International Taxation – Industry requires clarity from Budget 2011

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INTERNATIONAL taxation has been one of the most contentious and litigated areas of direct taxation, over the decades. This is also an area which has seen a lot of developments in the last few months. The FM could use the Budget as an opportunity to drive clarity in respect of some of the burning issues concerning international taxation, five of which, are dealt with below:

TDS rate applicable in cases of payments to Non-residents where PAN is not furnished

In terms of the provisions of Section 206AA (1) of the Income tax Act, 1961 ('ITA') which was introduced with effect from April 1, 2010, any person receiving any sum, income or amount which is liable to tax deduction at source, is required to his Permanent Account Number ('PAN') to the person responsible to deduct tax at source. In the event that the PAN details have not been furnished, the deductor is liable to deduct tax on the sum, income or amount payable to the deductee, at a rate which is highest of the rate specified in the ITA, the rate or rates that are in force or 20%. Nobody disputes the rationale behind this Section, which is to penalize transactions which are not supported by details of PAN.

While this reasoning is good, vis-à-vis the domestic transactions, this Section has been playing havoc in respect of payments to Non-residents. As we know, the payments to Non-residents could either be taxable in India or they could be exempt, under the provisions of the ITA or under the Double Taxation Avoidance Agreements ('DTAA'). While, there is no need for deduction of tax at source, under Section 195 of the ITA, in respect of income of the Non-resident which is exempt in India, the said Section imposes an obligation on the payer to deduct tax at source, in respect of the payment to the non-resident which results in income taxable in India. Till this Section 206 AA came into the tax statute, there were no issues for the Indian residents effecting payments to non-residents. All that they were required to see was, whether, their payment to the non-resident would result in taxable income in the hands of the non-resident. With this Section in force now, a new complication has arisen. Payments to Non-residents are also seemingly covered under Section 206AA and the Indian resident payers are now required to deduct tax at source at the maximum rate of 20%, when the PAN details are not furnished by such Non-residents.

This is a very unfortunate development which is already affecting the industry. The fact that, the Form 27Q which needs to be filed by the Indian resident, on a quarterly basis, compulsorily asks for a tax deduction rate of 20% to be effected when PAN details are not available, has further confirmed what seems to be the Departmental view that, payments to Non-residents who have not furnished PAN details would have to suffer TDS @ 20%.

Asking Non-residents to take PANs would be to mean that the provisions of the ITA would get extended to countries outside of India. While this could still be palatable in respect of Non-residents, payments to whom, are taxable in India, it would be grossly unfair to expect Non-residents who get payments for income which are not taxable in India, to get PANs. Many Non-residents get terribly scared when they hear of the PAN related requirements and many small and mid-sized Non-resident service providers have chosen to ignore the orders placed by the Indian importers, due to these provisions. Enough damage, therefore, would already seem to have been done in this area and the Industry would look forward to a statutory amendment or a clarification from the CBDT that the provisions of Section 206AA are not applicable to payments to Non-residents.

Board Circular required in the aftermath of withdrawal of Board Circulars Nos 23 and 786

The Board had taken a clear view, as expressed in its Circular No. 23 dated July 23, 1969 (which had been issued under the 1922 Income tax Act), clarifying the liability of non-residents in respect of income accruing or arising through or from, a business connection in India. As per the aforesaid Circular No. 23, even if a business connection existed under Section 9 of the Income-tax Act, 1961 ("the Act"), only so much of the profit which can be reasonably attributed to the operations of the business carried out in India could be subjected to tax in India. Circular No. 23 also provided clarifications on the taxability of non-residents in specific situations. Based on this Circular, interalia , the Courts have taken a clear view on the taxability of Non-residents in India. Very unfortunately, the CBDT has issued Circular No. 7/2009 dated October 22, 2009, withdrawing the above referred Circular No. 23 on the ground that the Circular No. 23 does not actually apply to a particular case, or tax payers were (incorrectly) interpreting it to claim relief which was not in accordance with the provisions of Section 9 of the Act or the intention behind the issuance of the Circular. In another damaging move, the CBDT has also withdrawn Circular No. 163 dated May 29, 1975 and Circular No. 786 dated February 7, 2000 which provided certain clarifications with respect to Circular No. 23. While Circular No. 163 provided further clarifications to Circular No. 23, Circular No. 786 indicated that tax is not deductible at source from payments made to non-resident agents on commission and other charges.

One wonders as to how the CBDT can come to a conclusion, after 40 years, that its earlier Circular issued in 1969, needs to be withdrawn and that, assesses / payers have been taking undue advantage of the Circular. How can a 40 year old binding Circular be unsettled, Mr FM, Sir? Needless to say, this sudden U Turn after a gap of 40 long years, has created a lot of confusion in the area of international taxation. It's a well-known fact that circulars issued by the CBDT carry more weight than the decisions of the Supreme Court, with the Departmental officers. Based on this new Circular No. 7/2009, the Departmental officers are seeking to unsettle the law with regard to international taxation, even in respect of judicially settled issues. As such, there are too many Circulars on taxability of payments to Non-residents. One would expect that a consolidated Circular is issued as part of Budget 2011 by the Board, which would clarify its position on the taxation of payments to Non-residents with regard to the taxability in typical situations, not withstanding that, the Courts are not bound by the Board's views.

