Will the Vodafone case hit FDI?

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The Vodafone judgement will definitely impact foreign investments into India. There appears to be a disconnect in the reasoning put forth and applied in the judgement. The first 150-odd pages set out good legal principles such as form over substance and the taxpayer's right to legitimately plan his economic affairs. But, later, it fails to apply these principles and does not adequately recognise the fact that the main acquisition agreement only contemplated a transfer of shares of the foreign company and certain inter-company loan obligations.

So, what part of the transaction is liable to be taxed? In the absence of guidance, the apportionment by the tax authority could be arbitrary. The decision as well as the tax department's approach creates tremendous uncertainty on what aspects of an offshore transaction may fall within the Indian tax net. The verdict has unfortunately not frowned upon the government's inclination to resort to retroactive amendments to tax laws and the fact that Indian laws were amended specifically in relation to the Vodafone transaction after it was consummated. Retroactive levy of taxes is arbitrary, creates uncertainty and is hence unconstitutional.

With respect to withholding tax obligations of non-residents, the Court has held that non-enforceability of such obligations on account of its extra-territorial character cannot be a ground to invalidate the liability to withhold. The Court has clearly stated that it is neither concerned with the difficulties arising out of, or the inconvenience caused to the taxpayer or with the practicality of the enforceability of the law. While accepting the jurisdiction of the tax department to proceed against Vodafone, the Court held that the transfer was a composite transaction involving not only the transfer of a foreign company's shareholding but also a transfer of various rights in relation to the Indian operating company. The department would now have to apportion income associated with such rights. It will be interesting to see how this apportionment would be done, as some of the stated rights were not even transferred! In the absence of a defined basis or mechanism of tax, an apportionment would be pure guesswork, involving significant arbitrariness and uncertainty in the application of the judgement.

In today's world where many jurisdictions compete for scarce capital, an important factor that foreign investors seek is regulatory certainty on tax, exchange controls and protection of investment. India cannot assume that foreign investments would continue irrespective of its legal environment. The tax department's general aggressive stance towards international transactions adds an additional element of risk that, in certain cases, may even be significant enough to alter the decision of whether to invest or not. How can we expect foreign investors to operate in such an environment of uncertainty and arbitrariness?

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Risk and return are two sides of a coin. well-planned strategies like clear land titles and better infrastructure can help india gain the investors confidence

Risk and Return are two sides of a coin. Higher risk needs to be compensated by higher return. India can attract foreign investment by offering high guaranteed return, tax-free income, exemption from local regulations regarding pollution, labour laws, etc. This can attract lots of investments in the near term but at an unacceptably high servicing cost in the future. This is a NO GO option as was experienced in Maharashtra's tryst with a power project a decade back.

India can substantially cut the cost of servicing investments by reducing risk perception. While some foreigners still view India as snake charmers' country, a vast majority are aware of the country's potential.

Like Vasco da Gama and Christopher Columbus, they are ready to invest in India. While the developed world is looking at below-potential growth for a long time to come, India can grow between 5-7 % on local savings or accelerate to 8-10 % by attracting appropriate foreign investment. To uplift the poor millions, we don't have any choice but to pursue rapid yet sustainable growth.

India has been endowed with resources (maybe including oil and gas if explored to the full potential), a billion plus consumers (incidentally the youngest in the world) and entrepreneurs. Lack of capital and execution constraints have hampered us but the world is willing to provide capital if India can provide efficient execution. India needs to ensure that the cost of capital is reasonable and that capital is allocated for productive purposes rather than to create asset price bubbles.

A lot of Mumbai's residential real estate looks overpriced and is getting into the bubble zone because of a combination of factors, including foreign capital. That is a missed opportunity. We have to use foreign capital to create adequate supply so that residential units are available to all at affordable prices. That's the only way to ensure that the next big film will be City billionaire rather than Slumdog millionaire.

India has all the basic ingredients to pursue higher growth. It can attract more foreign capital than it needs if an atmosphere of trust, confidence and comfort can be created. Trust can be gained by demonstrating well-planned strategies (like China offering factory land in SEZs with clear titles and adequate quantity, alongside proper connectivity, power and labour availability, and all the infrastructure necessary to carry out the business at lower costs).

Confidence can be gained by demonstrating the rule of law instead of a chalta hai attitude. Comfort can be gained by demonstrating ease of doing business every day, where hard work rather than regulatory arbitrage delivers. India needs to remember that certainty of return is a bigger pull than rate of return in attracting investments.

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