VIEWPOINTS

The *Vodafone* Decision: All Is Not Lost

by Aditi Mukundan and Bijal Ajinkya

Aditi Mukundan is a member of the International Tax Practice Group and Bijal Ajinkya heads the International Tax Practice Group of Nishith Desai Associates in Mumbai.

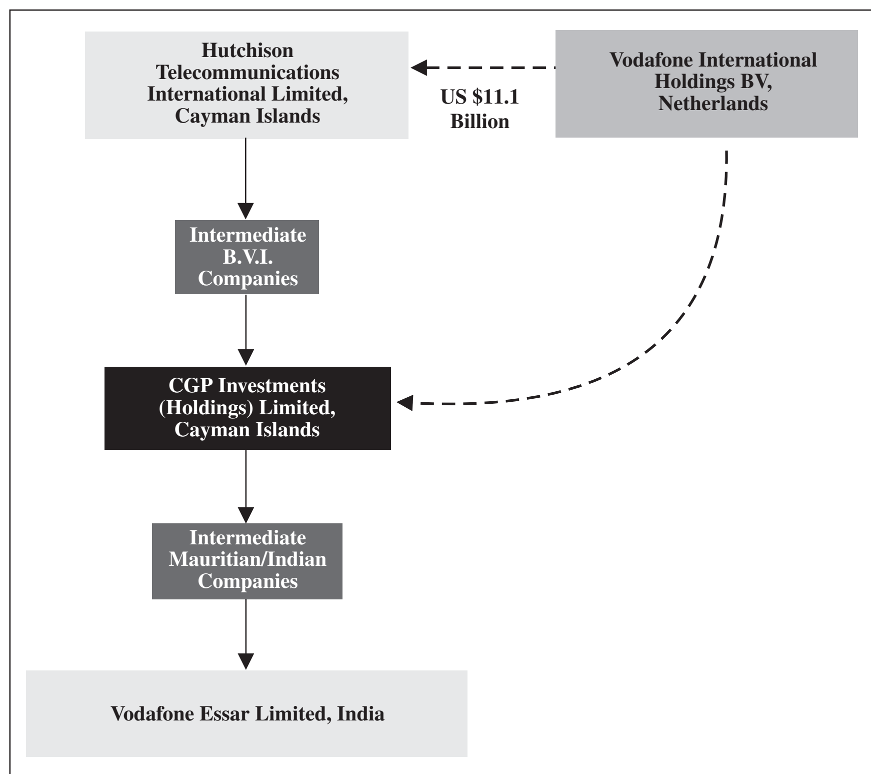
Nishith Desai Associates is special counsel to Vodafone in the case described in the article, and the views expressed are personal.

Could a simple transfer of shares of a non-Indian company by a nonresident purchaser and seller result in a great deal of chaos in the already complex world of taxation? Surprisingly the Indian revenue authorities have taken a rather aggressive stance and have sought to tax such a transaction. The much-awaited judgment delivered by the Bombay High Court on September 8, 2010, in the case of *Vodafone International Holdings B.V. v. Union of India & Anr.*, is only one step away from the Supreme Court pronouncement on whether the transfer of a share of a Cayman Islands company by another Cayman Islands company to an offshore company is liable to tax in India. This article examines the facts material to the Revenue's assessment, related legal principles, arguments advanced by the parties, and the court's verdict. The article concludes by analyzing the possible impact of the judgment on future international and cross-border transactions.

Factual Matrix

Material Facts

The *Vodafone* saga began with Dutch-based Vodafone International Holdings BV (Vodafone) acquiring Caymanian-based CGP Investments from Hutchison Telecommunications International Ltd. (Hutch) based in the Cayman Islands for US $11.1 billion. CGP Investments held various underlying subsidiaries in Mauritius, which along with certain Indian companies ultimately held a 67 percent stake in Hutchison (now Vodafone) Essar Ltd. (VEL), an Indian company and a dominant player in the Indian telecom industry. A simplified version of the corporate holding structure is shown in the figure.



