

The Path-Breaking Vodafone Judgment – Ringing in New Tunes

Introduction

The Supreme Court of India pronounced the much-awaited historic judgment in “*Vodafone International Holdings B.V. vs Union of India and Ors*” in which it absolved Vodafone International Holdings B.V. (“**VIH or Vodafone**”) from its liability to pay over \$2 billion in capital gains to the Indian tax authorities, finally putting to rest a dispute that has been watched with keen interest the world over. Apart from Vodafone, numerous companies engaged in or contemplating similar acquisitions would have heaved a sigh of relief on January 20, 2012. While the judgment has clarified several key concepts, discussed below, but the fundamental question before the apex court was whether Indian tax authorities had the jurisdiction to tax the gains arising to a foreign company by virtue of transfer of shares of a foreign holding company, which indirectly held underlying Indian assets.

The present bulletin summarizes this significant judgment.

The Controversy

VIH acquired controlling interest of a SPV, CGP Investments (Holdings) Limited (“**CGP**”) located in the Cayman Islands, directly. Thereafter, by virtue of this controlling interest, it acquired a 52% stake in Hutchinson Essar Limited (“**HEL**”) in India from Hutchison Telecom International Limited (“**HTIL**”). HEL was a joint-venture between the Hutchinson and Essar groups. The outcome of the acquisition was that VIH acquired control over CGP and its subsidiaries, including HEL. The Indian tax authorities issued a show-cause notice to VIH and sought an explanation why tax was not withheld on payments made to HTIL in this transaction. Subsequently, VIH filed a writ petition in the Bombay High Court (“**HC**”) challenging the jurisdiction of the tax authorities in the matter and contending that the transfer of shares was outside the territorial jurisdiction of India. The HC dismissed the petition and, in appeal, the Supreme Court (“**SC**”) too dismissed the case stating that it was necessary that the tax authorities first decided on the issue of its own jurisdiction over the transaction and even mentioned that in the event the conclusion was that they had jurisdiction, Vodafone could always go in appeal.

The outcome did not catch many by surprise – in essence, the tax authorities reiterated their jurisdiction over the transaction and treated Vodafone as an *assessee in default* for failure to deduct the withholding tax from the sale consideration and, predictably, VIH appealed at the HC. The HC ruled that the tax authorities had a *prima facie* case, and that the transaction involved the transfer of a capital asset in India. The view of that court was it was crucial to determine the source from which the profits had been generated. The HC observed that the price paid for the acquisition included controlling rights and other entitlements of the Indian business and so it was incorrect to conclude that the transaction was a mere share transfer between non-residents. Aggrieved by the order, VIH unsurprisingly preferred an appeal to the SC.

The Judgment

Reversing the decision of the HC, the SC held that VIH had no liability to withhold tax as the transaction was between two non-residents with no taxable presence in India. In its 295 page judgment, the SC also examined and established various other critical legal principles including tax avoidance versus tax evasion, parent-subsidiary relationship and the ambit of Section 9 and 195 of Act on non-residents. Some of these are briefly discussed below.

Tax Planning, Avoidance and Tax Evasion:

The SC discussed several Indian and English judicial precedents and held that **genuine strategic tax planning was not to be abandoned**. In fact, the ruling states that the tax authorities' must examine the transaction to ascertain its true nature and cannot start with the question as to whether the transaction was a tax deferral/saving device.

Extensive arguments were put forth while examining both the *Azadi Bachao Andolan*¹ and *McDowell*² judgments. Relying upon *Westminster*³ the majority ruling in *McDowell* had clearly held that tax planning was legitimate and was not impermissible provided it was within the framework of law and there were no colorable devices. In effect, a taxpayer could arrange his affairs so as to reduce tax liability, and the fact that the motive for a transaction was to avoid tax did not invalidate it unless a particular enactment so provided. However, the Indian tax authorities contended that the two rulings of *McDowell* and *Azadi* were contradictory and *Azadi* was not good law. In the latter case, the SC had extensively dealt with the concept of tax avoidance and posited that (a) routing of investment in India from Mauritius was not considered as a colorable device to evade tax, and (b) treaty shopping was not disapproved in absence of anti-avoidance legislation.

After analyzing the aforesaid and several other judgments, the SC held that that a document or a transaction ought to be looked at in order to construe the facts of a case and the intent of the parties. Tax planning within the framework of law is not to be frowned upon but if artificial devices are resorted to with the sole purpose of evading tax, the onus is on the revenue authorities to establish that the transaction was a sham. The SC stated that this continues to be good law and the SC found no conflict between the two judgments and, therefore, no merit in the tax authorities' argument that *Azadi* ought to be overruled.

