Retrospective taxes and arbitration

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The issue of retrospective taxation is a key hurdle for building confidence to invest in India and improve the faith in Indian doing business rankings. UPSC may focus on policy matters and fiscal outcome with respect to retrospective taxation.

In news: Cairn Energy Plc recently won a case as the Permanent Court of Arbitration ruled that the Indian government's retrospective tax demand against the company was "inconsistent" with the UK-India bilateral treaty.
Placing it in syllabus: Economy
Dimensions

1. What is the issue about?
2. About arbitration Vodafone and cairn disputes
3. GAAR and bilateral investment treaties and their effects on taxation

Content:

What is the issue about?

- The Permanent court of arbitration (based in Hague, Netherlands) has ruled that **India's demand of $1.2 billion in retrospective tax** was "in breach of the guarantee of fair and equitable treatment".
- The judgment has asked the government to pay $1.2 billion (roughly Rs 8,800 crore) to Cairn Energy Plc.
- The panel said that the **claimants are relieved from any obligation to pay it and ordered the respondent (Indian government) to neutralise the continuing effect of the demand** by permanently withdrawing the demand.

- The 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".

((Retrospective taxation effectively allows a country to pass a rule on taxing certain products, items or services and deals, and charge companies from a time before the date on which the law is passed)).

About arbitration Vodafone and cairn disputes:

- **Vodafone had acquired a controlling stake in Hutchison Essar in 2007** through a purchase that took place overseas in a deal valued at $11.2 billion.
- India's tax department said Vodafone should have withheld tax on the deal and issued a notice seeking Rs 11,218 crore, later augmented by Rs 7,900 crore in penalties.
- Vodafone filed an appeal against income tax notice and the Supreme Court held that **Section 9** of Income Tax Act 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.
- As the quantum of transaction and tax foregone by the tax department due to this Supreme Court ruling was huge, **Ministry of Finance amended Section 9 of Income-tax Act, 1961 vide Finance Act 2012.**
- It 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 **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.
- On September 25, the **Singapore seat of the Permanent Court of Arbitration unanimously decided that India's retrospective demand of Rs 22,100 crore as capital gains and withholding tax imposed on British telecommunication company Vodafone Plc for a 2007 deal was "in breach of the guarantee of fair and equitable treatment".**
- The same Act was used to tax Cairn Energy Plc transfer of shares as well.
- The **tax demand against Cairn Energy Plc dates back to the time when, Cairn UK transferred shares of Cairn India Holdings to Cairn India.**
- The Income Tax authorities contended that Cairn UK had made capital gains and slapped it with a Rs 24,500-crore tax demand.
- Owing to different interpretations of capital gains, the company refused to pay, which prompted cases in the Income-Tax Appellate Tribunal (ITAT) and the High Court.
- Cairn had lost the case at ITAT and a case on the valuation of capital gains remains pending before the Delhi High Court.

Bilateral investment treaties and their effects:

Vodafone and Cairn's win in the arbitration against the government in the retrospective taxation is very significant as it may cause other similarly placed companies to seek arbitral reliefs. India is entangled in more than a dozen such cases against companies over retrospective tax claims and cancellation of contracts.

Since the release of the model BIT in 2016, India has signed a total of four BITs with Belarus, Kyrgyzstan, Taiwan, and Brazil and is in the process of signing one with Cambodia and negotiating another with Philippines.

Except Taiwan, all the other nations are recipients of substantial Indian investments, significantly more than what India receives from these countries. The BITs are actually not in favour of India’s interest.

In countries characterized by political instability and judicial corruption, Indian investors will be left in a lurch at the mercy of the legal and political instability. Adding to that, it is unlikely that the developed countries, which are home to the biggest investors in India, will sign BITs on the terms the model BIT proposes.

The model BIT does not act as the cushion investors need while venturing into a foreign territory. There is no win for India or its investors in signing such BITs. Rather than pursuing a confused BIT approach, India should focus on reforming its domestic judicial system.

While a few steps have been taken in the right direction through the Commercial Courts Act, 2015 and the amendments to the Arbitration and Conciliation Act, 1996, there are a number of administrative and substantive aspects that need a complete overhaul.

It should rather enact a legislation like South Africa’s Protection of Investment Act, 2015 and discard BITs completely. Such legislation will allow India to make its commitments to foreign investors embedded in the domestic law. However, it can have no protections for Indian entities investing in foreign countries.

Hence the model BIT and the domestic legislation will have to be aligned to ensure a consistency in commitments as well as the dispute resolution processes.

Way forward:

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. However, retrospective amendment / retrospective tax by itself does not become unreasonable or invalid.

Validity/reasonableness of retrospective amendment/tax depends on facts and circumstances of each case and need to be analyzed on the merits of amendment in light of facts and circumstances under which such amendment is made.

Any retrospective amendment which benefits taxpayers needs to be welcomed. However, any unreasonable and unexpected new tax levy on a transaction which is closed in light of the then existing law would be unfair and cause disruption and its validity need to be analyzed.

Mould your thought:

1. The recent victory of Cairn over India in the retrospective taxation case has brought into fore the loopholes of Indian taxation system. Discuss.

Approach to the answer:

- Define retrospective taxation
- Write about recent Cairn case
- Write why the ruling went against India’s interests
- What needs to be done to deal with bilateral treaties?
- Conclusion