Section 206AA and its impact on transactions with non-residents

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Blue Consulting Pvt. Ltd.

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Introduction

- When Finance (No.2) Bill 2009 was presented, one proposal which attracted everyone's attention was section 206AA.
- This presentation aims to **analyze the applicability of Section 206AA on remittance to non-residents** in the light of various provisions of Income Tax Act, 1961 ('**Act**'), Income Tax Rules, 1962 ('**Rules**') and Double Taxation Avoidance Agreements (' **Tax Treaty**').
- Section 206AA is **operative w.e.f. 01.04.2010**
- As per Section 206AA(1), if a deductee fails to provide its PAN, the deductor shall withhold the tax at higher of the following rates:
  - at the rate specified in the Income Tax Act **OR**
  - at the rate or rates in force **OR**
  - at the rate of **20%**

Applicability on non-residents?

- Presently, (as per Rule 37BB of Income Tax rules, 1962) any person making payment to a non-resident which attracts withholding tax, is first required to obtain **a certificate from a practicing Chartered accountant in Form 15CB** and then to **upload an undertaking in Form 15CA online**. Even the payments which are not subject to withholding tax, also attract the provisions of Rule 37BB.

- Presently, there is an **ambiguity** about the applicability of Section 206AA on the remittance to non-resident which are **subject to withholding tax** in India**.**

- However, there is **no uncertainty** on remittance to non-resident which are **not subject to withholding tax** in India i.e. remittance for import of goods etc. Section 206AA(1) very clearly stipulates that *any sum or income or amount, **on which tax is deductible under Chapter XVIIB** shall be covered under this provision*.

- Presently, there are two schools of thoughts among the tax professionals. One of them is **against** the applicability of Section 206AA on transactions with non-residents attracting withholding tax and another is **in favor of** applicability of Section 206AA. In the next few slides, both schools of thoughts have been deliberated in detail.

Arguments **against** the applicability

- Section 139A of the Act inter alia deals with provisions for obtaining PAN. **Section 139(8)(d)** of the Act provides that the Board may make rules specifying the persons to whom the provisions of Section 139A shall not apply. **Rule 114C** of the Income tax Rules,1962 inter alia **provides that provisions of Section 139A shall not apply to non-residents**.

- Based on the harmonious construction of the provisions of Section 139A and 206AA, it can be contended that it could never have been the intention of legislature to penalize a taxpayer (read non-resident) for not complying a formality which he was never supposed to comply with it in the first place.

- **No corresponding changes has been made in Section 139A and Rule 114C.**

- Even if it is assumed that Section 206AA will also apply to transactions attracting withholding tax under Section 195, it is a settled law (based on various judicial precedents as well as Circular No. 333 dated 2-4-1982 issued by CBDT) that provisions of **Tax Treaty would override the provisions of the Act** if the same are beneficial to the tax payer. Accordingly, if there is a Tax Treaty with a country with which a transaction has been entered into and the tax payer chooses to be governed by the provisions of Treaty, penal provisions of Section 206AA should not be attracted.

- Although, Section 206AA which overrides the other provisions of the Act but it **does not expressly override the Treaty provisions**.

Arguments **in favor of** applicability

- Section 206AA **starts with an overriding clause** *'Notwithstanding anything contained in any other provisions of this Act,.....'* which clearly means that this Section shall override all the other sections of the Act, including Section 90 (related to Treaty provisions)

- Had the intention of legislature been otherwise, **either** the Section 195 and Section 90 would have been expressly excluded from the overriding clause **or** the words **'any person'** used for deductee in Section 206AA would have been **replaced** with **'any resident'** to make it very clear and specific.

- **To clarify the intention** of legislature, CBDT has come with out with a Press Release No. 402/92/2006-MC (04 of 2010) dated 20th Januray'2010 which mentions that the provisions of Section 206AA will also apply to all non-residents in respect of payments / remittances liable to withholding tax. In this circular, CBDT has advised all the deductees, including non-residents having transactions in India liable to withholding tax, to obtain PAN by 31st March'2010 and communicate the same to their deductors before tax is actually deducted on transactions after that date.

- Section 206AA require to withhold the tax at higher of the following rates if a deductee fails to provide its PAN to the deductor:
  - at the rate specified in the Income Tax Act **OR**
  - *at the rate or rates in force* **OR**
  - at the rate of **20%**

  As per provisions of **Section 2 (37A)** of the Act, **'rate or rates in force'** for the purpose of tax withholding under Section 195 of the Act has been defined to inter alia include the rates of income tax specified in the Finance Act of the relevant year or the rates of income tax specified in an Agreement entered into by Central Government under Section 90 of the Act (i.e. Tax Treaty).

