BMR Legal

ADVOCATES

Source and residence base of taxation- under domestic law and tax treaties

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Contents

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India’s Tax base under Domestic Law

Section 4: Charge of Income

- Charging Section for the entire Act. No charge of Income can flow without the application of Section 4.
- Is essentially the embodiment of Article 265 of the Constitution of India, which provides that *"no one has the right to levy or charge taxes except by the authority of law".*
- Provides that tax is applicable on the **total income** of the previous year of a person

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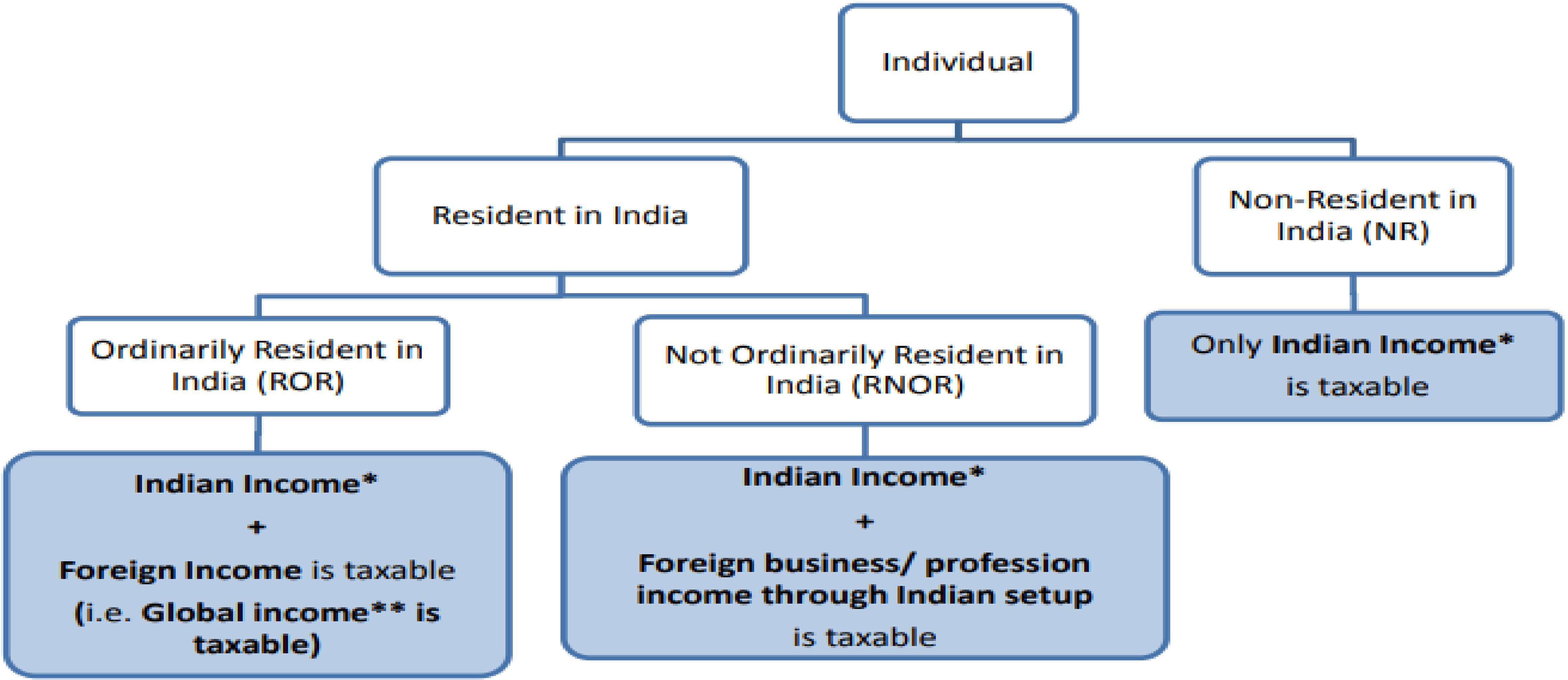

* Indian Income means any income accrued, received or deemed to be accrued or received in India.

** Along with the global income, individual also has to give disclosure for all Foreign Assets and Incomes.

Scope of Total Income
Section 5 of the Income-tax Act, 1961

What is the total income on which tax is to be levied for residents and non-residents?

- Section 5 of Income-tax Act, 1961:
- Section 5(1): Residents
- Section 5(2): Non-Residents

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Scope of Total Income
Section 5 of the Income-tax Act, 1961

Section 5(1): Following incomes, from whatever source derived, form part of the total income of a resident (ROR):

- Income which is received or is deemed to be received in India in the relevant PY by or on behalf of such person;
- Income which accrues or arises or is deemed to accrue or arise in India during the relevant PY;
- any income that accrues or arises outside India during the relevant PY.

