GROPING IN THE DARK: THE EXTENDING ARMS OF THE INDIAN INTERNATIONAL WITHHOLDING TAX

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The increasing attractiveness of India as an investment destination has heralded several legal controversies over the routing of these investments, and the legal regime governing them in India. At the forefront of this legal debate, are discussions on the applicability of the Indian Income Tax Act to such investments, and the entities to whom the tax liability attaches. This article deals with one such obligation – withholding tax, and the debates on the entities to which this obligation attaches, and the extent to which non-residents are covered by the scope of the Indian regime. This article, drawing on threads from international law and constitutional law, attempts to provide an answer to the legal quagmire created by statutory ambiguity, and the absence of conceptual clarity.

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I. Introduction

The French economist Jean Baptiste Colberte said in the 17th century that "*The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing*". If we were to apply this standard to the directionless groping of the international withholding tax provision contained in section 195 of the Indian Income Tax Act, 1961 ("ITA" or the "Act"), the verdict would be that it is a provision most lacking in artistic merit.

Section 195 has achieved notoriety on several counts, the most important being its contrarian approach in covering trading receipts and payments by non-residents, both of which form the subject of this paper. This analysis is particularly relevant in light of cases such as *Samsung*[1] and *Transmission Corporation*,[2] in which our generally vigilant courts have supported the imposition of unreasonable requirements under section 195, rather than address the uncertainty it creates.

Amidst this controversy, it is important for us to re-examine the (much talked about) 'uncertainty' resulting from the provision. What is the scope of its textual application, and can it legitimately be extended to trading receipts and payments by non-residents? In the first part of this paper, we will address these two questions by examining the statutory framework in which section 195 is contained, as well as case law on the subject.

The second part of this paper examines arguments of tax law design and comparative treatment by other countries to determine what *should* be the rightful reach of an international withholding provision.

After examining Indian jurisprudence, textual arguments and policy considerations on the subject, this paper seeks to demonstrate that there is no sufficient justification for the application of section 195 to trading receipts, in rulings in *Transmission Corporation*[3] and *Samsung*.[4] This paper will also argue that application of section 195 to payments by non-residents could result in a violation of international law, as a result of which the provision should necessarily be read down.

1 CIT v. Samsung Electronics, [2009] 227 CTR 335 (High Court of Karnataka).

2 Transmission Corporation v. CIT, [1999] 239 ITR 587 (Supreme Court of India).

3 Transmission Corporation v. CIT, [1999] 239 ITR 587 (Supreme Court of India).

4 CIT v. Samsung Electronics, [2009] 227 CTR 335 (High Court of Karnataka).

II. The Textual Arguments on Section 195

A. Applicability to trading receipts

Can section 195 legitimately be applied to trading receipts? The response to this question depends on an analysis of the statutory framework within which the Indian withholding tax provisions are contained as well as the text of section 195 and relating case law.

(i) Scheme of withholding tax provisions under the ITA

This part argues that the scheme of withholding tax provisions under the ITA requires certainty on the part of the withholder that there is income chargeable to tax. Such withheld amounts may constitute pure income, or may be part of gross payments with a determinable or indeterminable income component. However, a prerequisite for withholding tax provisions to apply is that there should be certainty as to the *existence* of income.

Section 4 of the ITA is the overarching charging provision relating to taxation of income under the ITA. Section 4(1) deals with the subject of charge and states that,

> 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. [emphasis supplied]

Further, section 4(2) deals with certain collection mechanisms contemplated by the Act, and states that "*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*". [emphasis supplied]

Does the term 'chargeable' in section 4(2) refer to a *potential* chargeability i.e. the theoretical ability of a payment to fall within any particular head contemplated under the Act? Or does it refer to the existence of an *actual* charge under section 4(1) i.e. the charge that would exist pursuant to the application of the relevant computation provisions and *subject* to the provisions of the Act under section 4(1)?

Neither, it seems.

It is relevant to note that the terms used in section 4(2) are 'chargeable' and 'income', whereas section 4(1) refers to income tax that shall be 'charged' on 'total income'. The definition of 'income' contained in section 2(24) is a broad and inclusive definition, whereas the term 'total income' defined in section 2(45) means 'the total amount of income referred to in section 5, computed in the manner laid down in this Act'. A literal reading of sections 4(1) and 4(2) would support the view that section 4(2) intends to cover a wider range of payments (which are 'income chargeable') as compared to section 4(1) (which only discusses 'total income' 'charged'). This difference in language appears logical, considering that the tax collection provisions are triggered prior to assessment when it is not possible to accurately determine the extent of total income that will actually be subject to charge.

Does the broader language used in section 4(2) then imply that tax should be withheld on all payments, irrespective of their composition? Nothing in section 4(2) or 4(1) seems to suggest this. Section 4(2) applies to *income* chargeable, and not to *payments* chargeable. Thus there must be *prima facie* certainty as to the existence of income. As per the ruling of the Supreme Court in *Emil Webber*,[5] although the inclusive definition of 'income' in section 2(24) adds several artificial categories to the concept of income, the expression 'income' does not lose its natural connotation on that account. Further, it is an accepted position that 'income' refers to real and not fictional or notional income.[6] Contingent income is not considered income until such point that the contingency takes place.[7]

Referring specifically to 'trading receipts', they may not be considered 'income' at the time of payment, as their characterization as income would be contingent on the deduction of all past, current and future expenses for the relevant year. The mere existence of a head of income relating to business profits and gains should not be sufficient to result in levy of withholding tax on trading receipts.[8]

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5 Emil Webber v. CIT, [1993] 200 ITR 483 (Supreme Court of India).

6 CIT v. Kalooram Govindram, [1965] 57 ITR 630 (Supreme Court of India).

7 *See*, Franklin v. IRC, 15 TC 464; Indian Overseas Bank v. CIT, 246 ITR 206 (High Court of Madras).

8 Here it is relevant to refer to the view on the term 'chargeable', which was taken by the Supreme Court in the case of P.C. Ray v. A.C. Chatterjee, [1959] 36 ITR 365 (Supreme Court of India), where it was held that the term 'chargeable' (in the context of the predecessor of section 195) related to any payments capable of being brought to charge under any head of the Act. This ruling came up in the context of the 1922 Act which did not contain provisions analogous to sections 4(2)

However, to the extent that any payment is in the nature of income specified in section 2(24) (or otherwise in the nature of income), the withholding tax requirements should apply.

Section 4(2) is the overarching provision authorizing deduction of tax at source and advance payment. Therefore, our interpretation of this provision would impact the interpretation of the other withholding tax provisions contained in Chapter XVII of the Act, including section 195. Chapter XVII begins with section 190, which is the general provision on deduction of tax at source. Section 190 states as follows:

> 1. Notwithstanding that the regular assessment in respect of any income is to be made in a later assessment year, the tax on such income shall be payable by deduction or collection at source or by advance payment…
> 2. Nothing in this section shall prejudice the charge of tax on such income under the provisions of sub-section (1) of section 4. [emphasis supplied]

Therefore, under section 190 as well, withholding tax obligations are applied only with respect to 'income'.[9] However, it is clarified that section 190 does not prevent the application of withholding taxes prior to assessment. It is further clarified that mere application of withholding taxes does not prejudice the *actual* charge in accordance with the provisions of section 4(1) and the Act.

