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Investment Treaties Interjecting Taxation's Realm: The Latest in Vodafone's India Saga

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Last month witnessed the release of the operative part of the award of the Permanent Court of Arbitration ('PCA') in the dispute initiated by Vodafone's Dutch entity against Government of India ('GOI') under the India-Netherlands Bilateral Investment Treaty ('Indo-Dutch BIT'). It is understood that the detailed award has been withheld in view of the request for confidentiality. However, from the operative portion it is evident that PCA has concluded that India was in violation of its commitment to fair and equitable treatment under the Dutch BIT. This award has many dimensions, ranging from propriety of retrospective tax laws, legislative reversal of court decisions, width of indirect transfer taxes, etc. Besides these, the seminal point of India's objection to the claim, which is examined in this blog, was the lack of tribunal's jurisdiction. India believes that tax provisions cannot be covered within the scope of investment treaties and, in particular, investment tribunals do not have the jurisdiction to adjudicate upon sovereign tax policy.

Background

In 2007, Vodafone International Holdings BV (Dutch tax resident) ('Vodafone Netherlands') acquired the entire share capital of CGP Investments (Holdings) Ltd. (tax resident of Cayman Islands) ('CGP'), from Hutchison group, with headquarters in Hong Kong. CGP indirectly owned 67% of Hutchison Essar Limited ('HEL'), an Indian entity which carried out telecommunication business in India. The sale was made by another Cayman Islands entity of Hutchison group. The transaction triggered inquiries by the Indian income tax authorities on the premise that the sale of CGP occasioned the transfer of 'controlling interest' in HEL. The Indian authorities sought "to tax the capital gains arising from the sale of the share capital of CGP on the basis that CGP, whilst not a tax resident in India, holds the underlying Indian assets". The case against Vodafone Netherlands was its failure to deduct tax on the consideration paid by it to Hutchinson, which made is liable for proceedings under the Indian Income Tax law, including for interest and penalty.

Vodafone Netherlands challenged the jurisdiction assumed by the Indian authorities before the High Court citing the offshore nature of the transaction and *inter alia* contending non-applicability of the tax-deduction provisions on transactions between non-residents. However, the High Court decided against Vodafone Netherlands.[1] In appeal, Vodafone Netherlands found its stand vindicated by the Supreme Court which annulled the tax proceedings against it.[2] The Supreme Court concluded that the transaction "fell outside India's territorial tax jurisdiction", being a transaction between non-residents and, thus, the tax deduction provisions were also not applicable.

The following months witnessed the presentation by the GOI of its legislative proposals to the Indian Parliament. The Finance Bill, 2012[3] was replete with retrospective amendments reversing the propositions[4] emerging from the Supreme Court decision. The official explanation[5] extended by the GOI was that "[c]ertain judicial pronouncements have created doubts about the scope and purpose" of the legal provisions, and "[t]herefore, there is a need to provide clarificatory retrospective amendment to restate the legislative intent in respect of [their] scope and applicability … and also to make other clarificatory amendments for providing certainty in law."[6] While changes were proposed to apply across-the-board to all persons, a specific 'validation' proposal was made which is understood to be solely for overturning the Supreme Court decision in favour of Vodafone Netherlands.[7] As a consequence, the demands quashed by the Supreme Court stood revived and recovery proceedings were initiated against Vodafone Netherlands.

Investment Treaty dispute

The application of 2012 retrospective amendments against Vodafone Netherlands led to strenuous discussions between it and the GOI. The consultation process failed owing to the GOI's refusal to revisit its position; in particular indicating that the retrospective legislation had parliamentary sanction and thus no longer within the government's realm. This led Vodafone Netherlands to initiate formal dispute in 2014 under the Indo-Dutch BIT which was referred to PCA in 2016 for arbitration.[8] India subsequently announced a settlement scheme[9] in 2016 but it was not opted by Vodafone Netherlands which continued to pursue the arbitration. In 2017, Vodafone initiated another investment arbitration against India invoking the India-UK BIT. This claim was challenged before the Indian courts which declined to interfere in the arbitration proceedings which are currently ongoing.[10] Issuing the award in 2016 arbitration, the PCA has specifically rejected the jurisdictional challenge by India which has fundamental objections to its tax laws being subjected to investment treaties.