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Scope of Total Income
Section 5 of the Income-tax Act, 1961

Proviso to Section 5(1): Following incomes from whatever source derived, form part of the total income of a person not ordinarily resident in India (RNOR) :

- income which is received or is deemed to be received in India in the relevant PY by or on behalf of such person;
- income which accrues or arises or is deemed to accrue or arise in India during the relevant PY;
- any income which accrues or arises outside India during the relevant PY if it is derived from a business controlled or a profession set up in India.

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Scope of Total Income
Section 5 of the Income-tax Act, 1961

Section 5(2): Total income of a person who is a non-resident includes all income from whatever source derived which:

- Is received or deemed to be received in India in the relevant previous year by or on behalf of such person; or
- Accrues or arises or is deemed to accrue or arise to him in India during the relevant previous year

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Sr. No	Particulars	Resident Ordinary Resident (ROR)	Resident Not Ordinary Resident (RNOR) – 5(1)	Non Resident (NR)– 5(2)
1	Income received in India	Taxed	Taxed	Taxed
2	Income Deemed to be receive in India	Taxed	Taxed	Taxed
3	Income accrues or arises in India	Taxed	Taxed	Taxed
4	Income deemed to accrues or arises in India	Taxed	Taxed	Taxed
5	Income accrues or arises outside India	Taxed	NO	NO
6	Income accrues or arises outside India from business/profession controlled/set up in India	Taxed	Taxed	NO
7	Income Other than Above (No Relation In India)	Taxed	NO	NO

Background on Tax base

- Indian tax regime is based on 2 ways of taxation(Section 5):
  - Residence based
  - Source based
- Section 9 creates a deeming fiction by applying source-based taxation

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India’s Tax base under Treaty Law

Tax base under tax treaties

- Article 1 of OECD Model

  “For the purposes of this Convention, the term "resident of a Contracting State" means ***<u>any person who, under the laws of that State, is liable to tax</u>*** *therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof as well as a recognised pension fund of that State.”*

- *Article 4(1) refers to domestic law to assess the residence of both individuals and companies.*

- What happens if an individual qualifies as a resident of both the contracting states?

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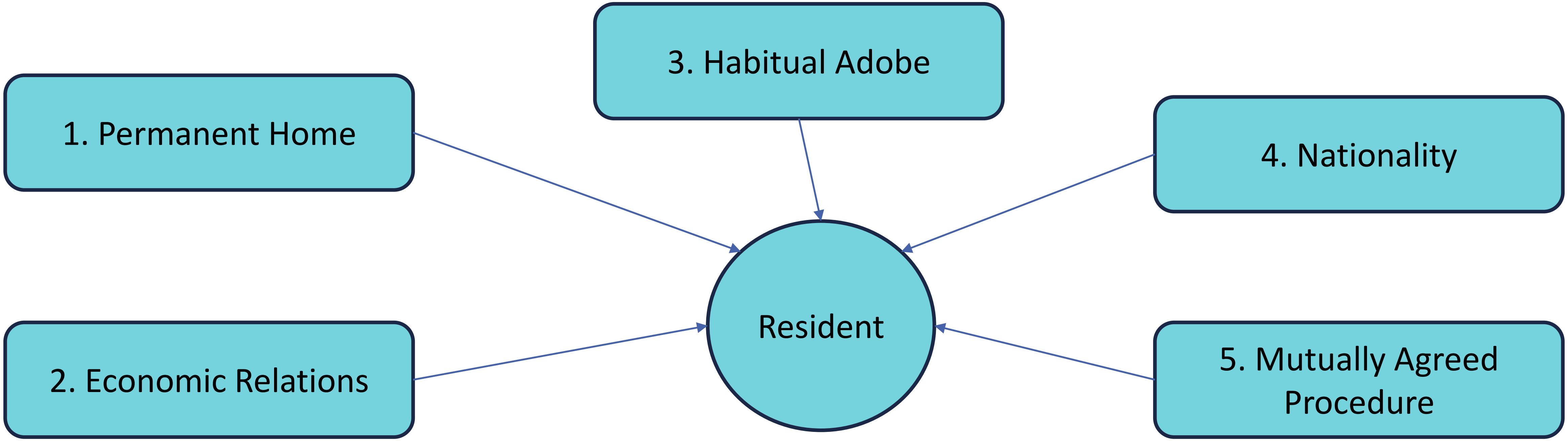
Tax base under tax treaties

- Article 4(2)&(3) provides for a solution; it provides what is colloquially called as 'Tie-breaker rule'.
- Article 4(2): Individuals



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Case study

- Pierre is single with French nationality.
- He works as a commercial representative in Germany between 1999 and 2002.
- He maintains a home in France
- He rents an Office in Germany
- From 2001, he rents an apartment in Germany for use during the week.

