Obtaining PAN by Non-Residents in India - Objectives and Implications

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Every non-resident entering into transactions with Indian payers is now familiar with the requirement of obtaining a Permanent Account Number (or PAN) in India to avoid higher withholding of tax at source. While the tax authorities have initiated this move to build up a database and strong information network, non-residents are finding it tricky to deal with such a requirement. There is fear that this move will enable the tax authorities to track every transaction, enforce statutory compliance and which eventually would entail a detailed verification of such non-resident by the authorities. Those planning a structured entry into India by avoiding a Permanent Establishment (PE) at the initial stages are more concerned.

This article aims to address various issues emerging out of the PAN requirement. It provides a pragmatic view on the legislature's basic intent to introduce such a requirement, statutory need for PAN enrollment, implications and suggested course of action.

Let's first take a step back and understand what the law has to say on PAN requirement. India Fiscal Budget 2009 made it mandatory for payers to obtain a PAN from payees effective April 1, 2010, failing which, the transaction suffers a minimum withholding of 20 percent. The intent, as indicated above, was just to strengthen internal databases. This issue of higher tax withholding is particularly important for non-residents since in most cases their income is taxable at 10 percent, which in absence of a PAN, suffers a 20 percent withholding. In other words, the recipient of income must flash a PAN in all the cases to avoid higher tax withholding, even when India has agreed to charge a lower rate (generally 10 percent) through the relevant tax treaty.

The overriding nature of this requirement gave rise to a controversy which was advocated by two contradicting views. Firstly, given the settled position in law, provisions of the tax treaties override the local tax regulations and thus, the procedure for collection and recovery of tax must be aligned to meet provisions of the tax treaties. Tax authorities, therefore, are not empowered to impose a rate higher than the treaty rate. However, at the same time, it can be argued that obtaining PAN is a procedural requirement merely for the purpose of tax withholding, with no apparent bearing on the final tax liability of the payee. The non-resident payee retains an option to file tax return in India and claim excess taxes withheld by the payer of income. In that sense, the requirement to withhold higher taxes, at best, operates as 'retain and refund' mechanism and thus the condition to obtain PAN holds merit.

Another issue which is vital for this discussion is whether all payments are subject to higher tax withholding or only those which give rise to tax liability in India are covered? Well, the answer is contained in the text of the legal provision itself which clearly state that only taxable transactions are subject to PAN requirement. In other words, in case the transaction is not taxable in India (whether due to an exemption in the local laws or operation of tax treaty), the requirement to obtain a PAN does not arise. However, this is easier said than done since the onus to withhold tax at source rests with the payer and convincing the payer is indeed, a challenging task. This

becomes even more challenging when the payers are vulnerable to tax litigations or in case of those transactions where the tax implications are subject to interpretation of tax treaties. Thus, in order to make an effective representation before the payer, the payee needs robust documentation and sound professional opinion backed by judicial precedence. Besides establishing a case for non-taxability, this will significantly mitigate the risk of attracting penal implications to the Indian payer in the event of a tax proceeding against such payer.

It is a general impression that obtaining PAN would enforce statutory compliances and thus indirectly lead to exposing the non-resident to a PE situation in India. This is a pure myth; and is best avoided. It is settled position that a PE or 'Business Connection' comes into play strictly on the basis of direct / indirect presence of non-resident in India or specific functions performed in India. With an improved information network through PAN, the tax authorities can at best make enquiries to ensure that no PE exists in a specific transaction. It is not possible for the authorities to initiate detailed verification proceedings without specific material / information on existence of PE or Business Connection in India. Thus, unless the transaction itself is vulnerable, there is no compelling reason to carry an impression otherwise.

In a situation where the non-resident fails to obtain PAN and suffers higher tax withholding, a question arises whether such excess tax can be claimed as a credit against the final tax liability of the payee in the country of his residence. In this context, one must examine the 'elimination of double taxation' clause of the relevant tax treaty, which in most cases, allows credit of tax in the non-resident's country of residence provided the tax has been withheld in accordance with provisions of such tax treaty. For example, a French company, not having obtained a PAN in India, suffers a higher withholding of 20 percent on gross amount of technical service fee received from an Indian payer. According to article 13 of the Indo-French treaty, the maximum rate of tax on technical services is 10 percent. In such cases, the tax authorities in France may limit the credit of withholding tax to only 10 percent (treaty rate), as against the actual withholding of 20 percent. This would clearly result into a sunk cost of 10 percent of gross technical fee for the French company unless it is successful in obtaining a tax refund from Indian tax authorities by subsequently obtaining a PAN and submitting a tax declaration. It therefore becomes imperative that credit provisions in the relevant tax treaty are closely examined prior to taking any specific position on obtaining PAN in India.

However, given that the non-residents are still apprehensive about obtaining PAN in India, they may insist the Indian payer to enter into tax-protected contracts i.e. entire cost of tax is borne by payer. Such a trend is generally seen in one-off transactions, where the 'perceived' risk-taking ability of the non-resident is low. A tax protected contract involves grossing up of tax liability (20 percent in case no PAN is available), which leads to increased cost of services / inputs to Indian payers and is best avoidable.

To sum it up, this requirement is statutory in nature and given that the objective is mere collection of information and strengthening of database, must be respected in its given form and

substance. While each business may have its own peculiarity, there have not been any notable instances of tax proceedings being triggered due to a mere compliance of obtaining PAN in India. Thus, in our opinion, non-resident businesses must view this requirement as routine business compliance with no strings attached.