In sum, the conclusions that may be drawn from the statutory framework are as follows:

a) Under section 4(1), tax is charged on 'total income' in accordance with and subject to the provisions of the Act i.e. subject to all applicable computation mechanisms, benefits etc.

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and 190 contained in the ITA (*Infra* note 9 on section 190). These provisions were introduced as clarificatory provisions pursuant to the recommendations contained in the report of the 12th Law Commission on the 1922 Income Tax Act ("12th Law Commission Report"). In the Notes to clause 199 of the 12th Law Commission Report, it is stated as follows in the context of the proposed section 4(2):

This clause is new and is intended to make it clear that there is some kind of liability to pay tax in cases where tax is deductible at source or payable in advance. Such charge of tax which is implied in the obligation to pay in advance etc. has been brought out more directly in this clause. [emphasis supplied]

This intention to apply withholding provisions to chargeable amounts, and not merely amounts hypothetically capable of charge, seems to be reflected quite clearly in the language of the provision when it refers to 'income' and not 'payments'.

b) Under section 4(2) and section 190(1), withholding tax obligations trigger prior to assessment (i.e. prior to computation) provided that there is 'income'. The overarching withholding provision contained in section 4(2) also mandates that such income should be 'chargeable'.

c) *Actual* charge continues to be determined under the provisions of section 4(1).

d) Thus, there is recognition that the taxpayer may not be certain of its actual tax liability (i.e. tax that shall be *actually charged*) as on the date of withholding, as the assessment would not have taken place. This implies that a certain part of withheld amounts could consist of non-income receipts. Nevertheless, the withholding provisions of the Act are considered applicable, and it is understood that the final tax liability of the taxpayer continues to be determined in accordance with the Act.

Evidently there is an adjustment mechanism contemplated here, which reconciles the pre-assessment withholding on 'chargeable income' with the final tax liability on 'total income' 'charged' to tax. If the liability post assessment is greater or lesser than the withheld amounts, the taxpayer would be permitted to make the relevant adjustment in its tax return. To this extent there is a consensus that the withholding does not represent the final liability relating to the income of the taxpayer.

Does the existence of an adjustment mechanism mean that tax can be withheld on all and any payments, irrespective of their composition? As discussed above, nothing in section 4 seems to suggest this, and neither does section 190 seem to support this line of argument.

In any case, the question may be less significant in the context of payments to residents. This is because the resident withholding tax provisions operate on a scheduler basis i.e. they apply to specific kinds of payments with a well defined income component. For example, the ITA imposes withholding tax requirements on payments to residents of interest on securities,[10] other kinds of interest,[11] certain

9 In the 12th Law Commission Report, the justification for the introduction of section 190 is that it is a provision which is, "*…intended to make it clear that there is some kind of liability to pay tax in cases where tax is deductible at source or payable in advance. It seems desirable to make a reference to this obligation to pay tax in advance etc. in the charging section itself…*".

10 Income Tax Act (43 of 1961), section 193.

11 Income Tax Act (43 of 1961), section 194A.

kinds of dividends,[12] insurance commissions,[13] other commission or brokerage amounts,[14] rental payments,[15] fees for professional or technical services,[16] etc. Further, the ITA specifies the rates at which tax is required to be withheld on each kind of payment. For example, tax is withheld on interest payments at the applicable rate of 30%, on rental payments and professional service fees at 10%, and on payments to contractors at only 1-2%.

What could be the justification for such a difference in withholding rates, when the total income of a resident is taxed at the rate of 30% (with the exception of capital gains)? Such a scheme appears to be in recognition by the ITA of the differing income components of different kinds of payments. Where interest is paid, there may not be a significant cost reimbursement involved in such payment, which means that a substantial part of the interest payment may be income taxable at 30%. On the other hand, payments to contractors may consist of a substantial cost reimbursement component, as a result of which the taxable component may only be 1-2% of the payment. It is significant to note that there is no catchall resident withholding provision applicable to general trading receipts. Thus, even though withholding provisions apply prior to assessment, the Act seems to be structured in a manner that attempts to capture only the approximate income component of gross payments.

In this manner, a scheduler basis of withholding reduces the problems inherent to a pre-assessment withholding tax. As discussed in the next section on policy considerations, withholding taxes across the world are generally levied on a scheduler basis, merely because it is most logical to do so.

With respect to non-residents however, the ITA does away with the scheduler system and withholds tax on the basis of a catchall provision in section 195, which extends to "payment of any sum chargeable to tax". This language has not been particularly harmful in situations such as payment of interest, where non-residents are taxed presumptively at a lower rate than residents, with the withholding tax subsuming all further liability.[17] However, the catchall international withholding provision has wreaked havoc in the context of sums such as trading receipts, where the income component is manifestly unclear at the time of payment to non-residents.

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12 Income Tax Act (43 of 1961), section 194 – this provision does not cover dividends which have been subject to dividend distribution tax under section 115-O.

13 Income Tax Act (43 of 1961), section 194D.

14 Income Tax Act (43 of 1961), section194H.

15 Income Tax Act (43 of 1961), section 194I.

16 Income Tax Act (43 of 1961), section 194J.

17 Income Tax Act (43 of 1961), sections 115D and 115E.

The next section examines how courts have (wrongfully) tended to draw analogy with resident withholding provisions, and applied section 195 to gross payments. We will examine whether such an approach is appropriate in light of the statutory scheme of the ITA and general principles of tax system design.

(ii) Understanding the Scope of Section 195

As discussed above, the scheme of the withholding tax provisions in the ITA contemplates withholding tax on a scheduler basis when payments are made to residents, with differential withholding rates for different kinds of payments. On the other hand, the international withholding tax provision contained in section 195 applies to all chargeable sums paid to non-residents. Section 195(1) states that,

> Any person responsible for paying to a non resident…. any interest or any other sum chargeable under the provisions of this Act…. shall, at the time of credit of such income to the account of the payee or at the time of payment… deduct tax at the *rates in force*. [emphasis supplied]

Notwithstanding the broad language in section 195, the term 'sum' should take colour from the provisions authorizing withholding of tax, which are section 4(2) and section 190. As discussed above, both these provisions permit tax to be withheld on 'income'. Therefore, the term 'sum chargeable' in section 195 must necessarily be read as 'income' chargeable, as section 195 may not go beyond the scope of the authorizing charging provisions.[18] As sections 4(2) and 190 do contemplate that tax be withheld on mixed receipts (discussed above) – the impact of reading 'sum' as 'income' would then be that a payment would be required to be *prima facie* income chargeable for the withholding obligation to trigger.

