

# THE VALIDITY OF RETROSPECTIVE AMENDMENTS TO THE INCOME TAX ACT: SECTION 9 OF THE ACT AND THE ISHIKAWAJIMA HARIMA CASE

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*This article discusses the contemporary issues surrounding §9 of the Income Tax Act, 1961. The core issue is discussed, giving specific importance to the ambivalent nature of the law in this area since Ishikawajima's case, such ambivalence lasting until the amendment in 2010, which has been bemoaned by lawyers across the country as a step too far in the exercise of Parliament's legislative powers. Three aspects of the constitutional validity of the section as amended in 2010, namely, the validity of the retrospective character of the amendment, the validity of the amendment vis-à-vis Art. 14 of the Constitution and the extra-territorial operation of the substantive levy of charge, are discussed at length by the researcher. In elaborately laying out the grounds for constitutional challenge, I also address aspects such as the weighty presumption of constitutionality that operates in regard to fiscal legislation, going on to prove how the criteria of 'palpable arbitrariness' is satisfied by the over-reaching nature of the amended section. In conclusion, I ponder upon the road ahead and chalk this out laying emphasis on the inherently dangerous nature of such an amendment, since similar provisions have been incorporated in the proposed draft Direct Taxes Code.*

## I. INTRODUCTION

“Every government has a right to levy taxes. But no government has the right, in the process of extracting tax, to cause misery and harassment to the taxpayer and the gnawing feeling that he is made a victim of palpable injustice.”<sup>1</sup>

-Nani Palkhivala

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<sup>1</sup> KANGA & PALKHIVALA, THE LAW AND PRACTICE OF INCOME TAX, ix (Dinesh Vyas ed., 2004).

The large number of ‘clarificatory’ amendments made to the Income Tax Act, 1961 (‘the Act’)<sup>2</sup> vide the Finance Acts, with the sole purpose of nullifying decisions of the courts has become an extremely alarming trend in recent years.<sup>3</sup> These amendments generally occur within months of an adverse decision by the Supreme Court and while purporting to clarify the law as it stands, they effectively change the position of law as interpreted by the courts, usually in favor of the department.

It is undisputed that the legislature does have the power to legislate with retrospective effect.<sup>4</sup> Looking at the frequency and number of amendments carried out, however, the question to be asked is whether this power can be used even if the sole motive is merely to overturn a decision of the courts. While it is said that such power is essential to the modern direct taxation regime, given the almost collusive attitude of the Department of Income Tax and Union Parliament in implementing these amendments, the manner, method and frequency of such amendments is nevertheless disturbing. The fundamental principle that must be borne in mind is that what is directly forbidden cannot be indirectly achieved.<sup>5</sup>

Just one example of this disquieting phenomenon would be the entire controversy surrounding the various interpretations of §9(1)(vii) of the Act. After the amendment to §9 of the Act in April, 2010 it would appear that the entire debate surrounding the taxability of fees for technical services, which started after the Supreme Court’s controversial decision in *Ishikawajima Harima Heavy Industries Ltd. v. Director of Income Tax, Mumbai*,<sup>6</sup> (‘*Ishikawajima*’) has finally been put to rest.

Though the position of law regarding the substantive provision imposing the levy of tax itself is now clear, what still deserves attention is the constitutional validity of the amendment made vide §4 of the Finance Act 2010. The question of extra-territorial operation of the section and the validity of the amendment’s thirty-four year retrospective operation are also aspects of the issue which deserve analysis. This note seeks to explore these aspects of the amendment, with the background of the controversial interpretations of the section itself.

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<sup>2</sup> No. 43 of 1961.

<sup>3</sup> Seven such amendments were made by the Finance Act, 2010 alone.

<sup>4</sup> *Maneka Gandhi v. Union of India*, (1978) 1 SCC 248: AIR 1978 SC 597.

<sup>5</sup> *Indira Nehru Gandhi v. Raj Narain*, 1975 Supp SCC 1: AIR 1975 SC 2299.

<sup>6</sup> (2007) 3 SCC 481: (2007) 288 ITR 408, AIR 2007 SC 929.

## II. THE GENESIS OF THE DEBATE – *ISHIKAWAJIMA* AND BEYOND

Until 2007, the provisions of §9(1)(vii)<sup>7</sup> seemed clear and unambiguous, when the Supreme Court ruling in *Ishikawajima* case<sup>8</sup> laid down a new test for taxability of fees for technical services rendered by a non-resident. Justice Sinha, speaking for a Division Bench of the Hon'ble Court, stated that for such fees to be taxable, the services concerned must be: (1) utilized in India; and (2) rendered in India.<sup>9</sup> The basis for this decision was the principle of territorial nexus, which the Supreme Court most appropriately described as 'internationally accepted'.

