Economic Reforms : Income Tax Without Borders

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Abstract

The concept of global village has spread far and wide almost dissolving national boundaries. A vast majority of countries levy tax on income earned by their residents from sources inside and outside their own territory, which means that they apply the "worldwide income principle" which otherwise is called income tax without borders. This concept of borderless taxation or cross border taxation has gained currency due to the emergence of multinational companies. Many issues like Transfer Pricing Place of Permanent Establishment, Double Taxation Treaty, U N Model Vienna Convention and other key issues are the result of debate on Taxation without Borders. These cross border transaction or taxation without borders from Indian perspective has, in recent past, have resulted in unsettling quite a few revenue officials as well as tax professionals. The present paper looks at the concept of tax without borders and its dimensions. This point of view paper tries to look into the debate with regard to the cross border taxation within the framework of Indian polity.

Keywords: *Borderless Taxation, Double Taxation, Constitution, Judiciary*

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INTRODUCTION

The concept of global village has spread far and wide almost dissolving national boundaries. This resulted in new problems between Resident State and Residuary State, giving rise to the new debate in international taxation. Many issues like Transfer Pricing Place of Permanent Establishment, Double Taxation Treaty, U N Model Vienna Convention and other key issues influenced the policy of Taxation without Borders.

A vast majority of countries levy tax on income earned by their residents from sources inside and outside their own territory, which means that they apply the so called "worldwide income principle" which is otherwise known as income tax without borders. Many countries levy tax on income derived by non-residents, if such income flows from sources situated within the country (source principle) meaning residents of the concerned countries are subjected to unlimited (or full) tax liability in their home country. Whereas, limited tax liability is imposed upon non-residents. In many a cases, there will be a co-existence of limited and unlimited tax liability leading to the origin of double taxation.

Along with this, the problem of international taxation is further complicated by several judicial pronouncements and conflicting orders of the Authority for Advance Ruling. This concept of borderless taxation or cross border taxation is attributed to the emergence and growth of multinational companies making business international. One of the practices of multinational corporations which have given rise to particular concern among the countries in which they operate is the fixing of prices of goods and services traded between the corporations and its affiliates located in different countries.

The validity of the tax is to be determined with reference to the competence of the legislature at the time when the taxing law was enacted. The law must be enacted by the appropriate body as per the guidelines enshrined in the Act. The tax laws must not violate the conditions laid down in the Constitution and at the same time must not contravene the special provisions of the Constitution. Tax in order to be valid must be authorized by a statute and also be levied or collected in strict conformity with the law. "No tax can be imposed by any bye law, rule or regulation unless the statute under which the subordinate legislation made specifically authorizes the imposition, and the authorization must be express not implied" (Bimal Chandra Banerjee Vs State of MP, 1971).

The Indian Constitution clearly enshrines that the statute should clearly and unambiguously convey the three components of the tax law, viz., the subject of the tax, the person who is liable to pay the tax and the rate at which the tax is to be paid. In present economic scenario, the economy of one country does not exist in isolation, but it affects and is affected by the policies and laws of other countries as well. It is undisputed fact that the taxation law of the country plays a significant role in international trade and business. Whether it is favorable or unfavorable the taxation affects the inflow and outflow of investment funds. It is here the agreements and treaties signed between different

countries come into play. States encourage international trade and commerce through bilateral treaties and procures a maximum benefit by taxing all accumulating income.

The fundamental principle of taxation is that no income should be taxed twice. International double taxation arises when two or more countries exercise jurisdiction over the same income and tax it resulting in double taxation for single income. In such a situation both, the country of domicile of the income earner and the country in which the income accrues, arises or is received, claim the right to tax it. (Pandey, 2000). This is the concept of 'Bilateral relief '. Today, almost all countries have entered into agreements for the purpose of double taxation avoidance or double taxation relief. Section 90 of Indian Income Tax Act 1961 states that the Central Government is empowered to enter into agreements with other countries for the purpose of double taxation relief. The OECD (Organization of European Economic Cooperation and Development) and the UN (United Nations) have prepared process of double taxation treaties applicable to all countries.

