UPDATES

Budget 2023: Proposed amendments to the Tax Deduction at Source framework

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Background

The Finance Bill, 2023 proposes several amendments to the Tax Deduction at Source provisions including covering certain new transactions as well as rationalising existing provisions.

The concept of tax deduction at source (**TDS**) was introduced with the aim of collecting tax from the source of income. While TDS has been found to be a convenient way of expeditiously augmenting the collection of tax revenue and obtaining information about taxable transactions, it also adds to the compliance burden of taxpayers.

At present, there are over 30 different sections governing TDS on payments made to residents alone, and several other sections for payments to non-residents. TDS rates range from 0.1% to 40% and vary depending on several factors, including the nature of the payment, residential status of the payee, past tax filings made by the payee, etc. Many TDS provisions have been subject to interpretational disputes and challenges leading to protracted litigation.

As a result, the TDS framework has become increasingly complicated and cumbersome over the years. There was widespread expectation that the Finance Bill, 2023 (**Bill**) would rationalise the TDS framework to reduce the compliance burden and give a boost to the government's efforts to promote ease of doing business in India. While the Bill has proposed some amendments with an intent to simplify and rationalise the TDS framework, certain proposals are expected to add to the complexity of the TDS regime. The key amendments are discussed below.

Key proposals under the Bill

1 Tax treaty relief to non-residents receiving income from mutual funds

Section 196A of the Income Tax Act, 1961 (**ITA**) provides for TDS at the rate of 20% on a non-resident's income from the units of an Indian mutual fund or the Unit Trust of India. The Bill proposes to allow the payer to withhold tax at any lower rate that the non-resident may be entitled to under the provisions of the tax treaty between India and the country of tax residence of the non-resident, so long as the non-resident provides a valid tax residency certificate.

This amendment was specifically required in light of the Supreme Court decision in 2020, in the case of *PILCOM* where it was held that if the applicable TDS provision requires deduction of tax at a certain rate, tax would be deductible by the payer at that rate without giving the benefit of any lower tax rate that may be available to the payee under the applicable tax treaty. The payee can procure a refund of any excess tax withheld by filing a tax return at a later stage. Based on this ruling, payers had been deducting tax at the specific rates prescribed under the ITA, despite the non-resident payee being entitled to avail of a lower tax rate provided in the relevant tax treaty. This resulted in blockage of cash-flow and increase in compliance burden for non-resident payees, since they were required to file income tax returns in India to secure a refund of the excess tax withheld and potentially undergo scrutiny proceedings.

The proposed amendment requires payers to consider lower tax rates (if any) provided under the applicable tax treaty for the purposes of tax withholding on income arising from units of an Indian mutual fund or the Unit Trust of India. This is expected to nullify the effect of the above ruling for these payments and will potentially ease out the cash flows of non-residents with respect to this income stream. Interestingly, a similar amendment was made to Section 196D (which pertains to specified payments to foreign institutional investors) through the Finance Act, 2021.

Key Observations

While these amendments are well-intended, they are too specific and do not address the concerns of all categories of non-residents who may be eligible to avail of lower rates under treaty provisions. For instance, Section 194LBA(2) of the ITA prescribes a TDS rate of 5% for interest payments made by a business trust to non-resident investors. Certain non-resident investors have been accorded a specific exemption under the treaty provisions for interest income received from India. Despite such an exemption, payers continue to withhold tax at the rate of 5% provided under Section 194LBA(2). Therefore, instead of amending different provisions of the ITA in a piecemeal manner, the government should consider introducing an overarching amendment covering all income payouts to non-residents in-line with the principle that a non-resident is entitled to avail of lower tax rates (if any) provided in the applicable tax treaty.

2 Nil or lower TDS certificate may be procured by non-resident unit holders earning interest income from a business trust

Under the ITA, interest income earned by a business trust is exempt in the hands of the business trust and is instead taxable in the hands of the investors (i.e., unit holders). Under Section 194LBA of the ITA, a business trust is required to deduct and deposit tax at the rate of 5% on the interest income of non-resident unit holders. Income of certain non-resident unit holders may be subject to tax at lower rates or may be entirely exempt due to their tax-exempt status or a specific exemption provided under the relevant tax treaty with India. In such cases, there is currently no mechanism under the ITA for deduction of tax on interest income at a lower rate.

