Cairns Tax Dispute: Permanent Court of Arbitration Ruling

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One of the most controversial legal issues in India has been with respect to the power with the Government to make retrospective amendments in taxing statutes. Pursuant to the Vodafone case, there were immense controversies on fairness of imposing tax implications with retrospective effect.

In news: Cairn wins arbitration ruling against India in tax dispute
Placing it in syllabus: Economy
Dimensions

- What was the tussle about?
- Was it similar to Vodafone Battle?
- Arguments by both Parties
- PCA Ruling
- India’s Retrospective Taxation Laws : Importance and Problems
- What is PCA?

Content:

What was the tussle about?

- The dispute stems from the much debated retrospective taxation issue.
- Fifteen years ago, in 2006-2007, Cairn UK had, as part of an internal rearrangement process, transferred shares of Cairn India Holdings to Cairn India.
- In the same year, Cairn not only undertook a corporate reorganization but also floated an Indian subsidiary, Cairn India, which in early 2007 got listed on the Indian Stock Market.

- Through the corporate reorganization process, Cairn Energy had transferred all of its India assets, which were until then held by nine subsidiaries in various countries, to the newly-formed Cairn India.
- The dispute started in early 2014 when Indian tax authorities started questioning Cairn Energy requesting information on the group's reorganization in the financial year 2006-07.
- Income-Tax authorities then decided that since Cairn UK had made capital gains by the reorganisation, it ought to pay capital gains tax up to Rs 24,500 crore.
- This, the department asserted, was the basis of the retrospective tax demand.
- The company interpreted Indian laws on capital gains differently, and refused to pay. Several rounds of litigation at the Income-Tax Appellate Tribunal (ITAT) and the High Court followed.
- After receiving a draft assessment order from the tax authorities, Cairn UK Holdings Ltd. appealed before the Income Tax Appellate Tribunal.
- The tribunal, while providing the company relief from back-dated interest demands, however, upheld the main tax demand.
- The company had initiated proceedings of arbitration under the U.K.-India bilateral investment treaty.
- But during this time, the government sold Cairn's almost 5% holding and seized dividends totalling ₹1,140 crore due to it from those shareholdings and set off a ₹1,590-crore tax refund against the demand.
- While Cairn Energy sold the majority of its India business, Cairn India, to mining giant Vedanta in 2011, income-tax authorities barred it from selling about 10 per cent, citing pending taxation issues.
- The payment of dividend by Cairn India to Cairn Energy was also frozen.

2012 Changes to Taxation:

In the Union Budget of 2012, the Income Tax Act, 1961 was amended to make sure that even if a transfer of shares takes place outside India, such a transfer can be taxed. This was done when the value of those shares is based on assets in India. And this was applied retrospectively.

The action against Cairn Energy was based on this move. India lost its arbitration case against Vodafone as well, with the government being asked to fork out around ₹80 crores.

Was it similar to Vodafone Battle?

- The Vodafone case in 2007 was triggered by Hong Kong’s Hutchinson Telecommunications’ sale of its stake in India’s Hutchinson Essar to Vodafone based out of the Netherlands.
- The Hong Kong firm made a capital gain on this, which the Indian tax authorities deemed fit to tax.
- They held that Vodafone should have withheld the tax, and therefore imposed liability on it.
- The Supreme Court quashed the taxman’s demand that the sale of shares, in this case, would amount to transfer of a capital asset within the meaning of Section 2(14) of the Indian Income Tax Act”.

Arguments by both Parties:

Main argument of Cairn Energy

- The claimants, Cairn Energy and Cairn UK Holdings argued that till the amendment was made to tax retrospectively in 2012, there was no tax on indirect transfers.
- Indirect transfers here meant transfer by a non-resident of shares in non-Indian companies which indirectly held assets in India.
- The application of the 2012 amendments, they alleged, constituted “manifest breaches” of the U.K.-India bilateral investment treaty.

Arguments of Indian Authorities

- India’s counter to the main charge of Cairn Energy was that its 2006 transactions were taxable irrespective of the 2012 amendments.
- It argued that “Indian law has long permitted taxation where a transaction has a strong economic nexus with India”.
- It said even if it is retrospective, it is “valid and binding applying the longstanding constitutional, legislative and legal framework in which the claimants have invested”.

