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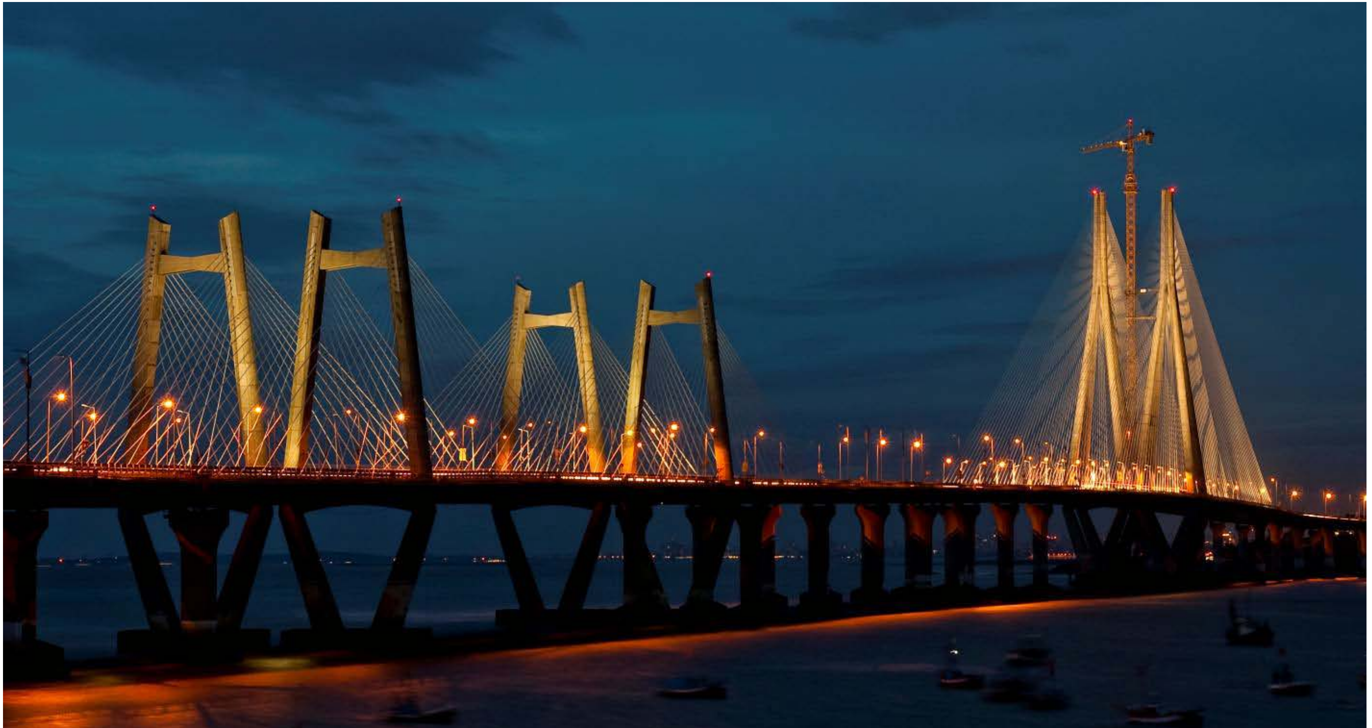
The Vodafone decision – a synopsis

20 January 2012



Background

The Supreme Court today delivered its verdict in the Vodafone case[1], putting an end to the nearly five-year old controversy surrounding the taxability in India of offshore transfer of shares of a Cayman Islands company by the Hutchison Group to the Vodafone Group.

In a landmark decision, the Supreme Court reversed the decision of the Bombay High Court and held that the Indian tax authorities did not have territorial jurisdiction to tax the offshore transaction, and therefore, Vodafone was not liable to withhold Indian taxes.

The Transaction

In February 2007, Vodafone International Holdings B.V (Vodafone or VIH), a Dutch entity, had acquired 100 percent shares in CGP (Holdings) Limited (CGP), a Cayman Islands company for USD 11.1 billion from Hutchinson Telecommunications International Limited (HTIL).

CGP, through various intermediate companies/ contractual arrangements controlled 67 percent of Hutchison Essar Limited (HEL), an Indian company. The acquisition resulted in Vodafone acquiring control over CGP and its downstream subsidiaries including, ultimately, HEL.

HEL was a joint venture between the Hutchinson group and the Essar group. It had obtained telecom licences to provide cellular telephony in different circles in India from November 1994.