This decision, which upset the settled position of law as it had stood for the previous 30 years, led to utter confusion in the minds of both the Revenue Department as well as the judiciary. Perturbed as the Department was by the new interpretation put forth by the Supreme Court and its ramifications on taxability of lucrative foreign services transactions, an amendment in the law was ensured within four months and incorporated in the Finance Act, 2007.<sup>10</sup> This was done by an Explanation inserted below §9(2), with retrospective effect from June 1, 1976. It essentially clarified that the incomes mentioned in §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.

The amendment, however, 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*,<sup>11</sup> 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 utilizing services in India laid down by the Supreme Court in the *Ishikawajima* case remained unaffected

<sup>7</sup> §9(1) Income Tax Act, 1961: 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 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.

<sup>8</sup> (2007) 3 SCC 481.

<sup>9</sup> It is the submission of the author that this decision was erroneous on several counts. These shortcomings are detailed in *Worley Parsons v. DIT*, 223 CTR (AAR) 209, discussed later in this note.

<sup>10</sup> 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.

<sup>11</sup> (2006) 286 ITR 182.

by the new explanation.<sup>12</sup> The Bombay High Court upheld this interpretation in its 2008 ruling in *Clifford Chance v. DCIT*.<sup>13</sup>

The conflicting interpretations next came up for adjudication in *Worley Parsons v. DIT*<sup>14</sup> before the Authority for Advanced rulings 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 §9(1)(vii)(c), which dealt 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 section and was a completely new and extraneous addition by the Supreme Court. Even so, 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 §9, was respected.

The matter came to a head with the Parliament vide the Finance Act 2010, amending the Explanation under §9(2), in words as precise and clear as possible, thereby doing away with the two pronged test laid down in the *Ishikawajima* case.<sup>15</sup> In *Ashapura Minichem Ltd. v. ADIT*,<sup>16</sup> 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 the *Ishikawajima* case was no longer valid in light of the retrospective amendment which took effect from June 1, 1976.

Yet, unanswered questions still persist, First, whether the grant of extra-territorial taxing power in §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

<sup>12</sup> The Division Bench of the Karnataka High Court even stated that "it is explicit from the reading of §9(1)(vii)(c) and the explanation to §9(2) that the ratio laid down by the Supreme Court in *Ishikawajima*'s case still holds the field."

<sup>13</sup> (2009) 318 ITR 237 (Bom); 82 ITD 106.

<sup>14</sup> (2009) 223 CTR 209 (AAR); 223 CTR (AAR) 209.

<sup>15</sup> *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.

<sup>16</sup> (2010) 5 Taxman 57 (Bom). *See generally*, *Linklaters LLP v. ITO*, (2010) 6 Taxman 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."

previously,<sup>17</sup> but in the light of the latest amendment they assume special significance in Indian tax jurisprudence.

### III. THE PRESUMPTION OF CONSTITUTIONALITY

While examining the constitutionality of a statute, the first and most basic obstacle encountered is the strong presumption in favour of the constitutionality of a statute,<sup>18</sup> a presumption which the Supreme Court itself has stated, 'only the clearest and weightiest evidence can displace'.<sup>19</sup> This presumption is taken even further in matters involving economic policy and exercise of discretion in fiscal matters. The interference of the Court in such matters must not happen unless 'the exercise of legislative judgment appears to be palpably arbitrary'<sup>20</sup> or 'the view reflected in the legislation is not possible to be taken at all.'<sup>21</sup>

Similarly, in the matter of the constitutionality of §9 of the Act, there is definitely a 'presumption in favour of the benevolent aspect of the legislator',<sup>22</sup> one which must be sustained taking into consideration 'matters of common knowledge, matters of common report, the history of the times and assuming every state of facts which can be conceived existing at the time of legislation'.<sup>23</sup>

At the same time it is just as well settled that such a presumption is a rebuttable one<sup>24</sup> and if it is in fact shown that a certain legislation is unfair to the point of palpable arbitrariness, the Courts may strike down such legislation as unconstitutional. It is submitted that §9 of the Act, as it stands, is unconstitutional and rebuts the presumption of constitutionality since firstly, it is beyond the legislative competence of the Parliament to the extent that it seeks

<sup>17</sup> *British Columbia Electric Railway Company Ltd. v. The King*, (1946) AC 527, approved in *Electronics Corporation of India Ltd. v. CIT*, 1989 Supp (2) SCC 624: (1990) 183 ITR 43 (SC), *G.V.K. Industries Ltd. v. ITO*, 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.

<sup>18</sup> H.M. SEERVAI, *CONSTITUTIONAL LAW OF INDIA* 455 (2002).

<sup>19</sup> *R.C. Tobacco v. Union of India*, (2005) 7 SCC 725.

