Constitutionality of Extra-Territorial Taxation of Off-Shore Services of Non-Residents under Income Tax Act, 1961

Nainy Singh1 & Dinkar Gitte2
1. (Faculty, School of Law, Alliance University, Bangalore, India)
Email: nainy.law@gmail.com
2. (Faculty, School of Law, Christ University, Bangalore, India)

Abstract

Income Tax Act, 1961 being a quintessential law for handling the tax base of Indian government, continues to be inundated with controversial rules that have been exposed to several interpretations from time to time. The notion that Indian resident has income tax liability is invariable undoubted. However, extension of this liability to non-residents is governed by rule of ‘extra-territoriality’. Indian laws with extra-territorial operation hold sanctity within the text of India constitution although remains a contentious issue. Plethora of judicial decisions embarked the questions of constitutionality of extra-territorial laws and attempted to project a holistic approach. Section 9 of the Act that taxes a non-resident’s income for services offered to an Indian resident is alleged to reflect the true intention of Indian constitution that validates laws which operate beyond the territory of India. This provision establishes tax liability for non-resident if the source of income is India based upon the doctrine of ‘territorial nexus’ which is a well-recognized principle of international law.

Key words – Tax, Extra-territorial, Non-resident, Offshore services, constitution, territorial nexus

1. INTRODUCTION

Can a legal provision imposing income tax on off-shore services be struck down as unconstitutional merely because it seeks to tax income received outside India despite the fact that it has sufficient territorial nexus with India? Section 9 (1) (vii) of the Income Tax Act, 1961 dealing with fees for technical services imposes tax upon a foreigner for the income earned by him where the same arises by virtue of a contract entered into and executed outside India. The tax is imposed because the payment is made by an Indian resident and such services are being utilized by him. The income tax is charged not on the basis of residence of the assessee but upon the residence of the person from whom the income is duly received. This provision, thus, has often been accused of being unconstitutional due to its extra-territorial operation.
The power of the parliament to make laws with extra-territorial effect is derived from Article 245 of the constitution of India. The Indian parliament is not prohibited from expanding its tax net as “good government demands a solution to the problems of a state attempting to collect revenue beyond its borders...and cooperation among the states should help to effect a more equitable distribution of the tax burden.”

Section 9 (1) (vii) cannot be alleged as unconstitutional despite having an extra-territorial operation having established that sufficient territorial nexus exists between the foreigner and the jurisdiction so levying the tax. The doctrine of territorial nexus is a well established principle especially where the source of income is in India.

**EXTRATERRITORIALITY**

A legislature of a country is presumed to formulate laws applicable to its own territory. However, such a presumption of sovereignty may be rebutted and certain laws may operate extra-territorially. This is the true intention reflected in Article 245 of the Indian constitution. It does not prohibit formulation of laws having extra-territorial operation upon establishment of some nexus or connection with India.

Article 245 of the constitution of India consists of two clauses. Clause (1) empowers the parliament to make laws for India while clause (2) validates such laws despite being operative outside India. This establishes that parliament is free to enact or formulate laws for the territory of India with its implementation essentially being the prerogative of the executive. It is submitted that Article 245 (2) does not grant any special or extraordinary power to the parliament to legislate upon extra-territorial matters which do not have any relationship with India. Otherwise, the same will be derogatory to the spirit of Article 51 of the constitution as well.

“Extra-territoriality is a doctrine of statutory interpretation and requires enquiry into the legislative intent.” Hence, a perusal into the history of Article 245 (2) establishes that parliament is empowered to enact laws with extra-territorial operation as long as the requirement of nexus is satisfied.

Section 65 of the Government of India Act, 1915 allowed the Indian legislature to make laws for all the subjects and his majesty within the other parts of India and all native Indian subjects beyond as well as within British India. It clearly suggests that Indian legislature is empowered to enact laws with extra-territorial effect in conformity with and in compliance of the doctrine of territorial nexus.

Moreover, there are basically three distinct models of taxation. To begin with,
territorial based taxation whereby income earned within the geographical boundaries of the country alone is subject to taxation. The other is the source based taxation which is dependent upon the location of the source of income. Finally, the residence based system wherein the residential status of the taxpayer becomes crucial in determining chargeability. However, India appears to follow a mixed system whereby the resident is taxed on his worldwide income and the non-resident is taxed by giving due regard to the doctrine of territorial nexus. A view that the doctrine applies only to a territorial tax system is unwarranted.

