Withholding tax – Contentious issues

Withholding tax is one of the most significant sources of collecting Income Tax under the Indian Income Tax regime. Under the Income Tax Act, 1961 (the Act), responsibility is cast upon the payer to withhold tax on various domestic as well as foreign payments at the source. Over the years, these provisions have assumed great significance and it has shored-up the tax collections of the Indian government.

However, interpretational issues and different views between the taxpayer and the tax authorities in some of these provisions have raked up substantial litigation, especially in the last few years.

This article covers some of the controversial issues surrounding some of the withholding tax provisions.

Software taxation and scope of the amended definition

The Finance Act, 2012 amended the definition of 'royalty' under Section 9(1)(vi) of the Act with retrospective effect from 1 April 1976 to include payments for the transfer of all or any right for use or right to use a computer software (including granting of a licence).

Pursuant to this amendment, the tax authorities have been seeking to tax every kind of software purchase under Section 9(1)(vi) as royalty. Furthermore, they have also been extending the applicability of this amendment to the tax treaty.

However, the contention of the taxpayers has been that the payment is for the use of 'copyrighted article' and not 'copyright' in the software. The amended definition under the Act cannot be extended to the tax treaties which do not provide for the taxation of software. Under the tax treaty, the taxability under royalty is that of the use of the copyright and not of the copyrighted article and hence, there would be no taxability and consequently no requirement to withhold tax at source.

There has been a plethora of decisions giving out dissenting views on software purchase taxation. The Karnataka High Court[1] has been consistently holding the view that there is no difference between copyright and copyrighted product and hence, any payment for the acquisition of software is royalty, not only within the meaning of the domestic law but also as per the tax treaty. However, the Delhi High Court[2]

[1] In the case of CIT vs Synopsis International Old Ltd [2013] 212 Taxman 454(Kar); CIT vs Samsung Electronics Co. Ltd [2012] 345 ITR 494/203 Taxman 477 (Kar)
[2] DIT vs Nokia Networks OY [2012] 25 taxmann.com 225 (Delhi); DIT vs Ericsson A.B. [2012] 204 Taxman 192

has held that there is a difference between copyright and copyrighted article and the expanded definition provided in the Act for software can not be imported into the treaty. It is interesting to note that the Mumbai Tribunal[3] has followed the Delhi High Court's ruling and has held that payment for software would not amount to royalty within the meaning of the tax treaty as the extended definition of the Act can not be read into the treaty.

To put this controversy to rest, the Supreme Court posted the final hearing for the software taxation matter in January 2018.

Payment for 'standard facilities' like lease line, broadband, etc.

Another clarification provided vide Finance Act, 2012, with retrospective effect from 1 April 1976, was with respect to the definition of the term 'process'. It was clarified that the term 'process' includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret.

Due to this clarification, another issue similar to that of software taxation that the taxpayers are grappled with is of taxability of payments for standard services such as transponder charges, leased line facility, interconnect charges and such similar other services.

The intent to amend the above definition was to provide certainty to the conflicting decisions rendered on this issue. However, the tax authorities have been attempting to cover a host of payments which clearly are not in the nature of royalty within the ambit of the amendment.

Again in this case, the Madras High Court[4] has imported the expanded meaning of the term 'process' within the meaning of the tax treaty and has held that transponder charges would amount to royalty. However, the Delhi High Court[5] has taken a view favouring the taxpayer. Thus, similar to software, to bring certainty to the taxability of such payments, a clarification on the scope of the amended provision is the need of the hour.

Reimbursement of expenses

Another commonly faced issue is the requirement to withhold tax on reimbursement of expenses.

The withholding tax requirement in the case of foreign payments arises on the 'sum chargeable to tax'. Thus, the income element in the payments is a pre-requisite for taxes to be withheld.

However, there are instances where taxpayers make reimbursements to their related concern for the payment made by them to a third party on the taxpayer's behalf.

On this issue, the Mumbai Tribunal decision (in the case of C. U. Inspections[6]) has held that payment to a third party, routed through a related concern, would not be considered as a reimbursement. It held that if the contention of the assessee is accepted, then the relevant provisions of the Act can be circumvented by simply following the modus-operandi to make the payment to the third party, not directly, but through an intermediary to make it appear as a reimbursement of the cost to the intermediary.

