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Retrospective Tax Law in India: Analysis of the Vodafone Saga and the Amendments of the Income Tax Act 1961

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No one likes paying a share of their income to the government but, everyone is forced to pay in the form of tax. The 'tax' is always unwillingly paid by citizens and corporations, both find creative ways to avoid them and some illegally evade them. Collection of Tax is essential for public infrastructure and welfare schemes which are essential to supporting the masses. Taxation generally a prospective topic can also be implemented retrospectively. Retrospective Taxation which has always been controversial made its debut in India in the year 2012 which caused a longing legal battle between Vodafone International and the government of India. The dispute had risen to the extent of involving other foreign governments and high diplomatic tensions. The paper analyses the entire Vodafone case[1], the Supreme Court's verdict, the infamous amendment brought by the government, its impact on the Indian economy, and how it influenced the investor decision. Despite the court's decision in favour of the company, the government circumvented the decision by abusing its legislative powers and implementing a retrospective effect. This decision started a chain reaction of legal battles for the company which later opted for arbitration against the government under the sections of the Bilateral Investment Treaty. The main focus of the paper lies in after effects of the amendment and it gives a timeline of the events that occurred in the saga.

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

Keywords: *retrospective, vodafone, taxation, amendment.*

INTRODUCTION

Taxation is an ancient concept that has been around from the likes of the Philosopher Chanakya to the Scottish economist Adam Smith. According to Chanakya 'Taxation should not be a painful process for the people'[2] whereas Smith believed that the taxes should be proportional to the income. Both were highly regarded personalities of their time and they promoted the idea of fair taxation. These tax laws are essential for any government to attract both national and international investors, these can make or break investment deals. To make an economy robust investment by investors is essential and they in turn expect better tax laws.

In the year 1860 Sir James Wilson, the first Finance Minister in British India introduced the modern taxation system in India. The tax laws in India have gone through a series of changes from its reforms in post-independent India to having new policies introduced in the period of economic liberalization to the latest with the introduction of Goods and Service Tax (GST) in the year 2017 and review of direct taxes in the last budget with expectations of new reforms. One such reform gaining a special spotlight in the history of tax laws was the retrospective amendment made through the Finance Bill 2012[3]. It made multiple changes in the tax laws with the introduction of GAAR (General Anti-Avoidance Rule) and amendments to the Customs Act 1962[4] and the Central Excise Act 1944[5] that aimed at improving the tax structure and compliance with the indirect transfer of shares payable under the capital gains tax. One of the important provisions in the Bill was a retrospective amendment to the tax law relating to capital gains tax on the indirect transfer of shares in foreign companies.

[2] 'Chanakya's Education' (*Central Reserve Police Force*) <https://crpf.gov.in/writereaddata/images/pdf/ChanakyaNitiShastraHinduOnline.pdf> accessed 11 December 2024
[3] Finance Act 2012
[4] Customs Act 1962
[5] Central Excise Act 1944

It is believed that the tax amendment on capital gains was influenced by the decision hailed in the Vodafone Case.[6] Which was against the government. This paper analyses the Vodafone saga and the alleged tax evasion case which led to multiple arbitrations and violations of Bilateral Investment Treatises against the government of India. The paper mainly discusses the timeline, the outcome of the events, and the effect of such retrospective amendments on the Indian taxation regime.

CONCEPTUAL FRAMEWORK OF RETROSPECTIVE TAXATION

The law passed by the parliament can have two effects prospective and retrospective effect, this paper discusses the latter. Article 20(1)[7] prohibits the legislature from making retrospective criminal laws but, it does not prohibit civil liability retrospectively therefore, tax can be levied retrospectively. According to the All-India Federation of Tax Practitioners, the doctrine of retrospective legislation can be defined as 'a law that has a backdated effect or is effective since before the time it is passed.'[8]

In the case of *Hitendra Vishnu Thakur,*[9] the Apex Court defined the boundaries and scope of amendment in any Act and its application in retrospective operation. The court held that:

"(i) A statute which affects substantive rights is presumed to be prospective in operation unless made retrospective, either expressly or by necessary intendment, whereas a statute which merely affects procedure, unless such a construction is textually impossible, is presumed to be retrospective in its application, should not be given an extended meaning and should be strictly confined to its clearly defined limits.

