Tax Hotline

July 09, 2008

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 8, 2008, Additional Solicitor General of India, Senior Advocate Mr. Mohan Parasaran, counsel for the Income-tax Department ("**Revenue**"), continued his submissions with respect to the chargeability of capital gains in light of the facts and circumstances of the instant case. The counsel pointed out that Vodafone International Holdings BV ("**Vodafone**") had made an application to the Foreign Investment Promotion Board ("**FIPB**"). This, he submitted, indicated that Vodafone acquired a controlling interest in Vodafone Essar Limited[1] ("**Vodafone India**"). It was further submitted that in the present transaction, neither Section 195 nor the show cause notice can be construed as extra territorial. The Revenue also contended that Vodafone was rightly classified as an 'Assessee in Default' for its failure to withhold tax from the consideration paid to Hutchison Telecommunications International Limited ("**HTIL**"). Finally, the counsel submitted that the retrospective amendments to Section 191 and 201 are machinery provisions and were amended to remedy the mischief, and hence wholly within constitutional precincts.

SUBMISSIONS ON CHARGEABILITY

On the first proposition, on chargeability, the counsel opened his arguments by stating that Section 5 of the ITA contemplates twin basis of taxation, i.e. based on residence under Section 5(1) and source of income in respect of non residents under Section 5(2). Section 9 introduces a deeming fiction by virtue of which income accruing or arising *directly or indirectly* through or from any business connection in India; property situate in India; or asset or source of income in India; or transfer of capital asset situate in India. Analyzing the constituents of the said Section, the counsel submitted that transfer of 67% of HTIL's economic interest and controlling stake in Vodafone India in favor of Vodafone is nothing but transfer of capital asset in the form of shares of Vodafone India, falling within Section 9. In support of the above submissions, the counsel for the Revenue also relied on judgments of various courts to substantiate that Section 9 must be construed strictly in interpreting each of the four constituents of the said provision. Further he also relied on decisions to demonstrate that the definition of property includes intangibles, i.e. controlling interest.

The counsel then referred to and relied on the definitions of 'Capital Asset', 'Transfer' and 'Assessee' under ITA. He contended that the definition of Capital Asset is an inclusive definition to mean property of any kind whether or not connected with business or profession. In this context he emphasized on the fact that it is not merely the shares which are transferred but intangible assets comprising a bundle of rights and controlling interest in Vodafone India, in favor of Vodafone, which lead to transfer of a capital asset situate in India. Relying on the definition of 'transfer' under the ITA, the counsel submitted that relinquishment of controlling interest of HTIL in Vodafone India, in favor of Vodafone was nothing but transfer to Vodafone, the capital asset situate in India. Referring to the definition of Assessee the learned counsel emphasized that the said definition included Assessee in Default for the purposes of Section 195 (failure to deduct withholding tax). In light of this, he categorically submitted that the crux of the issue which makes the transaction taxable under Section 9 was transfer of intangible controlling interest (67%) of HTIL in Vodafone India in favor of Vodafone and not the innocuous acquisition of shares of CGP Investments ("**CGP**") i.e. the Cayman Islands Company. *At this juncture, Mr. Chagla appearing for Vodafone intervened to state without prejudice that they do not dispute acquisition of indirect control in Vodafone Essar in India but as judicial precedents suggest transfer of controlling interest cannot be construed as an asset in the first place and such transfer of asset is merely incidental to the transfer of shares.* He indicated that he would further elaborate on this aspect in his rejoinder (rebuttal), as the hearing continues on July 9, 2008.

On his second proposition regarding submissions to FIPB the counsel for the Revenue pointed out that Vodafone was different from shareholders of Vodafone. The ultimate controlling entity as a result of the transfer of controlling interest of HTIL in Vodafone India is Vodafone. The learned counsel for the Revenue urged that in recent times of changing corporate jurisprudence, the principles laid down by the classic case of Solomon v/s. Solomon in terms of shareholder identity, apply, but with modifications suited to today's era.

At this juncture, Mr. Chagla intervened to submit that there was no change whatsoever in the shareholding in Hutch Essar pursuant to such transfer. The counsel for the Revenue stated that HTIL had conducted a competitive auction for sale of HTIL's interest in Vodafone India. Vodafone participated in this auction and agreed to pay USD 11.08 billion to acquire 67% of controlling stake in Vodafone India. Reference was made to certain correspondence / letters

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to FIPB by Vodafone to demonstrate that by the 'complex' transaction, HTIL, transferred a bundle of rights, both tangible and intangible along with economic and controlling interest to Vodafone in Vodafone India. The counsel strenuously urged that the transfer of CGP's shares was merely a medium, a vehicle to acquire controlling interest in Vodafone India. In this context, he urged the Court to consider that the shares of CGP so transferred were not even considered in determining the enterprise value of Hutch Essar. He further submitted that by transfer of 67% controlling stake of HTIL in Vodafone India, Vodafone acquired the right to appoint 8 directors and the Chairman in Vodafone India, by which Vodafone actually acquired management control in the Indian entity. Further, the counsel submitted that the intention of Vodafone was to acquire a stake in Vodafone India by acquiring shares of the CGP which was merely a vehicle to acquire controlling interest in Vodafone India. Hence there was no need whatsoever to invoke the doctrine of lifting corporate veil, when the intention of the parties is manifestly evident.

OBLIGATION TO WITHHOLD TAX

On the applicability of Section 195, counsel for Revenue submitted that neither the said Section nor the show cause notice issued to Vodafone for non compliance thereof can be construed as extra territorial. In this context, he submitted that under Section 1(2) of the ITA, the Act extends to the whole of India, in contra distinction to part of India and not outside India. According to the counsel for the Revenue a non resident can be taxed in India if he falls within the scope of Section 9, if the requirements there under are complied with. To this Mr. Chagla, the counsel for Vodafone cautioned the Court to the effect that this would lead to taxation of worldwide income in India merely by virtue of some connection with India. The counsel for the Revenue emphasized that Section 195 was a provision laying down machinery to collect tax and ought to be interpreted to give effect to the charging Section. He submitted that once Section 9 is triggered as a consequence thereof the machinery provision to collect the tax i.e. Section 195 comes into play. The counsel for the Revenue strenuously argued that the Court ought to give due credence to the internationally accepted 'Effects Doctrine' which has its root in the US, on the issue of territorial nexus with India. In this context, he categorically submitted that it is not only the transaction but the ultimate effect of the same, should determine the taxability. He drew support from the provisions of the US Anti Trust Law i.e. the Sherman Act to state that the principle of substantial effect must be followed so long as the same is not applied unilaterally. In light of the submissions advanced on Section 195, he submitted that Vodafone was therefore liable to deduct tax from the payments made to HTIL under Section 195, failure of which rendered Vodafone to be an Assessee in default.

RETROSPECTIVE AMENDMENTS

On the retrospective amendments to Section 191 and 201 he submitted that the amendments were introduced with a view to remedy the mischief and ensure that tax due and payable is not evaded. He relied on several decisions of various courts to contend that taxation statutes should be strictly construed and the procedural provisions laying down the machinery to tax must be so interpreted so as to make the same workable and not otherwise. The counsel for the Revenue would be continuing his submissions on the retrospective amendments tomorrow after which Mr. Chagla would rejoin to rebut the submissions made by the Revenue's counsel.

The hearing concluded today i.e. on July 9, 2008.We shall come back to you with our analysis of the today's developments in our final hotline, shortly.

- International Tax Team & M&A Team

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1 Earlier known as Hutch Essar Limited

* Previous commentaries: June 27, 2008, June 30, 2008 July 2, 2008, July 8, 2008

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