.

⁸⁷ Text to n 32.

2.3.2(a) *Equity Justifications*

Concerns about equitable distribution and redistribution of wealth, both within a state and among states, are vital factors in tax policy determination. Whether residence taxation is equitable depends of course on how one comprehends residence – as already discussed – and on how one conceptualizes tax ‘equity’. The typical considerations are ‘inter-person’ and ‘inter-nation’ equity.

Tax policy and scholarship has traditionally focused on equity within a single state, described as ‘inter-person’ or ‘inter-taxpayer’ equity, where equity is envisaged in terms of each individual’s ability to pay.⁸⁸ Taxation according to this measure requires that individuals with greater economic capacity pay more, thus achieving distributional goals. Note that this approach to tax equity focuses on individuals only. It is often said that corporations, being legal fictions, do not have ‘ability to pay’ in the tax policy sense; this is because corporations cannot engage in personal consumption and corporate wealth ultimately belongs to shareholders.⁸⁹ Nevertheless, in the absence of contemporaneous flow-through taxation of shareholders, a tax on corporations may be justified on equity grounds because it acts as a backstop for individual taxation, which itself may be justified according to ability to pay.⁹⁰

Ignoring that complication for purposes of the present chapter, the important observation is that inter-person equity determined based on ability to pay has been used

⁸⁸ RA Musgrave and PB Musgrave, *Public Finance in Theory and Practice* (5th edn, McGraw-Hill, New York 1989) 219, 223; Kaufman (n 24) 156–67.

⁸⁹ Musgrave and Musgrave (n 88) 373; D Shaviro, ‘The Rising Tax-Electivity of US Corporate Residence’ (2010) New York Univ School of Law, Public Law & Legal Theory Research Paper Series No 10-72, 14–15. For a contrary view see TS Adams, ‘The Taxation of Business’ in Nat’l Tax Association (eds), *Proceedings of the Eleventh Annual Conference 1917* (Nat’l Tax Association, New Haven CT 1918) 185, 191.

⁹⁰ The justifications for corporate tax are addressed in ch 3.

to gauge tax policy not only in a domestic fiscal setting but also internationally. It is relatively uncontroversial that, in a single state context, an equitable income tax system is one in which income is defined comprehensively.⁹¹ While the matter may not be obvious today, historically it was assumed that the logical extension of a domestically comprehensive tax base was an internationally comprehensive tax base.⁹² Thus inter-person equity was seen to require taxation of the worldwide incomes of resident persons, albeit with a credit or deduction for foreign taxes in recognition of the fact that the burden of foreign taxes reduces economic faculty. This philosophical approach was very influential in the development of the current international tax system, and continues to persuade governments around the world to enact some form of residence taxation in preference to a pure territorial system – that is, one in which all foreign source income is ignored for domestic tax purposes.⁹³

Today there are authors, notably the OECD⁹⁴ and various American tax lawyers,⁹⁵ who continue to make the case for worldwide taxation of a state's residents based on the ability to pay formulation of tax equity. The argument is that a tax base

⁹¹ One of the most thorough analyses is that of the Carter Commission: Canada, Royal Commission on Taxation, *Report of the Royal Commission on Taxation* (Queen's Printer, Ottawa 1966–67) (Carter Report) especially vol 2 pp 10–13, vol 3 pp 3–6, 22–25. A similar outlook is found in the Memorandum of Dissent in the Report of the Radcliffe Commission, where Lord Kaldor argued that 'no concept of income can be really equitable that stops short of the comprehensive definition which embraces all receipts which increase an individual's command over the use of society's scarce resources': Great Britain, *Final Report of the Royal Commission on the Taxation of Profits and Income* (Cmd 9474, London 1955) 355–56.

⁹² Economists' Report (n 26) 18; Carter Report (n 91) vol 4 p 503. For a more recent analysis see JC Fleming Jr, RJ Peroni, and SE Shay, 'Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income' (2001) 5 Florida Tax Rev 299.

⁹³ See V Thuronyi, *Comparative Tax Law* (Kluwer, The Hague 2003) 287–88, noting the 'remarkable convergence' of international tax policies including the almost universal adoption of some form of residence taxation.

⁹⁴ OECD, *Taxing Profits in a Global Economy: Domestic and International Issues* (OECD, Paris 1991) ch 2.

⁹⁵ eg Fleming et al (n 92) 301–06; HJ Ault, BJ Arnold and others, *Comparative Income Taxation: A Structural Analysis* (2nd edn, Kluwer, The Hague 2004) 345–50; Shaviro 2010 (n 89) 15–21.

which included only a resident's income earned in the home state but ignored any income earned in foreign states would fail as a comprehensive measure of that person's economic capacity and thus fail to further distributional goals within the home state. This position is reasonable if one believes that a significant portion of the economic interest that generated the foreign income actually stems from the home state, which is tenable in the case of income from FPI. Yet if the income arises from FDI, and the bulk of the economic interest relevant to that income consists of activities in the host state, it is less obvious that inter-person equity requires such income to be taxed. Authors including Vogel and Kaufman thus argue that that inter-person equity does not require the inclusion of all foreign income in the domestic tax base.⁹⁶ According to their views, inter-person equity requires a comparison not only between a taxpayer and his neighbours in the residence state, but between a taxpayer and his competitors in any foreign state where he earns income. The standard reply is that, under the international tax consensus, the host state is already given the primary right to tax active income and the impact of foreign taxes on ability to pay is accounted for via the tax credit mechanism.⁹⁷ It is thought to be socially acceptable to allow a taxpayer a credit for foreign taxes paid in respect of outbound FDI, provided that a 'fair share' of the tax revenue from such investment reaches the home treasury.

Unfortunately this is a rather arbitrary way of achieving tax equity, unless one makes the implausible assumption that the ratio of a resident's foreign and domestic efforts that contributed to the 'foreign source' income is equivalent to the ratio of the foreign and domestic tax rates. Perhaps that was broadly true at the beginning of the twentieth century, where high levels of economic activity occurred predominantly in

⁹⁶ Vogel 1988a (n 4) 84–85; Vogel 1988b (n 4) 396–97; Kaufman (n 24) 172–82.

⁹⁷ Avi-Yonah 1996 (n 25) 1326–28, 1333–36; Shay et al (n 79) 83; Shaviro 2010 (n 89) 19–21.

high tax states, but it need not be true today. Under a foreign tax credit system, the portion of international income that is taxed in the home state is entirely dependent on the foreign tax rate: a UK taxpayer earning income in Bermuda or Hong Kong will (in theory) pay a great deal of UK tax while a UK taxpayer carrying on the same activity in Denmark or Japan will likely pay no UK tax.⁹⁸ This makes little sense. In sum, while a system of worldwide taxation with foreign tax credits is broadly justified based on inter-person equity within a single state, the foreign tax credit is a most imprecise mechanism of ensuring that a ‘fair share’ of taxing rights is enjoyed by the home state.

Other recent scholarship has sought to judge tax policy on the additional basis of ‘inter-nation’ equity.⁹⁹ This is a controversial concept that is not grounded in the ability to pay approach but rather in the benefit approach or benefit principle, which requires that each taxpayer’s contribution be aligned with the benefits which he, she or it derives from public services in a state.¹⁰⁰ While the benefit principle is thought to be of little normative relevance in the taxation of a state’s residents, the equity justifications for source taxation are firmly grounded in benefit theory: the quality of a state’s physical infrastructure, labour supply, market conditions, legal system, and other benefits is widely considered to be a sound normative foundation for imposing ‘source’ taxation.¹⁰¹ This is not to say that one must be able to identify and measure specific host country benefits in order to justify the imposition of tax. Graetz observes that ‘one need not thoroughly embrace the benefit theory of taxation’, which is plagued by measurement

⁹⁸ MNEs with various foreign operations may be able to reduce this problem by pooling foreign tax credits from high and low tax states.

⁹⁹ Peggy Musgrave is generally credited as the first person to identify inter-nation equity as a separate consideration: see Musgrave 1963 (n 39) 15; RA Musgrave and PB Musgrave, ‘Inter-nation Equity’ in RM Bird and JG Head (eds), *Modern Fiscal Issues: Essays in Honour of Carl S Shoup* (Univ of Toronto Press, Toronto 1972) 63.

¹⁰⁰ Kaufman (n 24) 156–67.

¹⁰¹ eg Vogel 1988b (n 4) 395; Shay et al (n 79) 88–106; Ault et al (n 95) 345, 395.

and allocation difficulties, ‘to recognize a country’s legitimate claim to tax income produced within its borders’.¹⁰² Various commentators suggest that the allocation of taxing rights to ‘residence’ countries in the current international tax system undervalues the benefits provided by ‘source’ countries (again assuming that these are mutually exclusive locations). These scholars argue that inter-nation equity implies greater global fairness through redistribution to developing countries of the tax revenues arising from international transactions.¹⁰³ For example, Kaufman characterizes inter-nation equity as ‘a question of economic justice among nations’ and argues that such equity exists ‘only when states distribute, among themselves, the competence to tax in a way that conforms to prevailing views of justice internationally’.¹⁰⁴ Presumably this means that a just international tax system would reduce the gap in wealth between developed and developing countries.

In the author’s view, any attempt to further the nebulous goal of inter-nation equity must begin with an allocation of tax jurisdiction that is in accordance with economic interests. The precise method by which countries should assess respective economic interests, and the extent to which they should deviate from a purely economic apportionment to achieve international wealth redistribution,¹⁰⁵ are questions that cannot be answered in the abstract. A matrix of choices is available, and it is a question for the particular states negotiating a tax treaty to decide which allocations are appropriate. It is undeniable that an exclusively home-based system (worldwide), with

¹⁰² Graetz (n 5) 298.

¹⁰³ eg Vogel 1988b (n 4); Vogel 2002 (n 72); Kaufman (n 24); Kemmeren (n 9).

¹⁰⁴ Kaufman (n 24) 188, 202.

¹⁰⁵ Graetz observes that ‘[t]he responsibility of rich nations to ensure any baseline of resources for all humanity is a controversial idea’ and queries what role income taxation should play: Graetz (n 5) 300–01; cf RS Avi-Yonah, ‘Globalization, Tax Competition and the Fiscal Crisis of the Welfare State’ (2000) *Harvard Law Rev* 1573, 1648–51.

no allowance for host country taxation, would be inimical to inter-nation equity. Yet an exclusively host-based (exemption) system, because it ignores the home economic interest, would also be inimical to inter-nation equity. The economic and legal structure of the home state creates an environment in which residents can earn and enjoy income, whether at home or abroad, and thus the home state ‘benefits’ should not be ignored.¹⁰⁶ In other words, an exclusively ‘source-based’ system would achieve inter-nation equity only if it recognized the contribution of the home source. Thus some degree of residence / home source taxation is justified based on this measure of equity.

2.3.2(b) *Efficiency / Neutrality Justifications*

To a public finance economist, the touchstone for any tax policy is efficiency. Neutrality, which is closely related to efficiency, denotes an absence of distortions to economic decision-making. A neutral and therefore efficient international tax system is one which minimally distorts savings and investment decisions, such that resources are allocated to their most productive uses.¹⁰⁷ A criticism advanced by some legal scholars is that efficiency, however understood, is politically irrelevant and therefore should not be used to guide a state’s tax policy.¹⁰⁸ Even if one accepts that efficiency is relevant consideration, the criticism can be made that references to efficiency in the international tax literature have become an ‘alphabet soup’ or ‘battle of acronyms’ providing no clear direction for a state’s outbound international tax rules.¹⁰⁹ Yet it is at least worth considering how efficiency standards might justify or discredit residence taxation.

¹⁰⁶ OECD 1991 (n 94) 41.

¹⁰⁷ Musgrave and Musgrave (n 88) 60.

¹⁰⁸ eg Graetz (n 5) 271–77, 294–97; Vogel 1988a (n 4) 81; Vogel 2002 (n 72) 5.

¹⁰⁹ Shaviro 2009 (n 41) 122–27; Shaviro 2010 (n 89) 12–14.

CEN is considered to exist where a resident investor faces an equal effective tax rate whether it invests domestically or abroad, rendering ‘neutral’ its decision whether or not to export capital.¹¹⁰ This form of neutrality is contrasted with CIN, which obtains when all investments in a given state face the same effective tax rate regardless of the investor’s residence.¹¹¹ A concept related to CIN but introduced more recently is capital ownership neutrality (CON), which implies that the tax system should not distort who acquires or owns income-producing assets in any state.¹¹² Achieving total neutrality is impossible in the absence of a harmonized worldwide tax system, but the current tax system attempts to mitigate distortions through a balance of CEN and CIN objectives.¹¹³

The traditional view in economic theory was that a tax system should promote CEN rather than CIN; a system of worldwide taxation with foreign tax credits has routinely been justified on the basis that it promotes CEN and thus global welfare.¹¹⁴ The argument is that a purely ‘territorial’ system is inefficient because it puts tremendous pressure on where investment is located. Policy-makers have found intuitive appeal in this efficiency justification, believing that resident taxpayers should face an equal effective tax burden wherever they invest.¹¹⁵ It is thought that, while decisions to undertake FDI in a particular place will be based predominantly on factors like market size, labour supply, and public infrastructure, such decisions can be

¹¹⁰ Musgrave 1963 (n 39) 5–9; MP Devereux, ‘Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations’ (2008) 24 *Oxford Rev of Economic Policy* 698, 701–02.

¹¹¹ *ibid.*

¹¹² This concept was introduced separately by Devereux 1990 (n 2) and by Desai and Hines (n 3). For further discussion see Devereux 2008 (n 110) 703–04.

¹¹³ T Horst, ‘A Note on the Optimal Taxation of International Investment Income’ (1980) 94 *Quarterly J of Economics* 793; OECD 1991 (n 94) 38–39; IFA 2005 Congress (n 6) 34–35.

¹¹⁴ eg Musgrave 1963 (n 39) 5–9; H Grubert and J Mutti, ‘Taxing Multinationals in a World with Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?’ (1995) 2 *Int’l Tax and Public Finance* 439; JG Gravelle, ‘International Corporate Income Tax Reform: Issues and Proposals’ (2009) 9 *Florida Tax Rev* 469, 475–77. For a useful summary see Avi-Yonah 2000 (n 105) 1604–11.

¹¹⁵ eg OECD 1991 (n 94) 39–42, 265–81.

influenced at the margin by differentials in effective tax rates. To maintain equal tax burdens so that investment decisions will be based on business considerations, so the argument goes, states need the ‘protective overlay of residence taxation’.¹¹⁶

A common criticism of the CEN standard is that, even if it is a desirable feature of tax policy, it is almost impossible to achieve in an environment where MNEs are able to retain foreign profits in foreign subsidiaries: home taxation of foreign corporate profits is ‘deferred’, possibly indefinitely, unless one ignores the separate legal personality of CFCs and taxes the income on some flow-through basis.¹¹⁷ In the author’s view there is a more significant problem of principle with the CEN standard and its prescription of worldwide taxation. This is the assumption that income which is generated from activities in a foreign host state, but bears little or no tax in that state, should be subject to tax in the home state in order to ‘fill the hole’. Under certain conditions this may indeed promote global efficiency as understood in economic theory,¹¹⁸ but it is more likely that the governments of wealthy countries are happy to reap the revenue protection benefits of CEN-enhancing policies without having much theoretical concern with the CEN standard itself. There is some truth in Vogel’s argument that a purported CEN-enhancing policy is not really about promoting efficiency; rather, it is about protectionism and ‘fiscal imperialism’.¹¹⁹ Returning to the concept of economic interest, what the CEN standard suggests is that a state should tax economic interests that *do not exist* at home, in order to dissuade residents from carrying out direct investment elsewhere. If, as argued above, residence taxation should

¹¹⁶ Musgrave 2000 (n 73) 49.

¹¹⁷ eg Musgrave 1963 (n 39) 9–10, 24–25; Brean (n 11) 314–15; JB Slemrod, ‘Free Trade Taxation and Protectionist Taxation’ (1995) 2 Int’l Tax and Public Finance 471.

¹¹⁸ Devereux 2008 (n 110) 705–08; Gravelle (n 114) 475–77.

¹¹⁹ Vogel 2002 (n 72) 5; cf Kemmeren (n 9) 438–42.

be understood as home source taxation rather than worldwide taxation, then CEN is not a supporting principle, or even a relevant consideration, for this basis of taxation.

What of CIN and CON? These conditions are said to support taxation only by the host country, that is, a pure territorial system or at least a system involving the exemption of dividends from foreign affiliates.¹²⁰ Under such a system the total burden of taxes levied on enterprises investing in a foreign state equals the taxes imposed on domestic enterprises operating in those states, thus liberating FDI. The implication for ‘residence-based’ taxation is that it should be abolished, at least for FDI income. Beyond global efficiency claims, other arguments typically made in favour of such an approach are that it enhances international competitiveness and achieves greater simplicity in the tax system.¹²¹ This approach has an obvious appeal to MNEs; business representatives have for decades argued in favour of territorial exemption, complaining that home taxation increases costs and slows their expansion into foreign markets.¹²² This pressure has recently borne fruit in countries including the UK, Canada, and elsewhere, with governments adopting or enhancing dividend exemption measures for MNEs headquartered in those countries.¹²³

The CIN and CON standards are preferable to the CEN condition insofar as they imply taxation of international income by the states in which such income is actually generated. But there are at least two problems that deserve attention.

¹²⁰ Devereux 2000 (n 2); Desai and Hines (n 3).

¹²¹ For criticism see R Altshuler and H Grubert, ‘Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of US Multinational Corporations’ (2001) 54 Nat’l Tax J 787; ED Kleinbard, ‘Throw Territorial Taxation from the Train’ 114 Tax Notes 547 (5 February 2007); Gravelle (n 114) 477–83.

¹²² Picciotto (n 16) 14–15, 45–47; Shaviro 2009 (n 41) 124–25.

¹²³ See ch 1 text to nn 46–51.

The initial problem is that CIN and CON adherents often resort to arguments about international ‘competitiveness’ as though this is the dominant tax policy consideration. A goal of improving competitiveness for its own sake offers little guidance as to how a rational and principled tax system should work. Indeed, the most competitive position would be to abolish corporate income taxes, rather than waste time discussing how they should be internationally allocated. As suggested above with respect to governments’ purported adherence to the CEN standard, it seems that MNEs are happy to reap the tax savings produced by CIN-enhancing policies without having much theoretical concern with the CIN standard itself. This is evident from the fact that MNEs in the UK and Canada expect to be allowed to deduct financing expenses in respect of exempt foreign income, thus eroding the domestic tax base.¹²⁴ In the author’s view, if a state wishes to make tax concessions in order to enhance the competitive position of its MNEs, it can do so after determining what a principled system would look like.

The issue of principle with the CIN and CON standards and their prescription of exempting ‘foreign source’ income is the assumption that the geographic source of income can be adequately identified – and that such source will be entirely foreign.¹²⁵ The proper approach is to first determine whether and to what extent the purported ‘foreign source’ income is actually foreign. If there is a significant home economic interest involved in the generation of the income, whether earned through a branch or subsidiary, there is no efficiency justification for exempting the domestic portion of that

¹²⁴ The only argument in favour of the mismatch of debt (residence-based) and equity (source-based) is international competitiveness. For policy recommendations regarding limiting interest deductibility in an international context see, eg: AR Lanthier and JM Mintz, ‘Policy Forum: Seeking a More Coherent Approach to Interest Deductibility’ (2007) 55 CTJ 629; Arnold 2009 (n 69) ch 8. For comparative discussion see Int’l Fiscal Association (ed), *New Tendencies in Tax Treatment of Cross-Border Interest of Corporations*, Cahiers de Droit Fiscal International vol 93b (IFA, Brussels 2008).

¹²⁵ See Devereux 2008 (n 110) 712–13.

income from domestic taxation. Therefore, to the extent that CIN or CON mandates a ‘source-based’ international tax system, each would support residual home source taxation as much as it supports host source taxation.

2.3.3 Implications

Looking at the UK and Canadian rules for taxing outbound investment, neither the credit regime applicable to branch profits nor the exemption regime applicable to dividends achieves a fully justified allocation of taxing rights across home and host states. This is true whether one assesses these regimes in terms of equity or efficiency. The credit method starts with the proposition that, based upon the principles of inter-person equity and CEN, a taxpayer’s worldwide economic interests must be taxed in the home country, subject only to tax credits that can vary wildly based on the foreign location from which the profits ostensibly arise. This makes little sense in the context of economic interests. Even worse, the exemption method starts and ends with the proposition that, applying the principles of inter-nation equity and CIN / CON, so-called ‘foreign profits’ are to be regarded as arising without any contribution from endeavours in the home state. Here the portion of international income that is taxed in the home state is always nil. Again, this makes no sense in the context of economic interests.

The concern here is not to say with precision how the international tax base should be allocated or whether modified credit or exemption systems should be used to relieve double taxation. Whatever method a state adopts unilaterally or by treaty, it should be recognized that the economic interest in the home state is one part of the total economic interest and thus it can legitimately be taxed. Such taxation can be achieved, albeit crudely, by continuing with the credit systems currently applied to branch profits in the UK and Canada. It cannot be achieved by moving to complete exemption for

foreign dividends (or foreign branch profits), particularly when the deduction of interest on funds used to earn such dividends is unlimited. Perhaps what is needed is a modified exemption system that allows for a residual percentage of home state taxation, as employed in France and Germany.¹²⁶ What is important is that the role of the residence state be given some recognition in international tax rules.

2.4 CONCLUSIONS

This chapter has sought to demonstrate that the connecting factors of residence and source are both expressions of the broader principle of economic interest. The traditional view is that there are valid reasons to align income tax jurisdiction with each factor, leading to a global division of taxing rights which is related, rather imprecisely, to economic interests. However, recent scholarship has seized upon particular conceptions of equity and efficiency in order to criticize residence as a connecting factor. Many authors have endorsed retreating from a system of residence taxation with foreign tax credits; they favour a more ‘territorial’ approach because this is said to promote greater inter-nation equity, CIN / CON, or competitiveness.

It remains the case that most countries, whether developed or developing, continue to assert jurisdiction over residents’ worldwide incomes, specifically income from FPI and income from FDI earned through a branch. Even the increasingly common practice of exempting foreign dividends is, in a long list of countries including the UK and Canada, subject to the constraints of CFC legislation.¹²⁷ Indeed, the bulk of this thesis is devoted to critiquing the methods by which the governments of the UK and Canada zealously pursue the ‘foreign’ income of their ‘residents’ or challenge the

¹²⁶ I am thankful to Johannes Voget for this observation. See J Voget, *Tax Competition and Tax Evasion in a Multi-Jurisdictional World* (CentER Dissertation Series, Tilburg, The Netherlands 2009) ch 2.

¹²⁷ Discussed in ch 5.

‘non-resident’ status of investors. As a factual matter, residence continues to be critical in an era of globalization. As a normative matter, it is appropriate that residence and residence-based taxation continue to have some role because, when such taxation is combined with appropriate host state taxation and double taxation relief, it is consistent with the foundational principle of economic interest. Many of the arguments that are made in favour of exemption are laudable because they seek to align income tax jurisdiction with the location of substantial economic interests. But this is subject to an important reservation which has been stressed throughout this chapter. A territorial system of taxation would be deficient if it ignored the benefits provided by the home territory, which may be substantial.

An objection could reasonably be made that what is advocated in this chapter is a modified exemption system, not a system based on residence and source. Obviously, characterizing residence taxation as home source taxation is different in principle from treating residence taxation as worldwide taxation. However, the author takes the view that any reconsideration of residence and source taxation, as currently understood, ‘must be constrained by the premise that nations will continue to approach international taxation issues within a structure that does not depart radically from current international norms’.¹²⁸ It is easier to augment the meaning of residence, making it a better proxy for the home economic interest, than to abandon the residence concept altogether in pursuit of some new global tax order. Indeed, as states move towards the legal recognition of residence as a special form of source, it will become easier to develop the global apportionment system that most commentators desire.

¹²⁸ Shay et al (n 79) 86; cf Avi-Yonah 1996 (n 25) 1316; Schön (n 7).

CHAPTER 3

JUSTIFICATIONS FOR RESIDENCE-BASED CORPORATE TAXATION

3.1 INTRODUCTION

3.1.1 Corporations as Taxpayers

In the previous chapter it was argued that a legitimate international allocation of taxing rights must allow for some degree of residence-based taxation, with residence envisaged as the home source. For clarity the arguments were made at a high level of abstraction, considering any hypothetical person as the taxpayer and ignoring the complexities of integrated shareholder/company taxation. Here we consider the application of the jurisdictional principle of residence in the specific context of corporations and multinational enterprises (MNEs).

If a state wishes to tax corporations on a residence basis then it would be logical for that state to have: (i) some policy reason for imposing a corporate tax at all; (ii) some basis for imposing it in the corporation's state of residence; and (iii) some criteria thought to be indicative of corporate residence. This chapter addresses the first and second points, building upon the conclusions reached in the previous chapter. The current legal indicia of corporate residence, and their disjunction from the policy bases addressed here, are discussed in the following chapter. Exploring these topics in this order is quite deliberate. It avoids two common errors in reasoning about international corporate tax policy.

One such error is the tendency to confound arguments against so-called 'residence-based' taxation of corporations or corporate groups with arguments against

corporate income taxes generally. The two propositions are not the same. Much of the public finance literature proceeds on the stylized basis that all ‘firms’ are extensions of individuals without addressing the legal separation of shareholders and corporations.¹ This approach implicitly assumes that corporations are not subjects of taxation in their own right or, if entity taxation subsists, it is merely a legal ritual with no policy justification. If one takes this view then discussions about *how* and *where* corporations should be taxed become otiose: one has presumed they should not be taxed at all. In contrast, if one concludes that there is some policy justification for entity taxation, then discussions about how corporate tax burdens should be allocated in an international setting become meaningful.

The other, rather prevalent, error is to begin with the assumption that corporate residence is a meaningless contrivance – being based on the wholly formal act of incorporation – and then proceed to criticize ‘worldwide’ taxation of resident corporations insofar as it relies upon that contrivance.² This sort of argument is not enlightening; indeed, it can be seen as a truism. First, it is self-evident that taxation based on a meaningless concept will lack meaning, therefore deserving little support. Second, although perhaps less evident, it is reasonably clear that worldwide taxation unmitigated by foreign tax credits or foreign income exemptions is unsupportable in a global environment. None of that is disputed here. The author’s position is more limited: that economically substantial residence is a rational basis for home source taxation, whether of individuals or corporations.

¹ As Shaviro observes, ‘the traditional analysis of efficiency, no less than that of distribution, has been thrown off by a frequent failure to appreciate the full significance of mainly taxing income from international business activity at the entity level, rather than directly to the owners’: D Shaviro, ‘The Rising Tax-Electivity of US Corporate Residence’ (2010) New York Univ School of Law, Public Law & Legal Theory Research Paper Series No 10-72, 15.

² The tendency towards this view in the academic literature stems from the fact that the US relies exclusively on place of incorporation as the test of corporate residence and that the bulk of twentieth century tax literature was American.

3.1.2 Corporate Theories and Corporate Taxes

This chapter has three related goals. The first is to review the different ways in which the nature of the corporation is conceptualized, what are sometimes called rival theories of the corporation. The application of these theories to multinational groups is also discussed. The second goal is to emphasize that, although entity theory dominates corporate taxation, one can justify a corporate tax given any theory of the corporation. The final goal is to demonstrate that these justifications are apposite to both home and host state corporate taxation, whether applied to a single entity operating through foreign branches or to a multinational group of affiliated corporations. This has important implications for the policy choice between credit and exemption systems. Whether a MNE is organized as a single entity with branch operations, or as a group of affiliated entities, exempting foreign corporate profits from home state taxation is defensible only to the extent that those profits are ‘foreign’.

3.2 THEORIES OF THE NATURE OF THE CORPORATION

3.2.1 Overview

The taxation of corporations, and in particular residence-based taxation of corporations, was designed without any critical analysis of what a corporation represents. Couzin notes that the taxation of corporations ‘followed inexorably from the determination that the incorporated company was a person, whose obligations would include the liability to pay tax.’³ Rather than simply accepting that determination, it is useful to review the prevailing theories of the nature of the corporation⁴ so that we can consider the extent to

³ R Couzin, *Corporate Residence and International Taxation* (IBFD, Amsterdam 2002) 17–18; cf MJ McIntyre, ‘Determining the Residence of Members of a Corporate Group’ (2003) 51 CTJ 1567, 1568.

⁴ For further analysis see S Wheeler (ed), *The Law of the Business Enterprise: Selected Essays* (OUP, Oxford 1994); D Millon, ‘Theories of the Corporation’ [1990] Duke Law J 201.

which residence-based taxation is consistent with each. In broad terms, these are the corporation as a legal entity or fiction, the corporation as a real entity, the corporation as a socio-economic institution, and the corporation as a nexus of contracts.

3.2.2 Theorizing the Single Corporation

3.2.2(a) *The Corporation as a Legal Entity or Fiction*

The principle of the independent existence of corporations is fundamental to company law. It entails the complete separation of a corporation from its shareholders and the personification (sometimes described as ‘reification’) of the corporate form.⁵ The traditional conception of the corporation holds that legal personality is fictional and is a privilege bestowed by the state; thus it is often referred to as the fiction or concession theory.⁶ It may have been John Austin who introduced the term ‘legal person’ into English, a translation of the German term *juristische Person*.⁷ The separate legal personality of corporations became enshrined in English company law in the last half of the nineteenth century, albeit through a gradual and discordant process. The historical development of this principle is a fascinating subject in its own right; it can only be touched upon here.⁸

⁵ PL Davies, *Introduction to Company Law* (OUP, Oxford 2002) 9; PL Davies, *Gower and Davies’ Principles of Modern Company Law* (7th edn, Sweet & Maxwell, London 2003) 27–30; R Kraakman, J Armour, P Davies, and others, *The Anatomy of Corporate Law* (2nd edn, OUP, Oxford 2009) § 1.2.1.

⁶ Early expositions include: W Markby, *Elements of Law* (Clarendon Press, Oxford 1871) 58–60; WH Rattigan (tr), FC Savigny, *The Roman Law of Persons as Subjects of Jural Relations* (Wildy & Sons, London 1884) 176–79, 204–08. In *Sutton’s Hospital Case* (1612) 10 Co Rep 1, 77 ER 937 (Ex Ch) it was said that a corporation is a fiction that ‘rests only in intendment and consideration of the law’.

⁷ P Stein, ‘Nineteenth Century English Company Law and Theories of Legal Personality’ (1982/83) 11/12 *Quaderni Fiorentini* 502, 509–10.

⁸ The evolution of joint stock companies is discussed in HR Hahlo, ‘Early Progenitors of the Modern Company’ [1982] *Juridical Rev* 139. The rise of the incorporated company through the eighteenth and nineteenth centuries is analyzed in PW Ireland, ‘The Rise of the Limited Liability Company’ (1984) 12 *Int’l J of the Sociology of Law* 239. For an exhaustive history see: WR Scott, *The Constitution and Finance of English, Scottish and Irish Joint-Stock Companies to 1720* (CUP, Cambridge 1912) vol 1; RR Formoy, *The Historical Foundations of Modern Company Law* (Sweet & Maxwell, London 1923).

The corporate form has long been considered necessary to ensure perpetual succession of, and transferability of interests in, commercial organizations as well as religious and educational institutions. Blackstone acknowledged that the corporation was invented by the Romans but declared that English laws ‘have considerably refined and improved upon the invention, according to the usual genius of the English nation’.⁹ In the seventeenth and eighteenth centuries there were few commercial corporations in England; those that existed were incorporated by royal charters or by special Acts of Parliament. These were costly and difficult processes, thus most organized business was conducted through the partnership form, whether styled as a ‘partnership’ or a ‘company’.¹⁰ The growing phenomenon of the joint stock company, an organization which featured transferability of interests without legal incorporation, was commonly associated with speculation, fraud, and corruption.¹¹ The distaste for commercial corporations was entrenched in English legislation following the notorious collapse of the South Sea Company in 1720.¹²

The value of the corporate form of business organization was increasingly recognized through the nineteenth century by both businessmen and legislators. The repeal of the Bubble Act in 1825 allowed joint stock companies to exist and operate, though at first they were treated by the judiciary as being akin to partnerships.¹³ A series of legislative developments mandated significant change in this view: as of 1844 a joint

⁹ W Blackstone, *Commentaries on the Laws of England* (facsimile of 1st edn, Univ of Chicago Press, Chicago 1979) vol 1 pp 456–57. For the relevant American history see: JS Davis, *Essays in the Earlier History of American Corporations* (CUP, Cambridge 1917) vol 2; AA Berle Jr and GC Means, *The Modern Corporation and Private Property* (Macmillan, New York 1933) vol 1 ch 2; Millon (n 4) 205–40.

¹⁰ Formoy (n 8) pt 1. Ireland explains that the distinction between a partnership and a company during this era was economic rather than legal; neither was an incorporated firm: Ireland 1984 (n 8) 239–41.

¹¹ Formoy (n 8) pt 1; Scott (n 8) 448–71.

¹² On the South Sea Company and the Bubble Act 1720 (6 Geo I c 18) see: Formoy (n 8) pt 1 pp 23–29; J Carswell, *The South Sea Bubble* (Cresset Press, London 1960).

¹³ Stein (n 7) 505; JF Avery Jones, ‘Bodies of Persons’ [1991] BTR 453, 454–56.

stock company could be constituted upon registration if it provided certain information and complied with certain regulations, meaning that incorporation was no longer a privilege but a right;¹⁴ statutes of 1855 and 1856 granted members limited liability in respect of corporate debts, a key advantage that until that time had not followed from incorporation;¹⁵ and the Companies Act 1862 confirmed that an incorporated company was external to its members, rather than being a merger or association thereof.¹⁶ The period following those enactments is described by Couzin:

In the succeeding decades, as business corporations became more familiar and important in commercial life, the contours of their legal status continued to be debated with increasing frequency and intensity. It took some time to come to terms with the implications of the legal existence of the incorporated company and its quality as a ‘person’ at law. To employ an overused expression, judges suffered through a ‘paradigm shift’, from the company as a group of individuals to the corporation as an independent person, separate and distinct from its members.¹⁷

The completion of that paradigm shift is commonly associated with the *Salomon* decision.¹⁸ As is well known, there the House of Lords rejected the allegation that a joint stock company in which Mr Salomon held the large majority of shares (his wife and family holding the minimum six remaining shares) was an ‘alias’ or ‘myth’ designed to defraud creditors. Lord Halsbury LC considered it indisputable that ‘once the company is legally incorporated it must be treated like any other independent person

¹⁴ Joint Stock Companies Act 1844 (7 & 8 Vict c 110).

¹⁵ Limited Liability Act 1855 (18 & 19 Vict c 133); Joint Stock Companies Act 1856 (19 & 20 Vict c 47). The latter statute provided that ‘[s]even or more Persons, associated for any lawful Purpose, may, by subscribing their Names to a Memorandum of Association, and otherwise complying with the Requisitions of this Act in respect of Registration, form themselves into an Incorporated Company, with or without Limited Liability’ (s 3). At the same time the size of trading partnerships and unincorporated trading ‘companies’ was limited to twenty persons (s 4).

¹⁶ Companies Act 1862 (25 & 26 Vict c 89) ss 6, 18.

¹⁷ Couzin (n 3) 11; cf Ireland 1984 (n 8).

¹⁸ *Aron Salomon (Pauper) v A Salomon and Company, Limited* [1897] AC 22 (HL).

with its rights and liabilities appropriate to itself'.¹⁹ Lord Macnaghten famously held that '[t]he company is at law a different person altogether from the subscribers to the memorandum'. Speaking of the process of incorporation in rather anthropomorphic terms, he stated:

The company attains maturity on its birth. There is no period of minority – no interval of incapacity. I cannot understand how a body corporate thus made 'capable' by statute can lose its individuality by issuing the bulk of its capital to one person, whether he be a subscriber to the memorandum or not.²⁰

Numerous decisions in the UK, Canada and elsewhere have reaffirmed the 'individuality' or 'personhood' of corporations in both tax and non-tax contexts, treating the *Salomon* decision like a legislative edict or mantra.²¹ It is accurate to say that the modern understanding of separate legal personality 'is based on a conception of the company as not merely an entity with an independent legal existence from its shareholders but an *object* which has been effectively cleansed of them'.²²

All modern legal systems make available a form of business organization which has separate legal personality. It is for this reason that contemporary legal debate 'focuses on the problems generated by the acceptance of separate legal personality for the company, rather than upon the question of whether it should, in principle, be made

¹⁹ *ibid* 30.

²⁰ *ibid* 51.

²¹ The list is extensive. Two of the more important decisions, aside from *Salomon* itself, are *Macaure v Northern Assurance Co Ltd* [1925] AC 619 (HL) (holding that a controlling shareholder does not have any proprietary interest in the corporate assets) and *Lee v Lee's Air Farming Ltd* [1961] AC 12 (PC) (holding that a controlling shareholder may also be an employee of the company). For a Canadian view see *Army & Navy Department Stores Ltd v MNR* [1953] 2 SCR 496 (SCC).

²² PW Ireland, 'Capitalism without the Capitalist: The Joint Stock Company Share and the Emergence of the Modern Doctrine of Separate Corporate Personality' (1996) 17 *The J of Legal History* 41, 41.

available.’²³ This fact should be borne in mind when considering alternative theories of the corporation.

3.2.2(b) *The Corporation as a Real Entity*

The *Salomon* decision and similar decisions in the US made way for a proliferation of both public and private companies at the close of the nineteenth century and beyond. Scholarly inquiry into the nature of corporations came to be influenced by continental theories that saw the corporation as a ‘real entity’ rather than a legal fiction. In particular, Maitland introduced the work of German author Otto Gierke into English legal scholarship.²⁴ This version of the real entity theory asserted that a corporation was a ‘living organism’ with its own personality, will, and even moral duties, recognized but not created by law.²⁵ According to this view, the corporation may rest upon a substratum of individuals but is not identical with them, because out of the association of those individuals a new and distinct personality arises.

A more plausible version of the real entity theory – which gained prominence in the early twentieth century – was that a corporation, although not a living thing, was an entity comprising a coherent system of rules, imperatives, and values.²⁶ The attributes of this system were considered to be greater than the aggregated attributes of its human participants. *Salomon* itself can be seen as endorsing the real entity theory, as Lord

²³ Davies 2002 (n 5) 36; cf Kraakman et al (n 5) § 1.1–1.2.

²⁴ FW Maitland (tr), O Gierke, *Political Theories of the Middle Age* (CUP, Cambridge 1900); FW Maitland, ‘Moral Personality and Legal Personality’ in HAL Fisher (ed), *The Collected Papers of Frederic William Maitland* (CUP, Cambridge 1911) vol 3.

²⁵ Maitland 1900 (n 24) xxv–xxvi; Maitland 1911 (n 24) 307, 314–19.

²⁶ E Freund, *The Legal Nature of Corporations* (Univ of Chicago Press, Chicago 1897) 30–31, 58–59; AV Dicey, *Law and Public Opinion in England* (Macmillan, London 1905) 244–47. For an analysis of variants of this theory see MJ Phillips, ‘Reappraising the Real Entity Theory of the Corporation’ (1994) 21 Florida State Univ Law Rev 1061.

Halsbury declared that a company is ‘a real thing’ having ‘a real existence’.²⁷ As with the fiction theory, a key premise is the distinction between the corporate entity and its shareholders. The difference is the belief that the corporation – and its attendant economic power – come to exist due to private initiative and market forces rather than government concession.

3.2.2(c) *The Corporation as a Socio-Economic Institution*

A related and perhaps more sophisticated theory is that the corporation, or at least the publicly traded business corporation, represents a socio-economic institution. The classic exposition is by Berle and Means, who argued that the (American) corporation of the 1920s had ceased to be a private business device and had become a new form of social and economic organization, wherein property ownership was divorced from its management and control.²⁸ This is also known as the managerialist position due to its focus on the structural power wielded by corporate management groups.²⁹

The institutional/managerial school of thought recognizes that the process of incorporation does not itself give rise to a change in socio-economic organization. Berle and Means conceded that the existence of private corporations, even very large ones, involves ‘no radical shift in property tenure or in the organization of economic activity’ because the features of ownership and control remain bonded.³⁰ But a new ‘system’ or ‘institution’ appears when, due to the sheer size, increased complexity, and dispersed share ownership characteristic of public corporations, shareholders are transformed

²⁷ *Salomon* (n 18) 33–34.

²⁸ Berle and Means (n 9), particularly vol 1 chs 1, 5; cf PF Drucker, *Concept of the Corporation* (John Day, New York 1946).

²⁹ S Wheeler, ‘The Business Enterprise: A Socio-Legal Introduction’ in Wheeler (n 4) 15–18.

³⁰ Berle and Means (n 9) 4–6. They cited the Ford Motor Company as an almost unique example of a large private corporation.

‘from entrepreneurs into passive investors who [place] their economic interests in the hands of professional managers’.³¹ Unlike legal entity and organic real entity theories, this is a viable way of conceptualizing not only a single corporation, but also an enterprise involving many corporations carrying on some unified business under common control.³²

Opinion is divided regarding whether the corporate institution is legitimate or socially desirable: the anti-managerialist complains that corporate managers exercise significant power with little accountability to shareholders and without responsibility to employees, consumers, or the state;³³ the pro-managerialist argues that management expertise is to be welcomed and that management groups are entirely capable of good citizenship.³⁴ Whatever view one takes, the recent proliferation of scholarship on corporate social responsibility is indicative of our acceptance of corporations and corporate groups as important social institutions rather than mere legal tools.³⁵

It is difficult to give much clarity to this view of the corporation without delving into systems theory and other concepts from sociology. What can be said is that the

³¹ Millon (n 4) 214–15. The observed shift in power from management to private equity groups or institutional shareholders may mean that the interests of management become aligned with those of dominant shareholders, but the interests of minority shareholders – and of investors in the institutional shareholders themselves – remain detached. For further analysis see Kraakman et al (n 5) ch 2; B Cheffins and J Armour, ‘The Eclipse of Private Equity’ (2008) 33 *Delaware J of Corporate Law* 1 <<http://ssrn.com/abstract=1276397>>.

³² G Teubner, ‘Enterprise Corporatism: New Industrial Policy and the “Essence” of the Legal Person’ (1988) 36 *American J of Comparative Law* 130; V Bornschier and H Stamm, ‘Transnational Corporations’ in Wheeler (n 4) 333. Also see text following n 44.

³³ eg Berle and Means (n 9); J Bakan, *The Corporation: The Pathological Pursuit of Profit and Power* (revd edn, Constable & Robinson, London 2005).

³⁴ eg Drucker (n 28); Teubner (n 32).

³⁵ eg OECD, *Corporate Social Responsibility: Partners for Progress* (OECD, Paris 2001); RS Avi-Yonah, ‘The Cyclical Transformations of the Corporate Form: A Historical Perspective on Corporate Social Responsibility’ (2005) 30 *Delaware J of Corporate Law* 767; D McBarnet, A Voiculescu, and T Campbell (eds), *The New Corporate Accountability: Corporate Social Responsibility and the Law* (CUP, Cambridge 2007). For a discussion of corporate responsibility with respect to tax see J Freedman, ‘The Tax Avoidance Culture: Who is Responsible? Governmental Influences and Corporate Social Responsibility’ in J Holder and C O’Cinneide (eds), *Current Legal Problems*, vol 59 (OUP, London 2006) 359.

institutional/managerial theory sees the large public corporation (or corporate group) as possessing features distinct from those of its human participants, with group dynamics taking on independent significance. For this reason the institutional/managerial view can be seen as a variant of the real entity theory, although applied to a specific type of corporation. Indeed, American legal writers tend to assimilate this theory with the real entity theory.³⁶ It is also noteworthy that most sociologists and various legal scholars, often on the political left, contend that the institutional or real entity theory is the most accurate conceptualization of modern corporations and corporate groups.³⁷

3.2.2(d) *The Corporation as a Nexus of Contracts*

At odds with the personification of corporations are aggregate or contractual theories, which see corporate activity as a network of explicit and implicit bargains among individuals. Coase explained the firm, which could be a partnership, corporation, or group enterprise under common control, as a method of replacing market exchange transactions with internally coordinated production, thus eliminating bargaining costs.³⁸ The idea of the firm as a market substitute achieved wider acclaim in the early 1980s.³⁹ While there are differences in aggregate approaches, the common thrust is that the corporation represents a ‘nexus of contracts’ among various participants – shareholders, directors, managers, employees, and creditors – regardless of the legal formality of

³⁶ eg Millon (n 4); Phillips (n 26). Berle and Means sometimes referred to the public corporation as an ‘economic organism’: Berle and Means (n 9) 352–53.

³⁷ eg Avi-Yonah 2005 (n 35) 812–13 and the literature cited there. cf Phillips (n 26); Bakan (n 33).

³⁸ RH Coase, ‘The Nature of the Firm’ (1937) NS 4 *Economica* 386.

³⁹ The literature is vast. Key articles include: MC Jensen and WH Meckling, ‘Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure’ (1976) 3 *J of Financial Economics* 305; FH Easterbrook and DR Fischel, ‘Limited Liability and the Corporation’ (1985) 52 *Univ of Chicago Law Rev* 89, which is synthesized with other work by the same authors in *The Economic Structure of Corporate Law* (Harvard Univ Press, Cambridge MA 1991). An extensive literature review appears in WW Bratton Jr, ‘The New Economic Theory of the Firm: Critical Perspectives from History’ (1989) 41 *Stanford Law Rev* 1471. For a British company law perspective see BR Cheffins, *Company Law: Theory, Structure, and Operation* (Clarendon Press, Oxford 1997) 31–46.

separate personality. Thus the holism of the institutional/managerial theory is replaced by methodological individualism: a corporation is seen as having no attributes beyond those of its human constituents.⁴⁰

Aggregate/contractual theory dominates the thinking of economists and many corporate law scholars today.⁴¹ Proponents emphasize that adopting the nexus of contracts view is a valuable analytical exercise, useful for making normative claims regarding such issues as limited liability, corporate control transactions, and shareholder oppression; a key element is the preference for voluntary over mandatory regulation. It is said that corporate law statutes should be (and usually are) enabling rather than mandatory, containing ‘the terms people would have negotiated, were the costs of negotiating at arm’s length for every contingency sufficiently low’.⁴² Critics complain that advocates of this theory use the freedom of contract metaphor to support anti-regulatory policy objectives that benefit shareholders and no one else, and in any event it is hardly an accurate representation of how governments, populations, and even corporate managers view corporations.⁴³ Although the author finds those criticisms persuasive, it is beyond the scope of this thesis to determine which theory of the corporation is most credible. What is evident is that contractual theory stands in contrast to real entity theories and the institutional theory, and therefore may suggest different policy prescriptions.

⁴⁰ Phillips (n 26) 1062–63.

⁴¹ Although sometimes characterized as a modern theory, this is essentially how the nature of the business corporation was understood in the eighteenth and early nineteenth centuries: Bratton (n 39).

⁴² Easterbrook and Fischel 1991 (n 39) 15.

⁴³ eg Millon (n 4) 203, 231; Phillips (n 26) 1090–99.

3.2.3 Application to MNEs

The theories of the corporation reviewed above are directed predominantly at explaining the nature of a single corporate entity. This is understandable given that the prevalent form of business organization through most of the nineteenth and twentieth centuries was a single corporation, owned primarily by shareholders in one state, managed by directors and officers in that state, and carrying on any foreign business through branch operations.⁴⁴ The dominant form of international business organization is now a globally integrated network of corporations with geographically diverse shareholdings, management, and operations.⁴⁵ How should one's understanding of the corporate form change, if at all, when conceptualizing the global MNE?

Evidently the legal entity/fiction theory sees a MNE as a collection of independent entities, each given separate recognition by the laws of its home state. While some complain that this approach is 'anachronistic' and 'dysfunctional',⁴⁶ it is highly influential in any international legal regime that is not globally harmonized, including the tax treaty system. The modified real entity theory, institutional theory, and contractual theory are more amenable to describing corporate groups. Under such theories one can characterize a MNE as a unitary body with all foreign intermediaries and subsidiaries being equivalent to branch operations of the headquarters company. In some respects the controlled foreign company (CFC) regimes existing in the UK,

⁴⁴ Scott (n 8) 439–41; Avi-Yonah 2005 (n 35) 810–11. For examples of this pattern see the early corporate residence cases discussed in ch 4.

⁴⁵ MA Desai, 'The Decentering of the Global Firm' (2009) 32 *The World Economy* 1271; KA Strasser and P Blumberg, 'Legal Form and Economic Substance of Enterprise Groups: Implications for Legal Policy' (2011) 1 *Accounting, Economics, and Law* 4 <www.bepress.com/acl/vol1/iss1/4>. See also the evidence regarding foreign affiliates and investment at ch 1 text to nn 8–11.

⁴⁶ Strasser and Blumberg (n 45) 3.

Canada, and several other states reflect a unitary enterprise approach.⁴⁷ But even if such a vision could be given far-reaching legal effect in the face of national sovereignty concerns, it would not mean that government regulation of corporations becomes irrelevant. Instead it would involve reverting to the understanding of international business organizations that existed prior to the proliferation of separate entity MNEs. In either case inquiries into why and where corporations should be regulated, including why and where corporations should be taxed, remain relevant. Accordingly, the subsequent section of this chapter focuses on the justifications for corporate tax as applied to a single corporation. The analysis is then extended to MNEs.

3.3 JUSTIFYING CORPORATE TAXES GENERALLY AND RESIDENCE-BASED CORPORATE TAXES SPECIFICALLY

3.3.1 Overview

It is undoubted that entity theories traditionally have provided the support for corporate income taxation, and in particular residence-based corporate income taxation. The modern income tax was introduced at a time when variations of the legal entity and real entity theory dominated legal and political thought.⁴⁸ Nevertheless, one can justify a residence-based corporate tax given any theory of the corporation.

The separate taxation of corporations on any basis is a practice that it is often criticized but is grudgingly accepted. Various writers have reviewed the arguments for

⁴⁷ Discussed in ch 5.

⁴⁸ The Income Tax Acts of 1842 and 1853 imposed a duty in respect of 'the annual Profits or Gains arising or accruing to any Person' residing in the UK, applicable to all 'Bodies Politic, Corporate, or Collegiate, Companies, Fraternities, Fellowships, or Societies of Persons, whether Corporate or not Corporate': Income Tax Act 1842 (5 & 6 Vict c 35) ss 1, 40, 100 (Schedule D rules); Income Tax Act 1853 (16 & 17 Vict c 34) ss 1, 2 (Schedule D rules). For contemporary views see Freund (n 26); Dicey (n 26); *Salomon* (n 18). The first federal income tax statute in Canada imposed taxes on various 'persons', which included 'any syndicate, trust, association or other body and any body corporate': The Income War Tax Act, SC 1917 c 28 s 2. The statute was modelled on the UK legislation: B Alarie and DG Duff, 'The Legacy of UK Tax Concepts in Canadian Income Tax Law' [2008] BTR 228, 230–34.

and against corporate taxes.⁴⁹ Many economists emphasize that ‘source-based taxation of capital income’ – meaning corporate taxation generally⁵⁰ – is inefficient because: (i) it distorts corporate behaviour in favour of retaining earnings rather than distributing dividends; (ii) it distorts the allocation of investment in favour of debt rather than equity; (iii) it distorts the choice of business organization in favour of non-incorporated forms; and (iv) in an international context, it distorts the allocation of capital where national tax rates differ.⁵¹ Many commentators focus on the perceived inequity of taxing corporate income twice, first at the corporate level and then at the shareholder level, leading them to urge greater (or complete) integration of corporation and shareholder taxes.⁵² The supposed inequity of such ‘double taxation’ may lead corporate managers to feel vindicated when avoiding corporate tax.

Recently some legal academics have given greater attention to the disadvantages of complete integration and have sought to reaffirm the merits of a separate corporate tax.⁵³ Some of the arguments proffered represent pragmatic defences rather than theoretical justifications of a separate tax: it is said that corporation tax captures a portion of pure economic profits derived from business activity, enhances the fairness

⁴⁹ eg R Goode, *The Corporation Income Tax* (John Wiley & Sons, New York 1951) ch 3; WA Klein, ‘Income Taxation and Legal Entities’ (1972) 20 *UCLA Law Rev* 13, 43–51; Technical Committee on Business Taxation, *Report of the Technical Committee on Business Taxation* (Department of Finance, Ottawa 1998) (Mintz Report) 2.8–2.9.

⁵⁰ Ch 2 text to n 11.

⁵¹ eg AJ Auerbach, MP Devereux, and H Simpson, ‘Taxing Corporate Income’ in Institute for Fiscal Studies (ed), *Dimensions of Tax Design: The Mirrlees Review* (OUP, Oxford 2010) (Mirrlees Review) 837. For a useful overview of these arguments see M Gammie, ‘Reforming Corporate Taxation: An Evaluation of the United States Treasury Integration Proposals and Other Corporate Tax Systems in an International Context: Part 1’ [1992] *BTR* 148.

⁵² eg CE McLure Jr, *Integration of the Income Taxes: Why and How* (American Enterprise Institute, Washington DC 1976); A Warren, ‘The Relation and Integration of Individual and Corporate Income Taxes’ (1981) 94 *Harvard Law Rev* 717.

⁵³ RS Avi-Yonah, ‘Corporations, Society, and the State: A Defense of the Corporate Tax’ (2004) 90 *Virginia Law Rev* 1193; K Brooks, ‘Learning to Live with an Imperfect Tax: A Defence of the Corporate Tax’ (2003) 36 *UBC Law Rev* 621.

and progressivity of the income tax system by affecting primarily the wealthy, generates a good deal of revenue, and is politically popular. The first two arguments may support the taxation of business and investment income but fail to explain the separate taxation of corporations, while the second two arguments are not justifications at all. The more robust justifications of a separate corporate tax are addressed in turn below, with particular reference to residence-based corporate taxation.

3.3.2 The Withholding Rationale

3.3.2(a) As a Justification for Corporate Taxes Generally

The most convincing justification for corporate taxation is that, in the absence of contemporaneous ‘flow-through’ taxation of shareholders, corporate taxes serve an essential withholding function: they support the personal taxation of income accumulating to both resident and non-resident investors. As Brooks observes, ‘[f]ew tax analysts would deny that the corporate tax is essential for the purpose of preventing the undue deferral of tax in a realization-based individual income tax system’.⁵⁴

If we characterized a corporation as a conduit through which the income earned is passed to human shareholders (directly or through a chain of holding companies), then it would be sensible to tax shareholders on an annual accumulation basis, as with partnership taxation. In this way the comprehensiveness of the individual income tax base would be maintained. This type of flow-through taxation was advocated by various supporters of the comprehensive income tax. Henry Simons argued that there should be ‘no taxation of business as such and certainly no such taxes confined to incorporated business’.⁵⁵ In Canada, one of the Carter Commission’s conclusions was that equity and

⁵⁴ Brooks (n 53) 639.

⁵⁵ H Simons, ‘Federal Tax Reform’ (1946) 14 Univ of Chicago Law Rev 20, 56.

neutrality would be furthered by ‘a tax system in which there were no taxes on organizations as such’, instead taxing individuals on the accrued gains from their interests in such organizations.⁵⁶

It is generally recognized that flow-through taxation of corporate shareholders is plagued by almost insurmountable administrative problems. In particular, public companies would have to notionally allocate any retained earnings among numerous shareholders, some of whom might have held their shares for only a part of the year, and shareholders would face liquidity difficulties when asked to pay tax on undistributed earnings.⁵⁷ For these and other reasons countries choose to tax shareholders only when they receive dividends or dispose of their shares. This gives rise to the familiar problem of unlimited deferral: resident shareholders of domestic corporations could divert and store income that they otherwise would have earned directly, thus deferring home taxation; non-resident shareholders of domestic corporations could do the same, thus deferring host taxation; and non-resident shareholders of foreign corporations might escape tax altogether in respect of income arising in the host country. The solution is a tax at the corporate level.

It is worth pausing to note the difficulty of determining the incidence of corporate taxation. The withholding justification assumes that the corporate tax is actually borne by shareholders who would otherwise have been taxed on the income directly. Some recent research has suggested that a substantial portion of corporation tax

⁵⁶ Canada, Royal Commission on Taxation, *Report of the Royal Commission on Taxation* (Queen’s Printer, Ottawa 1966–67) (Carter Report) vol 4 p 4.

⁵⁷ Such compliance problems are a concern under CFC legislation, discussed in ch 5.

is shifted to employees through lower wages.⁵⁸ However, this research does not purport to be conclusive and there remain reasons to believe that at least some of the incidence of corporate tax is upon investors.⁵⁹ If capital owners are entirely shielded from the effect of corporate taxes, why is there so much theoretical and empirical literature regarding the rush of corporate capital from high tax to low tax jurisdictions?⁶⁰

Few commentators disagree that the corporate tax is an important withholding device. Notably, innovative proposals such as the comprehensive business income tax (CBIT) and allowance for corporate equity (ACE) models seek to mitigate distortions in the tax treatment of corporate debt and equity through a better corporate tax, not through the elimination of corporate tax.⁶¹ The debate has focused on the proper level of tax integration, that is, the degree to which corporate taxes should be refunded to shareholders when they pay tax on distributions and capital gains.⁶² It is here that one's theory of the nature of the corporation is influential. If one sees the corporation as an artificial legal entity and nothing more, one should concede a legal obligation to pay tax at the corporate level, although with complete or near-complete integration. Any tax differential would represent a fee to the state for the franchise of corporate personhood. Supporters of the contractual theory accept that the corporation is the legal focal point for the various bargains pursuant to which shareholders derive income. As such, they would consider it permissible to withhold tax at the corporate level provided there is

⁵⁸ W Arulampalam, MP Devereux, and G Maffini, 'The Direct Incidence of Corporate Income Tax on Wages' (2009) Oxford Univ Centre for Business Taxation Working Paper No WP09/17 <<http://ssrn.com/abstract=1704266>>.

⁵⁹ Mintz Report (n 49) 3.21–3.22; Avi-Yonah 2004 (n 53) 1202–03 and the literature cited there.

⁶⁰ See ch 1 text to nn 18–29.

⁶¹ Institute for Fiscal Studies, *Equity for Companies: A Corporation Tax for the 1990s* (IFS Commentary No 26, London 1991); SR Bond, 'Levelling Up or Levelling Down? Some Reflections on the ACE and CBIT Proposals, and the Future of the Corporate Tax Rate' in S Cnossen (ed), *Taxing Capital Income in the European Union* (OUP, Oxford 2000).

⁶² Goode (n 49) ch 10; Brooks (n 53) 639.

complete integration at the shareholder level. Those who view the corporation as a real entity or socio-economic institution would recognize the withholding function but would argue that it is only one function of the corporate tax; complete integration would in their view frustrate the benefits rationale discussed below.⁶³

Even those who see complete integration as the ideal recognize that it may not be feasible due to its complexity and attendant distortions to economic activity, particularly in an international context.⁶⁴ Most countries have designed their corporate and shareholder tax systems to allow partial relief for corporate taxes when distributions are made to shareholders, but there has been a movement away from full imputation systems in recognition of the complexities and distortions they create. The trend seems to be towards a classical system – imposing separate taxes at the corporate and shareholder level – but with a complete exemption for inter-corporate dividends, at least where the recipient company has a substantial shareholding in the paying company.⁶⁵

3.3.2(b) *As a Justification for Residence-Based Corporate Taxes*

Corporate taxes can legitimately act as a withholding device in respect of both residence and source taxation, yet using the traditional language of ‘residence’ and ‘source’ can obscure the argument. In chapter 2 the terms ‘home’ and ‘host’ were preferred and the residence of an enterprise was identified as the ‘home source’. When residence is seen this way, the value of the withholding function in the home state is apparent.

⁶³ Text beginning at n 69.

⁶⁴ R Boadway and N Bruce, ‘Problems with Integrating Corporate and Personal Income Taxes in an Open Economy’ (1992) 48 J of Public Economics 39; HJ Ault, ‘Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices’ (1992) 47 Tax Law Rev 565. For an exhaustive discussion see P Harris, *Corporate–Shareholder Income Taxation and Allocating Taxing Rights between Countries: A Comparison of Imputation Systems* (IBFD, Amsterdam 1996).

