

Development Authorities set up under the UP Industrial Area Development Act are not “local authorities” – lease rent paid to such authorities liable to withholding tax

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In brief

The Supreme Court (SC) in its recent decision,¹ held that tax would be withheld on lease rental payments made to Development Authorities set up under the UP Industrial Area Development Act (Development Authorities), as per section 194I of the Income-tax Act, 1961 (the Act) since it did not qualify as local authorities, hence the income exemption criteria as per section 10(20) of the Act was not satisfied.

In detail

Facts

- The Development Authorities had entered into a long-term (90 years) lease with Indian companies engaged in the business of real estate.
- The Indian company made a lump-sum payment towards the lease consideration at the time of execution of lease deed, and the balance was to be paid through annual lease payments.
- The revenue authorities served notice under section 201/ 201(A) of the Act to the Indian companies for not withholding tax under

section 194I and 194A of the Act on annual lease rental and interest payments made to the Development Authorities, respectively.

- The Indian company explained that the tax was not withheld pursuant to the advice received from the Development Authorities that withholding tax provisions were not applicable to them as they are Government authorities.
- The tax officer (TO) reject the contention of the Indian company holding them as “taxpayer-in-default” for non-withholding/ non-deposit of tax on lease rental and interest

payments made to the Development Authorities.

- The Indian company, aggrieved by the assessment and recovery proceedings, filed a writ petition before the Delhi High Court (HC).
- The Delhi HC held that the Development Authorities were not local authorities within the meaning of section 10(20) of the Act, and accordingly withholding tax under section 194I was applicable on lease rental payments.
- With regard to interest payment, the Delhi HC held that the Development Authorities were exempted under 194A(3)(iii)(f) of the

¹ Civil Appeal No. 15613 of 2017 and others

Act *vide* notification² dated 22 October, 1970.

- Section 194(A)(3)(iii)(f) specifies persons notified by the Central Government on whom withholding tax under section 194A of the Act will not be applicable.
- Aggrieved by the Delhi HC's decision the Indian company, Development Authorities and revenue authorities appealed before the SC.

Issues before the Supreme Court

- Whether the Development Authorities are "local authorities" within the meaning of section 10(20) of the Act, and hence, their income is exempt from income tax?
- Whether withholding tax under section 194I of the Act is applicable on lease rental payments made to the Development Authorities?
- Whether withholding tax under section 194A of the Act is applicable on interest payments made to the Development Authorities?

Development Authorities contentions

Exemption under section 10(20)

- The Development Authorities have been constituted under section 3 of the Uttar Pradesh Industrial Area Development Act, 1976. Thus, they are a local authority within the meaning of section 10(20) of the Act.
- The Development Authorities relied on a notification³ to contend that they were municipalities and hence covered under the definition of

"local authorities" under section 10(20) of the Act.

Applicability of withholding tax under section 194I on payment of lease rentals

- The Development Authorities relied on the circular⁴ to contend that they were "local authorities", and hence covered both under section 10(20) and 10(20A) of the Act. Therefore, withholding tax under section 194I of the Act would not be applicable to them.

Applicability of withholding tax under section 194A on interest payments

- Interest income of the Development Authorities was exempted from withholding tax as per section 194A(3)(iii)(f) of the Act.
- The Development Authorities being corporations established by Central/ State/ provisional Act have been notified⁵ by the Government for non-applicability of section 194A of the Act.

Revenue's contentions

- Revenue placed reliance on the Division bench of Allahabad HC's decision,⁶ to contend that the Development Authorities were not local authorities within the meaning of section 10(20) of the Act, as amended by the Finance Act, 2002.
- Accordingly, tax under section 194I of the Act was required to be withheld on lease rental payments made to the Development Authorities.
- The Development Authorities were not entitled to the benefit of exemption under section 194A(3)(iii)(f) of the Act as

they were not corporations established by the Central/ State/ Provisional Act.

Supreme Court's decision

Exemption under section 10(20)

- The SC in its recent ruling⁷ denied the exemption to the Development Authorities on the ground that they were not classified as "local authorities" under section 10(20) of the Act. SC held that the Development Authorities were not covered by the word/ expression of "Municipality" in clause (e) of Article 243P of the Indian Constitution.
- Therefore, in line with its own ruling, it held that since the Development Authorities were not "local authorities", as per section 10(20) of the Act, their income would not be exempt under the Act with effect from 01 April, 2003.

Applicability of withholding tax under section 194I on payment of lease rentals

- The SC observed that the definition of rent as contained in the explanation is a very wide. Accordingly, the annual lease rent paid to the Development Authorities would be covered as rent within the meaning of section 194I of the Act.
- The SC observed that the circular⁴ was issued to cover the entities that were exempt from taxation under section 10(20) and 10(20A) of the Act.
- The SC observed that post the amendment by the Finance Act, 2002 section 10(20A) has been deleted, hence, the circular⁴ was not applicable to the Development Authorities.

² Notification No. S.O. 3489 dated 22 October, 1970.

³ Notification no.6709/77-4-2001-56 Bha/99 issued by the Governor of Uttar Pradesh dated 24 December,2011

⁴ Circular no.599 issued by the CBDT on 22.10.1970

⁵ Notification No. S.O. 3489 dated 22 October, 1970

⁶ Writ Petition Tax No. 1338 of 2005

⁷ CIT v. Canara Bank [2018] 95 taxmann.com 81 (SC)

- Thus, the SC denied the benefit of the above circular⁴ to the Development Authorities on the account that it was not local authority as per section 10(20) of the Act.
- Therefore, the Indian company was liable to withhold taxes on the lease payments made to the Development Authorities.

Applicability of withholding tax under section 194A on interest payments

- The SC held that the issue regarding applicability of section 194A on the Development Authorities had already been decided *vide* its

decision⁷ dated 02 July, 2018.

- The SC in its decision had held that the Development Authorities were entitled to exemption of payment of tax under section 194A as they were corporations established by the State Act.
- Thus, SC held that the Indian company was not required to withhold taxes on interest payments made to Development Authorities.

The takeaways

- This ruling of the SC highlights that post amendment, *vide* the Finance Act, 2002 (i.e. with

effect from 01 April, 2003) only those authorities that are specifically covered in the definition of “local authorities” under section 10(20) of the Act, will be entitled to the benefit of exemption under section 10(20) of the Act.

- Section 194I would not be applicable to only those entitled to claim exemption under section 10(20) of the Act.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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