The Indian revenue authorities issued show cause notices to both Vodafone and VEL as to why they

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should not be treated as ''assessees in default,'' the former on the grounds of failure to withhold taxes at source and the latter as a ''representative assessee.'' In September 2007 the Revenue initiated proceedings against Vodafone in an attempt to recover around US $2.1 billion in taxes that, in its opinion, should have been withheld from payments made to Hutch. In response to this, both VEL and Vodafone filed writ petitions before the Bombay High Court challenging the validity of these notices. The Bombay High Court in its decision of December 3, 2008, dismissed Vodafone's writ petition on the grounds of nonmaintainability. Vodafone then filed a special leave petition (SLP) before the Supreme Court under article 136 of the Constitution of India against the decision of the Bombay High Court. However, the SLP remanded the matter to the tax authorities who, on the basis of the relevant agreements and facts, would decide the most fundamental issue of whether there existed a jurisdiction to issue a notice for subjecting the transaction to tax. However, the Supreme Court noted that Vodafone could approach the High Court if it was ruled against.[1]

Immediate Facts

In an elaborate order dated May 31, 2010, the Revenue issued a notice to Vodafone proposing to treat it as a statutory agent of Hutch. In a detailed examination of the transaction documents, the Revenue asserted that the basic object of this transaction was not merely the transfer of one CGP share.

Issues and Arguments

The Bombay High Court admitted the writ petition (dated August 4, 2010) filed by Vodafone and a division bench, comprising Justice Chandrachud and Justice Devodhar, heard both parties for nine consecutive days. Important principles of taxation were argued before the bench. Vodafone primarily contended that the transaction only concerned one share of CGP Investments in the Cayman Islands, which was a capital asset situated outside India, and that therefore no income had accrued or arisen or could be deemed to have accrued or arisen in India. In response the Revenue argued that the subject matter of the transaction on a true construction of the sale and purchase agreement (SPA) dated February 11, 2007, and other relevant documents qualifies as a composite transaction involving a transfer of rights in VEL by Hutch resulting in an accrual or deemed accrual of income for Hutch from a source of income in India (that is, capital asset situated in India that would therefore be taxed in India).

[1]Supreme Court order, dated Jan. 23, 2009, in Petition for Special Leave to Appeal (Civil) No. (s). 464/2009, reported in [2009] 179 TAXMAN 129 (SC).

Tax Planning, Business Structuring

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. Vodafone argued that there was no premeditated 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 mergers and acquisitions and is designed to achieve specific business objectives. In this regard the Bombay High Court reiterated and clarified the ground rules regarding the legitimate structuring of businesses.

The court stated that the taxpayer does not invite a ''moral dilemma''[2] or the risk of legal invalidation so long as legal structures and instruments of law are used for a bona fide purpose. This is subject to the absence of statutory provisions to the contrary and is inapplicable to a case involving a sham,[3] colorable device, or fraud. The court held that while interpreting fiscal legislation, it is guided by the plain language and the words used in the provisions. Rightfully recognizing the power of the legislature, and without disturbing settled principles of interpretation, the court limited its power to interpret fiscal and economic matters with the overarching need for certainty. This need for certainty, according to the court, is driven by considerations such as the lack of expertise on the part of courts and the constitutional mandate to the executive to make economic policy decisions.

In essence, the court accepted the doctrine of form over substance. This signifies that in fiscal matters the court would consider the form of the transaction over substance. It is a great relief that this court reiterated this settled legal principle in addition to aspects of the law on tax planning and tax avoidance, as laid down by the Supreme Court in *Union of India v. Azadi Bachao Andolan*,[4] which recognized the Mauritius route for investment into India, even if it was a case of treaty shopping. This much-needed elucidation would assist taxpayers in conducting transactions within the framework of the law. The key consideration while structuring businesses in a tax-efficient manner is that so long as the taxpayer does not resort to a colorable device or a sham transaction with a view to evade taxes and a genuine transaction is effected, the transaction will not contravene statutory provisions, legal concepts, and rules.

[2]*See* para. 56 of the judgment.

[3]The court's description of a sham was one that is ostensible but not real and bordering on a fraudulent employment of legal form or structure in aid of collateral ends.

[4][2003] 263 ITR 706 (SC).

