

SECTION 9 OF THE INCOME TAX ACT, 1961: DEFACED AND DEFILED?

PRATEEK ANDHARIA*

The Income Tax Act is routinely amended by the Parliament. While well-reasoned amendments aimed at rectifying defects in the law are justified, retrospective amendments, often a knee-jerk reaction to judicial decisions, are inherently problematic. This is especially true for the recent retrospective amendments made to section 9 which have been couched as 'clarificatory'. In this background, the paper seeks to examine these key amendments to section 9, tracing their origin in the relevant decisions of the Supreme Court, briefly discussing their validity against Part III of the Constitution and the doctrine of territorial nexus. In particular, it considers: first, the amendments to section 9(1)(i) made in response to the Supreme Court decision in Vodafone; second, the amendments to section 9(1)(vi) and the controversy surrounding the meaning of 'copyrighted article' vis-à-vis 'copyright'; third, section 9(1)(vii) and the post-2007 perplexities that have engulfed it. The conclusion presents how the Direct Taxes Code addresses these issues not only of constitutionality but also of commercial reasonableness and proposes a road ahead for our direct taxes legislation.

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* V Year, B.A., LL.B. (Hons.), National Academy of Legal Studies and Research (NALSAR), Hyderabad. The author can be contacted at prateek.andharia@gmail.com.

I. INTRODUCTION

When Nani Palkhivala penned a fiery critique of the 42nd Amendment to the Constitution, he most appropriately titled it *Our Constitution: Defaced and Defiled*.¹ Palkhivala, one of India's finest tax lawyers, saw the constitutional document as sacred and knowing all too well the fate of statutes such as the Income Tax Act, 1961, [*Hereinafter*, "the Act"] which were routinely amended to suit the Government's whims and fancies, and he hoped the Constitution would not suffer a similar fate.

Palkhivala can rest in peace – the basic structure doctrine he persuaded the Supreme Court to adopt has preserved the sanctity of the Constitution.² However, what has not changed in the last three decades is the arrogant impunity with which Parliament continues to tinker with the Act.³ That reasoned amendments aimed at rectifying defects in the law or curing existing loopholes are justified is trite law.⁴ This paper argues the unacceptability of mindlessly amending the Act retrospectively, something done too often as a knee-jerk reaction to a decision of the Supreme Court, and which creates more controversy than it clarifies.

The analogy of section 9 being defaced and defiled has been used to assist in understanding how serious this perennial flow of amendments is and how these have robbed the section of its original meaning, leaving it a shadow of its originally crafted self. Section 9 forms a part of the charging provisions of the Act and creates a legal fiction, deeming certain incomes to accrue or arise in India, and consequently, rendering them taxable under section 5.⁵ Therefore, tinkering with these provisions usually creates an entirely new substantive levy of tax and is hardly ever a mere clarification, leading to significant tax implications for assesseees. Very often, these

1 Nani Palkhivala, *OUR CONSTITUTION: DEFACED AND DEFILED* (1976).

2 Keshavananda Bharati v. State of Kerala, AIR 1973 SC 1461.

3 There were seven such amendments made in 2010 alone, and more than twenty-two such amendments in 2012.

4 *Ujagar Prints v. Union of India*, (1989) 3 SCC 488 [*Hereinafter*, "*Ujagar*"]:

If in the light of such validating and curative exercise made by the legislature granting legislative competence the earlier judgment becomes irrelevant and unenforceable, that cannot be called an impermissible legislative overruling of the judicial decision. All that the legislature does is to usher in a valid law with retrospective effect in the light of which the earlier judgment becomes irrelevant.

Ujagar, at 517. See also, *National Agricultural Co-operative Marketing Federation v. Union of India*, [2003] 260 ITR 548 [*Hereinafter*, "*National Agricultural*"].

5 Sampath Iyengar, *LAW OF INCOME TAX*, 74 (Rajaratnam ed., 11th ed., 2011).

assessee enter into voluminous transactions on the strength of interpretations of the statute handed down by the higher judiciary, only to be rudely surprised by a slew of retrospective amendments in the next Budget. This also has implications on India's position as a pre-eminent investment destination, as noted in a recent Supreme Court decision.⁶

In this article I seek to examine certain key amendments to section 9 of the Act, tracing their origin in the relevant decisions of the Supreme Court, while briefly discussing the validity of these statutory amendments against Part III of the Constitution. I shall, following this brief introduction to the subject matter, discuss in Part II of this paper the nature, the scope and content of section 9 of the Act so as to set the background of the subsequent analysis. Part III considers in particular the amendments to section 9(1)(i) of the Act made in 2012. Part IV discusses the amendments to section 9(1)(vi) and the controversy surrounding the meaning of 'copyrighted article' in contradistinction to 'copyright'. Part V examines in detail section 9(1)(vii) and the post-2007 perplexities that engulfed it. My conclusion presents how the Direct Taxes Code addresses these very issues and proposes a road ahead for our direct taxes legislation.

