EXTRA-TERRITORIAL OPERATION OF TAXING STATUTE: THE INCOME TAX ACT, 1961

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ABSTRACT

Jurisdiction is a sine-quo-non of sovereignty. It's an expression of power which the sovereign expresses over its subjects. While this principle is unambiguous, the power of a sovereign to legislate matters beyond its jurisdiction is a debatable one. There is no express prohibition with regard to the same in international law. But however states have to adhere to the doctrine of nexus in order to avoid arbitrariness. The position with regard to enforcement of taxing statutes beyond its territorial limits also functions on the same principle. It has resurfaced in the recent times especially with regard to the Indian Income Tax Act of 1961.There is no express provision in the Act which lays down that the Act shall have extraterritorial application. However based on the power granted by the parliament under Article 245 of the Indian Constitution it can be inferred that an Act which has extraterritorial operation cannot be declared to be illegal. Many cases have emerged before the Income tax authorities in the recent times with regard to enforcement of the Act vis-à-vis

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non-residents. This is so because the various provisions of the Act seek to charge tax based on particular criteria, for example based on residential status, place of accrual, deeming provisions and business connection. Therefore it can be said that the Act operates extraterritorially only when some nexus is established with the object sought to be taxed. This article seeks to explore this proposition.

The author has first attempted to establish the position in International Law with regard to extraterritorial operation of legislations of sovereign states. An attempt is made to delve into the doctrine of nexus is which is subsidiary to the above stated principle. Later the author has moved to the core issue of this article which is extraterritorial operation of the taxing statutes with special reference to the Income Tax Act, 1961. This involves discussion of various provisions of the Act which entail extraterritorial operation of the Act and also consideration of various topical judicial precedents on the position of Indian judiciary with regard to the same.

I. INTRODUCTION

A. Concept of Legislative Jurisdiction

Jurisdiction of a sovereign state is the power to affect the rights of persons, whether by legislation, by executive decree, or by judgment of the court. A state's jurisdiction flows from and is conditioned by the constituent elements of sovereignty i.e. independence in relation

to other states; territorial and political sovereignty. It is one of the most obvious forms of the exercise of sovereign power.[1]

Jurisdiction can be exercised through legislative, executive and judicial capacity. Legislative jurisdiction is basically the power of the state to enforce its laws or impinge legal interests. There is a however difference between the legislative competence of a country to make extraterritorial laws and their binding nature on the courts on one hand and the enforcement of laws on the other. Ordinarily, legislation does not apply to foreigners in respect of acts done by them outside the domains of the sovereign power enacting. This is one of the rules of international law which requires one state to respect the subjects and the rights of all other sovereign powers.[2]

However it is only a rebuttable presumption that the parliament does not assert or assume jurisdiction which goes beyond the limits established. But if a statute is clearly inconsistent with the international law it must be construed with whatever the effect of such a construction may be. Hence if the legislature in express terms applies to matters beyond its legislative capacity, the courts must obey the English legislature, however contrary to international comity such legislation be.[3]

Therefore although international law on one hand requires the states to respect other states territorial sovereignty it also doesn't prohibit extraterritorial operation of a legislative statute if the same is laid down in unequivocal terms in the municipal legislation.

As Cockburn CJ said in *R.* v. *Keyn:*[4] *"if legislature of a particular country should think fit by express enactments to render foreigners subject to its laws with reference to offences committed beyond the*

[1]Legal Status of Eastern Greenland Case, 1933 P.C.I.J. 48, Series A-B.
[2]R v. Jameson,(1896) 2 Q.B. 425.
[3]Niboyet v. Niboyet,(1878) 4 P.D. 1.
[4]R. v. Keyn,(1876) 2 Ex d 63.

limits of its territory, it would be incumbent on the courts of that country to give effect to the same".