⁶⁵ RJ Vann, ‘General Report’ in Int’l Fiscal Association (ed), *Trends in Company/Shareholder Taxation: Single or Double Taxation?*, Cahiers de Droit Fiscal International vol 88a (IFA, Sydney 2003); S Boon Law, ‘Trends in the Taxation of Outbound Foreign Direct Investment’ (2009) 63 BIT 257. The relevant UK and Canadian policy documents are referenced in ch 1 nn 42–53.

The rationale of the withholding function is that individuals should not be able to defer indefinitely the taxation of income which they could have earned personally. That rationale has obvious weight where resident individuals are shareholders in a corporation (domestic or foreign) that carries on business in the individuals' home country. It also applies where non-resident individuals are shareholders in a corporation (domestic or foreign) that carries on business in the host country. Employing the traditional legal language of residence and source, one might say that the withholding function is a strong justification for 'source' taxation.

In contrast, some commentators argue that residence-based taxation of corporations is not supported by the withholding function. Couzin states that the withholding function 'cannot justify taxation at the corporate level of foreign source income earned by foreign shareholders'.⁶⁶ Similarly, Vann observes that there is little sense in taxing a domestic corporation which is owned primarily by foreign residents and which carries on business exclusively in a foreign state or states, a situation that becomes increasingly common as ownership of MNEs diversifies.⁶⁷

There are two responses to this objection, which are apposite regardless of the theory of the corporation one adopts. The first is that the withholding function justifies a state imposing corporate tax on a domestic corporation if it has any resident shareholders. If the corporation carries on business in a foreign state, then from the perspective of resident shareholders the host state should have the primary right to withhold corporate tax on the income arising in the host state, while the home state

⁶⁶ Couzin (n 3) 17.

⁶⁷ RJ Vann, 'Problems in International Division of the Business Income Tax Base' (2007) Oxford Univ Centre for Business Taxation, 2007 Symposium Paper <www.sbs.ox.ac.uk/centres/tax/symposia/Documents/2007/Vann.doc> 3–8. In 2007 the UK government stated that foreign ownership of quoted UK companies had reached approximately 50 per cent: HM Treasury and HMRC, *Taxation of Companies' Foreign Profits: Discussion Document* (HM Treasury, London, June 2007) <www.hm-treasury.gov.uk/consult_foreign_profits.htm> (Foreign Profits Discussion) 7–8.

should have a residual right to withhold corporate tax in the home state, in accordance with the jurisdictional principles discussed in chapter 2. The administrative difficulties already mentioned would make it impractical to withhold tax at the corporate level solely in respect of resident shareholders while exempting non-resident shareholders. Thus the corporate tax is a necessary but imperfect withholding device.

The second response is more fundamental. It follows from the central argument of chapter 2 that corporate residence can and should be seen as a specific type of source, described there as the ‘home source’. The income earned by a corporation operating abroad, and from which states may legitimately withhold corporate tax, is generated both in the so-called source state(s) and in the so-called residence state because the intellectual endeavours of human beings which generate the income occur in both places. The objection raised above assumes that residence does not signify any economic nexus with a state and therefore cannot be associated with the generation of income. While this objection is convincing where corporate residence is signified by *de jure* concepts such as place of incorporation, it is less cogent where residence is based on a substantive, activities-based concept like effective management.⁶⁸

3.3.3 The Benefits Rationale

3.3.3(a) As a Justification for Corporate Taxes Generally

The other major justification for corporate taxes, sometimes maligned but in the author’s view legitimate, is that they approximate a general business benefits tax. There are two broad categories of benefits that can be identified. Ernest Seligman, whose thinking influenced the early tax analysis of the League of Nations, characterized these

⁶⁸ Discussed in ch 4.

benefits as the ‘franchise to be’ and the ‘franchise to do’.⁶⁹ The franchise to be consists of the legal privileges of the corporate form itself, notably limited liability for investors, free transferability of shares, centralized management, and continuity of existence through changes in ownership. The franchise to do comprises the more general benefits which make business activity possible and profitable: physical infrastructure, supply of skilled labour, favourable market conditions, and stable legal and regulatory systems, including those that protect property rights. As explained in the previous chapter,⁷⁰ it is difficult to justify any form of income taxation as recompense for specific benefits which accrue to specific taxpayers; nonetheless, it is generally accepted that the provision of a viable legal, economic, and social order underlies a state’s right to tax.

Unlike the withholding justification, the appeal of this argument depends to a great extent on which theory of the corporation one adopts. Those who characterize the corporation primarily as a legal entity or fiction would maintain that a corporate franchise has value. The legal fiction of corporate personality is important because it facilitates other core features including limited liability and transferability of shares.⁷¹ Traditionally, the value of the corporate franchise was highlighted more by American judges than by their British counterparts, who focused instead on the benefits of a stable legal and economic order.⁷² In Canada the early twentieth century legal culture, and the availability of appeals to the Judicial Committee of the Privy Council until 1949, ensured the prevalence of British views in this and other areas of tax law.⁷³ The

⁶⁹ ERA Seligman, *Essays in Taxation* (10th edn, MacMillan, New York 1925) 223–25.

⁷⁰ Ch 2 text to nn 100–102.

⁷¹ *Gower and Davies* (n 5) 27–30; Kraakman et al (n 5) § 1.2.2–1.2.3.

⁷² The UK perspective is exemplified in *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455 (HL), discussed in ch 4. The US history is addressed by Goode (n 49) 27 and Avi-Yonah 2004 (n 53) 1212–31.

⁷³ See generally Alarie and Duff (n 48).

subsequent adoption of the incorporation test of corporate residence in the UK and Canada, discussed in chapter 4, indicates that those governments believed (and still believe) that the corporate franchise is a benefit that in itself justifies domestic taxation.

Those who view the corporation as a nexus of contracts argue that the corporate franchise has only nominal value, as the features of legal personality, limited liability, free transferability of shares, and centralized management could be included in a contract that investors negotiated among themselves in the absence of transaction costs.⁷⁴ The objection is often raised that the more general business benefits which corporations are said to enjoy are available to unincorporated businesses as well. Moreover, it is said that the corporate income tax base is overly broad: it includes all of a corporation's income and thus does not reflect in any meaningful way the benefits of the corporate form.⁷⁵ According to the contractual theory, a well-designed benefits tax would tax at most the incremental income that is made possible by the corporate form due to the synergistic effects of aggregated investment and centralized management.

Adherents of the real entity or institutional theory would argue that the synergistic effects of corporate investment and management are substantial, particularly for large public corporations that have become centres of wealth and power. Avi-Yonah argues that corporate taxation 'is justified as a way for a liberal democratic state to limit excessive accumulations of power in the hands of corporate management, which is inconsistent with both democratic and egalitarian ideals'.⁷⁶ Even taking a more moderate view, one can tenably claim that separate taxation of corporations follows

⁷⁴ eg AP Polito, 'A Proposal for Integrated Income Tax' (1989) 12 *Harvard J of Law & Public Policy* 1009, 1014–15.

⁷⁵ McLure (n 52) 435; Polito (n 74) 1013–14.

⁷⁶ Avi-Yonah 2004 (n 53) 1249.

from the fact that corporations are embedded in our legal, economic, and social systems: corporations can hold property, can sue and be sued, can contribute to environmental damage, can champion charitable causes, and so on. When considering the government ‘bailouts’ provided to large financial institutions such as Royal Bank of Scotland in the wake of the 2008 financial crisis, one does not speak of government funds being paid to shareholders, managers, or other stakeholders: the funds were invested in Royal Bank of Scotland Group plc. It therefore seems appropriate that corporations or corporate groups are themselves proper subjects of government regulation, including taxation.

The business benefit justification is evidently most plausible when applied to the largest public corporations.⁷⁷ Even entity theorists should concede that it is sensible to tax small, owner-managed corporations more like a partnership or proprietorship, as such corporations do not benefit from amalgamation of diverse capital or aggregation of diverse legal rights. Gower and Davies note that the ‘balance of advantage and disadvantage in relation to incorporation’, including the disadvantage of taxation, will vary from one business context to another, at least for small firms, while for large business organizations ‘the arguments in favour of incorporation are normally conclusive’.⁷⁸ No doubt in recognition of this important difference, many tax systems provide a greater degree of integration of corporate and shareholder taxes for small and medium-sized private corporations.⁷⁹ This approach also suggests that wholly owned

⁷⁷ Goode (n 49) 29. Canada introduced legislation in 2006, effective 2011, that applies entity-level taxes to ‘specified investment flow-through’ trusts and partnerships and allows dividend tax credits to their unitholders, despite the absence of a withholding rationale given the flow-through nature of such vehicles. This is not a new idea. Maitland, in his discussion of group personality, highlighted the fact that the early income tax statutes imposed tax on the property of ‘unincorporate bodies’ as well as corporate bodies: Maitland 1900 (n 24) xxxiv; cf Avery Jones (n 13).

⁷⁸ *Gower and Davies* (n 5) 43–44.

⁷⁹ For discussion of special tax incentives that apply to ‘small businesses’ in the UK and Canada see: C Crawford and J Freedman, ‘Small Business Taxation’ in Mirrlees Review (n 51) 1028; P Bleiwas and J Hutson (eds), *Taxation of Private Corporations and Their Shareholders* (4th edn, Canadian Tax Foundation, Toronto 2010).

subsidiaries should be treated as extensions of the parent, perhaps justifying flow-through taxation.

3.3.3(b) *As a Justification for Residence-Based Corporate Taxes*

The benefits justification for a separate corporate tax should, to the extent that we accept the justification, apply to both home state and host state taxation. Home state taxation need not be justified based solely on the ‘franchise to be’ but by focusing on the ‘franchise to do’ in home and host states, recognizing the earning capacity of a corporation in both places.⁸⁰

A corporation which is established in its home state and which carries on business in a host state will obviously rely on each state’s legal system recognizing it as a subsisting entity with the right to carry on such business. Thus the franchise to be derives from each state, though the claim of the state where the company is incorporated would be stronger. For those who see the franchise to do as a freestanding justification for corporate tax, it should apply in any state where the corporation has an economic presence. This would include any host state where the corporation carries on business and, applying the principles discussed in chapter 2, the home state as well. Various benefits can be identified. One of the principal tax benefits available to a corporation by virtue of its residence in a state is, of course, its entitlement to rely on the state’s tax treaties.⁸¹ Similarly, residence in an EU state grants a corporation access to various rights under the EC Treaty that are unavailable to residents of third states.⁸² Returning

⁸⁰ Seligman (n 69) 236–37.

⁸¹ OECD, *Model Tax Convention on Income and on Capital* (OECD, Paris 2010) <www.oecd.org/ctp/tt/mtc> (OECD Model) Arts 1, 4[1]; OECD, *Commentaries on the Articles of the Model Tax Convention* (OECD, Paris 2010) (OECD Commentary) Art 4[8]–[8.8].

⁸² *Treaty on the Functioning of the European Union* (Consolidated Version, OJ 2010/C 83/47) <<http://eur-lex.europa.eu/en/treaties/index.htm>> especially Arts 49–54 (formerly EC Treaty Arts 43–48).

to the example of the financial rescues by governments following the 2008 financial crisis, it is clear that the home state benefits enjoyed by certain financial institutions were substantial. The provision of such benefits by the home state would seem to be a justification for the imposition of taxes by the home state, independent of the withholding justification.

3.3.4 Application to MNEs

3.3.4(a) Separate Entities or Unitary Enterprise?

It was observed above that the prevalent form of international business organization is an integrated MNE with geographically diverse shareholdings, management, and operations. Yet the international tax system as exemplified in the global network of bilateral tax treaties is based largely on the legal entity/fiction theory of corporations and separate entity accounting.⁸³ The separation of a corporation from its shareholders, whether those shareholders are individuals, intermediate holding companies, headquarters companies, or non-corporate vehicles, has various legal implications. Two such implications are that dividends received by resident shareholders in respect of shares of a foreign corporation are income from the shares, not some proportion of income (or capital) of the corporation itself,⁸⁴ and capital gains from dispositions of foreign shares are not gains on the underlying assets. Tax treaties generally provide no guidance regarding relief from ‘double taxation’ of corporations and shareholders resident in different treaty states, as this is double taxation only in an economic sense. The only relief contemplated is reduced withholding taxes on dividends with a credit in

⁸³ Vann 2003 (n 65); OECD Model (n 81) Art 9; OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD, Paris 2010).

⁸⁴ See *IRC v Reid's Trustees* [1949] AC 361 (HL) 383, 385–86 or, more recently, *First Nationwide v HMRC* [2010] UKFTT 24, [2010] SFTD 408 (FTT).

the shareholder's residence state, which has nothing to do with the underlying profits of the corporation paying the dividends.⁸⁵ It is left to individual states to decide whether to lessen the burden of economic double taxation when designing their outbound international tax rules.⁸⁶

If a state wishes to regard a MNE as a unitary enterprise where affiliates are equated with branch operations, this does not mean that taxation of corporations becomes unjustified. It involves reverting to the understanding of international business organizations that existed decades ago. A state would not be concerned about the taxation of dividends from foreign subsidiaries or capital gains from dispositions of foreign shares. Such transactions would generate income for the parent company itself, necessitating an analysis of the appropriate allocation of taxing rights over that income.⁸⁷ Therefore the same questions asked above about the justifications for corporate tax would need to be considered, albeit in the context of headquarters corporations with extensive international operations.

In the author's view one must choose some understanding of the global MNE before making policy prescriptions about international tax rules. What a state should not do is design a set of tax rules based partly on legal entity theory and separate entity accounting yet based partly on some institutional or contractual theory of unified MNEs. In particular, it is nonsensical for a state to tax a corporation's foreign branch income subject to tax credits, as though the domestic entity is an inviolable body all the income of which must be taxed by the home state, while at the same time exempting

⁸⁵ OECD Model (n 81) Arts 10[1]–[2], 23A[2]–[4], 23B[1]–[2].

⁸⁶ OECD Commentary (n 81) Arts 23A and 23B[2], [49]–[54].

⁸⁷ The relevant treaty article would of course be Art 7, the business profits article: OECD Model (n 81) Arts 7, 10[4], 11[4], 12[3], 21[2].

dividends distributed by foreign subsidiaries to a domestic parent, as though these dividends are in substance the ‘foreign profits’⁸⁸ of a unitary enterprise that must not be taxed by the home state. Either the foreign affiliate is a separate entity, in which case dividends paid by it are a separate source of income that should be taxable to the parent (with foreign tax relief), or the affiliate is an extension of the parent, in which case its income should be taxable to the parent on a *current basis* (with foreign tax relief).⁸⁹ Accrual taxation of the income of all foreign subsidiaries is not practically or politically feasible, thus the second best option is to regard distributed dividends as taxable income. The coherent approach is to apply a credit system to both branch profits and affiliate dividends, as in the US, or an exemption system to both branch profits and affiliate dividends, as in France, Germany, and the Netherlands. Unfortunately, an incongruous system prevails in the UK and Canada, with branch profits receiving credit treatment and most affiliate dividends now receiving exemption treatment.

3.3.4(b) *Recent Changes in the UK and Canada*

In 2009 the UK replaced the longstanding tax credit regime with an exemption for most foreign dividends received by UK resident companies.⁹⁰ This change is intended to prevent economic ‘double taxation’ and thus suggests a unitary enterprise view of MNEs. As argued previously, this change is unprincipled because it conflicts with the treatment of foreign branch profits, it is not supported by any limitation on interest

⁸⁸ In the Foreign Profits Discussion (n 67) HM Treasury and HMRC used the term ‘foreign profits’ to refer to dividends on shares of foreign companies and the underlying profits of foreign companies.

⁸⁹ For similar views see BJ Arnold, *Reforming Canada’s International Tax System: Toward Coherence and Simplicity* (Canadian Tax Foundation, Toronto 2009) 40–45.

⁹⁰ CTA 2009 pt 9A (ss 931A–931W), inserted by FA 2009 Sched 14. The government also intends to permit exemption of some foreign branch profits: HM Treasury, *Foreign Branch Taxation: Discussion Document* (HM Treasury, London 2010) <www.hm-treasury.gov.uk/tax_foreign_branches.htm>.

deductibility in the UK, and – most fundamentally – it ignores the home economic interest that may have contributed to the generation of the ‘foreign profits’.

The UK tax rules affecting outbound corporate investment, although not ideal, at least demonstrate some attempt to balance tax policy principles with international competitiveness concerns. The Canadian rules, in contrast, have little if any coherence. Under current legislation, branch profits are taxed with a foreign tax credit, while dividends distributed by a ‘foreign affiliate’ to a Canadian corporation are governed by one of two systems: exemption or indirect credit. Where dividends are paid from an affiliate’s ‘exempt surplus’, exemption applies.⁹¹ Where dividends are paid from an affiliate’s ‘taxable surplus’, Canadian tax is payable with what is effectively a credit for any withholding taxes and underlying foreign taxes paid by the affiliate.⁹² Very technical regulations determine whether each item of income earned by an affiliate should be added to the affiliate’s exempt surplus or taxable surplus accounts.⁹³ The key point is that exempt surplus includes all income from an ‘active business’ carried on in a ‘designated treaty country’ by a foreign affiliate that is resident in a designated treaty country. Taxable surplus consists of income that is not included in exempt surplus, mainly active business income earned in non-treaty countries and passive income.

The restriction of the exemption system to income earned in treaty countries by affiliates resident in treaty countries may have had a meaningful policy foundation in 1975. The restriction no longer has any justification, for two reasons. First, Canada has concluded tax treaties with countries such as Barbados that are well-known havens for corporate intermediaries. Amendments made to the legislation in 1995, designed to bar

⁹¹ ITA 1985 ss 90, 113(1)(a).

⁹² ITA 1985 ss 90, 113(1)(b)–(c).

⁹³ Income Tax Regulations, CRC 1977 c 945 (ITR 1977) reg 5907.

special purpose entities from the exemption system where they did not qualify as ‘residents’ under the relevant tax treaty, were made subject to express exceptions that defeated the purpose of those amendments.⁹⁴ Second, in 2007 the Canadian government introduced rules that extend the exemption system to countries that enter a Tax Information Exchange Agreement (TIEA) with Canada, hoping to improve exchange of information with non-treaty states. Specifically, the definition of ‘designated treaty country’ was enlarged from countries that have a treaty with Canada to countries that have a treaty or a TIEA with Canada.⁹⁵ Thus a new avenue to the exempt surplus / dividend exemption system was opened. The amendments also have a negative aspect: all income earned by an affiliate in a state (referred to as a ‘non-qualifying country’) is deemed to be ‘foreign accrual property income’ if that state does not have a tax treaty or TIEA with Canada and does not conclude a TIEA with Canada within five years of being invited to do so.⁹⁶ These amendments serve no tax policy purpose other than to induce tax havens to conclude TIEAs with Canada lest they suffer a retreat of Canadian investment. The beneficiaries of these developments are MNEs operating from Canada, who care little about the terms of a TIEA as long as one exists.⁹⁷

These recent legislative changes suggest that the UK and Canadian governments are more concerned with enhancing international competitiveness (and identifying tax

⁹⁴ ITR reg 5907(11.2)(a), (b), (c). These provisions ensure that dividends from a Barbados international business company – an entity that is subject to tax at a rate of between 1% and 2.5% – qualify for exemption treatment, despite the fact that Art 30[3] of the Canada–Barbados tax treaty specifically excludes Barbados international business companies from treaty benefits. Brian Arnold has argued that these exceptions provide ‘convincing evidence of the complete lack of integrity in the Canadian foreign affiliate rules’: BJ Arnold, ‘Unlinking Tax Treaties and the Foreign Affiliate Rules: A Modest Proposal’ (2002) 50 CTJ 607, 616; Arnold 2009 (n 89) 73.

⁹⁵ ITR reg 5907(11), as amended by SC 2009 c 2 s 112, applicable after 2007.

⁹⁶ ITA s 95(1) ‘foreign accrual property income’, ‘non-qualifying business’, ‘non-qualifying country’, as amended or inserted by SC 2007 c 35 s 26, applicable after 2008.

⁹⁷ N Boidman, ‘New TIEAs Extend the Playing Field for Canada’s Multinational Enterprises’ 59 Tax Notes Int’l 209 (19 July 2010).

evasion) than with achieving a meaningful allocation of taxing rights based upon where economic interests exist. Nonetheless, the fact that these changes have been made does not detract from the normative foundations for tax jurisdiction. Economically substantial residence remains a rational basis for corporate taxation in the home state, whether or not the home state chooses to exercise its taxing rights.

3.4 CONCLUSIONS

This chapter has reviewed rival theories of the corporation in order to emphasize that, although entity theories have dominated corporate taxation, one can justify a corporate income tax given any theory of the corporation. The most convincing justification is that the corporate tax serves an essential withholding function in a realization-based income tax system. A secondary justification is that the corporate tax constitutes some reimbursement for benefits associated with corporate activity, although the appeal of that rationale is highly dependent on one's view of the nature of the corporation.

It has been suggested that these justifications are relevant to both residence/home state and source/host state taxation, whether applied to separate, affiliated corporations or to a unified MNE seen as having a single home. This is because, in the absence of flow-through taxation of individual shareholders, states should start with the proposition that a corporation pays income tax in the place or places where it generates income. The modern tendencies to assume that corporate income is generated entirely outside the home country, or to exempt such income from home state taxation in the name of competitiveness, are flawed. If one is dealing with an international tax system that regards a globally integrated firm as a unitary enterprise, then the residence of that enterprise matters for determining an appropriate level of home source taxation for the enterprise as a whole. This can be achieved rather

arbitrarily through a credit system (applied to both branch profits and dividends), or preferably through an exemption system with residual residence state taxation (applied to both branch profits and dividends). If, in contrast, one accepts the prevailing system of separate entity accounting, then the residence of each corporation matters for determining an appropriate level of home source taxation for each corporation. The two approaches may in any event produce the same result, because the home economic interest of many foreign subsidiaries likely exists in the state of the parent. That issue is explored further in chapters 4 and 5.

CHAPTER 4

THE (DIS)CONNECTION BETWEEN CORPORATE TAXATION AND CORPORATE RESIDENCE

4.1 INTRODUCTION

4.1.1 The Puzzle of Corporate Residence

Having analyzed the theoretical justifications for residence-based taxation generally, and residence-based taxation of corporations specifically, we now consider how well the concepts of corporate residence for domestic law and tax treaty purposes align with those theoretical justifications. The answer is that, as currently formulated, they do not align very well at all.

It has been observed that residence taxation ‘requires the attribution to companies of a characteristic that serves the same function as the residence of individuals, defining a strong nexus for taxation based on personal attachment to the jurisdiction’.¹ If we were to consider where a corporation’s ‘centre of vital interests’ lies, we would seek a combination of all elements that contribute to a corporation’s existence and operation: shareholder creation and control, recognition of status by law, management and administration, and day-to-day business activity.² In practice, different states rely on different features for domestic law purposes. The common theme is that the existence or occurrence of the selected feature in the taxing state results in the entity’s income being subject to comprehensive taxation for domestic law purposes,

¹ R Couzin, *Corporate Residence and International Taxation* (IBFD, Amsterdam 2002) 5.

² J-M Rivier, ‘General Report’ in Int’l Fiscal Association (ed), *The Fiscal Residence of Companies*, Cahiers de Droit Fiscal International vol 72a (IFA, Brussels 1987) (IFA 1987 Congress) 51, 74.

such that we might speak of fiscal ‘allegiance’ rather than fiscal residence,³ echoing the term used in the early international tax studies of the League of Nations (LON).⁴ Further, the presence of the selected feature in the taxing state – and resulting comprehensive tax liability – generally results in the entity being entitled to the benefits of the state’s double taxation convention (DTCs or tax treaties),⁵ subject to dual residence rules and any anti-avoidance rules that apply.

It is thus incredibly important which features of an entity’s existence and operation are chosen by a state as the determinants of the entity’s residence/fiscal allegiance, as that decision triggers comprehensive tax liability (possibly mitigated by foreign tax credits or foreign income exemptions) and tax treaty entitlements. Some states determine residence/fiscal allegiance by employing *de jure* concepts such as location of incorporation, registered office, or corporate seat; others use more substantial concepts, such as place of central management and control or place of effective management.⁶ Both the UK and Canada, and various other Commonwealth jurisdictions, employ a disjunctive test where residence/fiscal allegiance is based upon incorporation or upon the highest functions of management and control. Where a corporation is resident in the UK or Canada under domestic law and is simultaneously resident in a treaty partner state under that state’s laws, the treaty preference criterion is often ‘place of effective management’ (POEM).⁷ As currently interpreted and applied, it

³ *ibid* 47–48.

⁴ Ch 2 text to nn 26–34.

⁵ OECD, *Model Tax Convention on Income and on Capital* (OECD, Paris 2010) <www.oecd.org/ctp/tt/mtc> (OECD Model) Arts 1, 4[1]; OECD, *Commentaries on the Articles of the Model Tax Convention* (OECD, Paris 2010) (OECD Commentary) Art 4 [3], [8]–[8.8]. This issue is discussed further at text following n 107.

⁶ IFA 1987 Congress (n 2) 52–58; OECD Commentary (n 5) Art 4 [21].

⁷ OECD Model (n 5) Art 4[3], discussed at text following n 114.

is doubtful whether any of these criteria necessarily represents a ‘strong nexus for taxation based on personal attachment’.

4.1.2 Understanding and Solving the Puzzle

It was suggested above that it is very important which features of an entity’s existence and operation are chosen by a state as the determinants of the entity’s residence. Yet there has been little consideration of this issue by policy-makers in the UK or Canada, as though the issue is somehow immutable, while recent interpretations by the courts have given primacy to legal form over economic substance, as though reality of the governance of multinational enterprises (MNEs) is not a legal concern. The purpose of this chapter is to analyze the origins and evolution of the concept of corporate residence in UK and Canadian domestic law, and in DTCs they have concluded. It is argued that residence concepts which were originally intended to reflect real activities of corporate management – and thus a substantial economic interest in a state – were largely eclipsed by legislative adoption of an incorporation test and were otherwise devitalized by judicial interpretations of the last two decades. Other countries, including many tax havens, inherited or elected to use the same residence tests. This evolution has brought us to the lamentable position where MNEs are able to exploit foreign statehood with ease, governments and revenue administrations complain about alleged ‘abuse’ of corporate residence, and tax policy commentators complain about the total irrelevance of corporate residence as a foundation for taxation. In the author’s view the chief difficulty is that the formulations of corporate residence in the current domestic laws of the UK, Canada, and most other states, and in prevailing treaty provisions as currently applied, largely fail to measure what residence should measure – real participation in the economic life of a nation.

4.2 CORPORATE RESIDENCE IN DOMESTIC LAW

4.2.1 Background

4.2.1(a) *Residence as a Corollary of Legal Personality*

It is not a coincidence that the common law development of a formulation of corporate residence occurred at much the same time as the judicial elucidation of separate corporate personality. By the time *Salomon* was decided the English judiciary were willing to accept that a corporation was a ‘real thing’ with a ‘real existence’,⁸ consistent with the real entity view of the corporation that was prevalent in the late nineteenth century.⁹ It followed that corporations could have, by analogy with an individual, real features. In 1922 Isaacs J of the Australian High Court observed that, as business corporations increasingly assumed the functions of individuals, ‘so more and more does the law attribute to them conceptually and by analogy individual attributes in keeping with the social functions they are in fact performing’.¹⁰ One such attribute is residence.

This is not to say that that corporate residence was an unprompted judicial invention. The English judiciary of the late nineteenth century had no choice but to ascribe residence to corporations for the purpose of applying the income tax law as Parliament had written it. Viscount Sumner later observed that ‘[r]esidence is not inherent in a company in the nature of things, and residence for the purpose of taxation is matter for express legislation’.¹¹ As the UK Parliament had not (until 1988) enacted a test of residence for corporations, the courts ‘felt bound to make the Acts work as they

⁸ *Aron Salomon (Pauper) v A Salomon and Company, Limited* [1897] AC 22 (HL) 33–34; cf *Royal Mail Steam Packet Company v Braham* (1877) 2 App Cas 381 (PC) 386.

⁹ Ch 3 text to nn 24–27.

¹⁰ *Australasian Temperance and General Mutual Life Assurance Society Ltd v Howe* (1922) 31 CLR 290 (HCA) 309.

¹¹ *Egyptian Delta Land and Investment Co Ltd v Todd* [1929] AC 1 (HL) 11.

found them'.¹² The Income Tax Acts of 1842 and 1853 imposed a duty in respect of 'the annual Profits or Gains arising or accruing to *any Person residing in*' the UK, which was extended to all 'Bodies Politic, Corporate, or Collegiate, Companies, Fraternities, Fellowships, or Societies of Persons, whether Corporate or not Corporate'.¹³ Apparently to avoid any doubt, the Income Tax Act 1842 declared that any reference to a 'Person' should be understood to include, unless otherwise provided, 'several Persons as well as one Person' and 'Bodies Politic or Corporate as well as Individuals'.¹⁴ Thus the earliest cases on corporate residence rightly begin by posing the question: is the relevant corporation 'a person residing in' the UK¹⁵ and therefore subject to the UK's national tax jurisdiction?¹⁶

Corporations were subject to income tax in the same sense as individuals until March 1965, when a separate corporation tax regime was introduced.¹⁷ Canada enacted income tax legislation in 1917 that applied generally to individuals and corporations,¹⁸ which remains the pattern today,¹⁹ although of course there are certain rules applicable solely to corporate taxpayers. The important point is that both systems are based on the

¹² *ibid* 12.

¹³ Income Tax Act 1842 (5 & 6 Vict c 35) ss 1, 40 and 100 (Schedule D rules); Income Tax Act 1853 (16 & 17 Vict c 34) ss 1 and 2 (Schedule D rules). Rules to the same effect existed since Pitt's income tax of 1799: JF Avery Jones, 'Bodies of Persons' [1991] BTR 453; D Sheridan, 'The Residence of Companies for Taxation Purposes' [1990] BTR 78.

¹⁴ s 192.

¹⁵ Whether a corporation is a person residing in a place actually involves two questions: (i) is a corporation a person? and (ii) if so, where does it reside? Thus it is accurate to use the word 'resident' as an adjective, denoting a quality of the person taxed. This is consistent with the jurisprudence on the residence of individuals, where the terms 'resident' and 'residence' are considered to represent a quality of the person charged: *Levene v IRC* [1928] AC 217; *Lysaght v IRC* [1928] AC 234; *Thomson v MNR* [1946] SCR 209 (SCC).

¹⁶ *AG v Alexander* (1874) LR 10 Ex 20 (Exch) 29–34; *The Cesena Sulphur Co v Nicholson*; *The Calcutta Jute Mills Co v Nicholson* (1876) 1 Ex D 428 (Div Ct) 444–45, 452; *The San Paulo (Brazilian) Railway Co v Carter* [1896] AC 31 (HL) 38–40.

¹⁷ Now CTA 2009.

¹⁸ The Income War Tax Act, SC 1917 c 28 s 2 ('person' and 'taxpayer').

¹⁹ ITA 1985 s 248(1) ('person' and 'taxpayer').

recognition of a corporation as a person; accordingly one must start from the proposition that the worldwide income of a corporation will be subject to tax in the respective country if it is resident there.²⁰

4.2.1(b) *Summary of Residence Formulations*

There are various factors that could be selected by legislators or judges as indicia of corporate residence, ranging from those which are essential to the commencement or recognition of the corporation's existence, through to those which are associated with the pinnacle of the corporation's activities, and on to those which are germane to its day-to-day business activities. The current law in the UK and Canada relies on an array of factors drawn from different parts of this spectrum.

First is the incorporation test, which provides that a corporation is deemed to be resident in the UK if it is incorporated there, subject to certain transitional exceptions. This deemed residence rule became part of UK law relatively recently, pursuant to the Finance Act 1988.²¹ A similar deemed residence rule has existed in Canada since 1965.²²

Of equal or greater significance is the test of corporate residence developed in the common law. The leading case is of course *De Beers Consolidated Mines Ltd v Howe*, which decided that a company resides where its 'central management and control' is actually exercised.²³ As explained below, central management and control has been characterized as the axis or pinnacle of a corporation's activities. Management

²⁰ ICTA 1988 ss 6, 8, rewritten to CTA 2009 ss 2, 5; ITA 1985 s 2(1).

²¹ FA 1988 s 66 and sch 7 (effective 15 March 1988), rewritten to CTA 2009 ss 14–15 and sch 2.

²² ITA 1985 s 250(4)(a) (effective 27 April 1965).

²³ [1906] AC 455 (HL) 458.

and control thus conceived is independent of factors which underlie the corporation's existence – notably, incorporation, registration, and shareholder control – and is removed from a corporation's practical management or daily business activities.

It also must be noted that, in the case of dual resident companies, the resolution of residence for tax treaty purposes is expressly given effect for domestic law purposes. Specifically, where a company is resident in the UK under either of the above formulations, but is also resident in a treaty partner state according to its domestic laws, and pursuant to the applicable treaty preference criterion the company is regarded as resident only in the treaty partner state, the corporation is deemed not to be resident for UK tax purposes.²⁴ This is known as the 'treaty non-resident rule'. An equivalent rule exists in Canada.²⁵ These rules serve to maintain consistency between treaty outcomes and domestic law. The concept of treaty residence and the residence preference criteria are explored below,²⁶ after we discuss the domestic law formulations of residence based on incorporation and on central management and control.

4.2.2 Residence Based on Incorporation

4.2.2(a) Common Law Rejection of Incorporation Test

Incorporation and registration are the most formal of factors that could be relied on to establish a corporation's residence. Recalling the discussion in chapter 2 of the different connecting factors for tax jurisdiction, the location of a corporation's creation or registration is analogous to an individual's place of birth or citizenship (nationality).²⁷

²⁴ FA 1994 s 249 (effective 30 November 1993), rewritten to CTA 2009 s 18.

²⁵ ITA 1985 s 250(5).

²⁶ Text beginning at n 107.

²⁷ Ch 2 text to n 20.

For individuals these factors are closely associated with the private international law concept of domicile. Obviously a corporation is unlike a human being: it is not born and cannot form an intention of living in a particular society. It is therefore difficult to think of the citizenship or domicile of a corporation. Yet for purposes of private international law a corporation's domicile is considered to be the country of incorporation,²⁸ and for purposes of tax law some countries do base their jurisdiction on the 'domicile' of legal entities, meaning place of incorporation or registration.²⁹

It is well known that the US relies on incorporation to determine worldwide taxing jurisdiction with respect to corporations, much as it relies on citizenship to determine jurisdiction over individuals.³⁰ English law charted a different course, deciding in the early cases that corporate residence should be based on factors more substantive than incorporation. The distinction can be traced to two influences. First, the English courts were more willing to adopt realist theories of the nature of the corporation, in contrast to the American adherence to the legal entity/fiction theory.³¹ Second was a concern about tax avoidance.

Before elaborating on these two influences, an observation should be made with respect to the judgments that preceded *De Beers*. Reading the nineteenth century cases in isolation might give one the impression that the place of incorporation or registration

²⁸ L Collins (ed), *Dicey and Morris on the Conflict of Laws* (13th edn, Sweet & Maxwell, London 2000) 1101; A Farnsworth, *The Residence and Domicil of Corporations* (Butterworths, London 1939) ch 6; *Gasque v IRC* [1940] 2 KB 80.

²⁹ Thus UK corporation tax legislation contemplates companies which are liable to tax in a foreign territory 'by reason of domicile, residence or place of management'. This issue arises in the context of attribution of income from controlled foreign companies (discussed in ch 5), availability of foreign tax credits, transfer pricing adjustments, and transitional exceptions to the incorporation test for residence. Canadian income tax legislation does not refer to corporate domicile at all. Both countries have concluded tax treaties where the residence article mentions domicile as a possibly relevant criterion, echoing the wording of OECD Model (n 5) Art 4[1].

³⁰ DN Shaviro, *Decoding the US Corporate Tax* (Urban Institute Press, Washington DC 2009) 103–04.

³¹ Farnsworth (n 28) 56–63.

was considered critical to corporate residence. However, it must be borne in mind that most corporate business was then organized in the form of a single corporation with foreign branches or agents. It is not surprising that the judiciary stressed the location of incorporation and registration when this generally coincided with the location of directorial control – what was sometimes styled the ‘seat’ of the enterprise. In the *Cesena Sulphur / Calcutta Jute Mills* decisions, Kelly CB highlighted the place of incorporation as a relevant factor but assumed this would be coexistent with the place where the governing bodies met and exercised their powers (which in these cases was England).³² Thus, the court mentioned incorporation only to buttress the conclusion which had already been drawn based on central management and control.³³

The judicial rejection of an incorporation test is evident from *De Beers*, decided 30 year later. The De Beers company was incorporated and registered in South Africa, which is also where it carried on most of the functions of its diamond mining business. The taxpayer’s counsel relied on a number of American authorities to support the argument that a corporation is a ‘legal persona whose only residence is the place of its incorporation’ and which has no legal existence abroad.³⁴ This idea is intrinsic in the legal entity/fiction theory of the nature of the corporation. The House of Lords rejected this position. Lord Loreburn, with whom the other Lords concurred, observed that ‘[i]n applying the construction of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual’. Recognizing that a company cannot ‘eat or sleep’, he reasoned that one should look to where the company ‘keeps

³² *Cesena Sulphur / Calcutta Jute Mills* (n 16) 445–46; cf *Alexander* (n 16) 30, 32.

³³ Discussed beginning at text to n 54.

³⁴ *De Beers* (n 23) 456. Similar submissions were made in *Cesena Sulphur / Calcutta Jute Mills* (n 16) 437.

house and does business’.³⁵ Crucially, Lord Loreburn thought it appropriate in the context of the income tax statute to determine residence based on a corporation’s *activities* – where it keeps house and does business – rather than its *existence*:

Otherwise it might have its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad.³⁶

This statement evidences a concern about the avoidance of UK taxation (‘escape the appropriate taxation by the simple expedient of being registered abroad’) and a belief that corporate taxation is justified by the benefits a state provides to corporate businesses (‘in England under the protection of English law’). The latter idea was referred to previously as the ‘franchise to do’.³⁷ It is apparent that Lord Loreburn did not think corporate taxation was well justified by the ‘franchise to be’, that is, by incorporation in a particular state.

Subsequent cases reaffirmed the view that incorporation was not a viable test of corporate residence. For example, in *Bradbury v English Sewing Cotton Co* Lord Wrenbury compared foreign corporate registration to foreign individual citizenship, observing that neither was determinative of a person’s liability to income tax in the UK’s residence-based system.³⁸ There, as in *De Beers*, the court was dealing with a company incorporated abroad (the US) but managed and controlled in the UK. Lord Wrenbury noted that the proposition that incorporation was not decisive had also been

³⁵ *De Beers* (n 23) 458.

³⁶ *ibid.*

³⁷ Ch 3 text following n 68.

³⁸ [1923] AC 744 (HL) 764–65; cf *American Thread Co v Joyce* (1912) 6 TC 1 (CA), *aff’d* (1913) 6 TC 163 (HL). The English Sewing Cotton Company was the UK parent of the American Thread Company, a subsidiary incorporated and registered in New Jersey.

accepted in the converse case of a corporation which was registered in the UK but was managed wholly abroad.³⁹

The English courts' willingness to discount incorporation as a factor establishing residence was tested in the *Swedish Central Railway* decision.⁴⁰ That case involved a corporation that was registered in England but was managed and controlled in Sweden, where it was constructing a railway. The majority of the House of Lords (Lord Atkinson dissenting) held that earlier decisions had not foreclosed the possibility of a corporation being resident in two places simultaneously. The majority concluded that the corporation's registration in the UK, in conjunction with other factors identified by the Commissioners, were sufficient to establish UK residence in addition to Swedish residence.⁴¹ The decision has been subject to academic criticism⁴² and was tightly circumscribed in the *Egyptian Delta* case.⁴³ There, Viscount Sumner noted that the term resident is 'exceedingly unsuited to describe' a legal entity and reasoned that the only 'analogy that is really possible between a natural person and a company is that of carrying on business at a place, great or small'.⁴⁴ Upon consideration of both the decided cases and desirable tax policy principles, the Court concluded that place of incorporation could not be determinative of residence. The same conclusion was reached by the Privy Council, on appeal from the Supreme Court of Canada, in *British*

³⁹ *Mitchell v Egyptian Hotels Ltd* [1915] AC 1022 (HL). However, in that case counsel had admitted that the company resided in England. For some reason Buckley LJ, as he then was, commenced his judgment by saying: 'This company is incorporated in the United Kingdom; it is therefore resident here.' Lord Atkinson later observed that '[t]here must be some mistake in the report of this statement, since incorporation does not necessarily imply residence': *Swedish Central Railway Co v Thompson* [1925] AC 495 (HL) 516.

⁴⁰ (n 39).

⁴¹ (n 39) 505. Unfortunately the report does not shed light on what these other factors were.

⁴² A Farnsworth, 'Union Corporation Ltd v IRC (case note)' (1952) 68 LQR 307; *Dacey and Morris* (n 28) 1103–104; Couzin (n 1) 79–82.

⁴³ (n 11) 16–18. Also see text to n 68.

⁴⁴ (n 11) 12–15.

Columbia Electric Railway v the King,⁴⁵ which involved a company incorporated and registered in England but entirely managed and controlled in Canada; Viscount Simon held that the company's residence was 'unquestionably Canadian'. To the extent that *Swedish Central Railway* remains relevant, it stands for the proposition that central management and control may be divided, rather than the more dubious proposition that incorporation alone can establish residence. That dubious proposition gained validity only by legislative amendment.

4.2.2(b) *Legislated Adoption of Incorporation Test*

Viscount Sumner's judgment in *Egyptian Delta* contains a thorough consideration of alternative residence formulations based on either a company's activities or a company's existence. In the course of his judgment he made this trenchant observation:

So far, my Lords, it does not seem to have occurred to any judge, that there might be two kinds of residence or two tests of its acquisition, one for the purpose of entangling foreign companies in British taxation and another for that of tying British companies down, so that they cannot wholly escape it. *I submit that such a doctrine is illogical in form and in substance unjust.*⁴⁶

The legislatures of the UK and Canada would appear to disagree that such a doctrine is illogical or unjust. As noted above, the Finance Act 1988 introduced the rule that a company is deemed to be resident in the UK if it is incorporated there, with certain companies incorporated in the UK before 15 March 1988 qualifying for an indefinite exception (generally, companies that migrated with Treasury consent and that carried on some business) or a five-year transitional exception, becoming UK resident on 15

⁴⁵ [1946] AC 527 (PC).

⁴⁶ (n 11) 23 [emphasis added]. Similar comments had been made by Lord Atkinson in his dissenting judgment in *Swedish Central Railway* (n 39), especially at 507–08 and 511.

March 1993 (including companies that migrated without Treasury consent).⁴⁷ The Canadian legislation provides that a corporation is deemed resident if it was incorporated in Canada after 26 April 1965; certain entities incorporated in Canada at an earlier date are also caught.⁴⁸ Importantly, these deeming rules apply even if the corporation would be considered non-resident according to the location of central management and control.

It is not readily apparent why the incorporation test was added to UK law or Canadian law. It is unlikely that the respective legislatures became captivated by the legal entity/fiction theory and its reliance on the ‘franchise to be’ as a justification for worldwide taxation. It is likely that the Canadian amendment was designed to bring Canadian law more in line with the US approach to corporate residence, particularly as the Canada–US tax treaty of the day defined a ‘Canadian enterprise’ or ‘United States enterprise’ as an enterprise carried on by an individual resident in the respective state or by a corporation, partnership, or other entity ‘created or organized’ under the laws of the respective state.⁴⁹ A key reason for adopting the incorporation test in the UK seems to have been the prevention of international tax avoidance, specifically the prevention of double non-taxation. The HMRC International Manual indicates that the incorporation rule was added to deal with so-called ‘nowhere companies’, being incorporated in the UK but managed and controlled in a state that does not use management and control as

⁴⁷ FA 1988 s 66 and sch 7, rewritten to CTA 2009 ss 14–15 and sch 2. One consequence of this rule was that, from 15 March 1988 to 29 November 1993, a UK incorporated company could not migrate by moving its management and control abroad, except with special Treasury consent applied for before 15 March 1988. The Treasury consent rules were repealed effective 1 July 2009: FA 2009 s 37 and sch 17.

⁴⁸ ITA 1985 s 250(4)(a). Deemed residence is also provided in the case of corporations that were incorporated in Canada before 27 April 1965 and thereafter became resident (on a common law basis) or carried on business in Canada: s 250(4)(b)–(c).

⁴⁹ *Convention Between the United States of America and Canada Relating to the Avoidance of Double Taxation and Prevention of Fiscal Evasion in the Case of Income Taxes* (1942) (as amended through 1966; terminated 1985) Protocol [3]. The 1942 treaty did not contemplate dual residence of corporations. The current treaty uses place of incorporation as the preference criterion: text to nn 116–117.

a residence test.⁵⁰ It thus can be seen as an opportunistic rule, imposing residence and residence-based taxation upon a company that would otherwise not face comprehensive taxation anywhere. Yet it is questionable why the UK (or Canada) should be concerned about this. As argued previously, corporate income taxation is difficult or impossible to justify if there is no real economic interest in the taxing state.

The governments of the UK and Canada nonetheless persist in emphasizing the role of incorporation as a connecting factor. A remarkable example of this is the interaction of the UK rule deeming a company to be non-resident for domestic law purposes when considered non-resident for treaty purposes (the treaty non-resident rule)⁵¹ with the UK controlled foreign company (CFC) regime. Under the treaty non-resident rule, a UK incorporated company is able to emigrate to another country by transferring its effective management there, if the destination country is one with which the UK has a tax treaty and if POEM is used as the residence preference criterion.⁵² If residence were awarded to the destination country pursuant to the treaty, the company would be treated as non-resident for *most* UK tax purposes. However, for companies migrating on or after 1 April 2002, the treaty non-resident rule is disregarded when applying the CFC regime to apportion foreign income to them.⁵³ The result is that, although the company itself has become non-resident by virtue of relocating its management, seemingly escaping comprehensive taxation in the UK, it remains taxable

⁵⁰ HMRC, *International Manual* (HMRC, London 2011) <www.hmrc.gov.uk/manuals/intmanual/Index.htm> 120040–120050.

⁵¹ (n 24).

⁵² Migration can give rise to taxes on accrued gains at the date of migration ('exit charges'): TCGA 1992 s 185. Even for relocations within the EU such taxes may be permissible, based on *Case 81/87 R v HM Treasury and IRC ex p Daily Mail and General Trust plc* [1988] STC 787 (ECJ).

⁵³ ICTA 1988 s 747(1B), inserted by FA 2002 s 90 (effective 1 April 2002). Apparently this provision was enacted to protect against revenue loss upon the introduction of the substantial shareholdings exemption, an exemption that greatly diminished the effect of exit charges as a deterrent to emigration: P Cussons, 'Finance Act Notes: Controlled Foreign Companies – Sections 89 and 90' [2002] BTR 317.

in the UK on its apportioned share of worldwide CFC profits based on the remnant of incorporation. In the author's view this demonstrates a lack of integrity in the corporate residence rules, making it difficult for the UK government to maintain that corporate residence is an economically substantial concept in UK law.

4.2.3 Residence Based on Central Management and Control

We have seen that the courts of the nineteenth and early twentieth centuries thought it appropriate in the context of the income tax statute to determine residence based on a corporation's activities rather than its existence. This approach is, at least potentially, consistent with the thesis that residence should denote a real economic interest in the home state. How successful such an approach is in reflecting an economic interest depends on the precise activities that are selected as demonstrating residence. Unfortunately, a combination of nineteenth century colonialism and twentieth century legal formalism has produced a 'highest functions' paradigm that often fails to reflect economic interest, making this test little better than the incorporation test.

4.2.3(a) De Beers – Central Management and Control as the 'Real Business'

De Beers is the decision which established most clearly that a company resides where its 'central management and control' is actually exercised. The legal test articulated by Lord Loreburn is of such importance that it is worth quoting in full:

The decision of Kelly CB and Huddleston B in the *Calcutta Jute Mills Co v Nicholson* and the *Cesena Sulphur Co v Nicholson*, now thirty years ago, involved the principle that a company resides for purposes of income tax where its real business is carried on. Those decisions have been acted upon ever since. I regard that as the true rule, and the real business is carried on where the central management and control actually abides.⁵⁴

⁵⁴ *De Beers* (n 23) 458.

Lord Loreburn went on to say that this was a question of fact to be determined by scrutinizing the corporation's course of business and trading. The pertinent facts included that the company was incorporated and registered in South Africa, it carried on most of the functions of its diamond mining business in South Africa, and its directors meetings were held in both Kimberley and London. However, a majority of its directors were resident in England and, according to the facts as determined by the Commissioners, it was at the directors' meetings in London that the 'the real control' was always exercised in virtually all the important business of the company except the mining operations themselves.⁵⁵ Lord Loreburn refused to disturb the Commissioners' finding of fact that 'the head and seat and directing power of the affairs of the appellant company were at the office in London'.

This decision was applied without reservation throughout the twentieth century, exhibiting a jurisprudential resilience that matches or exceeds that of *Salomon*.⁵⁶ It is the leading decision on corporate residence in Canada and various other Commonwealth jurisdictions.⁵⁷ Judges and commentators frequently point to the statement of Lord

⁵⁵ The facts of the case are provided in the Court of Appeal judgment: [1905] 2 KB 612 (CA).

⁵⁶ *American Thread Co v Joyce* (1912) 6 TC 1 (CA), aff'd (1913) 6 TC 163 (HL); *Mitchell v Egyptian Hotels Ltd* [1915] AC 1022 (HL); *New Zealand Shipping Co v Thew* (1922) 8 TC 208 (HL); *Bradbury v English Sewing Cotton Co* [1923] AC 744 (HL); *Swedish Central Railway Co v Thompson* [1925] AC 495 (HL); *Egyptian Delta Land and Investment Co v Todd* [1929] AC 1 (HL); *Union Corporation Ltd v IRC* [1952] 1 All ER 646 (CA), aff'd on other grounds [1953] AC 482 (HL); *Unit Construction Co Ltd v Bullock* [1960] AC 351 (HL); *Re Little Olympian Each Ways Ltd* [1995] 1 WLR 560 (Ch); *Untelrab Ltd v McGregor* [1996] STC (SCD) 1.

⁵⁷ Notable Canadian decisions applying *De Beers* include: *BC Electric Railway* (n 45) (although *De Beers* was not cited); *MNR v Crossley Carpets (Canada) Ltd* [1969] DTC 5015 (Ex Ct); *Bedford Overseas Freighters Ltd v MNR* [1970] DTC 6072 (Ex Ct); *Birmount Holdings Ltd v The Queen* [1978] DTC 6254 (FCA). For further discussion see: EG Kroft, 'Jurisdiction to Tax: An Update' in Canadian Tax Foundation (ed), *Corporate Management Tax Conference 1993* (Canadian Tax Foundation, Toronto 1994) 1:25–1:32; JS Hausman and GT Tamaki, 'Canada' in IFA 1987 Congress (n 2); and the reports from Australia, India, New Zealand, and Singapore in the same volume.

Radcliffe in *Unit Construction* that Lord Loreburn’s formulation of corporate residence ‘was as precise and as unequivocal as a positive statutory injunction’.⁵⁸

There is nothing to be gained by canvassing all of the cases which influenced *De Beers* and those which followed from it, as this has been done admirably elsewhere.⁵⁹ It is sufficient for our purposes to focus on the following key issues.

4.2.3(b) *Central Management and Control as Highest Functions*

Exercising central management and control is itself one aspect of carrying on business – indeed it is what Lord Loreburn styled the ‘real business’. This was made plain in *San Paulo Railway*,⁶⁰ was confirmed in *De Beers*, and is undoubtedly correct as a matter of tax policy. The courts have decided that such activities are not, however, equivalent to a company’s day-to-day trading operations or even with the practical management and oversight of those operations. The activities of central management and control have been variously described as the central point,⁶¹ the paramount authority,⁶² the head and brain,⁶³ the pivot and axis,⁶⁴ the superior and directing authority,⁶⁵ and other similar metaphors. HMRC describes such activities as ‘the highest level of control’ of the company’s business.⁶⁶ These are the functions of corporate governance which, in accordance with English company law, will usually be found where a majority or

⁵⁸ *Unit Construction* (n 56) 366.

⁵⁹ eg Couzin (n 1) ch 2; Sheridan (n 13).

⁶⁰ *San Paulo Railway* (n 16); cf *Malayan Shipping Co Ltd v FCT* (1946) 71 CLR 156 (HCA).

⁶¹ *Cesena Sulphur / Calcutta Jute Mills* (n 16) 454.

⁶² *American Thread* (HL) (n 56) 164; *Crossley Carpets* (n 57) [5].

⁶³ *San Paulo Railway* (n 16) 38.

⁶⁴ *Koitaki Para Rubber Estates Ltd v FCT* (1941) 64 CLR 241 (HCA) 244.

⁶⁵ *Union Corporation* (CA) (n 56) 658–62.

⁶⁶ Inland Revenue, Statement of Practice 1/90 (SP 1/90) [11], reproduced in *International Manual* (n 50) 120200.

totality of the board of directors meets to exercise its powers pursuant to the corporation's constitution. The relevant 'control' is not that which is wielded by a majority shareholder or by the shareholders at large through their voting power; it is the control exercised by directors through their oversight, management, and direction of the company's affairs.⁶⁷

While terms like 'central point' and 'paramount authority' would seem to suggest a single location for management and control, and thus a single corporate residence, several judgments including *Swedish Central Railway* and *Unit Construction* have allowed for the possibility that a corporation may have its management and control fragmented across jurisdictions.⁶⁸ It is open to debate whether that position is sensible or not as a matter of international tax policy. The possibility of divided residence is consistent with the thesis that residence be understood as a special form of source, yet for purposes of applying current tax treaties it would remain necessary to determine a 'paramount' residence. What is more important for our purposes is the judicial focus on highest functions to the exclusion of other business functions. This choice of residence formulation means that a company is not resident where it carries on productive operations, even on a substantial scale, unless that is also the place where the supreme and directing authority is exercised.⁶⁹ In *Calcutta Jute Mills*, a case in which the major productive operations occurred in India, Kelly CB stated the following in support of his conclusion that the company was UK resident:

⁶⁷ *American Thread* (CA) (n 56) 32–33; *Birmount Holdings* (n 57) [32]–[33]; cf *Automatic Self-Cleansing Filter Syndicate Co v Cuninghame* [1906] 2 Ch 34 (CA).

⁶⁸ In *Unit Construction* (n 56), Lord Radcliffe analyzed the earlier cases contemplating dual residence, notably *Swedish Central Railway*, *Egyptian Delta Land* and *Union Corporation*. He concluded at 366 that divided management and control, and thus divided residence, was possible: 'Though such instances must be rare, the management and control may be divided or even, at any rate in theory, peripatetic.' This position has been accepted in Canada: *Crossley Carpets* (n 57).

⁶⁹ *Koitaki Para Rubber Estates* (n 64) 244, 248–49.

Though the whole property and produce of the property is in India, and the whole capital is invested in India, and though the whole of the money which the company is ever entitled to receive, whether as profits or in any other shape, is earned in India, yet it all belongs to the company, who might at any moment virtually take possession of it. If, without their consent, anyone were to take possession of one of the jute mills, the company might immediately bring ejectment and recover it. It is the company located in England which can alone deal with, or authorize the dealing with, the property in any way.⁷⁰

Similarly, in *San Paulo Railway* Lord Halsbury asserted that, although the company in question dealt entirely with land, goods, and passengers in Brazil, ‘the person who governs the whole commercial adventure ... [and] makes the profits by his skill or industry, however distant may be the field of his adventure,’ is the person who is trading.⁷¹ Lord Davey expressed that conclusion in more moderate terms: ‘The business is therefore in very truth carried on, in, and from the United Kingdom, although the actual operations of the company are in Brazil, and in that sense the business is also carried on in that country.’⁷²

One cannot read these passages, and similar passages appearing throughout the early jurisprudence, without sensing the colonialism or imperialism that underlies them. The presence of such attitudes is not surprising when one considers that the entire progress of joint stock companies was closely associated with the progress of British colonization and the extension of foreign trade.⁷³ Modern observers might contend that the ‘real business’ of an international enterprise consists in the productive endeavours of its employees in the foreign state, rather than in the management activities of its

⁷⁰ *Cesena Sulphur / Calcutta Jute Mills* (n 16) 447.

⁷¹ *San Paulo Railway* (n 16) 38–39.

⁷² *ibid* 43.

⁷³ WR Scott, *The Constitution and Finance of English, Scottish and Irish Joint-Stock Companies to 1720* (CUP, Cambridge 1912) vol 1 pp 439–41; G Jones, *The Evolution of International Business* (Routledge, London 1996) 25–39.

directors in the home state. Much will depend on one's ideological perspective. It should be borne in mind that the language of the income tax statutes did not permit the courts simply to equate residence with 'trade' or 'business', as that would have conflated residence-based and source-based taxation as understood at the time.⁷⁴ Having decided to ascribe residence to a corporation on the basis of its activities rather than existence, it was necessary to select *specific* business activities for that purpose. Selecting the activities of the 'head and brain' rather than the 'hands and feet' was, if not theoretically ideal, at least logically defensible.

4.2.4 Central Management and Control in MNEs

4.2.4(a) Exploitation of the Highest Functions Paradigm

Many of the early cases on corporate residence concerned a single company, incorporated and registered in the foreign jurisdiction where the productive business was located, with a delegated or managing board in that foreign jurisdiction, but with the main or supervisory board making most of the decisions in England.⁷⁵ It is apparent that this was a common method of engaging in multinational ventures. Alas, it was a method that resulted in the relevant corporations being subject to worldwide taxation in Britain at a time when foreign tax credits were rudimentary or non-existent. Various enterprises that had been based in Britain responded so as to avoid the burden of worldwide taxation, first by moving the functions of central management and control to

⁷⁴ Couzin (n 1) 28–29.

⁷⁵ eg *De Beers* (n 23); *American Thread* (n 56); *New Zealand Shipping* (n 56).

the delegated or managing board in the foreign jurisdiction,⁷⁶ and later by incorporating subsidiaries with ostensibly independent boards in the foreign jurisdictions.⁷⁷

As noted in previous chapters, the dominant form of international business organization is now a globally integrated network of corporations, often with a single headquarters company and numerous foreign affiliates. Obviously this evolution in the mode of international enterprise challenges the efficacy of any tax system based on the twin concepts of separate corporate personality and corporate residence. This is especially true when, as explained below, courts that are asked to determine the tax residence of ‘offshore’ subsidiaries take a formal, entity-by-entity view of the matter. Thus Arnold argues that the test of corporate residence from *De Beers* has become a mere ‘tax planning device’,⁷⁸ while McIntyre observes that that the modern MNE can ‘exploit its androgynous nature to make corporate residence ineffective’.⁷⁹

At one time the UK government recognized that corporate residence might be better measured by looking at functions other than the ceremonial functions of central management and control. In a 1981 consultation document, the Inland Revenue stated that the established criteria had ‘become artificial with the passage of time and technical innovation’ and they ‘enabled companies to arrange a residence for tax purposes which may bear little relation to the seat of the company’s operations’.⁸⁰ It was suggested that the UK adopt a statutory test based upon ‘practical day to day management’, ‘principal

⁷⁶ eg *Egyptian Hotels* (n 56); *English Sewing Cotton* (n 56); *Egyptian Delta Land* (n 56).

⁷⁷ eg *Unit Construction* (n 56); *Untelrab* (n 56).

⁷⁸ BJ Arnold, ‘A Tax Policy Perspective on Corporate Residence’ (2003) 51 CTJ 1559, 1564.

⁷⁹ MJ McIntyre, ‘Determining the Residence of Members of a Corporate Group’ (2003) 51 CTJ 1567, 1570.

