Individual tax residence: determination can be a complicated task

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Some say tax residence is a matter only of academic concern, and that very few people need to practically resolve it. In reality, the issue is often on the horizon – and some individuals may not realise how close they are. Guillermo Narvaez, technical director at Kreston Global Tax Group, writes

Domestic laws generally define – or give the elements to define – the tax residence of individuals, and for most people this is not an issue.

For a person who is a national of a certain country, lives their whole life there and only has domestic business activities, there may not be any concern about tax residence. For some individuals, however, the situation is more complex.

Article 4 of the Model Convention of the OECD (MC) is dedicated to defining tax residence of both individuals and artificial persons. The scope of this note is only individuals and some of the possible issues individuals may confront when defining where they should pay taxes.

The issue is not only defining where a person should pay taxes for activity performed in a specific state, but in which state that person should be regarded as tax resident. The matter does not stop there, as such a person might be deemed a tax resident in more than one state. Being a resident for tax purposes in one state means a person has ‘full tax liability’ therein, and will be obliged to report all their income in that state.

It is possible that an individual liable to tax on a worldwide basis in one state may also qualify as tax resident in another state. In that situation, a person will have dual tax residence and, technically speaking, two different states in which to pay taxes. Hence, that person may face an issue of double taxation on a considerable scale.

Varying criteria

But where do these problems come from? The answer is straightforward: each state is free to define its own tax framework, and the criteria among states can vary in a sensitive manner. For instance, one state may consider that citizenship is the basic criterion when defining residence, while a second may define tax residence as habitually living in the state. Such diversity of criteria may create a double residence.

Obviously, a person in such a situation will have a dual tax residence if they are a citizen of the first state but live in the second. To solve these matters the MC and double tax agreements (DTAs) have introduced tie-breakers to avoid potential double taxation.

The following is a hypothetical case where a person (X) is a tax resident in two states at the same time according to their domestic laws – State A and State B.

The relevant features and activities of X in both states to define their dual residence are set out in the table.

In our example, State A considers all of its citizens as tax residents, while State B automatically considers as tax resident any person whose permanence has been longer than 183 days per year. Hence, X has a dual residence in both State A and State B.

The DTA brings in tie-breakers to resolve the question, in this order:

- Permanent home;
- Habitual abode;
- Centre of vital interests;
- Nationality;
- Mutual agreement.

It is clear that State A will aim to apply the nationality tie-breaker given that X is only a national of that state, but to get to that stage X needs to tie in the three previous tie-breakers.

X has a permanent home at their disposal in both states; however, X considers their 'real' home to be the one in State B where they live with their second spouse. Given that X spends substantial amounts of time in both states – broadly half the year in each – X may be deemed to have a habitual abode in both states.

So far, the assessment of X in both states is tied, so the next step in defining their tax residence is to determine where their centre of vital interests (CVI) is located. If, after analysing their centre of vital interests, X is still tied, then they will be a tax resident of State A given that they are a citizen of that state. In this situation, there is no need to apply the last resource of mutual agreement, which is always hard to obtain.

In our hypothetical case, the CVI will be the last tie-breaker rule to define the tax residence of X before applying the nationality tie-breaker, which clearly leads to State A becoming the winner state.

Objective test

The question of permanent home or habitual abode is an objective test, and similarly, nationality is usually a matter of fact and easy to confirm. Conversely, the CVI looks at different elements – objective and subjective – to define where a person has a stronger attachment. It involves a full interpretation of facts, economic matters, personal matters, and even personal feelings.

What is crucial to the application of Article 4 is the need to understand the context of the person in full scope and not simply just gather facts as if filling out a questionnaire. In this example, we may say that X is resident of State B according to the corresponding DTA and

the tie-breaker of Article 4 because:

- They spend most of the year in that state;
- They have a business to attend;
- They have their new family (i.e. their current spouse), and
- Investments have been made in that state.

All elements fulfil the scheme determined by the CVI and therefore we could conclude that X is or should be resident of State B. However, we could also conclude that X is resident of State A given that:

- It is the place where they were born and they are still a citizen of that country;
- They do not spend most of the year in State A but they spend a considerable part of it (almost half);
- In State A, X founded a permanent business before their entrepreneurship activity carried on in State B, and their children live there.

Hence, there are sufficient elements to determine that X is resident of either State A or B. The key to applying a dual residence tie-breaker in circumstances such as this is to look at where the strongest attachment of the individual lies.

In the case of X, if the CVI is still tied, State A would be the governing jurisdiction due to the fact that the following tie-breaker corresponds to the nationality one and X is a citizen of that state.

However, in my personal view, the context of X has not been completely revised given that it does not consider the full scope of what they expect to happen in the near future, and, even more relevant, the aims of spending their life in two different countries. These elements may not be definitive but may have a bearing. We need to ask questions such as:

- Do they expect to split their time between both countries for the rest of their life? Or is this just a transition?
- Will business in State A be carried on permanently or will the new economic activity in State B substitute the activity in State A when the entrepreneurship activity has matured?
- Is there really an attachment of X to their children?

Facts and context

To conclude, tax residence is a legal issue that must be solved with a proper analysis of the facts and context, having sufficient evidence to support the case, and making a reasonable interpretation of all elements including, of course, the legal resources at hand.

In this scenario, having analysed all the facts, evidence, and features of the specific case, I would say it is likely that X is a tax resident of State B, despite earlier indications to the contrary.

The determination of the issue of tax residence may have significant consequences for individuals in determining where a full tax liability will take place. If their decision is not the correct one, the implications could be catastrophic.

That is why any person with complex circumstances should make a thorough analysis of the facts and features that may define their tax situation.

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