Tax Hotline

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THE VODAFONE TAX CONTROVERSY NDA COMMENTARIES ON COURT PROCEEDINGS*

The Vodafone tax controversy concerns a cross-border M&A transaction between non-resident entities and its taxability in India. The facts before the Bombay High Court are unique and unprecedented, and the outcome could have a telling impact on global mergers and acquisitions, indirectly involving an Indian subsidiary. Nishith Desai Associates brings you updates on the final hearings as and when they develop in the courtroom.

On July 7, 2008, Senior Advocate Mr. Iqbal M. Chagla, counsel for Vodafone International Holdings BV ("**Vodafone**") started the day in court by continuing his proposition from the previous hearing on July 1, 2008. He completed this proposition dealing with the chargeability of capital gains tax in the hands of a non-resident under section 9 of the Income Tax Act, 1961 ("**ITA**"). Thereafter Senior Advocate Mr. Mohan Parasaran, Additional Solicitor General of India, arguing on behalf of the Income-tax Department ("**Revenue**") took over. Mr. Parasaran laid down the brief propositions which he wished to argue before the Court, and thereafter challenged the maintainability of the present writ-petition filed by Vodafone.

With respect to chargeability of a transaction between two non-residents, Mr. Chagla reiterated that under the ITA, a non-resident is liable to tax only with respect to income which accrues or arises in India or income which can be so deemed to accrue or arise in India. Under Section 9 of the ITA and in the facts and circumstances of the present controversy, only income *accruing or arising, whether directly or indirectly, through or from a business connection in India or through the transfer of a capital asset situated in India* can be brought to tax in India at the hands of a non-resident. The transaction in the present case is the transfer of share capital of a non-resident company and would accordingly not satisfy the definition of a capital asset situate in India. The counsel cited the judgment of the Delhi High Court in *CIT v/s. Quantas Airways Ltd.*[1]which states that *when an income accruing or arising from a business by reason of a legal fiction becomes assessable, it must be held that the same must be kept confined to receipts out of the business and not out of the sale of capital assets*. The counsel in continuation cited the judgment of the Bombay High Court in *Pfizer Corporation v/s. CIT*[2] which held that *the situs of the shares is the place where the register is kept*. Thus it was the submission that since the acquisition of shares is of CGP Investments (**"CGP"**), a Cayman Islands Company, the situs of shares will be in Cayman Islands at the registered office of such company and is therefore a capital asset situated outside India. The counsel also submitted that the expression *"directly or indirectly"* used in section 9 of the ITA relates only to income accruing or arising from a business connection in India and not to the transfer of a capital asset situate in India.

It was further submitted that the shares held in Vodafone-Essar Limited[3] ("**Vodafone India**") by CGP is an asset owned by CGP. Consequently, it was submitted that by acquiring shares in CGP, Vodafone did not acquire any interest in the assets of CGP, one of which could be the controlling interest in Vodafone India. This was supported by the judgment of the Constitution Bench of the Supreme Court in *Bacha F. Guzdar v/s. CIT*[4]where the Supreme Court emphatically held that*, a shareholder acquires a right to participate in the profits of the company may be readily conceded but it is not possible to accept the contention that the shareholder acquires any interest in the assets of the company.* Thus Mr. Chagla assumed against himself that even if controlling interest in a company is a capital asset, by acquiring the shares of CGP, Vodafone cannot be said to have acquired assets of CGP but only rights attached to the shares of CGP. Therefore Vodafone cannot be considered to have acquired a capital asset nor a controlling interest in Vodafone India.

Thus, in conclusion, the counsel for Vodafone contended that capital gains accruing from the sale of shares of CGP did not satisfy any of the conditions for it to be taxable in India. Thus as a necessary corollary, Vodafone could not have any responsibility to withhold tax from the consideration paid to Hutchison Telecommunications International Limited ("**HTIL**") for acquisition of shares of CGP.

Thereafter the counsel for the Revenue tried to level the field by first laying down factual circumstances and also quoting the management of Vodafone, HTIL and Essar[5], through which he attempted to show that the transaction in contemplation was for the sale of Indian mobile telecommunications operations belonging to HTIL to Vodafone. It was then argued that the present writ-petition was not maintainable. It was submitted that a mere show cause notice issued by the Revenue did not affect the rights of any person unless a final order affecting the rights of a party is passed, thus the present writ petition was not maintainable and was pre-mature.

It was further submitted that the scheme of Section 195 of the ITA was in the form of a tentative deduction subject to regular assessment and the deduction would not affect the rights of either parties. However it is also the statutory obligation of the payee to withhold tax on payments made to non-residents which are chargeable to tax. Failure to

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comply with this obligation lead to the issue of the show cause notice thereby requiring Vodafone to answer why it should not be treated as an *'assessee in default'*[6] under Section 201 of the ITA.

As the bench consisting of Justice S. Radhakrishnan and Justice A.V. Nirgude has been specially constituted to hear the matter, the hearing will continue everyday for the next few days. On July 8, 2008 Mr. Parasaran is expected to argue on the availability of an efficacious remedy under Section 195(2) and 197 of the ITA, defend the challenge made to the amendments brought about to the ITA by the Finance Act, 2008 and prove to the Court how the present transaction is *prima-facie* liable to capital gains tax and thereby attempt to prove Vodafone as an "assessee in default".

- International Tax Team & M&A Team

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1 [2002] 256 ITR 84 (Del.).

2 [2003] 259 ITR 391 (Bom.).

3 Earlier known as Hutch-Essar Limited.

4 [1955] 27 ITR 1 (SC), AIR 1955 SC 74.

5 Essar Group is the joint-venture partner of Vodafone in the Indian mobile telecommunications operations.

6 In India the tax payer is called an assessee.

* Previous commentaries: June 27, 2008, June 30, 2008 & July 2, 2008

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