Dissecting the Tax-Sovereignty perspective

There is not much ado about the acknowledged principle that, similar to defence, territorial integrity, state security, criminal justice system, etc., taxation is firmly within the exclusive realm of the sovereign.[11] The question instead is whether the sovereign forgoes its untrammelled prerogative to define tax law and policy upon executing a treaty. This debate is neither unique nor unprecedented. Bulk of international law is based upon bilateral and multilateral treaties, including treaties which limit the manoeuvrability of treaty-members in tax paradigm. The edifice of World Trade Organisation, as an illustration of a multilateral treaty, and Double Taxation Conventions, representing bilateral treaties, is pedestaled upon sovereign nations restricting their tax laws in wake of treaty commitments. Then why the sovereignty clamour in case of investment treaties? The argument is more nuanced than apparent. In the case of multilateral and bilateral treaties, the stated position is that there is no 'cession' of sovereignty and instead 'pooling' of sovereignty in so far as the treaty partners collaborate to define their respective taxing entitlements. This is in contrast to investment treaties wherein, by their very design, state-actions of the host country are pitted against their likely effect on third-party investors. To exemplify this aspect, for illustration, besides its Article 10 which provides for resolution of disputes between the contracting States, Article 9 of the Indo-Dutch BIT stipulates an arbitration mechanism to adjudicate "dispute between an investor of one Contracting Party and the other Contracting Party in connection with an investment in the territory of the other Contracting Party". In other words, the arena shifts from a typical state-versus-state dispute to state-versus-investor dispute in investment treaties.

The rub, furthermore, comes from a sovereign being subjected to defend its tax-policies before a tribunal. In other words, the actions of the State are treated, almost likely, at par with actions of private parties in the case of investment treaties. Instead of mutual negotiations, as in the case of tax treaties, a State is required to defend its tax policies *qua* the particular investor in the investment treaties paradigm. Questions thus arise, such as, whether an ad-hoc tribunal can appreciate the tax policies and laws of the host state *vis-à-vis* a formal court process; is a tribunal inherently unequipped, given its limited mandate, to examine the justifiability of the tax policy from the selective prism of the complaining investor; etc. Thus, the objection to bringing fiscal-law driven issues within the realm of the investment treaty.

Assessing the fairness of 'fair and equitable standard'

It is interesting to note that the 'fair and equitable standard' of treatment confirmed to the investor is housed under the provision which guarantees 'national treatment' and 'most favoured nation treatment' to the investors in the host country. Does this setting imply that the 'fair and equitable standard' is *vis-à-vis* all investors from the source country or is the test singular *qua* each investor. To illustrate in context of Dutch BIT, would the 'fair and equitable standard' be triggered only when the Indian law discriminates Dutch-investors as a class *vis-à-vis* Non-Dutch investors or extends even to examination of circumstances affecting each Dutch-investor. This issue gains importance between most taxation laws are agnostic to individual-parties and generally apply to a class of persons. Thus, the remit of the fair and equitable standard becomes crucial. One is handicapped, in the absence of the detailed award of the PCA, to determine if such argument was indeed raised by India to contend that the validation law specific to Vodafone Netherlands could not be assessed by the tribunal.

India has revised its position on scope of investment treaties explicitly objects to such investors' claims *qua* its tax policy and law. It has notified a revised BIT model[12] and reportedly terminated scores of investment treaties which are not in line with its revised position.[13] Unsurprisingly, the 'fairness and equitable standard' has been omitted in the revised model wherein protection is available only against limited situations enumerated in the treaty replacing the earlier *carte blanche* approach.[14] The 'fairness and equitable standard' appears to have been replaced by measure which guarantees procedural fairness, which exemplifies India's stand that substantive tax policy cannot be examined by the tribunal from a 'due process' perspective.

Latitude available to investment treaties

One is compelled to speculate the reasons for the award but clearly there are certain findings which can be expected in the award to have concluded such. Some of these would lie within the domain of investment law.[15] The tax-law related findings would pose interesting inquiries on the latitude of the BITs, particularly the issue whether the host-States give a wide-berth to the investors as regards compliance with their fiscal laws. To illustrate, did the tribunal conclude that the BIT can shield the investor even from a tax deduction obligation. This is because the case of India against Vodafone Netherlands has throughout been that it is obliged to deduct and remit tax from the payment made by it on the capital gain accruing to the seller and proceedings have been initiated against it owing to the default in such remittance. Such a conclusion would clearly raise eye-brows particularly because (i) the BIT itself states that the investments would be governed by law of host State[16] and (ii) tax-deduction obligation is arguably not a violation of fair and equitable standard.

On a larger level, the award also raises critical questions whether investment treaties overwhelm the taxation realm. To enumerate a few; does the execution of a BIT restrict the host State from revisiting its tax policies and laws; is "the untrammelled constitutional authority of Parliament to reinstate the law by legislatively overruling judicial decisions is restricted because the government has executed an investment treaty with another nation";[17] does the rigours of investment treaty constitute a reverse-discrimination against the citizens of the host State given the applicability of host State tax laws on them *vis-à-vis* the foreign investors; etc.

