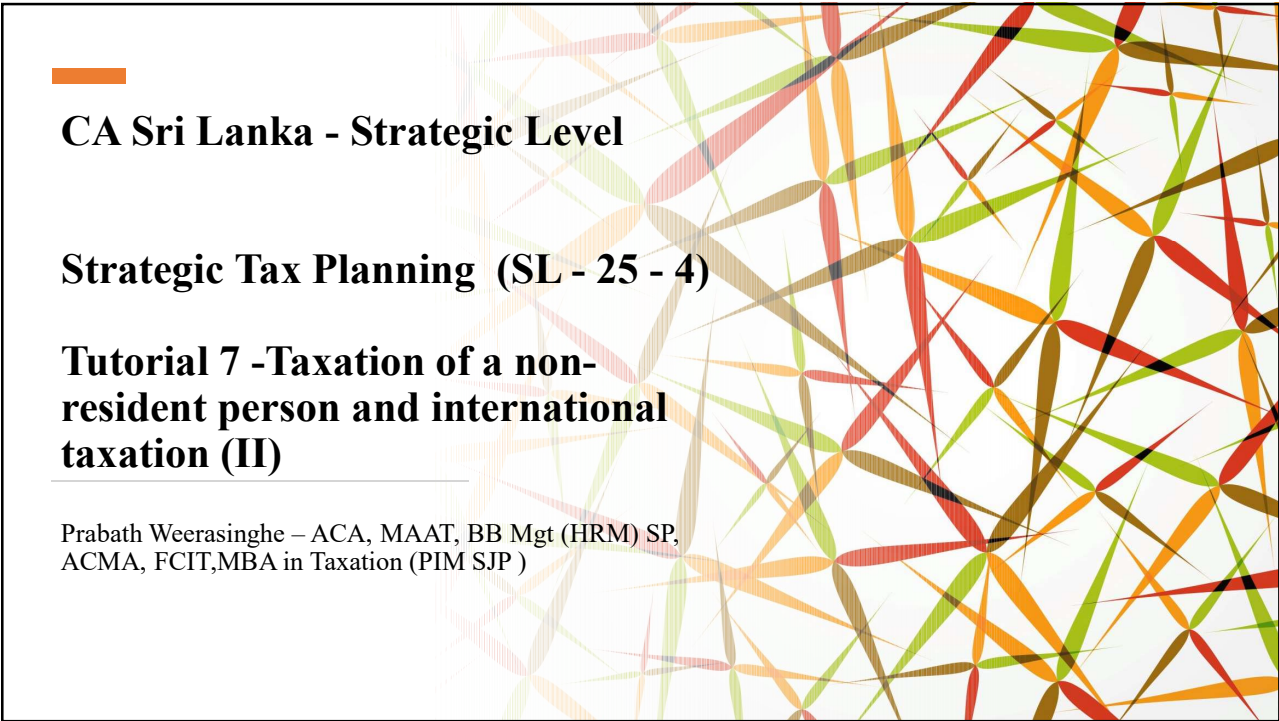




CA Sri Lanka - Strategic Level

Strategic Tax Planning (SL - 25 - 4)

Tutorial 7 -Taxation of a non-resident person and international taxation (II)

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Taxation of non-resident and international taxation

Key learning outcome

- **Assessing income tax liability of a non-resident person**
 - Resident status of an individual and company
 - Income arising in or derived from a source in Sri Lanka
 - Assessable Income from income sources for a non-resident
 - Taxable income and tax payable by a non-resident
 - Liability of an agent of a non-resident
- **Remittance tax**
 - Liability of a non-resident company for remittance tax
 - Ascertaining the remittance tax liability

Taxation of non-resident and international taxation

Key learning outcome

- **Double tax avoidance agreement** (Tax treaties)
 - Overlapping tax jurisdiction and method of avoiding double taxation
 - OECD Vs UN Model
 - Principles of operation of Double tax avoidance agreement

Double Taxation

Two (02) type of taxes are imposed by any government, which are direct and indirect tax.

Direct tax is based on gains and profit, whereas indirect tax is based on consumption.

As the tax based for indirect tax is consumption, it considered the economic activity conducts within a territory. Ex. Value added tax is imposed on taxable supply made within Sri Lanka.

In case of direct tax, both residency principle and source principle are followed. Ex. Resident person, shall be chargeable for income tax on income, wherever the source arises but non-resident person, is liable for tax on the income to the extent that the income arises in or is derived from a source in Sri Lanka.

Double Taxation

Principle of territorial sovereignty is widely used for imposition of income tax by many jurisdiction.

Accordingly, person who is a resident for Sri Lanka income tax purpose shall be a non-resident for tax in another jurisdiction.

According to the above principal, tax on income may be paid in both jurisdiction on the same source (Double taxation).

