

Comparative Study on Corporate Nationality Identification of China and the United States

Zifang Wang*

School of Administrative Law, Northwest University of Political Science and Law, Xi'an, China

*Corresponding author: 202210740402@stu.nwupl.edu.cn

Abstract. Since the emergence of multinational corporations, the determination of their nationality has become an important issue in international law. China and the United States have adopted different systems for determining the nationality of a company. China merely use the jurisdiction of incorporation while the United States introduce control test to decide the nationality of a corporation. In face of a more complex economic environment, the jurisdiction of incorporation rule, though widely accepted worldwide, has its drawbacks, such as companies evading policy regulations, difficulties in determining their, and conflicts between different regulations. Thus, the jurisdiction of incorporation rule shall be developed into a new method that is based on the jurisdiction of incorporation and also consider the actual relationship between the corporation and the country.

Keywords: Corporation; nationality; domestic law; bilateral treatment agreement.

1. Introduction

Since the emergence of multinational companies, the issue of corporate nationality has become an important matter in international law and domestic law. The Barcelona Traction case [1] of 1970 established the "place of incorporation rule," which became the standard for many countries in establishing relevant guidelines for a long period of time.

The standard of corporate nationality identification in China is the jurisdiction of incorporation rule. This rule has its own advantage. Since a company's place of incorporation is easily ascertainable. it provides a measure of certainty and predictability in choice-of-law matters for both state administrators and the regulated firms [2]. However, there are also many drawbacks such as problems of tax evasion and unidentifiable place of incorporation. The disadvantages would hinder the effective management of transnational corporations in China.

The corporate nationality identification standards in the United States is more complex than that of China, employing the place of incorporate rule initially while introducing factual connections by control test later. The control test standard better reflects the economic feature of a corporation thus it could reach better management of corporations.

Based on the drawback of the jurisdiction of incorporation rule and the challenge of protecting China's economic and security interests in the new global economy, we should rethink the concept of corporate nationality, this article looks at the developing process of corporate nationality identification in the U.S. and discuss how to promote the development of Chinese regulations.

2. The General Standard of Corporate Nationality Identification of China and the US

2.1. Two Kinds of Corporate Nationality Identification Standard

Two different standards of corporate nationality identification exist in today's international society. One is the jurisdiction of incorporation rule while the other is the control test.

2.1.1 The jurisdiction of incorporation rule

The jurisdiction of incorporation is the oldest and once the most widely used approach for determining a corporation's nationality. It follows the emergence of the world bourgeoisie.

The jurisdiction of incorporation rule is rooted in the concession or artificial person theory of the corporation that was prevalent in the first part of the nineteenth century, before it was in the statute law [3].

The jurisdiction of incorporation rule is also known as the incorporation doctrine or the internal affairs doctrine. According to this rule, a corporation is primarily governed by the laws of the state in which it is incorporated. So the nationality of the corporate is the place in which it registers.

The jurisdiction of incorporation rule is based on the recognition that each state has the authority to regulate and govern the corporations that are incorporated within its borders. It provides certainty and consistency in corporate governance by establishing a uniform set of rules for corporations within a particular state.

Under this rule, regardless of where a corporation conducts its business or where its shareholders or directors are located, the laws of the state of incorporation prevail in resolving internal disputes and governing the corporation's affairs.

2.1.2 Actual relationship: control test

The control test is a legal principle used to determine the nationality or citizenship of a corporation for the purpose of identifying its legal status and rights. It involves assessing the extent of control exercised by individuals or entities of a particular nationality over the corporation.

The control test is commonly applied in international law and corporate law to determine whether a corporation is considered a national or foreign entity. It helps identify the jurisdiction under which the corporation is subject to regulation and entitled to legal protections and benefits.

Under the control test, the nationality of a corporation is typically determined by examining factors such as:

Place of incorporation: The jurisdiction in which the corporation is legally incorporated or registered is often a significant factor in determining its nationality. The laws of that jurisdiction will generally govern the corporation's internal affairs.

Ownership and control: The control test also considers the nationality of the individuals or entities that own a controlling interest in the corporation. This can include majority shareholders, directors, or other controlling parties. If a corporation is predominantly owned and controlled by individuals or entities of a particular nationality, it may be considered a national entity of that country.

Principal place of business: The primary location in which the corporation conducts its business activities, known as its principal place of business, may also be relevant in determining its nationality. If the corporation's main operations are centered in a particular country, it may be considered a national entity of that country.

It's important to note that the control test may vary depending on the legal jurisdiction and the specific laws and regulations in place. Different countries may have different thresholds or criteria for determining corporate nationality.

2.2. Corporate Nationality Identification in China and the US

There are different approaches taken by China and the United States in determining the nationality of a company. China consistently follows the criterion of the place of incorporation, while the United States employs a more diverse set of criteria, including the control test and the economic commitment test.

