

DATE OF PUBLICATION

31.12.2022



THE LEGAL VIDYA

ISSN (O) : 2583 - 1550

VOLUME 3, ISSUE 2
THELEGALVIDYA.COM

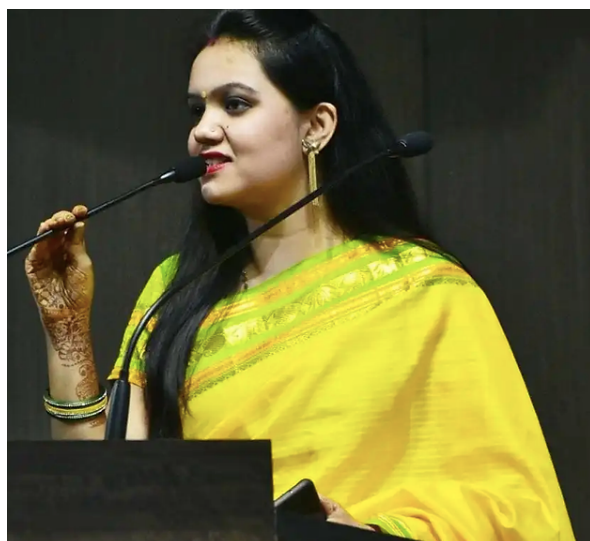


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Ma’am urges the young researchers to focus on the topics which are innovative and most importantly any field which interests their legal acumen.

Ma’am says that that research is at a very nascent stage in India, especially in the field of law and wishes to students that they should start focusing on improving their research skills and publishing quality papers.”

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The Legal Vidya is a student(s) initiative run online journal (Two Issues Per Year) started in 2020 with the aim of reaching youths of the nation, budding lawyers, students and academicians to bring forth the legal knowledge at your fingertips.

We are here to provide you with a lucid way of learning law with the help of daily blogs pertaining to the latest/other legal issues going on in the country.

We also provide legal advice and needed legal awareness to the masses with a pioneering objective of reaching the underprivileged and serving the idea of Free Legal Aid to them. (Article 39A of the Constitution of India).

We would be appraised to welcome blogs from the readers too. Readers can submit their blogs at contact@thelegalvidya.com.

Frequency Of Publication: Two Issues Per Year

Language: English

Start Year: 2020

Format Of Publication: Online

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ISSN (O) : 2583 – 1550

Open Access Law Journal

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The Legal Vidya
Volume 3 Issue 2, December, 2022, Page Nos. 18 to 26

**OVERDUE BUT INDISPENSABLE: JOURNEY AND WITHDRAWAL OF
RETROSPECTIVE TAXATION IN INDIA**

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INTRODUCTION

‘Every government has the right to levy taxes; however, no government has the right to cause misery and harassment to the taxpayer and the torment feeling that is made a victim of perceptible injustice while doing so..’

~Nani Palkhiwala

Over the centuries, there is a fundamental change that can be witnessed in the theories of the role played by a sovereign State. States have discarded the theory of being a mere protector of law and order and justice delivery systems and accepted the duty to establish the developed welfare state. Tax levy and collection has always been one of the most contentious tasks, with some seeing it as nothing more than legalized theft by the government. However, the functions of government are expanding so much that the need for revenue generation with proper structure is inevitable. The tax statutes or fiscal statutes are subjected to constant amendments as the need for the revenue differs every year. The government is duty bound to collect the revenue in such a way and to such an extent that the state does not run in deficit financing. Hence, the tax system is necessary notwithstanding the unwelcoming views of the people. The bar of controversies surrounding the taxation gained additional fuel when the government started implementing taxation retrospectively. The retrospective taxation on its face value sounds problematic as it raises liability on past transactions. However, the legality and constitutionality of the same have been upheld by the Courts several times.