While Section 197 of the ITA provides a mechanism to obtain a certificate from the tax authorities for allowing tax deduction at a lower or nil rate, it only covers certain kinds of income. Income received from the units of a business trust is currently not included in the kinds of income for which a certificate can be obtained under Section 197. The Bill proposes to extend the scope of Section 197 to include interest income from business trusts. As per the proposed amendment, non-resident taxpayers that are eligible for a tax exemption or a lower rate of tax will be able to obtain a lower or nil tax deduction certificate from the tax authorities.

Key Observations

This amendment is ostensibly aimed at reducing the compliance burden of filing an income tax return in India for claiming a refund of the excess tax withheld. However, procuring a lower or nil rate certificate from the tax authorities is often a time consuming and complicated process, particularly for non-residents without any presence in India. Here again, an overarching amendment that requires payers to consider lower tax rates provided under the treaty provisions for all income payouts to non-residents, would be welcome.

3 Relief from TDS/TCS at higher rates for certain non-filers of income-tax returns

The ITA contains special provisions that require TDS to be undertaken at higher rates in case of payments to non-filers of income tax returns. Similarly, there are provisions under the ITA that require tax collection at source (**TCS**) at higher rates from non-filers of income tax returns. These non-filers are referred to as '*specified persons*' under the ITA. A '*specified person*' has been defined to mean a person that has not furnished an income tax return for the preceding year by the prescribed due date, and the aggregate TDS and TCS in case of the person for the preceding year was INR 50,000 or more.

The definition of '*specified person*' specifically excludes non-residents that do not have a permanent establishment in India. However, the definition does not exclude other persons who are not required to file an income tax return in India. Therefore, such persons may be subject to higher TDS and TCS rates even though they are not required to file a tax return at all.

The Bill proposes to amend the definition of '*specified person*' to exclude a person that is not required to file an income tax return and is notified by the government in this regard.

Key Observations

While the intention of the proposed amendment is to restrict the scope of the provisions requiring the TDS and TCS at higher rates, it is subject to the government specifically notifying the persons eligible to be excluded from the definition of '*specified person*'. An unconditional relaxation in this regard (without the requirement of a specific notification) would be welcome.

4 Facilitating TDS credit for income already disclosed in the tax return of an earlier year

In most cases, tax is deducted by the payer in the year in which the income is actually paid. However, a payee following the accrual system of accounting may have already offered this income to tax in an earlier year. In such cases, the payee is often unable to claim a credit of the TDS deducted by the payer in the year of payment of the income, since credit is typically available only if the income is disclosed by the payee in the year of deposit of TDS.

To resolve this, the Bill proposes to provide the payee with an option to make an application to the tax officer to claim the credit of the TDS subsequently deposited for income declared in an earlier year. The application is to be submitted to the tax officer within two years from the end of the financial year in which the tax was deducted at source. The tax officer would be required to provide the credit of the TDS to the payee within four years from the end of the financial year in which the tax was deducted.

Key Observations

While this amendment is well-intended and proposes to address the issue of TDS credit mismatch, certain practical issues remain. The timeline of four years available with the tax officer to grant credit of TDS is quite protracted. Further, the requirement of having to file an application for seeking TDS credit as against an automated process adds another layer of compliance burden on the taxpayers. The government may wish to consider these aspects and make the process more seamless and taxpayer friendly.

5 Withdrawal of exemption from TDS on interest on listed securities

Section 193 of the ITA provides for TDS on payment of interest on securities to residents. However, as per this provision, no tax is to be deducted from interest payments on securities issued by a company, where such securities are in dematerialised form and listed on a recognised stock exchange in India.

The Bill proposes to withdraw this relaxation and require TDS to be undertaken at the rate of 10% on such payments.

Key Observations

The rationale provided behind the withdrawal of the relaxation is to eliminate the under reporting of interest income by payees. Given that the relaxation was only available in respect of interest income from listed securities and such securities are strictly regulated, the rationale behind the proposed amendment does not seem to be aligned with the overarching efforts of the government to simplify the TDS framework.