Conflicting Tribunal decisions on taxation of payments for software imports – what is the Government's view

The various benches of the Tribunals have taken conflicting views on the taxability of payments made by Indian importers to Non-residents towards the import of shrink-wrapped software. While most

Tribunals have taken the view that, such payments cannot be treated as royalty income, taxable in India, in a recent decision, the Delhi Income Tax Appellate Tribunal has held that payments effected by a resident to a non-resident for import of shrink-wrapped software is taxable as royalty income, in the hands of the non-resident, as reported in the case of Microsoft Corporation and others v. ADIT reported in 2010-TII-141-ITAT-DEL-INTL. Though, e ven after this decision, some Tribunals are continuing to take the view that, such payments would not be taxable in India, the Department seems to be taking a litigating stand and is taking up matters to the High Courts, etc.

Currently, depending upon the decision of the jurisdictional Tribunal, the software importers are taking a view. This is leading to certain absurd situations, wherein, a Delhi based importer could be asked to effect TDS on software imports, whereas, his own Bangalore office could cite the decisions of the Bangalore Tribunal in several cases and take the view that, no tax needs to be deducted for payments towards software imports.

It's an established law that, packaged software is treated as 'goods' by the State and Central Governments and even by the judiciary, for purposes of levy of indirect taxes. One wonders as to how, a transaction which is treated as 'goods' for purposes of indirect taxes, could attract TDS for purposes of direct taxes. It's high time that this differential treatment is put an end to and one hopes that the Board out with a Circular conveying its views, on this very important subject matter.

Exempt requirement of filing Form 15CB in respect of import of goods, capital goods, etc

In terms of the language used in Notification No. 30/2009 dated 25-3-2009 issued by the Board, it seems that the requirement of providing the chartered accountant's certificate in Form 15CB is applicable to all payments to non-residents including for import of materials, capital goods and spares. This is clear from the format of the certificate given in the said Notification.

The whole purpose of this requirement is to ensure that, the payer/remitter deducts tax at source, in respect of payments effected to Non-residents which are covered by Section 195 of the ITA and when, no tax is deducted, there is a justification for the same, based on a certificate given by a chartered accountant. In actual practice, this requirement has become a big nightmare for importers of materials, etc. who might have multiple imports on a daily basis. The lack of uniformity amongst the banks has added to the confusion, with some banks preferring to play it safe by insisting on 15CB certificates for all forex payments.

It would be good if the Government can come out with an amendment exempting imports of materials, capital goods, etc. from the requirement of providing Form 15CBs and also providing for an exemption from this requirement for imports of a value of up to US$ 1,000- or its equivalent so that, the small time exporters are spared from this requirement. Alternately, importers can be asked to submit quarterly certificates, instead of the current dispensation of having to submit the certificate every time a forex payment of effected.

For Heaven's sake – don't further complicate international taxation, till DTC comes into effect

One reads reports that the Finance Ministry might advance the implementation of some of the provisions of the Direct Taxes Code (‘DTC’), as they relate to international taxation, to April 2011, especially with regard to the provisions applicable to what are known as ‘Controlled Foreign Companies’ (‘CFC’s). As we know, the DTC is to take effect only from April 1, 2012. While this is not the forum to discuss the merits of demerits of the DTC, it is well known that the DTC contains several obnoxious provisions and some of these are relatable to ‘CFC’s, under which, a foreign company based in a country with a lower tax rate would be treated as a CFC and taxed accordingly in India, in cases where one or more Indian residents hold management control over this foreign company. These provisions can be implemented only after a thorough discussion and with the DTC already all set to become law from April 1, 2012, one does hope that the Government of the day does not go in for a hasty implementation of select provisions of DTC, with a view to increase its tax collections during FY 2011-12.

Before concluding….

International taxation is one area, where it seems, that the Government has not shown its magnanimity in accepting the decisions of the Apex Court and the High Courts, if its past Budget record is any indication. The insertion of the Explanation to Section 9(2) of the ITA, by the Finance Act, 2007, with retrospective effect from 1-6-1976 in the 2007 Union Budget, presumably, in order to overcome the impact arising out of the decision of the Supreme Court in Ishikawajma-Harima Heavy Industries Ltd v. Director of Income tax reported in - (2007-TII-01-SC-INTL), is a classic case, in this regard. With the DTC just a year away, one hopes that the Budget 2011 does not tinker with the existing provisions related to International Taxation and least of all, to go in for statutory amendments to overcome the impact arising out of judicial pronouncements.

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