India's revised BIT model and way forward

India's revised BIT model clearly has reflections on the future of investment treaties. A specific exclusion is carved out for "any law or measure regarding taxation, including measures taken to enforce taxation obligations".[18] If this was not enough, a detailed explanation has been added to *inter alia* declare that (i) what constitutes tax-measure is the sole prerogative of the host State, and (ii) such measures are non-justiciable.[19] Certain other clauses of the revised model clearly manifest India's learnings from the Vodafone arbitration. To enumerate a few, (a) the revised model also carries an obligation to treaty jurisdictional challenge as a preliminary issue and dismiss frivolous claims,[20] (b) mandatory publication of information (as opposed to continentality of tribunal proceedings),[21] (c) the tribunal's obligation to accord "high level of deference that international law accords to States with regard to their development and implementation of domestic policies",[22] (d) ability of the contracting States to jointly clarify scope of BIT provisions,[23] (e) non-binding nature of award *qua* third parties,[24] (f) widely framed exceptions and denial of benefit clauses,[25] etc.

To conclude, it is evident that Vodafone has pioneered another clear change in India's policy landscape. It's tax dispute has been instrumental is delineation and the subsequent legislative course-correction in capital gains, indirect transfer taxes, etc., not just in India but across the globe.[26] The outcome of enforcement and subsequent proceedings arising out of the PCA's award are anyone's guess but the arbitration experience of India is, similarly, bound to cause passionate review by other countries of their positions on scope of investment treaties. It will not be a surprise if moving forward the trend further gains momentum and as a global standard tax is excluded from scope of investment treaties.

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[1] High Court decision of September 8, 2010. See https://indiankanoon.org/doc/1488702/

[2] Supreme Court decision of January 20, 2012. See https://indiankanoon.org/doc/115852355/

[3] Finance Bill, 2012. See http://164.100.24.219/billstexts/lsbilltexts/AsIntroduced/Finance%20Bill,%20Eng..pdf

[4] For illustration, see Section 3, 4, 75 of the Finance Bill, 2012.

[5] Memorandum to Finance Bill, 2012. See https://www.indiabudget.gov.in/budget2012-2013/ub2012-13/mem/mem1.pdf

[6] *Id.*, pg. 19.

[7] Section 113, Finance Bill, 2012.

[8] See https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/581/vodafone-v-india-i-

[9] The Direct Tax Dispute Resolution Scheme, 2016, vide Chapter X, Finance Act, 2016.

[10] For details, see http://arbitrationblog.kluwerarbitration.com/2018/10/01/state-courts-and-bit-arbitrations-cautious-optimism-in-the-vodafone-v-india-saga/

[11] The Indian Supreme Court has categorically declared that taxation is an embodiment of sovereignty. See, Supreme Court decision of November 11, 2016 in *Jindal Stainless* https://indiankanoon.org/doc/141946357/

[12] Available at https://dea.gov.in/sites/default/files/ModelBIT_Annex_0.pdf

[13] See https://hsfnotes.com/arbitration/2017/03/16/mixed-messages-to-investors-as-india-quietly-terminates-bilateral-investment-treaties-with-58-countries/

[14] Relevant excerpts from Article 3 of India's revised BIT model state:

"3.1 No Party shall subject investments made by investors of the other Party to measures which constitute a violation of customary international law through: (i) Denial of justice in any judicial or administrative proceedings; or (ii) fundamental breach of due process; or (iii) targeted discrimination on manifestly unjustified grounds, such as gender, race or religious belief; or (iv) manifestly abusive treatment, such as coercion, duress and harassment.

3.2 Each Party shall accord in its territory to investments of the other Party and to investors with respect to their investments full protection and security. For greater certainty, 'full protection and security' only refers to a Party's obligations relating to physical security of investors and to investments made by the investors of the other Party and not to any other obligation whatsoever."

[15] For illustration, it is imaginable that the tribunal ought to have concluded that an indirect acquisition of capital interest in an Indian entity by acquiring a foreign parent entity which holds Indian interests *via* ineligible (i.e. non-BIT protected) corporate layers nonetheless amounts to investment for the purpose of the Indo-Dutch BIT.

[16] Article 11, Indo-Dutch BIT.

[17] See, Mukesh Butani & Tarun Jain, *What next after the Vodafone tax arbitration?* Available at https://www.fortuneindia.com/opinion/what-next-after-the-vodafone-tax-arbitration/104758

[18] Article 2.4(ii), India's revised BIT Model.

[19] *Ibid*. It states, "[f]or greater certainty, it is clarified that where the State in which investment is made decides that conduct alleged to be a breach of its obligations under this Treaty is a subject matter of taxation, such decision of that State, whether before or after the commencement of arbitral proceedings, shall be nonjusticiable and it shall not be open to any arbitration tribunal to review such decision."

[20] Article 21, India's revised BIT Model.

[21] Article 22, *ibid*.

[22] Article 23, *ibid*.

[23] Article 24, *ibid*.

[24] Article 27, *ibid*.

[25] Articles 32, 33, 35, *ibid*.

[26] For illustration, see OECD's Taxation of Offshore Indirect Transfers Toolkit, available at https://www.oecd.org/tax/taxation-of-offshore-indirect-transfers.htm

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