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TAXATION AND DUTY IMPLICATIONS IN INDIA

AUTHORED BY - PRACHI SINGH

Introduction

Taxation is a basic component of any economy, providing the government with its principal source of revenue while also allowing it to provide public goods and services. In India, taxes has a long and complicated history, evolving over centuries to fulfil the needs of economic growth, social development, and government. The Indian taxation system is divided into direct and indirect taxes, with various tariffs and levies imposed on goods, services, and earnings to provide a consistent revenue stream for the government.

India has a dual taxation system, with taxes levied at both the government and state levels. The system includes both direct taxes, which are charged on individuals and corporations based on their income and profits, and indirect taxes, which are assessed on the consumption of goods and services. The Goods and Services Tax (GST) was introduced in 2017, marking a dramatic shift in the indirect taxation landscape, with the goal of creating a unified market and eliminating cascading tax impacts.

Direct Taxes

1. Individuals and businesses pay direct taxes on their earnings. The main components of direct taxation in India are:
2. **Income Tax:** Under the Income Tax Act of 1961, income tax is levied on individuals, Hindu Undivided Families (HUFs), and corporate organizations using a progressive tax rate structure.
3. **Corporate Tax:** Companies operating in India are liable to corporation tax, which varies depending on their annual revenue and resident status.
4. **Capital Gains Tax:** This tax applies to earnings made from the sale of assets such as real estate, stocks, and bonds.
5. **Dividend Distribution Tax (DDT):** Previously imposed on enterprises that paid dividends, DDT was eliminated in 2020, shifting the tax burden to shareholders.
6. **Wealth Tax:** Although abolished in 2015, wealth tax was previously levied on persons and companies with assets surpassing a certain level.

Indirect taxes

Indirect taxes are levied on goods and services rather than income, and are eventually passed on to consumers. The Goods and Services Tax (GST) is India's most notable indirect tax, having replaced several earlier taxes like VAT, excise duty, and service tax. The major components of indirect taxes are:

1. Goods and Services Tax (GST) is a comprehensive tax that applies to the provision of goods and services in India. It is divided into three categories: CGST (Central GST), SGST (State GST), and IGST (Integrated GST) depending on interstate and intrastate transactions.
2. Customs duty: it is levied on imports and exports to regulate trade and generate money for the government.
3. Excise Duty: While GST has essentially replaced excise duty, it still applies to some goods such as alcohol and petroleum products.
4. Stamp duty is levied on the transfer of legal documents, such as property transfers and financial agreements.

Tax Framework Governing M&A Transactions in India

Mergers and acquisitions (M&A) transactions in India are subject to a variety of taxes, including capital gains tax, GST, and stamp duties. The taxes system for M&A transactions is complicated, necessitating meticulous planning to minimize tax payments and maintain compliance.

- Capital Gains Tax and M&A

Capital gains tax is an important factor in M&A transactions since it applies to gains resulting from the transfer of capital assets such as shares, property, and business ventures. Taxation is based on the holding duration and type of asset being transferred-

1. Short-Term Capital Gains (STCG): Gains on assets held for less than 36 months (12 months for listed securities) are taxed at higher rates.
2. Long-Term Capital Gains (LTCG): Gains on assets kept beyond the statutory term are taxed at a lower rate, with listed stocks liable to 10% tax beyond the Rs. 1 lakh exemption.
3. Tax Neutrality in Amalgamations: As per section 47 of the Income Tax Act, certain mergers and demergers are considered tax-neutral provided certain conditions are met, which means capital gains tax is not levied.

4. Impact on Shareholder: Shareholders of merging firms may be subject to capital gains tax if they receive cash or non-equity consideration.
 5. Cross-border M&A: Transactions involving foreign corporations may result in withholding tax requirements and treaty implications.
- GST Implications for M&A

The implementation of GST has streamlined indirect taxation, but its applicability in M&A transactions differs depending on the nature of the deal-

1. Slump Sale v. Itemized Sale: A slump sale (the transfer of a business as a going concern) is normally exempt from GST, whereas an itemized sale of assets attracts GST at the applicable rates.
 2. Input Tax Credit (ITC) Considerations: Merging entities must assess the eligibility and continuity of ITC on company assets and liabilities after the transaction.
 3. GST on Share Transfers: Share transactions are free from GST because they are classified as securities and are therefore not subject to GST.
 4. Treatment of Liabilities: Merging entities existing GST liabilities may be carried forward or amended in the new entity's tax filings.
- Stamp Duty in M&As

Stamp duty is a major cost component in merger and acquisition transactions, levied by state governments on the transfer of assets and securities:

1. Share Transfer: Transferring listed shares incurs a modest stamp duty, whereas unlisted shares are subject to higher charges.
2. Business Transfer Agreements: Stamp duty is imposed on agreements that transfer assets such as land, buildings, and intellectual property in accordance with state legislation.
3. Amalgamation Orders: Stamp duty is required for court-approved schemes of amalgamation and demerger, which varies by state.
4. State-Specific Variations: Stamp duty rates and rules vary by state, affecting overall transaction costs.

