IMPACT OF ABOLISHING RETROSPECTIVE TAXATION ON INVESTMENT SPACE IN INDIA

Ojaitra Arora & Hemant Srivastava, Amity Law School, Lucknow

ABSTRACT

The global pandemic has been catastrophic to all the sectors and the financial market is at record highs. It highlights the intricate relationship that exists between the economy and taxation by focussing on the dismissal of the most controversial retrospective taxation law from the books of Indian economy. This research paper fills the gaps in the lack of preparedness of Indian systems towards a sustainable future and will help us in understanding the impact of taxation on the country's economy. The global crisis clubbed with exhaustive retrospective tax demands had changed investor perspectives regarding how they should allocate their money in India. These factors caused the investors to lose confidence in India as an attractive investment destination. Regulators now need to cautiously shift the financial trajectory towards sustainability. The Indian systems are prepared to turn crisis into opportunity and intend on growing their economy during and after COVID-19. They intend to continue to do strategic investor- friendly deals by eradicating political complacency. If the investor economy has to be profitable in the long run, we will have to invest in the solutions to the problems.

1. INTRODUCTION

What was the previous impugned act? (The most controversial taxation law)

Today, human loss and tragedy of the COVID-19 pandemic makes for a highly uncertain economy. This pandemic is a global challenge that requires a global response. Taxation can play a crucial role in helping to sustain the economy but the flow of tax revenues has been patchy during this period. This is mostly because the taxpayers take a lot of time in paying taxes as a significant proportion of taxpayers have been stripped off their resources, affecting both natural and legal persons.[1]

The main question involved here is, how will the country manage to preserve its GDP and finance, in particular through taxation, if it does not put the taxpayers who are already in great difficulty, in an impossible position? This equation highlights yet another reality of the tax system's inadequacy. It should be remembered that taxation is not only a financial tool but also an instrument of economic policy.[2]

This may seem paradoxical but the foremost solution to this problem is to give up some part of the expected tax by means of tax reduction and tax exemptions. The goal of such tax relief is not to increase the advantage of the companies only for the benefit of shareholders but also to transform them into a vector of growth benefitting all the players of the economy which would ultimately allow the increase of global tax base in a healthier way.

Harbouring this in her heart and mind, the Finance Minister of India, Mrs. Nirmala Sitharaman, on 5th of August, 2021 introduced the Taxation Law Amendment Bill, 2021. This bill was introduced in an attempt to historically end the long-continued controversial amendment to the Income Tax Act, 1961. What was started as a misadventure in 2012 has been set right because the misadventure had backfired as the amount of economic damage it had done is perhaps unquantifiable. The bill provided that no retrospective tax demand shall be raised in future for capital gains from the sale of assets located in the country by foreign entities for any transaction that was undertaken before 28th May, 2012. It also ends such tax demands on existing indirect

[1] Thierry Afschrift, *Taxation during a pandemic: Challenges and Perspectives*, World Finance (Feb 01, 2021, 10:30 AM) https://www.worldfinance.com/strategy/taxation-in-times-of-a-pandemic-challenges-and-perspectives

[2] GIRISH A., RAVI G. "SYSTEMATIC APPROACH TO TAXATION" 202-210 (Wolters Kluwer, 42nd ed. 2021)

transfer of assets in India.

It is an outcome of India's major setbacks in arbitration cases involving long-term tax disputes with companies like UK gas major Cairn Energy PLC and telecom company Vodafone Group.[3] Thus, Mrs. Sitharaman has gone one step ahead, as compared to her predecessor Mr. Arun Jaitley who had left those orders to be decided as per the applicable laws, to invalidate and nullify the orders already given by the Government.

Explanation of terms like Retrospective Taxation, Capital Transactions under FEMA, Indirect Transfer of Assets, etc.

Retrospective Taxation allows a country to pass a law that allows for taxing certain products or services and is applied to the companies from a previous date i.e., before the date on which the law is passed. Usually, the companies take advantage of loopholes where the countries apply retrospective tax to correct irregularity in their taxation policies.

Any transaction that alters the assets and liabilities of residents outside India or of non-residents in India is a capital transaction under the Foreign Exchange Management Act, 1999 (FEMA).[4] Capital transactions like investments, foreign loan, transfer of immovable property, import/export are permitted by the Indian Government.

