Source and Residence Principles

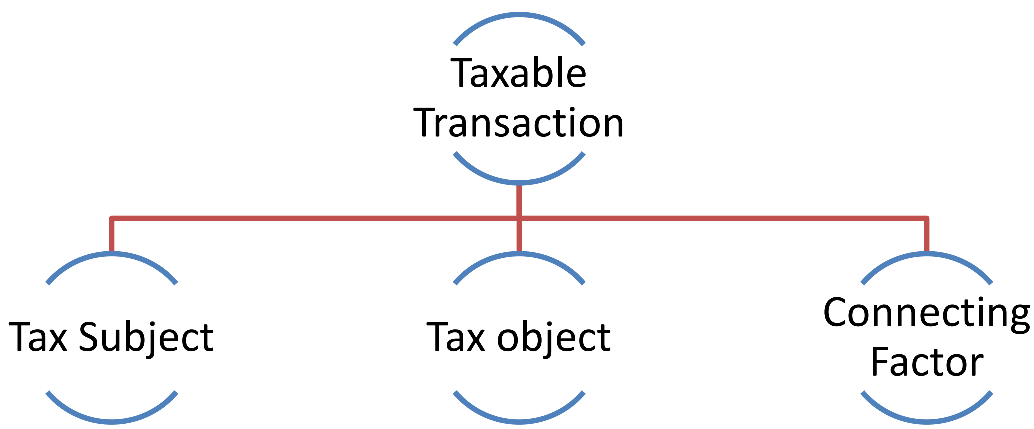
Meaning and Effect of International Taxation:

International Taxation refers to the global taxation rules and legislations which apply for cross border transactions.

Taxes are not international. Each country its own taxing rights under the domestic laws. More likely than not, when a taxpayer involves in a cross border transaction, he would end up with much higher tax liability compared to a domestic transaction. In many cases, the taxpayer would be subject to double or multiple taxation due to overlapping taxing rights.

Key Components of any Taxable Transaction:

For any transaction to be taxable, the following three components should be present:



Tax subject: Identity of tax payer or person's relationship to taxed object that creates tax liability ("Who can be taxed?")

There are two main categories of tax objects:

a. Residents: Taxable on worldwide income ("Unlimited/Full Liability)
b. Non-Residents: Taxable on income and gains within the country ("Limited Liability")

Tax Object: Identity of subject matter or facts of the case which cause tax liability ("What can be taxed?")

Connecting Factors: "Reasonable connection" between taxing powers of state and taxpayer or transaction. ("Why it can be taxed by this country?")

International taxation governs the taxing rights of sovereign nations. Each nation's rights depend on the fiscal jurisdiction. So the subject of the state sovereignty is the part of the globe to exclusion of any other state where it can exercise effective and acceptable power.

Fiscal Jurisdiction involves two rights of the State:

a. Right to legislate
b. Right to enforce

Limits to fiscal jurisdiction:

There are two schools of thought for a country's limit to fiscal jurisdiction.

- First school believes that there is no restriction on a State's power to tax and can also be exercised with regard to other states as well.
- The other school of thought confines the ability to tax to the territory which has the legally relevant connection.

Both the schools of thought accept that connecting factors give the state a right to tax.

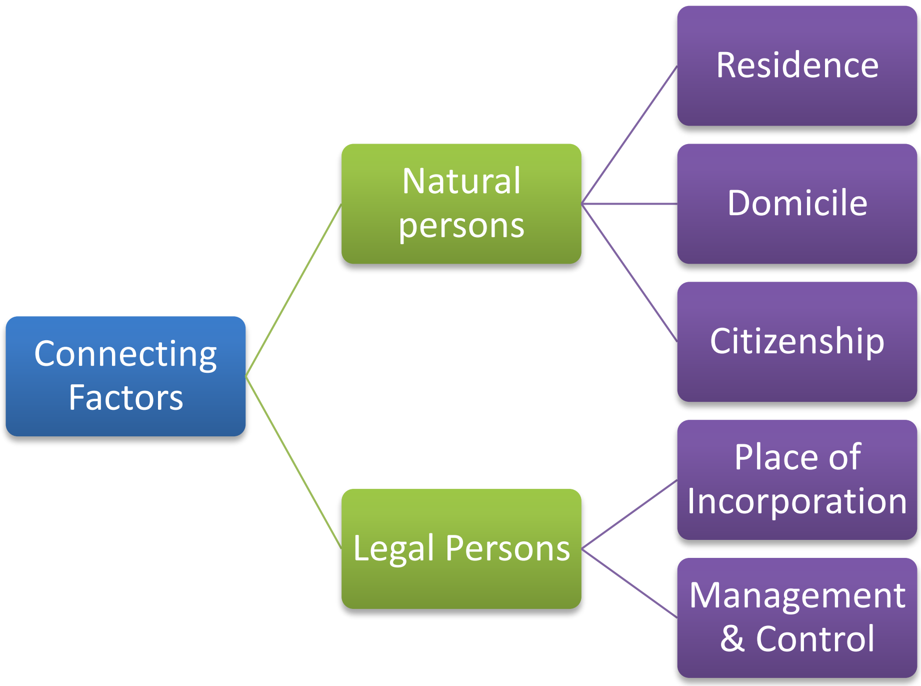
All these connecting factors link the taxpayer to the specific tax jurisdiction.

