Taxing Times: What Will the Vodafone Case Mean for Cross-border M&A?

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In 2007, Vodafone Group bought the Indian telecom assets of Hong Kong's Hutchison Telecommunications International Ltd. It paid US$11 billion for a 67% stake in Hutchison Essar. The latter was the operating company in India for what is now the third-largest operator with 111 million users. Vodafone was the buyer. Hutchison, the seller, made huge capital gains. Yet since then, Vodafone has been battling it out in the courts against the Indian Income Tax (IT) department, which has saddled it with a US$2.1 billion tax claim. Hutchison, which pocketed the capital gains, is nowhere in the picture.

Many important documents relevant to the deal have never been made public, so it is unclear if the tax claim is a result of Vodafone's overlooking a key issue or overconfidence. In such transactions, the buyer is supposed to deduct tax at source (or withholding tax) and pay that to the government. This is a transaction involving foreign companies and the seller can easily disappear once the money is in the bank. The buyer, on the other hand, has the Indian assets and, in a worst case scenario, those can be attached if there is any default.

The question many are asking is: Why is Vodafone left holding the bag? One possibility is that Vodafone is a better candidate to be the public face of the tax dispute, some analysts say. Hutchison, fat on the proceeds, may have found a less sympathetic court than Vodafone, which is being asked to pay up a second time.

The Real Issues

According to experts interviewed by India Knowledge@Wharton, the judgment may rewrite India's laws regarding taxation of mergers and acquisitions (M&As). This, in turn, could apply the brakes on cross-border deal-making in the country. According to the United Nations Conference on Trade and Development (Unctad), India was all set to become the No. 2 destination for foreign direct investment (FDI) -- the major component of which is M&A -- by December 2012, pushing the U.S. down to the No. 4 place in the process. That could be at risk now.

"The verdict will have far-reaching implications on future cross-border deals," says Suresh Surana, founder of RSM Astute Consulting Group, an accounting and consulting firm. "The costs related to tax on transfer of India assets have to be considered and negotiated. This verdict will discourage foreign investments in India at a time when we need strong capital inflows to achieve higher economic growth and capital investment."

"Foreign investments will not stop but it may not happen at the speed and the scale that India would want," says Nishith Desai, international tax and corporate counsel at Nishith Desai Associates. (Desai is special counsel to Vodafone; he notes that all views expressed are personal.) "Speed, for instance, will get impacted. It will be very problematic for parties to negotiate a deal because of the complexities involved and the uncertain tax implications."

No Impact on M&As

Franklin Allen, a Wharton professor of finance and co-director of the Financial Institutions Center, disagrees. "India is a booming economy," he says. "I am not sure it will have very much effect." He

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thinks it is a good ruling. "I am not an expert [on international tax laws]. But it seems reasonable to me. If most of the assets of the company are in India, it seems reasonable to me that the Indian government should be able to tax them."

"The Vodafone issue has been around for the past three years," says Pranay Bhatia, associate partner at Economic Laws Practice (ELP), a law firm. "I think most M&A transactions [since then] have been very careful in structuring the deals. It is not that people will drop an M&A deal if India is involved. But the return expectation is now going to be higher. This is because there is a higher tax risk weightage which will be assigned to India as a tax jurisdiction. But this is also going to give more clarity on how the Indian government is going to tax such deals. Therefore, while you may ascribe a higher risk weightage because there is going to be higher tax, there will no uncertainty."

In a 200-page order delivered on September 8, the Bombay High Court ruled that the Vodafone-Hutchison deal is taxable in India. But the implications are wider, experts point out. "The court has stated that the purchase of shares of a foreign company by one non-resident from another non-resident attracts Indian tax if the object is to acquire the Indian assets held by the foreign company," says Surana of RSM. "The key issue in case of Vodafone is not the stated law but the substantive nature of the transaction and the growing tendency of tax authorities worldwide to disregard structures not having commercial substance."

Complex Structure

The structure in this case was extremely complex with nearly 50 companies involved, some based in the Netherlands, the Cayman Islands, the British Virgin Islands, Mauritius, India and Hong Kong. The IT department had contended that the transaction was a "sham" and the "holding companies had no commercial operations." The court disagreed. "The court has upheld our stand," says a Vodafone spokesperson. The network of companies was not constructed for the purpose of fraud. (As Vodafone has gone to the Supreme Court, the matter is now sub judice.)

Essentially, the court upheld the IT department's contention that if the assets are in India, the taxation should also be in India. "In the present case, the subject matter of transfer is not just the shares of the Cayman Islands company but assets situated in India," ruled the court. "The obligation to deduct tax is not extinguished merely because the payment is made by a non-resident to another non-resident outside India."

The Bombay High Court has attempted a difficult distinction. On the one hand are the actual shares (in the Vodafone case, just one share of Cayman Island registered CGP Investments Holdings was transferred). This is not taxable. Balanced against this are the assets, brand value, goodwill and other intangibles owned by the company in India. This is taxable. The problem is to figure out how much it is worth. The court has passed the buck on this and left the valuation exercise to the IT assessing officer. The court has also bounced the ball back to the Supreme Court. It has barred action by the taxation authorities for eight weeks, while Vodafone files an appeal. The company didn't take that long; it went to the Supreme Court on September 14. "The appeal challenges the recent High Court judgment on the issue of jurisdiction. Vodafone remains convinced that there is no tax to pay on the Hutchison transaction and we will continue to defend this position vigorously," said the Vodafone spokesperson.