(ii) Law relating to forum and limitation is procedural, whereas law relating to the right of action and right of appeal even though remedial is substantive.

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[6] *Vodafone International Holdings BV v Union of India* (2012) 6 SCC 613

[7] Constitution of India 1950, art 20(1)

[8] 'Doctrine of Retrospective Taxation' (*All India Federation of Tax Practitioners*) <https://aiftponline.org/journal/2019/november-2019/doctrine-of-retrospective-legislation/> accessed 11 December 2024

[9] *Hitendra Vishnu Thakur v State of Maharashtra* (1994) SC 2623

(iii) Every litigant has a vested right in substantive law but no such right exists in procedural law.

(iv) A procedural statute should not generally speaking be applied retrospectively where the result would be to create new disabilities or obligations or to impose new duties in respect of transactions already accomplished:

(v) A statute which not only changes the procedure but also creates new rights and liabilities shall be construed to be prospective in operation unless otherwise provided, either expressly or by necessary implication."[10]

This Judgement led the way for the infamous amendment of 2012 presented by the then Finance Minister of India, Mr. Pranab Mukherjee, in the yearly budget. This amendment amended Section 9[11] of the Income Tax Act[12] and came to be known as the controversial retrospective tax law of India. The use of retrospective taxation isn't Indigenous to India but is practised in many countries like the US, UK, and Netherlands. Multiple Multinational corporations have been fined for capital gains and various other taxes retrospectively. Some governments also often argue that 'there is often a public interest for tax legislation to be enacted retrospectively...situation, where retrospective legislation might be justified, is to reverse a judicial decision with which the legislature disagrees.'[13] There are many economic and legal implications for the application of retrospective taxation. A major economic concern lies with investor confidence that changes are due to unfair and arbitrary application of such laws. Investor confidence could drastically change the foreign direct investment invested in a country. The legal implications include creating legal uncertainty for the taxpayers by disabling them from predicting their legal liability in the general course of business; the laws can sometimes also be contradictory to BIT's (Bilateral Investment Treaties), DTAA (Double Taxation Avoidance Agreement) and create a problem in international taxation. One such Landmark case

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[10] *Ibid*

[11] Income Tax Act 1961, s 9

[12] Income Tax Act 1961

[13] Pradeep Thakur, 'Retrospective taxation justified, even US, UK, Netherland's have done it, says government' *The Times of India* (New Delhi, 24 December 2018) <https://timesofindia.indiatimes.com/business/india-business/retrospective-taxation-justified-even-us-uk-netherlands-have-done-it-says-government/articleshow/67233966.cms> accessed 11 December 2024

that included the contradiction of such agreements is the case of Vodafone International Holdings BV v Union of India[14].

OVERVIEW OF THE VODAFONE CASE

The Vodafone case deals with the acquisition of The Hutchison Essar (an Indian subsidiary of Hutchison Telecommunications International Limited) by the Netherlands-registered British telecom giant Vodafone Group. In February of the year 2007, Vodafone International acquired a 67% controlling stake in the Indian subsidiary of Hutchison Essar from its parent company Hutchison Telecommunications International Limited (HTIL) which is a subsidiary of the Hong Kong-based Hutchison Whampoa Group for 11 billion Dollars.

The Deal was designed as such that Hutchison Whampoa diluted its indirect stake in the Indian company to Vodafone by transferring shares in HTIL, a corporation established in the Cayman Islands, which was the parent of Hutchison Essar. The transfer of HTIL's shares did not constitute a direct transfer of shares in India but, it involved the sale of shares in a foreign entity that owned assets in India. In August of the year 2007, when the income tax authority discovered the transaction it issued a show-cause notice under section 163[15] to Vodafone Essar Limited to reason why it should not be treated as a representative assessee of Vodafone. The same notice was challenged by Vodafone Essar Limited in Writ Petition No 1942 of 2007 before the Bombay High Court. Furthermore, the Deputy Director of Income Tax in Mumbai sent another show-cause notice under Sections 201(A)[16] and 201(1A)[17], questioning why Vodafone should not be regarded as an assessee-in-default for not withholding tax. A writ petition in the form of an amendment was filed in the Bombay High Court challenging the validity and jurisdiction of notices. The Court dismissed the Writ Petition on 08.09.2010 against which a Special Leave Petition (SLP) was filed in The Supreme Court.

