Tax Hotline

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VODAFONE VICTORIOUS IN MULTI BILLION TAX BATTLE

SUPREME COURT'S DECISION INSTILS NEW SENSE OF CONFIDENCE AMONG INVESTORS

The conclusion of this highly controversial case has brought much needed clarity on a number of issues surrounding cross-border transactions involving investments in India. The Supreme Court has not only provided relief to Vodafone, but has also ushered an environment of certainty and fairness.

Briefly, the controversy surrounded the acquisition of the entire shareholding of CGP, a company resident in the Cayman Islands by Vodafone, a company resident in the Netherlands, from HTIL, another company resident in the Cayman Islands. CGP indirectly held a 67% interest in the then Hutch Essar Limited (now Vodafone Essar Limited) through a number of downstream subsidiaries and call options in Mauritius and India.[1]

The moot question was whether this transfer of shareholding of CGP would amount to the transfer of a capital asset situate in India? The Revenue contended so, arguing that the capital gains arising from such a transaction was liable to tax in India. Consequently, it held Vodafone ought to have withheld taxes from the same and was liable to make good to the Indian tax treasury the default sum of approximately USD 2 billion. Vodafone challenged this order by way of a writ petition before the Bombay High Court on the basis that the Revenue had no jurisdiction to levy taxes on an offshore transaction between two non-resident entities with no territorial nexus with, or taxable presence in India. It was contended by Vodafone that no capital assets situate in India had changed hands due to which the question of taxation in India did not arise.

A BUMPY RIDE TO THE SUPREME COURT

The Bombay High Court had dismissed the writ petition on the ground that the transaction was not a mere transfer of the shareholding in CGP, which had no business operations of its own. It held that the transfer of shareholding in CGP represented only a part of the entire transaction. The High Court attempted to unravel the other part of the transaction by referring to various documents such as the term-sheet, share purchase agreement, shareholder's agreements, and various framework agreements. These documents provided for a host of rights such as non-compete rights, the right to temporarily use the Hutch brand, the telecom licenses etc. to Vodafone.

The High Court held that the transaction had two separate facets: the first being the sale of shareholding in CGP and the second being the transfer of the aforesaid property rights, which can be said to be situated in India. According to the High Court, that part of the consideration which was attributable to the second facet of the transaction could amount to the transfer of a capital asset situate in India; thus liable to tax.

On appeal by Vodafone, by way of a Special Leave Petition, the Supreme Court of India held that no part of the consideration was liable to tax in India. In doing so, it has crystallised certain principles, which are briefly summarised below.

RESPECT FORM OF THE TRANSACTION

The Supreme Court held that a document or a transaction ought to be looked at in order to construe the facts of a case. Further, it 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.

It further observed that section 9 of the Income Tax Act, 1961 ("**ITA**") was not a look-through provision, but a mere legal fiction with a limited scope which ought not to be further extrapolated. 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.

In the facts of the Vodafone transaction, the Court observed that the situs of the shares of CGP was in the Cayman Islands as there was nothing to indicate that the shares were situated in India. It further held that no property rights were extinguished by Hutch, as it did not own any such rights in its own capacity. It upheld the existing Indian jurisprudence that controlling interest and other shareholder's rights could not be seen as assets distinct from the shares themselves. Therefore, one could not adopt a dissecting approach to treat "property rights" emanating from the shareholding in CGP as capital assets situate in India. The judgment of the Bombay High Court was therefore set aside.

RESPECT CORPORATE VEIL UNLESS THERE IS A SHAM

The judgement does not imply that the separateness of a corporate entity is sacrosanct and could never be disregarded. 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. The Supreme Court reiterated the law of the land that the burden of proof that a transaction was sham lay with the Revenue. It held that a corporate business purpose of a transaction would be evidence that it was not undertaken as a colourable or artificial device. It was held that the stronger the evidence of a device, the stronger would be the need to evidence the existence of corporate business purpose.

The Court further held that a transaction could be said to be a sham, if it had no business purpose, or if it lacked continuity. The Court drew a distinction between a mala fide transaction preordained to avoid tax, and one which evidences bona fide investment to participate in the Indian economy. The bona fide of a holding structure, it observed, could be deduced from its continuity.

In the facts of the instant case, the Supreme Court observed that CGP had been in existence since the year 1998 and was validly carrying on the business of an investment holding company. Therefore, the Court held that it satisfied the twin test of business purpose and continuity. Importantly, it remarked that a structure, meticulously planned to reduce tax costs on exit, which would whittle down profits was bona fide and cannot be categorised as illegal.