Queries Remain

The court has also not clarified on another point. Vodafone argued that if the transaction had been done through Mauritius, it would not have been taxable. "The High Court has not replied to this argument," says Bhatia of ELP. "So it is not clear what happens if there is a treaty country that is involved in the sale."

"India [like many other emerging economies] has been traditionally and consistently following the 'source basis' of taxation as opposed to the developed nations which typically follow the OECD-mandated 'resident basis' of taxation," says Sudhir Kapadia, partner in professional services firm Ernst & Young (E&Y) India. "In the latter, a country has the right to tax only a tax resident because only a tax resident enjoys the benefits and the privileges of residency."

"Generally, as per international practice and the OECD model of the Double Tax Avoidance Agreement (DTAA), capital gains arising on transfer of assets are taxed in the country of residence of the

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seller only," says Surana of RSM. "However, in case of countries following source-based taxation and the UN model of DTAA, capital gains arising on transfer of assets are also taxed in the country wherein such capital assets are situated. Most of India's DTAAs follow the UN model and hence the capital gain arising on transfer of shares of an Indian company is liable to tax in India. However, certain DTAAs entered into by India -- notably with Mauritius, Cyprus and Singapore -- provide that such capital gains will not be liable to tax in India, but only in the country of residence of the investing company."

Logical Ruling -- with Riders

"On the face of it, the Vodafone ruling appears as a logical interpretation of the current law of the land," says Bhatia of ELP. "But if our law was so clear under the Indian Income Tax Act, then why is there a need for a specific inclusion to cover situations like this in the proposed Direct Tax Code?" The code, which is being discussed right now and which should come into effect in 2012, says that if 50% of the value of the shares being transferred is derived from assets situated in India, it is deemed to be taxable in India. Adds Desai: "The [Vodafone] ruling may not be in sync with principles of international tax law."

Similar cases involving Indian assets are cropping up. The London-listed Cairn Energy is negotiating a deal with Vedanta Resources, an Anil Agarwal-owned company also listed in London. This involves selling a majority stake in Indian subsidiary Cairn India to Vedanta Group companies. It requires permissions from the government and the Oil & Natural Gas Corporation, the public sector company that has a 30% participating interest -- a 30% production share -- in Cairn India. Cairn Energy CEO Bill Gammell, who has been lobbying extensively in New Delhi, says that all tax dues -- in both the U.K. and in India -- will be paid. The tax, he says, will be "hundreds of millions of dollars." A back-of-the-envelope calculation shows that if Cairn were to sell 40% from its 62.38% stake, the combined tax liability would be around US$850 million. If the sale percentage reaches 51% -- which will happen if there is inadequate response to the mandatory open offer to small shareholders -- the tax element would rise to US$1.1 billion.

Cairn would either have to pay taxes in the U.K. or in India. Surana of RSM says that the tax agreement between the two countries means that Cairn will get tax credit in the U.K. on whatever tax it pays in India.

Past Deals under the Microscope

The IT department is going after other M&As that fit the Vodafone pattern. S.S.N. Moorthy, chairman of the Central Board of Direct Taxes, told the media at the 7th International Tax Conference in New Delhi on September 13: "We are in the process of investigating other cases. They are in various stages of processing." Moorthy did not respond to further questions on this later, however, as the matter has become sub judice, after Vodafone filed an appeal in the Supreme Court.

What are the deals being scrutinized? In April 2007, Vedanta had bought a 51% stake in Indian iron ore miner Sesa Goa from Mitsui & Co of Japan for US$981 million. In 2006, SABMiller had acquired Foster's India -- the Australian beer company's Indian arm -- for US$120 million. Foster's is still being sold in India under the SABMiller umbrella. In 2004, GE sold a stake in India's largest business process outsourcing (BPO) firm Genpact to General Atlantic and Oak Hill Partners for US$500 million. Some of these cases are already in the courts.

The IT department cannot go too far back, however. "Earlier it was very open-ended," says Bhatia of ELP. "But a recent amendment has laid down a limitation of four years." Adds Kapadia of E&Y India: "The law of limitation -- the four years -- does not apply to withholding taxation. But recent judicial decisions seem to suggest that the same four-year rule should apply. Otherwise there is an indefinite liability on the person making the payment." There is no consensus on this however; Surana of RSM says it can extend to six years.

The Vodafone case is being keenly followed in other countries that still don't have their legal position clear. "With the Vodafone case, the Indian government is now recognized as someone who is laying down the rules for source taxation," adds Bhatia of ELP. Singapore and Hong Kong -- considered tax-friendly jurisdictions -- are formulating their own laws in this regard. They may well take a leaf out of India's book. Writes Mahesh Butani, partner at law firm BMR, in*Business*

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Standard: "...my last week's Euro money tax forum meeting made me realize that, besides curry, yoga and Bollywood, Vodafone has emerged a popular Indian theme."

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