[1] Vodafone International Holdings B.V. v. Union of India & Anr. [S.L.P. (C) No. 26529 of 2010, dated 20 January 2012]

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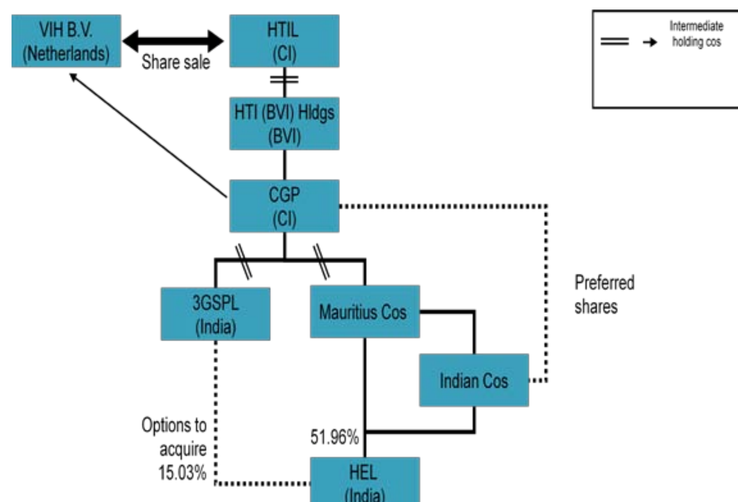
The structure and the flow of transfer are depicted below:



The Controversy

- In September 2007, the tax department issued a show-cause notice to Vodafone to explain why tax was not withheld on payments made to HTIL in relation to the above transaction. The tax department contended that the transaction of transfer of shares in CGP had the effect of indirect transfer of assets situated in India.
- Vodafone filed a writ petition in the Bombay High Court, *inter alia*, challenging the jurisdiction of the tax authorities in the matter. By its order dated 3 December 2008, the Bombay High Court held that the tax authorities had made out a *prima facie* case that the transaction was one of transfer of a capital asset situate in India, and accordingly, the Indian income-tax authorities had jurisdiction over the matter.
- Vodafone challenged the order of the Bombay High Court before the Supreme Court. In its ruling, dated 23 January 2009, the Supreme Court directed the tax authorities to first determine the jurisdictional challenge raised by Vodafone. It also permitted Vodafone to challenge the decision of the tax authorities on the preliminary issue of jurisdiction before the High Court.
- In May 2010, the tax authorities held that they had jurisdiction to proceed against Vodafone for their alleged failure to withhold tax from payments made under Section 201 of the Income-tax Act, 1961 (the Act). This order of the tax authorities was challenged by Vodafone before the Bombay High Court.
- By its order dated 8 September 2010, the Bombay High Court dismissed Vodafone's challenge to the order passed by the tax authorities. Vodafone filed a Special Leave Petition (SLP) against the High Court order before the Supreme Court. On 26 November 2010, SLP was admitted and the Supreme Court directed Vodafone to deposit a sum of INR 25000 million within three weeks and provide a bank guarantee of INR 85000 million within eight weeks from the date of its order.

The Judgment

- After a detailed hearing before a three-judge bench headed by the Chief Justice of India, the Supreme Court delivered its verdict on the case on 20 January 2012. The key highlights of the decision are as under.

Interpretation of Section 9(1)(i) of the Act

- At the heart of the controversy was the interpretation of Section 9(1)(i) of the Act. As per the said section, *inter alia*, income accruing or arising directly or indirectly from the transfer of a capital asset situated in India is deemed to accrue/ arise in India in the hands of a non-resident.
- In connection with the above, the Supreme Court observed that:
  - ➢ Charge to capital gains under Section 9(1)(i) of the Act arises on existence of three elements, *viz*, transfer, existence of a capital asset and situation of such asset in India.
  - ➢ The legislature has not used the words 'indirect transfer' in Section 9(1)(i) of the Act. If the word 'indirect' is read into Section 9(1)(i) of the Act, then the phrase 'capital asset situate in India' would be rendered nugatory.
  - ➢ Section 9(1)(i) of the Act does not have 'look through' provisions, and it cannot be extended to cover indirect transfers of capital assets/ property situated in India.
  - ➢ The proposals contained in the Direct Taxes Code Bill, 2010, on taxation of off-shore share transactions indicate that indirect transfers are not covered by Section 9(1)(i) of the Act.
  - ➢ A legal fiction has a limited scope and it cannot be expanded by giving purposive interpretation, particularly if the result of such interpretation is to transform the concept of chargeability which is also there in Section 9(1)(i) of the Act.
- Accordingly, the Supreme Court concluded that the transfer of the share in CGP did not result in the transfer of a capital asset situated in India, and gains from such transfer could not be subject to Indian tax.

Extinguishment of HTIL's interests

- The tax authorities further argued that the rights of HTIL over the control and management of HEL constituted "property" in the hands of HTIL. Accordingly, the extinguishment of such rights under the Share Purchase Agreement (SPA) resulted in a taxable transfer of a capital asset situated in India.
- In this context, the Supreme Court reiterated the 'look at' principle enunciated in Ramsay case, in which it was held that the Revenue or the Court must look at a document or a transaction in a context to which it properly belongs.