[14] *Vodafone International Holdings BV v Union of India* (2012) 6 SCC 613
[15] Income Tax Act 1961, s 163
[16] Income Tax Act 1961, s 201(A)
[17] Income Tax Act 1961, s 201(1A)

The main issues underlying the case were the jurisdiction of the income tax authority over the transactions and withholding of the Tax deductible at source under section 195[18]. The main issue was that the indirect transfer of shares amounted to liability to the levying of capital gains tax on the transaction.

The court overturned the decision by the Bombay High Court and held that the transferring of shares and shifting of controlling interest is part of a non-separable transaction and the transaction is based on a contractual right and not the property right to levy capital gains tax on. As the transaction took place between two non-resident companies Outside India no direct relation with India can be established hence section 195[19] wouldn't be applicable as it is only applicable to residents and cannot go across borders.

The Court also observed that the transaction made by companies was within the scope of Tax planning and not tax evasion and remarked that such practice of using offshore companies in Mauritius and the Cayman Islands is very common and constitutes a case of skillful tax planning. It also pointed out that the dealings between CGP Investments Holding and Vodafone Investments Holding were legitimate and considered in the interests of the investors and thus should not be seen as a sham or as a colourable device for tax evasion. Justice. K.S. Radhakrishnan also remarked that 'the demand of nearly Rs.12,000 crores by way of capital gains tax, in my view, would amount to imposing capital punishment for capital investment since it lacks the authority of law.'[20]

THE AMENDMENT OF SECTION 9 OF THE INCOME TAX ACT, 1961

The judgment by the Supreme Court had various implications in the later period and one of them included the Retrospective Effect of the Amendment brought by the Finance Bill of the year 2012. The government introduced various amendments in the form of clarifications in the Sections of the Act. The Clarifications included Explanation 2 in section 2(47),[21] which changed what constitutes a transfer and included all direct and indirect transfers made in or outside of

[18] Income Tax Act 1961, s 195
[19] *Ibid*
[20] *Vodafone International Holdings BV v Union of India* (2012) 6 SCC 613
[21] Income Tax Act 1961, s 2(47)

India. Section 9(1)(i)[22] was clarified with explanation 5 mentioning that the transfer of shares in foreign having a substantial value of the asset in India will be taxed and the effect of such will be from the year 1962.

When the Supreme Court differentiated between contractual rights and property rights in judgment, the amendment with the expansion of explanation in Section 2(14)[23] forged both the rights-making property rights, including management and control rights, nullifying the Judgement. The ambit of Section 195[24] was tremendously expanded by including the non-residents for deducting the tax at source.

The Indian Government brought the amendment with the intent to close the legal loopholes in the Indian tax laws and prevent the massive tax evasion being undertaken by multinational corporations using the corporate structures and tax heaven treaties. The Tax base of the Indian government was secured and any circumvention of such tax laws was prevented. This also gave new clarity to the tax laws and the taxpayers and having a retrospective effect restored the act to its original intent when it was framed.

While the government intended to improve the existing laws, others questioned the timing of the amended law. A new debate was led nationally and internationally criticizing the retrospective effect of the amendment, and the legislative and political motives behind the amendment were questioned. Indian Tax laws were deemed to be uncertain and a rhetoric by corporate lobbyists was established that this would lead to a chilling effect on future investments. It was also regarded as harmful to the business environment and would have an adverse impact than intended by the government. The Indian Parliament had mixed views on the amendment, the Congress party then the ruling government favoured the amendment citing the need to stop the tax leakage as the Vodafone case[25] had been established as a precedent potentially to be followed by other corporations for tax evasion. The opposition of the Bhartiya Janta Party dissented from the amendment, citing a loss of investor confidence and a weakening

[22] Income Tax Act 1961, s 9(1)(i)
[23] Income Tax Act 1961, s 2(14)
[24] Income Tax Act 1961, s 195
[25] *Ibid*

of India's position in international Trade. The opposition also warned of the potential economic consequences in the long term.

The amendment also overrode the Mauritius-India bilateral tax treaties, which made it clear that India can override such bilateral treaties questioning the commitment of the government to such international agreements. Many foreign governments especially the UK Government also expressed concerns over the retrospective taxation on the British giant Vodafone. Overall, India's long diplomatic standing was damaged which led to diplomatic tensions and an atmosphere of uncertainty was formed in the country. To further prevent eroding trust the next government call-backed the retrospective effect of the amendment and mitigated the loss in the business environment.

