Retrospective Taxation – the Indian Experience.

By Harish Salve

The art of taxation consists of so plucking the goose as to obtain the largest amount of feathers with the smallest amount of hissing . [Jean Baptiste Colbert]

The levy and collection of tax has historically been one of the most controversial exercises. Its critics have considered it nothing less than theft sanctioned by law. Its protagonists elevate it to the platform of a great instrument to finance State welfare and achieve the elusive dream of egalitarianism.

Like all such controversies, the truth may lie somewhere in between - especially when tax is imposed retrospectively.

Taxation has left its indelible mark on most societies. Even the architecture of civilizations has not been spared from the effects of taxation. Taxes on windows in the 17th Century impacted the architecture in England, Wales and Scotland and the tax based on frontages led to the defining feature of the architecture of buildings in Netherlands.

The evolution of democracies with elected governments and bills of rights gradually changed the perception of taxes as the price for civilization. Chief Justice Marshalls' *seductive cliché* that the power to tax involves the power to destroy was seemingly taken seriously by the Governments, until it was tempered by later judges and put to rest by the redoubtable Holmes with the trenchant observation that the power to tax is not the power to destroy while this Court sits !

Taxation in India also has a history similar to other taxes imposed in other colonies by foreign rulers. The first major tax to be imposed by the British was a tax on income. It was unsurprisingly resented because it was imposed to make India pay for the whole of the extra regiment sent to India , and also to recover *retrospectively* the costs of the regiment for the past six months.[1]

The tax was withdrawn for a while, but then it was imposed afresh in 1922 by enacting the Indian Income Tax Act 1922. This law continued in force, with amendments made from time to time although it suffered endless amendments which left it "*shapeless and order less*"[2]. Realising the need for a fresh code, the government established a Direct Taxes Administration Enquiry Committee in 1959, and based on its recommendations, as well as those of the Law Commission, a new act was put in place which came into force in 1961. In less than three decades of its existence this law suffered more than 66 amendments.

Apart from the Income Tax Act, the three significant tax legislation in the field of indirect tax India were the Central Excise and Salt act which was imposed in 1944, the Customs Act which was first imposed in 1868 and sales tax laws which operated at the provincial and then the State level of government.

The principal commodity taxes in the late 19th century were taxes imposed under the British tax collection system upon salt and alcohol for portable consumption. Commodities were added over a period of

[1] Major Wingate 1859 quoted in an article in the SARCAJC.

[2] The law of Income Tax by Kanga and Palkhivala – 8th Edition.

time, although a quantum change was made in 1942 when Excise duty was imposed on tobacco to raise finances for the war effort.
The tax on manufacture of goods continues under the 1944 Act as the principles of taxation in relation to indirect tax are – or at least were - fairly simple, and the procedure for levy and collection was exhaustively dealt with in the rules framed from time to time.

Similarly, the principles underlying the imposition of customs duty on imports and exports were fairly simple. The Sea Customs Act of 1878 was replaced in 1962 by the Customs Act which continues to be in force.

It is only in the mid-80s that the principles for valuation of goods became complex after India amended its laws to bring them in line with international principles of valuation and classification.

That apart, the growth in the economy as well as of economic activity generally and the proliferation of industry in India increased the impact of taxation and therefore disputes became more frequent and more complex even under the indirect tax laws.

Prior to this the two principal legislations that gave rise to disputes, which then led to Court decisions and which in turn prompted the occasional retrospective amendment, were the income tax law and the sales tax law, and the problems relating to retrospective taxation therefore centred around these legislation.

RETROSPECTIVE LAWS AND LEGISLATIVE COMPETENCE.

The Constitution of India imposes two limitations on the legislative power of Parliament or the State legislatures. The first is by way of legislative competence – in that the subjects of legislation are divided into three lists, with Parliament having the exclusive power to legislate on List I and the States having the exclusive power to legislate with respect to List II, and the two having concurrent power in relation to List III.

The second limitation is by way of Part III of the Constitution – the equivalent of a bill of rights. Tax laws are amenable to a challenge on the ground that they are discriminatory [violative of equality before the law] or that they are unduly burdensome and harsh and thus an unreasonable restriction on the right to carry on business.