⁸⁰ Inland Revenue, *Company Residence: A Consultative Document* (Board of Inland Revenue, London, January 1981) [2]. A consultation on CFC legislation was issued at the same time: ch 5 nn 25–28.

place of business', or incorporation.⁸¹ The latter two options were subsequently discarded; the Inland Revenue instead proposed to define residence based on where 'the management of the company's business as a whole is conducted', which was considered to mean the place of 'immediate day to day management'.⁸² In response to business pressure and a report by the Institute for Fiscal Studies,⁸³ the government ultimately decided that modifying the concept of corporate residence would result in 'upheaval' so the idea was abandoned.⁸⁴ The government instead elected to maintain the existing case law test and to enact specific rules aimed at international tax avoidance. Thus the central management and control test endures.

4.2.4(b) *Judicial Affirmation of Separate Residence*

The difficulties inherent in the central management and control test have been revealed in a number of cases, often involving a sole shareholder exerting influence over the decisions and actions of foreign subsidiaries.

The *Unit Construction* case is a notorious illustration of the possibility that the 'actual' exercise of central management and control may not abide where it formally should abide. The case concerned certain subvention payments that had been made by the appellant company, a wholly-owned Kenyan subsidiary of an English parent, to three other Kenyan subsidiaries. The deductibility of the subvention payments depended

⁸¹ *ibid* [6]–[7].

⁸² Inland Revenue, *International Tax Avoidance: Company Residence, Tax Havens and the Corporate Sector, Upstream Loans* (Board of Inland Revenue, London, November 1981) [2]–[3], clause 1(1).

⁸³ Institute for Fiscal Studies, *Report of the Working Party on Company Residence, Tax Havens, and Upstream Loans* (IFS Report Series No 3, London 1982).

⁸⁴ Inland Revenue, *Taxation of International Business* (Board of Inland Revenue, London 1982) Foreword by the Minister of State, Treasury.

upon whether the subsidiaries were resident in the UK.⁸⁵ The evidence showed that, although the subsidiaries were registered in Kenya and had boards which were distinct from the parent board, none of those boards ever took any decisions; they ‘stood aside’ in all matters of real importance.⁸⁶ On this evidence the Court held that the management and control of the subsidiaries was actually exercised by the parent board. It was immaterial that this usurpation of power was contrary to the subsidiaries’ corporate constitutions: ‘The business is not the less managed in London because it ought to be managed in Kenya.’⁸⁷

Couzin correctly observes that *Unit Construction* was not a revolutionary decision; rather, it applied that aspect of *De Beers* which held that central management and control must be determined by scrutinizing the actual business conduct rather than terms of the constating documents.⁸⁸ Nonetheless, one regularly sees warnings from revenue authorities and tax practitioners that, in determining the residence of a company, the law requires an examination of the substance of the company’s activities and not merely the legal form, with the example provided of a parent company usurping the control of an offshore subsidiary.⁸⁹ This is merely a recapitulation of the facts of *Unit Construction*. The case did not establish some rule of substance over form with respect to corporate residence – its scope is narrower. That narrow scope is

⁸⁵ The case is extraordinary in that the taxpayer, not the Revenue, was arguing that the companies were resident in the UK. It was essentially a loss importation arrangement.

⁸⁶ *Unit Construction* (n 56) 360, 364.

⁸⁷ *ibid* 363.

⁸⁸ Couzin (n 1) 86.

⁸⁹ eg SP 1/90 (n 66) [12]–[17]; G Clarke, *Offshore Tax Planning* (16th edn, LexisNexis, London 2009); Hausman and Tamaki (n 57) 265.

demonstrated by a series of more recent decisions, culminating in the 2006 judgment of the Court of Appeal in *Wood v Holden*.⁹⁰

Wood v Holden involved a sophisticated scheme to mitigate capital gains tax on the sale of shares of a family company. The critical element was a transfer of certain holding company shares from Copsewood Investments Ltd (CIL), a company registered in the British Virgin Islands, to Eulalia Holding BV (Eulalia), a Dutch incorporated company wholly owned by CIL. The holding company shares were later resold to an unconnected purchaser. The taxpayers contended that both CIL and Eulalia were non-resident companies and members of the same corporate group, meaning that no gain accrued on the initial disposal.⁹¹ The primary focus in the case was the residence of the Dutch incorporated company, Eulalia. The taxpayers argued that Eulalia was non-resident at all material times, either because its central management and control was exercised in the Netherlands and not in the UK (the common law test) or because its effective management was exercised in the Netherlands (relying on the ‘treaty non-resident’ rule⁹² and the UK–Netherlands tax treaty⁹³). The Revenue argued that Eulalia was resident in the UK, either on the standard of central management and control or on the standard of effective management. Their position was that the managing director of Eulalia, ABN AMRO Trust (AA Trust), had merely held meetings and signed documents as instructed by the taxpayers’ advisers in the UK, following a pre-ordained plan. The Special Commissioners agreed with that position.⁹⁴ The question on appeal

⁹⁰ [2005] EWHC 547, [2005] STC 789 (Ch), aff’d [2006] EWCA Civ 26, [2006] STC 443 (CA).

⁹¹ By reason of TCGA 1992 ss 14(2) and 171.

⁹² (n 24).

⁹³ *Convention between the United Kingdom of Great Britain and Northern Ireland and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains* (1980) (as amended through 1989; terminated 2011) Art 4[3].

⁹⁴ [2004] STC (SCD) 416.

was what degree of independence or initiative on the part of AA Trust, as managing director of Eulalia, would constitute ‘central’ or ‘effective’ management of Eulalia?

Both Park J in the Chancery Division and the judges in the Court of Appeal stressed that there is an important difference between actually exercising management and control and being able to ‘influence’ those who exercise management and control. On the one hand was *Unit Construction*, where the parent board had unconstitutionally usurped the management of its subsidiaries. On the other hand were several cases – all involving persons incorporating a special purpose corporation in another (low tax) jurisdiction – where the local management ‘did not take initiatives’ but responded to ‘proposals’ or ‘instructions’ that were presented to them.⁹⁵ In those cases the respective courts observed that the local management may have been ‘complaisant’ but they nevertheless retained their discretion to refuse to implement an ‘improper or unwise’ request. Park J felt it important to make the following observation:

... [I]t is possible (and is common in modern international finance and commerce) for a company to be established which may have limited functions to perform, sometimes being functions which do not require the company to remain in existence for long. Such companies are sometimes referred to as vehicle companies or SPVs (special purpose vehicles). ‘Vehicle’ has a belittling sound to it, but such companies exist. They can and do fulfil important functions within international groups, and they are principals, not mere nominees or agents, in whatever roles they are established to undertake. They usually have board meetings in the jurisdictions in which they are believed to be resident, but the meetings may not be frequent or lengthy. The reason why not is that in many cases the things which such companies do, though important, tend not to involve much positive outward activity.⁹⁶

⁹⁵ *Little Olympian* (n 56); *Untelrab* (n 56); *Esquire Nominees Ltd v FCT* (1971) 129 CLR 177 (HCA); *New Zealand Forest Products Finance NV v CIR* [1995] 2 NZLR 357 (NZHC); discussed in *Wood v Holden* (Ch) (n 90) [26]–[27], [51]–[53].

⁹⁶ *Wood v Holden* (Ch) (n 90) [25].

Based on the above, and on the Special Commissioners' finding that the directors of Eulalia 'were not by-passed' and did not 'stand aside' since their representatives 'signed or executed the documents', Park J held that the only conclusion open to them in law was that Eulalia was managed and controlled in the Netherlands.⁹⁷ He offered the alternative conclusion that, if there was any difference between the concepts of central management and effective management, Eulalia was effectively managed in the Netherlands and therefore non-resident pursuant to the treaty non-resident rule.⁹⁸

While *Wood v Holden* did not involve an active global enterprise, the same reasoning has been applied to special purpose subsidiaries of large MNEs, both before and since that decision.⁹⁹ Many legal commentators would contend that the decision in *Wood v Holden* is unassailable based on longstanding principles of company law and tax law, and various practitioners have commented on the correctness of the decision while disparaging the Special Commissioners' contrary opinion.¹⁰⁰ The author has heard both British and Canadian tax practitioners remark that the Special Commissioners were unduly focused on the 'reality' of the arrangement.¹⁰¹ The upper court decisions are applauded because they respect the separate legal existence of subsidiaries and fix the

⁹⁷ *ibid* [37], [64]–[72]. Technically, it is not for a UK court to decide where a company is resident if that is not the UK (unless required by CFC rules, foreign tax credit rules, or otherwise). It was sufficient to decide that Eulalia was not managed and controlled in the UK.

⁹⁸ *ibid* [73]–[81]. The Court of Appeal made no decision on this issue, although Chadwick LJ suggested that the two tests were equivalent: *Wood v Holden* (CA) (n 90) [6], [44].

⁹⁹ *Untelrab* (n 56) (UK-based food group with financing subsidiary registered in Jersey – held to be resident in Bermuda); *News Datacom Ltd v Atkinson* [2006] STC (SCD) 732 (Global media group with affiliate registered in Hong Kong – held to be resident outside the UK).

¹⁰⁰ eg R Fraser, 'Wood v Holden: The Final Decision' [2006] BTR 692; J Nitikman and L Jenkins, 'Corporate Residence in the UK Court of Appeal: Wood v Holden' (2006) 54 CTJ 472; P Owen, 'R v Holden: Establishing Residence' [2005] BTR 186 and [2005] BTR 390; M Milet and J Barsky, 'Corporate Residency in Multinational Groups' (2005) 13 Int'l Tax Planning 904.

¹⁰¹ cf *Wood v Holden* (CA) (n 90) [50], where Sir Christopher Staughton warned against speaking about what happened 'in real life' and what were the 'real decisions'.

residence of a subsidiary based on the directorial functions of *that* corporation's board. Such an approach is said to favour certainty and predictability in tax planning.

The author does not quarrel with those observations. As a matter of tax policy, however, one must question whether this formulation of corporate residence is consistent with the principles which animate residence-based taxation in the first place. Directors who manage some special purpose vehicle, yet who do so without 'initiative' because they are 'complaisant' to the will of some guiding party, are exercising little of the intellectual endeavour that is essential to economic interest. The purported residence of such entities may be described as 'clockwork residence' because of the meticulous design involved.¹⁰² Why is such a concept of residence, where offshore statehood can be purchased by hiring offshore trustees to manage offshore shelf companies, thought to be meaningful?

To be fair, it is conceivable that in particular circumstances a sole shareholder or other dominant party might wield such power over an ostensibly foreign entity as to give him or her the actual management and control, with local directors acting as 'mindless' nominees. This possibility was expressly contemplated in *Wood v Holden*,¹⁰³ and was held to have occurred in *Laerstate BV v HMRC*,¹⁰⁴ a recent decision of the First-Tier Tribunal where a company registered in the Netherlands was held to be managed and controlled in the UK on the basis that one of the two directors took a dominant role while in office and after resigning as director, making most of the key decisions regarding 'policy, strategic, and management matters' within the UK. Other recent decisions in the UK and Canada have demonstrated some judicial willingness, in

¹⁰² JDB Oliver, 'Company Residence – Four Cases' [1996] BTR 505.

¹⁰³ *Wood v Holden* (Ch) (n 90) [66].

¹⁰⁴ [2009] UKFTT 209, [2009] STI 2669 (TC) (FTT (Tax)). The decision was not appealed.

the case of foreign trusts employed in a tax avoidance scheme, to look beyond the formalities of trustee meetings to ascertain where the ‘realistic, positive management’ of the trust was exercised. This approach was taken in *Smallwood Trust v HMRC*,¹⁰⁵ although that case involved a determination of trust residence for treaty purposes (having nothing to do with central management and control) and in *Garron Family Trust v The Queen*,¹⁰⁶ where it was held that certain offshore trusts were actually managed and controlled in Canada and thus resident in Canada. These cases are discussed further in the context of treaty residence, below.

But given the forceful wording of the judgments in *Wood v Holden*, it can be expected that attempts to secure foreign residence for corporate entities will almost invariably succeed. The judgments in *Unit Construction* and *Laerstate* serve as warnings to taxpayers and their advisers that, if they wish to achieve ‘clockwork residence’ in a foreign jurisdiction, they must ensure that the clock is working. This does not mean that any substantial economic interest exists in the foreign state. Where in *De Beers* Lord Loreburn expressed concern about corporations avoiding UK taxation ‘by the simple expedient’ of being registered abroad, MNEs now avoid home taxation by the simple expedient of being managed and controlled abroad, with the entrepreneurship, initiative, and influence remaining in the home state. If central management and control is so lacking in substance, there is something to be said for using the incorporation test exclusively: while highly artificial, at least it saves the environmental cost of board members travelling abroad to carry out equally artificial board meetings.

¹⁰⁵ [2008] STC (SCD) 629, rev’d [2009] EWHC 777, [2009] STC 1222 (Ch), rev’d [2010] EWCA Civ 778, [2010] STC 2045 (CA).

¹⁰⁶ 2009 TCC 450, [2009] DTC 1568 (TCC), aff’d 2010 FCA 309, [2010] DTC 5189 (FCA). The decision to use the central management and control test to determine trust residence is itself controversial.

4.3 CORPORATE RESIDENCE FOR TREATY PURPOSES

4.3.1 Overview

The inadequacy of incorporation or central management and control as formulations of corporate residence, and thus as indicators of home economic interest, leads one to ask whether residence should be determined based on a different set of functions and activities. A useful source to consider is the range of definitions used for determining entity residence under the OECD Model and various tax treaties. Tax treaties are worded such that they apply to persons who are residents of one or both of the Contracting States.¹⁰⁷ Indeed, this is one of the notable benefits associated with residence in state.¹⁰⁸ Determining who is a resident involves a consideration of the relationship between residence under domestic law, tax liability under domestic law, and residence for treaty purposes, followed by an examination of the treaty preference criteria for resolving dual residence conflicts.

4.3.2 Domestic Liability and Treaty Residence

The residence of a taxpayer for domestic law purposes is, of course, a matter left to each state to determine. As stated in the OECD Commentary, tax treaties ‘do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as “resident”’.¹⁰⁹ The laws of the UK and Canada consider corporate residence to follow from incorporation or central management and control, as already discussed, while other states will use their own

¹⁰⁷ OECD Model (n 5) Art 1.

¹⁰⁸ Ch 3 text to n 81.

¹⁰⁹ OECD Commentary (n 5) Art 4 [4].

(possibly similar) rules. Other residence formulations, whether derived from case law or statute, will apply to individuals, partnerships, and trusts.

The tax liability of a person under domestic law is relevant because of the way residence is defined in most tax treaties. The first sentence of Article 4, paragraph 1 of the OECD Model defines the term ‘resident of a Contracting State’ as ‘any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature’.¹¹⁰ This is generally considered to mean that treaty residence requires comprehensive tax liability in a state based upon personal / subjective attachment to the jurisdiction.¹¹¹ The second sentence of Article 4, paragraph 1 provides that a resident of a Contracting State does not include a person ‘who is liable to tax in that State in respect only of income from sources in that State or capital situated therein’. While serving several purposes, one effect of this sentence is to ensure that a permanent establishment of a foreign enterprise does not qualify as a resident for treaty purposes. Whether this restriction is good tax policy is a separate question.¹¹² If residence were reformulated as a special form of source, turning residence taxation into a sort of territorial taxation, then according to the OECD Commentary a ‘resident’ of such a state would likely still qualify for treaty benefits.¹¹³

¹¹⁰ OECD Model (n 5) Art 4[1]. The OECD Model is silent on the temporal scope of this rule. If a person’s factual residence for part of a year results in deemed tax liability for the entire year, the person may be considered liable to tax ‘by reason of’ residence and thus a ‘resident’ for treaty purposes. For further discussion see the contrasting judgments in *Smallwood* (n 105) and G Loomer, ‘*Smallwood Trust v HMRC*: diverging opinions on the offshore residence of a trust (case comment)’ [2010] BTR 468.

¹¹¹ OECD Commentary (n 5) Art 4 [3], [8]–[8.8]; *Crown Forest Industries Limited v Canada* [1995] 2 SCR 802 (SCC); R Vann, “‘Liable to Tax’ and Company Residence under Tax Treaties’ in G Maisto (ed), *Residence of Companies under Tax Treaties and EC Law* (IBFD, Amsterdam 2009) 244–48.

¹¹² See Vann (n 111) 244–50.

¹¹³ OECD Commentary (n 5) Art 4 [8.3].

4.3.3 Current Treaty Preference Criteria

4.3.3(a) *Dual Residence for Treaty Purposes*

The other purpose of Article 4 of the OECD Model, aside from defining who is a resident of a Contracting State, is to resolve issues of dual residence through the application of preference criteria, also known as residence ‘tie-breaker’ rules. Where by reason of paragraph 1 a person other than an individual is a resident of both Contracting States, then it is deemed to be a resident only of the state in which its POEM is situated.¹¹⁴ Thus, for the purpose of treaties based on the OECD Model, POEM takes precedence over other residence tests that may be used in domestic law.

Most tax treaties negotiated by the UK and Canada include a residence tie-breaker rule for legal entities.¹¹⁵ The most common preference criterion is POEM, which is not surprising given that both countries are longstanding members of the OECD. But this is not the only criterion in use. Under the current Canada–US tax treaty a company that is resident in both Contracting States is deemed to be resident in the state under the laws of which it was created; if that cannot be determined then the resolution is left to the competent authorities.¹¹⁶ The preference for place of incorporation, although difficult to justify on a normative basis, is consistent with the US model tax convention¹¹⁷ and the American legal tradition generally. More typically,

¹¹⁴ OECD Model (n 5) Art 4[3].

¹¹⁵ Some of the UK’s older tax treaties, eg those with Belize (1947), Greece (1953), and Jersey (1952, as amended through 2009) have no tie-breaker rule. They simply provide that a company is treated as resident in one state or the other if its business is ‘managed and controlled’ there. This was common in British (and Canadian) tax treaties concluded prior to the first OECD Model (1963): see JF Avery Jones, ‘The Definition of Company Residence in Early UK Tax Treaties’ [2008] BTR 556.

¹¹⁶ *Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital* (1980) (as amended through 2007) Art 4[3].

¹¹⁷ US Department of the Treasury, *United States Model Income Tax Convention of November 15, 2006* <www.treasury.gov/resource-center/tax-policy/treaties/Pages/default.aspx> Art 4[4].

where POEM is not used the treaty provides that dual residence conflicts are to be settled by mutual agreement of the competent authorities, as in the UK–Canada tax treaty,¹¹⁸ the UK–US tax treaty,¹¹⁹ and the new UK–Netherlands tax treaty.¹²⁰ As the POEM criterion is most common, it is worth considering what is meant by ‘effective management’.

4.3.3(b) *Development of the POEM Concept*¹²¹

The issue of the ‘fiscal domicile’ of companies for tax treaty purposes was analyzed by the Technical Experts to the LON Financial Committee in their 1925 report.¹²² While the Technical Experts acknowledged that states were entitled to use their own definitions of fiscal domicile for domestic law purposes, they proposed that for tax treaty purposes the domicile of legal entities – specifically joint stock companies – should be the place ‘where the concern has its effective centre, ie, the place where the “brain”, management and control of the business are situated’.¹²³ This was expressed in their draft resolutions as ‘the real centre of management and control of the undertaking’,

¹¹⁸ *Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains* (1978) (as amended through 2003) Art 4[3].

¹¹⁹ *Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains* (2001) Art 4[5].

¹²⁰ *Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains* (2010) Art 4[4]. There are special rules for public companies participating in a ‘dual listed company arrangement’.

¹²¹ For related analysis see: JF Avery Jones, L De Broe, and others, ‘The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States’ [2006] BTR 695, 719–22; JF Avery Jones, ‘2008 OECD Model: Place of Effective Management –What One Can Learn from the History’ (2009) 63 BIT 183.

¹²² LON, Technical Experts to the Financial Committee, *Double Taxation and Tax Evasion Report and Resolutions submitted by the Technical Experts to the Financial Committee* (Doc F.212, LON, Geneva 1925). This and other LON and OEEC reports are available at <<http://setis.library.usyd.edu.au/oztexts/parsons.html>>.

¹²³ *ibid* 21.

echoing the allocation of taxing rights over international shipping income to the state where ‘the real centre of management and control of the undertaking’ was situated.¹²⁴ A key rationale given for adopting this residence definition was that it would prevent companies from ‘nominally transferring their headquarters to a place where the taxes are lower than in the country in which the effective centre of the business is situated’.¹²⁵ Presumably such a nominal transfer was believed to be possible under a more formal test like place of incorporation. Thus the focus was on ‘real’ and ‘effective’ residence as contrasted with ‘nominal’ residence, suggesting some elevation of substance over form. This preference continued in the drafting of later model conventions, although subtle changes in wording attenuated the fixation on ‘reality’.

Subsequent reports through the 1930s shortened the formulation of fiscal domicile of legal entities to the ‘real centre of management’, no longer referring to ‘control’.¹²⁶ This definition of fiscal domicile was adopted in the 1946 London draft model convention (London Draft) for companies, partnerships, and other legal entities.¹²⁷ It is interesting that the authors of the 1943 Mexico draft model convention (Mexico Draft) decided that the fiscal domicile of legal entities should be ‘the State under the laws of which they were constituted’.¹²⁸ According to the LON Fiscal Committee, the real centre of management test was used in ‘most’ tax treaties between European Countries, while the place of creation test was thought to be more consistent

¹²⁴ *ibid* 31, 34.

¹²⁵ *ibid* 21.

¹²⁶ LON Fiscal Committee, *Report to the Council on the Fifth Session of the Committee* (Doc C.252.M.124.1935.II.A, LON, Geneva 1935) 7.

¹²⁷ LON Fiscal Committee, *Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property* (LON, London 1946) Protocol Art 2[4]. This model is included with *Model Bilateral Convention for the Prevention of the Double Taxation of Income* (LON, Mexico 1943) in LON Fiscal Committee, *London and Mexico Model Tax Conventions – Commentary and Text* (Doc C88.M88.1946.IIA, LON, Geneva 1946) (London and Mexico Commentary).

¹²⁸ Mexico Draft (n 127) Protocol Art 2[4].

with American legal systems.¹²⁹ As in various other areas, the wording in the London Draft with respect to fiscal domicile prevailed.

Neither the Mexico Draft nor the London Draft revealed much concern with the possibility of legal entities being resident in both Contracting States under the treaty definition of residence; the analysis of dual residence focused on individuals. The subsequent work of the Organisation for European Economic Co-operation (OEEC) considered this issue in depth. In 1958 the OEEC Fiscal Committee proposed that, in the unlikely event that a legal entity was resident for treaty purposes in both Contracting States, then the conflict should be resolved by deeming the entity to be a resident of the state where the ‘place of effective management’ was situated.¹³⁰ This proposal was adopted from the final report of Working Party 2 of the OEEC Fiscal Committee.¹³¹ Interestingly, Working Party 2 had originally considered using ‘management and control’ as the tie-breaker, based on their belief that this was how the terms were used in existing UK tax treaties.¹³²

The decision to use POEM as the preference criterion for entity residence was stated to be based on three considerations. First, the Working Party and the OEEC Fiscal Committee noted that this criterion reproduced the treaty allocation rule with respect to income from international shipping and aircraft operations, used at the time in

¹²⁹ London and Mexico Commentary (n 127) 10–11.

¹³⁰ OEEC Fiscal Committee, *The Elimination of Double Taxation: 1st Report of the Fiscal Committee of the OEEC* (OEEC, Paris 1958) (OEEC 1st Report) [30], Art 3 [3], Annex C [20].

¹³¹ Working Party No 2 of the Fiscal Committee (Denmark–Luxembourg), *Final Report on the Concept of Fiscal Domicile* (Doc FC/WP2(58)1, OEEC, Paris 1958) <www.taxtreatieshistory.org> (Working Party Final Report).

¹³² In fact, as Avery Jones explains, the Working Party failed to understand what ‘central management and control’ meant in UK domestic law, and thus failed to understand that the term was inserted in UK tax treaties not as a residence tie-breaker but to forestall arguments based on *Swedish Central Railway* (nn 39–40) that corporate residence followed from incorporation: Avery Jones 2008 (n 115); Avery Jones 2009 (n 121) 184–85.

a number of existing tax treaties.¹³³ Second, the concept of ‘effective management’ was thought to be equivalent to that of ‘management and control’, the definition of corporate residence used in tax treaties concluded by the UK near that time,¹³⁴ although in retrospect that thinking was probably wrong. Perhaps most importantly, the OEEC observed that it ‘would not be natural to attach importance to a purely formal criterion like registration’,¹³⁵ again demonstrating some preference for substance over form with respect to entity residence.

These observations were reiterated in the commentaries to subsequent versions of the OECD Model¹³⁶ and the United Nations (UN) model tax convention.¹³⁷ While the specific reference to the residence formulation used in UK tax treaties was deleted in 1992, the current OECD Commentary continues to highlight the replication of the allocation rule for income from international shipping and aircraft operations.¹³⁸ The Commentary also states the following: ‘It would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company, etc. is actually managed.’¹³⁹ Although the word ‘real’ has been excised from the residence preference criterion and commentary thereon, the word ‘actually’ persists, echoing Lord Loreburn’s speech in *De Beers*.

¹³³ OEEC 1st Report (n 130) Annex C [19]; Working Party Final Report (n 131) 6.

¹³⁴ OEEC 1st Report (n 130) Annex C [19]; Working Party Final Report (n 131) 6.

¹³⁵ OEEC 1st Report (n 130) Annex C [18]; Working Party Final Report (n 131) 6.

¹³⁶ OECD, *Commentaries on the Articles of the Draft Convention* (OECD, Paris 1963) Art 4 [18]–[20]; OECD, *Commentary on the Model Double Taxation Convention on Income and Capital* (OECD, Paris 1977) Art 4 [22]–[24].

¹³⁷ See UN Department of Economic and Social Affairs, *Commentaries on the Articles of the United Nations Model Double Taxation Convention between Developed and Developing Countries* (UN, Geneva 2001) Art 4 [8]–[9] (quoting the OECD Commentary).

¹³⁸ OECD Commentary (n 5) Art 4 [23].

¹³⁹ OECD Commentary (n 5) Art 4 [22]. Canada and the US have nonetheless entered reservations that they retain the right to use place of incorporation as the tie-breaker and, failing that, to deny dual resident companies treaty benefits: OECD Commentary (n 5) Art 4 [27], [31]. This stance is consistent with the tie-breaker rule in the Canada–US tax treaty (n 116).

4.3.3(c) *Meaning of Effective Management*

The difficulty with using POEM as a residence preference criterion is that its meaning is far from certain. Even in the early OEEC reports it seems that the authors were not clear about the meaning of POEM; it was an odd mixture of civil law and English law concepts of fiscal domicile.¹⁴⁰ This has led commentators from various countries to assume that POEM is synonymous with the definition of entity residence under their own domestic laws.¹⁴¹ One sees this in the UK, where commentators¹⁴² and judges¹⁴³ have suggested that there is no difference between effective management and central management and control.

It does not help that the OECD Commentary on the meaning of POEM has changed a number of times. The current OECD Commentary defines POEM as follows:

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. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.¹⁴⁴

Prior to the 2000 revision to the OECD Commentary there was no definition offered, other than the stated considerations for using POEM as a tie-breaker, mentioned above. In 2000 a different version of the above definition was introduced. The first sentence was largely the same, but the second sentence stated that the POEM 'will ordinarily be the place where the most senior person or group of persons (for example a board of

¹⁴⁰ Avery Jones et al (n 121) 719–22.

¹⁴¹ Avery Jones 2009 (n 121) 186.

¹⁴² P Owen, 'Can Effective Management be Distinguished from Central Management and Control?' [2003] BTR 296.

¹⁴³ *Wood v Holden* (CA) (n 90) [6], [44].

¹⁴⁴ OECD Commentary (n 5) Art 4 [24].

directors) makes its decisions’, with the proviso that ‘no definitive rule can be given and all relevant facts and circumstances must be examined’. This wording suggested that effective management would ‘ordinarily’ be the same as central management and control as understood in UK domestic law. However, the second sentence was changed to the above in the July 2008 revision, making it less clear that the two concepts should be considered equivalent. The words ‘as a whole’ were also added to the first sentence. Although this amendment likely does not add much, it is notable that it echoes the Inland Revenue’s failed 1981 proposal to define corporate residence based on where ‘the management of the company’s business as a whole is conducted’.¹⁴⁵

So where does this leave us? In one sense we can interpret ‘effective’ as meaning real, substantial, or primary, as opposed to nominal, formal, or subordinate. This appears to be the interpretation that HMRC pursued unsuccessfully in *Wood v Holden* and successfully in *Smallwood*. In another sense it can mean giving effect to, as opposed to planning or strategizing. HMRC also seems to support this interpretation. HMRC has stated that the POEM of an entity ‘will normally be located in the same country as central management and control but may be located at the company’s true centre of operations, where central management and control is exercised elsewhere.’¹⁴⁶ The Statement of Practice on company residence suggests that the POEM may be different from the place of management and control where, for example, a company is ‘run by executives based abroad’ but the ‘final directing power’ rests with non-executive directors in the UK.¹⁴⁷ These interpretations suggest that POEM lies closer to the productive operations of the business, while management and control involves

¹⁴⁵ (n 82).

¹⁴⁶ International Manual (n 50) 120070.

¹⁴⁷ SP 1/90 (n 66) [22].

ultimate directing power. It is not clear that HMRC have sufficiently considered which interpretation of effective management they prefer. Perhaps, depending on the circumstances, they prefer whichever interpretation would support a finding of UK residence.

Some guidance is provided by a number of cases dealing with the treaty residence of trusts, where ‘effective management’ was interpreted as ‘realistic, positive management’, such that the court looked beyond the formal establishment of an offshore trust to the location where the real decisions were made.

The case of *Wensleydale’s Settlement Trustees v IRC*¹⁴⁸ involved the establishment of a purportedly foreign trust as part of an arrangement to avoid UK capital gains tax. The taxpayers’ goal was to have this trust considered resident in Ireland by operation of the POEM tie-breaker rule in the tax treaty between the UK and Ireland. Although the trustees had carried out certain formalities in Ireland, the Special Commissioner focused on where the proactive decision-making really happened, which was held to be the UK.¹⁴⁹

That analysis was applied by the Special Commissioners and a majority of the Court of Appeal in *Smallwood*, which again (as in *Wood v Holden*, *Wensleydale’s Settlement*, and various other cases) involved a capital gains tax avoidance scheme. Here the scheme relied on a carefully orchestrated sequence of trusteeships exercised in different states at different times within the same fiscal year, from Jersey to Mauritius to the UK. The relevant shares were disposed of by the trustees during the period of formal Mauritian residence, in the hope that the UK–Mauritius tax treaty would shield the gain

¹⁴⁸ [1996] STC (SCD) 241.

¹⁴⁹ It is notable that the Special Commissioner relied on three corporate residence cases: *Calcutta Jute Mills*, *De Beers*, and *Unit Construction*.

from taxation.¹⁵⁰ The argument turned on the residence of the trust for treaty purposes during the period of formal Mauritian residence, which necessitated a determination of where the POEM of the trust was located: the UK or Mauritius.¹⁵¹ The Special Commissioners relied on the OECD Commentary and the reasoning in *Wensleydale's Settlement*, seeking to determine 'in which state the real top level management (or the realistic, positive management) of the trustee qua trustee is found'.¹⁵² They applied that test to the facts and concluded that, although the appropriate meetings were held and the appropriate resolutions were taken by the trustees in Mauritius, the design and influence which emanated from Mr Smallwood and his advisers in the UK were such that the POEM was at all times in the UK. Although that decision was overturned by the High Court, a majority of the Court of Appeal restored the decision. Unfortunately, the analysis of the meaning of POEM by the Court of Appeal does not provide much clarity. Hughes LJ, with whom Ward LJ agreed, chose to consider the POEM of the trust for the entire year rather than just the period of formal residence in Mauritius, suggesting that if one focused just on the Mauritius period then the POEM of the trust would be Mauritius.¹⁵³ Patten LJ, dissenting, held on the basis of *Wood v Holden*, and the finding of fact that the trustees were not bound to act in a certain way, that the only possible conclusion was that the trust was effectively managed in Mauritius.¹⁵⁴

It should also be noted that a view of trust residence similar to that taken in *Wensleydale's Settlement* and *Smallwood* was espoused by the Tax Court of Canada and

¹⁵⁰ *Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Mauritius for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains* (1981) Art 13[4].

¹⁵¹ *Smallwood* (SpC) (n 105) [107]–[108]; *Smallwood* (CA) (n 105) [46]–[47], [65], [72]. Mann J in the High Court held that the issue of dual residence did not arise: *Smallwood* (Ch) (n 105) [44]–[47].

¹⁵² *Smallwood* (SpC) (n 105) [113]–[114], [130].

¹⁵³ *Smallwood* (CA) (n 105) [68]–[70].

¹⁵⁴ *ibid* [61]–[63].

Federal Court of Appeal in the recent *Garron* decision. Briefly, a number of Canadian individuals were direct or indirect shareholders in a Canadian company known as ‘PMPL’ and a corporate reorganization was undertaken so as to avoid capital gains tax on a future disposal of the PMPL shares. The structure involved the settlement of two Barbados trusts, each subscribing for shares in certain holding companies. The sole trustee of each trust was a corporation resident in Barbados (St Michael). Later the shares of the PMPL holding companies were sold by the trusts to a third party at a substantial gain, which was, so the taxpayers argued, exempt from Canadian taxation by virtue of the Canada–Barbados tax treaty.¹⁵⁵ Although various arguments were made in the case, much emphasis was placed on pieces of evidence illustrating that St Michael made no decisions of its own but merely put into effect decisions already made by the Canadian beneficiaries / shareholders and their advisers. Justice Woods concluded that it was appropriate to apply the ‘central management and control’ test of corporate residence in order to determine the residence of a trust; she went on to find that, because all of the key decisions were made in Canada, the trusts were resident in Canada at all times, for both domestic law purposes and treaty purposes.¹⁵⁶ This decision was affirmed by the Court of Appeal¹⁵⁷ but it is unclear whether the decision will have influence in the corporate context.

4.3.4 Alternative Treaty Preference Criteria

Given the confusion regarding the meaning of POEM, there is much to be said for adopting a new residence preference criterion in the OECD Model and in future tax treaty negotiations. When considering the normative basis for residence-based taxation

¹⁵⁵ *Agreement between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* (1980) Art 14[4].

¹⁵⁶ *Garron* (TCC) (n 106) [170], [265], [267].

¹⁵⁷ *Garron* (FCA) (n 106).

of corporations, it seems desirable to determine residence for treaty purposes based on where the ‘realistic, positive management’ of the corporation is found, the interpretation of POEM that has been applied to trusts. But it is not even clear that judges have a uniform view of what that means. Moreover, it is unlikely given the decision in *Wood v Holden*, and notwithstanding the decisions in *Smallwood* and *Garron*, that such an interpretation of POEM will be applied with respect to corporations: talk of the ‘reality’ of corporate residence is treated with derision. In the author’s view it is worth revisiting the ‘real centre of management’ test proposed in the London Draft¹⁵⁸ – or something similar – in order to legislatively restore the focus on the place where decisions are actually made.

This is not the only option. As noted above, in the new UK–Netherlands tax treaty the governments have broken away from using POEM as the preference criterion (which had been the criterion for 30 years). Dual residence of legal entities is now resolved by mutual agreement of the competent authorities; in the absence of agreement the entity is not considered resident in either state for the purpose of claiming treaty benefits.¹⁵⁹ The 2008 Explanatory Memorandum to the treaty indicates that the factors to be considered by the competent authorities are: (i) where senior management is carried on; (ii) where board meetings are held; (iii) where the headquarters are located; (iv) the ‘extent and nature of the economic nexus’ to each state; and (v) whether awarding residence to one state carries ‘the risk of an improper use’ of the treaty or ‘inappropriate application of the domestic law’ of either state.¹⁶⁰ This list of factors is

¹⁵⁸ cf Couzin (n 1) 260–66; Avery Jones 2009 (n 121) 186.

¹⁵⁹ (n 120).

¹⁶⁰ *Explanatory Memorandum to the Draft Double Taxation Relief and International Tax Enforcement (Taxes on Income and Capital) (Netherlands) Order 2008* (2008) Art 4. For further analysis see R Offermanns and PM Smit, ‘The New Netherlands–UK Tax Treaty 2008 – An Analysis’ (2009) 49 *European Taxation* 59.

consistent with the case-by-case approach to residence resolution suggested in the OECD Commentary.¹⁶¹ Obviously this sort of tie-breaker is least favourable to taxpayers as it is discharged only by the exercise of mutual administrative discretion. The author suspects that the amendment to the preference criterion was prompted in part by the decision in *Wood v Holden*.¹⁶² The stated intention of considering the economic nexus to each state when determining residence is very welcome. The stated concern about improper use of the treaty or domestic law is less welcome. What this statement really means is that the respective governments (or at least the UK government) are not happy with the artificiality of current corporate residence formulations. This suggests that the governments should endeavour to change those formulations by legislation.

4.4 CONCLUSIONS

It was argued previously that the justifications for a residence-based corporate taxation have force only where corporate residence is understood as a special form of source – what has been called the home source. But if a corporate tax is to reflect adequately the connecting factors of ‘residence’ and ‘source’ in an international setting, it is essential to have a concept of corporate residence that is meaningful. Unfortunately, neither of the principal tests of corporate residence employed in the UK, Canada, and other Commonwealth jurisdictions – incorporation or central management and control – is a satisfactory gauge of the home economic interest.

The incorporation test of residence is a *de jure* standard that bears little or no relation to economic activity. In the author’s view there was no tenable normative basis

¹⁶¹ OECD Commentary (n 5) Art 4 [24.1].

¹⁶² Note that the UK agreed to use POEM as the tie-breaker in the treaties recently concluded with France (2008), Germany (2010), and Hong Kong (2010). Presumably the UK government is not as concerned about tax avoidance schemes exploiting residence in these states.

for its introduction in the UK or Canada: achieving consistency with US norms and opportunistically taxing foreign-managed entities were not good reasons. The central management and control standard as currently understood is little better because it constitutes a ‘highest functions’ paradigm that is easily manipulated, notwithstanding that this standard could have been interpreted as ‘real’ and ‘actual’ management emanating from a state. Although the treaty concept of POEM similarly could be interpreted as ‘real’ and ‘positive’ management, to date that interpretation has been neglected by British and Canadian courts, at least with respect to corporations.

This results in an international tax system where corporate residence is at once a critical determinant of home state tax obligations and treaty entitlements, while at the same time being a legal artifice, divorced from economic reality and subject to constant exploitation. Governments and revenue administrations respond by challenging alleged international tax law ‘abuses’ that are made possible by their own corporate residence definitions, as explored in Part II of the thesis. This is a regrettable disconnection that needs to be addressed through legislative change, both in domestic law and tax treaties. As long as corporate residence remains a key feature in international tax rules, it is desirable to adopt a test or series of tests that focuses on where the practical, daily management or principal business operations exist (as suggested by the Inland Revenue 30 years ago) or on where the ‘real centre of management’ is situated (as suggested by the LON Fiscal Committee over 60 years ago). It is useful to recall the comment from *Cesena Sulphur / Calcutta Jute Mills* that the residence of a corporation should be found in ‘the place not where the form or shadow of business, but where the real trade and business, is carried on’.¹⁶³

¹⁶³ *Cesena Sulphur / Calcutta Jute Mills* (n 16) 452.

PART II

CHAPTER 5

OUTBOUND INVESTMENT: ATTACKING CORPORATE RESIDENCE THROUGH CONTROLLED FOREIGN COMPANIES LEGISLATION

5.1 INTRODUCTION

5.1.1 Offshore Residence and ‘Deferral’

It is ironic that the formulation of residence in *De Beers*¹ was intended to prevent tax-motivated manipulations of corporate residence, yet 100 years later this formulation, in concert with the incorporation formulation of residence, allows international tax avoidance to flourish. Residence based on either of these tests is essentially elective, as neither requires economically meaningful links with the selected jurisdiction.² Among other things, the current approach to corporate residence invites outbound investment structures using entities that may amount to little more than ‘letterboxes’ maintained by the shareholders’ advisers.

The introductory chapter highlighted recent reports illustrating the dramatic growth of multinational enterprises (MNEs) and their extensive networks of controlled foreign companies (CFCs), many of which are based in tax havens.³ Subject to the legal regimes addressed in this chapter, the use of tax haven subsidiaries not only allows retained earnings to be accumulated and reinvested offshore, it also allows the taxable profits of the parent company or other group companies to be reduced through intra-

¹ [1906] AC 455 (HL).

² BJ Arnold, ‘A Tax Policy Perspective on Corporate Residence’ (2003) 51 CTJ 1559; MJ McIntyre, ‘Determining the Residence of Members of a Corporate Group’ (2003) 51 CTJ 1567.

³ Ch 1 text to nn 6–11 and 20–25.

firm financing costs, royalties, and other payments.⁴ A MNE may thus defer, reduce, or even eliminate taxation in the states where the human endeavours giving rise to the income are actually occurring. Various commentators have observed that this state of affairs makes little policy sense and requires redress.⁵

There is little doubt that enhanced mobility of capital, particularly in the corporate form, undermines national tax systems in that it allows valuable components of economic interest to be artificially relocated and possibly to go untaxed. But this problem can be overstated. In chapter 2 we touched on the issue of ‘deferral’, meaning that the income of foreign subsidiaries is not taxable in the parent company’s state of residence until dividends are repatriated.⁶ Economists traditionally complained that deferral is inimical to capital export neutrality (CEN) because the ‘income of the enterprise’ may be taxed at a different rate in the subsidiary’s state of residence, thus distorting investment decisions.⁷ In current economic thinking this is less of a concern, as the focus has shifted to capital import neutrality (CIN) and capital ownership neutrality (CON), yet references to deferral persist. The fault in the term ‘deferral’, and indeed the term ‘repatriation’, is that each presumes its own conclusion about the scope of national tax entitlements. These terms assume a certain relationship between parent and subsidiary and then criticize the tax results, without recognizing that such a

⁴ eg R Zielke, ‘International Tax Planning with Tax Havens – Objectives and Strategies in a Multinational Group of Affiliated Corporations’ (2011) 65 BIT [forthcoming].

⁵ eg BJ Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison* (Canadian Tax Foundation, Toronto 1986) 70–71; S Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (Weidenfeld & Nicolson, London 1992) 93–94, 135–41; RJ Vann, ‘Problems in International Division of the Business Income Tax Base’ (2007) Oxford Univ Centre for Business Taxation, 2007 Symposium Paper <www.sbs.ox.ac.uk/centres/tax/symposia/Documents/2007/Vann.doc>; RS Avi-Yonah, KA Clausing, and MC Durst ‘Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split’ (2009) 9 Florida Tax Rev 497.

⁶ Ch 2 text to n 69.

⁷ Ch 2 text to n 117.

relationship may or may not exist. Vogel advised against the use of the term deferral because it is biased:

It implies that the income of a foreign-based subsidiary properly should be taxed in the parent's country when accrued and that this taxation is only 'deferred'. In other words, the term expresses a value judgement which should be open to discussion. It presupposes the outcome of such discussion and, therefore, should be avoided.⁸

This means that one cannot simply assume that the income earned by a foreign subsidiary should be taxed in the parent's home state. The legal response to the problem of deferral must be more balanced, recognizing the independent existence of affiliated corporations. Some CFCs will have substantial connections with the country in which they operate. It might be a corporation that existed and operated independently for some time and was later acquired by a MNE based elsewhere, while maintaining local directors, officers, and employees.⁹ The fact that the income of such corporations is not taxed in the parent company's home state until dividends are paid (and may not be taxed at all under an exemption system) is of little concern. At the other end of the spectrum are 'brass plate' or 'letterbox' subsidiaries, sometimes referred to as 'base companies', which consist of little more than the legal instruments testifying their creation.¹⁰ It is true that the practice of establishing such entities, rather than using integrated branch

⁸ K Vogel, 'Worldwide vs Source Taxation of Income – A Review and Re-Evaluation of Arguments (Part I)' (1988) 8–9 *Intertax* 216, 218; cf WW Park, 'Fiscal Jurisdiction and Accrual Basis Taxation: Lifting the Corporate Veil to Tax Foreign Company Profits' (1978) 78 *Columbia Law Rev* 1609, 1610.

⁹ eg the 2006 acquisition by Xstrata of a 100% interest in the Canadian mining company Falconbridge Limited (now Xstrata Nickel); the 2007 acquisition by Vodafone of a 67% interest in the Indian telecom company Hutchison Essar Ltd (now Vodafone Essar Ltd); or the 2009 acquisition by GlaxoSmithKline of a 100% interest in the US pharmaceutical company Stiefel Laboratories Inc.

¹⁰ OECD, 'Tax Havens: Measures to Prevent Abuse by Taxpayers' in *International Tax Avoidance and Evasion: Four Related Studies* (OECD, Paris 1987) (OECD 1987a) [11]; OECD, 'Double Taxation Conventions and the Use of Base Companies' in *International Tax Avoidance and Evasion: Four Related Studies* (OECD, Paris 1987) (OECD 1987b) passim. The term 'base company' seems to have been coined in WJ Gibbons, 'Tax Effects of Basing International Business Abroad' (1956) 69 *Harvard Law Rev* 1206.

operations, undermines equity and efficiency in that it weakens the power of the home state to tax the home economic interest.

5.1.2 The Confused Purpose and Effect of CFC Regimes

The standard legislative response to problem of ‘deferral’ via foreign entities has been a regime aimed at controlled foreign companies, also known as controlled foreign corporations or controlled foreign affiliates. The essence of CFC legislation is that certain income – often low taxed or passive income but not necessarily so – earned by a foreign corporation whose governance is dominated by domestic shareholders is apportioned to those shareholders on some accrual basis. The operation and implications of CFC legislation, particularly in the UK and Canada, are analyzed in this chapter.

The author is not the first to suggest that a CFC regime is an inelegant response to an unnecessary problem. Various scholars have argued previously that a tax system based on global apportionment of unitary business income would obviate the need for a CFC regime,¹¹ which is correct but ultimately based on a utopian vision of sovereign states relinquishing sovereignty. A smaller number of commentators have argued that, even given the constraints of national sovereignty, the contrivance of attributing CFC income to a parent corporation might be avoided if one abandoned the artifice of separate residence based on formal indicia like incorporation.¹² In other words, a state would have less reason to resort to taxing residents on accrued but undistributed earnings of ‘foreign’ subsidiaries if it employed an economically meaningful concept of residence, such as the real centre of management. Where the author departs from these

¹¹ eg PB Musgrave, ‘International Tax Base Division and the Multinational Corporation’ (1972) 27 Public Finance 394; Picciotto (n 5) ch 9; J Li, ‘Global Profit Split: An Evolutionary Approach to International Income Allocation’ (2002) 50 CTJ 823.

¹² eg R Weber-Fas, ‘Corporate Residence Rules for International Tax Jurisdiction: A Study of American and German Law’ (1968) 5 Harvard J on Legislation 175; J Bouthillier, ‘Residence-Based Taxation and FAPI: A World of Fictions’ (2005) 53 CTJ 179.

earlier arguments is in claiming that the CFC regimes of the UK and Canada, as applied by their respective revenue authorities, already seek to tax the income of ostensibly foreign companies on the basis that their real management is, or should be, located at home. CFC legislation is thus an awkward extension of residence-based taxation.

It is an ‘awkward’ extension in part because the legislation never purports to query the foreign residence of a CFC, and in part because the legislation is poorly targeted. A stated goal of the UK and Canadian regimes is to assert taxing rights over income that governments believe is ‘artificially located in’ or has been ‘artificially diverted to’ a foreign jurisdiction. Such a goal seems fair on first reading. However, an examination of the legislation and relevant policy statements reveals that this notion of artificiality is ambiguous: in one sense it denotes a lack of economic reality, particularly with respect to corporate establishment, and in another sense it suggests a lack of fiscal morality, alleged to subsist in a taxpayer moving economic activity abroad. Thus the intention of CFC legislation, at least as it has been expressed to date, seems to confound the objective reality/unreality of corporate establishment with the subjective desirability/undesirability of creating and earning income through such an establishment. This confusion results in CFC legislation being designed and applied in a manner that has more to do with stemming fiscally undesirable behaviour than with ascertaining an equitable share of economic interest. As explained below, using CFC rules to tax the objectively foreign income of objectively foreign corporations is difficult to sustain in a liberal state that respects freedom of movement, particularly in the context of European Community law. Moreover, this is an unsatisfactory approach because it fails to conform to the principle of economic allegiance addressed in previous chapters: income tax jurisdiction should, to the extent possible, be aligned with the locations of real economic interests.

5.2 HISTORY AND CONTEXT OF CFC LEGISLATION IN THE UK AND CANADA

5.2.1 Evolution of CFC Legislation

5.2.1(a) *Early Anti-Deferral Legislation in the US and Great Britain*

In 1938, one American commentator colourfully observed that ‘the increasing necessity and attractiveness of expanding international economic intercourse’, combined with increased tax avoidance and other changes, had ‘cooperated to disturb the splendid isolation in which the tax system of every country used to vegetate’.¹³ This was about the time that the earliest anti-deferral rules were introduced in the US: legislation enacted in 1937 applied to ‘foreign personal holding companies’ controlled by up to five US individuals.¹⁴ Similar concerns about avoidance of tax by British individuals, particularly through private companies and trusts based in the Channel Islands, led to legislation in 1936 preventing resident individuals from transferring assets abroad and escaping liability to tax on income enjoyed in respect of those assets.¹⁵

Both the American and British provisions were aimed at private wealth and therefore did not affect corporate structures employed by most MNEs. In the absence of some attribution mechanism, deferring US tax on foreign corporate income was a relatively easy matter given that, under US law, worldwide taxation applies only to US nationals and foreign nationality can be selected according to the jurisdiction of

¹³ H Wurzel, ‘Foreign Investment and Extraterritorial Taxation’ (1938) 38 Columbia Law Rev 809, 813.

¹⁴ Internal Revenue Code 1986 §§ 551–558; repealed in 2004 but similar rules apply to ‘personal holding companies’: Internal Revenue Code 1986 §§ 541–547. For discussion see RS Avi-Yonah, ‘The Structure of International Taxation: A Proposal for Simplification’ (1996) 74 Texas Law Rev 1301, 1324–26.

¹⁵ FA 1936 s 18; later ICTA 1988 ss 739–746, rewritten to ITA 2007 ss 714–750. For discussion see: Picciotto (n 5) 98–102; *IRC v Willoughby* [1997] 1 WLR 1071 (HL).

incorporation.¹⁶ Concerns about the use of foreign affiliates to bypass the prevailing system of worldwide taxation with foreign tax credits¹⁷ led the US government to enact the first CFC provisions in 1962.¹⁸ The Kennedy administration had proposed to eliminate deferral on almost all foreign corporate income, taxing foreign profits on an accrual basis and in effect treating foreign subsidiaries wherever located as equivalent to branches of a US entity.¹⁹ Fears of disastrous effects on the competitiveness of US businesses led Congress to enact a less radical regime. The legislation concentrated on what were perceived to be the main ‘abuses’, namely, the use of tax haven entities to shelter passive income and to shift certain active business income that the government felt could be easily diverted offshore and thus erode the US tax base. The latter category is sometimes referred to as income from ‘base company services’.

5.2.1(b) *Advancement of CFC Legislation*

Similar concerns about exploitation of corporate deferral motivated several OECD countries to introduce CFC legislation in subsequent decades. Canada, Germany, and Japan were the first to follow the US lead; Canada enacted the foreign accrual property income (FAPI) provisions in the course of the 1972 tax reform, made effective in 1976.²⁰ In the Canadian legislation a CFC is referred to as a ‘controlled foreign affiliate’

¹⁶ Avi-Yonah 1996 (n 14) 1325; DN Shaviro, *Decoding the US Corporate Tax* (Urban Institute Press, Washington DC 2009) 103–05.

¹⁷ eg SS Surrey, ‘Current Issues in the Taxation of Corporate Foreign Investment’ (1956) 56 *Columbia Law Rev* 815; DR Tillinghast, ‘Current Issues in the Taxation of Foreign Income’ in C Shaw (ed), *Legal Problems in International Trade and Investment* (Oceana Publications, New York 1962) 180.

¹⁸ Revenue Act 1962; codified in Internal Revenue Code 1986 §§ 951–965. These provisions are referred to as the ‘Subpart F rules’ because they appear in Subtitle A, Chapter 1, Subchapter N, Part III, Subpart F. The rules are explained in JE Rogers and EP Lemanowicz, ‘United States’ in Int’l Fiscal Association (ed), *Limits on the Use of Low Tax-Regimes by Multinational Businesses*, Cahiers de Droit Fiscal International vol 86b (IFA, San Francisco 2001) (IFA 2001 Congress) 903.

¹⁹ CFC income earned in developing countries was to be treated more leniently: Park (n 8) 1613; Picciotto (n 5) 109–12.

²⁰ The current rules appear in ITA 1985 Pt I Div B Subdiv i (ss 90–95) and associated regulations.

and CFC income is referred to as FAPI. Canada also has related anti-deferral rules: provisions affecting non-resident trusts were enacted at the same time as the FAPI rules and offshore investment fund rules were introduced in 1984.²¹ From the introduction of the FAPI provisions it was clear that they were designed to work in conjunction with the combined exemption / credit system for foreign affiliate dividends, supposedly preventing ‘abuse’ of corporate deferral²² (whatever that may mean).

By this point the UK had many years of experience with its legislation regarding transfers of assets abroad, but did not have a generally applicable CFC regime. That regime was introduced in 1984,²³ following a lengthy period of consultation. In the same year the UK provisions regarding offshore funds were introduced.²⁴ According to the initial consultation document published by the Inland Revenue, the introduction of a CFC regime was prompted by the increasing use of investment entities located in tax haven countries.²⁵ It claimed that the requirement of Treasury consent to corporate emigration had ‘for nearly thirty years been the main provision for countering international tax avoidance in the corporate sector’; the removal of exchange controls in 1979 and the planned easing of Treasury consents was seen to create a serious fiscal risk that could be mitigated by introducing a charge on ‘certain income of tax haven

²¹ ITA 1985 ss 94 and 94.1. New legislation regarding non-resident trusts and foreign investment entities has been under consideration in Canada for over 10 years, with the proposed text and effective date changing several times in that period. As part of the 2010 Budget, the Department of Finance introduced revised proposals yet again.

²² For further historical detail see: JS Wilkie and others, ‘The Foreign Affiliate System in View and Review’ in Canadian Tax Foundation (ed), *Corporate Management Tax Conference 1993* (Canadian Tax Foundation, Toronto 1994) 2:1; BJ Arnold, ‘The Canadian International Tax System: Review and Reform’ (1995) 43 CTJ 1792.

²³ FA 1984 ch VI (ss 82–91) and scheds 16–18. The current rules appear in ICTA 1988 Pt XVII ch IV (ss 747–756), scheds 24–26 and associated regulations. They are soon to be replaced: text to nn 139–146.

²⁴ FA 1984 ch VII (ss 92–100) and scheds 19–20; later ICTA 1988 Pt XVII ch V (ss 756A–764); repealed and replaced by the Offshore Funds (Tax) Regulations 2009/3001.

²⁵ Inland Revenue, *Tax Havens and the Corporate Sector: A Consultative Document* (Board of Inland Revenue, London, January 1981) (Inland Revenue 1981a).

companies under United Kingdom control'.²⁶ The Inland Revenue was at the same time also consulting on a more robust concept of corporate residence,²⁷ as discussed in chapter 4. The two consultations can hardly be viewed as unconnected. In subsequent publications the Inland Revenue resiled from its proposals regarding corporate residence but continued to refine the CFC legislation that was eventually enacted.²⁸

As of 2010 some form of CFC legislation was in place in at least 28 countries.²⁹ It is notable that some of these states would be considered emerging or developing economies³⁰ and a few are frequently described in the public finance literature as having 'exemption' systems.³¹ CFC legislation does not raise vast sums of revenue directly, yet it has indirect effects. Such legislation is largely prophylactic in that taxpayers plan their affairs to avoid application of the provisions.³² This behavioural effect undoubtedly stems the loss of domestic tax revenue through the shifting of passive investment income to tax havens, although more sophisticated tax planning arrangements that fit within the rules are at the same time legitimized.³³

²⁶ *ibid* [1]–[2].

²⁷ Inland Revenue, *Company Residence: A Consultative Document* (Board of Inland Revenue, London, January 1981).

²⁸ Inland Revenue, *International Tax Avoidance: Company Residence, Tax Havens and the Corporate Sector, Upstream Loans* (Board of Inland Revenue, London, November 1981) (Inland Revenue 1981b); Inland Revenue, *Taxation of International Business* (Board of Inland Revenue, London 1982).

²⁹ Countries in the order in which they introduced CFC legislation are: the US, Germany, Canada, Japan, France, the UK, New Zealand, Australia, Sweden, Norway, Denmark, Finland, Indonesia, Portugal, Spain, Hungary, Mexico, South Africa, Republic of Korea, Argentina, Italy, Estonia, Venezuela, Brazil, Lithuania, Israel, Turkey, and the People's Republic of China. This list is derived from BJ Arnold and MJ McIntyre, *International Tax Primer* (2nd edn, Kluwer, The Hague 2002) 89 and the author's own research conducted at the Oxford University Centre for Business Taxation.

³⁰ eg Brazil, Mexico, and Indonesia.

³¹ eg Argentina, France, Israel, and (since 2009) the UK. Also see RS Avi-Yonah, 'Back to the Future? The Potential Revival of Territoriality' (2008) 62 BIFD 471.

³² OECD Committee on Fiscal Affairs, *Controlled Foreign Company Legislation* (OECD, Paris 1996) 21.

³³ Picciotto (n 5) 149–50; Avi-Yonah 2009 (n 5) 499, observing that the US Subpart F rules 'permit massive levels' of income shifting.

5.2.2 Primary Features of CFC Legislation

5.2.2(a) *General Comments*

There are a number of excellent comparative analyses of CFC legislation.³⁴ That work demonstrates that countries are not unanimous in the way they define a CFC or in the types of activities or locations of establishment they consider to merit shareholder income attribution. Nor is it accurate in all cases to refer to the legislative effect as ‘income attribution’; in some countries, including Canada, the legislation operates by deeming shareholders to receive income in respect of the shares held (a ‘deemed dividend’ approach). While the precise mechanics of CFC regimes vary considerably, the universal characteristic is the current taxation in the shareholder’s home state of some portion of the undistributed profits of a CFC.³⁵ Achieving this type of flow-through taxation necessitates complex rules that prescribe the calculation and apportionment of CFC incomes from different locations and different activities. This complexity is exacerbated by detailed rules that are needed to support flow-through treatment, including relief for applicable foreign taxes, recognition of CFC losses, and relief to prevent double taxation in respect of actual dividend distributions and capital gains on disposals of CFC shares.³⁶ The goal of the present discussion is not to recite the UK or Canadian legislation in detail; rather, it is to highlight the key features and suggest what policy rationales underlie the legislation as written.

³⁴ Arnold 1986 (n 5); OECD 1996 (n 32); BJ Arnold and P Dibout, ‘General Report’ in IFA 2001 Congress (n 18) 21; M Lang and others (eds), *CFC Legislation, Tax Treaties and EC Law* (Kluwer, The Hague 2004).

³⁵ OECD 1996 (n 32) 19–20; IFA 2001 Congress (n 18) 64.

³⁶ OECD 1996 (n 32) 76–80; IFA 2001 Congress (n 18) 64–67; V Thuronyi, *Comparative Tax Law* (Kluwer, The Hague 2003) 297–98.

5.2.2(b) *Relevance of Ownership, Location, and Income*

As indicated above, it is not helpful to describe the aim of CFC legislation as preventing ‘deferral’ because that term presumes its own conclusion. The critical issue as articulated by Arnold is ‘to distinguish between “good” deferral and “bad” deferral, between foreign source income which should benefit from deferral and that which should not, between legitimate and illegitimate tax haven operations’.³⁷ This distinction is typically made by reference to three factors: (i) the degree of ownership and control of the foreign entity; (ii) the location in which the foreign entity is established or the income is earned; and (iii) the nature of the income earned by the foreign entity.