<sup>20</sup> *R.K. Garg v. Union of India*, (1981) 4 SCC 675: AIR 1981 SC 2138. For examples of the strong presumption in favour of the constitutionality of fiscal statutes, see also *Ganga Sugar Corporation Ltd. v. State of Uttar Pradesh*, (1980) 1 SCC 223, *State of Uttar Pradesh v. Kamla Palace*, (2000) 1 SCC 557.

<sup>21</sup> *Bhavesh D. Parish v. Union of India*, (2000) 5 SCC 471: AIR 2000 SC 2047.

<sup>22</sup> *Abhinav Chandrachud, How Legitimate is Non-Arbitrariness? Constitutional Invalidation in the Light of Mardia?* *Chemicals v. Union of India*, 2 INDIAN J. CONST. L. 179 (2008).

<sup>23</sup> *Ram Krishna Dalmia v. Justice S.R. Tendolkar*, AIR 1958 SC 538 at 547; *R.C. Tobacco v. Union of India*, (2005) 7 SCC 725.

<sup>24</sup> *State of Bihar v. Bihar Distillery Ltd.*, (1997) 2 SCC 453, *Ram Prasad v. State of Bihar*, AIR 1953 SC 215, *Ram Krishna Dalmia v. Justice S.R. Tendolkar*, AIR 1958 SC 538.

to tax fees for technical services that were not rendered in India and secondly, as it offends Art. 14 of the Constitution by treating dissimilar entities similarly.

#### IV. EXTRA-TERRITORIAL OPERATION SANS TERRITORIAL NEXUS: PARLIAMENT'S LEGISLATIVE COMPETENCE

“Taxes are the lifeblood of the government, but it cannot be over-emphasized that the blood is taken from the arteries of the taxpayers and, therefore, the transfusion has to be accomplished in accordance with the principles of justice and fair play.”<sup>25</sup>

-Nani Palkhivala

##### A. EXTRA-TERRITORIAL LAWS: THE CONSTITUTIONAL POSITION

To explore the validity of legislations having extra territorial operation, due consideration of the history of Art. 245 is required. §65 of the Government of India Act, 1915, dealt with the legislative power of the Indian legislature at that time. Clause (a) was strictly territorial; while clauses (b) and (c) allowed the legislature to make laws with extraterritorial effect, provided that the nexus requirements (‘all subjects of His Majesty’ and ‘all native Indian subjects’ respectively) were satisfied. The inclusion of clauses (b) and (c) was necessitated by a few decisions which imposed a strict nexus requirement.<sup>26</sup> Thus, clauses (b) and (c) widened the requirement of a nexus to that extent.

§99(1)<sup>27</sup> of the Government of India Act, 1935, which conferred legislative power, modified the position of law in so far as it permitted legislation only for ‘the whole or any part of British India’. It, however, also provided in §99(2) for certain exceptions to this rule.<sup>28</sup> The Privy Council in the *Wallace Brothers case*<sup>29</sup> clarified the position of law, clearly laying down the necessity

<sup>25</sup> KANGA & PALKHIVALA, *supra* note 1, ix.

<sup>26</sup> *Blackwood v. The Queen*, (1882) 8 AC 82; *Provincial Treasurer of Alberta v. Kerr*, (1933) AC 710.

<sup>27</sup> §99(1), Government of India Act, 1935: Subject to the provisions of this Act, the Federal Legislature may make laws for the whole or any part of British India or for any Federal State and a Provincial Legislature may make laws for the Province or for any part thereof.

<sup>28</sup> §99(2), Government of India Act, 1935: Without prejudice to the generality of the powers conferred by the preceding sub-section, no Federal law shall, on the ground that it would have extra-territorial operation, be deemed to be invalid insofar as it applies (a) to British subjects and servants of the Crown in any part of India or (b) to British subjects who are domiciled in any part of India wherever they may be or (c) to or to persons on, ships or aircraft registered in British India or any Federated State wherever they may be.

<sup>29</sup> *Wallace Bros. & Co. Ltd. v. CIT*, (1947-48) 75 IA 86. Speaking for a three judge bench, Uthwatt, J. stated that “the general conception as to the scope of income tax is that given

of a definite territorial nexus. In *A.H. Wadia v. CIT*,<sup>30</sup> however, while further impressing on the need for territorial nexus, the Bombay High Court declared that there was nothing unconstitutional about an extra territorial legislation as long as such nexus requirement is fulfilled.<sup>31</sup>

More recently, §§6(1) and 6(2) of the Indian Independence Act, 1947, provided that the legislature of each of the New Dominions shall have full power to make laws for that Dominion, including laws having extra-territorial operation.

