Impact of section 206AA on the rates of TDS, particularly in respect of payments to non-residents

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By S.K. Tyagi

Section 206AA was inserted in the Income-Tax Act, 1961 (the Act), by the Finance (No.2) Act, 2009, with effect from 1.4.2010. As per section 206AA, any person whose receipts are subject to deduction at source (TDS), i.e. the deductee, shall furnish his permanent account number (PAN) to the person responsible for deducting such tax (the deductor). If the deductee fails to furnish PAN, tax shall be deducted at higher of the following rates :

(i) the rate specified in the relevant provisions of the Act, or
(ii) the rate or rates in force, i.e. the rates mentioned in the Finance Act; or
(iii) the rate of twenty per cent (20%)

Hitherto, provisions of section 206AA were also applicable to non-residents, except in respect of payment of interest on long-term bonds, as referred to in section 194LC.

The aforesaid requirement under section 206AA was creating lot of problems and inconvenience in respect of payments to non-residents.

In order to reduce compliance burden, particularly in respect of payments to certain non-residents, sub-section (7) of section 206AA was substituted by the Finance Act, 2016, with effect from 1.6.2016, so as to provide that the provisions of section 206AA shall also not apply to a non-resident, not being a company or a foreign company, in respect of payments, other than interest on bonds, subject to such conditions as may be prescribed.

In view of the aforesaid reasons, different parameters are now applicable, as regards the requirement of furnishing PAN by the residents and the non-residents, to the person responsible for deducting tax at source. The relevant provisions of section 206AA applicable to residents and non-residents are discussed separately as follows :

I. Provisions of section 206AA are not applicable, in respect of certain payments to non-residents, after substitution of sub-section (7) of section 206AA.

As already stated, sub-section (7) of section 206AA has been substituted by the Finance Act, 2016, with effect from 1.6.2016. The newly substituted sub-section (7) of section 206AA, is reproduced as follows :

"*(7) The provisions of this section shall not apply to a non-resident, not being a company, or to a foreign company, in respect of—*

*(*i*) payment of interest on long-term bonds as referred to in section 194LC; and*

*(*ii*) any other payment subject to such conditions as may be prescribed."*

From the aforesaid provisions of newly substituted section 206AA(7), it may be seen that the provision of section 206AA shall not apply to non-residents, in respect of any other payment subject to such conditions, as may be prescribed. In other words, provisions of section 206AA shall also not apply to a non-resident who does not have PAN, subject to the conditions prescribed in respect thereof.

In this context, clause 176 of the Finance Minister's Budget Speech for 2016-17, is relevant and the same is reproduced as follows :

"***176.*** *Non-residents without PAN are currently subjected to a higher rate of TDS. It is proposed to amend the relevant provision to provide that on furnishing of alternative documents, the higher rate will not apply*."

Besides, in the memorandum explaining the provisions in the Finance Bill, 2016, under the heading "*Exemption from requirement of furnishing PAN under section 206AA to certain non-residents*", it is stated "*In order to reduce compliance burden, it is proposed to amend the said section 206AA, so as to provide that the provisions of this section shall also not apply to a non-resident, not being a company or to a foreign company, in respect of any payment, other than interest on bonds, subject to such conditions, as may be prescribed*".

Keeping in view the aforesaid aspects, the relevant issues in this regard are discussed as follows :

1. ***Alternative documents to be furnished in place of PAN by non-residents.***

   As already stated, as per section 206AA(7)(ii), provisions of section 206AA shall not apply to a non-resident, in respect of any other payment, subject to such conditions as may be prescribed.

   The aforesaid conditions have now been prescribed in a new rule 37BC of the Income-Tax Rules, 1962 (the Rules). The aforesaid rule 37BC has been inserted in the Rules, vide Notification No.S.O.2196 (E), dt.24.6.2016 [385 ITR (St) 26], with effect from 24.6.2016. For our purpose, sub-rules (1) and (2) of the aforesaid rule 37BC are relevant. For the sake of ready reference, the aforesaid sub-rules (1) and (2) are reproduced as follows :

"37BC. Relaxation from deduction of tax at higher rate under section 206AA.

(1) In the case of a non-resident, not being a company, or a foreign company (hereafter referred to as 'deductee') and not having permanent account number the provisions of section 206AA shall not apply in respect of payments in the nature of interest, royalty, fees for technical services and payments on transfer of any capital asset, if the deductee furnishes the details and the documents specified in sub-rule (2) to the deductor.