II. UNDERSTANDING SECTION 9 OF THE INCOME TAX ACT, 1961

Section 9 was designed as an aggregating provision, and it brought several independent and scattered provisions from the Indian Income Tax Act, 1922 together, collecting them under the head of 'incomes deemed to accrue or arise in India'.⁷ The section enacts into law a source rule of taxation,⁸ deeming a whole range of incomes, from interest and dividend to salary and royalty to 'accrue or arise' in India for tax purposes.⁹

These incomes, it must be noted, do not, accrue or arise in India *per se* and hence, by employing a legal fiction, the legislature has drawn them into the tax net due to their significant link with India.¹⁰ This section does not cover incomes

6 Vodafone International Holdings BV v. Union of India, 2012 (6) SCC 757, at ¶ 68 (Per Kapadia C.J.) [*Hereinafter*, "Vodafone"].

7 Kanga and Palkhivala, THE LAW AND PRACTICE OF INCOME TAX, 367 (Dinesh Vyas ed., 9th ed., 2004) [*Hereinafter*, "Kanga and Palkhivala"].

8 Explanatory Memorandum, Finance Bill, 2012.

9 Section 9(1), Income Tax Act, 1961.

10 Kanga and Palkhivala, *supra* note 7, at 368.

that actually accrue or arise in India since "a fiction is not needed to create a situation which exists in reality".¹¹ When discussing section 9, it is apposite to note that the section does not, by way of legal fiction, alter the entity with respect to whom the income arises, but rather uses the legal fiction to shift only the *situs* of accrual of the income.¹²

Section 9 covers within its ambit all persons, resident as well as non-resident and is therefore, most inclusive in nature.¹³ Due to its extremely wide import and significant impact on the tax liability of non-resident corporations, the section has been challenged as ultra vires the Constitution on the grounds of legislative competence as well as violation of fundamental rights.¹⁴ Nevertheless, the vires of section 9 has been confirmed each time, with the Supreme Court as well as numerous High Courts declaring it to be constitutionally valid.¹⁵

In its original form, the section applied *inter alia* to business connections, transfer of assets, income from property, dividend and salary. In the year 1976, however, three additional heads of income were added, namely, interest, royalty and fees for technical services.¹⁶ These three additions substantially modified the character of section 9 since liability was attached to non-residents based on an extremely sound territorial nexus previously. Post-1976 however, the section created liability for a non-resident in respect of his income outside India, even if the contract from which the income arose was performed entirely outside India, the only basis for attracting liability being the fact that the payment was made by an Indian.

Palkhivala argues that as these additions to section 9 proceed on a grossly inadequate territorial nexus, they are ultra vires and impermissibly operate with extra-territorial effect. In his landmark work, he famously wrote:¹⁷

If the Indian Parliament can cast the net wide enough to collect tax in such cases where the foreigners income has no nexus with India only

11 Commissioner of Income Tax v. Oriental Co. Ltd., [1982] 137 ITR 777.

12 Kanga and Palkhivala, *supra* note 7, at 368.

13 Commissioner of Income Tax v. Bhogilal, 25 ITR 50 (SC).

14 Abdul Azeez Dawood Marzook v. Commissioner of Income Tax, [1958] 33 ITR 154; GVK Industries v. Income Tax Office, [1997] 228 ITR 564; ECIL v. Union of India, [1990] 183 ITR 43.

15 AH Wadia v. Commissioner of Income Tax, [1949] 17 ITR 63.

16 Finance Act, 1976.

17 Kanga and Palkhivala, *supra* note 7, at 384.

because the income is derived from a transaction with an Indian, it can equally levy a tax on a hotel in a foreign country where an Indian goes to stay or dine, or on a foreign store where an Indian buys shirts or grocery, or on a foreign physician whose services are sought by an Indian while abroad.

Incidentally, Palkhivala's words proved most portentous as it was exactly these key aspects of extra-territorial operation and territorial nexus that the tax authorities and the Supreme Court grappled with for over three years in the context of fees for technical services under clause (vii).¹⁸ The principles on which the legal fictions created by section 9 are based, namely territorial nexus and deemed accrual, are key to an understanding of how and why they have proved so controversial and accordingly, must be borne in mind during the course of the subsequent discussion. It is against this background that I shall now proceed to consider three key clauses of the section and analyse their genesis, scope, judicial interpretation and consequent amendment.

III. SECTION 9(1)(i): SACRIFICED AT VODAFONE'S ALTAR?

A. Section 9(1)(i): A Primer

Section 9(1)(i) of the Act provides for the taxation of income from a variety of sources, and is perhaps couched in the broadest terminology among the many clauses of the section.¹⁹ Until recently, the most significant legal issues surrounding the interpretation of this section concerned the meaning of the term 'business connection', the question being what sort of business relationships constituted a 'business connection' under the Act.²⁰

18 *Infra*, Part V.

19 Section 9(1), Income Tax Act, 1961 reads:

The following incomes shall be deemed to accrue or arise in India:

(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India.

20 *Commissioner of Income Tax v. R.D. Aggarwal & Co*, [1965] 56 ITR 20; *Bangalore Woollen, Cotton and Silk Mills Co. Ltd. v. Commissioner of Income Tax*, [1950] 18 ITR 423; *Great Lakes Carbon Corporation (No 1) v. Commissioner of Income Tax*, [1993] 202 ITR 64. Here, it was a (prospective) amendment that inserted an Explanation defining 'business connection' and settling all interpretative controversy.