The theory of double taxation encompasses the concept of "Permanent Establishment" or "PE". The concept of Permanent Establishment is very crucial for the purpose of determination of tax liability. It is defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried out" (UN Model, 2001). The existence of permanent establishment is the decisive condition for taxing a foreign enterprise by a contracting state. But, the definition of a permanent establishment has been the subject of much controversy. Prof. Klaus Vogel stated that "growing economic inter-dependence on an international scale resulted in treaty practice narrowing more and more the definition of the term Permanent Establishment particularly among industrialized countries." (Vogel, 1997)

Discussion

The International Double Taxation arises, when two states exercise their sovereign power to tax the same person on the same income. Although, the fundamental principle of taxation is that no income can be taxed twice, countries apply different rules of taxation, which invariably lead to the problem of international double taxation. The three principles of rule of taxation generally applied are:

1. The Jurisdictional Principle

2. The Source Principle

3. The Nationality Rule

The Jurisdictional Principle: In this principle a state taxes the worldwide income of a person within its territorial jurisdiction. Indian Income Tax Act of 1961 follows the jurisdictional rule which is applied according to Section 5(1) of the Income-Tax Act 1961. All income of a person ordinarily residing in India for that assessment year is to be taxed.

The Source Principle: Under the source principle, income earned from all sources within the territorial jurisdiction of a state are to be taxed by the state. Here source is the point from where income originates or surfaces. (1941)

The Nationality Rule: This rule involves combining the nationality of a person along with the source or residence principle. It is not very common but is practiced in few states such as USA, Mexico and the Philippines. In USA, citizens worldwide are taxed on their income irrespective of residence. Companies incorporated in the US are taxed despite their place of management and control outside US.

Double taxation effects are more significant for a developing economy as no corporation wants to be taxed twice on income earned through a single transaction. Double taxation could create circum-stances where foreign investments are virtually nil and the concept of free flow of trade remains mere theoretical. To overcome this problem the taxation methodology has been changed. Double taxation treaty is an agreement between two contracting states to mitigate taxation of the income on a person whereby, a contracting state might relinquish its right to tax for obtaining certain economic advantages necessary for the smooth functioning of trade and investment in the economy.

Double Taxation Avoidance Agreement (DTAA) helps in accessing the state’s right to tax. The right to tax might be given to the country where the income arises or to the country of residence. This conflict of the interest between the source and the residence states remained unresolved giving rise to a need for uniformity of taxation laws which would act as guidelines and help reconcile such conflicting interests in the international field. The OECD model aimed at avoidance of double taxation in 24 developed countries in the beginning. Most of the countries do not have their own models; they tend to rely on the OECD or the UN model.

This concept of borderless taxation is nothing but the taxation of electronic commerce in its widest sense, meaning consumer and business transactions conducted over a network, using computers and telecommunications. In other words, it is nothing but exchange of goods or services for value on the Internet. It includes inter alia, online shopping, online trading of goods and services through electronic fund transfers, electronic data exchanges and online trading of financial instruments.

This method of carrying on a business is widely different from the traditional practice of business. Traditional businesses have rested squarely on the physical delivery of goods. However, in doing business via the Internet physical presence of goods is not required. Consequently, geographical boundaries between nations hold no significance. In such type of transactions physical delivery of goods is not necessary especially where the goods and services are available in digital form e.g., computer software, music magazines, drawings, etc.,where physical transactions are replaced by transfer of bytes. E-commerce transactions can be completed almost instantaneously across the world and irrespective of the time of the day. The term income tax without borders is not defined under international tax treaties. In fact, there is no such terminology called Borderless Taxation but it has assumed importance because of the circumstances under which various provisions of international taxation have assumed the status of borderless transactions.

Due to absence of national boundaries, and physical presence of goods and non-requirement of physical delivery, taxation of e-commerce transactions gives rise to several issues. International taxation arises from cross border transactions where the author of the transactions is in one country (Home State) and the transaction is in another country (Host State). Income arising out of such transactions will be subject to tax in both countries by virtue of personal attachment to the transfer in the home state and by virtue of 'economic attachment' to the income in the host state. This gives rise to double taxation on the same income. (Devarajan & Priya, 2004). The taxable jurisdiction of any country covers its national boundaries. Besides this, the territorial jurisdiction also includes territorial sea and airspace covering the territorial waters, continental shelf, and exclusive economic zone. The situation of cross border taxation becomes more complex due to economic and technological progress of a country. In order to find a solution the emphasis is placed on the effective management rather than on Permanent Establishment.

Double taxation agreements are mainly based on "recognized principles of international taxation". Tax conventions are international treaties concluded between two or more sovereign states. The main text of a treaty is completed by accompanying documents mainly called as 'protocol', sometimes as "exchange of letters", "exchange of notes", memo of understanding". Legally, these documents form

part of the treaty and their comments are equally binding as the provisions of the main text. (Mathur, Gorl & Sonntag, 2013).

