International Tax Workshop
Residence Vs. Source taxation

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Presentation agenda

- Introduction
- Connecting factors
- Residence and source-based systems
- Global Trends
- Global Reset

Taxing Rights?

TAXES AND ECONOMY?

Residence And Source Taxation

International taxation refers to the global tax rules that apply to transactions between two or more countries (also called states) in the world. The principles of international taxation are influenced by **tax equity** and **tax neutrality** within the national economic sovereignty of each nation.

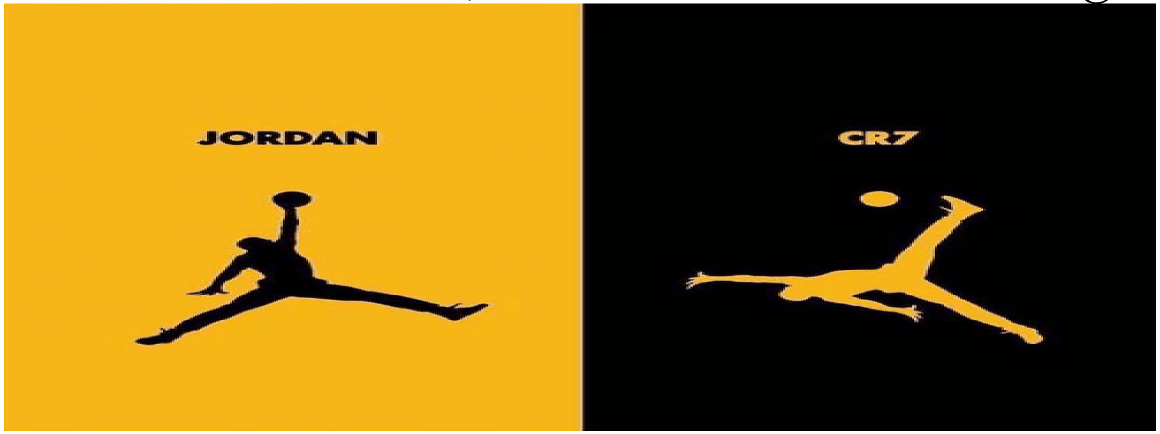
It also requires that taxpayers involved in cross border activities be neither discriminative against nor given undue preference in their tax burdens.

International Taxation

- Members of a community are mobile and may receive services from governments other than their own, the issue arises as to who are the persons from which particular government may appropriately extract taxes
- The key question is whom does the obligation to fund a particular government fall?
- The doctrine of economic allegiance which states that those who benefit from government services are obliged to fund the government then is called into question.

Residence Vs Source Taxation

In fact, a person can owe economic allegiance to more than one state i.e **divided allegiance** which raises the potential for double or multiple imposition of income tax and question as to whether double taxation is appropriate or not. If not, how relief can be organized.



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Connecting factors

Connections can be in form of a person or activity.

The person is taxed when there is connecting factors in that state also refereed to as economic allegiance.

Connecting factors include;

- Presence
- Residence/Domicile which may mean “meaningful presence”
- Citizenship
- Nationality

Connecting factors...

Activity raises "Source" issue such as,

- Payment arises from,
- Location of activity from which income arises
- Location of asset from which income is derived
- Location of liability etc

Source taxation is justified by the view that the country which provides the opportunity to generate income or profits should have the right to tax it.

Connecting Factors

- Tax laws impose a tax on tax subjects or persons (natural or legal) under the charging section only when the persons who have taxable objects or income for the relevant tax period.
- Connecting factors are based on residence, nationality, or domicile of the tax subject and on the source rules over the income or gain for the tax object.
- Residents might be taxable on their world-wide income(unlimited or full liability) and
- Non- residents are only taxable on the income and gains within the country (Limited liability)

Residence....

When there is double tax agreement, the connecting factors are derived from each of the tax treaties.

In the absence of the same, the Income tax law is applied.

In both cases, which are adapted from the OECD and UN Model Tax Treaties, **Residence** therefore must have qualitative and quantitative characteristics;

i) Residence of a particular kind and

ii) An intention of a particular kind.

A visit of section 2 of the Income Tax act on definition of residences depicts this.

Source Rules....

To be effective, source rules should enable the tax jurisdiction **to identify the income and its recipient, to quantify it and to enforce its taxing rights.**

Basic source rules include;

- Intangible property rights- Usually sourced either at the place where they are used or where the payer is resident.
- Sale of tangible goods- Where the ownership changes or title passes or country of residence of the seller
- Others include, where the contract is signed, where delivery takes place, where the contractual offer is accepted etc.
- Service Income- State it is performed , state of the payer, where the services are used or where the payment is received.

Residence …

OECD provides the criteria for individual(natural person) residence to include;

- Permanent home
- Centre of economic/vital interests or
- Habitual abode or
- Nationality or
- Settle by mutual agreements.

For corporate bodies, residence can be determined by;

- Place of incorporation or registered office

Residence….

- Place of residence of shareholders, directors or managers.
- Place of management or administration
- Place of central management
- Place of statutory seat
- Place where business is conducted
- Place where general meeting of shareholders is held and
- The place where its books and records are maintained.

Management can refer to management and control (Policy making) or operational management (Policy execution)

Effective management ; Refer to practical day-to day management irrespective of where the overriding control or superior management is exercised.

Residence and source application

Three methods are therefore applicable.

- Pure residence-based taxation
- Pure source-based taxation and
- Mixed residence-source based system.

