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# **THE DAWN OF AN ERA: REVOCATION OF RETROSPECTIVE TAXATION IN INDIA**

**By: Pritha Ghosh**

## **ABSTRACT**

Taxation has historically been a controversial exercise. The imposition of retrospective taxation during the British Era in India was highly resented. Since the introduction of retrospective tax in India through the Income Tax Act 1961, there have been more than sixty-six amendments. While tax laws are amenable to challenge on the grounds of legislative competence, the Supreme Court of India has given reasoned decisions to uphold the taxpayer's rights. However, the Government of India has attempted to bypass the Apex court's decisions by introduction of amended tax legislations, fundamentally altering the legality of the tax provisions. It is important to reflect on the consequences of these amendments which has led to a steep decline of foreign direct investments in the past. The question whether there may be other ways for the government to secure taxes on capital gains to regulate tax evasion is a crucial one to ask. Retrospective taxation has an adverse effect on business undertakings. Corporate taxes being one of the largest sources of revenue, the government must ensure that good governance is not deterred by political compulsions, ensuring the fundamental paradigms of taxation.

**Keywords: Retrospective tax, tax avoidance, tax evasion, foreign direct investments, good governance.**

## **INTRODUCTION**

The Taxation Laws (Amendment) Act, 2021 seeks to withdraw retrospective taxation in India. The demand to end retrospective tax on capital gains from sale of assets located outside India has long

been in demand in the international business community.<sup>1</sup> It has caused a huge disincentive for international corporations seeking to do business in India. Retrospective taxation was introduced through the Finance Act<sup>2</sup> in 2012. In 2013, these laws led to a downfall of India's index of Ease of doing Business in terms of investment friendliness, positioning it below countries like Uganda and Ethiopia. Uncertain tax climate in a country negatively affects the business environment and triggers corporate tax liabilities for Multinational Corporations (MNCs).<sup>3</sup>

On August 5, 2021, the Finance Minister, Mrs. Nirmala Sitharaman introduced The Taxation Laws (Amendment) Bill, 2021. With the introduction of the recent amendment, no retrospective demand shall be raised by the Government of India on indirect transfer of Indian assets, provided that the transaction was undertaken before May 28, 2012 (i.e., the day of enactment of the Finance Bill, 2012). All tax demands raised before this date for indirect transfer of Indian assets shall be nullified, subject to certain conditions. For example, if a company A invests in shares of company B and sells the investment before May 28, 2012, the resulting profit or capital gains from the transaction will not be taxed by the government. All taxes imposed by the government would be withdrawn and refunded without any interest. The amendment further states that if the taxpayer withdraws pending litigations and signs an undertaking not to claim for costs, damages or interest, no tax demand shall be imposed by the government.

The Government of India recognized the need for certainty in the business environment as an after-effect of the COVID-19 pandemic and to prevent a fallout in international business. Advance ruling mechanisms have been introduced for non-resident assesseees, allowing them to gain clarity on a business scenario before entering into transactions. As a result of this realization and as an aftermath of the decisions in the Vodafone case<sup>4</sup>, retrospective taxations have been revoked by the government.

The amendment was tabled with the purpose of providing “clarification” on taxation laws. It may

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<sup>1</sup> Harish Salve, Retrospective Taxation - The Indian Experience, pg.2

<sup>2</sup> Finance Act, 2012

<sup>3</sup> Melissa Cyril, India's Parliament Approves Bill to End Retrospective Taxation, Amend Tax Law, India Briefing from Dezian Shira & Associates (<https://www.india-briefing.com/news/author/india-briefing/>).

<sup>4</sup> *Vodafone International Holdings Pvt. Ltd. v. Union of India*, Ministry of Finance and Anr. 2009 (4) Bom CR258.

aim to cure the defect through revocation of retrospectivity. However, the amendment lacks “look-through” provisions. The issue in Vodafone and Hutchison transactions arose because the government was unsure whether the capital gain accrued upon acquisition of gains through a company outside India is taxable or not. In such cases, countries like Australia and Canada have inserted “look-through” provisions in contracts in order to ensure transparency in international commercial transactions.

