INTERNATIONAL TAX CONFLICTS – AN OVERVIEW

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Abstract:

Article covers the phenomenon of international taxation with a practical example and key issues of emerging point of taxation. Plethora of practical examples on tax conflicts is considered to provide simplified version and their types of tax conflicts. Advent of technology over a period of last two decades widens the scope of doing business worldwide. Technologies provided wings to many MNE to expand their businesses worldwide. As a result various business models emerged in 21st century which focused on taking the tax benefits of various countries tax laws. The very objective of this article is provides basic instincts on international tax conflicts arising during the course of international business. Article limits its discussion only on tax conflicts without discussing the various solution adopted by various tax jurisdictions to resolve such tax conflicts. Only few countries DTAA are considered to elaborate the concepts, however there are more than 3000 DTAA are exists worldwide, which are not taken for our research article. Taxation is a sovereign right of every country to levy tax and collect it. International taxation is a tax levied on cross border transactions, by domestic law. Every country wants to tax every person and every transaction which takes place in their country. This unilateral levy of tax creates issue of double taxation in different forms like juridical double taxation, economic double taxation etc. Article throws light on various tax conflicts in an international scenario from different countries point of view evolving in double taxation. Every effort is made to clarify the different tax conflicts in detail with proper example. It is very much clear that taxes are not International and at the same time there is no separate global tax law that governs cross border transactions. Tax treaties between countries are evolved as a solution to these tax conflicts. However, article concludes how these tax treaties provided scope for emerging new concepts of double non taxation in the form of shifting their profit from high tax country to low tax countries.

Key words: International Taxation, Tax Conflicts, Double Taxation, Source based Taxation, Residence based Taxation, Source Conflict, Residence Conflict.

INTERNATIONAL TAX CONFLICTS – AN OVERVIEW

Introduction:

Do you know Google, YouTube, Face book, Whatsapp? Some people revert back who don't know these? Are you talking to old generation? Yes, absolutely true that in today's globalised world every person irrespective of age, gender, location etc, uses these modern internet tools every now and then. The main reason to become so popular in the world is all these are absolutely free to use it. Whenever we get anything free, we usually turns up towards its usage when it fulfils our needs. But how these companies earns there profit? The answer for this is ADVERTISEMENT.

Normally when a business is done, its profit is computed based on their business turnover or from service rendered. But in case of above companies they will get amount across the world for providing advertisement services which spread across the world. Now the question arises from the point of taxation, in which country these software giant's works and from where their profit gets generated. Advertisements in these Google, YouTube, Face book etc are seen by millions of people across the world. Now it's time to say by every country that they contributed in earning profit of the company when millions of viewers from their respective country.

Let's consider another example, one of the multinational company's (MNC) purchase goods from country X, manufactures in country Y, stores in country Z and finally sold in country A. Please note that:

- ✓ while purchasing goods from country X, it pays full consideration to be payable for buying those goods;
- ✓ all kinds of payments are made in country Y for manufacturing those goods ;
- ✓ rent or lease amount or any other amount for storing those goods in country Z is paid;
- ✓ all kinds of taxes in respect of each country like sales tax (VAT) while buying goods in country X, excise duty for manufacturing in country Y, export duty in country Z when goods move from country Z to country A and even sales tax (VAT) in country A or any other similar kind of taxes in respective countries are paid.

  By doing all these activities in the form of business, that multinational company earns considerable amount of profit. Now question arises:

- ✓ Where that MNC has to book its profit?
- ✓ Where it has to pay tax on it profit?
- ✓ Is it right to identify sale point as taxing incidence, when factors contributing to earn profit (resulting through sales) locates at various country?
- ✓ Are there any international tax laws which look into these matters? and
- ✓ Series of questions like this goes on........

"The hardest thing in the world to understand is the income tax."- Albert Einstein. With all the nuances that the taxation system in the world is grappling with, the above quote from one of the greatest minds is clearly standing the test of time in its widest sense.