Today, under our present constitutional scheme, the Parliament may make laws which operate extra-territorially.<sup>32</sup> Arts. 245 (1) and (2)<sup>33</sup> of the Constitution prescribe the extent of laws made by Parliament and it is declared that no law made by Parliament shall be invalid on the ground that it would have extra-territorial operation.<sup>34</sup> Therefore, the Parliament undoubtedly has power to enact law having extra-territorial application.<sup>35</sup> On the face of it, it would appear that the law as it stands is clear and precise in disregarding any previous requirement of territorial nexus. This interpretation would also seem the most logical, keeping with the principle of sovereignty as enshrined in the Preamble, since the Government of India Acts gave law-making power to the legislatures of British India, while the Constitution gives such power to a sovereign and independent India.

## *B. JUDICIAL EXPOSITION OF EXTRA-TERRITORIAL TAXATION LAWS*

The view taken by the Supreme Court in this regard, in consonance with principles of international law and sovereignty, is that ‘a legislature which passes a law having extra-territorial operation may find that what it has enacted cannot be directly enforced but the Act is not invalid on that account,

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a sufficient territorial connection between the person sought to be charged and the country seeking to tax him, income tax may properly extend to that person in respect of his foreign income.”

<sup>30</sup> (1949) 17 ITR 63 (FC).

<sup>31</sup> *Per* Chagla, J. in his concurring opinion, “no limitation is placed upon the Legislature that the provisions of the Act of the Legislature passed should be intra-territorial in their character. It is entirely a matter of State policy to what extent the Indian Legislature should enact extra-territorial statutes. No Legislature would like to stultify itself and no Legislature would pass laws which it could not enforce; but those are not matters for a Court of laws.”

<sup>32</sup> *Vodafone International Holdings B.V. v. Union of India*, (2010) 7 Taxmann 13 (Bom).

<sup>33</sup> The Constitution of India, 1950, Art. 245(1): Subject to the provisions of this Constitution, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State. (2) No law made by Parliament shall be deemed to be invalid on the ground that it would have extra-territorial operation.

<sup>34</sup> *Electronics Corporation of India Ltd. v. CIT*, 1989 Supp (2) SCC 642: 83 ITR 43 (SC).

<sup>35</sup> *Maneka Gandhi v. Union of India*, (1978) 1 SCC 248: AIR 1978 SC 597.

and the courts of its country must enforce the law with the machinery available to them'.<sup>36</sup> In other words, while the enforcement of law cannot be contemplated in a foreign State, it can, nonetheless, be enforced by the courts of the enacting State to the degree that is permissible with the machinery available.<sup>37</sup>

Therefore, the question that arises is whether a nexus with something in India is necessary to establish tax liability in such cases. The Supreme Court has stated that unless such a nexus exists, Parliament has no competence to make such extra-territorial law. The provocation for an extra-territorial law must be found within India itself and while a law may have extra-territorial operation in order to serve a certain object, that object must be related to something in India in the first place. It is absolutely inconceivable that a law should be made by Parliament which has no relationship with anything in India.<sup>38</sup> It is just as true that this connection must be a real one and the liability sought to be imposed must be pertinent to that connection.<sup>39</sup>

Therefore, the presence of Art. 245(2) notwithstanding, there must be a territorial nexus between the transaction sought to be taxed and India, for a tax liability to be placed on such a transaction happening outside India. The question of the validity of §9 had arisen previously, in *Electronics Corporation of India Ltd. v. CIT*,<sup>40</sup> and the Supreme Court had referred the question of constitutionality to a Constitution Bench.<sup>41</sup> The case, however, was withdrawn on settlement and never came up for hearing. While discussing the challenge on the constitutional validity of §9, the Court stressed on the necessity of a territorial nexus, but also went on to state that if, due to such extra territorial application, un-enforceability arises as a consequence, this in itself cannot be found as sufficient basis to challenge the validity of the statute.

### C. THE AMENDMENT TO SECTION 9 OF THE INCOME TAX ACT, 1961: A STEP TOO FAR?

The new interpretation of §9, which has found legislative recognition through the amendment vide 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 letter and 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

<sup>36</sup> *British Columbia Electric Railway Company Limited v. The King*, (1946) AC 527, approved in *Electronics Corporation of India Ltd. v. CIT*, 1989 Supp (2) SCC 642: (1990) 183 ITR 43.

<sup>37</sup> *G.V.K. Industries Ltd. v. ITO*, 228 ITR 564.

<sup>38</sup> *Electronics Corporation of India Ltd. v. CIT*, (1990) 183 ITR 43.

<sup>39</sup> *The State of Bombay v. R. M. D. Chamarbaugwala*, 1989 Supp (2) SCC 642: AIR 1957 SC 699.

<sup>40</sup> 1989 Supp (2) SCC 642: (1990) 183 ITR 43 (SC).