The first concern is whether the shareholder’s interest in the foreign entity represents a controlling interest or a portfolio interest.³⁸ As CFC regimes are targeted at tax avoidance through the use of separate legal entities, the legislation generally applies only to entities over which domestic taxpayers have substantial influence – it is considered unfair to tax domestic shareholders on the undistributed income of a foreign corporation if they cannot compel the corporation to pay dividends. Reflecting these concerns, states use minimum ownership requirements and employ indirect and constructive ownership rules. Both the UK and Canadian CFC regimes include such provisions. The UK legislation applies to a non-resident company that is, among other things, ‘controlled by persons resident in the United Kingdom’, but imposes a tax charge only on a UK resident company that, alone or with connected or associated persons, has at least a 25 per cent interest in the CFC’s chargeable profits.³⁹ There are detailed rules regarding indirect and constructive ownership of shares. The Canadian

³⁷ Arnold 1986 (n 5) 8; cf IFA 2001 Congress (n 18) 40.

³⁸ For further discussion see: OECD 1996 (n 32) 31–39; IFA 2001 Congress (n 18) 40–44.

³⁹ ICTA 1988 ss 747(1)(b), 747(2)–(5), 752–752C.

legislation applies to a ‘controlled foreign affiliate’ of a Canadian taxpayer, which is defined as a ‘foreign affiliate’ of the taxpayer that is controlled by that taxpayer, either alone or together with non-arm’s length persons and up to four other Canadian residents.⁴⁰ There is a ten per cent minimum ownership requirement in that the entity must first be a foreign affiliate of the taxpayer.⁴¹ Again, there are detailed rules regarding indirect and constructive ownership.

The second basis for distinction, used by some but not all states, is the location in which the foreign entity is established or the income is earned.⁴² The concern here is to prevent CFCs from earning passive or ‘base-eroding’ income in jurisdictions that the domestic government considers to be tax havens or, more generally, low tax states. This objective may be achieved directly, attributing CFC income only where the tax rate in the host state falls below some threshold or where the state is included in a prescribed list of low tax states. Alternatively, the rules may operate by exception, exempting foreign entities or income where the tax rate in the host state meets some threshold or where the state is included in a prescribed list of high tax states. The UK legislation employs a combination of these methods, having followed the Japanese model.⁴³ A foreign entity is regarded as a CFC only where it is subject to a ‘lower level of taxation’ in its territory of residence,⁴⁴ which in broad terms means the foreign tax is less than three quarters of the ‘corresponding UK tax’.⁴⁵ Further, a list of excluded countries is

⁴⁰ ITA 1985 s 91(1), s 95(1) ‘controlled foreign affiliate’.

⁴¹ ITA 1985 s 95(1) ‘foreign affiliate’.

⁴² For further discussion see: OECD 1996 (n 32) 40–45; IFA 2001 Congress (n 18) 44–48.

⁴³ Inland Revenue 1981a (n 25) [4]–[8].

⁴⁴ ICTA 1988 ss 747(1)(c), 747(2).

⁴⁵ ICTA 1988 s 750, derived from FA 1984 s 85 (where a tax burden of less than half of the UK tax was considered a ‘lower level’). Even if the foreign entity’s tax burden meets this threshold, it will be deemed to face a lower level of taxation if it benefits from certain ‘designer rate tax provisions’: ICTA 1988 s 750A and Controlled Foreign Companies (Designer Rate Tax Provisions) Regulations 2000/3158.

provided by regulation,⁴⁶ removing the compliance burden involved in determining whether a company resident in any such state meets the comparative tax threshold or meets any other legislated exemption. The Canadian FAPI provisions were more like the US Subpart F rules in that they did not, until recently, distinguish between income earned by CFCs in low tax and high tax states – the distinction was made based solely on the type of income earned. Controversial changes introduced in 2007 ensure that otherwise active business income arising in states with which Canada does not conclude a tax treaty or tax information exchange agreement (TIEA) will be deemed to be FAPI. This amendment is discussed below.⁴⁷

The income distinction in CFC legislation is not as easily elucidated. Most countries distinguish between the passive and active income of CFCs and then go on to treat some ostensibly active business income (or active businesses) as ‘tainted’.⁴⁸ More specifically, the rules usually require income apportionment in respect of passive investment income and capital gains,⁴⁹ income derived from certain transactions with related persons, and income derived from providing other ‘base company services’. There seems to be little objection to accrual taxation of portfolio investment income. The more contentious issues are the treatment of so-called investment businesses and the demarcation of acceptable active businesses from ‘base-eroding’ active businesses. Both the UK and Canada have decided that attribution is warranted where a CFC carries on an ‘investment business’,⁵⁰ as explained below. The legislation may also require attribution where a CFC provides services primarily to other members of the same

⁴⁶ ICTA 1988 s 748(1)(e) and Controlled Foreign Companies (Excluded Countries) Regulations 1998/3081.

⁴⁷ Text to nn 80–82.

⁴⁸ For further discussion see OECD 1996 (n 32) 45–62; IFA 2001 Congress (n 18) 49–58.

⁴⁹ The UK rules do not apply to capital gains: text to n 120.

⁵⁰ ICTA 1988 sched 25 paras 6(2)(a) and 9; ITA 1985 s 95(1) ‘investment business’.

corporate group, such as captive insurance services, although the Canadian legislation provides broad exceptions in this regard.⁵¹

A regime that concentrates on the nature of the CFC's income, like those of Canada and the US, may be described as an income-based or 'transactional' approach, while a regime that focuses on the location of the CFC, like that of the UK or (formerly) Japan, is best described as an entity-based or 'jurisdictional' approach. In practice both approaches tend to produce similar results: an income-based approach may exempt income earned in certain locations and an entity-based approach may exempt entities that carry on certain activities.⁵² The fact that the Canadian legislation gives so much attention to particular income types is largely responsible for its horrendous complexity.⁵³ The current UK regime, while not a model of simplicity, is considered easier to comply with and administer because it focuses on entities rather than incomes and includes a range of blanket exemptions. Although the UK government had proposed in 2007 to move toward an income-based CFC regime to complement the foreign dividend exemption,⁵⁴ this plan changed in response to the (understandable) preference of business to maintain an entity-based system with exclusions for certain countries.⁵⁵

⁵¹ ICTA 1988 sched 25 paras 6(2)(b) and 11; ITA 1985 ss 95(2)(a), 95(2)(a.1)–(a.4) and 95(2)(b).

⁵² OECD 1996 (n 32) 20, 46, citing Arnold 1986 (n 5) 447; IFA 2001 Congress (n 18) 49–50.

⁵³ Income Tax Regulations, CRC 1977 c 945 (ITR 1977) reg 5907.

⁵⁴ HM Treasury and HMRC, *Taxation of Companies' Foreign Profits: Discussion Document* (HM Treasury, London, June 2007) <www.hm-treasury.gov.uk/consult_foreign_profits.htm> (Foreign Profits Discussion) ch 4.

⁵⁵ HM Treasury, *Reform of Controlled Foreign Companies (CFC): Policy Principles Document* (HM Treasury, London, July 2009) <www.hm-treasury.gov.uk/controlled_foreign_companies_archive.htm> (CFC Principles Document); HM Treasury and HMRC, *Proposals for Controlled Foreign Companies (CFC) Reform: Discussion Document* (HM Treasury, London, January 2010) <www.hm-treasury.gov.uk/controlled_foreign_companies_archive.htm> (CFC Discussion) esp [2.1]–[2.6].

5.2.3 Purported Rationales for CFC Legislation

5.2.3(a) *Anti-Abuse, CEN, or Other?*

CFC legislation and related anti-deferral regimes originated as a response to the relocation of profits and wealth to tax havens. Indeed, CFC provisions have often been described as ‘anti-haven’ legislation,⁵⁶ implying that their sole purpose is to prevent tax avoidance through the use of tax havens. Yet when CFC legislation was nascent it was unclear what the apprehended ‘avoidance’ was considered to comprise. Was this concept of avoidance restricted to the artificial separation of the location of taxable profits from the economic interests that produced the profits? Or was the concept meant to encompass any movement of profits or wealth to a controlled entity established in a low tax jurisdiction, whether or not the entity was genuinely connected with that jurisdiction and carried on productive activities there? The reality probably lay somewhere between these two theoretically pure positions. The lack of clear separation between the anti-abuse rationale of CFC legislation and what is essentially a CEN / protectionist rationale persists today.

In its 1996 report the OECD stated that, for countries which have CFC legislation, the primary rationale is an ‘anti-avoidance objective’, namely, to prevent the diversion of passive income and other base-eroding income to foreign entities whose governance is dominated by domestic interests.⁵⁷ CFC legislation is thus regarded as a supplement to other anti-avoidance legislation affecting MNEs, specifically transfer pricing and thin capitalization rules.⁵⁸ In fact, countries such as Luxembourg, the Netherlands, and Switzerland contend that CFC legislation is superfluous where a

⁵⁶ eg Arnold 1986 (n 5) passim; OECD 1987a (n 10) [46], [62]; Picciotto (n 5) ch 7.

⁵⁷ OECD 1996 (n 32) 11.

⁵⁸ OECD 1996 (n 32) 18–19; cf IFA 2001 Congress (n 18) 40, 54.

country has effective transfer pricing rules, thin capitalization rules, and general anti-avoidance measures.⁵⁹ In its 1996 report the OECD asserted that ‘more fundamentally, however, CFC legislation is generally seen as an instrument to guard against the unjustifiable erosion of the domestic tax base by the export of investments to non-resident corporations’; this rationale was characterized as the pursuit of CEN.⁶⁰ The use of the adjective ‘unjustifiable’ indicates that this is not purely a fiscal neutrality rationale: it implies that the domestic tax base is being diminished improperly. The repeated use in the 1987 and 1996 OECD reports of terms of opprobrium – such as ‘shifted’, ‘eroded’ and (most evocatively) ‘siphoned’ – when referring to the relocation of profits to tax havens also implies that the relocation is unjustified. But in what circumstances will a CFC structure diminishing the domestic tax base be unjustified?

This is a vexing question that different states have answered in different ways. As noted previously, the 1962 Subpart F legislation was a subdued version of the comprehensive anti-deferral framework originally proposed in the US. The introduction of those rules was prompted in part by the general US tax policy preference for CEN, which according to the economic theory of the time required all income of foreign entities to be taxed in the hands of US owners as it accrued.⁶¹ It is interesting that in the US there have been several other proposals to end ‘deferral’ on all or most foreign earnings of CFCs, yet no such proposal has been successful in the face of concerns

⁵⁹ IFA 2001 Congress (n 18) 39. See more recently the national reports in Int’l Fiscal Association (ed), *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, Cahiers de Droit Fiscal International vol 95a (IFA, Rome 2010) (IFA 2010 Congress). The use of general anti-avoidance measures is addressed in ch 7.

⁶⁰ OECD 1996 (n 32) 11–12.

⁶¹ PB Richman (now Musgrave), *Taxation of Foreign Investment Income: An Economic Analysis* (Johns Hopkins Press, Baltimore 1963); HJ Ault and DF Bradford, ‘Taxing International Income: An Analysis of the US System and Its Economic Premises’ in A Razin and J Slemrod (eds), *Taxation in the Global Economy* (Univ of Chicago Press, Chicago 1990).

about international competitiveness;⁶² indeed, under the Bush administration the tendency was to restrain the Subpart F rules.⁶³ It remains to be seen whether the proposals advanced by the Obama administration in 2008–2009 will result in more fundamental change.⁶⁴

The US and other states that have enacted CFC legislation seem to accept that completing abolishing deferral is neither realistic nor desirable. The main exceptions were, until recently, New Zealand and Sweden, whose legislation required accrual of all undistributed earnings of CFCs regardless of the business they conducted.⁶⁵ Accordingly, only these states could maintain that their regimes were fundamentally motivated by a policy preference for CEN; the New Zealand approach was characterized by the OECD as the pursuit of ‘maximal’ or ‘pure’ CEN.⁶⁶ New Zealand altered its position in 2009 when it implemented an exemption for most active business income earned by CFCs.⁶⁷

5.2.3(b) *Rationales Reflected in UK and Canadian CFC Regimes*

There is a good argument that a state which adheres to a philosophical approach of CIN or CON, and thus maintains a true exemption system, should not be concerned about deferral and would have no need for a CFC regime. Yet as the UK has moved to an exemption regime in respect of most foreign dividends, and as Canada expands the

⁶² Picciotto (n 5) 111–14; Avi-Yonah 1996 (n 14) 1325–26.

⁶³ Avi-Yonah 2008 (n 31).

⁶⁴ KA Parillo, ‘Obama’s Tax Proposals Merely a Patch, Panelists Say’ (2009) 54 Tax Notes Int’l 987.

⁶⁵ In both states an exemption applies if the foreign entity is resident in one of a short list of high tax countries. For further analysis see: B Howe, ‘New Zealand’ in IFA 2001 Congress (n 18) 717; M Dahlberg, ‘Sweden’ in IFA 2001 Congress (n 18) 827.

⁶⁶ OECD 1996 (n 32) 11, 25, 133–35.

⁶⁷ New Zealand Inland Revenue, *New Rules for Taxing Controlled Foreign Companies and Foreign Dividends* (Inland Revenue Policy Advice Division, Wellington 2009) <<http://taxpolicy.ird.govt.nz/publications/year/2009>>. Legislation implementing these changes was enacted in October 2009.

scope of its current participation exemption regime, policy-makers in both countries are concerned to maintain their CFC legislation in order to limit ‘abuse’ of the dividend exemption. Past policy statements regarding CFC legislation provide some insight into what this abuse was and is thought to involve.

The consultation documents that preceded the enactment of the UK provisions contain various observations regarding the purpose of the scheme. In 1981 the Inland Revenue stated that the aim was to impose a UK tax charge ‘on unremitted overseas income and capital gains where arrangements were made or transactions were entered into with the object of avoiding tax’.⁶⁸ The Revenue subsequently stated that the purpose of the rules was ‘to remove the tax advantage of accumulating income in low tax areas’, while protecting the competitiveness of UK companies with ‘genuine’ overseas activities.⁶⁹ Revised proposals were published in 1982, when the Revenue reiterated that there was a compelling case for ‘introducing measures aimed at tax avoidance through the accumulation of income in subsidiaries in low tax areas ... and the artificial diversion of business profits from the UK to such companies’.⁷⁰ These statements evoke both CEN / protectionist concerns and anti-avoidance concerns.

That ethos has evolved as the government has come to accept that US-style protectionism is less justifiable in an environment where enterprises are expanding into numerous states and have globally integrated functions. The Foreign Profits Discussion declared that the essential aim of the CFC provisions has always been ‘revenue protection’, that is, ‘[to] enable the UK to tax artificially located profits that are effectively within the control of the UK parent’, ‘to prevent the artificial location of

⁶⁸ Inland Revenue 1981a (n 25) [4].

⁶⁹ Inland Revenue 1981b (n 28) [5], [10]–[14].

⁷⁰ Inland Revenue 1982 (n 28) [11], [28].

profits’, and other similar expressions.⁷¹ The 2008 Pre-Budget Report and the Financial Secretary’s 2008 open letters to business representative bodies stated that a reformed CFC regime would reflect a ‘more territorial approach’ to taxing foreign subsidiaries.⁷² An essential part of this approach was that the legislation would move away from a default presumption that all activities that could have been undertaken in the UK would have been so undertaken had it not been for the offshore tax advantages. This outlook was confirmed more recently in the Treasury publications regarding CFC reforms.⁷³ In November 2010, the new government conceded that the current CFC regime is outdated and reassured businesses that the rules would be replaced in 2012, targeting artificial diversions of profits only.⁷⁴ All of this suggests that HMRC and the Treasury accept that the scope of CFC income attribution should be restricted to situations involving *artificial* diversion of profits abroad and should not encompass other profits that are genuinely earned abroad. We consider later how well the current rules are aligned with that objective and how the new rules might be better aligned.

Unlike the UK, in Canada there are very few official pronouncements with respect to the intention of CFC legislation (or corporate tax generally), thus one must look to reports of independent bodies appointed by government.⁷⁵ In 1998 the Technical Committee on Business Taxation characterized Canada’s FAPI provisions as ‘an anti-

⁷¹ Foreign Profits Discussion (n 54) [1.6], [2.18], [4.1].

⁷² Available at <www.hm-treasury.gov.uk/consult_foreign_profits.htm>.

⁷³ CFC Principles Document (n 55) [16] and [29]; CFC Discussion (n 55) [1.7]–[1.9].

⁷⁴ HM Treasury and HMRC, *Corporate Tax Reform: Delivering a More Competitive System* (HM Treasury, London, November 2010) <www.hm-treasury.gov.uk/corporate_tax_reform.htm> (Corporate Tax Reform) 14, 25–26.

⁷⁵ The deficiencies in Canada’s international tax policy process, in particular the secrecy under which the Department of Finance develops legislative amendments, have been widely criticized: eg Submission of the Tax Executives Institute to the Advisory Panel on Canada’s System of International Taxation (2008) <www.apcsit-gerefi.ca/index-eng.html> 3–5; BJ Arnold, *Reforming Canada’s International Tax System: Toward Coherence and Simplicity* (Canadian Tax Foundation, Toronto 2009) 23–28.

avoidance regime’ which is designed to ‘safeguard the Canadian tax base by preventing taxpayers from diverting income abroad’.⁷⁶ This suggests an anti-avoidance rationale, although the word ‘diverting’ is ambiguous. The Canadian Advisory Panel Report of 2008 is also equivocal regarding the purpose of the FAPI rules and related anti-deferral regimes; it states that the aim of these provisions is to prevent ‘erosion’ of the domestic tax base caused by ‘Canadian resident taxpayers transferring passive investments and certain business activities to foreign entities to avoid or defer the Canadian tax otherwise payable’.⁷⁷ This language leaves open to interpretation whether, in the Panel’s view, some fiscal neutrality goal is present.

More incisive than the Advisory Panel Report is Arnold’s recent evaluation of Canada’s international tax system; he concludes that, while the FAPI provisions may originally have been intended to counteract certain forms of corporate deferral, they are now seen primarily as measures to prevent abuse of Canada’s foreign dividend exemption.⁷⁸ This characterization of the purpose of the CFC regime is better than any other, but there are two problems with it. First, the rules do a poor job of actually preventing abuses of the dividend exemption, largely due to the broad exclusion for inter-affiliate payments.⁷⁹ Second, the policy basis for the CFC rules has been corrupted by the recent amendment deeming *all* income earned by a foreign affiliate in a state to be FAPI if that state does not have a tax treaty or TIEA with Canada and does not enter

⁷⁶ Technical Committee on Business Taxation, *Report of the Technical Committee on Business Taxation* (Department of Finance, Ottawa 1998) (Mintz Report) 6.19.

⁷⁷ Advisory Panel on Canada’s System of International Taxation, *Final Report: Enhancing Canada’s International Tax Advantage* (Department of Finance, Ottawa, December 2008) <www.apcsit-gcrfi.ca/index-eng.html> (Advisory Panel Report) [4.80]–[4.82].

⁷⁸ Arnold 2009 (n 75) 139–40.

⁷⁹ Text to nn 159–163.

into a TIEA with Canada within five years of being invited to do so.⁸⁰ This amendment is the negative aspect of the so-called ‘carrot and stick’ incentives directed at tax havens by the Canadian government; the beneficial aspect is the amendment linking dividend exemption to the negotiation of a TIEA.⁸¹ These amendments serves no tax policy purpose other than to induce tax haven countries to conclude TIEAs with Canada.⁸²

Aside from this deliberate policy distortion in Canada, it seems that the essential purpose of the Canadian and UK legislation – at least today – is to prevent the artificial diversion of profits to, or the artificial location of profits in, CFCs. Where revenue authorities or commentators refer to ‘deferral’ it can be assumed that the deferral contemplated is equivalent to artificial diversion of profits abroad. The critical question is what we mean by ‘artificial’.

5.2.4 International Law Implications

5.2.4(a) Acceptance of CFC Legislation in Practice

It is fair to say that there has been a gradual acceptance of CFC regimes as a matter of customary international law, evidenced by the spread of the US Subpart F rules to numerous other states in the late twentieth century. Avi-Yonah explains that, although the extension of domestic tax jurisdiction to encompass income of foreign entities would traditionally have been seen to violate international legal norms, and although MNEs complained vigorously that CFC rules would hinder their competitiveness,

⁸⁰ ITA s 95(1) ‘foreign accrual property income’, ‘non-qualifying business’, ‘non-qualifying country’, as amended or inserted by SC 2007 c 35 s 26, applicable after 2008.

⁸¹ ITR 1977 reg 5907(11), as amended by SC 2009 c 2 s 112, applicable after 2007. Also see ch 3 text to nn 95–97.

⁸² On this issue the Advisory Panel and Brian Arnold agree: they recommend that the government should cease linking the FAPI regime (as well as the dividend exemption) to the negotiation of a treaty or TIEA: Advisory Panel Report (n 77) [4.35]–[4.45]; Arnold 2009 (n 75) 69–74.

norms and attitudes evolved such that CFC rules should now be considered an accepted feature of the international tax system.⁸³

5.2.4(b) *Consistency of CFC Legislation with Tax Treaties*

As evidence of the customary acceptance of CFC legislation, some observers point to the fact that most existing tax treaties do not bother confirming the application of either state's CFC regime. Canada is an exception, in that it tends to codify the validity of its CFC legislation through express provisions in its treaties.⁸⁴ The current commentary⁸⁵ to the OECD Model Tax Convention,⁸⁶ incorporating revisions made in 2003, states that CFC provisions are now internationally recognized as a legitimate instrument to protect the domestic tax base; according to the OECD a tax treaty need not 'clarify' that such rules are consistent with the treaty.⁸⁷ Despite the position of the OECD, academic disagreement continues regarding the compatibility of CFC legislation with treaty obligations where such compatibility is not expressly confirmed.⁸⁸ The usual argument is that taxing domestic shareholders of foreign corporations on an accrual basis conflicts with the business profits article (Article 7 in the OECD Model) or the dividends article

⁸³ RS Avi-Yonah, 'International Tax as International Law' (2004) 57 Tax Law Rev 483, 486–90; cf Picciotto (n 5) 146.

⁸⁴ eg *Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains* (1978) (as amended through 2003) Art 27[3]. The UK generally has not insisted on such provisions, but see *Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains* (2003) Art 25[6], modified by Exchange of Notes LGB 03/170 (2003).

⁸⁵ OECD, *Commentaries on the Articles of the Model Tax Convention* (OECD, Paris 2010) (OECD Commentary).

⁸⁶ OECD, *Model Tax Convention on Income and on Capital* (OECD, Paris 2010) <www.oecd.org/ctp/tt/mtc> (OECD Model).

⁸⁷ OECD Commentary (n 85) Art 1 [23], 7 [14], 10 [37].

⁸⁸ For discussion see: D Sandler, *Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundaries* (Kluwer, The Hague 1998); Lang et al (n 34); S van Weeghel, 'General Report' in IFA 2010 Congress (n 59) 19–20, 29–32.

(Article 10 in the OECD Model). In the author's view there is little justification for these arguments. The practice of taxing domestic shareholders in respect of their share of the undistributed profits of a CFC is entirely consistent with the wider view of a state's jurisdiction to tax, which sees that jurisdiction as almost unlimited; yet it is also compatible with the more constrained view of such jurisdiction.⁸⁹ There is both a technical reason and a broader international tax policy reason for this compatibility.

The technical reason that CFC legislation accords with a state's jurisdiction to tax generally, and with its treaty obligations specifically, is that the domestic state does not purport to tax foreign corporations on their foreign income, but rather taxes the controlling shareholders on deemed accretions to their wealth. The decision in *Bricom Holdings Limited v IRC*⁹⁰ is instructive. That case involved a disputed CFC charge in respect of UK source interest income earned by a Netherlands subsidiary of a UK parent. The key issue was whether the UK should be prevented from levying a CFC charge related to the interest income when the subsidiary itself was taxable in respect of UK source interest only in the Netherlands under the UK–Netherlands tax treaty.⁹¹ The Special Commissioners and the Court of Appeal correctly held that the charge imposed by ICTA 1988 subsections 747(3) and (4) arises on an apportioned share of the CFC's notional 'chargeable profits', computed as if the CFC had been resident in the UK and had made all the necessary claims for relief; the charge does not represent a tax on profits of the CFC itself.⁹² Accordingly, the taxpayer could not rely on the treaty to displace the CFC rules. Some commentators maintain that *Bricom* is not dispositive of

⁸⁹ Arnold 1986 (n 5) 71–72. The jurisdiction to tax is discussed in ch 2 text following n 13.

⁹⁰ [1996] STC (SCD) 228, aff'd [1997] STC 1179 (CA).

⁹¹ *Convention between the United Kingdom of Great Britain and Northern Ireland and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains* (1980) (as amended through 1989; terminated 2011) Art 11[1].

⁹² *Bricom* (n 90) 1195–97; cf OECD Commentary (n 85) Art 7 [14].

the issue, but courts around the world continue to reach much the same conclusion as to the technical compatibility of their own CFC provisions.⁹³

Aside from technical arguments concerning the identity of the taxpayer and the nature of the tax liability, there is a broader justification for CFC legislation in international law. The willingness of the international community to tolerate CFC regimes exists because such regimes largely focus on ‘abusive’ arrangements rather than imposing some unilateral policy of worldwide taxation. The OECD Commentary suggests that CFC rules are compatible with tax treaties because they are an example of domestic anti-avoidance rules directed at abusive situations, specifically the use of ‘base companies’ to avoid tax in the residence state.⁹⁴ Disappointingly, the OECD Commentary goes on to say that states adopting CFC provisions in their domestic tax laws ‘seek to maintain the equity and neutrality of these laws in an international environment characterised by very different tax burdens’ and suggests that CFC rules should not apply where there is comparable taxation in the subsidiary’s state.⁹⁵ The statement is disappointing because it is clearly based on a CEN / protectionist rationale rather than an anti-avoidance rationale. The relative rate of taxation may raise questions about the motivation for establishing an affiliate in a particular place but is, in itself, a poor indicator of artificiality. It is notable that Belgium, Ireland, Luxembourg, the Netherlands, and Switzerland have entered observations on this part of the OECD Commentary, arguing that it is unjustified to make a blanket conclusion that CFC regimes comply with treaty obligations.⁹⁶ One may be suspicious of these states’

⁹³ IFA 2010 Congress (n 59) 29–32; BJ Arnold, ‘Tax Treaty News: Tax Treaties and Controlled Foreign Corporation Rules’ (2010) 64 BIT 306.

⁹⁴ OECD Commentary (n 85) Art 1 [22]–[23].

⁹⁵ OECD Commentary (n 85) Art 1 [26]. This view appears to be drawn from OECD 1987b (n 10) [47].

⁹⁶ OECD Commentary (n 85) Art 1 [27.4]–[27.9].

motives in making such observations, given that none of them have enacted CFC legislation and all are known as favourable locations for international holding companies. Nonetheless, there is merit in their position inasmuch as it acknowledges that current CFC legislation may undermine some arrangements where there has been no artificial diversion of profits.

In the author's view, the perceived 'abuse' targeted by CFC provisions subsists in the artificial separation of the location of taxable profits from the location of the economic interests that produced those profits. In other words, the rules tend to operate where the alleged 'foreign' character of the entity or its activities is artificial. The policy pronouncements made by the UK government between 2007 and 2010 regarding CFC reforms suggest that they agree with this view, although it has not been articulated as well as it might have been.⁹⁷ Avi-Yonah has opined that CFC rules are consistent with tax treaty obligations because they are an extension of residence-based jurisdiction to cover 'foreign' entities that are not genuinely foreign. He states that the authority to determine an entity's residence for treaty purposes stems from the authority of each state to determine an entity's residence under domestic law, which is confirmed by Article 4, not Article 7, of the OECD Model.⁹⁸ This seems to be an accurate explanation of what CFC rules are *trying* to do. The conceptual difficulty is that the rules do not operate by defining or re-defining the residence of ostensibly foreign entities. Oliver has argued that much of the initiative for the introduction of the UK CFC regime was 'an understandable reluctance to tinker with residence definitions',⁹⁹ which is evident from

⁹⁷ Text to nn 71–74.

⁹⁸ Avi-Yonah 2008 (n 31) 472.

⁹⁹ JDB Oliver, 'The OECD Model and Controlled Foreign Company Regimes' (1995) *Intertax* 556, 556–57.

the 1981 and 1982 consultation documents published by the Inland Revenue.¹⁰⁰ According to Oliver, if residence tests are satisfied and if there is no challenge to the transfer pricing between the entities, the compatibility of CFC regimes with tax treaties is questionable because it amounts to ‘attack[ing] the foreign company’s profits by the back door’.¹⁰¹ Put another way, CFC attribution amounts to attacking the foreign company’s residence by the back door. This should be considered a legitimate exercise of international tax jurisdiction if the foreign residence of the entity is artificial – that is, if it is not based on genuine attachment to the foreign state.

5.2.4(c) *Consistency of CFC Legislation with EU Law*¹⁰²

For the UK and other EU member states, a technical absence of conflict between its CFC rules and its bilateral treaty obligations does not ensure that its rules are compatible with EU law. In this context the broader issue of the legitimacy of CFC income attribution comes into focus.

The now famous decision of the European Court of Justice (ECJ) in *Cadbury Schweppes*¹⁰³ involved the application of the UK CFC provisions to a UK parent company in respect of the profits of two Irish subsidiaries carrying out group financing services, those profits being subject to a special Irish tax rate of ten per cent. Each subsidiary was a ‘controlled foreign company’ as defined in ICTA 1988 and did not benefit from any statutory exemption. It was conceded that the subsidiaries had been formed in Ireland largely for tax reasons. The ECJ applied the principle, derived from

¹⁰⁰ Text to nn 25–28.

¹⁰¹ *ibid* 557.

¹⁰² A wider discussion of EC Treaty freedoms and tax law is far beyond the scope of this chapter. For further analysis see: Lang et al (n 34); J Ghosh, *Principles of the Internal Market and Direct Taxation* (Key Haven, Oxford 2007); R de la Feria and S Vogenauer (eds), *Prohibition of Abuse of Law: A New General Principle of EU Law* (Hart, Oxford 2011) [forthcoming].

¹⁰³ Case C-196/04 *Cadbury Schweppes plc and anor v IRC* [2006] STC 1908 (ECJ).

earlier cases including *Centros*¹⁰⁴ and *Inspire Art*,¹⁰⁵ that freedom of establishment under Articles 43 and 48 of the EC Treaty¹⁰⁶ guarantees the liberty of EU nationals to establish companies or branches in other EU states, even if the sole purpose for establishing there is to enjoy more favourable legislation. The Court concluded that the UK regime for attributing CFC income, when applied to a company resident in an EU member state, constitutes a restriction on the freedom of establishment.¹⁰⁷ The Court went on to hold that such restriction is not justified on the grounds of prevention of abuse, except where the restriction relates to ‘wholly artificial arrangements which do not reflect economic reality’ and which are intended to escape the national tax normally payable.¹⁰⁸

The question that arises is what is meant by the term ‘wholly artificial arrangement’. The Advocate General’s opinion in *Cadbury Schweppes* was that the artificiality of an arrangement must be determined on a case-by-case basis and with reference to objective factors alone (contrary to the submissions of the UK government).¹⁰⁹ The ECJ seems to have accepted that artificiality could be discerned partly from a subjective element – the intention of obtaining a tax advantage by establishing the CFC. Nonetheless, the judgment indicates that artificiality is

¹⁰⁴ Case C-212/97 *Centros Ltd v Erhvervs-og Selskabsstyrelsen* [2000] All ER (EC) 481 [27].

¹⁰⁵ Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* [2003] All ER (D) 64 [95]–[96].

¹⁰⁶ Now *Treaty on the Functioning of the European Union* (Consolidated version, OJ 2010/C 83/47) <<http://eur-lex.europa.eu/en/treaties/index.htm>> (TFEU) Arts 49 and 54.

¹⁰⁷ *Cadbury Schweppes* (n 103) [46]. It is significant that the Court based its decision on the freedom of establishment rather than the free movement of capital (EC Treaty Art 56, now TFEU Art 63), as the former freedom does not extend to third states while the latter freedom does. Thus taxpayers cannot complain that the application of a member state’s CFC provisions interferes with their ability to establish subsidiaries in non-member states, a category that includes many tax havens. For further discussion see: S den Boer, ‘Freedom of Establishment versus Free Movement of Capital: Ongoing Confusion at the ECJ and in the National Courts?’ (2010) 50 *European Taxation* 250; M O’Brien, ‘Canada, Capital Movements, and the European Union: Some Tax Implications’ (2009) 57 *CTJ* 259.

¹⁰⁸ *Cadbury Schweppes* (n 103) [55], [75].

¹⁰⁹ *Cadbury Schweppes* (n 103) Advocate General’s Opinion [110]–[117].

predominantly an objective test: the Court concluded that an absence of artificiality could be proven ‘on the basis of objective factors which are ascertainable by third parties’, particularly the existence of staff, premises, and equipment in the host state.¹¹⁰

Although the extensive commentary¹¹¹ on *Cadbury Schweppes* has tended to focus on the words ‘wholly artificial arrangement’, the Court’s earlier observations on the purpose of the freedom of establishment are crucial:

[F]reedom of establishment is intended to allow a Community national to participate, on a stable and continuous basis, in the economic life of a member state other than his state of origin and to profit therefrom. ...

Having regard to that objective of integration in the host member state, the concept of establishment within the meaning of the Treaty provisions on freedom of establishment involves the actual pursuit of an economic activity through a fixed establishment in that state for an indefinite period Consequently, it presupposes actual establishment of the company concerned in the host member state and the pursuit of genuine economic activity there.¹¹²

It is significant that the ECJ borrowed the concept of ‘participating on a stable and continuous basis in the economic life of a member state’ from earlier cases regarding provision of services by individuals. The Court thus conceptualized corporate establishment by analogy to individual establishment, manifesting a real entity view of the corporation¹¹³ and recalling Lord Loreburn’s articulation of corporate residence in *De Beers* (where the company ‘keeps house and does business’).¹¹⁴

¹¹⁰ *Cadbury Schweppes* (n 103) [64]–[70], [75].

¹¹¹ eg P Simpson, ‘*Cadbury Schweppes Plc v IRC*: the ECJ sets strict test for CFC legislation’ [2006] BTR 677; G Meussen, ‘*Cadbury Schweppes*: The ECJ Significantly Limits the Application of CFC Rules in the Member States’ (2007) 47 *European Taxation* 13; G Maisto, P Pistone, and others, ‘A European Model for Member States’ Legislation on the Taxation of Controlled Foreign Subsidiaries (CFCs) – Part 1’ (2008) 48 *European Taxation* 503 and ‘Part 2’ (2008) 48 *European Taxation* 554.

¹¹² *Cadbury Schweppes* (n 103) [53]–[54]; cf Advocate General’s Opinion [42].

¹¹³ Ch 3 text to nn 24–27.

¹¹⁴ *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455, 458, discussed in ch 4.

In its later discussion of the anti-abuse justification for breaching freedom of establishment, the ECJ observed that the use of a ‘letterbox’ or ‘front’ subsidiary would be a wholly artificial arrangement in respect of which a state could legitimately curtail that freedom.¹¹⁵ What this really means is that a letterbox company is not an ‘establishment’ at all, again recalling *De Beers* and subsequent decisions that disregarded incorporation as an indicator of residence. Ghosh has convincingly argued that the essential issue in *Cadbury Schweppes* is not justification of a breach of an EC Treaty freedom – it is about whether the freedom has been exercised.¹¹⁶ In other words, rather than treating a wholly artificial CFC arrangement as some ‘abuse’ of the freedom of establishment, we should regard it as a failure to establish in the CFC’s ostensible state of residence. If one accepts that the motive of the taxpayer in establishing the CFC is irrelevant, then in the author’s view there is no answer to this argument; a wholly artificial arrangement is synonymous with a lack of actual establishment.

Of course, the Court in *Cadbury Schweppes* did not employ such an analysis, having addressed the use of ‘letterbox’ companies in the context of abuse and justification. This has led to an unfortunate state of confusion in the EU that is as yet unresolved. Ghosh complains that the tendency to conflate the concepts of breach and justification led to the ‘unintelligible’ judgment of the High Court in *Vodafone 2*,¹¹⁷ discussed further below. While there is as yet no common understanding of the meaning of ‘abuse’ and ‘wholly artificial arrangements’,¹¹⁸ many EU states including the UK have amended their CFC rules such that they are disappplied for companies in EU (or

¹¹⁵ *Cadbury Schweppes* (n 103) [68].

¹¹⁶ J Ghosh, ‘*Cadbury Schweppes*: Breach, Abuse Justification, and Why They Are Different’ in de la FERIA and Vogenauer (n 102).

¹¹⁷ *Vodafone 2 v Revenue and Customs Commissioners (No 2)* [2008] STC (SCD) 55, rev’d [2008] EWHC 1569, [2008] STC 2391 (Ch), rev’d [2009] EWCA Civ 446, [2009] STC 1480 (CA).

¹¹⁸ For extensive analysis see de la FERIA and Vogenauer (n 102).

EEA) states if they are ‘actually established’ there, usually by reference to premises, staff, and management.¹¹⁹

The implication of *Cadbury Schweppes* is that CFC income should be taxed exclusively in the foreign state if the CFC is a full participant in that state’s economy, and may be taxed in the parent’s home state if the CFC does not actually participate in the foreign state’s economy. The ECJ placed little or no emphasis on the tax rate in the subsidiary’s state (irrelevant), the type of activity performed by the subsidiary (irrelevant), or the shareholders’ motives for establishing the subsidiary (minimal relevance). Everything turns on whether the subsidiary genuinely participates, on a stable and continuous basis, in the economic life of its alleged residence state.

Unfortunately the ECJ did not elaborate on what genuine participation involves or what the opposite of genuine participation – a wholly artificial arrangement – would look like. No doubt, many MNEs and their advisers will argue that residence based on incorporation under the relevant domestic law constitutes genuine participation. But that cannot be right as a matter of international tax policy. Consistent with the principles addressed in Part I of this thesis, a corporation genuinely participates in the economic life of its alleged residence state only where it has a real and substantial economic interest there, arising from the efforts of individuals who really work there – what was referred to as the ‘home source’. A CFC that consists of a letterbox or a bank account is not a genuine participant according to this standard, thus it is entirely appropriate to attribute ‘its income’ to the people who earned the income. Moreover, reading *Cadbury Schweppes* in this way demonstrates how CFC legislation would ideally function, not only in the EU context of ensuring freedom of establishment, but in the wider

¹¹⁹ For further detail see Maisto et al (n 111). The UK amendments are discussed at text to nn 139–140.

international tax policy context of ensuring an equitable allocation of tax jurisdiction between home and host states. Thus, a CFC regime that required accrual taxation exclusively for artificial corporate establishments would be consistent with bilateral treaty obligations and international taxing rights more generally.

5.3 THE IMPRECISE SCOPE OF CFC LEGISLATION

5.3.1 Overview

Accepting that the only legitimate rationale for CFC legislation is to prevent ‘abusive’ or ‘wholly artificial’ structures – that is, structures involving artificial diversions of profits to ostensibly foreign entities – we should ask how well the UK and Canadian CFC regimes align with that rationale. It was explained above that this is purported to be the rationale of the legislation. The difficulty is that the existing CFC rules reach beyond the objective of preventing artificial relocation of taxable profits while at the same time ignoring many artificial relocations.

The UK and Canadian regimes are flawed in two ways. First, the definitions of ‘exempt activity’ (in the UK) and ‘active business’ (in Canada) are based on the proposition that certain income-generating activities, such as insurance, financing, distribution, and other intra-group services, cannot be carried out by a CFC without having been ‘artificially’ transposed from the shareholder’s home jurisdiction. The effect is to treat foreign companies carrying out these activities as if their real business originates from, or should have remained in, the home country. Seeking to tax income from real activities is justified – although this should occur for all types of activity – whereas taxing income from imagined activities is not. The second flaw consists in the existence and application of so-called ‘motive tests’. These provisions indicate that, where the subjective purpose or reason underlying some arrangement is to reduce the

tax burden facing an enterprise, the arrangement is necessarily ‘artificial’. These presumptions about artificiality are likely to be correct in many cases, yet they will not invariably be so. Accordingly, a regime based on such presumptions will not always further the legitimate objective of preventing artificial relocation of taxable profits, either in the EU context or in the wider context of equitable allocations of taxing rights.

5.3.2 Demarcation of ‘Acceptable’ and ‘Tainted’ Businesses

Let us consider the types of activity or business that, according to default rules in the UK and Canadian CFC legislation, are presumed to involve an artificial diversion of profits. The first and more obvious category comprises ‘activities’ that are entirely passive: the UK and Canadian regimes provide for accrual taxation of income from most foreign portfolio investment (FPI), although the UK regime does not apply to capital gains¹²⁰ and the Canadian rules exclude certain capital gains arising from active business assets.¹²¹ From the perspective of inter-person and inter-nation equity, accrual taxation of FPI income is justified if one believes that a significant element of the economic interest in FPI rests with those who provide the investment capital.¹²² It would seem that many states do believe this, given that the primary right to tax income from FPI has typically been awarded to the investor’s state of residence under tax

¹²⁰ ICTA 1988 para 747(6)(b). This means that UK groups can hold shares in foreign subsidiaries through foreign holding companies, avoiding UK corporation tax on any gains arising from disposals of the subsidiary shares by realizing such gains offshore (unless the close company rules in TCGA 1992 ss 13–14 apply, which is unlikely, and subject to the anti-avoidance rule in TCGA 1992 s 137). The OECD has questioned why the UK does not apply its CFC rules to capital gains: OECD 1996 (n 32) 53–54. Nonetheless, the government will continue to exclude capital gains when the CFC legislation is revised: CFC Discussion (n 55) [2.8].

¹²¹ FAPI includes half of any capital gain from the sale of property that is not ‘excluded property’: ITA 1985 s 95(1). In the main, the excluded property of a foreign affiliate is property used principally to earn active business income and shares of another foreign affiliate where substantially all of the property of the other affiliate is excluded property.

¹²² Avi-Yonah 1996 (n 14) 1308–10.

treaties, and that the use of offshore investment fund regimes is widespread.¹²³ It is less clear whether accrual taxation of income earned by CFCs from ‘investment businesses’ or from other ‘base company service businesses’ is justified.

Addressing all of the rules contained in the UK or Canadian legislation which demarcate acceptable activities or businesses from tainted activities or businesses is beyond the scope of this chapter. The provisions are so detailed that even past national reports dealing predominantly with description of the CFC legislation have not attempted more than a summary.¹²⁴ The goal here is to draw attention to the fact that, for a particular type of activity to escape tainted status because it is considered an ‘exempt activity’ (under UK law) or an ‘active business’ (under Canadian law), there is often some requirement that the CFC carrying on that activity be established on a substantial basis in its territory of residence. In essence, UK and Canadian CFC legislation is based on the premise that income from certain mobile activities should not be considered artificially diverted – and thus not subject to attribution – where the CFC is meaningfully established in its state of ostensible residence. The converse implication is that income from listed activities will be considered artificially diverted where the CFC is not meaningfully established in its ostensible state of residence. In principle this anti-avoidance approach is unobjectionable, as it seeks to align tax jurisdiction with actual economic interests. Unfortunately, both systems seem to misconstrue the anti-avoidance objective by focusing on other, irrelevant factors.

¹²³ IFA 2001 Congress (n 18) 44; Advisory Panel Report (n 77) [4.7], [4.91].

¹²⁴ IFA 2001 Congress (n 18); Lang et al (n 34).

5.3.2(a) *UK Legislation – Exempt Activities*

The basic structure of the current CFC rules in the UK remains substantially the same as it was in 1984. The key charging provisions are sections 747 and 752 of ICTA 1988, which apportion chargeable profits and creditable tax to UK residents in respect of the income of CFCs in which they have a relevant interest. As mentioned above, a CFC is defined as a company which is resident outside the UK, is controlled by persons resident in the UK, and is subject to a ‘lower level of taxation’ in its territory of residence.¹²⁵ Assuming that the requisite elements of foreign residence, control, and lower level of taxation are met, the profits of the CFC may be attributed to the controlling UK shareholders in proportion to their relevant interests in the CFC.¹²⁶ A UK corporate shareholder is liable for an amount equivalent to corporation tax on the apportioned profits, less any creditable tax, provided that the aggregate share of the CFC’s profits attributable to that company and to connected or associated persons is at least 25 per cent of the total.¹²⁷

On its face, section 747 requires apportionment of all income of foreign subsidiaries, the only threshold being the ‘lower level of taxation’ criterion. This would bring a massive number of foreign corporations within the CFC regime but for section 748, which sets out three objective exemptions and a final, subjective exemption.¹²⁸ No attribution of CFC income is made under section 747 if throughout the relevant accounting period the CFC is engaged in ‘exempt activities’, its chargeable profits do

¹²⁵ ICTA 1988 ss 747(1), 747(2).

¹²⁶ ICTA 1988 ss 747(3), 752.

¹²⁷ ICTA 1988 s 747(4), 747(5).

¹²⁸ ICTA 1988 paras 748(1)(b), (d), (e) and s 748(3), derived from FA 1984 ss 83(1)–(3). The former exemption based on ‘public quotation’ was repealed by FA 2007 because the government believed it was being used for highly artificial avoidance. The former exemption based on the CFC having an ‘acceptable distribution policy’ was repealed by FA 2009 in conjunction with the move to dividend exemption.

not exceed a de minimis amount of £50,000, or it is resident in a territory listed in the Excluded Countries Regulations and meets other conditions specified in those regulations. Even if none of these objective exemptions apply, a taxpayer may rely on the so-called ‘motive test’. The result of the exemptions is that in practice only a small share of CFCs are affected by the apportionment provisions.

The important exemption for present purposes is the exempt activities test.¹²⁹ This exemption reflects the idea that the CFC regime was not intended to apply to a foreign company that has a substantial presence in its residence state and either carries on genuine trading activities there or serves as a holding company deriving a substantial majority of its income from other exempt companies.¹³⁰

To qualify for this exemption there are two threshold conditions which must be satisfied throughout the accounting period: (i) the company must have a ‘business establishment’ in its territory of residence; and (ii) its business affairs must be ‘effectively managed’ there.¹³¹ These criteria appear to be designed to amplify the traditional legal tests of residence by requiring the CFC to have more substantive connections to its territory of residence in order to benefit from the exemption. First, a business establishment requires ‘premises’ that are, or are intended to be, occupied and used with a reasonable degree of permanence and from which the CFC’s business is wholly or mainly carried on; the ‘premises’ definition is almost identical to the treaty concept of permanent establishment.¹³² Second, the effective management of affairs

¹²⁹ ICTA 1988 para 748(1)(b).

¹³⁰ Inland Revenue 1981b (n 28) [5], [10]–[11], where the proposed exemption was referred to as the ‘genuine trading test’; Inland Revenue 1982 (n 28) [32], [40]–[41], where the name was changed to the ‘exempt activities test’.

¹³¹ ICTA 1988 sched 25 pt II paras 6(1)(a)–(b), derived from FA 1984 sched 17 pt II.

¹³² ICTA 1988 sched 25 pt II para 7.

requires that there be sufficient employees in the territory to deal with the CFC's worldwide business and, generally, that services provided to any persons resident outside the CFC's territory not be performed in the UK unless the relevant income is subject to UK taxation.¹³³ It is notable that, in its consultation document published in late 1981, the Inland Revenue had proposed a requirement that the business affairs of the CFC be 'independently controlled and managed' in its territory of residence, which would not be the case unless 'both the general direction of the company's affairs and its day to day management are in the hands of persons working in that territory who act independently of persons who are not resident there'.¹³⁴ It seems that this test was considered too robust and thus, in its 1982 consultation document, the Inland Revenue changed the 'independently controlled and managed' condition to the requirement that the CFC's 'business affairs in that territory are effectively controlled and managed there'.¹³⁵ This was later shortened to the requirement of effective management alone.

Assuming that these threshold conditions are met, there are further conditions regarding the CFC's main business and sources of income that must also be satisfied. There is no attempt in the legislation to define 'exempt activities'; instead the rules specify certain activities that are not exempt. These tainted activities are an 'investment business', dealing in goods for delivery to or from the UK or to or from connected or associated persons, and any wholesale, distributive, financial, or service business where 50 per cent or more of the gross trading receipts is derived from specified persons, including connected or associated persons.¹³⁶ This list includes a range of activities

¹³³ ICTA 1988 sched 25 pt II para 8.

¹³⁴ Inland Revenue 1981b (n 28) sched 1 ss 5(1)(b), 7.

¹³⁵ Inland Revenue 1982 (n 28) sched 1 ss 5(1)(b), 7.

¹³⁶ ICTA 1988 sched 25 pt II paras 6(1)(c), 6(2), 6(2A), 6(9), 6(11), derived from FA 1984 sched 17 pt II. Special rules apply to banking and insurance businesses, where the 50 per cent gross trading receipts test is modified.

which one might think could legitimately be carried on abroad, including leasing, shipping and air transport, banking, and insurance. The inclusion of international shipping and air transport services is particularly suspect: the rule seems to be designed to reverse the standard allocation of tax jurisdiction over profits from international shipping under Article 8 of most tax treaties, from the state where the shipping enterprise is effectively managed, to the UK if that is where the controlling shareholders reside.¹³⁷ Effective March 2000, the list of wholesale, distributive, and financial businesses was expanded to include the provision of any ‘services’ not yet covered.

In the last four years there has been a flurry of activity designed to ameliorate the CFC regime, including amendments to the exempt activities test. First, there were a number of measured responses introduced by the Finance Act 2007, driven largely by the decision in *Cadbury Schweppes*.¹³⁸ The revised rules enable a UK company to apply for its attributed CFC profits to be reduced, to the extent that the amount represents the ‘net economic value’ created by the efforts of individuals working for the CFC in business establishments in other EU member states (or in EEA states with which the UK has a TIEA).¹³⁹ Further, the exempt activities rules were modified such that a slightly different ‘effectively managed’ condition now applies to CFCs resident in other EU member states or EEA states: there must be sufficient individuals working for the company in the state who have the competence and authority to undertake all, or substantially all, of the company’s business.¹⁴⁰ The concept of business establishment and the list of non-exempt activities did not change. Among other commentators, Baker argues that neither the previous version of the legislation nor the amended version is

¹³⁷ Jurisdiction over shipping profits is discussed in ch 2 text to n 77 and ch 4 text to nn 133, 138.

¹³⁸ Text following n 102.

¹³⁹ ICTA 1988 s 751A.

¹⁴⁰ ICTA 1988 sched 25 pt II paras 8(5)–(6).

consistent with freedom of establishment under the EC Treaty as construed in *Cadbury Schweppes*.¹⁴¹ He also questions why these changes were necessary when a more thorough review of the taxation of foreign income was underway.

These amendments were minor compared to the envisioned overhaul of the CFC regime. As noted above, in 2007 HMRC and the Treasury had proposed moving to an income-based ‘controlled companies’ regime applicable to both foreign and domestic subsidiaries,¹⁴² where the exempt activities test could be more appropriately targeted. This was an ill-conceived plan that was welcomed by no one and was subsequently discarded. The 2008 Pre-Budget Report and the Financial Secretary’s 2008 open letters stated that a reformed CFC regime would reflect a more ‘territorial’ approach, focusing on profits that have been ‘artificially diverted’ from the UK. The intended focus was appropriate; the problem is that the government continued to assume that the artificiality of an arrangement could be discerned not only from a lack of genuine establishment and activity but from the very nature of the business carried on. Specifically, the 2008 documents persevered with the notion from the Foreign Profits Discussion that ‘mobile’ activities carried on by CFCs were ‘by definition’ susceptible to artificial diversion.¹⁴³ Such mobile activities would be a subset of the current list of tainted activities in the exempt activities rules, such as leasing, IP management, shipping, and financing.

The more recent CFC Principles Document and CFC Discussion continue the trend of focusing on income from mobile activities. There the government states that the ‘optimal solution’ is to have a CFC regime that reflects a more territorial approach

¹⁴¹ P Baker, ‘Are the 2006 Amendments to the CFC Legislation Compatible with Community Law?’ [2007] BTR 1.

¹⁴² Foreign Profits Discussion (n 54) ch 4.

¹⁴³ Foreign Profits Discussion (n 54) [1.16], [4.12], [4.19], [4.28]–[4.30].

‘whilst retaining ownership as an underlying principle’.¹⁴⁴ As Devereux has argued, it is unclear what this statement means; indeed, the two parts of the alleged solution seem to be in direct opposition.¹⁴⁵ Possibly what the government is trying to say is that a proper ‘territorial’ approach must recognize that the shareholders’ home territory is one of the territories – and indeed may be the most significant territory – where the income of an ostensibly foreign entity is earned. The CFC Principles Document stresses that the greatest risk of artificial diversion of profits comes from ownership of highly mobile assets, particularly IP and monetary assets, not because there is something inherently bad about activities involving such assets, but because these are ‘activities that require relatively little substance in terms of associated physical activity and employees’.¹⁴⁶ Thus the real concern is that the foreign company be genuinely established and carrying on business in its ostensible territory of residence. In the author’s view, activities such as IP management and financing are highlighted not because of the nature of the activities, but because for these activities it is particularly easy for a MNE to create the appearance that they are carried on by an entity whose establishment lacks substance.

Accordingly, when the CFC rules are revised the author would prefer to see the exempt activities test maintained in a modified form. The elements of the test should consist exclusively of the threshold conditions of ‘business establishment’ and ‘effective management’, with no further conditions as to the type of business that is conducted by the CFC, be it manufacturing, shipping, financing, IP management, or any other business. Under current rules, the type of business carried on is either a proxy for determining genuine establishment, in which case it is superfluous, or it is an additional

¹⁴⁴ CFC Principles Document (n 55) [27]–[29]; cf CFC Discussion (n 55) [1.8]–[1.9].

¹⁴⁵ M Devereux, ‘Proposals for Controlled Foreign Companies Reform: a Tale of Two Principles’ [2010] BTR 111.

¹⁴⁶ CFC Principles Document (n 55) [33]; cf CFC Discussion (n 55) chs 3–4, where there is a lengthy discussion of what constitutes ‘active management’ of IP.

requirement beyond genuine establishment, in which case it is incompatible with EC law and inconsistent with an equitable allocation of taxing rights. At the same time, the elements required in order to demonstrate that the CFC actually has a business establishment in its territory and is effectively managed in its territory should be strengthened: the author respectfully disagrees with Baker's view that the 2007 amendments place undue emphasis on the efforts of individuals working for the CFC. This is key to demonstrating that the foreign company participates on a stable and continuous basis in the economic life of its purported home state. Further, it would be preferable to see the 'effectively managed' condition restored to the 'independently managed and controlled' condition proposed in 1981. This would avoid importing the confusion that surrounds the meaning of 'place of effective management'¹⁴⁷ (the residence preference criterion used in many tax treaties), while providing assurance that the income of wholly owned subsidiaries, whatever their alleged business, does not escape taxation in the state where the profits are generated. The intent of such an approach is to be neither friendly nor harmful to multinational business. The intent is to be compatible with EU law and consistent with an equitable allocation of taxing rights based upon real economic interests.

5.3.2(b) *Canadian Legislation – Active Businesses*¹⁴⁸

As noted above, the Canadian legislation operates by attributing to a shareholder resident in Canada, as income from its shares of a controlled foreign affiliate (CFC), a pro rata portion of any foreign accrual property income (FAPI) derived by the CFC.¹⁴⁹

Due to the definitions of 'foreign affiliate' and 'controlled foreign affiliate', the rules

¹⁴⁷ Ch 4 text to nn 140–154.

¹⁴⁸ See generally J Li, A Cockfield, and JS Wilkie, *International Taxation in Canada* (LexisNexis, Toronto 2006) ch 13; Arnold 2009 (n 75) ch 6.

¹⁴⁹ ITA 1985 s 91(1).

apply only to non-resident corporations controlled by a small group of Canadian shareholders, and result in attribution only to those shareholders who hold at least ten per cent of any class of shares of the corporation.

The Canadian CFC legislation is income-based rather than entity-based, meaning that one must determine for each CFC the extent of its ‘income from an active business’ (not FAPI), ‘income from property’ (FAPI), and ‘income from a business other than an active business’ (FAPI).¹⁵⁰ Unlike the UK regime, the Canadian legislation does not employ a list of reasonably clear exemptions.¹⁵¹ Instead one is forced to wrestle with a series of complex, conflicting, and sometimes incoherent provisions that deem certain types of income to be income from an active business and certain others to be income from what may usefully be called a non-active businesses. In 1995 the definition of FAPI was revised substantially and several new definitions and related deeming rules were added, supposedly to prevent abuses of the rules. As a result, the current distinctions between active and non-active businesses seem to have little connection to the level of ‘activity’ involved and are instead premised on countering certain kinds of tax avoidance transactions undertaken by MNEs while permitting and even promoting other such avoidance transactions.

Consider first the types of activity that the legislation treats as tainted: activities that produce income from property and activities that produce income from a non-active business. A foreign affiliate’s income from property is defined to include income from an ‘investment business’. In broad terms, this is a business the principal purpose of which is to derive income from property such as dividends, interest, and royalties,

¹⁵⁰ ITA 1985 s 95(1).

¹⁵¹ There is a de minimis exemption of \$5,000, which Arnold describes as ‘meaninglessly low’: Arnold 2009 (n 75) 141.

income from insurance, or other investment-like income.¹⁵² Such a business is exempted, however, if it is conducted principally with arm's length persons, the operator employs more than five employees full time in the active conduct of the business (or equivalent employees), and the business is one of those listed, including regulated banking, real estate development, lending of money, leasing, and insurance.¹⁵³ The exemption from the investment business classification is somewhat akin to the UK exempt activities test, in that it imposes a minimum presence threshold through the five employee requirement and imposes an arm's length dealing requirement.

A comparison cannot be drawn, however, with the Canadian rules that deem certain activities to be non-active businesses, because here there is no exemption based on the CFC having a minimum presence. Chief among these rules is paragraph 95(2)(b), which deems the provision of 'services' by a foreign affiliate to be non-active (thus giving rise to FAPI) if, in broad terms, amounts payable for those services are deductible in computing a taxpayer's Canadian business income or are in fact performed by the taxpayer or certain non-arm's length persons. This rule is intended to prevent erosion of the Canadian tax base but it is more narrow than it appears because of the restricted definition of 'services'.¹⁵⁴ Finally, there are four additional base erosion rules that were added to the legislation in 1995.¹⁵⁵ These rules deem the business of a foreign affiliate to be non-active (thus giving rise to FAPI) if, in broad terms, it consists of buying property offshore and reselling it into Canada for use in a Canadian business, insuring or reinsuring Canadian risks, or holding Canadian debt or lease obligations,

¹⁵² ITA 1985 s 95(1) 'income from property', 'investment business'. Note the absurd circularity in defining 'income from property' as income from a business, the principal purpose of which is to derive income from property.

¹⁵³ ITA 1985 s 95(1) 'investment business' and numerous supporting definitions.

¹⁵⁴ ITA 1985 s 95(3).

¹⁵⁵ ITA 1985 paras 95(2)(a.1), (a.2), (a.3), (a.4).

unless more than 90 per cent of the affiliate's gross revenue from the respective activity is derived from arm's length persons.

Canadian tax practitioners are well aware that compliance with the investment business and base erosion rules is difficult, in part because their scope is uncertain and they can conflict with the deemed active business rules addressed below. The Advisory Panel, having heard from business representatives that these rules are excessively broad, recommended that the rules be reviewed to ensure that they are properly targeted and that they do not hinder genuine business transactions or the competitiveness of Canadian MNEs.¹⁵⁶ Arnold has taken a contrary view, arguing that the base company services rule is too narrow and that the 1995 base erosion rules were necessary to deal with 'obvious abuses' of the legislation.¹⁵⁷ In the author's view, the obvious abuse at which these rules were targeted was the use of letterbox companies as alleged resale affiliates, insurance affiliates, financing affiliates, and the like, where the affiliate had no substantial existence and was adding no value apart from tax savings.¹⁵⁸ In the absence of sensible corporate residence rules, establishment and management conditions like those employed in the UK exempt activities test, and effective transfer pricing enforcement, the Department of Finance chose to target certain CFC activities on a wholesale basis rather than artificial arrangements specifically.

