

## Vodafone decision: All is not lost, perhaps nothing

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*As Vodafone prefers a challenge before the Supreme Court, nothing prevents it from using the High Court's analysis to establish that, in form, none of the assets acquired by the Dutch company had the required degree of nexus with the territory India. At the moment, it looks like all may not be lost for Vodafone, say **Aditi Mukundan** and **Mahesh Kumar**, members of Nishith Desai Associates*



The High Court of Bombay has just upheld the Indian revenue department's jurisdiction to proceed against Vodafone on its \$11.1-billion acquisition of Hutchison's Indian telecom operations back in February 2007. While this may sound like an extract from the M&A

doomsday prophesy, there is more to the High Court's decision than meets the eye.

### The story so far

By way of a quick recap, the story began when Netherlands-based Vodafone International Holdings BV (**Vodafone**) acquired Cayman-based CGP Investments from Hutchison Telecommunication International Limited (**Hutch**) also based in the Cayman Islands. CGP Investments held a number of underlying subsidiaries in the BVI and Mauritius which ultimately held an approximately 67-per cent stake in Hutchison (now Vodafone) Essar Limited, one of largest players in the Indian telecom industry.

In September 2007, the tax department initiated proceedings against Vodafone in an attempt to recover around \$2.1 billion in taxes which, in its view, should have been withheld from payments made to Hutch. It justified its position by piercing the corporate veil of numerous intermediary entities to hold that the transaction led to the indirect transfer of controlling interest in the Indian operating company.

After moving the High Court and then the Supreme Court, the matter was finally sent back to the tax department to formally decide on the issue of whether it had jurisdiction to proceed against Vodafone.

By May 2010, on scrutinising innumerable transactional documents, the tax department issued a voluminous order establishing that it had the necessary jurisdiction to proceed against Vodafone.

Apart from stressing on its ability to look through the structure of the transaction, the department argued that the form of the transaction itself contemplated transfer of a bundle of assets situated in India rather than a single share of a Cayman-based company.

Vodafone, then, immediately filed a writ petition before the Bombay High Court challenging the Department's jurisdiction to pursue an offshore transaction of this nature, having absolutely no nexus with the territory of India.

Elaborate submissions were put forth to explain the commercial basis of the complex structure of the transaction and the reason for setting up each offshore entity in light of specific requirements under Indian telecom and exchange control laws.

It was urged that there was no pre-mediated intent to avoid tax and that the structure of the transaction including transfer of shares of an offshore holding company is a widely followed practice in cross-border M&As and is aimed at achieving specific business objectives. Therefore, the form of the transaction only involved the transfer of shares of a Cayman company between two non-residents and this should not give rise to any tax liability in India.

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While interpreting the various transaction documents, due diligence reports and regulatory disclosures, the High Court noted that the transaction involved the transfer of a number of rights and entitlements other than the shareholding in the Cayman entity alone.

These included a certain control premium, the right to use the Hutch brand in India, a non-compete agreement with the Hutch group, the assignment of intra-group loan obligations and certain option rights in relation to specific Indian entities.

The Court, in its 196 page order, accordingly dismissed the petition by stating that these diverse rights and entitlements acquired by Vodafone had sufficient nexus with the territory of India for the tax department to initiate proceedings against Vodafone.

### **High Court takes a balanced view**

A significant aspect of the judgment is the strong emphasis on 'form over substance of the transaction'- a fundamental principle of taxation that was read into law by the Supreme Court in the landmark case of Azadi Bachao Andolan which recognised the validity of the Mauritius route for investment into India.

In the interest of certainty, courts will only look at the form of the transaction which taxpayers can legitimately structure with a view to mitigate tax liability within the four corners of law. Therefore, as long as the transaction is not a sham or a colourable device, courts cannot disregard the form of the transaction or look through legally constituted entities on the basis of any underlying economic motive or ramification.

Also important is the court's acceptance of the separate legal identity of a company and the principle that ownership of shares does not imply direct ownership of the company's assets or any other right such as voting rights or controlling interest that are inextricably linked to the share. Therefore, sale of share of an offshore holding company would not automatically give rise to transfer of any underlying interests in India.

The court also held that for the transfer to be taxed in India there should be sufficient nexus between the asset transferred and the territory of India. For this, it is necessary that the legal situs of the asset is present in India. The implication of this reasoning is that assets such as shares of the Cayman entity and any shareholder rights that cannot be disassociated from such share may not have sufficient nexus for the offshore transfer to be taxed in India.

However, in a situation where such nexus does exist, the Court was of the view that any income arising from the transfer of the India situs asset (and chargeable to Indian tax) may be subject to withholding taxes even if it is a transfer between two non-residents.

As Vodafone prefers a challenge before the Supreme Court, nothing prevents it from using the High Court's analysis to establish that, in form, none of the assets acquired by the Dutch company had the required degree of nexus with the territory India. At the moment, it looks like all may not be lost for Vodafone.

### **Enter, big-picture lawyering**

Reiterating the right of taxpayers to legitimately plan their affairs, the Bombay High Court's decision provides a degree of certainty that India will respect the form of a transaction and will not tax offshore transactions lacking sufficient nexus with India. At the same time, the decision also prompts us to reconsider the manner in which cross-border transactions are documented and structured so as to clearly reflect the genuine commercial and contractual intentions of the parties.

The course of events surrounding the Vodafone saga brings out the importance of high level strategic thinking, also referred to as 'big picture lawyering' which becomes crucial while structuring today's complex cross-border M&As. This would require a holistic consideration of the entire legal scheme of the transaction, the underlying business objectives and the cumulative impact of different regulatory and tax regimes.

The structure would have to take into account diverse legal concerns ranging from the enforceability of tax indemnities to the ring fencing of potential legal risks. It would also entail coordination between the formal terms of the agreements and various disclosures or filings made before public authorities.

While we shall continue to learn from the structuring lessons of the past, it always pays to delve into the big picture.