However, with the emergence of India as a preferred global investment destination, trading in securities issued by Indian companies by non-residents has become commonplace. Under the Act, the sale of such securities, when not in the ordinary course of business, creates a liability to pay capital gains tax and consequently, these parties have sought to devise creative ways around this system.²¹ On the other hand, the Indian tax authorities have pursued these transactions keenly, as more often than not, these were high value transactions and the Department of Income Tax [*Hereinafter*, "Department"] was wont to permit these non-residents to exit their investments without first extracting their proverbial pound of flesh.

The five heads of income deemed to accrue in India under the section are business connection, property, asset, source of income or the transfer of a capital asset. The amendments I seek to discuss relate to the last head - that of transfer of a capital asset situate in India. The well established principles relating to the interpretation of this provision lay down three criteria for a transfer to be taxable: a) existence of a capital asset, b) transfer thereof and c) situation of such capital asset in India.²²

B. *The Vodafone decision*

While *Vodafone International Holdings BV v. Union of India*²³ [*Hereinafter*, "Vodafone"] was certainly not the first significant case that grappled with the taxability of incomes arising from the transfer of capital assets in India,²⁴ it can safely be described as the most important, both in terms of monetary value as well legal consequences.²⁵ The case concerned the transfer of control and management of an Indian telecom company, effected by the transfer of a single share between two non-resident companies, in the Cayman Islands. While on the face of it, the transaction bore no nexus to India, the transfer of this single share abroad saw assets worth over \$11 billion change hands through a complex network of holding

21 See, *Aditya Birla Nuvo Ltd. v. DDIT*, 242 CTR 561 (2011) (Bom), where the device of 'Permitted Transferee' was employed in a failed attempt to avoid tax. See also, *Azadi Bachao Andolan v. Union of India*, 263 ITR 706 (2003).

22 *Vodafone*, *supra* note 6, at ¶ 71.

23 *Vodafone*, *supra* note 6.

24 See *Commissioner of Income Tax v. Assam Consolidated Tea Estates Ltd*, [1987] 167 ITR 215; *Commissioner of Income Tax v. Quantas Airways Ltd*, [2002] 256 ITR 84.

25 Apart from importance in terms of the amendments that came close on the heels of the Supreme Court decision, it must be noted that the amount in dispute was over \$3 billion.

and subsidiary companies across the world.²⁶

The huge sum involved in the matter saw the Department attempt to use the case to set an example and push the limits of interpretation. What followed were several orders, appeals and petitions across all tiers of the Indian judiciary. When the Bombay High Court finally decided the matter in favour of the Department,²⁷ lawyers, accountants and the business community attacked it vehemently as an egregious misapplication of the law, setting the stage for an intense final battle before the Supreme Court.

In a decision penned by the then Chief Justice of India, Justice SH Kapadia, the Supreme Court allowed the appeal, overturning the Bombay High Court's decision on almost all counts. The Court discussed a variety of aspects of the transaction in a lengthy, structured and well-reasoned judgment, but I will confine myself to the points of principle on which much of the Supreme Court decision turned, as it is these principles that were sought to be ousted by the subsequent amendments.

The Court held that the transaction was not taxable under the law as it stood at that point in time. It dismissed the Bombay High Court's reasoning that there had been, in addition to the transfer of the share, a simultaneous transfer of 'other rights and entitlements' that constituted capital assets by themselves, rendering the transaction taxable.²⁸ The Supreme Court held that 'controlling interest' was merely an incident of the ownership of the share and not an independent capital asset capable of being transferred.²⁹ Furthermore, the Supreme Court held that, contrary to the submissions made by the Department, section 9(1)(i) was not a 'look through' provision, and did not allow for the taxation of indirect transfers, as such an interpretation would render the express statutory criteria of the capital asset being situate in India nugatory.³⁰ In this regard, it rejected the contention of the Department that alleged that the word 'through' in clause (i) meant 'in consequence of', holding this an impermissible extension of the statutory language.³¹

26 The factual matrix of Vodafone in general and the parties' holding structure in particular are extremely complex and a full description thereof would be beyond the scope of this article. For an elaborate analysis, see, Nishant Sharma, *The Vodafone Saga: Tax Planning And Corporate Veil Piercing* 7 NALSAR STUDENT LAW REVIEW 162 (2012).

27 *Vodafone International Holdings B.V. v. Union of India*, (2010) 329 ITR 126 (Bom) [Hereinafter, "Vodafone HC"].

28 *Vodafone HC*, *supra* note 27, at ¶ 136.

29 *Vodafone*, *supra* note 6, at ¶ 88.

30 *Vodafone*, *supra* note 6, at ¶ 71.

31 *Vodafone*, *supra* note 6.