Just as Canadian CFC legislation is inappropriately punitive with respect to foreign affiliates providing sales or services into Canada, it is unjustifiably generous with respect to foreign affiliates providing services to other foreign affiliates. Paragraph 95(2)(a) provides that various profits earned by a foreign affiliate that would otherwise

¹⁵⁶ Advisory Panel Report (n 77) [4.110]–[4.125].

¹⁵⁷ Arnold 2009 (n 75) 142, 168–69.

¹⁵⁸ eg *Spur Oil Ltd v The Queen* [1981] DTC 5168 (FCA) and other cases mentioned in ch 7 text to nn 70, 120–122.

be income from property – including income from an investment business – are deemed to be income from an *active business*. Critically, the legislation deems the receipt of interest, rents, royalties, and similar payments by a foreign affiliate from another foreign affiliate to be active business income if the amounts are deductible by the second affiliate in computing its earnings from a foreign active business.¹⁵⁹ Unlike the five employee requirement in the exemption from investment business status, there is no minimum presence requirement that needs to be met in order for such a ‘business’ to be treated as active. The OECD has criticized this aspect of the Canadian regime, particularly in the context of banking transactions, arguing that it ‘effectively sanctions domestic banks to establish banking subsidiaries without any real business presence in target territories’.¹⁶⁰ Arnold observes that, although the inter-affiliate payments exemption has some justification, it also allows Canadian MNEs to establish offshore financing and licensing companies and easily avoid Canadian tax on group interest and royalties, particularly where the companies are resident in treaty haven countries (or TIEA countries).¹⁶¹ This rule, in conjunction with Canada’s interest deduction and dividend exemption provisions, is known to give rise to massive erosion of the Canadian tax base through the use of structures involving financing affiliates in treaty havens such as Barbados, Ireland, and the Netherlands.¹⁶² The Department of Finance had proposed legislation in 2007 to curtail such transactions but, in response to

¹⁵⁹ ITA para 95(2)(a)(ii).

¹⁶⁰ OECD 1996 (n 32) 50.

¹⁶¹ Arnold 2009 (n 75) 160–63.

¹⁶² A very common arrangement involves a parent company borrowing funds in Canada, the parent using those funds to subscribe for shares in a Barbados ‘international business company’, the Barbados entity loaning funds to other foreign affiliates who carry on some active business elsewhere, the active affiliates paying (deductible) interest to the Barbados entity, the Barbados entity paying tax at a rate between 1% and 2.5%, and the Barbados entity paying (exempt) dividends to the Canadian parent. The Canadian parent thus enjoys tax-free dividends while claiming a deduction for interest paid on the borrowed funds. For a more technical description and examples see M Huynh, E Lockwood, and M Maikawa, ‘The Anti-Tax-Haven Initiative and the Foreign Affiliate Rules’ (2007) 55 CTJ 655.

complaints that the proposed rules would be hinder international competitiveness, the legislation was narrowed and ultimately repealed before it became effective.¹⁶³

Leaving aside the issue of interest deductibility and analyzing the inter-affiliate payments exemption itself, how does it compare to the provisions that deem certain base eroding services to be non-active? Such a comparison reveals that the Canadian CFC regime is based on no coherent policy other than preventing the movement of certain activities offshore, without much regard to whether the offshore arrangement is artificial or genuine. If the arrangement involves providing certain base company services to related companies in Canada, it generally results in accrual taxation in Canada, whether the foreign affiliate is a letterbox or a substantial operation with local premises, management, and employees. If the arrangement involves providing the same base company services to related companies carrying on business in third states, it generally results in deferral or complete exemption in Canada, again whether the foreign affiliate is a letterbox or a substantial operation with local premises, management, and employees. The legislation as currently written suggests that Canada is not concerned about ‘artificial diversion’ at all; it is concerned about reductions in the Canadian tax base with respect to intra-group income that could have been generated in Canada, while remaining blissfully unconcerned about reductions in a foreign state’s tax base with respect to intra-group income that could have been generated in that state. This approach, as emphasized several times above, is far from ideal because it is not based on aligning tax jurisdiction with the location of economic interests. Were Canada an EU state, its CFC legislation would be completely incompatible with Community law.

¹⁶³ In the 2007 Budget, the government proposed to eliminate the deduction of any interest on debt incurred by a corporation to finance foreign affiliates. This proposal was considered extreme and thus was replaced by ITA 1985 s 18.2, which would have restricted the deductibility of interest in situations where a Canadian corporation uses borrowed funds to finance a foreign affiliate and a second deduction for that interest is available in a foreign state (‘double-dipping’). The provision was scheduled to take effect in 2012 but was repealed in 2009.

Canada is of course free to ignore Community law, but it should not continue to ignore the equitable international allocation of taxing rights.

5.3.3 Application of ‘Motive Tests’

The other key feature of the UK and Canadian CFC regimes that deserves attention is the inclusion of provisions that focus on the main purpose or reason for creating or transacting with a CFC. The UK ‘motive test’ operates as an exemption from income apportionment, while the Canadian provision functions as a targeted anti-avoidance rule. Thus, HMRC can refuse to apply the UK exemption, and the CRA can choose to apply the Canadian rule, in order to achieve accrual taxation of foreign income that in the revenue administration’s view could or should have been (but was not) earned in the shareholder’s home state. The experience of MNEs has been that these purpose-based tests are vague and may be used overzealously in order to disregard the effectiveness of structures involving foreign subsidiaries.¹⁶⁴ Whatever the extent of their use in practice, it is difficult to regard these rules as internationally legitimate, as they purport to allocate taxing rights based upon a taxpayer’s subjective purposes or reasons rather than objective economic interests.

5.3.3(a) The UK Motive Test

Assuming that a UK parent company cannot rely on the ‘exempt activities’ test, the de minimis profits exemption, or the excluded countries exemption, it may still be able to rely on subsection 748(3) of ICTA 1988, which provides that no CFC apportionment is to be made for an accounting period if:

¹⁶⁴ J Freedman, G Loomer, and J Vella, ‘Corporate Tax Risk and Tax Avoidance: New Approaches’ [2009] BTR 74, 92–97; EJ Johnson, GC Lille, and JR Wilson, ‘A Reasoned Response to the CRA’s Views on the Scope and Interpretation of Paragraph 95(6)(b)’ (2006) 54 CTJ 571.

(a) in so far as any of the transactions the results of which are reflected in the profits arising in that accounting period, or any two or more transactions taken together, the results of at least one of which are so reflected, achieved a reduction in United Kingdom tax, either the reduction so achieved was minimal or it was not the main purpose or one of the main purposes of that transaction or, as the case may be, of those transactions taken together to achieve that reduction, and

(b) it was not the main reason or, as the case may be, one of the main reasons for the company's existence in that accounting period to achieve a reduction in United Kingdom tax by a diversion of profits from the United Kingdom ...¹⁶⁵

It is notable that this rule refers to the main purpose or purposes of a transaction and the main reason or reasons for a CFC's existence, yet it is regularly referred to as the 'motive test'. The name 'motive test' originated in the 1981 consultation document¹⁶⁶ regarding the CFC proposals and continues to be used today by taxpayers, the government, and the courts.¹⁶⁷ The subtle distinction in meaning between purpose, reason, and motive has been the subject of commentary and case law.¹⁶⁸ Although interesting, for the purpose of the present discussion that distinction is not critical. What is critical is that subsection 748(3) excuses a UK company from an apportionment of CFC profits where the subjective purpose / reason / rationale underlying the particular arrangement is something other than a reduction in UK tax. If one of the main purposes of a transaction or one of the main reasons for a CFC's existence is to reduce UK tax, then assuming that none of the objective exceptions applies the income must be apportioned.

¹⁶⁵ There is a comparable purpose-based exemption from the anti-avoidance rules applicable to transfers of assets abroad: ICTA 1988 s 741, rewritten to ITA 2007 ss 736–742.

¹⁶⁶ Inland Revenue 1981b (n 28) [5], [14].

¹⁶⁷ See Freedman et al (n 164) 92; CFC Discussion (n 55) [2.15]–[2.17]; *Vodafone 2* (n 117) passim.

¹⁶⁸ eg JF Avery Jones, 'The Mental Element in Anti-Avoidance Legislation' [1983] BTR 22; R Shiers, 'ABTA: the nature of "main purpose"' [2003] BTR 212. The latter note discusses *Association of British Travel Agents Ltd v IRC* [2003] STC (SCD) 194, which contains a detailed analysis of the proper application of the CFC motive test but is not concerned with the policy of the exemption.

It is readily apparent the motive test, read literally, does little to ensure that the CFC regime will apply only to ‘wholly artificial arrangements’ as required by *Cadbury Schweppes* (insofar as EU member states are concerned). The motive test might have ensured compliance with that standard if the ECJ in *Cadbury Schweppes* had decided that a wholly artificial arrangement was an arrangement driven by a tax avoidance purpose, as opposed to an arrangement driven primarily by commercial considerations. But the Court did not decide that. On the contrary, the ECJ expressly confirmed that freedom of establishment under the EC Treaty guarantees the liberty of EU nationals to establish subsidiaries in other EU states based on the sole purpose of enjoying more favourable legislation, including tax legislation.¹⁶⁹ Unfortunately, because the ECJ seemed to confound the exercise of the freedom of establishment and the justifications for a legislative breach of that freedom, the ECJ went on to make the cryptic suggestion that the UK national courts must determine whether the wholly artificial arrangement standard could be implemented through a judicious interpretation of the motive test.¹⁷⁰ That suggestion was a non-sequitur, as it directed the national courts to consider legislative compliance or non-compliance with an objective standard based on their interpretation of an exemption that relies solely on subjective factors.

The assertion that the limitation of CFC legislation to wholly artificial arrangements could be achieved via the motive test was considered at length by the Special Commissioners, the High Court, and the Court of Appeal in the *Vodafone 2* litigation, with each level deciding the matter differently.¹⁷¹ The case involved the creation by Vodafone Group plc of a wholly-owned financing company resident in

¹⁶⁹ *Cadbury Schweppes* (n 103) [65]–[66], [75].

¹⁷⁰ *Cadbury Schweppes* (n 103) [72]; cf Ghosh 2011 (n 116).

¹⁷¹ *Vodafone 2* (n 117).

Luxembourg, Vodafone Investments Luxembourg Sarl (VIL), which earned certain investment income from subsidiaries resident in Germany. HMRC had initiated an inquiry into the activities of VIL in order to determine whether an apportionment of profits should be made to the UK parent. VIL did not meet any of the objective exemptions in section 748 of ICTA 1988, in particular the exempt activities test.¹⁷² Ignoring the procedural details of the litigation, the essential issue was whether the motive test could be interpreted such that it would exempt a CFC resident in an EU member state from having its profits attributed in situations other than those where the CFC was part of an artificial arrangement. If the test could be so interpreted, as HMRC argued it could, the UK legislation could be considered compatible with EC law.

Justice Evans-Lombe in the High Court, agreeing with Special Commissioner Wallace, concluded that the motive test is not amenable to a ‘conforming interpretation’ that would confine its application to wholly artificial arrangements.¹⁷³ While he agreed that the broad policy rationale of CFC legislation is the counteraction of artificial arrangements, he held that the motive exemption does not guarantee that the legislation is restricted to such arrangements, for the obvious reason that the criteria upon which the exemption is based are subjective rather than objective. Justice Evans-Lombe decided that the UK CFC legislation must be ‘disapplied’ due to its incompatibility with the EC Treaty – not only for the benefit of Vodafone, but wherever the legislation would otherwise apply to CFCs resident in EU member states.¹⁷⁴ That rather startling decision was reversed by the Court of Appeal. Sir Andrew Morritt, with whom the other Judges agreed, refused to focus on the motive test alone. He adopted the position of

¹⁷² Even if VIL met the threshold conditions of having a ‘business establishment’ in Luxembourg and being ‘effectively managed’ in Luxembourg, its business (financial services) was conducted principally with connected companies and was thus tainted.

¹⁷³ *Vodafone 2* (Ch) (n 117) [39], [73].

¹⁷⁴ *ibid* [89]–[90].

counsel for HMRC that an additional exemption could be read into the CFC legislation, such that it would not apply in situations where a UK company establishes a CFC in a member state and, despite the existence of a tax avoidance purpose, the CFC is actually established there and carries on genuine activities there¹⁷⁵ (which seems to repeat the ‘exempt activities’ test minus the requirement about the type of activity). Thus the validity of the UK legislation was reaffirmed, albeit with a significant judicial gloss. In December 2009 the Supreme Court declined to hear Vodafone’s appeal; HMRC and Vodafone subsequently reached a settlement to satisfy Vodafone’s CFC tax liabilities.¹⁷⁶

The difficulty with both of these judgments is that there is a confusion between, on the one hand, the issue of objective establishment of a CFC in a member state such that freedom of establishment is demonstrably exercised, and on the other, anti-abuse justifications for a legislative restriction on freedom of establishment. What the Courts should have decided is this: the existing CFC legislation is incompatible with EC law, and thus must be disapplied, where a CFC genuinely participates in the economic life of its ostensible residence state; and the legislation should continue to apply where a CFC is not such a genuine participant, because there the freedom of establishment has not been exercised. In the author’s view, the correct analysis has nothing to do with purposes, reasons, or motives. To be fair, the confusion arising from the *Vodafone 2* decisions was to a large extent generated by the direction of the ECJ to the national courts in *Cadbury Schweppes*. That direction was itself influenced by the submissions of HMRC, who have a legitimate interest in maintaining the CFC legislation but who fail to recognize that such legislation should operate based on objective economic

¹⁷⁵ *Vodafone 2* (CA) (n 117) [39], [67].

¹⁷⁶ D Stewart, ‘Vodafone Settles CFC Dispute With HMRC’ (2010) 59 Tax Notes Int’l 320.

interests and should be indifferent to taxpayers' reasons for locating economic interests where they do.

HMRC suggest in the more recent CFC Principles Document that, in accordance with the migration to a more territorial tax system in the UK, there should be a redesigned motive test that would 'cover situations where a subsidiary that is properly established overseas is not engaged in activities intended to artificially divert UK profit'.¹⁷⁷ Such a test, it is said, would 'provide an opportunity for such an overseas subsidiary to demonstrate the non-tax related commercial rationale' for the transaction or the subsidiary's role in it.¹⁷⁸ Once again these statements are something of a non-sequitur, as they blur the issues of genuine foreign establishment, genuine foreign activity, and the subjective reasons for making those things foreign. The commercial or tax rationale for moving entities and activities into a foreign state should not be, and according to *Cadbury Schweppes* cannot be, relevant to CFC attribution. The existence of a tax avoidance purpose or reason may be relevant in prompting inquiry into the economic reality of the alleged foreign establishment and activity, but it is not relevant to the establishment itself or the activity itself.

5.3.3(b) *The Canadian Motive Test*

The Canadian legislation also contains a 'motive test', although it does not function like the UK's CFC exemption. Paragraph 95(6)(b) of ITA 1985 is a targeted anti-avoidance rule which operates in the context of the provisions regarding foreign affiliates and CFCs.¹⁷⁹ The rule states that:

¹⁷⁷ CFC Discussion (n 55) [2.17].

¹⁷⁸ *ibid.*

¹⁷⁹ The rule applies to non-resident trusts and foreign investment entities as well.

... where a person or partnership acquires or disposes of shares of the capital stock of a corporation or interests in a partnership, either directly or indirectly, and it can reasonably be considered that the principal purpose for the acquisition or disposition is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act, that acquisition or disposition is deemed not to have taken place, and where the shares or partnership interests were unissued by the corporation or partnership immediately before the acquisition, those shares or partnership interests, as the case may be, are deemed not to have been issued.

Evidently this provision differs from subsection 748(3) of ICTA 1988: it operates by reference to ‘principal purpose’ rather than ‘main purposes’ and ‘main reasons’ and, more fundamentally, its function is to recharacterize tax-driven arrangements rather than exempting commercial arrangements. Among other things, paragraph 95(6)(b) seems to allow the existence of a CFC to be ignored where the principal purpose of acquiring its shares is to permit the parent company to avoid Canadian tax. If the existence of a CFC were ignored pursuant to this rule then presumably all of its income would fall to be treated as the parent’s income; this would be more onerous than applying specific CFC provisions as it would amount to imposing comprehensive accrual in respect of that entity’s income.

For some time the view of the CRA had been that paragraph 95(6)(b) was a broad anti-avoidance rule, effective in countering an unspecified range of schemes that ‘abused’ the CFC rules or the dividend exemption for foreign affiliates.¹⁸⁰ Among other arrangements, the CRA believed that this rule would counteract ‘double-dip’ financing structures, particularly where the Canadian company employing the scheme was itself a member of a MNE with a foreign headquarters (although there appears to be no basis in law for the CRA to give greater scrutiny to foreign-owned MNEs).

¹⁸⁰ CRA, Income Tax Technical News No 32 (15 July 2005) 3; CRA, Income Tax Technical News No 34 (27 April 2006) 19–20; both available at <www.cra-arc.gc.ca/tx/tchncl/ncmtx/tnws3-eng.html>.

The CRA's stance was much undermined by the decision in favour of the taxpayer in *Univar*.¹⁸¹ That case involved a Canadian subsidiary (Univar Canada) of a US corporation borrowing substantially in order to capitalize a new Barbados financing affiliate (VWRB), with VWRB then purchasing certain notes from Univar Europe, earning interest on said notes, and distributing the funds as a tax-free dividend to Univar Canada.¹⁸² In economic terms, the effect was to shift foreign debt into Canada. The CRA sought to tax the interest income as if Univar Canada had acquired the European notes directly, stressing that the use of a Barbados intermediary was driven primarily if not exclusively by the low Barbados tax rate. The case was decided in the taxpayer's favour primarily on the basis that paragraph 95(6)(b) did not apply, because it could not reasonably be considered that the 'principal purpose' for the acquisition of the VWRB shares was to permit the taxpayer to avoid Canadian tax. Justice Bell held that the principal purpose of each of the relevant transactions was the overall commercial purpose of balancing the debt to equity ratios across the Univar corporate group, among other commercial and tax considerations.¹⁸³

The CRA continues to believe that paragraph 95(6)(b) will be effective to deny tax advantages associated with a variety of other arrangements that, in their view, unduly exploit the CFC rules or the foreign dividend exemption.¹⁸⁴ It is difficult to say whether this position has merit. Some commentators have argued that the provision is a constructive ownership rule and was never intended as a broader anti-avoidance rule.¹⁸⁵ Moreover, in the light of the *Univar* analysis, it seems that Canadian MNEs will always

¹⁸¹ *Univar Canada Ltd v The Queen* [2005] DTC 1478 (TCC).

¹⁸² By virtue of ITA 1985 ss 113(1)(a) and 95(2)(a)(ii), discussed at text to nn 159–162.

¹⁸³ *Univar* (n 181) [23]–[28], [46].

¹⁸⁴ CRA, Income Tax Technical News No 36 (27 July 2007) <www.cra-arc.gc.ca/tx/tchncl/nemtx/tnws3-eng.html>.

¹⁸⁵ Johnson et al (n 164).

be able to point to the overall commercial purpose of carrying on a global business to justify the specific methods by which such overall purpose is achieved. Where their methods involve the establishment of tax haven affiliates to carry out financing, shipping, IP management, or other mobile activities, it seems unlikely that a Canadian court would conclude that the principal purpose for creating the affiliate was tax avoidance. The reader will not be surprised to hear that, in the author's view, the CRA should cease focusing on the supposed purpose or purposes of the structure and should instead investigate other more pertinent matters: namely, whether the affiliate is genuinely established and genuinely carrying on business in its territory of ostensible residence. The CRA would be greatly assisted by legislative amendments to ensure that, for purposes of the CFC rules, genuine establishment requires real economic presence in the alleged residence state.

5.4 CONCLUSIONS

In this chapter it has been argued that the perceived 'abuse' targeted by CFC provisions subsists, at least in principle, in the artificial separation of the location of taxable profits from the location of the economic interests that produced those profits. Where CFC provisions require accrual taxation of profits that have been artificially separated from the economic interests that produced those profits, the legislation is and should be considered internationally legitimate. This should be true both in the context of EU law and in the wider international context. In contrast, where CFC provisions require accrual taxation of profits that are jurisdictionally aligned with the economic interests that actually produced those profits, the legislation should be considered contrary to international equity and, indeed, contrary to economic common sense.

Leaving aside entirely passive income from FPI, one must ask what is the appropriate treatment of foreign business income earned by a foreign entity. The traditional answer given by the OECD and some national governments is that ‘base company services’ should be subject to income attribution under CFC provisions. But what is meant by this? Is an entity a ‘base company’ because: (i) it is located in a tax haven; (ii) its establishment there is by virtue of minimal formal connections, such that it can be characterized as a ‘letterbox’; (iii) it provides services that are particularly mobile, such as financing, IP licensing, or shipping, especially to members of the same corporate group; or (iv) the main purpose or reason for establishing the entity was avoidance of shareholder state taxation? The assumption that all four elements will co-exist may often be true, and perhaps in earlier decades it was invariably true. Yet the co-existence of these elements is not guaranteed in an era when MNEs are highly integrated and may have numerous commercial and tax reasons for establishing particular entities in particular jurisdictions.

The author has argued that the most important of the above elements, according to *Cadbury Schweppes* and according to inter-nation equity more generally, is the second: the existence or lack of genuine participation in the CFC’s ostensible state of residence. In other words, what is the reality or unreality of the foreign residence of the CFC? The current parameters of CFC income attribution in the UK and Canada, specifically the exempt activities / active business exemption and the respective ‘motive tests’, are to some extent directed at this concern. Yet grafted on to this legitimate concern are notions of ‘abuse’ or ‘artificiality’ that are a function of the rate of taxation in the foreign state, the type of business carried on by the CFC in the foreign state, and the location of any related entities to which the CFC provides services. These factors may raise suspicions as to the objective reality of the foreign establishment, suggesting

to HMRC or the CRA that further investigation into the entity's establishment and activities is required, yet they are of no relevance to artificiality per se.

The publications issued by the Treasury and HMRC between 2007 and 2010 with respect to CFC legislation are to be applauded, in that they signify a considered move away from protectionism and towards a goal of taxing 'foreign' profits that are artificially – not genuinely – foreign. The Canadian Department of Finance would do well to take notice of this development, as the Canadian FAPI regime is currently a clutter of rules without any such rationale. However, it seems that even the revised UK regime will continue to emphasize the type of business carried on by the CFC and the reasons for its establishment. The author suggests that those factors are not relevant in a tax system that seeks to prevent what is *artificial*. Whether a tax system wishes to reach beyond what is artificial to capture what is *undesirable* is a separate question.

The appropriate way to counteract artificial relocation of corporate profits is to define 'location' in a way that reflects economic reality and is therefore resistant to being cultivated or feigned. Accordingly, UK and Canadian legislation should seek to better identify what income is earned in the residence / home source state and what income is earned in foreign / host source states, and to tax the home interest accordingly. This goal could be achieved by relying, in part, on a modified CFC regime, preferably using exemptions along the lines of the modified 'exempt activities' described above,¹⁸⁶ which of course has nothing to do with 'activities' but everything to do with local establishment. Were the UK and Canada to modify their CFC regimes in this way it would become even more clear that CFC legislation is simply an extension of residence-based taxation.

¹⁸⁶ Text following n 146.

CHAPTER 6

INBOUND INVESTMENT: ATTACKING CORPORATE RESIDENCE THROUGH TREATY ANTI-ABUSE RULES OR PRINCIPLES

6.1 INTRODUCTION

6.1.1 The Flexibility of the International Tax Treaty Network

It is notorious that the existing income tax treaty system, designed to allocate countries' taxing rights over profits from bilateral trade and investment,¹ struggles under the weight of global economic integration. The previous chapter addressed the practice of multinational enterprises (MNEs) establishing subsidiaries in tax havens with the intention or result of avoiding tax in the parent company's home state; the remedial mechanism of controlled foreign company (CFC) legislation is a domestic law response that has little to do with double taxation conventions (DTCs or tax treaties).² The situation is quite different where corporate structures are used to avoid tax in respect of inward investment. Specifically, the well-advised MNE is able to exploit the loosely coordinated tax treaty system, often by using intermediaries based in 'treaty havens', in order to minimize host country taxes applied to passive income streams and capital gains.³ Thus the formality of corporate residence creates opportunities for the unintended use or 'abuse' of tax treaties; the remedial mechanisms here involve the interpretation and application of treaty provisions themselves, rather than domestic law rules.

¹ The evolution of the tax treaty system is discussed in ch 2.

² However, it is sometimes argued that CFC legislation is incompatible with treaty obligations: ch 5 text following n 83.

³ S Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (Weidenfeld & Nicolson, London 1992) 134–41.

6.1.2 Identifying and Responding to Treaty ‘Abuse’

Evidently verbs such as ‘exploit’, ‘manipulate’, and ‘abuse’ when applied to tax treaties express value judgements – they are words of conclusion rather than analysis. Among other commentators, Rosenbloom has criticized the use of the term abuse:

Not only is it derogatory; it implies that the proper use of tax treaties can be identified. Yet differences over precisely that point lie at the heart of the current discussion. Because the term suggests what is being discussed is a point of common understanding and agreement, when plainly it is not, the usefulness of the term is questionable.⁴

As discussed elsewhere in this thesis, problems of terminology plague any analysis of tax avoidance behaviour, whether in the domestic law context or treaty context. The debate is muddled by the differing assumptions that underlie terms such as ‘unacceptable avoidance’, ‘aggressive avoidance’, or ‘abuse’ in contrast to ‘acceptable avoidance’, ‘mitigation’, or ‘planning’.⁵ Nevertheless, there seems to be a widely held view that there exist some international tax minimization activities – even if it is difficult to delineate them – that are so inconsistent with the object and spirit of a treaty that they may reasonably be labelled ‘abuse’. The typical but not exclusive pattern is where a special-purpose entity is established in a treaty state and is used as a ‘conduit’ to route dividends, interest, or royalties from the treaty partner to a third state.

This chapter explores the means by which tax authorities have sought to strengthen their tax treaties, through safeguards of varying nature and scope, in order to prevent what they consider to be tax treaty abuse. UK and Canadian perspectives are compared to international recommendations and the approaches of other states. The typical avenues of challenge may be grouped under two headings: the first involves

⁴ HD Rosenbloom, ‘Tax Treaty Abuse: Policies and Issues’ (1983) 15 *Law & Policy in Int’l Business* 763, 766.

⁵ See ch 7 text to nn 11–13.

purposive approaches to treaty interpretation, particularly for the terms ‘person’, ‘resident’, and ‘beneficial ownership’; the second comprises broader responses to tax avoidance, specifically reliance on treaty anti-abuse principles and domestic anti-avoidance rules. In recent years Canada, unlike the UK, has moved beyond making exhortations to litigating cases where the Canada Revenue Agency (CRA) believe that some abuse of a Canadian tax treaty has occurred. There is good reason to suspect that Her Majesty’s Revenue and Customs (HMRC) have closely monitored the Canadian approach and would proceed similarly in a case of perceived abuse of a UK tax treaty. While elements of the current Canadian approach have merit, to date it has been entirely ineffective. In the author’s view this failure is primarily due to the lack of critical inquiry into the essence of the supposed abuse, in particular the lack of segregation of concerns about artificial corporate residence or ownership (the objective component) with tax purposes or motivations (the subjective component). It is suggested that a more coherent response to conduit arrangements would be to identify by treaty those circumstances in which a purported intermediary is considered to lack genuine economic establishment – that is, residence – in the treaty state.

6.2 WHAT IS TREATY SHOPPING AND WHY IS IT A PROBLEM?

6.2.1 The Nature and Purposes of Tax Treaties

As discussed in chapter 2, the primary concern in international income taxation is the resolution of competing jurisdictional claims between ‘source’ and ‘residence’ states, mitigating the burden of double taxation that would arise in the absence of international agreement. It is generally accepted that double taxation is undesirable and it is commonly presumed that alleviation thereof, whether unilaterally or through tax

treaties, enhances transnational investment and global welfare.⁶ Most states, whether developed or developing, therefore seek to negotiate tax treaties.

The ideal would be to allocate tax jurisdiction via some multilateral treaty based on universally accepted terms and concepts, yet pleas for a multilateral agreement continue to seem utopian in the face of concerns over national sovereignty. Allocations of tax competence have in fact been achieved through a combination of unilateral statutory measures, bilateral tax agreements, and customary norms.⁷ The numerous tax treaties in existence exhibit great similarities in both structure and principle. This is not surprising given that most are based on the model conventions developed by the Organisation for Economic Co-operation and Development (OECD)⁸ and the United Nations (UN),⁹ models which were themselves derived from the draft conventions produced by the League of Nations.¹⁰ The UK and Canada boast two of the most extensive networks of tax treaties in the world: the UK has entered comprehensive DTCs with 119 separate nations;¹¹ Canada has entered 88 such treaties.¹²

⁶ These views are not universal. For alternative perspectives see: T Dagan, 'The Tax Treaties Myth' (2000) 32 *New York Univ J of Int'l Law and Politics* 939; RB Davies, 'Tax Treaties and Foreign Direct Investment: Potential versus Performance' (2004) 11 *Int'l Tax and Public Finance* 775.

⁷ Ch 2 text following n 24.

⁸ OECD, *Model Tax Convention on Income and on Capital* (OECD, Paris 2010) <www.oecd.org/ctp/tt/mtc> (OECD Model).

⁹ UN Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (UN, Geneva 2001) <www.un.org/esa/ffd/tax/> (UN Model). A revised UN Model is planned for 2011.

¹⁰ Ch 2 text to nn 53–59.

¹¹ According to the author's calculations, the UK has DTCs (in some cases covering income tax only) with 119 countries, including some members of the former USSR and the former Yugoslavia. A treaty with Bahrain has been concluded but was not in force as of January 2011. A list of the UK's tax treaties is maintained by HMRC at <www.hmrc.gov.uk/si/double.htm>.

¹² Canada has DTCs with 88 countries, excluding members of the former USSR. Treaties with four other countries (Colombia, Lebanon, Namibia, and Turkey) have been concluded but were not in force as of January 2011. A list of Canada's tax treaties is maintained by the Department of Finance at <www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp>.

There are two principal purposes of tax treaties. The first is the aforementioned reduction or elimination of double taxation on transnational trade and investment; the second is the prevention of tax evasion through an open exchange of information between the Contracting States.¹³ Where governments are interested predominantly in the latter objective they may negotiate a Tax Information Exchange Agreement (TIEA) – something that the UK, the US, Canada, and other countries have been actively doing since the 2008 financial crisis.¹⁴ Comprehensive tax treaties have other subsidiary goals, including ensuring that residents are not subject to discriminatory tax treatment in foreign jurisdictions, establishing mechanisms for settling disputes, and providing certainty to residents regarding their potential tax liabilities abroad. For present purposes we will focus on the widely accepted primary goal of DTCs – reducing or eliminating double taxation.

This aim is achieved by a pragmatic but imperfect division of taxing rights between ‘residence’ and ‘source’ countries. The incentive to engage in treaty shopping stems from the fact that the residence/home jurisdiction typically enjoys the dominant right to tax derivative or passive income, notably dividends, interest, royalties, and most capital gains.¹⁵ This is a dominant but not exclusive right. Many countries do retain jurisdiction to tax dividends, interest, and royalties at source by way of withholding taxes. Canadian income tax legislation, for example, imposes a 25 per cent withholding tax on various amounts paid or credited to a non-resident person, including dividends,

¹³ P Baker, *Double Taxation Conventions* (loose-leaf, Sweet & Maxwell, London 2007) [B.06]–[B.12]; OECD, *Commentaries on the Articles of the Model Tax Convention* (OECD, Paris 2010) (OECD Commentary) Art 1 [7].

¹⁴ See OECD, ‘The Global Forum on Transparency and Exchange of Information for Tax Purposes: a Background Information Brief’ (18 February 2011) <www.oecd.org/ctp/htp/cooperation>, and the growing list of TIEAs at <www.hmrc.gov.uk/si/double.htm> and <www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp>.

¹⁵ OECD Model (n 8) Arts 10[1], 11[1], 12[1], 13[5]; UN Model (n 9) Arts 10[1], 11[1], 12[1], 13[6].

some forms of interest, and most royalties.¹⁶ The UK legislation is more generous to inward investment in that withholding tax does not apply to dividends and is imposed on interest and royalties only in limited circumstances.¹⁷ UK taxation is further restricted by the Interest and Royalties Directive,¹⁸ which since 2004 has provided for the elimination of host state taxation on interest and royalty payments between associated companies in different EU Member States. Being associated for this purpose requires 25 per cent common ownership. The Interest and Royalties Directive does not apply to payments from UK companies to non-associated EU companies or to any companies outside the EU. In both the UK and Canada, withholding taxes if otherwise applicable are reduced where the income recipient is a resident of a state that has concluded a tax treaty with the UK or Canada, respectively.¹⁹ The reduced withholding tax rate is often five per cent for dividends paid to corporate shareholders with a substantial interest in the paying company, 15 per cent for dividends paid to other shareholders, and ten or 15 per cent for interest and royalties. The dividends and interest articles in the UK–Canada tax treaty²⁰ are representative: in addition to permitting home state taxation of amounts received, the Contracting State from which dividends or interest are paid is entitled to tax such amounts, limited to five or 15 per cent of the

¹⁶ ITA 1985 ss 212(1)–(2). Effective 2008, s 212 was amended to eliminate withholding tax on most interest payments made by a Canadian payer to a foreign lender with whom the payer deals at arm's length: SC 2007 c 3 s 59(2).

¹⁷ ICTA 1988 s 18, Schedule D Case III and former ss 349(1)–(2), rewritten to ITA 2007 Pt 15. In very broad terms, withholdings are at the basic rate of 20 per cent unless reduced by treaty.

¹⁸ Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made between Associated Companies of Different Member States [2003] OJ L 157/49 (Interest and Royalties Directive), implemented by FA 2004 s 98, rewritten to ITTOIA 2005 s 758.

¹⁹ OECD Model (n 8) Arts 10[2], 11[2]; UN Model (n 9) Arts 10[2], 11[2], 12[2].

²⁰ *Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains* (1978) (as amended through 2003) (UK–Canada DTC).

gross amount of the dividend or ten per cent of the gross amount of the interest where the ‘beneficial owner’ of the amounts is a resident of the other state.²¹

The UK–Canada DTC is, of course, based on the OECD Model. Some tax treaties concluded by the UK and Canada feature aspects of the UN Model, while those with the United States (US) follow more closely the model convention²² developed by the US Treasury. Both the UK²³ and Canada²⁴ have renegotiated their tax treaties with the US in recent years. The structure of the current US Model is substantially similar to that of the OECD Model but there are significant differences,²⁵ notably the inclusion of the ‘limitation of benefits’ provision, discussed in more detail below. Each model reflects different policy decisions on the allocation of jurisdiction between home and host states, with the UN Model being the most favourable to host states. Thus the UN Model permits source taxation with respect to dividends, interest, and royalties, while the US Model contemplates source taxation only for dividends.²⁶ In any event, all model conventions and all tax treaties based upon them cede jurisdiction over some types of

²¹ *ibid* Arts 10[1]–[2], 11[1]–[2].

²² US Department of the Treasury, *United States Model Income Tax Convention of November 15, 2006* <www.treasury.gov/resource-center/tax-policy/treaties/Pages/default.aspx> (US Model). The US Model has its own Technical Explanation: US Department of the Treasury, *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006* (US Commentary).

²³ *Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains* (2001) (UK–US DTC).

²⁴ *Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital* (1980) (as amended through 2007) (Canada–US DTC). This treaty was most recently amended by the *Protocol Amending the Convention between Canada and the United States of America with respect to Taxes on Income and on Capital* (2007) (Fifth Protocol).

²⁵ For analysis and comparison see RS Avi-Yonah and MB Tittle, *The Integrated 2006 United States Model Income Tax Treaty* (Vandeplas Publishing, Florida 2008).

²⁶ UN Model (n 9) Arts 10, 11, 12; US Model (n 22) Arts 10, 11, 12. One of the most significant provisions in the Fifth Protocol (n 24) is the elimination of withholding taxes on interest payments between residents of Canada and the US. Effective 2010 this exemption applies whether or not the parties deal at arm’s length; thus it is more generous than the recent amendment to the ITA 1985 (n 16).

income to the residence state, thus making treaty state residence attractive from a tax planning perspective.

6.2.2 Treaty Shopping Described

6.2.2(a) *OECD and UN Descriptions of Treaty Shopping*

As with other international treaties, a tax treaty reflects a balance of advantages that is agreed to by the Contracting States when it is negotiated. Treaty abuse, and in particular ‘treaty shopping’,²⁷ is considered to occur where this balance is undermined by persons who are not resident in either Contracting State seeking treaty advantages that would not ordinarily be available to them. In 1987 the OECD published an influential report (OECD Conduit Report) which addressed the use of tax treaties by a person ‘acting through a legal entity created in a State with the main or sole purpose of obtaining treaty benefits which would not be available directly to such person’.²⁸ The UN in 1988 published its own report on treaty shopping (UN Conduit Report), where it gave a substantially similar description of treaty shopping but, as we will see, reached different conclusions about its acceptability.²⁹

An example of a simple conduit arrangement should illustrate the issue. Assume an enterprise resident in Bermuda wishes to make some investment in Canada, perhaps by subscribing for shares or debentures of a Canadian company. Assume that the Bermudian enterprise will not deal at arm’s length with the Canadian company because

²⁷ There are other forms of treaty abuse, such as ‘rule shopping’, that need not involve establishment of corporate intermediaries. For discussion see S van Weeghel, *The Improper Use of Tax Treaties: with Particular Reference to the Netherlands and the United States* (Kluwer, London 1998) 124–58.

²⁸ OECD Committee on Fiscal Affairs, ‘Double Taxation Conventions and the Use of Conduit Companies’ in *International Tax Avoidance and Evasion: Four Related Studies* (OECD, Paris 1987) [1]. The key points from this report are reiterated in the OECD Commentary (n 13), esp at Art 1 [11]–[20].

²⁹ UN Department of Economic and Social Affairs, *Contributions to International Co-operation in Tax Matters: Treaty Shopping, Thin Capitalization, Co-operation between Tax Authorities, Resolving International Tax Disputes* (UN, New York 1988).

they will be part of the same corporate group. There is no tax treaty between Canada and Bermuda, so if the Bermudian enterprise invested directly it would face the prospect of (i) Canadian capital gains tax on a subsequent disposition of the investment, and (ii) Canadian withholding taxes on any dividends, interest, or royalties it received. If the destination country were the UK, similar issues would arise for interest or royalties, but not for capital gains or dividends. To minimize its tax burden the Bermudian enterprise makes use of a wholly-owned entity in a favourable jurisdiction, perhaps the Netherlands, to invest indirectly in the Canadian company. The Dutch entity, in the terminology of the OECD Conduit Report, acts as ‘a conduit for channelling income’ from Canada to the ultimate investor in Bermuda.³⁰ The OECD observed that such an arrangement usually acts to the detriment of the source/host state because through the treaty it has ceded tax jurisdiction to the conduit’s purported state of residence. In this example the tax treaty between Canada and the Netherlands ensures that Canadian capital gains tax on a disposition of the Canadian shares is avoided (unless the value of the shares derives principally from real property in Canada) and that Canadian withholding taxes on any dividends, interest, or royalties are reduced,³¹ ignoring for the moment any anti-avoidance responses. If the destination country were the UK, domestic law implementing the Interest and Royalties Directive³² as well as the tax treaty with the Netherlands would ensure that UK taxation of interest and royalties was eliminated,³³ again ignoring possible anti-avoidance responses. Although these are the

³⁰ OECD Conduit Report (n 28) [2].

³¹ *Convention between Canada and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (1986) (as amended through 1997) (Canada–Netherlands DTC) Arts 10[2], 11[2], 12[2], 13[7].

³² (n 18).

³³ *Convention between the United Kingdom of Great Britain and Northern Ireland and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains* (1980) (as amended through 1989; terminated 2011) (UK–Netherlands DTC) Arts 11[1], 12[1].

intended benefits of either treaty, this structure results in the benefits being extended to persons to whom the treaty was (arguably) not intended to apply.

Usually the effectiveness of such an arrangement stems from the fact that the treaty benefits outweigh the additional taxes in the conduit's purported state of residence, perhaps because that state has a preferential regime for holding companies or imposes low corporate taxes generally. UK and Canadian treaty partners which are favoured by tax advisers for these reasons include Barbados, Belgium, Ireland, Luxembourg, the Netherlands, and Switzerland.³⁴ The OECD Conduit Report categorized variations of the above-described arrangement as 'direct conduit' strategies and 'stepping stone' strategies.³⁵ For capital gains, even residents of the host state may be able to avoid domestic taxation by holding domestic assets via an entity resident in a treaty state, a strategy sometimes described as 'round-tripping'.³⁶ More complex arrangements involving multiple countries and multiple treaty links are also possible, limited only by the ingenuity of a taxpayer's advisers and, perhaps, by the anti-avoidance responses discussed below.

6.2.2(b) *Recent Examples of Alleged Treaty Shopping*

The three most recent and important examples of alleged treaty shopping, at least from the UK and Canadian perspectives, are described here to provide further illustration and context for the analysis which follows.

³⁴ See the foreign direct investment statistics cited at ch 1 nn 23–25 and HMRC, International Manual (HMRC, London 2011) <www.hmrc.gov.uk/manuals/intmanual/index.htm> 507030 (addressing the location of group treasury functions).

³⁵ OECD Conduit Report (n 28) [4]–[5].

³⁶ One would have to consider potential application of CFC rules. Also see the foreign trust cases, *Smallwood Trust v HMRC* [2008] STC (SCD) 629, rev'd [2009] STC 1222 (Ch), rev'd [2010] STC 2045 (CA) and *Garron Family Trust v The Queen* [2009] DTC 1568 (TCC), aff'd [2010] DTC 5189 (FCA) (discussed in ch 5 and ch 7).

First is the arrangement considered by the English Court of Appeal in *Indofood International Finance Ltd v JP Morgan Chase Bank*.³⁷ There the Indofood group, a large food production and distribution enterprise based in Indonesia, had borrowed money for use in its business. Rather than Indofood issuing notes directly to investors and having them face a 20 per cent withholding tax on the interest payments (for which Indofood was contractually liable), it had incorporated a special purpose company in Mauritius, which had issued the notes and on-lent the loan proceeds to the parent company. This structure resulted in the interest payments from Indonesia being subject to ten per cent withholding tax under the Indonesia–Mauritius tax treaty, with no additional tax on the interest payments from Mauritius to investors. All went well until Indonesia terminated its treaty with Mauritius because of perceived abuse. The issue was whether it would be effective for the Indofood group to interpose a new company in the Netherlands to act as intermediary between the parent company and the Mauritius company. The intention was for interest payments to be made from Indonesia to the Netherlands, thence to Mauritius, and thence to the ultimate investors abroad. The success of this structure depended on the proposition that the Dutch financing company would be the ‘beneficial owner’ of the interest received from the parent within the meaning of Article 11, paragraph 2 of the Indonesia–Netherlands tax treaty. The case was before the English courts because the notes were governed by English law. The Court of Appeal held that, in accordance with Indonesian law, the proposed Dutch company would not be considered the beneficial owner of the interest and thus the desired treaty relief would not apply.³⁸

³⁷ [2006] EWCA Civ 158, [2006] STC 1195 (CA).

³⁸ Discussed at text to nn 127–131.

*MIL (Investments) SA v Canada*³⁹ involved a different sort of tax strategy that relied on the former Canada–Luxembourg tax treaty.⁴⁰ An individual resident in Monaco owned all of the shares of MIL, originally established in the Cayman Islands, which in turn owned shares in a Canadian mining company (DFR). The DFR shares had significantly appreciated in value between 1993 and 1995. In order to avoid Canadian capital gains tax on a potential sale by MIL of the DFR shares, MIL underwent a corporate continuance from Cayman to Luxembourg in 1995. Summarizing and eliminating many of the technical aspects of the arrangement, the DFR shares were subsequently sold to another Canadian resource group. MIL claimed an exemption from Canadian tax on the \$425m capital gain by virtue of Article 13 of the Canada–Luxembourg DTC. It also paid no tax in Luxembourg by virtue of satisfying all requirements under the Luxembourg substantial shareholdings exemption. It is important to note that all shareholders of DFR, not just MIL, sold their shares and that there were sound commercial reasons to do so. The CRA nevertheless felt that the use of this structure for holding and disposing of the shares was a flagrant abuse of the Canada–Luxembourg DTC. As explained below, both the Tax Court and the Federal Court of Appeal concluded that the transactions did not result in any such abuse.⁴¹

The most recent decision is *Prévost Car Inc v Canada*,⁴² which involved a direct conduit strategy similar to those addressed in the OECD Conduit Report.⁴³ Two companies, one based in Sweden and the other in the UK, had established a holding

³⁹ [2006] DTC 3307 (TCC), aff'd [2007] DTC 5437 (FCA) (*MIL Investments*).

⁴⁰ *Convention between Canada and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* (1989) (terminated and replaced in 2001) (Canada–Luxembourg DTC).

⁴¹ Discussed at text to nn 170–172.

⁴² [2008] DTC 3080 (TCC), aff'd [2009] DTC 5053 (FCA).

⁴³ OECD Conduit Report (n 28) [10].

company in the Netherlands, Prévost Holding BV (PHBV), in order to hold shares in a Québec-based manufacturing company, Prévost Car Inc (Prévost). PHBV had no physical office or employees in the Netherlands or elsewhere and was managed by a Dutch advisory firm. Dividends paid by Prévost to PHBV were subject to the reduced five per cent rate of withholding tax under Article 10 of the Canada–Netherlands DTC.⁴⁴ Substantially equivalent amounts were paid pro rata to the Swedish and UK shareholders, in accordance with a shareholders’ agreement, although PHBV was not contractually obliged to pay those dividends. There was no additional taxation in the Netherlands on the dividends paid to the ultimate shareholders. If PHBV had not been established and the dividends had been paid directly from Prévost to the Swedish and UK investors, the withholding rates would have been 15 per cent and ten per cent respectively.⁴⁵ Thus the use of the Dutch intermediary achieved a slightly lower withholding rate. According to the taxpayers, a Dutch holding company had been chosen for both tax and commercial reasons, including that the Swedish and UK investors each wanted to operate via a joint enterprise based in a ‘neutral’ country. The CRA felt that the arrangement was abusive and sought to impose the higher rates of withholding tax applicable under the tax treaties with Sweden and the UK. As in *MIL Investments*, the Crown’s arguments were unsuccessful before the Tax Court and the Court of Appeal.⁴⁶

⁴⁴ (n 31).

⁴⁵ *Convention between Canada and Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (1996) Art 10[2]; UK–Canada DTC (n 20) Art 10[2].

⁴⁶ Discussed at text to nn 132–138.

6.2.3 The Discontent with Treaty Shopping

6.2.3(a) *Three Alleged Problems Created by Treaty Shopping*

It might be argued based on the hypothetical and actual examples given above that Canada's treaties with the Netherlands and Luxembourg, among others, have become 'treaties with the world'. This is precisely the view that was taken by the US Treasury in the early 1980s with respect to its tax treaty with the Netherlands, which the US believed was being exploited by non-residents worldwide to avoid US withholding taxes.⁴⁷ Since that time the US has been at the forefront internationally in guarding its treaty network against unwelcome beneficiaries. It is useful to step back and consider why the US, or any other state, might be unhappy about treaty shopping.

The primary concern put forward in the OECD Conduit Report is that treaty shopping breaches the 'principle of reciprocity'.⁴⁸ It has been said that reciprocity is 'a fundamental pillar on which each and every treaty stands'.⁴⁹ The problem arising with the typical conduit arrangement is that treaty benefits negotiated between two Contracting States are extended to third-country residents without that country having to make any concessions of its own: the benefits flow in only one direction. The OECD Commentary reiterates this point, observing that treaty shopping fails to accord with the balance of advantages negotiated in the particular treaty.⁵⁰ The UN Conduit Report was

⁴⁷ It was common for US corporations to obtain debt financing through subsidiaries in the Netherlands Antilles. At the time a protocol to the US–Netherlands tax treaty, under which interest payments were exempt from tax, applied to the Antilles. A 1981 report by RA Gordon, *Tax Havens and their Use by United States Taxpayers – An Overview* (US Treasury, Washington DC 1981) suggested that the US should consider terminating this treaty and other 'tax-haven treaties' in order to eliminate the potential for abuse. In 1987 the US terminated the Antilles protocol, virtually destroying the Antilles' financial sector. For further detail see Rosenbloom (n 4); van Weeghel (n 27).

⁴⁸ OECD Conduit Report (n 28) [7].

⁴⁹ van Weeghel (n 27) 116.

⁵⁰ OECD Commentary (n 13) Art 1 [8], [9], [11].

more equivocal with respect to this issue; the authors stated that, if one of the general objectives of tax treaties is to promote enhanced flows of international trade and investment, it is arguable that ‘it does not matter if the desirable result is achieved by the direct use of tax treaties or by their indirect use’.⁵¹

The second problem identified by the OECD is that treaty shopping may result in transnational income being exempted from taxation altogether or being subject to ‘inadequate taxation’.⁵² The OECD view is that Contracting States agree to sacrifice aspects of their tax jurisdiction with the expectation that the other state will impose a reasonably comparable level of taxation. If a conduit entity is able to take advantage of deductions such that it brings its taxable income to zero in its state of residence, or is able to make onward payments to the ultimate investor with little additional taxation, then the treaty relief upon which it relies may extinguish all taxation. The argument is that tax treaties are designed to prevent double taxation, not to create double non-taxation, a view which is reflected throughout the current OECD Commentary.

This is a contentious proposition, however. Various commentators have argued that existing treaties based on the OECD Model or UN Model cannot easily be seen as serving the objective of preventing double non-taxation.⁵³ The UN Conduit Report suggested that, for developing countries, double non-taxation could very well be a goal of its tax treaties:⁵⁴ developing countries that grant relief on inward investment may find

⁵¹ UN Conduit Report (n 29) 6–7.

⁵² OECD Conduit Report (n 28) [7].

⁵³ eg M Lang, ‘General Report’ in Int’l Fiscal Association (ed), *Double Non-Taxation*, Cahiers de Droit Fiscal International vol 89a (IFA, Vienna 2004) 73; BJ Arnold and S van Weeghel, ‘The Relationship between Tax Treaties and Domestic Anti-Abuse Measures’ in G Maisto (ed), *Tax Treaties and Domestic Law* (IBFD, Amsterdam 2006) 90–91. In *MIL Investments* (FCA) (n 39) at [8], the Federal Court of Appeal gave short shrift to the Crown’s argument that the Canada–Luxembourg DTC should be interpreted so as to prevent double non-taxation.

⁵⁴ UN Conduit Report (n 29) 7.

it desirable that equal relief be granted in other Contracting States in order to avoid frustration of their own incentives. While this may be true, in the author's view it does not mean that developing countries wish the tax advantages they provide to be exploited by persons who have no real economic connection with the country's treaty partners. India in particular has been aggressive in challenging structures involving investments routed through its treaty partner Mauritius, in part because Mauritius imposes minimal taxation on foreign-owned investment entities.⁵⁵

The final disadvantage of treaty shopping identified by both the OECD and UN is more convincing. This is the argument that treaty shopping destroys the incentive for countries to negotiate and conclude new treaties. In the hypothetical conduit arrangement described above, the state where the ultimate investor is resident (Bermuda) has little incentive to enter treaties of its own when its residents can simply take advantage of other state's treaty networks.⁵⁶ Thus the practice is inconsistent with the laudable goal of enhanced global tax harmonization. In particular, tax haven states will continue to dwell outside treaty networks, depriving both developed and developing states of funding that would otherwise be generated through taxation.⁵⁷

6.2.3(b) *Relating the Alleged Problems to the Alleged Abuse*

Upon reviewing the problems said to be created by treaty shopping, it becomes apparent that each problem is based on an implicit assumption that the entity established in the treaty state is somehow transparent, artificial, or irrelevant. Put another way, it does not

⁵⁵ To date the Indian courts have not been sympathetic to the revenue administration's views: *Azadi Bachao Andolan v Union of India* (2003) 6 ICLR 233 (SC India).

⁵⁶ OECD Conduit Report (n 28) [7]; UN Conduit Report (n 29) 7. The validity of this concern is demonstrated by the fact that several successful financial centres have few if any tax treaties, although many TIEAs have been concluded following the G20 Summit of 2009: text to n 14.

⁵⁷ RS Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) 113 *Harvard Law Rev* 1573, 1632–48.

make sense to talk about a lack of reciprocity, the spectre of double non-taxation, or disincentives to future treaty negotiation if the entity's independent existence and connection to the treaty state are recognized and if the income it receives is recognized as its own income. As between the source/host state where the investment is located and the treaty partner state where the direct investor is established, there *is* reciprocity, there *is* potential double taxation relieved by treaty, and there *is* fulfilment of the treaty objects. To conclude otherwise one must assume that the important relationship is the relationship between the source/host state where the investment is located and the third state where the indirect investor is resident, disregarding the direct investor (the 'conduit'). Pointing to the problems mentioned above does not greatly assist us in determining in what circumstances we should or should not make that conceptual leap.

In the UN Conduit Report the term 'abuse of tax treaties' was defined loosely as 'the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits the treaties were not designed to give them'.⁵⁸ The authors admitted that this definition begs a number of questions; notably, can we identify the persons whom a tax treaty is designed to benefit? In other words, how does a state distinguish between improper and bona fide arrangements? The OECD Conduit Report made the untenable assertion that the distinction was obvious. Specifically, it implied that improper conduit arrangements always involve entities having no shareholders resident in the same treaty state and having no substantial productive activities in that state.⁵⁹ If the lack of meaningful establishment is the concern (and in the author's view it is a legitimate concern) then surely there are more direct ways of addressing that concern; namely, by negotiating a more substantive definition of 'resident' in the relevant treaty article.

⁵⁸ UN Conduit Report (n 29) 2.

⁵⁹ OECD Conduit Report (n 28) [9], [23], [29], [37], [42].

Little progress has been made since 1988 in expounding the nature of treaty abuse. The current OECD Commentary, which was substantially revised in 2003 to clarify the views on this issue, states that it should not be ‘lightly assumed’ that a taxpayer has entered an abusive transaction.⁶⁰ The Commentary sets out the ‘guiding principle’ that treaty benefits should be denied only where ‘a main purpose’ for entering an arrangement was to secure a more favourable tax position and where obtaining that favourable treatment ‘would be contrary to the object and purpose of the relevant provisions’.⁶¹ The two elements of this guiding principle can be usefully described as the subjective component and the objective component.

These elements of treaty abuse have been expressed in slightly different terms by tax scholars, correspond to the international law doctrine of abuse of rights, and are usually embodied in the domestic anti-avoidance rules or principles of various states.⁶² For example, van Weeghel concludes that improper use of a tax treaty occurs where such use has the ‘sole intention’ of avoiding tax in either or both states and ‘defeat[s] fundamental and enduring expectations and policy objectives shared by both states’.⁶³ Vogel suggests that the limits of acceptable international tax planning are reached ‘where transactions are entered, or where entities are established, in other States, solely for the purpose of enjoying the benefit of particular treaty rules ... which otherwise would not be applicable’.⁶⁴ Rosenbloom observes that the term treaty shopping ‘connotes a premeditated effort to take advantage of the international tax treaty network,

⁶⁰ OECD Commentary (n 13) Art 1 [9.5].

⁶¹ *ibid.*

⁶² J Sasseville, ‘A Tax Treaty Perspective: Special Issues’ in Maisto (n 53) 57–58. The application of general anti-avoidance measures is addressed in ch 7.

⁶³ van Weeghel (n 27) 117, 258; cf Arnold and van Weeghel (n 53) 97.

⁶⁴ K Vogel, *Klaus Vogel on Double Taxation Conventions* (3rd edn, Kluwer, The Hague 1997) 117.

and careful selection of the most favourable treaty for a specific purpose'.⁶⁵ Evidently the definitions offered by Vogel and Rosenbloom, consistent with the first element of the OECD's guiding principle, stress the importance of deliberate, considered selection of a tax treaty.

The above expressions of the elements of abuse seems reasonable enough, yet in the author's view they are nebulous and require further explanation, particularly with respect to the objective component. It is unclear whether the UN agrees with the OECD's guiding principle for identifying treaty abuse.⁶⁶ Moreover, it is evident that various states and various taxpayers have differing perspectives regarding which uses of a tax treaty are 'contrary to the object and purpose' of the relevant treaty provisions or, in van Weeghel's formulation, defeat fundamental and enduring expectations and policy objectives shared by both states.⁶⁷

Returning to the three alleged problems with treaty shopping identified in the OECD Conduit Report, what can be discerned is that, at least in the OECD's view, a key factor is the intermediate entity's lack of substance in the treaty state. One has to wonder whether this factor is not sufficient for a finding of abuse in accordance with the OECD's guiding principle. It is questionable whether the main purpose or purposes of establishing such an entity are of any relevance to the identified problems of lack of reciprocity, double non-taxation, and disincentives to treaty negotiation. These

⁶⁵ Rosenbloom (n 4) 766–67.

⁶⁶ The current commentary to the UN Model merely quotes passages from the 1997 OECD Commentary, which lacks the analysis of the later OECD Commentaries. The commentary may soon be updated with recommendations on possible wording for treaty anti-abuse provisions: UN Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Abuse of Tax Treaties and Treaty Shopping* (UN Doc E/C.18/2005/2, Geneva 2005).

⁶⁷ For arguments that treaty shopping is simply intelligent tax planning see, eg, LB Terr, 'Treaty Routing vs Treaty Shopping: Planning for Multicountry Investment Flows under Modern Limitation of Benefits Articles' (1989) 12 *Intertax* 524; DA Ward, 'Abuse of Tax Treaties' in HA Alpert and K van Raad (eds), *Essays on International Taxation* (Kluwer, Deventer 1993); P Tadros, 'Caribbean Tax Treaties Create Unique Opportunities for Foreign Investment' (2004) 36 *Tax Notes Int'l* 873.

problems seem to constitute the very indicia of an arrangement being ‘contrary to the object and purpose’ of the applicable treaty, without regard to the subjective element. Nevertheless, the OECD and those states that take a fervent stance against treaty shopping continue to focus on both the objective and subjective components, indicating that a tax avoidance purpose is considered critical.

6.2.3(c) *UK and Canadian Perspectives*

Further insight into the views of government representatives regarding alleged treaty abuse can be obtained by looking at public statements of HMRC and the CRA, as well as their reactions to (and in Canada’s case initiation of) recent litigation.

Despite the fact that the UK imposes minimal withholding taxes, it is clear that HMRC are concerned about treaty shopping arrangements, including arrangements where the UK itself is selected as the conduit jurisdiction. The HMRC Enquiry Manual explains that Specialist Investigations become involved in cases of complex tax avoidance, with their specific areas of interest including ‘exploitation of tax haven companies’ and ‘tax treaty shopping’.⁶⁸ The HMRC International Manual draws attention to the fact that various UK tax treaties contain ‘anti-treaty shopping’ provisions; these are provisions inserted in the Articles governing dividends, interest, royalties, and other income which state that the reduced treaty rate shall not apply if it was ‘the main purpose or one of the main purposes of any person concerned’ with the creation or assignment of the shares, debt-claim, or the like ‘to take advantage’ of the relevant treaty Article.⁶⁹ Such provision are used in an increasing number of UK tax

⁶⁸ HMRC, Enquiry Manual (HMRC, London 2011) <www.hmrc.gov.uk/manuals/emmanual/index.htm> 0363.

