Deemed Residency – Concept and Issues Thereof

Introduction:

Residency is one of the important issues which has to be fixed before proceeding with determination of tax liability. Unless the residency of an individual or company or any entity for that matter is not fixed, there cannot be a way to determine the tax liability. Apart from the tax liability, the residency also gives a person a right to seek various reliefs. Till this point of time, we have seen instances where an individual was treated as a resident in more than one country and tried to resolve such issues by opting various measures namely by applying tie-breaker rules and place of effective management. However, the Finance Act, 2020 has opened up doors for new breed of resident, which is the subject matter of this article. The Finance Act, 2020 has amended Section 6 of Income Tax Act, 1961 ('ITA'/'Act') inserting a new sub-section to deal with residency of an individual, who is nowhere a resident. Let us understand the said concept and issues surrounding thereof.

Section 6(1) of ITA, an individual shall be treated as resident, if he is in India for a period of 182 days during previous year or if he is in India for a period of 365 days within 4 years immediately preceding previous years and 60 days or more during the previous year. The statutory limits provided under Section 6 above are being misused by some Individuals in order to become non-residents in India thereby avoiding the liability to pay tax in India.

Let us take an example, Mr. A is a citizen of India having high networth who is planning his stay across the countries in order to make sure that he is not a resident in anywhere in the world. In a particular year, he stays in India for period of 150 days (assuming that he stays less than 365 days in 4 years immediately preceding year) and remaining days in multiple countries. By virtue of his limited stay in India and other countries, he is not becoming resident in any country. As majority of the countries in the world tax an individual based on residence rule, being a non-resident in every country, such Individual is not liable to tax in any country on residence rule and thereby avoiding significant amount of tax payable to tax authorities.

This issue is addressed neither by the Income Tax Act nor by Double Taxation Avoidance Agreements ('DTAA') entered into by the India with various countries. However, DTAA does not address the issue when an Individual is not a resident in any country.

Deemed Residency:

By taking recommendations made by Direct Tax Task Force Committee into consideration, through Finance Bill 2020, it is proposed to amend section 6 of ITA to insert a new sub section (1A) so as to provide that, an individual, being a citizen of India, shall be deemed to be resident in India in any previous year, if he is not liable to tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature ('deemed resident').

Immediately after treating the inserting the sub section (1A) in section 6 to treat such person as deemed resident in India, there was a huge hue and cry from the non-residents regarding the taxability of the

income earned outside India. In this regard, Central Board of Direct Taxes ('CBDT') vide press release dated February 02, 2020, stated that income earned outside India is not liable to tax in India unless such income is derived from a business controlled or profession set up in India.

While passing the Finance Bill 2020, certain relaxations have been provided in Section 6 of ITA for the individuals who shall be the deemed resident. Under the amended provisions, only an individual, being a citizen of India, whose income other than income from foreign source[1] exceeds INR 15,00,000 in any previous year, shall be deemed to be a resident in India, if he is not liable to tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature.

In other words, if such individual is neither a citizen of India nor being a citizen of India, the income from foreign source does not exceeds INR 15,00,000 nor he is liable to tax in any other country or territory, then such individual would not be classified as 'deemed resident'. Hence, only on satisfaction of certain conditions, an individual would be falling under the ambit of 'deemed resident'.

Scope of Total Income vis-à-vis Deemed Residency:

Once he falls under the ambit of 'deemed resident', the next important aspect is the scope of his total income. As stated earlier, generally, majority of the countries stipulate that once an individual is 'resident' of a state, his global income would be taxable in such state. India also adopts similar mode of taxation. Hence, the next question, that would arise is, what is the scope of total income of 'deemed resident'.

Section 5 of ITA deals with the scope of total income. The said section subject to other provisions of the act, lays down the scope of total income for a person who is a resident, not ordinarily resident and non-resident, which is detailed as under:

Status	Received or Deemed to be Received in India	Accrues or Arises or is deemed to accrue or arise to him in India	Accrues or Arises to him outside India
Resident	Scoped -In	Scoped-In	Scoped-In
Not Ordinarily Resident	Scoped-In	Scoped-In	Scoped-In only if such income is derived from a business controlled in or a profession set up in India
Non-Resident	Scoped-In	Scoped-In	-

Hence, it is relevant to understand, whether the deemed resident is classified as resident or not ordinarily resident or non-resident to understand the scope of total time. From the perusal of Section 6, which deals with 'Residence in India', the deemed resident was covered under sub-section (6) which deals with a person who is 'not ordinarily resident'. Hence, an individual who becomes 'deemed resident' by virtue of Section 6(1A), he is classified as 'not ordinarily resident'.

