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Paper Writer

Bijal Ajinkya

Ms. Bijal Ajinkya co-heads the international tax practice of the multi-skilled, research based international law firm, Nishith Desai Associates (www.nishithdesai.com). She is a practice head of the Funds Practice Group and is actively involved in advising clients on fund formation including advice related to structuring, documentation, regulatory approvals, etc. She is a lawyer and has earned her Masters in international law.

Her practice includes international taxation, globalization, structuring of inbound/outbound investments, structuring of offshore funds, taxation of EPC contracts, taxation of ecommerce and software contracts, and international tax litigation.

Legal 500 2009-10 (Asia-Pacific) has recognized her as a leader in the field of taxation. She is a member of the International Bar Association and the Bar Council of Maharashtra & Goa. Bijal was a special lecturer at the Xavier's Institute of Management on International Law.

Source versus Residence: An Indian Perspective[1]

by Bijal Ajinkya

"If a glass contains whisky, but not water, it is not empty, and the same is true if the glass contains water, but not whisky. Similarly, a tax system that does not influence capital-import, but export, cannot be called neutral." — Prof. Vogel[2]

1. Introduction

There are several theories of taxation. According to one school of thought, "taxes are what we pay for civilized society."[3] The basis of such a 'contractarian benefit theory' is that people living in a society pay taxes as a necessary cost to procure access to certain essential public goods and other benefits of civilized society. So, while taxpayers and the State are bound by some sort of social contract, taxation may be viewed as the consideration received by the State for good governance. But, the burden of taxation cannot be distributed equally among a State's subjects, especially when some classes of persons either consume less public goods or do not have the means to contribute in taxes, proportionate to their consumption of public goods. Accordingly, another school of thought argued that taxation should be progressive and based on the ability to pay.[4]

Economists have also deliberated over the concept of 'optimal taxation' by reconciling the State's prerogative to collect a certain sum in tax revenues and the corresponding need for minimizing distortions in economic choices.[5] Therefore while the imposition of taxes is taken as a norm, the focus is on how to structure the tax system in a manner that achieves favourable socio-economic ends. With the globalization wave sweeping across the world and the exponential rise in cross-border trade and income flows, economists, jurists and policy makers are confronted with the task of developing a theory of optimal international taxation. Several questions arise in this respect. How do States justify and divide tax revenues arising from inter-State movement of income and capital? Does it make a difference if a State is a net capital importer rather than a net capital exporter? What happens when States begin to compete in order to maximize tax revenues? What if the competition is to secure non-tax gains in terms of greater foreign investments? Most importantly, how does the 'globalized' taxpayer manage his costs and maintain commercial viability within the international tax environment?

Many of these questions do not have precise answers. They are, however, still immensely relevant while examining a State's taxation policy and the limits of its fiscal jurisdiction. The focus of this paper is on two very important principles which States use to justify their right to tax- residence and source. It starts with a discussion of some of the conceptual issues, macroeconomic aspects and theoretical basis underlying residence and source rules adopted by States. More specifically, the paper seeks to examine these principles from an Indian

1 ©2010 Nishith Desai Associates

2 Klaus Vogel, "Which Method Should the European Community Adopt for the Avoidance of Double Taxation?", *Bulletin for International Taxation*, January 2004, at 5.

3 Per Oliver Wendell Holmes, Compania General De Tabacos *De Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927).

4 The 'ability to pay' theory can be traced to the writings of the Swiss philosopher Jean Jacques Rousseau (1712-1778), the French political economist Jean-Baptiste Say (1767-1832) and the English economist John Stuart Mill (1806-1873).

5 Frank Ramsey and James Mirrlees have discussed and developed some of the most influential theories on optimal taxation. See Frank P. Ramsey, "A Contribution to the Theory of Taxation", *Economic Journal* 37 (1927) at 47-61 and James Alexander Mirrlees, "Optimal Taxation and Government Finance" in Quigley and Smolensky (eds.) *Modern Public Finance*, (1994).

perspective with the object of identifying a trend in terms of where the policy seems to be heading. It concludes on a critical note by taking a strong position against recent developments in India's international tax policy and advocates the need to ensure certainty by structuring residence and source rules based on norms of efficiency and clearly identified macro-economic principles linked to a vision for the country's economic development.

2. Residence and source in international taxation

Residence and source may be understood as fundamental principles in international taxation law for the apportionment of fiscal jurisdiction between sovereign States. They are terms of art and have specific connotations in domestic or treaty law. Broadly put, the State of source or situs is the State where a certain income has its origin[6], while the State of residence is the State where the person earning such income resides. In any cross-border movement of income and capital, two or more States may seek to exercise its taxing rights in accordance with their domestic tax laws. If States decide to tax such income on a unilateral basis without any sort of co-ordination or agreement with the corresponding State, the same income may get taxed more than once, thereby creating a hindrance to free trade.

States around the world have, therefore, accepted as a general principle that international juridical double taxation should be avoided or minimized to whatever extent possible. The OECD Model Commentary observes that: "its harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries."[7]

States have reserved and delineated their fiscal jurisdiction through bilateral (or multilateral) double tax avoidance conventions that specify the respective taxing rights of the State of source and the State of residence in relation to different classes of income. For certain types of income, exclusive right to tax may be conferred upon a single contracting State (source or residence). Double taxation is accordingly resolved by the other contracting State being prevented from taxing the same income. With respect to other forms of income, both contracting States may reserve the right to tax. In some cases the right of the source State to tax may be limited. In either case, while the source State would exercise the immediate right to tax, double taxation may be avoided by the State of residence providing some sort of a credit or exemption for taxes paid in the State of source.

2.1. Allocation of taxing rights: Macroeconomic aspects

The choice between (or a combination of) source or residence based taxation alternatives has a number of macroeconomic ramifications apart from the mere avoidance of international juridical double taxation.[8] This choice may be influenced by the state of a country's economic development, the need for foreign investments and capital inflows, its international economic ties, the state of its tax administrative and enforcement machinery, and other such factors. The challenge in making this choice, based on a State's long-term economic policy, is evident when

6 See, Eric C.C.M. Kemmeren, "Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach", *Bulletin for International Taxation,* November 2006, at 431 and 432.

7 Para 1, OECD Model Commentary.

8 See, Krister Andersson, An Economist's View on Source versus Residence Taxation – The Lisbon Objectives and Taxation in the European Union", *Bulletin for International Taxation,* October 2006, at 395.

considers some of the pros and cons of choosing an exclusive residence based or source based taxation regime.