18 In this context, it is relevant to refer to the ruling in the case of P.C. Ray v. A.C. Mukherjee, [1959] 36 ITR 365 (Supreme Court of India) where the Hon'ble Supreme Court examined the applicability of section 18(3B), which was the predecessor of section 195(1), in relation to hire payments. The specific issue was as to whether hire payments could be considered 'any other sum chargeable' for the purpose of section 18(3B) as their chargeability would not be determinable as of the date of payment. Justice Chakravarti observed that the term 'chargeable' could be taken to mean "*not 'assessable to tax', but as liable in its nature to be brought into computation in an assessment, that is to say, as belonging to one or other of the heads of income, as set out in section 6 of the Act*". In this case, a parallel was drawn with the interpretation of the terms 'annual payment' under the old rule I of Case III of Schedule D to the English Income Tax Act. Reference was made to the ruling by the House of Lords in the case of Commissioners of Inland Revenue v. Corporation of London, where it was argued that the term 'annual payment' could not include trading receipts, as they would require expenses to be set off to be considered taxable income. The House of Lords recognized the distinction between 'pure income profit' and mere receipts, and stated that although there was "*no qualification or limitation in the words "annual payment", as appearing in rule I of Case III, a limitation had to be implied so as to*

As section 195 is a catchall withholding provision, we will examine four kinds of situations to determine what could be 'income chargeable': a) payments where the entire gross payment consists of income b) payments where none of the gross payment consists of income (for e.g. reimbursements) c) gross payments with identifiable income and non-income components (for e.g. capital gains) and d) gross payments with an uncertain, contingent income component (for e.g. trading receipts).

a) Only Income

In the first category where the entire payment consists of income, the questions relating to chargeability and any other 'sum' are moot as the entire payment would as such be chargeable under the provisions of the Act, as per the rates applicable to such income.

b) No Income

In the second category dealing with reimbursement type situations where there is no income, it would not appear that section 195 should be attracted. The language of the provision seems clear that withholding tax can only apply where there is any other sum 'chargeable to tax', which is clearly not the case where there are pure reimbursements with no income component. The ITA can only apply with respect to taxation of income and cannot apply to payments involving no income component. This view has been taken by some judicial authorities in cases such as *Dunlop Rubber Co. Ltd.*[19] and *K Ramabrahmam.*[20]

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exclude payments which, or the whole of which, could not be said to be income in the income-tax sense". Justice Chakravarti considered interpreting section 18(3B) in line with the House of Lords position on 'annual payment', but subsequently abandoned such an interpretation in favour of the broader interpretation of the term 'chargeable' which is discussed above. His justification for doing so, was that section 18(3C), the predecessor to our section 195(2), allowed for application to an Income Tax Officer in case a reduction was required on mixed receipts. As discussed in the section on scheme of withholding provisions, the issue is not so much as to the application of withholding tax to mixed receipts, as it is the contingent nature of the income from trading receipts. The application of withholding provisions requires certainty as to the existence of income per se, which is not satisfied when trading receipts are paid.

19 CIT v. Dunlop Rubber Co Ltd., [1983] 142 ITR 493 (High Court of Calcutta).

20 CIT v. K. Ramabrahmam, [1978] 115 ITR 369 (High Court of Andhra Pradesh). *See* also, ACIT v. Malayala Manorama, [2005] 94 ITD 121 (Income Tax Appellate Tribunal Cochin); M/s Cairn Energy India Pty Ltd., ITA Nos. 208 to 211 (2006) (Income Tax Appellate Tribunal Chennai); In Re Al Nisr Publishing, [1999] 239 ITR 879 (Authority of Advanced Rulings).

However, there are several contrary rulings such as the ruling of the Kerala High Court in *Cochin Refineries Ltd*,[21] which have held that withholding taxes can apply to reimbursements in situations where the reimbursements are 'characterised' (*sic*) as fees for technical services. Such a position seems to relate more to the fourth situation (discussed below), where the reimbursements are paid as part of a gross sum involving an income component. Pure reimbursements cannot be 'characterised', as they would first need to be considered income to be capable of characterization.[22]

The Delhi ITAT correctly appreciated this line of difference in the case of *Modicon*[23] where it was held that "*In the very nature of things, reimbursement of expenses cannot be considered as having an income element imbedded therein so as to attract section 195(1) of the Act*".[24] As stated in the case of *Hyderabad Industries*,[25] the purpose of deduction of tax at source is to facilitate collection of tax which is lawfully leviable under the Act, in advance and without waiting for the final assessment. The withholding tax provisions are not an authorization to the revenue to collect all and every payment irrespective of whether it is taxable.[26] It would not only be illogical to apply withholding taxes to reimbursements with no income component, but also beyond the scope of the ITA, which can only apply with regard to taxes on 'income'.

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21 Cochin Refineries Ltd v. CIT, [1996] 222 ITR 354 (High Court of Kerala). *See* also, the rulings in In Re Danfoss Industries Pvt Ltd, [2004] 268 ITR 1 (Authority of Advanced Rulings) and In Re Timken India Limited, [2005] 193 CTR 110 (Authority of Advanced Rulings).

22 *See*, CIT v. Tejaji Farasram Kharawala, [1968] 67 ITR 95 (Supreme Court of India); CIT v. Industrial Engineering, [1993] 202 ITR 1014 (High Court of Delhi); CIT v. S.G. Pgnatale, [1980] 124 ITR 391 (High Court of Gujarat).

23 ACIT v. Modicon, [2007] 14 SOT 204 (Income Tax Appellate Tribunal, Delhi).

24 Quoted with approval in Van Oord Acz India Ltd v. ACIT, [2008] 117 TTJ 835 (High Court of Delhi).

25 Hyderabad Industries Ltd v. ITO, [1991] 188 ITR 749 (High Court of Karnataka).

26 It is relevant to note that the *Hyderabad Industries* ruling did not consider the decision in CIT v. Superintending Engineer, Upper Sileru, [1983] 152 ITR 753 (High Court of Andhra Pradesh), which did not require the deduction of tax on specifically exempted payments. Further, the subsequent decision of the Supreme Court in Transmission Corporation v. CIT, [1999] 239 ITR 587 (Supreme Court of India), also did not require such deduction. Several lower authorities have also held, specifically in the context of whether section 195 should apply to non-chargeable amounts, that the provisions of section 195 are not attracted. *See,* Lufthansa Cargo India (P) Ltd v. DCIT, [2004] 91 ITD 133 (Income Tax Appellate Tribunal Delhi) which held that "*[the] language of section 195(1) is unambiguous on the subject*" and In re Al Nisr Publishing, [1999] 239 ITR 879 (Authority of Advanced Rulings).

c) *Determinable income and non-income components*

The next category deals with a situation where payment is made on a gross basis but where it is possible to bifurcate the income and non–income components (for example, capital gains). Such an issue was dealt with in *Mukherjee*,[27] where the court held that where it is possible to allocate the payment between what is chargeable and what is not, then tax would only be required to be withheld on the chargeable amounts.[28] This position is also supported by section 195(2) of the Act which deals with situations where the withholder is uncertain as to the quantum of tax to be withheld. Section 195(2) states as follows:

> Where the person… considers that the whole of such sum would not be income chargeable…he may make an application to the Assessing Officer to determine… the appropriate portion of such sum so chargeable, and upon such determination, tax shall be deducted under sub-section (1) only on that proportion of the sum which is so chargeable. [emphasis supplied]

From section 195(2), inference can be drawn that where the withholder *is* certain as to the quantum of tax required to be withheld, the withholding shall only apply to the income amount even in situations involving a gross payment. For example, when there is transfer of a capital asset, the withholding obligation can only extend to the chargeable gains and shall not extend to the entire payment. Further, as the income component is determinable, it would be possible for the payer to withhold tax at the rates in force.

