Residence based taxation: UN, OECD, BEPS & Indian scenario

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1. Introduction

Tax is a levy imposed on an individual or any form of legal entity. It is levied mainly for raising funds for governing the state and incurring expenditure for the same which includes scientific research, military, roads, railways and other infrastructures, public safety, healthcare, sanitation, education and other public works. The system of taxation was first introduced in Ancient Egypt in the form of forced labour or a charge on part of something, mainly on crop cultivation. The practice of levying tax began in India in the 11th century.

The kick-start for globalisation was in the century ending 1914. This however deteriorated on the outbreak of World War I and II. During the mid-World War phase, global trade picked up the pace. At this juncture, tax levied by various countries posed burden and affected the business.

Most of the countries had a self-contained tax code that levied tax on Global income earned by its residents. In addition to it, tax is also levied on non-residents on income sourced within the country. This concept of tax levy lead to double taxation when foreign trade started expanding. The Domestic tax laws were unable to resolve this issue of double taxation.

Double taxation of an income may happen in two ways; when the same income is taxed in two countries in the hands of a single taxpayer (jurisdictional double taxation) or taxation of the same income in the hands of two taxpayers (economic double taxation). To prevent double taxation of income from transnational activity, the residence country conventionally yields tax jurisdiction to the source country, either unilaterally through its domestic tax law or bilaterally through a tax treaty. The residence country typically adopts one or a combination of two mechanisms for this purpose. The first mechanism exempts residents from taxation on their foreign sourced income, or at least on certain types of foreign source income. This is known as a "territorial" or "exemption" system. The second mechanism grants residents a tax credit, applied against domestic taxes imposed on foreign source income, for the amount of foreign income taxes paid.[2]

Further, the adoption of resident based taxation to the world wide income with relief from international double taxation by way of providing foreign tax credits, potentially contributes to the sustainability of a common equilibrium level of corporate income taxation[3].

Most developed countries adopt residential status as the basis of taxation, but in certain circumstances the source or territoriality principle is also adopted to tax income in the country where it arises. The common objective of the Governments while negotiating tax treaties or Double Taxation Avoidance Agreements ('DTAA's') is to ensure that tax revenues

[2] The Future of Source-Based taxation of the income of multinational enterprises- *Robert A. Greent*
[3] See Roger H. Gordon, Can Capital Income Taxes Survive in Open Economies2, 47J. FIN. 1159 (1992) (arguing that the United States' dominance as a capital exporting country during much of the postwar period and its maintenance of a worldwide system of income taxation might have contributed to the survival of a non-zero equilibrium level of capital income taxes during this period, in spite of the openness of national economies).

are shared in a manner most optimal to both. The common objectives of DTAA's, would be to remove the burden of double taxation which harms free movement of goods, capital, services, technology and persons between Countries.

DTAA's entered into by India are generally a mix of both source based taxation and residence based taxation rules. The main negotiation takes place in assigning the right to tax the income between the countries. A country would like to keep with it the right to tax its resident on his global income whereas, the country of source would also like its stake of claim in the income. Therefore, a settlement has to be agreed under the DTAA allowing the country of source to take a percentage of the income. For e.g. Royalty, Fee for Technical Services (FTS) taxed at a decided rate in the country in which it is earned. In certain cases, the right to tax is left with the country of residence unless there is substantive activity in the country of source, for e.g. business profits are taxed in the country of residence unless the business is carried on through a Permanent Establishment ('PE') in the source country. Further, the Indian domestic laws also emphasizes that income of a non-resident will be deemed to accrue or arise in India whether or not the non-resident has a residence or business connection or place of business in India or non-resident has provided services in India.

The International Fiscal Association in 38th Congress in Buenos Aires has resolved that the source system of taxation is preferable. However, this may work to the disadvantage of developing countries with lesser economic resources. Therefore, most DTAAs have a combination of both source as well as residence form of taxation. The source rule is also sometimes referred to as the "classification or assignment rule" as it classifies the income with reference to the source. The country where the income is generated gets the right to tax it. The logic behind this is that the country which has nurtured the income e.g. in case of royalties and patents, may have allowed tax breaks in the development of the patents and would now want a share of the revenue earned from those royalties or patents.

Therefore, while negotiating DTAAs, countries try to bargain hard in their best interests and often compromise at a mutually agreed tax rate. This compromise may be reached in the form of a lower rate of tax at which the source country is allowed to tax the income. While taxing an income, there could also be another issue, on whether the income should be taxed on gross basis or net basis. A balance in the scheme/right of taxation between the countries is sought to be achieved so as to make it an easy and level playing field for all. This is a challenge as even the way of doing business has changed, from the traditional method to e-commerce method. Therefore, establishing jurisdiction over income has become even more difficult.

