Tax Alert

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THE VODAFONE CASE

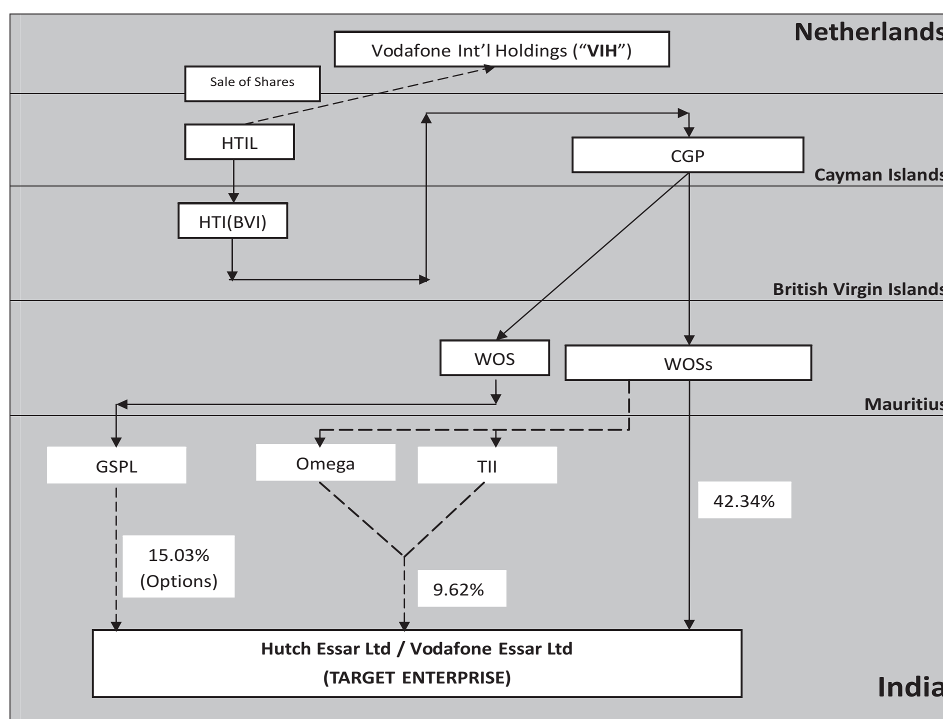
In a judgment having far reaching consequences, a three judge bench of the Supreme Court of India, in the eagerly awaited (the world over) decision in the case of Vodafone International Holdings BV vs. Union of India ("the Vodafone case"), has while dismissing the case of the Revenue that sale of shares of a non resident company by one non resident to another non resident outside India resulted in indirect transfer of underlying assets in India and gave rise to capital gains taxable in India, laid down some very important legal principles on issues like, tax avoidance and evasion, parent subsidiary relationship, complex holding / investment structures, the scope of deeming provision of section 9(1)(i), applicability of tax withholding provision under section 195 to non resident payers, which we seek to focus on in this tax alert.

Overview of the facts and controversy:

Hutchison Essar Ltd. (HEL), a company incorporated in India, was a joint venture of the Hong Kong-based Hutchison Group and the India-based Essar Group. Hutch India (HEL) was in the business of providing telecommunication service in India. Hutchison Tele-communication International Ltd. (HTIL), a Cayman Island company of Hutchison Group had a step-down wholly owned subsidiary (WOS), viz. CGP, a Special Purpose Vehicle (SPV), registered in Cayman Islands ("CGP"). CGP held 42.34% shares in HEL through 100% subsidiaries (in Mauritius), 9.62% shares indirectly through TII and Omega (which were not subsidiaries) and 15.03% through unrelated companies of AG, AS and IDFL, by virtue of HTIL having the right (indirectly) to exercise call and put options therein.

The stake of HTIL in CGP was acquired by Vodafone, a UK-based mobile phone group, through its Netherlands based SPV, viz. Vodafone International Holdings BV ("Vodafone"), for a total consideration of $11.2 billion. Pursuant to the consent of Essar Group, a new joint venture called Vodafone Essar Ltd. (the new name of HEL) came into existence. Estimated capital gains of $ 2 billion accrued to HTIL in the above transaction.

