Analysis: Tax lawyers mull law, jurisprudence & world post-Vodafone

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Vodafone: Making the tax laws a little less confusing

Economic Laws Practice (ELP) and Nishith Desai Associates (NDA) analysed the legal implications of the Vodafone judgment yesterday – a decision law firms across the board commended for boosting India's image as an investment destination, upholding the rule of law and settling many questions.

In an online seminar yesterday, ELP managing partner Rohan Shah commended the Supreme Court's Friday judgment in Vodafone International Holding BV v Union of India clearing a capital gains tax bill worth around Rs 11 crore ($2.4bn).

"After this judgment, India stands out positively to the extent that there is no taxation on indirect transfers, as opposed to other jurisdictions where indirect transfers are taxed," said Shah.

"If the government is bold enough not to tax indirect transfers it'll be good for India as an investment destination. It is important that the government looks at this as an opportunity. This would actually position India as a preferable investment destination to others."

An Amarchand Mangaldas client alert email made the same point and added: "The judgment represents the robustness of the Indian judiciary system."

"India can always be known for the fact that Rule of Law will prevail," agreed Shah. "Here the justice system will not yield under the pressure of numbers. The judiciary will pull up the government irrespective of cost and consequence.

"The [Vodafone] matter has been put to bed within two years – that is some outstanding jurisprudence. The judiciary has given something to India to sit and talk about. The judicial quality in most parts of the world is not so outstanding."

He also welcomed the Supreme Court's express recognition that certainty of policy had an effect on foreign direct investment (FDI).

Since Friday, law firms specialising in tax have worked overtime to analyse the legal implications of and gaps in the judgment.

Small gaps

Some uncertainties remain surrounding Mauritius, Section 195 of the Income Tax Act 1961, and whether a particular transaction structure will be held as legitimate or sham, according to Shah.

Nevertheless, he said, this judgment was a very positive development. "What it does is to lay certain very clear principles that will obviate a large part of the controversy. Clearly there is no taxation on indirect transfer."

Legislative intervention?

Apprehending that a legislative reaction to the decision would disturb the principle of certainty of policy, which could deter FDI, Shah commented: "One thing that is possible, and in this matter almost probable, is an amendment. Will there be an amendment? There are two questions in this regard. Will there be a prospective amendment, and will there be a retrospective amendment?

"Retrospective amendments will do irreparable harm to India's image as an investment destination. The real problem would be if a retrospective amendment was passed. The government should respect the Supreme Court decision and go for any amendment only to apply in the future."

"This judgment brings relief to the international investor community, investing in India. The SC has reiterated that genuine tax planning is the tax payer's right," said Khaitan & Co in a press release.

Non-resident share transfers

Friday's judgment had arrived at the finding that where shares are transferred between two non-resident entities for a consideration paid outside India, India has no taxing jurisdiction even if the underlying capital asset or value is related to a business conducted in India.

Economic Laws Practice (ELP) explained in its seminar that transactions such as AT&T, Sab-Miller and others, which are between two non-residents, will be impacted by this judgment in different ways depending on whether the parties are from treaty jurisdictions or non-treaty jurisdictions. Parties from treaty jurisdictions will not only benefit from support under the provisions of the Act, but would also be free from the tax net if the treaty does not provide for 'limitation of benefits'.

Nishith Desai Associates (NDA) said in a press release:

> "The Supreme Court noted that the primary objectives of withholding taxes were to ensure that taxes payable by non residents were secured at the earliest, and to avoid difficulties in collection. It held that Vodafone had no liability to withhold taxes as the transaction was an 'outright sale' of a capital asset outside India between two non-residents with no taxable presence in India."

ELP summed up: "Section 195 of the Act is applicable only when the transaction is liable to tax in India."

Look 'at', not 'through': Strict interpretation of charging provisions

Second, the SC upheld that the charging provision needs to be strictly and not purposively interpreted.

ELP:

> "If government intends to tax such transaction, it must be reflected clearly in the provisions and tax treaties. It is important for the tax administration, as well as the Courts, to 'look at' the legal nature of the transaction, in its entirety and holistically. A dissecting approach ought not to be adopted. 'Look through' is permissible only in instances where it can be established on the basis of facts and circumstances that the transaction is a sham or is for the purposes of tax avoidance."

NDA: "It [SC] indicated that it was important to *look at* a corporate holding structure with a view to uphold the very basis of corporate law, which provides for the separate legal entity doctrine."