India's tax and levy framework has important ramifications for individuals, corporations, and international investment. Key areas affected are:

1. Economic Growth and the Business Environment: A well-designed tax policy encourages investment and entrepreneurship while assuring compliance and revenue collection.

2. Foreign Direct Investment (FDI): Tax regulations, such as corporation tax rates and exemptions, influence the flow of international investments.
3. Ease of Doing Business: A simplified tax system improves transparency and minimizes the compliance cost for enterprises.
4. Consumer Prices and Inflation: Indirect taxes such as GST raise the cost of products and services, influencing consumer spending habits.
5. Government Revenue and Public Welfare: Taxes collected support important services such as infrastructure, healthcare, and education, thereby contributing to national development.
6. Sector-Specific Impacts: Certain industries, such as real estate, technology, and medicines, confront distinct tax problems and incentives.
7. Regulatory Ambiguity: The frequent changes in tax legislation and various interpretations cause legal uncertainty for firms and investors.

Key Case Studies and Judicial Precedents

1. Vodafone International Holdings BV v Union of India (2012)¹

The Vodafone International Holdings BV vs. Union of India case is one of India's most significant tax litigation disputes, involving indirect asset transfers and the idea of retrospective taxation.

Background of the Case

Vodafone International Holdings BV, a Vodafone Group Plc subsidiary based in the Netherlands, paid roughly \$11.1 billion for a 67% share in Hutchison Essar Limited (HEL), an Indian telecom business, in 2007.

The transaction involved the purchase of Cayman Islands-based CGP Investments, a holding firm managed by Hutchison Telecommunications International Ltd. (HTIL). Because CGP Investments indirectly owned shares in an Indian firm (HEL), the Indian tax authorities alleged that Vodafone should have deducted withholding tax before making the payment to Hutchison. The Indian tax authorities requested ₹11,000 crores (roughly \$2.2 billion) in capital gains tax, claiming the transaction entailed the indirect transfer of Indian assets.

¹ Vodafone International Holdings BV v. Union of India, (2012) 6 SCC 613.

Supreme Court's Verdict (2012)

The Supreme Court of India found in Vodafone's favor, finding that Indian tax regulations at the time did not encompass indirect transfers of Indian assets by foreign companies. It stressed that Vodafone was not required to deduct tax at the source because the transaction occurred outside of India. The court also determined that the transaction was legally constituted and did not involve tax evasion.

Retrospective Tax Amendment by the Indian Government

In reaction to the verdict, the Indian government amended the Income Tax Act of 1961 retrospectively, allowing tax officials to tax indirect transfers of Indian assets even if they took place outside of India. This change went into effect in 1962, which means that previous transactions may potentially be subject to tax scrutiny.

International Arbitration and Policy Change

Vodafone challenged India's retrospective tax law in international arbitration under the India-Netherlands Bilateral Investment Treaty. In 2020, the Permanent Court of Arbitration (PCA) in The Hague decided in favor of Vodafone, ruling that India had violated the BIT's fair and equitable treatment provisions. Following this verdict and much criticism, the Indian government repealed the retrospective taxation statute in 2021 and agreed to repay all amounts collected under it.

Key takeaways from the case

- **Clarity about Indirect Transfers:** The case underscored the importance of precise tax regulations governing indirect transfers of Indian assets by overseas firms.
- **The Impact of Retrospective Taxation:** The Indian government's retrospective revision caused investor concern and sparked legal battles, affecting India's worldwide investment climate.
- **International Arbitration and Investor Rights:** The decision established a precedent for foreign investors that use bilateral investment treaties (BITs) to challenge disadvantageous tax regulations.
- **Policy Reforms:** In response to international pressure and arbitration rulings, India eliminated retrospective taxation in an effort to improve its investment-friendly image.

2. McDowell & Co. Ltd. v Commercial Tax Officer (1985)²

The McDowell & Co. Ltd. vs. Commercial Tax Officer (1985) case is a significant Supreme Court of India decision that established a precedent in tax law by distinguishing between tax avoidance and lawful tax planning. It reinforced the concept that tax authorities might dismiss fake transactions that lacked commercial substance.

Background of the Case

McDowell & Co. Ltd., a liquor manufacturing company, attempted to lower its excise duty liabilities by arranging its transactions in a way that minimized tax exposure. The corporation conducted its sales through intermediaries, arguing that the transaction structure legitimately minimized its tax liabilities. The Commercial Tax Officer contested the transaction, claiming that it was an artificial arrangement created primarily for tax avoidance.

