

EY Tax Alert

Recent updates regarding compliance on payment of rent under Section 194-IB of the Income-tax Act, 1961

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Executive summary

This Tax Alert aims to provide an update on developments in relation to compliance requirement to deduct tax at source (TDS) on rent paid to residents by individuals and / or Hindu Undivided Family (HUF), under Section 194-IB of the Income Tax Act, 1961 (the Act).

The Finance Act 2017 introduced Section 194-IB with effect from 1 June 2017, requiring TDS deduction at 5% where rent paid is higher than INR 50,000 per month. The Finance (No. 2) Act 2024 reduced the applicable rate of TDS to 2% effective 1 October 2024, creating ambiguity for tax deductors regarding the applicable rate of TDS for the Financial Year (FY) 2024-25, particularly for tenancies that continued past this date. Two views emerged on the TDS rate application, leading to practical challenges where tax deductors who deducted TDS taking the conservative view, i.e 5% for period 1 April 2024 to 30 September 2024 and 2% for the period 1 October 2024 to 31 March 2025, are facing discrepancies in the tax credit allowed by the Income-tax department. The Income-tax department is restricting the tax credit to an amount equivalent to 2% on rent for the full financial year creating a challenge for both the tax deductor (tenant) and the tax deductee (landlord). Tenant will have to claim a refund of the "excess" tax deducted as also pay to the landlord the shortfall in rent because of this excess deduction of tax at source. Landlord will have to pay additional tax and interest for the shortfall in tax credit.

Additionally, the Income-tax department has issued notices to taxpayers for non-compliance with TDS provisions while claiming HRA exemptions in previous financial years. Defaulting taxpayers may consider belated compliance.



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Background

- ▶ The Finance Act 2017 introduced Section 194-IB in the Act with effect from 1 June 2017.
- ▶ Section 194-IB requires an individual or HUF, other than specified individuals with business / professional income, to deduct TDS:
 - ▶ Where the monthly rent paid by such person exceeds INR 50,000
 - ▶ The rent is payable to a landlord who is a resident
 - ▶ The TDS is to be deducted at a specified rate.
- ▶ The requirement to deduct TDS arises at the time of credit of rent for the last month of the FY or the last month of tenancy, if the property is vacated during the year, as the case may be, or at the time of payment thereof, whichever is earlier. The Explanatory Memorandum to Finance Bill 2017 and Circular issued by Central Board of Direct Taxes (CBDT)¹ clarifies that it is a one-time annual compliance.
- ▶ The specified rate effective 1 June 2017 was 5%.
- ▶ The Finance (No. 2) Act 2024 reduced the applicable rate of TDS from 5% to 2% effective 1 October 2024.

Update 1: Ambiguity in effective rate of TDS for FY 2024-25

- ▶ Given that the change in TDS rate was implemented during FY 2024-25, there was no explicit clarity provided by the Income-tax authorities regarding the applicable TDS rate where tenancy subsisted as on 1 October 2024 - more particularly, since it is a one-time annual compliance either in March or last month of tenancy, whichever is earlier.
- ▶ This has led to lack of clarity for the tax deductors (tenants) who were required to deduct TDS in March 2025 / last month of tenancy post 1 October 2024, as the case maybe.
- ▶ Section 194-IB(2) of the Act suggests that TDS may be deducted at the rate applicable at the time of crediting rent for the last month of the FY or the last month of tenancy, whichever is earlier. This leads to two views:
 - ▶ **View 1:** TDS should be deducted at the rate of 2% for the entire rent paid during the FY 2024-25, if the deduction occurs post 1 October 2024.
 - ▶ **View 2:** Another approach may be to consider TDS rate of 5% for the period from 1 April to 30 September 2024 and 2% thereafter.

