TDS ON PAYMENT TO NON-RESIDENTS

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Wait a second, what!? TDS is applicable on payment to non-residents as well!? But if the income is received outside India, why would tax implications arise on such transactions in India? Aur yeh TDS kahaan se aaya picture mein?

Draft karnewaalon ne puri Ramayanlikh di, and you are asking ki Ram kauntha? Chalo phir, let's get some clarity. It all starts with King Dashrath, i.e., Section 9 of the Income-tax Act, 1961 ('the Act').

Chargeability of income under the Act:

Firstly, Indian Taxation is based on the concept of Accrual, i.e., all incomes accruing/received in India are taxed in India, unless specified otherwise. Further, clause (i) of sub-section(1) of Section 9, prescribes that income shall be deemed to be accrued in India if it arises, directly or indirectly, through or from any business connection, any property, any asset or any source of income, or through any transfer of a capital asset in India. These terms are defined in detail in Section 9.

So yes, if any income accrues to a non-resident, by one or more of the above ways, such income would be taxable in India, unless stated otherwise, even if it is received out of the country.

Here arises an issue. Most non-residents, if not all, who are deriving some sort of income from India do not have a PAN or file returns in India. So, how can we tax such incomes? What tools may be used for the same? Herein lies the answer to the question that yeh TDS picture meinkaiseaaya.

With a significant growth of international markets due to the heavy impact of globalization, promotion of multi-national businesses and a never-before-seen interconnect between the countries, the number of cross-border transactions is on a steep rise. This makes it even more important to incorporate a stable and sustainable system of tax recovery by the government, to reduce the risk of misuse of powers and resources, especially in times where operations are highly liberalized. TDS surely proves to be one such system.

It would be tedious, if not impossible, to track down each and every income being received outside India. Here, a well-designed mechanism for recovery of tax before such money is transmitted outside India, TDS provides a way out. Provisions for deduction of tax in cases where payments are to be made to a non-residentare laid down in Section 195 of the Act.

TDS Provisions under Section 195 of the Act:

Section 195(1) of the Act says that 'any person' responsible for paying to a non-resident, any sum chargeable to tax under the provisions of the Act, shall at the time of credit or payment, whichever is earlier, deduct income-tax thereon at the *rates in force*[1]. Hence, in case of payment made by any person to any non-resident, which is taxable in India, tax should be deducted under Section 195 of the Act. However, certain sections such as 194LB, 194LC and 194LD, lay down provisions for taxing certain specific incomes payable to a non-resident. If any transaction falls under such sections, the provisions of such sections shall prevail over the provisions of Section 195.

It is important to note that TDS is not applicable in all cases where payments have to be made to non-residents, but in only those cases where such sum is chargeable to tax in India, i.e., is accrued or deemed to accrue or arise in India as per the provisions of Section 9 of the Act.

[1] *As per Part II of Schedule I of the relevant Finance Act.*

Example: TDS rates in case of income by way of capital gains earned by non-resident individuals:

Income by way of short-term capital gains referred to in section 111A	15 per cent
Income by way of long-term capital gains referred to in section 112(1)(c)(iii)	10 per cent
Income by way of long-term capital gains referred to in section 112A exceeding INR 1,00,000/ -	10 per cent
Other income by way of long-term capital gains	20 per cent

What is interesting to see here is that TDS might be deductible when a non-resident makes payment to another non-resident (sum is neither paid nor received by an Indian resident), provided such incomes are deemed to accrue or arise in India as per Section 9 of the Act.

Now that you're aware that TDS may have to be withheld in case of payment to non-residents, apniRamayan ko aagebadhatehain.

So, tax is to be deducted under Section 195 of the Act on payments made to non-residents at the rates applicable as per the Finance Act, right? Seems easy. But that's not all. After all, what's life without a little complication;)

Introduction to Double Tax Avoidance Agreement:

The Indian tax structure levies tax on incomes received by non-residents, however, the respective nations of the goods/service provider ('Contracting State') would also want to tax the same, on the contention that such income is received in such Contracting State. This can trigger double-taxation and fallout between the dealing countries. In case of such difficulties, Section 90 and 90A come to the rescue.

Sections 90 and 90A enable the Indian Government to enter into contracts with other nations or adopt such agreements entered into by specified associations of both countries respectively. Such agreements basically provide logical conclusions about taxability of an item in one of the two countries dealing in a particular transaction. Such agreement/contract is also known as the 'Double Taxation Avoidance Agreement' or 'DTAA' or a 'tax treaty'.

A DTAA is to be referred under such circumstances where certain income is taxable in both the countries that are part of a transaction. It is a pact signed by two nations that encourages capital investment, trade in goods and services, and other economic activities between the two nations by preventing International Double Taxation. This suggests that there are agreed-upon tax rates and jurisdictions for certain types of income that originate in one country and are received by tax residents of another country.