Legal battles of *Vodafone*¹ and *Cairn*² cases illustrate how aforementioned amendment caused a havoc for the country in the International Arbitration regime as well. Imposition of retrospective taxation was an explicit violation of various Bilateral Investment Treaties (BITs) and led to significant financial ramifications for the specific foreign companies, resulting in exorbitant litigation both within India and outside. The said international controversies have paved the way for a need to rethink the government's stance regarding retrospective taxation. Surprisingly, the government of India has recently brought an amendment with a view to ending the controversies and disputes surrounding the retrospective amendment. Through this article, the authors aimed to analyze the conundrums of retrospective taxation followed by its implications on the Indian economy and the International Arbitration regime. The authors have based their analysis on two landmark judgements of *Vodafone* and *Cairn Energy*, concluding with their opinions and constructive suggestions.

A GLANCE AT RETROSPECTIVE TAXATION: INDIAN PERSPECTIVE

The concept of taxation is considered to be a systemic approach to generate revenue for an elected government, the prime objective of which is to attempt a drive towards an egalitarian state. At this stage, it is important to deconstruct the controversial phenomenon called "Retrospective Taxation." The process of levying tax can be done to the transaction which has occurred in past and such process will be termed as retrospective taxation. The collection of tax is said to be valid if it is collected with the authority of law by the virtue of Article 265.³ It is significant to note that the advocates of retrospective taxation always use the absence of any constitutional provisions prohibiting the retrospective operation of law to support its validity. The said proposition was confirmed by the Court in the case of *Chhotabhai Jethabhai Patel case*, wherein it was stated that when the authority is given to collect the taxes, the legislature is equally competent to make the retroactive and retrospective law to affect the liability from the date which was earlier than the actual date of imposition of liability.⁴

It is also important to note that the competent legislature can make laws that may operate negatively for some class people. The Apex Court in *Ashok Kumar v. Union of India* made the apt remark regarding the validity of any law by stating that "if the legislature is competent to make a particular law, its motive in making it or the fact that the law would operate harshly on some person is irrelevant."⁵ Hence, retrospective taxation may result in harsh consequences for any individual but that doesn't invalidate the law merely on such grounds.

Albeit, the makers of the Indian Constitution and judicial pronouncement have evolved the scope of Article 14 of the Indian Constitution in such a way that any arbitrary actions by the government can be held to be

¹ *Vodafone International Holdings B.V. v Union of India & Anr.*, (2012) 6 SCC 613.

² *Cairn Energy PLC and Cairn UK Holdings Limited (CUHL) v. Government of India*, PCA Case No. 2016-7.

³ INDIA CONST. art. 265.

⁴ *Chhotabhai Jethabhai Patel And Co v The Union Of India And Anther*, 1962 AIR 1006.

⁵ *Ashok Kumar v Union of India*, 1988 SCR (2) 800.

unconstitutional under the said Article.⁶ In the case of *R.C. Tobacco Pvt Ltd v. UOI*, the Court noted that firstly it has to be decided that the retrospective application is oppressive and confiscatory so as to violate the constitutional principles enumerated under Articles 14 and 19 of the Constitution.⁷ Thus, the parties who want to challenge the validity of any retrospective taxation can bring a claim under Article 14 of the Indian Constitution by arguing that such taxation is unreasonable or arbitrary and violative of Part III of the Constitution.

One might question that if retrospective taxation is such a controversial step by the government, what is the prime purpose behind the levying tax retrospectively? The foremost rationale behind bringing the retrospective tax is to bridge the existing gap between current and past taxation policy. Majorly, such actions are taken when the gap or difference is very extensive. It has been seen that situation often arises wherein the ambiguous nature of provisions has been used as a loophole to further the agenda of tax evasion. In such situations, provisions regarding retrospective taxation have been inserted as a clarification to cease the loophole to exist and thereby act as a rectification.⁸ Surprisingly, there are multiple instances where the provisions of retrospective taxation are incorporated as a result of validating clause. The validating clause with respect to taxation signifies the amended provision validating collection of taxes even though an otherwise judgement of the Court exists on such tax collection. On its face value, such amendment or change in provisions look problematic as it nullifies the judgement of the Court. The validity of such clause has been rendered by the pronouncement in the case of *Shri Prithvi Cotton Mills Ltd. v Broach Borough Municipality*. the separation of power and its connection with accepting the validating clause was reflected. The Court denoted that by the virtue of having the power to make retrospective law, the legislature can correct or modify or amend the provision in such a way that it would validate the past collection even in the existence of contrary judgment.⁹ Albeit, the amendment has to be done in such a way that it hits the very basis on which the Court's decision was pronounced and the same decision was not possible in an altered situation.¹⁰ Hence, the situation may arise where the retrospective taxation will be justified as a necessary evil to avoid a greater evil. Retrospective taxation is not a newly adopted concept. The said tool has been used by the government very frequently after the independence. However, it is recently in limelight because of Vodafone and Cairn Case. Earlier, the dispute and challenges relating to retrospective taxation by the Indian Government were addressed in the domestic courts but the said cases-initiated tension in the international arbitration regime relating to retrospective taxation.

