amarchand mangaldas
advocates & solicitors

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VODAFONE'S RECENT LANDMARK TAX VICTORY IN THE SUPREME COURT[1]

1. Backdrop

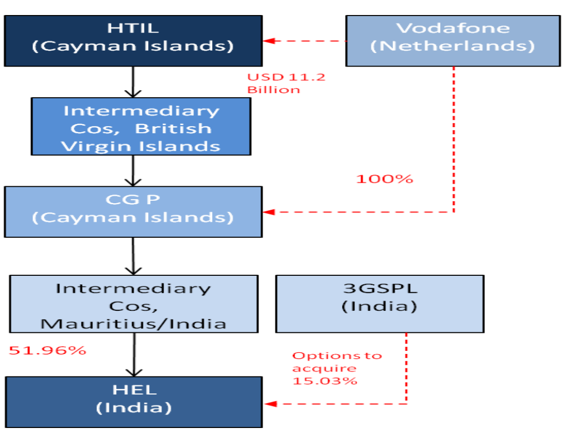
(a) In 2007, Vodafone International Holdings B.V., Netherlands ("**Vodafone**") acquired a single share which represented the 100% shareholding in CGP (Holdings) Limited, a Cayman Islands company ("**CGP**") for a consideration of USD 11.8 billion from Hutchison International, Cayman Islands ("**HIL**").

(b) CGP effectively controlled a 67% stake in Hutchison Essar Ltd. ("**HEL**") through intermediary Mauritius & Indian companies/ contractual arrangements. The acquisition resulted in Vodafone acquiring control over CGP and its downstream entities, including HEL.

(c) HEL was a joint venture between Hutchison and Essar group, for providing cellular telephony in India.

(d) Vodafone also filed an application with Foreign Investment Promotion Board ("**FIPB**"), and subsequent to the approval paid the consideration.

(e) Following is the diagrammatic representation of the structure:



2. Past judicial proceedings

(a) The Tax Authorities issued a notice to Vodafone contending that the transaction is taxable in India and Vodafone was required to withhold tax under Section 195 of the Indian Income-tax Act, 1961 ("**IT Act**") on the purchase consideration.

(b) Vodafone filed a writ petition in the Bombay High Court, challenging the jurisdiction of the Tax Authorities. The High Court dismissed the writ petition, observing prima facie taxability of the transaction against which Vodafone filed Special Leave Petition ("**SLP**") in the Supreme Court ("**SC**").

(c) In January 2009, SC directed the Tax Authorities to first determine its jurisdiction over Vodafone. In May 2010, the Tax Authorities passed an order confirming that they had jurisdiction over Vodafone.

(d) Vodafone then challenged the said order before the Bombay High Court by way of a writ petition. On September 8, 2010, the Bombay High Court ruled against Vodafone *[329 ITR 126 (Bom HC)]* and held that the consideration paid by Vodafone to HIL was for the acquisition of the CGP share together with various rights and entitlements in India. Further, withholding tax provisions were applicable to non-resident payers, provided there was a sufficient territorial connection or nexus between the non-resident and India.

(1. Vodafone International Holdings B.V. v. Union of India & Anr. [S.L.P. (C) No. 26529 of 2010, dated January 20, 2012])

(e) Considering the overall facts of the case, Bombay High Court held that the transaction did have a nexus with India and directed the Tax Authorities to apportion the capital gains which resulted to HIL between the transfers of the various assets, as a result of such nexus with India.

(f) Aggrieved by the Bombay High Court judgment, Vodafone filed an SLP before the SC. SC admitted the SLP but directed Vodafone to deposit an amount of USD 500 million (INR 25,000 million) and furnish a bank guarantee of USD 1,700 million (INR 85,000 million), for its alleged withholding tax liability in India.

Since Vodafone's arguments were accepted by the SC, we do not set them out as they are dealt with in the judgment (discussed below). It is, however, worth setting out what the Tax Authorities argued in response.

3. Key contentions by the Tax Authorities before the Supreme Court

(a) Section 9 of the IT Act, which governs the taxation of transfers of capital assets situated in India by non-residents, should be given the widest possible interpretation and should be interpreted purposively. The words 'situated in India' used in Section 9 should not be construed literally but construed 'purposively' to mean that it must be traceable to a source in India.

