

The Role of Corporate Residence in Tax Matters and its Relationship with the Provision of Dividend Relief: A Comparative Analysis between the UK and the US Tax Systems

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Abstract

The aim of this paper is to illustrate the main features and issues related to the concept of corporate residence, showing to what extent it can have an impact on the provision of dividend relief. To this purpose, I will use the examples of the UK and the US, analysing the concept of residence and explaining why some emerging tax theories are trying to abandon it. Then, I will study the relevant connection between the concept of corporate residence and the provision of dividend relief. Residence is related to the elements of the legal autonomy of corporations. However, this separation of corporations from their shareholders is the main cause for economic double taxation and for other distortions related to corporate income taxes that need to be solved by dividend relief. Abandoning the concept of residence and attributing the corporate profit directly to shareholders would make the use of dividend relief unnecessary. Therefore, the advantage of relating the corporation to the place in which taxes can be enforced is obtained at the cost of the distortions created by corporate taxation and the dividend relief systems.

Keywords: tax, residence, corporate, dividend, relief

1. Introduction

The problem of the volatility of the concept of residence is under the green light in tax policy. Indeed, the possibility of setting up a company in any country has shown some of the fallacies of corporate taxation. Taxing corporations according to their residence makes it possible to move intangible properties in the country of major convenience for tax purposes, facilitating aggressive tax planning and generating a loss of investments in economies with higher tax rates. Overall, the mobility of the companies' residence is due to the artificiality that characterises corporate taxation, which derives both from the artificiality of attributing a personal connotation to a corporate entity, and from the artificiality of wanting to relate this entity to a specific jurisdiction and tax it accordingly.

The taxation of corporate income creates a problem of economic double taxation, due to the fact that the generation of profits at the corporate level and the distribution of dividends at the shareholder level are both taxed. Countries normally provide dividend relief, in several ways, to reduce the distortions related to double taxation. In this context, the concept of residence might influence the provision of dividend relief. Furthermore, the idea of taxing according to residence often clashes with the idea of taxing according to source, namely where the activity is held. The fact that residence can be different from source is a relevant problem, which has several consequences. It creates double taxation of the same cash flow because there are often two jurisdictions that claim to tax the profit of the corporation. Countries use different methods to solve this issue, which will be furtherly analysed.

This problem is very hard to solve and, despite it being under the attention of a large number of scholars, few complete solutions are envisaged. For example, the OECD in its revolutionary anti-Base Erosion and Profit Shifting ("BEPS") Plan had to stick to the idea of source and residence, probably because it would have been indeed too difficult to change².

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² Avi-Yonah, R.S., Xu, H. (2017). Evaluating BEPS. *ELR*, 1, 1-11.

The aim of this paper is to illustrate the main features and issues related to the concept of residence, and to show how it can influence the provision of dividend relief. To this purpose, I will first analyse the concept of residence, explaining why some emerging tax theories are trying to abandon it. Then, I will study the relationship between corporate residence and dividend relief systems and between the concept of non-residence, which is complementary to the concept of residence, and the provision of dividend relief. In doing so, I will use the examples of the US and the UK, illustrating their legislative frameworks, taking into account, in particular, their differences and the *ratio* behind their legislative choices. In the end, I will conclude the paper outlining the main considerations that can be extracted from it.

2. The concept of residence in corporate taxation

Residence in corporate taxation is a general concept that relates a corporation to a specific jurisdiction through a nexus that is defined by law. It is not a straightforward concept since there is no universal definition of residence. On the contrary, residence can have multiple meanings, according to the jurisdiction and to the context. Every legal system has its own definition of residence, which can significantly differ from one another.

The US has a very specific definition of residence, contained in the IRC s. 7701(4), assigning the status of “domestic” to corporations that are created or organised in the US or under the law of the US. This provision does not include the place of management and control. Unlike the US, other countries, including the UK, define resident corporations as the set of all the entities that are incorporated in the country and that are managed and controlled in the country. In particular, in the UK the definition of “central management and control” derives from case-law, from the Case *De Beers Consolidated Mines v Howe* [1906] AC. Then, the CTA s. 14 states that a company is also considered resident in the UK when incorporated there, as an additional feature to the central management and control definition. This appears as a completely different approach respect to the one of the US. Indeed, the US corporate residence system has been defined as “elective” meaning that a shareholder is completely free to choose whether to install its company in the US and make it resident there or if not³. This is because every person is free to choose whether to set up a company in the US or not.

However, it must be borne in mind that the concept of corporation is itself an artificial concept⁴. Detecting the residence of an individual is a completely different exercise than detecting the residence of a corporation. The concept of residence of a corporation is a legal fiction, which can be shaped at will. For example, a group of shareholders, all residing in a specific country, may decide to set up a company in another jurisdiction, incorporating it there and meeting the other criteria of the specific legal framework, and then make it operate in their own country. The company, in this case, is just a “conduit”, used to lead the activity it is set up to lead. Doubts may arise when considering whether in such a case it would be sensible to tax the company according to its residence.

