The sovereign right to tax is not absolute

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Mains GS 3 : Government policies and interventions for development in various sectors and issues arising out of their design and implementation.

Context:

- Recent amendments in the Taxation Laws (Amendment) Act nullify the tax clause provision that allows the government to levy taxes retrospectively.
- The 2012 amendment overturned the Supreme Court's decision in Vodafone International Holdings v. Union of India and made the income tax law retroactively applicable on indirect transfer of Indian assets.

The retrospective taxation:

- The retroactive amendment resulted in Vodafone and Cairn Energy suing India before Investor-State Dispute Settlement (ISDS) tribunals of India-Netherlands and India-U.K. bilateral investment treaties (BITs).
- Both the tribunals held that India's retroactive amendment of tax laws breached the fair and equitable treatment provision of the two BITs.

Sovereign right to tax:

- Several ISDS tribunals have recognised the fundamental principle that taxation is an intrinsic element of the state's sovereign power.
- For instance, in a case known as Eiser v. Spain, where foreign investors challenged a tax imposed by Spain on electrical producers under the Energy Charter Treaty, the tribunal held that the power to tax is a core sovereign power of the state that should not be questioned lightly.

- In El Paso v. Argentina, where the investors challenged several facets of Argentinian tax measures as breaching the United States-Argentina BIT, the tribunal held that the tax policy of a country is a matter relating to the sovereign power of the state, and thus “the State has a sovereign right to enact the tax measures it deems appropriate at any particular time”.
- The ISDS tribunals have also held that whenever a foreign investor challenges states’ taxation measures, there is a presumption that the taxation measures are valid and legal.
- For instance, an ISDS tribunal in Renta 4 v. Russia said that when it comes to examining taxation measures for BIT breaches, the starting point should be that the taxation measures are a bona fide exercise of the state’s public powers.

Limits on the right:

- Notwithstanding the state’s sovereign right to impose taxes and the presumption about the validity of taxation measures, there are certain limits on the exercise of this public power.
- The two most used BIT provisions to challenge a state’s taxation measures are expropriation and the fair and equitable treatment provision.
- In the context of expropriation, one of the key ISDS cases that explained the limits on the state’s right to tax is Burlington v. Ecuador.
- In this dispute, investors challenged Ecuador’s windfall tax imposed on excess profits resulting from oil exploration under the United States-Ecuador BIT.
- The tribunal held that under customary international law, there are two limits on the state’s right to tax.
- First, the tax should not be discriminatory; second, it should not be confiscatory. In another ISDS case, EnCana v, Ecuador, a Canadian corporation sued Ecuador for value-added taxes under the Canada-Ecuador BIT.
- The tribunal held that a state’s tax measures would amount to an expropriation of foreign investment if the tax law is extraordinary, punitive in amount, or arbitrary in incidence.

fair and equitable treatment:

- In the context of the fair and equitable treatment provision, foreign investors have often challenged taxation measures as breaching legal certainty, which is an element of the fair and equitable treatment provision.
- Although legal certainty does not mean immutability of the legal framework, states are under an obligation to carry out legal changes such as amending their tax laws in a reasonable and proportionate manner.

Public policy justification:

- The tribunal in Cairn Energy v. India said that taxing indirect transfers is India's sovereign power and the tribunal would not comment on it.
- However,such matters are not of "absolute, unquestioning deference and there are limits o n it".
- Thus, India's right to tax in the public interest should be balanced with the investor's interest of legal certainty.
- In the context of amending tax laws retroactively, such an action should be justified by a specific purpose that could not be accomplished by applying taxes prospectively.
- The tribunal held that the public purpose that justifies the application of law prospectively will usually be insufficient to justify the retroactive application of the law.
- There must be an additional public purpose to justify the retroactive application of the law.
- For example, India argued that the 2012 amendment was to ensure that foreign corporations who use tax havens for the indirect transfers of underlying Indian assets pay taxes.
- However, the tribunal held that this objective could be achieved by amending the income tax law prospectively, not retroactively.
- It is critical to bear in mind that the tribunal did not rule against retroactivity of tax laws per se but against the retroactive application that lacked public policy justification.

Carving out taxation measures

- India in its 2016 Model BIT carved out taxation measures completely from the scope of the investment treaty.
- Nonetheless, carving out taxation measures from the scope of the BIT does not mean that states are free to do as they please.
- As it was held in Yukos Universal v. Russia, if states act in bad faith towards foreign investors or abuse their right to tax or adopt mala fide taxation measures, they won't be able to take the benefit of the carve-out provision.

Conclusion:

The biggest takeaway from this nine-year-long sordid episode of retrospective taxation is that India should exercise its right to regulate while being mindful of its international law obligations, acting in good faith and in a proportionate manner.

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