Furthermore, the introduction of an amendment to bypass the Supreme Court judgment in the Vodafone case<sup>5</sup>, hurts the evolution of good politics and governance in the country. The Supreme Court of India had followed the American precedents, rejecting the notion that retrospectivity would render the tax laws as arbitrary. The legislature fundamentally altered the conditions based on which the Supreme Court gave its decision. This affects separation of powers between the two organs, one of the vital features of our democracy.

The aim of this article is to study the effect of revocation of retrospective taxation in India and bring the limitations of the amendment to the forefront by establishing the case of Vodafone. This article deals with retrospectivity in taxation laws limited to India. The question of constitutional legitimacy has been limited to discussions of legislation within India. This paper deals with the Vodafone-Hutchison case. The discussion has been limited to the liability of the Government of India in both cases. The author recognizes that the cases involve transnational transactions which come with its own jurisdictional complexities. Thus, this article proceeds with strict adherence to the Indian Constitution<sup>6</sup> and the jurisdiction of the laws passed in India.

The paper examines the Taxation Laws (Amendment) Act, 2021 and its contribution to decision making by the Government and the judicial concerns raised by experts. On the basis of the study, we conclude that retrospective taxation marks the beginning of a new era for national and international business entities. The purpose of introduction of the amendment raises serious questions and despite opposition, there is a long way to go in order to secure the Indian financial and tax markets by way of legislation. Part I of the Article expands on the intricacies of the

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<sup>5</sup> *id.*

<sup>6</sup> The Constitution of India, 1950

retrospective application of taxation laws. Part II of the Article explains the retrospectivity effect and analyzes it in light of the Vodafone-Hutchison Case.

## BACKGROUND

With the dynamic nature of business worldwide, the need for evolving tax laws has become imperative. Countries ensure to collect their fair share of the revenue by levying taxes on transnational transactions. However, when governments attempt to gain revenue through retrospective application of laws, it often results in disturbing the foundations of business with international players and ultimately lands on the shoulders of the taxpayers in the country.<sup>7</sup>

### Retrospective Laws & Constitutional Validity

Tax laws are subject to limitations in two ways. Firstly, the Constitution of India imposes limitations on the power of the Parliament and State legislature through the application of subjects in various lists. List I, Union List, on which the Parliament has the power to legislate, List II, State List on which the State legislatures have the power to legislate and List III, Concurrent List, on which both the Parliament and the State legislatures have power to legislate.

Tax laws are subject to limitation by Part III of the Constitution i.e., on the grounds of violation of fundamental rights of persons. Tax laws may be violative of equality before the law. In several cases in the past, the Supreme Court has held that “mere retrospectivity would not render tax laws arbitrary and capricious”. However, the distinctive feature of these cases was that the amendments sought to “correct drafting flaws which defeated the legislative intent, or correcting a feature found unconstitutional, on account of which, the windfall fell upon the taxpayer.”

Therefore, the question arises whether the amendments introduced in 2021 were the result of the legislature intending to correct the law in a manner such that it does not defeat the legislative intent or whether it is for its own protection.

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<sup>7</sup> End of Retrospective Tax Era on Indirect Share Transfer, CNBCTV18 (<https://www.cnbctv18.com/economy/end-of-retrospective-tax-era-on-indirect-share-transfer-10425601.htm>).

### **The Problem of Retrospective Taxation**

In 2012, the government announced that retrospective tax would be applicable on indirect share transfers, enabling India to tax gains on all commercial transactions executed after 1 April, 1961 involving foreign entities with investments in India. Even back then, the move was seen as a retrograde step for the Indian economy. Consequently, litigations in both domestic and international forums were filed. Tax demands were raised in seventeen deals executed before 2012. According to India's Bilateral Investment Treaties, retrospective application of tax violated India's obligations to provide 'fair and equitable treatment to foreign investors.'<sup>8</sup>

The retrospective amendments caused a drop in the Foreign Direct Investments (FDI) proposals in India. In 2012-13, there was a decline of \$22.42 billion, a 38 per cent dip in the FDI inflow compared to the previous year. This decline put pressure on India's balance of payments and negatively impacted the value of the Indian currency. An expert committee was constituted headed by Mr. Parthasarthy Shome, which concluded that, "...[R]etrospective application of tax law should occur in exceptional or rarest of rare cases, and with particular objectives: to correct the anomalies in the statute, or to clarify the details, or to protect the tax base from abusive tax planning schemes."