CRITICAL ANALYSIS AND SHIFT IN INDIA'S APPROACH TO RETROSPECTIVE TAXATION

To critically argue based on legal analysis of the amendment it violated the principle of certainty, which states that 'the law must be clear, precise and unambiguous, and its legal implications foreseeable.'[26] Making unprecedented changes in the law made foreign and institutional investors uncertain and created ambiguity in the business environment. Many believed that Vodafone was selectively targeted by the tax department as throughout the department's history they hadn't brought any retrospective effect until Vodafone. The selective targeting along with the questionable timing of the amendment raised questions regarding the true intent behind the amendment.

In the year 2018, the then Finance Minister Mr. Arun Jaitley at the Economic Times Global Business Summit said, 'I always felt Vodafone tax decision was an erroneous decision... This govt will not be taking any retrospective decision'.[27] The damage to foreign direct investment had been done and the new government tried its best to combat the economic repercussions of

[26] 'Legal certainty definition' (*Lexis Nexis*, 2025) <https://www.lexisnexis.co.uk/legal/glossary/legal-certainty> accessed 11 December 2024

[27] 'Vodafone tax was a very bad idea, says Arun Jaitley at ET GBS' *The Economic Times* (Mumbai, 24 February 2018) <https://economictimes.indiatimes.com/news/economy/policy/vodafone-tax-was-a-very-bad-idea-says-arun-jaitley-at-et-gbs/articleshow/63056988.cms?from=mdr> accessed 11 December 2024

the retrospective effect. There was a loss in investor confidence across the world as the investors feared taxing their investments retrospectively. The overall fear sentiment in the market led to a fall in foreign direct investment. India is a competitive foreign investment destination among other developing countries like Vietnam, Bangladesh, and Indonesia the change made India lose its competitive edge over the other countries. This started a falling domino of downturn in Indian investments. The impact could be seen in the Mergers and Acquisitions sectors where the companies avoided taking over Indian assets fearing long tax battles with the government. This caused huge reputational damage to the Indian economy and the Indian business environment. The Vodafone Company also filed a case against the government for violation of Bilateral Investment Treaties in the Permanent Court of Arbitration. The filing of the case also caused more damage to the Indian reputation making the Indian business environment more hostile and in dispute with other foreign governments. This also damaged India's global trade relations with its trading partners and impacted the investment decision in the country.

The Government was also pressurised to make changes as the Permanent Court of Arbitration ruled in favour of Vodafone. The award was passed on 25/9/2020 and it stated that 'the tax demanded by the government of India was not payable as per the treaty'[28], to change the investment rhetoric, the later government took many reformative steps starting with a call-back of the amendment to make the country a more investor-friendly destination. The replacement of the retrospective tax effect was made possible with the introduction of the Taxation Laws (Amendment) Bill, 2021[29] by then finance minister Ms. Nirmala Sitharaman. This was a necessary step to be taken by the government to restore investor confidence in the investing environment of the country. This action was a step in the right direction for future long-term economic benefits.

[28] Mukesh Butani and Tarun Jain, 'What next after the Vodafone tax arbitration?'(*Fortune India*, 30 September 2020) <https://www.fortuneindia.com/opinion/what-next-after-the-vodafone-tax-arbitration/104758> accessed 11 December 2024

[29] Taxation Laws (Amendment) Bill 2021

CONCLUSION

The rectification of the amendment took 9 years and with a hefty amount of undisclosed cost imposed by the permanent court of arbitration. Every coin has two sides and so did the Vodafone case, the case reinstated the promise of an independent judiciary which remained uninfluenced by the government's stands. The downside to the case was the government's role of violating the principle of fairness by implanting retrospective taxes and disrupting the economic investor environment. The case also highlighted the need for tax reforms in the country which has been the need of the hour. Reforms in the simplification of tax codes with exemptions to certain classes of companies like renewable energy sector companies must be promoted. Having stable and predictable tax laws would not only boost investor confidence but also would lead to economic stability. The future retrospective taxation lies uncertain and it shouldn't be promoted. In all, it was a lesson learned by the government for abusing the legislative powers for a mere increment in tax collection. Now, the state has an important role in the future to play i.e. the maintenance of the trust of foreign companies and investors.