Once he is classified as 'not ordinarily resident', the scope of total income shall be restricted to received or deemed to be received in India and accrues or arises or is deemed to accrue or arise to him in India. The income which accrues or arises to him outside India is not to be included unless such income is derived from a business controlled in or a profession set up in India.

With the above introduction, let us examine certain consequential aspects which arise because of

[1] Explain foreign source

inclusion of the concept of deemed resident and as not ordinarily resident thereof.

Deemed Residency vis-à-vis Treaty Benefit:

As stated earlier, one of the conditions mentioned in sub section (1A) to section 6 of ITA, to treat an individual to be deemed resident, is that such individual is not liable to tax in any other county or territory by reason of his domicile or residence or any other criteria of similar nature. One may find the similar language in model tax conventions. Generally, as per Article 1 of Double Tax Avoidance Arrangements ('DTAA'), a person can access the benefits of DTAA provided such person is resident of one or both the contracting states. In other words, a person shall be eligible to access the treaty benefits only if he is resident of at least one contracting state to the arrangement.

The concept of resident is dealt with by Article 4[2] of DTAA under which an Individual is treated as a resident of a contracting state, if such individual, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of effective management or any other criteria of similar nature and also includes that state and any political subdivision or local authority thereof. In other words, if such person is not liable to tax therein by reason of his residence, domicile or other criteria of similar nature then such individual will not be resident of such contracting state, thereby denial of treaty benefits.

Hence, the question that arises for consideration is, whether a deemed resident by virtue of Section 6(1A) would be treated as resident for the purposes of Article 4? If the response is affirmative, then he may access the treaty benefit and if not, he would not. Now, let us proceed to examine the said aspect.

To illustrate with an example, let us assume, an individual being a citizen of India, who is not a resident in any other jurisdiction, derives income from a profession setup in India with source outside India, say country X. Let us also assume that such individual is not a resident of country X and such income is taxable in country X as per the local laws (based on source rules) of such country.

Further, such income is also taxable in India as per Section 5 read with section 6 of the ITA as stated earlier (since the income is from a profession set-up in India, the same shall be scoped-in, even though such individual is RNOR). In this context, whether such an Individual can claim benefits of DTAA between India and country X ?.

As stated earlier, as per Article 1 read with Article 4 of DTAA, an Individual can claim benefits of DTAA if such individual is liable to tax therein by reason of his **residence, domicile or other criteria of similar nature.** As assumed that since the individual is not a resident of country X, he shall become deemed resident by virtue of Section 6(1A) of ITA. Now, the question would be that, whether he would also qualify as resident for the purposes of Article 4. To satisfy the conditions mentioned in Article 4 of DTAA, individual needs to satisfy the following two conditions:

a. He shall be liable to tax in India and

[2] Article 4 of UN Model Convention 2017

b. such liability arises by the reason of his residence, domicile or other criteria of similar nature.

If above two conditions are satisfied, such individual may claim benefits under DTAA otherwise he may not. Now, let us proceed to examine, whether the individual in our example, satisfies the two conditions.

He shall be liable to tax in India:

The first condition is that the individual shall be liable to be taxed in India. Normally seen, the deemed resident is liable to be taxed in India to the extent of total income as per Section 5. Hence, on a plain reading of the first condition, one can conclude that he is liable to tax in India. Further, it is clarified by Honourable Supreme Court in the matter of Azadi Bachao Andolan[3], liable to tax and payment of tax are two different aspects and there is no requirement of reading of payment of tax into liable to tax. Hence, if the deemed resident would be said to satisfy the first condition, if he can prove that there is a liability to tax in terms of Section 5 despite of the fact there is no payment. As explained above, an Individual can claim benefits of DTAA if such person is liable to tax therein by reason of his residence, domicile, or other criteria of similar nature. In the above example, liability to pay tax in India arises in the hands of an Individual because such person a resident under section 6(1A) of the Act. Hence, such person is treated as resident under Article 4 of DTAA and can claim benefits provided under DTAA.