The Permanent Court of International Justice in the case of *SS Lotus* (*France* v. *Turkey*) [5] has held that-

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 and in which it cannot rely on some permissible rule of international law. Such a view would only be tenable if international law contained a general prohibition to states to extend the application of their laws and the jurisdiction of their courts to persons property and acts outside their territory and if, as an exception to this general prohibition, it allowed states to do so in certain specific cases. But this is certainly not the case under international law as its stands at present. *Far from laying down a general prohibition to the effect that states may not extend the application of their laws and the jurisdiction of their courts to persons, and property and acts outside their territory, it leaves them in this respect a wide measure of discretion which is only limited in certain cases by prohibitive rules*; as regards other states, every state remains free to adopt the principles which it regards as best and most suitable…In these circumstances, all that can be required of a state is that it should not overstep the limits which international law places upon its jurisdiction.

Hence it is apparent that international law doesn't limit the territorial jurisdiction of a particular state to its citizens only. Except in few cases, a state can exercise its sovereignty over aliens. It is imperative to note that the above inference is a rather extreme one because international law is being superimposed by what a municipal legislation prescribes. This is why the above cited judgment was met with widespread criticism. Although no legitimate connection was established Turkey's claim over French seaman for act of

[5]France v. Turkey, (1927) P.C.I.J., Series a, No 10.

manslaughter was upheld solely on the basis of Turkey's sovereign power to exercise jurisdiction.

It would therefore be intolerable if states were permitted without any justifying legitimate interest to attempt to control the doings of foreigners in their own countries.[6]

The modified position regarding exercise of legislative jurisdiction can be summarized as follows:

1) The two generally recognized bases for jurisdiction of all types are the territoriality and nationality principles
2) Extraterritorial acts can only lawfully be the object of jurisdiction if certain general principles are observed

- that there should be a substantial and bona fide connection between the subject matter and the source of the jurisdiction.
- that the principles of non-intervention in the domestic or territorial jurisdiction of other states should be observed.
- Jurisdiction is not based upon a principle of exclusiveness; the same acts may be within the lawful ambit of one or more jurisdictions. However an area of exclusiveness may be established by treaty.[7]

Hence, for a state to exercise jurisdiction there has to be some nexus between the person or property and the state seeking to exercise its jurisdiction. This is a more tenable approach because it is unacceptable that extraterritorial operation of legislation should be a matter of sovereign discretion.

[6]Extraterritorial Jurisdiction And The United States Anti Trust Laws, BYIL, 150-151 (1957).

[7] IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 313 (Oxford university Press) (2003).

II. EXTRA-TERRITORIAL OPERATION OF TAXING

A. Position under International Law

We have looked into the legislative competence of a state to legislate with regard to person, property beyond its territorial jurisdiction. Now let us examine the same with reference to taxing statutes.

The principles discussed under the preceding head broadly apply to extraterritorial operation of taxing statutes. The power to tax is one of the attributes of sovereignty and the jurisdiction to exercise the power is coterminous with the bounds of sovereign jurisdiction; it's an incident of sovereignty and is co-extensive with that to which it is incident.[8] The taxing power of a state is unlimited and it is a generally accepted principle of international law that right to tax which is an aspect of sovereignty extends to aliens also.[9]

Further when tax is levied on aliens, the law of nations appears to offer few restrictions beyond the possible requirement that the tax be in a broad sense uniform and general in its operation and in the case of resident alien, income-tax may doubtless be assessed according to the amount of income from whatsoever source derived, and whether or not from assets outside of taxing statute.[10]

Therefore there is no express prohibition or principle which limits the tax jurisdiction of states. However these few restrictions on power of a state to tax and the undisputed right to tax of a sovereign seems good only in theory. This is because in this growing world of transboundary transactions it is not feasible to function with the concept of unfettered right to tax. If it were to be adopted, endless

[8]Joseph H Veale, Jurisdiction To Tax, HLR 32, 587 (1918).
[9]OPPENHEIM, OPPENHEIM INTERNATIONAL LAW256-220 (Oxford University Press 7th ed.,)(2005).
[10] I.P. GUPTA, INTERNATIONAL LAW IN RELATION TO DOUBLE TAXATION OF INCOME56 (LexisNexis Butterworths, New Delhi) (2007).

jurisdiction claims would arise. Therefore are practical limitations to the exercise of unbridled tax jurisdiction by the states.