Where is Pierre resident in the years 1999- 2002?

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Case study- Solution

- For 1999 and 2000: French Resident, as he has a permanent home in France
- From 2001, we need to use Article 4 in greater depth:
- ‘Permanent Home’ in both states
- Vital Interests arguably evenly divided
- Place of habitual abode cannot be easily established
- Nationality is the determining factor

Therefore, most likely treaty resident of France.?

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Tax base under tax treaties

- Article 4(3): Companies

"Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its ***<u>place of effective management</u>***, ***<u>the place where it is incorporated</u>*** *or otherwise constituted and any other relevant factors."*

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Tax base under tax treaties

- Article 4(3): Companies

Para 24 to Article 4

> *"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."*

Factors to determine

- Where the key decision-making is made in relation to the entity's action.
- Must take into account relevant facts and circumstances

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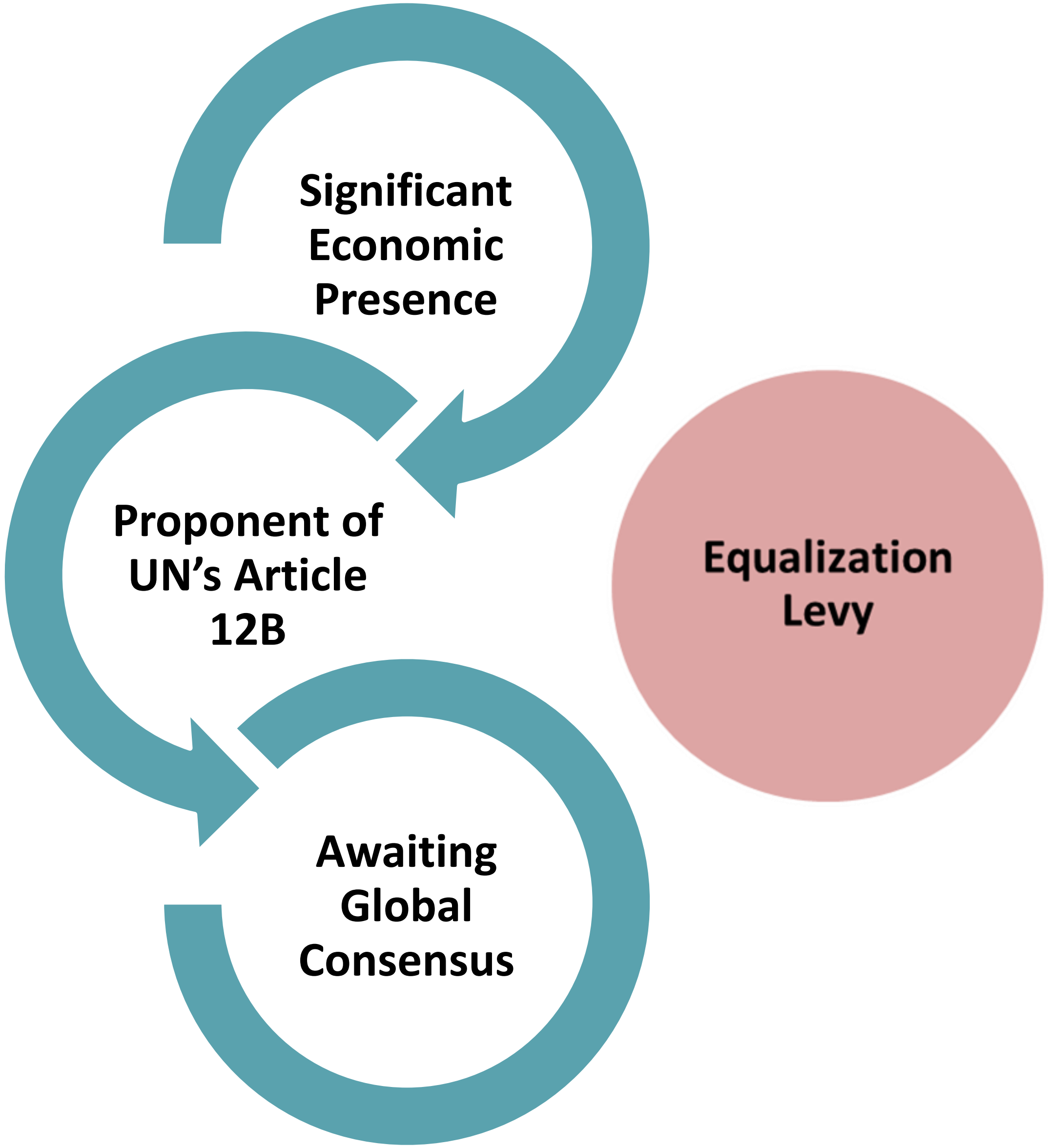
Needs for New Age Economy