Indirect Transfer of Assets means that when a foreign company holding its shares has a substantial interest in Indian entities, derives its value from Indian assets. Explanation 5 to Section 9(1)(i) of the Finance Act Amendment, 2012 was introduced[5] to clarify that an asset being a capital asset (being any share or interest in an entity incorporated outside India) shall always be deemed to have been situated in India if they derive, directly or indirectly, their value substantially from the Indian assets.

What is the issue and how has it been proposed to be resolved?

[3] Aparna Banerjea, *Govt nullifies retro tax; introduces Bill to amend Income Tax Act*, LiveMint (Aug 05, 2021, 07:52 PM) https://www.livemint.com/economy/govt-to-amend-income-tax-act-nullify-retro-tax-demands-11628164822039.html

[4] The Foreign Exchange Management Act, 1999, No. 42, Acts of Parliament, 1999 (India)

[5] The Finance Act, 2012, No. 23, Acts of Parliament, 2012 (India)

The bill addresses both future and existing demands under the retrospective amendment. Mrs. Sitharaman pointed out that retrospective taxation continues to be a sore point for investors. It has tarnished India's image as an investor-friendly country. When passed, the bill is probably going to effectively end India's dispute with Vodafone and Cairn Energy and also in 15 other similar cases where the IT Department had raised tax demands supporting the retrospective tax laws.[6] This step could help restore India's reputation as an unbiased, good and predictable regime aside from helping put an end to unnecessary, prolonged and expensive litigation. This is going to put an end to some of the legacy issues and can show investors that India is a destination which will provide them with tax certainty.

2. FINANCE ACT, 2012 AMENDMENT

History behind the Retrospective Taxation law *(Vodafone and Cairn Energy case studies)*

The Finance Act amendment was introduced by the then Finance Minister, Pranab Mukherjee in 2012 to amend the Income Tax Act, 1961.This amendment gave legal backing to retrospective taxation for indirect transfer of Indian assets and also aimed to attack the transactions that managed to escape taxation in India. The Chief Architect of the legislation, Mr. Mukherjee, himself stated that the purpose of the legislation was to nullify the Supreme Court ruling in the Vodafone tax case.

Vodafone India Services Pvt. Ltd. Vs Union of India, Ministry of Finance and Anr. (Bombay High Court)

The Dutch arm of Vodafone Company, Vodafone International Holdings (VIH), bought CGP Investments (Holdings) Ltd, a Cayman Islands-based company in 2007 for $11.1 billion. CGP held a majority stake of 67% in an Indian firm, Hutchison Essar Limited (HEL). Vodafone, through acquisition, got a command over CGP and its subsidiaries including HEL. In September 2007, a show-cause notice was given to Vodafone by the Indian Tax Department to clarify the rationale why the tax was not retained on installments made to Hutchison Telecommunications International Limited in connection to the above-said transaction. The transfer of shares in CGP had an impression of the indirect transfer of assets in India.

[6] Aayush Akar, *Analysis of the Taxation Laws (Amendment) Bill, 2021*, Taxmann (Aug 05, 2021, 09:00 PM) https://www.taxmann.com/post/blog/9055/analysis-of-taxation-laws-amendment-bill-2021/

The issue raised was whether the transfer of shares between two foreign companies, resulting to extinguishment of interest in an Indian company held by a foreign firm, amounted to transfer of capital assets in India and whether such transaction is tax-chargeable in India?

The Court held that any profit arising from the transfer of a corporation in India has got to be considered as a profit of the corporate which actually owns and controls it. Therefore, the recipient of the interest was Hutchison and hence is liable for capital gains tax.
It also held that when a far off company's substantial interest is held in an Indian company, the municipal laws of India would be applicable and hence Indian Tax laws are going to be applied. It was clearly evident that if you earn value from India, you shall be taxed in India. If not, the taxpayers will attempt and try to exploit the fortuitous loopholes in India's taxation laws.

Vodafone International Holdings vs Union of India[7] (Supreme Court)

The issue raised in court was whether the Indian Tax authorities can tax a sale of shares between two non-resident companies in an offshore transaction in which the stake of the Indian company is acquired on the basis of that transaction?