The first important challenge to retrospective changes being made was a by way of challenge to amendment in 1951 imposing a duty on an manufactured tobacco which was brought into force retrospectively i.e. from the date of the introduction of the Bill and not from the date in which the law came into force.

This legislation was challenged in Court on two bases. The first was that the State legislature lacked the legislative competence to enact a sales tax law with retrospective effect. The argument was that sales tax was primarily an indirect tax, the essential feature of which was that its' burden could be passed on to the consumer. Where it was imposed retrospectively, the burden of the past could not be so passed on to the consumer and therefore it ceased to be an indirect tax and for that reason was unconstitutional. This argument was tersely dispatched, following decisions of the Privy Council holding that the method of collecting the tax was an accident of its administration, and the fact that it could not be passed on did not affect its essential characteristic. The Court also followed and cited with approval the decision of the privy Council in Colonial's sugar refining Co Ltd versus Irving which had stated the proposition with clarity-if there was a power to impose taxation conferred by a constitution, the legislature could equally make the law retroactive and impose the duties from a date earlier than that from which it was imposed[3].

The Supreme Court accepted that tax laws were subject to the discipline of Part III of the Constitution. However the Indian Supreme Court chose to follow the American decisions that had rejected the suggestion that mere retrospectivity would render a tax laws arbitrary and capricious.

These principles laid down in 1962 were followed consistently in a host of cases. The defining feature of these cases was that the amendments which are made retrospectively related invariably to either correcting some drafting flaw which clearly defeated legislative intent, or correcting some feature on account of which the Court found the law unconstitutional. As the Court explained in 1963, while they could not be any dispute that the legislature in India had the power to make retrospective legislation, it would be open to a party affected by such laws to contend that the retrospective operation creates a situation which could be described as an unreasonable restriction which violates the right to carry on business or the right to hold and dispose property.

[3] Chhotabhai v Union 1962 Supp 2 SCR 1

While in theory the Court did subject tax laws to the fundamental rights to carry on business, and the right to hold and dispose of property, in practice the only few occasions on which the Court did strike down laws were situations where the tax was brazenly discriminatory. There is no reported decision in which on account of the retrospectivity itself the Court found the law imposing a tax retrospectively falling foul of constitutional limitations.

The bar was set rather high- the reasonableness of each retroactive tax depends on the circumstances in which it comes to be made, and the test of the length of time covered by the retrospective operation could not by itself be a decisive test. For e.g. where a statute may have continued to be in operation for years and was then found to be constitutionally flawed on account of a feature which was amenable to correction by an amendment, , if after the final judicial verdict the law was amended and brought into place retrospectively, the length of time would be irrelevant.

In a later case decided in 1969[4] the Supreme Court cited article that had appeared in the Harvard Law Review which suggested that "*it is necessary that the legislature should be able to cure inadvertent defects in statutes oh their administration by making what has been aptly called small repairs*".

Clearly what the Court had in mind were cases where on account of bad drafting or introducing some feature in the tax law which made it unconstitutional, the State stood to suffer loss of revenue and there was a corresponding windfall upon a taxpayer. In such a situation the legislature could legitimately make a retrospective amendment and

[4] Buckingham and Carnatic Mills case

also introduce a validating clause.

VALIDATING CLAUSES-THEIR VALIDITY.

One of the interesting issues which has recurred in Indian jurisprudence is the challenge to validating clauses that seek to override judicial verdicts.[5]

The Indian Constitution recognizes separation of powers. In the early 60s, the Supreme Court of India dealt with challenges to the constitutional validity of statutes brought into force with retrospective effect in a manner so as to nullify the effect of a decision of the Court. The Court recognised that as a facet of the power to make laws with retrospective effect, it was open to the legislature to correct the defect and change the basis on which the decision of the Court had been rendered, and having done so it was open to legislatively declare that notwithstanding anything contained in any judgment or decree of a Court, the imposition or tax for the past also would be valid. The key feature of such legislation had to be correction or change of the very basis on which the decision had been given. As the Court explained "*a Court's decision must always bind unless the conditions on which it is based are so fundamentally altered that the decision could not have been given in the altered circumstances*".[6]

