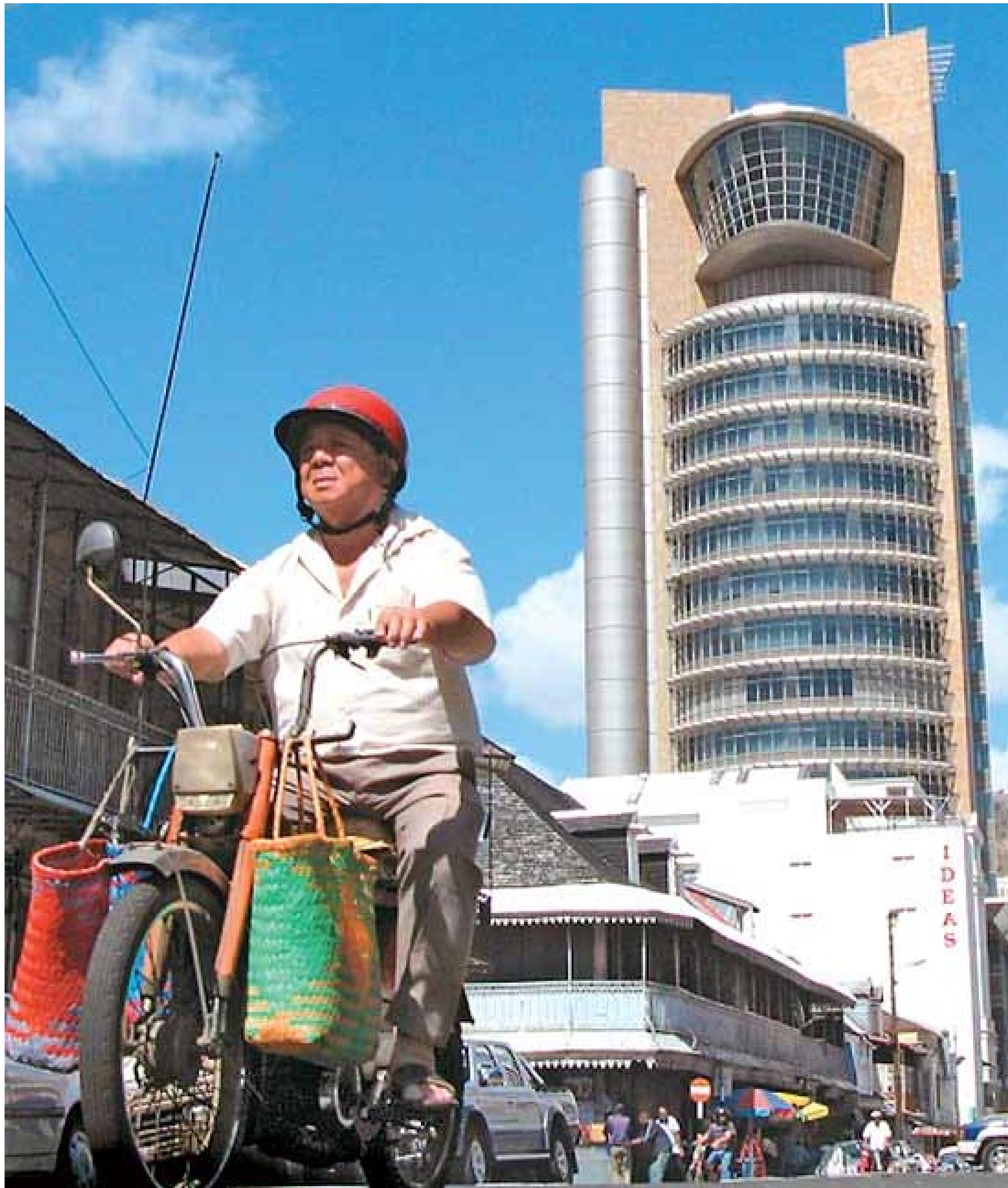

Mauritius central bank in Port Louis. DTAA with the country is being renegotiated.