6 Scope of 'benefits' and 'perquisites' expanded to cover 'monetary' benefits

As per Section 28(iv) of the ITA, <u>any *benefit or perquisite*, whether convertible into money or not, arising from business or the exercise of a profession</u> is chargeable to tax under the head '*Profits and gains of business or profession*'. The terms '*benefit*' and '*perquisite*' are not defined under the ITA and have therefore been a matter of interpretation. There has also been debate around whether '*cash*' or '*monetary*' benefits would be covered within the ambit of Section 28(iv). In 2018, the Supreme Court of India in the case of *Mahindra and Mahindra Ltd*. settled the issue by holding that only benefits or perquisites of non-monetary nature (i.e., in kind) would be covered within the ambit of this provision. Monetary benefits or perquisites would be excluded from the purview of the provision. As per the ruling, a waiver of loan by a lender constitutes a monetary benefit in the hands of the borrower. Such a monetary benefit cannot be taxed under Section 28(iv).

The Finance Act, 2022 introduced Section 194R (with effect from 1 July 2022) as per which an obligation was imposed on the person responsible for providing any *benefit or perquisite*, whether convertible into money or not, arising from business or the exercise of a profession to deduct tax at source at the rate of 10% on the value of such benefit or perquisite. The amendment was aimed at bringing the transactions subject to tax under Section 28(iv) within the TDS net. The Central Board of Direct Taxes (**CBDT**) issued circular 12 of 2022 as guidance for undertaking TDS under Section 194R. As per the circular, TDS under Section 194R would apply to benefits or perquisites that are in cash or in kind or partly in cash or partly in kind. This was despite the decision of the Supreme Court in the case of *Mahindra and Mahindra Ltd.* (and other decisions pronounced on similar lines) as per which cash/monetary benefits are outside the purview of Section 28(iv) and should therefore not be subject to TDS under Section 194R.

Following the issuance of this circular, concerns were raised by the banking industry (and other lenders) that they would be required to withhold tax while waiving loans. This would lead to hardship as the lender would need to incur the additional cost of TDS in addition to the cost of the loan that has been waived. To address these concerns, the CBDT issued circular 18 of 2022 exempting certain categories of banks, public and state financial institutions and non-banking financial companies from withholding tax under Section 194R at the time of waiver of loans or one-time settlement with borrowers. Given that the exemption was extended to specific lenders, the legislative intent was to *generally* subject such transactions to TDS (and tax).

To codify the legislative intent of taxing such transactions, the Bill proposes an amendment to Section 28(iv) to the effect that *cash* or *monetary* benefits or perquisites would also be covered within the ambit of the provision. Further, it is proposed to insert an explanation to Section 194R clarifying that TDS under Section 194R would apply to *any* benefit or perquisite, whether in cash or in kind or partly in cash and partly in kind.

Key Observations

While the exceptions provided in circular 18 of 2022 should still apply, given the proposed amendments, it will be important to revisit all business arrangements such as debt restructuring/loan waiver arrangements (other than those specifically exempted) to evaluate whether a '*cash*' or '*monetary*' benefit arises. If so, there would be an obligation on the provider to deduct tax on such benefit or perquisite, and on the recipient to report and pay applicable tax on such income. Given that the terms '*benefit*' and '*perquisite*' are not defined in the ITA, these amendments are expected to substantially increase the compliance burden on taxpayers and could lead to protracted litigation.

7 Rationalisation of threshold for application of TDS on winnings from lotteries, games and races

Section 194B of the ITA requires the person responsible for paying to any person any income by way of winnings from any lottery or crossword puzzle or card/other games exceeding INR 10,000 to deduct tax at the rates in force (currently 30%) at the time of payment. Similarly, Section 194BB requires the person responsible for paying to any person any income by way of winnings from a horse race exceeding INR 10,000 to deduct tax at the rates in force (currently 30%) at the time of payment. As a matter of practice, several payers applied the threshold of INR 10,000 under these provisions to each transaction, instead of applying the limit to the aggregate payments made during the year.

