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Vodafone Vindicated

VODAFONE VINDICATED

In much needed respite to Vodafone and other such offshore deals under the Income Tax Department's ("IT Department") scanner, such as GE-Genpact, Mitsui-Vedanta Group, Idea-AT&T, SABMiller-Foster and Sanofi Aventis-Shanta Biotech, the Supreme Court ("SC"), on January 20, 2012, set aside the judgment of the Bombay High Court in the Vodafone-Hutch deal.

As discussed in our newsletter of September 10, 2010 (copy available here), the Bombay High Court had upheld the Indian tax authorities' assessment of Vodafone to capital gains tax liability in India, resulting from its acquisition in Cayman Islands of controlling stake of mobile phone operator Hutchison Essar ("Hutch") in 2007.

The SC, as part of its judgment, has directed the IT Department to return Rs. 25,000 million (approximately US$ 503 million) deposited by Vodafone, along with interest of 4%, within two months from the date of judgment. The SC Registry has also been directed to return the bank guarantee given by Vodafone within four weeks of the judgment.

LexAnalysis:

The SC verdict, delivered by a three member bench consisting of Justice S.H. Kapadia (Chief Justice of India), Justice Swatanter Kumar and Justice K.S. Radhakrishnan, clarifies several controversial points of law, inter alia, concerning India's jurisdiction to tax overseas transactions and tax avoidance/ evasion. The key legal issues addressed by the judgment are as follows:

1. Sanctity of Genuine Tax Planning: The judgment upholds the sanctity of genuine tax planning. The exception being tax planning that is carried out through artificial or colorable devices which would be treated as illegal.

   The Revenue argued that the SC decision in the case of Azadi Bachao Andolan should be revisited in light of the previous distinguishing decision in the case of McDowell and the "substance over form" approach should be adopted whilst viewing the impugned transaction. The Bench analysed its earlier judgments in the Azadi Bachao Andolan and McDowell cases, to hold that in cases of treaty shopping and/or tax avoidance, there is no conflict between McDowell and Azadi Bachao Andolan (as was contended by the Revenue). Thus, the law in India has not done away with the Westminster principle (which states that "given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance") except in case of use of artificial and colorable devices.

2. Holding Structures: The SC recognized that special purpose vehicles and holding companies have a place in legal structures in India, be it in company law, takeover code of the SEBI or even under the income tax law. It stated that 'pre-ordained' transactions created for tax avoidance purposes have to be differentiated from transactions that evidence 'investment to participate' in India. It held that every strategic foreign direct investment coming to India should be seen in a holistic manner and the following factors would help evidence 'investment to participate': (a) the concept of participation in investment, (b) the duration of time during which the holding structure exists, (c) the period of business operations in India, (d) the

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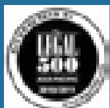

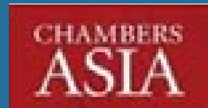

generation of taxable revenues in India, (e) the timing of the exit, and (f) the continuity of business on such exit.

Looking at the Vodafone-Hutchison transaction holistically, it was held that Vodafone/Hutch were not "fly by night" operators and the structure was not a sham, as the Hutch structure had been in place since 1994, had regularly paid income tax (running into hundreds of crores) to the IT Department, and moreover, the agreement between Vodafone and Hutch indicates "continuity" of the telecom business on Hutch's exit.

The SC also rejected the Revenue's contention that the Cayman Island entity ("CGP"), holding directly/indirectly 67% equity interest in the Indian entity, Hutchison Essar Limited ("HEL"), whose share was proposed to be transferred, stood interposed at a later stage in the transaction in order to avoid tax. The SC held that CGP had been interposed to enable a smooth transition of business and therefore it had a legitimate business or commercial purpose.

3. "Look At" Test/Anti-Avoidance Rule: The SC held that Section 9(1)(i) of the Income Tax Act, 1961 ("IT Act") which inter alia defines 'income deemed to accrue or arise in India' is not a "look through" provision. The question of providing "look through" in a statute or treaty is a matter of policy. Section 9(1)(i) cannot be subjected to 'purposive' construction to bring within its ambit 'indirect transfers'.

   Also, whilst Revenue authorities are permitted to invoke the "substance over form" principle, it may only be done after applying the "look at" test (at the threshold itself) to ascertain the true legal nature of the transaction.

4. Extinguishment of Rights: The primary argument advanced on behalf of the Revenue was that the transaction evidences a transfer of Hutch's property rights in HEL by their extinguishment and consequent to such extinguishment, there was a transfer of a capital asset situated in India.

   The SC held that Hutch only had 'de facto' control over HEL and a persuasive position in matters relating to voting, nomination of directors and management rights. 'De facto' control is not a legally enforceable right. Minority shareholders/investors had participative and protective rights (including right of first refusal, call and put options which provided for exit) which flowed from CGP's share and existed in the Hutchison structure even before the Vodafone-Hutch deal. Such rights had to be settled as the Hutchison structure required the parent and subsidiary to work as a group. Consequently, there was no extinguishment of rights as contended by the Revenue.

5. Situs of Shares: The SC rejected the Revenue's argument that the CGP share was situated in India as the underlying assets (HEL) stood situated in India. It held that, as per the Indian Companies Act, 1956, the situs of the shares would be where the company is incorporated and where its shares can be transferred.

6. Other Rights and Entitlements: The SC also rejected the High Court's decision that Vodafone had acquired the CGP share along with other 'rights and entitlements' which constituted 'capital assets' within the meaning of Section 2(14) of the IT Act. The other rights and entitlements alleged to have been transferred along with CGP's shareholding, included control premium, non-compete agreement, consultancy support, customer base, brand licences, operating licences, etc. The SC held that all such rights and entitlements were an integral part of the holding-subsidiary structure which existed for almost thirteen years and generated huge revenues. Payment of US$ 11.08 billion was for purchase of the entire investment made by Hutch in India, i.e., for the entire 'package'. It was not open to the Revenue to split the payment and consider a part of such payment for

each of the above ‘rights and entitlements’.

It further held that controlling interest is not an identifiable or distinct capital asset independent of the holding of shares. It is an inherently contractual right and cannot be considered as a capital asset unless the Statute stipulates otherwise. Thus, there was no transfer of a ‘capital asset’ situated in India and section 9(1)(i) of the IT Act was not attracted.

7. Applicability of Section 195: The SC held that no liability to deduct tax at source (withholding tax) under Section 195 of the IT Act arose, as the transaction was between two non-residents, the capital asset (CGP share) was situated outside India and section 9(1)(i) of the IT Act was not attracted, hence, there was no nexus with the underlying assets in India. The SC further stated that in order to establish a nexus, the legal nature of the transaction has to be examined and not the indirect transfer of rights and entitlements in India. Consequently, it was held that Vodafone cannot be proceeded against as a ‘representative assessee’ under Section 163 of the IT Act.

Can it End on Shifting Sands?

Foreign investors and non-residents can breathe a sigh of relief as similar international transactions can be implemented without fear of getting caught in the taxman’s noose. The respite may, however, prove to be ephemeral at best in light of the Direct Tax Code (likely to be implemented in 2013, replacing the IT Act) that seeks to tax income from transfer of shares between two non-residents when the assets owned by the foreign company in India represent at least 50% of the total value of assets owned by it. Following Vodafone judgment, the Finance Ministry has already spelled out its intensions to ensure taxability of such transactions under the Direct Tax Code.

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