TAX LAWS: VODAFONE CASE

Zoozoo's Got The Number

Vodafone verdict opens up the tax havens debate

ARINDAM MUKHERJEE

Caller Calls Tune

- Government unlikely to ask for review of SC judgement as it would be seen as anti-FDI
- New Direct Tax Code expected to fix tax liability on capital gains in India
- Treaties with tax havens like Mauritius being reworked to stop misuse by shell firms
- Stricter scrutiny of similar M&A cases expected; no more blanket exemptions

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It hasn't escaped anyone's attention that the Vodafone tax case verdict was quite exquisitely timed. Come to think of it, the value the Indian government derived from it was worth more, much more than the $2.5 billion immediately at stake. Faced with a sagging economy and faltering global image as an investment destination—and fresh from a reversal on opening up investments into multi-brand retail—upa-ii needed to send out a strong signal that India (genuinely) welcomed foreign direct investment (FDI).

The SC verdict on January 20—which cleared Vodafone of its $2.5-billion tax liability in the 2007 Hutch acquisition deal—didn't disappoint. In sum, the SC says the transfer of shares in an offshore entity between two non-residents cannot be taxed in India, and that the Indian tax authorities have no jurisdiction here. This has thus been touted by the world as a victory for India's independent judiciary. It has also got the government working on a counter-strategy, which will play out in the months to come.

For now, though, as expected, many corporate law firms salute the verdict as a confidence-boosting development. Says Dinesh Kanabar, tax head at KPMG, "You need certainty in tax laws. Now the SC has said that the government should frame policies that make tax implications clear." Clearly, the apex court has based its judgement on existing laws, cutting out interpretations used by the income-tax department to put forth its views. Adds Druv Sanghavi of Nishith Desai Associates, "A negative judgement might have been viewed as judicial approval to uncertainty."

Immediately, there are indications that several other similar cases will benefit from this judgement and may escape any tax payout in India. This includes Cadbury's-Kraft, Sanofi-Aventis, SAB Miller-Foster and Essar-Vodafone. Pranay Bhatia, associate partner with law firm Economic Laws Practice, says, "The SC has interpreted the current law such that all similar deals will find shelter under this interpretation." The revenue implications from these company deals put together could be significant.

The Indian corporate sector, however, sees all of this as the calm before the storm. The Direct Taxes Code (DTC)—which will most likely be implemented from April this year—may reverse the situation. "It will force the government to come up with clear legislation on M&As that happens overseas," warns FICCI secretary-general Rajiv Kumar. The industry body feels something might come up as early as the Union budget in March.

"The tax dept is to blame...they were aware of such transactions, that the law was such and didn't move an amendment ." H.P. Ranina, Tax Expert

Even if the DTC doesn't come into effect this year, the government is going to work on changing the tax laws. An anti-avoidance limitation clause will be introduced for Mauritius, Cayman Islands and Cyprus—this will prevent shell companies from taking advantage of India's double tax avoidance agreement (DTAA) with these countries. The Mauritius DTAA is being renegotiated currently, and the changes will be visible very soon, possibly when their PM visits India next month. "The current laws are not adequate to tackle cases like this. Irrespective of the Vodafone judgement, we will see some changes in rules on General Anti- Avoidance Rules," says Mukesh Butani, managing partner, BMR Legal.

Indeed, far from the mandatory champagne popping, the legal and tax fraternity is (rather seriously) debating the state's next moves. It has been a contentious debate because the I-T department's view challenges the existing taxation system. "Under the present legal framework, the SC judgement is appropriate... but morally, there's need for a rethink," says tax expert ICRIER director Parthasarathi Shome (see interview).

Others are now taking softer positions. "Both views are possible. Another judge could have taken a different view. The income-tax department's view also has some validity and the Bombay HC had upheld it," says tax expert H.P. Ranina. Some are also voicing doubts about the way the apex court looked at the issue. Says Hemant Batra, managing partner at corporate law firm Kaden Boriss, "It (the verdict) will set a wrong precedent and create a superior class of companies who will never pay capital gains in India. While the judgement says the capital assets were not based in India, it cannot be ignored that the capital assets derived liquidity from a business in India."

What helped the verdict was the routing of investments or acquisitions through the Mauritius or Cayman Islands-based companies—the latter featuring in the Vodafone case. Because of India's DTAAs with these countries, many firms use this route to avoid any tax liability in India. In the last decade, 40 per cent of FDI into India has come via the Mauritius route. Ranina feels the government should have checked this route in time to avoid such cases. "The tax department is to blame as they were aware of such transactions and that the law was such and didn't move for an amendment. They should have done it much earlier."

Clearly, more stringent tax rules are being crafted by the government. Will that affect India's standing as an investment decision? Unlikely, as FDI into China continues to flow in despite similar tax measures. India's taxman knows that only too well.

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