

# **POLICY BRIEF ON SOURCE V RESIDENCE**

*“Render therefore to all their due; taxes to whom taxes are due, customs to whom customs, fear to whom fear, honour to whom honour”- Romans 13:7*

The term ‘residence’ as regards taxation should not be confused with other often used terms in matters territory such as ‘domicile’, ‘citizen’ or ‘nationality’. The justification for use of the term “residence” is given in the case of *Calcutta Jute Mills Co Ltd v Nicholson*<sup>1</sup>, that dealt with the definition of residence, albeit for artificial persons, where it was held that;

“While the definition of the word residence is founded upon the habits and relations of natural man and is therefore inapplicable to the artificial and legal person to whom we call a corporation. For the purpose of giving effect to the words of the legislature, an artificial residence must be assigned to this artificial person, and one formed on the analogy of natural persons”

The principle of residence in taxation was born out of a need to illustrate whether a nexus existed between the income arising and whether countries would be able to levy tax on that said income. Such attachments are often provided for under the domestic laws of countries. Domestic law rules for determining residence differ from country to country. Such rules determine whether to tax the person who earned the income depending on whether the income was obtained within the country’s borders or to the activity from which the income is earned. The principle brought out in the first instance is ‘Residence taxation’ and that in the second instance is referred to as ‘Source taxation’.

## ***Residence Principle.***

The residence basis of taxation provides that a country is able to levy tax on income of that person regarded as resident for tax purposes without consideration of where the income was sourced. The rationale for residence taxation has been described in the South African case of *Kergeulen Sealing and Whaling Co Ltd v CIR*<sup>2</sup> where the court postulated;

“... a resident for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him”

It is night to point out that Kenya’s income tax as well introduces the concept of residence taxation under section 2(1) of the Income Tax Act. It provides as follows as regards residence of corporate entities;

“resident” when applied in relation –

b) To a body of persons, means; -

i) That the body is a company incorporated under a law of Kenya; or

ii) That the management and control of affairs of the body was exercised in Kenya in a particular year of income under consideration; or

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<sup>1</sup>*Calcutta Jute Mills Co Ltd v Nicholson* [1876] ITC 83 at 103

<sup>2</sup>*Kergeulen Sealing and Whaling Co Ltd v CIR* (1939) AD at 487

- i) That the body has been declared by the Minister, by notice in the Gazette, to be resident in Kenya for any year of income

In the above definition of residence of legal entities such as companies, the first two tests provided for under the act are borrowed from both the OECD and UN model Conventions which define a resident in Article 4 to be;

“ .... The “resident” of a contracting state means the person who, under the law of that state is liable to tax therein by reason of his domicile, residence, place of effective management or any other criteria of a similar nature...”

Kenya is just one of the countries that has borrowed such criteria for residence and it is this factor that in some cases results in huge problems. Two states may use the residence basis of taxation but may not have a similar definition of residence. International congruence of the definition has to be obtained. Difference in the tests provided under domestic law regarding residence means that in some instances individuals and corporations as well may likely fulfil all tests and will thus be resident and therefore taxable in more than one jurisdiction. Thus, enters tax treaties. They are fundamental in resolving residence-residence conflicts (which will be discussed later). Persons who find themselves to be resident in both contracting states will be deemed treaty subject and will thus be able to claim rights and benefits of the treaty.<sup>3</sup>

### ***Source Residence***

Income tax is as well imposed in a country by reason of the connection of the country and the place of generation of the income i.e. from economic activities generated within its territory. There are numerous instances where the source principle is preferred over the residence principle and it is a very popular concept amongst developing and capital importing countries.

For instance, income is often taxed where the activity resulting in the income has a nexus with that country e.g. income obtained from the extractive sources in a country e.g. oil and minerals clearly has a strong connection to the country and there can be no dispute that they have been ‘sourced’ in the country and therefore such persons must be taxed regardless of where they may live.

The term source residence as well has no definition in the legal instruments of most countries and Kenya is no different. The source principle first appears in section 3(1) of the Income Tax act. It provides as follows;

“Subject to, and in accordance with this Act, a tax to be known as Income tax shall be charged for each year of income upon all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya” (emphasis mine)

Most countries in the world have not applied the source or residence principles with a 100% degree of purity. This is because, as regards source residency, it restricts the country’s tax base and will therefore in most countries be supplemented by “source plus provisions” that may seek to provide an exhaustive list of all categories of income that will be regarded as sourced within that country. This is not a given however, and some country rely solely on general source principles and the burden of establishing the definition and rules around source taxation falls on

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<sup>3</sup>Klaus Vogel., Klaus Vogel on Double Taxation Conventions 223 (3<sup>rd</sup> ed. London; Kluwer Law International 1997)

the courts. It should be noted however, that source taxation in its purest form is dangerous to international trade and investment and therefore could curtail financing for development as the tax burden imposed on the investor might be too high and will thus discourage investment.

### **Conflicts that arise out of Source and Residence Principles**

The conflicts that arise are three-fold;

- i) Residence- Residence conflicts
- ii) Residence- Source conflicts
- iii) Source – Source Conflicts

#### ***Residence- Residence Conflicts***

As was earlier eluded, such conflicts arise in a situation whereby double taxation results by reason that a person fulfils resident criteria and is therefore liable to tax in each of the jurisdictions. This would result in double taxation. E.g. a situation where Country A's residency test is 'place of incorporation' whilst Country B' applies the 'place of control and management' test. The result on the taxpayer who fulfils both residency test is double taxation.

This type of conflict has been envisaged and has resulted in the creation of tie-breaker rules. The resident article both in the OECD MC (Article 4) and UN model conventions, provide a tie-breaker rule for determining residency where an entity is resident in two different countries. These rules help to assign the residency to only one of the states demanding tax.

#### ***Residence- Source Conflicts***

This type of conflict arises where even though the states apply different principles of taxation, in residence or source, the income arising falls within the ambit of both those principles. This would result in the taxpayer being levied tax twice.

Steps have been taken to resolve this type of conflict through tax treaties whereby two contracting states for instance grant exclusive rights to tax a particular type of income to only one of the states or also by permitting both this source and residence taxation but then mandating the country which taxes on residence to provide certain reliefs on the tax it seeks to impose. All in all, such distributive rules can be found under the UN model from articles 6 to 22.

#### ***Source- Source Conflicts***

Such conflicts come about where each of the contending states levies income on the basis that it has been derived from activities within its borders. The taxation of income from services is a prime example, whereby a state may seek to levy tax on income from certain services if the service is paid for by a resident of that state while the other state will contend to impose tax on the income from certain services by reason that the services are performed within its territory.

Tax treaties are usually the best instruments to use in resolving such disputes. The UN and OECD models contain comprehensive rules that determine the source of income from treaty purposes.

## **Conclusion**

It is clear from our discussions above that it is fundamental for countries to enter into double tax agreements in order to avoid instances of double taxation. The importance of granting of residence status (whether source or residence) in the field of international tax cannot be overstated, it is the bedrock under which all double tax agreements are negotiated from. Residence has been defined as a gateway to double tax agreement benefits and some scholars even insist that it is a condition for the application of a tax treaty<sup>4</sup>.

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<sup>4</sup>Michael Lang, Introduction to the Law of Double Taxation Conventions, 83 (Amsterdam, International Bureau of Fiscal Documentation 2013)