2.2.1 Corporate nationality identification in China

For a long time, the legal basis for determining the nationality of a company in China has been primarily Article 191 of the "Company Law". Article 2 states that "The term "company" as mentioned in this Law refers to a limited liability company or a joint stock company limited set up within the territory of the People's Republic of China according to the provisions of this Law", Article 191 states that a foreign company, as referred to in this Law, means a company that is established outside China in accordance with foreign laws. And Article 2 of Foreign Investment Law of the People's Republic of China also states that foreign-invested enterprises mentioned in this Law refer to enterprises that

are wholly or partly invested by foreign investors and registered within the territory of China under the Chinese laws. Thus, the standard for determining the nationality of a company in China is the jurisdiction of incorporation rule.

However, in terms of international treaties, it seems that China's criteria for determining corporate nationality have relaxed to some extent. Prior to 1983, the criteria for determining corporate nationality were relatively singular, adopting an absolute establishment location standard for corporate legal nationality. After that, the criteria gradually loosened, with other standards being adopted in certain treaties [4]. For example, China is one of the contracting parties to the Washington Convention, and Article 25(2)(b) of the Washington Convention establishes the following two criteria: first, a legal entity with the nationality of a contracting party other than the disputing party; second, a legal entity with the nationality of the disputing party, but considered as a national of "another contracting party" with the "consent" of the disputing party due to "foreign control" [5]. However, despite some relaxation in international treaties, overall, China still adheres to the absolute establishment location standard in the issue of corporate nationality. Chinese Ambassador Liu Zhenmin made a statement in 2003 within the framework of the United Nations General Assembly on the issue of determining corporate nationality in diplomatic protection, affirming that China still adheres to the absolute establishment location standard.

2.2.2 Corporate nationality identification in the US

The determination criteria for corporate nationality in the United States are more complex and have evolved from the traditional criterion of jurisdiction of incorporation to incorporating the concept of "actual connections." This method of assessing actual connections is also undergoing continuous changes.

Prior to the 20th century, the U.S. predominantly followed the traditional criterion of jurisdiction of incorporation in various aspects of corporate matters. The Restatement (Second) of Conflict of Laws, Chapter 13, specifically addressed the legal application for commercial corporations.

In the early 20th century, the U.S. gradually began to adopt the requirement of actual connections. As an alternative to the jurisdiction of incorporation criterion, the control test method emerged. The application of this method was primarily driven by two factors - wartime concerns and exclusionary policies.

The control test method was employed in the Alien Exclusion Laws enacted in the United States between 1916 and 1930 [6]. These laws imposed new or stricter restrictions on foreigners participating in infrastructure development or other strategically significant industries.

In the later half of the 20th century, the control test method was further extended to other areas, and some states began to challenge the traditional criterion of jurisdiction of incorporation. For example, in the case of *Sobieski v. Western Air Lines* [7], the California court ultimately determined that a Delaware corporation had significant connections with California and should comply with California's requirement of cumulative voting system.

It is worth noting that the control test method primarily focuses on the nationality of individuals who have influence or control over the company, rather than the company itself. This method has a certain limitation, as individuals with control may not necessarily be influenced by their own nationality when making decisions.

Regarding issue, some scholars argue that the term "nationality" is not applicable to companies, while others propose improvements such as the economic commitment test.

Economic commitment test is a method proposed by American scholars to determine corporate nationality. The test primarily examines the extent to which a company economically depends on a specific country in order to determine its nationality. The economic dependency test typically takes into account the following aspects to assess a company's nationality:

Location of the company's headquarters: The test focuses on whether the company has established its headquarters in a specific country, as well as the size and importance of the headquarters.

Primary operating locations of the company: The test considers the country where the company conducts its main production, sales, and business activities.

Distribution of the company's ownership: The test analyzes the company's ownership structure, including the nationality of shareholders and the extent of their investment and control over the company.

Tax arrangements of the company: The test examines the company's tax planning activities, including whether it reduces its tax burden by establishing subsidiaries in specific countries or utilizing tax incentives offered by certain countries.

Employment and staff situation of the company: The test takes into account the company's employment situation in specific countries, including the nationality and distribution of employees' work locations.

Through a comprehensive assessment of these factors, the economic dependency test can determine the extent to which a company economically depends on a specific country, thus determining its nationality. The purpose of this test method is to prevent companies from evading legal and tax obligations by establishing false headquarters or utilizing tax incentives.

The difference between the economic dependency test and the control test is that the former focuses on considering the company's economic dependence on a specific country to prevent tax avoidance behavior. The latter focuses on considering the nationality of natural persons who have actual control over the company and serves the purposes of warfare and exclusion [8].

3. Problems of Determining the Nationality of Corporations in China

As mentioned earlier, China has consistently adopted the jurisdiction of incorporation as the criterion for determining company nationality. While this criterion has the advantages of stability and ease of implementation, it also has several drawbacks that are difficult to address.

3.1. Tax Avoidance

Many companies choose to establish themselves in countries with lower taxes or more lenient tax policies in order to reduce their tax obligations [9]. These companies transfer their profits to the jurisdiction of incorporation to avoid paying higher taxes in other countries. This type of tax avoidance results in a loss of tax revenue, impacting a country's fiscal stability and the provision of public services.