2.1.1. *Analysis of exclusive residence based taxation*

Residence based tax rules are generally easy to apply and there is a relatively higher degree of certainty with respect to the trigger point for tax liability. It is simpler to determine the State of residence of an individual or a corporation than to conclude on the source or situs of a specific income stream. For instance one does not have to determine whether a host of servers spread across the world and used in a complex e-commerce transaction, may be viewed as a permanent establishment ("**PE**") in a particular contracting State. Under a residence based tax regime, the State of residence of the enterprise owning and operating the servers would exercise the right to tax any income from such a transaction. A State may lay down certain bright line tests[9] for residence in terms of a number of days' presence, place of control or management, etc. In case of conflict of residence rules between two States, the relevant tax treaty may provide some sort of an objective 'tie breaker' test to determine the State of residence.

Some scholars also argue that exclusive residence based taxation also allows for application of progressive tax rates, which have a role in ensuring vertical equity. The assumption is that 'ability to pay' may be determined only by a consideration of total (worldwide) income without having any regard to source.[10]

Residence based taxation is also said to allow a country to achieve a state of 'capital export neutrality' ("**CEN**"). This concept was proposed by Prof. Musgrave in the following words: "export neutrality means that the investor should pay the same total (domestic plus foreign) tax, whether he receives a given investment income from foreign or from domestic sources..."[11] CEN puts domestic players and entities having global operations on a similar plane, by ensuring parity in respect of the tax costs of doing business within the country or in any offshore jurisdiction.[12] This would, of course, entail each country adopting a uniform system of residence based taxation. In a situation where the State of source also exercises the right to tax, CEN would require availability of full tax credit at the State of residence for taxes paid in the other State.[13]

The challenge in implementing such a system is that it is necessary to have certain definite, standardized and internationally accepted criteria for residence. It may also lead to disproportionate taxing rights exercised by certain capital exporting countries or a possible shifting of residence base to low cost jurisdictions. Subject to resolution of these issues, it has been argued that exclusive residence based taxation is more efficient than exclusive source based taxation. However, this thinking has gradually shifted in favour of a more prominent source based approach.

9 See, Avi-Yonah, Reuven S., "The Structure of International Taxation: A Proposal for Simplification", 74 Texas Law Review 1301 (1996), at 1311,

10 Robert A. Green, "The Future of Source-Based Taxation of Income of Multinational Enterprises", 79 *Cornell Law Review* 18 (1993), at 29.

11 Richard Musgrave, "Criteria for Foreign Tax Credit", in *Taxation and Operations Abroad,* Symposium, 1960, at 84.

12 This of course, does not take into consideration the non-tax benefits of doing business offshore including setting up service / manufacturing centers in low cost developing countries.

13 If countries around the world followed a system of restricted tax credits, it would affect CEN since the overall tax burden would vary depending on the source of investments. The other assumption that needs to be made is that the tax rates in the offshore jurisdiction are lesser than the tax rates in the State of residence.

2.1.2. *Analysis of exclusive source based taxation*

The logic behind exclusive source based taxation is that States have a right to tax all income that is generated within its territory. A source or territorial based taxation system therefore seeks to compensate the source country for its contribution to sustenance of the economic activity. It therefore conforms with the benefit principle which Prof. Skaar has considered very critical while examining the scope of the PE concept in international tax treaties.[14]

Economists argue that source based taxation leads to 'capital import neutrality' ("**CIN**") which "means that capital funds originating in various countries should compete at equal terms in the capital market of any country."[15] The principle is that irrespective of where the capital originates, as long as the source State taxes such income uniformly, there is some sort of parity in the tax costs of investing and doing business in a specific jurisdiction. Further, foreign investors importing capital into a specific State (and deriving taxable income) are put on a similar plane as compared to domestic players.

CIN is supposed to be far superior to CEN in the sense that it minimizes distortions in cross-border capital flows by not giving any special incentive for businesses to relocate towards low tax jurisdictions. Further, capital importing countries are also able to collect their due share of tax revenues. For these and several other reasons such as the relative stability in the price of goods and services, there seems to be a greater preference for CIN. Prof. Vogel was in fact a strong supporter of source based taxation which, in his view, best achieves the ends of neutrality.[16] He also factored in transaction and production costs while asserting that CEN can never be a reality since these costs will always vary from jurisdiction to jurisdiction.[17] However, from the perspective of CIN, the tax costs as well as the transaction or production costs can largely remain constant in the State of source irrespective of where the investments originate.

Source based taxation is also supported by the principle of economic allegiance which originated in the League of Nations times and was considered as a guiding principle for determining the respective taxing rights of the State of source and residence. There have also been views that the source State should receive a larger share of the taxing rights since there is greater economic allegiance with the State of source, which also was more capable of enforcing these rights at the point of origin.

The obvious limitation of source based taxation is the difficulty in applying conventional source based rules in a modern day transactions involving intangibles and a fleeting presence in the territory of the source State. Unless there is some sort of consensus among States regarding the structure and exact threshold for taxation, and the scope for conflicting interpretations is reduced, source based taxation may in several cases lead to double taxation.

For a broad analysis of the two regimes, it is interesting to note the International Chamber of Commerce (ICC)'s preference for source based taxation based on an exemption system.[18] It justifies this approach on the following grounds:

- It is a simple system and minimizes administrative costs as well as costs of compliance.

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14 Arvid A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (1991), at 559.

15 Richard Musgrave (1960), at 85.

16 See, Vogel (2002), at 5.

17 See Klaus Vogel, "Taxation of Cross-Border Income, Harmonization, and Tax Neutrality under European Law", in Klaus Vogel (ed.), *Taxation of Cross-Border Income, Harmonization, and Tax Neutrality under European Law* (1994), at 26, 27.

18 http://www.iccwbo.org/policy/taxation/id556/index.html (last visited May 31, 2010). The ICC's analysis focuses on income streams in the form of dividends.

- It encourages businesses to become global through export of capital and international trading.
- Domestic tax incentives of the source country are preserved and the non-resident entity is able to take full advantage of the same.

3. Overview of residence / source rules in India

3.1. Domestic law

The domestic law on residence and source may be largely gathered from sections 5, 6 and 9 of the Income-tax Act, 1961 ("**ITA**"). Residents are taxable on all income that is received in India, that accrues in or is deemed to accrue in India or that accrues to him outside India during the fiscal year.[19] A resident is essentially taxed on a world-wide basis. Non-residents, on the other hand are taxed on their India-source income, or income that is received in India or has accrued or is deemed to accrue in India.[20] The ITA also recognizes an intermediate category known as resident but not ordinarily resident ("**RNOR**") who is taxable on India-source income as well as income that accrues outside India but is derived from a business controlled in or a profession set up in India.[21]

The criteria for acquiring Indian residency vary on the basis of the type of legal entity. An individual becomes a resident of India if he is in India (i) for an aggregate period 182 days in the financial year; or (ii) a period aggregating 365 days over the last 4 years and 60 days in the relevant financial year. Otherwise, he would be assessed as a non-resident.[22] He may be considered an RNOR if he is a non-resident for 9 of the 10 years preceding the financial year or has been in India for a period of 729 days over the last 7 years.[23]

A company is treated as an Indian resident if it is incorporated in India or if the control and management of its affairs are wholly situated in India.[24] On the other hand, an HUF, firm or association of persons ("**AOP**") may normally be considered a resident unless in cases where the control and management of its affairs are wholly situated outside India.[25] The same rule applies to other categories of persons.

