Payments to Non Residents – Grossing Up and Section 206AA

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Section 206AA of the Income Tax Act, 1961 has been inserted by the Finance Act 2009 w.e.f. 01.04.2010. The provisions of Section 195 read with Section 206AA has been surrounded with increased controversies and complexities. This article primarily intends to discuss the various possible ways of determining the withholding tax in respect of remittance made to a non-resident beneficiary in the absence of PAN.

Applicable provisions:-

The provisions of **Section 206AA** of the Income tax Act, 1961 have been reproduced hereunder:-

(1) Notwithstanding anything contained in any other provisions of the Act, any person entitled to receive any sum or income or amount, on which tax is deductible under Chapter XVIIB shall furnish his Permanent Account Number to the person responsible for deducting such tax, failing which tax shall be deducted at the higher of the following rates, namely:—

i. at the rate specified in the relevant provision of this Act; or
ii. at the rate or rates in force; or
iii. at the rate of twenty per cent.

The Press Release dated 20.01.2010 also clarifies that "All deductees, including non-residents having transactions in India liable to TDS, are advised to obtain PAN by 31st March 2010 and communicate the same to their deductors before tax is actually deducted on transactions after that date".

Rate or rates in force:-

For the purposes of deduction of tax u/s 195 of the Act, the rate or rates in force is defined u/s 2(37A)(iii) read with Circular No 728 30/10/1995 of the Act, to mean:- the rate or rates of income-tax specified in this behalf in the Finance Act of the relevant year or the rate or rates of income-tax specified in an agreement entered into by the Central Government u/s 90 or an agreement notified by the Central Government under section 90A, whichever is applicable by virtue of the provisions of section 90, or section 90A, as the case may be.

Applicability of Section 195A:-

Further, pursuant to the provisions of **Section 195A**, where under an agreement or other arrangement, the tax chargeable on any income is to be borne by the person by whom the income is payable, then, for the purposes of deduction of tax under those provisions, such income shall be increased to such amount as would, after deduction of tax thereon at the rates in force for the financial year in which such income is payable, be equal to the net amount payable under such agreement or arrangement.

Interoperability of 195, 195A, 206AA:-

We may understand the aforementioned with the help of an example:-

The remitter M/s X (in India) pays a sum of Rs 1,00,000 as fees for technical services to M/s Y (in UK). The beneficiary, M/s Y is a tax resident of UK as per the Tax Residency Certificate furnished by him and does not possess a PAN. The tax liability is respect of such transaction, is to be borne by M/s X. Accordingly, the provisions of Section 195A and 206AA become applicable. The rate at which the tax chargeable needs to be grossed up has to be analyzed.

A possible view which may be taken is that the tax treaty is a distinct code in itself and the provisions of Section 206AA shall not apply. The tax chargeable under no circumstances may exceed the rates specified in the treaty. The fact that Treaty overrides the domestic Act is not derived from Section 90(2) but is an established principle of international law.

However, the above position may not hold good as Section 206AA may be considered as an anti-avoidance provision. For that matter, the international law (including OECD and UN commentaries) recognize the fact that anti-avoidance provisions are specifically enacted to prevent misuse of Treaty benefits and that the same shall override the Treaty. Furthermore, it is important to mention that Section 206AA begins with a non-obstante clause and may very well construe to override the provisions of Section 90(2) of the Act.

Proceeding on the presumption that Section 206AA shall be applicable even in cases where Treaty benefits are available, the issue which now arises is the rates at which grossing up is required to be done in cases where payments are to be made net of taxes.

The grossing up provision – namely Section 195A – provides that the tax chargeable shall be grossed up at the **rates in force** for the financial year. **Rates in force** as is defined u/s 2(37A) mean the rates specified by the Finance Act or in accordance with any agreement or arrangement entered into by the Central Government u/s 90 or such agreement as is notified u/s 90A. The said definition does not make any mention to Section 206AA and in any case Section 206AA being an anti-avoidance provision cannot be construed to be the rates in force for the relevant financial year. Accordingly the payment of Rs 1,00,000 may be grossed up at the rate of 15% being lower of:-

- 25% as per the Finance Act or
- 15% as per the DTAA between India-UK.

Thus, the income on which tax is required to be deducted may be determined at Rs 117,647 (i.e. Rs 100,000 X 100/85).