The matter was escalated to the Supreme Court of India, which issued a critical verdict on tax planning and evasion.

Supreme Court Verdict (1985)

The Supreme Court decided against McDowell & Co., concluding that the transaction was organized solely to dodge taxes and had no legitimate business objective. It asserted that tax evasion and tax avoidance are distinct. While tax evasion is unlawful, tax avoidance, especially through fake transactions, should be discouraged. Genuine tax planning is permitted; however, colorable devices (sham transactions) should be prohibited. Courts and tax officials have the authority to pierce the corporate veil and investigate the true intent of a transaction.

The significance of the judgment

- **Anti-Tax Avoidance Stance:** The case established a precedent that tax authorities may dismiss transactions that lack genuine commercial substance.
- **Encouragement of Substance over Form:** Tax structures must be assessed based on economic substance rather than legal form.
- **Impact in future tax cases:** The decision affected subsequent verdicts, including the Vodafone case (2012), and changed India's approach to General Anti-Avoidance Rules (GAAR) under the Income Tax Act.

² McDowell & Co. Ltd. v. Commercial Tax Officer, (1985) 3 SCC 230.

Key Takeaways

- Taxpayers must verify that their tax planning tactics are commercially viable and not simply tools for tax avoidance.
- Tax authorities can dismiss transactions that lack genuine substance.
- This case laid the groundwork for India's GAAR structure, which enables tax officials to examine transactions for avoidance methods.

3. Cairn Energy v India (2020)³**Background of the Case**

Cairn Energy, a UK-based oil and gas exploration corporation, entered the Indian market in the 1990s and established Cairn India to oversee its operations. In 2006, as part of a corporate restructure, Cairn Energy transferred shares in Cairn India Holdings (a Jersey-based subsidiary) to Cairn India Limited, a newly constituted Indian firm. Cairn India was thereafter placed on Indian stock exchanges via an initial public offering (IPO), and Cairn Energy gradually relinquished its stake.

The Indian tax authorities argued that Cairn Energy owed capital gains tax on the reorganization and requested approximately ₹10,247 crore (\$1.4 billion) in taxes, fines, and interest, citing retrospective tax regulations imposed in 2012 (after the Vodafone case).

Legal Battle and International Arbitration

Cairn Energy appealed the retrospective tax claim to the Income Tax Appellate Tribunal (ITAT), but the issue was not decided in its favor. The company subsequently filed an international arbitration case under the UK-India Bilateral Investment Treaty (BIT), claiming that India's tax demand violated fair and equitable treatment rules.

In December 2020, the Permanent Court of Arbitration (PCA) in The Hague decided in favor of Cairn Energy, ordering India to refund \$1.2 billion, plus interest and damages. Reimburse Cairn for legal fees incurred during the arbitration. The tribunal found that India's tax demand was inconsistent with international investment protection norms and violated its treaty responsibilities.

³ Cairn Energy PLC v. India, PCA Case No. 2016-7 (2020).

India's Response and Repeal of Retrospective Taxation

Initially, India refused to comply with the arbitration verdict and opposed it in courts. Meanwhile, Cairn Energy filed legal action to recover Indian government assets in overseas countries, including properties in Paris and New York. Faced with worldwide criticism and a detrimental impact on foreign investor confidence, the Indian government overturned the contentious retrospective tax law in August 2021, proposing to return collected sums under certain conditions. Cairn Energy later resolved with the Indian government in 2021, accepting the repayment and agreed to drop enforcement measures against Indian assets abroad.

Key takeaways from the case

- **End of Retrospective Taxation:** The case resulted in a significant policy shift, with India abolishing retrospective tax measures to restore investor trust.
- **International Arbitration Precedent:** The decision highlighted the significance of bilateral investment treaties (BITs) in safeguarding foreign investors from arbitrary taxation.
- **India's Investment Climate:** The case emphasized India's tax issues, as well as the importance of transparent and stable tax regulations in attracting foreign investors.
- **Legal and Diplomatic Implications:** India suffered diplomatic and financial pressure as a result of Cairn Energy's enforcement efforts in many worldwide countries.

4. GKN Driveshafts (India) Ltd. vs. ITO (2003)⁴

Background of the Case

GKN Driveshafts (India) Ltd., a renowned auto-component maker, received a reassessment notice from the Income Tax Department under Section 148 of the Income Tax Act of 1961. The reassessment was initiated because the Assessing Officer had "reasons to believe" that taxable income had eluded assessment. The corporation opposed the reassessment notice, claiming that it was not provided access to the documented reasons prior to being asked to react.

Key Legal Question

The case focused on whether an assessee (taxpayer) has the right to acquire a copy of the recorded reasons for reassessment before raising objections.

⁴ GKN Driveshafts (India) Ltd. v. ITO, (2003) 1 SCC 72.