For ease of understanding, the aforesaid structure has been put in simple diagrammatic form, as below:



N.B.: 1. Where the percentage of shareholding has not been expressly specified, the percentage may be read as 100%
2. Dotted lines represent indirect holding

The said offshore transaction between HTIL (the vendor) and Vodafone for transfer of entire shareholding of CGP was subject matter of dispute before the Indian Revenue authority. It was the claim of the Revenue that HTIL has transferred controlling interest to the extent of 67% in HEL by way of sale of share of CGP. The Indian Revenue, being of the view that since the above transaction resulted in extinguishment of certain rights of HTIL in HEL and, alternatively in indirect transfer of assets in India, capital gains chargeable to tax in India arose and Vodafone was thus under an obligation to withhold tax at source while making the payment of the sale consideration, in terms of section 195 of the Income-tax Act, 1961 ("the Act"). Accordingly, notice was issued to Vodafone to show cause as to why it should not be treated as an "assessee-in-default" for failing to withhold the Indian capital gains tax on payment of the sale consideration.

Vodafone moved the Bombay High Court challenging the jurisdiction of the Indian Revenue to examine the transaction of transfer of shares of a foreign company entered into between two non-resident companies.

The High Court dismissed the above writ petition, against which Vodafone preferred an appeal to the Supreme Court ("SC"). The SC dismissed the appeal on January 23, 2010 directing that the jurisdictional issue, as to whether the Indian Revenue had the jurisdiction to examine and tax the above transaction, should first be determined by the concerned income-tax authority after Vodafone had submitted all documents. The SC further stated that if the jurisdictional issue was decided against Vodafone, it could move the Bombay High Court to challenge the decision on the preliminary issue of jurisdiction.

Pursuant to the SC order, the Revenue passed an order on May 31, 2010, reiterating its jurisdiction in respect of the above transaction and treated Vodafone as an assessee-in-default under section 201(1) of the Act for not deducting tax from the aforesaid payment of sales consideration.

This order was challenged by Vodafone before the Bombay HC by way of a writ petition. The Revenue's case, briefly stated, was that the sale consideration received by HTIL was towards the transfer of its business/economic interests as a group in India and that the subject-matter of the transaction was transfer of various intangible rights / interests of HTIL in HEL and not an innocuous acquisition of shares of the Cayman Islands SPV, viz. CGP.

Vodafone's case, on the other hand, was that the aforesaid transaction was a transfer of share capital of a non-resident company (the Cayman Island SPV) and was not a transfer of capital asset situated in India. The controlling interest in a company was not an asset separate and distinct from the shares but was an incident arising from the holding of a particular number of shares. Since by virtue of acquisition of shares of the Cayman Islands SPV, Vodafone acquired the controlling interest only *indirectly*, there was no direct transfer of a capital asset situate in India so as to give rise to any tax liability. Consequently, Section 9, which deems income arising, inter alia, through the transfer of a capital asset situate in India, was not attracted on the facts of the case and the procedural provisions of Section 195 of the Act relating to withholding tax were not applicable.

The Bombay HC, vide order dated September 08, 2010, dismissed the writ petition and upheld the jurisdiction of the Indian Revenue to examine the transaction on the ground that the transaction in question had a significant nexus with India, in view of change in the controlling interest in HEL and transfer of diverse rights and entitlements. The HC, for the first time, introduced the theory of apportionment, according to which that part of the consideration which had direct and sufficient territorial nexus with India could be brought to tax in India The HC set-aside the matter to the Revenue for apportionment of the sale consideration.

Vodafone moved the SC, challenging the judgment of the Bombay HC.