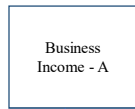
Double Taxation

Grounds, which creates possibilities for double taxation:

- Dual residency claim
- Dual source claim
- Conflict of residence against source
- Economic double taxation

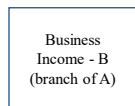
Double Taxation

Country 1 - Enterprises incorporated in country 1 (resident person for tax purposes of country 1)



☹ Income from business A & B are liable for tax at country 1. (Resident)
However, income from business B, which is already liable for Tax at country 2, is again taxed at country 1

Country 2 - Branch office of Enterprise A established at country 2 -Nonresident person for tax for country 2 (Source)



Income from business B (branch) is liable for tax at country 2

Double Taxation Avoidance Agreement (Treaties)

Tax treaties remain as international agreements

Also, it is part of the domestic tax law

Models followed for guideline for negotiation and formation of double tax avoidance agreement.

There are two main models

1. OECD Model (Organization for Economic Cooperation and Development) – Taxation based on residence principle
2. UN Model (United Nation) – Taxation based on source principle

Double Taxation Avoidance Agreement (Treaties)

Sri Lanka has entered into double tax avoidance agreement with 45 countries.

Double tax avoidance agreement supersedes the domestic tax law (Inland Revenue Act).

However, if any provision of the domestic tax law give more beneficial tax treatment a non-resident such benefit shall be available for the non-resident

Double Taxation Avoidance Agreement (Treaties)

Type of treaties

1. Income Tax Treaties
2. Estate & Gift Tax Treaties
3. Limited Treaties
 - i. Limited to information exchange
 - ii. Limited to administrative assistant
 - iii. Limited to taxation of Shipping and Airline operation

Double Taxation Avoidance Agreement (Treaties)

Objectives of tax treaties

- Elimination of double taxation
- Prevention of tax evasion and tax avoidance
- Allocation of taxing rights
- Facilitate to cross broader trade and investments
- Prevent tax discriminations
- Provide consultation and support to resolve tax dispute
- Promote foreign investments

Double Taxation Avoidance Agreement

Structure of a tax treaty

Title and preamble

Chapter I - Scope

Article 1 :- Person covered

Article 2 :- Taxes covered

Chapter II - Definitions

Article 3 :- General

Article 4 :- Resident

Article 5 :- Permanent Establishment (PE)

Double Taxation Avoidance Agreement

Structure of a tax treaty (Contd..)

Chapter III – Taxation of Income

Article 6 to Article 21

Chapter IV - Taxation of Capital

Article 22 :- Capital

Chapter V – Method of elimination of double taxation

Article 23 :- Exemption method, Credit method

Chapter VI AND VII – Special and final provisions (Tax Administrative)

Double Taxation Avoidance Agreement

Structure of a tax treaty (Contd..)

Chapter II - Definitions

Article 4 :- Resident

“resident of a Contracting State” means any **person** who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of head office, or any other criterion of a similar nature.

Double Taxation Avoidance Agreement

Structure of a tax treaty (Contd..)

Chapter II - Definitions

Article 4 :- Resident

Incase of an individual is a resident of both Contracting States, then his status shall be determined as follows :

- he shall be deemed to be a resident of the State in which he has a permanent home available to him ;
- if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests) ;
- if the State in which he has his centre of vital interest cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode (period of time a taxpayer spends in each country);

Double Taxation Avoidance Agreement

Structure of a tax treaty (Contd..)

Chapter II - Definitions

Article 4 :- Resident

Incase of an individual is a resident of both Contracting States, then his status shall be determined as follows :

- if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national ;
- if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

In a case of a person other than an individual is a resident of both Contracting States, the competent authorities of the States shall settle the question by mutual agreement

Double Taxation Avoidance Agreement

Chapter II - Definitions

Article 4 :- Resident Resolution of dual residence

Annexure 01

Double Taxation Avoidance Agreement

Structure of a tax treaty (Contd..)

Chapter II - Definitions

• Article 5 :- Permanent Establishment (PE)

“Permanent Establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Allocation of taxing right to jurisdiction for business profit. Accordingly, business profit is taxed exclusively in the State of residence of the enterprise unless there is a permanent establishment in the other State.

If there is a permanent establishment exist in the other State profit attributable to such permanent establishment shall be tax in the other State.

Double Taxation Avoidance Agreement

Structure of a tax treaty (Contd..)

Chapter II - Definitions

• Article 5 :- Permanent Establishment (PE)

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Double Taxation Avoidance Agreement

• Article 5 :- Permanent Establishment (PE) (Contd..)

Rule applicable for determination of Permanent Establishment

1. Basic Rule
2. Construction PE (Construction Clause)
3. Agency Type PE
4. Service Type PE

Double Taxation Avoidance Agreement

- Article 5 :- Permeant Establishment (PE) (Contd ..)