Earlier, the guiding principle in determining the source of income and the location of earning profit was to ask the question "what has been done to earn the profit?" at present, the relevant question would be "what and where has the revenue generating activity been carried out?"

In case of tangible goods profits arises when they are delivered. However, with the increased use of technology and e-commerce, it is necessary to adopt appropriate systems to determine point of taxation. This is to ensure that a country does not lose out on the right to tax an income e.g. an international book store or record company selling its books or records

in India either through an exclusive agent or by setting up its brand shop in India would be taxed; however if the same company sells goods through Internet, which are directly delivered through mail/courier it would become very difficult to capture such sales and further there would be no business connection/ PE to bring that company to tax in India.

The business models under the digital economy present some key characteristics which are potentially relevant as far as tax laws are concerned. These features include mobility, reliance on data, network effects, the spread of multisided business models, a tendency toward oligopoly or monopoly and volatility. The different types of business models comprises several varieties of e-commerce, online advertising, application based stores, participative networked platforms, cloud computing, high speed trading, and online payment services etc. The digital economy has also accelerated and spread the global value chains in which MNEs can integrate their operations undertaken across the world. There are some recent developments and guidance provided in the tax regulations that has tried to identify and tackle some key challenges posed by digital economy. The same is broadly discussed in this book in a separate chapter.

2. Conclusion

India is expanding the scope of income under source based taxation like any other capital importing country. India is also aggressive in enforcing its source based taxation rule, especially in the fields of electronic commerce, 'equalisation levy' is a classic example for this.

The recent amendments made to the definition of 'Business Connection' by expanding the scope of Dependent Agent and including the concept of 'Significant Economic Presence' to protect tax leakage from digital economic activities, reflects Indian Tax Laws intention to move towards consumption based taxation approach.

Further, as evident from the last G20 summit held at Argentina in July 2018, India and the other developing countries are pushing for better 'Global Digital Tax Rules' for getting their fair share of taxes due from the businesses run on a digital platform. The Indian Government is highly promoting digital business, and given the number of internet users in the world's second largest country in terms of population, it is a serious market for global digital players. Similar, to France's GAFA (Google Apple Facebook Amazon) tax, India may also come up with a similar tax regime in the near future. A significant step in this direction is introducing the concept of data localisation by the Indian Government and mandating the MNC's to store the data of Indians in India.

Further, India has already started making amendments in its tax statutes in line with the recommendations by OECD under the BEPS project, in a phased manner. Indian tax systems beleives that source based taxation system helps in compensating the source country for its contribution to sustenance of the economic activity. Therefore, it follows the principle of benefit test, which is relevant in examining the scope of the PE under international tax treaties.

The concept of PE as provided in tax treaties cannot be undermined in a country like India. Whether or not a source country has the right to tax business profits of a foreign company

would depend wholly on the existence or non-existence of a PE of that company in the source country. The concept of business connection as defined in the Act is broader than that of PE as defined in most of the tax treaties. The tax treaties provide for specific exclusions for a number of activities including those that play ancillary role which describes a lower threshold for tax exposure in India.

India has been successful in negotiating PE conditions/ thresholds in number of tax treaties. A number of treaties signed by India have incorporated service PE which seeks to capture services provided by employee of a foreign country spending certain amount of time in India in providing the services. Service PE exposure in India has gained special significance in the context of cross-border deputations or secondments, a business management strategy that has become quite popular among today's MNEs. The above move of Indian Tax Authorities gives an indication of gradual shift from the conventional source based taxation.

The source based taxation has both pros and cons on the taxation system that requires careful evaluation. However, requirement for source based taxation persists for several reasons including:

1. It is a simple system of levying tax on income earned in India and the provisions paid down focuses on minimising administrative cost as well as the cost of compliance;

2. It encourages Countries to promote business globally through export/ import of capital and international trading.

3. Credit of taxes paid in the source country is preserved and the non-resident entity is able to take full advantage of the same in the resident country.

As an international approach, source based taxation at least prevents potential erosion of tax base but has its own pit falls as it does not take into account a long term approach from an international perspective. At the same time, the source based taxation is not excluded from its own limitations. The application of conventional source based taxation rules to modern day transactions involving intangibles and a fleeting presence in the territory of the source state is difficult. Unless there is some sort of consensus among states regarding the structure and exact threshold for taxation and the scope for conflicting interpretations is reduced, source based taxation may in several cases lead to the double taxation. Considering a long term perspective one needs to develop a comprehensive approach in the direction of resident based taxation with check and balances so that tax base of both the countries does not get eroded and promotes global businesses.