Source Vs Residence Basis of Taxation

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(**Note** – Aim of this write-up is not to deliberate on complexities of involved provisions of tax laws, but, to consider the changes in manner of taxation from time to time, on a bird's eye-view perspective).

1. Core principles

Right from the ancient days of Arya Chankya, theories of taxation of subjects by the state, have assumed crucial importance. Ways and manner of collecting taxes typically vary, but all are in one voice to say that, "taxes are what we pay for a civilized society". It is a sort of a social contract. This initial principle got enlarged over ages and, taxes have now become crucial source to ensure, and demonstrate, social justice. It got further enlarged on the point that, by resorting to taxation, what is attempted is, vertical and horizontal equity. Residence based taxation is built on the popular belief that, every country has right to tax it's subjects (national sovereignty). Source based taxation relates to quest that, a country has right to tax all activities/ transactions/events which take place on it's soil (territorial/sovereignty). Whereas, the Residence based taxation relates to attempting.

capital export neutrality (CEN), the So urce based taxation relates to capital import neutrality (CIN). It is not the focus at present to deliberate amongst these two. But, these two methods of taxation, based on their respective core principles, resulted into the emergence of the third (and more important) principle that, double taxation ought to be avoided for ensuring free flow of capital and smooth happening of business transactions. After the waves of globalisation, this emerged principle led to entering into DTAA between various countries. After the super-fast arrival of digital economy, and after experiencing some harmful practices, the yester-years core principles started asking for a revisit; leading to BEPS and MLI, etc. The saga of changing winds continues. We have witnessed attempts of inducing free flow of funds and seamless business transactions through some taxing measures. We have also witnessed some anti-evasion measures. At one hand, provisions are made not to identify certain activities as a taxable event; and at the other hand, provisions are made to identify some activities as taxable events. Till date, many oscillations are being experienced, and the journey has remained complex, yet, fascinating.

2. Different Eras being witnessed

Here is a quick table of different (and broad), time-zones, being witnessed by one and all. These are

Era	Years	Particulars
I.	Pre-Year-1920	Residence based Taxation.
II.	Year 1920 to Year 2011	Residence based and Source based Taxation.
III.	Post 2011	Duel Taxation, with layer of MLI (Threat of base erosion due to digital economy realised by all, leading to BEPS programs implementation, etc.).
III.	Year 2021 onwards	Vibrant Taxation System which copes up with digital economy, leading to recognition of "modern sources" of taxation OR Pillar-1 + Pillar-2 (Global profits of entities to be centralised hypothetically, and distributed amongst bonafide nations in proportion to "assets" + "employees" + "market", etc. etc.).

3. What is a "source" for taxation –

This crucial term "source" of taxation, is not defined in the ITA or in the DTAA, though it has been used at number of places. The said term has been interpreted by various courts. In the case of **Rhodesia vs. Comr. of Taxes– 9 ITR Suppl. 45, 52 (PC),** regarding a source of income, it was observed as ".something, which a practical man would regard as a real source of income..". In the case of **Seth Shiv Prasad vs. CIT – 84 ITR 15 (All)** it was observed as "..a spring or fount from which a clearly defined channel of income flows.." In the case of **Performing Rights Society Ltd vs. CIT – 106 ITR 11 (SC),** as per facts of that case, the assessee, an English company, got license to broadcast it's musical works from All India Radio Stations.

As the contract was entered into in London, it was claimed that, no accrual of income takes place from India. Negating this proposition, it was observed that, "..income derived from broadcast of copyright music from the stations of All India Radio arose in India...". Courts by and large, have been considering the place of real activity, as the origin of income, which can be classically understood as the "source".

Pursuits were continuous in identifying sources for taxation. As stated earlier, the pursuits were of a two-fold nature, identifying events for taxation at one hand and identifying events as not eligible for taxation at the other hand.