Only the domestic tax law determines what the connecting factors are.

The connecting factors are generally based on residence, nationality or domicile of tax payer for tax subject and on the source rules over income or gain for tax object. Other factors which can create a connecting factor can include:

- Situs of Transaction or asset
- Nature of transaction or business operation
- Character of payment

Types of Connecting Factors:



What is double taxation?

There would have been no need for International tax principles if every person or income was subject to taxation only in one state.

Double taxation arises when two or more countries get the competing taxing rights.

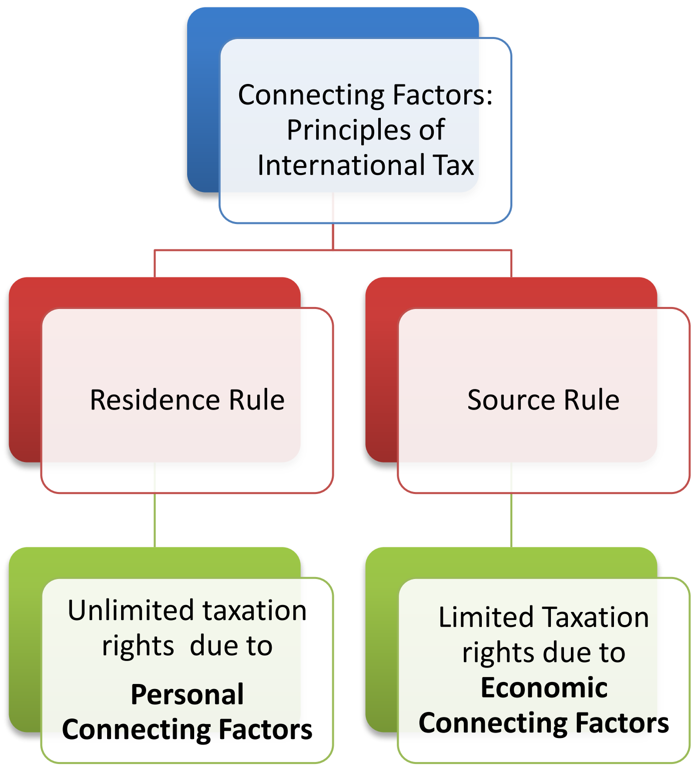
Why does Double taxation arise at all?

Double Taxation primarily arises due to connecting factor conflicts. Double taxation is over taxation due to overlapping taxing rights.

The varying definitions lead to connecting factor conflicts:

- Source-Source Conflicts: Two or more countries claim that same income is sourced in both the countries
- Residence-Residence Conflicts: Two or more countries consider same taxpayer as tax resident in their country
- Residence-Source Conflicts: Taxing same income twice; Country where it is derived under “source rules” and then in the country of residence of taxpayer under “residence rules.” This is the most common form of juridical double taxation.
- Mismatching Tax systems: This could be due to the following reasons:
  - Characterization of income: Same income is classified differently as income or capital differently.
  - Two or more tax systems provide for differing rules for computation of tax or income differently.
  - Entity conflict: classified as different entities in both tax systems.

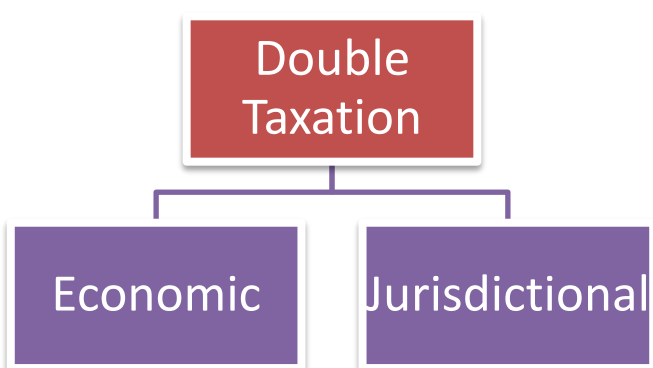
How do domestic laws in normal countries apply connecting factors to international tax principle?



Residence Rule: Unlimited taxation rights are granted to country of residence due to the personal attachment factors. Countries chose impose taxes on worldwide income due to the protection it offers to the tax subject.

Source Rule: Limited taxation rights are granted due to the "economic attachment" of persons. Source country deserves right to tax due to the economic attachment of the persons. Income derived from economic activities within territory

Types of Double Taxation:



Economic Double taxation: Double taxation on same income in the hands of different persons. The same object is taxed on legally separate persons but economically similar subjects in two jurisdictions.