International taxation is a tax levied on cross border transactions, by domestic law. Roy Rohatgi (2007) in his book Basic International Taxation says "Taxes are not International. There is no separate global tax law that governs cross border transactions. There is no international tax court or administrative body for international tax issues." Yes, it's true that there is no concept called as International Taxation but for our convenience we say, the international aspects of income tax laws of a particular nation, as international taxation. As per Wikipedia, International taxation is the study or determination of tax on a person or business subject to the tax laws of different countries or the international aspects of an individual country's tax laws as the case may be.

It is the domestic tax law of the country which levies tax on cross border transactions giving birth to the term called "International Taxation." But defining the law in the context of cross border transactions is quite difficult task. Therefore international taxation is the study of implication of domestic tax law on cross border transactions. International Tax Law governs the taxing rights of Sovereign nations dealing with direct tax as well as indirect tax.

Need for International Taxation

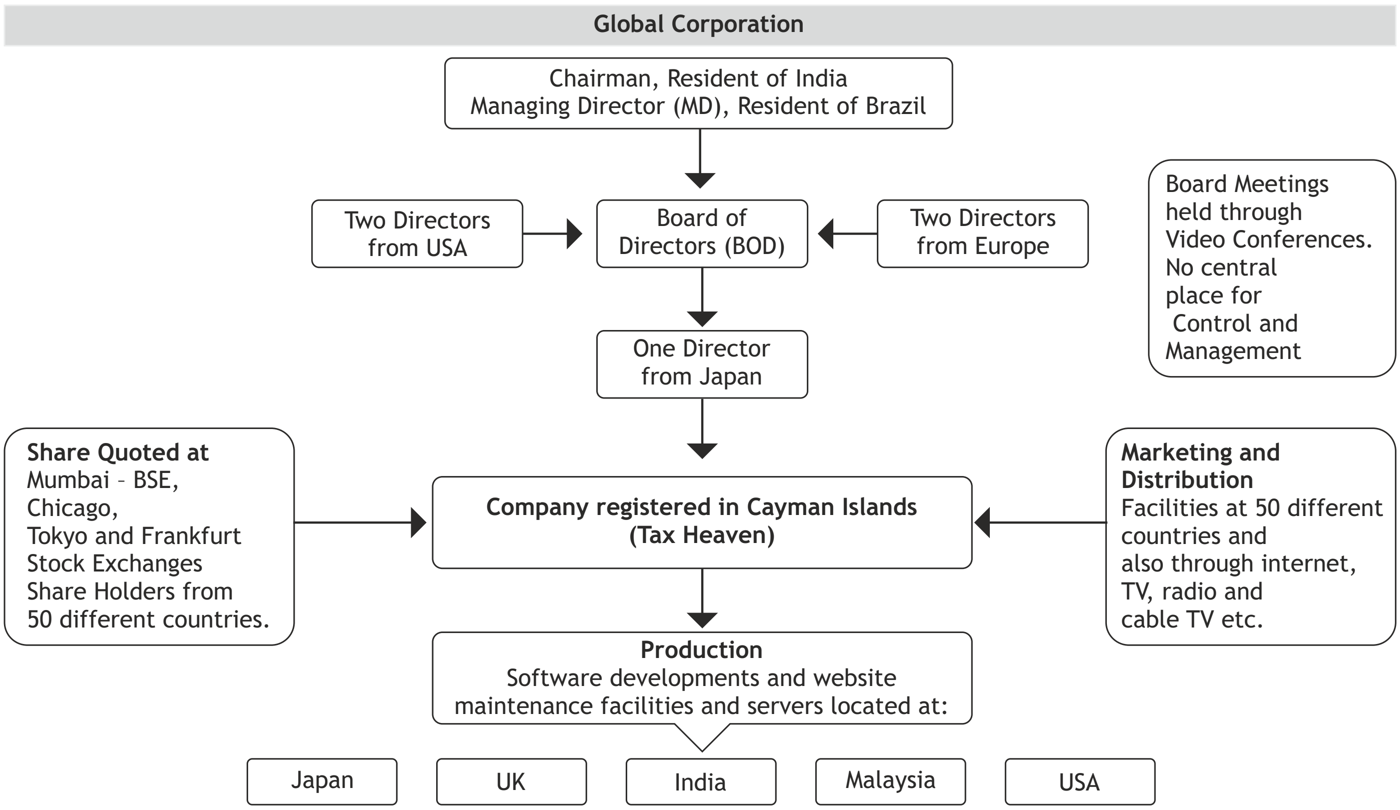
In the world of technology, doing business worldwide is becoming simple like doing business from home. But it poses multiple questions on tax law. Look at the given below structure of global company.

