India Practice Group

To: Our Clients and Friends

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# India: A new dawn?

In 2012, virtually every sector of the Indian economy slowed down, including agriculture, mining, manufacturing and services. At the end of the year, economic growth stood at around 5.3%. It was a huge disappointment for a country whose economy had been racing ahead at 8% plus for the last eight years.

The Indian government admits that investment is critical to revive the economy. Faced with declining growth figures, it has taken some steps to liberalise the economy and make it easier for foreign businesses to invest money into sectors such as retail, aviation and insurance. The long-awaited reforms were the biggest initiated in nearly ten years.

What follows below is a summary of some of the legal reforms that were made in India in 2012.

### Foreign Direct Investment in Single and Multi-Brand Retail Trading

One of the more controversial developments in India in 2012 was the change in policy by the Indian government on investment by foreign companies in single brand retail trading and multi-brand retail trading in India. Previously, foreign companies could only invest in the sale and promotion of single branded products through a joint venture with an Indian company, in which they could invest up to 51%.  Furthermore, investment by foreign companies wanting to sell multi-branded products, such as supermarkets, was completely prohibited.

In a shift in policy last year the Indian government increased foreign direct investment in single brand retail trading up to 100%. As a result, retailers of single branded goods no longer require a partner through which to sell their goods in India thereby providing them with more control over their investment and sales strategy. The government also removed the prohibition on foreign direct investment in multi-brand retail trading, allowing foreign companies to invest up to 51% in multi-brand retail trading subject to certain conditions. The latter reforms on multi-branding retail trading were not without resistance. Despite the changes becoming effective on 20 September 2012, the opposition party attempted to prevent such reforms arguing the adverse impact on small family businesses and filed a motion in the Indian Parliament demanding a withdrawal of such decision. The motion was only defeated early in December allowing the reforms to now go through.

In addition to the reforms on retail trading, the government is now allowing foreign airlines to make investments of up to 49% in the Indian aviation sector. It has raised the foreign direct investment cap in broadcasting from 49% to 74% and is allowing foreign investment in power exchanges. Foreign institutional investors are also now allowed to invest up to 23% in commodity exchanges and the government is even proposing to increase the foreign investment ceiling in the Indian insurance sector to 49% (from the present 26%) and to allow foreign investment in the Indian pension sector (also expected to be 49%).

It is hoped that these reforms will lead to an increase in foreign investment into India, following a decline in 2012.

In particular, it is hoped that the reforms relating to single and multi-brand trading will appeal to foreign retailers seeking to enter the vast Indian retail marketplace. The potential opportunities for retailers that are able to successfully navigate India's foreign direct investment policies are huge. India's population is approximately 1.25 billion people, compared to an estimated 315 million people in the United States. India also has a growing middle class with rising incomes. This has resulted in an increase in spending power, changes to consumer tastes and heightened brand awareness. Furthermore, there has already been an increase in shopping centres and malls to adapt to changes in the habits of Indian consumers. With the opening up of foreign investments in single and multi-brand retail trading, this is likely to increase even further with more demand for quality retail space.

It has been announced that Ikea's proposal to invest $1.93 billion in India has already been cleared by the Foreign Investment Promotion Board in India. Supermarket giants Walmart, Carrefore and Tesco are also seeking to open up more stores in India through appropriate tie-ups. More are expected to follow.

## Arbitration

In September 2012, in the case of *Bharat Aluminium Co v Kaiser Aluminium Technical Services Inc* ("*Bharat*") the Supreme Court of India overruled the severely criticised decisions in *Bhatia International v Bulk Trading* ("Bhatia") and *Venture Global v Satyam Computers* ("*Venture*") which related to the Indian courts' ability to interfere in international arbitration proceedings.

The cases of *Bhatia* and *Venture* related to the interpretation of the Indian Arbitration and Conciliation Act 1996 ("Arbitration Act"), which has two distinct parts:

- Part I applies where the place of arbitration is in India and confers significant powers on the Indian courts to grant interim measures, to appoint and replace arbitrators and to review arbitral awards.

- Part II is concerned with the recognition and enforcement in India of foreign arbitral awards which fall within the scope of the 1958 New York Convention and the 1927 Geneva Convention.