The Decision:

The Supreme Court, vide order dated, January 20, 2012, reversed the decision of the Bombay High Court and held that Vodafone was not required to withhold tax from the payments made to HTIL. The Supreme Court held that offshore transaction of acquisition of shares of CGP by Vodafone International Holdings BV (VIH) from HTIL was a bonafide, structured Foreign Direct Investment ("FDI") investment in India which fell outside India's Revenue's territorial tax jurisdiction and hence was not taxable. The important principles of law enunciated by the Supreme Court in arriving at the above conclusion are as below:

(a) Tax avoidance / evasion –Azadi Bachao Andolan vs. McDowell

The Revenue had contended that introduction of CGP in the HTIL structure was an after thought and its interpretation was a device to evade tax which ought to be disregarded for tax purpose.

The Revenue submitted that the Supreme Court that the five members decision of the Supreme Court in the case of *McDowell and Co. Ltd. vs. CTO (1985) 3 SCC 230*, should be followed and the later decision of the Supreme Court in the case of *Azadi Bachao Andolal: 263 ITR 706*, wherein *paragraph 45 of the full bench decision* stating the circumstances in which transactions which attempt to evade tax could be ignored was not considered, was

not good law. The Supreme Court in McDowell's case in paragraph 45 held that "tax planning may be legitimate provided it is within the framework of law". In the latter part of para 45, it held that "colourable device cannot be a part of tax planning and it is wrong to encourage the belief that it is honourable to avoid payment of tax by resorting to dubious methods."

The Supreme Court in the case of *Union of India vs. Azadi Bachao Andolan (2004) 10 SCC 1,* apart from the issue of validity of Circular(s) issued by Central Board of Direct Taxes (CBDT) in relation to Indo – Mauritius DTAA extensively dealt with the concept of tax avoidance / evasion. The Supreme Court in that case followed the principle laid down by the House of Lords in the case of *Commissioner of Inland Revenue vs. His Grace the Duke of Westminster 1935 All E.R. 259,* that *"Every man is entitled if he can to order his affairs so that the tax attracting under the appropriate Acts is less than it otherwise would be …….. given that a document or transaction is genuine, the Court cannot be go behind it to some supposed underlying substance."* In the later decision of House of Lords in the case of *W.T. Ramsay Ltd. vs. Inland Revenue Commissioner (1981) 1 All E.R. 865,* it was held that *"Westminster did not compel the Court to* ***look at*** *a document or a transaction, isolated from the context to which it properly belonged. It is the task of the Court to ascertain the legal nature of he transaction and while doing so, it has to* ***look at*** *the entire transaction as a whole and not to adopt a dissecting approach."*

The Supreme Court in the above case did not agree with Justice Chinnapa Reddy's observations in McDowells's case that the Duke of Westminster's case is dead.

The Supreme Court in Vodafone's case, dealing with the contention raised on behalf of the Revenue that the decision in the case of *Azadi Bachao Andolan* need to be overruled in so far as it departs from principle laid down in the earlier decision in the case of *McDowell and Co. Ltd.*, held that there was no conflict between the two decisions. The Supreme Court observed hat even the decision of House of Lords in Ramsay did not discard the principle in Westminster's case but read it in the proper context by which "device" which was colourable in nature had to be ignored as fiscal nullity. The Supreme Court further observed that *"the decision in the case of Ramsay lais down the principle of statutory interpretation rather than an over-arching anti-avoidance doctrine imposed upon tax laws."*

The Supreme Court tracing the jurisprudence on the issue which had developed in England over the years, held that the Revenue cannot start with the question as to whether the transaction was a tax deferment / saving device but that the Revenue should apply the **look at** test to ascertain its true legal nature. It was observed that genuine strategic planning had not been abandoned by any decision of the English Courts till date.

In terms of the aforesaid decision of the Supreme Court, it follows, that tax planning within the framework of law is not to be frowned upon and only if artificial/colourable devices, sham transactions, are resorted to with the sole purpose of evading tax, that the Revenue could ignore the same. The onus is on the Revenue to establish that the transaction was a sham.

In Azadi Bachao's case routing of investment in India from Mauritius was not considered as a colourable device to evade tax and treaty shopping was not disapproved in absence of anti-avoidance legislation. The same position would thus continue to prevail in terms of the decision of the Supreme Court in Vodafone's case.