The Court clarified that Vodafone International Holdings and Hutchison Telecommunications International Limited are international companies and that the sale was made outside India, so the source of income is outside India. The tax is levied based on the source and not where the product is purchased from. The provision for the collection of income tax must not be extended ambiguously to impose a tax burden that would not be otherwise taxable.
The sale of Hutchison's CGP shares to Vodafone constitutes a transfer of capital assets under Section 2(14) of the Income Tax Act[8] and therefore not subject to capital gains tax. The Apex Court ruled that the order of the High Court of demand of nearly Rs. 12,000 billion as capital gains tax lacks the authority of law and was therefore vacated.

The judgment of the Supreme Court was harshly criticized and was considered to be arbitrary in nature. The verdict was condemned on the grounds that the law would invite foreign companies to evade taxes in India and jeopardize the country's potential profits.

[7] Vodafone International Holdings B.V. [2012] 17 taxmann.com 202 (SC)
[8] The Income Tax Act, 1961, No. 43, Acts of Parliament, 1961 (India)

Despite the Supreme Court's verdict in the case, the Indian government retrospectively amended the Income Tax Act 1961 in 2012; giving itself the power to go after mergers and acquisitions deals all the way back to 1962 if the asset was in India. This also allowed the government to impose tax demand and slap a tax bill of Rs. 7,990 crores on Vodafone arguing that the company should have withdrawn the tax before paying Hutchison. This modification was considered to be a poorly drafted law and was criticized by investors all over the world.
The Legislature introduced subsequent amendments to the IT Act, 1961 to overturn the Supreme Court's judgement. Section 9(1)(i) of the IT Act provides that income deemed to originate in India consists of any income generated directly or indirectly:

- Through any business relationship in India
- From or through any property in India
- Through any asset or source of income in India
- Through the transfer of capital assets located in India

The following explanations were inserted to Section 9(1) (i) through the Finance Act Amendment, 2012:

Explanation 4- It clarifies that the word 'through' shall mean, include and shall be deemed to have always included 'by means of', 'in consequence of' or 'by reason of'.
Explanation 5- It clarifies that an asset or capital asset being shares or interest in an entity registered outside India shall be deemed to have been situated in India if the share or interest substantially derives its value from the assets located in India, directly or indirectly. However, the shares shall not derive their value from the assets located in India if on the specified date, the value of such assets:

- Does not represent at least 50% of the value of all the assets owned by the entity
- Does not exceed Rs. 10 crores

Through such amendments, the coverage of Section 9(1)(i) had retrospectively increased to include indirect transfer of assets.

Cairn Energy Case Study

Cairn Energy is Europe's leading oil and gas exploration and development companies.[9] In early 2006, Cairn attempted to separate its Indian business to allow Indian investors to share in the success of the company, to raise capital to finance the development of the fields and to return some value to its shareholders.

For the initial public offering (IPO), Cairn reorganised the group into Cairn India Limited (CIL) based in India. This change brought full transparency to Indian authorities by Cairn complying with all regulatory requirements and obtaining all approvals from the Indian Foreign Investment Promotion Board. Cairn employed several Indian and international advisors and received the advice which consistently and explicitly stated that there were no taxes payable in India in connection with the restructuring.

Cairn sold down its stake in CIL to PETRONAS in 2009 and to Vedanta in 2011. These transfers were the responsibility of the Indian tax authorities as they involved shares in the CIL. In Januay 2014, Cairn Energy was preparing to sell its last stake in CIL when India's IT Department decided to launch a retrospective tax investigation into the company. As a result, Cairn was restricted to sell its remaining stake in CIL which was subsequently sold by the IT Department and proceeds and dividend payments were received as profits. The tax department claimed to have identified unallocated taxable income from stock transfers in preparation for the IPO in 2006. It referred to the retrospective Indian tax legislation of 2012 that the department wanted to apply to the 2006's transactions.
This issue had a significant negative impact on Cairn and many international investors. The action led to many potential investors questioning the risk of investing in India.

The Hague Case

Last year in September, the Permanent Court of Arbitration at the Hague, Netherlands delivered that India's tax imposition on Vodafone, including interest and penalties, breached an investment treaty between India and Netherlands. Vodafone had cited that it violated the "fair and equitable treatment" clause under the Bilateral Investment Treaty which led to the quashing of India's tax claim.

