STEP JOURNAL+

Residency rules locked down

Wednesday, 09 March 2022

Shabnam Shaikh and Ipshita Bhuwania reveal how residency rules have affected non-resident Indian citizens during COVID-19

Key Points

What is the issue?

As the onslaught of the COVID-19 pandemic slows down, international borders are gradually opening up. However, India, which was hit particularly badly by the virus, especially by the second wave in April 2021, saw restricted movement for residents who are still largely unable to travel freely.

What does it mean for me?

This unprecedented situation continues to raise significant tax issues for cross-border elements. An estimated 28 million non-resident Indians (NRIs) are settled outside India.

What can I take away?

Due to prolonged lockdowns and travel restrictions, NRIs have been forced to stay in India, thereby triggering residency rules and Indian tax consequences.

Extant residency rules

As per the Indian *Income Tax Act 1961* (the Act), an individual is said to be an Indian resident if, during the relevant financial year, they are in India for a period of 182 days or more, or for a period of 60 days or more and the total duration in India during the four financial years preceding the relevant year was 365 days or more. This 60-day threshold is increased to 182 days if the individual is an Indian citizen and leaves India in any previous year for the purposes of employment outside India.

However, the 60-day threshold is increased to 120 days if the individual is an Indian citizen and stays in India for 120 days or more (but fewer than 182 days) and has India-source income exceeding INR1.5 million in the given financial year.

The individual in this case is deemed to be resident but not ordinarily resident (RNOR). RNOR status is also granted to tax residents who have been an NRI in nine out of ten preceding financial years or have stayed outside India for 729 days or fewer in the previous seven financial years. Unlike a tax resident, an RNOR is required to pay taxes only on Indian-sourced income, not global income.

Guidance by Indian authorities

For the financial year commencing in 2019, India's Ministry of Finance provided certain relief for individuals stranded in India. It issued a notification on 8 May 2020 confirming that if an individual was unable to leave India between 22-31 March 2020, or was quarantined in India from 1 March 2020 and was unable to leave before 31 March 2020, the relevant days could be disregarded when calculating the total duration of their stay. However, following this notification, there was no further relaxation offered by Indian authorities in terms of determination of tax residency.

This led to a writ petition being filed by Dubai-based NRI Gaurav Baid before the Indian courts. Baid had travelled to India in March 2020 but was unable to travel back before the expiry of the 182-day period and consequently qualified as a tax-resident in India. The Supreme Court of India (the Court) subsequently passed an order[1] in February 2021, whereby it pointed out that the applicability of the abovementioned notification was only for the period of March 2020 and there was no clarity on the residency status of individuals who could not travel back after this period. The Court thus directed Baid and other taxpayers to make a representation before the Central Board of Direct Taxes (CBDT) and directed the CBDT to tackle similar matters in the following weeks.

As a result, the CBDT was flooded with representations. On 3 March 2021, *Circular No. 2 of 2021* (the Circular) was released with clarifications on tax residential status. *Inter alia*, the CBDT stated that:

- A short stay in India would not ordinarily result in Indian tax residency.
- If a general relaxation is provided for stay in India, it may result in a case of double non-residency if the individual does spend more than 182 days in India and fewer than 182 days elsewhere.
- The provisions under a double taxation avoidance agreement (DTAA) will ensure that liability to tax does not arise in both jurisdictions.
- Under the extant law, credit is available for tax already paid in any other jurisdiction.

Implications for residential status

The Circular was heavily criticised for not offering any general reliefs or relaxations and came as a blow to NRIs.

First, the Circular claimed that it would be unjust to provide general relaxations as it may lead to double non-residency. The *Finance Act, 2020* amended the residential status provisions under the Act by including a provision for deemed residency for individuals based on citizenship, the first of its kind under the Indian tax law. If an Indian citizen has Indian-source income exceeding INR1.5 million and is not liable to tax in another jurisdiction, they will be deemed to be RNOR in India.

In relation to this, it is necessary to discuss recent amendments. The *Finance Act, 2021* has defined the phrase 'liable to tax' under the Act to mean an instance of there being an income tax liability on a person under the applicable law of any jurisdiction and includes a case where, after the imposition of such tax liability, an exemption has been provided. Going by this definition, jurisdictions like the UAE and Bahrain, which impose no personal tax, will be an example of a jurisdiction where no liability to tax exists. Therefore, if an Indian citizen has stayed in India beyond 120 days and has stayed in the UAE for the rest of the year, it is likely that such person will qualify as RNOR.

The Circular also did not address instances of managerial personnel being stranded in India and carrying on business in India that would result in the creation of a place of effective management, due to which such foreign company would be considered a resident in India. Issues arising due to the unintended establishment of a business connection or a permanent establishment were also not addressed.

Further, the Circular does not set out any mechanism for non-DTAA jurisdictions, except to state that it would consider providing relaxations to any individual or class of individuals liable for double taxation on a case-by-case basis. This will likely result in considerable ambiguity and, ultimately, litigation since the CBDT would have complete discretion in such cases. Another spate of litigation may be initiated by NRIs from tax-neutral jurisdictions like the UAE who may not have the option to make a representation to the government since their complaints will not relate to 'double taxation' but to 'taxation of income in India'.

International guidance

In cognisance of the requests made by member countries, the OECD released an updated guidance on 21 January 2021 on international tax issues caused due to forced stay because of travel restrictions. Certain important learnings include the following:

- COVID-19 restrictions should not impact permanent establishments and tax residence or create situations of double taxation. Most countries that have released an official tax guidance have taken this view while others, like the US, have provided a specific carve-out period for the 'substantial presence' test.
- Cessation of activity or change of location should be due to a public health measure imposed by the government of at least one of the two countries involved.
- A public health measure would include quarantine periods but would not cover situations where the government has merely recommended against travel without banning it.
- If an individual does not relocate after a public health measure is lifted, then their subsequent physical presence and residence should not be overlooked for tax purposes.

Conclusion

The evolving nature of the COVID-19 pandemic has made many a matter unpredictable, especially on the tax front. In the backdrop of such uncertainty, it remains to be seen how the conversation around tax residency,

through guidance from CBDT and developments in the judicial arena, develops further in India. Any concrete steps in this regard would be a relief to a great number of individuals with an Indian nexus.

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[1] WP(C) No. 136/2021

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