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Stateless Income and Taxation Law: Tapping the Untapped

Dr. Girjesh Shukla
Himachal Pradesh National Law University, Shimla

ABSTRACT: *The Annual Financial Statement for the Financial Year 2020-21 has brought many reforms in direct taxation. After sweeping reforms in indirect taxes via Goods and Services Tax (GST), the Government of India continued the much-desired reforms in the direct taxes as well. One of such reform is made rules pertaining to residency requirement under Section 6 of the Income Tax Act, 1961. With these amendments, the tax reforms have come to a more logical conclusion. Both these amendments have attempted to tap the untapped sources of taxation. These amendments are based on the fundamental premise that Indian citizens, irrespective of their sources of income, have the legal responsibility to pay taxes unlike an individual who is not a citizen of India. Further, by putting a cap on minimum income limit from foreign sources, the policy of taxing Indian citizen for their foreign income will not disrupt the rational tax system.*

This work presents a critical analysis of 'stateless Income' under the tax law and examines the above two premises whiling imposing the tax on Indian citizens on their foreign income.

KEY WORD*: Stateless Income, Taxation, Tax Avoidance, Tax Law, Principle of Territoriality.*

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I. INTRODUCTION

The Annual Financial Statement for the Financial Year 2020-21 has brought many reforms in direct taxation. After sweeping reforms in indirect taxes via Goods and Services Tax (GST), the Government of India continued the much-desired reforms in the direct taxes as well. One of such reform is made rules pertaining to residency requirement under Section 6 of the Income Tax Act, 1961, hereinafter referred as Act of 1961. In fact, the journey for reforming the 'residency rule' prescribed under Section 6 of the Act, 1961 begin with the introduction of 'Place of Effective Management (POEM)' by the Finance Act, 2016. However, with the amendments in Explanation 1(b), to Section 6(1) and insertion of Sub-section (1A), the reform has come to a more logical conclusion. Both these amendments have attempted to tap the untapped sources of taxation. These amendments are based on the fundamental premise that Indian citizens, irrespective of their sources of income, have the legal responsibility to pay taxes, unlike an individual who is not a citizen of India. Further, by putting a cap on minimum income limit from foreign sources, the policy of taxing Indian citizen for their foreign income will not disrupt the rational tax system.

This work presents a critical analysis of 'stateless Income' under the tax law and examines the above two premises whiling imposing the tax on Indian citizens on their foreign income. For this purpose, the work is divided into four parts. Part-I of the work examines the concept of 'statelessness' under the tax law. The Part-II of the paper, author will examine the recent amendments made under the Income Tax Act, 1961 relating to residency rule. Finally, the Part-III will critically outline the reasons behind change in tax policy initiated by government of India and its impact on Indian economy in general.

PART-I: STATELESS INCOME & TAXATION

The duty to pay taxes is based on the rule of 'residency' rather than the 'citizenship'. Thus, all the individuals, irrespective of their citizenship, are required to pay taxes once they fulfil the residency requirement. This rule is much closer to doctrine of 'sovereignty' or 'territorial sovereignty' as often quoted and debated under public international law. As per the rule notion of 'territorial sovereignty', states, which are subjects of international law, are free to legislate in their territorial limits only. Legislations enacted by these states, inclusive of executive action or policies, will have the enforcement limit qua the territorial jurisdiction. Most of the Tax Jurisdictions currently use territorial-based regimes instead of worldwide regimes. Twenty-seven of the thirty-four members of the Organization for Economic Co-operation and Development ("OECD") have territorial regimes. The principle of territoriality is not new. The state conceptualised through Peace Treaties of Westphalia (1648) has recognised that each State is sovereign over its own territory, and while interacting with other states the 'sovereignty' shall be protected and preserved. Thus, the sovereignty had become fundamental to the international legal order. This notion of sovereignty ruled the world legal order for centuries, and is reflected in the United Nations Charter through Article 2(1) which inter alia states that "the [UN] Organization is based on the principle of the sovereign equality of all its Members".

