TDS on Commission Paid To Foreign Agents—Divergent Views!

Over the past few decades, India's contribution to the international trade has increased noticeably. This steep rise in India's share in the international trade could not be possible if the Indian enterprises wish to carry out their operations entirely from India. For better exploitation of the business opportunities available in the overseas markets, the Indian enterprises have increased the appointments of foreign agents who work on commission basis for the Indian businesses. The issue that arises in such type of transactions is that, whether the Indian enterprise is required to deduct, from the payment made to the foreign agent, tax at source under the Income-tax Act, 1961 (the Act). If at all, the tax is required to be deducted, then it has to be deducted under which section of the Act.

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Introduction

Over the past few decades, India's contribution to the international trade has increased noticeably. Just to put the things into perspective: India's total merchandise trade increased over three-fold from US$ 252 bn in FY 2006 to US$ 792 bn in FY 2012. Furthermore, the Exports-GDP ratio increased from 12.3% in FY 2006 to 16.3% in FY 2012[1].

[1] Source: http://www.eximbankindia.com/fore-trade.pdf

In Section 195(1), the crucial expression is 'any other sum chargeable under the provisions of this Act'. It would thus mean that the person making payment to the non-resident would be liable to deduct tax if the payment so made is chargeable to tax under the Act.

This steep rise in India's share in the international trade could not be possible if the Indian enterprises wish to carry out their operations entirely from India. For better exploitation of the business opportunities available in the overseas markets, the Indian enterprises have increased the appointments of foreign agents who work on commission basis for the Indian businesses.

The modus operandi in which this transaction moves forward is that the Indian enterprise appoints a foreign party as its agent for the purpose of soliciting customers for the overseas business of the Indian enterprise. The foreign agent explores the overseas market, finds more and more customers and then forwards the list of such probable customers to the Indian enterprise. Then, the Indian enterprise deals with such probable customer on its own, carries forward the export to such customer and finally, realises the sale consideration from the customer on its own account directly. For the services rendered by the overseas agent, he is paid an export commission by the Indian enterprise.

The Issue

The issue that arises in such type of transactions is that whether the Indian enterprise is required to deduct, from the payment made to the foreign agent, tax at source under the Income-tax Act, 1961 (the Act for short). If at all, the tax is required to be deducted, then it has to be deducted under which section of the Act.

Analysis

Article 265 of the Constitution of India states that no tax shall be levied except by authority of law. There are three stages in imposition of a tax. There is the declaration of liability; that is the part of the statute which determines what persons in respect of what property are liable. Next, there is the assessment. Liability does not depend on assessment that *ex hypothesis* has already been fixed. But the assessment particularises the exact sum which a person liable has to pay. Lastly come the methods of recovery, if the person taxed does not voluntarily pay [*Lord Dunedin in Whitney v. Commissioners of Inland Revenue, (1926) AC 37*, quoted in *Chatturam v. CIT (1947) 15 ITR 302, 308 (FC)*]. It means, for any taxing provision to be levied, there must be a charging prerequisite. In case of payments made to non-residents, Section 195 of the Act deals with the deduction of tax at source from the payments made to such non-residents. The relevant extracts of Section 195 of the Act are reproduced herein for the sake of ready reference:

> *"Any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest or* ***any other sum chargeable under the provisions of this Act*** *(not being income chargeable under the head "Salaries" shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force:....."*

A bare perusal of Section 195 clearly shows that any person responsible for paying to a non-resident any other sum chargeable under the provisions of the Act shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash, or by the issue of a cheque, or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force. In Section 195(1), the crucial expression is 'any other sum chargeable under the provisions of this Act'. It would thus mean that the person making payment to the non-resident would be liable to deduct tax if the payment so made is chargeable to tax under the Act. Impliedly, if the payment is not chargeable to tax under the Act, the payer would not be liable to deduct tax at source. The chargeability to tax mentioned in the above provision is directly linked with Section 4 which is the main charging section. In other words, if the charge under Section 4 fails, automatically Section 195 would be inapplicable. Section 195 of the Act will be applicable only if the payment made to the non-resident is chargeable to tax. At this instant, it would be pertinent to refer to the Section 4, the relevant provisions of which are as under:

> *"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".*

Thus, Section 4 makes it evident that the income tax shall be charged for a particular year in accordance with the provisions of this Act. In this regard, Section 5 of the Act which deals with the scope of total income provides, in the case of a non-resident assessee, provides as under:

"(2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which—

(a) is received or is deemed to be received in India in such year by or on behalf of such person ; or

(b) accrues or arises or is deemed to accrue or arise to him in India during such year.

Explanation 1.—Income accruing or arising outside India shall not be deemed to be received in India within the meaning of this section by reason only of the fact that it is taken into account in a balance sheet prepared in India.

Explanation 2.—For the removal of doubts, it is hereby declared that income which has been included in the total income of a person on the basis that it has accrued or arisen or is deemed to have accrued or arisen to him shall not again be so included on the basis that it is received or deemed to be received by him in India."

