SOURCE AND RESIDENCE BASE OF TAXATION- UNDER DOMESTIC LAW AND TAX TREATIES

CA Prerna Peshori

RESIDENCE VS SOURCE

- Foundation for Jurisdiction to tax between sovereign states
- Are these concepts defined?
- Can this conflict ever be resolved?

RESIDENCE CONCEPT – FOR INDIVIDUALS

- Denotes personal connection
- Residence, domicile, citizenship are they same?
  - US citizens are residents of US
  - UK domiciled are residents of UK
- Tests for residency
  - Time spent in the country – No of days test
  - Connections with a particular country
    - centre of vital interest, permanent home, habitual abode (Australia, Netherlands, Germany or France)
    - Close relations with country – Canada or Netherlands
    - place of employment (France, Japan, NZ)

  - Citizenship test (US)
  - Generally leads to world-wide taxation (except for countries following territorial system of taxation)

RESIDENCY IN INDIA – FOR INDIVIDUALS

- No of days test
- 2 kinds of residents – Ordinary & not ordinary
- >182 days during the PY or
- 60 days during the PY AND 365 days in the 4 PPY
- **Exception: 60 days replaced to 120 days**
  - Indian citizen or PIO coming on visit to India having TI (from other than foreign sources) > Rs. 15 Lakhs

- **Exception: 60 days replaced to 182 days**
  - For Indian citizen going outside India for employment or member of crew of Indian ship
  - Indian citizen or PIO coming on visit to India
- New concept of deemed residency – Indian citizen not liable to tax in any country & having TI (from other than foreign sources) > Rs. 15 Lakhs

RESIDENCY IN INDIA – FOR INDIVIDUALS

- Additional Test for establishing ordinary residency
- Resident in 2/10 PPY AND
- Presence of > 730 days in 7 PPY

ROR	World-wide income taxable in India
RNOR	Income accruing or arising in India except if business controlled in or profession set-up in India
NR	Income accruing or arising in India

RESIDENCE CONCEPT – FOR CORPORATES

- Legal seat - Incorporation test (US)
- Place of management – India, Australia, Canada, Ireland, Denmark, France, Germany, Netherlands, UK
- India follows both – Company resident in India if
  - Incorporated in India or
  - POEM in India
- For HUF/Partnerships/AOPs
  - Resident in India except where control and management of its affairs is situated wholly outside India.

RESIDENCE UNDER THE TAX TREATIES

- Treaty applies only when person is resident of either or both Contracting States
- Article 4 attempts to resolve conflict of dual residency
- Refers to residency under domestic tax laws
- Tie-breaker for individual
  - Permanent Home
  - Centre of Vital Interest
  - Habitual Abode
  - Nationality
  - MAP
- Tie-breaker for corporates
  - POEM
  - MAP post MLI

ECONOMIC ALLEGIANCE

- In the early 1920s, with the increase in global trade, the League of Nations took upon itself the task of studying the issue of global double taxation which had shown signs of becoming an issue affecting businesses.
- The possibility of formulating general principles which would become the basis of an international tax framework and which would be capable of preventing double taxation was one of the foremost objectives of that study.
- ‘Economic Allegiance’ was coined at that time
- Economic allegiance is based on factors aimed at measuring the existence and extent of the economic relationships between a particular state and the income or person to be taxed.
- 4 factors comprising economic allegiance
  - origin of wealth or income
  - situs of wealth or income
  - enforcement of the rights to wealth or income
  - place of residence or domicile of the person
  - entitled to dispose of the wealth or income
- Among those factors, the study also concluded that in general, the greatest weight should be given to “the origin of the wealth [i.e., source] and the residence or domicile of the owner who consumes the wealth [i.e., residence]

SOURCE CONCEPT

- Vogel observed that ‘source’ refers “to a state that in some way or other is connected to the production of the income in question, to the state where value is added to a good”.
- The place where wealth is produced
- Source depends on characterisation of income
- Active Income - Business Income
  - Where it is carried on usually
  - PE is the yardstick
  - For service income – there is difficulty
- Passive income - Dividends/Interest/Royalties/Technical services
  - Pay Rule – related to connecting status of residence of payer
  - Use rule - connecting status of the underlying asset out of which the income arises or is associated
  - Rental income/Capital gains – location of asset

SOURCE CONCEPT IN INDIA

- Doing business with India vs Doing Business within India – RD Agarwal Case (SC)
- Section 5 – income accruing or arising or deemed to accrue or arise in India
- Section 9 – Deemed Accrual

9(1)(i) – Income accruing directly/indirectly from or through

- Business Connection
  - Incl. Dependent Agent but excludes Independent agent
  - Includes SEP
- Asset/ Property /source
- Transfer of capital asset situated in India (incl. shares of F Co deriving their value substantially from India)

9(1)(ii)/(iii) – salaries earned in India for services rendered in India or payable by GOI to Indian citizen for service o/s India

9(1)(iv) – Dividends paid by I Co incl. paid o/s India

9(1)(v)/(vi)/(vii) – Interest/Royalties/ FTS

- Payable by
  - GOI
  - Resident of India (Except for B/P carried o/s India or for source o/s India
  - NR if for B/P carried on in India

IS SOURCE REALLY DEFINED?