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Shares and Controlling Interest

Section 2(14) of the Income Tax Act, 1961, provides for an inclusive definition of the term ''capital asset.'' The relevant part of the section defines a capital asset as ''property of any kind held by an assessee, whether or not connected with his business or profession.'' Shares are capital assets the transfer[5] of which results in capital gains that are taxable under the ITA.[6] Recognizing the rights attached to the ownership of these shares, the court, relying on basic principles of company law, explained that these rights attach to and are inseparable from the ownership of shares. The court clearly characterized ''controlling interest''[7] and held that:

> A controlling interest is an incident of the ownership of the shares in a Company; something which flows out of the holding of shares. A controlling interest is, therefore, not an identifiable or distinct capital asset independent of the holding of shares.[8]

Giving life to the doctrine of separate legal personality, the court distinguished the business of a corporation from the business of its shareholders.

Finding a Nexus and Apportioning Income

Countries are guided by either the source or resident rule to tax income. An important question discussed by the parties in *Vodafone* was whether the Revenue could establish a nexus[9] to tax the transfer of one CGP Investments share. Under section 5(1) of the ITA, the worldwide income (including any income that is actually or deemed to accrue or arise, or is received) of a person resident in India is brought within the ambit of total income. Under subsection (2) of the ITA, for a nonresident the only income that is taxable is income that is received or deemed to have been received, or income that has accrued or arisen or has been deemed to have accrued or arisen, in India.

Section 9(1) of the ITA states that income is deemed to accrue or arise in India (directly or indirectly) through or from any business connection, property, asset, source of income, or transfer of a capital asset situated in India.

Vodafone contended that there is no income that accrues or arises in India since the right to receive the money was outside India, under a contract entered into outside India, and payment was made outside India. According to the Revenue, the deeming is a fiction and all income derived by a nonresident from whatever source is brought within the ambit of the provisions if there is a nexus.[10]

Recognizing that international tax policy seeks to mediate between the claims of residents and source in an effort to ensure that income is taxed only once, the court in sections 5 and 9 of the ITA stated:

> Parliament has been careful to ensure that even while adopting a deeming fiction in defining incomes which are deemed to accrue or arise in India that there must exist a nexus with India upon which the jurisdiction to tax is founded.[11]

The court also discussed the rules of apportionment applicable when the income can be taxed in more than one jurisdiction and the taxpayer engages in a composite activity. Relying on cases such as *CIT v. Qantas Airways Ltd.*[12] and *CIT v. R.D. Aggarwal & Co.*,[13] the court stated that the situs of the capital asset is the crucial jurisdictional condition that must be fulfilled in order to tax income arising from the transfer of a capital asset. The court held that ''the situs of the capital asset within India is what determines exigibility to tax.''[14]

Importantly, the manner in which the consideration should be apportioned is determined at a later stage by the Revenue during the course of the assessment proceedings.

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[5]Section 2(47) states:

> transfer, in relation to a capital asset, includes,
> (i) the sale, exchange or relinquishment of the asset; or
> (ii) the extinguishment of any rights therein; or
> (iii) the compulsory acquisition thereof under any law.

[6]Section 45(1) states:

> Any profits or gains arising from the transfer of a capital asset effected in the previous year shall, save as otherwise provided in sections 54, 54B, 54D, 54E, 54EA, 54EB, 54F, 54G, and 54H, be chargeable to income tax under the head ''Capital gains,'' and shall be deemed to be the income of the previous year in which the transfer took place.

[7]The court observed that the extent of shareholding that is sufficient to vest in the shareholder an interest that assumes the character of a controlling interest may vary from case to case.

[8]*See* para. 70 of the judgment.

[9]To establish nexus is a condition precedent to exercise jurisdiction to tax nonresidents. *See* para. 77 of the judgment.

[10]The Revenue also stated that unlike OECD countries, India has a wide net of source-based taxation to preserve its tax base. *See* para. 54(xvii) of the judgment.

[11]*See* para. 81 of the judgment.

[12]256 ITR 84. In this case Qantas Airways, a nonresident carrying on worldwide air transport, sold an aircraft (its capital asset) outside India. It was questioned before the Delhi High Court whether the sale of capital assets was income proportionately assessable under the ITA. The court held that its capital assets had nothing to do with the business connection for the purposes of sections 5 and 9 of the ITA.

[13](1965) 56 ITR 20.