Indeterminable Income Component

This brings us to the fourth and most contentious category – where gross payments are made and the income component is not clearly determinable. Commentators have stated that rulings such as *Mukherjee*[29] cannot be construed to mean that in every payment, pure profits can be isolated and tax deduction confined to such amount.[30] Courts have tended to take the view that unless the income component of a gross payment is clearly determinable, the withholder

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27 P.C. Ray v. A.C. Mukherjee, [1959] 36 ITR 365 (Supreme Court of India).

28 *See* also, the rulings in CIT v. Superintending Engineer, Upper Sileru, [1983] 152 ITR 753 (High Court of Andhra Pradesh); Sanyasi Rao v. Government of Andhra Pradesh, [1989] 178 ITR 31 (High Court of Andhra Pradesh) and Transmission Corporation v. CIT, [1999] 239 ITR 587 (Supreme Court of India).

29 P.C. Ray v. A.C. Mukherjee, [1959] 36 ITR 365 (Supreme Court of India).

30 S. Iyengar, Law of Income Tax 9632 (10th edn., 2008).

has either of two options, namely, to withhold on the entire gross payment or to approach an Assessing Officer for clarity as to the amount required to be withheld.

Does 'indeterminable' refer to the quantum of income, or can it relate to the very existence of such income? As per the interpretation of section 4(2) discussed above, it seems apparent that the withholding tax provisions can only trigger if there is *prima facie* income. If the quantum of income is determinable (as in the case of capital gains), the withholding may be limited to the quantum. If the quantum of income is indeterminable (as in the case of fees for technical services), the withholding is required on a gross basis at specified rates, unless reduced by an application under section 195(2). However at minimum the withholder should have certainty that income exists.

It is questionable to apply section 195 to trading receipts, as it is impossible to determine an income element to the receipt at the time of payment. Unlike other kinds of payments which may constitute 'income' prior to assessment, trading receipts can only be income upon application of the relevant deduction and computation provisions contained in the Act. The taxable 'profits and gains' are the surplus by which the receipts exceed the expenditure.[31] The very existence of profits and gains is thus contingent upon a variable quantum of expenditure.

Unfortunately, case law has tended to ignore the issue of whether trading receipts can be considered 'income' for the purposes of 4(2) and 190(1). Instead, the focus has always been on whether 'sum chargeable to tax' under section 195 could include mixed receipts, with courts moving on the presumption that trading receipts *are* mixed receipts.

The leading authority on this issue is considered to be the ruling of the Supreme Court in *Transmission Corporation*,[32] which was an appeal from the ruling of the Andhra Pradesh HC in the case of *Superintending Engineer, Upper Sileru*.[33] The issue was as to the applicability of section 195 to trading receipts, and it was held by the Andhra Pradesh HC that,

> We are not impressed with the argument that … the whole of such sum must be chargeable as income under the Act. In other words, what is contended is that where the sum paid to any person is not wholly chargeable under the provisions of the Act, then the

31 *See*, Calcutta Co Ltd. v. CIT, [1959] 37 ITR 1 (Supreme Court of India).

32 Transmission Corporation v. CIT, [1999] 239 ITR 587 (Supreme Court of India).

33 CIT v. Superintending Engineer, Upper Sileru, [1983] 152 ITR 753 (High Court of Andhra Pradesh).

> application of s. 195 is ousted. If this contention is to be accepted, s. 195(2) will be rendered otiose…

On appeal, the Supreme Court analysed the scheme of the chapter relating to collection and recovery of tax[34] and drew parallels with resident withholding provisions such as section 194C and stated that these provisions revealed the "*intention of the Legislature to enforce tax deduction at source even in respect of gross sums, the whole of which do not represent income chargeable under the Act*".[35] Thus a substantial part of the analysis related to the applicability of the withholding tax provisions to *mixed (gross) payments*, rather than the issue of *existence* of income at the time of withholding. This has also been the approach taken in previous cases analyzing the application of section 195.[36]

In one instance the Hon'ble Supreme Court did consider the issue of 'income', and observed that the components of section 195 make it amply clear that the term 'sum chargeable to tax' refers to any 'sum on which income tax is leviable', and that such a sum may be "*income or income hidden or otherwise embedded therein*".[37]

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34 "*Section 190, inter alia, provides that notwithstanding that the regular assessment in respect of any income is to be made in a later assessment year, the tax on such income shall be payable by deduction…*". Transmission Corporation v. CIT, [1999] 239 ITR 587 (Supreme Court of India).

35 The scheme of tax deduction at source applies not only to the amount paid which wholly bears "income" character such as salaries dividends, interest on securities, etc., but also to gross sums, the whole of which may not be income or profits of the recipient, such as payments to contractors and sub-contractors and the payment of insurance commission... It is true that in some cases, a trading receipt may contain a fraction of the sum as taxable income, but in other cases… it may contain a large sum as taxable income under the provisions of the Act.

Transmission Corporation v. CIT, [1999] 239 ITR 587 (Supreme Court of India).

36 For example in Turner Morrisson v. CIT, [1953] 23 ITR 152 (Supreme Court of India), it has been stated that, …if on the taking of accounts it be found that there was no profit during the year, then the question of receipt of income, profits and gains, would not arise, but if there were income, profits and gains, then the proportionate part thereof attributable to the sale proceeds received by the Agents in India were income, profits and gains, received by them at the moment the gross sale proceeds were received...

Quoted with approval by the Calcutta High Court in the case of Anglo India Jute Mills v. S.K. Dutt, [1956] 30 ITR 525 (High Court of Calcutta).

37 The scheme of Sub-sections (1), (2) and (3) of Section 195 and Section 197 leaves no doubt that the expression 'any other sum chargeable under the provisions of this Act' would mean 'sum' on which income-tax is leviable... Consideration would be - whether payment of sum to non-resident is chargeable to tax under the provisions of the act or not? That sum may be income or income hidden or otherwise embedded therein.

See, Transmission Corporation v. CIT, [1999] 239 ITR 587 (Supreme Court of India).