<sup>41</sup> It was observed that "the question is one of substantial importance, especially as it concerns collaboration agreements with foreign companies and other such arrangements for the better development of industry and commerce in India".

supersede those treaties.<sup>42</sup> Such a situation, in which the Parliament confers on itself powers to cast the net of taxation far and wide, would lead to a manifest absurdity and patent unreasonableness insofar as transactions of foreigners will be taxable irrespective of a real territorial nexus with India. It was the opinion of the learned author and jurist, the late Sri N. A. Palkhivala, that if such a proposition were accepted, the Indian Parliament could 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.<sup>43</sup>

§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 criteria of 'rendering of services in India', so as to uphold the fundamental principle of territorial nexus.<sup>44</sup> By expressly removing this criterion by way of the latest amendment to §9, Parliament has shown absolute disregard to the principle of territorial nexus, since mere utilisation of a service in India does not and cannot constitute adequate territorial nexus for the purposes of imposing tax liability. In the absence of any rational or reasonable territorial nexus, §9 is unconstitutional as it purports to tax enterprises providing services outside India, the basis of such extra-territorial operation being without any territorial nexus whatsoever.

Palkhivala further 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 so as to restrict their scope only to those cases where on the facts a sufficient territorial nexus exists.<sup>45</sup>

The most basic line of reasoning against this argument is that §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.<sup>46</sup> Further, given competence, if it is the will of the legislature to tax certain trans-

<sup>42</sup> This was the principle laid down by Estey, J. of the Supreme Court of Canada in *Queen v. Melford Developments*, 82 DTC 6281, which was later upheld in *Citizen Watch v. IAC*, (1984) 148 ITR 774, 787. §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".

<sup>43</sup> KANGA & PALKHIVALA, *supra* note 1, 384.

<sup>44</sup> *Ishikawajima Harima Heavy Industries Ltd. v. DIT*, (2007) 3 SCC 481.

<sup>45</sup> KANGA & PALKHIVALA, *supra* note 1, 384.

<sup>46</sup> The Constitution of India, 1950, Entry 82, List I, Seventh Schedule: 'Taxes on income other than agricultural income.' When read with Art. 246(1), the Parliament derives its power to

actions, it can do so and the Constitution further extends this right to permit extra territorial legislation as well,<sup>47</sup> by way of Art. 245. This argument, however, 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.<sup>48</sup> Therefore, in the author's opinion the extra territorial operation of §9 to the extent laid down in the amended §9, is unconstitutional.

## V. TREATMENT OF UNEQUALS AS EQUAL – A CLEAR VIOLATION OF ARTICLE 14

This part explores how the amendment brought in by the Finance Act, 2010 erases a relevant and necessary distinction between two classes of assesseees, with no real basis for doing so. It is argued that in eradicating this most relevant distinction, the Parliament has acted in clear violation of Art. 14, forcing two groups differently situated to be treated on equal footing in law.

### A. ARTICLE 14 AND EQUAL PROTECTION OF THE LAWS

Art. 14<sup>49</sup> guarantees equal protection of law to all persons, but at the same time this does not prevent the State from applying different laws to people situated differently. It is, however, well established that such a classification must be founded on an intelligible differentia and this differentia must have a rational relation to the object sought to be achieved by the statute.<sup>50</sup> The corollary to the rule that the same law should apply to persons similarly situated is that unequals should not be treated equally.<sup>51</sup>

Justice Felix Frankfurter once famously declared that there is no greater inequality than the equal treatment of unequals.<sup>52</sup> The Supreme Court of India has read this very principle into the right to equality, stating that Art.

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legislate on all taxes on income. For the purposes of the Act, §9 read with §§5(2)(b) and 4(2) of the Act ensure that such income becomes chargeable to tax in India.

<sup>47</sup> *Maneka Gandhi v. Union of India*, (1978) 1 SCC 248; AIR 1978 SC 597.

<sup>48</sup> SIBBREN CROSSEN, *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).

<sup>49</sup> *The Constitution of India*, 1950, Art.14: The State shall not deny to any person equality before the law or the equal protection of the laws within the territory of India.

<sup>50</sup> *State of West Bengal v. Anwar Ali Sarkar*, AIR 1952 SC 75, *Budhan v. State of Bihar*, AIR 1955 SC 191; *Harakchand v. Union of India*, (1969) 2 SCC 166; AIR 1970 SC 1453; *State of Bombay v. F.N. Balsara*, AIR 1951 SC 318.

<sup>51</sup> M.P. JAIN, *INDIAN CONSTITUTIONAL LAW* 1002 (2003).

<sup>52</sup> *Dennis v. United States*, 339 US 162, 184 (1950) (dissenting opinion).

14 would be violated even if there is similar treatment of groups situated in dissimilar circumstances, or if 'unequals are treated as equal'.<sup>53</sup>

### *B. THE AMENDMENT OF SECTION 9: AN EXERCISE IN IGNORANCE OF INEQUALITY*

What the amendment clearly seeks to do is put an end to the differential application of §9(1)(vii) to persons rendering technical services in India and persons rendering these services outside India. After *Ishikawajima's* case,<sup>54</sup> these two groups were treated differently as the latter group was taxable only in the country of residence and not in India.<sup>55</sup> Enterprises which conclude contracts, employ personnel, invest funds and other such resources, and effectively render services outside the territory of India are, by the new amendment being treated exactly at par with enterprises carrying out all such activities essential to the rendering of technical services within the territory of India. These two classes of enterprises therefore differ in relation to their contribution to and relationship with the Indian economy and hence treating them in an alike manner would be extremely unreasonable.