Supreme Court Ruling (2003)

The Supreme Court ruled in favor of GKN Driveshafts, creating an important procedural safeguard in tax reassessment proceedings. It established a two-step process that tax officials must follow when issuing reassessment notices:

- **Providing Recorded grounds:** After receiving an objection, the tax authorities must inform the assessee of the grounds for reopening the assessment before continuing.
- **Allowing Opportunity to Object:** The assessee must be given a fair opportunity to file objections to the reassessment, and the objections must be resolved by a speaking order before proceeding with further tax assessment.

Impact of the Judgment

- **Strengthened Taxpayer Rights:** The verdict increased procedural fairness by forcing tax officers to follow due process before reassessment.
- **Reduced Arbitrary Reassessments:** Authorities could no longer send reassessment notices without recording the grounds, preventing taxpayer harassment.
- **Standardized Procedure:** The verdict provided a standardized approach to dealing with reassessments, ensuring transparency in tax processes.

Key Takeaways

- Before requiring taxpayer responses, tax authorities must explain why they are reassessing.
- Taxpayers must be given the opportunity to register objections, which must be resolved before the reassessment can proceed.
- The verdict increased procedural fairness in tax disputes, resulting in a more balanced approach to reassessments.

5. Hindustan Lever Ltd. vs. R.B. Wadkar (2004)⁵

Background of the Case

Hindustan Lever Ltd. (HLL), now renamed as Hindustan Unilever Ltd. (HUL), underwent a corporate restructuring that included the transfer of shares. The disagreement arose when the tax authorities attempted to impose capital gains tax on the transaction, claiming that the sale

⁵ Hindustan Lever Ltd. v. R.B. Wadkar, (2004) 9 SCC 438.

price was undervalued, resulting in a smaller tax responsibility. The Income Tax Department argued that the share transfer should be taxed based on fair market value (FMV), not the reported transaction price. The assessing officer, R.B. Wadkar, sought to reassess the tax liability using this premise.

Issues

- The dispute centered on whether the taxation of share transfers should be determined exclusively by the legal structure of the transaction or whether the economic substance should take precedence.
- Should tax authorities have the authority to question a transaction's claimed value and levy taxes based on the FMV?

Bombay High Court Ruling (2004)

The Bombay High Court ruled in favour of Hindustan Lever Ltd., ruling that taxation on share transfers must be based on economic substance rather than purely legal form. The court made the following major observations:

- Economic substance over legal form: The court highlighted that the actual economic impact of the transaction, not simply its formal framework, must be considered.
- Fair Market Value Assessment: If a transaction is made at a much lower price than market value, tax authorities may investigate whether it was an artificial arrangement to reduce tax burden.
- No automatic reassessment: In the absence of solid evidence of tax evasion, the recorded transaction value should be accepted.

Impact of the Judgment

- Strengthened Tax Authorities' Powers: The verdict affirmed tax authorities' power to scrutinize transaction values in circumstances where asset underreporting is suspected.
- Precedent in Transfer Pricing Cases: The case established the groundwork for transfer pricing legislation in India, which ensure fair valuation in inter-company transactions.
- Reinforced anti-tax avoidance measures: The ruling was consistent with global efforts to reduce tax evasion through artificially low valuations in M&A and restructuring transactions.

Key Takeaways

- Economic substance is more important than legal form in taxation.
- If tax authorities detect underpricing, they may contest transaction valuations.
- A balance is required between avoiding tax evasion and ensuring fair business dealings.

Conclusion

India's tax system has undergone considerable revisions to conform with global standards and increase compliance. While issues such as tax evasion and onerous regulatory requirements persist, ongoing developments in tax legislation, digitization, and simplification of tax procedures promise to boost efficiency and economic growth. The complexities, expenses, and ambiguities of the Indian tax system have a substantial impact on the structuring and implementation of M&A deals.

In the coming years, sustaining long-term economic growth will require a more transparent, predictable, and investor-friendly tax climate. India's move toward tax policy stability, avoidance of retrospective taxation, and improved dispute resolution systems will boost investor trust. By guaranteeing tax law consistency, the government can attract foreign direct investment (FDI) and enhance ease of doing business.

Furthermore, tax simplification initiatives and policy improvements will be critical for reducing tax litigation and increasing efficiency. Streamlining procedures, preserving tax neutrality in company reorganization, and integrating digital tax administration will result in a more efficient tax system. The adoption of global best practices, such as the Base Erosion and Profit Shifting (BEPS) principles, demonstrates India's commitment to a fair and equitable tax system.

With continuing advancements, India will be able to build a more strong and competitive tax environment that promotes economic growth, helps enterprises, and, eventually, benefits taxpayers. As taxation remains a key factor in investment decisions, India's emphasis on tax rationalization and policy consistency would pave the path for long-term economic growth.