(b) The Tax Authorities argued that the SC decision in *Union of India* vs. *Azadi Bachao Andolan* (2003) 132 Taxman 373 (SC) should be revisited in the light of the previous distinguishing decision in the case of *McDowell and Co Ltd vs. Commercial Tax Officer* (1985) 154 ITR 148 (SC). Heavy reliance was also placed on the 'Ramsay principle' enunciated by the UK Courts which allows application of the 'substance over form' approach.

(c) The CGP share had been interposed at the last minute to artificially remove HTIL from the Indian telecom business (reference was made to the Due Diligence Report of Ernst and Young).

(d) Situs of the CGP share can only be in India, as the entire business purpose of CGP was to have control over HEL, an Indian company. The sale of the CGP share was nothing but an 'artificial tax avoidance scheme'. The transaction should be viewed as extinguishment of HTIL's property rights in India and CGP share was merely used to transfer capital assets in India.

(e) Section 195 refers to the term 'person', which is widely defined under Section 2 to include a foreign company. Even otherwise, Vodafone had presence in India on account of its shareholding and Joint Venture with Bharti Airtel and therefore, on the date of payment to Hutch, Section 195 was applicable to Vodafone. Alternatively, Vodafone could be treated as a 'representative assessee' of HTIL.

4. Landmark Decision:

The three member bench of the SC, headed by Lord Chief Justice Kapadia delivered their verdict in favour of Vodafone setting aside the judgment of the Bombay High Court. SC discussed at length certain key points which are discussed below:

(a) Tax avoidance vs. Tax evasion

(i) SC in the cases of McDowell and Azadi Bachao had laid down principles with respect to tax avoidance and tax evasion. Tax avoidance is planning which reduces or negates tax liability in legally permissible ways and has legal sanction. Tax evasion on the other hand is criminal and should be outlawed. The question that arose was whether tax planning is permissible under the Indian Income tax laws. In this regard, the SC held that there is no conflict between McDowell and Azadi Bachao. Tax planning is permissible and legitimate if is within the four corners of law. However, artificial tax planning, while not amounting to evasion, may be struck down.

(ii) It stated that genuine strategic tax planning had not been abandoned. Thus, it cannot be said that all tax planning is impermissible.

(iii) Further, SC observed that the Tax Authorities read words into a statutory provision which are not there. Section 9, even read purposively, did not extend to indirect transfers of capital assets situated in India.

(iv) The Direct Tax Code Bill ("**DTC**") proposes to tax income from transfer of shares of a foreign company by a non-resident, where at any time during 12 months preceding the transfer, the fair market value of the assets in India, owned directly or indirectly, by the company, represents at least 50% of the fair market value of all assets owned by the company. It specifically provides for indirect transfer of a capital asset situated in India. SC noted that this indicates that indirect transfers are not covered by the existing Section 9(1) (i).

(v) Every tax payer is entitled to arrange his affairs so that his taxes shall be as low as possible and that he is not bound to choose those patterns which replenish the treasury.

(b) Corporate Holding Structures

(i) It is a common practice in international law, which is the basis of international taxation, for foreign investors to invest in Indian companies through an interposed foreign holding or operating company, such as Cayman Islands or Mauritius based company for both tax and regulatory purposes.

(ii) A subsidiary and its parent are totally separate and distinct legal entities and should be treated as such for tax purposes unless there is evidence to suggest that the parent exercises more than persuasive power (as shareholder) over the subsidiary.

(iii) In establishing foreign holding companies, foreign investors are able to avoid the lengthy approval and registration processes required for a direct transfer (i.e. without a foreign holding or operating company) of an equity interest in a foreign invested Indian company.

(c) FDI to be seen in a holistic manner

(i) Every strategic foreign direct investment coming to India, as an investment destination, should be seen in a holistic manner.

(ii) To test whether a transaction was preordained or if there was an investment to participate, the following factors should be taken into consideration:

- the concept of participation in investment,
- the duration of time during which the Holding Structure exists;
- the period of business operations in India;
- the generation of taxable revenues in India;
- the timing of the exit;
- the continuity of business on such exit.