3.2. Regulatory Arbitrage

Some companies choose to establish themselves in loosely regulated jurisdictions to evade strict legal and regulatory requirements. These companies can enjoy fewer regulatory constraints in their jurisdiction of incorporation, thereby reducing their legal obligations in areas such as the environment, labor rights, and consumer protection. This conduct of regulatory arbitrage causes losses to stakeholders and may lead to unfair competition.

3.3. Concealment of Ownership

The company nationality determination based on the jurisdiction of incorporation allows companies to hide their true ownership structure. Companies can obscure ownership by establishing subsidiaries in multiple countries and using complex equity structures, making it difficult to trace the ultimate controllers of the company. This concealment of ownership makes it challenging for regulatory bodies and stakeholders to understand the true operations and decision-making processes of the company.

3.4. Cross-border Capital Flow Restrictions

The company nationality determination based on the jurisdiction of incorporation enables companies to circumvent capital controls and foreign exchange restrictions in their home country. This leads to an imbalance in the distribution of capital globally, exacerbating global wealth inequality and financial instability.

4. Suggestions on the New Corporate Nationality Identification Standard

4.1. Domestic Law

Under domestic law, the new system for determining corporate nationality should adopt a fusion of establishment location and control standards, with the control standard being an exceptional case.

On one hand, due to the development of economic globalization and the complexity of corporate organizational structures, the relationship between a company and its establishment country, in terms of loyalty obligations and protection provided, may weaken, leading to potential issues of "selecting nationality" and evading the law. The absolute establishment location standard would be unable to effectively regulate and control companies. On the other hand, the determination based on the control standard is more complex and even subject to differences in interpretation. Additionally, modern corporate ownership and governance structures are often quite flexible, making the determination of corporate nationality based on control standards not only costly but also unstable. Taking these factors into consideration, a system should be adopted that combines the establishment location and control standards, rather than completely overturning the existing establishment location standard. For example, a negative list system could be implemented [10], with the control standard serving as a criterion for determining whether a company is included in the negative list. Furthermore, when including a company in the negative list, further distinctions should be made based on different types and degrees of control, including existing non-compliance measures, future non-compliance measures, and specific measures targeting certain industries [11].

4.2. Application Relationship between Domestic Law and Bilateral Investment Agreements

In addition, since the existing criteria for determining corporate nationality vary among major countries in the world, there may be differences between the criteria for determining corporate nationality in the bilateral or multilateral investment agreements that China has signed and its domestic law. How should the relationship between the two be balanced?

Firstly, according to Article 142 of the General Principles of the Civil Law, if international treaties that China has concluded or participated in have different provisions from its domestic civil laws, the provisions of the international treaties shall apply, except for provisions that China has declared to reserve. The Civil Code of China lacks a similar provision to Article 142 of the General Principles of the Civil Law. China's Constitution and constitutional laws, including the Legislation Law and the Law on the Procedure of Ratifying Treaties, also do not have clear provisions regarding the application relationship between domestic law and international treaties. At present, Chinese laws and regulations have not established a legislative model that primarily applies treaties directly. Therefore, how to handle the application relationship between domestic law and international treaties must be based on explicit provisions made by China's unilateral laws and regulations.

Secondly, the criteria for determining corporate nationality in international law are fragmented [12], and different standards can be adopted in domestic law and bilateral or multilateral investment agreements. Fragmentation refers to the diversification and independent development of branches within the international legal system, reflecting the impact on the existing and traditional systems of international customary law and treaty legislation. In order to adapt to this change, in the design of the system, it may be permissible to have differences in the criteria for determining corporate nationality between domestic law and bilateral or multilateral investment agreements, while adopting stricter standards in the management of the negative list under domestic law.

5. Conclusion

This article focuses on the issue of corporate nationality determination, conducting research and discussions. Through comprehensive analysis of relevant laws, regulations, academic literature, and case studies, the article analyzes the problem and puts forward some viewpoints.

The article finds that China and the United States adopt different criteria for determining corporate nationality. China adopts the place of incorporation rule, while the United States combines the place of incorporation rule with the control test standard. Some scholars have also proposed the economic commitment test standard.

Regarding the determination of corporate nationality, although the establishment location standard has the advantages of being easy to determine and stable, its flaws should not be overlooked. It can lead to issues such as tax avoidance, regulatory arbitrage, concealment of ownership, and restrictions on cross-border capital flows. The control test standard the economic test standard focus more on the actual connection between the company and the country, which can effectively address these issues. However, they also have drawbacks such as high confirmation costs and low stability.

Therefore, in response to these issues, the article proposes suggestions for China's system of determining corporate nationality in domestic law and the application relationship between domestic law and bilateral investment agreements. It suggests a comprehensive consideration of both standards, adopting a system that initially refers to the establishment location standard and then considers the control test standard for determining corporate nationality. It also allows for differences between domestic law and bilateral investment agreements in the issue of corporate nationality determination.

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