The Big Picture: End of Retro Tax

Why in News

Recently, the Government of India has introduced the **Taxation Laws (Amendment) Bill, 2021** in the Lok Sabha.

Key Points

- The bill aims to **drop tax claims against companies on deals before May 2012** that involve indirect transfer of Indian assets.
    - The bill is quite significant as it **deals with the issue of retrospective taxation.**
- The scrapping of the retrospective levy **provides clarity to investors by removing a major source of ambiguity** on taxation laws.

Background

- In 2007, the **Vodafone** Group bought a Cayman Islands-based company which indirectly held a majority stake in Indian firm Hutchison Essar Ltd.
    - For this, the Indian government for the first time **raised a demand for capital gains** and withholding tax from Vodafone, under the **Income Tax Act of 1961.**
- Following this, the **Supreme Court** in 2012, ruled in favour of Vodafone. Later, the Finance Act was amended in 2012 giving the Income Tax Department the power to **retrospectively tax** in such deals.
    - The amendment essentially said that **from April 1962 onwards,** any capital gains that arose out of a transaction even if it is international in nature but has underlying assets located in India, then the entities will have to provide for the capital gains to the Union Government of India.
- Vodafone then initiated arbitration in 2014 invoking the **Bilateral Investment Treaty (BIT)** signed between India and the Netherlands in 1995.
    - In 2020, the **Permanent Court of Arbitration (PCA)** at the **Hague (Netherlands)** ruled that India's retrospective imposition of a tax liability was **a violation of the BIT with Netherlands and the arbitration rules of** UNCITRAL**.**

Retrospective Taxation

- It allows a country to **pass a rule on taxing certain products,** items or services and deals and charge companies **from a time behind the date on which the law is passed.**
- Retrospective taxation hurts companies that had knowingly or unknowingly interpreted the tax rules differently.
- Apart from India, many countries including the **USA, the UK, the Netherlands, Canada, Belgium, Australia and Italy have retrospectively taxed companies.**

Salient Features of the Bill

- **Doing Away with Retrospective Taxation:** The Bill proposes to amend the Income Tax Act, 1961 so as to ensure that **no new tax demand can be raised on the basis of the retrospective amendment** if the transaction was carried out prior to May 28, 2012.
- **Conditions of Nullification of Tax:** Tax raised for the indirect transfer of Indian assets before May 2012 would be **"nullified on fulfillment of specified conditions"** such as the withdrawal of pending litigation and an undertaking that no damages claims would be filed.
- **Refund of Retrospective Tax:** The bill also proposes to **refund the amount paid by the companies facing trial** in these cases **without interest** thereon.

Capital Gain

- This gain or profit **comes under the category of 'income'.**
- The capital gain tax will be required to be paid for that amount in the year in which the transfer of the capital asset takes place.
- Capital gains **can be reduced by deducting the capital losses** that occur when a taxable asset is sold for less than the original purchase price.

Impact on Global Investors

- **Clarity to Investors:** The amendment could provide more clarity to the international investors regarding all the prospective or already existing investments.
- **Instilling Credibility:** Upon clearance, the bill will also **create a sense of credibility in the industry for partnering with the Government of India** in resolving an issue.
    - The current cases will be allowed to reach their logical conclusion.
- **More Committment towards Investment:** There is a fear of tax terrorism and tax uncertainty among the investors. If the law is passed, there will be greater certainties and **industries will be more forthcoming and committed to investing in India.**
- **Addressing Stressed Sectors:** The bill is also an opportunity for addressing some stressed sectors like the telecom and oil exploration sectors.
- **Issue Associated:** The Bill allows for the refund only of the principal amount in these cases and not the interest.
    - However, in some of these cases, the interest component is sizable, which these companies are not likely to let go.

Way Forward

- **Ensuring Consistency to the Investors:** Be it fluctuating trade tariffs or shifting GST rates and rules, India needs to demonstrate greater clarity and consistency in policy across the board to fix its broken credibility.
- **Establishing a Business Friendly Climate:** The addressal of the long pending demand of foreign investors for removal on retrospective tax levy on indirect transfers would go a long way in placing India as a more attractive investment destination and rekindle the hope that there would be no longer any ghost of retrospective taxation norms being applied.
- **Dispute Resolution Mechanism:** India needs to craft meaningful and clear dispute resolution mechanisms in cross-border transactions to prevent the disputes from going to international courts, and save the cost and time expenditure.
- **Bringing Changes in Arbitration Mechanism:** India is in need of a better **Arbitration Mechanism** especially when it today stands at a juncture of quick economic recovery and the COVID-19 pandemic.
    - Improving the arbitration ecosystem will also have a positive impact on the **Ease of Doing Business.**

Conclusion

- The removal of retrospective taxation is clearly the right thing to do as the retrospective

amendment inflicted great damage to the country’s reputation for offering an attractive and predictable investment climate.
    - Such retrospective amendments militate against the principle of tax certainty.
- Also, it is really important for the industries, business community and the investors to have complete clarity on how the taxation laws in India work.