¹ Circular No. 2/2018 dated 15 February 2018

▶ This is illustrated as follows:

Particulars	View 1	View 2
	Rent (in INR)	Rent (in INR)
01 April 2024 till 30 September 2024	3,60,000	3,60,000
01 October 2024 till 31 March 2025	3,60,000	3,60,000
Total Rent for the Financial Year 2024-25	7,20,000	7,20,000
TDS @ 5% for rent paid from 01 April 2024 till 30 September 2024	18,000	-
TDS @ 2% for rent paid from 01 October 2024 till 31 March 2025	7,200	-
TDS @ 2% for rent paid from 01 April 2024 till 31 March 2025	-	14,400
Total TDS payable	25,200	14,400

Practical challenge faced by the tax deductors for FY 2024-25²

- ▶ While deducting tax, the tax deductors (tenants) who opted for View 2 above (the conservative approach), i.e 5% for period 1 April 2024 to 30 September 2024 and 2% for the period 1 October 2024 to 31 March 2025, are facing discrepancies in the tax credit allowed by the Income-tax department.
- ▶ The tax which was deducted by the tax deductors was also duly deposited with the Income-tax authorities when filing the withholding tax return (Form 26QC). However, it has been observed that while processing the said Form 26QC as filed by the tax deductors, the Income-tax department (TRACES) is restricting the tax credit to an amount equivalent to 2% on rent for the full financial year, ignoring the actual tax deducted and deposited. Hence, creating a challenge for both the tax deductor (tenant) and the tax deductee (landlord).

Update 2: Mismatch in HRA claims for past financial years

- ▶ Recently, the Income-tax department has issued letters to multiple individual taxpayers for non-compliance with the provisions of Section 194-IB of the Act where such taxpayers have claimed HRA exemption in their Income-tax returns for past financial years (i.e FY 2023-24 and

earlier), but at the same time have not complied with TDS provisions where monthly rent exceeds INR 50,000.

Practical challenge faced by the tax deductors for past financial years

- ▶ While the letters issued by Income-tax department appears to highlight the TDS non-compliance rightly, the taxpayers, both employees and landlord, are now left with limited options given the due date to amend the Income-tax return for past years has lapsed.

Next steps

▶ For short credit of tax for the FY 2024-25:

Given the Income-tax department has not allowed full tax credit of the tax deducted and duly deposited, the tax deductors (tenants) will need to claim the residual tax as refund via TRACES portal (the tax which was deposited with the Income-tax authorities but not allowed as tax credit) as also pay to the landlord the shortfall in rent payment due to the shortfall in tax credit.

Further, it may be noted that the landlords who have deposited their advance tax as per the provisions of Section 209 of the Act, based on the initial TDS deducted from the rent by the tenant, may face additional interest and tax liabilities, if such full tax credit is not allowed and refund is issued to the tax deductor (tenant).

▶ For mismatch in HRA claims for past tax years:

The taxpayers have not done the requisite compliance with the provisions of Section 194-IB of the Act may consider doing any of the following:

- ▶ Comply with the provisions of Section 194-IB of the Act belatedly. This option may involve practical challenges since the landlord would have already paid tax on the rental income while filing Income-tax return for the respective year.
- ▶ Obtain Form 26A from the landlord and pay the interest as per the provisions of the Act. This is a facility available under the Act in case of TDS defaults to establish that despite such TDS default by the payer, the payee has filed Income-tax return, accounted for relevant income and paid tax on returned income. This absolves the deductor from paying the principal amount of TDS and limits the interest levy till the date of filing of Income-tax return by the deductee. But it does not absolve the payer from penalty unless reasonable cause is shown.

- ▶ File updated tax return under Section 139(8A) of the Act for the respective year to rectify the incorrect HRA claim, where applicable. This requires payment of shortfall of tax, interest and additional tax (on both tax & interest) but relieves the taxpayer from penalty and prosecution.

Comments

These recent updates pertaining to compliance with TDS on rental income highlights Income-tax authorities' focus on transparent reporting, genuine HRA claims and tax compliance.

The taxpayers (both tenants and landlords) are required to consult with their tax advisors for next steps carefully after evaluating the procedural timelines, administrative requirements and costs involved.

This also highlights the need for the taxpayers to understand the compliance requirement for TDS on rental payment and the potential implications of the recent amendments, as well as the importance of regularizing any TDS defaults to mitigate penalties and interest.

Please note the above discussion is applicable to resident landlords. TDS rate and compliance varies in case the landlord qualifies as a non-resident. Further, the ambiguity in rate of TDS under Section 194-IB of the Act arises only for the FY 2024-25 due to change in the rate effective 1 October 2024.

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