[9] Cairn Energy, *Cairn Energy and Government of India- Retrospective tax arbitration proceedings*, Cairn Energy (Dec 23, 2020, 11:34 AM) https://www.cairnenergy.com/media/2827/cairn-india-arbitration-background-international-december-2020.pdf

In December, Cairn Energy was also prompted to move the arbitration court at Hague for relief. It contended that by imposing retrospective tax, India had violated the terms of the UK- India Bilateral Investment treaty. The treaty's main purpose was to protect against arbitrary decisions by laying down that India would treat UK investments in a "fair and equitable manner" but it was not respected. The Court awarded a relief of $1.2 billion to Cairn but India refused to pay the compensation and so Cairn initiated recovery proceeding against India across countries wherein a French Tribunal froze some 20 Indian assets situated in Paris as part of a security for the amount owed to Cairn.[10]

These adverse rulings against the government of India discouraged the foreign investors from investing in India. India was no more seen as an investor friendly country and was disregarded to be capital intensive.

3. TAXATION LAWS (AMENDMENT) BILL, 2021 (SOLUTIONS PROPOSED)

Positive Provisions (Investors Side)/ Proposed mechanism of Redressal

The new bill provides for the nullification of the tax claims made on offshore transactions before 28th May, 2012. The Government proposes to refund the principal amount in full to the litigants on the condition that the companies will need to withdraw the cases and furnish undertakings that they will not claim cost damages or interest.[11] This means that in addition to dropping the cases, companies like Vodafone, Cairn and others will have to commit to not seeking legal damages, recouping the costs of litigation or bringing file cases related to retrospective taxes against the government in the future. There is an assurance from the government's side too that its demand for retrospective tax will also be withdrawn.

This is a welcome move as this time the government has come up with a legislative solution rather than an executive one which highlights the finality of the situation. It recognises the importance of certainty in tax laws, which is a key factor in building confidence in India as an attractive investment destination. It portrays a strong message that the government is committed to the ease of doing business, does not want to litigate and that the foreign investment is welcome in India.

[10] The Hindu, *Centre moves to redact Retrospective Tax Law*, Civils Daily (Aug 06, 2020, 02:30 PM) https://www.civilsdaily.com/news/centre-moves-to-redact-retrospective-tax-law/
[11] The Taxation Laws (Amendment) Bill, 2021, No. 120, Acts of Parliament, 2021 (India)

4.2- Impact on Pending and Concluded allocations

Impact on Pending Allocations

The Fourth Proviso to Explanation 5 of Section 9(1)(i) states that[12] the provision on "indirect transfer of Indian assets", of Explanation 5 shall not apply to gains derived from the transfer of Indirect Indian assets prior to 28th May, 2012 to:

- An appraisal will be conducted in accordance with Sections 143, 144, 147 or 153A or 153C
- An order will be issued to enhance the appraisal or increase the appraiser's liability or reduce a refund that has already been issued pursuant to Section154
- An order to be passed establishing a person as an assessee in default under Section 201(1)

To put it another way, the retrospective amendment of this explanation shall be ignored if there was an indirect transfer of the assets situated in India before 28th May, 2012. Thus, all the proceeds arising from such a transfer are not taxable in India. Therefore, all evaluations or rectification applications pending before the authority in relation to the calculation of income from indirect transfer of assets are considered completed without additions.

Impact on Concluded Allocations

The Fifth Proviso to Explanation 5 of Section 9(1)(i) states that[13] the "indirect transfer of Indian assets" provision of Explanation 5 shall not apply to gains arising through indirect transfer of an Indian asset before the 28th May, 2012 to:

- An assessment made in accordance with Sections 143, 144, 147 or 153A or 153C
- An order to be passed enhancing the assessment or increasing the liability of the expert or reducing a refund already made in accordance with Section 154
- An order to be passed deeming a person as a delinquent appraiser under Section 201(1)
- An order to impose a penalty according to Chapter XXI or under Section 221

To put it another way, the retrospective amendment of this explanation shall be ignored if there was an indirect transfer of the assets located in India before 28th May, 2012. Thus, any income

[12] The Taxation Laws (Amendment) Bill, 2021, No. 120, Acts of Parliament, 2021 (India)
[13] The Taxation Laws (Amendment) Bill, 2021, No. 120, Acts of Parliament, 2021 (India)

from such a transfer is not taxable in India. Therefore, all evaluations or rectification applications pending with the authorities in relation to the calculation of income from indirect transfer of assets shall be considered to never have been passed.

