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Federalism And Territorial Operation Of State Legislation

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INTRODUCTION

The Problem of territorial operation of laws enacted by the component states is equally demonstrated in all the federations, as the national laws can have extra-territorial operations whereas the state laws cannot have. The present chapter aims to study how for judiciary in India has been able to neutralize the effect of the prohibition to extra territorial operational of state laws.

PROBLEM OF EXTRA-TERRITORIALITY IN GENERAL

The legislative competence to enact laws having extra-territorial operation is an attribute of sovereignty. The dependent commonwealth countries has always limited power to the making of laws restricted to operate within the territory of the colony, unless extra- territorial jurisdiction could be said to have been conferred expressly or by necessary implication. The lack of such power in the Denomination Parliament of Canada to legislative extra-territorially, was held by the Judicial Committee of the Privy Council, as one of the grounds nullifying a Canadian Act 1888 which purported to abolish the right of appeal in criminal cases with or without special leave of Judicial Committee. This pronouncement of the Court had significant effect upon Imperial Conference of 1926 in which, the founder members of the Commonwealth described themselves that, "They are autonomous communities." As a result, it was resolved by the Imperial conference of 1926 and 1930, that power to legislate with extra-territorial effect should be granted to Dominions. Consequently in 1931, Dominions were given the power to legislate with extra-territorial operation, by Section of 3 of Stature of Westminster.

As has been earlier discussed a federal policy is the negation of the principal of legislative sovereignty as understood in British sense and the legislative powers are divided between the Centre and the federating units. The attribute of sovereignty, therefore, is divided between the two parallel sets of legislature, therefore, is divided between the two parallel sets of legislature. Both, the Central and the State Legislature are sovereign within their respective spheres and have full powers to legislate on matters allotted to them. Though, the federal Constitutions do not say that the Provincial Legislatures are 'no-sovereign.' the Constitution,

ISSN:0971-1260
Vol-22-Issue-02-April-June-2019

however, makes it clear that the national Parliament shall have power to enact laws having extra-territorial Operation. But, States are not granted such a constitutional concession. This is the position in all the federal countries, viz. Canada, Australia, U.S.A. and India.

MEANING OF THE EXPRESSION EXTRA-TERRITORIALITY OF OPERATION

It is an established fact that Union Parliament in all the federations has power to enact extra-territorial laws whereas the State Legislature has not. The pertinent question then is: What does the expression "extra-territoriality of operation "mean? This expression does not mean that one state can pass laws for another state or the several systems of laws will be in operation regulating a particular sphere within any given state. "Extra-territorial legislation", points out Professor Where, "simply means legislation which attaches significance for the Courts within the jurisdiction to facts and events occurring outside the jurisdiction". The Solicitor-General of Great Britain during the debate on the Statue of Westminster Bill, pointed out in the House of Commons, that:

"It means only that each nation has the capacity to legislate outside the three mile limit of its own territory, in respect of its own subjects in such a way as to make them amenable to law, as administered in its own courts, when they come within its jurisdiction'.

This principle of extra-territoriality of operation has significance as judicial notice regarding the validity of a law enacted by the Central Parliament before the municipal Courts, within the State, In A.H. Wadia V. Commissioner of Income Tax, the Federal Courts of India, observed ," A legislation may offend the rules of international law, may not be recognized by foreign courts, or there may be practical difficulties in enforcing them but these are questions of Policy with which domestic tribunals are not concerned." The only limitation, therefore on extra-territorial legislation by Parliament is the consideration of the practicability of law.

TERRITORIAL OPERATION OF LAWS IN INDIA

The scheme of the distribution of legislative powers between the Centre and the States as adumbrated under Articles 245 and 246 read with the three lists of the Seventh Schedule, provides that the Legislature of a State may make law for "whole or any part of the State with respect to matters enumerated in the State and the Concurrent lists. The Union Parliament on the other hand, is authorized to enact laws for "the whole or may part of the territory of India on topics mentioned in the union and concurrent lists. The territorial jurisdiction of the two sets of Legislature, within which the laws enacted by them would be applicable, is, thus,

