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Finance Act 2023 – Taxing times ahead for Non-residents!

The Finance Bill, 2023 (**'Bill'**) was passed by the Parliament and received presidential assent on 31st March 2023, and is now the Finance Act, 2023 (**'Finance Act'**). The Bill was approved with more than sixty changes as compared to the draft Bill which was introduced in the budget session on 1st February, 2023.

The Finance Act has introduced amendments in the Income Tax Act, 1961 (**'IT Act'**) relating to taxation of non-resident whether a foreign company or otherwise (**'Non-Residents'**).

In this alert we have briefly summarised one such change in the rate of tax on royalty and fee for technical services earned by Non-Residents from 10% to 20%, the previous position, current amendments and the impact of the amended provisions on Non-Residents.

Increase in tax rates on royalty and fee for technical services

Section 115A(1)(b) of the IT Act deals with taxability of royalty and fee for technical services earned by Non-Residents not connected to a permanent establishment ('PE') or a fixed place in India. The said section earlier prescribed a special tax rate of 10% on the gross amount of royalty and fee for technical services. The tax rate was so increased by applicable surcharge and education cess.

The Finance Act has now doubled the rate of tax from 10% to 20%, to be effective from the financial year beginning 1st April 2023. The applicable surcharge and cess rates remain the same.

This amendment was not part of the changes proposed by the Bill when it was tabled in the budget session on 1st February 2023 and made an appearance only in the draft amendments to the Bill, which was then approved as the Finance Act by the Parliament.

Background and pre-amendment position

The prescribed tax on royalty and fee for technical services under the domestic law was 10% (plus applicable surcharge and cess, which generally works out to 10.92%). This tax rate under the IT Act was either at par with most tax treaties and in some cases considered to be more attractive as compared to some treaties such as India-USA and India-UK which provide for a 15% tax on royalties and fee for included/ technical services (albeit without any surcharge or cess).

The other significant benefit of availing the rate under the IT Act as opposed to treaty rates, is the exemption to Non-Residents (subject to complying with prescribed conditions) from filing income tax returns in specified circumstances where the Non-Resident had no other Indian sourced income) besides royalties, fees for technical services, dividends and interest) and the tax deductible at source under the applicable IT Act provisions has been deducted from such income, which is not less than the rate prescribed in this section 115A i.e. 10% (plus applicable surcharge and cess).

Thus most Non-Residents were choosing to avail of the tax rate under the IT Act as opposed to claiming treaty benefits, which has its own additional formalities to be complied with.

New Position

Now, with the increase in tax rate under the IT Act form 10% to 20%, most Non-Residents will have to resort to claiming treaty benefits where the applicable treaty provides for a lower rate of tax. However, this though on the face of it looks ok, this comes with its own complexities such as:

- Furnishing a Tax Residency Certificate (**'TRC'**) and providing additional information by filing Form 10F; and
- Obtaining a tax registration in the form of a permanent account number (**'PAN'**) and consequently filing a tax return in India.

The problem for a Non-Resident is not necessarily solved once he obtains a TRC. Most tax treaties provide the benefit for a lower tax rate is available provided that the recipient is the 'beneficial owner' of such income. The term 'beneficial owner' has not been defined under the IT Act, however a beneficial owner can be said to be a person who is recognized as an owner since the particular arrangement belongs to that person or is for his / it's benefit, even though legal title may belong to someone else.

Circular 789[1] ('**Circular'**) issued by the Central Board of Direct Taxes ('CBDT'), specifically with respect to *"taxation of income from dividends and capital gains under the Indo-Mauritius Double Tax Avoidance Convention (DTAC)"* clarified that *"wherever a certificate of residence is issued by issued by the Mauritian Authorities, such Certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly*". Even though the said Circular was issued in relation to the India-Mauritius treaty, the said principle has been applied in various judicial precedents[2] as well. However, there have been some precedents[3] recently where the tax authorities have taken a contrary view and tried to lift the corporate veil to examine the beneficial ownership of the person claiming a benefit under the treaty.

This could present hurdles specially when the recipient of the royalties or fees for technical services is an entity such as a disregarded entity or a pass though like an LLP or Trust where it is the holder or beneficiaries rather than the entity itself who is subject to tax in that jurisdiction.

Road ahead after the amendment

As seen above, with the earlier 10% tax rate under the IT Act, and an equal or in some cases higher rate under the Indian tax treaties, the Non-Residents preferred to be taxed under the domestic law at 10%, with lesser compliances, such as exemption from filing tax returns, or the need to furnish a TRC and form 10F etc. and consequently not having the need to take any registrations such as PAN in India.

Now, with the change in rate from 10% to 20%, Non-Residents may seek to claim treaty benefits, since most treaties would have lower rate of 10% or 15% for royalties and fee for technical services. This would, however, not only necessitate providing additional information such as TRC, Form 10F etc., as described above, but also, the exemption from filing tax returns in India, as explained above, may not be applicable. This would again increase the compliance burden on Non-Residents and also necessitate obtaining PAN registration in India.

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[1] Circular No. 789 dated 13th April 2000 read with Circular No. 1/2003 dated 10th February 2003

[2] Assistant Director of Income-tax (International Taxation)-2(1), Mumbai.v. Universal International Music BV [2011] 45 SOT 219 (Mumbai)

[3]Blackstone FP Capital Partners Mauritius V Ltd. v. Deputy Commissioner of Income-tax, International Taxation [2022] 138 taxmann.com 328 (Mumbai - Trib.), Deputy Commissioner of Income-tax (International Taxation).v. HSBC Bank (Mauritius) Ltd. [2020] 117 taxmann.com 750 (Mumbai - Trib.), AUTHORITY FOR ADVANCE RULINGS (INCOME TAX), NEW DELHI "AB" Mauritius, [2018] 90 taxmann.com 182 (AAR - New Delhi)

This change will also result in additional tax burden in case of Non-Residents where India does not have a tax treaty with the jurisdiction of a Non-Resident. This may also impact those arrangements where the agreements provide that the resident payer would bear the applicable withholding taxes and make the payments to Non-Residents on a grossed up basis.

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