

Tax Hotline

October 14, 2014

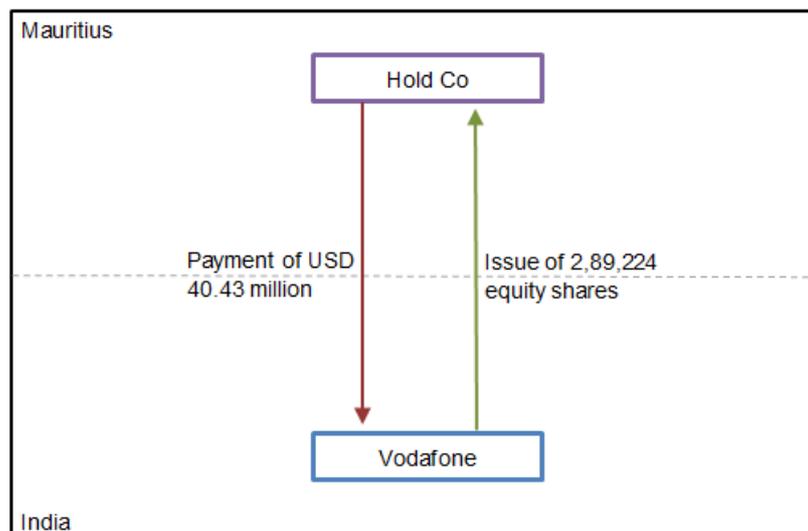
VODAFONE VICTORIOUS IN MULTI MILLION TRANSFER PRICING BATTLE, YET AGAIN!

- Bombay High Court holds that shares issued at a premium by a resident entity to a non-resident entity is a capital account transaction and does not give rise to any income;
- Income arising from an International Transaction between AEs must satisfy the test of 'income'; as provided under the ITA and fall under any of the charging provisions. In the absence of income, no international transaction can arise;
- 'Income' as defined under the ITA cannot be given a broader meaning to include notional income within its ambit;
- Transfer pricing provisions under the ITA are not a code by itself but only a machinery provision to compute ALP.

Recently, the Bombay High Court ("Court") in the case of *Vodafone India Services Pvt. Ltd. v. Union of India*¹ held that shares issued at premium by a resident entity to a non-resident entity didn't give rise to income and there is no 'international transaction' to trigger transfer-pricing provisions as provided under the Income Tax Act, 1961 ("ITA").

BACKGROUND

Vodafone India Services Pvt. Ltd. ("Vodafone"), a wholly owned subsidiary of a non-resident company, Vodafone Tele-Services (India) Holdings Limited ("Hold Co") issued 2,89,224 equity shares of the face value of INR 10/- each on a premium of INR 8,509/- per share to the Hold Co in the Assessment Year ("AY") 2009 – 10 ("Transaction"). The fair market value of the issue of equity shares was determined at INR 8,519/- per share in accordance with the methodology prescribed under the Capital Issues (Control) Act, 1947.



During the scrutiny assessment proceedings, the Assessing Officer ("AO") referred the Transaction to the Transfer Pricing Officer ("TPO") for calculation of its Arm's Length Price ("ALP"). The TPO, rejecting the price at which the shares were issued, determined the ALP at INR 53,775/- per share. It also held that (i) the Transaction was an International Transaction² and would be governed by transfer pricing provisions as provided under the ITA; and (ii) the amount of deficit caused by the issuance of shares at a lower premium will be considered as a loan extended by Vodafone to the Hold Co and the interest on such loan would therefore have a bearing on the profit of Vodafone. The TPO, thus, made a total

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adjustment of USD 229.22 million which included interest at the rate of 13.5% p.a. on the deficit amount that was re-characterized as a loan given by Vodafone to the Hold Co. However, the TPO left it on the AO to determine whether any income has arisen to Vodafone on account of the Transaction.