Which immediately raises the question of what should be considered "*income hidden or otherwise embedded therein*"? This statement has perhaps contributed most to the flurry of activity at the lower levels, with opinions divided on the true implications of the *Transmission Corporation* ruling.[38] Certain cases have ruled that the Supreme Court intended section 195 to apply only to chargeable amounts, and that there could be no withholding tax liability in the absence of chargeability.[39]

A majority of cases have however favoured the imposition of withholding tax on a broad nature of payments, irrespective of whether they should constitute chargeable income. In the recent case of *Samsung*,[40] the Karnataka High Court imposed withholding tax obligations on several resident assessees in respect of payments to non-resident software suppliers, and seemed to go a step further than *Transmission Corporation*, in stating as follows:

> [If] the payment bears the character of a semblance of an income receipt in the hands of the non-resident recipient, then the obligation on the part of the resident payer who makes such a payment to the non-resident recipient is like a guided missile which gets itself attached to the target.

Did *Transmission Corporation* truly intend that withholding provisions should apply to any payment bearing "*semblance of an income receipt*"? Even if the Hon'ble Apex Court did suggest this (and it does not appear to have done so), such an interpretation seems unacceptable under the express provisions of the Act. All payments bearing a "*semblance of an income receipt*" can by no means be considered 'income' for the purposes of sections 4(2) and 190, as read with 2(24) and related case law. Further, in the specific context of *Samsung*,[41] the business income of the non-resident software suppliers was *prima facie* not 'chargeable' on account of double taxation treaty benefits. Thus, there was a presumption as to the lack of 'chargeable income' for the non-resident income recipient. This leads one to ask: was *Samsung*[42] still justified in imposing a withholding tax obligation on the Indian payers?

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38 A case in point is that of Frontier Offshore v. DCIT, [2009] 314 ITR 193 (High Court of Madras), where both the taxpayer as well as the revenue tried to place reliance on Transmission Corporation in support of their stand!

39 Lufthansa Cargo India (P) Ltd v. DCIT, [2004] 91 ITD 133 (Income Tax Appellate Tribunal Delhi).

40 CIT v. Samsung Electronics, [2009] 227 CTR 335 (High Court of Karnataka).

41 CIT v. Samsung Electronics, [2009] 227 CTR 335 (High Court of Karnataka).

42 CIT v. Samsung Electronics, [2009] 227 CTR 335 (High Court of Karnataka).

In the case of *Eli Lilly*,[43] it was stated in the context of section 192 that "*[the] liability of deducting tax at source is in the nature of a vicarious liability, which pre-supposes existence of primary liability. The said liability is a vicarious liability and the principal liability is of the person who is taxable*".

The liability to deduct can only exist if there is a principle liability to pay.[44] In cases like *Samsung*[45] where there is no certainty as to the income component of trading receipts, and a *prima facie* certainty as to the absence of chargeability, there seems little justification to apply section 195. It may be relevant for us to consider the appropriate position on the issue before application of section 195 begins to spiral beyond control.

Some additional points are listed below:

Determining the rates in force: Section 195 mandates that tax be withheld at the 'rates in force', as against several of the other withholding tax provisions in the Chapter which specify the rate of withholding. The 'rate in force' is not the same as the 'maximum marginal rate'. In the context of business income, application of the 'rate in force' would first require a determination of the quantum of income at the end of the year. If tax is withheld at the maximum marginal rate of 40%, this could disadvantage taxpayers such as start-ups and capital intensive companies with lower taxable income, who may be eligible to a rate of 10% under the Act but who would have tax withheld at the rate of 40%, thus resulting in a lack of liquidity and inability to carry on business in India. Such a result could not have been intended by section 195.

The conclusion that may be derived is that section 195 only seeks to apply with respect to sums where one may determine the 'rates in force'. For example in the context of fees from technical services, withholding taxes apply to the gross payment at the rate of 10%. In the context of salaries, the employer has sufficient control over the payments to the employee to be able to determine the rates in force. In the context of trading receipts, the computation provisions cannot be applied at the time of payment, as a result of which it would be impossible to withhold tax at the "rates in force" with respect to such payments.

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43 CIT v. Eli Lilly & Co, [2009] 312 ITR 225 (Supreme Court of India).

44 This view is supported by the justification given by the 12th Law Commission Report with regard to why sections 4(2) and 190 should be introduced. *Supra* notes 8 and 9.

45 CIT v. Samsung Electronics, [2009] 227 CTR 335 (High Court of Karnataka).

Application to the Assessing Officer: As discussed above, courts have held that the existence of section 195(2) supports the imposition of section 195 on mixed receipts. However, they have not considered the impact of section 195(2) on receipts where the *existence* of income is uncertain and contingent. Section 195(2) refers the taxpayer to the Assessing Officer in situations where the receipts are not 'wholly' taxable, and permits the Assessing Officer to reduce the withholding amount. This implies that the Assessing Officer himself should be capable, of determining the income component at the time of payment. If he is unable to do so, as would happen with payments such as trading receipts, such payments should be excluded from the purview of section 195(2), and therefore from the purview of section 195(1).

With respect to the requirement of a *prima facie* determination of 'income chargeable', there are several cases, primarily at the tribunal level, which state that the any determination of chargeability lies, not with the person required to withhold, but solely with the Assessing Officer.[46] This was also the view taken by the Karnataka High Court in the case of *Samsung*, where it was stated that,

> … determining the taxability of the non-resident assessee…cannot be an exercise that can be resorted to even for the purpose of determining the extent of obligation on the part of the resident… as an answer for that can be obtained only by going through the procedure envisaged under section 195(2) of the Act…

In another recent case, the Mumbai Income Tax Appellate tribunal applied *Samsung* and held that, "*…it is not for the assessee to assume that no tax is deductible at source and, in the absence of any certificate obtained under section 195(2) of the Act, tax has to be deducted at source*".[47]

Such an interpretation converts section 195(2) into an obligation in every situation where payment is made, irrespective of how clear it may be that the income should not be taxable.[48] This does not appear to be the appropriate view,

46 Van Oord Acz India Ltd v. ACIT, [2008] 117 TTJ 835 (High Court of Delhi); Mangalore Refinery and Petrochemicals Ltd v. DDIT, [2009] 311 ITR 91 (Income Tax Appellate Tribunal Mumbai); Frontier Offshore v. DCIT, [2009] 314 ITR 193 (High Court of Madras); In Re IMT Labs (AAR 676 of 2005) (Authority of Advanced Rulings).

47 ACIT v. M/s Anchor Health and Beautycare Pvt. Ltd., (ITA No. 7164/Mum/2008).

48 It was argued by Sohrab Dastur in Frontier Offshore v. DCIT, [2009] 314 ITR 193 (High Court of Madras); that the requirements under section 195(2) cannot be converted into an obligation whereas they are in fact intended as a benefit to the taxpayer. Unfortunately the Chennai ITAT did not accept the argument.

especially considering that sections 4(2) and 190 impose a withholding requirement only with respect to 'chargeable income'. The discretion of the withholder to make a determination of *prima facie* chargeability is implicit in the language of the provision.