- RD Agarwal Case (SC) – Business connection as 'real and intimate relation between the trading activity carried on outside the taxable territories and trading carried within the territories, the relation between the two contributing to the earning of income by the NR in the trading activity
- Barendra Prasad Ray (SC) – UK Solicitor appearing before Calcutta HC had business connection in India due to real and intimate connection with Indian solicitors of the client and proceedings before the court
- Ishikawajima Harima (SC) – For services to be taxable in India – they should be rendered & utilized in India
  - Explanation to Section 9 – It is irrelevant whether or not NR has rendered services in India
- Volkswagen Finance Pvt Ltd (Mum) - "Virtual and intangible business connections are perhaps far more critical, important and commonplace than the conventional brick and mortar business connections half a century ago, and, therefore, to disregard these business connections as a real and intimate business connection leading to earning of income by the non-residents, only because Hon'ble Courts, while delivering judgments several decades ago, could not visualize the same and hedge their observations about such possibilities, will certainly be travesty of justice."

SOURCE UNDER TREATY LAW

- Treaty does not provide for source concretely
- Business Income – PE
  - Fixed place of business
  - Dependent Agency
  - Service PE
  - Construction/Installation PE
- Force of attraction rule
- Rental income – where immovable property is situated
- Capital Gains – location of asset
  - Securities usually residence country
- Dividend – where company paying dividends is resident
- Interest/Royalties/FTS
  - Residence of payer or where PE is situated
- Services – where fixed base is situated

TAX NEUTRALITY

- Capital Export Neutrality – The investor should pay the same total (domestic plus foreign) tax, whether he receives a given investment income from foreign or from domestic sources
- Capital Import Neutrality – Capital funds originating in various countries should compete at equal terms in the capital market of any country.

EXCLUSIVE RESIDENCE BASED TAXATION

- Higher connection with the person therefore easy to apply and brings certainty & simplicity
- In line with capital export neutrality
- Political accountability, redistribution of income and equity considerations
- Followed for shipping activities and now being even advocated for e-commerce
- Lopsided approach
- Exclusive residence based taxation might result in capital flight
- Risk of double taxation

EXCLUSIVE SOURCE BASED TAXATION

- The logic behind exclusive source-based taxation is that states have a right to tax all income that is generated within its territory.
- Source-based taxation is also supported by the principle of economic allegiance
- In line with capital import neutrality
- Limitations of source based taxation
  - Conventional source rules are difficult to apply to modern day transactions
  - Rise in Intangibles
  - Could result in double non taxation
  - Characterisation of income

TAX TREATIES – AS A MEANS TO RESOLVE RESIDENCE –SOURCE CONFLICT?

- Treaties provide for distribution of taxing rights
- Distribution is depending on characterisation of income
- Full right to tax – Immovable property, capital gains
- Limited right to tax – Passive income – royalties, FTS, Int, Dividend
- No right to tax – Capital gains
- Conditional right to tax – Business Income

SOURCE & RESIDENCE CONCEPT IN DIGITAL AGE

- Traditional source & residence concept hinged on physical presence
- In Digital age – physical presence is almost redundant

JUDICIAL PRECEDENCE FOR E-COMMERCE TRANSACTIONS

- Kolkata Tribunal in the case of ITO v Right Florist Pvt Ltd – website is not a PE
- Delhi Tribunal in Amadeus Global Travel – booking fees received from Indian entities by nonresident companies providing Computerised Reservation System are liable to be taxed in India. The Tribunal came to such a conclusion on the ground that these companies have a “virtual” presence in India which constitutes a “virtual” PE.
- E-bay International AG (Mum) - income earned by eBay, from operating India-specific websites are not in the nature of “Fees for Technical Services”
- Google India (Bang) - payment made to Google Ireland under the Adwords Programme cannot be characterized as royalty

NEW CONCEPTS

- Pillar 1 – Redefining source rules
- Significant Economic presence
  - Interaction with users in India
  - provision of download of data or software in India
- Equalisation levy
  - E-commerce operations
  - Advertisements
- Redefining these concepts is need of the hour

THANK YOU

REACH OUT ON
PRERNAPESHORI@PESHORICONSULTANTS.COM
+919730166366