In *Bhatia* the Supreme Court considered a request for interim relief under Part I of the Arbitration Act even though the matter related to an ICC arbitration seated in Paris. The Supreme Court held that the provisions of Part I of the Arbitration Act that applied where the place of arbitration is in India would also apply to international commercial arbitrations seated outside of India, unless the parties had expressly or impliedly excluded its application. This decision was followed by *Venture* Global in which the Supreme Court also held that an LCIA award given in London could be challenged in India on the public policy grounds for reviewing arbitral awards referred to under Part I of the Arbitration Act. As a result, these decisions considerably expanded the scope for Indian courts to interfere in arbitrations seated outside India.

The decision of the Supreme Court in *Bharat* in September 2012 overruled these decisions holding that Indian courts would have no jurisdiction over international commercial arbitrations held outside of India and that instead the courts in the jurisdiction of the seat of arbitration would have exclusive jurisdiction in matters related to appointment, interim measures, challenge and other such provisions contained in Part I of the Arbitration Act. The decision has had the effect of ensuring that Indian arbitration law is now at par with the arbitration laws of other international jurisdictions and has eased the difficulties that foreign investors have been facing in enforcing foreign awards in India against Indian parties.

The only negative point from the decision was that unfortunately in *Bharat* the Supreme Court held that the law would only apply prospectively to agreements entered into <u>after</u> 6 September 2012. As a result the application of the Arbitration Act to an arbitration arising as in respect of a dispute under an agreement entered into on or before 6 September 2012 will still be subject to the old regime, whilst the application of the Arbitration Act to an arbitration arising as in respect of a dispute under an agreement entered into on or after 7 September 2012 will be subject to the new regime.

In fact, based on this decision, the parties in *Bharat* who challenged the law laid down by *Bhatia* and *Venture*, and who have been successful in their challenge, will still be subject to the old law laid down by *Bhatia* because it related to arbitration following a dispute under an agreement entered into before the date of this judgment.

## Foreign Lawyers Practising in India

The question of foreign lawyers practising in India is unlikely to be resolved in the near future. However, the good news is that last year, the Chennai High Court in *AK Balaji v. The Government of India, Ashurst LLP, White & Case et al*, ruled that although foreign law firms are not generally allowed to practise in India, they are not debarred from coming to India and conducting arbitration proceedings in respect of disputes arising out of a contract relating to international commercial arbitration.

## The Vodafone Tax Dispute

There has been a great deal of coverage relating to the dispute between the Indian tax authorities and Vodafone. As background, the Indian revenue authorities had initiated litigation against Vodafone in relation to the purchase by Vodafone of an offshore company which indirectly held assets in India. Claims were initiated against Vodafone on the basis that Vodafone had failed to withhold Indian taxes on payments made to the seller. The amount claimed in tax and interest was around $2 billion.

The Supreme Court of India held in favour of Vodafone in January 2012 and stated that no Indian tax was required to be withheld on a transfer of offshore assets between two non-residents. That should have been the end of the matter. However, in last year's budget, the former Finance Minister, Pranab Mukherjee, amended the tax law with retrospective effect in order to be able to tax indirect transfers of assets, thereby nullifying the Supreme Court's decision in the Vodafone case and causing uncertainty amongst foreign investors as to the stability of India's business environment.

As a result of concerns from the business community, the government set up an independent committee known as the Parthasarathi Shome Committee to re-examine the controversial retrospective tax amendment. The view of the committee was that retrospective amendments are wrong, save in exceptional circumstances. They recommended that the tax amendments proposed should only apply prospectively. Alternatively, if the government did decide to apply such tax amendments retrospectively, their recommendation would be to not charge interest or penalties arising as a result of such retrospective amendments. It also recommended that the tax should only apply to sellers, rather than buyers, as in the Vodafone case.

The recommendations have been welcomed by the business community and they are likely to be accepted by new Finance Minister Chidambaram (especially as Shome was recently appointed as his adviser).

However, until the recommendations are passed into legislation Vodafone is still technically liable to pay tax to the Indian tax authorities pursuant to the retrospective laws passed last year and this month the Indian tax authorities served a notice on Vodafone reminding them of the amounts being claimed. The Indian government has been in continuing discussions with Vodafone since the notice was served to see whether a deal can be reached over the tax due, and the international business community will be keen to see what the conclusion of such discussions will be as well as what changes will be implemented in the forthcoming Finance Bill 2013.