⁶⁹ International Manual (n 34) 506010, 573120, 573121.

treaties.⁷⁰ Consistent with this approach, Article 5 of the Interest and Royalties Directive as implemented in the UK withdraws the benefits of the Directive in relation to transactions where ‘the main purpose or one of the main purposes of any person concerned’ is to take advantage of those benefits.⁷¹

Evidently these characterizations of treaty abuse are substantially if not exclusively focused on the subjective component identified above. There is no suggestion that tax-motivated arrangements are abusive only where they are contrary to the object or purpose of the relevant treaty – unless HMRC adopt the questionable position that, where a person implements an arrangement with a main purpose of obtaining treaty benefits, the tax-motivated arrangement is by definition contrary to the object and purpose of the treaty. Other HMRC statements do suggest that objective factors are relevant when considering cases of potential treaty abuse. The International Manual was amended in 2007, following the decision in *Indofood*,⁷² to state that the decision reflects an implicit anti-avoidance rule and is consistent with the UK’s ‘existing policy’ against treaty shopping.⁷³ Specifically, HMRC stated that:

... interpreting “beneficial ownership” in what the Court of Appeal called its “international fiscal meaning” clearly gives effect to the purpose and object of the DTC by excluding abusive cases such as “treaty shopping” from the benefits of a DTC.⁷⁴

⁷⁰ Text to nn 153–154.

⁷¹ FA 2004 s 104, rewritten to ITTOIA 2005 s 765, implementing Interest and Royalties Directive (n 18) Art 5. The Directive itself refers to ‘principal motives’ rather than ‘main purposes’.

⁷² (n 37).

⁷³ International Manual (n 34) 332050.

⁷⁴ *ibid.*

The meaning of this statement, and its relevance to the subjective and objective components of treaty abuse, are explored in the discussion of ‘beneficial ownership’ below.

Relative to HMRC, the CRA have stated more often and more zealously that they will challenge aggressive tax avoidance arrangements involving offshore entities, including ‘treaty shopping’ arrangements.⁷⁵ The CRA again seem to emphasize the subjective component of treaty abuse, referring to a taxpayer establishing residence in a treaty state ‘in order to avail itself’ of treaty provisions ‘for tax avoidance purposes’. The Advisory Panel on Canada’s System of International Taxation (Advisory Panel) conceded that ‘treaty shopping’ should be policed appropriately, yet it made no recommendations on how to achieve this.⁷⁶ Unfortunately neither the CRA nor the Advisory Panel have clarified what they consider to be the characteristics of treaty shopping, other than to say that such arrangements seek to avoid tax on the disposition of Canadian property or to reduce withholding tax on outflows of dividends, interest, or royalties. The weakness in this description is that there are many legitimate investments made by non-residents which, by virtue of a tax treaty between Canada and the investor’s country, will be immune to Canadian capital gains taxes or will face reduced Canadian withholding taxes – that is precisely what the treaty is intended to achieve. Similar to the OECD Conduit Report, the CRA seem to presume that the distinction between acceptable and abusive structures is obvious. Also echoing the OECD Conduit Report, the CRA have occasionally suggested that their concern is with arrangements

⁷⁵ A Nymark, ‘Strategic Priorities for the CCRA’ in Canadian Tax Foundation (ed), *2003 Conference Report* (Canadian Tax Foundation, Toronto 2004) 6:1, 6:3; CRA, *Income Tax Technical News No 30* (21 May 2004), *Income Tax Technical News No 34* (27 April 2006), and *Income Tax Technical News No 35* (26 February 2007), each available at <www.cra-arc.gc.ca/tx/tchncl/ncmtx/tnws3-eng.html>.

⁷⁶ Advisory Panel on Canada’s System of International Taxation, *Final Report: Enhancing Canada’s International Tax Advantage* (Department of Finance, Ottawa 2008) <www.apcsit-gcrfci.ca/index-eng.html> (Advisory Panel Report) [5.61]–[5.68]. The Advisory Panel merely concluded that the government ‘should continue to monitor developments in this area’.

where an intermediary in a treaty state has no physical offices, employees, assets, or significant activities, and is obligated to remit payments to a third party.⁷⁷ It is the author's view that focusing on these factors, all of which are objectively ascertainable, is more fruitful than evaluating a taxpayer's purposes or motivations.

The point at which the use of tax treaties is considered to become abuse is perhaps better illustrated by examining the challenges recently mounted by the CRA and Department of Justice in *MIL Investments*⁷⁸ and *Prévost*.⁷⁹ It is likely that HMRC have closely monitored the Canadian approach, particularly in *Prévost*; the case is considered internationally important as it is the first common law decision that directly examines the meaning of 'beneficial owner' for tax treaty purposes. The specific legal challenges to the arrangements, and the failure of those challenges, are discussed below in the context of other responses to treaty abuse.

6.3 CURRENT RESPONSES TO TREATY ABUSE

6.3.1 General Approach to Interpretation of Treaty Terms

Tax treaties, like other treaties, have a dual nature. They are international agreements according to which sovereign governments agree to divide jurisdiction but they also become part of the domestic law of each Contracting State.⁸⁰ This means that a tax treaty is simultaneously subject to the rules of interpretation in public international law

⁷⁷ CRA, Comments from 2006 Meeting of IFA, Canadian Branch (2006); CRA, Round Table Responses from 2009 IFA Conference (2009).

⁷⁸ (n 39).

⁷⁹ (n 42).

⁸⁰ The incorporation of a treaty into domestic law happens either upon ratification or upon enactment of separate legislation, depending on the constitutional tradition of the specific country: Baker (n 13) [F.01]; Vogel (n 64) 24–25. In the UK and Canada separate legislation is required.

and domestic tax law. There is a vast literature on the interpretation of tax treaties.⁸¹ As various scholars have explained, the rules of international law governing the interpretation and application of treaties, arising from the *Vienna Convention on the Law of Treaties* (Vienna Convention)⁸² and other sources of international law, are as much applicable to tax treaties as they are to any other type of treaty.⁸³ It is sufficient for present purposes to observe that British and Canadian courts, along with courts in most other countries, accept that DTCs should be interpreted accordingly.

The leading domestic authorities on tax treaty interpretation are the decision of the Court of Appeal in *Memec plc v IRC*⁸⁴ and the decision of the Supreme Court of Canada in *Crown Forest Industries Limited v Canada*,⁸⁵ each to similar effect. In *Memec* the Court approved the statement by Mummery J in *IRC v Commerzbank AG*⁸⁶ as capturing the correct approach; namely, that treaty terms should not be interpreted literally in accordance with English law but purposively in accordance with the intentions of both treaty states. In *Crown Forest* Justice Iacobucci observed that treaty terms should be given a liberal interpretation that best implements the true intentions of the Contracting States. The courts in both countries accept that due consideration must

⁸¹ eg Baker (n 13) esp [E.01]–[E.35]; Vogel (n 64) esp 32–51; DA Ward, ‘Principles to be Applied in Interpreting Tax Treaties’ (1980) 34 BIFD 545; JF Avery Jones, ‘Interpretation of Tax Treaties’ (1986) 40 BIFD 75; F Engelen, *Interpretation of Tax Treaties under International Law* (IBFD, Amsterdam 2004). In Canada it is also necessary to consider the Income Tax Conventions Interpretation Act, RSC 1985 c I-4.

⁸² (1980) TS 58 Cmnd 7964; [1980] Can TS 37; also available at <<http://untreaty.un.org/ilc/texts/texts.htm>>.

⁸³ RS Avi-Yonah, ‘International Tax as International Law’ (2004) 57 Tax Law Rev 483; Engelen (n 81) ch 10.

⁸⁴ [1998] STC 754 (CA).

⁸⁵ [1995] 2 SCR 802 (SCC).

⁸⁶ [1990] STC 285 (Ch) 297–298, summarizing the approach set out in *Fothergill v Monarch Airlines Ltd* [1981] AC 251 (HL).

be given to relevant model treaties, model commentaries,⁸⁷ and the principles expressed in Articles 31 and 32 of the Vienna Convention. Of particular note is paragraph 1 of Article 31 of the Vienna Convention, which provides that a treaty ‘shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose’.

Clearly this approach does not entail disregarding the text of the treaty. As Engelen observes, the basic assumption underlying Articles 31 and 32 of the Vienna Convention is that the treaty text is presumed to be the authentic expression of the intention of the Contracting States: ‘the starting point of interpretation is the elucidation of the meaning of the text, not an investigation ab initio into the subjective intentions of the parties’.⁸⁸ Some terms used in a tax treaty will be clearly defined in the treaty itself, while others will be defined by reference to the domestic laws of the Contracting States. Article 3(2) of the OECD Model directs that any term not defined in the treaty shall, unless the context otherwise requires, have the meaning that it has at that time under the domestic law of the State applying the treaty. It is important to note that the proviso ‘unless the context otherwise requires’ does not operate as some freestanding substance over form rule. Generally, the most appropriate domestic meaning of a term for the purposes of Article 3(2) will be ascertained by reference to the text, context, and purpose of the relevant domestic law, which may be insufficient to meet policy objectives that are peculiar to the treaty.⁸⁹ Of particular concern here, the text, context,

⁸⁷ The OECD Commentaries are a widely-accepted guide to the interpretation of treaties based on the OECD Model, yet there is some uncertainty regarding their legal status: Vogel (n 64) 43–47; Engelen (n 81) 439–73; JF Avery Jones, ‘The Effect of Changes in the OECD Commentaries after a Treaty is Concluded’ (2002) 56 BIFD 102. For recent judicial confirmation of the utility of the OECD Commentaries see *Smallwood* (n 36) and *Prévost* (n 42).

⁸⁸ Engelen (n 81) 541.

⁸⁹ For discussion see: JF Avery Jones, ‘Article 3(2) of the OECD Model Convention and the Commentary to It’ (1993) 33 *European Taxation* 252; Engelen (n 81) 473–77; MN Kandev, ‘Tax Treaty Interpretation: Determining Domestic Meaning under Article 3(2) of the OECD Model’ (2007) 55 *CTJ* 31.

and purpose of the relevant domestic law may not evince an interpretation that prevents perceived abuse of the treaty.

6.3.2 Interpreting ‘Person’ and ‘Resident’

6.3.2(a) Relevance of the Terms

As discussed in chapter 4, Article 1 of the OECD Model provides that the treaty in question ‘shall apply to persons who are residents of one or both of the Contracting States’. This is of vital importance because only those who are ‘persons’ and ‘residents’ of either Contracting State are entitled to treaty benefits. Article 3(1) of the OECD Model confirms that the term person includes a company. Article 4(1) provides that a resident of a Contracting State is ‘any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation’, or similar criterion. The relevant articles of the UN Model and the US Model are substantially similar in these respects. Most of the UK’s tax treaties and all of Canada’s tax treaties are expressly restricted in their application to persons who are residents of the relevant Contracting States, although the precise definition of resident varies from treaty to treaty. In virtually all tax treaties⁹⁰ the determination of a person’s status as someone who is liable to tax by reason of residence or other factors is made under domestic law.⁹¹

The first implication of these provisions is that treaty benefits will be unavailable where an entity in a conduit arrangement is not a ‘person’. The OECD Conduit Report observed that an entity which is not a juridical person liable to tax in is

⁹⁰ A notable exception is the Canada–United Arab Emirates tax treaty, Article 4[1] of which sets more rigorous conditions for an individual or company to qualify as a resident of the United Arab Emirates.

⁹¹ Ch 4 text to nn 109–113.

own right, such as a partnership or other fiscally transparent entity, could be excluded from treaty benefits.⁹² In its 1999 report on partnerships, the OECD observed that even if a partnership is taxed as if it were a person under domestic law it normally cannot qualify as a ‘resident’ for treaty purposes.⁹³ The more recent work of the OECD on collective investment vehicles (CIVs) suggests that a CIV should be treated as a person for treaty purposes if it is treated as a person under the domestic tax law of the state of establishment, and should be treated as a resident of that state unless it is treated as a flow-through entity for domestic tax law purposes.⁹⁴ These views are adopted in the current OECD Commentary and are not particularly contentious.⁹⁵

Further, Article 4(1) of the OECD Model excludes from the class of residents any person who is who is liable to tax in the Contracting State ‘in respect only of income from sources in that State...’. This provision ensures, among other aims, that branch operations of foreign enterprises cannot qualify as residents in their own right.⁹⁶ In *Crown Forest*, the critical issue was whether a Bahamas shipping corporation could claim the benefit of the Canada–US DTC as a ‘resident of the United States’ simply because the corporation had a place of management in the US. The Bahamas corporation filed income tax returns in the US but paid no tax there because it qualified as a foreign corporation exempt from US tax. The Supreme Court decided that the treaty

⁹² OECD Conduit Report (n 28) [13].

⁹³ OECD Committee on Fiscal Affairs, *The Application of the OECD Model Tax Convention to Partnerships* (OECD, Paris 1999).

⁹⁴ OECD Committee on Fiscal Affairs, *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles* (OECD, Paris 2009) (CIV Report).

⁹⁵ OECD Commentary (n 13) Art 1 [2]–[6.34], Art 4 [8.8].

⁹⁶ In *Commerzbank* (n 86), a treaty exemption from taxation on US-source interest was obtained by UK branches of German and Brazilian banks because the 1945 treaty between the UK and the US did not expressly restrict treaty benefits to residents. For further discussion see R Vann, ‘“Liable to Tax” and Company Residence under Tax Treaties’ in G Maisto (ed), *Residence of Companies under Tax Treaties and EC Law* (IBFD, Amsterdam 2009) 244–50.

was inapplicable, holding that a person must be liable to tax in a Contracting State on its worldwide income to be considered a ‘resident’ under the treaty. Specifically, it held that the criteria for determining residence in Article 4(1) ‘entail being subject to as comprehensive a tax liability as is imposed by a state’.⁹⁷ This position was expanded more recently in *TD Securities (USA) LLC v the Queen*,⁹⁸ where the Tax Court held that a limited liability company based in the US, the sole member of which was a US resident corporation, should be considered a resident of the US for purposes of the Canada–US DTC (prior to amendments made by the Fifth Protocol, effective 2007). This was so notwithstanding that the entity’s income flowed through and was taxed in the shareholder’s hands under US domestic law. The Court suggested, however, that under the limitation of benefits rule in the Fifth Protocol, the same result would not obtain where the member or members of a US limited liability company are foreign residents.⁹⁹

6.3.2(b) *Shortcomings of this Approach*

The UK and Canada could rely upon these basic provisions to deny the application of a tax treaty where a third state resident purported to obtain treaty benefits via a partnership, branch, or other fiscally transparent entity ‘located’ in the treaty partner state. The argument would be that the conduit was not established in the state and thus was not a treaty resident. The difficulty is that any well-advised MNE seeking to exploit a state’s treaty network will take the steps necessary to ensure that it achieves residence status in that state. It will typically use an affiliated corporation or trust, establishing formal residence in accordance with the state’s domestic laws.

⁹⁷ *Crown Forest* (n 85) [40].

⁹⁸ 2010 TCC 186, [2010] DTC 1137 (TCC).

⁹⁹ *ibid* [102]–[107]. Also see text following n 141.

This practice is, of course, not difficult. The OECD Commentary correctly observes that tax treaties do not concern themselves with the domestic laws of the Contracting States under which a person is to be treated as fiscally resident and, consequently, subject to comprehensive tax liability in that State. Nor do treaties set out minimum standards which the provisions of domestic laws on residence have to meet: ‘In this respect the States take their stand entirely on the domestic laws’.¹⁰⁰ We have already seen that the corporate residence rules in the UK and Canada endorse legal form over economic substance; the situation is the same in any state that uses place of incorporation as a residence test. The UN Conduit Report observed that, while Article 1 of the UN Model delimits the range of persons that a tax treaty is designed to benefit, this limitation does not mean that the advantages of a treaty will never extend beyond territorial boundaries, particularly to foreign shareholders.¹⁰¹ Thus, while it is true that a tax treaty must be interpreted in good faith and in accordance with its context and purpose, such interpretation does not amount to a substance-over-form approach that a court could employ to disregard the separate legal personality and residence of a corporation under relevant domestic law.

The only circumstance in which a treaty-specific concept of residence becomes relevant is when a person is considered a resident of both treaty states under their respective domestic laws.¹⁰² As discussed in chapter 4, in such circumstance Article 4 of the applicable treaty generally sets out preference criteria (‘tie-breaker rules’) for awarding residence to one Contracting State, which for corporations is usually the

¹⁰⁰ OECD Commentary (n 13) Art 4 [4].

¹⁰¹ UN Conduit Report (n 29) 3.

¹⁰² Unless the domestic law test and treaty preference criterion are the same. See OECD Commentary (n 13) Art 1 [10.1] regarding the use of ‘place of effective management’ as a domestic law residence test.

‘place of effective management’.¹⁰³ Nevertheless, only a poorly-advised MNE is likely to engage in activities that would result in a conduit corporation being resident in both the intended residence state and a treaty partner state, thereby bringing the preference criteria into play. In the normal case of the well-advised MNE, the fiscal residence of any intermediary would be determined solely by the domestic laws of the intended residence state.

A brief mention of *Indofood* should be made here. The ratio of the decision concerned the beneficial ownership of interest income that would flow from the Indonesian parent company to the proposed Dutch financing company and onward to the Mauritian financing company. In his reasons the Chancellor went on to observe that, in his view, both the proposed Dutch company and the existing Mauritian company would probably be considered resident in Indonesia for treaty purposes on the basis that they would be effectively managed there.¹⁰⁴ The Chancellor, relying on the definition of ‘effective management’ suggested in the OECD Commentary, observed that although the board of the new financing company might act independently in some matters all of the ‘key’ decisions would be made in Indonesia.¹⁰⁵ His reasoning is similar to that of the Special Commissioners in *Wood v Holden*¹⁰⁶ and is unconvincing because, among other things, neither the upper courts’ reversal in *Wood v Holden* nor any other cases on fiscal residence were put before the Court. The other Judges (including Chadwick LJ, who wrote the main appeal judgment in *Wood v Holden*) were sceptical about the Chancellor’s statements on this matter and preferred to decide the case solely on the

¹⁰³ OECD Model (n 8) Art 4[3]. See ch 4 text to nn 114–120.

¹⁰⁴ *Indofood* (n 37) [51]–[57]. The Chancellor assumed without explanation that the companies would be resident in Indonesia under Indonesian law, thus giving rise to dual residence under Article 4 of the relevant treaties.

¹⁰⁵ *Indofood* (n 37) [55]–[57].

¹⁰⁶ [2005] STC 789 (Ch), aff’d [2006] STC 443 (CA), discussed in ch 4 at text following n 90.

beneficial ownership issue. In short, while one may sympathize with the Chancellor's views on corporate residence, they are unlikely to have influence in future tax cases.¹⁰⁷

6.3.2(c) *Objective and Subjective Elements*

Whether a corporate intermediary is a 'person' and a 'resident' entitled to the desired treaty benefits are objective questions. A non-resident's motives or purposes in establishing such an entity are not relevant to its legal status as a person or resident under domestic law and – since tax treaties look to domestic law for this purpose – under the relevant treaty provisions. HMRC's characterization of treaty shopping relies very much on the subjective component and it is therefore not surprising that HMRC do not raise the residence status of a conduit entity as a possible ground for challenge, despite their approval of *Indofood*. The CRA appear to take a slightly different view.

The CRA view regarding which persons are entitled to the benefits of Canada's tax treaties is consistent with *Crown Forest* and the OECD Commentary: a person is considered liable to tax on the basis of residence if the person is subject to the most comprehensive form of taxation as exists in the relevant state.¹⁰⁸ The CRA have conceded that it does not necessarily follow from this requirement that a person actually pays tax to a particular jurisdiction. For example, it could be that an entity is fully subject to the tax jurisdiction of a state but the domestic law imposes low or nil rates of tax on such entities (such as pension funds) or on some forms of income. The CRA have expressed the following opinion:

In these cases, the CRA will generally accept that the person is a resident of the other Contracting State unless the arrangement is abusive (eg treaty shopping where the person is in fact only a "resident of convenience").

¹⁰⁷ See the observations in *Smallwood* (SpC) (n 36) [116]–[118].

¹⁰⁸ Technical News 34 (n 75); Technical News 35 (n 75).

Such could be the case, for example, where a person is placed within the taxing jurisdiction of a Contracting State in order to gain treaty benefits in a manner that does not create any material economic nexus to that State.¹⁰⁹

This comment suggests that the CRA divine some distinction between residence and residence of convenience, with that distinction being made on the basis of the subjective motives for establishment in the foreign state ('in order to gain treaty benefits') or the objective extent of establishment in that state ('material economic nexus'). While the overall tenor of this view is understandable, it once again tends to confound the objective and subjective components of treaty abuse. In an ideal world one might identify treaty abuse by questioning the economic reality of an entity's nexus with a state, consistent with the second element of the CRA's opinion above. Yet in the case of corporate entities this will not be possible without significant changes in the understanding of corporate residence, despite the Chancellor's observations in *Indofood*. The fact remains that corporate residence will be determined according to the provisions of the domestic laws of the Contracting States, provisions which currently tend to be formalistic and not amenable to substance-over-form analysis. It is therefore not surprising that in *MIL Investments* and *Prévost*, discussed below, the CRA did not seek to challenge the residence status of the respective holding companies.

6.3.3 Interpreting 'Beneficial Ownership'

A second feature of tax treaties that may be relied upon by governments to prevent more blatant conduit arrangements – assuming the conduit entity qualifies as a person and a resident – is the concept of 'beneficial ownership'. We noted above that the passive income articles in the OECD Model and the UN Model allocate tax jurisdiction to both the residence/home state and the source/host state, with limits set on source taxation

¹⁰⁹ Technical News 35 (n 75).

where the ‘beneficial owner’ of the income is a resident of the other state. This means that, where a UK or Canadian entity pays dividends, interest, or royalties to a treaty-resident investor, reduced withholding taxes generally apply only if the recipient is the beneficial owner of the payment.¹¹⁰

6.3.3(a) *History of the Term in Tax Treaties*

The concept of ‘beneficial ownership’ is employed in the OECD Model, other model conventions, and numerous tax treaties worldwide. The terms ‘beneficial owner’, ‘beneficially owned’, or ‘beneficially entitled’ appear in all newer UK tax treaties¹¹¹ and in every one of Canada’s tax treaties.¹¹² Yet prior to the *Prévost* decision there was no British or Canadian jurisprudence interpreting the beneficial ownership requirement in the treaty context.

Tax scholars have established that the first reference to this concept appeared in the 1966 protocol to the former UK–US tax treaty, replacing an earlier requirement in the dividends, interest, and royalties articles that the recipient be ‘subject to tax’ on the income in its state of residence.¹¹³ The term was also used in the UK–Canada tax treaty of 1966. The concept was adopted in the 1977 OECD Model and from there found its way into various countries’ tax treaties. Prior to the widespread inclusion of this term, it was possible for states to reach the same result by interpreting the terms ‘paid’ and

¹¹⁰ A similar restriction applies in FA 2004 s 98, rewritten to ITTOIA 2005 s 758, implementing Interest and Royalties Directive (n 18) Art 1.

¹¹¹ Some treaties not amended after the introduction of the 1977 OECD Model use only a ‘subject to tax’ requirement for dividends, interest, and royalties: eg the treaties with Barbados, Greece, Israel, and Portugal.

¹¹² Of Canada’s 88 tax treaties currently in force, 75 refer to beneficial ownership in the Articles for dividends, interest, and royalties, while 13 refer to it only with respect to dividends (each of these was negotiated or last amended before 1985).

¹¹³ JF Avery Jones, L De Broe, and others, ‘The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States’ [2006] BTR 695, 753–54.

‘received’ such that they referred only to the ultimate recipient of an amount.¹¹⁴ Thus, the US Tax Court in *Aiken Industries v CIR* held that interest payments made from a US corporation to a related Honduras corporation, where an equivalent amount of interest was paid onward to a related Bahamas corporation, were not actually ‘paid’ to the Honduran entity.¹¹⁵ The court considered that the Honduran entity did not have ‘complete dominion and control’ over the funds; therefore the treaty exemption from US withholding tax did not apply. This decision, however, was influenced by anti-avoidance doctrines that are peculiar to the US. The Canadian case *MacMillan Bloedel Ltd v MNR* demonstrates a very different approach.¹¹⁶ There the Revenue argued that interest paid on Canadian debentures to two nominees, a US firm of stockbrokers and a US bank, were not ‘received’ by the nominees but were in substance received by the beneficial owners of the interest. The Tax Review Board was not willing to read a ‘beneficial ownership’ requirement into the interest article of the (former) Canada–US tax treaty. Instead it applied the treaty literally and allowed the reduced withholding rate on the interest payments. Under more recent tax treaties, the express restriction of relief to the beneficial owner of dividends, interest, or royalties ensures a more sensible result.

6.3.3(b) *Conflicting Meanings*

The difficulty that has arisen with the interpretation of beneficial ownership in tax treaties is that there is no universally accepted meaning for the term. Much like the concept of ‘place of effective management’, the tendency of tax practitioners is to assume that the term means whatever it means under their home state’s domestic

¹¹⁴ See van Weeghel (n 27) 59–64.

¹¹⁵ (1971) 56 TC 925 (USTC).

¹¹⁶ (1979) 79 DTC 297 (TRB).

laws,¹¹⁷ although here that assumption may be warranted. This has given rise to a tension between the common law meaning and what has been described as the ‘international fiscal meaning’.

The OECD Conduit Report made reference to the original commentary to the 1977 OECD Model, which stated that an agent or nominee would not qualify as a beneficial owner. The OECD Conduit Report added ‘conduit company’ to the list of potentially excluded persons, asserting that:

... a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company).¹¹⁸

The UN Conduit Report similarly stated that a person would not be considered a beneficial owner if the person was ‘a mere nominee or agent’ or ‘a conduit company’ whose powers over assets were so narrow as to render it ‘a mere fiduciary or administrator’.¹¹⁹ These statements are not contentious insofar as a nominee, agent, fiduciary, or administrator is by definition a nominal owner only – none would qualify as a beneficial owner under any understanding of that term. The status of CIVs is perhaps less clear.¹²⁰ Even more debatable is whether a ‘mere fiduciary’ or ‘administrator’ should encompass an intermediate corporation in a corporate group, despite having independent legal personality and exercising independent powers. Put another way, is a company that is substantially or wholly owned by another, and is therefore likely (but not obliged) to pay to its parent company any amounts received by

¹¹⁷ Ch 4 text to nn 140–143.

¹¹⁸ OECD Conduit Report (n 28) [14].

¹¹⁹ UN Conduit Report (n 29) 8.

¹²⁰ CIV Report (n 94) [28]–[31] and Annex 1.

way of dividends or interest, the beneficial owner of amounts it receives? Each state's answer to that question will depend on how the term beneficial ownership is understood in its domestic law, and on how its domestic approach to tax avoidance moderates or amplifies that understanding.

Given that its origins lie in the UK–US DTC and UK–Canada DTC, beneficial ownership is clearly a common law concept derived from the distinction between legal and equitable ownership.¹²¹ Lawyers working in common law systems might illustrate the distinction by pointing to the different rights and obligations of a trustee and beneficiary under a trust. A beneficial owner is distinguished from a mere legal owner by the fact that he, she or it can ultimately exercise the rights of ownership in the property.¹²² It follows that a parent company is not the 'beneficial owner' of the assets of its subsidiary because a shareholder has no proprietary interest in the assets of a company. The concept is well-established in common law legal systems and appears throughout UK and Canadian tax legislation.

Yet the OECD Commentary, drawing on the statements from the OECD Conduit Report quoted above, states that the term beneficial owner is not used 'in a narrow technical sense'.¹²³ The Commentary entreats states to give the term what Baker describes as an 'international fiscal meaning', not derived from the domestic laws of the Contracting States.¹²⁴ Two reasons that the OECD takes this view are: (i) it believes the term should be interpreted in the light of its anti-avoidance purpose; and (ii) it hopes to

¹²¹ Avery Jones et al (n 113) 747–54.

¹²² *Ayerst v C & K (Construction) Ltd* [1976] AC 167 (HL) 177; *J Sainsbury plc v O'Connor* [1991] STC 318 (CA) 328–30; *Jodrey Estate v Nova Scotia (Minister of Finance)* [1980] 2 SCR 774 (SCC) 784. For detailed analysis see: AK Rowland, 'Beneficial Ownership in a Corporate Context: What is it? When is it Lost? Where Does it Go?' [1997] BTR 178; C Brown, 'Beneficial Ownership and the Income Tax Act' (2003) 51 CTJ 402.

¹²³ OECD Commentary (n 13) Art 10 [12], Art 11 [9], Art 12 [4].

¹²⁴ Baker (n 13) [10B]–[14].

achieve an internationally consistent meaning for the term notwithstanding that most civil law jurisdictions do not recognize the common law duality of legal and equitable ownership. Some civilian states are inclined to interpret beneficial ownership as ‘substantive’ or ‘effective’ ownership.¹²⁵ Even among continental European states there is no general agreement as to the meaning of the term.¹²⁶ Thus the OECD prefers an autonomous treaty meaning, independent of any domestic law.

6.3.3(c) *Indofood*

The alleged international fiscal meaning of beneficial ownership was heavily relied upon in *Indofood*.¹²⁷ As noted above, the success of the planned structure depended on the proposition that the Dutch financing company would be the beneficial owner of the intended interest payments within the meaning of the Indonesia–Netherlands tax treaty. The Court of Appeal held unanimously that the Dutch company would not be the beneficial owner of the interest and thus the treaty relief aspired to would not apply. It reached this conclusion by considering how beneficial ownership would be understood *by an Indonesian court*, having regard to a circular published by the Indonesian Director General of Taxes on this issue, the Indonesian principle of substance over form in tax matters, Article 31 of the Vienna Convention, and the interpretation of beneficial ownership suggested by the 2003 OECD Commentary. The Court refused to adopt a ‘technical and legal’ approach, focusing instead on the commercial and practical reality of the arrangement.¹²⁸ On that basis it decided that neither the Dutch company nor the

¹²⁵ The French text of UK and Canadian tax treaties (eg treaties with France and Belgium) uses the term ‘*le bénéficiaire effectif*’. The Spanish text (eg treaties with Spain and Argentina) uses the term ‘*el beneficiario efectivo*’.

¹²⁶ C du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties* (IBFD, Amsterdam 1999); JDB Oliver and others, ‘Beneficial Ownership and the OECD Model’ [2001] BTR 27.

¹²⁷ (n 37).

¹²⁸ (n 37) [44].

Mauritian company would beneficially own the interest payments they received because neither would have the ‘full privilege to directly benefit from the income’.¹²⁹

The *Indofood* decision caused concern among tax practitioners, who were quick to point out that the case is of no precedential value in the UK or Commonwealth.¹³⁰ This is because the case related to Indonesian law and, in any event, the relevant UK tax jurisprudence with respect to beneficial ownership was not put before the Court. As noted previously, HMRC nevertheless claim that the *Indofood* decision reflects an implicit anti-avoidance rule and that such an approach is consistent with the UK’s ‘existing policy’ against treaty shopping.¹³¹ It would appear that the CRA, at least until recently, also subscribed to this view.

6.3.3(d) *Prévost*

In *Prévost* the CRA asserted that the Swedish and UK investors had abused the Canada–Netherlands DTC by routing dividends from the Canadian operating company through the Dutch holding company PHBV.¹³² Specifically, the CRA assessed on the basis that the ‘beneficial owners’ of the dividends paid by *Prévost* were the corporate shareholders of PHBV in Sweden and the UK, rather than PHBV itself. The Department of Justice, when arguing the case, did not deny that PHBV existed or that it qualified as a resident of the Netherlands. They argued instead that PHBV was a mere conduit company which exercised no real control over the funds it received from *Prévost*. In

¹²⁹ (n 37) [42]–[44].

¹³⁰ eg R Fraser and JDB Oliver, ‘Treaty Shopping and Beneficial Ownership’ [2006] BTR 422; M McGowan, ‘*Indofood* Court Expands Interpretation of Beneficial Ownership’ (2006) Tax Notes Int’l 1091. Also note the stark contrast of the Indian Supreme Court decision in *Azadi Bachao Andolan* (n 55).

¹³¹ The International Manual states that the *Indofood* conclusion regarding beneficial ownership in the treaty context is ‘now part of UK law’: International Manual (n 34) 332050. This view is criticized in R Fraser and JDB Oliver, ‘Beneficial Ownership: HMRC’s Draft Guidance on Interpretation of the *Indofood* Decision’ [2007] BTR 39.

¹³² (n 42).

support of this they pointed to the shareholders' agreement under which substantially all of the Prévost dividends were paid onward to the 'ultimate' corporate shareholders, as well as the fact that PHBV lacked any meaningful presence in the Netherlands. They submitted that the term 'beneficial owner' had no settled meaning in Canadian tax law and should be given an international fiscal meaning, an argument no doubt inspired by the decision in *Indofood*.

In some ways this argument was dead before it even began. First is the obvious fact that Canada, being a jurisdiction in the Anglo-Commonwealth legal tradition, has ample experience with the distinction between legal and beneficial ownership in domestic law. Article 3 of the Canada–Netherlands DTC, consistent with the OECD Model, directs that undefined treaty terms shall have the meaning taken from the domestic law of the relevant State 'unless the context otherwise requires'.¹³³ The only way to escape the domestic law meaning of beneficial ownership would be to argue that the context otherwise requires, with 'context' interpreted broadly so as to incorporate other sources mentioned in Articles 31 and 32 of the Vienna Convention. Yet even if one took this approach, it is not obvious how one would arrive at an 'international fiscal meaning' that serves an anti-avoidance purpose. Moreover, Canada has publically acknowledged in the context of the Canada–US DTC that the term 'beneficial owner' should be construed under the domestic law of the source/host state.¹³⁴ It is therefore unsurprising that this argument found no favour in the courts.

¹³³ Canada–Netherlands DTC (n 31) Art 3[2].

¹³⁴ The US Treasury's Technical Explanation to the Fifth Protocol (2008), available at <www.treasury.gov/resource-center/tax-policy/treaties/Pages/default.aspx>, states that the term 'beneficial owner' should be determined under the internal law of the host country in question. It implies that only nominees, agents, and conduits would not be regarded as beneficial owners under the domestic laws of Canada and the US (pp 9–10). It goes on to say that treaty shopping is prevented only through express anti-abuse rules in the treaty or in domestic law (pp 51–61). Canada has acknowledged that it agrees with the Technical Explanation: Minister of Finance, News Release 2008-052 (10 July 2008)

The Tax Court in *Prévost* adopted the purposive approach to treaty interpretation enunciated in *Crown Forest*, having regard to the OECD Conduit Report, the 2003 OECD Commentary, and Article 31 of the Vienna Convention, but failed to see how any of this could amplify the Canadian (or Dutch) meaning of beneficial ownership. Having considered extensive submissions and expert evidence on the matter, Justice Rip observed that one is the beneficial owner of income under Canadian or Dutch law unless one is *legally obliged* to release the income to someone else. He concluded as follows:

In my view the “beneficial owner” of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. ... In short the dividend is for the owner’s own benefit and this person is not accountable to anyone for how he or she deals with the dividend income. When the Supreme Court in *Jodrey* stated that the “beneficial owner” is one who can “ultimately” exercise the rights of ownership in the property, I am confident that the Court did not mean, in using the word “ultimately”, to strip away the corporate veil so that the shareholders of a corporation are the beneficial owners of its assets, including income earned by the corporation.¹³⁵

Justice Rip reiterated that PHBV was a duly constituted legal entity carrying on corporate activity in accordance with Dutch law and that there was no ‘predetermined or automatic flow of funds’ from PHBV to its shareholders.¹³⁶ Accordingly PHBV was held to be the beneficial owner of the dividends paid to it by *Prévost* and the five per cent withholding tax rate was maintained.

The Federal Court of Appeal, in a brief judgment, dismissed the Crown’s appeal. It could discern no error in the Tax Court’s factual findings or legal conclusions. Justice Décarý observed that the broad interpretation of beneficial ownership advanced by the

<www.fin.gc.ca/news08/08-052e.html>. Equivalent views are expressed in the US Treasury’s Technical Explanation to the 2002 Protocol amending the UK–US DTC (2003) (pp 37, 46, 77), available at <www.treasury.gov/resource-center/tax-policy/treaties/Pages/default.aspx>.

¹³⁵ *Prévost* (TCC) (n 42) [100].

¹³⁶ *ibid* [102]–[103].

Crown ‘opens up a myriad of possibilities which would jeopardize the relative degree of certainty and stability that a tax treaty seeks to achieve’.¹³⁷ He further stated that the Crown seemed to be urging the Court ‘to adopt a pejorative view of holding companies which neither Canadian domestic law, the international community nor the Canadian government’ have adopted.¹³⁸

6.3.3(e) *Objective and Subjective Elements*

As with corporate personality and residence, the beneficial ownership of income streams should be seen as an objective issue. A non-resident’s motives or purposes in establishing an intermediate entity are irrelevant to that entity’s status as a beneficial owner or otherwise. HMRC and the CRA nonetheless seem to have confused the objective issue of beneficial ownership with unrelated subjective and objective issues. HMRC’s approval of *Indofood* states that the decision supports the government’s existing, purpose-based approach to treaty shopping (a subjective approach), while the CRA’s position advanced in *Prévost* attempted to relate beneficial ownership to the holding company’s lack of presence in its jurisdiction of residence (a separate objective issue). This imprecise approach resulted in total failure for the government in *Prévost*, and is unlikely to be effective against perceived treaty abuses in future.¹³⁹

The author understands that, following the decision in *Prévost*, there has been some consideration given to introducing a more substantive definition of beneficial ownership for Canadian tax treaty purposes. Whether this would be achieved through blanket legislation or via renegotiation of individual treaties is unclear. The Advisory

¹³⁷ *Prévost* (FCA) (n 42) [15].

¹³⁸ *ibid.*

¹³⁹ The CRA nonetheless maintain that arrangements much like that in *Prévost* are open to challenge: CRA 2009 (n 77).

Panel recommended, based upon submissions made to them, ‘that it might be best to wait for a globally agreed definition before taking unilateral action in this regard’,¹⁴⁰ a comment consistent with the pro-competitiveness tenor of their report.

6.3.4 Applying Limitation of Benefits Rules

The limited efficacy of the interpretive approaches reviewed above suggests that, if a state wishes to exercise greater control over who may use its tax treaties, it should include express statements to that effect within its treaties. Existing treaty provisions of this nature fit into two categories: those that look at objective factors relating to the qualities of the person seeking treaty benefits; and those that consider the subjective intentions of the person seeking treaty benefits. Such provisions are known as ‘limitation on benefits’ or ‘limitation of benefits’ (LOB) articles.¹⁴¹ Alternatively, a state may advance the view that a principle prohibiting treaty abuse is inherent in all of its tax treaties, without requiring expression in the text. A final approach – discussed in the next chapter – is for a state to have recourse to its domestic anti-avoidance laws to counter tax treaty abuse.

Neither the OECD Model nor the UN Model includes express anti-abuse provisions. This seems to follow from the conclusion reached in the UN Conduit Report that it is not possible to say as a general rule that provisions prohibiting abuse should be a standard feature of tax treaties; the UN stated that it is for each state to consider the probability and extent of any abuse and to weigh that against the economic benefits of the treaty left unguarded.¹⁴² It remains the case that a few of the largest developed

¹⁴⁰ Advisory Panel Report (n 76) [5.66].

¹⁴¹ eg FA Vega Borrego, *Limitation on Benefits Clauses in Double Taxation Conventions* (Kluwer, The Hague 2006).

¹⁴² UN Conduit Report (n 29) 19.

nations, notably the US, the UK, and Germany, have independently made policy decisions to incorporate LOB articles in their tax treaties.

6.3.4(a) *Objective LOB Articles*

The US has been vigilant in guarding its treaty network from unintended use since the introduction of its own model convention 30 years ago. The US holds strongly to the view that its tax treaties should include express provisions preventing access by residents of third countries.¹⁴³ This is achieved by the very detailed LOB rules in Article 22 of the US Model. In the UK–US DTC these provisions appear as Article 23;¹⁴⁴ in the Canada–US DTC they appear as Article 29A.¹⁴⁵

In general, these rules do not rely on an analysis of taxpayer motives but instead set forth a series of objective tests to determine whether a person has a sufficient economic nexus with a Contracting State to warrant treaty benefits. The US article delineates who is a ‘qualified person’, which includes resident individuals, certain publicly traded companies, and certain other companies for which at least half of the voting shares are owned by qualified persons. A resident who is not a ‘qualified person’ may nevertheless be entitled to treaty benefits with respect to an item of income derived from the source state if the resident ‘is engaged in the active conduct of a trade or business’ in the residence state (other than certain investment businesses) and the income is derived in connection with that trade or business. The US view is that ‘Article 22 effectively determines whether an entity has a sufficient nexus to the Contracting

¹⁴³ US Commentary (n 22) Art 22.

¹⁴⁴ UK–US DTC (n 23) Art 23; cf *Convention between the United Kingdom of Great Britain and Northern Ireland and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains* (2006) Art 22.

¹⁴⁵ Canada–US DTC (n 24) Art 29A. The article was added to the treaty in 1995, but at the time applied unilaterally in favour of the US. It was not until the Fifth Protocol that the provision was made reciprocal.

State to be treated as a resident for treaty purposes'.¹⁴⁶ In effect, the US LOB article introduces more substantive conditions for fiscal residence than exist under most states' domestic laws – conditions that are far more substantive than the US incorporation rule.

6.3.4(b) *Other LOB Articles*

Other states employ LOB articles that are less methodical than the US provisions. Of particular interest are the treaties negotiated by Germany and by the UK.

Germany tends to include a general statement about prevention of abuse in its tax treaties. For example, Article 29(6) of its tax treaty with Canada sets out the following general rule:

Nothing in the Agreement shall be construed as preventing a Contracting State from denying benefits under the Agreement where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Agreement or of the domestic laws of that State.¹⁴⁷

A very similar provision appears as Article 29A(7) of the Canada–US DTC, supplementing the detailed LOB rules. The new UK–Germany tax treaty,¹⁴⁸ although lacking an express provision of this nature, is supplemented by a Joint Declaration about 'improper use of the Convention' and taxation of pension schemes; the declaration regarding improper use reads as follows:

Having regard to paragraphs 7 to 12 of the Commentary to Article 1 of the OECD model tax convention, it is understood that this Convention shall not be interpreted to mean that a Contracting State is prevented from applying its domestic legal provisions on the prevention of tax evasion or

¹⁴⁶ US Commentary (n 22) Art 22 [1].

¹⁴⁷ *Convention between Canada and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income and Certain Other Taxes, the Prevention of Fiscal Evasion and Assistance in Tax Matters* (2001) Art 29(6).

¹⁴⁸ *Convention between the United Kingdom of Great Britain and Northern Ireland and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* (2010).

tax avoidance where those provisions are used to challenge arrangements which constitute an abuse of the Convention.¹⁴⁹

Treaty benefits can, therefore, be denied under these treaties where allowing the benefits would constitute an ‘abuse’ of the treaty. This approach, which evidently is vague, would presumably take account of both objective and subjective elements. The UK–Germany Joint Declaration states that an ‘abuse’ is considered to occur where ‘a main purpose for entering into certain transactions or arrangements is to secure a more favourable tax position’ and obtaining that treatment ‘would be contrary to the object and purpose of the relevant provisions of the Convention’.¹⁵⁰ This statement reproduces the OECD guiding principle for identifying treaty abuse.¹⁵¹

However, the current tendency of the UK is to deny particular treaty benefits where a person involved in an arrangement has a dominant tax avoidance purpose, without reference to the object and purpose of the treaty itself. The language employed recalls that of the CFC motive test, discussed in the previous chapter,¹⁵² and other targeted anti-avoidance rules (TAARs) used throughout UK tax legislation. For example, the interest article of the UK–Canada DTC contains the following exclusion:

The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment.¹⁵³

¹⁴⁹ *Joint Declaration by the United Kingdom of Great Britain and Northern Ireland and the Federal Republic of Germany on the Occasion of the Signing on 30th March 2010 in London of the Convention between the United Kingdom of Great Britain and Northern Ireland and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* (2010) (UK–Germany Joint Declaration) [1].

¹⁵⁰ *ibid.*

¹⁵¹ OECD Commentary (n 13) Art 1 [9.5]; text to nn 60–61.

¹⁵² Ch 5 text following n 164.

¹⁵³ UK–Canada DTC (n 20) Art 11[11], inserted in 2003.

There are similar exclusions for dividends, interest, royalties, and other income in many newer or recently amended UK tax treaties.¹⁵⁴ This is now a common UK treaty provision and has gained wider acceptance in the OECD Commentary.¹⁵⁵ Canada has followed suit by negotiating equivalent provisions in a handful of tax treaties recently concluded with smaller countries.¹⁵⁶

The UK–US DTC takes a slightly different approach, denying relief from source state taxation in respect of dividends, interest, royalties, and other income paid under or as part of a ‘conduit arrangement’. In broad terms this means a transaction or series of transactions which is structured such that a treaty-resident entity receives an item of income but pays substantially all of that income in any form to a resident of a third state not entitled to similar treaty benefits, and which ‘has as its main purpose, or one of its main purposes, obtaining such increased benefits’.¹⁵⁷ Again the subjective component is critical.

¹⁵⁴ eg the treaties with Australia, France, Germany, Hong Kong, Oman, and Saudi Arabia. The language used in the new tax treaty with the Netherlands (*Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains* (2010)) is particularly interesting. Article 10[3] of the new treaty provides:

No relief shall be available under this Article if it was the main purpose or one of the main purposes of any person concerned with an assignment of the dividends, or with the creation or assignment of the shares or other rights in respect of which the dividend is paid, or with the establishment, acquisition or maintenance of the company that is the beneficial owner of the dividends and the conduct of its operations, to take advantage of this Article. In any case where a Contracting State intends to apply this paragraph, its competent authority shall in advance consult with the competent authority of the other Contracting State.

There are equivalent rules for interest, royalties, and other income. Apparently these provisions were included at the insistence of the Netherlands: R Offermanns and PM Smit, ‘The New Netherlands–UK Tax Treaty 2008 – An Analysis’ (2009) 49 *European Taxation* 59, 62–63.

¹⁵⁵ OECD Commentary (n 13) Art 1 [21.4].

¹⁵⁶ eg the treaties with Mexico, Oman, and Peru.

¹⁵⁷ UK–US DTC (n 23) Art 3[1].

6.3.4(c) *Implications*

The difficulty with applying a ‘main purposes’ test or other subjective test for abuse is that, as noted in the UN Conduit Report, it is ‘a notoriously difficult business’ to show that arrangements have been entered into for the main purpose of benefiting from a treaty.¹⁵⁸ The UN therefore encouraged the use of objective tests instead. In any event, there are as yet no judicial decisions on disqualification from UK or Canadian tax treaty benefits under an express LOB article, whether objective or subjective.¹⁵⁹ The structures proposed or used in *Indofood*, *MIL Investments*, and *Prévost* likely would have failed under a US-style LOB provision because the controlling shareholders of the treaty entities were not residents of the relevant treaty states and, from all indications, the entities carried on no active business. One can only speculate whether the Canadian decisions would have been different had the respective tax treaties contained purpose-based anti-treaty shopping provisions. The observations made in *MIL Investments*, discussed below, suggest that the outcome would have been the same.

6.3.5 **Applying Other Anti-Avoidance Rules**

Some jurisdictions take the view that a principle prohibiting treaty abuse is inherent in all of their tax treaties, obviating the need to express such a principle through any kind of LOB provision. This argument derives from public international law, particularly Article 31 of the Vienna Convention, which provides that a treaty ‘shall be interpreted in good faith’, and Article 26 thereof, which provides that every treaty ‘is binding upon the parties to it and must be performed by them in good faith’.¹⁶⁰ It is said that the

¹⁵⁸ UN Conduit Report (n 29) 8, 17–18; cf OECD Conduit Report (n 28) [42].

¹⁵⁹ The issue did not arise in *Crown Forest* because the then-current version of the Canada–US DTC did not contain a LOB article.

¹⁶⁰ Engelen (n 81) ch 6; N Goyette, ‘Tax Treaty Abuse: A Second Look’ (2003) 51 CTJ 764, 765–75.

obligation to interpret and perform a treaty in good faith creates an autonomous ‘abuse of law’ principle with respect to tax treaties, similar to the domestic doctrines applied by some states. The OECD Commentary entreats Contracting States to interpret and apply tax treaties in accordance with the guiding principle mentioned previously, suggesting this may be sufficient to disregard abusive transactions without recourse to express LOB rules or domestic anti-avoidance rules.¹⁶¹ The OECD recognizes, however, that not all states share this view. There is a reasonable argument that the principle of good faith in the interpretation and application of tax treaties relates solely to the good faith of the Contracting States, not of taxpayers who seek to rely on the treaty.¹⁶²

6.3.5(a) *International Approaches*

An interesting example of the application of an implicit anti-abuse principle is the decision of the Swiss Federal Supreme Court in *A Holding ApS v Federal Tax Administration*.¹⁶³ As in *Prévost*, the case involved an international flow of dividends through special purpose companies. An individual resident in Bermuda was the sole shareholder of a Bermuda company, which in turn owned a Guernsey company, which in turn owned a Danish holding company, which in turn owned all of the shares of a Swiss operating company. It was claimed that dividends distributed by the Swiss company to the Danish entity were exempt from Swiss withholding tax by virtue of the tax treaty between Switzerland and Denmark. The Danish holding company had no assets or employees and its only activity was to receive and pay dividends. It was accepted that the holding company was a resident of Denmark for purposes of Danish law and that it took beneficial ownership (albeit briefly) of the Swiss dividends. The

¹⁶¹ OECD Commentary (n 13) Art 1 [9.3]–[9.5]; text to nn 60–61.

¹⁶² Engelen (n 81) 124–28; cf *MIL Investments* (n 39).

¹⁶³ (2005) 8 ITLR 536 <www.bger.ch/>. For commentary in English see: S Oesterhelt and M Winzap, ‘Swiss Supreme Court Decision on Treaty Abuse’ (2006) 46 *European Taxation* 461.

issue was whether these dividends could be denied the treaty exemption from Swiss tax on some other basis. The tax treaty with Denmark did not have an express anti-abuse principle, unlike some Swiss tax treaties, and the Swiss domestic tax avoidance legislation apparently did not apply to this situation. The Supreme Court nonetheless decided that, by virtue of international law, all Swiss tax treaty provisions must be interpreted so as to prevent abuses of the treaty. It considered this arrangement to be abusive and therefore denied the treaty relief claimed.

That decision was atypical in that the court was unable to ground its decision in any express provision in the treaty or in any domestic anti-avoidance rule. Courts in other civil law jurisdictions and the US have reached similar conclusions about the ineffectiveness of conduit arrangements that seek treaty benefits; however, these decisions tend to rely on domestic anti-avoidance rules as applied to international transactions.¹⁶⁴ Decisions of this nature include: the *Bank of Scotland* case,¹⁶⁵ where the French Supreme Administrative Court interpreted ‘le bénéficiaire effectif’ in the light of the French doctrine of abuse of law; *Del Commercial Properties*,¹⁶⁶ where the US Court of Appeals, affirming the decision of the Tax Court, applied the US step-transaction doctrine in concluding that certain loan payments purportedly made from a US corporation to a Dutch intermediary were in substance made to the ultimate Canadian lender; and *Indofood*,¹⁶⁷ where the Court of Appeal considered the Indonesian legal principle of substance over form when interpreting ‘beneficial ownership’. There are other such decisions but the relevance of any of them in the UK or Canada is limited.

¹⁶⁴ Discussed further in ch 7.

¹⁶⁵ *Bank of Scotland v Ministre de l’Economie, des Finances et de l’Industrie*, Case 283314 (29 December 2006) <www.legifrance.gouv.fr/>. For commentary in English see B Gibert and Y Ouamrane, ‘Beneficial Ownership – A French Perspective’ (2008) 48 *European Taxation* 2.

¹⁶⁶ *Del Commercial Properties Inc v Commissioner of Internal Revenue*, 251 F.3d 210 (DC Cir 2001).

¹⁶⁷ (n 37).

6.3.5(b) *UK and Canadian Perspectives*

We have seen that a growing number of UK tax treaties contain express provisions against treaty shopping. HMRC also take the view that beneficial ownership has an international fiscal meaning that serves an anti-avoidance purpose, a view that is almost certainly wrong in the light of *Prévost*. Beyond this, there is no evidence that HMRC believe that all UK tax treaties reflect some implied anti-abuse principle derived from international law. As for Canada, the few Canadian tax treaties that contain express anti-treaty shopping or anti-abuse rules appear to have been designed that way at the insistence of the other Contracting State, notably the US and Germany. The Canadian tax treaties that are often exploited in treaty shopping arrangements, such as those with Barbados, Luxembourg, and the Netherlands, have no such rules.

The question becomes whether UK and Canadian tax treaties that are devoid of anti-abuse rules should be read as containing an implied anti-abuse principle, similar to the approach in *A Holding ApS*. In 2003 and 2004 the CRA expressed the view that, where it identified cases of treaty abuse, it would seek to deny benefits through two related approaches:¹⁶⁸ it would rely on an inherent principle against the abuse of treaties and would also challenge the arrangement under Canada's general anti-avoidance rule (GAAR).¹⁶⁹ Both of these approaches were advanced in *MIL Investments*.

As explained previously, *MIL Investments* involved a complex series of transactions that resulted in no taxation in Canada (or Luxembourg) on a significant capital gain realized on the disposition of shares in the Canadian company DFR. One of the arguments made by the Crown was that the exemption under Article 13 of the

¹⁶⁸ Technical News 30 (n 75). The Advisory Panel observed that these dual approaches exist but said nothing more: Advisory Panel Report (n 76) [5.67]–[5.68].

¹⁶⁹ The GAAR is set out in ITA 1985 s 245. The application of the GAAR is discussed in ch 7.

Canada–Luxembourg DTC could be denied on the basis of an anti-abuse rule inherent in the treaty. Justice Bell analyzed the relevant provisions of the Vienna Convention, the OECD Commentary applicable at the time the treaty was concluded, and the context and purpose of the relevant treaty provisions. None of this persuaded him that the ‘carefully negotiated treaty’ should be read as including an implied anti-abuse rule.¹⁷⁰ In any event, he considered that ‘the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive’ under the GAAR,¹⁷¹ as discussed in the next chapter. Thus it seems unlikely that, had the treaty contained an *express* provision against abuse similar to Article 29(6) of the Canada–Germany DTC or Article 29A(7) of the Canada–US DTC, it would have been applied by the Court in this case.

One might complain that Justice Bell’s analysis was very traditionalist and out of step with current international tax thinking. Among other things, he refused to consider revisions to the OECD Commentary published later than the conclusion of the Canada–Luxembourg DTC and seemed to insist that there be an ‘ambiguity’ in the treaty before looking to its broader context and purpose. This approach is at odds with the interpretive framework set out in *Memec* and *Crown Forest* and applied most recently in *Smallwood* and *Prévost*. Nevertheless, the government’s appeal with respect to the GAAR was dismissed¹⁷² and there is no reason to believe that the Federal Court of Appeal would have disturbed the Tax Court’s conclusion with respect to the alleged treaty anti-abuse principle drawn from international law. It is therefore unremarkable that the Department of Justice did not argue in favour of an implied treaty anti-abuse principle when it argued *Prévost* the following year.

¹⁷⁰ *MIL Investments* (TCC) (n 39) [87].

¹⁷¹ *ibid* [72].

¹⁷² *MIL Investments* (FCA) (n 39).

6.4 CONCLUSIONS

Numerous states, both developed and developing, have encountered the problem of unintended beneficiaries exploiting their tax treaty networks. Different states have responded to treaty shopping differently, based on their individual perceptions of the severity of the problem and their individual legal traditions. HMRC and the CRA are concerned about aggressive international tax planning, including treaty shopping, but to date the legal challenges to such structures have been unsuccessful except where made under foreign laws. These results will be welcomed by some MNEs and their tax advisers, on the view that the arrangements in *MIL Investments* and *Prévost* (and indeed *Indofood*) were legitimate and deserved to be vindicated. Yet if governments believe that arrangements of this nature are antithetical to their tax treaty policy, they must query how they can effectively forestall such arrangements without actively discouraging inward investment.

One should first consider why the arguments advanced in Canada have failed. In *Prévost*, the challenge hinged upon the court accepting an interpretation of beneficial ownership borrowed from international fiscal law and scholarship. Aside from the obvious problem that this approach ignored the domestic legal meaning of the term, it was tantamount to using ‘beneficial ownership’ as a surrogate anti-avoidance rule. This approach is not likely to succeed in any Anglo-Commonwealth legal system, where beneficial ownership has an established meaning and where tax avoidance rules are carefully circumscribed. Even jurisdictions that have an anti-avoidance ethos which is more favourable to the revenue authorities, such as Germany, Switzerland, and the US, have countered conduit arrangements not by extending the concept of beneficial ownership but by invoking treaty anti-abuse principles or domestic anti-avoidance rules. The arguments advanced in *MIL Investments* were perhaps more tenable than those in

Prévost. However, Canadian courts are not yet willing to accept that the decision to establish an entity in a particular state is in itself abusive. The overall commercial purpose of investing abroad will, in most if not all cases, be considered sufficient to justify the particular structure employed. It seems highly unlikely that a UK court dealing with a UK tax treaty would decide differently.

Given these constraints it appears that there are three possibilities open to the UK and Canadian governments.

The first option would be to terminate specific tax treaties considered most susceptible to abuse, which would be a radical and possibly counter-productive action. Treaties that are favourable to inward investment also tend to be favourable to outward investment. Termination of such treaties is not a realistic option when the inclination of the UK and Canadian governments is to enhance competitiveness.

A preferable avenue would be to renegotiate specific tax treaties so as to include express rules against treaty shopping, limiting benefits to the intended class of beneficiaries. In the author's view, it would be best to use objective LOB rules rather than purpose-based TAARs or vague statements about 'abuse'. Provisions that seek to deny benefits where there is 'abuse' (as in the Canada–Germany DTC) or where the beneficiary has a tax avoidance 'main purpose' (as in many UK tax treaties) are virtually useless; such provisions offer no guidance to taxpayers regarding what is and is not acceptable, and are unlikely to be fruitful following the decision in *MIL Investments*. It would be more effective to employ rules in the form of US-style LOB provisions which, in conjunction with beneficial ownership requirements, should counteract any arrangement deserving the title 'conduit arrangement'.

It was not until 2007 that the LOB provision in the Canada–US DTC was made reciprocal, thus permitting Canada to deny treaty benefits to US conduit entities.¹⁷³ Canada and the UK would do well to renegotiate other tax treaties to include provisions of this nature, as they ensure that only residents with a substantial economic nexus in the treaty partner state can enjoy the benefits of the treaty.¹⁷⁴ The ‘substance’ of that economic nexus could be determined based on objective factors, such as the proportion of shares ultimately held by residents of the treaty partner state or the degree of business activity carried on in the treaty partner state. The factors chosen would determine whether the tax structures used in *MIL Investments*, *Prévost* or other variations would or would not be barred from treaty entitlements. If the British or Canadian governments believe that it is appropriate to add a subjective element they could do so. Which factors to adopt is a policy decision. The important point is that control over the use of international agreements negotiated by the UK and Canada would be restored to the governments of those countries and their treaty partners, rather than being in the domain of MNEs, their tax advisers, and the revenue authorities.

A more fundamental response, of course, would be to reconfigure the definitions of entity residence in domestic law and tax treaties. In attacking treaty shopping arrangements, what tax authorities are essentially challenging is the perceived abuse that arises from a person’s lack of connection with the Contracting State through which it seeks to obtain treaty benefits. Redefining who is a ‘resident’ for treaty purposes is a corollary to express LOB provisions, and if done correctly could render such provisions superfluous.

¹⁷³ Fifth Protocol (nn 12 and 145).

¹⁷⁴ The UK has done so with Japan (n 144).