4. Situations where, events are identified as " not taxable" events

The popular belief of taxing a "source" per se, and conversely, not taxing activities which do not yield to a "source" of taxation; has been respectfully appreciated in number of situations. This process appears based on yet deeper principle that, unless a subject mixes with the economy, it ought not to be visited with taxation. Through the beautifully drafted words of the ITA, 1961 and through many DTAAs to which India has been a party, one can witness the zeal in yester - years, not to assume domain over such transactions, which do not result into a "source" by themselves. Here are some examples,

Section/Article	Point
10(6)(vi)	Short stay exemption to a Non-Resident.
9(1)(i), Explanation-1(b)	Activities of mere purchase of goods for export not to be leading to any taxable event in India.
9(1)(vii), Explanation-2	Services of construction, assembly, mining or like projects not to be considered as "fees for technical services".
9(1)(vii)	Services utilised in a business or "source" outside India, not to be considered as "fees for technical services" for taxation in India.

Article-12(4) of DTAA between USA and India	Payment for such services, which, do not make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design; are not to be considered as "fees for included services" for taxation.
Article-5 of DTAAs	Establishments of non-residents not to be taxed unless stipulated "days".
Article-14 of DTAAs	No taxation for independent personnel (like professionals, etc.) unless.

Many similar examples exist in the taxation system (ITA + DTAAs) at present. These exceptions to general taxation, can be considered as, a recognition of concept of "absence of source" based on the deeper concept of "absence of mixing in the economy". As stated, pursuit appears that, free flow of capital and smooth business functioning ought to be ensured, without any double taxation.

5. Situations where, events are identified as "taxable" events

At the same time, the pursuit of protecting and increasing the tax base, has also been witnessed from time to time. Many approaches are assumed in this regard, more importantly, in recent times of last 10 years. At one hand, scope of "resident" is enhanced and at the other hand, scope of "sources" are enhanced. Charge of tax is becoming tougher day-by-day. Here are few examples.

Section/Article	Point
6(1A)	Citizens of India, having income more than Rs. 15 lacs in India, is to be charged on his global income (on RNOR basis), if such global income is not liable to tax in any other country.
6(3) read with Explanation	Non-Indian companies having their place of effective management in India, are considered as resident for taxation in India.
9(1)(i) read with Explanation-2A	Significant Economic Presence (i.e. SEP) recognised as a tax eligible event, provided the thresholds are met.
9(1)(i) read with Explanation-3A(i)	Advertisements targeted for Indian customers recognised as a taxable event.
9(1)(i) read with Explanation-3A(ii)	Sale of "data" of Indian residents or of persons who use internet protocol address located in India, recognised as a taxable event.
9(1)(i) read with Explanation-3A(iii)	Use of "data" of Indian residents or of persons using internet protocol address located in India, recognised as a taxable event.
9(1)(i) read with Explanation-5	Location of a "share" in India, it such "share" derives substantial value from assets located in India.
9(1)(vi) read with Explanation-3 & 4	A cross border sale of copyrighted softwares was assumed as "Royalty" leading to highly debatable creation of a "source" of taxation.
Section 165 of Finance Act, 2016	Equalization levy of 6% on online advertisement payments made to non-residents.
Section 165A of Finance Act, 2016	Equalization levy of 2% payable on consideration received/receivable.

Many similar examples exist in the taxation system (ITA + DTAAs) at present. Interplay between ITA and DTAA is becoming stringent due to compulsion of TRC before sourcing a DTAA. Further, as per the super-imposed layer of MLI, sourcing a DTAA is to become tougher every time.

Above referred "sources" of taxation are considered as "inchoate sources" for the purpose of present discussion. Taxation through these "inchoate sources" is disputed at various levels, and that by itself, is a separate subject matter of discussion. These 'inchoate sources" taxation, may lead to adverse and harsh taxation, though these steps were inevitable due to harmful tax policies of some digital players. These measures were resorted to for protecting and enhancing the tax base. In the process, some adverse situations are getting formed.

