



March 17, 2009

The Honorable Max Baucus  
Chairman  
Committee on Finance  
United States Senate  
Washington, DC 20510

The Honorable Charles Grassley  
Ranking Member  
Committee on Finance  
United States Senate  
Washington, DC 20510

**Re: Proposals to Change the Definition of Corporate Residency**

Dear Senators Baucus and Grassley:

On behalf of the Organization for International Investment (OFII), we are writing to comment on a specific proposal contained in a bill, S. 506, recently referred to the Senate Finance Committee that would significantly alter the definition of corporate residency for foreign-based multinationals. We urge you to reject this proposal.

OFII is a business association representing the U.S. subsidiaries of many of the world's largest international companies. The U.S. subsidiaries of companies based abroad directly employ over 5 million Americans and support an annual U.S. payroll of over \$364 billion. As evidenced by the attached OFII membership list, many OFII members are household name companies with historic and substantial U.S. operations. On behalf of these companies, OFII advocates for the fair, non-discriminatory treatment of U.S. subsidiaries. We undertake these efforts with the goal of making the United States an increasingly attractive market for foreign investment, which will ultimately encourage international companies to conduct more business and employ more Americans within our borders. Given the recent global financial turmoil, as well as companies' increasing ability to conduct worldwide operations through other jurisdictions, OFII's mission is more critical than ever to sustaining and rebuilding the American economy.

OFII appreciates the recognition you have given to the important contributions that foreign multinationals make to growth of the U.S. economy and U.S. employment. This proposal would diminish those contributions.

The proposal would treat certain foreign corporations as U.S. corporations for U.S. federal income tax purposes, if the corporation's primary place of management and control is in the United States, under a facts and circumstances test looking to where the executive officers and senior management of the corporation exercise day-to-day responsibility for the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries). The proposal requires that for foreign multinational companies that operate under a more decentralized management

structure, the location of individuals who are not executive officers or senior management of the foreign corporate headquarters (such as directors of subsidiaries of the foreign parent company) may be taken into account in treating the foreign multinational as a U.S. corporation.

We urge you to reject the proposal to treat foreign corporations as domestic corporations under this complex factual test. The proposal to change the definition of corporate residency would impose major new burdens on all foreign corporations, both publicly and non-publicly traded, and a large number of their foreign subsidiaries. It would create major compliance and administrative burdens for both the government and taxpayers, domestic and foreign. It could result in similar changes in foreign tax law to the potentially severe detriment of U.S. multinationals. It is a draconian remedy to a theoretical concern. The proposal would potentially cause great harm to the U.S. economy and U.S. employment by discouraging foreign investment in the United States and forcing top management of foreign multinationals to steer clear of the United States. The resulting harm to the U.S. economy is particularly dangerous given the recent global financial turmoil.

Our detailed comments are attached. We would be happy to further discuss our views with your staff and can be reached at 202-659-1903. Thank you in advance for your consideration. We appreciate your willingness to consider our serious concerns with this proposal.

Sincerely,

A handwritten signature in black ink, appearing to read 'Nancy McLernon', written over a horizontal line.

Nancy McLernon  
President & CEO  
Organization for International Investment (OFII)

## **Proposals to Change the Definition of Corporate Residency Raises Significant Policy Concerns**

### **Introductory Comments**

On March 2, 2009, Senator Levin introduced S. 506, the Stop Tax Haven Abuse Act, which was referred to the Senate Finance Committee.<sup>1</sup> In particular, section 103 of this bill (the "Proposal") would change current tax law in several ways, including amending the Internal Revenue Code Section 7701 definition of corporate residency by treating certain foreign corporations as domestic corporations for U.S. federal income tax purposes if the management and control of the corporation occurs, directly or indirectly, primarily within the United States. This paper highlights the principal reasons why the Proposal's amended corporate residency provision should be rejected.

### **Background and Summary of the Proposal**

The Proposal would maintain the current law place-of-organization test for determining the tax residency of corporations organized under U.S. law. However, the tax residency of corporations organized under foreign law would dramatically change. In general, the Proposal applies to a foreign corporation that is either: (1) publicly traded, or (2) has aggregate gross assets that equal or exceed \$50 million in value. Such foreign corporations would be taxed as U.S. corporations for U.S. federal income tax purposes if the "management and control" of the corporation occurs, directly or indirectly, primarily in the United States.

The Proposal provides that a corporation's "management and control" will be considered to occur primarily in the United States if substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the corporation are located within the United States. To the extent individuals other than executive officers or senior management exercise such day-to-day responsibilities of a corporation, the Proposal would treat such individuals as executive officers or senior management in determining whether the corporation is managed and controlled in the United States.