Apart from concept of sovereignty, the states have confirmed the principle of territoriality due to many factors. Prof. Kleinbard argues that “the recognition of the separate tax personas of different juridical persons, even when commonly owned, the deductibility of intra-group interest, rents and royalties, the freedom of a multinational enterprise to deal with a subsidiary as an independent actor for arm’s-length contracting purposes, and the freedom to situate the economic rents attributable to unique business opportunities in a low-taxed affiliate” are the reasons behind stateless income. He further states that stateless income also flourishes because of nations’ collective failure to develop robust ‘source rules’ for income derived from intangible assets.

To deal with ‘stateless income/entities’ the BEPS Action 13 report states that an Multinational Enterprises (MNE’s) Country-by-Country Reports (CbCR) should include tax jurisdiction-wide information relating to the global allocation of the income, taxes paid and economic activity in tax jurisdictions in which the MNE operates. The report further provides for specific instructions to all the state to have separate data of all constituent entities that are not resident in any tax jurisdiction for tax purposes. The report identifies following entities which are marked as ‘stateless entities’:

(a) **Non-transparent entities with no tax residence**: Entities that are not transparent for tax purposes, but do not meet the requirements to be considered tax resident in any jurisdiction. In the first case, unless the entity undertakes activity through a permanent establishment (PE), or measures such as controlled foreign corporation rules apply, there is a risk that profits may not be taxed anywhere.
(b) **Transparent entities resident in a different jurisdiction:** Entities that are tax transparent in the jurisdiction in which they would otherwise be resident, which are held by constituent entities resident in a different jurisdiction. In such cases, whether the entity’s profits would be subject to tax or not will depend upon whether the entity is viewed as tax transparent in the jurisdiction of the entities that own it (resident in a different jurisdiction), and whether the hybrid mismatch rules recommended under BEPS Action 2 apply.
(c) **Transparent entities resident in the same jurisdiction:** Entities that are tax transparent in the jurisdiction in which they would otherwise be resident, which are held by constituent entities resident in the same jurisdiction (e.g., shareholders, partners). In this case, whether the entity’s profits are subject to tax will depend upon the tax rules applicable to the entities that own it (in the same jurisdiction).

Stateless Income & The Income Tax Act, 1961

The Income Tax Act, 1961 confirms the territoriality rule. Section 5 of Income Tax Act, 1961 provides the general rule pertaining to the ‘total income’ of a person, and the provision is in conformity with the ‘principle of territoriality’. For academic convenience, the author has used the expression ‘Indian Income’ and ‘Foreign Income’ throughout the work. The expression ‘Indian income’ or ‘foreign income’ is not defined anywhere in the Act of 1961. However, about this work, an income ‘received/deemed to be received in India’ or ‘accrues/arises or deemed to accrue/arise in India’ could be referred as ‘Indian Income’. The income which ‘accrues or arises outside India’ could be called as ‘foreign income’.

According to Section 5 of the Act, 1961, the ‘total income’ of a person who is ‘resident of India’ in accordance with the Section 6 of Act of 1961, shall include all his ‘Indian income’ as well as ‘foreign income’, however, if the person is ‘resident but not ordinary resident’ (RNOR) his ‘foreign income’ shall not form the part of total income unless the same is derived from a business controlled in or a profession set up in India. Thus, a person who is ‘resident and ordinary resident’ of India (ROR) is required to pay income tax on all the income derived from whatever sources. If the assessee is RNOR, he would pay income tax on ‘Indian income’ along with such ‘foreign income’ which is ‘derived from a business controlled in or a profession set up in India’. The corollary of this rule is found in sub-section (2) of Section 5, which inter alia provides that the total income of a non-resident Indian would include ‘Indian Income’ only. Thus, the ‘foreign income’ received by a non-resident Indian is excluded from the total income. This is further to be noted that the Sub-section (2) of Section 5 begins with the phrase ‘subject to other provisions of this Act’. Under the Income Tax Act, 1961, there are certain categories of income which though have the characteristics of a ‘foreign income’ but, by virtue of deeming provisions, are categorised as ‘income deemed to accrue or arise in India’, and thus forms the part of total income of a non-resident Indian. These categories of income often accrue by way of ‘business connection’, as defined under Section 9 of the Act, 1961.