ISSN:0971-1260
Vol-22-Issue-02-April-June-2019

constitutionally defined. Within the constitutional limits prescribed, both the Central and the State Legislature have equally sovereign powers to exercise their respective legislative powers. The Constitution explicitly makes the laws enacted by Union Parliament immune from being challenged on the grounds of its extra-territoriality of operation. To illustrate it: Suppose a married Hindu resident of India goes to France and he marries a French girl there. He may be prosecuted in India, for crime of bigamy committed abroad, even though bigamy is not punishable in France. Section 4 of I.P.C. gives extra-territorial operation to Indian Penal Code. In Mubarak Ali Ahmed V. State of Bombay, the Supreme Courts of India observed that if a foreigner initiates an offence from outside the territories of India, he can be punished for an offence committed within India, if the essentials of the offence occur within India. The High Courts of Goa upheld the vires of Goa Daman Dieu (Banks Reconstruction) Regulation 1962, in Agencia Commercial International Ltd. v. Custodian of Banco National Ultramarino. The High Court held that the order issued by the President was valid under Article 240 read with Article 245(2) and it could not be invalidated on the ground of the extra-territoriality of its operation. No such constitutional concession is granted to the State Legislatures. Prima Facie an Act will be application only to the territory whose legislature has enacted it. In this way, the legislative powers granted to the State Legislatures are limited to persons. And objects situated within the territory of the concerned State. The two clauses of Article 245 taken together make it clear that a state legislature cannot pass laws with extra-territorial operation. The state is, therefore, in weaker position in comparison to the Union Parliament, so far as the extra-territorial operation. Of law is concerned a state law may be challenged on the ground of extra-territorially. if it affects a person residing outside the territorial limit of the limit of the state and impugned law may be liable to be struck down.

RESCUING STATE LAWS

The Judiciary has come up the rescue of the laws enacted by the State Legislature, if they are challenged on the ground of extra-territoriality. In such cases judiciary has applied the principle of 'Territorial Nexus". In Bengal Immunity Co. Ltd. v. State of Bihar, Venkatarama Ayyar J. pointed out two different meanings of the expression 'extra-territorial operation'.

"The words 'extra-territorial operation' are used in two different senses as connoting, firstly, laws in respect of acts or events which take place inside the State, but have operation outside, and secondly, laws with reference to the nationals of a State in respect of their acts outside, in its former sense, the laws are strictly speaking "intra-territorial" and under Article

ISSN:0971-1260
Vol-22-Issue-02-April-June-2019

245 (1) it is within the competency of the Parliament and the Legislatures to enact the laws with extra-territorial operation in that sense. The Words 'laws with' extra-territorial operation in Article 245 (2) must be understood in their strict sense as having reference to laws of a State for their national in respect of acts done outside the State.

The expression "extra-territorial" in the first sense as clarified by V. Ayyar J. means 'intra-territorial' i.e. having some territorial connection between the State and the object of legislation. To arrive at such conclusion i.e. to justify a State law as intra-territorial, where it is challenged on the ground of extra-territoriality, the Courts have evolved, applied and given due deference to the principle of "Territorial Nexus."

DOCTRINE OF TERRITORIAL NEXUS

The principle of territorial nexus is a judicial device, evolved through judicial interpretations to save laws enacted by non-sovereign legislatures such as those of colonies and federating units under federal systems like American State or Canadian Provinces or to enact laws extra-territorially. The principle of territorial nexus makes it clear that through the legislative power of a states Legislature is, prima facie, confined to the person and objects within the territorial limits of the State this territorial jurisdiction is extended by applicability of this principle. "This means, says Dr. D.D. Basu, "that once a state Legislature, competent to legislate with respect to particular subject, has some connection with a person, object or operation of the Act may extended to persons, object or activity within its territorial limits which connection is relevant or pertinent to the subject matter of legislation, the application or operation of the act may extend to person, objects or activities (as the case may be). The validity of a state law, when challenged as having extra-territorial operation, "depend, on the sufficiency of the purpose for which is used the territorial connection.