There were some cases in which an amendment failed to 'cure the

[5] a Validating Clause is a provision that validates a recovery or a demand of tax notwithstanding the judgment of the Court to the contrary.
[6] Prithvi Cottons case 1969 2 SCC 283

defect' - in those cases the Court held that the law seeking to validate past collections would constitute a usurpation of judicial power and would therefore be unconstitutional. However if the amendment carefully altered the basis of the judgment which had declared a demand or a recovery of tax illegal [irrespective of whether it was merely a matter of interpretation or on account of some feature of the law the Court had found the statute to be unconstitutional] then the legislature could not only legislate retrospectively but could also validate past collections or past demands.

CLARIFICATORY OR RETROSPECTIVE – WHO DECIDES.

A number of retrospective amendments of recent times have been passed off as "*clarificatory*" or *declaratory*".

Where the amendment is not made expressly retrospective, but is statutorily described as being a clarification (i.e. by use of words such as "*for the removal of doubts it is clarified"*) the Supreme Court has held that the mere legislative assertion that an amendment is a clarification is not conclusive, and whether a change is clarificatory or whether it is a substantive change (and therefore not retrospective) as it is a matter of statutory interpretation and therefore for the Courts to adjudicate.[7]

Where a law is challenged as being unconstitutional, the legislative assertion that the law is clarificatory would be of no avail.

[7] Union of India versus Martin lottery 2009 12 SCC 209

CURRENT TRENDS.

Retrospective legislation did occur from time to time but for the most it was designed to deal with some Court verdict which upset the existing law or upset the existing understanding of the law.

The first controversial retrospective amendment was in 1983. The Income tax Act conferred a tax exemption upon new industrial undertakings as percentage of Capital employed in such undertakings. Since the inception of the exemption, a Rule that had been in place for computation of the capital employed . This Rule was struck down by various High Courts as being inconsistent with the parent Act insofar as it provided for excluding long-term liabilities from the computation of Capital Employed. Parliament retrospectively amended the parent statute itself and engrafted the Rule in the parent statute. This retrospective amendment was challenged on the ground that business undertakings had altered their position acting on the face and belief that the parent law would prevail and that the Rules that were plainly inconsistent would be ignored, and therefore if the law was now retrospectively altered to ratify as it were rules that were illegal, it would seriously upset settled affairs and thus be harsh and burdensome.[8] The majority judgment held the rules were valid even as they were framed, and therefore the retrospective amendment was really clarificatory in nature. The issue of such a challenge to retrospectivity was not decided by the majority.

The dissenting judgement which accepted the proposition that the

[8] *Lohia Machines Ltd and Anr vs. Union of India -(1985) 152 ITR 308 (SC)*

original rules were ultra-vires, struck down the retrospective amendment to the statute is being an unreasonable restriction on of the right to carry on business.

Recent years have seen a spate of retrospective changes made to direct tax laws and also to indirect tax laws. One common feature of most of these changes in the decades of 1980s and the early 1990s was that they either cured some defect or made some change which could not, in all fairness, be condemned as a change of law as such – it was more a case of parliamentary intent missing fire. The trend has distinctly changed in recent times.

The trend has clearly changed since 2000. Moreover this is clearly discernible in the realm of direct tax law-possibly on account of the fact that in current times, after the rationalisation of indirect taxes (partly on account of WTO commitments) direct taxes particularly corporate tax have become the largest source of revenue.

These changes have not merely been procedural –but to substantive laws as well. For eg. in 2001, retrospective changes were made with effect from 1961 to disallow a claim of expenses, [which would otherwise constitute a legitimate business expense] where the income in relation to which such expenses had been incurred is exempt from tax. There was no language in the law to suggest any such disallowance – just the assertion of the tax office, and that too in recent times. The assertion of the tax office was, by retrospective amendment, made the law in force.

Over the years, such changes have become a steady stream as it were. The one area of greater concern is the retrospective amendments dealing with incomes of non-resident assesses.