Principle of separate entity and business purpose

The SC maintained that - in law and for tax treaty - a subsidiary and parent are separate tax payers, despite the fact that shareholder influence may curb directors' autonomy. In the context of taxation of a holding company structure, the SC reiterated that **corporate veil may be lifted only if it is established that the transaction was a sham or there was abuse**. The burden of proof in such a case was squarely on the tax authorities who had to establish tax avoidance in the creation and/or use of such structure(s). The SC

¹ Union of India vs. Azadi Bachao Andolan (2004) 10 SCC 1

² *McDowell and Co. Ltd. vs. CTO* (1985) 3 SCC 230

³ *Commissioner of Inland Revenue vs. His Grace the Duke of Westminster* 1935 All E.R. 259

provided examples of corporate entities used for circular trading, round-tripping or for facilitating payment of bribes as being valid grounds for disregarding the separateness of a corporate entity. It held that the tax authorities may invoke the principles of “*substance over form*” or “*piercing the corporate veil*” only if an indirect transfer is made by a non-resident enterprise through “abuse of organization/legal form and without reasonable business purpose” which results in tax avoidance and disregard the transaction at the threshold applying the fiscal nullity test. Drawing a distinction between *mala fide* transactions predetermined to avoid tax, and those which evidence *bona fide* investment to participate in the Indian economy, the SC observed that the *bona fide* of a holding structure could be deduced from its continuity. In other words, a transaction could be said to be a sham if it had no business purpose, or if it lacked continuity. The SC cautioned that the revenue authorities should look at the documents or the transaction in the context to which it properly belongs and as a whole instead of adopting a dissecting approach.

After viewing the facts, the SC reached a reasoned conclusion that the shares of CGP were transferred only for a commercial benefit and not with the object of tax evasion. The structure was in existence over a decade, it was not created or used as an instrument for tax avoidance, VIH was not a short-time investor and it did not introduce any new practice to grant itself a “controlling interest.” Applying the above tests in a holistic manner, the SC determined that while ascertaining the essence of a transaction, courts and tax authorities should necessarily consider and factor the following crucial elements, *viz.*:

- the duration during which a 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 should be considered to differentiate between tax evasion and tax planning.

Section 9 – Income Deemed to Accrue or Arise in India

Section 9(1) of the Act describes and deems certain incomes under specified circumstances to accrue or arise in India which would then be taxable. Sub-section (i) specifically provides that *all income accruing or arising, whether directly or indirectly through transfer of capital assets situate in India* would attract tax liability. The tax authorities argued that the scope of the statute was wide enough to cover indirect transfers as well and the provision was a “look through” provision so that if there was a transfer, of a capital asset, situated in India, it meant income from capital gains accruing or arising outside India would be fictionally deemed to accrue or arise in India.

The SC held that a legal fiction had limited scope and could not be expanded by giving it a purposive interpretation particularly when it would transform the concept of chargeability under the Act. Under this provision, capital gains could be “deemed to accrue or arise in India” only if the capital asset transferred was “situate in India.” The words “situate in India” would be meaningless and rendered ineffective should the *situs* of the capital asset transferred be ignored. Section 9(1)(i) clearly applied to transfer of a capital asset situated in India and it could not, by virtue of interpretation, be extended to cover indirect

transfers of capital assets or property situated in India. Given that the Direct Taxes Code Bill, 2010, which is not yet in force, covers taxation of indirect transfers expressly, consequently, absent an unambiguous inclusion, the word “indirect” could not be read on the basis of a purposive construction. The words “directly or indirectly” in the law were to be applied to “income” and not to “transfer” of a capital asset.

Scope of Section 195 of the Act

The tax authorities contended that since the transfer of the controlling interest is taxable in India, Vodafone should have deducted tax at source as it was a sale outside India of a capital asset in India. According to SC, section 195(1) of the Act imposed a duty upon the payer of any income to a non-resident to deduct withholding tax and only that amount would be taxed that was “chargeable to tax.” Since the shareholding in CGP was a property located outside India and involved an offshore transaction between two non-residents, there was no liability to capital gains tax. Section 195 would apply only if payments were made from a resident to another non-resident and not between two non-residents outside India. The SC held that the tax authorities had failed to establish any nexus with Section 9(1)(i) of the Act, and, therefore, there was no charging provision to levy tax on the transaction as required by the Act. In such a case, the question of deduction of tax at source could not arise. More importantly, the apex court further clarified that section 195 of the Act does not apply if a person has no tax presence in India even if the transaction is liable to tax in India. The tax presence has to be seen vis-à-vis the transaction subjected to tax and not generally.