DOCTRINE OF TERRITORIAL NEXUS AND LEGISLATION UNDER GOVERNMENT OF INDIA ACT, 1936

The doctrine of territorial nexus was deeply-rooted in judicial interpretation, before the commencement of the Constitution of India 1950. The principle evolved by the Federal Court and the Privy Council has been very valuable guide for judicial interpretation in post constitution era. It is, therefore, most desirable to discuss some of the important judicial pronouncement of the Privy Council and the Federal Courts while interpreting the impugned laws under G.I. Act, 1935. The Government of India Act, 1935, empowered the Federal

ISSN:0971-1260
Vol-22-Issue-02-April-June-2019

Legislature to "make laws for the whole or any part of British India" and provincial Legislatures to "make laws for the Province or any part thereof." By Section 99(2) certain matters were enumerated and Federal Laws on those matters were made immune from being challenged on the ground of extra-territoriality. Thus, both the Federal (except in respect of matters provided in section 99(2) and the provincial Legislature were subject to the rule forbidding extra-territorial legislation. It is necessary to make it clear, at the very outset that there was no general declaration of exempted from extra-territoriality of Central law as it is explicitly provided under the laws on topics not covered by Section 99(2) were to satisfy the principle of territorial nexus in order to survive themselves, otherwise were liable to struck down.

The doctrine of Territorial Nexus evolved and applied by Judiciary under American, Australian and Canadian Constitutions, was for the first time applied by Federal Court in Governor-General v. Raleigh Investment Co. In the instant case. The Raleigh Investment Co. Which was registered in England and held share in nine Sterling Companies also registered in England but carried on business in India? Brought a suit for the recovery of income –tax and super-tax paid under protest. The taxes were imposed under section 4 of the Income Tax Act, 1922, which was challenged as ultra vires in so far as it provided. That the total income of a non-resident in British India should include all income profits and gains from whatever source which "are deemed to accrue or arise to him in British India during such year'' and that "a dividend paid without British India shall be deemed to be income accruing and arising to British India to the extent to which it has been paid out of profits subjected to income-tax in British India" It was contended on behalf of companies that the India Legislature was seeking to impose taxation upon a person not resident within British India, in respect of property which was not situated within British India, and therefore,

Territorial Nexus Theory and State legislatures

According to provisions of Article 245, Legislature of a State may make laws for the whole or any part of the State, but it has not been given power to project the operation of its laws beyond its territories. A similar idea is also expressed in Clause (3) of Article 246, which states that the Legislature of any State has exclusive power to make laws "for such State or any part thereof" with respect to matters enumerated in the State List.

ISSN:0971-1260
Vol-22-Issue-02-April-June-2019

Thus, it is clear from the above provisions that State Laws, unlike the Union Laws, cannot have extra-territorial operation. In other words, the State has to exercise its law-making power only for the State and not beyond it. Every State, therefore, has an undeniable power to govern persons residing within its territory, locally situated tangible and intangible property and local business activities. No controversy arises in such cases as to the territorial competence of the State to govern them. But, when a company registered in one State carries on its business in several other States also. or when a trust situate in one State owns a large part of its endowed property in another State, or when several vital aspects or ingredients of a single transaction take place in two or more States, the question arises which State has territorial competence to make law to govern persons or acts as the case may be. Such a problem, in fact, came before the Supreme Court in certain State tax and trust law cases. It would be interesting to examine various decisions of the Supreme Court, wherein it tried to tackle the problem.

Problems of much interest arose in sales tax cases. It may be noted here that a sale transaction contains several ingredients such as, for example, the agreement to sell, delivery of goods, transfer of title in the goods from the seller to the buyer, etc., and it is needless to say that a sale completes only when all the ingredients are fulfilled. But different ingredients of a sale transaction may take place in two or three different States in which case all the three States may claim the right to impose the sales tax on a single sale' transaction on the ground that one of the important ingredients of sale had taken place within their territory. Such a multiple claim, besides leading to multiplicity of taxation, creates the problem of extra-territorial operation of the State taxing laws. It is, therefore, quite essential that Parliament and judiciary should endeavour to locate the sale and state clearly which State, in such a situation, can be said to have overwhelming territorial connection with the sale transaction.

The opportunity presented itself before the Supreme Court in three important cases. One such case was *Poppatlal Shah V. State of Madras.* This case arose under the Government of India Act of 1935. The appellant's trading firm was carrying on its trading activities in Madras. It used to receive orders from Calcutta merchants for supply of certain articles and in all such cases the firm used to despatch such articles to Calcutta by rail or steamer after having drawn the railway receipt and bills of lading in the name of the vendor firm and sent to the firm's bankers to Calcutta, who used to deliver the same to the consignees on payment of prices and other charges. Evidently, though agreement for sale took place in Madras and at the time of