Statutory imposition of tax on aliens becomes meaningless unless there is some person or property from which it can be recovered within the state. All countries have adopted a pragmatic approach, and do not attempt to exercise jurisdiction over matters, persons or things with which they have absolutely no connection.[11] Hence recognizing the practical difficulty and to avoid friction, states generally refrain from enforcing their taxing statutes to person, or property to which no connection can be established.

B. Position in Various Countries

The above stated principle is illustrated even in other countries. In *Colquhoun* v. *Brooks,*[12] Lord Herschell observed that "The British Income-tax Acts themselves impose a territorial limit, either that from which the taxable income is derived must be situate in the United Kingdom or the person whose income is to be taxed must be resident here."

Even, the US Supreme Court has held that visible territorial boundaries do not always establish the limits of a State's taxing power, but due process requires some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax.[13]

Also in *Imperial Tobacco Co of India* v. *Commr. of Income Tax* [14] it has been held that international law prohibited Pakistan from

[11]Id.

[12]91889]014 AC 493, p 504, 2 TC 490, p 499 (HL). These observations were quoted and applied in Whitney v. IRC, (1926) A.C. 37, 10 T.C. 88 (HL).

[13]Miller Bros v. Maryland,(1954) 347 U.S. 342.

[14]Imperial Tobacco Co of India v. Commr. of Income Tax, (1958) 27 Int LR103. See also Johmon v. Commr of Stamp Duty, (1956) A.C. 331, where an Australian state, a subordinate legislature, was regarded as not competent to levy a tax when there is no relevant territorial connection with the state or no relevant nexus between the taxed property and the state.

imposing its tax on an Indian company resident in India with reference to its profits earned in India. It was stated that a legislature has authority to tax foreigners only if they earn or receive income in the country for which that legislature has the authority to make laws.

Thus, even though states are always trying to stretch their arms as far as possible to bring in revenue and explore every remote avenue, they are also mindful of the fact that arbitrary exercise of tax jurisdiction is unwarranted in international law. Therefore realizing:

(a) The futility of enacting laws which cannot be enforced adequately,

(b) The equality of sovereign states in matters of taxation.

(c) The need for certain minimum standards for the fiscal protection of aliens if there is to be any meaningful intercourse of investment or technology, the jurisdiction to tax aliens in customary international law has come to be intimately associated with certain standards which fall into two main categories:

- Taxation based upon the presence of alien property within the tax jurisdiction
- Taxation based upon the economic activity of the alien within the jurisdiction[15]

Therefore if a person has a property or is carrying out his business in a particular country of which he isn't a citizen then he is subject to the fiscal jurisdiction of that particular country. Although right to tax aliens without any limitations may be theoretically sound, but it's more plausibly and desirable to exercise the same adhering to the standards listed above

[15]AR Albrecht, The Taxation of Aliens Under International Law, BYIL, 145-185 (1952).

C. Position in India

We have understood the basic principle which governs tax jurisdiction under international law. Now let us examine position in India with regard to the same.

Sub-section (1) of 6 of the Independence Act 1947 ran "The legislature of each of the new dominions[16] shall have the power to make laws for that Dominion, including laws having extra-territorial operation". Sub-section (2) enacted "No law or provision of any law made by the legislature of either of the new dominions shall be void or inoperative on the ground that it is repugnant to the law of United Kingdom, or to any order, or to repeal or amend any such Act, order rule or regulations in so far as it is part of the law of Dominion".

It can be deduced from the above that the concept of extra-territorial operation is not of recent origin. These provisions had no restrictions with regards to its operation and were specifically inserted to do away with the limitations contained in the legislations on its operation.