It was also held that there had been no 'extinguishment of rights' in the present case, and consequently no 'transfer', a pre-requisite for the levy of capital gains tax. This was concluded on the basis that the right that was alleged to have been extinguished was the intangible right to nominate directors to the board of subsidiary companies, which the Court held was not an enforceable right capable of extinguishment.³² It was also opined that the *situs* of the transferred share could not be determined on the basis of where the 'underlying assets' are located, but rather where the share itself is situated.³³

C. The Post-Vodafone Amendments

Vodafone's Pyrrhic victory at the Supreme Court gave it respite for just under three months, for the Finance Act, 2012 quickly amended the statute to codify the arguments that were rejected before the Supreme Court. As is always the case, the amendments were proclaimed to be 'clarificatory' and 'for the removal of doubts', intending only to explain the law as it always was and settle the apparent 'misunderstanding' created by judicial decisions.³⁴ It is of significance that all of the amendments were made with retrospective effect.

The amendments covered the length and breadth of the Supreme Court decision, reversing almost every interpretation placed by the Court on the language of section 9 and its allied provisions. The amendment process began from the very basics, and started by altering all the relevant definitions. Section 2(14), which defines 'capital asset' was amended to include 'any rights in or in relation to any Indian company', specifically mentioning rights of management and control.³⁵ This brought the law in consonance with the Bombay High Court ruling that such rights were capital assets.³⁶ Section 2(47) was amended to 'explain' the term 'transfer' as including the disposition of any interest, including transfers characterised as flowing from the transfer of shares of a non-resident.³⁷

The charging section, section 9 came next, two explanations being appended thereto. The first was as clear and unambiguous a rejection of the Supreme Court's

32 *Vodafone*, *supra* note 6, at ¶ 74.

33 *Vodafone*, *supra* note 6, at ¶ 82.

34 Explanatory Memorandum, Finance Bill, 2012. The language used to explain the reason for amendment was simply: "Certain judicial pronouncements have created doubts about the scope and purpose of Section 9 ..."

35 Section 3(i), Finance Act, 2012.

36 *Vodafone HC*, *supra* note 27, at ¶ 136.

37 Section 3(iv), Finance Act, 2012.

decision as possible, stating that the term 'through' meant 'in consequence of', thereby permitting the taxation of indirect transfers.³⁸ The second was as ambiguous a provision as any, stating that a capital asset would be deemed to be situate in India if it 'derived value substantially from the assets located in India'.³⁹ Together with amendments to the relevant tax deduction at source (TDS) provisions, these amendments operated to nullify the effect of *Vodafone*.

In my opinion, the strongest challenge to the amendments would be against their retrospective effect. Leading cases such as *Ujagar Prints*, and *National Agricultural* clearly state, that a retrospective tax liability cannot be imposed on a party by way of amendment.⁴⁰ It is settled law that the only retrospective amendments that can be made to a taxation statute are those that are clarificatory in nature and any amendment that seeks to create a new substantive levy can only be prospective.⁴¹ Further, it is well-settled that the clarificatory nature of an amendment is to be judged not on the basis of whether it is inserted by way of explanation or proclaims itself to be for the removal of doubts, but on the nature of liability it creates.⁴² On this basis, the amendments mentioned above clearly disturb the settled position of law and create a fresh liability and are by no means merely a clarification of the existing law and consequently, can have only prospective effect.

IV. SECTION 9(1)(vi): A ROYALTY MESS

A. Royalty income and Section 9(1)(vi)

Under the Act, before the amendment, the term 'royalty' was defined in section 9 exhaustively, as meaning any consideration for the transfer of any rights in respect of various intellectual property and services related thereto.⁴³ This

38 Section 4(a), Finance Act, 2012.

39 Section 4(a), Finance Act, 2012.

40 *Ujagar Prints*, *supra* note 4; *National Agricultural*, *supra* note 4.

41 *Id.*

42 G.P. Singh, *PRINCIPLES OF STATUTORY INTERPRETATION*, 453 (8th ed., 2003).

43 Explanation 2 to section 9 read:

Explanation 2: For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for: (i) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property ... (iii) the use of any patent, invention, model, design, secret formula or process or trade mark or

definition of royalty was largely in consonance with international jurisprudence on intellectual property and its taxability.⁴⁴ The definition brought within the ambit of 'royalty' sums payable or receivable on account of the transfer of various rights, enumerated by way of Explanation.

The question whether receipts on transfer of software are assessable under the Act as 'royalty' arose after the verdict of the Supreme Court in *Tata Consultancy Services v. State of Andhra Pradesh*⁴⁵ [Hereinafter, "TCS"]. There, the Supreme Court held, in what is in my opinion a well considered decision, that software in a CD was 'goods' and liable to customs duty under the Customs Act, 1962. The Court arrived at this conclusion after considering a range of foreign decisions from US and England, and making reference to several treatises on software licensing and intellectual property.⁴⁶ The rationale behind this decision was that even if the relevant CD or floppy disk was a copyrighted article and carried with it certain intellectual property, the language of the statute was wide enough to include such property as 'goods'.⁴⁷

It is submitted that the decision operated on the basis of basic commercial principles that clearly differentiated between the transfer of a right and the transfer

similar property; (iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill ... (v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or (vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v).

Explanation 3 to section 9 read:

"Explanation 3: For the purposes of this clause, "computer software" means any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customized electronic data."

