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End Retrospective Taxation of Cross-Border Investments

by [cogitASIA Staff](#) • October 10, 2018 • [0 Comments](#)

By Mukesh Butani —



Government of India official buildings on the Rajpath at Raisina Hill in New Delhi, India. Source: Wikimedia user A.Savin, used under a creative commons license.

- **Status: *In Progress*** – The Modi government has not amended the Income Tax Code in a way that precludes applying law retrospectively but has created a new committee that has blocked fresh attempts to use the “retrospective” principle to foreign investors.
- **Difficulty: *Medium*** – This will take legislation, which could prove contentious. However, since most amendments to the Income Tax Code are included in the omnibus Finance Bill, further amendments seem possible.

This is the fifth installment in a [series of articles](#) on the [Modi Reforms Scorecard](#) by the staff and experts at the Wadhvani Chair in U.S.-India Policy. The series seeks to provide analysis on why reforms marked as “Incomplete” or “In Progress” have not been completed, and what impact such reforms could have on specific sectors or the economy at large.

When the Modi government won majority in 2014, they pledged to initiate tax reforms as a key priority, and to reverse India’s stance on retrospective tax amendments. To foreign investors, the focus of reforms was the amendments to the Income Tax Act that were [introduced in 2012](#) to undo Vodafone’s withholding tax victory in the Supreme Court. This tax decision by the Singh government led to a sharp decline of global views of India’s investment climate. As an interim measure, then Prime Minister Manmohan Singh appointed an expert committee under Dr. Parthasarathi Shome, which made [wide-ranging recommendations](#) to dilute the rigors of law.

The Modi government's [first budget in July 2014](#) announced a clear intent not to legislate retrospective law, despite noting that Parliament retains the right to legislate in situations where courts have not interpreted the law, keeping in mind its legislative intent. So far, the government has adhered to its commitment. So why does it not resonate with investors? The reality is that most in India's tax fraternity believe that the government missed an opportunity to reverse the 2012 law.

Rather, the Modi government announced a series of measures including a host of subordinate legislation, [FAQ's for interpretation](#), reopening of past cases — which required [an approval of a committee](#), an enabling framework for settlement, and discretionary power to waive interest and penalties. The only category of taxpayers who were not spared from the application of law were those who were either dealt with by the administration or were awaiting adjudication, including cases that were taken up in arbitration given that few investors decided to pursue their claims under the Bilateral Investment Treaties. The most significant cases are either awaiting outcome of the investment arbitration (like Cairn) or they are yet to undergo the arbitration process (like [Vodafone](#)). It is debatable if the government should have taken proactive steps to deal with the process in a speedier fashion or if it should not have pursued the claims by annulling the retrospective laws.

Under the Constitution of India, the Parliament has right to legislate retrospective laws, and it equally has powers to repeal the law retrospectively. Understandably, in a democracy such actions may trigger public interest litigation where they would be tested in the courts. Defending such public interest litigation would have been an exercise worth pursuing for the government. Looking at revenue considerations, given the quantum of tax revenue involved in these disputes, the government must determine the merits of pursuing such cases and weigh that against creating an enabling investment climate and certainty on tax policy. From a tax payer standpoint, decision to forego tax revenue for fulfillment of a promise, against retrospective law, in form and substance, would have boosted investor confidence.

The Indian legal process tends to be time consuming, expensive, and uncertain. Trials in Indian courts take their own time given the [burden](#) of cases on judiciary at all levels. For investors, certainty of law is of primary importance. When investors witness such cases lingering in court battles and complex arbitration processes, a sense of caution and anxiety often sets in.

The Vodafone case hit headlines not just in the business and investment fraternity, but also attracted attention of tax administrators of several emerging Economies. Following China and India's experience, the Organization for Economic Cooperation and Development (OECD) initiated a set of anti-avoidance measures to deal with such situations and bring to tax income in source jurisdictions. The tax profession has recognized that such offshore transactions would attract taxes in the new world order, as India has done. The difference being its applicability for periods before the law was introduced and if it would bind parties to an agreement keeping in mind the law it existed or was understood to be ordinarily interpreted.

The other unique aspect of retrospective taxation laws, when read with the subordinate legislation, is that the strictest interpretation is applied to all forms of offshore internal business reorganizations. The debate is not about extra-territoriality of retrospective taxation, but the outcomes that result from the lack of implementation of several of the Shome committee's recommendations, such as exempting offshore business reorganizations or stocks listed in overseas recognized stock exchanges, among others.

With events such as tax reforms in the United States and Brexit, multinational enterprises must revisit the structures leading to internal reorganizations. If any of these firms trip over an indirect tax law in India and trigger potential new tax obligations, the government of India should take another look at the provisions and attempt to bring to tax only those transactions which are anti-abusive in

nature or which yield to situations of non-taxation in India and offshore jurisdictions. Surely, that was the underlying intent when the “retrospective” amendment was made to India’s Income tax Law in 2012. However, that is not the way it has turned out.

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