(b) Holding structures – separate entity principle to be respected:

The Supreme Court noted that in law and for tax treaty purposes a subsidiary and parent are separate/ distinct tax payers, notwithstanding that the autonomy of directors of a subsidiary may be restricted, because of shareholders' influence; that being an inevitable consequence of any group structure. The Court explained that there is difference between having power and having persuasive position, and held that directors and not shareholders are the managers of a company and their powers are not obliterated because of shareholder's influence, except where subsidiaries are created as sham.

The Court further recognized the existence and validity of holding company structure, in corporate as well as tax laws, observing that Special Purpose Vehicles (SPVs) and Holding Companies have a place in legal structures in India, be it company law, takeover code under SEBI and even the income-tax law.

It was noted that foreign investors investing in India through companies interposed in Mauritius, is common practice for both tax and business purposes. For example, such companies are interposed to avoid lengthy approval and registration process, which is required in case of direct transfer. Thus, it facilitates exit of a foreign investor. In terms of the aforesaid decision, it appears that the aforesaid reason may well afford a business/commercial purpose for having intermediary entity(ies) in an investment structure.

According to the Court, when it comes to taxation of a holding structure, the burden is on the Revenue to allege and establish abuse, in the sense of tax avoidance in the creation and/or use of such structure(s). Such structures are to be otherwise respected.

The Supreme Court held that on application of judicial anti-avoidance rule, the Revenue may invoke the "substance over form" principle or "piercing the corporate veil" test, only if indirect transfer is made by the non-resident enterprise through,

"abuse of organization/legal form and without reasonable business purpose", which results n tax avoidance, and disregard the transaction/structure. The Supreme Court gave examples of application of such anti avoidance rules in situations, such as, circular trading, round tripping, payment of bribes, wherein the structure though having a legal form, could be discarded.

The Supreme Court further held that, where an entity which has no commercial / business substance and has been interposed only to avoid tax then it would be open to the Revenue to discard such entity applying the test of fiscal nullity. However, the structure/ transaction needs to be disregarded at the threshold. The Supreme Court, further cautioned that while doing so, the Revenue should **look at** the documents or the transaction in the context to which it properly belongs and as a whole instead of adopting dissecting approach.

Applying the above tests, the Supreme Court concluded that strategic foreign direct investment coming to India, as an investment destination, should be seen in a holistic manner. While doing so, the Revenue / Courts should keep in mind the following factors:

- the concept of participation in investment,
- the duration of time during which the Holding Structure exists;
- the period of business operations in India;
- the generation of taxable revenues in India;
- the timing of the exit;
- the continuity of business on such exit.

In fact, exit coupled with continuity of business was held to be an important tell-tale circumstance to indicate commercial/business substance of the transaction.

The Court further observed that there is a conceptual difference between preordained transactions created for tax avoidance and a transaction which evidences investment to participate in India. The Supreme Court observed, that Hutchison structure was in place since 1994 and was put up for 'participation in investment' in India and was not a 'preordained' transaction. The Court noted that Hutchison has paid huge amount of taxes in India over the year and that HTIL or Vodafone were not fly by night operators / short time investor. The issue of defacto vs legal control, legal rights vs participation rights, etc., were not material in such a situation.

In short, the onus will be on the Revenue to identify the scheme and its dominant purpose. The corporate business purpose of a transaction is evidence of the fact that the transaction is not undertaken as a colourable or artificial device. The stronger the evidence of a device, the stronger the corporate business purpose must exist to overcome the evidence of a device. Generally, a structure involving intermediaries in one or more jurisdiction put in place for making investment in India would be considered as having commercial/business purpose.

(c) Interpretation of section 9(1)(i) – whether it is a "look through" provision:

Section 9(1) of the Act deems certain incomes to accrue or arise in India. Section 9(1)(i) of the Acts deems, inter alia, "all income accruing or arising, whether directly or indirectly .... through transfer of capital assets situate in India.", to accrue or arise n India and hence taxable in India.