[14]*See* para. 91 of the judgment.

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Tax Collection and Deduction — Section 195

Vodafone urged the court to adopt a contextual interpretation of section 195[15] according to the established principles of conflict of laws and legislative intent. Vodafone believed that section 195 was inapplicable to offshore entities making offshore payments, but the Revenue argued that the expression ''person'' as used in the section is not restricted to a person resident in India.

The court concluded that chargeability and enforceability are distinct legal concepts and that the following factors are guiding rules based on which section 195 is to be interpreted:[16]

- section 195(1) provides for a tentative deduction subject to regular assessment;
- the section postulates two prerequisites — there must be a payment made to a nonresident, and such payment must be a sum chargeable under the ITA;
- the obligation to deduct tax arises when the sum (the entire sum need not be chargeable) payable to a nonresident is chargeable to tax under the ITA;
- the liability to deduct tax arises if the tax is assessable in India;
- fiscal legislation is based on the principle that a sufficient territorial connection or nexus is required between the person sought to be charged and the country seeking to tax him;
- provisions dealing with tax deduction at source (TDS) are in the nature of machinery provisions and constitute an integrated code, not independent of the charging provisions that determine assessability to tax; and
- the Parliament, while imposing a liability to deduct tax, has imposed it on a *person* responsible for paying tax without limiting the same to a person *resident* in India.

Therefore the court decided that there is no limitation of extraterritoriality involved although the Parliament is aware that the law can be enforced within the territory to which the ITA extends.

Factual Assertions

FIPB Process

On March 19, 2007, the Foreign Investment Promotion Board (FIPB) sought a clarification from Vodafone of the circumstances in which it had agreed to pay a consideration of US $11.08 billion for acquiring 67 percent of VEL. Accordingly, Vodafone clarified that this price took into account a control premium, use of and rights to the Hutch brand in India, a noncompete agreement, loan obligations, and an entitlement to acquire subject to Indian foreign investment rules a further 15 percent indirect interest in VEL. In arriving at the consideration Vodafone had not individually placed a price on each of the components. FIPB in its letter dated May 7, 2007, communicated its approval to allow the transaction subject to compliance with Press Note 3 of 2007 dated April 19, 2007, and the sectoral cap of foreign direct investment. Under India's current exchange control regime, the prescribed limit for foreign investment in the telecom sector is 74 percent.

Vodafone argued that there is no legal requirement of obtaining permission of the FIPB, but merely a noting requirement for a transfer of shares,[17] whereas the Revenue, based on an analysis of the SPA, contends that the transaction in question is subject to the consent and approval of the FIPB.

Transaction Documents

The court examined the term sheet agreement dated July 5, 2003, and that of March 15, 2007; the SPA dated February 11, 2007; the tax deed of covenant; and the brand license agreement believed that the true nature of the transaction was not merely the transfer of the solitary CGP Investments share. As part of the consideration paid by Vodafone to Hutch of US $11.01 billion, the revenue authorities argued that there were various rights and entitlements that were being transferred to Vodafone, such as control premium; the right to appoint directors; use of and rights to the Hutch group; the value of nonvoting, nonconvertible preference shares; and various loan obligations.

The court in this regard stated:

> The transactional documents are not merely incidental or consequential to the transfer of the CGP share, but recognized independently the rights and entitlements of HTIL [Hutch] in relation to the Indian business which were being transferred to Vodafone.[18]

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[15]The relevant part of section 195 states:

(1) Any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest or any other sum chargeable under the provisions of this Act not being income chargeable under the head ''Salaries'' shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force.

[16]*See* para. 199 of the judgment.

[17]On February 20, 2007, Vodafone submitted an application to the FIPB under Press Note 1 (2005 series) regarding the proposed acquisition of an indirect interest in VEL from Hutch. According to Vodafone, the application was submitted to enable the FIPB to note the revised position following the completion of the overseas transaction.

[18]*See* para. 134 of the judgment.

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Commercial Contracts

Given that the Revenue's case rested on the true legal interpretation of the transaction documents noted above, the court reiterated the judgment of the House of Lords in *Investors Compensation Scheme Ltd. v. West Bromwich Building Society & Ors.*[19] The court in this case stated that while interpreting commercial contracts, courts must duly consider the relevant facts, meaning of the document conveyed (to a reasonable person having the required background knowledge as was available to the parties while entering into the contract), and the ''natural and ordinary meaning'' of the terms keeping common sense as the touchstone.