It has been argued above that enterprises rendering services from abroad and those doing so from India are two distinctly dissimilar groups of people for the purposes of charging income tax. The elimination of a differentiation between certain groups could, however, be made and as long as the measure which has been put into place has nexus with the object sought to be achieved, it passes constitutional muster.<sup>56</sup> In the case of the present amendment, however, the elimination of such discrimination does not seem to have any rational nexus with the object of the provision, that is, to tax only those incomes in the nature of fees for technical services arising out of a territorial nexus with India. The lack of a territorial nexus has been pointed out in the previous section and the object of levying tax bearing in mind this principle is defeated with the elimination of the present distinction.

Therefore, by eliminating a clearly relevant distinction between two classes of persons, without any regard to the object of the distinction in the first place, the amendment is clearly arbitrary, unreasonable and can therefore be held invalid as it violates Art. 14 of the Constitution.

<sup>53</sup> *Chiranjit Lal v. Union of India*, AIR 1951 SC 41; *Om Narain v. Nagar Palika Shahjahanpur*, (1993) 2 SCC 242.

<sup>54</sup> *Ishikawajima Harima Heavy Industries Ltd. v. DIT*, (2007) 3 SCC 481.

<sup>55</sup> The nature of tax liability in such cases would depend on the terms of the Double Taxation Avoidance Agreement between the country of residence and India.

<sup>56</sup> *Godrej & Boyce Mfg. Co. Ltd. v. DCIT*, 2010 TIOL 564 HC (Bom). In this case, a similar argument was put forth, albeit unsuccessfully, in challenging the constitutional validity of Rule 8D of the Income Tax Rules and §14A of the Income Tax Act. The Bombay High Court did not accept the argument and cited the strong presumption of constitutionality as the primary reason for upholding the impugned section and rule, while striking down its retrospective effect.

## VI. RETROSPECTIVE APPLICABILITY OF THE AMENDMENT – A NEW LEVY?

This section explores how the retrospective character granted to the amendment to §9 is in itself flawed, such retrospective character introducing an absolutely new levy and is not of merely clarificatory nature as alleged by the Department. While retrospective legislation is permissible, there are nevertheless certain restrictions that can effectively curb the exercise of such power.

### A. *THE CONSTITUTIONAL POSITION ON RETROSPECTIVE TAXATION LEGISLATION*

A taxing statute is usually prospective i.e. levying the tax on the income to be earned or transactions which will take place in future. This is for the reason that, at the time of entering into a transaction, the tax payers must have knowledge of the tax which he is expected to pay. It also provides an opportunity to the taxpayer of carrying out cost-benefit analysis of the proposed transaction and to decide whether or not to enter into such a transaction.<sup>57</sup> This is the generally accepted system that transcends all systems of taxation across the world.

It is, however, just as true that the Parliament has the power to legislate retrospectively and a law can never be invalidated simply on the ground that it is retrospective in operation. A statute that is retrospective is generally presumed to be unjust and oppressive unless such retrospective effect is provided in the statute expressly or impliedly.<sup>58</sup> Tax statutes may be retrospective if the legislature clearly so intends but the reasonableness of each retroactive tax statute will depend on the circumstances of each case and if the retrospective feature of a law is arbitrary and burdensome, the statute will not be sustained.<sup>59</sup> In testing whether a retrospective imposition of tax is so harsh so as to violate Art. 19(1)(g), the relevant factors include the period of retrospectivity and the degree of any unforeseen financial burden imposed for the past period.<sup>60</sup> It is also the established position of law that a mechanical test based on the length of time covered by the retrospective operation of an Act cannot be applied in determining its validity.<sup>61</sup>

<sup>57</sup> Pradip R. Shah, *Retrospective Amendments – High-time for Introspection by India*, April 1, 2010 available at <http://www.caclubindia.com/articles/retrospective-amendments-high-time-for-introspection-by-india-5144.asp>. (Last visited on March 10, 2011).

<sup>58</sup> VEPA P.SARATHI, *INTERPRETATION OF STATUTES* 467 (2003).

<sup>59</sup> SUTHERLAND, *STATUTES AND STATUTORY CONSTRUCTION* 131-133 (1943).

<sup>60</sup> *Ujagar Prints v. Union of India*, (1989) 3 SCC 488; AIR 1989 SC 516 (532).