There are still some advantages to relate corporate income tax to corporate residence. One of the most important reasons is that corporate taxation acts as a proxy of personal income tax. Waiting for the profit to flow to shareholders might lead to problems, like outflows in low-tax jurisdictions or indefinitely retained profits. Taxing the corporation in its place of residence guarantees the enforcement by the country in which the actual wealth is. Otherwise, taxes could be claimed but could not practically be enforced⁵. The taxation of a corporation in its jurisdiction of residence can be seen as a withholding tax on the wealth invested by shareholders in the corporation. The great advantage of creating a geographical nexus through the concept of residence is fundamental to tax enforcement. As furtherly analysed, the consequence of imposing this withholding tax is to find a way to reduce the effects of double taxation⁶.

Another reason that can be mentioned is the benefit principle, which states that entities physically residing in a country have to pay taxes in order to contribute to the common good. However, it is arguable whether corporations, as wholly artificial entities, do benefit from a country and, overall, whether the shareholders that are resident in a foreign country should be linked to those benefits.

³Fleming, J.C., Peroni, R.J., Shay, S.E. (2016). Defending Worldwide Taxation With A Shareholder-Based Definition Of Corporate Residence, *BYU L. Rev.*, Research Paper No. 17-20, 1681-1714.

⁴Harris, P. (2013). *Taxation of corporate income*, Cambridge: Cambridge University Press, 181.

⁵ A principle of international taxation is that countries do not enforce taxes in the name of other countries.

⁶ See *infra*, section 3.

Therefore, I believe that there are several reasons why residence is still playing a fundamental role in corporate taxation. However, the problems it creates must be faced, considering that there are other ways of taxing corporations, which can have different advantages or issues. For example, a destination-based cash-flow tax (DBCFT)⁷ would abandon the concepts of source and residence and establish corporate taxation according to the place of final consumers, considered to be the most immovable element related to corporations. Another idea that has been put forward is to adopt worldwide taxation with a shareholder-based definition of corporate residence⁸, although the theory is not easy to implement. In the context of the European Union, a formulary apportionment in the CCCTB project is based on corporation-related elements, such as assets, sales, and workforce⁹.

3. The relationship between the concept of corporate residence and the provision of dividend relief

As aforementioned, the artificiality of the concept of corporate taxation creates a situation in which corporate profits are taxed both at the corporate level and at the shareholders' level. Taxing both the generation of profit and its distribution creates a situation of double taxation. Generally, countries try to solve this issue through the provision of dividend relief, using different methods to reduce the double-burden. They can provide deductions, exemptions or credits to the taxpayers to compensate the second levy over the same amount. However, problems arise when the residence of companies and shareholders differ. In such cases, the methods might change their features and tax treaties can intervene to help to solve these issues.

The concept of corporate residence and the provision of dividend relief can be considered to be connected. Indeed, it is the idea of giving legal autonomy to corporations and relating them to a specific jurisdiction that generates the problem of double economic taxation. If corporate residence did not exist, there would be very different problems regarding dividend relief. We would have a collapse of separate entities, creating a direct allocation of profits to the shareholders. Although this would create other problems, it would certainly solve all the primary distortions related to corporate income taxation¹⁰.

Apart from drastic changes to the concept of corporate residence, we can take into account how countries act and check their actual behaviours. The concept of corporate residence of the US is considered to be elective¹¹. Therefore, we can consider it as "more flexible" than the one adopted by the UK, which is "stricter" because it includes also companies that are managed or controlled in the UK. As regards the provision of dividend relief, we can see how the UK adopts a much more flexible rule, excluding all dividends received by corporate entities. On the other hand, the US has a stricter rule, which makes the grant of a tax deduction depend on the control over the subsidiary that distributes the dividends. Only when more than 80% of the subsidiary is controlled by the parent company, the full amount becomes deductible. Otherwise, only half of the dividend is deductible for control over less than 20% of the subsidiary, and 65% for the other cases. These behaviours might suggest that stricter rules on residence might allow more generous rules on dividend relief. By contrast, when considering shareholders subject to personal income tax, the two legal frameworks are aligned.

An important consideration to make is that being resident in a country is fundamental for getting access to the national dividend relief system, which is normally designed to work in domestic situations. As we will see in the following section¹², dividend relief methods might not be consistent when applied in cross-border situations.

4. The concept of non-residence and the provision of dividend relief

In understanding how the concept of residence affects the provision of dividend relief, it is important to underline how the status of non-residence interacts with dividend relief. Cross-border situations shape the functioning of dividend relief methods, showing how the inclusion or the exclusion from the concept of resident company might have an impact.

⁷Devereux, M., Vella, J. (2014) Are We Heading towards a Corporate Tax System Fit for the 21st Century?. *Fiscal Studies*, 35, 449-475.

⁸Fleming *et al.*, *op. cit.*, n. 2.