ISSN:0971-1260
Vol-22-Issue-02-April-June-2019

such agreement the goods were lying in the State of Madras, the delivery of goods and the transfer of title in the goods to the buyer admittedly took place in Calcutta. The sole point that required consideration was, whether in these circumstances the sale transactions were liable to be taxed under the General Sales Tax Act of Madras? it may be noted that under the above mentioned Act read with the explanation appended to it by the Madras General Sales Tax (Amendment) Act of 1947, Madras had right to impose tax on sale or purchase of goods, despite the fact the contract of sales or purchase had taken place elsewhere in another State, if, at the time of such contract of sale or purchase, the goods were actually within the Province of Madras. Sections 99 (1) and 100 (3) of the 1935 Act, which corresponded to Articles 245 (1) and 246 (3) of the Constitution respectively, clearly laid down that Provincial Legislature could make laws with respect to matters enumerated in the Provincial List only for the whole or any part of the Province; and Entry 48 in the Provincial List authorised the Provincial Legislature to levy tax on the sale of goods. One of the contentions before the Supreme Court, therefore, was that the Provincial Legislature functioning under 1935 Act was constitutionally incompetent to enact a legislation of this character which was capable of operating on sale transactions concluded outside the Province.

In the above case, speaking for a unanimous Court, Mr. Justice Mukerjee (as he then was) said that the relevant section of the 1935 Act "admits of no dispute that a Provincial Legislature could not pass a taxation statute which would be binding on any other part of India outside the limits of the Province, but it would be quite competent to enacts legislation imposing taxes on transactions concluded outside the Province, provided there was sufficient and a real territorial nexus between such transactions and the taxing Province. Proceeding further, he stated that "the legislative practice in regard to sales tax laws adopted by the Provincial Legislatures prior to the coming into force of the Constitution has been to authorise imposition of taxes on sales and purchases which were related income manner with the taxing Province by reason of some of the ingredients of the transaction having taken place within the province or by reason of the production or location of goods within it at the time when the transaction took place. If in the Madras Sales Tax Act the basis adopted for taxation is the location of the place of business or of the goods sold, within the Province of Madras, undoubtedly it would be a valid piece of legislation to which no objection could be taken. Thus, in the above case, the Supreme Court has laid down a rule that in the case of an inter-State sale transaction only a Stale, which has "sufficient and real territorial nexus" with such

ISSN:0971-1260
Vol-22-Issue-02-April-June-2019

sale transaction, may have the right to levy sales tax and the "location of the place of business or of the goods sold" constitutes such sufficient territorial nexus.

In *State of Bombay v. The United Motors Ltd.* the Supreme Court was called upon to pronounce its opinion on the scope of the power conferred on State Legislatures by Article 246 (3) read with Entry 54 in the State List of the Seventh Schedule to the Constitution, to wit, the scope of the exclusive power of State Legislature to make laws "for such State or any part thereof" with respect to "taxes on the sale or purchase of goods other than newspapers". Speaking for the majority, Chief Justice Patanjali Sastri said "the expression 'for such State or any part thereof cannot, in our view, be taken to import into entry 54 the restriction that the sale or purchase referred to must take place within the territory of that State.' All that it means is that the laws which a State is empowered to make must be for the purposes of that State. This decision seems to lay down the principle that the concept of "territoriality of State law" postulated in Articles 245 (1) and 246 (3) is fulfilled, when a law, which a State is empowered to make, is made for the "purposes of the State". In other words, the territorial nexus has been established on the theory of "State purposes". But it may be pointed out here that every law made by a State Legislature is for the purposes of that State, or at least it is purported to be so. A tax imposed on a sale transaction, whether by a State wherein goods were lying at the time of such contract, or by a State where title in goods passed from the seller to the buyer, is avowedly for the purposes of the taxing State, and it is hardly possible to visualise a situation wherein a State would ever disavow such purposes. It is, therefore, submitted that the "State purpose' theory is too vague to be relied on to sustain a sales tax legislation or to ascertain territoriality of a State law.

As to the "sufficiency" rule, however, the position of the Supreme Court is not different in this case. Here, as in *Poppetlal Shah case*, location of goods has been construed sufficient to establish the territorial nexus with the situs State. This principle has been clearly enunciated when Patanjali Sastri, C.J. stated: "in the case of Sales Tax it is not necessary that the sale or purchase should take place within the territorial limits of the State in the sense that all the ingredients of a sale, like the agreement to sell, the passing of title, delivery of the goods, etc., should have a territorial connection with the State. Broadly speaking, local activities of buying or selling carried on in the State in relation to local goods would be a sufficient basis to sustain the taxing power of the State, provided, of course, such activities ultimately resulted in a concluded sale or purchase to be taxed.

