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Case Analysis: Cairn Energy V the Republic of India (PCA Case No. 2016-7)

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Abstract

The given article illustrates the facts and the analysis of the famous case where the Scottish firm, Cairn India had won an international arbitration case against the Government of India. The company Cairn Energy is basically occupied in the exploration of oil and natural gas in India. The dispute mainly revolves around the tax and investment arbitration agreement between the company and the Government of India. The issue was highlighted when a notice regarding non-filing of tax, was received by Cairn Energy from the department of Income Tax in 2014. The company imposed allegations against the Government of India that the Indian government has violated the terms of the India-UK Bilateral Investment Promotion and Protection Agreement (BIPA) by initiating the retrospective amendment in the Finance Act, 2012. Cairn also claimed that the company has suffered significant damage due to the Indian government's action. In the verdict announced by the Permanent Court of Arbitration, the Indian government has been asked to pay damages worth Rs 8,842 crores (USD 1.2 billion) to the Scottish firm. This article encapsulates the facts, analysis, and the final award declared by the Permanent Court of Arbitration.

Keywords: Arbitration, retrospective tax, award, income tax, foreign direct investment

FACTS OF THE CASE

The roots of the given dispute are directly connected to the amendment made in 2012, in *section 9(1) (i) of the Income Tax Act 1961 [1]*. The amendment was made soon after the very famous Vodafone case. The claim was instituted by Cairn Energy PLC together with Cairn UK Holdings Ltd against the Republic of India. The Claimant in its petition for International arbitration argued that the agreement has been violated on the part of the respondent's and the respondent was held answerable for the aforesaid infringement of the treaty.

In 2006, the Cairn group of companies formed 'Cairn India Limited' which was incorporated in India and the newly formed company received the share transfer from 'Cairn India Holdings limited' incorporated in New Jersey. The Income Tax department claimed that in the aforesaid transaction placed in 2006, they identified an un-assessed taxable income against Cairn India. The outstanding amount of tax stated by ITD is the US $1.6 billion-plus interest and penalties. Further, CHUL's assets were also seized by the Income Tax department to enforce its tax demand [2].

On *21st December 2020*, the award was announced in favour of Cairn Energy by the international arbitration tribunal. The tribunal held that the Indian government has failed to fulfill the terms of the agreement and ordered India to pay USD 1.2 billion as damages.

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The claimant in the given case has discovered USD 70 billion of Indian assets overseas to accumulate payment due from the respondents. This move will place India in the group of Venezuela and Pakistan which faced similar actions [3]. The respondents had filed an appeal against this verdict on the grounds of tax avoidance by the UK oil major. The respondents in the court of arbitration appealed for a stay order on the enforcement of the award in other jurisdictions [4].

The Indian government has to pawn money in some financial security equivalent to the value of assets to save its assets from such seizure and such guarantee will be returned if the court does not find any merit in cairn's case. Cairn Energy is now moving to the courts to get a declaration that if the Indian government fails to make payments then in such a case the state-owned entities such as Air India should be held liable for the discharge of the arbitration award.

ISSUES

The various issues involved in this case can be summarized as:

1. Whether there has been a breach of the UK-India bilateral treaty on the part of the Indian government?
2. Whether the imposition of retrospective tax regime of 2012 on the claimants is arbitrary and discriminatory in nature?
3. Whether or not the transaction of 2006 carried by the Cairn group in India was comprised with the motive of tax avoidance?

CLAIMANTS CONTENTIONS

The following are the various strong contentions presented by the claimants in the case to support their claim or to hold their claim valid before the international court of arbitration. The claimants in the case contended that:

- The application of retrospective tax amendment of 2012 to the claimants was inconsistent with the obligations of good faith.
- The amendment of 2012 to the claimants was arbitrary and discriminatory.
- The amendment is discriminatory in the sense that it was selectively applied and enforced against the claimants by the respondents.
- The specific manner in which the tax amendment was applied to the claimants by the Income Tax department was arbitrary and carried lack of good faith for them.
- While enacting the amended law the non-arbitrary standards were not followed by the Indian government even after giving a virtual guarantee of its arbitrary application.
- The claimants also contended that the respondents had breached Article 3(2) of the Bilateral Investment Treaty since they failed to accord the company with the standards of fair and equitable treatment.
- The respondents in the case had no rational basis to conclude that the unit of the corporation has realized capital gain as a result of the 2006 transactions and thus the application of retrospective tax regime to the company is arbitrary and inequitable.
- There is a complete denial by the claimants with regard to the 2006 transactions that these transactions gave rise to any capital gain subject to any taxation.

The claimants also submitted before the tribunal that the legality objection by the respondents does not fall within the ambit of Article 1(b) of the Bilateral Investment treaty. They further argued that the Government of India had also breached the Article 3(1), Article 5, and Article 7 of the BIT [5].

RESPONDENTS CONTENTIONS

The respondents in their contention clearly repudiate the claim that there has been any breach of FET (Fair and Equitable treatment) on their part. They denied to this very contention of the claimants that concerned to the violation of FET standards.

They gave the following reasons in their defense that why as a matter of Indian Tax law regime, the 2006 transactions were taxable in the respective assessment year irrespective of the amendment of 2012.