Limited exceptions from this treatment would apply. In particular, the Proposal would not apply to a corporation organized under foreign law if: (i) it is a controlled corporation under section 957, (ii) it would be a member of a U.S. affiliated group (if it were a domestic corporation) the common parent of which is domestic under the regular rules of section 7701(a)(4), and (iii) the U.S. parent has substantial assets, other than cash and cash equivalents and other than stock in foreign subsidiaries, that are held for use in

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<sup>1</sup> A companion bill, H.R. 1265, was introduced in the House of Representatives by Representative Lloyd Doggett.

the active conduct of a trade or business in the United States.<sup>2</sup> The Proposal would apply to taxable years beginning on or after two years after the date of enactment.

OFII has previously commented on prior proposals to amend the corporate residency rules.<sup>3</sup> These proposals were limited to publicly traded foreign corporations.<sup>4</sup> In a statement accompanying the Proposal, Senator Levin indicated that the amended corporate residency provision was expanded to apply to non-publicly traded foreign corporations to address situations involving the offshore hedge fund industry.<sup>5</sup>

## **Principal Reasons Why the Proposal Should be Rejected**

### **The Proposal Would Cause Jobs and Decision Makers To Leave the United States**

Foreign-based multinational companies' employment of U.S. individuals in executive and senior management roles provides significant benefits to the U.S. economy. In addition to creating jobs, the individuals serving in those roles gain valuable insight on global business practices.

Replacing the traditional corporate residency test with a fact intensive management and control test would likely dissuade foreign multinational companies from locating top management in the United States and encourage jobs to leave the United States – an effect that would have an obvious negative impact on the U.S. economy. Moreover, to the extent they are delegated strategic management decisions, employees of related corporations are included in the Proposal's definition of a corporation's "executive officers and senior management." Because many foreign multinationals have substantial operations in the United States (conducted through U.S. subsidiaries fully taxed on their worldwide income) and often include U.S. executives in major policy decisions, it is not uncommon for one or more officers of a U.S. subsidiary to sit on the global management committee of the foreign parent, an arrangement that likely strengthens the U.S. business. This facet of the management and control definition would cause foreign multinationals to limit the participation of U.S. executives in policy decisions, adding further harm to the U.S. economy.

Adding to the potential harm to the U.S. economy is the fact that the proposal comes at a time when many U.S. and foreign multinationals are decentralizing corporate

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<sup>2</sup> The Proposal would also grant exceptions for certain non-publicly traded foreign corporations that no longer meet the criteria under the bill and that receive a waiver by the Treasury Department.

<sup>3</sup> OFII previously commented on a proposal included by the Joint Committee on Taxation. See Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05 (January 27, 2005).

<sup>4</sup> See, e.g., S. 96, a bill introduced in the 110th Congress by Senator Kerry, which treats certain U.S.-managed and controlled publicly traded foreign corporations as U.S. corporations for U.S. federal income tax purposes. Certain transition rules from the Kerry bill would apply, including an exception from the bill for certain corporations created or organized in a U.S. treaty jurisdiction on or before the date of enactment.

<sup>5</sup> Although beyond the scope of this paper, the Proposal would dramatically change the rules for investment management companies by treating foreign corporations as U.S. corporations if the assets of such corporation consist primarily of assets managed on behalf of investors and decisions about how to invest the assets are made in the United States.

management by focusing on global business units.<sup>6</sup> Multinationals increasingly find it more efficient to have their senior management direct the operations of a particular business line, which may be conducted worldwide, rather than a specific legal entity.

The decision on where to locate top management for a major line of business will involve a variety of factors. Where a substantial part of the business of the global unit takes place in the United States or the United States comprises a large part of the market for the global business unit, there are natural business reasons for locating management for the global business unit in the United States.

For example, major customer relationships may be with one or more U.S.-based multinationals. In addition, the United States may be the place where technological innovation in a particular field tends to occur, making it desirable for top management to be present there. However, if there is a meaningful concern that doing so could convert the foreign multinational to a U.S. corporation for U.S. tax purposes, this will be a powerful incentive to keep the top management outside the United States.

The location of top management of the business unit will impact decisions regarding sources of supply, location of key support functions, location of employees and the like. For example, in the case of a particular business unit, it may be desirable to have the research and marketing functions proximate to top management. The loss of the top management jobs may also mean the loss of research and marketing jobs and expenditures, all of which would tend to move higher paying U.S. jobs and support staff outside the United States. If top management for the business unit is located in the United States, this is highly likely to have a positive impact on the U.S. economy. The corollary is also evident; if top management of the business is located outside the United States more of the business unit's functions (and jobs) are likely to be located outside the United States, to the detriment of the U.S. economy.