[1]CAI, (2016), Aspects of International Taxation – A study, Revised edition of ICAI, P 1.

[2]Roy Rohatgi, (2007) Basic International Taxation, Second Edition, Taxmann Publication, P 1.

k[3]Residence of a Global Corporation

A Global Corporation having own websites and providing services on the web



Where is the Company Truly Resident?

Where should it pay its main tax on the Global Income?

Answering these questions becomes very difficult until we analyse these facts and circumstances in accordance with respective domestic tax laws. In India these are tested based on Company's residential status as per section 6(3) i.e. Place of Effective Management (PoEM). Issues of these kinds are emerging day by day as the mechanisms of doing business are changing. Even individuals who earn income from the world must comply with all the tax provisions of countries wherever he earned.

[3]CA Rashmin C. Sanghvi, Conceptual paper on Residence and Tax Incidence, Web article, Pg 21

Double Taxation:

Every country has its sovereign right to tax either on goods or services or income. With this, Government may control movement of goods or capital across national borders. Normally, [a country's sovereign right to tax is based on two connecting factors.

a. Personal: Residence, Domicile & Citizenship

b. Economical: Activity or the transaction or the event which generates income or capital. i.e. Control and Management, PoEM, Place of incorporation.

These connecting factors give rise to:

a. the residence jurisdiction of taxation – based on the residence of a person

b. the source jurisdiction of taxation – based on the economic activity or transaction or the event which generates income or capital]

[5]Two common principles of international taxation which may lay the foundations for many national tax systems are the **Residence Principle** and the **Source Principle.** According to the residence principle, residents of the country are taxed uniformly on their world-wide income, regardless of the source of income (domestic or foreign). This type of taxation approach is also known as **"Worldwide Tax System".** Examples of country following this system are India, USA, Chile, South Korea, Ireland, Mexico etc. According to the source principle, income originating in the country is uniformly taxed, regardless of the residency of the income recipient. This type of taxation approach is also known as "Territorial Tax System". Examples of country following this system are Australia, Austria, Canada, Denmark, Turkey, Switzerland, Finland, Germany etc.

The domestic tax laws of most of the countries, including India, grants unlimited taxation rights to the country of residence of the person. This means, domestic tax laws of a country want to tax the income or capital arising out of the person's activities in that country or in any foreign country. This is called as "Worldwide Income Principle" or "Unlimited Tax Liability". Similarly, when a country levies tax on the income that is derived from economic activities carried out by a person who is a non resident of that country is called "Source Taxation" or "Source Jurisdiction Principle" or "Limited Tax Liability".

National tax law establishes connecting factors between taxpayer and the taxing state such as residence, citizenship, source of income, place of activity, location of property etc. Every country follow different taxing approach and levy of tax based on connecting factory leads to overlapping of multiple jurisdictions. Determination of tax, based on these connecting factors creates conflicting taxing rights

[4]Karnataka State Chartered Accountants Association (KSCAA) (R) 2016, International Taxation – Practice Concept by Group Dynamics, First Edition, KSCAA, P 17.

[5]Jacob Frenkel, Assaf Razin & Efraim Sadka, (December 1990), Basic concepts of international taxation, Working paper 3540 of National Bureau of Economic Research, Cambridge, P 2.