## GAAR – General Anti Avoidance Rules

The Shome Committee was also tasked with considering the provisions of the General Anti Avoidance Rules, known as "GAAR". GAAR was also introduced by former Finance Minister Pranab Mukherjee and created great tension when the first draft was introduced.

It was proposed that GAAR would be introduced through a new chapter of the Direct Taxes Code 2009. Under the proposals GAAR would be invoked if a taxpayer shall have entered into an arrangement and the main purpose of that arrangement is to obtain a tax benefit and the arrangement:

(i) has been entered into, or carried out, in a manner not normally employed for bona fide business purposes;

(ii) has created rights and obligations which would not normally be created between persons dealing at arm's length;

(iii) results, directly or indirectly, in the misuse or abuse of the provisions of this Code; or

(iv) lacks commercial substance, in whole or in part.

These proposals were heavily criticised for lacking clarity and granting wide ranging powers to the Indian tax authorities.

The Shome Committee recommended that the implementation of GAAR should be postponed for three years. This would allow time for the tax authorities to train personnel in the use of GAAR and to gain a fuller understanding of how the rules should be applied. Its advice is that GAAR should be used sparingly and not to raise additional revenues for the tax authorities. The Shome Committee also recommended that a monetary threshold be applied to the application of GAAR, namely 3 million Indian Rupees in a given year for a tax payer.

Recent press releases from the Finance Ministry suggest that some of the major recommendations have been accepted. However, confirmation will only come once the Finance Bill 2013 is released early this year.

## Looking ahead in 2013

This briefing has focused on the legal reforms that were made in 2012. However, despite pressure being placed on the Indian government, they have still not implemented the proposed bill relating to anti-corruption. Corruption remains a big problem in India, impacting on the business community in general. For example, in 2012 there was:

- a telecoms scandal, relating to allegations that phone licences were mis-sold, costing the country about $40bn (£25.5bn);
- the "coalgate" scandal, which centred on the government's allotment process that enabled well-connected businessmen and politicians to obtain rights to undeveloped coal fields in India;
- and more recently an investigation into spending on lobbying by global retail giant Walmart to facilitate its entry into India.

Whilst there have been a number of bills over the years seeking to deal with corruption, India has so far failed to implement any of them. The most recent being considered is the Lokpal Bill (also referred to as the Lokpal and Lokayuktas Bill, 2011) which seeks to provide for the establishment of an independent ombudsman with the power to inquire into allegations of corruption against certain public officials. It is hoped that this will finally be passed into legislation this year.

At the beginning of 2012, there was still uncertainty surrounding Indian tax laws on indirect acquisitions of Indian businesses, which was further compounded through the proposal to implement retrospective tax legislation and far reaching anti-avoidance rules. India has gone someway to alleviate such concerns, but foreign investors may still wish to wait until legislation has been passed before they are ready to invest.

Similarly, the Indian courts have gone some way to clarify the provisions of the Indian Arbitration and Conciliation Act 1996. However, it is a pity that the ruling only applies prospectively, meaning that many contracting parties who entered into contracts prior to the ruling still have the uncertainty of whether the determination of a dispute through an international commercial arbitration held outside India will be open to challenge in the Indian courts. Practitioners will be watching to see how this ruling will be applied.

The most significant impact on India's economy has been the relaxation on the laws relating to foreign direct investment. The changes in laws permitting 100% foreign direct investment in single branded retail trading and 51% investment in multi-branded retail trading should not only increase investment by foreign retailers looking to market to the vast growing middle class population of India, but should also have the effect of enhancing retail space, improving infrastructure and creating further jobs and training opportunities. It will be interesting to see the impact that this will have in 2013.

India has made some significant changes to its laws to promote its economy which are already having an impact upon the perception of the business environment in India. Only recently Goldman Sachs reported that it expects India's economic growth to accelerate to 6.5% in 2013 and further to 7.2% in 2014, in part driven by some of the reforms that have taken place over the past year.

It is hoped that there will be no further opposition to the implementation of the reforms and recommendations of the Shome Committee so that investor confidence in India can continue to improve. It is also hoped that legislation on anti-corruption can finally be implemented, giving India even more credibility as a place in which to do business.

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