- This was because these transactions of 2006 the company had made capital gain in the same year and thus the company was liable to pay tax on such capital gain.
- These transactions were taxable under "look at" doctrine since there were undertaken as tax avoidant transactions.
- These transactions were taxable under 2(47)(vi) of the Income Tax Act, 1961 irrespective of the aforesaid amendment as they necessitate indirect transfer of immovable property.

The respondents further argued that the process of corporate reorganization carried on by the Cairn Energy in 2006 was intentionally designed to evade applicable taxes and thus was tax abusive. They also argued in their defense that these transactions were also to be taxable as sham transactions.

The learned counsel on behalf of the Indian government points out the jurisdictional issue before the tribunal. They submitted that as per Article 9 of the BIT the ongoing dispute does not fall within the jurisdictional limits of the tribunal. This was because it concerns with the returns not the investments. According to the respondents the given tax dispute was not arbitrable [6].

LIABILITY

It has been alleged by the claimants namely, Cairn Energy that an arbitrary and discriminatory treatment was done to them by the Indian government. They also alleged bad faith on the part of the respondents as they retrospectively applied capital gain tax on a transaction by CIHL when the same transaction was not liable to tax. There is a breach of obligations on the part of the respondents under the treaty by enforcing the oil major for the payment of the tax demand.

RELEVANT LAWS APPLICABLE TO THE CASE

The most difficult question which the tribunal had faced is that what the relevant laws applicable to the case are. Since the seat of arbitration is in Hague and the dispute is an international arbitration case, it is governed by the international law. However, the dispute arose because of the 2012 amendment in the Indian Income Tax Act, 1961 where the Indian Revenue Department issued notice to the claimants' regarding avoidance of capital gain tax therefore the Indian laws were thus also applied by the tribunal.

INVESTMENT PROMOTION AND PROTECTION AGREEMENT (BIPA)

Under BIPA India had signed approximately 83 agreements with countries such as the UK, Russia, Germany, and the Netherlands. These agreements are signed to promote Foreign Direct Investments (FDI) and for the assurance of most favored nation status plus fair and equitable treatment. It was contended by the claimants that they have been treated unfairly and inequitably by the respondents, in breach of their obligations under *Article 3(2)* of the aforesaid treaty between India and the UK.

THE 2012 AMENDMENT [RETROSPECTIVE TAX LEGISLATION]

Retrospective tax is a tax which is imposed on the transactions of the past. For example- if there is any amendment in the present tax regime, the aforesaid transaction will also affect the past transactions. One such major example is the 2012 amendment which results in the insertion of Section 9(1) (i) in the Income Tax Act. This was one of the most controversial amendments in the Indian tax regime. Soon after the decision of the Supreme Court in Vodafone case the given amendment was introduced by the Finance Act of 2012 to nullify the verdict given by the Apex Court of India in this case [7]. The infamous Vodafone PLC case and the Cairn Energy's case against the Government of India were the two major cases which were impacted by this amendment.

The claimants (Cairn Energy PLC) contended that the retrospective change of 2012 in the Indian tax law regime was not elucidatory in nature. The amendment was forced to impose tax liability on a retrospective basis to the receivables from the sale of shares of a foreign company. The amendment was made soon after the very famous Vodafone case and had implicated the British telecom to win an Rs 11000 crores tax case in the Supreme Court of India. The respondents denied the contentions given by the Cairn group by contending that the said amendment in no way breaches the UK-India Bilateral Treaty and also said that the 2006 transactions were taxable under the Indian tax regime even before the aforesaid amendment of 2012.

TRIBUNAL's ANALYSIS

The arbitration tribunal in its decision ordered the Indian government to compensate the claimants for the total loss suffered by them and declares that the jurisdiction over the claimant's claim is admissible. The tribunal upholds the decision that the Indian government has failed to fulfill its obligations under the UK-India Bilateral Investment Promotion and Protection Agreement (BIPA) and International Law. The respondent has failed to provide the claimants an equitable and just treatment in violation of Article 3(2) of the aforesaid treaty. The respondents have been asked to pay the costs of arbitration and legal representation to the claimants. US$ 2,005,700.42 has been directed as reimbursement cost for the arbitration and US$ 20,389,413.97 as the cost incurred for arbitration proceedings [8].

CONCLUSION

The award was passed in favour of the company i.e. Cairn Energy and the Indian government were held liable to pay damages to the company. The award declared is non-arbitrary in nature and the Government of India was held accountable for the contravention of an agreement between the two governments. The Arbitral Tribunal was also of the view that the claimants are liable to recover the maximum of the Arbitration costs.

The question of vital importance which the tribunal had to decide upon is whether or not the transaction of 2006 carried by the Cairn group in India was comprised with the moto of tax avoidance. The Tribunal green signalled these 2006 transactions as they were not carried in lieu of tax avoidance by the company and the award was decided in the favour of the investors.

The British Oil major also filed a case against the Government of India to cease its various assets overseas. The company had filed to cease the assets of Air India in the New York District court. The current status of the case as of now the UK oil major has agreed to withdraw all the lawsuits against the republic of India against a settlement of Rs 7,885 crore as tax refund [9]. Vedanta has also agreed to withdraw its suit against the government. This will be a huge step resulting into the favour of the Indian government although the government has to refund a heavy amount to the company. After all these defeat firstly in Vodafone's case then in Cairn's case the government has to relook its retrospective tax regime and the respective amendment, otherwise it will become quite difficult to attract foreign investments into the country. These cases have severely impacted the economy of the country.

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