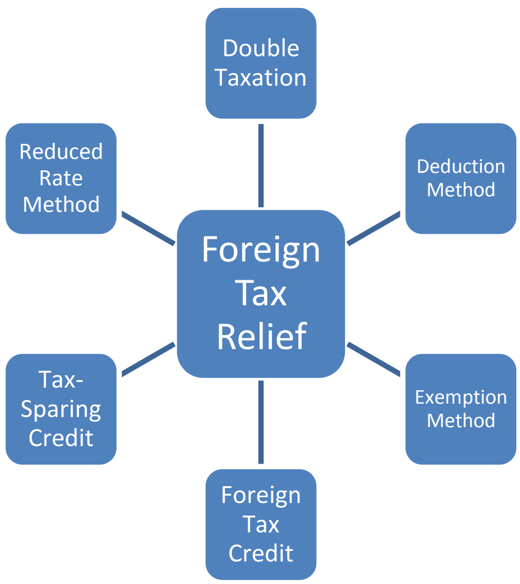
Juridical Double Taxation: Double taxation on the same tax object and subject matter and for identical periods. They are a result of conflicting tax systems.

International tax law is primarily concerned with reducing the juridical double taxation.

Modes of Foreign Tax Relief:

Taxes on income may be taxed in source state through withholding tax or tax payment under assessment procedure. Unless foreign income is tax exempt, Double Tax would arise if it was taxed again in the state of residence.

The foreign source of income residents can be treated in domestic law in various ways:



1. Foreign income is taxable despite the fact that taxes were suffered on same income in the source country (Double Tax)
2. Foreign income is taxable but taxes paid are deductible as an expense in the source country.(Deduction Method)
3. Foreign income is exempt from tax (exemption method)
4. Foreign income is taxable, but taxes paid on foreign income are credited against taxes due (foreign tax credit)
5. A credit is given for notional taxes that are not actually payable in source country (Tax-sparing credit)
6. Foreign income is taxable; but at a reduced rate (Reduced Rate Method)

How is Double Taxation relieved?

This double liability is often mitigated by tax treaties between countries. However when a tax treaty does not exist, unilateral tax relief can be provided.

Types of relief/credit on foreign income

- Double tax relief (DTR)
- Unilateral tax credit (UTC)

What is double tax relief (DTR)?

A DTR is the credit relief provided for under an Avoidance of Double Taxation Agreement (DTA) to reduce this double taxation. A DTR is granted by allowing the tax residents to claim a credit for the amount of tax paid in the foreign country against the Residence tax that is payable on the same income. It is estimated that more than 2500 bilateral treaties and protocols are in existence today.

What is unilateral tax credit (UTC)?

Between countries which do not have a DTA, UTC may be allowed for foreign tax paid by Home tax residents on the certain types of income derived from foreign country.

DTR and UTC in India:

India has comprehensive Double Taxation Avoidance Agreements (DTAA) with 88 (signed 88 DTAAs out of which 85 have entered into force) countries. This means that there are agreed rates of tax and jurisdiction on specified types of income arising in a country to a tax resident of another country. Under the Income Tax Act 1961 of India, there are two provisions:

i. Section 90 is for taxpayers who have paid the tax to a country with which India has signed DTAA
ii. Section 91 provides relief to tax payers who have paid tax to a country with which India has not signed a DTAA.

Thus, India gives relief to both kinds of taxpayers.

Common Techniques of International Tax planning:

The most common and popular tax planning techniques are:

Split of Pre-tax profits among various tax beneficial jurisdictions through source allocation (Profit Sharing): A MNC could appropriately structure its worldwide business structures to optimize taxes. A manufacturing process can be split to make high value added activities in a low tax base and semi-finished low-profit processing goods can be done in a high tax base area. Sales and marketing activities can be carried out through overseas entities.

Extraction of pre-tax profits from high-tax countries through legitimate tax deductible charges (Base Erosion): Taxable profits can be shifted from high tax jurisdictions to low taxed countries through tax deductible expenses like interest, royalty, management expenses. It can be achieved through use of acceptable transfer pricing and commercial substance rules within the group.

Exemption of taxable income due to lack of connecting factors with tax jurisdiction (Connecting Factors) Tax planning involves breaking or fracturing the connecting factor with either home country or host country or both.

Use of third countries to reduce taxes (Treaty Shopping): Treaty shopping can reduce withholding taxes and rationalize tax burden. Use of intermediary tax heavens reduces withholding taxes in the source country and also impose minimal taxes on incomes derived in the host countries. As per a report in early nineties, more than half of world's financial transactions took place in offshore financial centers.

Conclusion:

According to a 2006 Report, International financial services generate about USD 2 trillion a year in revenue. The forecast is expected to triple by 2020.

The international taxation revolves around the different tax systems in the world. The scope of taxation and tax rules differ significantly. An international tax planner shall be most sought after with the increasing globalization and vanishing border lines. Understanding the basic tenets and principles of international taxation strongly shall more clearly elucidate the systems built on these tenets.