Section 195 is *not* a blanket provision covering all nature of payments. In the words of the Hyderabad ITAT in the case of *Cheminor Drugs Ltd*,[49] "*…the provisions contained in section 195 are urgent provisions meant for collecting tax during the financial year itself. Therefore, the nature of enquiry and the nature of adjudication... u/s 195(1) shall necessarily be summary and generally peremptory in nature*". However, the enquiry is not done away with completely; it continues to be important albeit in a shortened form.

Thus the correct view seems to be the one taken by the Delhi ITAT in the case of *Lufthansa*[50] where it has been held as follows:

> We also find no merit in the contention… that…the assessee cannot raise the plea that the income of the non-resident… was not chargeable to tax… The law on the subject is quite clear. If the payments to non-resident are not chargeable to tax, the assessee can always take this plea even if it has made no application Under Section 195(2) of the Act.

Taxpayer's rights: In the context of trading receipts it has been stated in *Transmission Corporation* that "*[the] said provision is for tentative deduction of income-tax thereon subject to regular assessment and by the deduction of income-tax, the rights of the parties are not, in any manner, adversely affected*".[51]

The statement that the taxpayer's rights are not adversely affected is not accurate in the context of payments such as trading receipts. Withholding of tax at maximum marginal rate on every payment could adversely affect the right of the taxpayer to conduct business, as the tax withheld would (in every situation) far exceed the actual taxable income, thus reducing the liquidity available to the taxpayer. As discussed above, the use of the term 'rates in force' in section 195 seems to suggest that the provision should only apply to payments on which the 'rates in force' are determinable.

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49 Cheminor Drugs Ltd v. ITO, [1999] 76 ITD 307 (Income Tax Appellate Tribunal Hyderabad).

50 Lufthansa Cargo India (P) Ltd v. DCIT, [2004] 91 ITD 133 (Income Tax Appellate Tribunal Delhi).

51 CIT v. Samsung Electronics, [2009] 227 CTR 335 (High Court of Karnataka).

(iii) In sum

What is important for us to analyse in the context of trading receipts, is not whether they should be considered 'mixed receipts' (comprising of a sum actually charged and other sums), but whether any part of them can be considered 'income' for the purposes of section 4(2) and 190. The characterization of the trading receipt as income could only take place at the end of the year, after factoring in all the receipts and expenditure. This is notably different from the consideration of payments such as capital gains, interest etc. in relation to which the existence of income is generally determinable outright. Further, it is not appropriate to compare withholding on general trading receipts at 40% with the withholding on resident contractors at 2% – this is because contractor payments are withheld on a presumptive basis specified by the Act, whereas the Act makes no presumptions as to what should be the income component of general trading receipts.

If section 195 is sought to be applied to all trading receipts received by non-residents, as suggested by *Samsung*, would this include all one-off purchases by non-residents? How about online purchases and payments by individuals? How far are we willing to extend the withholding tax net? If such tax is applied at the maximum marginal rate on gross receipts, would it even be possible for the non-resident to continue to carry on business in India? It may become important for us to analyse the constitutional validity of section 195, at least to the extent that it is sought to be applied to non-resident citizens carrying on business in India. Hopefully the Supreme Court will consider some of these issues at the hearing of the special leave petition filed in the case of *Samsung*.[52]

B. Applicability to payments by non-residents

The second point of analysis is the interpretation of section 195 with respect to the imposition of a withholding tax requirement upon non-residents. Under section 195(1), tax is required to be withheld by "*any person responsible for paying to a non-resident*". This language brings within its ambit any payment to a non-resident, including payments made by other non-residents. This of course brings forth a policy question on the usefulness of imposing a withholding tax requirement on non-resident payers, considering that it may be easier to collect tax directly from the non-resident taxpayer. However, the policy issues are discussed in the next part on what the law *should* be.

52 SLP Nos. 34310-34311 of 2009 (Supreme Court of India).

In this part, we will examine the rightful interpretation of section 195 in light of our international law obligations.

(i) Our international law obligations

It is a fundamental principle of customary international law that a sovereign is supreme within its territory. Beginning with the treaty of Westphalia and now a part of customary international law, this concept of territorial supremacy of sovereigns has a corollary, which is that no external actors have the right to act on the territory of another sovereign, unless they have been allowed express authority to do so. The rule does not as such limit the 'prescriptive jurisdiction' of a State, i.e. the jurisdiction of a State to prescribe laws in relation to foreign acts which relate to its territory. However, it does act as a strict limitation on 'enforcement jurisdiction', which means that there are restrictions on how a state may enforce its laws on persons who do not reside within its territory.

Discussions on the exercise of power by one sovereign in relation to the territory of another sovereign have typically arisen in the context of criminal disputes in the past. In Oppenheim's treatise on international law, it has been stated that"*[a] State must not perform acts of sovereignty in the territory of another State…It is ... a breach of International Law for a State to send its agents to the territory of another State to apprehend persons accused of having committed a crime.*"[53]

Further, in the landmark judgment of the Permanent Court of International Justice in the 1927 *Lotus* case,[54] it was stated as follows:

> The first and foremost restriction imposed by international law upon a State is that – failing the existence of a permissive rule to the contrary – it may not exercise its power in any form in the territory of another State…It does not, however, follow that international law prohibits a State from exercising jurisdiction in its own territory, in respect of any case which relates to acts which have taken place abroad…[55]

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53 Oppenheim's International Law 295 and n.1 (H. Lauterpacht edn., 1955). c.f. United States v. Humberto Alvarez Machain, [1824] 22 US 391.

54 *The Case of the S.S. "Lotus"*, 1927 PCIJ (Ser. A.), No. 10.

55 *Ibid. See* also, the *Corfu Channel* case where it was held by the International Court of Justice that a British minesweeping operation on Albanian territorial waters was a violation of Albanian sovereignty and international law, as it was conducted without permission from Albania. In this case it was stated that, "*Between independent States, respect for territorial sovereignty is an essential foundation of international relations*", *The Corfu Channel Case* (United Kingdom v. Albania), 1949 ICJ 4.

Specifically in the context of revenue matters, we may derive persuasive value from the ruling of the United States Supreme Court in the 1824 case of *The Apollon*[56] where it was held that it was not permissible for American revenue authorities to seize a foreign vessel docked in a Spanish port.[57] Justice Story held as follows:

> …however general and comprehensive the phrases used in our municipal laws may be, they must always be restricted in construction to places and persons, upon whom the legislature has authority and jurisdiction… It would be monstrous to suppose that our revenue officers were authorized to enter into foreign ports and territories, for the purpose of seizing vessels which had offended against our laws. It cannot be presumed that Congress would voluntarily justify such a clear violation of the laws of nations.[58]

Thus the position in international law seems clear that a country cannot enforce its laws on the territory of another sovereign unless authorized to do so by international custom or the express consent of the other sovereign.[59] The next section will discuss how this should impact our interpretation of section 195.