In 1976, a series of changes were made in the scope of total income deemed to accrue arise in India to non-resident assessees. This provision was frequently amended as more and more categories of incomes of non-residents were brought to tax in India . The most prolific amendments were to the definition of *royalty* earned by a foreign enterprises in an endeavour to tax incomes in which the only connection with India was that the service received from the non-resident was used by a resident assessee in India. It was no different from taxing Ede and Ravenscrofts for the profits they earn on sale of collars and bands to Indian counsel !

Although the Indian Constitution provides that a law does not become unconstitutional solely on account of the fact that it has extraterritorial operation, the question whether Parliament could make a law that directly seeks to tax income that has no territorial nexus with India, is a vexed issue which has not been resolved.

In a decision given in 2007[9] the Supreme Court accepted the proposition that the provisions of a statute have to be construed in harmony with the principle that income which has no territorial nexus with India would not fall within the mischief of the fiction of "*income deemed to accrue arise in India"*.

This decision has been sought to be retrospectively modified by a number of amendments made to provisions where this principle of presumption against extraterritoriality would apply. The validity of

[9] Ishikawajimas' Case 2007 3 SCC 481

some of these provisions has been put in issue but the matter has not yet been decided by the Indian Courts.

India has witnessed in recent times and exponential growth in foreign direct investment. Prior to the breakup of the USSR Indian had very close economic relations with the USSR including by way of rupee-ruble trade and was able to finance a significant portion of its major imports such as oil and arms through this special relationship. The breakdown of the USSR also saw the lowest point of the Indian economy-Indian foreign exchange had reached a point where in order to prevent defaulting on foreign loans repayment schedules, India had to pledge planeloads of its gold reserves to raise more loans.

The wave of economic reform which put India on the path of becoming a market economy can therefore be traced to 1991. With this change came the need for foreign investment.

During this period not just India but a large number of developing economies saw quantum growth in foreign direct investment-by mid-1990s the FDI flows became greater than the flows of official development assistance.

With increasing FDI came the presence of MNCs. By 2005 almost 36% of FDI flows were rooted to the developing countries. India has had its fair share of foreign investment. On account of this the Indian service industry has grown exponentially, and a large part of the growth is attributable to the advent of foreign investment and the presence of MNCs in India.

Indian tax law has undergone significant changes to deal with the economic change in which a significant portion of tax revenues now flows from either multinational corporations carrying on business in India, or from transactions that are transnational with one of the parties receiving income being a non-resident.
Even the size of businesses in India has grown. In the 1980’s, a tax dispute involving Rs.10 million [GBP 100,000] was considered a huge dispute – now it would considered insufficient to justify the fee of an eminent silk ! Assessments of income measured in terms “ billion dollars” are now reasonably common.

The two areas that have seen significant changes are the provisions for taxing in India offshore income of non-residents [on the basis of some connection with India] and enacting provisions for transfer pricing determination so that in transactions between associated enterprises operating within India and outside India, the fair amount of income attributable to in India can be brought to tax under Indian tax law. All such laws are relatively new to Indian jurisprudence, and drafting them is a daunting task for Indian draftsmen. Fiscal legislation is experimental and more so in new areas which are evolving to keep pace with the changing dynamic of global business.

However the interest of certainty and stability, and the need to inculcate public faith in the dispute resolution process, demand that laws are not frequently changed. Every time the income tax Department misreads the law, it is not necessary to change the law to accord to the intent of the assessing officers. There is no harm in accepting that the Courts are better judges of Parliamentary intention and if they find that the assessing officer has misread the law, unless the situation is such as to clearly warrant Parliamentary intervention, certainty and stability would demand that the law be not changed for the asking.

Recognising the need for certainty, the income tax law has been amended to provide for machinery whereby non-resident assessees can obtain then advance rulings in respect of potential transactions. The *raison d'être* of such a mechanism is to impart certainty before or transactions entered into. If interpretations of law by advance ruling authorities are frequently tinkered with, it erodes public confidence in the procedure prescribed and defeats the fundamental purpose underlying their creation.

The biggest blow to the reputation of the Indian system has been the retrospective amendment in the Vodafone case.

THE VODAFONE CASE.