The tax payer entering into a cross border transaction may be liable to be taxed in his home country on his income. This is generally called as “Residence Rule”. He may also be taxed in the country from where he earns income even though he is not a resident of that country. This is refereed to as “Source Rule”. International Tax treaties like any other international treaty, are binding and the government which is party to treaty, cannot, generally deny any benefits that are available to a taxpayer under the treaty. The tax payer, who wants to access a treaty, should necessarily be a resident of at least one of the two countries in which the treaty is accessed. The Finance Act, 2012 has inserted new sub-section (4) in section 90 of the Act with effect from 1st April 2013. It states that, asseessee claiming benefit under any treaty should first prove his residence in that country. Now a non resident asseessee shall be entitled to claim benefit under treaty only after producing a certificate, containing such other particulars as may be prescribed of his being a resident in any country outside India, obtained from the government of that country. In situations where the taxpayer is a resident of both the countries and as the domestic tax law criteria for determining the residential status would differ from country to country the treaties provide a mechanism to determine the residential status of such tax payer by applying “tie breaking test.” Now the resident of a third country cannot have access to treaty. However, if he establishes an entity in one of the two countries that have entered into a treaty in order to take advantage of the provisions of that treaty then it is called “treaty shopping”

The Indian Supreme Court in one of the celebrated judgments in the case of Union of India vs *Azadi Bachao Andolan* (Thar & Agrawal, 2013) held that “the benefits of the India Mauritius Tax Treaty cannot be denied to a national of the third state who establishes a company in Mauritius in the absence of any limitation clauses being incorporated in the treaty itself. “Treaties are entered into at a political level and leave several considerations as their basis. Many developed countries tolerate or encourage “treaty shopping” even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to significant loss of tax revenue. The court cannot judge the legality of “treaty shopping” merely because one section of thought considers it improper. The court cannot characterize the act of incorporation under the Mauritian law as sham or a device actuated by improper motives”. “If it was intended that nationals of the third state should be precluded from the benefits of the Indo-Mauritius Double Taxation avoidance convention, then a suitable term of

limitation to that effect should have been incorporated therein. There are no disabling or disentitling conditions under the convention prohibiting the resident of a third nation from deriving benefit there under. The motives with which the residents of a third country have been incorporated in Mauritius are wholly irrelevant. The whole purpose of the convention is to ensure that the benefits there under are available, even if they are inconsistent with the provisions of the Income Tax Act. The principle of piercing the veil of incorporation cannot apply". (Klaus, 1997).

In this context, the concept of Taxation without borders justifies the subject. The areas in which these borderless transaction occurs are:

1. The concept of Permanent Establishment
2. Double Taxation Avoidance Agreements (DTAAs)
3. Development of Model Convention
4. Transfer Pricing Regulations
5. Taxation of E-commerce Transactions
6. Thin Capitalization
7. Tax sparing
8. Controlled Foreign Corporations
9. Taxation of Services
10. Royalties
11. Partnerships
12. Business profits

13. Interests, Income from real property Dividends, & Associated Enterprises
14. Capital Gains
15. Insurance
16. Aerospace Defense
17. Oil and Gas Sector
18. Film Production and Film distribution
19. Courier Business
20. Model Transport Operators
21. Leasing

Conclusion

The cross border transaction or taxation without borders from Indian perspective has, in recent past, have unsettled quite a few of the revenue officials and tax professionals. The conservative approach of the Reserve Bank of India coupled with the fact that Indian economy is not significantly connected with the global trade, allowed India to meltdown. Also, the Finance Act 2012 seeks to retrospect on many judicial decisions, notably the Supreme Court decision with regard to Vodafone telecommunications company and seeks to tax offshore transfers of shares or interest in a company outside India. Finance Act 2012 proposes a number of new provisions including taxation of unexplained money, credits, investments and expenditures at the highest rate of 30 percent. Some of the key amendments made by Finance Act 2012 that have far reaching consequences on cross-border transactions are given below;

1. Taxability of Indirect Transfers (Section 2(14),2(47) 9(1)(i) and 195 of Income Tax Act, 1961.
2. Insertion of GAAR (General Anti Avoidance Rules)

3. Cross border Investments-Regulatory framework for Investment in India
4. Taxation of Dividend Outflow

5. Taxation of Capital Gain

6. Important issue of No Capital Gain Tax on Share Transfer at NIL Value

In the era of global village, globalization and technological innovations have triggered a wave of restructuring. The world is heading towards establishment of borderless economic structure. India is witnessing a number of cross border mergers and takeovers. The existing legal framework is not fully equipped to cope with the myriad complications of cross border mergers and acquisitions. Indian laws require suitable modifications to facilitate cross border mergers and acquisitions. The companies Act, FEMA Regulations and SEBI Regulations require suitable amendments to facilitate taxation in international trade and business. Further, more clarity is expected in classification of income in capital gains and whether conversion of preference shares/warrants into equity shares is a taxable event.

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