Lessons Learned

In light of the relevant facts and issues argued and the legal principles examined and discussed, the court affirmed the tax department's jurisdiction to proceed against Vodafone. However, it has not determined whether any part of the payment made by Vodafone is actually chargeable to tax in India. In principle the court concluded that income earned by a nonresident from an offshore transaction cannot be taxed in India unless the assets transferred have sufficient nexus with the territory of India.

Vodafone has preferred an appeal before the Supreme Court. As the matter is being reconsidered, one may say that the High Court's analysis can nevertheless be relied on to establish that none of the assets acquired by Vodafone had the required degree of nexus with India, following the form-over-substance doctrine. There might still be a ray of hope for Vodafone and all may not be lost.

This judgment marks a victory for the taxpayer in some ways, as the right to legitimately plan its affairs has been supported. Further, absent sufficient nexus with India the Bombay High Court has provided a degree of certainty that India will respect the form of a transaction and will not tax offshore transactions. It is important to note that the court has respected the form of the structure set up by Hutch and has not doubted its commercial basis.

The court has refused to don the garb of the legislature by reading into provisions of fiscal legislation guided by the constitutional mandate. Recently courts have shown a clear judicial trend toward recognizing that only payments that are per se chargeable under the ITA are subject to section 195 treatment and corresponding withholding obligations.[20]

A possible criticism of the judgment could be that although the court has clarified core principles of tax law, there is a disconnect in terms of the application of such principles to the facts of Vodafone's case. Specific reference can be made to the court's stance on the nature of controlling interest. On one hand, reiterating the common-law principle that a share is a distinct capital asset in its own right, the court stated that a controlling interest which a shareholder acquires is incidental to the holding of shares and does not have a separate existence distinct from the shareholding. On the other hand, the court has held that there is a change in the controlling interest in VEL, despite there being no corresponding transfer of VEL shares.

Moreover, the court has held that ''the transaction between the parties covered within its sweep, diverse rights and entitlements.''[21] However, the form of this transaction only contemplated transfer of certain offshore loan entitlements and shareholding in the Cayman entity that is legally distinct from the underlying controlling interest in the Indian operating company. The other rights and interests are vested with various downstream subsidiary companies, and it may not be possible to suggest that these were transferred in law. The obvious question that now arises is: How is the Revenue going to assign values to these rights given that the petitioner has not paid a separate consideration for them? It is likely that little or no part of the consideration paid by Vodafone may be considered taxable in India given that the transaction between Vodafone and Hutch only involved transfer of specific non-Indian-based assets such as shares of a foreign company and certain loan entitlements. These key legal concepts are likely to have a significant impact on the final outcome of Vodafone's appeal to the Supreme Court.

What one takes away from this judgment is that due importance needs to be attached to carefully drafting documents in cross-border transactions to reflect the genuine commercial and contractual intentions of the parties. At the same time, due to the prevailing uncertainties regarding the Indian tax implications of offshore M&As, it makes much sense to opt for advance rulings so that there is proper assessment of the extent of tax exposure and the related risks of doing business in India.[22] ◆

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[19](1997) UKHL 28.

[20]This has been clearly explained in the court's judgment, followed by the Supreme Court's view that TDS obligation under section 195(1) arises only if the payment is chargeable to tax in the hands of a nonresident recipient, in *GE India Technology Centre Private Ltd. v. Commissioner of Income Tax & Anr.*, Civil Appeal Nos. 7541-7542 of 2010, delivered on Sept. 9, 2010.

(Footnote continued in next column.)

[21]These rights include a control premium; use of and rights to the Hutch brand in India; a noncompete agreement with the Hutch group; the value of nonvoting, nonconvertible preference shares; and various loan obligations.

[22]*See* Harshal Shah and Bijal Ajinkya, ''The Rising Popularity of Advance Rulings in India,'' *Tax Notes Int'l*, July 20, 2009, p. 219, *Doc 2009-13676*, or *2009 WTD 136-9*.

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