The Proposal would encourage foreign multinational corporations with significant U.S. investments to outsource critical employment-generating functions from the United States. This is directly harmful to the U.S. economy. The foreign multinational community makes significant contributions to the U.S. economy by "insourcing" jobs to the United States.

Even where business units that are globally run from the United States are presently too small to cause a problem, the uncertainty of when their growth would cause a problem would discourage the establishment of even small globally run businesses in the United States. Take the case of the prototypical U.S. subsidiary of a foreign multinational corporation where the U.S. operations are an important contributor to the overall success of the global enterprise. It would not be unusual for: (i) the CEO of the U.S. subsidiary, and possibly other U.S. executives, to sit on management committees of the foreign parent, (ii) U.S. executives to serve as global leaders for specific business units or product lines, and (iii) one or more key supportive functions, such as research and development, to be run by a U.S. executive. It is also common for executives and managers located in the United States to perform stewardship and/or oversight functions

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<sup>6</sup> See "What is a Global Business Manager, Harvard Business Review, August 2003.

for non-U.S. operations of the foreign parent where those operations are geographically closer to the U.S. While any one of these functions may not alone cause the primary place of management and control of the foreign multinational to be in the United States, there would be a serious concern that the combination might tilt the balance.

Foreign multinationals would have to be vigilant with respect to the length of time spent by their senior managers and executives in the United States, since the accumulation of too much U.S. travel time could potentially result in the foreign parent company being considered a U.S. corporation for U.S. federal income tax purposes. Similarly, the discretion of foreign multinationals to recruit U.S. executives for key management positions may be restricted unless those U.S. executives are relocated on a full-time basis to another country.

Rather than risk being treated as a domestic corporation, with all the negative U.S. tax costs associated with that result, the Proposal would encourage the foreign parent to move top management functions away from U.S. executives, and/or move those individuals outside the United States, at potentially great cost to the U.S. economy and U.S. employment.

### **The Proposal Would Conflict With U.S. Tax Treaties**

The Proposal is particularly problematic as applied to corporations located in countries with which the United States has entered into a tax treaty. Although the precise language used in the residency articles of U.S. tax treaties varies, a corporation is generally considered a resident of the Contracting State in which it is liable to tax by reason of its place of management or place of incorporation. In the event that a corporation would be considered a resident of both the United States and the other Contracting State under that provision, the corporation often is denied treaty benefits unless the competent authorities mutually agree otherwise.

The primary purpose of a U.S. tax treaty is to avoid the double taxation of corporations resident in either of those signatory countries. The Proposal would be in direct conflict with, and override, twenty-five U.S. income tax treaties that resolve dual corporate residency in favor of the country in which the corporation is created or organized.<sup>7</sup> Most of the remaining treaties address dual residency by depriving the dual resident corporation of access to the benefits of the treaty, absent a favorable decision by the competent authorities of the two countries. This would result in double taxation of income earned by these corporations which would find themselves deprived of the protection of treaty benefits based, not on any action on their part, but a unilateral change in U.S. law.

Under the Proposal, corporations organized under foreign law but deemed to be managed and controlled from within the United States would immediately become dual residents

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<sup>7</sup> The treaties that would be overridden as a result of this tie-breaker rule are the U.S. income tax treaties with Australia, Austria, Bangladesh, Barbados, Canada, Cyprus, Egypt, Greece, Hungary, Indonesia, Korea, Morocco, Norway, Pakistan, Philippines, Poland, Romania, Slovakia, Slovenia, South Africa, Sri Lanka, Sweden, Trinidad and Tobago, and Turkey.

for tax treaty purposes. Therefore, in order to maintain their entitlement to treaty benefits, these corporations would have to petition the competent authorities of the United States and the treaty country for a residency determination. This would create needless conflict and uncertainty and would grant unprecedented decision-making power to the competent authorities who were never intended to exercise such influence. We believe that companies in this situation would not be willing to jeopardize their treaty entitlement status as a result of such unusual discretion, and opt simply to remove their officers and management from the United States, rather than take the uncertain steps necessary to preserve their entitlement to treaty benefits.