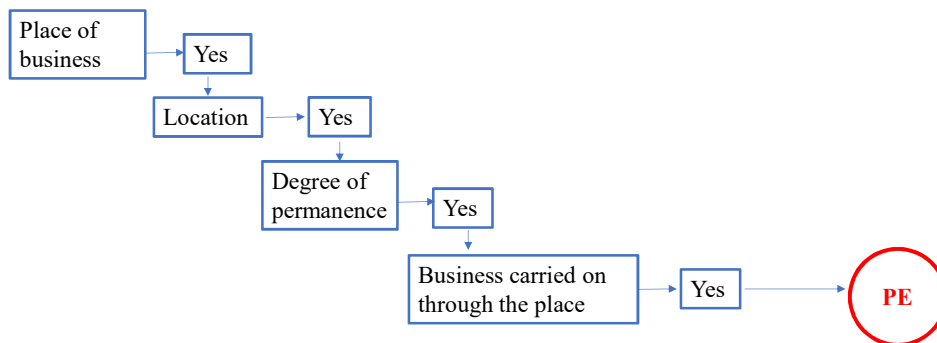
Rule applicable for determination of Permeant Establishment

1. Basic Rule :- **fixed place of business** through which the business of an enterprise is wholly or partly carried on.
 - Fixed place of business,
 - Location Test
 - Permanence Test
 - Business activity Test

Double Taxation Avoidance Agreement

Article 5 :- Permeant Establishment (PE) (Contd ..)

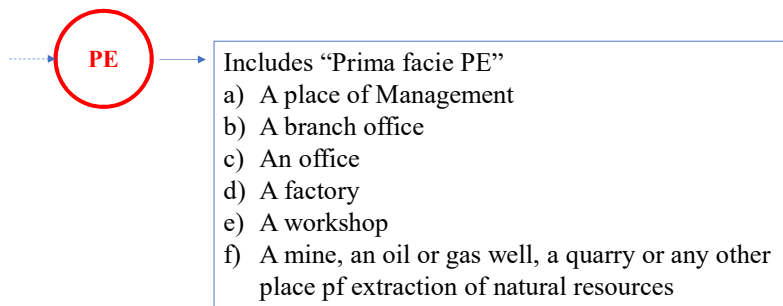
1. Basic Rule :- **fixed place of business**



Double Taxation Avoidance Agreement

Article 5 :- Permanent Establishment (PE) (Contd ..)

1. Basic Rule :- fixed place of business



Double Taxation Avoidance Agreement

Article 5 :- Permanent Establishment (PE) (Contd ..)

1. Basic Rule :- fixed place of business summary

1. Exists a place of business
2. Place of business is located at a certain area
3. Person carrying out business activity has a right to use the place
 - i. Use of place of business must last for a period of time
 - ii. Activities performed through the place are business activities

Double Taxation Avoidance Agreement

Article 5 :- Permanent Establishment (PE) (Contd ..)

2. Construction Clause

- a) Building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than 183 days within any 12-month period ; (UN Model more than 6months)
- b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue within the contracting state for a period or periods aggregating more than 183 days within any 12-month period commencing or ending in the physical fiscal year concerned. (UN Model – Activity PE to cover even consultation project)

Double Taxation Avoidance Agreement

Article 5 :- Permanent Establishment (PE) (Contd ..)

- 2. Activity Test – Construction clause where period threshold is met (covers more than one construction or installation project).

Activity covered – a building site, a construction, assembly or installation or development of natural resources including supervisory

Double Taxation Avoidance Agreement

Article 5 :- Permanent Establishment (PE) (Contd ..)

3. Agency type PE

When the following conditions are met Agent could constitute a PE

- Dependent agent or an independent agent acting outside the ordinary course of business
- Act on behalf of the principle
- Agent must have authority to conclude contracts and must habitually exercise this authority
- Legally and commercially depend upon the principle
- Contract negotiated and entered by the agent is binding the principle

Double Taxation Avoidance Agreement

Article 5 :- Permanent Establishment (PE) (Contd ..)

4. Service PE (Activity PE)

The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue within the contracting state for a period or periods aggregating more than 183 days within any 12-month period commencing or ending in the physical fiscal year concerned. (UN Model – Activity PE to cover even consultation project)

Double Taxation Avoidance Agreement

Article 5 :- Permanent Establishment (PE) (Contd ..)

Negative PE

“permanent establishment” shall be deemed not to include :

- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise ;
- b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery ;
- c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise ;

Double Taxation Avoidance Agreement

Article 5 :- Permanent Establishment (PE) (Contd ..)

Negative PE

“permanent establishment” shall be deemed not to include :

- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or for collecting information, for the enterprise ;
- e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.
- f) the maintenance of fixed place of business solely for above activities

Double Taxation Avoidance Agreement

Article 5 :- Permanent Establishment (PE) (Contd ..)

- an insurance enterprise of a Contracting State shall, except with regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than agent of an independent status to whom following paragraph applies.
- Where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in that other State as an agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, a person acts exclusively or almost exclusively on behalf of one or more to which it is closely related, such person will not be considered an agent of an independent status.
- The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other (Subsidiary PE).

Double Taxation Avoidance Agreement

Article 5 :- Permanent Establishment (PE) (Contd ..)

However, a subsidiary PE is created if,

- It is authorized to conclude contracts for or on behalf of the enterprise (Parent Company) and all conditions under Agency clause are met.
- Where it is a place of management of the parent (or vis a versa) or if two affiliates perform joint business
- Where a contract between the subsidiary and the client requires participation of the parent company or the equipment or know-how of the parent company.