

**Chamber of Income-tax Consultants**  
**Tax deduction at source from payments to Non-residents**  
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**Importance of the subject:**

The subject of Tax deduction at source (TDS) from payment to Non-residents is important from 3 specific angles:

- i. The first is basic - If proper tax is not deducted at source, the payer is liable for interest and penal consequences. Prosecution is also possible.
- ii. The second is - expenses may be disallowed u/s 40(a)(i) / 58(1)(a)(ii) and 58(1)(a)(iii).
- iii. The payer may be held as an agent of the non-resident and be liable to tax in the like manner and to the same extent as the non-resident u/s. 160 to 163.

There is no threshold limit. TDS has to be deducted, however small may be the payment. Therefore it is important for a resident tax payer to know its responsibilities.

The reason for such provisions is that it is difficult to recover tax from a non-resident. Hence before the money leaves India, proper tax should be deducted.

Legally, not only a resident, but even a non-resident, who pays to another non-resident any income which is liable to tax in India, is required to deduct tax at source. Therefore even non-residents are required to comply with the tax deduction provisions.

This is a special machinery to deduct tax at source from payments being made to non-residents. The machinery is implemented through Income-tax Act, as well as FEMA.

Under the Income-tax Act, sections 192, 195, 195A, 196C, 196D and other provisions provide for deduction of tax at source.

Under FEMA, all banks are required to ensure that due tax has been paid before the remittance leaves India.

## **Scope of the article:**

Essentially to deduct tax at source, one needs to know the subject of non-resident taxation. Tax on non-resident is a whole subject by itself. It is not my intention to cover this subject as it is covered very well in other articles. Here the focus is on TDS provisions specifically, and important practical issues.

On the subject of TDS per se, there are not many legal controversies. However there are controversies and practical issues on the machinery provisions and practical application. Some of these issues are dealt with in this article.

Further, there are issues relating to TDS which are common in case of payments to residents and non-residents. For example, is there any liability on the deductor, if the recipient has paid the tax and there is no loss to the Government? Such issues are not discussed.

The objective of the special issue in which this article will be published is to discuss some advanced issues. Therefore regular issues have only been discussed briefly.

### **1. The basic provision:**

1.1 Section 195 is the basic provision under which, if any person has to make any payment to a non-resident, proper tax has to be deducted at source – if it is deductible. The necessary conditions to be satisfied to deduct tax at source are:

- i. Payment should be to a non-resident.
- ii. Payment should amount to an income to the non-resident.
- iii. The income should be chargeable to tax in India.

If the above conditions are satisfied, then the tax has to be deducted at source at the prescribed rates stated in the Finance Act.

Payment of salary is not covered by section 195. For salary, section 192 applies.

Dividend u/s. 115-O is exempted from tax deduction provisions as the same are not taxable in India.

### **1.2 When is the tax required to be deducted at source?**

Tax is required to be deducted at source at the time of credit of income, or payment in cash or kind, whichever is earlier. The explanation to section

195(1), clarifies that credit means even if the payment is credited to suspense or any other account, it amounts to credit.

However if the Government, public sector bank or public financial institution (banks and financial institutions as explained u/s. 10(23D)) pays any interest; tax has to be deducted at source, only at the time of payment.

Thus foreign banks do not get this benefit. Even co-operative banks do not get the relief. They are required to deduct tax on credit or payment, whichever is earlier.

## 2. **Kinds of payments:**

### 2.1 One can broadly divide payments into 3 kinds:

i. Payments not liable to tax in India – because they are exempt from tax, or because they are not taxable due to DTA.

ii. Payments taxable on a gross basis – either under income-tax act, or a DTA.

iii. Payments which are liable to tax on net income basis.

### 2.2 The incomes which are exempt from tax under the income-tax act, are not liable to deduction of tax at source. For example, no tax is deductible on interest paid on NRE funds.

But what if the income is taxable as per the Income-tax Act, but not taxable due to a DTA? For example, pension received by a US resident from an Indian company is taxable only in USA and not in India (Article 20(1) of India-US DTA). Does it mean that the payer need not deduct tax at source?

