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TAX FLASH NEWS

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Withholding tax certificate directing Indian entities to deduct tax at a higher rate without giving valid reasons is unsustainable in law

Recently, the Delhi High Court in the case of Bently Nevada LLC[1] (the taxpayer) held that withholding certificate which directs Indian entities to deduct tax at a higher rate on the payments made to the taxpayer is unsustainable in law since it was not based on valid reasons and was contrary to the legal requirement provided in Section 197(1) of the Income-tax Act, 1961 (the Act) read with Rule 28AA of the Income-tax Rules, 1962 (the Rules).

Facts of the case

The taxpayer, a U.S. based company, is a subsidiary of another U.S. based company. It is engaged in the business of supply of goods from outside India. During the financial year (FY) 2019-20, the taxpayer electronically filed an application seeking nil withholding tax certificate under Section 197 of the Act. Alternatively, the taxpayer sought a lower withholding of tax in respect of remittances to be received from customers. The tax department replied on TRACES[2] portal requesting the taxpayer to furnish the audited copy of its India specific account and projected accounts of the company for the current year.

The taxpayer contended that it did not have any office/Permanent Establishment (PE) in India. Therefore, it was not required to maintain books of accounts in India. As per the prevailing laws in the USA, financial statements of a group entity were required to be consolidated with the financial statements of its respective holding company. The question of getting the financial statements audited would arise only in respect of the consolidated national statements prepared by the holding company.

The taxpayer contended that earlier, in AY 2002-03, the tax department computed profits of the taxpayer by adopting 'deemed profitability' at 10 per cent of the revenues/sales as per Rule 10 of the Rules. Reference was made to the earlier Tribunal ruling wherein it was held that the approach of the AO in estimating income at 10 per cent in the sales made in India in respect of the taxpayer was in order and does not require any interference. Subsequently, the Delhi High Court concurred with the said view of the Tribunal. The taxpayer contended that it had been regularly obtaining lower withholding certificates under Section 197 of the Act from the tax department whereby the taxpayer was permitted to receive remittances from its customers after deduction of tax at lower rate of the sum remitted.

However, the Assessing Officer (AO) rejected the contention of the taxpayer and issued the certificate authorising deduction of tax from the payments made to the taxpayer by different entities which purchased its goods at higher rate (i.e. 5 per cent).

The taxpayer challenged this withholding certificate by filing a writ petition before the Delhi High Court.

High court decision

The AO who is supposed to exercise a quasi-judicial function acted under the dictation of his superior who simply asked him to increase the Tax Deduction at Source (TDS) percentage from 1.5 per cent to 5 per cent without any reason whatsoever. No reasons were given as to why the TDS rate should not be NIL as requested for by the taxpayer and instead why it should be increased from 1.5 per cent to 5 per cent. Thus, the direction given by the Commissioner of Income Tax (CIT) for issuing TDS certificate at 5 per cent was only for two ostensible reasons, the first being that the PE had been held to be there in India. This cannot be per se the reason for increasing the TDS from 1.5 per cent to 5 per cent. The second reason was that 'accounts have not been given'.

[1] Bently Nevada LLC v. ITO (W.P.(C) 7744/2019, 29 July 2019) – Taxsutra.com
[2] TDS reconciliation and correction enabling system

The High Court observed that there was both arbitrariness and non-application of mind at various levels which vitiates the withholding certificate. No reasons have been indicated as to why the CIT felt that the TDS rate should be 5 per cent instead of 1 per cent. The AO mechanically followed the advice and prepared a fresh note simply stating that 'considering the facts and circumstances of the case' the TDS certificate should be at 5 per cent. The settled legal position in administrative law is that orders passed by a statutory authority under 'dictation' of a superior officer or anyone else is bad in law. The High Court relied on the decision of Anirudhsinhji Karsansinhji Jadeja[3] wherein it was observed that if a statutory authority has been vested with jurisdiction, he has to exercise it according to its own discretion. If the discretion was exercised under the direction or in compliance with some higher authority's instruction, then it will be a case of failure to exercise discretion altogether.

Rule 28AA of the Rules prescribes the procedure to be followed by the AO who is approached with an application under Section 197(1) of the Act. How the AO is to estimate the 'existing and estimated liability' is indicated in Rule 28AA(2) of the Rules. The file produced before the Court by the tax department indicates that the above factors were not kept in view and no reference was made to Rule 28AA of the Rules. The withholding certificate simply states that the rate of TDS should be 5 per cent, which obviously does not satisfy the requirements of the law. Even if one were to accept the explanation offered by the tax department that on the online portal only a certificate was posted and not the reasons for the decision, then there should be a separate written order communicated to the taxpayer giving the reasons for fixing the TDS rate under Section 197(1) of the Act since this was mandated by law. The decision which was quasi-judicial in nature, has to be taken by the AO under Section 197(1) of the Act on objective criteria and be based on relevant material provided by the taxpayer and available with the tax department. It must be supported by reasons available on the file which conform to the requirement of Section 197 of the Act read with Rule 28 AA of the Rules. Those reasons must be communicated to the taxpayer. It cannot be taken, as in the instant case, on the dictation of an officer superior to the AO. The High Court relied on the decision of Tata Teleservices (Maharashtra) Ltd[4] and observed that there have to be proper reasons for the order under Section 197 of the Act.

Accordingly, the High Court held that the withholding certificate which directs TDS to be deducted at 5 per cent on the payments made by the Indian entities to the taxpayer was unsustainable in law since it was not based on valid reasons and was contrary to the legal requirement provided in Section 197(1) of the Act read with Rule 28AA of the Rules. The impugned certificate is hereby quashed.

Our comments

The taxpayer may apply for nil/lower rate of withholding tax certificate under section 197 of the Act. The Bombay High Court in the case of Tata Teleservices (Maharashtra) Ltd held that the AO, if satisfied, with the application made, bearing in mind the provisions of the Act and the Rules, is obliged to grant the certificate. Similarly, in the case of McKinsey and Company Inc.[5], the Bombay High Court emphasised that the AO has to be provide proper reasons while passing an order under Section 197 of the Act.

As per the Rule 28AA of the Rules, the AO needs to consider the existing and estimated liability. However, in the instant case the AO determined the higher rate based on its superior order and had not given any reason for a higher rate of withholding of tax. The Delhi High Court held that withholding certificate which directs Indian entities to deduct tax at a higher rate was unsustainable in law since it was not based on valid reasons and was contrary to the legal requirement provided in Section 197(1) of the Act read with Rule 28AA of the Rules.

[3] Anirudhsinhji Karsansinhji Jadeja v. State of Gujarat [AIR 1995 SC 2390]
[4] Tata Teleservices (Maharashtra) Ltd v. DCIT [2018] 253 Taxman 343 (Bom)

[5] McKinsey and Company Inc. v. UOI [2010] 324 ITR 367 (Bom)

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