One of the greatest success stories in India was (before it unravelled in the last three years) the telecom sector. India opened up mobile telephony from 1996. The original fixed licence fee regime was boldly scrapped by the government in 1999 when it was found to be an impediment in the growth of the telecom industry. The revenue sharing regime was then introduced and Indian Telecom thereafter exploded at a rate of growth hitherto unknown in the sector. In its finest years, despite the prices of mobile telephony coming down benefiting the consumer, the exponential growth in the business made it a lucrative investment option. Those who had initially ventured into the trade, risking political as well as fiscal uncertainty (this was the first major infrastructure sector opened up in India for foreign investment) managed to create substantial values. The licenses are given by the government on a circle-wise basis[10], and each such circle became an investment Centre. The success encouraged telcos to acquire Pan India licenses and hook up operations so as to become Pan Indian service providers. Hutchison, who is a reputed global telecom player, was one of the first to enter India. Having come into India by investing in the license of one circle, and encouraged by the success, Hutch together with its Indian partner grew its business to make it Pan India. This was achieved in two ways-organic growth by setting up its own operations by obtaining new licenses for new circles, and by acquiring other small telecom players who had existing operations in other circles. On account of this kind of growth, the ownership structure of the Hutchison Telecom operations in India was fairly complex-although in no way unusual for such multinational operations.

Hutchison which is a Hong Kong-based group, made its Indian investment through a listed company in Hong Kong, which in turn held shares in downstream companies in the Cayman Islands, which companies in turn held shares in downstream companies based in

[10] the large metros are a Circle, and in other areas, it generally is district wise

Mauritius (a favoured investment destination for investments into India due to a favourable tax treaty-which continues unamended) and which Mauritius companies then held shares in an Indian holding company which controlled operational subsidiaries in India.

When Hutchison decided to exit India , and Vodafone which was keen to enter India agreed to buy the Hutchison Telecom operations in India, the deal was structured like all such deals -Vodafone acquired an appropriate company below the listed company in Hong Kong, the acquisition of which gave them equity interests and control over all the downstream companies and thereby control over the Indian operations.

This transaction was outside India, the agreements entered into in England and Hong Kong, monies paid outside India, and control taken over by changing the boards of the companies in Cayman Islands and Mauritius et cetera.

Hutchison and Vodafone were correctly advised that this transaction, in which the capital gain accrued upon the acquisition of a share of the Cayman Islands company outside India was not taxable in India for the simple reason that (unlike other regimes elsewhere) Indian legislation had not been amended to provide for "look-through" provisions were in appropriate cases (defined with clarity in the statute) the tax authorities could tax a gain in a jurisdiction where the ultimate assets (from which the values derived in the upstreams shares) are located, even if the immediate source of the gain [such as the transfer of a share of an upstream company] was outside the jurisdiction.

Apart from the language of the law, and the fact that the provision which would bring such a gain to tax had not been added to the Indian statute[11], Hutchison and Vodafone presumably -and rightly – derived some comfort from the fact that Hutchison had similarly acquired shares in a number of offshore companies who had Telecom operations in India through downstream companies, and who exit India by selling their upstream company shares to Hutchison, and at no point of time had the income tax department suggested that these transactions were liable to tax on their capital gains in Hutchison had never deducted any tax [for deposited in India] when it paid for such shares.

The income tax department in fact publicly declared that their attempt to hold the transaction between Vodafone and Hutchison taxable was a "test case".

There is no harm in a tax department running a test case, and if the assessee is ultimately found to be within the dragnet of the law, it is no defence to such an assessee that it was wrongly advised and was ignorant of the law. One important detail was that the assessee who derived the gain on account of the increase in the value of the Indian business was not Vodafone but Hutchison. If the general understanding of the tax department and all assessees was that such transactions are not taxable , it was inherently unfair to run such a test case against Vodafone holding it responsible for *failing* to deduct tax on the sum paid by it to Hutchison.

[11] the Australian and Canadian Courts had held such gains as not being taxable, which led to amendments inserting *look through* provisions

It is inherently unfair to suggest that in a "test case" scenario, a purchaser of an asset who has paid money could be held to have "failed" to deduct tax.

The second major conceptual flaw in this approach is that it amounts to extending procedural provisions for withholding tax to offshore transactions which have consummated in jurisdictions to which Indian tax law does not apply.