44 V. Niranjan, *A Software Transfer Agreement and its Implications for Contract, Sale of Goods and Taxation* 8 JOURNAL OF BUSINESS LAW 799 (2009).

45 *Tata Consultancy Services v. State of Andhra Pradesh*, [2004] 271 ITR 401.

46 *First National Bank of Springfield v. Department of Revenue*, 421 NE2d 175 (1981); *Compuserve INC. v. Lindley*, 535 N.E. 2d 360; *St Albans City and District Council v. International Computers Ltd.*, (1996) 4 All ER 481; Roger Pressman, *SOFTWARE ENGINEERING* (1996); Rahul Matthan, *THE LAW RELATING TO COMPUTERS AND THE INTERNET* (2000).

47 *TCS*, *supra* note 45, at ¶ 44. The Court gave an analogy to a valuable painting, reasoning that surely tax could not be levied only on the canvas and paints just because the final work was created with investment of intellect and was a copyrighable work.

of a good. The question of royalty can only arise when a 'right' is transferred and not on the transfer of a good *per se*. Merely because a good has an element of intellectual property, its sale cannot be taxed as royalty, since such a transaction clearly constitutes a sale *simpliciter* and not an assignment of rights.⁴⁸ It must be noted that such sales agreements usually carry extremely restrictive covenants as to modification and use. Therefore, the characterisation of such transactions as sale and such commodities as goods was legitimate and justified.

B. *The Rigmorale Begins – Interpretation, Re-Interpretation and Mis Interpretation*

However, the decision seemed to produce an unintended consequence. Assesseees were quick to apply this ratio, albeit pronounced in a wholly different context, to argue that when a particular software was sold, especially if it was 'shrink-wrapped', 'canned' or 'off the shelf' software, there was a transfer only of a 'copyrighted article' and not the transfer of a 'copyright' *per se*. The consequence of this was that any payment made or received in this regard was not assessable as 'royalty' under clause (vi) and its corresponding provision in the relevant double taxation avoidance agreement [*Hereinafter*, "DTAA"]. The position quickly gained currency and was endorsed by a Special Bench of the Delhi tribunal as well as the Authority for Advance Rulings [*Hereinafter*, "AAR"].⁴⁹

Following this, most practitioners believed that the law was settled and that such transactions could not be assessed for the purposes of royalty income under section 9. They were proven wrong when the Delhi Bench of the ITAT surprised everyone by taking a contrary view and holding the assessee liable to tax under clause (vi).⁵⁰ It must be noted that this view was contrary to the earlier special bench ruling of the very same tribunal and can be described as *per incuriam*.

What followed was a series of conflicting decisions by different tribunals, the AAR, and various High Courts. Some followed the ratio in *TCS* and upheld the

48 This principle is well explained by the Income Tax Appellate Tribunal (ITAT) in *Sonata Information Technology v. ACIT*, (2006) 103 ITD 324, at ¶ 3 (Bang):

The assessee had sold the software bought in fully packed condition as received from the overseas vendor to various customers in India without opening the package. The assessee acquires during the course of business a copyrighted article whereas the copyright remains with the owner or the seller. What the assessee acquires is the material object available off the shelf which is different from copyright.

49 *Motorola Inc. v. DCIT*, [2005] 95 ITD 269 (SB); *Dassault Systems KK v. DIT*, (2010) 229 CTR 105 (AAR).

50 *Gracemac Corporation v. ADIT*, (2010) 134 TTJ (Del) 257.

essential difference between 'copyright' and 'copyrighted articles' while others held assessee liable to tax, on the principle that the right to use the copyrighted article created in itself a liability to tax under the head of royalty income. The Mumbai bench of the ITAT and the Delhi High Court took the former view, respecting the fundamental commercial difference between the two and exempting assessee from liability.⁵¹ The Bangalore Tribunal, the Karnataka High Court and the AAR however, subscribed to the latter view and held against the assessee.⁵² However, some semblance of order seemed to return to the field when both the Mumbai and Pune Tribunals followed the former view in early 2012, thereby introducing a degree of consistency in the law.⁵³ Alas, this respite was short-lived.

C. The Amendment and its Validity

While the amendments to section 9(1)(i) got the lion's share of media and critical attention following the budget, a key amendment was made to clause (vi) as well. The Finance Act, 2012 inserted three new Explanations to this clause, and brought within the tax net income arising from the transfer of computer software.⁵⁴ The amendment nullified, with retrospective effect, all the decisions that had favoured the assessee and instead, took the view of the Karnataka High Court.⁵⁵

The Explanation declared that the expression 'transfer of rights in respect of property' in Explanation 2 'always included' the right to 'use a computer software'. It then went further and stated that the possession or right and its location in India were irrelevant factors in determining whether a particular income was royalty or

51 ADIT v. TII Team Telecom International, 140 TTJ (Mum) 649; DIT v. Ericsson AB, [2012] 343 ITR 470 (Delhi).

52 CIT v. Samsung Electronics Co. Ltd., [2012] 345 ITR 494 (Kar); *In Re* Millenium IT Software Ltd., 62 DTR 1 (AAR); ING Vyasa Bank v. DDIT, (2012) 143 TTJ (Bang) 249.

