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UPDATE: FINANCE BILL MAY NULLIFY INDIA'S SUPREME COURT'S RULING IN VODAFONE CASE

As we predicted, the struggle over taxation of indirect foreign investment in India is not at an end. *See Milbank Client Alert, February 23, 2012*. On March 16, 2012, India's Finance Minister Pranab Mukherjee introduced this year's Finance Bill ("Bill") which includes provisions requiring the taxation of indirect foreign investment in India, and which would be applied *retroactively,* defying international norms. This Bill seeks to override the recent *Vodafone* ruling by the Supreme Court of India which held that the Indian Tax Department ("ITD") cannot assess capital gains taxes on the sale of shares of foreign companies that indirectly own shares in an Indian Company. [1]

The Bill amends Section 9 of the Income Tax Act of 1961.[2] The ITD invoked Section 9 as its basis for the claim that tax was owed by the foreign parties in the *Vodafone* case. The amendments would expand the meaning of "through" to include "by means of," "in consequence of" or "by reason of."[3] In addition, the definition of "capital asset" in Section 9 would be amended to include any share or interest of a foreign entity that derives value, either directly or indirectly, from an asset located within India.[4] These modifications to Section 9 would allow the ITD to require withholding taxes on indirect foreign investment in India. The government has chosen to classify these changes as clarificatory amendments, even though these changes are in direct conflict with the Supreme Court's January holding in *Vodafone*. Moreover, the Bill is to be implemented retroactively, "[n]otwithstanding anything contained in any judgment, decree or order of any Court or Tribunal or any authority."[5]

1 *Vodafone International Holding B.V. v. Union of India & Anr.*, Civil Appeal No. 733 of 2012, Supreme Court of India, Jan. 20, 2012.
2 Section 9(1)(i) of the Act states, "All income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India . . ."
3 The Finance Bill, 2012, Bill No. 11 of 2012, ch. III (4)(a) (Mar. 16, 2012).
4 *Id.*
5 *Id.* at ch. III (4)(a), ch. III (113).

The passage of retroactive legislation is not new to India.[6] But, labeling these significant changes as clarifications and imposing them retroactively, regardless of court orders, has lead many Indian commentators to suggest that the government is corroding the legitimacy of Indian courts, weakening the rule of law by destroying the separation of powers, and reducing foreign investors' faith in India's institutional safeguards by eroding the clarity and certainty of taxation laws within India.[7] It is unclear the extent to which this Bill will be applied to previous transactions. The amendments to Section 9, by their terms, apply retroactively to April 1, 1962, the date the Income Tax Act came into effect.[8] India's legal code currently does not allow the reopening of cases after a period of seven years,[9] but the Bill proposes allowing the reopening of tax assessments for indirect foreign investment for sixteen years following the indirect investment.[10] Although Finance Secretary R. S. Gujral stated that the government does not plan on raising new tax demands against Vodafone, it is unclear if the retroactive effective date of the amendments to Section 9 will affect entities that previously entered similar transactions. Other entities may be subject to retroactive taxation on previous transactions that indirectly involved assets located in India, entities which believed their tax disputes settled and unreviewable.[11]

The Supreme Court denied the Indian Government's review petition for the decision in *Vodafone*, leaving legislation as the government's only option to overturn that case's holding.[12] Whether or not the Indian Government pursues Vodafone, other taxpayers remain concerned. Their last line of defense may be that the Bill, if passed, may not withstand judicial scrutiny. Under Indian law, a retrospective bill must be reasonable, not be arbitrary, or violate any rights. It's unclear if this Bill meets theses standards.

The prospective application of this Bill would not be challenged on this basis, and would apply to taxpayers entering into transactions indirectly involving assets located in India. The Indian Parliament is expected to pass this Bill in early May of this year.

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6 Arvind Datar, *Overruling the Judiciary*, THE INDIAN EXPRESS (Mar. 20, 2012).
7 *Id.*
8 The Finance Bill, 2012, ch. III (4)(a).
9 Income Tax Act, 1961, §149 (1962); Amrit Dhillon, *Government Nullifies 'Vodafone' Ruling, Allowing India to Tax Nonresident Firms*, DTR-52 (Mar. 19, 2012)
10 The Finance, Bill, 2012, ch. III (62).
11 Stephanie Soong Johnston, *India Budget includes Retroactive Tax Amendments*, THE NOTES INTERNATIONAL 13 (March 26, 2012).
12 Dhananjay Mahapatra, *Supreme Court Dismisses Centre's Petition Seeking Review of Vodafone Tax Judgment*, THE TIMES OF INDIA (Mar. 20, 2012).