It seems that the Income Tax Act, 1961, by and large, confirms the ‘principle of territoriality’ in levying taxes on income which have direct or indirect connection with the territory of India. It is because of this reason that the Act of 1961, hitherto, has maintained the requirement of territoriality in terms of ‘residence requirement’ or ‘business connection’ for making the assessee liable to pay taxes on his/her income. The non-resident Indians were exempted from paying taxes to their ‘foreign income’.

The residency requirement for imposing taxes on income sometimes results into ‘statelessness’. This can be understood with following hypothetical situation. Mr. A is citizen of India. For last 10 years, he stayed at different parts of the world. Mr. 'A' works as professional service provider and does not have permanent residence anywhere except in India. For the Financial Year 2018-19 he visited India in connection with professional services and stayed for a period 150 days. By virtue of Section 6(1) of the Act, 1961 the residency requirement will not be complied of, and he shall be treated as non-resident. There is all possibility that Mr. 'A' has might have stayed in those countries/tax jurisdictions where similar rule of residency is required for tax liability. Thus, Mr. 'A' might have escaped from paying taxes in all those jurisdictions. This situation is referred as 'statelessness' under the tax law. It may further be pointed out that 'statelessness' is different from 'liability to pay tax'. A particular income might be exempted from taxes due to specific policy of the state. For example, 'agricultural income' is exempted from taxes in India. Similar exemption may be available in other countries as well. Non-payment of taxes due by availing exemption clause cannot be referred as 'statelessness'. The 'statelessness' in taxation is limited to no liability to pay taxes due to non-fulfilment of residency requirement.

PART-II: FINANCE ACT 2020 AND TAXING THE 'STATELESS INCOME'

The recent amendments in the Income Tax Act, 1961 introduced two major provisions under residency rule. The memorandum to the Finance Bill, 2020, provides the rationale for inserting these provisions. It says that

"The issue of stateless persons has been bothering the tax world for quite some time. It is entirely possible for an individual to arrange his affairs in such a fashion that he is not liable to tax in any country or jurisdiction during a year. This arrangement is typically employed by high net worth individuals (HNWI) to avoid paying taxes to any country/ jurisdiction on income they earn. Tax laws should not encourage a situation where a person is not liable to tax in any country. The current rules governing tax residence make it possible for HNWIs and other individuals, who may be Indian citizen to not to be liable for tax anywhere in the world. Such a circumstance is certainly not desirable; particularly in the light of current development in the global tax environment where avenues for double non-taxation are being systematically closed."

It is in this background, the Finance Act, 2020 (12 of 2020) is required to be examined. The Finance Act 2020 inserts following amendments with respect to residence rule:

"In section 6 of the Income-tax Act, with effect from the 1st day of April 2021, –

(a) in clause (1), in Explanation 1, in clause (b), for the words "substituted" occurring at the end, the words "substituted and in case of the citizen or person of Indian origin having total income, other than the income from foreign sources, exceeding fifteen lakh rupees during the previous year," for the words "sixty days" occurring therein, the words "one hundred and twenty days" had been substituted;
(b) after clause (1), the following clause shall be inserted, namely:— "(1A) Notwithstanding anything contained in clause (1), an individual, being a citizen of India, having total income, other than the income from foreign sources, exceeding fifteen lakh rupees during the previous year shall be deemed to be resident in India in that previous year, if he is not liable to tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature;
(c) in clause (6), in sub-clause (b), for the words ''days or less'' occurring at the end, the following shall be substituted, namely: — ''days or less; or
(d) a citizen of India, or a person of Indian origin, having total income, other than the income from foreign sources, exceeding fifteen lakh rupees during the previous year, as referred to in clause (b) of Explanation 1 to clause (1), who has been in India for a period or periods amounting in all to one hundred and twenty days or more but less than one hundred and eighty-two days; or (d) a citizen of India who is deemed to be resident in India under clause (1A).

