Other Hotline

April 17, 2012

THE RETROACTIVE TAX RAT RACE

UNLIKE UK AND CHINA'S LIGHT-HANDED APPROACH, INDIA WANTS TO SLAM EVERY OFFSHORE DEAL SINCE 1962

Dear Friend,

We are happy to let you know that an article titled 'Retroactive tax: Unlike UK and China, India wants to slam every offshore deal since 1962' appeared on April 13, 2012 in The Economic Times, a prominent business daily in India. The link to the article is as below:http://articles.economictimes.indiatimes.com/2012-04-13/news/31337558_1_tax-sale-tax-avoidance-retroactive-legislation

We would very much welcome your comments on the article. Thanks

Sincerely,

Nishith Desai

The slew of retroactive proposals in India's Budget 2012 has shaken the global investor community. When the UK Chancellor of the Exchequer expressed his concerns over the proposal to retroactively tax offshore M&As, the Indian finance minister is reported to have said, "If UK can introduce retroactive legislation, why can't we?"

Tax officials argue that even China introduced retroactive legislation a few years ago to tax Vodafone-like offshore share transfers. But does this, by itself, justify penalising investors for legitimate transactions carried out in the past? A closer comparison with developments in UK and China will reveal the shortcomings of India's approach to retroactive legislation. As a response to the tax department's defeat in the $11.1-billion Vodafone case, the government moved quickly in proposing an amendment in Budget 2012 for taxing sale of shares of a foreign company whose value is substantially derived from assets located in India. The proposal, which is retroactively effective from 1962, will create tremendous difficulties for foreign investors. It potentially covers sale or pledge of shares of foreign listed companies, India-focused funds and pooling vehicles, and even international group restructuring involving underlying Indian assets. Investors would be exposed to double taxation since they would also be taxed in their home country without any credit for taxes paid in India. The ambiguities in the proposed retroactive proposal will give rise to immense uncertainty and litigation.

UK, on the other hand, has been very reasonable in its approach towards retroactive taxation. For instance, as a response to the Court of Appeals decision in Padmore vs IRC (1987), UK introduced retroactive rules to counter abusive structures using offshore partnerships. There was, however, an assurance that taxpayers such as Mr Padmore who had a received a favourable court verdict would not be affected. Another retroactive amendment introduced in 2008 to counter abusive transactions did not impact pending or decided court cases. A recent 2012 amendment, which seeks to tax buyback of debt using abusive arrangements, is retroactive for a period of only around half a year. The UK government believes that retroactive legislation is not to be taken lightly and this is evident from its judicious approach.

China, in December 2009, introduced a new law (Circular 689) to tax sale of offshore holding companies having underlying Chinese interests by disregarding the intermediary entity in specific circumstances. The law seeks to capture abusive structures aimed at tax avoidance. Clearly, this would exclude situations where foreign investors are motivated by genuine business and commercial considerations while investing into China using an intermediary holding company. Most importantly, the Chinese amendment was retroactively introduced for a period of only two years and was not aimed at overriding any established judicial precedent. It is, therefore, not surprising that this new measure was not met with the kind of resentment and uproar as witnessed in India.

Applying the Chinese rules to the Vodafone-Hutch acquisition, a transaction of this nature may not be caught within the tax net. The Supreme Court held that the Hutch structure was backed by genuine commercial considerations and, hence, cannot be disregarded as a sham. While proposing the retroactive amendment to tax offshore share transfers in general, India cannot take support from the Chinese rules, which clearly do not penalise foreign investors who do not engage in abusive transactions.

India's frequent and casual resort to retroactive taxation is a mockery of rule of law. It breaches the legitimate expectations of taxpayers and erodes the confidence of investors. Recent studies by the World Bank reveal that countries such as UK and China are far ahead of India on parameters such as ease of doing business and paying taxes. India also ranks far behind in the worldwide corruption perception index. Much of China's growth is linked to the proactive steps taken in welcoming foreign investment. Unlike India, UK has a charter of taxpayer rights that guarantees that the tax department will use its powers reasonably. Therefore, when countries such as UK engage in retroactive legislation, investors clearly have a sense of confidence that the measures shall be proportionate and

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reasonable.

Ambiguously-worded retroactive and extra-territorial legislation coupled with general anti-avoidance provisions providing unbridled discretionary powers to the tax department without any accountability will make it difficult for investors to rationally organise their affairs. India should not to be swayed by euphoria and introduce such amendments in a hurry without considering the broader ramifications. We should focus on creating a stable legal, economic, political and corruption-free environment that is superior to that in countries such as the US, UK, China and the Philippines, which are already working hard towards reviving their economies and attracting investors. Today, the time is ripe for India to introduce a second phase of liberalisation and globalisation.

Mahesh Kumar & Nishith Desai
You can direct your queries or comments to the authors

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