(2) The deductee referred to in sub-rule (1), shall in respect of payments specified therein, furnish the following details and documents to the deductor, namely:—

(i) name, e-mail id, contact number;

(ii) address in the country or specified territory outside India of which the deductee is a resident;

(iii) a certificate of his being resident in any country or specified territory outside India from the Government of that country or specified territory if the law of that country or specified territory provides for issuance of such certificate;

(iv) Tax Identification Number of the deductee in the country or specified territory of his residence and in case no such number is available, then a unique number on the basis of which the deductee is identified by the Government of that country or the specified territory of which he claims to be a resident"

From the aforesaid sub-rule (1), it may be seen that in case of a non-resident, not having a permanent account number (PAN), the provisions of section 206AA shall not apply, in respect of payments in the nature of interest, royalty, fees for technical services and payment on transfer of any capital asset, if the deductee furnishes the details and the documents specified in sub-rule (2) to the deductor.

As per the aforesaid sub-rule (2), the deductee referred to in sub-rule (1), shall in respect of payments specified therein, furnish the details and documents to the deductor listed in clauses (i), (ii), (iii) and (iv) thereof.

The requirements prescribed in the aforesaid clauses (i), (ii), (iii) and (iv) of sub-rule (2) are self-explanatory and it should not be difficult for a non-resident receiving any payment from a resident in India, to furnish the details and documents as listed in the aforesaid clauses (i), (ii), (iii) and (iv) .

2. ***Otherwise also, applicability of rate of TDS at 20% to non-residents, was not upheld by the ITAT.***

There was a controversy whether section 206AA applies to non-residents or not, in terms of the provisions of Double Taxation Avoidance Agreement (DTAA). The provisions of section 90(2) of the Act, prescribes that provisions of the Act are applicable to the extent that they are more beneficial to the assessee and since section 206AA prescribes higher rate of withholding tax, it would not be beneficial to the assessee and therefore, the rates prescribed in DTAA would prevail.

Earlier the CBDT had clarified vide Press Release, dt.20.1.2010, that section 206AA would also apply to all non-residents in respect of payments / remittances liable to TDS.

However, thereafter, the Tribunal in the following cases held that in case of non-resident, even in the absence of PAN, TDS would be deducted as per the rates prescribed in the DTAA :

(i) Dy.DIT (IT) Vs Serum Institute of India Ltd [2015] 118 DTR (Trib) 157 (Pune)

(ii) Dy.CIT (IT) Vs Infosys BPO Ltd [2015] 126 DTR (Trib) 30 (Bang)

In this regard, it is relevant to state that the provisions of the DTAA override the provisions of the Income-Tax Act, 1961.

In the present context, the provisions of section 90(2) of the Act are very relevant. When the requisite Notification has been issued under section 90, the provisions of section 90(2) spring into operation and an assessee who is covered by the provisions of Double Taxation Avoidance Agreement (DTAA), is entitled to seek the benefits there under, even if the provisions of DTAA are inconsistent with those of the Act. In other words, the provisions of the DTAA will override the provisions of the I.T.Act, 1961.

In this connection, a reference may also be made to Circular No.333, dated 2.4.1982 [137 ITR (St.) 1], issued by the Central Board of Direct Taxes (CBDT). For the sake of ready reference, the same is reproduced as follows :

"Circular No.333, dated April 2, 1982.

Subject : Conflict between the provisions of the Income-Tax Act, 1961, and the provisions of the Double Taxation Avoidance Agreement – Clarification.

It has come to the notice of the Board that sometimes effect to the provisions of double taxation avoidance agreement is not given by the assessing officers when they find that the provisions of the agreement are not in conformity with the provisions of the Income-Tax Act, 1961.

2. *The correct legal position is that where a specific provision is made in the double taxation avoidance agreement, that provision will prevail over the general provisions contained in the Income-Tax Act, 1961. In fact the Double Taxation Avoidance Agreements which have been entered into by the Central Government under section 90 of the Income-Tax Act, 1961, also provide that the laws in force in either country will continue to govern the assessment and taxation of income in the respective country except where provisions to the contrary have been made in the Agreement.*

3. *Thus, where a Double Taxation Avoidance Agreement provides for a particular mode of computation of income, the same should be followed, irrespective of the provisions in the Income-Tax Act. Where there is no specific provision in the agreement, it is the basic law, i.e. the Income-Tax Act, that will govern the taxation of income.*

(Sd.) K.R.Gupta,

Director, Central Board of Direct Taxes

[F.No.506 / 42 / 81-FTD]"

From the aforesaid Circular of the CBDT, it is clearly established that in case there is a beneficial provision under the DTAA, the same would prevail over the provisions of the respective statutes.