Source rules prescribed under the ITA vary on the basis of characterization of income. Income accruing directly or indirectly from any business connection, property or asset in India or from the transfer of any capital asset situate in India is deemed to have their source in India.[26] Therefore, capital gains accruing to a non-resident from the transfer of shares of an Indian company would be considered India source income and the same would be taxable in India. Dividends paid by an Indian company are always treated as India source income.[27] Interest payments received by a non-resident have their source in India as long as the debt is incurred in connection with the payer's business or profession carried on in India.[28] Likewise, non-resident royalty income or fees for technical services is also treated as having Indian source as long as the underlying rights, information, property or service is used in connection with the payer's business or profession carried on in India.[29]

19 Section 5(1), ITA.
20 Section 5(2), ITA.
21 Proviso to Section 5(1), ITA.
22 Section 6(1), ITA.
23 Section 6(6), ITA.
24 Section 5(3), ITA.
25 See section 4.2 of this paper for a detailed discussion on the residency of AOPs and some of its Indian tax implications.
26 Section 9(1)(i), ITA. See section 5.1 of this paper for a detailed discussion on issues with the concept of business connection.
27 Section 9(1)(iv), ITA.
28 Section 9(1)(v), ITA.
29 Sections 9(1)(vi) and (vii), ITA.

Domestic source rules may often conflict with the source rules under an applicable tax treaty. In such situations, the ITA provides that the domestic rules may apply only to the extent it is more beneficial to the taxpayer.[30]

3.2. *Treaty law*

In terms of treaty practice one could say that India has relied on both the OECD as well as the UN model conventions. Both these models are based on a host of earlier treaties and deliberations from the time of the League of Nations leading to the adoption of a blend of residence and source based rules.[31] The economic justifications and theoretical basis for favouring residence or source alternatives seems to have had much influence on the shape of several modern tax treaties that we see today. It is in this context one may appreciate section 90(1) of the ITA which allows India to enter into tax treaties not only for the purpose of providing relief against double taxation but also to "promote mutual economic relations, trade and investment."

India has, however, adopted a number of positions in its treaty practice that vary from the standard OECD approach. For instance, India has adopted a lower threshold for PE exposure in a number of its treaties.[32] India has also generally reserved its right to tax royalties and fees for technical services in the various treaties signed by it.

With respect to capital gains from alienation of shares, there have been relatively few treaties such as those with Mauritius, Singapore and Cyprus where the right to tax is allotted to the State of residence. In most treaties such gains are taxable in the source State. In this regard, one may consider the interesting position adopted in the India-US tax treaty where capital gains would be taxed as per the domestic laws of India and the US.[33] However, due to conflicting domestic source rules, such gains from the sale of shares of an Indian company would get taxed in both countries, thereby leading to double taxation and difficulties in obtaining tax credits. The emergence of Mauritius as a popular jurisdiction for investing into India may be viewed against this backdrop. The use of Mauritian intermediate entities allows investors to avoid any potential double taxation under the India-US tax treaty. Under the India-Mauritius tax treaty gains from the alienation of shares of an Indian company are taxable only in Mauritius (State of residence).[34] It is therefore not surprising that virtually over 44% of India's foreign direct investment is received through Mauritius.[35]

3.3. *Double taxation relief*

In terms of double taxation relief, India has adopted both credit and exemption based approaches in its various tax treaties.[36] Under the tax credit approach, the State of residence will provide a credit for taxes paid in the source State. The credit will be available as a deduction from the tax payable in the State of residence.[37] Under the tax exemption approach,

30 Section 90(2), ITA.

31 For discussions on the origin of the OECD Model Convention, see, John F. Avery Jones, *et al*, "The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States", *Bulletin for International Taxation*, 220, June 2006.

32 This is discussed in greater detail in section 5.2 of the paper.

33 Article 13, India-US tax treaty.

34 Article 13(4), India-Mauritius tax treaty.

35 http://dipp.nic.in/fdi_statistics/india_FDI_March2010.pdf (last visited May 31, 2010).

36 It may be noted that in cases where India does not have a treaty with the other State, section 91 of the ITA provides for a credit method for double tax relief in respect of taxes paid in the other State.

37 The amount of credit however cannot exceed the tax payable in the State of residence.

income that is taxed in the source State is exempt from taxation in the State of residence which would only tax the net amount.

In a number of treaties[38] India has also accommodated a unique form of credits referred to as 'tax sparing credits'. The logic behind the ordinary credit method is that a deduction is given for taxes actually paid in the source State. However, with a view to incentivise certain kinds of international transactions, the State of residence may provide a deemed credit up to a specified percentage irrespective of the tax paid or payable in the source State.

It must be noted that relief under the exemption or credit systems may be available only in cases where the State of source exercises its taxing rights in accordance with the provisions of the tax treaty. However if there are certain conflicts of qualification or characterization of income, questions may arise as to whether the State of residence would be forthcoming while providing double taxation relief. In significant cases, States may have to resolve such issues through Mutual Agreement Procedure.

Sections 4 and 5 of the paper discusses and analyses some of the trends in India's domestic and treaty law practice while applying residence and source rules.

4. Trends in residence-based taxation in India

4.1. Dilemma of the returning Indian

With the exponential growth in business opportunities in India, we are now witness to a new trend of reverse migration, where foreign individuals such as NRIs are returning back to India in large numbers. Of relevance to this paper, is a peculiar tax consequence arising when the returning individual is a US citizen.