⁶ INDIA CONST. art. 14.

⁷ *R.C. Tobacco Pvt Ltd v UOI*, (2005) 7 SCC 725

⁸ Standard, B., n.d. *What is Retrospective Tax?*. [online] Business Standard. Available at: <<https://www.business-standard.com/about/what-is-retrospective-tax#collapse>> [Accessed 14 November 2021].

⁹ *Shri Prithvi Cotton Mills Ltd. v Broach Borough Municipality*, 1970 AIR 192.

¹⁰ *Id.*

VODAFONE AND CAIRN

VODAFONE INTERNATIONAL HOLDINGS B.V. v UNION OF INDIA & ANR.¹¹ :

FACTS: In 2007, British telecom giant Vodafone paid \$11 billion for a majority stake in Hutchison Whampoa. This transaction was handled by Vodafone's Dutch subsidiary. The Indian government immediately demanded Rs 7990 crore from Vodafone for capital gains.

ISSUE: The legal question was whether the share transfer between two foreign companies amounted to a transfer of capital assets in India, and whether such a contract is taxable in India.

POINT OF LAW: The Indian government won at the Bombay High Court, so Vodafone quickly filed an appeal with the Supreme Court. In 2012, the Supreme Court ruled in Vodafone's favour. The Supreme Court made its decision based on Section 9 of the Income Tax Act, which says that tax authorities can't tax capital gains from the indirect transfer of shares of an Indian company when the main transaction was between two foreign companies buying a foreign company with a majority stake in the Indian company. As a result of this Supreme Court decision, a huge number of transactions and taxes were not done by the tax department.

So, Section 9 of the Income-tax Act of 1961 was changed by the Finance Act of 2012 to say that if you own shares or have an interest in a foreign company or entity, you are considered to be in India if a large part of its value comes from assets in India. Taxes were put on any capital gain from the sale of these shares or interests in a foreign company that gets a big part of its value from assets in India. The government didn't stop there, though. It also made the new tax apply back to 1962. The India-Netherlands Bilateral Investment Treaty was used as the basis for Vodafone's appeal to the The Hague Court of Arbitration. In this situation, India lost.

CAIRN ENERGY PLC AND CAIRN UK HOLDINGS LIMITED (CUHL) v. GOVERNMENT OF INDIA¹²:

FACTUAL MATRIX: A number of cross-border transactions were changed by the Vodafone decision and the change to Income Tax Act Section 9(1)(i) that came after it. In 2015, the Indian government gave Cairn UK Holdings Limited (Cairn UK) a draught tax assessment of 10,247 crores for an alleged capital gain from an internal corporate restructuring in 2006. This was similar to what Vodafone had to pay. In 2014, India's income tax department decided that the transfer of shares in Cairn Jersey in 2006 had the same effect as transferring the business in India. As a result, Cairn UK had to pay capital gain tax in India because the country's income tax laws had been changed in a way that made them apply backwards. The Income Tax Department sent Cairn a notice that he needs to pay Rs. 22,100/- crore.

¹¹ Vodafone International Holdings B.V. v Union of India & Anr., (2012) 6 SCC 613.

¹² Cairn Energy PLC and Cairn UK Holdings Limited (CUHL) v. Government of India, PCA Case No. 2016-7.