53 DDIT v. M/s. Solid Works Corporation, [ITA No. 3219/MUM/2010, 8/01/2012]; Allianz SE v. ADIT, [2012] 51 SOT 399 (Pune).

54 Explanation 4 to section 9(1)(vi) reads:

Explanation 4: For the removal of doubts, it is hereby clarified that the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred. Explanation 5: For the removal of doubts, it is hereby clarified that the royalty includes and has always included consideration in respect of any right, property or information, whether or not: (a) the possession or control of such right, property or information is with the payer; (b) such right, property or information is used directly by the payer; (c) the location of such right, property or information is in India.

55 CIT v. Samsung Electronics Co. Ltd., [2012] 345 ITR 494 (Kar).

not.⁵⁶ In essence, the amendments did not 'clarify the law' as it purported to do, but rather sought to modify completely the meaning of the term 'royalty' itself. For, how else can a determination as to whether an income is royalty income or not be independent of the possession or control of such right?

It is submitted that the proposition put forth by the amendments is bad in law and untenable, being contrary to the fundamental principles of commercial law in general and intellectual property rights law in particular. Nevertheless, the Department seemed to have acted in undue haste and without fully considering all the consequences of the amendment. The aspect of DTAA's and their definitions of royalty were completely ignored in the zeal to twist the law – significantly handicapping the actual utility of the amendments. All of India's DTAA's carry definitions of royalty similar to the un-amended clause (vi) and since the assessee can, under section 90(2) of the Act pick the Act or DTAA, whichever is more beneficial, the amendments have proven toothless.

In the case of *DDIT v. B4U International Holdings Ltd.*,⁵⁷ this is exactly what the Bombay Tribunal held, granting the assessee exemption based on the DTAA. Article 7 of the DTAA applies to income in the nature of business profits, derived from a permanent establishment. Therefore, in the absence of a permanent establishment and with the income being held to be not in the nature of royalty payments, the assessee could take benefit of the treaty and wind up with no tax liability. The classic proverb of 'haste makes waste' rings truer than ever for the Department, which amended section 9 all for naught.

V. SECTION 9(1)(vii): TECHNICAL NUANCE TURNED TO TECHNICAL NONSENSE

A. The *Ishikawajima* case and subsequent uncertainty

Section 9(1)(vii) was one of the first provisions of section 9 to generate significant controversy in Indian tax jurisprudence regarding extra-territorial operation.⁵⁸ The provisions of section 9(1)(vii)⁵⁹ were relatively unambiguous

56 Section 4(b), Finance Act, 2012.

57 *Ishikawajima Harima Heavy Industries Ltd. v. DIT*, (ITA No. 880/Mum/2005).

58 *Electronics Corporation of India Ltd. v. CIT* (1990) 183 ITR 43. See generally, Prateek Andharia, *The Validity of Retrospective Amendments to the Income Tax Act – Section 9 of the Act and Ishikawajima Harima's case* 4 NUJS LAW REVIEW 269 (2011).

59 Section 9(1), Income Tax Act, 1961 read:

The following incomes shall be deemed to accrue or arise in India: (vii) income by way of fees for technical services payable by – (a) the

until 2007, when the Supreme Court ruling in *Ishikawajima Harima Heavy Industries Ltd. v. DIT*⁶⁰ [*Hereinafter, "Ishikawajima"*] laid down a new test for taxability of fees for technical services rendered by a non-resident. Justice Sinha, delivering the judgment for the bench, stated that for such fees to be taxable, the services concerned must be (a) utilised in India and (b) rendered in India.⁶¹

This decision, which upset the settled position of law as it had stood for more than thirty years, led to complete confusion in Indian tax administration. Perturbed as the Department was by the new interpretation put forth by the Court and its consequences on the taxability of lucrative services transactions, an amendment in the law was ensured within months and incorporated in the Finance Act, 2007.⁶² This was done by an Explanation inserted below section 9(2), with retrospective effect from 1976. The Explanation essentially stated that the incomes mentioned in Section 9(1), sub-sections (v), (vi) and (vii) would be included in the total income of the non-resident, regardless of whether the non-resident had a 'residence, place of business or business connection in India'.

However, this amendment turned out to be inadequate to change the exposition of the law as stated by the Supreme Court. In *Jindal Thermal Power Co. Ltd. v. DCIT*,⁶³ the Karnataka High Court held that while the amendment clearly did away with the criteria of residence, place of business and business connection, the twin criteria of rendering and utilising services in India laid down by the Supreme Court in *Ishikawajima* remained unaffected by the explanation.⁶⁴ The Bombay High

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.

60 *Ishikawajima Harima Heavy Industries Ltd. v. DIT*, 2007(3) SCC 481.

61 It is the submission of the author that this decision was erroneous on various counts. These shortcomings are detailed in *Worley Parsons v. DIT*, 223 CTR (AAR) 209, discussed later in this paper.

62 Explanation to section 9(2) read:

Explanation - For the removal of doubts, it is hereby declared that for the purposes of this section, 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.