Furthermore, the new corporate residency rule would run contrary to articulated U.S. treaty policy with respect to the residency articles contained in tax treaties. Article 4(4) of the 2006 U.S. Model Income Tax Treaty (the "Model Treaty") contains a tiebreaker rule for determining the residency of a company that, under paragraph 1 of that Article, would be treated as a dual resident, *i.e.* a resident of both Contracting States. The tiebreaker rule provides as follows:

Where by reason of the provisions of paragraph 1 a company is a resident of both Contracting States, then if it is created or organized under the laws of one of the Contracting States or a political subdivision thereof, but not under the laws of the other Contracting State or a political subdivision thereof, such company shall be deemed to be a resident of the first-mentioned Contracting State.

As noted, there are currently 25 U.S. income tax treaties that use this tie-breaker rule in favor the country in which the company is created or organized.

The Treasury Technical Explanation to the Model Treaty further makes clear that where a dual resident company is created or organized under the laws of only one of the Contracting States, it will be considered a resident of that Contracting State under the laws of which it is created or organized. In this regard, the Model Treaty and the Treasury Technical Explanation indicate a strong policy preference for a residency test based on place of incorporation. The Proposal's use of a management and control test would undermine that stated treaty policy.

### **The Proposal Would Replace an Objective and Administrable Standard With a Subjective Test That Will Lead to Significant Taxpayer Uncertainty in Applying the Tax Law**

The Proposal would replace an objective, easily understood and readily administrable test of corporate residency that has been a fundamental part of U.S. tax law since its inception with a subjective, imprecise standard. The vague place of management and control test would significantly add to the complexity of U.S. tax law and materially increase tax controversy to the detriment of both taxpayers and the Internal Revenue Service. While there are other countries that use a management and control test, we are aware of no other country in the world that employs a so-called place of management or control test that requires such a detailed factual determination of the residency of a company based on the

location of the day-to-day management of certain decision makers in the company's "chain of ownership."

The disadvantages in administering any type of management and control test were previously noted by the American Bar Association ("ABA"). In its 2006 report<sup>8</sup> reviewing alternatives to the corporate residency test based on place of incorporation, the ABA Task Force on International Tax Reform stated that replacing that test with one based on facts and circumstances, such as the management and control test, posed substantial difficulties. First, given the remarkable tax results of a change in residence classification, the inherent uncertainty of such a fact intensive inquiry makes its application inappropriate in this context. Further, the difficulty involved in administering such a detailed test would likely make it no less manipulable than the current place of organization test. The Task Force ultimately concluded that addressing underlying dissatisfaction with the operative provisions of current law would produce more equitable results.

In addition, the expansion of the bill to apply to non-publicly traded companies will present enormous and dramatic adverse implications and complexities for foreign-controlled multinational companies. Unlike prior proposals, the Proposal would require all foreign corporate entities within a foreign-parented group to be tested under this new factual standard, calling into question whether hundreds or thousands of foreign corporate subsidiaries within a single foreign multinational group are subject to U.S. taxation.

### **The Proposal Would Invite Retaliation From Other Countries**

OFII is concerned that a willingness on the part of the United States to enact laws that override its international agreements would invite retaliatory actions on the part of our treaty partners. If the United States were to adopt a policy of characterizing non-U.S. corporations as U.S. residents, it would not be surprising to see other countries consider enacting similar measures, the scope of which could be equal to or greater than this proposal. Consider the reaction in the United States if one of our major treaty partners changed its definition of corporate residency in a similar manner as the Proposal, with the result that major U.S. multinationals were threatened with treatment as tax residents of the treaty partner (meaning, as one example, that dividends paid by a U.S. multinational to its U.S. shareholders would be subject to foreign withholding tax).

### **Reliance on the Substantial Presence Test Contained in the U.S.-Netherlands Income Tax Treaty as a Precedent is Inappropriate**

In his press release explaining the provisions included in the Proposal, Senator Levin stated that the amended corporate residency test is similar in concept to the substantial presence test contained in the U.S.-Netherlands income tax treaty (the "Netherlands Treaty"). For several reasons, reliance on this treaty provision as precedent is misguided.

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<sup>8</sup> American Bar Association Section of Taxation, Report of the Task Force on International Tax Reform, 59 Tax Lawyer 649, 750-755 (2006).

First, the substantial presence test in the Netherlands Treaty is not, as suggested in the press release, a test of corporate residency. A Netherlands publicly-traded company will be a Netherlands tax resident within the meaning of the Netherlands Treaty without regard to whether it meets the new substantial presence test included in the limitation on benefits article of that treaty. Rather, the substantial presence test is a limitation on the ability of a publicly-traded company to claim treaty benefits if the company does not have a substantial presence in its residence jurisdiction. This is a minimum nexus standard that was formulated for a very different purpose than a residency standard.