6. Threats and challenges of past period

Over past many years, the pursuit of various states, of maintaining/preserving their source based taxation rights, have posed some challenges. It is felt, at times, these responses assume anti-trade nature. Here are some examples –

a) At times, we witness endless war with tax authorities on aspect of making TDS on cross-border services. Whether or not, these services lead to presence of a "source" in India, is lost sight off. Many unresolved mysteries still exist in this regard. For example,

(i) A rudimentary service does not lead to a "source" per se.

(ii) A service subsumed into imported products is not liable to be "utilised" as such.

(iii) Automated services are void of "human intervention".

(iv) Noscitur A Socii principle has to be reached before characterising a service as an eligible "FTS" under section 9(1)(vii) as well as under Article-12 of DTAA (having no "Make-Available" rule).

b) Issue of characterisation of payments for shrink-wrapped software licenses, whether a Royalty or a mere business income, was a dispute area for over 15-20 years.

c) Typically, gross revenue based TDS mechanism provided in local laws and in DTAAs leads to extra costs. For example, consider case of some enterprise running in a tax loss situation in (say) Germany, and providing some technical services in India. A withholding of 10% tax will lead to a permanent loss and extra cost of business. Same is case for an enterprise whose final tax liability on net income, in the state of residence is much lower, compared to tax withholding on gross revenue in state of source; again leading to a permanent loss and extra cost of business. No direct mechanism exists for lowering such tax withholding/TDS.

d) Due to characterisation of normal business activities into streams of 'Royalty' or 'Fees for Technical Services', needless disputes arise on transfer pricing, timing differences and so on.

e) Consider the classic case of Equalisation Levy (E-L), which is not a part of direct tax enactment in India. Now, E-L was imposed, due to emergence of digital economy, due to which, source state's tax base is eroding. Yet, it has been imposed in a manner, which creates inherent difficulties in claiming the tax credit. As a result, it leads to extra cost of doing business.

7. Tussle between Countries/states

Similar to India, many other countries have started imposing taxes akin to Equalization Levy, such as Digital tax, Electronic Transaction Tax, Non Resident Tax, etc. All these moves are on similar lines as of India, i.e. to protect and enhance tax base of events, i.e. "sources" in their respective countries. It has been in the public news recently, that USA is proposing a retaliatory action against imposition of Equalization levy by India and other countries, on the on-line supplies of e-commerce operators or on the digital services. These retaliatory moves are bound to be countered through some other means. The Tussle will continue, though the process will hamper the core principles of free flow of capital and seamless business transactions across various jurisdictions.

8. Emergence of "modern sources"

As transpires, the Legislative thinking is leaning towards identification of modern sources which yield income. This thinking is akin to reality, though it has lagged in time. These "modern sources" are expected to replace the "inchoate sources" of past periods with a jet speed. Now, arguments will keep on emerging; whether the manner is correct or not, whether the quantification is appropriate or not, and so on. For example, the definition of "SEP" in Explanation-2A of section 9(1)(i) could be criticized on literal interpretation view, saying that, "SEP" may cover all cross border deals of simple purchase/procurement of goods and services. A purposive interpretation could settle such literal reading. Relevant Explanatory Memorandum reveals the intent behind introduction of "SEP, i.e. intent to overcome issue of absence of physical presence in actual transactions (taking place through digital/virtual presences) in India. Objections can also be raised for other "modern sources" like "data" or "user base" or "target audience" and so on. Point is, the need of locating these "modern sources" was a MUST, which has been now legislated, and which will possibly eliminate "inchoate sources". And the attribution principle will lead to a 'net income' taxation instead of 'gross revenue' taxation. This fall-out will be most precious, albeit tough to implement. Corridors of tax department will be flooded with applications for lower/NIL TDS certificates, considering quantum of 'net income' as against the 'gross revenue' taxation. Indeed, this tedious procedure will be quite challenging, though it will be a welcome situation as against potential /permanent loss taking place in taxing the gross revenue in an ad-hoc manner presently. In short, challenges and difficulties will be many, though these issues will finally enhance the cross-border trade and commerce.

9. Recent Notification and impact on "source" based taxation

Vide notification dated 3/5/2021, CBDT has notified the thresholds of recognizing Significant Economic Presence (SEP) as under –

(i) Transactional payments over Rs. 2 CR in a previous year.

