Associated Press

September 8, 2010

Indian court upholds big tax bill against Vodafone

By ERIKA KINETZ
AP Business Writer

In a landmark ruling Wednesday, an Indian court said Vodafone Group Plc is liable for an estimated $2.6 billion in taxes for its 2007 acquisition of one of India's largest mobile phone companies.

The decision sets a precedent that could impact hundreds of foreign transactions and have a chilling effect on foreign investment, tax experts say.

"We will very seriously consider an appeal," a Vodafone executive said Wednesday after the verdict.

The Bombay High Court said Vodafone won't have to pay any tax for at least eight weeks, while it considers an appeal to the Supreme Court, the nation's highest court. The tax amount due is also up for negotiation.

"We expect them to pay the tax unless the Supreme Court stays it," Tax Department attorney B.M. Chatterjee told The Associated Press after the verdict.

In May 2007, Vodafone International Holdings BV — a Dutch subsidiary of the British telecom giant — acquired a 67 percent stake in CGP Investments Ltd., a Cayman Islands company, which held the India telecom assets of Hong Kong's Hutchison Telecommunications International Ltd.

Vodafone maintains that it did not owe tax on the $11 billion transaction because it took place between two foreign entities.

But the court rejected Vodafone's argument, ruling that the deal is taxable in India because it involved the indirect transfer of Indian assets, which accrue revenue in India.

"The Indian tax authorities acted within their jurisdiction," said judge D.Y. Chandrachud, reading from the 196-page judgment, which he said was the longest he's written in over a decade on the bench.

India's tax authorities have a fearsome reputation among foreign investors, and the verdict is being closely watched by companies like SABMiller, General Electric and AT&T, which have also been swept up in the tax department's increasing activism over the last three years.

"This was definitely a test case," said Nishith Desai, founder of Nishith Desai Associates, an international tax and corporate law firm based in Mumbai, India's financial center also known as Bombay. The firm is helping advise Vodafone on the case.

He said the judgment could impact similar cases now awaiting judgment — like SABMiller's acquisition of Foster's Indian beer business, Aditya Burla Nuvo's acquisition of shares in Idea Cellular from AT&T Mauritius and GE's sale of its back office operations to Genpact.

"Most of these cases were waiting for the outcome of Vodafone," he said.

It could also embolden tax authorities to open investigations into potentially hundreds of foreign transactions going back up to seven years, he said.

He said the High Court's ruling is likely to chill foreign investors.

"They will say there was an offshore transaction having nothing to do with India and now India is taxing it," he said. "It will definitely send negative ripples, but for someone willing to look at nuance there is a positive side."

The positive is that the court upheld the right of foreign companies to structure offshore deals to minimize taxes and that parts of the transaction may not be subject to Indian tax.

Most cross-border mergers and acquisitions are structured through offshore entities and thus involve the indirect transfer of underlying Indian assets.

Sudhir Kapadia, a tax partner at Ernst & Young in Mumbai, said China, like India, has taken steps recently to expand its tax net to include such indirect transfers of domestic assets.

On the bright side, he said, foreign companies now have greater clarity about Indian tax law.

"What foreign companies really want out of the tax policy is, first and foremost, certainty," he said.

India's Parliament is now considering a new direct tax code, set to be implemented in 2012, which incorporates a measure — the so-called "Vodafone tax" — which would make acquisitions by foreign entities taxable if their target company has more than half its assets in India.

The timing of Vodafone's huge tax bill could not have been worse.

Vodafone agreed in May to fork over $2.5 billion for third-generation spectrum that the Indian government auctioned off, and months of blistering competition among India's 15 mobile operators has driven down call rates to less than 1 cent a minute.

In May, Vodafone had to write down the value of its Indian business by more than 25 percent, or 2.3 billion pounds ($3.5 billion).

India generated just 7 percent of Vodafone's group revenues in the year ended March, but with over 100 million subscribers — a third of the group's total — Vodafone's fast-growing India business is a key long term asset, according to Moody's analyst Ivan Palacios.