Besides, it is noteworthy that every statute or legislation has some effect or consequence beyond a defined territory. It cannot be judged as outside the limits of the constitution merely due to such effect. The doctrine of territorial nexus has been legitimately recognized as an international principle. A statute taxing an off-shore transaction may be upheld as valid upon establishment of nexus between the state imposing the tax and the person liable to pay tax.

As a taxing statute enacted by the Union insists upon fulfillment of requirement of nexus, a pertinent question arises as to which elements would constitute a true connection or nexus. It is submitted that a nexus should be such that irrespective of its weaknesses, it is capable enough to validate the law so promulgated by the Parliament. The capability and sufficiency should be determined on the basis of rationality of such nexus. In other words, a law which has extra-territorial effect cannot be alleged as unconstitutional merely due to non-sufficiency of nexus. In *Electronic Corporation of India Limited v Commissioner of Income Tax*, the Supreme Court held that the “law enacted by parliament may have an extra-territorial operation in order to sub-serve the object and that object must be related to something in India.” The principle underlying territorial nexus is that the connection with India must be real and not illusory or fanciful as reiterated in *State of Bombay v RMDC*. Nevertheless, a Union Law without territorial nexus is definitely ultra vires and must be struck down as unconstitutional.

Thus, article 245 (2) rightly suggests that a law cannot be invalid simply because it has an extra-territorial operation. In other words, such laws cannot be struck down due to their extra-territorial effect unless it fails to show sufficient nexus. The law needs to portray some form of relationship with India else the parliament would be wholly incompetent to legislate or enact such law. Once a nexus is established, India will have the right to tax it.

It is therefore submitted that section 9 (1) (vii) (b) articulates a requirement of nexus and laws having such nexus shall be constitutionally valid as observed in *GVK Industries Ltd. v Income Tax Officer.* The

---

court held in this case that section 9 (1) (vii) (b) cannot be said to be unconstitutional for want of legislative competence.\textsuperscript{9}

Moreover, the retrospective amendment made to section 9 (1) (vii) neither renders the requirement of nexus irrelevant nor does it take away all the other requisites of the same.\textsuperscript{10} It should be given a wider interpretation. It simply regards residence or place of business or business connection as baseless. In other words, the amendment does not exclude the requirement of nexus completely. Instead it prescribes utilization of services as the only condition for establishing nexus contrary to the requirement of utilization and rendition of service as stated in \textit{Ishikawajima-Harima Heavy Industries Ltd. v Director of Income tax}\textsuperscript{11}. Being one of the most prominent cases where the notion of extra-territoraility was vehemently talked about, it ousted the Indian fiscal jurisdiction on ground of ‘residence’ of taxpayer and not that of ‘recipient’ of service. Here, Japanese based appellants had transferred offshore supplies of equipment and other materials to an Indian based company abroad and the dispute centered round its exigibility to pay income tax on these supplies. The Indian-Japan tax treaty insisted upon liability for tax where the income is reasonably attributable to the operations carried out in India. Since the services were rendered outside India, these were excluded from the tax bracket as profits on sale did not arise in India. The materials were supplied outside India and payments were also received outside leading to conclusion of transaction on high seas. The treaty provisions did not apply to these circumstances. Nevertheless, the apex court reiterated crucial principles for fastening tax liability in respect of offshore services primarily stating that mere signing of a contract in India holds no material significance where all activities or services are performed outside India. Hence, it does not lead to a permanent establishment in India. Invariably, notions of connectivity or territorial nexus are also withheld and cannot be extended endlessly simply because location of source of income is situated within India. The decision emanates from assumption that ‘supply of goods’ is inextricably linked with ‘service’. By virtue of Finance Act 2010, it has been clearly established that utilization of services alone is relevant for taxation of off-shore transactions. It is noteworthy that in this case the apex court went in favour of the assessee who was an Indian resident. The court, however, made a glaring error. As far as section 9 (1) (vii) is concerned, court relied upon clause (c) which applies only when a non-resident pays and not otherwise.

In other words, say, there is an Indian company which conducts business of consultancy services in Sri Lanka through retail outlets. Part of such business is carried on in India being part of the same

\textsuperscript{9}GVK Industries Ltd. v Income Tax Officer, (2011) 4 SCC 36 (Supreme Court).

