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TAX FLASH NEWS

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No withholding of tax on salaries paid by an employer in India to its non-resident employees working outside India. Foreign tax credit may be availed at withholding stage for resident employee

Background

The Income-tax Act, 1961 (the Act)[1] provides for taxation of income including salary, based on the residential status of the individual, when such income is due, received or accrued.

In this context, the Authority for Advance Rulings (AAR) has recently in the case of Texas Instruments (India) Pvt. Ltd.[2] (the taxpayer) held the following:

- Salary received in India by an employee qualifying as non-resident (NR), in respect of employment rendered outside India, accrues outside India. Consequently, the same would not be taxable in India and the Indian employer would not be obliged to withhold tax at source in India; and
- Foreign Tax Credit (FTC) may be considered at the withholding stage by the Indian employer while determining withholding tax on salary income for employees qualifying as Resident and Ordinary Resident (ROR) in India.

Facts of the case

- The employer, an Indian entity, had sent an employee on an assignment to the United States of America (USA) for two years, during which the payroll was with the group entity in the USA (USA entity).
- During the tenure of the USA assignment, the employee had received a part of the salary in India. However, all services were rendered in the USA and no services were rendered in India.
- The employee had qualified as an NR in India for the tax year (TY) 2011-12, ROR in India for the TY 2012-13, and resident in the USA for the years 2010, 2011 and 2012.
- The employee would file returns in the USA as a resident for the years 2010, 2011 and 2012, and would be taxable in the USA on the entire salary paid in the USA and in India, as the related services were rendered in the USA.
- The Indian employer, had posed the following questions seeking a ruling from the AAR:
  - Question 1: Whether the Indian employer is obliged to withhold taxes on the salary paid in India to the employee in TY 2011-12, when the employee qualified as an NR in India; and
  - Question 2: Whether the Indian employer can consider a claim of FTC at withholding stage in respect of the taxes paid in the USA by the employee in TY 2012-13, when he/she qualified as a ROR in India.

Indian employer's contention

Question 1:

- The employee's residential status in India was NR for TY 2011-12.
- The scope of total income[3] taxable in India of a NR comprises income received in India, including salary received by the employee in India. However, this is subject to the other provisions contained in the Act.

[1] Section 5,6 and 9 of the Act
[2] Texas Instruments (India) Pvt. Ltd (AAR No 1299 of 2012) – Taxsutra.com
[3] Section 5(2) of the Act

- Total income needs to be computed in the manner laid down in the Act[4], after providing for reliefs such as treaty reliefs.
- This would mean that the taxability of salary income would need to be determined first and the benefit of treaty override is available in order to compute the taxable total income.
- Salary for employment exercised in the USA would not accrue in India, as services are not rendered in India. This is substantiated based on the provisions of law[5], related judicial precedents[6] and commentary on OECD Model Convention[7]. Further, the employee is entitled[8] to adopt either the provisions of the Act or the Double Taxation Avoidance Agreement between India and the USA (the Treaty), whichever is more beneficial to him. As per the Treaty[9], the salary received by a resident of the USA in respect of employment shall be taxable only in the USA as the employment is not exercised in India.
- Having regard to the above, the salary though paid in India would not accrue in India and therefore, would not be taxable in India.
- An employer is required to withhold taxes[10] only when salary is chargeable to tax in India. In the instant case, since the salary paid in India is not taxable in India, there is no obligation cast on the employer to withhold taxes at source on such salary.
- Furthermore, taxes are required to be withheld at source considering the average rate of tax[11], which is determined by dividing income-tax on total income by the total income. In the instant case, as the total income with respect to salary paid in India would not be chargeable to tax in India, the average rate of tax works out to be Nil.
- Reliance was also placed on certain judicial precedents[12], wherein it was held that withholding tax provisions would not apply in a case where income itself was not chargeable to tax in India, under the head 'Salaries', provided certain conditions[13] were satisfied.
- Interpretation on corollary lines was also drawn citing judicial precedents[14] which had held the salary received outside India would be subject to tax in India, where employment was rendered in India.

