Increase in IT withholding rate could make technology imports costlier – Mar 4, 2013

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IN terms of Section 115A of the Income tax Act, 1961, the prescribed tax rate in respect of income of non-residents, in respect of royalty and fees for technical services received/receivable in pursuance of an agreement made on or after June 1, 2005 is 10%. As we know, India has Double Taxation Avoidance Agreements with about 84 countries. The tax rate to be adopted by the payer/recipient of services, in respect of payments to non-residents in respect of royalties and fees for technical services, is the lower of the tax rate prescribed in Section 115A (which is currently at 10%) and the rate specified in the DTAA, which ranges from 10% to 30%. However, in respect of transactions with parties located in countries with which India does not have a DTAA, the withholding rate for payments by Indian importers of services would be governed solely by the tax rate prescribed in Section 195A.

The proposed increase in the tax rate prescribed in Section 115A would affect Indian importers of services in two ways.

Firstly…..in respect of payments to parties who are from countries with whom India has a DTAA, the withholding tax rate could go up, depending on the country's DTAA with India. For instance, in the case of the DTAA with the US, the tax rate prescribed for payments for royalties and technical fees is 15%. In the light of the proposed increase in the tax rate specified in Section 115A to 25%, the Indian payer would now be required to deduct tax at source, under Section 195 of the Income tax Act, at 15%, since this is the lower tax rate, as compared to the proposed 25%. In many other cases, where the tax rate prescribed in the DTAA is 20%, the withholding tax rate to be adopted by the Indian payer, while effecting payment to the non-resident would go up to 20%. Remember…. in respect of both these examples, the current withholding tax rate is only 10%.

Secondly….Indian Parties also deal with their counter-parties located in countries with whom, India does not have a DTAA, eg. Hong Kong. In this case, the withholding tax rate to be adopted would be the rate prescribed by Section 115A, in the absence of a DTAA.

There can be no issues where the non-resident payee is willing for tax to be deducted at source in India. The problem arises when the non-resident payee is not willing to bear the tax burden, which is the situation, in most cases. These cases are covered by Section 197A, which talks of the grossing-up methodology, which essentially means that the Indian payer will have to bear the impact of the tax to be deducted at source as the non-resident recipient is not willing to bear the withholding tax. Till now, in terms of Section 197A, the grossing up percentage would work out to 11.1% of the payment, which in effect, is equivalent to 10% representing the tax.Now… in one stroke, with the FM proposing to increase the tax rate under Section 195A from 10% to 25%, Indian payers, who are required to pay royalties and technical fees to non-residents in cases where the non-residents are not willing to bear the withholding tax, will now have to shell out a whopping 33.33% on the amounts paid by them (which would effectively mean an effective withholding tax of 25%) , as contrasted to the currently applicable grossing up percentage of 11.11%.

In a majority of the cases….. the non-residents are just not interested in the Indian income tax law and insist on getting paid, the entire amount agreed to by the Indian payer, irrespective of withholding taxes. Now, with this draconian amendment, such Indian companies/payers will have to bear the additional tax burden of about 22.2% and this would affect the entire spectrum of technology imports including software imports.

Despite that this rate of 10% has been in vogue from June 1, 2005, the significantly increased rate would make import of services and technology costlier for Indian importers, in most cases. The FM would need to re-visit this proposal and fix the new rate at a more reasonable level, say, 15%.