\textsuperscript{10} Explanation to section 9 (1) (vii) of the Income Tax Act, 1961 makes it clear that a resident’s income is not taxed where the fees are payable in respect of services utilized 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.

\textsuperscript{11}Ishikawajima-Harima Heavy Industries Ltd. v Director of Income tax (2007) 288 ITR 408 (Income Tax Tribunal).
entity. The person paying money to Sri Lanka is a resident. As per Palkivala, these services are outside the territory.\textsuperscript{12} In this case, the person utilizing the services is a resident while the services are being offered off-shore. So, if section 9 (1) (vii) (b) is applied strictly such services will be taxable since they have been utilized in India. Parliament amended section 9 by adding an explanation to sub-section (2) but it says something else and the judgment still stands.

In \textit{Re Worley Parson Pty. Ltd. v Directorate General of Income Tax}, a decision by Authority of Advanced Ruling (AAR), it was observed that reliance was wrongly placed upon clause (c) instead of clause (b) which actually applies to a resident.\textsuperscript{13} AAR did not hold that the judgment is not binding. Rather, it just went to the extent of saying that Ishikawajima was decided on consideration of wrong law. Similarly, the court in \textit{Ashapura Minechem v Additional Directorate of Income Tax} regarded Ishikawajima as bad law.\textsuperscript{14} It emphasized place of utilization of service as the only relevant factor for determining taxability. In \textit{Commissioner of Income Tax v Siemens Aktiengesellschaft}, it was held that the “ratio of Ishikawajima has been overcome by the amendment as it takes away all the requirements of territorial nexus.”\textsuperscript{15} The retrospective amendment has overruled many judicial decisions that laid down rendition of service as one of the necessary conditions for taxability of off-shore services. Hence, it is submitted that the place of utilization of services alone is to be given due regard and is sufficient to determine tax jurisdiction. The place of rendition of service is wholly irrelevant under both the clauses of (b) and (c) section 9 (1) (vii).

\textbf{CONCLUSION}

The validity of laws with extra-territorial operation has always been debated over in many nations with enormous judicial decisions on the point. Besides, various tests have been laid down to assess whether a law has an extra-territorial application or not. However, the controversy surrounding taxability of section 9 (1) (vii) is well settled by the recent decision of the court in \textit{GVK Industries Limited v Income Tax Officer}. It is submitted that the impugned section is constitutional and within the legislative competence as long as there exists a nexus between the taxpayer and the jurisdiction so imposing the tax. A taxing statute, thus, necessitates a nexus requirement. The explanation to sub-section (2) of section 9 (1) (vii) was added with retrospective effect from 1976. The parliament, thus, overruled Ishikawajima’s case. It is no more a good law. So, now, only the two requirements under the explanation are the sole criteria. However, this is contrary to fair taxation as

\begin{itemize}
  \item \textsuperscript{12} DINESH VYAS, KANGA, PALKHIVALA & VYAS- THE LAW AND PRACTICE OF INCOME TAX 15-25 (9\textsuperscript{th} ed. 2004).
  \item \textsuperscript{13} Re Worley Parson Pty. Ltd. v Directorate General of Income Tax, (2009) 223 CTR 209 (Authority of Advanced Rulings)
  \item \textsuperscript{14} Ashapura Minechem v Additional Directorate of Income Tax (2010) 5 Taxman 57 (Bombay High Court)
  \item \textsuperscript{15} Commissioner of Income Tax v Siemens Aktiengesellschaft (1991) 187 ITR 108 (Supreme Court).
\end{itemize}
it adversely affects tax planning. Besides, the businessmen suffer as it becomes impracticable for them to reformulate business plans. So far as the taxpayer is a resident under section 9 (1) (vii) (b), his liability to pay tax for off-shore services cannot be challenged on the ground of extra-territoriality upon existence of any nexus or nexus of utilization.

With respect to section 9 (1) (vii) (c), all the requirements of nexus as such has not been taken away by the retrospective amendment. Hence, both the provisions are within the limits prescribed under the Indian constitution. The view upholding the constitutionality of section 9 (1) (vii) and establishment of territorial nexus is extremely crucial in order to bring various arrangements and agreements entered into with the foreign counterpart within the tax net.

REFERENCES