[6]Mark P. Keightley and Jeffrey M. Stupak, (2014), US International Corporate Taxation: Basic Concepts and Policy Issues, Congressional Research Service 7-5700 www.crs.gov published on 2.12.2014, P 1

[7]Mark P. Keightley and Jeffrey M. Stupak, (2014), US International Corporate Taxation: Basic Concepts and Policy Issues, Congressional Research Service 7-5700 www.crs.gov published on 2.12.2014, P 1

between countries which lead to double taxation. Interplay of taxing rights of different countries results in double taxation. Following are the different countries which follows different kind of taxation approach.

1. No personal (income) tax at all: Cayman Islands, Maldives, Kuwait, Bahrain etc
2. Territorial taxation only: Botswana, Singapore, Lebanon, Costa Rica etc. No foreign income of resident assessees chargeable to tax under the domestic tax law.
3. Residential taxation: India, Australia, Canada, France, Germany etc.
4. Citizenship based taxation along with residential taxation: USA and Eritrea.

Double Taxation is often an unintended consequence of tax legislation . Double taxation is the levying of tax by two or more jurisdictions on the same declared income (in the case of income taxes), assets (in the case of capital taxes) or financial transactions (in the case of sales tax) . Double taxation can take different forms and occur in different situations. There kare two types of double taxation namely:

- ➢ Juridical Double Taxation
- ➢ Economic Double Taxation

Juridical Double Taxation means when the same person is taxed twice on the same income by more than one country/ jurisdiction. When the same income is subject to tax in more than one country and in the hands of same person, then it results in juridical double taxation. For example Mr. Steve Smith, an Australian cricket player earns income in Australia and also earns income in India whenever he plays in India. Now Mr. Steve Smith being resident of Australia liable for his worldwide income and hence Australian Tax Authority levies tax on his entire worldwide income. But at the same time Indian Government also levies tax on that portion of his income which he earns in India based on source principle. Thus income earned in India is subject to double taxation. Another example to say is company X is registered in India having a branch in Germany. Branch of the company earn profits in Germany and liable for tax in Germany and later profit after tax repatriated to head office in India. Now Company X in India is taxed on the total profit including branch profit. Hence, branch profit is liable for double taxation.

Economic Double Taxation means where the same income is taxed twice in the hands of different tax payers. Taxation of two different tax payers on the same income is called economic double taxation. For example when company earns profit is liable for tax on it. After payment of tax, company distributes it to its share holders in the form of dividend. Later, when shareholders receives dividend, such amount so received is treated as income in the hands of shareholders and liable for tax. Hence profit and dividend constitute the same income but results in taxation in the hands of company as well as in the hands of shareholders. Please note that dividend in India is treated as exempted income whereas in USA it is treated as taxable income. Another example for economic double taxation is export and import. Assume both country of export as well as country of import levy tax on both export and import respectively. Here exporter pays tax on export of goods whereas the importer pays tax on import of the same goods leading thereby economic double taxation.

[8]http://www.ey.com/Publication/vwLUAssets/Global_Executive_2011/$FILE/GE_2011_Global_Executive.pdf

[9]ttps://www.investopedia.com/terms/d/double_taxation.asp

[10]https://en.wikipedia.org/wiki/Double_taxation

Goods' being the subject matter of taxation incurs double taxation in the form of export duty in exporting country and import duty in the importing country.

Tax Conflicts:

Tax conflicts mean levy of tax by two or more different tax jurisdiction either on the same income or on the same person. When taxing jurisdiction looks at taxing subject, whether it is income, asset, economic activity etc, from different angle creates tax conflict. Some of the common reasons for tax conflicts are defining a particular type of income (royalty vs. business income), taxability of an entity (Partnership Firm Vs Partners), different tax system (Worldwide Vs Territorial), etc. For example dividend is treated as tax free in India where as it is taxable in USA. Further to say, "USA considers partnership firm as a transparent entity whereby its partners are taxed and not the firm whereas in India, it considers partnership firm as a separate entity and firm is taxed giving an exemption to partners" . Even Definition of resident varies from country to country. Look at the following examples:

- ❉ In Denmark an individual is treated as resident if he/she resides in Denmark for more than half year.
- ❉ An individual resides in a country for a period of 182 days or more during the tax period is consider to be Resident in that country. This definition is adopted by Barbados, Guernsey, India, Malaysia and many more.
- ❉ In Belarus, Botswana, Brazil, Croatia, Georgia, Malta, Pakistan, Peru etc the period of stay is 183 days or more to qualify an individual as resident.
- ❉ In case of corporate normally it becomes resident of that country where it gets registered. Apart from this they will also becomes resident based on PE principle, PoEM principle, control and management principle etc.

Following are the different types of tax conflicts resulting in double taxation.

- Residence Vs Residence Conflict
- Residence Vs Source Conflict or Source Vs Residence Conflict
- Source Vs Source Conflict
- Triangular Cases
- Income characterisation Conflict
- Assessee Characterisation Conflict

Residence Vs Residence Conflict:

This conflict arises whenever a person becomes resident in two or more countries for particular tax period. Here both countries asserts their taxing rights based on residence principle. Consider tax laws of India and Canada, wherein India specifies a period of 182 days or more and Canada specify a period of 183 days or more during the tax period to become a resident of that particular country. In a year of 365 days if a

[11]ICAI, (2016), Study material of Diploma in International Taxation, Paper 2, Part – I, ICAI, P 1.8.

person stay 182 days in India and 183 days in Canada then he/she becomes resident of both country resulting in resident vs. resident conflict. Another example, a person from USA having US citizenship stays in India for a period of 182 days or more in India will become liable to pay tax both in US and in India. Figure 1 exhibits it more clearly.

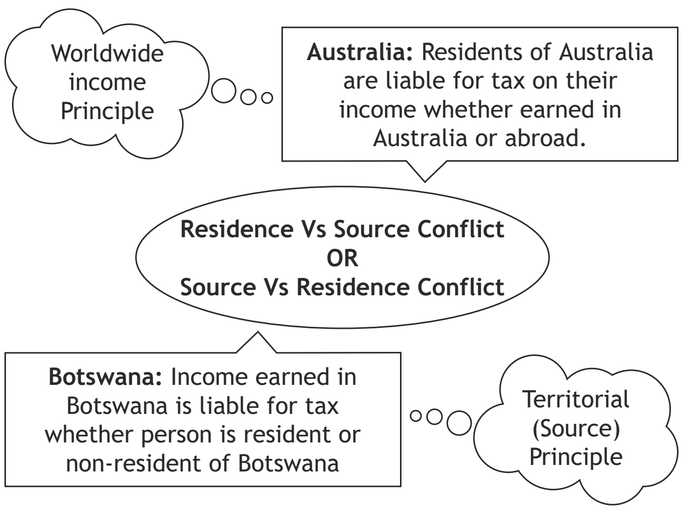


Figure 2 – Residence Vs Source Conflict OR Source Vs Residence Conflict

Source Vs Source Conflict:

This conflict arises whenever an income becomes tax object in two or more countries. In this case both countries asserts right to tax on the income as per their respective domestic tax law, based on source jurisdiction rule. For example, Mr. Sharma resident of India is the owner of a property which is situated in US. Mr. John who is resident of US does business in US as well as in India. To do business in US, he wanted property in US and hence approached Mr. Sharma. Later both agreed and had lease agreement of such property and signed the agreement in India. Now as per lease agreement lease amount should be paid to Mr. Sharma in India. Now US Government taxes such income because property situated in US (Source rule). India too taxes same income because lease agreement is the source of income and lease amount is received in India (Source rule).

Another example to quote is Dividend income. In India, Dividend Distribution Tax is levied on company giving an exemption to the share holder, when they receive it. However in US, Dividend income is taxable in the hands of receiver. Here, the same dividend income is taxed both in India and US when US resident received dividend from Indian company based on source rule of both country. This results in source vs. source conflict. Pictorial representation is given in Figure 3.

