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INDIA NULLIFIES RETROSPECTIVE APPLICATION OF INDIRECT TRANSFER (VODAFONE) TAX

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On 13 August 2021, the Taxation Laws (Amendment) Act 2021 (Act) received the Presidential assent, withdrawing retrospective effect of the much-controverted indirect transfer tax.

Background

Indirect transfer tax (colloquially referred to as 'Vodafone Tax') was introduced in the Indian income tax law in 2012 to treat capital gains earned in an offshore transfer of shares (or interest) in a foreign entity as India sourced, and hence, taxable in India, if such shares (or interest) derive '*substantial value*' from Indian assets (2012 Amendment). The 2012 Amendment was introduced in response to, and to nullify the effect of the Supreme Court verdict in the case of *Vodafone International Holdings B.V v Union of India ([2012] 1 S.C.R. 573)*. The apex court had ruled that in absence of a 'look-through' tax provision, gains arising on transfer of shares of a foreign company, being an asset situated outside India, are not taxable in India. The most controversial part of the 2012 Amendment was that it was introduced as a change only to clarify that this was the position all along since 1961 and it was not a substantive change to the tax provision. This effectively meant that the transactions closed prior to 2012, were also hit by the 2012 Amendment. One such transaction was the Hutch - Vodafone transaction, wherein Vodafone had acquired shares of a Cayman based company, which indirectly held a majority stake in an Indian company, from Hutchison Telecommunications International Limited. The transaction closed in 2007, and Vodafone was treated as a defaulter for not withholding India tax on the acquisition. Despite the apex court deciding in favour of Vodafone, the 2012 Amendment reopened the tax dispute and the government kept chasing Vodafone for the tax demand of INR 20,000 crores (approx.), including interest and penalties. Similarly, in the case of *Cairn U.K. Holdings v. DCIT (International Tax) (Delhi ITA no. 1669/Del/2016),* Cairn UK Holdings Limited (Cairn UK) had, as part of an internal restructuring, transferred shares of its Jersey-based subsidiary, Cairn India Holdings Limited to its Indian subsidiary, Cairn India Limited. The tax authorities held that transaction to be taxable in India and raised a tax demand of INR 24,500 crores (approx.).

After several rounds of litigation at various judicial fora, both Vodafone and Cairn UK initiated arbitration proceedings against the Indian government by invoking India's Bilateral Investment Protection Treaties with Netherlands and UK, respectively. The arbitral tribunals in both cases observed that India had breached the investment treaties which provide that, investors of each country must be accorded fair and

equitable treatment and they must enjoy full protection and security in the territory of the other party, at all times.

These indirect transfer tax disputes became landmark and invited significant criticism for the Indian government. The retrospective application had come as a shock and caused much damage to India's reputation shaking investor confidence in the Indian tax environment which, since then, was being viewed as uncertain by the international community.

The Act— Key Aspects

Now, in a rather surprising but welcome move, the Indian government has withdrawn the retrospective application of 2012 Amendment for transactions undertaken before 28 May 2012 (*i.e.* the date on which the 2012 Amendment had received Presidential assent). Accordingly, all pending assessments shall be deemed to have been concluded without additions for such income. There are certain conditions such as the taxpayer withdrawing or furnishing an undertaking for withdrawal of pending litigation and to the effect that no claim for cost, damages, interest etc., shall be filed.

Further, the taxpayers will lose interest on the tax demands that were already deposited by them during the proceedings.

Comments

Surely a bold step, but a timely correction by the Indian government may have worked better for building investor confidence in India's tax system in terms of certainty for foreign investors and may have reinforced faith in the present government's promise of not introducing any retrospective changes. While the move is delayed, it does end almost a decade long legal battle for the taxpayers who have been challenging the retrospective application of this tax provision. After having lost in the arbitration proceedings, this move indicates the Indian government's stand on the issue. Rolling back a decade old law which did not align too well with the overall policy objective of the country showcases government's flexibility in the overall larger interest.

Better late than never! This step is in alignment with the apex court's celebrated observation in the case of *Distributors (Baroda) Pvt Ltd v Union of India* (1985 AIR 1585), wherein it remarked that "*to perpetuate an error is no heroism*".

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