Explanation. — For the purposes of this section, the expression "income from foreign sources" means income which accrues or arises outside India (except income derived from a business controlled in or a profession set up in India)."

The provision added by the Finance Act, 2020 of are of great significance.

Deemed Resident—

The Sub-Section (1A) added to Section 6 prescribed provisions for 'deemed resident', and thus, it will create a tax liability based on the criteria of 'Indian income' of the assessee, rather than his period of stay in India. Thus, an individual, who happens to be an Indian citizen, and have more than fifteen lakhs rupees 'Indian income' shall be 'deemed to be Indian Resident'. However, this deeming provision is subject to one qualification that his 'foreign income' was not liable to taxin any other country or territory by reason of his domicile or residence or any other criteria of similar nature.

The expression "liable to tax" does not necessarily mean "subject to tax". Thus, 'liable to tax' includes a situation where a person is subject to taxes in country of his residence and it is immaterial whether the person actually pays the tax or not. To that extent, the author believes that the amendment required further clarification.

Person of Indian Origin—

Before the amendment of 2020, an Indian citizen or a person of Indian origin (PIO), could have come to visit India in any previous year, and he could have stayed here till 181 days, and still he might not have declared. However, by Amendment of 2020, if such citizen or PIO is having more than fifteen lakhs rupees Indian income, then his period of stay is curbed, and he will be treated resident if stays beyond 120 days.

PART-III: CRITIQUE ON THE AMENDMENTS

The recent amendments in the Income Tax Act 1961 supposedly addressed the issue of stateless income. Its impact could be examined differently. The scope of this paper was to explore the general principle. The amendments seem to be based on certain assumptions. Firstly, that the existing residency rule has tendency to provide tax avoidance, and thus a shift is required from principle of territoriality. Whether or not this will result into complete doing away of residency rule, is something yet to be examined. Secondly, the taxes imposed on taxpayers are required to be appropriate, and they should not have an adverse effect on their economic activity. The economic cut-of limit i.e. income from Indian sources of more than fifteen lakhs would not hamper or desist the assessee from continuing their economic/business activity in India. Thirdly, the principle of ‘neutrality in taxes’ which entails that the tax system raises revenue while minimising discrimination in favour of, or against, any particular economic choice is taken care by these amendments. And lastly, by these provisions tax avoidance would be tackled more effectively, which in turn promote effectiveness and fairness in the Indian Taxation.

However, many non-resident Indians would not face issues of having dual tax residence, economic interests, and dual citizenship. These changes are likely to cause difficulty for high net-worth individuals to determine their tax residence. Government of India is urgently required to address the same.

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[1]. See Philip Dittmer, A Global Perspective on Territorial Taxation, SPECIAL REPORT (Tax Found., Washington, D.C.), Aug. 10, 2012.

[2]. Ibid

[3]. In the CbCR model template, the residence jurisdiction of these entities is recorded as ISO code X5 (“stateless”)

[4]. https://www.oecd.org/tax/tax-policy/anonymised-and-aggregated-cbcr-statistics-disclaimer.pdf

[5]. Section 9, Income Tax Act, 1961

[6]. Edward D. Kleinbard, *Stateless Income*, Florida Tax Review, Vol. 11(2011), p. 699. Prof. Kleinbard defines the term “stateless income” to mean income derived by a multinational group from business activities in a country other than the domicile (however defined) of the group’s ultimate parent company, but which is subject to tax only in a jurisdiction that is neither the source of the factors of production through which the income was derived, nor the domicile of the group’s parent company.

[7]. Finance Act, 2020, w.e.f. 1-4-2021

[8]. Union of India v. Azadi BachaoAndolan, 263 ITR 706 (SC); See also, Emirates Shipping v. ACIT, 349 ITR 493 (Delhi).

[9]. PIO as per the Explanation to clause (e) of section 115C, Income Tax Act, 1961

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