The answer is “yes” because what is liable to deduct tax at source is “sum chargeable under this act”. A DTA is entered under section 90. If as per the DTA, the amount is not taxable in India, then there is no liability.

Section 2(37A)(iii) states that “rate or rates in force” for the purpose of section 195 means rates 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 under section 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.”

It is a settled issue that the Income-tax Act or the DTA, whichever is more beneficial, applies. Thus rates as per the Income-tax Act or the DTA should be considered.

- 2.4 Payments like interest, royalty and fees for technical services are generally liable to tax on gross basis. Here the resident needs to determine the taxability and the rate of tax.
- 2.5 If the payment is of business nature, tax is payable at regular rates.
3. **Issues to be considered by the resident payer:**

To determine whether any tax has to be deducted while making payment to a non-resident, following issues need to be considered:

- Whether the payee is a resident or a non-resident.
- The country of residence of the payee (to determine which DTA will apply).
- Category of payment – whether the payment is of a type for which tax is payable on a gross basis, or is it regular business payment.
- In respect of incomes like interest, royalty and Fees for technical services, whether the recipient is the “beneficial owner”.
- Taxability of income.
- The rate applicable under the Income-tax Act and the respective DTA.
- If there is a DTA, is there a most favoured nation clause.
- Is it advisable to apply to the Income-tax officer, or can the payer rely on a certificate of a Chartered Accountant!
- Several legal precedents in India.

The issues are compounded because the payee may not like to give all the details to the payer.

This problem is compounded if as per the agreement between the parties, the tax is to be borne by the payer.

On the other hand, if the payee has to bear the tax, it is in the payee's interest to give proper details. Alternatively, he can obtain a certificate from the Income tax officer regarding how much tax should the payer deduct.

4. **Procedure if full tax does not have to be deducted at source:**

4.1 **Application by the payer:**

Under section 195(2), the payer can make an application to the Assessing Officer to determine how much tax should be deducted at source. Based on the certificate from the Assessing Officer, the payer can deduct tax at source.

4.2 **Application by the payee:**

Under sections 195(3) and 197, the payee can also make an application to the Assessing Officer for determining the tax to be deducted at source. Based on the certificate, the payee can deduct tax at source.

**Example:**

A foreign company is in the business of publishing trade journals. The entire business is outside India. In India, he has appointed an agent to get advertisements. The agent is a business connection / PE. In such a case, the business income is taxable in India. The company / agent receives payments from several Indian persons. How much tax should be deducted at source by the advertisers?

Under section 195(2), the advertisers can approach the Assessing Officer and obtain a certificate. However each advertiser will obtain a certificate in his own manner. There could be so many variations. In such a case, it is advisable that the Foreign company should apply under sections 195(3) / 197 and obtain the certificate. This will help it to obtain one certificate with a uniform rate.

4.3 In case of salary, section 195 is not applicable. The non-resident employee can make an application under section 197. The employer cannot make the application. The CBDT circular no. 147 [F. No. 275/80/74-ITJ], dated 28-10-1974 also states that the employer should get the employee to obtain a certificate from the Assessing Officer. Otherwise the employer should deduct tax at source.

**Example:**

An employee is deputed to the US. He becomes a non-resident. The Indian company continues to pay salary in India. It is taxable in India u/s. 5 itself.

The source of income is in India. It deducts tax at source. As per the India-US DTA, salary will be taxable only in USA. Under the DTA, income is taxable in the country where services are rendered. (Article 16). The employee in such a case has to claim a refund. In small cases, it may be all right. However in large cases, it can cause difficulties. This is because tax is payable in USA also. If tax is deductible in India it creates financial difficulties. Therefore in such cases it is advisable to obtain a certificate from the department.

5. In subsequent paras, I have discussed some practical issues which a payer can come across, if he has to deduct tax at source.

6. **Purchase of immovable property by a resident from a non-resident:**

When a resident buyer pays price of a property to a non-resident seller for buying the property, he is required to deduct tax at source.

