

# Source and Nexus

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# Source

## Source and Source of Income

- Source is a point of origin or procurement
- Source may exist without income, but a natural income does not exist without source
- Source of income needs to be established for any receipt to be taxed

## Section 5

- Under Section 5 “total income of a person includes all incomes from whatever source derived”
- Section 5 taxes residents on their income sourced to India or even outside India
- Non-residents are taxed on India sourced income only
- Section 5 dispenses with type of source due to the prefix ‘whatever’

## “Source” under International Law

- League of Nations conducted a study in 1920 to formulate principles for international tax framework for preventing double taxation
- The study recommended “Economic allegiance” should be the basis for designing an international tax framework
- Economic allegiance is based on factors to measure the existence and extent of the economic relationship between State and the income or person to be taxed

# Source

- The four factors of economic allegiance are
  - (i) origin of wealth or income,
  - (ii) situs of wealth or income,
  - (iii) enforcement of the rights to wealth or income, and
  - (iv) place of residence or domicile of the person entitled to dispose of the wealth or income
- Conclusion of such study was to give most weightage to “the origin of the wealth (i.e., source) and the residence or domicile of the owner who consumes the wealth (i.e., residence)”
- Bilateral tax treaties adopt the “classification and assignment of sources” method. Different types of income are subject to different distributive rules
- If income falls under more than one category, then double tax treaties resolve the conflict through ordering rules
- Distributive rules - granting one contracting state the exclusive (or priority) right to exercise domestic taxing rights, while reserving a residual taxing right for the other contracting state

# Nexus

- Nexus signifies a link or a connection
- Nexus is the connection between the income of a taxpayer and a taxing jurisdiction
- Under tax law, nexus is relationship between a taxing jurisdiction like a state and a business/stream of income
- Nexus is a pre-requisite for taxing authority to impose tax

## **Territorial Nexus**

- States have right to tax all income generated within its territory
- Such system compensates the source country for its contribution to sustenance of the economic activity
- Law of a state are not applicable outside the territorial boundary of that state, except incase of nexus between state and object
- Nexus/ connection should be real and not illusionary

# Nexus

## Digital Economy

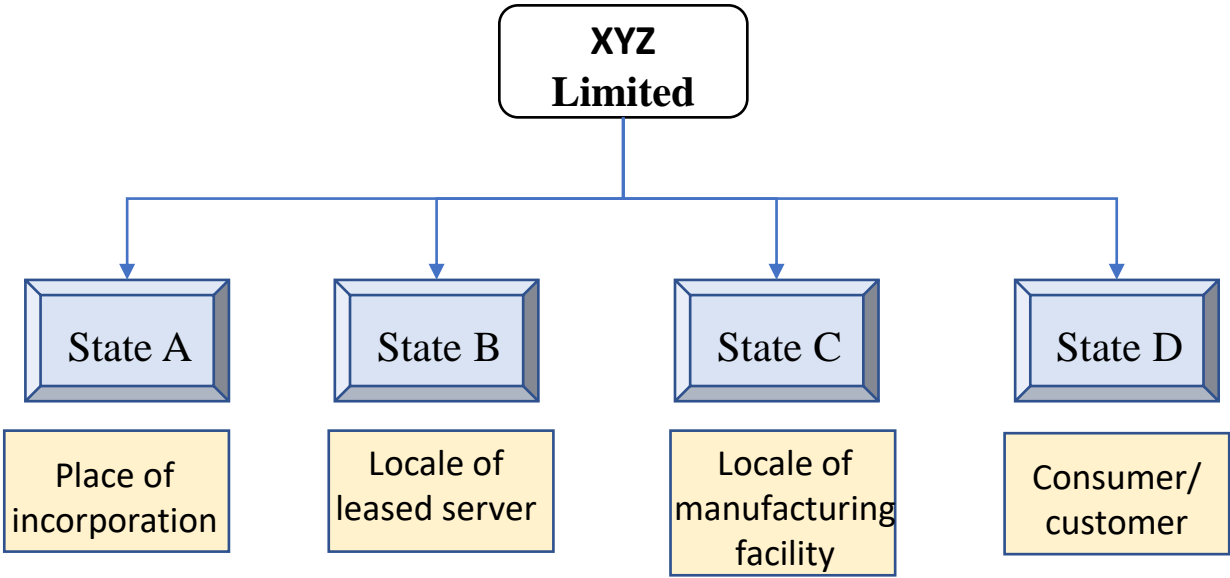
- Fundamental elements of the global tax system determining where taxes should be paid ("nexus" rules based on physical presence) and what portion of profits should be taxed ("profit allocation" rules based on the arm's length principle) are increasingly under challenge
- Current rules are based on the physical presence of taxpayers and assets. They are not suited to a digital economy characterized by intangible assets and ubiquitous services with undeterminable locations
- Today, three important phenomena facilitated by digitalization - scale without mass, reliance on intangible assets, and the centrality of data - pose serious challenges to the foundation of global tax system
- Internet transactions have no central point, no physical location, and hence, may not fall within any country's jurisdiction. This could lead to 2 possibilities - double taxation or non-taxation
- Tax challenges in the digital economy – As per the BEPS Action Plan 1, the challenges could be captured under three broad categories:
  - Nexus
  - Data
  - Characterization

# Nexus

## **OECD Initiative to address Tax Challenges of Digital Economy**

- OECD and G20 nations constituted BEPS project to target tax strategies aimed at artificially shifting profits to low or no-tax locations
- Action Plan 1 “Addressing the Tax Challenges of the Digital Economy” of BEPS deals with tax aspects of the digital economy
- BEPS Committee, among others, recommended new nexus based on Significant Economic Presence

**Source v Nexus**



Reason for tax	Source or nexus?	Source or nexus?	Source or nexus?	Source or nexus?
Form of presence	Legal or statutory presence	a) Expenditure b) Leased asset	Business Operation	Product consumption & payment

**Points for discussion**

**Source of income**

- Is source of income an economic phenomenon?
- Is expenditure also a source of income?
- Is source the genesis of attribution yardstick?

**Nexus**

- Is nexus person specific?
- Is it necessary that nexus for tax purpose need to be economic?

**Source v nexus**

- Every source of income constitutes a nexus; while every nexus may not have a source.
- Is source subservient to nexus or vice-versa?

**Emerging trends:**

- (a) Transaction tax or tax on gross basis is the new norm
- (b) Distancing of transaction tax from tax on income
- (c) Whether multilocal levy should ensure that overall income taxed does not exceed the real income earned?