JUDGEMENT:

India was the target of a complaint that Cairn sent to the Investor-State Dispute Settlement Arbitral Tribunal in The Hague. In December 2020, a three-person arbitral panel ruled in favour of Cairn, saying that India had broken the India-UK BIT's fair and equal treatment rule. The tribunal told India to pay Cairn UK more than \$1.2 billion in compensation for losses caused by the expropriation of its investments in India in 2014, as well as continued attempts to impose retroactive tax measures and a failure to treat the company and its investments fairly and equitably.¹³

It's important to remember that Cairn has sued Air India. Cairn wanted to bring charges against Air India and call it the "alter ego of the Indian government" because the Indian government owns it and has a lot of power over it. People say that Air India is "legally indistinguishable from the state itself" and that the Indian government should be held jointly and severally responsible for the amounts owed to Cairn.

Cairn's seizure of assets can't be called unfair or illogical because it's reasonable for an investor to expect that a country's laws will be enforced within its legal framework, which will be protected by the courts. Even if a law is changed after the fact, it throws all of the investor's fiduciary calculations off.

INTERNATIONAL COMMERCIAL ARBITRATION AND RT : INTERACTION OF BILATERAL INVESTMENT TREATIES (BITS), AND FAIR AND EQUITABLE TREATMENT CLAUSES (FET)

The Vodafone and Cairn cases, which got a lot of attention, are a stark reminder that international law limits even the sovereign taxation rights of states. States are in charge of taxes and can decide if a transaction is taxed or not. So, India can defend its right to use its sovereignty to take measures for security or taxation. But the way taxes are collected, like when they are used to target, discriminate against, or unfairly impose liability on foreign investors, can be tested fairly under a BIT.

The BIT was made so that investments made by different countries would be safe. Before making a cross-border investment, the investor usually wants to know that the relationship will last for a long time. Contracting countries have to treat countries that invest in them in a way that is "fair and equitable" (FET). The FET clause has been used in a number of international disputes in the past few years. This rule is being used more and more in BIT arbitrations. BIT and investment arbitration cases are an area of law that is always changing. The basics of BIT arbitration in India have been called into question by the number of investment arbitrations and post-arbitration proceedings. India has made a number of mistakes as a disputing party in BIT arbitrations. Sometimes this was because of weak treaty

¹³ Hindustan Times. 2021. *Due to its 2012 blunder, India's Cairn challenge at The Hague is likely to fail*. [online] Available at: <<https://www.hindustantimes.com/opinion/due-to-its-2012-blunder-india-s-cairn-challenge-at-the-hague-is-likely-to-fail-101617111890763.html>> [Accessed 14 November 2021].

clauses and sometimes it was because India didn't know enough about the law. So, in this section, the authors will look at Bilateral Trade Investments and related clauses, which are an important part of India's experience with international arbitration.

Because of a violation of the FET clause in the BITs, arbitral tribunals ruled in favour of the investor in both the Cairn and Vodafone cases. In the Cairn case, the tribunal decided if the FET standard was broken by applying the 2012 change backwards. Even though there is no one-size-fits-all definition of what a FET clause is, ideal FET clauses include transparency and respect for legitimate expectations, the stability and consistency of the law and administrative decisions, the application of due process, and protection from unfair and arbitrary treatment.

The tribunal used the test of a clear and important public policy goal that justifies not only general changes to regulations but also their use in the past. India tried to defend itself against the retrospective amendment by saying that fighting systemic tax evasion by foreign investors was not a good enough reason to apply the 2012 amendment backwards. This was because India had not shown that systemic tax evasion was happening, and India had other legal tools to deal with tax evasion through abusive transactions.

When it comes to FDI disputes, India is getting more and more involved in BIT-initiated arbitration proceedings and post-award proceedings that make it hard to enforce awards. The recent case of Devas Multimedia Private Ltd v. Antrix Corporation, NCLT, Bengaluru Bench, shows how complicated things can get even after a foreign investor or company is given a good decision. In the case of Antrix, Devas won a commercial arbitration award, and its investors won a number of treaty arbitration awards. During the stage of enforcing the award in India, however, a National Company Law Tribunal issued an order at the end of May 2021 to close down Devas on the grounds that the company was set up in India through fraud.