Question 2:

- The employee who would qualify as a ROR in India for the TY 2012-13, is entitled to claim FTC[15] on the taxes paid in the USA.
- Any employee working under more than one employer during any TY, can furnish the details of salary and taxes deducted at source to one of the employers, and such employer is obliged to consider the same while arriving at the total taxes to be withheld[16].
- Considering that withholding tax provisions apply only to the extent of actual tax liability, the provisions of treaty override relief need to be made available to the employee, at the withholding tax stage without having to wait to seek this relief only at the time of filing his/her return of income.
- In view of the above, placing reliance on judicial precedents[17], the Indian employer would need to consider FTC in respect of taxes paid in the USA while arriving at the taxes to be withheld at source in India.

Tax department's contention

Question 1:

- Any salary received in India is liable to tax in India[18] and hence needs to be subject to withholding tax.
- Salary due from an employer in India is chargeable to tax in India and therefore, triggers withholding tax obligations in India.
- Where there is an Indian employment contract, this evidences employer-employee relationship in India. Therefore, employment is exercised in India and physical presence or place where services are actually rendered is not relevant.

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[4] Section 2(45) of the Act
[5] Section 15 read with explanation to Section 9(1)(ii) of the Act
[6] DIT v. Sri Prahlad Vijendra Rao (ITA No 838/ 2009), CIT v. Avtar Singh Wadhwan [2001] 247 ITR 260 (Bom)
[7] Para I of Klaus Vogel commentary on Article 15 of the OECD Model Convention
[8] Under Section 90 of the Act
[9] Article 16 of the Treaty
[10] Section 192 of the Act
[11] Section 192 read with section 2(10) of the Act
[12] British Gas India Private Limited (AAR/725/2006), Coromandal Fertilizers Ltd [1991] 187 ITR 673 (AP)
[13] Under Section 192(2) of the Act
[14] CIT v. Eli Lilly [2009] 297 ITR 300 (Del)
[15] Article 25 of the Treaty
[16] Section 192(2) of the Act.
[17] British Gas India Private Limited (AAR/725/2006), Coromandal Fertilizers Ltd [1991] 187 ITR 673 (AP)
[18] Section 5(2) of the Act

Question 2:

- Claim of FTC involves interpretation of the articles of the Treaty and, several conditions like actual payment of taxes in the USA, attribution of tax to income, etc., need to be satisfied for allowing FTC.
- Such expertise would be only available with the Revenue and an employer would not have either the opportunity or the expertise to carry out such exercise at the time of withholding tax at source.
- There is an additional requirement for obtaining a Tax Residency Certificate (TRC) in order to avail Treaty benefits, from TY 2012-13 onwards.
- Further, Section 192 of the Act does not provide for allowing FTC at the withholding stage.
- In view of the above, the Indian employer cannot give benefit of FTC at the time of withholding tax at source.

AAR's observation and ruling

Question 1:

- Under the Act, income tax shall be charged[19] in accordance with and subject to provisions of the Act, on the total income of a taxpayer. The total income chargeable to tax for a NR[20] is subject to other provisions of the Act.
- In view of the above, chargeability of salary to tax[21] as well as treaty override provisions[22] would need to be given effect to in the computation of total income.
- The judicial precedents as cited by the Indian employer as well as other precedents[23] have held that the actual place of rendering services is the key test in determining place of accrual of salary to a NR and that salary received in respect of services rendered outside India has to be considered as being earned outside India.
- It was immaterial as to whether the employer was an Indian entity or not. The only material point for consideration is the place where the services were rendered. This is also borne out by the Commentary on the OECD Model Convention as cited by the Indian employer which draws reference to the personal presence for exercise of employment and the related provisions of the Act[24].
- In view of the above reasoning, as the employment was exercised in the USA, it could be said that the related salary income did not accrue in India.
- The AAR also relied on its own decision[25], as well as the other decisions cited by the Indian employer, wherein it was held that unless there is a liability on the employee to pay tax on income from salaries, there would not be any obligation for the employer to withhold tax at source thereon.
- Given the above, the AAR held that the Indian employer is not required to withhold taxes on the portion of salary paid in India to its NR employee.