However, a reading of commentary of Article 4 of OECD / UN Model Tax Convention 2017, would present a different picture. OECD[4] in its preliminary remarks to commentary on Article 4 of DTAA has explained that domestic laws of the various states impose comprehensive liability to tax – full liability to tax – based on the taxpayers' personal attachment to the state concerned. OECD further mentions that conventions do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as 'resident' and, consequently, is fully liable to tax in that State. They do not lay down standards which the provisions of the domestic laws on 'residence' have to fulfil in order that claims for full tax liability can be accepted between the Contracting States. In this respect the States take their stand entirely on the domestic laws. The relevant part of the commentary is as under:

Paragraph 1 provides a definition of the expression "resident of a Contracting State" for the purposes of the Convention. The definition refers to the concept of residence adopted in the domestic laws (see Preliminary remarks). As criteria for the taxation as a resident the definition mentions: domicile, residence, place of management or any other criterion of a similar nature. ***As far as individuals are concerned, the definition aims at covering the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax). It also covers cases where a person is deemed, according to the taxation laws of a State, to be a resident of that State and on account thereof is fully liable to tax therein[5].***

From the above, it would mean that the definition of resident under Article 4 covers those individuals who are liable to tax, basis the various forms of personal attachment, in the country on **comprehensive basis**. Interestingly, Finance Bill has been amended the original Finance Bill introduced in the Parliament, so as

[3] [2003] 263 ITR 706 – SC
[4] Organisation for Economic Co-operation and Development
[5] OCED Commentary Article – 4 of Model Tax Convention.

to provide that such individual is treated as RNOR. Further, amended Finance Bill provided that such Individual is liable to tax in India as a resident only when such Individual has income other than from foreign sources exceeding INR 15,00,000. As stated earlier, RNOR is not liable to tax on the income derived outside India except under certain circumstances.

Hence, the essential question that would arise is that whether RNOR is treated as '**liable to tax'** in India on '**comprehensive basis',** given of the fact that income accrued or arises outside India is not required to be included in scope of his total income**.** If such individual is not 'liable to tax' in India on **comprehensive basis**, then reading in light of the commentary, he may not be considered as resident under Article 4 of DTAA and thereby not eligible for benefits of DTAA.

In this regard, one needs to decode the phrase 'comprehensive basis'. Whether the income accruing or arising outside India and exclusion of such income from the scope of total income for deemed resident (RNOR) can be stated that such RNOR is liable to tax on comprehensive basis?

As per the Oxford English Dictionary, the word 'comprehensive' means 'including all, or almost all, the items, details, facts, information, etc., that may be involved' and the word 'fully' means 'completely'. However, since RNOR is liable to tax on only certain types of income as specified in Section 5 and by taking a literal interpretation, there is a chance that individual may not be considered to be 'liable to tax' in India on comprehensive basis and is not a resident in India under Article – 4 of DTAA and is there by not eligible to benefits therein.

However, individual may argue that he is a citizen of India and his tax liability arises in India because of his citizenship in India and by virtue of Section 6(1A). And a treaty shall be interpreted in contrary to an ordinary taxing statute and must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned. If individual is denied the benefit of DTAA then, individual is liable to tax in two jurisdictions on the same income which is definitely not the objective of any DTAA.

Further, according to Klaus Vogel "Double Taxation Conventions establishes an independent mechanism to avoid double taxation through restriction of tax claims in areas where overlapping tax claims are expected, or at least theoretically possible. In other words, Contracting States mutually bind themselves not to levy taxes or to tax only to a limited extent in cases when the treaty reserves taxation for the other Contracting State either entirely or in part. Contracting States are said to waive 'tax claims' or more illustratively to divide 'tax sources', 'taxable objects', amongst themselves".