The issue may be said to stem from the fundamental difference between US and Indian tax residency rules. In the US a person may be taxed on her worldwide income if she is a US citizen or a green card holder or satisfies the substantial presence test. In India, however, one becomes a tax resident solely on the basis of the number of days one is present in India.[39] Therefore, if a US citizen/green card holder returns to India and meets the residency threshold under the ITA, it leads to a dual-residency situation requiring the application of the tie-breaker test under the India-US tax treaty.[40]

The other complication is the savings clause in the India-US tax treaty which states that US reserves the right to tax its citizens as if the treaty is not in effect.[41] This would however, not preclude entitlement to double taxation relief. Under Article 25 of the India-US tax treaty, US would provide a credit to US citizens as per its own foreign tax credit rules.[42] Therefore, subject to domestic limitations, US citizens should be able to get some credit for taxes paid in India. From an Indian perspective, there is a possibility that India may not allow any credit to US citizens for taxes paid in the US. As per the Treaty, credit would be available only in respect of

38 For example, one may consider India's tax treaties with Greece, Brazil and Mauritius.

39 Refer section 3.1 of this paper.

40 In such situations, Article 4(2) of the India-US tax treaty provides that the individual's country of residence will be determined by considering (in order of relevance) the location of the individual's: (i) permanent home; (ii) centre of vital interests and (iii) habitual abode. If the dual-residence issue cannot be resolved though the tie breaker test, the contracting States would have to take recourse to mutual agreement procedure.

41 Article 1(3), India-US tax treaty. Note that this situation would not arise if the individual is only a green card holder rather than a citizen.

42 Section 901 of the US Internal Revenue Code provides foreign tax credit subject to the limitations set out under sections 902 to 904. It may also be noted that Article 25(3) of the India-US tax treaty provides that relief under Article 25 would be subject to the source rules in the domestic laws of the contracting State as apply for the purpose of limiting foreign tax credit.

income taxed in accordance with the provisions of the treaty. However, due to the savings clause, the US citizen would be taxed in accordance with US domestic laws as if the treaty has not come into force. It may also be noted that the difference in the timing of the financial years in India and the US[43] also creates certain difficulties in claiming foreign tax credit.

The present structure of the credit rules under the India-US treaty neither provides any certainty as to the applicability of source and residence rules, nor does it confer any sort of relief from double taxation — truly a dilemma for US citizens returning to India.

4.2. *AOP: Hidden trap for unincorporated JVs*

The concept of AOP takes many a foreign joint venture partner by surprise. An AOP is treated as a separate taxable entity. It would become a resident of India even if a fraction of its control or management is situated in India. As a resident, an AOP would be taxed on its worldwide income. In other words, a foreign entity that is considered to be part of such an AOP may be taxed on more than just its India source income.

Further, being a tax resident of India, the income earned by the foreign entity (within the AOP) would not be entitled to any beneficial treaty relief, and India would free to exercise its powers of unlimited residence based taxation. Considering that the foreign entity's State may not subscribe to a concept such as the AOP, the inconsistency in residence rules may lead to difficulties in claiming tax credits.

The formation of an AOP under the ITA would depend on the degree of association in the commercial relationship between various entities within the AOP that would otherwise be taxed independently. Indian courts have laid down a number of factors, the existence of which would lead to the creation of an AOP. These include:

i. Common purpose or common action with object to produce profit or gains;

ii. Sharing of revenues, expenditure, losses and liabilities;

iii. Combination in joint enterprise; and

iv. Some kind of scheme for common management.

Cross-border (unincorporated) joint ventures are common in large scale turnkey projects in India where an Indian entity collaborates with a foreign entity in undertaking a comprehensive set of activities including design, manufacture, supply, testing, commissioning, training and transfer of technology. For instance in the case of *Geoconsult ZT GmbH v. DIT*[44], an Austrian company entered into a JV with two Indian entities for the purpose of providing a range of services in connection with an Indian infrastructure project. It was seen that the foreign company, which received the major part of consideration managed the JV and co-ordinated among the members. Although there was some form of demarcation of responsibilities, there was a provision for reassignment of work in case of breach of obligations by a member. It was held that that the unity of action, common management and planned co-ordination among the JV partners led to the creation of an AOP.

43 Indian financial year runs from April to March while in the US, it is January to December.

44 [2008] 304 ITR 283 (AAR)

This decision can be contrasted against a recent advance ruling in the case of *Hyundai Rotem and Mitsubishi v. DIT*[45], where certain Japanese, Korean and Indian companies entered into a consortium to execute a project for the Delhi Metro. A specific declaration was expressed in the agreement that there was no intention to create a JV to carry on business in common. Each member bore its own losses and retained its profits separately. The members played independent and designated roles without any agency relationship or control between their activities. Therefore, although the consortium was for mutual benefit, it was held that an AOP was not constituted.

One must admit that it is difficult to objectively distinguish between JVs of the type examined in *Geoconults* and those that are similar to the *Hyundai-Mitusbishi* JV, especially when the commercial object of such arrangements are largely the same. The absence of bright line tests to determine when an AOP comes into existence adds a new challenge to the structuring of cross-border JVs, considering that the possible implications could include disentitlement to treaty benefits and foreign tax credit issues. From a policy perspective, legal fictions such as AOPs provide increased scope for India to exercise its residence based taxation rights.

4.3. *Diluting the test of control*

The test of corporate residence in India has always been quite straightforward: either the company is incorporated in India or the control and management of its affairs are wholly situated in India.[46] The expression, 'control and management' signifies the controlling and directive power of the company or its 'head and brain'[47] and may normally be attributed to its Board of Directors. Further, the words, 'wholly situated' imply the functioning of such power at a specific place with some degree of permanence. One could therefore say with a sense of certainty that a company may be considered an Indian resident if its Board of Directors is based in and regularly meets and functions from India.

The proposed Direct Tax Code ("**DTC**") has, however, introduced a radical change to the settled concept of corporate residence by stating that even if the place of management and control of a foreign company is partly in India, it would be considered an Indian resident, taxable on its worldwide profits.[48] A slightly contrasting version of this rule is explained in the Discussion Paper annexed to the DTC, which speaks in terms of control or management of company's affairs being wholly or partly situated in India.

The absurdity of the DTC proposal becomes evident when one tries to contemplate a situation where the 'place' of management can be considered to be partly situated in India. Another question that arises is: what exactly is part control or management? The ambiguous nature of this provision would raise much concern among foreign companies having directors or branches in India. One can only conclude that it is a sign that India is definitely considering an enhancement of the scope of is residence based taxation rights.

45 Decided on 23.03.2010

46 Section 6(3), ITA.

47 *CIT v. V.V.R.N.M. Subbiah Chettiar* [1947] 15 ITR 502 (Mad.).

48 Section 4(3)(b), DTC.

5. India's expanding source frontiers

5.1. *The ambiguous 'business connection'*

Business profits earned by a non-resident are taxable in India only to the extent they have arisen directly or indirectly through a business connection of the non-resident in India. The expression, 'business connection' has been defined in inclusive terms, much in contrast with the precise phraseology used in the definition of PE under various tax treaties signed by India. As per the ITA, 'business connection' is said to specifically include the following activities carried out through a person acting on behalf of the non-resident:

- Habitual exercise in India of an authority to conclude contracts on behalf of the non-resident;
- Habitual maintenance in India of a stock of goods or merchandise from which he regularly makes deliveries; or
- Habitual securing of orders in India, mainly or wholly for the non-resident or other related non-residents.