Implications of Transfer of Controlling Interest

The view expounded by the HC was that, apart from the transfer of shares of CGP, other rights and entitlements were transferred which could qualify as *capital assets* as defined in section 2(14) of the Act and, consequently, the consideration connected with such capital assets was liable to tax in India. Disagreeing, the SC again underscored the need to examine the entire transaction holistically and realistically and concluded that – in effect - a share and not an asset sale had been completed. Reinforcing existing law, the court’s view was that controlling interest is not a distinct capital asset *de hors* the holding of shares and, in fact, it is an incidence of ownership of shares. Depending on the percentage of ownership, shareholders may assume a controlling interest. Shares and the rights which emanate from them flow together and cannot be dissected. So, where a transaction involves transfer of shares, lock, stock and barrel, such a transaction cannot be broken up into separate individual components, assets or rights such as right to vote, right to participate in company meetings, management rights, controlling rights, control premium, brand licenses and so on, as shares constitute a bundle of rights. In other words, it would be inappropriate to adopt a dissecting approach and treat “property rights” emanating from one’s shareholding as capital assets situated in India and bring them within the ambit of the tax liability.

Scope of Section 163 and Concept of Representative Assessee

The tax authorities had expounded an alternative argument *viz.* that VIH could be proceeded against as a “representative assessee” under section 163 of the Act. Under this

section, a non-resident may be assessed through his agent due to the inherent difficulties in ensuring his physical presence during the assessment proceedings and the possibilities of effecting recovery of the due taxes. The following qualify as agents of a non-resident:

- An employee or trustee
- Any person who has any *business connection* with the non-resident
- Any person from or through whom the non-resident is in receipt of any income
- Any person who has acquired a capital asset in India from the non-resident.

The SC held that the facts did not demonstrate that transfer of a capital asset in India had taken place and, consequently, section 163(1)(c) of the Act did not apply. A representative assessee is liable only “as regards the income in respect of which he is a representative assessee.” Merely because a person is an agent or is to be treated as an agent, would not lead to the automatic conclusion that he becomes liable to tax on behalf of the non-resident. Rejecting the contention of the tax authorities, the SC concluded VIH cannot be proceeded against even under Section 163 of the IT Act as a representative assessee.

The Implications

Simply put, the judgment will (or should) go a long way in restoring the faith of the foreign investors in India. The tax laws of any jurisdiction are complex but in this case when so many divergent views are expressed by the tax authorities and the judiciary, throwing the doors wide open to subjectivity, the ensuing result is confusion and an (in)ability to reach a conclusive position. The apex court has definitely changed that. Until this unique case, there has been no prior precedent where the Indian tax authorities have attempted to tax capital gains arising on transfer of shares of a foreign holding company of an Indian subsidiary on the basis that such transfer involves an indirect transfer of the underlying Indian assets. The SC has definitely given a thumbs-up to legitimate tax planning while stipulating that structures that are colorable devices cannot be respected for tax purpose. It recognized that use of holding companies and investment structures are **(and should be)**⁴ driven by business and commercial purpose and cautioned that the use of these elements in international structures should not lead to an automatic conclusion of tax avoidance.

Apart from setting a binding precedent for other similar transactions, the path-breaking judgment should also assist those corporations with similar circumstances undergoing scrutiny currently. It remains to be seen whether the (dissatisfied) tax authorities will scrutinize other transactions and plan creative arguments to bring them within the ambit of the tax and enhance their revenue. At the very least, this judgment will ensure that foreign investors will be exceedingly careful when structuring their investments into India, whether through offshore or onshore entities as nobody would want to spend millions in protracted litigation contesting tax liability.

⁴ Emphasis Supplied

In Summation

Despite the best efforts of the Indian tax authorities to tax the transaction, they were unsuccessful. Coming six weeks before the annual budget announcement, millions would be observing how the battered government in an election year would use this judgment to frame both its short and medium term fiscal policy. Will it take cue from the annals of its pages and thousands of documents on record to bring about change in the law so that such transactions come within the tax ambit in the future? There is no crystal ball that will accurately forecast the next steps of the government, but, for the moment, it is noteworthy that the SC **(a)** ordered the tax department to return the \$2 billion deposited by Vodafone in 2010 in the next two months, along with interest calculated at 4% per annum from the date of withdrawal by the department up to the date of payment; and **(b)** ordered its registry to return the enormous bank guarantee deposited by Vodafone within the next four weeks. Only time will tell about the possibility of amendments to the law - until then, professionals will continue to speculate BUT Vodafone will definitely be laughing all the way to the bank!

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