Since then, India has assumed the status of sovereign Independent Republic and it enjoys complete legislative freedom.[17] This power has to be studied with special reference to Article 245 of the constitution of India. Sub-section (2) of Article 245 lays down that "No law made by the parliament shall be deemed to be invalid on the ground that it would have extra-territorial operation". As explained by Justice Kania, C.J., "*In case of sovereign legislature, questions of extra-territoriality of any enactment can never be raised by the municipal courts as a ground for challenging its validity. The legislation may offend the rules of international law, may not be recognized by the foreign courts or there may be practical difficulties in enforcing them*

[16]India and Pakistan.

[17]A.C. SAMPATH IYENGAR, THE LAW OF INCOME TAX (Bharat Law House (P.) Ltd.,New Delhi, 10th ed.)(2005).

but these are questions of policy with which the domestic tribunals are not concerned."[18]

Hence the effect of this provision is that the parliament has been given power expressly by the constitution itself to make legislations which have extraterritorial operation and its incumbent upon the judiciary to give effect to the same without any qualification.

Doctrine of Nexus

Now that it is clear a statute can be given extra-territorial operation by the power granted under Article 245 of the constitution let us now looked at when extra-operation can be given effect.

An Act is said to have extra-territorial operation if it seeks to regulate, punish or directly deal with any act done beyond its territorial limits or seeks to impose a liability on property situate outside its jurisdiction or on a person resident outside.[19]

A parliamentary statute having an extra-territorial operation cannot be ruled out from contemplation in order to sub serve the object, but the object must be linked to something in India,[20]

Hence a state law can have extraterritorial operation subject to the doctrine of territorial nexus. The principle of territorial nexus is well illustrated in the landmark case of *Wallace Bros & Co. Ltd* v. *CIT*.[21] In this case a company which was incorporated in United Kingdom also had a subsidiary in India. The earning from business India contributed substantially to entire income of the company. It was held that India could not only levy an income tax on the portion accruing from India but also on the entire income of the company,

[18]A.H.Wadia v. Income Tax Comissioner, A.I.R. 1949 F.C. 18, 25.
[19]Wallace Bros & Co. Ltd v. CIT, (1945) 13 I.T.R. 39 (FC) affirmed on appeal to Privy Council in (1948) 16 I.T.R. 240 (P.C.); London & South American Investment Trust v. British Tobacco Co., L.R.(1935) A.C. 500; see also Raleigh Investment Co Ltd v. Governor-General in Council, (1947) 15 I.T.R. 332 (P.C.).
[20]Electronics Corporation of India Ltd v. CIT, (1990) 183 I.T.R. 43 (SC).
[21]Wallace Bros & Co. Ltd v. CIT, (1945) 13 I.T.R. 39 (FC).

since there was a sufficient territorial nexus between the company and India for this purpose.

Also in the case of *State of Bihar* v. *Charusila Devi,*[22] the Bihar legislature enacted the Bihar religious Trusts Act 1950, for the protection and preservation of properties appertaining to the Hindu religious trusts. Now question arose whether the Act would apply to trust properties situated outside the State of Bihar. This question arose because there were some cases where part of the property was situated in Bihar and part of the same property outside. The observation of the court is as follows:

"....The question, therefore, narrows down to this in so legislating, has it power to affect trust property which may be outside Bihar but which appertains to the trust situate in Bihar ? In our opinion, the answer to the question must be in the affirmative. The trust being situate in Bihar the State has legislative power over it and also over its trustees or their servants and agents who must be in Bihar to administer the trust. Therefore, there is really no question of the Act having extra-territorial operation. In any case, the circumstance that the temples where the deities are installed are situate in Bihar, that the hospital and charitable dispensary are to be established in Bihar for the benefit of the Hindu public in Bihar gives enough territorial connection to enable the legislature of Bihar to make a law with respect to such a trust. This Court has applied the doctrine of territorial connection or nexus to income-tax legislation, sales tax legislation and also to legislation imposing a tax on gamblingHence, so long as the Act selected some fact or circumstance which provided some connection or territorial nexus between the person who is subject to the tax and the country imposing the tax, its validity would