If Vodafone had deducted tax from Hutchison from consideration payable under an English law agreement arrived at outside India and to be performed outside India, Hutchison could have legitimately treated Vodafone as being in breach, for the provisions in the Indian income tax law which statutorily declare that deduction of tax would constitute a constructive receipt of the money by the recipient, have no application outside India. Quite plainly, it would amount to applying Indian law to a commercial transaction outside India between two non-Indians were no part of the transaction (for sale of the share) takes place in India-which would be contrary to settled principles of Conflict of laws.

Vodafone therefore closed the transaction by paying the entire sale consideration to Hutchison, acquired the upstream share and control of the Indian entities.

The Indian tax department found it easier to pursue Vodafone (who now had a business presence in India and could be embarrassed if it refused to cooperate with the Indian tax authorities) and the only way it could do it was by alleging that Vodafone was an assessee in default for having failed to deduct tax.

When the matter was still in the Indian Courts in proceedings by way of judicial review, Prime Minister Gordon Brown wrote to Prime Minister Manmohan Singh complaining about a retrospective application of tax laws-on the footing that similar transactions had never been taxed in the past.

The response of the Indian Prime Minister unexceptionable - that there was no retrospective application of any law but a controversy as to an application of existing Indian law to such transactions, and that it would be resolved **finally** in the Indian Courts.

The Supreme Court of India, in a judgment that repays study, held that under the law as it stood, the transaction will not taxable in India. It rejected the suggestion that there had been any attempt at impermissible tax avoidance by resort to artifices, finding that the creation of the structure which was in place had been driven by commercial considerations and could not be condemned as a tax saving device.

In the immediately next Finance Act, the provision relating to taxation of income non-residents was drastically amended virtually to override every single legal argument that the Supreme Court of India had accepted while holding that the transaction was not liable to tax. The Memorandum to explain the provisions of the Bill had this to say:

Certain judicial pronouncements have created doubts about the scope *and purpose of sections 9 and 195. Further, there are certain issues in respect of income deemed to accrue or arise where there are conflicting decisions of various judicial authorities. Therefore, there is a need to provide* ***clarificatory*** *retrospective amendment to restate the legislative intent in respect of scope and applicability of section 9 and 195 and also to make other clarificatory amendments for providing certainty in law.*

The power of the Indian Parliament to make such laws is not in issue-such an amendment posed a serious question mark upon the wisdom of those who proposed such amendments. The fallout of the amendment has established that it was a huge mistake-two expert committees set up to examine this issue has categorically held so.

What however was a serious assault on the rule of law was to hold that these amendments were being brought "for the removal of doubts".

To say that there was a need to clarify the law posits that the tax officer was right, and the High Court and Supreme Court were both so wrong that they completely missed discerning the parliamentary intent. This undermines the foundation of the rule of law in which the Courts [and not the executive] have the last word in the matter of statutory interpretation and discerning parliamentary will.

Besides, comity between institutions it called for greater respect being shown for the painstaking judgment of the Supreme Court which examined the law not just in India but in other jurisdictions to come to the conclusion that India did not have *look through* provisions whereby such a transaction could been taxed, that the settled law on the subject was that if shares are transferred which carry controlling interest, there is a single transaction of the transfer of a share-not two transactions in parallel in which there is a transfer of shares and a transfer of control.

It is open to Parliament to notionally provide, for purposes of imposing tax on transnational transactions, that an offshore transfer of a share is deemed to bring about the transfer of an asset in India in specified circumstances-in fact other jurisdictions have done so. What is objectionable is to suggest that such a major change of policy in its tax law is "*for the removal of doubts*". The Supreme Court noticed that amendments which would enable such tax to be levied had been proposed in the draft Direct Taxes Code which was in public domain for discussion and which had not yet been legislated upon.

THE FALLOUT OF THE RETROSPECTIVE AMENDMENT.

The only explanation for this action is, to borrow the expression used by the late renowned tax jurist Mr. N.A Palkhivala (criticising a retrospective amendment which had been made in 1983), a triumph of bureaucratic obstinacy over good sense.