CORPORATE HOLDING STRUCTURES BACKED BY IMPORTANT BUSINESS CONSIDERATIONS

Justice K. S. Radhakrishnan, in his separate concurring judgment explained the meaning of the expression "business purpose" in the context of corporate holding structures. It was observed that corporate structures were primarily created for business and commercial purposes, with a view to maximise returns for shareholders. With a view to achieve this objective, legal entities, distinct from its shareholders could be validly set up for operational purposes, tax avoidance, mitigation of risks etc. Especially in transnational investments, the judge remarked, the use of a tax neutral and investor jurisdiction to establish a special purpose vehicle is motivated by the need to create tax efficient structures and to avoid the incidence of double taxation. Drawing a distinction between domestic and transnational investments, the judge remarked that the former was meant to stay within the home country, suggesting that the scope for cross-border tax planning may be limited in such cases. However, a planned, tax-efficient exit route formed good business and commercial reasons, which 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.

MAURITIUS ROUTE UPHELD (TRC MAY NOT BE CONCLUSIVE IF THERE IS A SHAM)

The Supreme Court specifically discussed and upheld the validity of the Mauritius route. As per article 13 of the India-Mauritius tax treaty, capital gains arising from the alienation of any property[2] 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.

The Supreme Court held that 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. However, it also held that the existence of a tax residency certificate does not prevent enquiry into a tax fraud like round tripping or other illegal activities. In his obiter, Justice Radhakrishnan noted that the existence of such a certificate does not prevent the Revenue from examining special contracts, agreements or arrangements effected by Indian residents or overseas companies.

In the facts of the instant case, the Supreme Court concluded that the sale of CGP cannot be said to be aimed at evading taxes in India, as the same end could have been achieved, had the shares of Hutch Essar Limited been sold by the downstream subsidiaries in Mauritius on account of a valid business purpose.

AZADI BACHAO ANDOLAN REMAINS LAW OF THE LAND

The Supreme Court held that the judgments in Azadi Bachai Andolan and McDowell were not conflicting and both espoused the correct interpretation of the law. In McDowell the Supreme Court had upheld tax planning as legitimate as long as it was within the framework of the law; colourable devices though could not be said to be legitimate. On the other hand, in Azadi Bachao Andolan it addressed the question of whether using the Mauritius route was tantamount to a colourable device.

Identifying no conflict between the two judgments, the Supreme Court found no merit in the Revenue's argument that Azadi ought to be overruled.

NO WITHHOLDING TAXES ON NON-RESIDENTS NOT HAVING PRESENCE IN INDIA

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. After reviewing cases such as Clark v. Oceanic Contractors, and Eli Lilly, Justice Radhakrishnan further remarked that withholding tax provisions under section 195 of the ITA would apply only in cases where payments are made by a resident to a non-resident. In other words, it has been held that payments between non-residents are not subject to withholding taxes under the ITA.

VODAFONE NOT A REPRESENTATIVE ASSESSEE

The Supreme Court also rejected the Revenue's argument that Vodafone be treated as a representative assessee for Hutch's tax liability. It pointed out a number of technical failures of the argument. Firstly, it observed that section 163, which provides for who may be regarded as a representative assessee, does not relate to withholding tax provisions. Secondly, a person ought to be an agent of the recipient of income in order to qualify as a representative assessee. Further such agency ought to be for the purposes of that income which can be deemed to accrue or arise in India, and not all agents could qualify as representative assesses. It was observed that none of these conditions were satisfied in the instant case.

ALL'S WELL THAT ENDS WELL?

Clarity and predictability are not only cornerstones of good fiscal laws, but are also fundamental to the fruition of every person's right to carry on one's occupation or business. The Vodafone controversy had created an environment, which was perceived as hostile, and had created a bottleneck around many cross-border mergers, acquisitions and foreign investment into India.

It is not for a moment suggested that the quest for foreign investment justifies fraudulent tax evasion. However, what is viewed as legitimate tax planning and what is intolerable tax evasion cannot be left to conjecture and surmise. 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.

The rule of law lends credibility to policy. The controversy had also created a perception that the Government's stated policy towards liberalisation was not harmonised with executive action. In its unequivocal interpretation of the law, the Supreme Court has upheld the rule of law, and vindicated democracy in India. It is hoped that the judgment is not negated by amendments to the ITA with retrospective operation.

– The International Tax Controversy Team
You can direct your queries or comments to the authors

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[1] Our earlier coverage of the Vodafone case can be accessed here. For the complete facts of the case, please refer to the holding structure and list of dates and events.

[2] Other than immovable property, assets of a permanent establishment, or ships and aircraft operated in international traffic.