The aforesaid legal proposition is also supported by the judgement of the Apex Court, in the case of *Union of India Vs. Azadi Bachao Andolan [2003] 263 ITR 706 (SC).*

The aforesaid judgements of the Tribunal are mainly based on the premise that the provisions of the DTAA, will override the provisions of the Act. The aforesaid judgements of the Tribunal may briefly be discussed as follows :

(a) *Dy.CIT (IT) Vs Serum Institute of India Ltd [2015] 118 DTR (Trib) 157 (Pune)*

It was held in this case that section 206AA does not override the provisions of section 90(2) and therefore, where tax has been deducted from the payments made to non-residents on the strength of the beneficial provisions of the DTAA, the provisions of section 206AA cannot be invoked to insist on tax deduction at the rate of 20 per cent, notwithstanding the fact that PANs were not furnished by the non-residents.

(b) Dy.CIT (IT) Vs Infosys BPO Ltd [2015] 126 DTR (Trib) 30 (Bang)

It was held in this case that there is no scope for deduction of tax at the rate of 20 per cent, as provided under the provisions of section 206AA, when the benefit of DTAA is available to the non-resident recipient of the payment, in question.

From the aforesaid judgements of the Tribunal, it is clearly established that rates of TDS, in respect of payments to non-residents will prevail over the rate of TDS at 20%, as laid down under section 206AA of the Act. Therefore, even without the substitution of sub-section (7) of section 206AA, the provisions of section 206AA were not applicable in respect of rate of TDS, regarding payments to non-residents.

II. In certain cases, the provisions of section 206AA are not applicable, even in respect of payments to residents.

In this connection, the relevant aspects / scenario are discussed as follows :

1. Charging section for TDS – Section 4(2)

In the present context, it will be necessary to examine the very basis authorizing TDS, in respect of certain payments. In this regard, it will be relevant to refer to the charging section for TDS, viz. section 4(2) of the Act. In this context, it will be necessary to examine the provisions of section 4 of the Act. For the sake of ready reference, section 4 of the Act, is reproduced as follows :

"4. Charge of income-tax.

(1) Where any Central Act enacts that income-tax shall be charged for any assessment year at any rate or rates, income-tax at that rate or those rates shall be charged for that year in accordance with, and subject to the provisions (including provisions for the levy of additional income-tax) of, this Act in respect of the total income of the previous year of every person :

***Provided** that where by virtue of any provision of this Act income-tax is to be charged in respect of the income of a period other than the previous year, income-tax shall be charged accordingly.*

(2) In respect of income chargeable under sub-section (1), income-tax shall be deducted at the source or paid in advance, where it is so deductible or payable under any provision of this Act."

From the aforesaid provisions of section 4(1), it may be seen that income-tax shall be charged on the total income of the previous year of every person, at the rates provided in the Finance

Act. Thus, total income is the tax base. Therefore, if the total income is below taxable limit, then no income-tax will be chargeable.

As per section 4(2) in respect of income chargeable under section 4(1), income-tax shall be deducted at source or paid in advance, where it is so deductible or payable under any provisions of the Act. **It will, therefore, clearly imply that no tax will be deductible at source in a case where the total income of the recipient is below taxable limit.**

2. ***Whether PAN is necessary in respect of all the employees for TDS, under section 192 of the Act.***

We may now examine the impact of section 206AA of the Act on TDS, under section 192 of the Act, in respect of income under the head "*Salaries"*. It may be stated in this regard that the provisions of section 192 in relation to TDS, are quite unique and different from the provisions under other sections falling within Chapter XVII-B of the Act. The reason for the same is that TDS under section 192 is deductible on the estimated income of the assessee, under the head "*Salaries*" for the relevant previous year / financial year.

If we now look at the provisions of section 206AA, it would clearly imply that the provisions of section 206AA will not apply if the income under the head "*Salaries*", for the relevant financial year is below taxable limit.

In order to make the position absolutely clear in this regard, it would be appropriate to refer to Circular No.8 of 2010, dt.13.12.2010, issued by the Central Board of Direct Taxes [Reported in 330 ITR (St) 22]. The aforesaid Circular relates to income-tax deduction from salaries, during the financial year 2010-11, under section 192 of the Act.