PCA Ruling:

- In its judgment, the Permanent Court of Arbitration at The Hague said Cairn Tax Issue was not just a tax related issue but an investment related dispute, and therefore under the jurisdiction of the international arbitration court.
- It said India “failed to accord Cairn Energy’s investments fair and equitable treatment” under the bilateral protection pact it had with the United Kingdom.
- the PCA at The Hague has once again ruled that the Indian government’s retrospective demand was “in breach of the guarantee of fair and equitable treatment”.
- It has noted Cairn UK’s argument that the demand on them was made after the Vodafone retrospective tax demand, which has since been set aside by Indian courts.
- It said that Indian government must pay roughly Rs 8,000 crore in damages to Cairn.
- The arbitration tribunal also said that India must not make any more attempts to recover “the alleged tax liability or any interest and or penalties arising from this alleged liability through any other means”.

As reported by Indian Express, the Indian government is learnt to have decided to file an appeal against the arbitration award in the retrospective tax demand case involving Cairn Energy. Government sources indicated that the Centre will also consider contesting other suits filed by Cairn Energy at various international courts.

“The government will file an appeal against Cairn arbitration award soon and will contest its sovereign rights to tax. It will also strongly contest other suits filed by Cairn Energy at various other international courts,” an official said.

India’s Retrospective Taxation Laws : Importance and Problems

- Retrospective tax is nothing but a combination of two words “retrospective” and “tax” where “retrospective” means taking effect from a date in the past and “tax” refers to a new or additional levy of tax on a specified transaction.
- Hence, retrospective tax means creating an additional charge or levy of tax by way of an amendment from a specified date in the past.
- For eg: Levy of tax on indirect transfers by Finance Act 2012 retrospectively from 1961; Introduction of Section 14A for disallowance of expenditure related to exempt income in the year 2001 with retrospective effect from April 1962.
- Many a time retrospective amendments are carried out to undo some of the decisions of judicial bodies which went against legislative intent or for removing certain anomalies in law.
- Sometimes it may be simply to benefit taxpayers in genuine cases and do away with undue hardship or difficulties faced by taxpayers.

Problems:

- Retrospective amendments tend to modify vested rights or impose obligations which cause unnecessary financial burden.

- Retrospective tax is not so easily welcomed by taxpayers as it creates an additional levy on the transaction which is already concluded when the provisions of law are different.
- Taxpayer would have planned his finance and tax based on the law as it existed at that time and disturbing the same by way of unjust and unwarranted retrospective amendments is unreasonable.
- However, validity/reasonableness of retrospective amendment/tax depends on facts and circumstances of each case and need to be analysed on the merits of amendment in light of facts and circumstances under which such amendment is made.

Major retrospective amendments/tax in Indian income tax

- Till date one of the major and most controversial retrospective amendment carried out was bringing indirect transfer under the tax bracket by Finance Act 2012.
- The Supreme Court in the case of Vodafone held that Section 9 does not authorize tax authorities to tax capital gains derived from indirect transfer of shares of Indian companies while the main transaction was between two foreign companies to acquire a foreign company which had majority shares in Indian company.
- It may be noted that the quantum of transaction and tax foregone by the tax department due to this Supreme Court ruling was huge.
- Therefore, Government of India (Ministry of Finance) amended Section 9 of Income-tax Act, 1961 vide Finance Act 2012 and provided that shares or interest in any foreign company/entity shall be deemed to be situated in India if such shares or interest derives its substantial value from assets located in India.

- Any capital gain from transfer of such shares or interest in foreign company deriving its substantial value from assets located in India was brought under tax levy.
- Government did not stop at this amendment of the new levy but made it effective retrospective from 1962.
- This would mean the Vodafone case where entire transactions were already carried out and ruling was also pronounced by the Supreme Court could be brought to tax with this retrospective amendment.

What is PCA?

- It is an **intergovernmental organization** located in The Hague, Netherlands.
- The PCA was constituted through two separate multilateral conventions – the **Convention for the Pacific Settlement of International Disputes,** concluded at The Hague in 1899 and the convention revised in the **second Hague Peace Conference** in 1907. The nations have to sign and ratify any one of these conventions to become a member of PCA.
- It is not a court in the traditional sense but **provides services of an arbitral tribunal** to resolve disputes that arise out of international agreements between member states, international organizations or private parties. It is the **first permanent intergovernmental organization to provide arbitration.**
- The cases span a range of legal issues involving territorial and maritime boundaries, sovereignty, human rights, international investment, and international and regional trade.
- **Rulings are binding in nature**. But the PCA has **no powers to enforce** the rulings.
- There are **no sitting judges** for the organization. Parties select their arbitrators.
- India is a member of PCA. India ratified the 1899

convention in 1950.
- The organization is not a United Nations agency, but the PCA is an **official United Nations Observer**.

Mould your thought: What is a retrospective Tax? List out the uses and problems associated with retrospective taxation.

Approach to the answer:

- Introduction
- Define retrospective tax
- Discuss the circumstances it is used with example
- Mention the problems with using it
- Conclusion