This amendment was not a one of a kind. The last few years have seen a spate of such amendments. In the past amendments were normally made were the government was keen to get over the judgment of the Supreme Court or at least a judgment of the High Courts on a particular issue. Of late amendments including retrospective amendments have been made to get over decisions of tax Tribunal's and even in some cases advance ruling authorities.

There was considerable international disquiet over this retrospective amendment. The government at one time seemed to hope the controversy would go away if Vodafone challenge the retrospective amendment in the Supreme Court of India for the reason that if the amendment was struck down, it would solve the political problem of unscrambling the amendment, and if the amendment was upheld, it possibly could provide some moral justification for the change.

Unfortunately for the government, Vodafone refused to oblige and as the press reports suggest, it has decided to pursue its remedies under bilateral investment treaties.

Left with the political problem of unscrambling such an amendment when justification for such an amendment failed to convince those who mattered thereby creating a serious dent in FDI proposals to India, the government then took to appointing an expert committee for rendering advice on the matter. This expert committee was headed by one of the most respected economists of India – Mr. Parthasarthy Shome . After examining the matter in some detail, this is what he had to say.

The Committee concluded that retrospective application of tax law should occur in exceptional or rarest of rare cases, and with particular objectives: first, to correct apparent mistakes/anomalies in the statute; second, to apply to matters that are genuinely clarificatory in nature, i.e. to remove technical defects, particularly in procedure, which have vitiated the substantive law; or, third, to "protect" the tax base from highly abusive tax planning schemes that have the main purpose of avoiding tax, without economic substance, *but not to "expand" the tax base…….*

Thus, the above facts clearly show not only the absence of any evidence proving that these retrospective amendments are clarificatory in nature but also demonstrate lack of any legislative intent of taxation of capital gains arising on account of indirect transfer.

Unfortunately despite this, the matter remains where it was without any resolution.

Sometime 2013, the World Bank published a report downgrading India in the index of investment friendliness-from its position of 131 in 2011, India was moved to 134. India's position remained below countries like Uganda, Ethiopia, Yemen et cetera while its smaller neighbours like Sri Lanka fared better. To address this fall in confidence, the government appointed a committee headed by another eminent Indian Mr Damodaran. The remit of this committee was generally to examine issues which contributed to this decline, the committee squarely addressed the question of retrospective taxation and had the following to say:

It has often been said that death and taxes are equally undesirable aspects of human life. Yet, it can be said in favour of death that it is never retrospective. Retrospective taxation has the undesirable effect of creating major uncertainties in the business environment and constituting a significant disincentive for persons wishing to do business in India. While the legal powers of a Government extend to giving retrospective effect to taxation proposals, it might not pass the *test of certainty and continuity. This is a major area where improvements should be attempted sooner rather than later ….”*

There is now near unanimity amongst jurists and economists on what constitutes the paradigms for fair taxation. Amongst the ten commonly accepted rules, are equity and fairness, certainty, tax neutrality, economic growth and efficiency, transparency and visibility.

Major changes to tax laws which amend fundamental principles retrospectively are plainly violative of each of these paradigms. Assessees are entitled to plan their affairs and make investments based on the state of the law at the time when they make investment. Changing the rules of the game after the match has been played at the brazen violation of the principles of equity and fairness.

Certainty is one of the most important principles in present times were transnational investment is the lifeblood of economic growth in developing economies.

In the guiding principles of good tax policy issued by the American Institute of certified Public accountants (in 2001) explaining the stand principles it said "*certainty is important to us tax system because it helps to improve compliance with the rules and to increase respect for the system. Certainty generally comes from care statutes as well as timely and understandable administrative guidance that is readily available to taxpayers*". A retrospective amendment hardly qualifies as a sensible measure by this yardstick.

Economic growth and efficiency are important for all economies in present times-its need in developing economies where economic growth is vital to raise hundreds of millions from abject poverty to decency levels of survival is critical. As the guidelines of the American Institute of Certified Public Accountants wisely said

“The tax system should not impede or reduce the productive capacity of the economy. The tax system should neither discourage nor hinder national economic goals, such as economic growth, capital formation, and international competitiveness. The principle of economic growth and efficiency is achieved by a tax system that is aligned with the economic principles and goals of the jurisdiction imposing the tax.”