(ii) Interactive users over 3 lakhs Above thresholds demonstrate that, casual connections or such transactions which do not create any dent of "mixing in economy" are not the target situations for making an "SEP". The "mixing in economy" principle is addressed in an ad-hoc quantification way. Be that as it may, in many a situation, the above thresholds would be met easily. As such, all those web-sites and portals wherefrom downloads take place or, which have many users attached, etc.; will enter into the taxation ring of "SEP" now. And very rightfully so, considering the core principle of "mixing in economy". adventurous to say that, GOOGLE or YAHOO or NETFLIX have not mixed with the Indian economy. The old yardsticks of taxing physical presences are being replaced by logical presences such as "SEP"/"data"/"users"/"customers" and so on. In one sense, the moves are in right direction, albeit they pose difficulties of implementation.

10. Optimistic fall-out of recognition of modern "sources"

As said earlier, many conscious amendments vide Explanation-2A + Explanation-3A have been inserted into the ITA, 1961. Now, assuming that, similar amendments take place under the DTAAs in the years to come, the inchoate and artificial sources which have emerged in the tax system might find their way out. E-L, being a short- term measure will certainly move out as per the specific intent revealing from Explanatory Memorandums of Budget 2016 and Budget 2020. Now, once these "modern sources" assume the field, number of tax controversies will be non-issues. Here are some examples.

a) Assuming that SEP is triggered for Microsoft; downloads of WINDOWS software will lead to taxation, and concluding the long- drawn litigation on "copyright" v. "copyrighted products".

b) If "users" criteria is applied for GOOGLE; litigation of existence of a "PE" of GOOGLE, or, whether payment for "AdWords" algorithm is Royalty or not, will be a non-issues.

c) If "Indian customers" criteria is used for Advertisements on NETFLIX; issues of Equalization Levy for Online Advertisements will be irrelevant.

d) Assuming "SEP" is triggered for knowledge database companies (say GARTNER) due to consideration paid for access to database; issue of Royalty will not arise anymore.

e) Assuming "SEP" is triggered for lease of satellite transponders to TV channels for relaying programs; issue of Royalty does not survive Firstly, with recognition of these "modern sources", the attempts to tax "inchoate sources" may get a full-stop. Secondly, while taxing the modern "sources", only income attributable to India will be liable for tax as per the express declarations in section 9(1)(i). In short, if these "modern sources" lead to appropriate taxation, it would lead to roll-back of the core principles of avoiding double taxation and ensuring free flow of capital and seamless business across various jurisdictions.

11. Optimistic fall-out of Pillars based taxation

At the same time, we are witnessing another paradigm shift from traditional taxation approach to a new top-down approach under Pillar-1 and Pillar-2. In Pillar-1, it is sought to consolidate global profits of an enterprise and allocate part of it to the various markets where the products are sold. "Market" or "Marketing Intangible" is give key importance in this approach. In one sense, a yet new "source" rule is evolving. If the Pillar-1 based taxation gets introduced, it may overcome artificial inchoate sources assumed in many situations. Extra cost situations of permanent losses of tax withholding will disappear. It is true that, reaching a consensus of all states for a uniform measure like Pillar-1 is an extremely tough challenge. All pervasive mechanism acceptable to various states for implementing Pillar-1 is yet to evolve. But, considering experience of MLI, it can be argued that, such a tax policy could become a reality of tomorrow. Further, under Pillar-2 mechanism, harmful taxation practices of tax heavens and treaty shopping could be eliminated. It can be expected that, with such changes mechanism, tussle between residence v. source based taxation may diminish to a large extent

12. Conclusion

From an optimistic perspective, it is felt, through the resolve of taxing the "modern sources", situation may finally settle for net income taxation, removing potential and permanent losses of tax payments in source states and concluding issues of characterisation and timing differences..

79.7
16.8
17.3
16.9
50.8
13.4
36.7
18.7
12.9
1.9