Most investment arbitrations now follow conventions like the ICSID Convention and the UNCITRAL Arbitration Rules. India has not signed the ICSID Convention, which is a popular place for BIT arbitrations. But some recent 2019 decisions, like Tenoch Holdings Limited (Cyprus), Maxim Naumchenko (Russian Federation), and South-East Asia Entertainment Holdings Limited, give BIT arbitrations in India some hope.

To make the international arbitration system even stronger, it is important to think about what will happen if a treaty obligation is not met. For example, the global lockdown imposed on the majority of nations could make the obligations of a treaty less satisfying. Investors may be able to get their money back if something goes wrong. Since most BITs allow for expropriation (both direct and indirect) and general exceptions, India should work on making it a habit to interpret comprehensive BITs in all of its international treaties. This will make sure that there is the least amount of confusion and outside interference.

SCRUTINIZING RETROSPECTIVE TAXATION & AMENDMENT 2021

Retrospective taxation is termed as unreasonable and obstructive as it disturbs the tax planning and management done by assesses. The creation of additional burden and tax planning can be tackled by big firms and businesses but when the same is happening with the small scale businesses, such retrospective taxation can deprive their rights of doing business given under Article 19 of the Indian Constitution.¹⁴

Retrospective taxation can also be questioned on the grounds of principle of taxation. *Kautilya* (Chanakya) gave multiple basic principles of taxation which are still accepted as governing rules of the tax system. *Kautilya* portrays that there should be stability in the tax structure.¹⁵ The retrospective tax is not only antithesis to stable tax structure but if applied such taxation rigidly it will have the capacity to destabilize the already existent stable structure.

The great economist Adam Smith has also propounded “Canons of Taxation” which serve as a guide to taxing authority. One of the canons is a ‘*canon of certainty*’ which advocates the taxing system should be certain. Adam Smith thought that the tax that each person must pay should be clear and not up to chance, and that both the person paying the tax and everyone else should know when and how much they have to pay.¹⁶ It is also important to note that certainty in the tax system is beneficial to the taxpayer as well as to the authority as it results in more tax compliance. Retrospective taxation breaches the principle of certainty.

Adam Smith also proposed the convenience canon. If the retrospective taxation is scrutinised from the said principle, the unreasonableness of such taxation will be reflected comprehensibly. Retrospective taxation is rather one of the most inconvenient forms of taxation as a taxpayer can never prepare or plan to deal with such liability. It is important to note that these concepts of the tax system being stable, certain and convenient is not only a theoretical concept but has equal practical force.

Increasing India's ranking in the ease of doing business index is one of the government's top priorities for economic development. A higher ranking in the ease of doing business index will entice more foreign companies and investors to expand their operations in India. The 'Committee for Reforming the Regulatory Environment for Doing Business in India' submitted its report to the Ministry of Corporate Affairs in 2013, which included some

¹⁴ INDIA CONST. art. 19.

¹⁵ Sihag, B., n.d. *Kautilya on Principles of Taxation*. [online] Researchgate. Available at: <https://www.researchgate.net/publication/46545932_Kautilya_on_principles_of_taxation> [Accessed 13 November 2021].

¹⁶ Seth, T., n.d. *Canons of Taxation Enunciated By Adam Smith – Discussed!*. [online] Economics Discussion. Available at: <<https://www.economicsdiscussion.net/taxes/canons-of-taxation-enunciated-by-adam-smith-discussed/1948>> [Accessed 13 November 2021].

observations on the impact of retrospective taxation on the ease of doing business. According to the report, retrospective taxation has the unintended consequence of increasing economic uncertainty and acting as a significant barrier for anyone wishing to do business in India.¹⁷

As India works to establish a reputation as an investment-friendly country, it is critical that it make prudent decisions regarding foreign investment and foreign investors, as well as uphold its sovereign obligations to other countries under international treaties. Recognizing sovereign powers while exercising them in accordance with international law and practise is the way forward.¹⁸ National economic goals such as economic growth, capital formation, and international competitiveness should not be discouraged or hampered by the tax system.