ISSN:0971-1260
Vol-22-Issue-02-April-June-2019

The "sufficiency" rule is further explained in *Tata lron & Steel Co. Ltd. V. State of Bihar* by S.R. Das, C.J., when he said that "the presence of the goods at the date of the agreement for sale in the taxing State or the production or manufacture in that State of goods the property wherein eventually passed as a result of the sale wherever that might have taken place, constituted a sufficient nexus between the taxing State and the Sale.

The principle that emerges from these decisions is that in all inter-State sale transactions it is the situs State, that is, the State wherein the goods are located or being produced at the time of the contract of sale, which has the sufficient territorial nexus to impose the tax on such transactions. Thus, these decisions have, in effect, fixed the situs of sale in inter-State sale transactions in the situs State, that is, the place wherein the goods are located at the time of the contract of sale.

As a matter of fact, the legal problem in inter State sale transactions is not so much about the avoidance of extra-territorial operation of State laws as about the prevention of multiple taxation. In the absence of the fixation of the situs of the inter-State sale transaction in one State, it is quite natural for a State, taking advantage of the presence within its territory one of the ingredients of such sale, to treat such sale as a local sale and fasten sales tax thereon. When a State does it, it can hardly be accused of operating its sales tax law extra-territorially, for by virtue of its law the sale might be deemed to have taken place within its territory if one of the ingredients of the sale had taken place within the State. Unless and until a law, binding on all States alike, fixes the situs of sale on some basis in :one State, only the State Law is a guide as to the actual location of the sale, and lf a State imposes sales tax on the transaction on the ground that, according to its law, the transaction had taken. place within its territory, it cannot be said the State has no territorial nexus to exercise its taxing power, because no supervening law at that point of time stated where else exactly such a sale must be deemed to have taken place

But, such a state of affair, no doubt, will lead to multiple taxation. The way out of this situation, therefore, lies in the fixation of situs of sale in one State for all practical purposes, which solution would help not only to ascertain the extraterritorial character of a State law and prevent its extraterritorial operation but also to put an end to the practice of multiple taxation. The Supreme Court has, therefore, rightly endeavoured to locate the situs of sale in one State and it has succeeded in its attempt when it consistently enunciated the doctrine of territorial nexus and established the nexus in a State wherein the goods are located at the

ISSN:0971-1260
Vol-22-Issue-02-April-June-2019

time of the contract of sale of goods. It may be mentioned here that this doctrine has been accepted and given effect to by Parliament when it enacted the Central Sales Tax Act of 1956 in pursuance of certain provisions of the Constitution and declared. *Inter alia*, that a sale or purchase of goods shall be deemed to have taken place inside a State if the goods are within the State at the time the contract of sale is made.

A slightly different situation arose in the *State of Bombay V. R.M.D. Chamarbagwala.* The respondent was a owner of R.M.D.C. (Mysore) Ltd. Company incorporated in the State of Mysore, which was running a newspaper called "Sporting Star" printed and published at Bangalore, through which Company carried on a betting and gambling business, euphemistically called the Prize Competition or the R.M.D.C. Cross-words, for which entries were received from various parts of India, including the State of Bombay, through agents and depots established in those places to collect entry forms and fees for being forwarded to the head office at Bangalore. The State of Bombay sought to tax such activities that were taking place within its territory and by amending suitably the Bombay Lotteries Prize Competitions Control and Tax Act of 1948. The State undoubtedly had authority under entry 62 of the State List to impose a tax on betting and gambling. But, it was contended that the impugned Act operated extraterritorially in as much as it affected the trade-or business of conducting prize competitions outside the State and was, therefore, beyond the competence of the State Legislature and invalid. The long and short of the argument was that there was no sufficient territorial nexus between the State and the activities of the respondent, who was not in the State, and, therefore, the State of Bombay could not exercise its taxing power.

The principles enunciated by the Supreme Court in the following cases 1. State of Bombay v. R.M.D. Chamarbagwala 2. State Bihar v. Smt Charushila Dasi 3. Khayerbari Tea Co.Ltd v. State of Assam etc. These cases may conveniently be reduced into four main propositions as follows:-

1. In all inter-State sale transactions, the State, wherein the goods are located at the time of the contract of sale, or wherein the goods are produced subsequently In pursuance of the contract of sale, possesses sufficient territorial jurisdiction to levy a tax on such transactions. The sale situs has, therefore, been fixed by law in a State wherein the goods are lying at the time of the contract of sale.

