

Dispute Resolution Hotline

October 06, 2020

VODAFONE INVESTMENT TREATY ARBITRATION AWARD – PART II

Examining India's powers to pass retroactive tax legislations in light of the Vodafone arbitration award

BACKGROUND

As we discussed in Part I of the Series, the Indian revenue authorities had initiated high profile litigation against Vodafone on the basis that Vodafone had failed to withhold Indian taxes on payments made to the selling Hutch entity. The Supreme Court of India held in favour of Vodafone that no Indian tax was required to be withheld on a transfer of offshore assets between two non-residents.

Shortly thereafter, the Finance Act, 2012 introduced a number of amendments to undo the impact of the Supreme Court ruling. These included a validation clause¹ which could enable the Revenue Authorities to deprive the Supreme Court Ruling of its finality, substantive amendments to the definitions of "capital asset" and "transfer", as well as an addition of Explanation 5 to section 9(1)(i) of the Income Tax Act, 1961 ("ITA"), "clarifying" that an offshore capital asset would be considered to have a situs in India if it substantially derived its value (directly or indirectly) from assets situated in India. All of these amendments were enacted to take effect retroactively from 1962. Amendments were also introduced, with retroactive effect, to procedural provisions relating to withholding tax (Explanation 2 to s. 195 of the ITA). These provisions are referred to as "**Retroactive Amendments**".

Thereafter, Vodafone invoked arbitration under the India – Netherlands BIT and eventually received a favourable award that India had violated the "fair and equitable treatment" guaranteed to Vodafone under the BIT.

In this Part, we examine how Indian courts have looked at retrospective amendments in tax law in the past, and the impact of the Vodafone award on tax matters going forward.

LAW RELATING TO RETROSPECTIVE LAWS AND IMPOSSIBILITY OF PERFORMANCE

The Supreme Court in *CIT v. Vatika Township Pvt. Ltd.*² laid down the general principles for classification of retrospective amendments. Essentially, it provided that the presumption against retrospective operation was not applicable to clarificatory statutes and in that case retrospective operation is generally intended.

This is of course relevant to the Retroactive Amendments that were termed as clarificatory amendments but in fact introduced a new scheme of taxation of indirect transfers.

Judicial precedents also indicate that a scope of a provision cannot be enlarged by adding an explanation and that the purpose of an explanation is to explain the meaning and intention of the provision or clarify vagueness.

Oddly enough, the Retroactive Amendments in itself were vague on what constitutes substantiality and manner of computation of capital gains for an indirect transfer. This led to further amendments such as introduction of restricting exemptions, small shareholder exemptions, meaning of substantiality, as well as detailed rules on computation of fair value, and capital gains. Given that a new scheme of indirect taxation was introduced, it is hard to argue that the Retroactive Amendments were "clarificatory" or "declaratory".

The question that comes up is that that if a substantive amendment is couched under a clarificatory language, in that case, can such a provision be operational on a retrospective basis?

Even while considering retrospective amendments, the Supreme Court in *Vatika* has considered the principle of fairness in that it is not possible for a law passed today to apply to the events of the past and that legislations with modify accrued rights or impose new obligations have to be treated as prospective unless the legislative intent to be give a retrospective effect.

This ties in with the well-established principle³ of *lex non cogit ad impossibilia* – law does not compel man to perform what he cannot possibly perform.

Applying this to the case of Vodafone, it is impossible for Vodafone to withhold taxes on a transaction that it believed *bona fide* to be non-taxable in the first place. Such an obligation could amount to performing an act back in the past which is an impossibility.

A similar view has been expressed by the Bombay High Court⁴ in the context of Explanation 6 to s. 9(1)(vi) where it has held that the payor could not have contemplated TDS where such liability was brought about by a retrospective amendment.

Despite these principles and obvious flaws of retrospective applicability of substantive tax laws, it is by no means a general proposition that the imposition of tax with retrospective effect will render such provision inapplicable. In fact, even in case of amendments that are not clarificatory but substantive in nature, retrospective effect may be given to such amendments if specifically, so provided and the legislative intent for retrospectivity will be looked into. However,

Research Papers

Compendium of Research Papers

January 11, 2025

FAQs on Setting Up of Offices in India

December 13, 2024

FAQs on Downstream Investment

December 13, 2024

Research Articles

INDIA 2025: The Emerging Powerhouse for Private Equity and M&A Deals

January 15, 2025

Key changes to Model Concession Agreements in the Road Sector

January 03, 2025

The Revolution Realized: Bitcoin's Triumph

December 05, 2024

Audio

Securities Market Regulator's Continued Quest Against "Unfiltered" Financial Advice

December 18, 2024

Digital Lending - Part 1 - What's New with NBFC P2Ps

November 19, 2024

Renewable Roadmap: Budget 2024 and Beyond - Part I

August 26, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

"Investment return is not enough" Nishith Desai with Nikunj Dalmia (ET Now) at FIIB event in Riyadh

October 31, 2024

Analysing SEBI's Consultation Paper

it is not clear as to how to maintain a balance between legislative intent and impossibility of performance of a tax obligation – what test do you apply to strike down a retrospective amendment?