[22] State of Bihar v. Charusila Devi, A.I.R. 1959 S.C. 1002; Anant Prasad Lakshminiwas Ganeriwal v. State of A.P., A.I.R. 1963 S.C. 853; Shrikant Bhalchandra Karulkar v. State of Gujarat, (1994) 5 S.C.C. 459; State of Bombay v. RMDC, A.I.R. 1957 S.C. 699.

not be open to challenge on the ground that it is extra-territorial in operation…

Thus after a perusal of the above judgments it can inferred that the courts considered two things while deterring the extra-territorial operation of a legislation. The connection must be real and not illusory; there has to be a definite nexus and second, this connection should be attributable to the person or property sought to be charged. In the *Chaurusali Devi case* discussed above it could be argued that since the 1950 Act had the effect of affecting property situated outside its extraterritorial in nature. But here it is pertinent to note that merely because, while giving effect to a legislation within a territory, it has effect on the property situated outside its territory a law cannot be said to be extra-territorial.

D. Provisions of Income Tax Act which Entail Extraterritorial Operation

a) § 9(1) (I)

Below discussed are some of the provisions of the Income Tax Act which entail the extra territorial operation of the Act.

§ 9 deals with what categories of income are deemed to accrue or arise in India. *InRe Mustaq Ahmed* [23] has laid down the scope of § 9 as, certain income is deemed to accrue or arise in India, even though it may actually accrue or arise outside India. This section applies to all assesses irrespective of their residential status and place of business. Hence it can be seen that this section seeks to bring the income within its ambit by way of a deeming fiction which reflects upon the extra-territorial nature of the Act.

Further § 9(1) (i) deals with the concept of business connection. A business connection involves a relation between a business carried on by a non-resident which yields profits or gains and some activity in

[23]In Re Mustaq Ahmed, (2009) 176 Taxman 65 AAR New Delhi.

India which contributes to the earning of these profits or gains. A business connection can also arise between a non-resident and a resident if both of them carry on business and if non-resident earn income through such a connection.[24]

In the recent case of *Worley Parsons Services Pty. Ltd., In Re* [25] the court has laid down the meaning of business connection thus in order to be "effectively connected", the Permanent establishment should be engaged in the performance of royalty generating services. There must be a real and intimate connection and clear co-relation between the services giving rise to royalty and the permanent establishment.

Therefore when you seek to tax a permanent establishment business connection must be proved. Because it may so happen that the business carried out by the permanent establishment is not related to that of the main company.

Laso in another recent case of *CIT* v. *Eli Lilly and Company (India)*[26] the Court relying on the commentary by *Kanga, Palkhivala & Vyas, The Law and Practice of Income Tax,*[27] on the question of extra-territorial operation of the 1961 Act, has held thus:

> *"The general concept as to the scope of income-tax is that, given a sufficient territorial connection or nexus between the person sought to be charged and the country seeking to tax him, income-tax may extend to that person in respect of his foreign income. The connection can be based on the residence of the person or business connection within the territory of the taxing State; and the situation within the State of the money or property from which the taxable income is derived Applying the above test, if payments of home salary abroad by foreign company to expatriate has any connection or nexus with his*

[24]CIT v. Ashok Jain, (2002) 121 Taxman 328 (Del.).
[25]Worley Parsons Services Pty. Ltd., In Re, (2009) 312 ITR 273 AAR.
[26]CIT v. Eli Lilly and Company (India) Pvt. Ltd., (2009) 312 ITR 225 SC.
[27] KANGA, PALKHIVALA &VYAS, THE LAW AND PRACTICE OF INCOME TAX 10 (LexisNexis Butterworths, 7th ed.).

rendition of service in India, then such payment would constitute income which is deemed to accrue or arise to the recipient in India."

