

Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes

North Block, New Delhi
Dated 26th March, 2015

Subject: Clarification regarding Explanation 5 to clause (i) of sub-section (1) of section 9 of Income-tax Act, 1961 ('Act') - regarding

Section 9 of the Income-tax Act provides for incomes which are deemed to accrue or arise in India. Clause (i) of sub-section (1) of the said section reads as under:-

“9. (1) 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.”

2. The Finance Act, 2012 inserted Explanation 5 to clause (i) of sub-section (1) of section 9. The said explanation reads as under:-

“*Explanation 5.*—For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India”

3. A number of representations have been received by the Board stating that the purpose of introduction of Explanation 5 was to clarify the legislative intent regarding the taxation of income accruing or arising through transfer of a capital asset situate in India. Apprehensions have been expressed about the applicability of the Explanation to the transactions not resulting in any transfer, directly or indirectly of assets situated in India. It has been pointed out that such an extended application of the provisions of the Explanation may result in taxation of dividend income declared by a foreign company outside India. This may cause unintended double taxation and would be contrary to the generally accepted principles of source rule as well as the object and purpose of the amendment made by the Finance Act 2012.

4. The matter has been examined in the Board. The Explanatory Memorandum to the Finance Bill 2012 explains the purpose of the amendment to section 9 (1)(i) in the following words:-

“Section 9 of the Income-tax Act provides cases of income, which are deemed to accrue or arise in India. This is a legal fiction created to tax income, which may or may not arise in India and would not have been taxable but for the deeming provision created by this section. Sub-section (1)(i) provides a set of circumstances in which income accruing or arising, directly or indirectly, is taxable in India. One of the limbs of clause (i) is income accruing or arising directly or indirectly **through the transfer of a capital asset situate in India**. The legislative intent of this clause is to widen the application as it covers incomes, which are accruing or arising directly or indirectly. The section codifies source rule of taxation wherein the state where the actual economic nexus of income is situated has a right to tax the income irrespective of the place of residence of the entity deriving the income. Where corporate structure is created to route funds, the actual gain or income arises only in consequence of the investment made in the activity to which such gains are attributable and not the mode through which such gains are realized. Internationally this principle is recognized by several countries, which provide that the source country has taxation right on the gains derived of offshore transactions where the value is attributable to the underlying assets.....

.....Certain judicial pronouncements have created doubts about the scope and purpose of sections 9 and 195. Further, there are certain issues in respect of income deemed to accrue or arise where there are conflicting decisions of various judicial authorities.

Therefore, there is a need to provide clarificatory retrospective amendment to restate the legislative intent in respect of scope and applicability of section 9 and 195 and also to make other clarificatory amendments for providing certainty in law.”

5. The Explanatory Memorandum clearly provides that the amendment of section 9(1) (i) was to reiterate the legislative intent in respect of taxability of gains having economic nexus with India irrespective of the mode of realisation of such gains. Thus, the amendment sought to clarify the source rule of taxation in respect of income arising from indirect transfer of assets situated in India as explicitly mentioned in the Explanatory Memorandum. Viewed in this context, Explanation 5 would be applicable in relation to deeming any income arising outside India from any transaction in respect of any share or interest in a foreign company or entity, which has the effect of transferring, directly or indirectly, the underlying assets located in India, as income accruing or arising in India.

6. Declaration of dividend by such a foreign company outside India does not have the effect of transfer of any underlying assets located in India. It is therefore, clarified that the dividends declared and paid by a foreign company outside India in respect of shares which derive their value substantially from assets situated in India would not be deemed to be income accruing or arising in India by virtue of the provisions of Explanation 5 to section 9 (1) (i) of the Act.

7. This may be brought to the notice of all concerned for strict compliance.