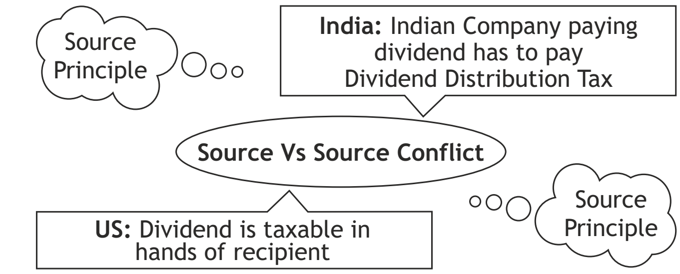


Figure 3 – Source Vs Source Conflict

Triangular Cases:

This conflict arises when three countries are involved and levies tax on a particular transaction. Let's consider company A is located in country A has a branch B in country B. Branch does business through PE in country C. Now income earned in country C through PE is taxed in country C. The same income treated as branch income in country B. Similarly while consolidating income of parent company A, the income of branch B is also considered. Hence the income is taxed in all three countries A, B and C. Interplay of residence vs sourse vs residence or source vs residence vs source rule give birth to triangular case of conflicts. Let's see an example : Queen Mary ship sails from country X to Country Y carrying cargo and passengers. The Government of country X may claim that income from shipping operations is sourced from

[12]CA Rani N. R. (2016), International Taxation – Practice Concept by Group Dynamics, Chapter 1: Introduction, Karnataka State Chartered Accountants Association (R), Bangalore p 20-22

country X, since Queen Mary sails through the territorial waters of country X. Mean while, the Government of country Y may also claim that since the cargo and passengers that produce the income from shipping operations are sourced in country Y, it has the right to tax the income from shipping operations of Queen Mary. Both the countries assert the right to tax based on the principle of source jurisdiction. Further to state that if shipping company is resident of country Z due to its place of effective management (PoEM) in country Z, then Country Z will get right to tax the global income of the shipping company. Given below picture depicts the triangular conflict:

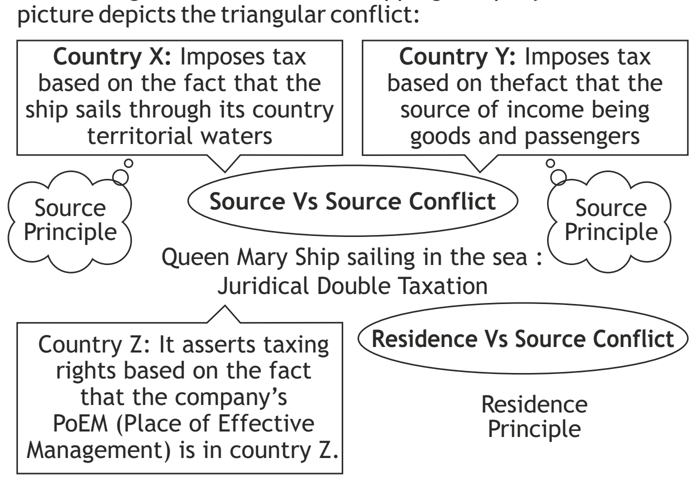


Figure 4 - Source vs Residence Vs Source Conflict - Triangular Conflict

Income Characterisation Conflict:

There are instances where a particular income is considered in two different forms by two different countries. For example, royalty receipt is treated as royalty income in source country whereas the same is treated as business income in the country of residence. For instance, assume that Company X is doing business in India. Over a period of time it built its brand name throughout the globe. Meanwhile Company X started business in UK as its branch. Later on branch in UK using its parent company brand name it started to expand its business worldwide through providing franchise. Whenever payment for providing franchise is received by UK branch office, it is treated as royalty payment as per the US tax laws. Whereas such income is treated as branch business income while consolidating income of Parent Company X in India. This is how income characterisation creates conflict and leads to double taxation.