(iii) SC further said that the onus will be on the Tax Authorities to identify the scheme and its dominant purpose. The corporate business purpose of a transaction is evidence of the fact that the impugned transaction is not undertaken as a colourable or artificial device.

(d) 'Look at' approach and not 'Look through' approach

(i) The '**look at**' principle enunciated in Ramsay case: It is the task of the Tax Authorities/Court to ascertain the legal nature of the transaction and while doing so it has to **look at** the entire transaction as a whole and not to adopt a dissecting approach.

(ii) The Tax Authorities cannot start with the question as to whether the impugned transaction is a tax deferment/saving device but that it should apply the '**look at**' test to ascertain its true legal nature.

(iii) The Tax Authorities may invoke the 'substance over form' principle or 'piercing the corporate veil' test only after it is able to establish on the basis of the facts and circumstances surrounding the transaction that the impugned transaction is a sham or tax avoidant.

(iv) The question of providing 'look through' in the statute or in the treaty is a matter of policy and it has to be expressly provided for in the statute or in the treaty. Similarly, limitation of benefits has to be expressly provided for in the treaty.

(e) Hutch structure was not created as a sham

(i) Referring to the test laid down with respect to 'investment to participate', SC observed that the Hutch structure had existed for a considerable length of time, generating taxable revenue in India from 1994.

(ii) It cannot be said that HTIL or VIH were a 'fly by night' operator/ short time investor and hence, the Hutch structure was not created or used as a sham or tax avoidance scheme.

(iii) SC further went on to say that where the court is satisfied that the transaction satisfies all the parameters of 'participation in investment' then in such a case the court need not go into the questions such as de facto control vs. legal control, legal rights vs. contractual rights.

(f) No extinguishment of rights

(i) As a group holding company, HTIL had no legal right to direct its downstream companies in the matter of voting, nomination of directors and management rights, but it only occupied a persuasive position/ influence.

(ii) All rights flowed from the CGP share, which was the entire investment sold to Vodafone. There was no extinguishment of other rights as alleged by the Tax Authorities.

(iii) A controlling interest is an incident of ownership of shares in a company, something which flows out of the holding of shares. It is not an identifiable or a distinct capital asset independent of the holding of shares. Shares and the rights which emanate from them flow together and cannot be dissected.

(iv) SC observed that this transaction concerns an offshore transaction involving a structured investment. This case concerns 'a share sale' and not an asset sale.

(g) Role of CGP

(i) Vodafone could have either acquired the share of CGP or it could have acquired the shares other subsidiaries.

(ii) The share in CGP was acquired not merely because it held shares in subsidiary companies but for a smooth transition of business on divestment by HTIL. The transaction was structured at an appropriate tier so that Vodafone acquired same degree of control as was hitherto exercised by HTIL in a straightforward manner by directly acquiring a single company.

(iii) It could not be said that CGP had no business or commercial purpose.

(iv) SC rejected the argument of the Tax Authorities that the situs of the CGP shares was situated in the place where the underlying assets were situated. The situs was the Cayman Islands.

(h) Valuation: Not a basis for taxation

(i) The Tax Authorities had argued that Vodafone paid US $11.08 billion for 67% of the enterprise value of HEL plus its downstream companies having operational licences. It bought an upstream company with the intention that rights flowing from the CGP share would enable it to gain control over the cluster of Indian operations or operating companies which owned telecom licences and other business assets.

(ii) SC held that valuation cannot be the basis of taxation. The basis of taxation is profits or income or receipt which in this situation is capital gains from transfer of a capital asset.

(i) India-Mauritius Tax Treaty

(i) In the absence of a 'limitation of benefit' clause and the presence of Circular No. 789 of 2000 and tax residency certificate, on the residence and beneficial interest/ ownership, at the time of sale/ disinvestment/exit , the Tax Authorities cannot deny the treaty benefits to such Mauritius companies.

(ii) Setting up of a wholly owned subsidiary with genuine substantial long term FDI in India from/through Mauritius, can never be considered to be set up for tax evasion.

