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OPINION POINT

Management Based Definition for Domestic Corporations

By Jonathan Schwarz*

This article is to consider proposals to adopt a management based definition for U.S. domestic corporations from a United Kingdom perspective and, in particular, to respond to the article by Sarah Giddings (*Should a Mailbox Be Enough? A Proposal to Redefine Domestic Corporation Status*, NEWSQUARTERLY, Winter 2009, at 7).

The expressions "domestic corporation" and "foreign corporation" as the basis for determining whether an entity is liable to tax on worldwide or only U.S. sources, stand in contrast to the traditional U.K. approach. Historically, worldwide taxation in the U.K. has been by reference to "residence." This term has largely remained undefined by statute and accordingly, U.K. taxing jurisdiction has been based on the interpretation of the word by the courts. The challenge in this respect was identified already in the 19th century in *Calcutta Jute Mills Co Ltd v Nicholson* (1876) 1 TC 83 when Baron Huddleston observed at 103:

> Now the definition of the word "residence" is founded upon the habits and relations of the natural man and is therefore inapplicable to the artificial and legal person whom we call a corporation. But for the purpose of giving effect to the words of the Legislature an artificial residence must be assigned to this artificial person, and one formed on the analogy of natural persons.

The definitive formulation of this analogy was by Lord Loreburn in *De Beers Consolidated Mines v Howe* (1906) 5 TC 198, at 213, at the beginning of the 20th century as follows: "A company resides, for the purposes of Income Tax, where its real business is carried on … I regard that as the true rule; and the real business is carried on where the central management and control actually abides."

The central management and control (CMC) test has since been adopted not only in the United Kingdom but throughout the Commonwealth as the criterion for corporate residence. The place where central management and control is to be found is where the directors of the company meet in order to transact their business. This test has not been without its difficulties. Identification of such a place requires meaning to be given to the notions of management and control and a determination as to who exercises them. This was not straightforward even at the time of the *De Beers* case.

That case concerned a South African incorporated company, listed on the London Stock Exchange, whose head office was in South Africa, where the shareholders meetings were held. Profits were made out of diamonds mined in South Africa, and

* Barrister, Temple Tax Chambers, London, UK.

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sold in South Africa. Some of the directors lived in South Africa, and there were directors' meetings both there and in London. The majority of directors lived in England. The directors' meetings in London were the meetings where the real control was always exercised over most of the important business of the company, except the mining operations. London meetings controlled the negotiation of the diamond sales contracts, determined policy on the disposal of diamonds and other assets, the working and development of mines, the application of profits, and the appointment of directors. London meetings determined matters that required the majority of all the directors, including all expenditures except wages, materials, etc., at the mines, and the amounts spent by the directors in South Africa. Finding the company U.K. resident, the House of Lords determined that residence was by reference to the highest decision-making authority. More complex questions arise as a result of modern transport and communications technology where decision-making can take place simultaneously without a particular geographic nexus.

Place of Effective Management

Central management and control can be exercised in more than one jurisdiction, resulting in dual or multiple residence (*Swedish Central Railway Co Ltd v Thompson* (1925) 9 TC 342). In order to address the question of dual residence, the OECD adopted the "place of effective management" (POEM) as the tiebreaker in article 4(3) of the OECD model Double Taxation Convention. In addition to the Commonwealth CMC test, a number of jurisdictions adopt management based criteria for corporate residence. A study by the OECD has indicated that although there are some common elements they are not all identical. *See* OECD Discussion Draft, *The Impact of the Communications Revolution on the Application of "Place of Effective Management" as the Tie Breaker Rule* (2001), **http://www.oecd.org/dataoecd/46/27/1923328.pdf**. *See also* Jonathan Schwarz, *Residence of Companies*, *in* Booth: Residence, Domicile and UK Taxation (13th ed. 2009/10).

Although the meaning of POEM in the treaty context is unsettled, it is clear that it is not the same as CMC. CMC establishes domestic residence. There can be more than one CMC. There can only be one POEM on the other hand, as its function is to resolve dual residence problems. *Trevor Smallwood Settlor of the Trevor Smallwood Trust v R & C Comrs* [2008] UKSPC 669. *See also* Schwarz on Tax Treaties ch. 5, ¶ 14-200 (CCH 2009). It is also clear that where the conflict is between residence based on incorporation or other formality, the management based POEM trumps incorporation. Thus the CMC and POEM can be in the same jurisdiction but need not be.

In light of this distinction, adoption of POEM as a test of domestic residence would appear to be misconceived. It would be bound to give rise to confusion between U.S. domestic and treaty meanings. Reasons for rejecting the argument that CMC and POEM have the same meaning from a U.K. perspective include that, if they do mean the same thing, then firstly, POEM could not function as a tiebreaker and, more importantly, if it could, no country would wish to sign a treaty that always resolved dual residence disputes in favour of the U.K. South Africa has placed itself in an awkward position by adopting the POEM as a domestic rule. *See* South African Income Tax Act 1962 s. 1 "resident" (b) ("person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic"). If the expression has the same meaning in domestic law as it has for treaty purposes, a determination of residence will always require a comparison to find a closer connection using the tiebreaker methodology. By comparison to CMC it would involve ceding jurisdiction even in non-treaty cases.

In 1988 the U.K. adopted an incorporation test for U.K. incorporated companies. Similar approaches have been taken in other jurisdictions, such as the Republic of Ireland and South Africa. Pressure to do so in the case of the U.K. and Ireland came, not from domestic sources, but from other tax administrations as a result of so-called "U.K. non-resident companies." Their concern was companies incorporated in the U.K. but managed and controlled outside the U.K. that presented the appearance of a U.K. entity. Modern exchange of information mechanisms probably makes this concern somewhat out of date. Another benefit of a more formal test is convenience. U.K. case law indicates that a detailed factual inquiry is required, at least in the more difficult cases. The adoption of formal criteria makes the compliance process mechanical.

Conclusion

The United States is undoubtedly out of step with the very many jurisdictions that adopt both incorporation and management based tests. Placing the debate in the context of avoidance is, however, likely to obscure the real issues that confront all tax systems as to the appropriate connecting factors for taxing corporate profits in the 21st century. Elsewhere, including the U.K., residence based corporate taxation is increasingly questioned. The real challenge is not so much to follow 19th and early 20th-century English judges but to identify those relevant factors. ■