Vodafone V/S Tax Department: Round 4!

Late Friday night, just before this show went on air, the Tax Department issued a Rs 12,000 crore tax demand to Vodafone.

And it's finally here. All 3700 pages of it! Sorry, 3761 pages of it. Now this marks Round 4 in the battle between Vodafone and the Tax Department.

Remember, in 2007 UK-based telecom company Vodafone bought Hutchison Hong Kong's 67% stake in Indian telecom company Hutch Essar for a little over USD 11 billion.

The transaction was executed through a Hutchinson company located in the Cayman Islands

Round 1: began in September 2007, when the Tax Department issued a show cause notice to Vodafone that said Vodafone was liable to pay withholding tax on the purchase amount.

Round 2: Vodafone filed a writ at the Bombay High Court disputing the tax department's jurisdiction in an overseas transaction. But the petition was dismissed and Vodafone then appealed to the Supreme Court marking the third round of hostilities.

In January 2009, the Supreme Court sent the case back to the Tax Department to decide on the jurisdiction issue.

And so it has—in a 761 page order with 3000 pages of annexures the tax department has claimed jurisdiction, made arguments to support that claim, with some help from China, and slapped another show cause notice on Vodafone. CNBC-TV18's Isha Dalal tries some speed reading this week!

Not really speed reading, because no one's got their hands on this order yet.... But after dozens of conversations with both sides and independent tax experts...here's what I've pieced together:

This time, the Income Tax department has launched a 3 pronged attack against Vodafone. The first offensive is one that harks back to the first show cause notice of 2007.

Then and now - the tax department holds Vodafone as an assessee in default for not making its withholding tax payments on time.

The department insists that whether an income is chargeable or not, withholding tax must be paid. Now this argument has been tested in court quite frequently this past year.

In the Samsung case the Karnataka High Court upheld the department's view that tax must be deducted on all overseas payments, whether or not that income is taxable. But not all courts agree.

Nishith Desai, Nishith Desai Associates says, "Samsung case which you just referred to has already been differentiated in Delhi in Van Oord and Chennai special bench has also said that Samsung case is not properly decided. Samsung case itself is before the Supreme Court."

Sudhir Kapadia, Partner, EY says, "What the tax department is trying to say is those powers are open to them, the seller of the business cannot shy away from tax liability if any but that does not obviate the payer from his withholding tax obligations. The rebuttal to that is if there is no tax liability, the TDS does not arise and if the position of the payer is very clear that there is not tax liability, the question of approaching the department for determination also does not arise."

PAGEBREAK

Speaking of tax liability, that brings me to the most important aspect of this case - the one regarding jurisdiction. The tax department claims it is the actions of Vodafone itself that gives it grounds to claim jurisdiction over the Vodafone-Hutch transaction

This change in brand, filings with the FIPB, due diligence of Hutch, a sale purchase agreement centered around Hutch, and disclosures to the stock exchanges.

The Tax Department claims all these actions by Vodafone prove that the subject matter of the transaction with Hutch was an Indian asset, even if the transaction was done offshore.

Nishith Desai, Nishith Desai Associates says, "You cannot ignore the form. Even the Supreme Court of India has held, in the Azadi Bachao case that you can't just ignore form. It's a legitimate form of doing business."

Mohan Parasaran, Additional Solicitor General, Govt of India says "Here is a classic case where the real beneficiary was someone else, not the bunch of companies which were situated in Cayman Islands, Therefore this was a fit case where they were all facades to get some sort of a tax benefit so therefore you have to lift the corporate veil to find out who is the real owner, who is the beneficial owner and who ultimately benefited."

Sudhir Kapadia, Partner, EY says "Here I would like to point out that the direct tax code, the proposed direct tax code has a provision for taxation of indirect transfer of shares… we will see in what shape or form it will finally come… but this to me demonstrates that under current law it is not possible to bring under the tax net such indirect transfer of shares."

And now for the final offensive. Aside from this order, the department has issued another show cause notice in an attempt to block Vodafone from passing on the liability to Hutchinson

A surprise show cause notice that adds insult to injury! The department has held Netherlands-based Vodafone International Holdings can be held an agent or 'representative assessee' of Hutch, and therefore tax can be recovered from Vodafone on Hutch's behalf.

Mohan Parasaran, Additional Solicitor General, Govt of India says "The department wants to safeguard itself from all angles. Now it is trying to fasten liability directly on Vodafone by proceeding under Section 163, by treating Vodafone as a representative agent."

Nishith Desai, Nishith Desai Associates says, "Here the question is if it is fundamentally chargeable. If that is not there, then the whole basis doesn't exist!"

And so we're back to the core issue of jurisdiction. The final view on taxability will impact not just Vodafone but scores of other cases such as GE-Genpact, AT&T's sale of idea shares, the SAB Miller case and others which are still pending. But that final view is a long time coming.

Expect two long drawn battles—one on jurisdiction and if that is proved, then one on the tax amount and the penalty for late payment. Remember it's been 3 years since the first show cause notice and maybe that many till an unappealable conclusion.