Activities carried out by brokers, general commission agents or any other agent of independent status are excluded from the scope of 'business connection'.

The Supreme Court in the case of *CIT v. R.D. Agarwal*[49] explained the concept of 'business connection' as "a real and intimate relation between the trading activity carried on outside the taxable territories and the trading activity within the territories, the relation between the two contributing to the earning of income by the non-resident in the trading activity." In another case[50], the Supreme Court viewed it in terms of a "real, substantial and systematic or organised course of activity or conduct with a set purpose." It is therefore clear that the existence of a 'business connection' implies a degree of continuity and does not contemplate a mere stray or isolated transaction.

The concept of 'business connection' is broader than that of PE in most tax treaties where specific exclusions have been provided for a number of activities including those that play an ancillary role. It prescribes a lower threshold for tax exposure in India. Fundamentally, a PE may be understood as a "virtual projection of the foreign enterprise of one country into the soil of another country."[51] On the other hand, a number of cross border commercial arrangements stretching over a period of time may be viewed as business connections. The effect is that the requirement of some sort of presence of the non-resident entity in India (either by itself or through an agent), in a way, gets diluted.

For this reason, in the case of *Re: International Hotel Licensing Company S.A.R.L*[52]., marketing and business promotion activities carried out by a foreign company outside India in relation to the business of a prominent international hotel chain operating in India was held to give rise to a business connection. Similarly, in a much earlier case[53], a UK barrister and patent expert

49 [1965] 56 ITR 20 (SC).

50 *Narain Swadeshi Weaving Mills v. Commissioner of Excess Profits Tax* [1954] 26 ITR 765 (SC).

51 *Commissioner v. Visakhapatnam Port Trust* 144 ITR 146, 162.

52 [2007] 288 ITR 534(AAR). It may be noted that the company was based in Luxembourg and at the time of the ruling, India did not have a tax treaty with Luxembourg, because of which, the company could not take advantage of a more beneficial PE threshold.

53 *Barendra Prasad Ray v. ITO*, [1981] 129 ITR 295 (SC).

appointed by an Indian client to make an appearance before the Calcutta High Court was said to have a business connection in India in view of his 'real and intimate' connection with the Indian solicitors of the client and the proceedings before the Court. Such a construction stands in contrast with the UK position which only taxes foreign entities that carry on a trade 'within' the UK as opposed to with the UK. In fact, it almost seems that the ambit of 'business connection' has been understood on the lines of the broad 'effectively connected income' threshold applicable in the US.

The inclusive nature of the concept of 'business connection' clearly demonstrates India's inclination toward adopting more flexible source rules in order to capture a wider range of cross-border activities. It is of special significance in transactions where a tax treaty is not applicable for one reason or the other.

5.2. *Encompassing PE Positions*

India has been successful in negotiating broader PE thresholds in a number of treaties. Recently, it has also expressed numerous reservations on the 2008 draft of the OECD model commentary.

5.2.1. *Secondment blues*

A number of treaties signed by India have incorporated service PE clauses which seek to capture services provided by employees of a foreign country spending a certain amount of time in India.[54] For example under the US treaty, a service PE may be constituted if the employee of the US entity has an aggregate presence of 90 days India. In the case of services provided to an Indian related entity, even a single day's presence of the employee in India will give rise to a service PE.

Service PE exposure in India has gained special significance in the context of cross-border deputations or secondments, a business management strategy that has become quite popular among today's MNCs. The case of *DIT v. Morgan Stanley*[55] decided by the Supreme Court is a good illustration of this point. The US based company had seconded a number of personnel to its Indian subsidiary which served as its outsourcing arm. It was held that stewardship services provided by one set of employees did not give rise to a service PE since they were sent for the purpose of monitoring and quality control, and served the interests of the US company rather than the Indian subsidiary. Employees deputed to the Indian subsidiary, on the other hand, were held to give rise to a service PE especially since the deputed employees exercised a lien over their employment with the US company, which in turn retained control over the employees' terms of employment.

But does this mean that all employee secondments give rise to service PE exposure? In a recent case[56], a Malaysian company supplied technical personnel to its Dutch parent for providing services in connection with a construction project in India. The Tribunal held that a service PE was not constituted since, although the personnel were still employed by the Malaysian company, they served under the control, direction, and supervision of the Dutch company. It therefore seems that one may carve out an exception to the application of the service PE clause in cases where the agreement is for supplying personnel as opposed to providing services through personnel.

54 These include tax treaties with the US, UK, Singapore, Canada and Australia.

55 292 ITR 416 (SC).

56 *DCIT v. Stock Engineer & Contractors BV*, 2009 TIOL 30 ITAT. The Tribunal based its decision on an earlier decision in the case of *Tekniskil v. CIT*, 222 ITR 551.

5.2.2. *Securing orders with caution*

The scope of agency PE under the OECD model convention is restricted to the habitual exercise of authority by the dependent agent in India to conclude contracts on behalf of the non-resident. In several treaties an agency PE may also arise if the dependent agent habitually maintains a stock of goods in India from which he makes regular deliveries on behalf of the non-resident. In addition to this, certain treaties have covered situations where the dependent agent habitually secures orders in India for the non-resident or other related non-residents.

The expression, 'securing orders' is amenable to a variety of interpretations. From an Indian treaty perspective, guidance may be taken from the exchange of letters between the Indian and US Governments which clarify that a person shall be considered to habitually secure orders in India only if:

- such person frequently accepts orders for goods or merchandise on behalf of the non-resident;
- substantially all of such person's sales related activities in India consist of activities for the non-resident;
- such person habitually represents to persons offering to buy goods or merchandise that acceptance of an order by such person constitutes the agreement of the non-resident to supply goods or merchandise under the terms and conditions specified in the order; and
- the non-resident takes actions that give purchasers the basis for a reasonable belief that such person has authority to bind the enterprise.

The addition of the 'securing orders' clause expands the scope of agency PE to situations where an entity does not act in a representative capacity (in the contractual sense) but merely provides some sort of marketing services to a foreign client. In such case there is an ambiguity as to whether this clause would cover situations where the Indian entity may not directly solicit clients but may engage in some sort of general marketing using advertisements, public displays, etc.