(ii) Reading down section 195

There is a general presumption as to the territoriality of statutes, in the absence of express language to the contrary.[60] As the Act does not clearly specify applicability of the provision to non-resident payers, the term 'person' should necessarily be interpreted as meaning 'resident' payers.

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56 In Re The Apollon, [1824] 22 U.S. 362.

57 In the case of Government of India v. Taylor, [1955] AC 491, it was stated per Lord Somervell of Harrow that, Our courts will apply foreign law if it is the proper law of a contract, the subject of a suit. Tax gathering is not a matter of contract but of authority and administration as between the State and those within its jurisdiction… it would be remarkable comity if State B allowed the time of its courts to be expended in this regard the tax gatherers of State A.

58 *Ibid.*

59 *See*, King of Hellenes v. Broston, (1923) 16 LI.L. Rep. 190; *In Re* Visser, Queen of Holland v. Drukker, [1928] Ch. 877; Sydney Municipal Council v. Bull, [1909] 1 KB 7 c.f. Government of India v. Taylor, [1955] AC 491.

60 Jagir Kaur v. Jaswant Singh, AIR 1963 SC 1521 (Supreme Court of India); Kerala v. Malayalam Plantation, AIR 1964 SC 1722 (Supreme Court of India).

Further, there is a presumption that the Legislature intends to respect the rules of international law.[61] Therefore, if the rule in international law is that a sovereign shall not act on the territory of another sovereign unless authorised, the presumption is that the Legislature would act within the boundaries of this rule unless specified to the contrary.[62] This implies that our enforcement provisions relating to seizure, recovery etc. are limited to the territory of India, which suggests that the withholding provisions should also be considered applicable only to the extent that the Indian revenue authorities can initiate recovery when there is failure to withhold.[63]

It is on this ground that the commentary by Kanga and Palkhivala states, that section 195 cannot apply to non-resident payers:

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61 Maneka Gandhi v. Union of India, AIR 1978 SC 597 (Supreme Court of India). In the leading commentary by Justice GP Singh on the interpretation of statutes, it has been stated that, "*The presumption that a statute is not intended to apply to persons outside the territories of the State enacting it is particularly strong in the case of foreigners, for as to them the normal presumption is further strengthened by another presumption that the Legislature intends to respect the rule of International Law*". G.P. Singh, Principles of Statutory Interpretation 589 (11th edn., 2008).

62 Halsbury's Laws of England, Volume 36, 414; *Ex Parte Blain*, 12 Ch. D. 522, states that,

[The] broad, general, universal principle that English legislation, unless the contrary is expressly enacted or so plainly implied as to make it the duty of an English court to give effect to an English statute, is applicable only to English subjects or to foreigners who by coming into this country... But, if a foreigner remains abroad, if he has never come into this country at all, it seems to me impossible to imagine that the English legislature could have ever intended to make such a man subject to particular English legislation.

63 In the case of CIT v. B.C. Srinivasa Shetty, [1981] 128 ITR 294 (Supreme Court of India), the Supreme Court refused to apply a charging provision on the grounds that its application was not supported by the relevant computation provision. It was stated that:

[The] charging section and the computation provisions together constitute an integrated code. Where there is a case to which the computation provisions cannot apply at all, it is evident that such a case was not intended to fall within the charging section… the legislative pattern discernible in the Act is against such a conclusion. It must be borne in mind that the legislative intent is presumed to run uniformly through the entire conspectus of provisions pertaining to each head of income.

It is also a fundamental principle of statutory interpretation that the Act should be read as a whole. *See,* Philips India Ltd. v. Labour Court, (1985) 3 SCC 103 (Supreme Court of India); Osmania University Teachers Association v. State of AP, AIR 1987 SC 2034 (Supreme Court of India). If the legislative intent is presumed to run uniformly through the Act, then the withholding provisions should be read in light of what is possible to enforce under the enforcement provisions in case of a default on withholding. Thus if international law considerations restrict our power of seizure and recovery on the territory of another sovereign, the presumption should be that section 195 cannot be made applicable with respect to non-resident payers who have no presence or property on the Indian territory, especially as the provision does not specifically cover such payers.

> This section does not apply to payments made outside India by one foreigner to another even if the other has rendered services in India. A country does not recognize or enforce the revenue laws of another country. Therefore, if a payer in a foreign country, bound to make the payment under a contract governed by the laws for that land, were to seek to deduct Indian income tax, the payee would be entitled to object to the deduction on the ground that no deduction can be made in that country, which is not authorized by the laws of that country or by the terms of the Agreement.[64]

This seems to be the correct position in law. However, in practice revenue authorities continue to apply section 195 to payments by one non-resident to another. Most recently, and infamously in the case of *Vodafone*,[65] a non-resident payer was issued a show cause notice for failure to withhold tax on payments made to another non-resident, in relation to consideration for transfer of a non-Indian asset.

Some of the support for this view seems to be on the ground that the Indian *charging* provisions can apply extraterritorially. In *Eli Lilly*[66] which involved the extraterritorial applicability of section 192, it was held that,

> …it cannot be stated as a broad proposition that the TDS provisions which are in the nature of machinery provisions to enable collection and recovery of tax are independent of the charging provisions which determines the assessability in the hands of the employee-assessee…. Therefore, if any payment of income chargeable under the head "Salaries"" falls within Section 9(1)(ii) then TDS provisions would stand attracted.

What *Eli Lilly*[67] failed to consider is that the machinery provisions include not only withholding, but also the enforcement provisions contained in the Act. To the extent that the enforcement provisions cannot apply, there is a presumption that the machinery provisions should not apply. To this extent there is a difference between the extraterritorial applicability of charging provisions which are governed by the limitations on 'prescriptive jurisdiction', and machinery provisions which are governed by the limits of 'enforcement jurisdiction'. This

64 J.B. Kanga & N.A. Palkhivala, The Law and Practice of Income Tax (9th edn.).

65 Vodafone International Holdings BV v. Union of India, [2009] 311 ITR 46 (High Court of Bombay).

66 CIT v. Eli Lilly & Co, [2009] 312 ITR 225 (Supreme Court of India).

67 CIT v. Eli Lilly & Co, [2009] 312 ITR 225 (Supreme Court of India).

point of difference between the extraterritorial scope of charging and enforcement provisions was correctly appreciated in the case of *Clark* v. *Oceanic*,[68] in which the House of Lords held that a British withholding tax provision could not apply to a non-resident.[69] It was stated by Lord Lowry that "*there is nothing to establish that personal chargeability (expressly imposed, I may add) has any rational or legal connection with a duty (allegedly created by implication) to make deductions in respect of the chargeability of others*".

Previous cases which have examined the extraterritorial application of enforcement provisions have looked at enforcement relating to Indian property.[70] It is uncertain how section 195 will be sought to be enforced in a situation where the person required to withhold has no presence in India.