It was the contention of the Revenue that income from sale of CGP share would fall within section 9(1)(i) of the Act, as the said section provides for a **"look through"** approach, in view of the use of word "through" and 'indirect' in the said section . It was contended that there was transfer of control over HEL in consequence of/through transfer of CGP share outside India, and the same resulted in indirect transfer of asset, viz., controlling/management right in HEL, etc., and hence there was deemed accrual of income in India. The Supreme Court disagreeing with the arguments advanced by the Revenue, held as under:

(i) Section 9(1)(i) is a deeming provision. A legal fiction has limited scope and cannot be expanded by giving purposive interpretation particularly if the result of such interpretation is to transform the concept of chargeability altogether.

(ii) The word 'indirect' qualifies income and not transfer. Section 9(1)(i) of the Act cannot by a process of interpretation be extended to cover indirect transfers of capital assets / property situate in India. To do so, would amount to changing the content and ambit of that section.

(iii) If indirect transfer of a capital asset is read into section 9(1)(i), then the words "capital asset situate in India" would be rendered nugatory.

(iv) The words underlying asset do not find place in section 9(1)(i) and cannot be read therein.

(v) The provision for subjecting to tax transfer of shares of a foreign company by a non resident, which represents at least 50% of the fair market value of assets in India in the proposed DTC Bill, 2010, indicates that indirect transfers are not covered by the existing section 9(1)(i) of the Act.

The Supreme Court noted that provisions like "look through" and "limitations of benefits" have to be expressly provided in the Statute and cannot be read into by process of interpretation, as they are policy matters.

(d) Whether HTIL's property rights in HEL were extinguished:

It was contended by the Revenue that HTIL under the Share Purchase Agreement with Vodafone (SPA), extinguished its rights of control and management in HEL, which were "property rights", and hence there was transfer of capital asset chargeable to capital gains tax in India. According to the Revenue such extinguishment took place dehors the CGP share by virtue of the various clauses of SPA, which itself disregarded the corporate structure and the legal entities interposed between HTIL and HEL. It was also contended that HTIL had defecto control over such downstream subsidiaries, which control was subject matter of SPA, dehors the holding in CGP.

The Supreme Court held that present case, when looked at holistically, was concerned with the sale of shares and not with sale of assets. There was a sale of entire investment made by HTIL through a top tier company, i.e., CGP.

In any case HTIL had no legal right to direct its downstream companies in the matter of voting, nomination of directors, etc. The Court accordingly concluded that applying the 'look at' test and without resorting to the dissecting approach, extinguishment of rights, if any, took place because of the transfer of the CGP share and not by virtue of various clauses of SPA. The Court noted that such rights flowed from Shareholder Agreement and even without the SPA, the transaction could ensue.

The Court also refuted the Revenue's contention that CGP was a late entrant in the HTIL structure and interposed for avoiding tax. The Court explained the commercial purpose of CGP and the sale of shares at the level of CGP and not the subsidiaries below.

(e) Whether acquisition of CGP share could be divorced from various other rights and entitlements flowing therefrom:

The Bombay High Court had held that the transfer of shares of CGP in itself was not adequate to achieve the object of consummating the transactions between HTIL and Vodafone. There was transfer of other rights and entitlements which constituted capital assets within the meaning of section 2(14) of the Act and hence the sale consideration of the extent relatable to such capital assets was liable to tax in India.

The Supreme Court reversing the decision of the Bombay High Court, held that considering the subject matter of the transaction from a commercial and realistic perspective, there was a share sale and not asset sale. The Supreme Court further held that a controlling interest is an incidence of ownership of shares in a company which flows out of holding of shares. The controlling interest is, therefore, not identifiable or distinct capital asset independent of holding of shares. Rights of shareholders may assume character of a controlling interest where the extent of the shareholding enables the shareholder to control the management. Shares and the rights which emanate from them flow together and cannot be dissected.