However each of these methods could present challenges

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Which method does Kenya apply?

Global trends

1. CONFLICTS OF RESIDENCE AND SOURCE;

- Double/multiple taxation arise when the connecting factors grant competing taxing powers to two or more states on the same income.
- Divided allegiance also causes double taxation. A person may owe economic allegiance to more than one country at the same time.
- In income tax, the activity giving rise to the income is located in one country (The source country) and the person deriving the income is resident in another country (the residence country).

Global Trends

- The source country may impose its *in rem* tax on the income generating activity and the residence country may impose its *personal tax* on the person deriving the income.
- Sometimes, it may also arise where 2 countries claim the source of the income is in their jurisdictions or by two countries claiming the person is resident in their jurisdiction.

Global Trends

- Domestic tax systems provides for unilateral relief eg section 39 of the income Tax Act
- Juridical double taxation conflicts are largely solved through tax treaties negotiated under the principles of international tax law accepted by foreign states. These treaties ensure a fair distribution of global tax revenues among nations (Inter-nation equity) ,they also attempt to achieve global tax neutrality where tax issues do not affect the economic choices of taxpayers on international transactions(Section 41 of Income Tax Act)

Kenya Treaty Network

Kenya has 14 double tax treaties. France, Germany, India, Iran, Norway, South Africa, Sweden, United Kingdom, Zambia, United Arab Emirates, Qatar, South Korea, Denmark and Canada.

Global Trends

2. CONFLICTING DEFINITIONS OF CONNECTING FACTORS.

Any taxable transaction must exhibit;

- A tax subject; the identity of the taxpayer , or a person related to the taxed object that creates a tax liability.
- Tax object; The identity of the subject matter or the facts that cause the tax liability.
- Connecting factors; The reasonable connection between the taxing powers of the state and the taxpayer or the transaction without a connecting factor between either the taxpayer or the business activity and the tax jurisdiction, a state cannot levy its tax.

Global Trends….

Due to each country following its own tax practices under its own legal system, the following conflicts may arise;

- Source-source conflict; Two or more states claim the same income of a taxpayer as sourced in their jurisdiction.
- Residence- residence conflicts; Two or more countries regard the same taxpayer as tax resident in their country
- Residence- source; same income is taxed twice, first by the country where its derived under its source rules and then in the country where the taxpayer resides

Global Trends….

- Income characterization conflicts; Two states characterizes or classify the same income or capital differently And therefore apply differing tax provisions
- Entity conflicts; An entity is characterized differently under domestic rules of the two states and therefore subject to different taxation eg partnership deemed transparent or opaque.
- Mismatching tax systems; The two tax systems provide for differing rules for assessment, definition of taxable income or computation of taxes. These include income tax, total income ,residence, domicile,

Global Trends....

immovable property, permanent establishment etc.

- Other causes of international double taxation (using citizenship as a connecting factor)… *Jus soli* which means lack of being born on a certain territory and *Jus sanguinis* which is lack of being born in a certain family.

Case Study….

Assume country A and country B both tax income at a rate of 50%, and a resident of A derives 100 units of income from a source within B. How much would the resident have after taxation by the two countries?

Case Study

That income could first be taxed by B at 50% (paying 50 units in taxes) at source, and the remaining income

of 50 units could be taxed by A at 50% (paying taxes of 25 units) on the basis of residence jurisdiction. So the taxpayer would be left with only (100-50-25) = 25 units, paying an effective tax rate of 75%.

Pure residence-based system

Pure residence taxation is unrealistic, for three reasons.

- Countries are unlikely to give up the right to collect tax from foreigners doing business within their economy and territory.
- It would reduce revenues in poor developing countries, who rely heavily on source-based taxation, in favour of the rich developed countries where investors reside.
- Residence taxation is much easier to evade or avoid, by channeling international investments through tax havens with bank confidentiality and other secrecy provisions in havens make it hard for the residence country to get information about its residents' foreign source income.

Pure Source-based system….

This might also not be an option that has been favoured since;

- It enables investors, especially transnational corporations (TNCs), to play countries off against each other to obtain the lowest source-based tax rate. This type of tax competition already exists for active business income.
- The problem would get much worse if pure source-based taxation were extended to passive income as well, since financial flows are extremely mobile and not tax would be paid on the same.

The Global Reset

The distinction between residence and source is very hard to apply to businesses that operate in an internationally integrated manner, as with most MNEs more so in passive or fictional business functions, such as providing insurance, raising finance by floating bonds and lending the proceeds, and owning physical assets (e.g. ships) or intellectual property (e.g. patents and trade-marks).

It is extremely difficult to deal with this by the traditional approach of allocating rights to tax between the country of residence of the investor and the country of source of the income, since both source and residence are fluid concepts which can be manipulated.

Global Reset....

- The main international initiative against international tax avoidance, the OECD's drive against ` harmful tax practices', tries to do so by strengthening both source and residence taxation, but only by the rich OECD countries, and by attacking tax havens, many of which are poor developing countries.
- An important element in this, which is central to the OECD initiative, is improved exchange of information for tax purposes. An effective means to bring this about would be to impose withholding taxes at source on payments to non-cooperative countries.

Global Rest

EOI STANDARD
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AMAZON TAX
PLANNING
INCOME
GOOGLE
LIABILITY
TRANSFER
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TAX
MATTERS
AUDIT
MULTINATIONAL
BASE EROSION
AFRICA
ENTERPRISE
TRANSPARENT

Q&A