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Hidden Bombs in India's Budget for Foreign Investors

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A proposal by the Indian government last week to change its tax code retroactively to 1962 in order to collect capital gains taxes on offshore acquisitions involving Indian assets has sent shudders through corporate executives, investors and lawyers.

Most of the attention has focused on what the change might mean for Vodafone, which India has argued owes $2.2 billion in taxes on its $11 billion purchase of the Indian wireless operations of Hutchison Whampoa in 2007. Overall, the government estimates that $8 billion similar in tax payments are under litigation.

But India's tax authorities appear to be pursuing much more than that. Lawyers and analysts say the tax authorities could go after billions more through other proposals that were tucked inside the budget presented by the finance minister, Pranab Mukherjee, on Friday. "The budget proposes a number of regressive, retrograde and extraterritorial provisions that would significantly increase tax costs and alter the dynamics of cross-border transactions and mergers and acquisitions," Nishith Desai, managing partner at law firm Nishith Desai and Associates, wrote in an analysis of the budget.

One proposal would allow the Indian tax authorities to override court orders by changing a clause in the country's finance laws to allow them to act "notwithstanding anything contained in any judgment, decree or order of any court or tribunal or any authority." Some analysts have interpreted that change to mean that the government could have the last word in any tax dispute in cross-border deals, or those between an Indian and foreign company.

Another measure would allow the government to tax transactions that took place as many as 16 years ago, up from six now, which Mr. Desai argues would make it more burdensome for taxpayers to maintain documents and could greatly increase the risk of a lawsuit.

Even India's cherished technology industry is not spared: One change would retroactively allow the government to tax all software transactions, including licensing of rights.

It is unclear whether such changes would withstand judicial scrutiny but in the past India's courts have upheld similar changes to laws.

Mr. Mukherjee acknowledged Sunday that retroactive amendments to laws was "not ideal," but he added that Parliament has approved such changes before and the Supreme Court has not struck them down. "Every finance minister will have to protect the interests of the government from a revenue point of view," he told reporters.

The finance minister added that he would ensure that the proposal would cause investors to be taxed appropriately. "India is not a no-tax country. If someone offered to invest $200 billion in India only if there is no tax, I will not allow it. This is because India is not a tax haven, zero-tax or low-tax country," he said.

In a column published in the Indian Express, lawyer Arvind P. Datar listed a number of instances in which the Indian government passed retroactive changes after losing a legal fight in the Supreme Court. (The capital gains proposal was motivated by a ruling from the court in January that the government could not tax the Vodafone-Hutchison transaction.)

Mr. Datar and other legal experts argue that the government should use retroactive amendments in special circumstances and only when they are in the public interest. But by frequently using such changes, the government is infringing on the judiciary's right to interpret laws, they say.

"The question of clarifying the law, after the Supreme Court has categorically come to the conclusion that the law as it stood did not tax such transactions, shows scant respect for the judgment of the court," wrote Harish Salve, a former Solicitor General of India and who is now representing Vodafone. "I have no doubt in my mind that no foreign investor would now have any faith in any of the institutional safeguards."

Vodafone is not alone. Analysts said the government would likely seek to tax several other deals, including SAB Miller's acquisition of Foster; Kraft Food's acquisition of Cadbury's Indian business; Aditya Birla Nuvo's buyout of a 16 percent stake in Idea Cellular India from AT&T; Tata Industries' acquisition of a 17 percent stake in Idea Cellular India from AT&T; and Vedanta's deal to buy a 51 percent stake in Sesa Goa from Mitsui.

"We have more than half a dozen cases that are being examined at various levels," said Dinesh Kanabar, deputy chief executive officer and chairman of the tax practice at KPMG India. "Now the courts would have to go back and examine them from the point of view of the new law. The question is whether you can retrospectively impose withholding obligations on parties who in their calculations of their liabilities and incomes had not factored in a retrospective change."

Analysts and corporate executives are worried that the move will harm India's reputation with foreign investors at a time when policy makers are trying to court direct investment from abroad to help shore up the slowing economy. "This is most retrograde," said Deepak Parekh, chairman of Housing Development Finance. "Our policy makers should realize we do not live in isolation. We need F.D.I., foreign technology and capital."

Not surprisingly, India's finance secretary, R. S. Gujral, who reports to Minister Mukherjee, defends the proposal. He points out that China has also added a retroactive tax on offshore deals, without seeming to suffer any loss in foreign investment. Foreign direct investment in China increased 17 percent in 2010 and 10 percent in 2011. "The apprehension that the retrospective amendments would create negative sentiment for FDI is not correct," he said. Foreign direct investment "comes when there is profitability and does not come only on account of zero tax."

Will foreign investors now seek to divert their resources to countries like Brazil and South Africa at the expense of India? It's hard to say.

The government appears to be betting that it will only lose a few investors, but others are not so sure. "It does make India less attractive," said Ved Jain, chairman of the National Council on Direct Taxes, Associated Chambers of Commerce and Industry of India. "However the government believes that India has enough to offer in terms of a market to be a good investment and this shall not hamper the foreign investment in India."