Nishith M Desai: Driving investment away

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Cases such as Vodafone and E*Trade are scaring foreign investors away, says *Nishith M Desai*

The renowned Indian political strategist, Chanakya (350-283 BC) had once remarked: “Taxation should not be a painful process for the people. There should be leniency and caution while deciding the tax structure. Ideally, governments should collect taxes like a honeybee, which sucks just the right amount of honey from the flower so that both can survive.” More than two millennia later, against the backdrop of the global economic meltdown, in a time when cross-border income and capital flows have become critical determinants of economic growth and competitiveness, these enduring words once again echo within the halls of the Indian tax authorities and policy makers.

Over the last two decades, as a result of liberalised fiscal and investment policies, India has stood witness to record GDP growth rates, flourishing services and manufacturing sectors, an exponential rise in foreign direct investment, burgeoning forex reserves, reduced fiscal deficits, vast internal demand and an increasingly pro-active role in international trade and policy. As a consequence, India has secured a prominent slot in the emerging-markets strategy of MNCs around the world seeking to expand, diversify and consolidate their global operations.

Today, while the investing world assesses India’s status as a preferred investment destination, it is difficult to ignore a contradiction that has surfaced in recent times: On one side, we see an overt commitment towards globalisation and on the other, the sudden aggressiveness of the Indian tax authorities in matters of international taxation. The manner in which the Indian tax authorities have cast the tax net over a number of MNCs such as Vodafone, E*Trade and General Electric has distorted the economics of several cross-border merger, acquisition and investment strategies.

The infamous Vodafone controversy is regarded by many as the most poignant reflection of the sudden shift in the Indian government’s policy towards what can be classified as new-age fiscal extremism. The transaction between Vodafone and Hutchison essentially involved a transfer of shares of a Cayman Islands-based company from the Hong Kong-listed Hutchison group to a Vodafone subsidiary resident in the Netherlands. Being completely extra-territorial, the transfer could not have any conceivable tax implications in India, especially considering that the Indian tax authorities had never expressed a concern with hundreds of similar transactions entered into, in the last 50 years. They, however, decided to assume jurisdiction over the Hutchison-Vodafone transaction and issued a notice to Vodafone with the object of recovering a sum of around $2 billion for failure to withhold tax.

Recognising the legitimacy of cross-border tax planning, the Supreme Court in the landmark case of Azadi Bachao Andolan (2003) upheld the validity of the ‘Mauritius route’, which contributes to around 44 per cent of India’s FDI. However, in the case of E*Trade, this did not preclude the Indian tax authorities from denying a Mauritian company from taking benefit of the India-Mauritius tax treaty. The Mauritian company was accordingly asked to withhold taxes on payments made to another Mauritian company for acquiring shares of an Indian company, thereby rendering the tax treaty virtually inconsequential.

The rise in the volume of tax litigation, whether at the first appellate stage or at the level of the Income Tax Appellate Tribunal (ITAT) is clear evidence of the increasing tension between the tax authorities and taxpayers. Statistics indicate that while more than 35,000 appeals were filed with the ITAT in a single fiscal year (2007-08), the number of cases pending at this stage are far in excess of 70,000. Considering the highly adversarial trend in India, tax risks have emerged as one of the most critical considerations while MNC’s formulate their

India strategies. A recent Pricewaterhouse Coopers (PWC) survey concludes that the tax risks primarily stem from unpredictable rulings from the tax authorities and the prevailing uncertainty.

The Supreme Court, in the case of Ishikawajimaharima (2007) unequivocally espoused that unless there is a direct, substantial and foreseeable nexus with the territory of India, India cannot exercise its right to tax. Considering these well-settled principles of domestic taxation as well as international law, the government should not indiscriminately pierce longstanding global corporate structures and tax transactions that materialise far away from India's fiscal frontiers.

Another disturbing Indian policy trend is a habitual recourse to retrospective amendments, especially covering ongoing matters having significant revenue implications. The Supreme Court in Lohia Machinery (1985) had deemed fiscal amendments imposing a retrospective levy to be constitutionally invalid. Retrospective amendments made by the government to the domestic withholding provisions subjecting non-residents to penal consequences for failure to withhold taxes (especially while the Vodafone controversy was sub judice before the Bombay High Court) has added a new degree of unreasonableness to the ordinary notion of tax enforcement and compliance.

The evolution of tax policy has been accompanied by the recognition of a number of internationally accepted taxpayer rights such as: (i) Enforcement of tax laws in a fair, equitable and non-arbitrary manner; (ii) non-retroactive imposition of taxes; (iii) certainty and stability in tax laws; (iv) guarantee against double taxation and good-faith interpretation and enforcement of tax treaty provisions; and (v) efficient redressal of tax disputes within a reasonable time.

The ambiguities and contradictions in various domestic provisions dealing with international tax coupled with the lack of clarity from the government's side have made it difficult for foreign companies to efficiently plan their cross-border investments. In addition to well conceived legislative drafting, it is essential to create an enhanced relationship and dialogue between the government and the industry with a view to ensure that fiscal policy is not counter-productive and does not stand in the way of India's commitment to globalisation.

As the new Congress-led government formulates India's counter recessionary fiscal policy, it has to understand that the nation cannot afford a trade-off that sacrifices foreign investment in the interest of addressing speculations of revenue loss. The experience of the last two decades has demonstrated that the influx of foreign capital inevitably leads to increased economic growth and a rise in tax revenues. While the tax authorities and policy-makers determine the fate of multinationals such as Vodafone, E*Trade and General Electric, the investing world can only hope that the outcome is a function of the rule of law and not one that is influenced by the vagaries of fiscal convenience.

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