Implications on section 9 of Act

This principle has important implications for the reading of Section 9 of the Income Tax Act.

ELP:

> "The section cannot be extended to cover indirect transfers of capital assets or property situated in India. The legislature has not used the words 'indirect transfers' in Section 9(1)(i) of the Act. If the words 'indirect transfers' are read into the aforesaid Section, the same would render the express statutory requirement of sub-clause (4) nugatory."

NDA:

> "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 rendered ineffective, opined the court, should the *situs* of the capital asset transferred be ignored."

ELP clarified that absent a specific taxing provision for indirect transfers such as in the Direct Tax Code (DTC) Bill 2010, Section 9 cannot be extrapolated.

Situs

ELP:

> "The situs of the shares will be determined by the location of the company whose shares are sold and not the underlying assets. The situs of the shares would be where the company is incorporated and where its shares can be transferred. The situs cannot be determined on the basis of the location of the underlying assets".

Anti-avoidance: Genuine or pre-ordained transaction?

Another finding related to the question of anti-avoidance principles and the difference between genuine and pre-ordained transactions.

NDA:

> "The Supreme Court observed that the general anti-avoidance rule, *per se*, was not new to India, and has been judicially recognised. However, it emphasised that the separateness of a corporate entity ought not to be fleetingly disregarded. The corporate veil may be lifted only if it is established that the transaction was a sham or a colourable device. It cited instances of corporate entities being used for circular trading, round-tripping of funds, or for facilitating the payment of bribes, as being valid grounds for disregarding the separateness of a corporate entity."

ELP:

> "The onus of determining whether a transaction is preordained is placed on the revenue which has to discharge the obligation based on the factors such as duration of time during which the holding structure existed, the period of business operations in India, generation of taxable revenue in India during the period of business operations in India, the timing of exits, continuity of business on such exits".

The third judge: Radhakrishnan

ELP and NDA both noted that Justice Radhakrishnan's was not in fact a dissenting judgement, unlike initially reported by some media, but was a concurring judgment.

NDA added that Radhakrishnan said that "a planned, tax-efficient exit route formed good business and commercial reasons, and is generally beyond the scope of judicial scrutiny. In other words, international corporate structures aimed at reducing tax implications on exit from India should satisfy the 'business purpose' test".

The Mauritius route under DTAA

By a corollary to these findings, the SC also upheld the so-called 'Mauritius route'.

As per article 13 of the India-Mauritius tax treaty, capital gains arising from the alienation of any property would be taxable only in the state in which the alienator is resident. Therefore, capital gains arising from the transfer of shares of an Indian company by a resident of Mauritius would not be taxable in India. However, Mauritius exempts capital gains arising from the transfer of shares, thus resulting in "double non-taxation" between the two jurisdictions.

NDA noted that, subject to tax fraud enquiry, "the benefits of the India-Mauritius tax treaty could not be denied in the absence of a 'Limitation of Benefits' provision, even if the initial investment did not originate in Mauritius".

Azadi Bachao upheld: Legitimacy of tax planning

Also by upholding the judgments in Azadi Bachao and Mc Dowell's as the law of the land, the SC gave legitimacy to the practice of tax-planning, explained ELP and NDA.

Representative assessee liability

ELP: "Section 161 makes a Representative Assessee liable only if the eventualities stipulated in Section 161 are satisfied and the transaction is liable to tax in India."

Corporate law implications

ELP observes that the judgment has certain implications on Indian corporate law as well:

> "Clear demarcation has been recognized between the concept of 'Control', 'Participation Rights' and 'Protective Rights'. Control vests in the board and not in Shareholding and controlling interest is not a separate capital asset.

> "Also there is clear recognition that the transfer of shares itself is a distinct transaction. Transfer of shares cannot and should not be dissected in its individual component. Certain level of rights pass inherently with shareholding and these rights may enhanced or curtailed through agreements, the substantive character of the transaction as a sale of shares is not diluted on account of any enchantment or curtailment of rights."

ELP partner Vikram Nadkarni noted: “There is nothing wrong and unusual about shareholder’s agreements. Nothing in law prohibits them. So this judgment puts to rest many controversies in corporate law.”

NDA’s press releases concluded: “While the verdict in this case was based on the facts and circumstances of the transaction, the judgment has laid down clear and predictable guidelines distinguishing what is permissible and what is not. By placing the burden of proof on the Revenue, the Supreme Court has coupled discretion with accountability.”

Tags: Economic Laws Practice Elp Mauritius Nishith Desai Associates Tax Vodafone