The Sixth Proviso of this explanation states that any amount refundable to such person must be repaid to him but without any interest in accordance with Section 244A.[14] The relief in cases of concluded appraisals shall be granted only to those who meet the following conditions:

If the assessee has appealed to an appeals court or submitted a writ petition to the Supreme Court against an order related to such income, has shall either withdraw the appeal or the writ petition in the prescribed form and manner.

If such person has initiated or has given notice of any proceeding for arbitration, conciliation or mediation under any applicable law or an agreement between India and another country, whether for investment protection or otherwise, he has to withdraw the claim or submit an undertaking to withdraw the claim in the prescribed procedure.

The said person shall undertake in the form and manner prescribed and waive his direct or indirect right to seek or pursue any legal remedy or claim in relation to the said income which he may otherwise be entitled under any law currently in force, in equity, under any statute or under any agreement that India has made with any country outside India, whether for investment protection or otherwise

Or any such other condition as may be prescribed

5. PROBABLE WAYS OF IGNORING INDIRECT TRANSFER TAX BY THE INVESTORS

Tax Indemnity Negotiation

A representation is an assertion of past/ existing fact given by one party to induce the other to enter into an agreement whereas a warranty is a promise that the representation will be true along with an implied promise of indemnity if it is false.[15] Indemnity is when the shareholders agree to indemnify the company for breaches of the shareholder's reps and warranties.

[14] The Taxation Laws (Amendment) Bill, 2021, No. 120, Acts of Parliament, 2021 (India)
[15] Aakansha Joshi and Sujjain Talwar, *Representations, Warranties, Indemnities and Insurance in M&A*, Lexology (Sept 04, 2020, 05:16 PM) https://www.lexology.com/library/detail.aspx?g=49cd5fa5-b348-4af5-a9ad-1e36e3928f74

The most probable way of ignoring indirect transfer tax could be the Tax Indemnity Negotiation. It is when the investors insist that the company be made liable for retrospective tax demands. This clause is important in the agreements between the corporation and the investors as it is the company that should be made responsible for paying tax liabilities of the past since they owned the business during that period. Investors can opt for tax insurance to reduce the risk involved in the case that the tax is ultimately payable.

SPACs for Indian Businesses

A Special Purpose Acquisition Company (SPAC) is formed to complete a merger/ acquisition with one or more businesses, which is identified after raising money from the public investors by way of an IPO. It is done by a shell corporation with the objective to identify private companies which can be acquired and taken public.[16]

Investors can use this method to escape from the indirect transfer taxes as on a SPAC IPO, no tax implications ought to surface in India since a SPAC listing is a blank cheque company with no underlying Indian assets but on subsequent trading of SPAC shares there could be tax implications for a SPAC deriving its substantial value (>50%) from India. Shareholder's holding less than 5% of the SPACs capital and those who are able to claim exemption[17] from tax under the relevant tax treaties are still on the brighter side and not subject to indirect transfer implications.

6. IMPACT ON INDIA'S TAX TREATIES WITH NETHERLANDS AND MAURITIUS

Benefit of getting a company listed in Netherlands

Interest is increasing in the Netherlands as a prime location for foreign investors seeking to avoid tax havens and blacklisted jurisdictions. Foreign investors are attracted by the favourable tax system, internationally focused economy and pro-business government of Netherlands. The country has extensive tax treaties and bilateral investment network. These offer protection for the indirect investments of a Dutch holding company through local subsidiaries. It is possible to incorporate a private limited corporation with 1 share having a value of 1 cent. The

[16] *Devarsh Shah and Dharmvir Brahmbhatt*, *Tax Implications on SPAC: To SPAC or Not To SPAC?* The CBCL Blog (Sept 04, 2020, 05:16 PM) https://cbcl.nliu.ac.in/taxation/tax-implications-on-spac-to-spac-or-not-to-spac/

[17] S.R Patnaik, *Assessing Indian Tax Considerations for successful offshore listing of Indian companies,* Cyril Amarchand Mangaldas Blog (Sept 22, 2020, 09:21 AM)https://tax.cyrilamarchandblogs.com/2020/09/assessing-indian-tax-considerations-for-successful-offshore-listing-of-indian-companies/#more-2154

repurchase and redemption of one's own shares is flexible.