The problem with the government's approach to taxation is that it fails to pass the test of certainty and continuity. Retrospective taxation is violative of the fundamental paradigms for fair taxation: equity and fairness, tax neutrality, efficiency, economic growth, transparency, certainty and visibility. Applying taxes on transactions executed in the past is like changing the air traffic routes after the airplane has already landed at the airport. The Indian government's approach can at best be described with the expression used by the eminent jurist, Mr. Nani Palkhiwala as "a triumph of bureaucratic obstinacy over good sense".

### **The Income Tax Act, 1961 & the Finance Act, 2012**

The Taxation (Amendment) Act, 2012 amends the Income Tax Act, 1961 and the Finance Act,

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<sup>8</sup> Whalley Jason, Curwen Peter, *Managing Tax by Organizational Means: The Case of Vodafone*, 2014, *Public Money & Management*, 34:5, 371-378, DOI: 10.1080/09540962.2014.945809 (<https://www.tandfonline.com/doi/abs/10.1080/09540962.2014.945809>).

2012. Under the 2012 amendment, tax liability was imposed on the income earned from the sale of stock shares of a foreign company on a retrospective basis. Non-residents need to pay taxes for income accruing through business connection, property, asset or source of income situated in India. The 2012 amendment clarified that for a company which is registered and incorporated outside India but derives substantial value from assets located within India, the company's shares will be deemed to have always been situated in India. Thus, the income earned from such sale is liable to be taxed before the enactment of the act.

### **The Taxation (Amendment) Act, 2021<sup>9</sup>**

The Taxation (Amendment) Act, 2021 ("the Act") proposes to nullify the retrospectivity of the tax imposed on such persons, provided that they fulfill the following conditions:

- (i) all litigations in this regard must be withdrawn, the persons must sign an undertaking to withdraw the applications,
- (ii) all arbitration, conciliation or mediation proceedings must be withdrawn,
- (iii) the persons undertake to waive off their right to seek or pursue any remedy or raise a claim available under any bilateral agreement,
- (iv) other conditions, as may be prescribed by the government.

### **Impact on Pending and Concluded Assessments**

If the person fulfills these conditions, any and all tax liability will be waived off. Moreover, the government will refund the tax amount to eligible persons, without any interest. Therefore, the indirect transfer of assets situated in India before 28th May, 2012 shall have no retrospective effect. The income accruing from such transfers will not be taxable in India. Thus, all pending litigations and applications shall be automatically dismissed and concluded.

Where the assessee has initiated any arbitration, conciliation or mediation proceeding, or filed a writ petition, the person shall withdraw such proceedings and undertake to waive off their rights to pursue any remedy. The assessee shall be refunded the amount paid as taxes on capital gains without any interest on the amount.

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<sup>9</sup> The Taxation (Amendment) Act, Section 9, Section 15 (2021).

### **Validation Clause**

Under the Finance Act, 2012, the validation clause validated all demands raised with regards to indirect transfer of assets. Moreover, decisions given by the Supreme Court beyond the ambit of Section 9 were to be disregarded. With the 2021 amendment, the section has ceased to apply to persons who have withdrawn litigations and undertake to waive off the right to claim against damages.