Earlier there was an issue as to whether section 195 applies when the whole of the payment is income, or does it apply even where only some component of the payment is income. This issue has been considered by the Supreme Court in the case of Transmission Corporation (239 ITR 587). Tax has to be deducted on the income embedded in the gross payment. Thus tax has to be deducted at source on any payment made to a non-resident (provided of course the payment or any portion of the payment is taxable in India).

In such cases, there are difficulties faced by the deductor. These are discussed below:

6.1 The first is how to determine the cost. If the seller gives his purchase agreement, then it may be possible to know the cost. However the property could be constructed. The buyer may not have bills for material, contractor or labour.

6.2 If the property is acquired prior to 1.4.81, the market value may not be available.

6.3 The seller is willing to invest in capital gains bonds, or buy / construct another property. The investments can be made within the prescribed time which can be upto 3 years in case of property to be constructed.

The prescribed time for deducting TDS and paying to the government is a maximum of 2 months from the end of the month in which payment is made / credited to the non-resident's account.

Can the buyer wait till the seller invests in the bonds or the flat?

What if the buyer waits, but the seller cannot invest?

One practical way could be that the buyer makes the payment directly for the bonds or the flat, on behalf of the seller. This will give at least a reasonable assurance to the buyer that capital gains of the seller are exempt from the tax to the extent of the investment.

There is a further possibility, that the seller does not hold bonds / flat for 3 years. In that case, the capital gains tax is payable. Is the buyer responsible? In this situation, one can safely argue that the buyer has taken reasonable steps to ascertain the tax. If subsequently, the seller does not fulfill the conditions, the buyer cannot be held to be responsible.

6.4 What are the other options?

6.5 The seller can approach the Assessing Office and obtain a certificate regarding tax to be deducted at source.

For obtaining a certificate, the income-tax department asks for various documents and information. Most of these are normal. However there is one issue which is serious. In Mumbai, a representative assessee is also required. A person who is agreeable to be a representative assessee, is required to give an undertaking to that effect. Representative assessee can be considered to be liable to tax in the same manner as the principal person. This can be a serious liability, which normally no person should agree to.

However practically, some persons without understanding the implications agree to be a representative assessee.

There is however an issue of legal validity of the undertaking to become a representative assessee. Can an undertaking be legally binding? Let us see the specific sections which can apply.

***“Representative assessee.***

**160.** (1) For the purposes of this Act, “representative assessee” means –

(i) in respect of the income of a non-resident specified in sub-section (1) of section 9, the agent of the non-resident, including a person who is treated as an agent under section 163;

***Who may be regarded as agent.***

**163.** (1) For the purposes of this Act, “agent”, in relation to a non-resident, includes any person in India –

- (a) *who is employed by or on behalf of the non-resident; or*
- (b) *who has any business connection with the non-resident; or*
- (c) *from or through whom the non-resident is in receipt of any income, whether directly or indirectly; or*
- (d) *who is the trustee of the non-resident;*  
*and includes also any other person who, whether a resident or non-resident, has acquired by means of a transfer, a capital asset in India :”*

If the buyer agrees to be a representative assessee, it is all right. Legally, he does not even have to give an undertaking. The Income-tax act makes him a representative assessee.

The department however takes an undertaking even from persons who are not a party to the transaction at all. And some people give it. In my opinion, such an undertaking to become a representative assessee has no validity.

For example, a person commits a theft, and some other person agrees to bear the punishment, the court cannot punish the other person. The law does not authorise such a punishment.

To become a representative assessee, a person should be an agent of the non-resident (section 160(1)). Alternatively, the person should be covered under section 163(1). Two clauses of section 163 which most frequently apply are clauses (b) and (c). Under the clauses, if a person has a business connection with the non-resident; or if the non-resident is in receipt of any income from the person, then in these cases, the person can become a representative assessee. If the conditions are not satisfied, then a person cannot become a representative assessee. Giving an undertaking, does not change the law.

The above is a legal argument. There is no legal precedent I am aware of. Practically, a person should not agree to be a representative assessee without understanding full implications.