Now, to discuss the application of Section 206AA, which states any person who is entitled to receive any sum or income or amount, on which tax is deductible under Chapter XVIIB, shall furnish his PAN, in the absence of which the tax shall be deducted at higher of the rates specified in the relevant provisions of the Act, rates in force or 20%.

The tax liability on such grossed up income is determined in the light of the following possible views discussed hereunder:-

I. The provisions of section 206AA begin with a non obstante clause. Accordingly, it has an overriding effect over all other provisions of the Act, Thus, tax may be deducted on such amount so grossed up, at **higher of** the following:-
    - Rate prescribed under the relevant provisions of the Act i.e. Section 115A which requires deduction of tax at the rate of 25% in respect of payments towards royalty and fees for technical services; or

- Rate or rates in force u/s 2(37A)(iii) i.e. 15% being:-
    i. 25% as per the Finance Act or
    ii. 15% as per the DTAA between India-UK; or
- At the rate of 20%

Accordingly tax may be deducted at 25% of Rs 117,467 being Rs 29,412.

The beneficiary may claim refund of taxes paid in excess of the rate prescribed by the DTAA by subsequently filing a return in India.

II. One of the three limbs of Section 206AA require determining tax as per the relevant provisions of the Act. Thus, the term “rate as per the relevant provisions of the Act” includes within its ambit the provisions of Section 90(2) wherein the assessee is entitled to adopt the rate as per DTAA over that prescribed in the Act, in case provisions of DTAA are more beneficial to the assessee. Thus, the assessee may opt rate as per Section 115A or that specified in the DTAA to determine the rates as per the relevant provisions of the Act.

Thus, as per the provisions of Section 206AA, tax may be deducted on such amount so grossed up, at **higher of** the following:-

- Rates u/s 115A of the Income Tax Act, 1961 or as per the DTAA between India and UK u/s 90(2) whichever is more beneficial to the assessee i.e. 15%
- Rate or rates in force u/s 2(37A)(iii) i.e. 15% being:-

  25% as per the Finance Act or

  15% as per the DTAA between India-UK
- At the rate of 20%.

Accordingly tax may be deducted at 20% of Rs 117,467 being Rs 23,529.

Judicial Precedents

A similar view has been held by the **ITAT Bangalore Bench 'C' in the case of Bosch Ltd. v. Income-tax Officer, International Taxation, Bangalore [2012] 28 taxmann.com 228 (Bangalore - Trib.) wherein it was held that:-**

“In the instant case, the recipients are non-residents and admittedly the income exceeds the taxable limit prescribed by the relevant Finance Act. In the circumstances, the recipients are bound and are under an obligation to obtain the PAN and furnish the same to the assessee. For failure to do so, the assessee is liable to withhold tax at the higher of rates prescribed under section 206AA i.e. 20% and the Commissioner (Appeals) has rightly held that the provision of section 206AA are applicable to the assessee. [Para 21]

As regards grossing up under section 195A, it can be seen that the income shall be increased to such amount as would after deduction of tax thereto at the rate in force for the financial year in which such income is payable, be equal to the net amount payable under such agreement or arrangement. A literal reading of section implies that the income should be increased at the rates in force for the financial years and not the rates at which the tax is to be withheld by the assessee.

In view of the same, it is opined that the grossing up of the amount is to be done at the rates in force for the financial year in which such income is payable and not at 20% as specified under section 206AA. [Para 23]”

Conclusion

Thus, an analysis of the provisions enumerated in the Act suggests that the grossing up of the income chargeable to tax should be done at the rates in force and not the rate at which the tax is to be withheld as is also supported by the ITAT Ruling in the case of Bosch Limited [2012] 28 taxmann.com 228.

Further, the decision in the case of Bosch Limited analyzed the issue of tax deduction in respect of payments towards royalties and fees for technical services in the light of the rate of 10% existing prior to the amendments made by the Finance Act, 2013. However, fresh issues have emerged pursuant to the increase in the rates at which the tax is required to be deducted, from the existing 10% to 25%, without any corresponding increase in the upper cap of 20% as is specified in Section 206AA. Thus, only jurisprudence would determine as to which of the plausible views pertaining to the rate at which the tax is to be deducted on such payments shall prevail.