CHAPTER 7

OUTBOUND AND INBOUND INVESTMENT: ATTACKING CORPORATE RESIDENCE THROUGH GENERAL ANTI-AVOIDANCE RULES OR PRINCIPLES

7.1 INTRODUCTION

7.1.1 Measures of Last Resort

Two matters bear repeating at the outset of this chapter. First, global tax minimization strategies often rely on the establishment of subsidiaries and intermediaries in ‘base countries’ and ‘treaty havens’, respectively, acting as convenient receptacles for income or losses. Second, governments and revenue authorities are particularly sensitive to the revenue loss that is precipitated by international tax planning.¹ The previous two chapters analyzed specific legislative and administrative responses to the purported ‘exploitation’, ‘manipulation’, or ‘abuse’ of tax rules relating to offshore residence. Beyond these specific anti-avoidance tools, tax authorities who view a given international tax minimization structure as ‘unacceptable’ may invoke overarching countermeasures in the form of domestic general anti-avoidance rules (GAARs) or similar interpretive principles.

The inevitable breadth and uncertainty of general anti-avoidance measures means that tax authorities, including Her Majesty’s Revenue and Customs (HMRC) and the Canada Revenue Agency (CRA), will prefer to dispute the effectiveness of a tax avoidance arrangement through reliance on specific legislation. This would include objective controlled foreign company (CFC) tests, subjective ‘purpose tests’ or ‘motive tests’ contained in CFC rules, treaty limitation of benefit rules, and any other relevant

¹ Ch 1 text following n 54.

targeted anti-avoidance rules² (TAARs), where such rules exist. On occasion HMRC or the CRA will even challenge the purported separate existence or residence of an entity employed in the arrangement.³ Whichever specific arguments are made, broad anti-avoidance rules or interpretive principles may be called upon as measures of last resort.⁴ As Tiley observes, more cynical commentators regard the use of a general anti-avoidance measure as a ‘confession of failure’ with respect to specific provisions.⁵ Whether that characterization is accurate or not, the fact remains that a GAAR or similar interpretive principle is one avenue for challenging an international tax avoidance arrangement.

A state’s general anti-avoidance measure may take the form of a codified GAAR as in Canada and various other Commonwealth jurisdictions, a judicially recognized principle or doctrine as in the US and some European states, or a facet of statutory interpretation as in the UK. Although these approaches are ostensibly quite different, they have led to similar outcomes in practice and thus are functionally similar. The universal feature of these approaches is that they are applied to render a transaction or arrangement ineffective for domestic tax law purposes where the impugned transaction, or more commonly the impugned series of transactions viewed in composite, was ‘aggressive’, ‘abusive’, ‘unacceptable’, or the like, which are more provocative ways of

² Consistent with UK usage, the term TAAR is used herein to refer to an anti-avoidance rule that applies where the ‘main purpose’ or ‘one of the main purposes’ of a transaction is tax avoidance: eg TCGA s 16A. Specific anti-avoidance rules that do not reference ‘main purposes’ are not described as TAARs.

³ eg *Furniss v Dawson* [1982] STC 267 (Ch), aff’d [1983] STC 549 (CA), rev’d [1984] AC 474 (HL); *Wood v Holden* [2005] STC 789 (Ch), aff’d [2006] STC 443 (CA); *Garron Family Trust v The Queen* [2009] DTC 1568 (TCC), aff’d [2010] DTC 5189 (FCA).

⁴ eg *Furniss v Dawson* (n 3); *Garron* (n 3); *Univar Canada Ltd v The Queen* [2005] DTC 1478 (TCC); *MIL (Investments) SA v The Queen* [2006] DTC 3307 (TCC), aff’d [2007] DTC 5437 (FCA) (*MIL Investments*).

⁵ J Tiley, ‘The Avoidance Problem: Some UK Reflections’ in J Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (Oxford Univ Centre for Business Taxation, Oxford 2008) 69.

saying that it was inconsistent with Parliamentary intention.⁶ Where the alleged ‘abuse’ goes beyond domestic law and involves reliance on a double taxation convention (DTC or tax treaty), Canada follows the approach espoused by the Organisation for Economic Co-operation and Development (OECD), which is to apply its GAAR to tax treaties just as it does to domestic law,⁷ while the UK approach, being an interpretive approach only, presumably may be applied in a treaty context.⁸ The application of domestic anti-avoidance measures to tax treaties is legally distinct from the invocation of anti-abuse principles that are expressed or implied in a tax treaty itself,⁹ although the results tend to be similar.

The goal of this chapter is to discuss the prevailing general anti-avoidance approaches in the UK and Canada specifically to elucidate how corporate residence issues are often implicated, although rarely discussed, in tax avoidance litigation. The author is not concerned with the theoretical basis for or legitimacy of Canada’s GAAR or the UK’s anti-avoidance jurisprudence, nor is the author proffering an argument as to the exact nature of the approach that prevails in either regime, be it interpretive, constitutional, or quasi-constitutional. This has been done commendably by others.¹⁰ The goals are: first, to explain the framework within which international tax avoidance activities are often challenged; and second, to demonstrate that underlying many tax disputes is a dissatisfaction on the part of the revenue authority, whether acknowledged in the litigation or not, that taxable income or capital gains are ostensibly being moved

⁶ Text to nn 24–28.

⁷ Text to nn 110–112.

⁸ Text to nn 104–109.

⁹ See ch 6 text to nn 160–167.

¹⁰ eg GS Cooper (ed), *Tax Avoidance and the Rule of Law* (IBFD, Amsterdam 1997); J Tiley, ‘Tax Avoidance Jurisprudence as Normal Law’ [2004] BTR 304; E Simpson, ‘The Ramsay Principle: A Curious Incident of Judicial Reticence?’ [2004] BTR 358; J Freedman, ‘Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament’ (2007) 123 LQR 53.

outside the home state's tax jurisdiction without any real establishment or real activity taking place in the foreign state. Arguments about corporate residence being seen as futile, cases often are argued based on such things as the motives of the taxpayers, the purposes of the transactions, and the pre-ordination or interconnectedness of the transactions – none of which is satisfactory as a guide for determining whether the transaction is one within the intent of the relevant legislation or treaty.

7.1.2 Identifying and Responding to 'Abuse' (Again)

There is wide recognition by tax scholars that terms like 'abusive', 'aggressive', and 'unacceptable' tax avoidance are circular – they express a conclusion rather than any analysis. This is the same problem inherent in the term 'deferral' (discussed in chapter 5) and the term 'treaty shopping' (discussed in chapter 6). Yet revenue authorities and some commentators continue to use these terms as though their meaning is understood. The term 'unacceptable' is particularly troubling because, as Freedman explains, it suggests that acceptability to government ministers or to revenue authority representatives is being substituted for acceptability to Parliament and the courts.¹¹ Even if the terms unacceptable or abusive are restricted to tax avoidance that is ineffective because it is contrary to Parliamentary intention as discerned from the language and context of the legislation, it remains notoriously difficult to distinguish acceptable tax avoidance (or 'planning' or 'mitigation') from unacceptable tax avoidance. Freedman has described the attempts in the UK to make such a distinction as 'unhelpful';¹² Edgar, in a discussion of the Canadian GAAR, argues that the distinction

¹¹ J Freedman, 'The Tax Avoidance Culture: Who is Responsible? Governmental Influences and Corporate Social Responsibility' in J Holder and C O'Conneide (eds), *Current Legal Problems* vol 59 (OUP, London 2006) 361–68.

¹² J Freedman, 'Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle' [2004] BTR 332, 336 and 350; cf Freedman 2007 (n 10).

is ‘hopelessly unclear’.¹³ It is nonetheless instructive to examine what types of international tax avoidance arrangements that HMRC and the CRA *have considered to be unacceptable* and thus worthy of challenge under the general anti-avoidance rule or principle that was extant at the time. This is because here, more than with the specific anti-avoidance approaches discussed previously, the objective and subjective components of the perceived abuse are brought to the forefront where they might be addressed separately and directly.

British and Canadian revenue authorities and courts, when considering potential application of a general anti-avoidance measure to an international tax minimization structure, have not engaged in much separate or direct consideration of the objective and subjective components of the alleged abuse. The specific issue of corporate residence, except in the rare cases where it is expressly argued, is often conceded, assumed, or muddled with other issues. This is unfortunate because the very issue of corporate residence – specifically the perceived lack of bona fide establishment abroad – is often one source of the revenue authority’s apprehension that an international tax avoidance arrangement is ‘unacceptable’. As explained below, where one concedes that the tax avoidance motive of a multinational enterprise (MNE) in implementing an international avoidance structure is largely irrelevant, the distinction between ‘acceptable’ / ‘deserving’ structures and ‘unacceptable’ / ‘undeserving’ structures often reduces to the distinction between real economic establishment abroad and formal residence abroad.

¹³ T Edgar, ‘Designing and Implementing a Target-Effective General Anti-Avoidance Rule’ in DG Duff and H Erlichman (eds), *Tax Avoidance in Canada After Canada Trustco and Mathew* (Irwin Law, Toronto 2007) 222.

7.2 SUMMARY OF GENERAL ANTI-AVOIDANCE APPROACHES

7.2.1 International Overview and Comparison¹⁴

There are various domestic approaches to addressing tax avoidance, all of them emanating from the same concern that the tax base should not be eroded by transactions which comply formally with tax legislation or a tax treaty but which are in substance contrary to the purpose (or ‘spirit’) thereof. As noted in the introductory chapter, the OECD in 2008 sought to define ‘aggressive tax planning’ as taking a tax position ‘that is tenable but has unintended and unexpected tax revenue consequences’,¹⁵ a definition that has been adopted by HMRC.¹⁶ A more recent study by the government of Québec declared that an ‘aggressive tax planning’ scheme is generally described as ‘a tax avoidance transaction that complies with the letter of the law while abusing its spirit’.¹⁷

Courts in the US have for many years employed judicial doctrines known as ‘step transaction’, ‘substance over form’, and ‘economic substance’ to disregard transactions that comply technically with the law but are motivated predominantly by their expected tax benefits.¹⁸ The US economic substance doctrine was finally codified

¹⁴ There is a large industry in tax avoidance and, it seems, an even larger one in tax avoidance literature. For good descriptions and comparisons of general anti-avoidance measures see: D Pickup, ‘In Relation to General Anti-Avoidance Provisions: A Comparative Study of the Legal Frameworks Used by Different Countries to Protect Their Tax Revenues’ in Freedman 2008 (n 5); B Arnold, ‘A Comparison of Statutory General Anti-Avoidance Rules and Judicial Anti-Avoidance Doctrines as a Means of Controlling Tax Avoidance: Which is Better? (What would John Tiley Think?)’ in J Avery Jones, P Harris, and D Oliver (eds), *Comparative Perspectives on Revenue Law: Essays in Honour of John Tiley* (CUP, Cambridge 2008); Finances Québec, *Aggressive Tax Planning* (Government of Québec Working Paper, Québec 2009) <www.finances.gouv.qc.ca/en/page.asp?sectn=2&contn=276> ch 3; DG Duff, ‘Tax Avoidance in the 21st Century’ in C Evans and R Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thomson Reuters, Sydney 2009).

¹⁵ OECD, *Study into the Role of Tax Intermediaries* (OECD, Paris 2008) <www.oecd.org/dataoecd/28/34/39882938.pdf> 10–11, 87.

¹⁶ HMRC, *A Code of Practice on Taxation for Banks: Consultation Document* (HMRC, London 2009) <www.hmrc.gov.uk/consultations/index.htm> (COP 2009) 17.

¹⁷ Finances Québec (n 14); cf COP 2009 (n 16) 5, 6, 15.

¹⁸ DA Weisbach, ‘Formalism in the Tax Law’ (1999) 66 *Univ of Chicago Law Rev* 860; AC Infanti, ‘United States’ in G Maisto (ed), *Tax Treaties and Domestic Law* (IBFD, Amsterdam 2006) ch 13.

in 2010,¹⁹ supported by strict penalty provisions. The legal systems of several European states, including France, Germany, Switzerland, and the Netherlands, incorporate doctrines regarding abuse of law and abuse of rights, both of which are deeply rooted in civil law traditions; these doctrines are known variously as *abus de droit*, *fraude à la loi*, and *fraus legis*.²⁰ In some of these jurisdictions general principles preventing abuse of law are buttressed by express provisions in domestic tax legislation and tax treaties. The UK prefers to deal with aggressive tax avoidance through numerous TAARs and (what appear to be) ordinary principles of statutory interpretation,²¹ although the Treasury has announced that a study group will re-examine the case for a GAAR.²² The tradition in developed Commonwealth countries, including Canada, Australia, New Zealand, and South Africa, is to rely on a statutory GAAR.²³

Evidently these approaches differ in their precise constitutional basis, interpretation, and application. This results in different frameworks for the analysis and judicial resolution of tax avoidance problems across countries. Nonetheless, all of the approaches involve similar elements and tend to produce similar outcomes. In Canada, other GAAR countries, and the US, a tax authority who believes that a transaction or arrangement is ineffective under domestic tax law (or a tax treaty) will first seek to establish that the impugned transaction or series of transactions had tax avoidance as its

¹⁹ Health Care and Education Reconciliation Act of 2010, Pub L No 111-152, s 1409, inserting section 7701(o) of the Internal Revenue Code.

²⁰ M Greggi, 'Avoidance and *abus de droit*: The European Approach in Tax Law' (2008) 6 eJournal of Tax Research 23; Z Prebble and J Prebble, 'Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law' (2008) 62 BIT 151.

²¹ Tiley 2004 (n 10); Freedman 2007 (n 10); Institute for Fiscal Studies, Tax Law Review Committee, *Countering Tax Avoidance in the UK: Which Way Forward?* (IFS, London 2009) <www.ifs.org.uk/publications/4461>.

²² HM Treasury, 'Government Announces Tax Avoidance Clampdown' News Release 68/10 (6 December 2010); HM Treasury, 'Details of Avoidance Study Group Set Out' News Release 04/11 (14 January 2011).

²³ Pickup (n 14); D Dunbar, 'Statutory General Anti-Avoidance Rules: Lessons for the United Kingdom from the British Commonwealth' (2008) 62 BIT 529.

main or primary purpose. This element of a typical tax avoidance arrangement is not as important in UK tax law, except of course where a relevant TAAR expressly refers to ‘main purposes’. The second element is to show that the transaction, or series of transactions viewed in composite, was ‘abusive’, ‘aggressive’, ‘unacceptable’ or the like, meaning that it was inconsistent with legislative intention as discerned from a purposive interpretation of the relevant legislation (or tax treaty). The difficulty faced by a court in applying any general anti-avoidance measure, be it a statutory GAAR, overriding principle, or judicially developed interpretive framework, is determining exactly what the intention of the legislature was in enacting particular tax legislation or concluding a particular tax treaty.

As judges and commentators in the UK, Canada, and other jurisdictions have observed, it is rare that the intention, purpose, or policy of tax legislation is ‘evident’,²⁴ rather, it is common for tax legislation to be plagued by such detail and complexity as to obscure any underlying policy that might exist. This is true in a variety of areas, including legislation regarding the taxation of financial instruments and – more relevant to the present discussion – CFC legislation. Domestic tax rules affecting foreign entities and activities, including but not limited to CFC legislation, are founded on policies that are often unclear and conflicting: economic substance, political obligation, inter-nation equity, and others.²⁵ Where tax legislation lacks an apparent policy, it is difficult for courts to provide one, whether they are applying a statutory GAAR or interpreting

²⁴ eg Freedman 2007 (n 10) 54–55, 70–71, discussing Lord Nolan’s comments in *IRC v Willoughby* [1997] 1 WLR 1071 (HL) 1079.

²⁵ The (ambiguous) policy of CFC legislation is addressed in ch 5.

legislation purposively in the absence of a GAAR.²⁶ Accordingly, courts construing such legislation are often unable to conclude that a tax avoidance arrangement is contrary to the supposed policy and thus ineffective. Differences across states in the outcomes of litigation involving general anti-avoidance measures seem to arise not from differences in the nature of the state's approach, but from the varied levels of judicial willingness to search for or supply a view of what the legislature's intention might have been had it been fully informed of all avoidance possibilities.²⁷ Judges in the UK and Canada take a relatively orthodox view of what is meant by Parliamentary 'intention' and of the limits on the judicial authority for ascertaining it.²⁸ It therefore comes as little surprise that British and Canadian courts, confronted with the incoherence of the policies behind domestic tax rules affecting international activities, rarely conclude that an international tax avoidance structure is fiscally ineffective unless specific legislation so provides.

7.2.2 Avoidance / Abuse of Domestic Tax Law

7.2.2(a) UK Approach – Purposive Statutory Interpretation

There is, as yet, no single general anti-avoidance rule in UK tax legislation.²⁹ The apparent preference of Ministers – at least those preceding the current government – has been to rely on highly specific rules and purpose-based TAARs to respond to known

²⁶ Gammie has expressed this proposition well. 'If there is no coherent policy behind what is sought to be taxed, it is quite unlikely that the legislative definition of the tax base will be clear. The courts, whose function it is to interpret that legislation, will not be able to supply coherence where policy makers themselves have failed to do so. Overlaying the legislation with a statutory [GAAR] will not resolve that fundamental policy problem any more than a judicial anti-avoidance doctrine will.': M Gammie, 'Barclays and Canada Trustco: Further Comment from a UK Perspective' (2005) 53 CTJ 1047, 1047–48.

²⁷ Pickup (n 14), particularly with respect to judicial attitudes in Australia.

²⁸ For an excellent discussion of the nature of Parliamentary intention see Freedman 2007 (n 10) 70–75 and the literature cited therein.

²⁹ This may change in future: see n 22.

avoidance schemes in respect of particular taxes. Some TAARs are so broadly worded that tax advisers come to refer to them as ‘mini GAARs’,³⁰ yet they remain confined to particular types of transactions involving particular taxes. Where HMRC consider that a specific anti-avoidance rule or TAAR is unlikely to apply to a tax avoidance arrangement, or at least recognize that the position is uncertain, they may call upon the judicially-developed interpretive approach originating from the *Ramsay* decision.³¹

The emergence, expansion, and recasting of the *Ramsay* ‘approach’ have been discussed by many commentators and are well known. It will suffice to make the following brief observations.

Before the House of Lords decided *Barclays Mercantile Business Finance Ltd v Mawson*,³² the *Ramsay* decision was described as a ‘new approach’ to tax avoidance – a legitimate description given the comments made to that effect by the judges themselves, particularly Lord Wilberforce in *Ramsay*,³³ Lord Diplock in *IRC v Burmah Oil Co Ltd*,³⁴ and Lord Brightman in *Furniss v Dawson*.³⁵ Yet those judges were careful to state that they were not creating some overriding legal principle in the nature of the US economic substance doctrine or European abuse of law principles. They affirmed that the principle derived from the *Duke of Westminster* case³⁶ – that taxpayers are entitled to organize their affairs so as to pay the least tax possible under the law – is still apposite in UK tax

³⁰ eg TCGA s 16A and s 137. Reactions to TCGA s 16A are discussed in J Freedman, G Loomer, and J Vella, ‘Corporate Tax Risk and Tax Avoidance: New Approaches’ [2009] BTR 74, 95–99.

³¹ *WT Ramsay Ltd v IRC; Eilbeck v Rawling* [1982] AC 300 (HL).

³² [2004] UKHL 51, [2005] 1 AC 684 (HL) (*BMBF*).

³³ (n 31) 326.

³⁴ [1982] STC 30 (HL) 32.

³⁵ (n 3) 524–26.

³⁶ *IRC v Duke of Westminster* [1936] AC 1 (HL).

law. Yet it was recognized that the ‘*Westminster* principle’ alone does not provide a resolution.

The pertinent judgments indicate that the meaning of the *Westminster* principle is simply this: a transaction, assuming it is not a ‘sham’, is not invalidated by the fact that the taxpayer’s motive for undertaking it was tax avoidance unless the legislation so provides.³⁷ *Ramsay* did not purport to widen the orthodox definition of a sham transaction, that is, a transaction involving acts intended to give the appearance of creating legal rights and obligations different from those which were actually created.³⁸ Nor did *Ramsay* suggest that a taxpayer must have a commercial motive for undertaking a transaction. Instead the House of Lords made two critical insights. First, they recognized that the *Westminster* principle does not tell us what is meant by the least tax possible ‘under the law’ because one must ascertain what the law is intended to allow and not allow.³⁹ In this regard *Ramsay* signified a more contextual and purposive interpretation of tax legislation, marking an end to the formalism that had pervaded statutory interpretation through much of the twentieth century.⁴⁰ The second insight made in *Ramsay* was that, notwithstanding that each step in a transaction was a genuine step producing its intended legal result, a court was not confined to considering each step in isolation for the purpose of determining the fiscal effects. Lord Wilberforce stated that it was the proper task of the courts to ascertain the legal nature of any transaction to which tax consequences might attach, and if the legal nature emerged

³⁷ eg *Ramsay* (n 31) 323–24 [Lord Wilberforce]; *Craven v White*; *IRC v Bowater Property Developments Ltd*; *Baylis v Gregory* [1985] STC 531 (Ch), aff’d [1987] STC 297 (CA), aff’d [1989] AC 398 (HL) 503–504 [Lord Oliver], 519–20 [Lord Goff]; *IRC v McGuckian* [1997] STC 908 (HL) 916 [Lord Steyn].

³⁸ *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786 (CA) 802 [Diplock LJ]. See text following n 113.

³⁹ *Burmah Oil* (n 34) 32 [Lord Diplock]; *McGuckian* (n 37) 916 [Lord Steyn].

⁴⁰ *BMBF* (n 32) [33].

from a series of transactions which were intended to operate as such, the court should have regard to the series of transactions (or ‘composite transaction’) rather than the separate steps.⁴¹

Both *Ramsay* and *Burmah Oil* involved circular and self-cancelling tax avoidance schemes that were bereft of commercial purpose – what Oliver LJ in *Furniss v Dawson* described as ‘fiscal phantasmagoria’.⁴² One also hears the expression ‘pure tax schemes’. In retrospect one might regard those cases as a reasonable evolution of the sham doctrine,⁴³ although it is controversial whether an identifiable ‘sham doctrine’ even exists⁴⁴ and, if it does, what the precise meaning of ‘sham’ is.⁴⁵ In any event, the innovation in *Furniss v Dawson* was the application of the *Ramsay* approach to a series of transactions designed to achieve an overall commercial result. That case involved the transfer of operating company shares to a holding company in the Isle of Man and the onward sale of those shares to the intended purchaser.⁴⁶ Lord Brightman, in what is generally regarded as the firmest statement against tax avoidance in UK jurisprudence, held that where a taxpayer enters a pre-ordained series of transactions and there are steps inserted that have no commercial purpose ‘apart from’ the avoidance of tax, the inserted steps are to be ‘disregarded’ for fiscal purposes, whether or not the transactions achieve a commercial end.⁴⁷

⁴¹ *Ramsay* (n 31) 324–25.

⁴² *Furniss v Dawson* (CA) (n 3) 563.

⁴³ M Gammie, ‘Sham and Reality: The Taxation of Composite Transactions’ [2006] BTR 294.

⁴⁴ eg B McFarlane and E Simpson, ‘Tackling Avoidance’ in J Getzler (ed), *Rationalizing Property, Equity and Trusts* (LexisNexis, London 2003) 135; M Conaglen, ‘Sham Trusts’ (2008) 67 CLJ 176.

⁴⁵ See text following n 113.

⁴⁶ The facts are set out at text following n 123.

⁴⁷ *Furniss v Dawson* (n 3) 526–27. All of the Law Lords concurred with this reasoning. Lord Brightman’s choice of words suggests that a tax avoidance purpose is itself a commercial purpose, a view that some

Lord Brightman's exposition of what he called 'the Ramsay principle' would seem to invalidate a wide variety of tax planning arrangements, including many international arrangements involving special purpose subsidiaries. Whether one thinks that would have been a positive or negative development, his view of the matter was circumscribed by subsequent decisions including *Craven v White*,⁴⁸ *IRC v McGuckian*,⁴⁹ and *Macniven v Westmoreland Investments Ltd.*⁵⁰ Lord Hoffmann's speech in *Westmoreland* was particularly important because he criticized the foundations of the Revenue's formulation of the *Ramsay* principle: Lord Hoffmann said that the Revenue's formulation, drawn from *Furniss v Dawson*, looked less like a principle of construction and more like 'an overriding legal principle, superimposed upon the whole of revenue law without regard to the language or purpose of any particular provision'.⁵¹ He observed that the courts have no constitutional authority to impose such a principle.

In *BMBF* the House of Lords writing as a Committee confirmed that it is the basic duty of the courts to construe any tax legislation in accordance with its particular context and purpose. The Appellate Committee stressed that one must avoid 'sweeping generalisations' about the invalidity of arrangements that include elements designed primarily or exclusively to avoid tax.⁵² The approach endorsed in *BMBF* is perhaps best summarized by the following statement made by Ribeiro PJ in *Collector of Stamp Revenue v Arrowsmith Assets Ltd*, cited by the Appellate Committee and by numerous commentators thereafter:

business people and tax advisers would agree with. More recent decisions in the UK and Canada indicate that tax avoidance purposes and commercial purposes are seen as mutually exclusive categories.

⁴⁸ (n 37).

⁴⁹ (n 37).

⁵⁰ [2001] UKHL 6, [2003] 1 AC 311 (HL).

⁵¹ *ibid* [29].

⁵² *BMBF* (n 32) [37].

[T]he driving principle in the *Ramsay* line of cases continues to involve a general rule of statutory construction and an unblinkered approach to the analysis of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.⁵³

The mercifully brief judgment in *BMBF*, along with the concurrent judgment in *Scottish Provident Institution v IRC*,⁵⁴ was described by Tiley as ‘a process of cleansing’ which swept away the ‘chaos’ created by previous decisions.⁵⁵ Nonetheless, as Tiley and others have argued, the decisions produced more uncertainty going forward. This is not a criticism of the decisions but simply a recognition of the fact that it is extraordinarily difficult to say with certainty which transactions are intended to fall within the scope of particular statutory provisions. Even if one is to treat a series of transactions as a composite whole because that is how the parties regarded them, one must ascertain whether the arrangement in question was the sort of arrangement that Parliament had intended would benefit from, or otherwise fall within, the legislation relied upon. Thus, in *BMBF*, the Appellate Committee concluded that there was nothing in the impugned financing transactions that took them outside the intent of the capital allowances regime,⁵⁶ whereas in *SPI* the Committee held that the impugned option on which the loss was claimed was not a ‘qualifying contract’ within the intent of the legislation and therefore the taxpayer did not suffer a loss for tax purposes.⁵⁷

One might distinguish the results in *BMBF* and *SPI* on the basis that *BMBF* involved an arrangement that had some commercial purpose in that it furthered the

⁵³ [2003] HKCFA 46, [2004] 6 ITLR 454 [35], cited in *BMBF* (n 32) [36].

⁵⁴ [2004] UKHL 52, [2004] 1 WLR 3172 (HL) (*SPI*).

⁵⁵ J Tiley, ‘*Barclays and Scottish Provident: Avoidance and Highest Courts; Less Chaos but More Uncertainty*’ [2005] BTR 273.

⁵⁶ *BMBF* (n 32) [39]–[42].

⁵⁷ *SPI* (n 54) [18]–[26].

taxpayer's business of finance leasing, while *SPI* involved a scheme for manufacturing a tax loss without the possibility of an economic loss. Where a series of transactions amounts to a 'pure tax scheme', it should be an easy matter for the courts to conclude that the transactions must be viewed in composite, possibly going on to find that such composite transaction was not within the intent of the legislation or otherwise failed to produce the legal result that the taxpayer desired.⁵⁸ However, it is notable that in *BMBF* the Appellate Committee approved of the results of several earlier decisions, including *Furniss v Dawson*.⁵⁹ This means that the transactions undertaken there, despite having a clear commercial purpose, were considered (at least in retrospect) to fall outside the sphere of transactions that Parliament had intended should benefit from the relevant legislation.⁶⁰ For transactions like this which have an overall commercial purpose, the question of consistency with legislative intention will be a more difficult one. The only way to assist the courts in this regard will be for Parliament to demonstrate, through constitutionally appropriate means, what the intention, purpose, or policy of the legislation is.

As Avery Jones,⁶¹ Braithwaite,⁶² and others have argued, the best way for Parliament to do this is not to enact more detailed rules but to provide guiding principles according to which the substantive rules can be understood. Freedman has suggested the adoption of a general anti-avoidance principle to overlay the substantive tax rules,⁶³ in

⁵⁸ Gammie 2006 (n 43). Recent examples include *Astall and anor v HMRC* [2009] EWCA Civ 1010, [2010] STC 137 (CA) and *Bayfine UK Products and anor v HMRC* [2009] STC (SCD) 43, rev'd [2010] EWHC 609, [2010] STC 1379 (Ch). The decision of the Court of Appeal in *Bayfine* was pending at the time this thesis was completed.

⁵⁹ *BMBF* (n 32) [35].

⁶⁰ The decision in *Furniss v Dawson* is discussed at text following n 139.

⁶¹ JF Avery Jones, 'Tax Law: Rules or Principles?' [1996] BTR 580.

⁶² J Braithwaite, 'Making Tax Law More Certain: A Theory' (2003) 31 Australian Business Law Rev 72.

⁶³ Freedman 2004 (n 12); J Freedman, 'A GANTIP: Was it Really Such a Bad Idea?' (2009) 976 Tax J 8.

effect providing the constitutional authority to deal with avoidance which Lord Hoffmann and others have said the judiciary does not possess. Yet even with such a principle there is a need for clarity and coherence in the substantive tax legislation.⁶⁴ As discussed below, achieving clarity and coherence is particularly difficult in relation to international tax rules.

It is an open question whether the UK will continue to eschew an overarching GAAR. The introduction of a GAAR was debated in 1998 when the Inland Revenue sought consultation on proposed wording,⁶⁵ but the idea was eventually dismissed. More recently, the Budget of June 2010 announced that HMRC would begin an ‘informal engagement’ on the merits of introducing a GAAR as one element of renewed defences against tax avoidance;⁶⁶ a study group has now been commissioned to examine that issue.⁶⁷ If and when a GAAR is formally proposed or enacted, one hopes that HMRC would issue guidance illustrating, among other things, what sorts of transactions are considered susceptible to challenge. Currently there are references to arrangements thought by HMRC to be ineffective under the *Ramsay* / *BMBF* approach but they are scattered throughout HMRC manuals and are expressed in vague terms.⁶⁸

⁶⁴ Gammie 2005 (n 26) 1047–48; Freedman 2007 (n 10) 90.

⁶⁵ Inland Revenue, *A General Anti-Avoidance Rule for Direct Taxes: Consultative Document* (Inland Revenue, London 1998) <<http://webarchive.nationalarchives.gov.uk/20100512151403/http://hmrc.gov.uk/consult/index.htm>>. The consultation followed from proposals contained in Institute for Fiscal Studies, Tax Law Review Committee, *Tax Avoidance* (IFS, London 1997) <www.ifs.org.uk/publications/1908>.

⁶⁶ HMRC, *Enforcement and Compliance – Summary of Announcements* (HMRC, London 2010) <www.hmrc.gov.uk/budget2010/enforcement.htm>.

⁶⁷ (n 22). For discussion see: A Goodall, ‘The Prospect of a GAAR’ (2010) 1037 Tax J 8; J Freedman, ‘GAAR: Challenging Assumptions’ (2010) 1046 Tax J 12.

⁶⁸ eg HMRC, *Corporate Finance Manual* (HMRC, London 2011) <www.hmrc.gov.uk/manuals/cfmmanual/index.htm> 39020 (‘Artificial payments of interest’); HMRC, *International Manual* (HMRC, London 2011) <www.hmrc.gov.uk/manuals/intmanual/index.htm> 509010 (‘Tackling avoidance’).

7.2.2(b) Canadian Approach – The GAAR

Canada's GAAR was introduced in 1987 in response to what the federal government viewed as the excessive formalism of Canadian courts with respect to tax avoidance. Prior to that date the jurisprudential confusion in this area was similar to, if not worse than, the unease in the UK. There were two main sources of this confusion. First, the 1952 version of the Income Tax Act included a rule stating that, in computing a taxpayer's income, no deduction could be made 'in respect of a transaction or operation that, if allowed, would unduly or artificially reduce the income'.⁶⁹ This rule was typically relied upon in conjunction with provisions regarding the conferral of benefits on persons not dealing at arm's length with the taxpayer, notably in international transfer pricing disputes,⁷⁰ and was not seen as a general anti-avoidance provision. Court decisions regarding 'undue or artificial reductions' were difficult to reconcile.⁷¹ Second, in the 1970s and 1980s there was developing in the case law an interpretive rule to the effect that, when a taxpayer entered into a transaction solely for the purpose of avoiding tax and without a *bona fide* business purpose, the transaction could be ignored for fiscal purposes because it was a 'sham'.⁷²

The decision of the Supreme Court in *Stuart Investments Ltd v The Queen*⁷³ definitively rejected that tendency, restoring the orthodox view of a sham transaction as expressed by Diplock LJ in *Snook*.⁷⁴ Estey J stated that the essence of a sham

⁶⁹ ITA 1952 s 137(1), renumbered as s 245(1) by SC 1970-71-72.

⁷⁰ eg *Spur Oil Ltd v The Queen* [1981] DTC 5168 (FCA); *Indalex Ltd v The Queen* [1988] DTC 6053 (FCA); *Irving Oil Ltd v The Queen* [1991] DTC 5106 (FCA).

⁷¹ As discussed in *Shell Canada Ltd v Canada* [1999] 3 SCR 622 (SCC) [52]–[60].

⁷² V Krishna, *Fundamentals of Income Tax Law* (Carswell, Toronto 2009) 797–800.

⁷³ [1984] 1 SCR 536 (SCC).

⁷⁴ (n 38).

transaction is the element of ‘deceit’ whereby the taxpayer ‘creates a façade of reality’.⁷⁵ Moreover, the Court reaffirmed the continuing relevance of the *Westminster* principle in Canadian law, rejected the adoption of a US-style business purpose test as a standalone doctrine, and clarified that the proper duty of the courts was to interpret tax legislation in accordance with its ‘object and spirit’.⁷⁶ The similarities to *Ramsay*, at least as that case is understood through the lens of *BMBF*, are evident.

The decision in *Stuart* was in one sense a victory for the Crown in that it confirmed the need for purposive interpretation of tax legislation. Nevertheless, the Department of Finance believed that the decision was inadequate and that some form of business purpose requirement should be codified. The result was the introduction of the GAAR in 1987, effective 1988, replacing the ‘undue or artificial reductions’ provision.⁷⁷ The Canadian GAAR is perhaps best described as an amalgam of the US business purpose test and the UK composite transaction doctrine, albeit expressed in terms of ‘abuse’. The related Explanatory Notes suggested that the GAAR :

... seeks to distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs.⁷⁸

There is a large literature with respect to the Canadian GAAR which cannot be discussed in detail here.⁷⁹ It is sufficient to review the key features of the GAAR and the

⁷⁵ *Stuart* (n 73) 545–46.

⁷⁶ *ibid* 578–80.

⁷⁷ ITA 1985 s 245, effective for transactions undertaken after 12 September 1988.

⁷⁸ Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Department of Finance, Ottawa 1988) 461.

⁷⁹ For detailed analysis see: B Arnold ‘The Long, Slow, Steady Demise of the General Anti-Avoidance Rule’ (2004) 52 CTJ 488; B Arnold, ‘Confusion Worse Confounded: The Supreme Court’s GAAR Decisions’ (2006) 54 CTJ 167; DG Duff, ‘The Supreme Court of Canada and the General Anti-

prevailing judicial attitude towards its interpretation and application. In essence, the GAAR may be relied upon to deny a ‘tax benefit’ that would be obtained through an ‘avoidance transaction’ or through a series of transactions that includes an ‘avoidance transaction’.⁸⁰ An avoidance transaction is a transaction that, but for the GAAR, would result in a tax benefit, unless it ‘may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes’.⁸¹ Even if these conditions are satisfied, the tax benefit will be denied only if the transaction would result in a ‘misuse’ or ‘abuse’ of provisions of the ITA 1985, a tax treaty, or certain other legislation.⁸²

The Supreme Court of Canada took the opportunity to elucidate the meaning of the GAAR in *Canada Trustco Mortgage Co v Canada*⁸³ and *Mathew v Canada*,⁸⁴ eliminating some of the conceptual uncertainty that had been created by lower court decisions. The Court first dealt (briefly) with the concept of tax benefit, which includes any ‘reduction, avoidance or deferral of tax’ payable under the ITA 1985 or that would be payable but for a tax treaty. In practice, the existence of a tax benefit in a tax planning arrangement is rarely disputed. Next, the Court observed that the function of the avoidance transaction concept is ‘to remove from the ambit of the GAAR transactions or series of transactions that may reasonably be considered to have been undertaken or arranged primarily for a non–tax purpose’.⁸⁵ Determining whether a transaction constitutes an avoidance transaction, said the Court, requires an objective

Avoidance Rule: *Canada Trustco* and *Mathew*’ (2006) 60 BIT 54; and the articles collected in Duff and Erlichman (n 13).

⁸⁰ ITA 1985 s 245(2).

⁸¹ ITA 1985 s 245(3).

⁸² ITA 1985 s 245(4).

⁸³ 2005 SCC 54, [2005] 2 SCR 601.

⁸⁴ 2005 SCC 55, [2005] 2 SCR 643.

⁸⁵ *Canada Trustco* (n 83) [21], [32].

consideration of the relative importance of any tax and non-tax purposes underlying it. As suggested in *Canada Trustco*⁸⁶ and explicitly confirmed in subsequent cases,⁸⁷ the fact that a series of transactions was undertaken primarily for some overall commercial purpose does not preclude a finding that the primary purpose of one or more steps in the series was tax avoidance. The third and most important element of the analysis is to determine whether a given series of transactions including one or more avoidance transactions results in ‘abusive tax avoidance’ as contemplated by the GAAR. This depends critically upon the purpose or policy of the relevant provisions.⁸⁸

The Supreme Court adopted the following two-stage framework to determine if an avoidance transaction results in an abuse of the ITA 1985. One must first interpret the provisions giving rise to the tax benefit to determine their ‘object, spirit and purpose’, employing an approach that is at once textual, contextual, and (somewhat redundantly) ‘purposive’. The Court stated that the Crown bears the onus of demonstrating the object, spirit, and purpose of the substantive legislation; it is not the role of the courts to ‘search for some overarching policy’ and then to use that policy to override the statutory language, as that would place the formulation of tax policy in the hands of the judiciary.⁸⁹ The Court also urged caution in assessing the purpose of tax legislation, observing that the ITA 1985 ‘is a complex statute through which Parliament seeks to balance a myriad of principles’.⁹⁰ Second, one must determine whether the impugned avoidance transaction frustrates the identified object, spirit, or purpose of the relevant provisions. The Court insisted that the GAAR is not an overriding ‘economic

⁸⁶ *ibid* [34].

⁸⁷ *MacKay v The Queen* 2008 FCA 105, [2008] DTC 6238 [21]; *Garron* (TCC) (n 3) [343].

⁸⁸ *Canada Trustco* (n 83) [44]–[45].

⁸⁹ *ibid* [41].

⁹⁰ *ibid* [53], citing *Shell Canada* (n 71) [43].

substance’ or ‘economic realities’ test – it requires a rigorous analysis of the individual transactions in the context of the specific provisions relied upon.⁹¹ With that conceptual foundation, the Court observed that abusive tax avoidance exists:

... where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.⁹²

In the author’s view this formulation sets a very high threshold for a finding of abuse, depriving the GAAR of any substantial impact beyond that which could be achieved through ordinary statutory interpretation. The author agrees with those commentators who have questioned whether the Canadian GAAR as interpreted in *Canada Trustco* achieves anything more than if the Supreme Court had applied the purposive approach to statutory construction adopted by the House of Lords in *BMBF*.⁹³

The CRA have had little success in applying the GAAR after *Canada Trustco*, although of course there are exceptions, most of them involving arrangements where all transactions in the series were avoidance transactions,⁹⁴ comparable to *Ramsay* or *SPI*. The resulting incentive is for the CRA to invoke more specific anti-avoidance rules where possible, similar to the current HMRC approach.

⁹¹ *ibid* [56]–[60]. See more recently *Collins & Aikman Products Co v The Queen* 2009 TCC 299, [2009] DTC 958 [72] where Boyle J stated: ‘Determining the purpose of the relevant provisions or portions of the Act is not to be confused with abstract views of what is right and what is wrong nor with arbitrary theories about what the law ought to be or ought to do. These latter views and theories are unhelpful in purposive and contextual statutory analysis and may even create mischief unless they are grounded in the realities of the codified legislation.’

⁹² *Canada Trustco* (n 83) [60].

⁹³ J Freedman, ‘Converging Tracks? Recent Developments in Canadian and UK Approaches to Tax Avoidance’ (2005) 53 CTJ 1038; Gammie 2005 (n 26); Arnold 2008 (n 14).

⁹⁴ eg *Mathew* (n 84); *Lipson v Canada* 2009 SCC 1, [2009] 1 SCR 3.

Unlike HMRC, the CRA have a rather formalized process for deciding whether to issue assessments and argue appeals on the basis of the GAAR. Proposed assessments and advance ruling requests where the GAAR is in issue generally must be approved by the GAAR Committee in Ottawa, unless they deal with fact situations previously addressed.⁹⁵ The Committee consists of senior officials within the CRA, the Department of Justice, and the Department of Finance. The CRA occasionally make known the types of arrangements that they consider to be under scrutiny pursuant to the GAAR.⁹⁶ It is unsurprising that many of the identified arrangements involve the use of foreign companies and trusts.

7.2.3 Avoidance / Abuse of Tax Treaties

7.2.3(a) International Approaches

Although not common in the UK, the most internationally visible method of challenging alleged abuses of a tax treaty, aside from pursuing arguments about a lack of ‘beneficial ownership’ of income,⁹⁷ is to rely on a state’s internal laws prohibiting abusive tax avoidance. A threshold issue is whether the application of domestic anti-avoidance rules to tax treaties is permitted under international law. This issue is largely academic in the UK and Canada so it will be addressed only briefly here.

⁹⁵ CRA, Income Tax Technical News No 22 (11 January 2002); CRA, Income Tax Technical News No 32 (15 July 2005); both available at <www.cra-arc.gc.ca/tx/tchncl/ncmtx/tnws3-eng.html>; C Campbell, *Administration of Income Tax* (Carswell, Toronto 2003) [7.10].

⁹⁶ eg CRA, Income Tax Technical News No 34 (27 April 2006) <www.cra-arc.gc.ca/tx/tchncl/ncmtx/tnws3-eng.html>.

⁹⁷ Discussed in ch 6.

The commentary to the OECD Model Tax Convention⁹⁸ favours the view that domestic anti-avoidance rules do not have to be expressly incorporated in tax treaties in order to condition the application of treaties. The OECD Commentary on this issue was substantially expanded in 2003 and 2008 but unfortunately the analysis is rather meandering, perhaps because it attempts to fuse a wide variety of national perspectives. In essence, the OECD argues that taxes are imposed by domestic law and are merely relieved by treaties, thus an abuse of the provisions of a tax treaty would also be an abuse of the provisions of domestic law under which the tax is levied.⁹⁹ The OECD concludes that there is no conflict between domestic anti-avoidance rules and tax treaties. Some commentators have argued that the views expressed in the OECD Commentary are unsound; they believe that a state which adopted the OECD position would be engaging in a unilateral treaty override, possibly amounting to a breach of international law.¹⁰⁰ The opposing view is that a state's domestic tax laws and tax treaties must be interpreted concordantly; this will of necessity involve application of anti-avoidance rules in addition to other domestic tax provisions.¹⁰¹ This position is said to be substantiated by Article 3, paragraph 2 of the OECD Model, which provides that any term not defined in a treaty shall, unless the context otherwise requires, have the meaning that it has at that time under the domestic tax law of the state applying the

⁹⁸ OECD, *Model Tax Convention on Income and on Capital* (OECD, Paris 2010) <www.oecd.org/ctp/tt/mtc> (OECD Model); OECD, *Commentaries on the Articles of the Model Tax Convention* (OECD, Paris 2010) (OECD Commentary).

⁹⁹ OECD Commentary (n 98) Art 1 [9.1]–[9.2], [22]–[22.2].

¹⁰⁰ eg P Baker, *Double Taxation Conventions* (loose-leaf, Sweet & Maxwell, London 2007) [F08]–[F10]; BJ Arnold and S van Weeghel, 'The Relationship between Tax Treaties and Domestic Anti-Abuse Measures' in Maisto (n 18) 92–98.

¹⁰¹ eg N Goyette, 'Tax Treaty Abuse: A Second Look' (2003) 51 CTJ 764. The US takes it as given that the limitation of benefits provisions in its tax treaties work in conjunction with domestic anti-avoidance rules: US Department of the Treasury, *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006* (US Commentary) Art 22 [1]. For further discussion see Infanti (n 18).

treaty.¹⁰² For example, if a transaction like the one undertaken in *Furniss v Dawson* was considered not to be a ‘disposal’ as contemplated by domestic tax law, presumably it would not qualify as an ‘alienation’ under the capital gains article (often Article 13) of the relevant treaty.

Whichever view is correct as a matter of international law, for many states it appears to be a matter of international custom to mutually agree that their respective anti-avoidance regimes, especially general rules, may be invoked to counter alleged tax treaty abuse. As recently observed by van Weeghel, ‘it seems that in many countries the application of general anti-avoidance rules can be reconciled with tax treaty obligations’ while it may be more difficult to reconcile specific anti-avoidance provisions (such as CFC legislation) with such obligations.¹⁰³

7.2.3(b) UK Approach

The UK is exceptional in that it does not have a general anti-avoidance ‘regime’ as such and therefore has no need to refer to such a regime in its tax treaties. The UK approach in its newer tax treaties is to incorporate TAARs in specific treaty provisions,¹⁰⁴ or to adopt express limitation of benefit (LOB) provisions.¹⁰⁵ Although there are no cases directly on point, were a UK court asked to address perceived treaty abuse on the basis of the *Ramsay* line of cases, one assumes it would proceed by applying the relevant treaty provisions construed purposively to the relevant transactions viewed realistically.

¹⁰² Extensive analysis appears in: Int’l Fiscal Association (ed), *How Domestic Anti-Avoidance Rules Affect Double Taxation Conventions*, IFA Congress Seminar Series vol 19c (Kluwer, The Hague 1995); Int’l Fiscal Association (ed), *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, Cahiers de Droit Fiscal International vol 95a (IFA, Rome 2010) (‘IFA 2010 Congress’). Further literature regarding Art 3[2] is noted in ch 6 n 89.

¹⁰³ S van Weeghel, ‘General Report’ in IFA 2010 Congress (n 102) 19.

¹⁰⁴ eg the treaties with Australia, Canada, France, and the Netherlands: ch 6 text to nn 153–54.

¹⁰⁵ Specifically the treaties with the US and Japan: ch 6 text to n 144.

It seems artificial to characterize such an approach as the application of a domestic anti-avoidance rule to a tax treaty; rather, it is better described as interpretation of the treaty itself. There is a forceful argument that the UK ‘approach’ is as well suited to treaty interpretation as it is to interpretation of domestic law,¹⁰⁶ given the established principles of treaty interpretation expressed in *Fothergill v Monarch Airlines Ltd*¹⁰⁷ and subsequent cases.¹⁰⁸ The contrary position taken by some commentators is that UK courts might be more hesitant to deny tax benefits under a purposive interpretation of a DTC than under a purposive interpretation of domestic law, given the fact that a DTC is the result of ‘hard bargaining’ between states and its text cannot easily be displaced.¹⁰⁹ The author considers the latter argument unconvincing in the light of the principles of interpretation set out in the Vienna Convention, in conjunction with the fact that most of the UK’s treaty partners have their own general anti-avoidance regimes. Even if one adopts the controversial view that despite *BMBF* there exists a *Ramsay* ‘principle’ that goes beyond statutory interpretation, the international consensus seems to be that such a principle would be entirely applicable to abuse of UK tax treaties.

7.2.3(c) *Canadian Approach*

In Canada the situation is clear: the GAAR applies to abusive avoidance of the provisions of a DTC as much as it does to abusive avoidance of domestic law. Canadian tax treaties other than those with Germany and the US do not expressly incorporate Canadian anti-avoidance rules, yet the absence of such provision in Canada’s other treaties is no longer of concern. A retroactive amendment to the GAAR enacted in 2005

¹⁰⁶ I Roxan, ‘United Kingdom’ in Maisto (n 18) 344–53.

¹⁰⁷ [1981] AC 251 (HL).

¹⁰⁸ See ch 6 text to nn 81–87.

¹⁰⁹ P Morton and L Sykes, ‘United Kingdom’ in IFA 2010 Congress (n 102) 816, citing *UBS AG v HMRC* [2007] EWCA Civ 119, [2007] STC 588 [63].

ensures that the GAAR applies not only to an abuse of the ITA 1985, but to an abuse of the Income Tax Regulations, the Income Tax Application Rules, and each of Canada's tax treaties.¹¹⁰ While the retroactive scope of the amendment may be deplored,¹¹¹ in *Canada Trustco* the Supreme Court accepted that the amendment is effective to make the GAAR, at least in principle, applicable to tax treaty abuse.¹¹² Following *Canada Trustco* there have been a few cases where the courts have addressed the application of the GAAR to an alleged abuse of a tax treaty. As discussed in the next section, these challenges have met with little success.

7.3 OFFSHORE RESIDENCE AS AVOIDANCE

7.3.1 Can Non-Residence Constitute Avoidance?

In *Burmah Oil* Lord Diplock observed that, in contrast to the straightforward avoidance scheme in *Duke of Westminster*, '[t]he kinds of tax-avoidance schemes that have occupied the attention of the courts in recent years ... involve inter-connected transactions between artificial persons, limited companies, without minds of their own but directed by a single master-mind'.¹¹³ Were he writing in 2010 he might have added that these artificial persons are very often incorporated in low tax jurisdictions.

There are varied types of international tax planning arrangements that HMRC or the CRA have considered unacceptable and thus deserving of challenge under some

¹¹⁰ SC 2005 c 19 ss 52 and 60, effective for transactions undertaken after 12 September 1988. Even before this amendment there was indication in the case law that there was no inconsistency between the GAAR and Canada's tax treaties: *RMM Canadian Enterprises Inc v The Queen* [1997] DTC 302 (TCC) [56]. For discussion see N Goyette and PD Halvorson, 'Canada' in IFA 2010 Congress (n 102) 171.

¹¹¹ GT Loomer, 'Taxing Out of Time: Parliamentary Supremacy and Retroactive Tax Legislation' [2006] BTR 64; B Alarie, 'Retroactivity and the General Anti-Avoidance Rule' in Duff and Erlichman (n 13) <<http://ssrn.com/abstract=1107489>>.

¹¹² *Canada Trustco* (n 83) [7]; cf *MIL Investments* (TCC) (n 4) [28]–[31].

¹¹³ *Burmah Oil* (n 34) 32.

form of general anti-avoidance measure. It is impossible to canvass all of them here. Of particular interest are those arrangements that rely in part on the foreign residence of a special purpose company or trust. Perhaps the most direct avenue of attack has been to treat the foreign entity, or arrangement involving that entity, as a sham. More commonly, transactions involving a foreign entity have been characterized as ineffective (UK) or abusive (Canada) under domestic law. Thirdly, and to date for Canada alone, transactions involving an entity based in a treaty country have been challenged as an abuse of the relevant treaty.

7.3.2 Domestic Law – Sham Doctrine

There has been little success in the UK or Canada with the argument that a sophisticated tax avoidance arrangement involving the use of an offshore company is somehow a sham. This is probably because the orthodox definition of a sham transaction prevails in British and Canadian law. As explained previously, a ‘sham’ as described in *Ramsay* and *Stubart* involves some deceit – the creation of a façade to hide the parties’ true intentions. According to this view of the matter, sophisticated parties would be unlikely ever to enter a tax avoidance sham: the parties hope to achieve precisely what the legal documents purport to achieve.¹¹⁴ That the transactions are highly complex and artificial does not in itself make the transactions shams. Indeed, a high degree of complexity and artificiality may suggest just the opposite.¹¹⁵

It should be noted that this concept of sham, which comes close to a finding of fraud / evasion, is not the only feasible conception. The High Court of Australia has observed that judges should not be loath to reach a conclusion of sham, suggesting that

¹¹⁴ Gammie 2006 (n 43) 315; A Shipwright (ed), *Tax Avoidance and the Law* (Key Haven Publications, Oxford 1997) 27.

¹¹⁵ eg *Ensign Tankers (Leasing) Ltd v Stokes* [1992] 1 AC 655 (HL) 681–82; *Shell Canada* (n 71) [39].

a sham can be established through ‘the demonstration, by evidence or available inference, of a disparity between the transaction evidenced in the documentation (and related conduct of the parties) and the reality disclosed elsewhere in the evidence’.¹¹⁶ This approach, described as ‘an assertion of the essential realism of the judicial process’,¹¹⁷ might be equated with the ‘unblinker’ approach to the facts recommended in *BMBF*. More ambitious commentators might even describe it as a ‘substance over form’ approach. Presumably, were this concept of sham embraced it would be easier for a court to conclude that an international transaction involving flows of funds through wholly-owned conduit entities, where those entities had no substantial existence and served only to achieve tax benefits, involved or amounted to a sham. This does not seem to be the favoured approach in the UK or Canada, although there are exceptions.

7.3.2(a) *Early Success in Applying Sham Doctrine*

Judicial willingness to adopt a substance over form approach has occasionally resulted in an entity’s existence being treated as illusory. One must acknowledge *Littlewoods Mail Order Stores Ltd v McGregor*, where Lord Denning dismissed the existence of a wholly-owned subsidiary in a profit reduction scheme, stating that despite the general principle of separate legal personality the subsidiary was the ‘creation’ and ‘puppet’ of Littlewoods in fact and it should be so regarded in law.¹¹⁸ This approach, characterized as ‘lifting the corporate veil’, was similar to that taken in some early US decisions.¹¹⁹

¹¹⁶ *Raftland Pty Ltd as Trustee of the Raftland Trust v Commissioner of Taxation* [2008] HCA 21, (2008) 246 ALR 406 (HCA) [145].

¹¹⁷ *ibid* [152].

¹¹⁸ (1969) 44 TC 519 (CA). The other judges dissociated themselves from this broad statement.

¹¹⁹ DS Baker and VS Killingsworth, ‘An American View through the Corporate Veil’ (1978) 6 *Int’l Business Lawyer* 267, cited in *Stuart* (n 73) 554–55.

Littlewoods merits comparison with several Canadian tax cases that arose prior to the enactment of the CFC regime in 1975 (and well before the GAAR in 1988) that involved a MNE establishing an affiliate in a tax haven, often Bermuda, and using that entity as a wholesaler or reinsurer. The typical arrangement involved a Canadian operating subsidiary of a US or UK parent which, having previously purchased some commodity directly from a related company, began to purchase the commodity indirectly via a tax haven subsidiary, with a substantial profit being booked in the subsidiary's jurisdiction. Generally the interposed company was a letterbox: it negotiated nothing, it took no deliveries of the commodity, and it made no deliveries of the commodity; its only activity was to keep proper records and to pay dividends free of tax to its Canadian parent. On at least one occasion the court concluded that the interposed entity was a 'sham' and could be disregarded for tax purposes, because it had no bona fide business purpose and was merely an extension of its parent company.¹²⁰ The Court claimed to rely on the definition of sham in *Snook*, stating that 'the acts performed and the documents executed' were intended to give third parties, including the Revenue, 'the appearance of rights and obligations different from the actual rights and obligations' of the parties; the Judge assumed, however, that the 'actual rights and obligations' were synonymous with the real 'nature and substance' of the commercial relationship.¹²¹ Perhaps unfortunately, in tax law it is usually not plain that those two things can be equated. In any event, this sort of argument was generally unsuccessful when raised against similar international structures,¹²² although adjustments to the parties transfer pricing were sometimes upheld.

¹²⁰ *Dominion Bridge Co Ltd v The Queen* [1975] DTC 5150 (FCTD), aff'd [1977] DTC 5367 (FCA).

¹²¹ *ibid* [48]–[53].

¹²² eg *Spur Oil* (n 70); *Indalex* (n 70); *Irving Oil* (n 70).

7.3.2(b) *Modern Failure in Applying Sham Doctrine*

These older cases are of limited relevance today, the best evidence of which is *Furniss v Dawson*.¹²³ There the Dawson family, wishing to sell their shares in two UK operating companies to an unconnected company called Wood Bastow, sought to defer the capital gains tax that would have arisen on a direct disposition by undertaking the following transactions. First, a wholly-owned ‘investment company’ called Greenjacket Investments Ltd was incorporated in the Isle of Man, a British Crown Dependency that imposes no capital gains tax or stamp duty. The operating company shares were exchanged for shares in Greenjacket, which then sold the operating company shares to Wood Bastow. The taxpayers contended that they could rely upon Finance Act 1965, Schedule 7, paragraphs 4 and 6,¹²⁴ which treated an exchange of shares or debentures as a tax-free reorganization of capital. If those provisions applied, the tax cost of the operating company shares was increased to current market value upon the exchange, Greenjacket realized no gain on the sale of those shares to Wood Bastow, and the accrued tax liability was rolled over to the Greenjacket shares. It had been argued before the Special Commissioners and Vinelott J that: (i) the entire arrangement was ‘so invaded by fiscal considerations’ that one must ignore the corporate identity of Greenjacket and treat the company as the alter ego of the Dawsons; (ii) in the alternative, the acquisition of the shares by Greenjacket as if it were an independent entity which could choose for itself whether to sell the shares was not genuine; and (iii) in the further alternative, Greenjacket was a bare trustee or otherwise not a beneficial owner of the operating company shares at any time. Each of these claims was a variation of the sham argument. Neither the Special Commissioners nor Vinelott J

¹²³ (n 3).

¹²⁴ Now TCGA 1992 ss 127 and 135, subject to the TAAR in s 137, discussed below.

accepted those claims.¹²⁵ Arguments that Greenjacket or the transactions involving Greenjacket were not genuine were not pursued in the further appeals.

Similar arguments had been made by the Crown in the earlier case of *Floor v Davis*.¹²⁶ The structure there involved a disposal of shares in a UK company (IDM) to a holding company (FNW) in order to defer capital gains tax on a sale of the IDM shares to an American purchaser (KDI).¹²⁷ FNW was subsequently wound up and, due to the particular features of its share capital, most of the sale proceeds were distributed to a Cayman Islands company. The Crown cited *Littlewoods* in support of the view that FNW was a ‘vehicle’ for the transfer of the shares to KDI and its existence should be ignored.¹²⁸ All of the Court of Appeal Judges, including Eveleigh LJ dissenting in the result,¹²⁹ accepted that the sale to FNW was a genuine transaction. Some years later, in *Craven v White* and its companion cases, the Crown evidently had learned that it was not worth pursuing arguments that the existence of corporate intermediaries, or transactions with corporate intermediaries, were shams.

Today, arguments in this vein are highly unlikely to succeed if raised against a sophisticated international tax avoidance arrangement, because with sophistication comes caution and attention to detail. There are rare cases where the sham doctrine is fruitfully applied,¹³⁰ but these never involve the sophisticated global operations of a MNE.

¹²⁵ *Furniss v Dawson* (CA) (n 3) 552.

¹²⁶ [1978] Ch 295 (CA), aff’d [1980] AC 695 (HL).

¹²⁷ It is not stated in the case reports where FNW was resident. In *Craven v White* (n 37), Lord Templeman stated at 483 that FNW had been based in the Isle of Man.

¹²⁸ *Floor v Davis* (n 126) 300.

¹²⁹ *ibid* 313.

¹³⁰ eg *Hitch v Stone* [2001] STC 214 (CA); *Faraggi v The Queen* [2009] DTC 5585 (FCA).