To curb the practice of splitting a winning into multiple transactions, the Bill proposes that tax would be deducted on the aggregate amount of winnings exceeding INR 10,000 during a given financial year.

Key Observations

Given that the rate of TDS is quite high, this proposal will adversely impact the gaming industry to a certain extent. However, this is also expected to standardise the industry practice in this respect, and remove the competitive disadvantage faced by gaming operators that applied the provision conservatively even prior to the amendment.

8 New provision for TDS on net winnings from online games

Given the recent spurt in the user base for online games, the Bill has proposed a new Section 194BA to provide for TDS at the rates in force (currently 30%) on '*net winnings*' from online gaming. In case there is a withdrawal from the user account during the financial year, tax would have to be deducted at the time of such withdrawal on the '*net winnings*' comprised in the withdrawal. In addition, tax would also need to be deducted on the amount of '*net winnings*' remaining in the user account at the end of the financial year. The manner of calculation of '*net winnings*' is to be separately prescribed.

The proposed amendment also states that in a case where the '*net winnings*' are either wholly in kind or partly in cash and kind and the cash component is not sufficient for meeting the TDS liability, the person responsible for paying the winnings must ensure that the tax liability has been discharged prior to releasing the winnings.

Key Observations

Unlike other TDS provisions under the ITA, there is no monetary threshold for the applicability of TDS on winnings from online games. For instance, this is at variance with the annual threshold of INR 10,000 that is proposed to be made applicable to Sections 194B and 194BB as discussed above. It is also unclear as to why online games have been carved out and dealt with separately under a special section, given that Section 194B already deals with winnings from gaming.

This may potentially trigger interpretational issues and debates regarding the applicability of Section 194B and Section 194BA to cases of online betting and gambling. Notably, this will be a challenge in case of winnings of less than INR 10,000 as such winnings would not clear the monetary threshold prescribed under Section 194B but would potentially still be subject to TDS under Section 194BA (since no monetary threshold has been provided under Section 194BA). There may be further issues and complexities when the formula for the computation of '*net winnings*' is prescribed.

9 Penalty and prosecution for failure to comply with TDS provisions on transactions in kind

The ITA provides for penalties and prosecution for failure to comply with the TDS provisions. Section 271C provides for a penalty for cases where there has been a failure to withhold tax, or where there has been a short withholding of tax. In such cases, a penalty equivalent to the tax not withheld (or short withheld) may be imposed. Section 276B of the ITA provides for prosecution in case there is a failure to deposit the tax that has been withheld. These provisions currently do not expressly provide for penalty/prosecution for a failure to comply with TDS provisions for transactions <u>in kind</u>.

This is particularly relevant in light of certain provisions that have recently been introduced in the ITA – Section 194R and Section 194S. As discussed above, Section 194R deals with TDS on benefits or perquisites arising from business or profession. The provision states that in case the benefit or perquisite is partly or wholly in kind, the person responsible for providing the benefit or perquisite is required to ensure that requisite amount of tax has been paid before releasing the benefit or perquisite.

Section 194S deals with TDS in case of a transfer of virtual digital assets (**VDAs**). Since the consideration for the transfer of a VDA could be the receipt of another VDA (i.e., an exchange, or a transaction in kind), the provision requires the person responsible for paying the consideration to ensure that the required amount of tax has been paid before releasing the consideration.

Similarly, winnings from online games may also be fully or partly in kind. As discussed above, under the newly proposed Section 194BA, where the '*net winnings*' are wholly or partly in kind, the person responsible for paying the net winnings is required to ensure that tax has been paid in respect of the net winnings before releasing the winnings.

The Bill proposes to amend the existing provisions to provide for penalties and prosecution in case of a failure to comply with TDS obligations under Sections 194R, 194S and 194BA for transactions in kind.

Key Observations

The TDS framework is only an interim collection mechanism of taxes that are the primary liability of the person earning the income. Given this, prosecution and imposition of penalty are extremely harsh consequences. There has been widespread expectation that tax laws would be decriminalised (particularly the failure to deposit TDS in a timely manner). The proposed amendments expanding the scope of the penal and prosecution provisions are contrary to other amendments in the Bill that propose to decriminalise certain offences, such as those under the Goods and Services Tax laws.