

Tax Hotline

August 06, 2021

INTERNATIONAL TAX UPDATE: INDIA MOVES TO REVOKE RETROACTIVITY OF 'VODAFONE' TAX – AN END TO THE SAGA?

Yesterday, the Indian Government introduced the Taxation Laws (Amendment) Bill, 2021 (“**Bill**”) before the Lok Sabha proposing to amend the indirect transfer provisions contained in Section 9 of the Income-tax Act, 1961 (“**ITA**”). The infamous indirect transfer provisions were introduced in the ITA as a knee-jerk reaction to the Supreme Court’s decision in *Vodafone International Holdings*¹ with retroactive effect from April 1, 1962. The indirect transfer tax provisions essentially expanded the source rules for taxation in India of capital gain income arising to non-residents from sale of shares of entities situated outside India. Post introduction of the indirect transfer tax provision, the income-tax department raised a demand of USD 2.1 billion on Vodafone International Holdings B.V. regarding it as an assessee-in-default for non-withholding of taxes on payments made to the selling Hutch entity.

The new Bill proposes to place an embargo on future tax demands arising out of any indirect transfer of Indian assets undertaken before May 28, 2012. It also proposes to nullify tax demands already raised for indirect transfers made before May 28, 2012 subject to fulfilment of certain conditions.

BACKGROUND

Before delving into the amendments proposed by the Bill, a brief recap of the impact of the indirect transfer provisions on foreign investors is merited. Since their inception, the indirect transfer tax provisions have been a source of protracted litigation (as also acknowledged by the Statement of Objects and Reasons of the new Bill) and tax uncertainty for foreign investors. From a lack of clarity on the threshold for applicability of the provisions, the manner of valuation and apportionment of gains, applicability to investment funds, availability of treaty benefits – the saga of the indirect transfer tax has taken quite a few twists and turns. Some of the prominent cases dealing with indirect transfer provisions include the Delhi High Court decision in *DIT v. Copal Research Limited*² clarifying the meaning of ‘substantial’ in the indirect transfer tax provisions before the statute was amended to define the term, the Delhi Tribunal decision in *Cairn U.K. Holdings Limited*³ upholding a tax demand of USD 1.6 billion against Cairn U.K Holdings Limited in relation to group restructuring of Indian assets, and the Andhra Pradesh High Court decision in *Sanofi Pasteur Holding SA*⁴ holding that retroactive unilateral amendments to the ITA have no impact on the interpretation of tax treaties. The indirect transfer tax provisions invited severe criticism from stakeholders and the international community as such retroactive amendments militate against fundamental principles of tax certainty and damage India’s reputation as an attractive investment destination.

The Statement of Objects and Reasons of the Bill states that pursuant to introduction of the indirect transfer tax provisions, tax demands have been raised in 17 cases. The demands raised under the indirect transfer tax provisions also spurred investment treaty arbitration cases against India – among which are Vodafone International Holdings BV v. The Republic of India (“**Vodafone arbitration**”); and Cairn Energy Plc and Cairn UK Holdings Limited v The Republic of India (“**Cairn arbitration**”).

In the past few months, the respective arbitral tribunals have ruled in favour of the foreign investors against India in the Vodafone and Cairn arbitrations:

- The tribunal constituted in the Vodafone arbitration⁵ held that India had violated the ‘fair and equitable treatment’ standard guaranteed to Vodafone International Holdings B.V. under the 1995 Bilateral Investment Promotion and Protection Agreement between the Republic of India and the Kingdom of Netherlands; and
- The tribunal constituted in the Cairn arbitration⁶ held that India had failed to uphold its obligations under the 1994 Bilateral Investment Treaty between Republic of India and United Kingdom and under international law.

Please refer our detailed analysis of the Vodafone arbitration [here](#) and the Cairn arbitration [here](#).

AMENDMENT PROPOSED BY THE BILL

The Bill proposes:

- **An embargo on future tax demands:** The Bill proposes to provide that the indirect transfer tax provisions would not apply to income accruing or arising as a result of an indirect transfer undertaken prior to May 28, 2012. This is sought to be achieved by legislatively mandating the non-application of indirect transfer tax provisions on (i) assessments or reassessments initiated under specified sections, (ii) orders passed enhancing a tax assessment or reducing a refund and (iii) orders passed deeming a person to be an assessee-in-default for not withholding taxes in respect of indirect transfers prior to May 28, 2012.
- **Nullification of tax demands raised:** The Bill proposes that demands raised for indirect transfers of Indian assets made prior to May 28, 2012 shall be nullified, subject to fulfilment of the following conditions by the person in

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whose case such demand has been raised:

- Withdrawal or an undertaking for withdrawal of appeal filed before an appellate forum or a writ petition filed before a High Court or the Supreme Court of India;
 - Withdrawal or an undertaking for withdrawal of any proceedings for arbitration, conciliation or mediation initiated by such person such as under a bilateral investment treaty; and
 - Furnishing of an undertaking waiving their rights to seek or pursue any remedy or any claim in relation to such income whether in India or outside India.
- **Refund of amounts paid:** The Bill proposes that the Government shall refund the taxes paid in cases where the application of indirect transfer tax provisions is being withdrawn due to fulfilment of the conditions mentioned above. However, the Bill provides that no interest shall be paid by the Government on such refund of taxes.