ISSN:0971-1260
Vol-22-Issue-02-April-June-2019

2. In all other inter-State business activities the territorial nexus has been fixed in a State or States wherein the actual business activities are carried on through agents or promoters of the company irrespective of the fact of its place of incorporation. But, the territorial nexus theory enables the forum State to exercise its taxing power strictly in respect ·to the volume of business actually carried on within its territory and not to tax the total volume of the business of an outside company. The commercial situs for the purpose of exercising the taxing power has, therefore, been fixed in the Forum State wherein the actual business activities take place, and not in the place where the company has residence.

3. In all matters related to trust and its property, the resident State, that is, the State where the trust resides and carries on its work, has sufficient territorial nexus to make law with respect to the trust and its activities and the utilisation of income received from the outside property endowed to the trust.

4. With respect to the corpus of the property of the trust, it is only the situs State, that is, the State wherein the real property situate, which has sufficient territorial nexus to make law.

The first two propositions relate to the taxing power of the State. A tax payment is generally viewed as an exaction for the maintenance of Government in consideration of protection afforded. This is, of course, one of the views. This view has been described by Prof. S. Corwin as "the benefit-protection theory of taxation. The basis of the first two propositions relating to territorial nexus doctrine is obviously the benefit-protection theory of taxation for the first proposition postulates in effect, that the State, which affords protection to goods lying within its territory, must be given the power to levy a tax on sale transactions in regard to those goods even though such transactions took place outside its territory; and the latter connotes, in fact. That the State, which afforded protection to business activities within its territory, must be given the power to impose tax on such activities without any regard to the residence of the company. The last two propositions relate to the general legislative powers of the State. They seem to have been based on the theory of effectiveness in that it is only the resident State which could effectively control the activities of the trust and trustees residing within its territory, and the situs State which could effectively make regulatory laws with regard to the corpus of the property located within its territory.

ISSN:0971-1260
Vol-22-Issue-02-April-June-2019

These principles and theories, no doubt, give sufficient guidance to solve jurisdictional problems. But, the jurisdictional problems, which an Indian constitutional lawyer may have to face, at any time, are not exhausted by the cases already decided by the Supreme Court. States have exclusive power to levy taxes on agricultural income, and duties in respect of succession to 'agricultural land. Suppose an individual, who resides in one State, owns large tracts of agricultural lands situate in another State. In such a case which State has jurisdiction to collect agricultural income tax or succession duty? A tax on agricultural income being a direct tax, both the tax and its incidence fall on the same individual; the residence of the individual, on whom such tax is imposed, is undoubtedly an important factor in deciding the jurisdictional competency of a State. Similarly, a succession duty being a duty on the transmission of property and on the person, who succeeds to the agricultural estate, the residence of such person is an important factor to be taken into consideration in solving the jurisdictional problems. The resident State has, no doubt, effective control over the persons within its territory, and if the theory of effectiveness is applied the inevitable conclusion would be that the resident State possesses territorial jurisdiction to levy and collect agricultural income tax and succession duties in such cases. But, such a view would deprive the situs State substantially of its tax revenue, which it would naturally expect to get from the agricultural property situate within its territory in return to the protection it afforded to such property and to the non-resident owners in exploiting it. Therefore, if the benefit-protection theory of taxation is applied the scale definitely tilts in favour of the situs State. The question, therefore, boils down to this: in such cases of dualism, that is, cases wherein the owner resides in one State and his agricultural property is located in another State, which 'one of the competing theories must be applied to decide the territorial jurisdiction of the State? The theory of effectiveness is, no doubt, an important theory to solve many jurisdictional problems. But, its use in these particular cases deprives the situs States of their legitimate income which they could legitimately expect from the property situate within their territory. Besides, if the situs State is fully aware that it could not expect much tax revenue from the property owned by non-residents, it would find no reason to extend necessary protection to the non-residents to exploit such properties within its territory. If the problem is analysed in a pragmatic way one may come to the conclusion that in such cases the benefit-protection theory of taxation must of necessity be applied to resolve the jurisdictional problem in favour of the situs State.

ISSN:0971-1260
Vol-22-Issue-02-April-June-2019

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