5.2.3. *Attracted to PEs?*

The fundamental principle of taxation of business profits under the treaty is that only income that is attributable to the PE is taxable in the country of source. Therefore not only should the PE be in existence, the income has to necessarily be earned in connection with business carried out through the PE. In this regard, it is interesting to note a concept referred to as a PE's 'force of attraction'. Conceptually, "the force of attraction rule only implies that when an enterprise sets up a PE in another country it brings itself within the fiscal jurisdiction of that another country to such a degree that such another country can properly tax all profits that the enterprise derives from that country—whether through the PE or not."[57]

With respect to a PE's force of attraction, one may consider two possibilities. Firstly, the treaty may provide that as long as the foreign enterprise has a PE, any income earned by it from sources within the country would be taxable even if had nothing to do with the existence of the PE. Such a 'general force of attraction' seems to have been generally rejected in international treaty practice. However, there are several treaties such as India's treaty with the US which adopt some sort of a 'restricted force of attraction'.

57 *DCIT v. Roxon Oy*, [2007] 106 ITD 489 (Mum).

The restricted force of attraction clause provides that only such income received by a non-resident from activities that are similar to those carried out by its PE, would be attributable to the PE. The fact still remains that the income was never earned in connection with business carried out through the PE. Such a concept can drastically increase the scope of source State taxation. For example, one may consider the facts examined by the Supreme Court in the case of *Ishikawajma-Harima Heavy Industries Ltd. v. DIT*[58], where it was held that payments received by a non-resident from offshore supply of goods cannot be attributed to a PE that the non-resident has in India on the basis of the principle of territorial nexus. The basis for this view is that such offshore supply of goods does not have sufficient nexus with the territory of India for it to be taxed in India. However, applying the 'force of attraction' principle, it may be possible in certain circumstances to attribute such offshore services to the PE in India.[59] One may then have to examine whether a more beneficial position is available under the ITA.

5.2.4. *Sourced in Cyber Space*

With the dawn of e-commerce, countries have had no choice but to relook at their tax policies and examine how they would apply to the new e-paradigm. There are certain features of the multi-billion dollar e-commerce industry such as decentralization and remote operability that pose special challenges to the existing international tax framework.

India also is not new to such challenges. The observation of the Mumbai Tribunal in the case of *STAR Ltd. v. DCIT*[60] aptly describes the present situation: "In the modern cyber age and particularly in the business of communication and telecasting through satellite and transponders, a business place or a permanent establishment does not mean a structure of bricks and mortar alone....permanent establishment and every such ingredient of a taxable relation between non-residents and India are to be inferred from the nature of the business operations carried on by the concerned parties."

In the case of *Amadeus Global Travel v. DCIT*[61], the Government sought to tax income earned by a Spanish company which provided access to a fully automatic computer reservation and distribution system ("**CRS**"). Airline companies entered into 'Participating Carriers Agreements' for display of their information/products, etc. through the CRS which was integrated within specific computer terminals located in the premises of the Indian subscribers and connected via nodes. However, access rights and operability of CRS were fully controlled by Spanish company. As consideration, it received a 'booking fee', computed on the basis of the 'net booking' made through use of the CRS. It was strangely held that the operation of the CRS system gave rise to a fixed place of business of the Spanish company in India.

While there has been limited e-commerce related PE jurisprudence in India, one tends to wonder how the traditional source rules would apply to more complex models of e-commerce[62] involving multiple servers located around the world, each undertaking

58 [2007] 288 ITR 408.

59 The possibility of taking such a view may be inferred from the analysis of the Mumbai Tribunal in the recent case of *Airlines Rotables vs. JDIT*, ITA No. 3254 / Mum / 06, decision dated May 21, 2010. Here, while suggesting that certain offshore services could not be taxed whether a PE existed or not, the Tribunal observed that "The existence of a PE in a country cannot warrant or justify taxation of all the profits arising to a foreign enterprise in that country. Even if there is a PE, *one cannot infer application of the force of attraction principle and proceed to bring to tax all the profits of the foreign enterprise whether or not they relate to the PE.*"

60 [2006] 99 ITD 91 (Mum).

61 (2008) 113 TTJ (Delhi) 767.

62 Dale Pinto, "Exclusive Source or Residence-Based Taxation – Is a New and Simpler World Tax Order Possible?", *Bulletin for International Taxation*, July 2007 at 291.

independent value added activities. In the case of cloud computing, clients can store and access their data and applications virtually from anywhere around the world. Depending on the degree of control over the cloud server, a question then arises as to whether it creates any sort of PE exposure to the client.

It is worth noting that the Indian Government has expressed a number of reservations on the 2008 draft of the OECD model commentary which are of special relevance to e-commerce. The reservations are as follows:

- Geographic and commercial coherence are not prerequisites. Even work carried out for different clients in a distinct geographic unit could create a basic rule PE.
- Tangible and intangible property could by themselves constitute a permanent establishment of the lessor in certain circumstances.
- Industrial, Commercial or Scientific (ICS) equipment may constitute a permanent establishment of the lessor in certain circumstances.
- A website may also constitute a place of business.

The approach adopted by the Government seems to be absurd and fails to take into account the true nature and functionality of e-commerce models. By no stretch of imagination can a website or software or for that matter, intangible property (such as copyrights, patents, licences, etc.) be considered as places of business that may give rise to a PE. Such a wide construction of source rules would be difficult to justify in theory or practice and should be avoided.

5.3. *A tangible presence for intangibles?*

The legal situs of intangibles gives rise to several interesting issues in the application of domestic source rules especially considering the complex cross-border structures that are devised to house and transfer such assets in the course of international mergers and acquisitions. It is well known that intangibles such as trademarks, patents and copyrights are key drivers of modern businesses. In fact, much of the value of an acquired business may relate to the value of the underlying intangibles. But as the name suggests, an 'intangible' can neither be touched nor does it occupy any determinate space. So, in a cross-border acquisition of intangibles an issue arises as to which country has the right to tax. The ruling in the case of *Foster's Australia v. CIT*[63] is a good illustration of this point.

In this case the Australian company had licensed the well known Foster's brand to an Indian company thereby providing it with exclusive rights to use the Foster's trade marks and brew, package, label, and sell Foster's Lager beer. As part of an acquisition of Indian operations by a UK based group, the Australian company assigned its brand licence to the acquirer. The agreements were executed outside India and the transfer was between two non-residents. The question that arose was whether the acquisition led to the transfer of a capital asset situate in India. It was observed that the Foster's brand name was used in India for more than a decade and became inextricable components of the Indian business operations. The commercial exploitation of the trademarks and brand, aided by the marketing and advertising efforts of the Indian company was said to have resulted in the creation of a valuable intangible asset in India.