ANALYSIS

The Bill comes as a positive and welcome move by the Indian Government, seeking to remove a thorn in the side of foreign investors since the enactment of the retroactive tax in 2012.

However, the devil lies in the detail and the timing of introduction of the Bill. *First*, the Bill seeks to provide no relief to taxpayers that have paid tax demands raised for indirect transfers undertaken prior to May 28, 2012 without contesting its applicability. This can lead to an incongruous situation where taxpayers have gone out of pocket paying high tax demands for a taxing provision that has been made ineffective prior to May 28, 2012, paving the way for constitutional challenges to the Bill. It also does not address a situation wherein notices were issued but no tax demand has been raised. *Second*, the Bill provides that taxpayers who have paid the tax demand in dispute and are now withdrawing their appeal / arbitration proceeding, will be issued refunds of the taxes without any interest, thereby, disregarding provisions of Section 244A of the ITA. This seems to be very unreasonable and unfair to taxpayers whose disputes have been pending for decades. The provision for refund under Section 244A is an equitable provision seeking to compensate a taxpayer for unjustly denying them the use of their funds, in the same manner as the Government levies interest on delayed payments by the taxpayer. A refusal to pay this due to a taxpayer, baked into a legislation, can set a dangerous precedent. *Third*, the Bill does not provide any remedy to taxpayers whose assets have been seized or sold by the tax department pursuant to a tax demand raised under the indirect transfer tax provisions. For example, the tax department sold part of Cairn UK's shares in Vedanta to recover part of the tax demand, realizing and seizing proceeds of USD 216 million. It also seized dividends worth USD 155 million due to Cairn UK and offset of a tax refund of USD 234 million due to Cairn UK as a result of overpayment of capital gains tax on a separate matter. Even if Cairn UK was to withdraw its proceedings against the income-tax department, it is unclear how Cairn will be compensated for these amounts seized by the tax department.

While the intent of the amendment proposed by the Bill is fully appreciated, one cannot ignore the damage caused by the preceding nine year-long saga and help wondering how much of it could have been avoided by swifter action by the Government. Both the Vodafone and the Cairn arbitrations have been extensively tracked by the international tax community and the investor community in general, giving them cold feet with respect to any potential plans to invest in India. The awards of the tribunals in both proceedings came as a huge blow to the Indian government with both companies seeking to actively enforce their international arbitral awards. In fact, Cairn recently moved a French court to freeze the Indian government's assets in the country in lieu of damages.⁷ It has also dragged Air India Ltd. to a US Court to seek payment of the arbitration award.⁸

In this backdrop, while the Bill will provide relief to taxpayers, one hopes that it also serves as a learning experience for the Indian and other Governments on the pitfalls of aggressive and unilateral legislation to expand their tax base in a world increasingly driven by cross-border investments and resource-sharing. The actual impact and effectiveness of the Bill will depend on whether taxpayers actually choose to withdraw their appeals / arbitration proceedings from international courts on the basis of this promise from the Indian Government.

– Ipsita Agarwalla, Varsha Bhattacharya & Ashish Sodhani

You can direct your queries or comments to the authors

¹ Vodafone International Holdings BV v. Union of India (2012) 6 SCC 613. Pertinent to note that the Supreme Court not only quashed the demand of INR 120 billion by way of capital gains tax but also directed refund of INR 25 billion deposited by the Vodafone along with interest at 4% p.a. within two months

² DIT v. Copal Research Limited (2014) 371 ITR 114 (Delhi HC)

³ Cairn U.K. Holdings v. DCIT, decision dated March 9, 2017, ITA No. 1669/Del/2016

⁴ Sanofi Pasteur Holding SA v. DoR [2013] 257 CTR 401 (AP)

⁵ The arbitral tribunal comprising of L.Y. Fortier, R. Oreamuno Blanco and F. Berman directed India to reimburse legal costs of approximately INR 850 million to Vodafone

⁶ PCA Case No. 2016-7. Tribunal comprising Mr. Laurent Levy, Mr. Stanimir Alexandrov and Mr. J. Christopher Thomas QC ordered India to pay to Cairn INR 90,000 million in damages for the 'total harm' suffered by Cairn as a result of India's breaches

⁷ Upadhyay, P. (2021, August 5). Retrospective Tax On Indirect Transfers To Be Made Prospective: New Bill. The Bloomberg Quint. <https://www.bloombergquint.com/business/retrospective-tax-on-indirect-transfers-to-be-made-prospective-new-bill>

⁸ Nag, Anirban. (2021, May 5). Cairn Drags Air India to U.S. Court Over Tax Spat With State. The Bloomberg Quint. <https://www.bloombergquint.com/global-economics/cairn-drags-air-india-to-a-u-s-court-over-tax-spat-with-state>

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