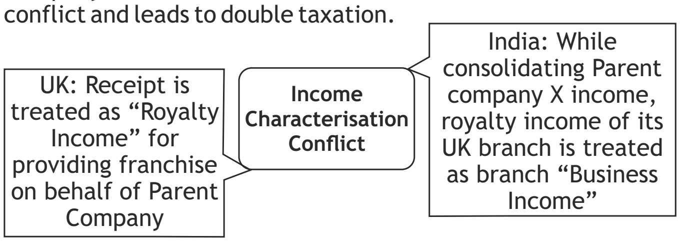


Figure 5 - Income Characterisation Conflict

Assessee Characterisation Conflict:

For taxing any tax subject must be defined in the respective domestic law as assessee or person. Normally all individuals are treated as assessee in all the country whereas other than individuals, such as firm, AOP, LLP etc may or may not treated as assessee in all the countries. This definition of assessee creates conflict in imposing taxing in two different jurisdictions. Example, firm is treated as transparent entity in USA and not taxed but partners are taxed as an individual. But in India firm is treated as person (assessee) and taxed on firm's income by giving exemption to partners. Considering this scenario, two individuals from USA establishes business in India by creating partnership firm. Now, any income earned by firm is taxed in India and share of profit received from firm is taxed in USA which creates assessee characterisation conflict leading to double taxation.

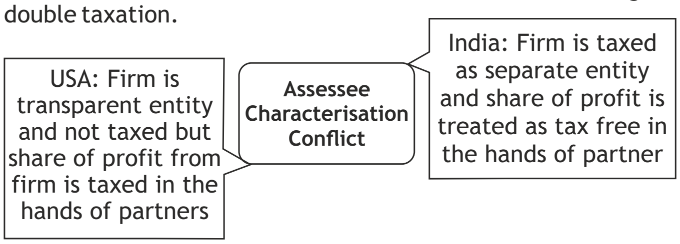


Figure 6 - Assessee Characterisation Conflict

Conflicts so far discussed are hurdles to do business worldwide and even for every country to expose itself to the global world. If these conflicts persist then no global companies will take step into any country to expand its business. Therefore, we need solutions to all these conflicts. To provide good platform and ease of doing businesses for global companies, countries came together to resolve these conflicts and agreed and shared certain taxing rights among themselves. These are called Tax Treaties. i.e. Double Tax Avoidance Agreement (DTAA).

Solution to Tax Conflicts:

The need for agreement for double tax avoidance arises because of conflicting rules in two different countries about chargeability of income on the basis of receipt and accrual, residential status etc. As there is no clear definition of income and taxability thereof, which is approved internationally, an income may become liable to tax in two countries. Double taxation occurs when an individual is forced to pay two or more taxes for the same income, asset, or financial transaction in different countries. Double taxation occurs mainly due to overlapping tax laws and regulations of the countries where an individual operates his business. In such a case, the two countries have an agreement for double tax avoidance, popularly known as DTAA – Double Taxation Avoidance Agreement or Tax Treaty, in which case the possibilities of solution to tax conflicts are:

- The income is taxable only in one country
- The income is exempt in both countries
- The income is taxable in both countries, but credit for tax paid in one country is given against tax payable in the other country

Conclusion:

Tax authorities need to evolve their tax laws with the change in doing business worldwide. Similarly use of technology by tax authorities to resolve these tax conflicts either by exchange of information among countries or through amending domestic tax laws. Developments taken place worldwide during last two decades resolved these tax conflicts issues but provided scope for getting undue advantages of loopholes in various DTAA leading to shifting of profit from high tax jurisdiction to low tax jurisdiction or tax haven countries. Various countries including India adopted many solutions such as providing foreign tax credit, exemption to foreign incomes, etc based on their countries domestic laws. However, consensus adoption of international tax rules among countries as unified method is essential to built strong and transparent tax system between tax payer and tax authorities.

[13]CA Rajkumar S. Adukia (17-5-2012), DTAA & Taxation, retrieved from https://taxguru.in/income-tax/double-tax-avoidance-agreements-taxation.html

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