This ruling pronounced by the Mumbai Tribunal provides more clarity on reimbursement payments carried on within group companies. Indian entities effecting remittances to foreign related concerns should clearly analyse the nature of the remittance in the context of the ultimate beneficiaries/service providers before remitting it as a reimbursement. Needless to say, the importance of documentation cannot be undermined in strengthening the case for not withholding tax on reimbursements.

Another related issue with respect to reimbursement is the reimbursement of salaries of foreign employees deputed in an Indian company. Whether such reimbursement would attract withholding tax as 'fees for technical services' or the same can be construed as pure reimbursement not requiring any withholding is a contentious issue which involves substantial litigation.

[3] ADIT vs Siemens Aktiengesellschaft [2013] 33 taxmann.com 480 (Mumbai - Tribunal)

[4] Verizon Communications Singapore Pte Ltd [2014] 361 ITR 575/224 Taxman 237 (Mag)(Mad)

[5] DIT v. New Skies Satellite BV [IT Appeal No. 473 and 474 of 2012]

[6] C. U. Inspections (I) Pvt Ltd vs DCIT [2013] 142 ITD 761

Notice pay recovery

It is a settled principle that tax can be levied only on 'real income' and not on any 'hypothetical income'. This principle has been supported in some of the landmark Supreme Court decisions[7].

One such place where this principle would hold applicability is the taxability of notice pay recovery. Notice pay recovery is the amount that is withheld or recovered by the employer from the amount paid to the employee for not serving the notice period.

The issue is whether the said recovery is taxable in the hands of the employee or would it be allowed as a deduction in the hands of the employee while computing his taxable income. A pertinent point here is that the deduction provision under the Income Tax Act (Section 16) does not provide for this deduction.

In the case of notice pay recovery, the employee is under a contractual obligation to serve the notice period. Only when the notice period is served it can be said that the employee has earned the salary for that period. Till then, the notice pay cannot be treated as income in the employee's hands.

The Ahmedabad Bench of the Income Tax Appellate Tribunal (Tribunal), in the case of Nandinho Rebello[8], has examined this issue. Taking cognisance of the 'real income' theory, though not expressly, the Tribunal held that there is no need to refer to Section 16 of the Act. The employee received the salary after deducting the notice pay recovery. Accordingly, only the actual salary received by the employee is taxable. Thus, in essence, the Tribunal upheld the 'real income' theory.

[7] CIT vs Shoorji Vallabhdas & Co. [1962] 46 ITR 144 (SC); Godhra Electricity Co. Ltd vs CIT [1997] 225 ITR 746 (SC)

[8] Nandinho Rebello vs DCIT, [2017] 80 taxmann.com 297 (Ahmedabad - Tribunal)

Credit for withholding tax

Form 26AS is the summary statement of the gross income and the corresponding tax withheld by various parties on the taxpayer's account in a particular year.

However, as per Section 199 of the Act read with Rule 37BA of the Income Tax Rules, credit for withholding tax should be claimed in the year in which income is offered to tax.

It is possible that the other party has accrued the expense and withheld the tax in either the prior or the subsequent year and, as such, the income shown in Form 26AS may not be offered in the same year. To that extent, there could be inter-year differences in income and withholding tax credit claim.

At the time of assessment, the tax officer verifies whether the income reflected in Form 26AS is offered to tax in the same year. In the case of a mismatch, a general tendency of the tax department is to add the notional income to the taxable income of the taxpayer. Furthermore, due to mismatches in withholding tax credits, even the said credit may not be granted. The onus is on the taxpayer to reconcile the differences which may (sometimes due to factors such as high volume, error by the other party in withholding tax statement, etc.), become a very tedious task. For the irreconcilable items, there is a possibility that not only the credit may be denied, but also the gross amount would be added to the taxable income resulting in a dual hit.

These are only a few examples of the controversies in some of the payments. The government has recently constituted a committee to draft a new tax code. Hopefully all the issues above will be addressed in the new code to ease doing business in India.