### **VODAFONE - HUTCHISON CASE<sup>10</sup>**

#### **Factual Background**

In May 2007, Vodafone International Holding, a Dutch firm transacted and bought a 67% share in Hutchison Telecommunications International Limited (HTIL), based in the tax haven of Cayman Islands. HTIL had a consumer base in India, and had established itself as a telecommunication giant with mobile and internet services. Legally, CGP investments, a company based in Cayman Islands and fully owned by Hutchison, owned small entities based in Mauritius. These Mauritius based entities owned the 67% stake in Hutchison Essar Ltd. Business between India and Mauritius based entities was convenient due to the existing bilateral treaties.

As HTLL planned to exit from India, it sought to sell its shares. Vodafone International Holdings paid \$11 billion to HTIL to acquire CGP Investments, in turn gaining full control over Hutchison's operations in India.

In 2007, the Indian tax authorities raised a demand of over \$2 Billion or Rs. 7 crores in capital gains and withholding tax from Vodafone Essar. The government contended a case of tax avoidance saying that since the transaction involved the sale of Indian assets, any gains from such taxes would be taxable in India. On the other hand, Vodafone argued that the transaction was executed between a Cayman based company and a Dutch company. Since the transaction did not involve the sale of any business within India, Vodafone is not liable to pay taxes. When the matter reached the Supreme Court, the SC ruled that Vodafone was not liable to pay taxes. In an

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<sup>10</sup> *Vodafone International Holdings Pvt. Ltd. v. Union of India, Ministry of Finance and Anr.* 2009 (4) Bom CR258.

unprecedented move, the government introduced a new amendment to the tax legislation in 2012 in an attempt to recover the allegedly due taxes from Vodafone, by way of retrospective legislation. Tax authorities could now levy taxes on transactions dating back to 1962.

Under Article 9 of the India-Netherlands Bilateral Investment Treaty and the India-United Kingdom Bilateral Investment Treaty (BIT), Vodafone filed a case at the Permanent Court of Arbitration (PCA), The Hague in 2014. Vodafone contested the new tax amendment, amounting to a violation of fair and equitable treatment. The court ruled in favor of Vodafone and ordered the Government of India to return the entire amount of taxes collected so far and to pay an additional compensation amount of Rs. 40 Crores. The demand for retrospective taxation on capital gains was in breach of the United Nations Commission on International Trade Law (UNCITRAL).

### **Revocation of Retrospectivity: The Good, the Bad and the Future**

If Government of India disregarded the ruling of the PCA, it would have adversely affected the corporations based in India as well as the confidence of investors around the world. As the ruling marks a setback in the country's retrospective legislation, it also marks a new beginning of certainty in the Indian market. The Vodafone case<sup>11</sup> illustrates the lack of 'clarificatory' nature of the amendment as well as lack of any attempt to correct the legislative intent behind the Act. As the Government tries to grapple with the recovery phase post-COVID-19, the greetings of the global investor community are a warm welcome. The amendment will ensure more certainty in the market as no more legislation would be passed on a retrospective basis.

### **Recommendation: "Look-Through Provisions"**

The addition of "look-through" provisions as an alternative is proposed by the author. According to this rule, the transfer gains taxed on an entity are looked through beyond the entity itself to determine the entity which has real ownership of the property. Much like the principle of 'lifting of corporate veil', this rule seeks to look through the company in order to find the real beneficiary of the property or assets. Inclusion of this provision in the Taxation Amendment Act, 2021 would prove to be helpful in prospective taxation cases.

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<sup>11</sup> *id.* at 7.

## CONCLUSION

The revocation of retrospective taxation marks a new beginning for business as usual in India. Companies and investors are equally protected from indirect taxes on capital gains on international sale of assets. The move is a welcome step towards encouraging foreign direct investments in India as well as for the growth of the new generation of global investor economy in the country. The government's decision to bypass the Apex Court's decision may be seen as a threat to the principle of separation of powers in India. Uncertainty and inequity in the market increases the cost and risk of doing business. The tax amendment introduced by the Indian government will have a cross-sectoral impact. Globalization has catalyzed the income of capital and developmental growth in India. With global evolution comes global morality. The norms of fairness, transparency and equity are the fundamental principles of this morality. The capacity of the government to uphold these principles in the face of populism and political compulsions will mark the test of good governance and a true democracy.