Vodafone in its submissions to the AO, *inter alia*, stated that the transaction of issuing shares cannot be governed by transfer pricing provisions as provided under the ITA as no income arises and / or is affected by it. However, the AO without dealing with submissions on this point passed a draft assessment order adding the entire amount of USD 229.22 million as determined by the TPO to Vodafone's income.

Post this, Vodafone filed objections to the draft assessment order with the Dispute Resolution Panel ("DRP"). In the objections, Vodafone made it clear that its submissions did not deal with the issue of jurisdiction but was restricted only to computation / valuation / quantification of ALP in respect of the Transaction. On the issue of jurisdiction, Vodafone filed a separate petition in the Court. The Court accepting the view that a jurisdictional issue arises for consideration, directed that Vodafone should submit its objections on the jurisdictional issue to the DRP within two weeks and the DRP would decide the issue of jurisdiction before considering issue of valuation / quantification of ALP within two months from the date on which the Vodafone files its objections with the DRP on the issue of jurisdiction. ([Click here for our hotline on this issue](#))

After objections were filed with the DRP on the issue of jurisdiction, the DRP passed its order holding that the deficit caused due to under charging or premium should be considered as income arising from the issue of shares and transfer pricing provisions should apply to such a transaction. The reasons given by DRP were:

- 'Income' as defined under the ITA should be construed broadly embracing all types of receipts or incomings. International Transaction as defined under the ITA includes capital financing like purchase of marketable securities and in case a narrow meaning is given to 'income', then purchase of marketable securities, could never come within the ambit of the definition of income. Similarly, a transaction of business restructuring or reorganization is considered as an International Transaction under the ITA and even when there is no formal transfer of source of income or tangibles, the AO has been given the power to tax the income forgone under the transfer pricing provisions;
- Since the issue of shares by Vodafone was not at ALP as determined by the TPO, it resulted in lesser premium being garnered by Vodafone. This income could have been used by Vodafone to enhance its potential income. Thus, even if 'income' is not given a broad meaning, the AO has jurisdiction to invoke transfer pricing provisions as the share premium forgone has impacted potential income;

Aggrieved by the order of the DRP, Vodafone filed a petition in the Court.

ORDER OF THE COURT

The Court quashing the order of the AO, TPO and DRP ruled in favor of Vodafone. The Court held that issue of shares at a premium by Vodafone to its Hold Co does not give rise to any income as it a capital account transaction and hence transfer pricing provisions should not apply to such a transaction. The Court came to this conclusion by giving the following reasons:

- *Meaning of 'income'*: 'Income' as defined under the ITA has a well understood meaning and it will not in its normal meaning include 'capital receipts' unless specified. Amounts received on issue of shares including premium is a capital account transaction and in the absence of express legislation, no amount received, accrued or arising out of a capital account transaction can be subject to tax as 'income'. Section 56 is the only provision under the ITA, which taxes premium received by a company from a resident in excess of the fair market value of the shares. However, in the present case, the premium has been received from the Hold Co, a non-resident. Further, income as defined under the ITA includes within its scope the provisions of Section 56 of the ITA which indicates the intent of the legislature to tax issue of shares to a resident, when the issue price is above its fair market value. Therefore, neither the capital receipts received by Vodafone from issue of shares to its Hold Co nor the deficit in the premium charged by Vodafone can be considered as 'income' as defined under the ITA. Further, the golden rule of interpreting a taxing statute is that the intent or purpose is irrelevant and the words of the taxing statute have to be interpreted strictly. Accordingly, by seeking aid of the intent of the legislature, the definition of 'income' cannot be given a broader meaning.
- *'Income' does not include notional income*: 'Income' cannot be given a broader meaning to include notional income within its ambit and issue of shares at a premium does not exhaust the universe of applicability of transfer pricing provisions as provided under the ITA. Transaction on capital account or on account of restructuring would become taxable to the extent it impacts income i.e. under reporting of interest or over reporting of interest paid or claiming of depreciation etc. and it is that income which has to be adjusted to the ALP;
- *Potential income cannot be subject to tax*: Income which Vodafone could have made if it had not under valued the price of its shares cannot be the basis of taxation. Transfer pricing provisions are invoked to ensure that there is no manipulation of prices/consideration between Associated Enterprises ("AEs") and only after calculation of the ALP is the transaction charged to tax. The entire consideration received cannot be a subject-matter of taxation.
- *'Income' is necessary for ALP to be applicable*: ALP is meant to determine the real value of the