Second, the substantial presence test of the Netherlands Treaty is a two-factor test. It looks at both the location of trading in the company's shares and the location of management. To be comparable to the treaty test, the proposed residency test would need to also look to both factors and, consistent with the treaty's approach, if the shares of a non-U.S. publicly traded company are predominantly traded outside the United States, this should be sufficient to avoid having the company treated as a U.S. corporation.

Third, the Netherlands Treaty includes an exception to the loss of treaty benefits based on failure to meet the substantial presence test that fundamentally distinguishes it from the corporate residency test in the Proposal. Specifically, a taxpayer that would otherwise not qualify for treaty benefits for this reason can seek a discretionary grant of treaty benefits from the source country's tax authority.

Fourth, while the substantial presence test in the Netherlands Treaty only applies to publicly-traded companies, the test in the proposal would apply to all foreign corporations, both publicly traded and non-publicly traded.

Fifth, applying the Netherlands Treaty's substantial presence test as precedent for the proposal appears to suggest that there is clear precedent as to how such a test is to be applied in practice. However, the Netherlands Treaty's substantial presence test generally has not been tested in practice and as such there is no meaningful guidance to draw from.

### **The Proposal Would Introduce Significant Tax and Compliance Costs**

The potential tax costs of the deemed conversion of a foreign corporation for U.S. federal income tax purposes could be severe. Would this, for example, be a taxable reorganization? Further, the corporation's foreign subsidiaries, previously outside the U.S. tax jurisdiction, would instantly become controlled foreign corporations ("CFCs"), fully subject to U.S. tax under the complex Subpart F rules. Existing arrangements between affiliates, structured without U.S. tax considerations, potentially could have disastrous Subpart F consequences. Moreover, these changes in residency status may be inadvertent, resulting from management personnel changes. For example, under the Proposal, a foreign corporation allowing an executive of its U.S. subsidiary to serve in a decision-making role may be classified as a U.S. corporation, such that its subsidiaries would become CFCs. If the foreign corporation subsequently replaced that executive with one from another country, its conversion back to foreign resident status may constitute an outbound transfer of its assets, including the stock of its CFCs.

Transactions with the foreign corporation structured to account for foreign tax consequences could have major negative U.S. tax consequences. Dividends paid to public shareholders would suddenly become subject to U.S. withholding tax, potentially leading to lower total shareholder returns and lower share prices. The proposed two-year delayed effective date would do little to alleviate these problems. Treatment of interest and dividends as U.S. source income subject to U.S. withholding tax would not be altered by a two-year delay. Similarly, companies may have limited flexibility to alter existing business arrangements since changing these arrangements could have major business and legal consequences far beyond tax considerations. Furthermore, given the scarcity of working capital in the current economic climate, it is likely that affected companies would immediately take measures to preserve the future returns expected by shareholders. Accordingly, such companies may view the removal of all top management from the United States as the only safe way to avoid the extensive and severe consequences of classification as a U.S. corporation for tax purposes.

It is also unclear as to whether a foreign corporation, once characterized as a U.S. corporation under this new standard, could ever be treated as a foreign corporation in a later year, even if management and control were not in the United States. For example, it is not clear whether a later change in status from a U.S. corporation to a foreign corporation under the Proposal would result in additional exit charges or whether the change in status would be prevented as a result of the application of the anti-inversion rules of section 7874.

The administrative burden on both taxpayers attempting to comply with the recharacterization of a company as a U.S. resident and the IRS in auditing the company would be immense. Consider, as one immediate and obvious example, the challenge of restating the historic assets, liabilities, and earnings based on U.S. tax standards of a foreign incorporated company that has operated under different and clear rules for decades.

In addition, the Proposal could significantly increase the already burdensome financial and regulatory compliance costs that multinationals face. Even if a foreign corporation did not meet the test of being a U.S. corporation under the Proposal, to the extent it is at risk of such a reclassification, it may have to compute its tax liability as such for financial reporting purposes. This would be a costly additional financial burden for many foreign corporations.

## **Conclusion**

The Proposal's amended corporate residency provision would have severe negative consequences, both short term and long term. Most immediately, it would impose major new burdens on all foreign corporations, both publicly and non-publicly traded, and a large number of their wholly owned foreign subsidiaries. It would also create major compliance and administrative burdens for both the government and taxpayers. Furthermore, it could precipitate similar changes in foreign tax law to the potentially severe detriment of U.S. corporations. The resulting harm to the U.S. economy is particularly dangerous given the recent global financial turmoil. We urge you to reject this proposal.

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