<sup>61</sup> *Rai Ramakrishna v. State of Bihar*, (1963) 50 ITR 171. Gajendragadkar, J. (as he then was), speaking for the five judge bench of the Supreme Court, went to the extent of saying that “we may have a statute whose retrospective operation covers a comparatively short period and yet

If, by a curative exercise made by the legislature, the earlier judgment becomes irrelevant and unenforceable, that cannot be called an impermissible legislative overruling of the judicial decision.<sup>62</sup> The Supreme Court considered a similar question in *National Agricultural v. Union of India*.<sup>63</sup> Here, by amendment, Parliament had substituted the word “of” in §80P(2)(a) (iii) of the Act, which had previously been construed by Supreme Court as “belonging to”, with the phrase “grown by”.<sup>64</sup> The Supreme Court held that the clear effect of the amendment would be that the section would be read with the substituted phrase and that the provision and its retrospective effect from April 1, 1968 were valid. The Court, however, went on to state that if it had been found to be an imposition of an altogether new tax liability, the court would have considered the amendment to be excessively and unreasonably retrospective violating the assessee’s fundamental rights under Arts. 19(1)(g) and 14 of the Constitution.

The position of law regarding retrospective amendments is that a statutory provision that is not expressly made retrospective but is nevertheless of an explanatory, declaratory, curative or clarificatory nature must be judicially construed as retrospective.<sup>65</sup> An explanation brought on the statute book is usually clarificatory in nature and is given retrospective effect since in the eyes of the law; a new explanation brought to a provision in the statute simply explains the law as it has always been in the main provision.<sup>66</sup> In cases where a new Explanation is inserted, retrospective effect is generally presumed, as is the clarificatory nature of the amendment.

If a clarificatory explanation seeking to get over previous judicial decisions is seen to be amounting to a ‘new’ levy – or is in substance a change in law, the retrospective amendment will then be rendered unconstitutional.<sup>67</sup> In such cases, the presumption of constitutionality cannot be carried to the extent of always holding that there must be some undisclosed and unknown reasons

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it is possible that the nature of the restriction imposed may be of such a character as to introduce a serious infirmity in the retrospective operation. On the other hand, we may get cases where the period covered by the retrospective operation of the statute, though long, will not introduce any such infirmity.”

<sup>62</sup> *Ujagar Prints v. Union of India*, (1989) 3 SCC 488: 179 ITR 317.

<sup>63</sup> (2003) 5 SCC 23: 260 ITR 548.

<sup>64</sup> There is a similarity with the facts of the present case, since with §9(1)(vii), the section is silent on rendering of services but the Supreme Court read it in later as a requirement, following which Parliament, by amendment has expressly removed rendering of services as a criterion for tax liability under the section.

<sup>65</sup> *Allied Motors (P) Ltd. v. CIT*, (1997) 3 SCC 472: 224 ITR 677; *CIT v. India Steamship*, 196 ITR 917.

<sup>66</sup> *Laxmi Industries Ltd. v. ITO*, 231 ITR 514; *CIT v. Sri Jagannath*, 191 ITR 676; *ITO v. Manoharlal*, 236 ITR 357.

<sup>67</sup> *National Agricultural Co-operative Marketing Federation of India v. Union of India*, (2003) 5 SCC 23: 260 ITR 548.

for subjecting certain individuals or corporations to hostile or discriminating legislation and such a law may be struck down if found to be unreasonable.<sup>68</sup>

While it is clear that the Parliament most definitely has the power to enact retrospective legislation, it is also just as clear that the power to amend enacted law with retrospective effect is not only subject to the question of competence but also to several judicially recognized limitations.<sup>69</sup> Art. 19(1)(g),<sup>70</sup> in granting the right to practice any profession, or to carry on any occupation, trade or business, carries with it a further safeguard against imposition of an unreasonable tax burden.<sup>71</sup>

### *B. THE FINANCE ACT, 2010: INTRODUCING A NEW LEVY?*

With respect to the amendment to §9, the position of law prior to the amendment was that no person who was paid fees for technical services rendered outside the territory of India could be liable to tax.<sup>72</sup> The amendment, however, clearly purports to retrospectively tax all such payments for services rendered abroad as well, which clearly amounts to the creation of a new tax liability altogether. Therefore, the amendment though in the form of an explanation, is not a clarification and on the contrary, seeks to create a fresh tax liability.

The implications of this retrospective amendment can be far-reaching and of considerable importance to multinational enterprises, especially in cases of headquarter companies rendering centralized services to affiliates across the globe.<sup>73</sup> While the judicial pronouncements favouring the Department, like in *DDIT v. Tata Iron & Steel Co.*,<sup>74</sup> continue to exclude taxability of offshore services under §9 as long as the recipient of services was a non-resident of India (and the services are related to business or profession or other source of income in India), the amended §9 brings such services into the tax net as well. The retrospective amendment will also lead to reopening

<sup>68</sup> R.K. Dalmia v. Justice Tendolkar, AIR 1958 SC 1938.