Therefore in deciding whether there exists a business connection various considerations come into play. For example if a person is acting on behalf of his employer, as an agent then the extent of authority of the agent, whether the employer carries out his business activities through the agent, the authority of the agent to act on behalf of the employer etc. All these are crucial in determining whether the Act can be applied extra-territorially since all these create a nexus with the object sought to be taxed.

b) § 9 (1) (II)

Sub-section (ii) of the same section provides that income earned under the head salaries is deemed to accrue or arise at the place where the services is rendered. Therefore if the service is rendered in India but the payment is made outside India still the income is deemed to have arisen in India. However sub-section (iii) of the § 9 further provides that salary paid by Indian government to an Indian national is deemed to accrue in India even if the salary is paid outside India.

The above provisions in a way are extra-territorial in nature because they seek to bring within their ambit even the payment which was made outside in India. These provisions however cannot be held to be arbitrary because the accrual of the salary in India and in case of Sub-section (iii) nationality is taken into consideration. These are sufficient grounds to bring salary income within the purview of Income Tax Act.

c) § 9 (1) (V), (VI) AND (VII)

Sub-Section (v), (vi) and (vii) of § 9 deal with income by way of interest payable, by way of royalty and by way of fees for technical services. The relevant portion of the section is being provided below

(*v*) income by way of interest payable by

(*a*) The Government; or

(*b*) a person who is a resident, except where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of 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 interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person in India;

(*vi*) income by way of royalty payable by

(*a*) the Government; or

(*b*) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of 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 royalty is payable in respect of any right, property or information used or services utilised for the purposes of 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:

(*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:

Now the explanation to these sub-sections is what has to be considered. It reads as-

for the removal of any doubts, it is hereby declared that for the purposes of this § where income is deemed to accrue or arise in India under clauses (v)(vi) and (vii) of Sub-section (1), such income shall be included in the total income of the non-resident, whether or not the non-resident has a residence or place of business or business connection in India.

Under this explanation if the income falls under any one of the heads mentioned in clauses (v), (vi) and (vii) then, income of a non-resident will deemed to have arisen in India without the requirement of residence or business connection. This overtly reflects upon the extra-territorial nature of the Act since it doesn't take into account the doctrine of nexus.

Predictably the question of constitutionality especially of § 9 (1) (vii) was referred by the Supreme Court to a larger bench. The Supreme Court very aptly pointed out that the issue here is whether the various heads mentioned under § 9 (1) (vii) adhere to the nexus principle or not. The Supreme Court held that the issue is one of substantial importance as it concerns collaboration agreements with foreign companies and others for development of industry and commerce in the country.

An opinion of the same reflected in *Kanga, Palkhivala & Vyas, The Law and Practice of Income Tax'*[28] is worth making a mention:

"If the scope and validity of these clauses are questioned before a court of law, the alternatives before the court would be either to strike down the provisions as *ultravires* to the to the legislative powers of the Indian parliament or to read down the provision so as to restrict their scope only to those cases where on facts a sufficient nexus exists between India and the foreigner's income accruing or received abroad."

d) § 6 (2)

Another instance of extra-territoriality as affecting non-residents would be where a firm or a Hindu undivided family carries on business outside India but it is treated as resident in India on the ground that its control and management is not wholly without India. This is contained in Section 6 (2) of the Act. Now how do we determine what is control and management? The courts have laid down that control and management means *de facto* control and management and not merely the right to control and manage. It is basically the place where the head, the seat and the directing power are situated. The head and the brain is situated at a place where vital decisions concerning the policies of the business, such as raising finance and its appropriation for specific purposes, appointment and removal of staff, expansion and extension, or diversification of businesses., are taken into consideration.[29]

Therefore based on the above criteria unless and until the control and management of its affairs is situated wholly outside India it will be amenable to tax. Also if a firm's place of control is partly in India and partly outside India then it will be treated as a resident firm. The defense that part of the management and control is situated outside

[28] Id.

[29] CIT v. Nandlal Gandalal, (1960) 40 ITR 1 SC; San Paulo Railway Co. v. Carter,(1886) AC 31 (HL).