It is evident that there was a need to take political action to settle the conundrum of retrospective taxation. Thus, the Taxation Laws (Amendment) Bill¹⁹, Parliament recently passed Bill 2021, which amended the Income Tax Act to ensure that no new tax demand can be raised based on the retrospective amendment if the transaction occurred prior to May 28, 2012. In cases where a demand has already been made such as in 17 cases, the order will be nullified if certain conditions are met. The conditions being withdrawal of appeals and claims.²⁰ The government has taken this step with a dual objective. One being that the government has made it a policy to have a predictable tax regime and to avoid retrospective taxation. The second important goal is that the government doesn't support the idea of Indian tax law being adjudicated through foreign tribunals. This is an attempt to resolve the dispute through the sovereign means of Indian law, rather than through arbitration.

The latest amendment to the law is a strategic step, in response to the government suffering setbacks in its arbitration case against Cairn Energy and the latter obtaining an order to freeze Indian assets in Paris last month. This step has been welcomed by the appellants of international arbitration disputes as well, because Cairn Energy has withdrawn its appeal and stopped seizing assets in exchange of refund of the tax amount they paid.

The decision to eliminate retrospective taxation would boost trust between the government and industry. He stated that the government is pushing the envelope on reforms and that recent legislative changes will benefit small investors and depositors. Prolonging the continuance of retrospective tax has only tarnished the country's image as

¹⁷ Mca.gov.in. 2013. *Report of the Committee for Reforming the Regulatory Environment for Doing Business in India*. [online] Available at: <https://www.mca.gov.in/Ministry/annual_reports/DamodaranCommitteeReport.pdf> [Accessed 13 November 2021].

¹⁸ Loya, K. and Desai, V., 2021. *The Cairn Energy v. India Saga: A Case of Retrospective Tax and Sovereign Resistance against Investor State Awards - Kluwer Arbitration Blog*. [online] Kluwer Arbitration Blog. Available at: <<http://arbitrationblog.kluwerarbitration.com/2021/07/02/the-cairn-energy-v-india-saga-a-case-of-retrospective-tax-and-sovereign-resistance-against-investor-state-awards/>> [Accessed 14 November 2021].

¹⁹ PRS Legislative Research. 2021. *The Taxation Laws (Amendment) Bill, 2021*. [online] Available at: <<https://prsindia.org/billtrack/the-taxation-laws-amendment-bill-2021>> [Accessed 14 November 2021].

²⁰ Nishithdesai.com. 2018. *Bilateral Investment Treaty Arbitration and India With special focus on India Model BIT, 2016*. [online] Available at: <https://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research_Papers/Bilateral_Investment_Treaty_Arbitration_and_India-PRINT-2.pdf> [Accessed 14 November 2021].

a business-friendly destination, prompting many to draw unfavorable international comparisons. Even if it was forced to do so, the government has done well in putting this issue to rest.

CONCLUSION AND A WAY FORWARD

The expression of sovereignty, particularly in modern civilisation, is determined by pragmatism and due process. The retrospective amendment demonstrated that the Indian bureaucracy has a long way to go in changing its conservative mindset. The international controversies resulting from the Vodafone and Cairn case made the Indian Government rethink its proposition relating to retrospective taxation. The 2021 Amendment by removing retrospective taxation paved a way for modernise economic growth. The said step will represent India as a promoter of ease of doing business. While much has been done to encourage investment and foreign companies, a more welcoming approach to Bilateral Investment Treaties (BITs) would provide additional impetus to foreign investments in India. Since the model BIT was published in 2016, India has signed BITs with only a few countries, including Brazil, Kyrgyzstan, and Belarus. Foreign investors may be concerned that they do not fully understand India or trust the legal system's ability to deliver justice quickly. The presence of BITs aids in the resolution of information asymmetry and provides a framework of checks and balances for foreign investors. In the event of a dispute, for example, a hearing at a neutral forum provides insurance against policy risk and offer speedy justice.

The country is currently at a crossroads in which rapid economic recovery following the Covid-19 pandemic is critical, and foreign investment can play an important role in promoting faster economic growth and employment. Removing retrospective taxation and promoting ease of doing business will help in attracting FDIs and foreign entities to set up their business in India. Such positive step will generate opportunities for employment and ensures economic growth of the country thereby achieving Sustainable Development Goals (SDGs) 8²¹; decent work and economic growth.

²¹ *Id.*