<sup>69</sup> National Agricultural Co-operative Marketing Federation of India v. Union of India, (2003) 5 SCC 23: 260 ITR 548 (SC).

<sup>70</sup> The Constitution of India, 1950, Art. 19(1): All citizens shall have the right—(g) to practise any profession, or to carry on any occupation, trade or business.

<sup>71</sup> Ram Bachan v. State of Bihar, AIR 1967 SC 1404.

<sup>72</sup> See *Ishikawajima Harima Heavy Industries Ltd. v. Director of Income Tax*, (2007) 3 SCC 481: 288 ITR 408, AIR 2007 SC 929; *Worley Parsons v. DIT* (2009) 223 CTR (AAR) 209, *Clifford Chance v. DCIT* 318 ITR 297; *Jindal Thermal Power Co. Ltd. v. DCIT*, (2009) 225 CTR (Kar) 220.

<sup>73</sup> Amit Aggarwal, *International Taxation: Retrospective Amendment clears the Air on taxation of Offshore Services*, November 27, 2010 available at <http://www.taxmann.com/Expertopinon/INTERNATIONALTAXATIONRetrospectiveamendment.htm> (Last visited on March 10, 2011).

<sup>74</sup> 2009 TIOL 569.

of cases concluded on basis of decisions in favour of the taxpayer and subsequently, the recovery of taxes with interest. The Department could even initiate withholding tax scrutiny of returns for payment to non-residents and then proceed to recover applicable taxes along with interest from the remitters. Therefore, it is submitted that since a new tax burden is being imposed with retrospective effect, the amendment is not merely clarificatory and in light of the disastrous and far reaching consequences of such an amendment, it is liable to be struck down as offensive to Arts. 19 and 14.

## VII. CONCLUSION

“[We Indians]...endure foolish laws and maddening amendments which benefit none except the legal and accountancy provisions, and instinctively prefer to circumvent the law than to fight for its repeal.”<sup>75</sup>

-Nani Palkhivala

Until the Supreme Court’s decision in the *Ishikawajima* case, §9 carried the same meaning as it does after the amendment by the Finance Act, 2010. While the judgment was landmark in the sense that it gave a new interpretation to the provision, it suffered from several infirmities. For one, a basic error that was committed was the reading in of an additional criterion which hitherto existed nowhere in the statute; that of ‘rendering services in India’. In doing so, the Court ignored a fundamental tenet of taxation law, that of strict interpretation, best stated by Rowlatt J. in *Cape Brandy Syndicate v. IRC*, (1921) 1 KB 64 and approved in *CIT v. Ajax Products Ltd.*, (1965) 55 ITR 741.

“In a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing to be implied. One can only look at the language used.”

Not only does the principle of strict interpretation apply in all taxing statutes, but also in the present context, the principle that sections which impose a charge should be strictly construed<sup>76</sup> assumes significance in light of the fact that §9 forms a component of the sections that impose a charge.

That, however, does not mean that the resulting position of law after the case was undesirable in any way. The judgment impressed upon the internationally accepted principle of territorial nexus and effectively modified the law as it stood to incorporate that principle as a restriction to the source rule in the Act. Notwithstanding these issues, the law as it stands today does not

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<sup>75</sup> KANGA & PALKHIVALA, *supra* note 1, viii.

<sup>76</sup> *I.R. v. Countess of Longford*, 13 TC 573, 620 (HL); *Kerala SIDC v. CIT*, 246 ITR 330.

paint a pretty picture, and in the words of Palkhivala, ‘it is difficult to conceive of more powerful fiscal deterrents to keep away foreign collaborators.’

Nevertheless, the Parliament is having no second thoughts on the matter whatsoever, explicitly including in the charging section of the proposed Direct Taxes Code, the taxability of fees for technical services whether or not the services are rendered in India, the payment is made in India, the non-resident has a residence or place of business or any business connection in India or the income has actually accrued in India.<sup>77</sup> Many believe that the constitutional question over §9, after the 2010 amendment, has been relegated to a mere academic discussion, but with the path breaking judgments in the *Clifford Chance*<sup>78</sup> and *Linklaters*<sup>79</sup> cases both still to be determined and pending in appeal to the Supreme Court and Bombay High Court respectively, one most definitely cannot say that the matter of constitutional validity is well and truly settled.

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<sup>77</sup> §§5(2) (h) and (i); 5(5) (a), (b), (c) & (d) impose the charge on fees for technical services. The tax is deductible under §195(2) read with Entry 8 of the Third Schedule and Entry 3 of the Fourth Schedule.

<sup>78</sup> *Clifford Chance v. DCIT*, 318 ITR 297.

<sup>79</sup> *Linklaters LLP v. ITO*, (2010) 6 taxmann 38 (Mum- ITAT).