An exception that proves the rule is the recent decision in *Antle et al v The Queen*.¹³¹ There a Canadian resident individual agreed to sell certain shares to an unrelated purchaser. To avoid tax, he embarked on a plan whereby he purported to settle a Barbados trust in favour of his spouse, to convey the shares to the trust which would then sell them to his spouse in Canada, who in turn would sell them to the intended purchaser, with the proceeds going to the trust and being returned to her as a capital distribution. If this ‘step-up strategy’ (as it was known) worked as designed, the taxpayer would not just defer but eliminate a taxable capital gain in respect of the shares by virtue of the fact that jurisdiction to tax capital gains rests with Barbados under the Canada–Barbados tax treaty¹³² and Barbados does not tax capital gains. The Federal Court of Appeal agreed with the Tax Court judge that the purported trust was not validly constituted because it lacked certainty of intention and certainty of subject matter, and went on to conclude that the trust was a sham.¹³³ Interestingly, Miller J said it was ‘disingenuous’ to suggest that the Barbados trustee had any discretion whether or not to sell the shares to the taxpayer’s spouse; in his view the sale was ‘absolutely preordained’ and there was only a pretence of trustee discretion.¹³⁴ One wonders whether the same indictment could have been made in respect of Greenjacket in *Furniss v Dawson*, FNW in *Floor v Davis*, or Eulalia in *Wood v Holden*.¹³⁵ Whatever the case may be with personal trusts, it seems that the principle of separate corporate personality (and separate corporate residence) is too vigorous to be undone by the sham doctrine. It

¹³¹ [2009] DTC 1732 (TCC), aff’d [2010] DTC 5172 (FCA).

¹³² *Agreement between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* (1980) (Canada–Barbados DTC) Art 14[4].

¹³³ *Antle* (FCA) (n 131) [16]–[22].

¹³⁴ *Antle* (TCC) (n 131) [67].

¹³⁵ (n 3). The facts are discussed in ch 4 at text following n 90.

is unremarkable that one rarely sees HMRC or the CRA make allegations of sham in current international avoidance cases.

7.3.3 Domestic Law – Ineffective / Abusive Avoidance

Assuming that the impugned transactions involve no sham and that no specific anti-avoidance rule or TAAR applies, the revenue authority may be driven to argue that transactions involving a foreign entity are ineffective (UK) or abusive (Canada) according to domestic law. As discussed previously, this involves demonstrating to a court that the impugned transaction or series of transactions is inconsistent with the intention, purpose, or policy of the legislation. Judgments regarding these issues are difficult to rationalize and reconcile, largely because the intention of tax legislation affecting international activities is nebulous.

7.3.3(a) *UK Decisions Regarding ‘Pure Tax Schemes’*

Courts in the UK have had little difficulty in concluding that series of transactions having an international element but no commercial purpose should be viewed in composite, where that is precisely how the parties viewed the series of transactions themselves. On some occasions, both before and since *Ramsay*, it was concluded that such composite transactions were fiscally ineffective because they were not within with the intention of the relevant legislation or because they were captured by a specific anti-avoidance rule. Notable examples are *Chinn v Hochstrasser*,¹³⁶ *Eilbeck v Rawling*,¹³⁷ and *McGuckian*.¹³⁸ It is interesting that the schemes in each of those cases involved the use of settlements based in the Channel Islands. There is perhaps less scope for pure tax

¹³⁶ [1981] AC 533 (HL).

¹³⁷ (n 31).

¹³⁸ (n 37).

schemes today, due to the introduction of the disclosure rules and the proliferation of TAARs in UK tax law. It appears that more recent schemes, such as those involving international tax arbitrage carried out by financial institutions, are addressed not through application of the *Ramsay* / *BMBF* approach as such, but instead through very technical arguments that rely on specific anti-avoidance rules.¹³⁹

7.3.3(b) *Furniss v Dawson and Craven v White – Rationalizing the Decisions*

In *Furniss v Dawson* Lord Brightman, far from treating any of the transactions as a sham or suggesting that the arrangement had no commercial purpose, described the arrangement as ‘a simple and honest scheme which merely seeks to defer payment of tax until the taxpayer has received into his hands the gain which he has made’.¹⁴⁰ Nonetheless, Lord Brightman decided that the insertion of the corporate reorganization into the overall sale transaction, though genuine, could be ‘disregarded’ for tax purposes.¹⁴¹ The result was the Dawsons being treated for tax purposes as having made a direct disposal of the operating company shares to Wood Bastow, with the proceeds being received by Greenjacket in the Isle of Man. The choice of the word ‘disregard’ was regrettable, although fair enough as an informal description of what the Court decided.

Before saying more about that case, it is helpful to consider the contrasting result in *Craven v White*.¹⁴² Two of the three cases in the combined appeal – *Craven v White* itself and *Baylis v Gregory* – involved offshore share exchange transactions very

¹³⁹ eg *Bank of Ireland Britain Holdings Ltd v HMRC* [2008] EWCA Civ 58, [2008] STC 398. cf *Bayfine* (n 58).

¹⁴⁰ *Furniss v Dawson* (n 3) 518.

¹⁴¹ *ibid* 527.

¹⁴² (n 37).

much like the transaction in *Furniss v Dawson*, again relying on the reorganization exception in Schedule 7 to the Finance Act 1965. In both cases, all of the issued shares of a UK operating company were transferred to a Manx holding company in exchange for shares of the holding company, with the avowed intention that the holding company would then sell the underlying shares to a prospective purchaser.

The wrinkle in each of these arrangements, which turned out to be critically important to the taxpayers' victories, is that the originally intended purchasers declined to complete their purchases from the Manx holding companies, leaving the respective shareholders to find alternate buyers. Lord Oliver, giving the leading speech for the majority, said that the approach in *Ramsay* and *Furniss v Dawson* was applicable only where, among other things, the series of transactions was pre-ordained and the intermediate transaction (here, the offshore reorganization) was not even contemplated as having an 'independent life'.¹⁴³ He considered that the shareholders' need to identify and negotiate with new purchasers after implementing the reorganizations amounted to *ex post* evidence of the independent life of those reorganizations. Thus the transactions were considered effective according to their terms.¹⁴⁴

Much ink has been spilled in attempts to rationalize the results in *Furniss v Dawson* and, to a lesser extent, *Craven v White*. In *Craven v White* itself Lord Oliver stated that the only way *Furniss v Dawson* could be 'properly understood or rationally justified as a proper exercise of the judicial function' was the premise that the intermediate transfer to Greenjacket, whose statutory consequences would otherwise have resulted in tax deferral, did not constitute a 'disposal' as contemplated by Finance

¹⁴³ (n 37) 507.

¹⁴⁴ Lord Templeman and Lord Goff dissented in *Craven v White* but not in the other appeals.

Act 1965, Schedule 7.¹⁴⁵ Substantially similar comments were made by the House of Lords in *BMBF*.¹⁴⁶ The most thorough explanation, however, was offered in *Westmoreland*. There Lord Hoffmann said that the judgment in *Furniss v Dawson* did not entail the recharacterization of the transactions as a direct sale to Wood Bastow: the relevance of the ultimate sale to Wood Bastow was to place the transaction with Greenjacket in its proper context so as to determine whether this was the type of ‘disposal’ or ‘exchange’ that Parliament had contemplated when it enacted the provisions providing relief from capital gains tax on a corporate reorganization.¹⁴⁷

There is nothing necessarily wrong with these justifications, yet they are frustrating because they do not explain *why* the Greenjacket reorganization fails to qualify as an ‘exchange’ within the intent of the legislation while the *Craven v White* and *Baylis v Gregory* reorganizations do qualify. The assertion that these results followed from a purposive construction of the legislation could be more easily understood if there was some discussion in the cases of what the purpose of the corporate reorganization relief was. Gammie anticipates this criticism when he says: ‘It would be naïve to think that Parliament had any particular type of exchange in mind when in 1965 it enacted this provision. The only true reflection of Parliament’s mind is in the statutory language it uses.’¹⁴⁸

Today, the share exchange in *Furniss v Dawson* would (presumably) fail according to the TAAR in subsection 137(1) of the TCGA 1992, which provides that an

¹⁴⁵ *Craven v White* (n 37) 502–03.

¹⁴⁶ (n 32) [35].

¹⁴⁷ *Westmoreland* (n 50) [45]–[48], discussed further in: JF Avery Jones, ‘*Macniven v Westmoreland*: The Humpty Dumpty school of judicial anti-avoidance’ (case comment) (2001) 6 Private Client Business 378; Gammie 2006 (n 43) 300–03.

¹⁴⁸ Gammie 2006 (n 43) 301.

exchange of shares or debentures does not qualify as a reorganization under section 135 unless the exchange is effected for bona fide commercial reasons and is not part of a scheme or arrangement of which the main purpose, or one of the main purposes, is tax avoidance. This provision appears to codify the suggestion of Peter Millett, who was counsel for the Crown in *Floor v Davis*, *Ramsay*, *Burmah Oil* and *Furniss v Dawson*, that the corporate reorganization provisions should apply only to transactions for which the main purpose is a commercial purpose.¹⁴⁹ As with the CFC motive test,¹⁵⁰ and the anti-treaty shopping TAARs in newer UK tax treaties,¹⁵¹ the deficiency in this sort of test is that it focuses entirely on subjective considerations with no regard to objective economic effects. As such, it tells us nothing about which types of avoidance transactions (to use the Canadian term) are within or outside the intention of the statute – it simply declares that all transactions with a main tax purpose are offside.

Let us assume that subsection 137(1) did not exist. Would a court presented with a *Furniss v Dawson* arrangement conclude that the transaction, construed realistically, did not involve an ‘exchange’ of shares with the holding company as contemplated by the relevant provisions of the TCGA 1992, interpreted purposively? In what circumstances would a court conclude this? This can only be answered by first identifying the purpose or policy of the relevant provisions.

Although not addressed in the cases discussed above, one presumes that the purpose or policy of the corporate reorganization provisions is to allow shareholdings to be exchanged without realizing accrued tax liabilities where the exchange happens between members of the same economic group; this serves to recognize the economic

¹⁴⁹ P Millett, ‘Artificial Tax Avoidance: The English and American Approach’ [1986] BTR 327.

¹⁵⁰ Ch 5 text following n 164.

¹⁵¹ Ch 6 text following n 152.

reality that, despite the separate legal identity of companies, ultimate ownership has not changed.¹⁵² Any accrued capital gains tax liability on the original shareholding is not eliminated but is transferred to a different shareholding, typically shares in a holding company. In the author's view, this is a sensible policy *if* the relevant holding company has some independent existence within the corporate group, and *if* all relevant entities in the corporate group are resident in the UK; the policy loses coherence when the 'holding company' is simply a conduit for facilitating share transfers, particularly where the holding company is established outside UK tax jurisdiction. Nonetheless, former Schedule 7 to the Finance Act 1965 and current section 135 of the TCGA 1992 seem to allow tax-free reorganizations, including international reorganizations, in anticipation of a third party sale, subject only to the TAAR in subsection 137(1).

The main concern of the Inland Revenue in *Furniss v Dawson* and *Craven v White* was the transitory existence and single function of the relevant holding companies, rather than their foreign residence as such. At the Court of Appeal level in *Furniss v Dawson*, Oliver LJ described the type of tax deferral arrangement at issue, suggesting that it must be 'familiar to company lawyers and taxation advisers alike'; he observed that in the instant case the investment company was located offshore but that could be disregarded 'as an irrelevant refinement'.¹⁵³ That characterization was perhaps too forceful, as the Manx residence of the companies was not entirely irrelevant. It is true that, for purposes of UK taxation, the Dawsons had deferred rather than eliminated the capital gains tax liability inherent in the operating company shares because that liability was now built into their Greenjacket shares. However, residence in the Isle of Man was important in avoiding stamp duty on a subsequent sale of the holding

¹⁵² *Westcott v Woolcombers Ltd* [1986] STC 182 (Ch) 190 [Hoffmann J], *aff'd* [1987] STC 600 (CA).

¹⁵³ *Furniss v Dawson* (CA) (n 3) 552.

company shares, and would also be relevant in avoiding the complication of any local capital gains taxes if the operating company shares were held by the holding company for a period of time over which their value increased further – a real possibility in *Craven v White* and *Baylis v Gregory*. Such liabilities could not arise precisely because the Isle of Man imposes no stamp duty or capital gains tax. In *Craven v White* Lord Templeman made the following acknowledgement of the prima facie legitimacy of the transactions:

If a taxpayer *mindful of the immunity from taxation enjoyed by a Manx company* transfers assets to a company in the Isle of Man, the immunity of that company will continue and may be enjoyed indirectly by the taxpayer subject to an express provision by Parliament to the contrary. Parliament intends that a taxpayer shall be free to place an asset out of reach of the taxing provisions. The courts have neither the power nor the desire to interfere.¹⁵⁴

In sum it appears that the Manx residence of Greenjacket (and other holding companies) contributed to the viability of this common tax structure, although it was not essential to the main objective of deferring UK taxation of the underlying gain.

These cases illustrate that, when analyzing a taxpayer's use of an offshore special purpose company to avoid tax, it is difficult to separate the issue of substantial, independent existence of the company from substantial, independent residence of the company. The two issues are intertwined. The author suspects that the Inland Revenue were even less happy about the use of offshore entities in these tax deferral structures than they were about the use of domestic entities in similar structures. It seems that in *Furniss v Dawson* and related cases the Revenue doubted whether the 'independent life' of the Manx entities was deserving of legal recognition. This position is implicit in claims by counsel for the Revenue, repeated in some of the judges' speeches, that the

¹⁵⁴ *Craven v White* (n 37) 489 [emphasis added].

relevant Manx entity was a ‘commercially superfluous party’ or a conduit used to ‘channel’ the sale of the underlying shares.¹⁵⁵ The arguments made in *Craven v White*, summarized by Gibson J in the Chancery Division, are rife with references to the degree of establishment of the holding company Millor: the taxpayer’s counsel stressed that Millor was a ‘permanently established investment company’ rather than a ‘temporary device’, ‘Millor exists’, and Millor was the beneficial owner of the UK company shares for several weeks;¹⁵⁶ counsel for the Crown claimed that Millor did not behave ‘as an investment company should’, having served its single purpose.¹⁵⁷ Even more illustrative of the Revenue’s position is the summary given by Lord Oliver of the following exchange with counsel for the Crown. Lord Oliver said that counsel:

... accepted in the course of argument that if, in *Furniss v Dawson*, the Dawsons had formed Greenjacket for the purpose of carrying on a building business in the Isle of Man to be financed out of the proceeds of the shares in the operating company, it would not have been permissible to disregard the share exchange as an effective disposition for tax purposes even though the identical events occurred in the identical sequence.¹⁵⁸

Thus it seems that the reorganization and immediate onward sale would have been considered acceptable if the Manx company had been established in the Isle of Man with the intention of participating in the Manx economy on some substantial basis.

If this is an accurate representation of the Inland Revenue’s views (at the time) as to why the transactions in *Furniss v Dawson*, *Craven v White* and *Baylis v Gregory* should not qualify as exchanges within the intent of the legislation, this signifies that the perceived unacceptability or ‘abuse’ subsists not in the taxpayer’s motives, or even in

¹⁵⁵ eg *Furniss v Dawson* (CA) (n 3) 561–62 [Oliver LJ]; *Craven v White* (CA) (n 37) 340–41 [Mustill LJ]; *Craven v White* (HL) (n 37) 497 [Lord Oliver]; cf *Floor v Davis* (n 126) 307.

¹⁵⁶ *Craven v White* (Ch) (n 37) 545–46.

¹⁵⁷ *ibid* 546.

¹⁵⁸ *Craven v White* (HL) (n 37) 516.

the pre-ordination or interconnectedness of the transactions. It subsists in the economically unsubstantial existence and, perhaps, unsubstantial foreign residence of the relevant holding company.

A final observation on section 137 of the TCGA 1992 is warranted. In the author's view this provision improperly focuses upon the transaction's main purpose or purposes, rather than upon the economic effect of the transaction. This approach is too sweeping in an international corporate context. A UK-resident parent company might wish to initiate a reorganization, including an international reorganization, precisely to avoid future tax liabilities in the UK; in the author's view this should be unobjectionable provided that: (i) the reorganization has real economic substance; and (ii) any alleged non-resident entities involved in or created in the course of the reorganization are, in an economically substantial sense, established outside the UK. The challenge for Parliament is to explain what is meant by 'economic substance' in these contexts, but there is no reason why that cannot be done. Parliament can also provide that any tax liabilities that accrued while shares were held in the UK are realized upon those shares being removed from UK jurisdiction, subject to any limitations under EU law. The current focus on the 'main purposes' of such a transaction is misplaced.

7.3.3(c) *Canadian Cases – Relevance of Residence*

Unlike the UK, Canada does not have the benefit of decisions from its highest court regarding the application of its general anti-avoidance measure to international arrangements involving special purpose companies. Lower court decisions are conflicting, with only one judgment written after *Canada Trustco* suggesting, in *obiter dicta*, that the GAAR applied to nullify the tax benefit of the arrangement.

One of the first GAAR decisions after *Canada Trustco* was *Univar*.¹⁵⁹ As discussed in chapter 5, that case involved a Canadian corporation (Univar Canada) borrowing to capitalize a Barbados financing affiliate (VWRB), with VWRB then purchasing certain notes from Univar Europe and distributing the resulting interest income as a tax-free dividend to Univar Canada.¹⁶⁰ The case was decided in the taxpayer's favour primarily on the basis that the anti-avoidance rule in paragraph 95(6)(b) of the ITA 1985 did not apply because the principal purpose for the acquisition of the VWRB shares was not to permit the taxpayer to avoid tax. The Court went on to consider the Crown's alternative submission that the GAAR applied so as to deny the dividend exemption. Oddly, the Court reasoned that the taxpayer had obtained no 'tax benefit' because the comparator transaction suggested by the Crown – the taxpayer acquiring the notes directly and earning interest income – had never been contemplated by the taxpayer's advisers as a possibility.¹⁶¹ The Court also concluded that there had been no 'avoidance transaction', apparently because there was ample evidence of an overall commercial purpose of balancing the debt to equity ratios across the Univar corporate group, among other considerations.¹⁶² Justice Bell made the following rebuke of the Crown's argument: 'Respecting the undue emphasis on "tax strategy", all business transactions, if properly analyzed, planned and implemented, must involve an acute awareness of the tax effect of every aspect thereof.'¹⁶³ Put another way, the overall commercial purpose of restructuring the group's debt was seen to justify any tax

¹⁵⁹ (n 4).

¹⁶⁰ By virtue of ITA 1985 s 113(1)(a) (permitting exemption of dividends received from foreign affiliates to the extent that the underlying income is 'active business income' earned in a treaty country) and s 95(2)(a)(ii) (deeming certain passive income received by a foreign affiliate from other foreign affiliates carrying on an active business to be 'active business income'). These provisions are discussed in ch 5 text to nn 159–162.

¹⁶¹ *Univar* (n 4) [44].

¹⁶² *Univar* (n 4) [45]–[48].

¹⁶³ *Univar* (n 4) [65].

planning that might be used to achieve that purpose. The Court thus found it unnecessary to address the contention that the interposition of VWRB resulted in an abuse of any provision of the ITA 1985.

The reasoning in *Univar* is far from illuminating. In the light of *Canada Trustco* and subsequent cases, the observation that there was no tax benefit here is surely mistaken, and the conclusion that there was no avoidance transaction is suspect as well. However, had Justice Bell accepted that those elements were present and gone on to consider whether the transactions frustrated the object, spirit, or purpose of the relevant provisions – particularly the tax exemption for dividends from foreign affiliates – he undoubtedly would have concluded that there was no abuse, and rightly so. It is difficult to see how the transactions in question could be said to ‘lack a proper basis’ relative to the purpose of that provision or could be characterized as ‘wholly dissimilar’ to the transactions contemplated by that provision.¹⁶⁴ In the author’s view the abuse does not subsist in the taxpayer’s actions but in the provisions themselves: Canada has expressly chosen to pursue the questionable policy of allowing deduction of interest on borrowed money used to earn exempt dividends, along with the fatuous policy of granting full exemption for dividends from foreign affiliates incorporated in treaty havens but carrying on no real business there.

Univar is one of several cases where the Canada–Barbados DTC¹⁶⁵ was critical to the viability of the arrangement. Yet it does not appear that counsel for the CRA raised the issue of abuse of the treaty itself, focusing instead on the alleged abuse of Canada’s foreign affiliate provisions. Two more recent cases involving the Canada–

¹⁶⁴ *Canada Trustco* (n 83) [60].

¹⁶⁵ (n 132).

Barbados DTC were *Garron*¹⁶⁶ and *Antle*,¹⁶⁷ in which the Crown argued that there had been abuse of both domestic law and the treaty.

As discussed in chapter 4, *Garron* involved a corporate reorganization in which two Barbados trusts were settled, each subscribing for shares in certain holding companies and subsequently disposing of those shares at a capital gain. The taxpayers hoped that the gains would be exempt from Canadian taxation by virtue of Article 14 of the Canada–Barbados DTC. A number of arguments were made by the Crown as to why this series of transactions did not produce the intended tax result. Justice Woods’ primary conclusion was that the trusts were resident in Canada at all times, for both domestic law purposes and treaty purposes.¹⁶⁸ As such there was no need to consider application of the GAAR. Nevertheless Woods J went on to discuss this issue. Applying the analysis from *Canada Trustco*, she accepted that there was an obvious tax benefit here and that the corporate reorganization involved a number of avoidance transactions.¹⁶⁹ However, she concluded that the Crown failed to demonstrate how the arrangement resulted in an abuse of any domestic tax law provisions.¹⁷⁰ She also concluded that the Canada–Barbados DTC was not abused, as discussed below.

Antle was decided at about the same time as *Garron*. The primary conclusion in *Antle* was that the purported Barbados spousal trust was a sham, as already discussed.¹⁷¹ Although the Federal Court of Appeal declined to express any views on the matter, Miller J went on to find, in *obiter dicta*, that the result obtained by the series of

¹⁶⁶ (n 3).

¹⁶⁷ (n 131).

¹⁶⁸ *Garron* (TCC) (n 3) [170], [267].

¹⁶⁹ *ibid* [343]–[345].

¹⁷⁰ *ibid* [348], [367]–[368].

¹⁷¹ Text following n 131.

transactions was abusive of the ITA 1985 and thus the intended tax benefit could be disregarded pursuant to the GAAR. Applying the analytical framework from *Canada Trustco*, he considered in detail the object, spirit, and purpose of the relevant provisions. He stated that the impugned structure ‘blatantly frustrated’ the object and spirit of the domestic provisions allowing tax-deferred exchanges of property with a spouse and certain anti-avoidance rules applicable to non-resident trusts.¹⁷² Moreover, Miller J concluded that the scheme undermined the general principle in Canadian tax law that when a resident individual disposes of capital property outside the marital unit, he or she should be liable to taxation on any increase in value unless a specific exemption applies.¹⁷³ The notion that there is some general principle, inherent in Canadian tax legislation, that disposals of capital property by Canadian residents at increased value should be subject to taxation is initially attractive. However, it is difficult to reconcile that position with the decisions in *MIL Investments* and *Garron*, both capital gains tax avoidance cases where the GAAR was held not to apply. Justice Miller’s observation that the Canada–Barbados DTC was also abused is addressed in the next section. What is most interesting about that aspect of the decision is that, as in *Garron*, the Crown argued that the unsubstantial residence of the respective trusts in Barbados was a factor militating in favour of application of the GAAR.

7.3.4 Tax Treaties – Ineffective / Abusive Avoidance

The previous chapter dealt at length with a range of state responses to alleged abuses of tax treaties, including application of express or implied treaty anti-abuse principles. There is much overlap between the application of treaty anti-abuse principles and the application of domestic anti-avoidance measures to alleged treaty abuse. Among other

¹⁷² *Antle* (n 131) [89]–[95], [117].

¹⁷³ *ibid* [118], [121].

similarities, it is apparent that revenue authorities believe that these approaches can be applied to recharacterize transactions with foreign special purpose entities.

7.3.4(a) UK

As discussed above,¹⁷⁴ there is no principled reason why the *Ramsay / BMBF* approach could not be applied to the abuse of a UK tax treaty – although it is more likely that a British court would use the term ‘ineffective’ rather than ‘abusive’. Were a UK court asked to address perceived tax avoidance that somehow exploited a tax treaty, one assumes it would proceed by applying the relevant treaty provisions construed purposively to the relevant transactions viewed realistically. Such an approach is better described as interpretation of the treaty itself. Accordingly it is difficult to identify any UK cases where the *Ramsay / BMBF* ‘approach’ was expressly applied to treaty interpretation.

The structures in *Furniss v Dawson*, *Craven v White*, and *Baylis v Gregory* did not rely on the (limited) treaty between the UK and the Isle of Man for their intended effect; they relied on UK domestic legislation which applied whether the relevant holding company was resident in the UK or the Isle of Man. Thus it is unsurprising that there were no allegations that the treaty was ‘abused’. More recent tax litigation has involved transactions that HMRC could have challenged as ‘abuses’ of an applicable UK tax treaty. For whatever reason HMRC or their counsel have chosen not to pursue that line of argument. Two examples should serve to illustrate this pattern.

¹⁷⁴ Text to nn 104–109.

In *Smallwood Trust v HMRC*,¹⁷⁵ discussed in chapter 4, the taxpayer sought to escape UK capital gains tax on a disposal of shares through the use of an orchestrated sequence of trusteeships exercised in different states at different times within the same fiscal year, from Jersey to Mauritius to the UK. In theory, the composite transaction doctrine could have been applied to ignore the brief period of Mauritian residence or to treat the whole arrangement as an ineffective use of the tax treaty between the UK and Mauritius.¹⁷⁶ Instead the courts embarked on a technical analysis of the relationship between domestic chargeability, treaty residence, and place of effective management, as discussed earlier.

The *Bayfine* case¹⁷⁷ involved the use of hybrid entities under the American ‘check-the-box’ regulations and reliance on the treaty between the US and the UK.¹⁷⁸ In broad terms, the goal was to use multiple debt contracts to create an allowable loss in the UK for which group relief could be obtained, as well as an equivalent UK profit on which no UK tax would be payable after obtaining credit for US tax. Counsel for HMRC had argued that the arrangement was a tax avoidance scheme with ‘no commercial purpose or effect apart from Bank of America’s fees’.¹⁷⁹ The Special Commissioners, having held that certain specific anti-avoidance rules did not apply, did not consider whether the arrangement was an ‘abuse’ of the UK–US DTC. They did look at the multiple debt contracts in composite based on the reasoning in *BMBF* and

¹⁷⁵ [2008] STC (SCD) 629, rev’d [2009] EWHC 777, [2009] STC 1222 (Ch), rev’d [2010] EWCA Civ 778, [2010] STC 2045 (CA).

¹⁷⁶ BJ Arnold, ‘Tax Treaty News’ (2009) 63 BIT 266, 267: ‘I find it curious that the blatant tax avoidance aspect of the case was apparently not argued by the government or dealt with by the judge.’

¹⁷⁷ (n 58).

¹⁷⁸ *Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains* (2001) (UK–US DTC).

¹⁷⁹ *Bayfine* (SpC) (n 58) [10].

SPI,¹⁸⁰ but, rather than attempting to ascertain whether the arrangement was fiscally ineffective overall, they considered the more technical issue of where the profit in substance arose and which state was required to credit the taxes paid in the other state. The High Court disagreed with the Commissioners' conclusion regarding the latter issue.¹⁸¹

The approaches adopted in *Smallwood* and *Bayfine* are not mentioned here in order to disparage them. On the contrary, by steering away from vague concepts of 'abuse' – or, more accurately, inconsistency with treaty intention – HMRC and the courts are directly addressing the critical issues of where a taxpayer is resident and where income or gains are sourced pursuant to the relevant domestic law and the relevant treaty. The Canadian approach has been very different.

7.3.4(b) *Canada*

Canada has been more active than the UK in challenging alleged abuses of its tax treaties. There are probably two reasons for this. First, Canada was until recently a capital importing country; it thus has more comprehensive withholding taxes, which are reduced where the income recipient is resident in a treaty country.¹⁸² Second, the functioning of Canada's foreign dividend exemption and CFC regime is (regrettably) tied into its tax treaty network.¹⁸³ The government desire to prevent 'unacceptable' uses of Canadian tax treaties prompted the retroactive amendment to the GAAR mentioned above. Yet the very high threshold for a finding of abuse under the GAAR, stemming

¹⁸⁰ *ibid* [12]–[14].

¹⁸¹ *Bayfine* (Ch) (n 58).

¹⁸² Discussed in ch 6.

¹⁸³ Discussed in ch 3 and ch 5.

from *Canada Trustco*, almost guarantees that the exploitation of a tax treaty will not be considered ‘abuse’. This is illustrated by a number of recent decisions.

As discussed in the previous chapter, *MIL Investments*¹⁸⁴ is one of the two leading cases on treaty shopping in Canada. That case involved a continuance of a holding company (MIL) from the Cayman Islands to Luxembourg, followed by a sale of its shares in a Canadian mining company (DFR) in such a way that the gain would be exempt from Canadian tax under the Canada–Luxembourg tax treaty.¹⁸⁵ The Crown argued that the taxpayer had abused the capital gains tax relief in the treaty, with the result that the tax benefit should be denied pursuant to the GAAR. After observing that the GAAR could in principle apply to the treaty, Justice Bell referred to *Canada Trustco* and various Canadian decisions recognizing the legitimacy of tax planning in commercial arrangements. His primary conclusion was that none of the transactions (including the continuance from Cayman to Luxembourg) was an avoidance transaction. While accepting that one of the ‘driving forces’ of the transactions was to ensure the sale of the DFR shares in a tax effective manner, he concluded that the overall commercial purpose was sufficient to exculpate the transactions,¹⁸⁶ much as he had decided in *Univar*.¹⁸⁷ He nevertheless went on to consider whether, had one or more of the transactions been an avoidance transaction, it would have constituted an abuse of the Canada–Luxembourg DTC. His conclusion was unequivocal: ‘the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive’.¹⁸⁸ He held

¹⁸⁴ (n 4).

¹⁸⁵ *Convention between Canada and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* (1989) (terminated and replaced in 2001) (Canada–Luxembourg DTC).

¹⁸⁶ *MIL Investments* (TCC) (n 4) [53]–[54].

¹⁸⁷ Text to nn 162–163.

¹⁸⁸ *MIL Investments* (TCC) (n 4) [72].

that a court must examine ‘the use of the selected treaty’ rather than its *selection*. Turning to the text of the specific treaty provisions relied upon, he could discern no reason why those provisions should not apply to a Luxembourg holding company owned by a foreign shareholder.

The Federal Court of Appeal agreed, saying it was clear that: (i) the Canada–Luxembourg DTC intends to exempt Luxembourg residents from taxation on gains from the disposition of certain Canadian property; and (ii) under the terms of the tax treaty, the shares of DFR held by MIL were such exempt property. The Court held that, if the tax relief was intended to be limited to portfolio investments, or to non-controlling interests in immovable property, then ‘it would have been easy enough to say so’ in the tax treaty.¹⁸⁹

The CRA and Department of Justice may fear that this interpretation of the GAAR amounts to its annihilation so far as treaty shopping is concerned. This is likely why the GAAR was not invoked in the subsequent treaty shopping case, *Prévost Car Inc v The Queen*,¹⁹⁰ as an alternative to the beneficial ownership argument. The analysis in *MIL Investments* seems to ensure that any inward investment strategy exploiting a Canadian tax treaty, no matter how blatant the tax avoidance aspect, will be immune to the GAAR provided the intermediate entity is formally established in the particular treaty state and meets the technical requirements of the particular treaty provisions relied upon.

The decision in *MIL Investments* has not dissuaded the CRA from raising GAAR assessments with respect to transactions whereby Canadian taxpayers undertake

¹⁸⁹ *MIL Investments* (FCA) (n 4) [7].

¹⁹⁰ [2008] DTC 3080 (TCC), aff’d [2009] DTC 5053 (FCA).

outward or ‘round the world’ investments in reliance on a tax treaty. The key decisions are *Garron* and *Antle*. We have seen that the arrangements in each of those cases involved, in broad terms, the purported settlement of a Barbados trust and the transfer of appreciated capital property into that trust on a rollover basis, either pursuant to the corporate reorganization provisions (*Garron*) or pursuant to the spousal rollover provisions (*Antle*), so that the capital property could be sold to a third party without realizing a taxable capital gain in Canada. Both arrangements relied on the allocation of tax jurisdiction to Barbados under the Canada–Barbados DTC. Woods J in *Garron* held that the trusts were resident in Canada, while Miller J in *Antle* held that the purported trust was invalid, such that recourse to the GAAR was unnecessary in either case. Nonetheless, both judges went on to consider application of the GAAR to the treaty.

In each case the Crown made several arguments in support of the view that the transactions, which were admitted to be avoidance transactions, abused the Canada–Barbados DTC. In *Garron* it was claimed that the transactions constituted treaty abuse because they were structured so as not to fall within specific domestic anti-avoidance rules applicable to non-resident trusts and CFCs.¹⁹¹ This seems to be something of a non-sequitur, thus it is unsurprising that Justice Woods found this line of argument unconvincing. The same sort of implausible argument was made in reverse by the taxpayer’s counsel in *Antle*: they urged that the arrangement must be within the object, spirit, and purpose of the treaty because it was not specifically prevented by domestic anti-avoidance rules or by a treaty anti-avoidance rule!¹⁹² Justice Miller found it impossible to accept that reasoning. In short, both judges felt that no policy as to what the Canada–Barbados DTC was intended to allow or not allow could be discerned from

¹⁹¹ *Garron* (TCC) (n 3) [371]–[379], [384]–[387].

¹⁹² *Antle* (TCC) (n 131) [101], [106]–[108].

the lacunae in Canadian tax rules applicable to CFCs and non-resident trusts. In both cases there were arguments as to whether the treaty was intended to allow double non-taxation, something which resulted here because Barbados does not tax capital gains.¹⁹³ This argument received little comment in *Antle* and was dismissed by Woods J in *Garron* much as it has been in other decisions, including *Smallwood*.¹⁹⁴

More interesting was the assertion that the GAAR should apply to deny treaty benefits because Article 14, paragraph 4 of the treaty ‘is designed to exempt only true non-residents of Canada’ from Canadian taxation.¹⁹⁵ It was claimed by the Crown in *Garron* that granting treaty benefits to a trust having only the minimum formal connections with Barbados would invite avoidance by Canadian residents and thus should be considered contrary to the purposes of the treaty, whereas it was claimed by the taxpayer in *Antle* that this is precisely what the treaty contemplated. In *Garron* Justice Woods responded to the Crown’s argument as follows:

The problem that I have with this argument is that, if accepted, it would result in a selective application of the Treaty to residents of Barbados, depending on criteria other than residence. It seems to me that this is contrary to the object and spirit of the Treaty, which is apparent in Article I and Article IV(1). Residents of Barbados, as defined for purposes of the Treaty, are entitled to the benefits of Article XIV(4) as long as they are not also residents of Canada.¹⁹⁶

She said that if a trust is a resident of Barbados according to Article 4, meaning that it is a person liable to taxation therein by reason of domicile, residence, place of management, or similar criterion, then it can rely on the exemption in Article 14; the strength of the trust’s connection to Barbados is irrelevant. Similarly, in *Antle* Justice

¹⁹³ *Garron* (TCC) (n 3) [388]–[391]; *Antle* (TCC) (n 131) [97]–[99].

¹⁹⁴ *Smallwood* (Ch) (n 175) [40].

¹⁹⁵ *Garron* (TCC) (n 3) [357], [380]; cf *Antle* (TCC) (n 131) [103]–[104], [110]–[111].

¹⁹⁶ *Garron* (TCC) (n 3) [381].

Miller accepted that the Canada–Barbados DTC does not have a LOB provision or any other restriction beyond Article 4 on who should qualify as a Barbados resident entitled to exemption from Canadian tax under Article 14. Miller J stated repeatedly in his judgment that a trust that is resident in Barbados can rely on Article 14 and that, beyond the text of the provision, no further purpose could be discerned: ‘Article XIV(4) simply is what it is’.¹⁹⁷ Both judges, being unable to ascertain any object, spirit, or purpose of Article 14, concluded that the transactions did not result in any abuse of the Canada–Barbados DTC itself. The difference in *Antle* was that Justice Miller was willing to conclude that there was an abuse of the ‘joint operation’ of the relevant domestic law provisions and the treaty, whereas Justice Woods was not.¹⁹⁸

These cases are informative as to the views of the CRA and Department of Justice regarding when the GAAR should apply to the exploitation of a tax treaty. They also demonstrate that there is a significant gap between what the revenue authority believes to be the object and spirit of a tax treaty and what Canadian courts are able to identify as that object and spirit. Just prior to the completion of this thesis, the Federal Court of Appeal affirmed the *Antle* decision without expressing any view on the application of the GAAR,¹⁹⁹ and affirmed the *Garron* decision with only a brief discussion of the GAAR, agreeing with Woods J that, if the trusts had been resident in Barbados, they would have been entitled to rely on the treaty exemption.²⁰⁰

¹⁹⁷ *Antle* (n 131) [99], [111].

¹⁹⁸ *Antle* (n 131) [120].

¹⁹⁹ *Antle* (FCA) (n 131) [22]–[23].

²⁰⁰ *Garron* (FCA) (n 3) [89]–[90].

7.4 CONCLUSIONS

There are numerous exhortations in the judges' speeches in *Furniss v Dawson*, *Craven v White*, and other cases preceding *BMBF* and *Canada Trustco* that revenue authorities and courts are obliged to regard a series of related transactions 'realistically' in order to determine what the 'real' transaction was. The approach endorsed in *BMBF* and *Canada Trustco* reduced the emphasis on the supposed economic reality or unreality of a transaction, instead focusing on whether the impugned series of transactions was consistent with an identifiable purpose of the relevant legislation or treaty. This analytical process, whether carried out as normal statutory interpretation or as an application of a GAAR, has little to do with the subjective motives of the taxpayer or the purposes of the transactions. It has much to do with the objective legal effect of transactions, how closely that legal effect corresponds to the economic substance of the transactions, and most importantly the degree to which the relevant legislation or treaty provisions are designed around concepts of economic substance.

The various cases discussed in this chapter illustrate that one source of the unreality in many international tax avoidance arrangements is the use of entities that are technically non-resident but which are not participants in their alleged country of residence in an economically substantial way. Suppose one were to resurrect the distinction between 'commercial' and 'juristic' concepts proposed by Lord Hoffmann in *Westmoreland*.²⁰¹ Would a corporation's residence be considered a commercial or juristic concept? Undoubtedly a lawyer answering that question would consider corporate residence to be a juristic concept, particularly where it is based on incorporation, an inherently formal act. Were HMRC to adopt the CRA approach of

²⁰¹ (n 50) [33]–[35], [58]–[59].

pointing to the unsubstantial foreign residence of a special purpose vehicle as a factor indicative of ‘abuse’, they would be aspiring to a commercial – not juristic – concept of residence. If one takes the view that residence is somehow a commercial concept, it is entirely reasonable to argue that an international avoidance arrangement is ineffective – perhaps even a ‘sham’ – where it relies upon transactions with entities that are foreign only in a juristic sense. This is because the parties involved usually have no intention to participate in the economic life of the selected offshore jurisdiction in any meaningful way. Yet such a view of corporate residence is not tenable under current law. Here, at least, economic unreality is the legal reality.

The author has suggested that the specific issue of corporate residence, when it arises in the context of a challenge under a general anti-avoidance rule or principle, is usually conceded, assumed to be satisfied, or muddled with other issues. This is unfortunate because the exploitation of corporate residence is often one source of the revenue authority’s unhappiness with an international tax avoidance arrangement. Specifically, if we concede that the tax avoidance motive of a MNE in implementing an international avoidance structure is largely irrelevant (which in the author’s view we should), the distinction between ‘acceptable’ structures and ‘unacceptable’ structures under a general anti-avoidance measure often reduces to the distinction between real economic establishment abroad and formal residence abroad.

A recurring pattern seems to be that a revenue authority’s dissatisfaction with a given tax avoidance arrangement, achieved through the use of a corporation (or trust) having only the minimum formal connection with its residence state, is manifested as a challenge to the ‘artificiality’ of the structure in vague terms – the argument as to lack of meaningful residence being unavailable under current law. Aside from *Furniss v*

Dawson, the efforts of HMRC and the CRA in this context have been rewarded with a dismal litigation record. Nor is this situation desirable from a taxpayer perspective, with MNEs having to expend substantial resources defending against arguments – even if those arguments are unlikely to prevail in court – that their use of foreign entities to achieve some tax result constitutes ‘abuse’ of the law.

There would be less need to resort to general anti-avoidance measures in the future if international tax rules, including but not limited to the definitions of corporate residence in domestic law and tax treaties, were better expressed and were informed by concepts of economic substance. Some hope is offered by the recent decisions in *Smallwood*, *Bayfine* and *Garron*: these decisions illustrate that the courts may prefer to resolve disputes about the effectiveness of international tax avoidance arrangements based on a purposive view of what domestic residence entails (*Smallwood* and *Garron*), what treaty residence entails (*Smallwood*), and where income has its source (*Bayfine*). This approach is preferable to challenging international avoidance through the cipher of ‘abuse’, yet it could be much assisted by enacting improved rules, in both domestic tax law and tax treaties, as to the intended meaning of residence.

CHAPTER 8

CONCLUSION

8.1 CORPORATE RESIDENCE AS A UNIFYING FLAW

8.1.1 Business, Legislative, Administrative, and Judicial Views

The period from 2005 through 2010 saw increased attention on the issues of global tax competitiveness and corporate mobility. Corporate groups have threatened to emigrate unless their home state, be that the UK, US, Canada, or other traditionally high-tax jurisdiction, takes measures to reduce corporate tax rates, exempt ‘foreign’ profits, and constrain or repeal their controlled foreign company (CFC) regimes. Unlike the US, the British and Canadian governments have for the most part acquiesced to these demands, hoping to prevent a mass exodus of profitable multinational enterprises (MNEs) to Bermuda, Ireland, Switzerland, or other ‘competitive’ jurisdictions. Those MNEs that have retained their headquarters in the UK or Canada – for commercial, historical, or other reasons – are in any event able to mitigate the burden of home state taxation through the judicious selection of ‘offshore’ jurisdictions as locations for special purpose subsidiaries and intermediaries. The UK Treasury and Canadian Department of Finance appear to tolerate such tax planning to the extent that it enhances the competitiveness of MNEs headquartered in the respective countries.

In the same time period there has been a flood of litigation where the fiscal residence of corporations and trusts has been implicated. In some of these cases, Her Majesty’s Revenue and Customs (HMRC) or the Canada Revenue Agency (CRA) have directly challenged the purported foreign residence of a special purpose entity. More typically the revenue authorities have sought to apply CFC legislation to tax haven

subsidiaries, deny treaty benefits to tax haven intermediaries, or otherwise challenge a tax minimization arrangement involving foreign entities on the basis that the arrangement constituted ‘aggressive tax planning’, if not a ‘sham’. It is true that some of the relevant cases did not involve the operations of MNEs, being concerned with capital gains tax avoidance schemes created for high-net worth individuals: *Wood v Holden*; *Smallwood Trust*; *Antle*; and *Garron*. Yet many important cases involved challenges to the use of foreign subsidiaries in sophisticated arrangements implemented by corporate groups: *Cadbury Schweppes*; *Indofood*; *News Datacom*; *Vodafone 2*; *MIL Investments*; *Prévost*; and *Univar*.

Three observations can be made about all of this. First, in the developments mentioned above the concept of entity residence is pervasive and pivotal, as explained in the introductory chapter. Second is the fascinating record of litigation failures and successes. In those cases involving capital gains tax avoidance schemes that employed evanescent foreign trusts, the taxpayers were always unsuccessful. In those cases involving international tax planning (whether contrived or not) that employed foreign corporations, the taxpayers were virtually always successful, either at first instance or on appeal, with the exception of *Indofood*, a case that relied on the application of foreign law to a hypothetical situation and, as such, is already regarded as an inconsequential judicial oddity. This litigation record leads to the third observation: there is a significant and unresolved gap between what MNEs believe to be the ‘legitimate’ or ‘acceptable’ use of foreign special purpose corporations, and what HMRC and the CRA believe to be the ‘legitimate’ or ‘acceptable’ use thereof, with the courts almost invariably holding that such arrangements are fiscally effective.

What is the reason for this difference in understanding? This thesis has sought to demonstrate that a key source of difficulty is the disjunction between corporate residence as a legal fiction (borrowing the language from *De Beers*, the ‘simple expedient’¹ of registration) and residence as a substantive concept (borrowing the language from *Cadbury Schweppes*, ‘participating on a stable and continuous basis in the economic life’² of a state). Evidently these cases dealt with different subjects and at different times: corporate residence for domestic law purposes at the beginning of the twentieth century and freedom of establishment for EU law purposes at the beginning of the twenty-first century. It is nonetheless useful to compare these cases because they reveal the same difficulties inherent in delimiting tax jurisdiction based upon a corporation’s residence.

There are good reasons to determine corporate residence based on meaningful economic links with a jurisdiction, and at one time the House of Lords was willing to consider those reasons in fashioning a legal test for corporate residence. However, the evolution of legislative and judicial views in the last 80 years has led to an apparent preference of legal form over economic substance with respect to corporate residence specifically and global tax minimization arrangements generally. The result is in an international tax system where corporate residence is at once a critical determinant of tax obligations and treaty entitlements, while at the same time being a legal artifice that is subject to exploitation. Revenue authorities, whose role is to administer the tax legislation, are quite properly focused on taxpayer compliance with international tax rules. Yet HMRC and the CRA are also zealously challenging what they describe as ‘aggressive international tax planning’, often referring to structuring that relies on

¹ *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455 (HL) 458.

² Case C-196/04 *Cadbury Schweppes plc and anor v IRC* [2006] STC 1908 (ECJ) [53]–[54].

‘letterbox’ companies and other special purpose vehicles established in tax havens. In order to transform a revenue authority *belief* that such structuring is unacceptable into a judicial *conclusion* that such structuring is ineffective, the legal formulation of corporate residence will have to change.

8.1.2 Reconciling the Views

It is probably not possible, let alone desirable, for the government’s views regarding the proper scope of tax jurisdiction to be completely aligned with the views of MNEs and their advisers. Yet it is possible and desirable for the separate branches of government to have views on this matter that are reasonably coherent and consistent as among themselves.

In chapters 2 and 3 it was argued that, relying on the principle of economic interest and viewing residence as a special form of source, it is possible to justify residence-based taxation of corporate income. However, it is difficult or impossible to justify taxing a corporation’s income, and especially its worldwide income, based solely on the fact that the corporation is incorporated in the taxing state. To achieve alignment of the legislative and administrative views regarding the proper scope of corporate tax jurisdiction, the respective branches of government need to reach a consensus as to which corporate tax they endorse: a corporate tax that is premised on real economic interests; or a corporate tax that is premised on bare legal connections. Before this can happen, the legislature itself needs to decide which approach it prefers.

As stated in the *Egyptian Delta* decision over 80 years ago, it is both ‘illogical’ and ‘unjust’ for a legislature to apply different tests of fiscal allegiance depending on

whether a corporation is ostensibly domestic or ostensibly foreign.³ It is most unfortunate that the UK and Canada ignored this admonition. By adopting place of incorporation as a test of corporate residence, the respective legislatures expressed fidelity to the legal fiction view of the corporation rather than a more substantive view. Many foreign subsidiaries – and, more recently, corporate headquarters⁴ – are resident in tax haven states by virtue of being incorporated there or managed and controlled there. It is easy to see why these formulations of corporate residence are adopted by tax havens: most of the prominent tax havens are former or current British colonies or British Crown dependencies⁵ and, moreover, allowing residence by incorporation greatly facilitates local establishment. The governments of the UK, US, Canada, and other states that define residence based on incorporation can hardly complain that smaller economies adopt the same tests to their own advantage. Nor should they complain that it is contrary to the spirit of whatever legislation or treaty is at issue where MNEs, in order to reduce their tax burdens, rely on residence-based jurisdiction stemming from the act of registration abroad. If bare legal attachment to the UK, US, or Canada is considered sufficient to impose worldwide taxation in that state, why is bare legal attachment to Barbados, Bermuda, Jersey, Ireland, or Switzerland not sufficient to impose worldwide taxation (at a low or zero rate) in those states?

It is somewhat hypocritical that the UK and Canada have adopted legislative measures that work in the opposite direction. The most notable of these is CFC legislation, which effectively enlarges the scope of residence jurisdiction over corporations and corporate groups. As explained in chapter 5, the UK and Canadian

³ *Egyptian Delta Land and Investment Co Ltd v Todd* [1929] AC 1 (HL) 23.

⁴ Ch 1 text to nn 26–29.

⁵ S Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (Weidenfeld & Nicolson, London 1992) 129–31, 271; D Dharmapala and JR Hines, ‘Which Countries Become Tax Havens?’ (2009) Working Paper <<http://ssrn.com/abstract=952721>>.

CFC regimes operate, in part, by requiring foreign subsidiaries to have economically meaningful connections to their residence states – premises, employees, effective management – in order to avoid income attribution to domestic shareholders. This amounts to an admission that the standard tests of corporate residence in domestic law, which are often the same tests used by the tax havens in question, do not reflect economic reality. Much to the same effect are treaty limitation of benefit (LOB) rules which, as explained in chapter 6, tend to require more substantive connections to the purported residence jurisdiction than exist under residence tests in domestic law and, accordingly, under the residence article of the relevant tax treaty. Even in the absence of express LOB rules, the varied arguments made in treaty shopping cases including *Indofood* and *Prévost* tend to be directed at letterbox companies having no physical offices, staff, or productive business. Again this is an admission of failure regarding current formulations of corporate residence.

It is possible to recognize and address this failure more comprehensively and more coherently. It is open to the UK and Canadian governments to embrace an economically substantial definition of corporate residence in their domestic laws and tax treaties. A corollary to this approach is that the incorporation test would be repealed, both as a domestic residence formulation and (in Canada's case) as a treaty tie-breaker rule. The most fundamental benefit of pursuing such an approach is that it would greatly enhance the coherence of the rules defining the boundaries of the respective states' jurisdiction to tax. In addition, there would no longer be any basis for the revenue authorities to perceive a difference between 'residence' and 'bona fide residence', nor any basis to challenge the establishment and use of foreign entities, without more, as 'abuse'.

8.2 REFORMULATING CORPORATE RESIDENCE

8.2.1 Towards an Enhanced Domestic Formulation

As suggested in chapter 4, if the UK or Canada wishes to adopt an economically substantial definition of corporate residence, it should by legislation enact a test or series of tests that focuses on economic interests within the jurisdiction. The first legislative action should be to repeal the incorporation test. As long as this formulation of residence exists in domestic law, it evinces a policy of exercising tax jurisdiction based on formal connection alone, without regard to the presence or absence of any economic interest. The second, more difficult legislative action would be to set out what Parliament believes to be an economically substantial formulation of residence.

One could define corporate residence consistent with the proposals made by the Inland Revenue in 1981, looking to the principal place of business, location of practical daily management, or place where ‘the management of the company’s business as a whole is conducted’.⁶ One might also borrow the treaty concept of ‘place of effective management’ (POEM), but this is not recommended given the confusion surrounding the interpretation of that expression, and the likelihood that judges in the UK and Canada might equate the term with ‘central management and control’. Another, perhaps preferable option would be to forgo a single test and instead use a cumulative series of factors including place of central management and control, location of executive management, and place of substantial business operations.⁷ One factor could even be where a majority of the shareholders reside,⁸ which admittedly would have severe

⁶ Inland Revenue, *International Tax Avoidance: Company Residence, Tax Havens and the Corporate Sector, Upstream Loans* (Board of Inland Revenue, London 1981) [2]–[3], clause 1(1); cf R Couzin, *Corporate Residence and International Taxation* (IBFD, Amsterdam 2002) 260.

⁷ See BJ Arnold, ‘A Tax Policy Perspective on Corporate Residence’ (2003) 51 CTJ 1559.

⁸ See MJ McIntyre, ‘Determining the Residence of Members of a Corporate Group’ (2003) 51 CTJ 1567.

consequences if applied to the global affiliates of a MNE. Whatever specific factors were chosen, it would be ideal to enact a statement of principle in the legislation to provide guidance as to how the substantive residence rules should be interpreted. Such a principle would make clear that a corporation is considered resident if the ‘real’ decisions regarding policy, strategy, and management matters are ‘actually’ made in the jurisdiction. This would restore the focus on the reality of corporate management, as the judges in *De Beers* and other early residence cases had sought to do. Alternatively, such a principle could adopt the language from *Cadbury Schweppes* and declare that a corporation is to be considered resident where it participates in the domestic economy on a stable and continuous basis, and should be considered non-resident only where it participates in a foreign economy on a stable and continuous basis.

One effect of an enhanced residence formulation is that it would reduce the need to rely on a CFC regime, possibly making such rules unnecessary, and greatly reduce the scope for revenue authority complaints about ‘aggressive tax planning’ involving tax haven subsidiaries. The exception to this would be where the UK or Canada wishes to impose CFC attribution, or otherwise tax foreign income, where the relevant foreign entity is a *full participant* in the economy of its residence state yet the UK or Canada sees fit to deny the effect of that participation because: (i) the entity carries out certain ‘mobile’ activities thought to erode the domestic tax base; or (ii) the ‘main purpose’ of establishing abroad was tax avoidance. For the UK, reliance on such factors would not be legitimate to the extent that the foreign entity was actually established in an EU member state. Moreover, as stated at several points in this thesis, the author’s own view is that reliance on such factors to allocate international tax jurisdiction is not normatively justified, within or outside the EU.

8.2.2 Towards an Enhanced Treaty Formulation

Making changes to corporate residence formulations as suggested above would effectively end the use, by UK or Canadian shareholders, of letterbox companies in ‘base havens’ that do not have treaties with the UK or Canada. However, domestic law changes would not affect the use of ‘treaty haven’ affiliates if the residence articles in tax treaties remain as they are. To achieve further coherence the UK and Canada would want to negotiate changes in the residence articles of their treaties.

A first step would be to break the link between treaty residence and domestic liability that is based upon domestic residence.⁹ The residence article of the relevant treaty could state explicitly who is to be considered a ‘resident’ of the respective Contracting States. For corporations the required criteria could be similar to those mentioned above in relation to domestic law. An effective but less elegant option is to leave residence articles as they are but to include LOB provisions that deny treaty benefits to residents who are not ‘qualified persons’, consistent with US practice.

It is also desirable to enhance the treaty preference criteria used to resolve dual residence conflicts. A simple option would be to maintain the POEM criterion but to negotiate and conclude explanatory memoranda with our treaty partners, explaining that the POEM of an entity is to be interpreted as the place of realistic, positive management – that is, the place where the ‘real’ decisions are made – as applied to trusts in *Wensleydale’s Settlement* and *Smallwood*. A better option might be to abandon the POEM criterion in favour of a new formulation like ‘real centre of management’, as suggested by League of Nations Fiscal Committee,¹⁰ again with supporting provisions

⁹ OECD, *Model Tax Convention on Income and on Capital* (OECD, Paris 2010) <www.oecd.org/ctp/tt/mtc> (OECD Model) Arts 1, 4[1].

¹⁰ Ch 4 text to nn 122–129.

or explanatory memoranda to illustrate what this means. A less desirable option is to have dual residence conflicts resolved only by mutual agreement of the competent authorities, as in the UK's treaties with Canada, the US, and now the Netherlands.¹¹ This approach is undesirable because it provides no guidance to taxpayers or courts regarding determinations of treaty residence.

Similar to the observation made above regarding domestic residence definitions and CFC rules, enhanced treaty residence definitions could render LOB rules in tax treaties superfluous and greatly reduce the scope for revenue authority complaints about treaty shopping. The exception, once again, would be where a foreign entity is a *full participant* in the economy of the treaty partner state yet the UK or Canada sees fit to deny the effect of that participation because the 'main purpose' of establishing abroad was tax avoidance. The same observations made above regarding unjustified reliance on subjective factors would apply here.

8.2.3 Responding to Anticipated Policy Concerns

There are a number of concerns which one anticipates would be raised, whether by governments or by taxpayers, in response to the proposals made here. Two of these concerns deserve attention. First is a technical concern regarding the feasibility of determining residence based on the suggested formulations. Second is a competitiveness concern, which questions the desirability of implementing any change to residence formulations.

First, one may ask whether the 'management of the business as a whole' standard, the 'real centre of management' standard, or some other standard requiring 'participation on a stable and continuous basis', is justiciable or practically attainable. In

¹¹ Ch 4 text to nn 118–120, 159–162.

the author's view these standards are without doubt justiciable. These were essentially the paradigms that were used by the House of Lords in *De Beers* and other early residence cases, and that have been used in recent offshore trust cases including *Smallwood* and *Garron*. But is such a standard practical in the context of a modern MNE? What about financing companies, intellectual property management companies, reinsurance companies, and the like? As observed in *Wood v Holden*, these special purpose vehicles may have limited functions and limited periods of existence. The response to these questions was offered in chapters 1 and 2: namely, that income tax jurisdiction should be based on where income is earned, and income is earned only through the endeavours of human beings. The author does not accept the assertion that, in modern business, capital or technology creates income on its own or with minimal input from human beings. It is likely the case that the real centre of management of many special purpose vehicles is the location of the corporate headquarters, meaning that such entities would be considered resident in the same state as the parent company. This result, in the author's view, is unobjectionable: it achieves alignment of international tax jurisdiction with actual economic interests.

The second concern relates to competitiveness. Some MNEs will argue, as they would have when the Inland Revenue consulted on company residence in 1981, that adopting an economically substantial residence test would drive businesses away from the UK (or any other country that followed this approach). A corporate exodus is something that governments fear and, as recent changes to tax rules affecting outbound investment suggest, will actively seek to prevent.

There is undoubtedly a disadvantage in being the state that moves first in any international tax measure that is seen as uncompetitive. So yes, one can expect that an

enhancement of residence formulations would initially drive some MNEs to emigrate. These emigrations would involve the actual movement of people and activities, not simply the incorporation of a shell company in Jersey and the movement of ceremonial management and control to Ireland. The result would be revenue loss for the UK, Canada, or other state that adopted a substantive residence formulation.

One response to this concern is that other states with substantial headquarters activity, including the US and Japan, also have tax measures which result in expansive residence-based tax jurisdiction and which make it difficult for existing parent companies to emigrate.¹² Further, the proliferation of CFC regimes in both developed and developing states suggests that there is some international consensus as to the legitimacy of extending residence-based jurisdiction to foreign subsidiaries.¹³ Changing the formulation of corporate residence in domestic law and tax treaties is a more direct way of achieving this extension of jurisdiction. Thus there is reason to believe that other states would be willing to enhance their own residence formulations.

More fundamentally, this approach has the benefits of coherence and transparency – the intentions of Parliament as to who should be subject to domestic tax jurisdiction are made plain. The intentions of Parliament are not buried in the complexity of CFC rules or re-imagined by the revenue authority through the application of treaty anti-abuse principles or general anti-avoidance measures. As stated in the introductory chapter, the author's intent is not so much to advocate creating some new, expansive formulation of corporate residence. Nor is the author's intent to be harmful to MNEs. What is desirable is to have a formulation of residence that reflects

¹² D Shaviro, 'The Rising Tax-Electivity of US Corporate Residence' (2010) New York Univ School of Law, Public Law & Legal Theory Research Paper Series No 10-72.

¹³ RS Avi-Yonah, 'Back to the Future? The Potential Revival of Territoriality' (2008) 62 BIFD 471.

the normative basis for residence taxation, and to bring the stated law into line with the current practice of revenue authorities with respect to corporate residence issues. If we wish to tax the income of resident entities or enterprises on the basis of an understanding of corporate residence that reflects economic substance, it is consistent with the rule of law to have that understanding of residence expressed in the law. It is contrary to the rule of law to have that understanding of residence revealed only through the discretionary application of anti-avoidance rules to particular taxpayers. If the legislatures in the UK and Canada do *not* wish to introduce a formulation of corporate residence based upon real economic interests, and prefer to continue with highly artificial residence rules buttressed by detailed anti-avoidance rules, then HMRC and the CRA must re-evaluate their belief that there is such a thing as ‘aggressive international tax planning’.

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