The AAR[6] in the case of Alimohammed Rafik[7] held that '*as already pointed out the several articles in the DTAA which specifically concern individuals would make no sense at all, if individuals living in UAE are treated as excluded from the benefits of the agreement because they are not currently subjected to any tax in UAE. It is difficult to conceive of a large number of such provisions being inserted in the agreement*

[6] Authority for Advance Ruling
[7] [1995] 79 Taxman 75 (Delhi)

merely to meet a situation which does not arise on the date of the agreement but may possibly arise in the future. These provisions are consistent only with the interpretation that certain benefits qua Indian tax are intended to be conferred on individuals resident in UAE even though they are not liable to tax in their State' and concluded that that an individual, though at present is not actually liable to pay any income-tax in Dubai, should also be considered to be a resident of Dubai for the purposes of the DTAA as, being a person living in Dubai and having sources of income there, he is certainly liable to be called upon to pay income-tax under the tax laws of that country.

The AAR has expressed the similar view in the case of Emirates Fertilizer Trading Co. WLL, In re[8].

Further, the Hon'ble Mumbai Tribunal in the case of Green Emirate Shipping & Travels[9] held that *"The expression 'liable to tax' is not to be read in isolation but in conjunction with the words immediately following it i.e., 'by reason of domicile, residence, place of management, place of incorporation or any other criterion of similar nature'. That would mean that merely a person living in a Contracting State should not be sufficient, that person should also have fiscal domicile in that country. These tests of fiscal domicile which are given by way of examples following the expression 'liable to tax by reason of', i.e., domicile, residence, place of management, place of incorporation, etc., are not more than examples of locality-related attachments that attract residence type taxation. Therefore, as long as a person has such locality-related attachments which attract residence type taxation, that 'person' is to be treated as resident and this status of being a 'resident' of the Contracting State is independent of the actual levy of tax on that person. Therefore, being 'liable to tax' in the Contracting State does not necessarily imply that the person should actually be liable to tax in that Contracting State by virtue of an existing legal provision but would also cover the cases where other Contracting State has the right to tax such persons - irrespective of whether or not such a right is exercised by the Contracting State."*

The above discussed views which are held by AAR and Hon'ble Tribunal are upheld by the Hon'ble Delhi Tribunal in the case of Vinod Arora [10] and Mushtaq Ahmad Vakil[11].

In the above cases, the appellants were residents in UAE and earned income from source in India. In respect of income earned by such residents, revenue has argued that respective Individual is not liable to tax in UAE and thereby not eligible to benefits of DTAA as he is not a resident under Article -4. The AAR as well as Hon'ble Mumbai Tribunal and Delhi Tribunal pointed out that mere because taxing rights are not exercised by the UAE does not render the assessee ineligible to claim benefits of DTAA.

Similar to the above situation, Government of India has imposed tax liability on deemed residents with regard to income accrued or received in India and income sourced outside India, if such income is derived from a business controlled in or a profession set up in India. The Government of India has deliberately exercised its right not to tax any other income (i.e., other foreign sourced income). By applying the rulings given by above discussed authorities to our example, it can be concluded that a person deemed to be resident in India is liable to tax in India on comprehensive basis by reason of his citizenship and is

[8] [2005] 142 Taxman 127 (AAR)
[9] [2006] 100 ITD 203 (MUM.)
[10] [2012] 26 taxmann.com 23 (Delhi)
[11] I.T.A. Nos.3424, 3425 & 3426/Del./2010

considered as resident within the meaning of section eligible to claim benefits of DTAA between India and other countries.

Claiming of Foreign Tax Credit:

Assuming, if the individual in our above example, is not able to access benefits of DTAA between India and country X, then there arises a question whether such individual can claim foreign tax credit ('FTC') under Section 91 of the Act?

Section 91 provides that any person who is **resident in India** earns any income from any source outside India and such person has paid taxes in respect of such income in any country with which India does not have DTAA then, such person may claim credit of tax paid in such other country under Section 91 of ITA.

Before going forward, it is required to understand whether the deemed resident as provided in sub section (1A) of section 6 of the ITA is considered as resident for the purposes of Section 91. In other words, whether RNOR is considered as 'resident' under Section 91 to obtain relief therein. If such RNOR has not been considered as resident for purposes of Section 91, then such individual is not entitled to benefits under Section 91.