The Supreme Court reiterated that a holistic approach needs to be adopted as opposed to dissecting approach and as a general rule, in a case where a transaction involves transfer of shares, lock, stock and barrel, such a transaction cannot be broken up into separate individual components, assets or rights such as right to vote, right to participate in company meetings, management rights, controlling rights, control premium, brand licenses and so on, as shares constitute a bundle of rights.

(f) Situs of CGP share:

The Court held that situs of CGP share was in Cayman Island only and would not shift to India, even if underlying assets were in India. The Court made it clear that situs of shares is where the company is incorporated and where the shares can be transferred, which in the present case was Cayman Island.

(g) Section 195 - Whether applicable to non-resident payers:

The Supreme Court held that since shareholding in CGP, a non resident, was property located outside India, there was no liability for capital gains tax arising in India on offshore transfer of such shares between two non residents, and consequently the question of deduction of tax at source under section 195 of the Act did not arise.

More importantly the Court observed that if a person does not have tax presence in India, then liability for tax deduction under section 195 does not arise, even if the transaction is liable to tax in India. It was further observed, that the tax presence has to be seen vis-à-vis the transaction subjected to tax and not generally.

Justice K. S. Radhakrishnam in a separate but concurring decision, went even a step further to hold that section 195 of the Act is applicable to payments made by resident to non-residents and not to payment by non-resident to another non-resident outside India.

(h) Scope of Section 163:

While dealing with the alternate contention of the Revenue that Vodafone could be proceeded against as "representative assessee" under section 163 of the Act, the Supreme Court held that merely because a person is an agent or is to be treated as an agent, would not lead to the automatic conclusion that he becomes liable to tax on behalf of the non resident. A "representative assessee" is liable only "as regards the income in

respect of which he is a representative assessee". On facts, as there was no transfer of a capital asset in India, section 163(1)(c) of the Act did not apply.

For the above mentioned reasons the Indian Revenue was held not to have territorial tax jurisdiction in respect of the offshore transaction of sale of share of CGP between two non-residents and the order of the Bombay High Court was set aside.

Our Comments:

It was perhaps the first time that the Indian judiciary had to deal with a highly complex transnational investment structure and answer difficult questions regarding the tax implications arising therefrom. The Supreme Court needs to be complemented for comprehensively analyzing the various issues, examining the investment structure with dispassion and not suspicion, and more importantly for taking a holistic rather than a pedantic view of the matter appreciating the business realities, without getting influenced by the magnitude of the revenue involved.

While Vodafone may have won and the Revenue's gamble did not ultimately pay off, it would be unfortunate if the judgment is viewed from the prism of victory or defeat, losing sight of the various important legal principles it lays down.

Is the Mauritius route now totally safe for making investments in India? Perhaps yes; but not where it is used for round triping, or nefarious activities like, funding corruption, terrorism, etc.

Is interposing of entities in structures non questionable? Perhaps yes; but not where the entity is interposed later on, at the time of exiting the structure, as an artificial device solely for avoiding tax.

The judgment certainly is not a carte blanche for throwing caution to the winds while entering into cross border transactions or devising investment structures.

While the observations of the Supreme Court regarding the limited applicability of provisions of section 195, in case of payment by non-residents, will cockle the hearts of many, it is not clear as to whether the judgment of Justice K.S. Radhakrishnan, which is neither approved nor rejected by the other two Judges, holding that provisions of section 195 apply only in respect of payment by resident to non resident, would constitute a binding precedent.

It is hoped that the Government, which is competent to amend the law retrospectively, would have the grace to accept the decision of the Court and heed the advice of the Court regarding having certainly and stability in fiscal laws. If the Government intends to tax such transactions, specific legislation, applicable prospectively, may be introduced instead of disturbing the prevailing position.

Perhaps unwittingly, the aforesaid judgment may prove to be a blessing in disguise for the beleaguered Government, which has come in for lot of flake due to policy reversals it had to face on the issue of FDI in retail, etc., in view of potential increase in FDI inflow. The Government should, in fact, be thankful to the Supreme Court.

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