III. The Policy Arguments on Section 195

The policy analysis on enforcement provisions needs to keep in mind the discourse on the connections between taxpayer's rights and human rights. "*It is generally accepted that taxpayer's rights should be identified and interpreted as a species of human rights and in the context of the international human rights obligations into which states have entered.*"[71] Further, the international community recognizes that, particularly in procedural areas, there is great need for and support of taxpayer's rights.[72]

For example in the case of *Hentrich*,[73] where the French tax administration had a right to acquire undeclared real estate at a 10 percent premium, the European Court of Human Rights held, in the context of the European Convention on Human

68 Clark v. Oceanic, [1983] 2 WLR 94.

69 It is relevant to mention that in the recent case of Agassi v. Robinson, [2006] UKHL 23, the withholding tax obligation was considered to be applicable to non-resident payers. However, commentators are of the view that unlike in the case of *Clark*, the statutory provision in *Agassi* was clear as to the applicability to non-residents. (*See*, C. Norfolk, *Agassi v. Robinson: Territorial Limitation on Withholding Obligation – Some Confusion in the House of Lords*, [2006] 6 Brit. Tax Rev. 684). In a situation where specific language is absent from the provision, the presumption should continue to lie against the application of such a provision to non-residents.

70 *See*, Ram Kumar Dhanuka v. Union of India, [2001] 252 ITR 205 (High Court of Rajasthan).

71 D. Bentley, Taxpayer's Rights: Theory, Origin and Implementation 48 (1st edn., 2007).

72 Persson-Osterman demonstrates that particularly in procedural areas, the ECHR has strengthened taxpayers' rights. *See*, Bentley, 42.

73 Hentrich v. France, 296A Eur. Ct. H.R. (1995).

Rights, that while the collection of taxes did not violate the taxpayer's civil right to protection of property,

> [There] must also be a reasonable relationship of proportionality between the means employed and the aim sought to be realized… A fair balance must be struck between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights, this balance being destroyed if the person concerned has had to bear an individual and excessive burden.[74]

What constitutes this 'fair balance'? When we determine whether our withholding tax provisions achieve this fair balance, it is as important for us to understand their policy objectives as well as determine whether the actual provision satisfies such policy objectives. For example if the provisions are intended at simplification of collection mechanisms through advance collection of tax, the actual withholding provisions should not aim to exclude non-taxable amounts or transactions which would add to the administrative complexity of tax collection. This policy analysis will examine what we are trying to accomplish through section 195, how we are we trying to accomplish it, and whether we are successful.

A. Should the provision be extended to trading receipts?

A withholding tax intends to simplify the process of tax collection by requiring the payer to withhold tax, prior to assessment. Therefore, while the taxpayer continues to be taxable under the provisions of the Act, and while withheld amounts do not generally represent the final liability of the taxpayer, there is a presumption that the withholding relates to taxable amounts. In situations involving contingent income, it does not appear justifiable for the taxpayer or economically efficient for the revenue to require that tax should be withheld. This also appears to be the approach taken by most countries with respect to their international withholding tax provisions. Commentators Hugh Ault and Brian Arnold state, in their leading work on comparative taxes,[75] that,

> All of the systems here under consideration impose a gross based withholding tax on certain categories of income. Sometimes the withholding tax is part of the domestic system and is applied to

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74 *Ibid*.

75 H. Ault, B. Arnold *et al*, Comparative Income Taxation – A Structural Analysis (2nd edn., 2004).

> residents and non-residents alike, although for non-residents it represents a final tax. In other cases the withholding tax is aimed only at foreign persons. The income subject to withholding tax is typically investment type income that is not connected with a business activity and that is deemed to have a domestic source. Thus the structural rules involve issues as to the classification of the income by type as well as source.[76]

Further, Victor Thuronyi states, in his book on Comparative Tax Law, that,

> Virtually all countries withhold tax on wages… A few countries such as Colombia, impose ex-tensive withholding on other types of domestic payments. Withholding on payments to non-residents is, of course, typical, and the resulting tax normally is a final one. The main difference, therefore, lies in the extent to which withholding is used as a collection device in the case of domestic payments other than wages. Only a few countries make extensive use of withholding on domestic payments other than wages, interest and dividends.[77]

There seem to be two important points to note from the comparative tax commentaries referred to above:

1. **Kinds of income covered**: Internationally, non-resident withholding taxes are only applied to passive investment incomes on a scheduler basis. Passive income does not generally involve a significant cost component, and is also an area of concern for revenue authorities on account of increased capital mobility in the globalised world. A solution is to require the resident payer to withhold taxes upon payment to the non-resident of specified passive incomes.

2. **Presumptive tax**: Internationally, the withholding tax on non-residents typically represents a final tax. Non-residents are thus taxed on a presumptive basis on certain kinds of income, unlike residents who may be taxed on their total income. For example in the Indian context, section 115D provides specific means of computation in relation to certain passive income of non-residents, and section 115E prescribes a separate, lower rate of tax which presumes the income component of such passive income payments. The withholding tax rates applicable to non-residents earning such income are equal to the prescribed presumptive rates, thus doing away with the requirement of future adjustments.

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76 Ault *et al*, 406.

77 V. Thuronyi, Comparative Tax Law 210 (1st edn., 2003).

Both these positions are in line with the justification for imposition of a withholding tax. When the Indian international withholding tax is structured as a catch-all provision, it involves an increased possibility that tax refunds would be required – thus resulting in administrative complexity which is problematic both for the revenue authorities as well as the taxpayer.

B. Should the requirement to withhold tax be applied to non-residents?

In the section above on reading down section 195, we discussed how our international law obligations should result in a narrow interpretation of section 195. Even from a policy perspective, it does not appear desirable that a provision intended at simplification of tax collection should attach withholding requirements to a non-resident payer who is as remote as (or possibly, remoter) compared to the actual taxpayer. In such situations, it would appear more logical for the tax authorities to directly recover tax from the taxpayer, especially considering that the actual taxpayer is more likely to have a presence in India against which tax can be enforced.

IV. Conclusion

The confusion surrounding the applicability of section 195 to trading receipts and payments between non-residents seems to stem primarily from a misunderstanding of the statute and basic principles of tax system design, rather than a void in the statutory framework. Nothing in the statutory framework seems to support imposition of withholding tax on trading receipts and payments by non-residents. Neither do policy considerations support future imposition of such a tax.

What we need to keep in mind is that a withholding tax is merely a pre-assessment method of collection of revenue. It is not the sole collection method, and the ultimate liability for payment continues to remain with the taxpayer. A withholding tax can, by its very nature, trigger only when there is certainty as to the existence of income. It can by its very nature be applicable only when such application simplifies the process of tax collection rather than promoting a refund system. Hopefully subsequent rulings on section 195 will come to the aid of the harrowed tax payer by giving due consideration to these aspects.