63 A.A.R. No. 736 of 2006.

Accordingly it was held that the situs of the asset was in India. The following was the basis for the conclusion drawn: "By reason of such collaborative effort and the circulation of product (beer) bearing the imprint of applicant's trademark and brand over a length of time and the undoubted goodwill it generated in Indian market, the applicant's trademark and brand established their presence, rather predominant presence, on the Indian soil and it continued to hold its sway in India on the date of transfer."

The fact that ownership rights over the intangible vested with the non-resident entity, that it originated and was registered under laws of the non-resident's country and that the transfer document was executed outside India did not seem to matter while determining the situs of the intangible. A similar position was adopted more than a century ago by the UK House of Lords in the case of *Commissioners of Inland Revenue v. Muller*[64] where it was held that 'goodwill' is inseparable from the business to which its adds value, and exists where the business is carried on.

The application of the Foster's ruling puts forth certain difficulties especially considering the business operations and holding structures adopted by today's MNC whose intangibles are spread across the globe. One may especially wonder how such an analysis may be applied to offshore transactions entered into by MNCs such as Google which may not have any sort of physical presence in most countries around the world but have built up some of the strongest global brand names.

5.4. *Nexus may not always matter*

Since the Supreme Court's decision in *Ishikawa*[65], it has been an established position of law that offshore services provided by a non-resident outside India do not have the required degree of territorial nexus to justify taxation in India. This position was reaffirmed by the Bombay High Court in its decision in the case of *Clifford Chance*[66], where income earned by the UK law firm from services provided by its partners outside India in connection with an Indian project, was held not to be taxable in India. The Court identified a dual test for taxability of such services in India: (i) utilization of services in India; and (ii) rendition of services in India. The doctrine of territorial nexus mandates that both tests be met for the service to be subject to taxes in India.[67]

The 2010 Finance Act has, however, completely reversed this position. Today, services provided by non-residents outside India may still be caught within India's tax net. By overriding the Supreme Court's position in *Ishikawa,* the Government has made it clear that the doctrine of nexus is irrelevant while exercising its fiscal jurisdiction. The new provision has been recently applied by the Mumbai Tribunal in the case of *Ashapura Minechem v. ADIT*[68] where offshore testing services provided by a Chinese company were held taxable in India.

This new law is bound to impact several conventional cross-border service models including engineering, procurement and construction contracts, turnkey projects and international financial services, and professional services.

64 (1901) AC 217.

65 [2007] 288 ITR 408.

66 (2009) 176 Taxman 458.

67 A similar view was adopted more recently by the Bangalore bench of the Income Tax Appellate Tribunal in the case of *M/s Bovis Lend Lease (India) Pvt. Ltd.* 2009-TIOL-666-ITAT-BANG, where it was held that income from offshore administrative, legal and accounting services provided by a Singapore entity was not taxable in India.

68 ITA No. 2508 / Mum / 08, decision dated May 21, 2010.

In this context, one may also consider the proposal to tax offshore interest accruals linked to India based investments as contemplated under the draft DTC. As per the Code, interest payments made by non-residents in respect of borrowings that are invested in India would be deemed to have accrued in India. Therefore if a US Company uses leverage to make an acquisition in India, the interest payments made to its foreign lenders would be taxable in India. The US company may have to accordingly withhold tax on these amounts—a classic case of extraterritorial exercise of India's fiscal jurisdiction.

The taxation of offshore transactions and interest accruals is also likely to give rise to tax credit issues. There is a doubt as to whether a foreign service provider or lender can get credit in its country of residence for taxes paid in India due to the application of an inconsistent source rule.

The Government's disregard for the requirement of territorial nexus seems to ignore the fact that this principle is an integral part of India's Constitutional scheme. Such extraterritorial operation of tax laws also militate against customary international law principles of sovereignty and comity of nations. In the words of the US Court of Appeals[69], domestic interests are sometimes "too weak and the foreign harmony incentive for restraint too strong to justify an extraterritorial assertion of jurisdiction." Clearly, offshore transactions that do not have any direct, substantial and foreseeable nexus with the territory of India cannot be taxed in India.

5.5. *Ignoring form, while widening source*

Does India have a right to tax transactions that manifest far away from its fiscal shores? From the Supreme Court's decision in *Ishikawa*, one may answer this question in the negative. As explained above, without sufficient territorial nexus with the object being taxed, India does not obtain the jurisdiction to tax it. The question that then arises is: when is the nexus sufficient? For instance, does India have a right to tax income earned by Hutch, Cayman Islands from the sale of shares of CGP Investments, another Cayman Islands entity to a Dutch company that was part of the Vodafone group?

The infamous *Vodafone* saga seems to represent a new phase in India's efforts to expand its source frontiers. The US$ 11.1 billion received by Hutch was in respect of transfer of shares of a Cayman Island based company which had a number of underlying subsidiaries in various countries including India. It is quite hard to imagine that such offshore transactions between two non-residents could result in the 'transfer of a capital asset situate in India'. The Government initially sought to justify its jurisdiction by using an interesting principle known as the 'effects doctrine'. As explained by Justice Learned Hand, a State may impose liabilities even upon persons not within its allegiance, for conduct outside its borders that has consequences or *effects* within its borders and these liabilities other states will ordinarily recognize.[70] The theory is that a State has the right to legislate in respect of all offshore activities that have some sort of an effect within its territory. The origin of the effects doctrine can be broadly traced to early nineteenth century in US jurisprudence and it seems to have been used more in an antitrust rather than a tax context. Over the years, a number of US Courts have circumscribed the applicability of the effects doctrine to only those acts by non-residents that have a 'direct and substantial effect' in the territory of the US.[71]

69 Timberlane Lumber (9th Cir. 1976) 549 F.2d 597.

70 Alcoa case, 148 F. 2d 416

71 *Timberlane Lumber case*, (9th Cir. 1977) 549 F. 2d. 597 narrowed down the scope of the effects doctrine by laying down specific factors to be considered while applying the 'substantial effect' threshold including the degree of impact in the US and the possible harm to US' trade and foreign relations if the doctrine is applied.

The other basis for asserting fiscal jurisdiction over Vodafone's offshore transaction is that the true object of the transaction was to indirectly acquire the controlling interest and other assets in relation to Hutch's Indian subsidiary. Therefore by going into the realm of commercial motives and anti-avoidance, the Government has sought to pierce the corporate identities of numerous foreign intermediate companies so as to establish that the offshore transaction was essentially in respect of an onshore capital asset, which clearly gave India the requisite authority to cast its tax net.