Section 2(30) of the ITA defines the word 'non-resident' to mean a person who is not a 'resident' and only for the purpose of Section 92, 93 and 168, RNOR is treated as 'non-resident' to mean that for all other provisions of the Act, RNOR is treated as 'resident'. Further, there is no concept of 'resident and ordinary resident' under ITA to limit the definition 'resident' to such class alone. ITA defines 'not ordinary resident' and not 'ordinary resident' in India. Such 'not ordinary resident' is also covered under the definition of 'resident' for all other provisions of the Act where there is a reference to the word 'resident'. In this regard, it is prudent to interpret the law to include the RNOR in 'resident'. The Honourable Delhi Tribunal in the matter of Aditya Khanna[12] held as under:

The provisions of section 6 of the income tax act provides for qualification of the persons who are residents in India. The provisions of section 6 (6) carves out another category of person in 'Residents', who is said to be 'not ordinarily resident' in India. However such persons are also 'resident'. The category is also called a 'resident but not ordinarily resident' in India. Therefore persons who are 'resident but not ordinarily resident' in India are forming larger group of the persons who are 'resident' in India.

Given the above discussion, a person who is a 'not ordinary resident' under the Act is considered as resident for the purpose of Section 91 of the Act. Having understood that RNOR is also considered as resident, now let us move forward to understand whether such RNOR is eligible to claim benefits of Section 91.

Section 91 provides for giving credit of tax paid in respect of tax paid in any other country when there is no DTAA with such other country. In other words, to access Section 91, the primary condition that should be satisfied is that there should not be DTAA with another country in respect which income is liable to tax.

[12] [2019] 105 taxmann.com 323 (Delhi - Trib.)

However, one needs to appreciate the fact that one of the main purposes and objective of the DTAA is to provide relief to the person from double taxation. Section 91 was inserted to provide relief to other individuals, if Government of India has not entered into agreement with any other country for providing relief from double taxation.

Even though there is an agreement with other countries, as the individual is not able to access benefits of DTAA as the individual is not a 'resident' under DTAA, denying the benefits of Section 91 is not in line with the objective of DTAA. Further, DTAA benefits are not available to the individual merely because of inherent limitations (he is classified as RNOR instead or Resident) on the individual which are otherwise available to such individual, hence benefits of Section 91 shall not be denied. If the individual is denied from benefits of DTAA and benefits of Section 91, then that it is a clear case of double taxation of the same income which is not the intention of the legislature for inserting Section 6(1A).

Further, many judicial fora, in dealing with DTAA between India and USA, have held that resident shall not be denied from claiming benefits of Section 91 merely because that India has entered into DTAA with USA. The Honourable Mumbai Tribunal in the case of Tata Sons Ltd[13] explained the interplay between Section 90 and Section 91 and granted the relief under Section 91 even though there was a DTAA.

The Honourable Tribunal pointed out that, if one adopts a literal interpretation of the provision by bearing in mind the undisputed position that tax credit provisions under Section 91 are more beneficial to the individual vis-à-vis the tax credit provisions in related tax treaties inasmuch as while Section 91 permits credit for all Income-taxes paid abroad - whether State or Federal, relevant tax treaties permit credits in respect of only Federal taxes, it will result in a situation that an resident will be worse off as a result of the provisions of tax treaties.

Further, the Tribunal held that Circular 621, dated 19-12-1991 issued by the CBDT states that 'since the tax treaties are intended to grant relief and not put residents of a Contracting State at a disadvantage vis-à-vis other taxpayers, section 90 of the Income-tax Act has been amended to clarify any beneficial provision in the law will not be denied to a resident of a contracting country merely because corresponding provision in a tax treaty is less beneficial'

Similar view was also upheld by Co-ordinate bench of Ahmedabad Tribunal in the case of Dr. Rajiv I. Modi [14] and the Hon'ble Delhi Tribunal in the case of Aditya Khanna (supra).

By invoking above judicial interpretations into amended section 6 and section 91, it is legally tenable to claim benefits under section 91 of the Act by deemed resident who is resident but not ordinary resident in India.

Given the above discussion, deemed resident as specified under sub section (1A) of section 6 can claim credit of foreign tax paid on income earned from outside India.

[13] [2011] 10 taxmann.com 87 (Mum.)
[14] [2017] 86 taxmann.com 253 (Ahmedabad - Trib.)