“FAIR AND EQUITABLE TREATMENT” STANDARD IN VODAFONE’S CASE

In light of the above discussion, it would be interesting to see how the arbitral tribunal viewed the Indian tax department’s claim against Vodafone from a “fair and equitable” treatment standpoint. While we do not have the text of the full award, the obligation to provide ‘fair and equitable treatment’ includes guarantees such as providing stable and predictable legal framework to foreign investors , following due process while modifying the legal framework that might potentially impact foreign investors, adopting measures in a transparent and non-arbitrary manner, among others.

Looking at the events from that lens, the following facts emerge –

- Vodafone entered into the Indian market in 2007 as it purchased the shares of a Cayman entity which indirectly held an Indian entity that housed the Indian telecom business. In this transaction, it had not made any gains or profits for which it had to discharge taxes as a primary taxpayer. A withholding tax obligation, is not a primary tax liability but a procedural obligation put in place to ensure ease of recovery of taxes by the Indian tax authorities. Prior to the Vodafone case, there has not been a single case of indirect transfer being held has taxable prior to the Vodafone transaction.
- This was followed by initiation of a high profile tax claim against Vodafone, which was eventually ruled in favour of Vodafone by the Supreme Court. Within months of the Supreme Court ruling, the legislation was amended on a retroactive basis where substantive changes were made to the existing law and termed as “clarificatory amendments”. The effect of the Retroactive Amendments was overruling the ruling of the Supreme Court.
- Given the number of amendments and rules added post introduction of Retroactive Amendments also add to the view that the Retroactive Amendments were introduced in haste, targeting the Vodafone tax claim.

Subject to the detailed ruling, it is possible that the arbitral tribunal may have considered the above series of events to indicate unfair and inequitable treatment to Vodafone, especially considering the manner in which the existing legal framework for taxation was disrupted by India, in an arbitrary and seemingly targeted manner by introducing the Retroactive Amendments. The fact that the tax claim against Vodafone was in respect of its withholding tax liability, and not primary tax liability, also adds to the gravity of the treatment meted out by India to Vodafone.

IMPACT OF VODAFONE ARBITRATION AWARD ON TAX MATTERS GOING FORWARD

Tax certainty and stability, especially for foreign investors is key to boost investment in the country.

Interestingly, but not surprisingly, the Supreme Court’s ruling in Vodafone and consequent Retroactive Amendments was not the first attempt of the legislature to overturn the judicial interpretation by the Supreme Court. In Finance Act, 2010, after the *Ishika Wajima Harima*⁵ ruling, a clarificatory retrospective amendment was introduced to s. 9 in order to bring within the tax net, income in the nature of fees for technical services, whether or not the non-resident has rendered services in India.

Further, lately, there have been several rulings of tribunals which have sought to deny treaty benefits for grandfathered investments i.e. sale of shares of an Indian entity by a Mauritius seller, acquired prior to April 1, 2017. This is especially worrisome considering Circular 789 of 2000 unequivocally provides that Mauritius tax residents would be entitled to benefits of the tax treaty and accordingly will not be liable to pay Indian capital gains taxes on sale of Indian shares. This position has been confirmed by the Supreme Court in *UOU v. Azadi Bacha Andolan*⁶ which has held that treaty benefits should be granted subject to there being a valid tax residency certificate.

Given these developments, tax uncertainty continues to be a growing cause of concern for foreign investors. The India-Mauritius BIT has been terminated, and in any case unlike the Netherlands BIT, in the Mauritius BIT there is a specific exclusion for matters relating wholly or mainly to taxation. Having said that, it is possible that a similar claim cannot be initiated under the BIT if it relates to *purely* tax matters. However, cases can be distinguished despite specific tax exclusions based on their facts and circumstances.

Also, given the kind of criticism India is receiving owing to the Vodafone award, it would be interesting to see whether it changes its approach to ensure tax certainty and a stable environment to boost investment, especially today, in India’s troubled economy.

ENFORCEMENT OF THE INTERNATIONAL INVESTMENT TREATY ARBITRATION AWARD IN INDIA

Is an international arbitral award, resulting from an investment treaty arbitration, the end of the process for foreign investors? Are there further hurdles in the waiting?

For answers on how to navigate the Indian legal system to reap benefits of an international arbitral award, stay tuned for Part III of our series tomorrow.

– Shipra Padhi & Rajesh Simhan

You can direct your queries or comments to the authors

¹ Clause 119 of the Finance Bill

² 367 ITR 466 (SC)

³ CIT v/s. *Cello Plast* (2012) 209 Taxmann 617

⁴ CIT v. NGC Networks (India) Pvt. Ltd. (Income Tax Appeal no. 397 of 2015).

⁵ *Ishikawajima-Harima Heavy Industries Ltd v. Director of Income-tax* , CASE NO. APPEAL (CIVIL) 9 OF 2007

⁶ 263 ITR 706 (SC).

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.