The plain language of Section 5 provides that in the case of a non-resident assessee, the total income takes within its ambit two types of incomes: one, the income which is received or is deemed to be received in India; and second, the income which accrues or arises or is deemed to accrue or arise to him in India. In the present case, we are concerned with the latter limb of this scope. Section 9 of the Act provides for the income deemed to accrue or arise in India. This is a fiction created by the enactment which is essential in fixation of the charge under the Act. The relevant extracts of Section 9 are reproduced herein for the sake of ready reference:

"(1) The following incomes shall be deemed to accrue or arise in India:—

(i) all income accruing or arising, whether directly or indirectly, through or from any ***business connection*** *in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India.*

Explanation 2.—For the removal of doubts, it is hereby declared that "business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident,—

(a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or

(b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or

(c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident:

Provided *that such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having an independent status, if such broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business:*

The crux of the Circular No. 23 dated 23rd July, 1969 and Circular No. 786 dated 7th February, 2000 has been that, as regards extent of profits attributable to India, only that portion of the profit, which can reasonably be attributed to the operations of the business carried out in India, is liable to tax.

Provided further *that where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident (hereafter in this proviso referred to as the principal non-resident) or on behalf of such non-resident and other non-residents which are controlled by the principal non-resident or have a controlling interest in the principal non-resident or are subject to the same common control as the principal non-resident, he shall not be deemed to be a broker, general commission agent or an agent of an independent status.*

(ii) ...
(iii) ...
(iv) ...
(v) ...
(vi) ...

(vii) income by way of ***fees for technical*** *services payable by—*

a. the Government ; or

b. a person who is a resident, except where the fees are payable in respect of services utilised in a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India ; or

c. a person who is a non-resident, where the fees are payable in respect of services utilised in a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India :

Provided *that nothing contained in this clause shall apply in relation to any income by way of fees for technical services payable in pursuance of an agreement made before the 1st day of April, 1976, and approved by the Central Government.*

Explanation 1.—……

Explanation 2.—For the purposes of this clause, "fees for technical services" means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head "Salaries".”

Issuance of Circular No.7/2009 by CBDT (withdrawing Circular Nos. 23 & 786) and the ruling of the AAR in the case of *SKF Boilers* and *Driers Pvt Ltd*, the pandora's box has been opened and the matter has again become an issue for litigation.

Section 9, as aforesaid, creates a legal fiction and provides that certain income shall be deemed to accrue or arise in India. In the present case, we are concerned with clause (i) and clause (vii) of the Section 9(1). Let us analyse each of these clauses one-by-one:

Section 9(1)(i): Business connection

- The plain language of Section 9(1)(i) of the Act provide that all income accruing or arising, whether directly or indirectly, through or from any business connection in India, shall be deemed to accrue or arise in India. Applying the above legal provisions of the Act to the factual matrix of the case, it becomes apparent that the question which needs to be addressed is that whether the income earned by foreign commission agents, whose work is limited to soliciting customers in relation to the overseas business of the Indian enterprise and forwarding the list of such probable customers to the Indian enterprise, accrues or arises from any business connection in India. In other words, does this foreign agents commission have any business connection with India.
- This matter has been the subject matter of various Circulars issued by the Central Board of Direct Taxes (CBDT). The relevant extracts of one such Circular (*Circular No.23 dated 23-July-1969*) is as under:

“Foreign Agents of Indian Exporters: - A foreign agent of Indian exporter operates in

his own country and no part of his income arises in India. His commission is usually remitted directly to him and is, therefore, not received by him or on his behalf in India. ***Such an agent is not liable to income-tax in India on the commission.****"*

- The abovementioned Circular No. 23 mentioned that the foreign agents of Indian exporters are not liable to income tax in India on the commission. This Circular was relied by the Honourable Supreme Court of India in the case of *CIT vs. Toshoku Ltd* reported at *(1980) 125 ITR 525 (SC)* wherein the Apex Court held as under:

  "...if no operations of business are carried out in the taxable authorities, it follows that the income accruing or arising abroad through or from any business connection in India cannot be deemed to accrue or arise in India... ***The commission amounts which were earned by the non-resident assessee for services rendered outside India cannot, therefore, be deemed to be incomes which have either accrued or arisen in India...****"*

Section 9(1)(vii): Fees for technical services

- If the amount paid by the Indian enterprise to the foreign agent is in the nature of 'fees for technical services' as defined in the Explanation 2 to Section 9(1)(vii) of the Act, then such income in the hands of the foreign agent shall be deemed to accrue or arise in India, and consequently, such foreign agent commission shall be chargeable to tax in India, and consequently, the Indian business enterprise shall be liable to deduct tax at source from such foreign agent commission under section 195 of the Act at the rates in force.
- In this regard, the relevant extracts of the ruling pronounced by the Authority for Advance Rulings (AAR), in the case of *Spahi Projects (P) Ltd.* reported at (2009) 315 ITR 374, are as under:

  "...Explanation 2 to Section 9 contains an inclusive definition of business connection but it applies only to a business activity carried out through a person acting on behalf of a non-resident. That situation does not exist here. Where no business operations are carried out in India by Zaikog, the attribution in terms of cl. (a) of the Explanation is not possible and therefore, no income can be deemed to accrue or arise in India merely because Zaikog promotes the business of the applicant in South Africa. As the income of Zaikog on account of the commission paid to it by the applicant is not chargeable to tax in India by virtue of art. 7 of DTAA and s. 9(1)(i) r/w the Explanation thereto, the applicant is not obliged to deduct the tax at source under s. 195...