  Accordingly, in view of the specific mention of 'rate or rates in force' under the Section 206AA, it appears that Section 206AA would have an overriding effect over all other provisions of the Act, including the Tax Treaty

Implications of applicability on non-residents

- Many a times, withholding tax is borne by the resident payer. In such a case, a non-resident payee may not agree to apply for PAN as he is getting the payment without deduction of tax. Here, the overall cost of services / product shall go up for the resident payer as withholding tax shall be grossed up at the rate of 20% if withholding tax rate as per Act or Treaty is lower. Further, to make the matter worse, the effective rate of withholding tax after grossing up comes out to be 25% and not 20%. It can be better understood with the help of following example:

  For example, an **Indian company ABC Ltd** enters into an agreement with **XYZ Inc of USA** to avail some technical services for INR 200,000 (to be paid in USD). As per agreement, withholding tax, if any, shall be borne by ABC Ltd. XYZ Inc don't have PAN in India and don't wish to apply either. Withholding tax rate on this transaction as per Act and Treaty is 10%.

  In this case, provisions of Section 206AA shall be attracted and ANC Ltd will be required to withhold the tax @ 20% (i.e. because the withholding tax rate as per Act and Treaty is lower) and withholding tax is to be borne by ABC Ltd.

  As per Section 195A, if withholding tax on any income is to be borne by the deductor then such income shall be increased to an amount which, after deduction of tax, shall be equal to the amount payable as per the agreement. Let's apply it on the above example:

  $$\frac{\text{INR } 2{,}00{,}000 \times 100}{80} = \text{INR } 250{,}000$$

  Withholding tax @ 20% shall be calculated on INR 250,000 (instead on INR 200,000) which comes to INR 50,000 and the net amount payable to XYZ Inc. shall be INR 200,000 (i.e. INR 250,000 – INR 50,000) which is as per the agreement.

  Now, if we calculate the percentage of INR 50,000 in relation to INR 200,000 it works out to be 25%.

….contd. (Implications)

- In majority of the cases, FTS (Fee for Technical Services) and Royalty payable to non-residents attracts the withholding tax / TDS @ 10%. Now, with the applicability of this new provision, the deductor will be required to withhold the tax @ 20% if a non-resident payee doesn't furnish its PAN. It would be difficult to convince a non-resident to apply for PAN specially where a transaction is not of a recurring nature or involve a very small amount.

- This provision will cause more hardships to Small and Medium Enterprises (SME) because they generally have low negotiating power while dealing with a non-resident for availment of services (which attracts withholding tax). The non-resident may not like to deal with a SME if he is insisted for PAN registration. Similarly, where agreements provide that withholding tax is to be borne by SME, the cost of service will be go up (as discussed in the previous slide).

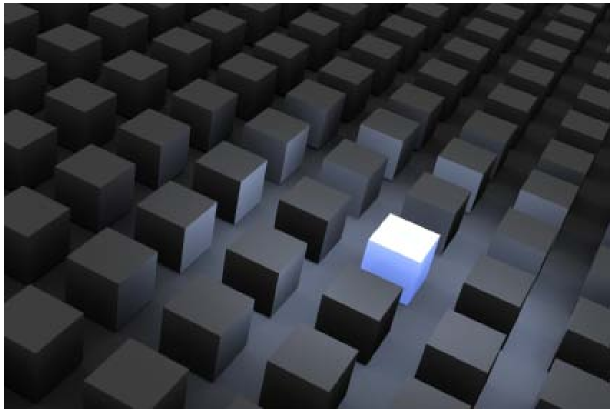
Conclusion

- Having regard to the overriding clause of Section 206AA and subsequent Press release by CBDT, it is advisable to apply the provisions of Section 206AA on remittances to non-residents which are subject to withholding tax.

- Non-residents service provider/vendor need to be educated about the provisions of Section 206AA and at the same time they need to be convinced about the hassle free process of obtaining PAN.

- In the future contracts or agreements with non-residents, it would be advisable to mention about the requirement of PAN to avoid the penal provisions of Section 206AA.

- In case of agreements which require that withholding tax is to be borne by the deductor and where a non-resident is not having PAN, some benefit (on account of reduction in withholding tax liability) may be passed on to the non-resident if he agrees to apply for PAN. It will be a win-win situation.



About us

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which you see in sleep
A dream is that
which dose not let you sleep"

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