Royalty & FTS Income of Non-residents - Tax Modification

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Geetika Gupta
Chartered Accountant

Ashish Chadha
Chartered Accountant

The tax rate on royalty and fees for technical services ('FTS') along with the withholding tax rate on such payments under the Income-tax Act ('Act') has been increased from 10% to 20% (plus applicable surcharge and cess) with effect from 1 April 2024 (i.e., assessment year 2024-25) vide the Finance Act 2023. This is a substantial shift by India in the taxation landscape concerning Royalty/FTS income of non-resident taxpayers from India. This move of doubling the tax rate from the existing rate could bring a dent in the cashflows in the hands of non-residents.

This article analyses the ramifications originating from this amendment, throwing light on crucial points for consideration for non-resident taxpayers to ensure diligent compliance to the updated tax regulations.

The key points for consideration post the amendment made are as under:

Benefits of Double Taxation Avoidance Agreements ('DTAA')

Section 90 of the Act provides for opting the beneficial tax rate in a case where the transaction is with a tax resident of a country with which a tax treaty has been entered into. Many non-resident taxpayers in the past have been opting for withholding at the rates prescribed under the Act (i.e., 10% plus applicable surcharge and cess), as this provides them an exemption from filing tax return in India.

However, considering the enhanced tax rate of 20% (effective tax rate being 21.84% including surcharge and cess) in the Act, which is higher than the tax rate provided for in majority of the tax treaties, the non-resident taxpayers are now likely to opt for the beneficial tax rate under the DTAAs. The DTAAs commonly provide for concessional tax rates or exemptions for specific income categories, including royalty and FTS. In order to enable them to do so, they would be required to undertake certain compliances such as obtaining Permanent Account Number (if not obtained earlier), furnishing of Tax Residency Certificate ('TRC'), filing of Form 10F, furnishing of a No-Permanent Establishment ('PE') declaration certificate, and filing of a tax return in India.

Potential scrutiny assessment exposure

The intensified tax rate on Royalty/FTS income would enlarge the bucket of taxpayers claiming beneficial provisions/ rate as per the DTAAs. This would add to the likelihood of deepened scrutiny proceedings by

Indian tax authorities, primarily in cases where the tax withheld in India falls short of the revised rate.

In instances where non-resident taxpayers receive royalty income from an Indian enterprise and the tax withheld falls below the amended rate of 20%, they must prepare themselves for potential enquiries and increased risk of scrutiny and accordingly, should maintain robust documentation to substantiate compliance with the revised tax regulations, specifically in respect of the Principal Purpose Test, Substance Test or other specific LoB clauses (such as beneficial ownership etc.).

Obtaining tax registration (PAN) and filing tax return in India

For the purpose of fulfilling the various compliance obligations in India under the Act, the non-resident taxpayers obtain a PAN in India. The PAN, being a unique identification number, is quoted in overabundance in India inter alia including financial transactions, tax return filings, tax refund claims and business activities.

Further, there are specific instances wherein the non-resident taxpayers are obliged to file their tax return in India. Such circumstances *inter alia* include cases where taxes withheld fall below the amended tax rate of 20% (plus applicable surcharge and cess) or cases where the taxpayer is eligible to claim a lower tax rate in accordance with the DTAA. Further, non-resident taxpayers ought to file their tax return in India to claim a tax refund. As an illustration, if a non-resident taxpayer's royalty income is subject to a reduced tax rate of 15% in accordance with the relevant DTAA and taxes have been withheld by the payer at the amended rate of 20% (plus applicable surcharge and cess) under the Act, filing of a tax return in India is of utmost significance to claim the refund of excess tax withheld.

Applying for a lower/ Nil withholding tax certificate

In a case where the payer/ payee if of the belief that the amount to be paid/ received by them is not chargeable to tax (wholly or partly), the Act provided for a mechanism to apply for a lower/ Nil withholding tax certificate from the tax authorities for such transaction. Section 195(2) of the Act provides that where the payee considers that the sum payable to the non-resident is not chargeable to tax, he may make an online application in Form 15E to the tax officer. Further, Section 197 of the Act provides that the payee may file an online application before the tax officer in Form 13, justifying as to why the deduction of income-tax in his case is required at any lower rate or no deduction of income-tax is required.

It is pertinent to note that the increase in the rate of tax and withholding for Royalty/FTS income imposes an adverse effect on the cash flow of non-resident taxpayers. As a result, the non-resident taxpayers or respective payers may consider availing the option of filing lower/ Nil withholding applications provided for under Section(s) 195/197 of the Act. By going through this process, the non-resident taxpayers can assess the taxability of the underlying income and potentially diminish the impact of increased taxation.

Author's comments

The amendment in the tax/withholding rate for Royalty/FTS income would trigger intense tax implications for non-resident taxpayers in India.

In a case where the non-resident taxpayer continues with its position of non-filing of tax return in India, it will have to bear an additional cost in the form of increased withholding tax at the rate of 20% (plus applicable surcharge and cess).

Alternatively, in a case where the non-resident taxpayer adopts a position of claiming the beneficial tax rate provided in the respective DTAA, the risk of Indian tax authorities denying the availability of the treaty benefit and applying the amended tax rate as per the Act could not be ruled out. Accordingly, analyzing the availability of the DTAA benefit, specifically in terms of fulfillment of tax residence, principal purpose test, other LoB clauses, substantiated by the underlying facts and documentation (highlighted above) will become imperative.

Ensuring proactive compliance with the amended tax regulations, robust record-keeping, obtaining of a PAN, and prompt filing of tax return in India will be pivotal obligations for non-resident taxpayers going

forward.

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