63 *Jindal Thermal Power Co. Ltd. v. DCIT*, [2006] 286 ITR 182.

64 The Karnataka High Court even stated that "it is explicit from the reading of Section 9(1)(vii)(c) and the explanation to section 9(2) that the ratio laid down by the Supreme Court in *Ishikawajima's* case still holds the field". *Id.*, at ¶ 6.

Court upheld this interpretation in its 2008 ruling in *Clifford Chance v. DCIT*.⁶⁵

The amendment next came up for adjudication in *Worley Parsons v. DIT*,⁶⁶ before the AAR in 2009, in which several hitherto disregarded aspects of the *Ishikawajima* judgment were brought to light. For one, the Supreme Court's entire judgment revolved around section 9(1)(vii)(c), which deals with payments for fees for technical services made by a non-resident, while in that case the fees were payable by a resident, the Indian company Petronet LNG. Secondly, the criterion of 'rendering' was nowhere to be found, even in the inapplicable clause and was a completely new and extraneous addition by the Supreme Court. However, stating that 'we have to respect the observations of the Supreme Court and the spirit behind it, without invoking the doctrine of *per incuriam* as far as possible', the underlying principle of the judgment i.e. applying the test of a territorial nexus while taxing transactions under section 9, was respected.

B. The Final Amendment

The matter was sought to be resolved finally by Parliament vide the Finance Act, 2010, which amended the previously inserted Explanation under section 9(2) to, in words as precise and clear as possible, do away with the two pronged test laid down in the *Ishikawajima* decision.⁶⁷ In *Ashapura Minichem Ltd. v. ADIT*,⁶⁸ the Income Tax Appellate Tribunal, for the first time since April 2010, had the opportunity to adjudicate on the position of law after the amendment. It held that the test laid down in *Ishikawajima* was no longer valid in light of the retrospective amendment, which incidentally took retrospective effect from way back in 1976.

65 *Clifford Chance v. DCIT*, [2002] 82 ITD 106.

66 *Worley Parsons v. DIT*, 223 CTR (AAR) 209.

67 Explanation to section 9(vii)(2) read:

Explanation - For the removal of doubts, it is hereby declared that for the purposes of this section, income of a non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of sub-section (1) and shall be included in the total income of the non-resident, whether or not, (i) the non-resident has a residence or place of business or business connection in India; or (ii) the non-resident has rendered services in India.

68 *Ashapura Minichem Ltd. v. ADIT*, (2010) 5 TMN 57 (Mum). See generally, *Linklaters LLP v. ITO*, (2010) 6 TMN 38 (Mum- ITAT):

As the law stands now, utilization of these services in India is enough to attract its taxability in India. To that effect, recent amendment in the statute has virtually negated the judicial precedents supporting the proposition that rendition of services in India is a sine qua non for its taxability in India.

However, the unanswered questions that still persist are whether the grant of extra-territorial taxing power in section 9 by the new amendment is *ultra vires* the constitution and if so, whether such power can be granted by a retrospective amendment. These issues are not new and have been discussed at length previously,⁶⁹ but in the light of the latest amendment, assume special significance in Indian tax jurisprudence.

C. *The Constitutional Validity of the Final Amendment*

It is submitted, with respect, that the new interpretation of section 9, which has now found legislative recognition through the amendment in the Finance Act, 2010, will be contrary to the well-settled international norms of taxation on a foreigner in respect of his income accruing, arising and received outside the taxing State. It is also against the spirit of the various tax treaties entered into by India with foreign countries, though a charge imposed by domestic law does not, and cannot supersede those treaties.⁷⁰ Such a situation, in which the Parliament confers on the Department powers to cast the net of taxation far and wide, would lead to patent unreasonableness in so far as transactions of foreigners will be taxable irrespective of a real territorial nexus with India.

Section 9(1)(vii)(b) of the Act, read with the newest amendment, seeks to charge a foreigner in respect of his income outside India only because the payment is made by an Indian resident for mere utilisation of services, even where the income arises under a contract which is made and performed entirely outside India and neither the income nor the contract has any real connection with India. The Supreme Court in fact, read in the additional criterion of 'rendering of services in India', so as to uphold the fundamental principle of territorial nexus.⁷¹ By expressly removing this criterion by way of the latest amendment to section 9, Parliament has shown utter disregard to the principle of territorial nexus, since now, mere utilisation of a service by an Indian resident is supposed to constitute adequate territorial nexus for the purposes of imposing tax liability, a most untenable proposition.

69 *British Columbia Electric Railway Company Limited v. The King*, (1946) A.C. 527, approved in *Electronics Corporation of India Ltd. v. CIT*, (1990) 183 ITR 43; *G.V.K. Industries Ltd. v. ITO*, [1997] 228 ITR 564 (AP). In *Electronics Corporation of India Ltd.*'s case, the matter was further referred to a Constitution Bench but the case was withdrawn before it came up for hearing.

70 This was the principle laid down the Supreme Court of Canada in *Queen v. Melford Developments*, 82 DTC 6281, which was later upheld in *Citizen Watch Co Ltd v. IAC*, [1984] 148 ITR 774. Section 90 of the Act embodies this very principle as it states that "the provisions of this Act shall apply to the extent they are more beneficial to that assessee".