  There could possibly be no controversy that Zaikog will not be rendering services of a managerial, technical or consultancy nature and therefore, the liability to tax cannot be fastened on it by invoking the provisions dealing with fee for technical services..*"*

- Thus, the AAR, in the above case, has categorically stated that the amount paid by an Indian business enterprise to its foreign agent as commission will not be covered in the definition of 'fees for technical services' as defined in the Explanation 2 to Section 9(1)(vii) of the Act.

Judgment of the Supreme Court in the case of *Toshoku Ltd.* is still the law of the land as regards the applicability of TDS provisions to foreign agents' commission paid by Indian exporters.

TDS liability under section 195 of the Act

Once it is established that the amount of commission paid by the Indian enterprise to its foreign agent is not chargeable to tax under the provisions of the Act, it becomes evident that the payer of such commission shall not be required to deduct tax at source under section 195 of the Act from such commission.

This position has been further strengthened by the clarification given by the CBDT in its Circular No. 786 dated 7th February, 2000. The relevant extracts of the said circular are reproduced herein for the sake of ready reference:

"The deduction of tax at source under section 195 would arise if the payment of commission to the non-resident agent is chargeable to tax in India. In this regard attention to CBDT Circular No. 23 dated 23rd July, 1969 is drawn where the taxability of 'Foreign Agents of Indian Exporters' was considered alongwith certain other specific situations. It had been clarified then that where the non-resident agent operates outside the country, no part of his income arises in India. Further, since the payment is usually remitted directly abroad it

cannot be held to have been received by or on behalf of the agent in India. Such payments were therefore held to be not taxable in India. The relevant sections, namely section 5(2) and section 9 of the Income-tax Act, 1961 not having undergone any change in this regard, the clarification in Circular No. 23 still prevails. ***No tax is therefore deductible under section 195*** *and consequently, the expenditure on export commission and other related charges payable to a non-resident for services rendered outside India becomes allowable expenditure."*

A bare perusal of the abovementioned Circular makes it apparent that no tax is required to be deducted by the Indian exporters to their foreign agents since such payments are not taxable in India.

Conflicting Position

The crux of the aforesaid Circulars [Circular No. 23 dated 23rd July, 1969 and Circular No. 786 dated 7th February, 2000] has been that as regards extent of profits attributable to India, only that portion of the profit, which can reasonably be attributed to the operations of the business carried out in India, is liable to tax. Further, the TDS provisions under section 195 of the Act are not applicable on the commission paid by the Indian exporters to their foreign agents. However, subsequently, the CBDT issued Circular No. 7/2009 dated 22nd October, 2009 withdrawing the aforesaid Circulars. The reason mentioned for such withdrawal was that interpretation of the Circular (No. 23 dated 23rd July, 1969) by some of the taxpayers to claim relief is not in accordance with the provisions of section 9 of the Income-tax Act, 1961 or the intention behind the issuance of the Circular (No. 23 dated 23rd July, 1969). As a result, the matter became a subject of opposing views.

Furthermore, the AAR, in the case of *SKF Boilers and Driers Pvt. Ltd.* reported at (2012) 248 CTR (AAR) 121, has pronounced the following ruling:

"We are concerned with the source of income of the two non-resident agents who had earned commission from the business activity of the applicant. Sections 5 and 9 of the Act thus proceed on the assumption that income has a situs and the situs has to be determined according to the general principles of law. The words 'accrue' or 'arise' occurring in section 5 have more or less a synonymous sense and income is said to accrue or arise

when the right to receive it comes into existence. No doubt the agents rendered services abroad and have solicited orders, but the right to receive the commission arises in India when the order is executed by the applicant in India. The fact that the agents have rendered services abroad in the form of soliciting the orders and the commission is to be remitted to them abroad are wholly irrelevant for the purpose of determining the situs of their income. We follow the ruling of this Authority in [Rajive Malhotra AAR 671 of 2005, 284 ITR 564]. We therefore hold that the income arising on account of commission payable to the two agents is deemed to accrue and arise in India, and is taxable under the Act in view of the specific provision of Section 5(2)(b) read with section 9(1)(i) of the Act. ***The provision of section 195 would apply, and the rate of tax will be as provided under the Finance Act for the relevant year."***

Conclusion

After the above discussion, one thing is certain that post the issuance of Circular No.7/2009 and the ruling of the AAR in the case of *SKF Boilers and Driers Pvt Ltd (supra)*, the pandora's box has been opened and the matter has again become an issue for litigation. Having said that, one thing that still remains in favour of the non-applicability of the TDS provisions under section 195 of the Act is that as on date, the judgment of the Hon'ble Supreme Court in the case of *Toshoku Ltd. (supra)* is still the law of the land as regards the applicability of TDS provisions to foreign agents' commission paid by Indian exporters. ■