- 6.6 An option has been given by circular no. 10 dated 9<sup>th</sup> October 2002. A Chartered Accountant can certify the amount of tax payable. If the buyer wants to rely on the certificate of the seller, he can deduct tax at source according to the certificate.

There is an issue relating to the certificate.

The certificate strictly applies only in case the funds are required to be remitted abroad to the non-resident. If the payment has to be made in India, can a certificate be issued? My view is that the procedure prescribed for the certificate is a machinery provision. We have to take the process to a logical conclusion. The purpose of introducing the certificate was to do away with the need to go to the Assessing Officer. Hence in my view the certificate can be issued for “payments to non-residents” and not just when the funds are to be remitted.

**7. Deduction of tax at source in case of sale of mutual funds:**

7.1 On sale of equity oriented mutual funds, a non-resident will normally earn short term or long term capital gain. Short term gain is liable to tax @ 10%, and Long term gain is tax exempt.

7.2 On redemption of units, what should be the rate of tax to be deducted at source?

Some mutual funds deduct tax at source @ 10%, some others deduct tax @ 30%.

7.3 The reason is that due to possibility of ease in trading, the transactions of trading in mutual funds and shares are more likely to be considered as business income and not short term gains. In fact the principles for distinction have been laid down by the courts several years ago. (e.g. G.Venkata Swami Naidu & co. Vs. CIT (1959) 35 ITR 594.) If the asset is acquired with the intention to sell it at a profit, the profit on realisation will be business income.

7.4 The Finance Act prescribes the rate of tax in Schedule I, part II. In case of non-residents and foreign companies, the rate prescribed for Short term gain is 10%, and for Long Term gain it is NIL. However how will a mutual fund know whether the transaction by a non-resident amounts to short term gain or a business income. If the mutual fund deducts tax @ 10%, and the department’s view is that the income should be considered as business income, the mutual fund may face difficulties.

It may be advisable to have a clear rate of tax prescribed in the Finance Act – at which mutual funds have to deduct on “redemption”. Then the treatment as business income or short term gain may be left to the investor.

7.5 However in case of Long term gain, the mutual funds generally do not deduct tax at source. Legally, even in case whether mutual funds units are sold after 12 months, the gain could be business income.

What would happen in such cases where the mutual funds do not deduct tax at source and it is held that the income is business income?

**8. Interest paid to Indian branches of foreign banks:**

Residents take loans from foreign banks that have branches in India. Interest is payable to the branches. As the banks are non-residents, tax is required to be deducted at source.

There are several small businessmen or individuals who take housing loans. In case of housing loans, the interest is deducted from the savings account. No one really bothers to check.

Most of the times, the foreign banks obtain a certificate from the department that no tax is deductible at source. However there would be some new banks who may not have obtained the certificate due to non-fulfillment of conditions prescribed in rule 29B.

If such cases, the resident payers carry a risk of TDS defaults. I think there is impracticality in the law. It can be improved by – either amending the law, or CBDT issuing a circular that the borrowers paying interest less than the threshold amount, need not deduct tax at source.

**9. Capital Gain on sale of shares on stock exchange:**

**9.1 NRIs and FIIs can invest on the stock exchange under the portfolio scheme under FEMA rules.**

On the stock exchange, it is not possible for the buyer to know who is the seller.

Therefore the responsibility is cast on the banks under section 204(iia) in case of NRIs. In case of Long Term Gain under chapter XII-A, the banks are required to deduct tax at source before crediting the sum to the NRE account. This provision applies only in case of investment on repatriable basis. This provision is now redundant as Long Term Gain is exempt from tax.

However there is no provision for short term gain. There is also no provision in case of capital gain on sale of non-repatriable securities. In such cases, who is responsible to deduct tax at source?

Under FERA rules, RBI had advised the banks, that in case of remittance of funds to non-residents, they should deduct tax at source or have a certificate from the Assessing Officer. The banks were following this procedure for capital gain under portfolio investment scheme on non-

repatriable basis. However, in case of shares sold on the stock market, which are not under portfolio investment scheme, there was no guidance.