⁹See the European Commission proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2016) 683.

¹⁰ Harris, *op. cit.*, n. 3, 46.

¹¹See *supra*, section 2.

¹² See *infra*, section 4.

Inbound Investments

From the perspective of dividend flows, inbound investments are the investments that foreign shareholders make in the country under analysis, normally in a resident company. Therefore, dividends are paid from a resident entity to a foreign country. In this situation, the country of residence of the company tends to apply a withholding tax on dividend outflow, although there are exemptions. The classical system would then impose ordinary taxation on the company, creating the usual double taxation on corporate income. However, even some dividend relief methods, aimed at eliminating double taxation on corporate income, can have the same effect in those kinds of cross-border situations. For example, the dividend exclusion system, which fully eliminates double taxation in domestic situations, would work like the classical system in this case.

The UK does not have any mechanism to tax out-flowing dividends, both if they are directed to other companies or individuals. It employs “pure exemption” on foreign income. The US will apply a withholding tax on dividends that come from activities in the US and that are flowing towards a non-resident entity.

Those dividend relief situations are allowed because the business entity operating on the territory is a recognised resident subsidiary of a foreign parent company or shareholder. In case it was not recognised as such, the business activity would be considered as sourced in the country through a permanent establishment, in case associated with a company resident in a foreign country¹³. In this case, countries tend to tax PE's activities as corporate income.

The UK will tax the PE with its corporate tax but will not apply a withholding tax as a form of coherence with the treatment of companies. In the opposite way but by the same grounds of coherence, the US will apply a withholding tax on the PE (Branch profit tax), which is necessary to make sure that withholding tax on companies is not avoided through PEs.

The UK and the US maintain coherence in their systems both in case of resident and sourced businesses. In the context of inbound investments, they show how the concept of residence might lose some of its importance. In fact, when they are targeted as the place to invest, both countries tend not to differentiate between resident and sourced business activities. However, non-residence plays a fundamental role, because the shareholders that will receive their dividend would be granted relief if they were resident¹⁴.

Outbound Investments

From the perspective of dividends, outbound investments are situations in which resident shareholders set up a company in a foreign jurisdiction. Therefore, the dividends flow in the jurisdiction of the shareholders or parent company from a foreign company. The foreign company will tend to apply a withholding tax. According to the classical system, there would be ordinary taxation at the level of the shareholders with a relief on the withholding tax paid outside. In this situation, some dividend relief systems might not work, such as the dividend deduction, because of the problems of recognition of foreign taxes on corporate income or simply for the impossibility to grant the corporation dividend relief to a corporation that is resident in a foreign country.

Furthermore, we can have cases where the activities are conducted in a foreign country through a PE by resident companies. In this case, it is fundamental that the residence of the company is recognised by the country where it is supposed to be resident, otherwise, no relief would be granted. On the contrary, source taxation would apply.

5. Conclusion

In the light of the analysis carried out in the paper, there are several factors to consider when studying the concept of corporate residence. Although I do not think that the concept of residence will totally be abandoned, I agree with the fact that it will evolve in the future.

¹³If it was an individual that conducted the business activity, the person would be subject to personal income tax. However, this scenario would be out of the scope of this paper.

¹⁴ What the foreign country will actually do is not of interest in this paper. However, it must be considered that if the shareholders were placed in a high-tax jurisdiction, they would get a relief for the withholding tax, but would not receive any relief for corporate taxation paid in the country of the company. In case they were resident in a low-tax jurisdiction, the shareholders would not be taxed.

This evolution could be more or less drastic, according to what path will be selected by the future trendsetters in international taxation. It might be related to the final consumers which are less mobile than intermediate subsidiaries. On the other hand, it might become a concept related to the shareholders, accompanied by a more cooperative way of imposing taxes between countries. It might also become less artificial through a relationship with physical elements of corporations, such as assets, workforce or even innovative concepts as pollution or negative externalities in general. However, the future of residence is uncertain because countries tend to have different approaches. As we have seen, the UK and the US have a completely different approach to residence, one mainly based on the effectivity of having central management and control in its territory, while the other focused on where the company is set up. This different view will probably be reflected in the approach taken to solve the mobility of corporate residence in the future.

I illustrated the relevant connections between the concept of corporate residence and the provision of dividend relief. Problems arise because residence is based on elements of legal autonomy of corporations. In fact, this separation of corporations from their shareholders is the main cause for economic double taxation and for other distortions related to corporate income taxes that need to be solved by dividend relief. Without the concept of residence and attributing the corporate profit directly to shareholders, dividend relief would become unnecessary. Therefore, it can be stated that the advantage of relating the corporation to the place in which taxes can be enforced is obtained at the cost of the distortions created by corporate taxation and the dividend relief systems. Moreover, in the last part of the paper, we saw how the concepts of corporate residence and non-residence are fundamental to the grant of dividend relief and how they might potentially influence the very structure of the dividend relief systems.

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