Comparison between the Act and the relevant DTAA:

Adding on, section 90 or 90A of the Act, as the case maybe, provides that tax on such incomes should be calculated at the rates as per relevant Finance Act, or rates specified in respective DTAAs, whichever is ***more beneficial*** to the ***taxpayer***. Accordingly, TDS shall be withheld under section 195 of the Act at such rates, wherever applicable. With this, the circle of withholding tax implications in case of payments to non-residents, comes to an end.

Example:

Let's cover it all together with an example.

Que: Say, Illogical Publications Limited, a company incorporated India, publishes a book written by Mr.Ban Drown, an author from the United States of America. As per the terms of contract entered by the parties, the publication house has to pay a royalty of 2% of the MRP of the book on every copy of Mr. Drown's book sold in India, as a consideration to acquire the right to publish the book.As the advisor of Illogical Publications Limited, you are required to shed light on the withholding tax implications on payment of such royalty.

Ans:

Understanding the Transaction:

Illogical Publications Limited ('IPL') has published a book written by Mr. Ban Drown. As per the agreement between both the parties, IPL is required to pay Mr. Drown, a royalty of 2% of the price of the book on every copy sold.

Analysis:

The provisions of section 195 of the Income-tax Act, 1961 ('the Act') requires every person responsible for making a payment to a non-resident of any sum chargeable to tax under the Act, to withhold tax at the time of credit in the books of account or at the time of payment, whichever is earlier.

Taxability under the Act:

- Royalty has been defined under Explanation 2 to section 9(1)(vi) of the Act to inter alia include the consideration for transfer of all or any rights (including the granting of a license) in respect of any literary work. Looking at this definition, our transaction squarely falls under the ambit of 'Royalty'.

- On referring Part II of Schedule I of the Finance Act 2023, we come to know that income of a non-resident by way of royalty shall be taxed at the rate of 20% (plus applicable surcharge and cess).

For comparison, we now evaluate the provisions of the India – USA DTAA ('the DTAA').

Taxability under the DTAA:

- Clause 1 and 2 of Article 12 of the DTAA prescribes a TDS rate of 20% of the gross amount payable in case of royalties.

- Clause 3 of Article 12 of the DTAA defines royalty, *inter alia,* payments of any kind received as a consideration for the use of, or for right to use, any copyright of a literary work.

- Thus, one may conclude that the tax rate applicable as per the India – US DTAA in case of the instant transaction would be 20%.

- One interesting point to note here is that no surcharge or cess needs to be calculated in addition to the 20% under the DTAA since in Article 3 of the DTAA implies that the tax rate mentioned in the DTAA covers all taxes including income tax and surcharge thereon.

Conclusion:

Although a rate of 20% is applicable in both the cases, i.e., under the Act and under the provisions of the DTAA, additional surcharge and cess would be required to be calculated under the Act, however, the same is not required in case of the DTAA. Since a flat rate of 20% would be more beneficial to the taxpayer, treaty benefit should be availed.

Additional Masala:

At last, here are some other related points to be considered at the time of dealing with transactions with a non-resident:

1. To avail the treaty benefit, certain documentation is necessary to be obtained from payee -Form 10F, Tax Residency Certificate issued by the appropriate authorities, No PE ('Permanent Establishment') Declaration and in cases where the payee does not have a PAN in India, a declaration as per Rule 37BC.

Further, where PAN is not furnished by the payee, and no declaration is provided, penalty provisions of section 206AA of the Act shall be applicable. Accordingly, TDS would have to be deducted at higher rates as prescribed in section 206AA.

2. Information in Form 15CA (filed by the payer) and 15CB (filed by a CA) would have to be furnished to the Income Tax Department in accordance with Rule 37BB of the Income-tax Rules, 1961.

3. Foreign tax credit in respect of taxes paid in India could be availed by the non-resident pertaining subject to the provisions of the tax treaty with the respective countries and the laws of respective States.

4. If the Assessing Officer is satisfied that the total income of the recipient justifies the deduction of income-tax at lower rates than the rates prescribed / no deduction of income-tax, a certificate may be obtained from him to that extent[2]. Accordingly, tax on such incomes is to be deducted as per the rates specified in such certificate.

One would have to carefully read the relevant provisions of the Act along with the DTAA for understanding the implications of the above points.

The magic of these provisions lies in the fact that implications of each and every transaction are different. One must analyze every transaction separately and take a call on the withholding obligations, which I find to be extremely engaging and intriguing. There's no such thing as monotony and even the slightest of differences can lead to changes in taxability of a transaction. The subtlety and depth of these well-crafted laws is definitely a thing of beauty!

[2] *Section 197*