Under FEMA also, the regulations state that banks should ensure that before remitting the funds, proper tax is deducted at source. However if the funds are to be deposited in the NRO account, there is no way in which tax is deducted at source. Most of the banks credit the funds in the NRO account.

- 9.2 In case of FIIs, tax is deductible under section 196D. This is a specific section. Therefore it overrides section 195.

Under section 196D, there is no tax deductible on capital gains earned by FIIs.

Tax is deductible only on income earned by FIIs under section 115AD. Income of an FII can comprise only of interest, or income from exchange traded derivatives.

Thus in case of interest, the payer will have to deduct tax.

However in case of income from derivatives, section 115AD has no application. Section 115AD deals only with dividend, interest and Capital Gain. The manner in which derivatives are traded on the stock exchange in India is that there is no delivery of any securities. The transactions are settled within the specified period in cash. Therefore all derivative transactions give rise to business income. In such a case, the income would not be covered under section 115AD. Therefore section 196D will not apply. Section 195 will apply. In this case, as the income is business income, the payer has to deduct tax. However as the derivatives are traded on the stock exchange, there is no one specifically in charge of TDS.

## 10. **Refund of Excess TDS:**

- 10.1 Due to some reasons, there could be a situation where the Indian resident has deducted tax at source and deposited the same with the Government. Subsequently, the contract with the non-resident has been cancelled. In such a situation, the income does not accrue to the non-resident and yet tax has been paid. Earlier there was a difficulty in recovering the tax, as there was no provision. It was possible to recover the tax only if the non-resident could file the return. As the non-resident would not have earned any income, he was not interested in filing the return.

CBDT has issued a circular no. 790 dt. 20.4.2000. As per the circular, the deductor can apply for a refund.

Two situations have been stated in the circular where a refund can be made. One is where no remittance has been made to the non-resident and the contract is cancelled. In such a case, TDS is paid to the government where there is no income.

The other is where remittance has been made to the non-resident, and subsequently the contract is cancelled. In this situation, the funds would be remitted to the resident. Thus the non-resident would have refunded the amount. As the amount is refunded, there is no income.

The difficulty is if the non-resident has not remitted the funds to the resident. The funds stay with the non-resident. The resident can try to recover the amount by legal means. He may or may not recover the amount. It is possible that the costs involved are not commensurate with the amount to be recovered. He may therefore not be interested in recovering the amount. In such situations, it may be difficult for the deductor to get the refund.

- 10.2 In case of excess TDS from salary, CBDT has issued separate circulars. Circular: No. 285 [F. No. 275/77/79-IT(B)], dated 21-10-1980 states that refunds can be made to the deductor subject to the procedure laid down.

In some situations, the employer bears the income tax of employees who come for a short employment. What happens if the employee has left India and then a refund is due to him?

CBDT has issued Circular no. 707, dated 11-7-1995 whereby a refund can be given to the employer if the non-resident person gives an authorization to that effect.

#### 11. **Payment to foreign shipping company / its agent:**

Income from shipping is governed by section 172. The section applies notwithstanding anything contained in any other provision of the income tax act. Section 172 is a self contained code. The non-resident shipping company has to pay tax at the prescribed rate within 30 days of the departure of the ship. The master of the vessel has to arrange for payment of tax. Only then does he get the clearance for departure.

The payment by Indian residents can be made to the shipping company or the agent. CBDT has issued a circular No. 723, dated 19-9-1995 stating that tax has to be paid in terms of section 172. Section 195 has no application. Therefore no tax has to be deducted at source as the master of the ship has to make arrangements for the tax payment before the departure.

**12. Summary:**

The whole thrust of tax deduction from payments to NRIs is that once the funds have left India, it is difficult for the Government of India to recover the same. Therefore tax should be deducted at source before the funds leave India.

The difficulty is that in some cases, the Indian resident payers do not have full details of the non-residents. This makes the things difficult. In such situations, the non-residents need to take steps for obtaining appropriate certificates from the Income-tax department. Alternatively they have to file the return and claim refunds.