In this connection, we may refer to paragraph 4.8 of the aforesaid Circular which specifically deals with section 206AA. For the sake of ready reference, the aforesaid paragraph 4.8 is reproduced as follows :

4.8 Section 206AA

4.8.1. Finance (No.2) Act, 2009, w.e.f. 1.04.2010 has inserted section 206AA in the Income-tax Act which makes furnishing of PAN by the employee compulsory in case of payments liable to TDS. If employee (deductee) fails to furnish his / her PAN to the deductor, the deductor shall make TDS at a higher of the following rates :

i. at the rate specified in the relevant provision of this Act; or

ii. at the rate or rates in force; or

iii. at the rate of twenty per cent.

4.8.2. The deductor has to determine the tax amount in all the three conditions and apply the higher rate of TDS. ***This section applies to any person entitled to receive any sum or income or amount, on which tax is deductible under Chapter XVII-B of the Income-tax Act****. As Chapter XVII-B covers all payments including salaries, salaries are also covered by section 206AA. In case of salaries there can be following situations :*

(a) Where the income of the employee computed for TDS under section 192 is below taxable limit.

(b) Where the income of the employee computed for TDS under section 192 is above taxable limit.

In first situation, as the tax is not liable to be deducted, no tax will be deducted*. In the second case, if PAN is not furnished by the employee, the deductor will calculate the average rate of income-tax, based on rates in force as provided in section 192. If the tax so calculated is below 20 per cent., deduction of tax will be made at the rate of 20 per cent. and in case the average rate exceeds 20 per cent., tax is to be deducted at the average rate. Education cess at 2 per cent, and Secondary and Higher Education Cess at 1 per cent. is not to be deducted, in case the TDS is deducted at 20 per cent. under section 206AA of the Income-tax Act."* (Emphasis added)

From the aforesaid para 4.8.2, it may be seen that in case of salaries there can be the following two situations :

(a) Where the income of the employee computed for TDS under section 192 is below taxable limit.

(b) Where the income of the employee computed for TDS under section 192 is above taxable limit.

It has been specifically stated in the aforesaid situation (a) that as the tax is not liable to be deducted, no tax will be deducted. In other words, where the income of the employee computed for TDS under section 192 is below taxable limit, no tax will be required to be deducted at source, even if the employee does not furnish his PAN to the employer.

3. Section 206AA of the Act is read down from the Statute by the Karnataka High Court and is made inapplicable to persons whose income is less than the taxable limit.

The provisions of section 206AA, r.w.s.139A have caused unnecessary harassment and inconvenience to certain persons whose income is below taxable income.

In this context, the following provisions of the Act and Rules may be looked into :

(i) As per section 206AA(2), no declaration under sub-section (1) or sub-section (1A) or sub-section (1C) of section 197A, shall be valid unless the person furnishes his PAN in such a declaration.

(ii) As per section 206AA(3), in case any declaration becomes invalid under sub-section (2) of sections 206AA, the deductor shall deduct tax at source, in accordance with the provisions of sub-section (1) of section 206AA.

(iii) As per sub-section (4) of section 206AA, no certificate under section 197 shall be granted, unless the application made in that section contains the PAN of the applicant.

(iv) As per rule 114B, every person shall quote his PAN in all documents pertaining to the transactions specified in the Table under rule 114B. The aforesaid Table contains as many as eighteen (18) such transactions.

In all the aforesaid transactions, no exception has been provided, in respect of those persons whose income is below taxable limit.

In view of the aforesaid reasons, the small investors and other persons having low incomes face unnecessary and uncalled for difficulties. For such persons, the judgement of the Karnataka High Court, in the case of *Smt.A.Kowsalya Bai Vs. Union of India [2012] 346 ITR 156 (Karn) : 74 DTR 193 (Karn),* has brought immense relief.

In this case, petitioners were small investors. For depositing their savings out of their income, they approached concerned investment agencies, being Respondent Nos.3 and 4, for earning better interest / returns. They did not have any source of income other than their investment. Besides, their total income was below taxable limit. The petitioners even filed Form No.15G, as required under section 197A of the Act, to enable the third and fourth Respondents not to deduct tax at source, as per section 193 of the Act, relating to TDS in respect of interest on securities.

According to petitioners, the third and fourth Respondents informed them that even Form No.15G filed by them could not be accepted for the purpose of exemption from TDS, unless their PAN is communicated, pursuant to the provisions of section 206AA. The grievance of the petitioner was that the persons like them (individual investors) were not assessees and not assessed to income-tax.