Netherlands maintains a concept of horizontal monitoring[18] whereby an agreement is concluded between the Dutch tax authorities and the taxpayer, in which both parties agree to discuss potential tax issues. Another advantage is the active involvement of the government that creates conditions to maintain an attractive business environment.

Recent amendment (MFN clause)

The 10% tax rate on dividends under the India-Netherlands tax treaty has been lowered to 5% following the recent amendment to the MFN (Most Favoured Nation) clause of the treaty. Investments of Dutch companies are exempted from capital gains when shares of Indian companies are sold. The treaty allows capital gains to be taxed in India when 10% or more of the shares of an Indian company are sold to an Indian resident. Investors coming through the Netherlands will get a more favourable capital gains scheme than those from Mauritius, Singapore or Cyprus. The economic substance requirement is higher i.e, a company tries to ensure that only legitimate investors can benefit from the tax treaty.
Recently, India also revised its dividend taxation system.[19] The stakeholder would now have to pay taxes instead of the distribution tax previously paid by Indian distribution companies without further tax in the hands of a non-resident shareholder. This is beneficial to all the investors who have similar MFN clauses in their tax treaties with India.

Indirect Taxes involved in Netherlands

There are no regulatory restrictions on Foreign Direct Investment (FDI) in Netherlands. If a foreign MNC maintains its group companies in a Dutch intermediate holding cooperative, there is no withholding tax on dividends or Dutch income tax levied. There is no capital tax, interest withholding tax or stamp duty. It also provides relief from double taxation on all types of income. Transfer tax levied on the acquisition of property in the Netherlands is 2% for private residences and 8% for other immovable property.

[18] Loyens Loeff, *What does the new approach of Horizontal Tax Monitoring mean for your company*, Loyens Loeff (Dec 20, 2019, 12:00 PM) https://www.loyensloeff.com/en/en/news/news-articles/what-does-the-new-approach-of-horizontal-tax-monitoring-mean-for-your-company-n17913/
[19] Ritu Shaktawat and Rahul Jain, *First Indian Tax ruling on Beneficial Interpretation of MFN clause in India Netherlands Tax Treaty*, Lexology (Sept 04, 2020, 05:16 PM) https://www.lexology.com/library/detail.aspx?g=7334b2c0-8a52-4a29-bb2b-a0b4e06eb73c

Recent amendment in Mauritius Tax treaty

As per the recent amendment in India-Mauritius tax treaty[20], India can now tax capital gains from the transfer of Indian shares acquired after April 1, 2017. This prevents the phenomenon of round tripping whereby people avoid tax by sending funds abroad and then bringing them back to India via Mauritius-based companies. This amendment would also help curb tax evasion, tax avoidance and double taxation.

CONCLUSION

During the economic aftermath of the COVID-19 pandemic, India was not at the forefront of raising capital but the current pattern of government policies has taken a turn and made India a favourable regime for the foreign investment. Today, the country stands at a juncture where foreign investment is essential to promote faster economic growth and employment, and thus a rapid post-pandemic economic recovery is the need of the hour. The introduction of the Taxation Laws (Amendment) Bill speaks highly of the Government's commitment towards the foreign investor community.

The bill displays that the Indian bureaucracy is evolving and changing its old thinking of stubbornness, for in the 21st century, good politics is good economics! The retrospective amendment was evidence that the Indian political system lacked the maturity to take the final step and acknowledge mistakes for the public good by transcending political compulsions. It invited criticisms from stakeholders globally that such amendments go against the principle of tax security and remain to be a sore spot for potential investors.

India's Foreign Direct Investment (FDI) regime is again considered the most liberal in the world. More than just inviting foreign investors from around the world, the government is now focussing on assuring them that deep structural reforms are underway to support their investments. This is making the valuation of the Indian business attractive by providing an impetus to its popularity in the international investor community. IN CRISIS LIES OPPORTINITY!

[20] K. R Sekar, *India-Mauritius tax treaty amendment: What could be the impact on key stakeholders*, Financial Express (May 16, 2016, 05:28 AM) https://www.financialexpress.com/opinion/india-mauritius-tax-treaty-amendment-what-could-be-the-impact-on-key-stakeholders/256025/