(iii) However, the SC also stated that tax residency certificate does not prevent enquiry into a tax fraud. For example, where an overseas corporate body is used by an Indian resident for round tripping or any other illegal activities, nothing prevents the Tax Authorities from looking into such special agreements, contracts or arrangements to treat it as tax evasion.

(j) Withholding obligations for payments to Non-residents - Section 195 of the IT Act

(i) Section 195(1) imposes a duty upon the payer of any income specified therein to a non-resident to deduct tax at source unless such payer is himself liable to pay income-tax thereon as an agent of the payee. Thus, the person on whom the obligation to deduct tax at source is imposed is not the person who has earned the income. Assessment has to be done after liability to deduct tax at source has arisen. In the case of capital gains, the purchaser is required to deduct the tax from the sale price.

(ii) SC noted that the present case concerns the transaction of 'outright sale' between two non-residents of a capital asset (share) outside India and hence Vodafone was not obliged to withhold tax on the sale consideration paid to HTIL.

(k) Vodafone cannot be treated as a representative assessee - Section 163:

(i) SC held that merely because a person is an agent or is to be treated as an agent, would not lead to an automatic conclusion that he becomes liable to pay taxes on behalf of the non-resident. It would only mean that he is to be treated as a 'representative assessee'.

(ii) Section 161 of the IT Act makes a 'representative assessee' liable only as regards the income in respect of which he is a 'representative assessee'.

(iii) On facts of this case, SC held that since there is no transfer of a capital asset situated in India, Vodafone cannot be a representative assessee.

5. Observations of Justice K S Radhakrishnan

(a) It is difficult to agree with the conclusions arrived at by the Bombay High Court that the sale of CGP share would amount to transfer of a capital asset within the meaning of Section 2 (14) of the IT Act.

(b) Also difficult to agree with the conclusions that the rights and entitlements flow from framework agreements, shareholders agreements, term Sheet, loan assignments, brand license, etc, which form integral part of CGP share attracting capital gains tax.

(c) Tax demand on this transaction by way of capital gains tax, would amount to imposing capital punishment for capital investment, since it lacks authority of law and therefore stands quashed.

(d) Section 195 would apply only if payments made from a resident to another non-resident and not between two non-residents situated outside India.

(e) Concurs with all the other directions given in the judgment delivered by the Lord Chief Justice.

6. Conclusion

SC set aside the Bombay High Court judgment asking Vodafone to pay USD 2 billion of income tax on a transaction which had been done overseas. It also directed the Tax Authorities to refund Vodafone the deposited amount of USD 500 million (INR 25000 million) with interest @ 4% within two months from the date of the judgment.

This Judgment shows robustness of Indian judiciary and will create confidence for foreign investors investing in India. This is a welcome judgment, in as much as it:

(a) clears uncertainty over cross border transactions and provides clarity over tax incidence in India;

(b) clarifies how documents should be interpreted in tax matters.

While delivering the judgment, the SC has concluded FDI flows towards location with a strong governance infrastructure which includes enactment of laws and how well the legal system works. Certainty is integral to rule of law. Tax policy certainty is crucial for taxpayers (including foreign investors) to make rational economic choices in the most efficient manner.

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Mumbai
V floor , Peninsula Chambers,
Peninsula Corporate Park,
GK Marg, Lower Parel
Mumbai - 400 013
Tel: (91 22) 24964455 Fax: 24963666
Email: am.mumbai@amarchand.com

New Delhi
Amarchand Towers,
216, Okhla Industrial Estate, Phase III
New Delhi - 100 020
Tel: (91 11) 41590700 Fax: 26924900
Email: am.delhi_corp@amarchand.com

Bangalore
201 Midford House, Midford Garden,
Off MG Road, Bangalore - 560 001
Tel: (91 80) 41124950 Fax: 26924900
Email: am.bangalore@amarchand.com

Kolkata
Anand Lok, 227, A.J.C. Bose Road
Kolkata- 700 020
Tel: (91 33) 28650268 Fax: 22472349
Email: amsscal@amarchand.com

Hyderabad
1-10-20/2B, 4th Floor, Pooja Edifice,
Chickoti Gardens, Begumpet
Hyderabad - 500 016
Tel: (91 40) 66336622 Fax: 66492727
Email: am.hyd@amarchand.com

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