One example of an amendment made at the same time is a good illustrative example of how costs are multiplied by retrospective amendment.

The tax department sought to bring to tax income earned by companies that own satellites and rent satellite space to broadcasters-even where the broadcasters are non-resident and the companies that own the satellite are non-resident, the contracts between them are outside India, the payments are outside India and the uplinking is outside India.
In the first instance, they sought to tax sums paid for renting satellites capacity as "royalty" on the specious ground that the

satellite process the data of the broadcasters and thereby the broadcasters use the software et cetera of the satellites, and therefore any sums paid in such a situation would be taxable in India as the technology is being used in India upon its down linking.

When this claim failed in the High Courts, a retrospective amendment was brought to displace the reasoning of the High Court. Since the appeals of the revenue are pending in the Supreme Court, it was perhaps felt that there is no need for validating provision as the appeals will now have to be disposed of on the basis of the amended statute on account of its retrospective beauty.

This kind of uncertainty and inequity in tax laws drives up the cost of doing business in India by increasing the risk of doing business. The higher the risk, the greater the return that would be demanded by an investment in India and it will necessarily impact economic growth and efficiency. The problem of such amendment says that while the amendment may relate to one sector, the increased perception of risk is cross sectoral as it generally creates a sense of uncertainty in the belief of a system in the rule of law.

The government of India has shown remarkable restraint while dealing with the question of tax avoidance. While the tax department keeps up its attempt to persuade the Supreme Court of India to drift away from the *Duke of Westminster* and move closer to the patriotic approach which guided Justice Learned Hand in *Helvering v Gregory*, the retrospective amendment brought into place post Vodafone did not alter the judgment of the Court which the adhered to the Duke of Westminster principle as further evolved the later English cases from

Ramsey to *Craven*. Instead, the government has wisely pursued the path of the GAAR although the proverbial devil still lies in the details. What is important is a clear declaration that the rules of GAAR would be applied prospectively. What remains to be seen is if at some point of time in the near future, this declaration of prospective application is revised retrospectively.

All life is an experiment. Principles of economics and principles of governance are also experiments. Besides mankind has a tendency to do the right thing-although at times after exploring other options. The government of India made retrospective amendments in the past to tax laws. These primarily impacted Indian business and therefore did not create the kind of international furore which the Vodafone amendments have created. Indian businessmen-especially in the 1980s and 1990s-were used to the style of governance which was reflected in the Vodafone retrospectivity. Besides before the opening up of global markets to Indian investors, even if they lost faith in the fairness of the administration, had little choice. And there was not much to lose-because whatever else the tax department may have been known for, fairness was not one of its renowned attributes.

Through the 1970s and 1980s India flirted with socialism where it was fashionable to tax the rich and it was morally justified to impose harsh burdens on private profit-profit was after all almost a vice.

The world is changed at a rapid pace and so has the Indian economy. Globalisation and free flow of capital which has brought in huge value and growth to India has also brought about dramatic change in the business culture and character. There is a corresponding expectation that economic governance would follow global norms of fairness and transparency.

Add to this the communication explosion of the 21st Century-the Vodafone controversy was an accident waiting to happen.

The judgement of the Vodafone case was an example of how a Supreme Court could rise to the occasion, familiarise itself with current trends of tax jurisprudence and render a judgement which established that the Indian judiciary had no bias in favour of the Indian state and was unflinching when it came to striking down a huge demand of billions of dollars.

The retrospective amendment was an iteration that the Indian bureaucracy is still a long way to go in changing its old mind-set of obstinacy. The post-amendment dithering despite expert committee reports to the contrary are evidence of the fact that the Indian political system has evolved up to the point of inviting criticism but lacks political maturity to take the final step. The evolution will be complete when the political system accepts that good economics is, in the 21st Century good politics, and good governance is the courage to acknowledge mistakes, for public good and public interest are best served by institutions that have the resilience and strength not merely to invite criticism but to do the right thing without being deterred by populism or passing political compulsions. The capacity to act in the interest of public good transcending political compulsions is the ultimate test of a mature democracy.