India cannot be taken by the plaintiff. Hence this reflects as to how the Income tax Act is given extra-territorial operation based on residential status.

e) § 195 (1) & (2)

This is another grey area with regard to extra-territorial operation of the Act. The relavent portion of § 195 reads as follows:

(1) 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….

(2) Where the person responsible for paying any such sum chargeable under this Act to a non-resident considers that the whole of such sum would not be income chargeable in the case of the recipient, he may make an application to the [Assessing] Officer to determine, [by general or special order], the appropriate proportion 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.

Under this § if any person is making payment to a non-resident and if the same falls under one of the heads of income then the person has to deduct tax. Also if he feels that the income is not chargeable then he has to obtain a certificate for the same from the Assessing Officer. The problem arises when the transaction is between two non-residents. This is because the section reads as "any person responsible for payment…" Now, does the word person include non-resident is the main question.

In order to answer the same let us first look at the scope of § 195, of the Act as illustrated in the commentary *'Kanga, Palkhivala & Vyas, The Law and Practice of Income Tax'*:

> *"This section does not apply to payments made outside India by one foreigner to another even if that 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 of 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.*[30]

The above commentary makes it amply clear that when transactions is between to non-resident he can't be subjected to the revenue authorities of India.

Now let us take a look at the judicial decisions. In *Shrikumar Poddar* v. *Dy. CIT*.[31] it was held that if the payment is not made in India provisions of § 195 could not be applied to such a payment and consequently there would be no liability to deduct tax by a non-resident out of the payment made to a non-resident outside India. In absence of a nexus, no tax can be imposed on a subject without words in the act clearly showing an intention to.

Furthermore, where the salary is paid for the services rendered in India then such payment becomes chargeable to tax in India under the head 'salaries' and consequently, the provisions of § 192 become applicable. The fact that the employees as well as employer were non-resident, the fact that the payment was made outside India and the fact

[30]KANGA, PALKHIVALA & VYAS, supra note 27.
[31]Shrikumar Poddar v. Dy. CIT, (1998) 65 ITD 48 (Mum.); Coltness v. Black, 287 316 (HL); CIT v. Hindustan Bulk Carriers, (2003) 179 CTR (SC).

that contract of employment was also out of India, are not relevant. What is relevant is the place where the services are rendered.[32]

The Court in *Satellite Television Asian Region Ltd.* v. *DCIT* [33] held that the expression used in § 195 is "any person responsible for paying to a non-resident" has qualified the character of the recipient/payee as "non-resident". If the payment is made to a non-resident whether it is in India or outside India or in any manner, the person making the payment is liable for deducting the tax at source.

Shrikumar Poddar case emphasises upon the place of payment. It lays down that if payment is not made in India then there can be no nexus to bring the income under the purview of Income Tax Act. Babcock power case however dismisses all other considerations and lays down that the place where the service is rendered is decisive and deciding factor. But the recent Satellite television case clearly states that if a person is making payment to non-resident then he has to deduct tax at source.

Therefore although the question whether the expression "any person" used in 195 includes a non-resident has not been answered in clear terms, the concept of non-resident taxation revolves around the place of payment, place where the services were rendered which have been decided on case to case basis. Hence there is no straight jacket formula for the same.

However the recent case of *Vodafone International Holdings B.V. v. Union of India & Anr*[34] has clarified the position with regard to non-resident taxation to a certain extent. In this case Hutchison Telecommunications International Limited (HTIL) transferred certain shares of CGP Investment to Vodafone International Holdings BV

[32]Babcock Power (Overseas Projects) Ltd. v. Assistant Commissioner of Income Tax,(2002) 81 ITD 29 (Del.).
[33]Satellite Television Asian Region Ltd. v. DCIT, (2006) 99 ITD 91 (Mum.).
[34]Vodafone International Holdings B.V. v. Union of India & Anr, (2008) 175 Taxman 399 (Bom.).