The Hon. High Court took notice of the relevant provisions of the Act and held that section 206AA of the Income-Tax Act, 1961, makes it conditional for every person who wishes to have a transaction in a bank or financial institution, including small investors, invariably to have a

permanent account number. **This runs contrary to what has been contemplated under section 139A. Persons whose income is below the taxable limit need not have a permanent account number and also they need not furnish income-tax declaration or returns.** Of course, under the Finance Act, it is made clear that a person whose income is less than the taxable limit, is not taxable. Such of the small investors who come forward to invest their savings from earnings as security for their future, by virtue of section 206AA, necessarily have to give their permanent account number. Poor and illiterate persons find it difficult to approach various Government departments, particularly the Income-Tax Department, to get their permanent account numbers.

In view of the aforesaid reasons, the Hon. High Court, allowing the petitions, **held that it is not necessary for such persons whose income is below the taxable limit, to obtain permanent account number.** Such investments / savings from their earnings or by way of agriculture or any other source in banking and financial institutions, would also further the financial position from the point of the country's economy. But imposing condition on such small depositors to invariably obtain a permanent account number would cause hindrance and discourage such small investors to come forward to invest their money for secured returns and as security for their future. **Section 139A and section 206AA are made inapplicable to persons and read down from the statute for whose income is less than the taxable limit as per the Finance Act, 1991. Banking and financial institutions shall not invariably insist upon permanent account number from such small investors or from persons who intend to open an account in the bank or financial institution.**

From the aforesaid judgement of the Karnataka High Court, it may be seen that in view of the genuine difficulties of small investors, section 206AA is read down from the Statute and is made inapplicable to persons whose income is less than the taxable limit. Accordingly, the banking and financial institutions have been directed not to insist upon PAN from such small investors like the petitioners, as well as from persons who intend to open an account in the bank or financial institution.

III. Conclusion

In the light of the detailed discussion in the preceding paragraphs I and II, the position in respect of rates of TDS regarding payments to non-residents and residents, in view of the provisions of section 206AA of the Act, may be summarized as follows :

1. Regarding payments to non-residents

As regards the impact of section 206AA on the rates of TDS in respect of payment to non-residents, the present position may briefly be stated as follows :

(i) The provisions of section 206AA, as in the past, will not apply to payments of interest on long-term bonds, as referred to in section 194LC of the Act.

(ii) As per the provisions of sub-section (7) of section 206AA, r.w.r.37BC of the Rules, the provisions of section 206AA shall not apply in respect of payments in the nature of interest, royalty, fees for technical services and payment on transfer of any capital asset, if the deductee furnishes the details and documents specified in sub-rule (2) of rule 37BC, to the tax-deductor.

The details and documents to be furnished to the tax-deductor, as listed under clauses (i), (ii), (iii) and (iv) of sub-rule (2) of rule 37BC, are self-explanatory and it should not be difficult for a non-resident receiving any payment from a resident in India, to furnish the same to the tax-deductor.

(iii) Otherwise also, in view of the legal position that the provisions of the DTAA override the provisions of the I.T.Act, 1961, section 206AA will have no impact on the TDS rates, in respect of payments to non-residents.

2. ***Even in respect to payments to residents, in certain cases, the provisions of section 206AA will not be applicable***

In this connection, the relevant aspects / scenario are as follows :

(i) As per the provisions of section 4(2) of the Act, no tax will be deductible at source, in a case where the total income of the recipient is below taxable limit and accordingly, the provisions of section 206AA would be irrelevant.

(ii) Even in respect of TDS under section 192 of the Act, in respect of income from salaries, section 206AA will not have any impact in cases where the income of the employee is below taxable limit.

(iii) As per the aforesaid judgement of Karnataka High Court, section 206AA is read down from the Statute and is made inapplicable to persons whose income is less than the taxable limit.

Accordingly, the banking and financial institutions will not insist upon PAN from such small investors who intend to open an account in the bank or financial institution.

S. K. TYAGI
M.Sc., LL.B., **Advocate**
Ex-Indian Revenue Service
Income-Tax Advisor
Website: www.sktyagidt.com

Office : (020) 26133012
: (020) 40024949
Residence : (020) 40044332
E-mails : sktyagidt@airtelmail.in
: tyagi@sktyagidt.com

Flat No.2, (First Floor)
Gurudatta Avenue
Popular Heights Road
Koregaon Park
PUNE - 411 001