71 *Ishikawajima*, *supra* note 60.

It is submitted that in the absence of any rational or reasonable territorial nexus, section 9 is unconstitutional as it attempts to tax enterprises providing services outside India, the basis of such extra-territorial operation being devoid of any real territorial nexus. Palkhivala opines that that if the scope and validity of these clauses were to be questioned before a court of law, the alternatives before the court would be either to strike down the provisions as *ultra vires* the legislative powers of the Indian Parliament or to read down the provisions and restrict their scope only to those cases where the facts and circumstances demonstrate a sufficient territorial nexus.⁷²

The most basic line of reasoning against such a challenge is that section 9 simply purports to tax any payments by a resident, made on account of fees for technical services and since fees for technical services fall under the head of income, such payments fall under the Parliament's legislative competence.⁷³ Further, given competence, if it is the will of the legislature to tax certain transactions, it can do so and the Constitution further extends this right to permit extra territorial legislation as well,⁷⁴ by way of Article 245(2). However, this argument is overly-simplistic and suffers the basic flaw of not taking into account the principle of territorial nexus, which has been re-affirmed several times as one fundamental to any source-based taxation regime.⁷⁵ Furthermore, a Constitution Bench of the Supreme Court has recently stated that legislation having no nexus with aspects and causes within India is *ultra vires* the competence of Parliament.⁷⁶

Therefore, it is the submission of the author that the extra territorial operation of section 9, to the extent laid down in the newest amendment is unconstitutional. A challenge to the *vires* of the amendment may also be levelled on the basis of Article 14 and Article 19, but a detailed discussion thereof is beyond the scope of this article.⁷⁷

72 Kanga and Palkhivala, *supra* note 7, at 384.

73 Entry 82, List I, Seventh Schedule, Constitution of India 1950: "*Taxes on income other than agricultural income*". When read with Article 246(1), the Parliament derives its power to legislate on all taxes on income. For the purposes of the Act, section 9 read with section 5(2)(b) and 4(2) of the Act ensure that such income becomes chargeable to tax in India

74 Maneka Gandhi v. Union of India, AIR 1978 SC 597.

75 Sijbren Clossen, *TAXING CAPITAL INCOME IN THE EUROPEAN UNION: ISSUES AND OPTIONS FOR REFORM* 103 (2000); Brian J. Arnold, *THE TAXATION OF CONTROLLED FOREIGN CORPORATIONS: AN INTERNATIONAL COMPARISON* 65 (1986); Edwin van der Bruggen, *CURRENT TRENDS IN ASIAN AND INTERNATIONAL BUSINESS TAXATION* 182 (2002).

76 GVK Industries Ltd. v. ITO, (2011) 4 SCC 36.

77 For a detailed analysis of the constitutional validity of the amended section 9, see, Andharia, *supra* note 58.

VI. CONCLUSION

'Those who do not learn from history, are doomed to repeat it.'

- George Santayana

One cannot deny the fact that amendments are an essential legislative tool and have great utility in clarifying the law when controversy emerges, for the object of any interpretative exercise is to ascertain the intention of the legislature, which no one can supply better than the legislature itself. What are problematic are retrospective amendments, made in a post-facto manner to overcome adverse decisions of the Courts. An amendment, especially to a taxation statute, must always be prospective in nature, unless it operates purely as a clarification.

The above three examples I have chosen to discuss are just a microcosm of what has long been set practice in taxation law, and a keener analysis will surely reveal hundreds of situations such as these over the last fifty years.⁷⁸ What is perhaps most worrisome is that the Department never seems to learn from its numerous mistakes and continues to bring in amendments in haste to overcome adverse judgments. As of today, the draft Direct Taxes Code contains all the provisions as newly amended - surely, they are condemned to repeat their follies unless a new mechanism is evolved. I would propose that if there is in fact an adverse decision of a court that interprets the law against the Department's intention, a high-powered committee or group under the CBDT should be tasked with its review and only then should amendments be recommended. Furthermore, as far as possible, such amendments should be only prospective in nature.

These measures would introduce consistency in Indian tax law, a feature woefully absent at present. Furthermore, such a considered multi-tier review and recommendation process would avoid situations such as those that have arisen under clauses (vi) and (vii), where a hasty amendment was added, only to be interpreted by the courts as insufficient to overcome the relevant judicial decision.

India is one of the world's fastest growing economies and a major destination for foreign investment. Nevertheless, the one thing that investors look for when investing their funds, apart from commercial gain, is certainty and consistency in the legal regime governing their investments. Taxation law has a major role to play in creating such a conducive atmosphere for investment and to that end, it is hoped that reforms to our system of amending the Act are made as soon as possible, if

78 Kanga and Palkhivala, *supra* note 7, at 2.

Section 9 of the Income Tax Act, 1961: Defaced and Defiled?

our position as a preferred investment destination is not to be lost. While no such systemic change appears to be on the cards, in the words of Alexander Pope,⁷⁹ hope springs eternal.

⁷⁹ Alexander Pope, *AN ESSAY ON MAN*, 1 (1733).