(Vodafone NL), which is a wholly-owned subsidiary of Vodafone. CGP Investments, held 67 per cent stake in Vodafone Essar Ltd (VEL), which is an Indian company. The Indian tax authorities issued show-cause notices to both the buyer Vodafone NL. This is because it was being treated as 'assessee in default' for failure to withhold tax at source when they made payment to HTIL. The same was challenged before the High court of Bombay.[35]

The court held that

"……Prima *facie, the petitioner has not only become the successor in interest in that Joint Venture to HTIL, but also has acquired a beneficial interest in the license granted by the department of Telecommunications in India to its group companies, now known as VEL It is an admitted fact that VEL (earlier HEL), a subsidiary of the petitioner in which the petitioner has acquired 67% interest, was a group company of HTIL and now a group company of the petitioner. Any profit or gain which arose from the transfer of a group company in India has to be regarded as a profit and gains of the entity or the company which actually controls its, particularly when on facts, the flow of income or gain can be established to such controlling company (HTIL). Therefore, the recipient of the sale consideration was none other than HTIL and this was a consequence of divestment of its Indian interests in H-E Group, liable for capital gains. The petitioner themselves, by their various declarations, made it apparent and clear that the purpose of their acquiring shares in GDP was to acquire the controlling interest of 67% in HEL*.

..... where the dominant purpose of entering into agreements between two foreign companies was to acquire business and economic interests in an Indian company controlled by the other foreign company, the transaction would be subject to municipal laws

[35]Mr Pranav Sayta, Tax Leader Transaction Tax, Ernst & Young Business Line, Tax Leader Transaction Tax, Ernst & Young, (Dec 13, 2008), http://www.thehindubusinessline.com/2008/12/13/stories/2008121350060900.htm

of India, including the Income-tax Act, as income from such transaction would be deemed to accrue or arise in India. The Petitioner has admitted that HTIL has transferred their 67% interests in HEL qua their shareholders, qua the regulatory authorities in India (FIPB), qua the statutory authorities in USA and Hong Kong and the Petitioner has also admitted acquiring 67% held by HTIL in HEL. This being the case, a different stand cannot be taken before the tax authorities in India and a different stand cannot be put forth by either HTIL or the Petitioner.

The court in this case made a reference to the international principle of effects doctrine.

"……*Another aspect to be noted is the American principle of "Effects Doctrine" which is as follows: Any state may impose liabilities, even upon persons not within its allegiance, for conduct outside its borders that has consequences within its borders which the state represents....*"

Therefore, merely because the transaction is between two non-resident companies it can't be said it is not subject to the municipal laws of India. If this transaction has effect on India, then definitely the Income Act can be made applicable to the transaction.

III. CONCLUSION

The concept of extra-territorial operation of taxing statutes is rooted in the concept of legislative jurisdiction. In International Law a state can exercise jurisdiction beyond its legislative competence only on if it can establish nexus to the person, property it seeks to impose penalty upon. The position seems to be the same with regard to application of taxing statutes. Even States have more or less adopted a pragmatic approach and have refrained from exercising their fiscal jurisdiction arbitrarily.

In the recent times the extra-territorial operation of the Income Tax Act 1961 has become a moot point. The power to enact extra-territorial laws is provided in the constitution itself. Applying the act extra-territorially will not be illegal if it adheres to the doctrine of nexus. In many cases which have been discussed above the Indian income tax authorities have imposed tax liability based on place of accrual, residential status, place of payment of income, place where the services were being rendered because they constitute nexus. However the nexus must be real and not illusionary. The issue therefore is not whether these grounds constitute nexus for application of the act.

This brings us to the recent case of *Vodafone International Holdings B.V case.* In this case the court held that the act would be applicable although the transaction was between two non-residents based on the source rule i.e. the capital asset situate in India. This is in consonance with Direct Tax Code 2010 which seeks to tax certain indirect transfers based on the source rule.

It can be seen that where the tax authorities have imposed liability in the above discussed cases they have successfully established nexus (territory, source etc) which is real. Therefore I would like to conclude that so long as the authorities impose the tax liability based on some definite, real connection it can't be said that the extraterritorial operation is arbitrary.