In this regard, one may also consider the new General Anti-Avoidance Rules proposed in the draft DTC which provides unfettered powers to the tax authorities to disregard legal entities or individual transactions, re-characterize legal instruments and incomes and also override specific treaty provisions.[72]

The taxman's approach, described by some as 'new-age fiscal extremism'[73], has created much uncertainty in the international business environment. The use of anti-avoidance and substance over form arguments results in a widening of source based taxation to an extent that poses considerable challenges to the structuring of cross-border investments, mergers and acquisitions. It seems that little regard has been given to the Supreme Court's decision in *Union of India v. Azadi Bachao Andolan*[74] which has abundantly clarified that India respects the form of a transaction and would not disregard lawful transactions capturing the genuine commercial intentions of the parties.

6. Concluding thoughts

In terms of a general policy trend, India seems to be quite aggressive in asserting as well as expanding its source based taxation rights. This is quite typical of capital importing countries which fundamentally rely on taxation at source.[75] India has also been increasingly 'dynamic' while enforcing its source tax rules, especially in the context of electronic commerce and cross-border movement of intangibles. Both, treaty as well as the domestic law practice suggests that India is poised to defend itself against any sort of potential erosion of tax base. At the same time, one is confronted with a very unsettling question: Has India (consciously) decided on the direction towards which its residence and source rules should evolve?

As discussed in the initial part of this paper, India has the option of using its international tax policy framework to achieve a number of ends, viz. encourage inbound investments, incentivise foreign collaborations and transfer of technology, promote specific types of industries and income flows or even encourage Indian industries to globalize. The policy objectives may also include fostering of strong international trading and political relations, increasing foreign exchange reserves, enhanced GDP growth as well as having a more prominent role in world economic affairs. From an economic efficiency perspective, India may consider it desirable to achieve capital import neutrality along with minimization of compliance and enforcement costs.

So, what does India want to achieve? The difficulty in answering this question becomes apparent from some of the conclusions that may be drawn from the recent trends in the enforcement of residence and source rules in India:

- *Increasing reliance on ambiguous standards*: Tax laws have to be interpreted strictly. In the famous words of Justice Rowlatt, "In a taxing act one has to look merely at

72 Section 112 read with section 161, DTC.

73 Nishith Desai, "Driving investment away from India: Foreign investors have become weary of cases such as Vodafone and E*Trade", *Tax Notes International*, Volume 55, Number 1, at 7.

74 [2003] 263 ITR 706 (SC).

75 See, McLure, Jr., Charles E., "US Tax Laws and Capital Flight from Latin America", 20 University of Miami Inter-American Law Review 321 (1989), at 325-326.

what is clearly said. There is no room for any intendment. Nothing has to be read in, nothing has to be implied. One can only look fairly at the language used."[76] Clear and objective tax rules allow people to plan their behaviour with ease and make rational economic choices. There is, however, a high degree of subjectivity in India's application of source and residence rules whether in terms of treaty practice, domestic law provisions or in the proposed DTC. The resulting uncertainty serves as a deterrent to investing or doing business in India.

- *Disconnect with industry understanding*: Enforcement of source and residence rules have to factor in new developments in the industry and the peculiarities of each transaction. This becomes very important in the context of e-commerce as well as space commerce transactions which pose challenges to the application of conventional residence and source rules. There are also a number of complex triangular situations giving rise to difficulties in determination of source and in providing relief from double taxation. The Indian Government, however, seems to distance itself from the industry perception and is ever ready to apply the source/residence standards on subjective lines.

- *Overriding judicial precedent*: In a time when the Apex Judiciary has been actively engaged in bringing about some sort of certainty in the application of international tax rules on the basis of Constitutional and international law principles, India has on a number of occasions overturned such precedent through retrospective legal amendments with a view to establish revenue friendly positions. The abject disregard for judicial wisdom has a negative effect on the evolution of source and residence jurisprudence in India.

- *Violation of international law principles*: Most principles of international taxation that are adopted by developed countries and which have manifested in various bilateral and multilateral conventions have their origins in early juristic writings and State practices. For example, the principle of nexus or economic allegiance, which limits the source State's fiscal jurisdiction, seeks to respect the sovereign rights of independent States. Co-ordination and co-operation between States on issues such as source, residence and taxing rights is a step towards international harmony and comity of nations. India's ignorance of such well established principles of international law and its uncertain tax positions is bound to be viewed in negative light by taxpayers and Governments around the world.

- *Economic distortion*: The uncertainty stemming from India's application of source and residency rules also leads to economically inefficient behaviour. Apart from the increased costs of tax compliance, significant amounts are expended in implementing tax mitigation structures as well as in defending positions over protracted litigation. The taxman's approach has in certain cases increased administrative/enforcement costs to an extent that may not justify the increase in revenues.

- *Tax payer rights*: The importance of tax payer rights has never been recognized in the application of residence and source rules in India. These internationally recognized rights include fair enforcement of tax laws; non-retroactive imposition of taxes; certainty and stability in tax laws; guarantee against double taxation and good-faith interpretation and enforcement of tax treaty provisions and efficient resolution of tax disputes.

76 *Cape Brandy Syndicate v. IRC*, (1921) 1 KB 64 (p 71).

- *Adversarial approach*: The excessively adversarial approach of the Indian taxman is evidenced by the large backlog of cases at the tax tribunals and High Courts. This is quite in contrast with the OECD-recommended, 'enhanced co-operation' between taxpayer and the State, where both are viewed as partners working together for achieving common socio-economic ends.
- *Lack of vision*: The most serious criticism that may possibly be levelled against India's approach to source and residence is that it is not backed by any overt policy level macro-economic strategy. There was a time when the Government passionately defended the Mauritius tax treaty before the Supreme Court[77] on the basis of the amount of capital investment and foreign exchange that entered the country through Mauritius. It was even accepted that treaty shopping through the use of intermediate shell companies in tax havens such as Mauritius is a legitimate instance of tax planning and has to be respected. Today, the Government seems to be quite inclined towards disregarding tax treaty commitments[78] and is ready to look through most international transaction structures on grounds of anti-avoidance. Is this sudden *volte-face* justified by any economic rationale? Or is the Government just myopic, being solely concerned with maximizing revenues through whatever means possible. It is necessary for India to clearly lay down a policy on the basis of which it would interpret and enforce its residence and source rules so as to assure certainty and also achieve specific economic targets.

Considering that the revised draft of the DTC would be released for a second round of public scrutiny within a month or so, the time is ripe to address these issues with the object of reforming India's current approach to international taxation.

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77 *Union of India v. Azadi Bachao Andolan*, [2003] 263 ITR 706 (SC).

78 This is visible from the taxman's denial of treaty benefits to *E*Trade, Mauritius* in complete disregard to the position laid down by the Supreme Court. The Authority for Advance Rulings however has reject this view in a recent ruling issued in favour of E*Trade.