India’s fight for a fair share of taxes



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India’s Road Map on Digital Taxation

February 3, 2016
- Report of Committee on Taxation of E-Commerce under the Chairmanship of Mr. Akhilesh Ranjan

April 1, 2016
- Enforcement of 2016 Equalisation Levy

2016/2017
- Introduction of tax on OIDAR services under Indirect tax laws

2018
- Introduction of SEP under income tax law

April 18, 2019
- Consultation Paper on Profit Attribution released by CBDT

2020
- Equalization Levy
- TDS on consideration received by e-commerce participants
- Amendment to SEP (Explanation 2A)
- Insertion of Explanation 3A under Section 9

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Migration from FAR to FARM Analysis

Concept of Source Based Taxation

India for the purpose of attributing appropriate profits to digital business models exploring (for specified business) ‘Market Analysis’ along with FAR

For the purpose of taxing digitalized businesses FARM analysis could possibly yield better results versus traditional FAR analysis

This analysis factors market access related benefits derived on account of digitalized economy

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Significant Economic Presence: Digital PE

Extension of the scope of ‘Business Connection’ to Digital Business Models

Inserted vide Finance Act, 2018: Explanation 2A of Section 9

Significant economic presence (‘SEP’) of a non-resident in India shall constitute “business connection” in India

‘Significant Economic Presence’ shall mean:

- Transaction in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India, if aggregate of payments from such transactions during the previous year exceed a prescribed amount; or
- Systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India as may be prescribed

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Significant Economic Presence

Proviso to Explanation 2A to Section 9

Transactions or activities shall constitute a significant economic presence whether or not

the agreement for such transactions or activities is entered in India; or

the non-resident has a residence or place of business in India; or

the non-resident renders services in India

Only so much of the income as is attributable to (a) and (b) is deemed to accrue or arise in India

Intended to target internet-based businesses that may not have a ‘place of business’ or a ‘physical presence’ in the country from where they are actually generating significant revenues

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Practical Implications of SEP

- The first and foremost challenge is the low thresholds, owing to which a large number of non-residents could get covered under the SEP.
- Secondly, as also explained above, the definition is widely worded. This would imply that even if goods are sold or services are rendered from outside India, the same may result in SEP in India if the revenue or user thresholds are exceeded. This may likely bring within the ambit of SEP, transactions of goods sold, or services rendered from outside India, thereby creating SEP for such non-residents, even though there may not be any activities undertaken by the non-resident in India or there may not be much change in business model due to digital advancements.
- The provisions as they stand today, are much wider and go beyond taxing digital business and transactions and seek to cover all and any transactions that non-residents may have with persons in India.
- The other question is whether income streams like royalties, cost recharges, etc could also result in SEP.
- The concept of continuity and regularity which are attributes of a business connection are disregarded in the manner in which the provisions are currently drafted. Stand-alone, stray and isolated transaction could also be held to constitute SEP, if the monetary thresholds are breached.

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Equalization Levy (EL) - Snapshot

Particulars	2016 Equalisation Levy	2020 Equalisation Levy
Introduction	Finance Act, 2016 (w.e.f 1-06-2016)	Finance Act, 2020 (w.e.f 1-04-2020)
Scope	Limited to B2B supplies	Applicable both to B2B and B2C supplies
Compliance Obligation	Indian Payer/Recipient of services	Non-resident Recipient of Consideration
Services	Online advertisement service including provision of digital services	Online sale of goods or provision of services, facilitation services including combinations
Rate	6%	2%
Exclusions	(i) Services connected with an Indian PE of NR service provider (ii) Annual consideration below threshold of INR 0.1mn (iii) Services not for purpose of carrying out business or profession (i.e., B2C services)	(i) E-commerce operator having Indian PE (ii) Supply subject to 2016 Equalization Levy* (iii) Gross consideration below INR 20mn

*i.e., where the activity in question namely, online advertisement and related activities are already subject to 2016 Equalization Levy at 6%

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What Lies ahead

Upcoming concepts

- **Article 12B of UN Model:** Article 12B grants new taxing rights to the 'source state' on any income derived from ADS. This includes advertising services, digital content services, social media services, etc
- **Pillar One:** which applies to large multinationals, will reallocate certain amounts of taxable income to market jurisdictions, resulting in a change in effective tax rate and cash tax obligations, as well as an impact on current transfer pricing arrangements.
- **Pillar Two:** The rules ensure that large multinational enterprises pay a minimum level of tax on their income in each jurisdiction where they operate, thereby reducing the incentive for profit shifting and placing a floor under tax competition, bringing an end to the race to the bottom on corporate tax rates.

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