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transaction entered into between AEs. It is a re-computation exercise to be carried out only when income arises in case of an international transaction between AEs. It does not warrant re-computation of a consideration received / given on capital account. It permits re-computation of income arising out of a capital account transaction, such as interest paid/received on loans taken/given, depreciation taken on machinery etc. All the above are cases of income being affected due to a capital account transaction. However, in the present case, even though the issue of shares is a capital account transaction there is no income that arises out of the transaction and hence the shortfall of ALP as computed does not give rise to any income.

- *Transfer pricing provisions are only machinery provisions:* The chapter under the ITA dealing with transfer pricing provisions is not a code by itself but only a machinery provision to compute ALP. It is a settled position that a charge to tax must be found specifically mentioned in the ITA and in the absence of a charging section in the chapter it is not possible to read a charging provision into the chapter. Even income arising from an International Transaction between AEs must satisfy the test of 'income'; as provided under the ITA and fall under any of the charging provisions. In the present case there is no charging provision to tax capital account transaction in respect of issue of shares at a premium.

CONCLUSION

The judgment is welcomed not only by Vodafone but also by 20 other companies which are stalled in similar tax-related dispute with the Indian Revenue Authorities. The Court while pronouncing its judgment has gone into the intent of the legislature when enacting transfer pricing provisions and has laid down that transfer pricing provisions were introduced under the ITA to get over transfer mispricing/manipulation/abuse. Transfer pricing provisions have not replaced the concept of income or expenditure as normally understood under the ITA but are existing to ensure that qua International Transaction between AEs, the profits are not understated nor losses overstated by abuse of either showing lesser consideration or higher expenses between AEs than would be the consideration between two independent entities, uninfluenced by their relationship.

The Court has once again clarified that taxing provisions cannot be read on the basis of intent but need to be construed strictly on the basis of what has been said. Further, what has not been provided under the ITA cannot be presumed to exist without there being an express provision for the same. While, the Central Board of Direct Taxes has said that they are reviewing the judgment and will then decide the next course of action, it is more certain than not that the Revenue will file an appeal with the Apex Court to finally decide the issue.

This is another multi-million battle that Vodafone has won, the first one being on the issue of indirect transfer of assets. Such high profile litigation being instituted against MNCs time and again definitely raises a question of intention of the Revenue Authorities in people's mind. The number of such litigations being instituted against MNCs creates further tension in the existing adversarial environment in India characterized by the large backlog of cases. Further, the new Government has always in its public statements stated that there will no 'tax terrorism' but cases like these tend to show what the real picture is. The Court in the judgment has itself recognized that the arguments which were raised by the tax authorities were bereft of any sanctity under law. Such kind of actions result in creating ambiguities where none exist and is an example of executive overreach of power. Government should be cognizant of the ramifications prior to filing any appeal and should stick to the stance of not introducing retrospective amendment to the existing law.

A trust based taxation system is the need of the hour. Further, it is imperative that certainty, fairness and stability should continue to serve as guiding principles and not the amount of tax that can be collected. It is necessary to guarantee and enforce internationally recognized taxpayer rights and safeguards have to be included to counter excessive discretion and corruption.

– Ashish Sodhani & Rajesh Simhan

You can direct your queries or comments to the authors

¹ Writ Petition No. 871 of 2014

² Section 92B of the ITA

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