Question 2:

- There is no doubt that the employee is entitled to benefit of claim of FTC[26] under the Treaty.
- Under the Act[27], in respect of payments received by an employee from more than one employer, the employee could furnish details of salary paid and tax deducted to one of the employers, who would then need to take consideration of such details, at the time of computation of withholding tax.
- The AAR agreed with the judicial precedents cited by the Indian employer and held that FTC can be considered by the Indian employer at the withholding stage.
- The AAR acknowledged that the machinery provisions of the Act do not provide for claim of FTC at withholding stage. However, in the absence of any other provision to provide such a benefit, the Indian employer could consider the same while computing withholding tax.
- In view of the above, while the Indian employer can provide for FTC benefit at the time of computing withholding tax, there is equally an obligation cast on him to exercise due diligence in satisfying about the details of period of residence, TRC, details of income earned and taxes deducted, the period of income, etc., before doing so.

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[19] Section 4 of the Act
[20] Section 5(2) of the Act
[21] Section 15 read with explanation to section 9(1)(ii)
[22] Section 90 of the Act read with Article 16 of the Treaty
[23] Utanka Roy v. DIT (International Taxation), (2016) 390 ITR 109 (Cal)
[24] Explanation to section 9(1)(ii)

[25] British Gas India Private Limited, (AAR 725/2006)
[26] Article 25 of the Treaty
[27] Section 192(2) of the Act

- Where the Revenue believes there is a failure of the Indian employer in carrying out such due diligence, appropriate action under the Act may be taken by them.

Our comments

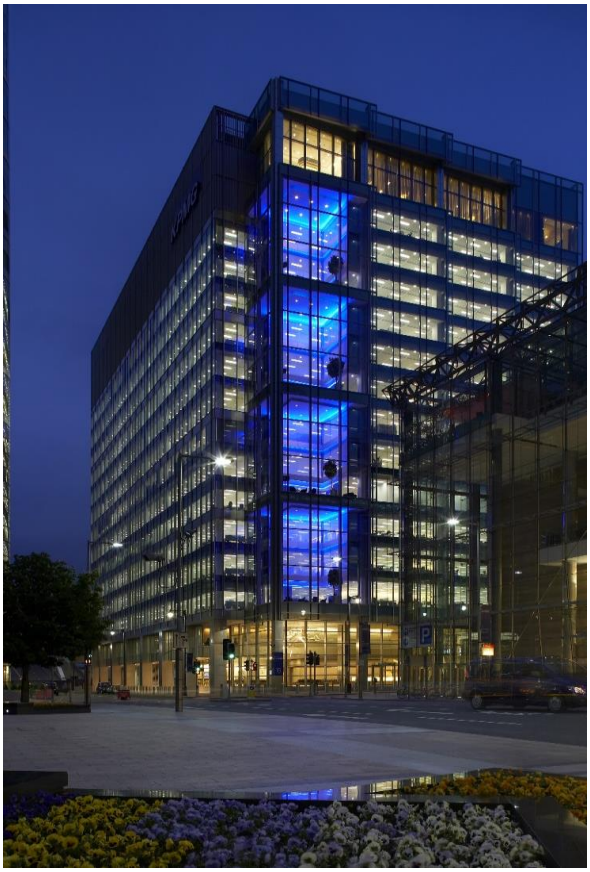
Any ruling of the AAR is binding only upon the applicant and the Revenue in respect of that applicant.

It may be imperative to take into consideration the amendments introduced vide the Finance Act 2012 and Finance Act 2013 and related notifications, such as obtaining a Tax Residency Certificate (TRC), mandatory filing of return of income to claim treaty benefits. Therefore, the Revenue would seek such information and documents where the employer/employee propose taking benefits under the tax treaties.

It is interesting to note that while the AAR has acknowledged that the machinery provisions are not conducive for considering FTC at the withholding stage, it has held that a claim of FTC could be provided at the time of withholding. There could be a practical challenge for employers in quantification of the taxes paid overseas due to difference in tax years. There could also be challenges to ascertain the actual taxes paid overseas considering taxes withheld may be refunded at a later point in time or may be subject to litigation. Also, the current forms and rules do not provide for guidance on disclosing such claim while filing the withholding tax return in India or issuing a withholding tax certificate in India. Lastly, the current regulations also provide for filing Form 67 prior to or along with a return with a claim of FTC. Such compliance provisions also need to be taken cognizance of.

Further, as the AAR has opined that the Revenue could initiate appropriate action, where it believes that the employer's due diligence in quantifying the claim of treaty benefits is not sufficient, litigation in this respect cannot be ruled out.

In view of the above, applicability of the said decision requires evaluation of the facts on a case to case basis.



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