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It is the task of the Revenue/ Court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a whole, and not adopt a dissecting approach.

- By applying the 'look at' test discussed above, the Supreme Court held that extinguishment took place because of the transfer of the CGP share and not by virtue of various clauses of SPA.
- The Supreme Court went on to hold that where a structure has existed for a considerable length of time and where the Court is satisfied that the transaction satisfies all the parameters of 'participation in investment', then in such a case, the Court need not go into questions such as *de facto* control vs. legal control, legal rights vs. practical rights, etc in the context of determining taxability.

Role of CGP in the transaction

- In dealing with the tax authorities' contention that CGP was interposed at a late stage in the transaction in order to bring in a tax-free entity and thereby avoid capital gains in India, the Supreme Court observed as follows:
  - Two routes were available, namely, the CGP route and the Mauritius route. It was open to the parties to opt for any of the two routes. The transaction of sale was structured at an appropriate tier (i.e. the CGP route), so that the buyer acquired the same degree of control as was hitherto exercised by HTIL.
  - Under the Indian Companies Act, 1956, the situs of the shares would be where the company is incorporated and where its shares can be transferred. In the present case, it was asserted that transfer of CGP shares were recorded in Cayman Island and this was not disputed by the tax authorities.
- Considering the entirety of the facts of the case, the Supreme Court held that the sole purpose of CGP was not only to hold shares in subsidiary companies but also to enable a smooth transition of business. Therefore, it could not be said that CGP had no business or commercial substance.
- Additionally, the Supreme Court also rejected the argument of the Revenue that since CGP was a mere holding company, the situs of its share was situated in India where its underlying assets were located.

Rights and entitlements

- The tax authorities had contended that the transfer of the CGP share was not adequate in itself to achieve the object of consummating the transaction between HTIL and VIH and that intrinsic to the transaction was a transfer of other 'rights and entitlements'. It was further contended that such "rights and entitlements" constituted 'capital assets', gains from the transfer of which were liable to tax in India. On this issue, the Supreme Court concluded that:
  - As a general rule, in a case where a transaction involves transfer of shares, such a transaction cannot be broken up into separate individual components, assets or rights. The present transaction was 'a share sale' and not an 'asset sale' and concerned sale of an entire investment.
  - A controlling interest is an incident of ownership of shares in a company, which flows out of the holding of shares and hence is not an identifiable or distinct capital asset independent of the holding of shares.
- In essence, the Supreme Court concluded that the character of the transaction was an alienation of shares, and that when parties had agreed on a lump sum consideration, there was no question of allocation of such consideration for transfer of any other rights or entitlements.

Holding and Subsidiary structures

- Adverting to the issue of "substance" in a subsidiary company, the Supreme Court observed as follows:
  - It is a common practice in international law, which is the basis of international taxation, for foreign investors to invest in Indian companies through an interposed foreign holding or operating companies, such as a Cayman Islands or Mauritius based company for both, tax and business purposes.
  - If a Non-Resident makes an indirect transfer through abuse of the organisation form/ legal form and without a reasonable business purpose, which results in tax avoidance or avoidance of withholding tax, then the tax authorities may disregard the form of the arrangement or the impugned action through use of holding companies and may re-characterize the equity transfer according to its economic substance and impose tax.
- The Supreme Court also went on to conclude that the corporate business purpose of a transaction is evidence of the fact that the impugned transaction is not undertaken as a colourable or artificial device.

Anti-avoidance Rules and earlier decisions in *McDowell*[2] and *Azadi Bachao Andolan*[3] case

- In response to the various arguments put forth by the Revenue regarding the conflict between McDowell case and Azadi case, the Supreme Court observed as follows:

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2 Union of India v.Azadi Bachao Andolan [2003] 132 Taxman 373 (SC)

3 McDowell and Co Ltd v. Commercial Tax Officer [1985]154 ITR 148 (SC)

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- The Revenue cannot start with the question as to whether the impugned transaction is a tax deferment/ saving device, but it should apply the "look at" test to ascertain true legal nature of the transaction.
- The authorities may invoke the "substance over form" principle or "piercing the corporate veil" test only after it is able to establish on the basis of the facts and circumstances surrounding the transaction that the impugned transaction is a sham or tax avoidant. Every strategic foreign investment coming into India should be looked at in a holistic manner, bearing in mind factors such as: the concept of participation in investment, the duration of time during which the holding structure exists; the period of business operations in India; the generation of taxable revenues in India; the timing of the exit; and the continuity of business on such exit.
- Merely because at the time of exit, capital gains tax becomes not payable or exigible to tax would not make the entire "share sale" (investment) a sham or a tax avoidant.
- The McDowell decision cannot be read as leading to a conclusion that all tax planning is illegal, illegitimate or impermissible and that there is no conflict between the Supreme Court's decisions in the McDowell and the Azadi Bachao Andolan case.
- The question of providing "look through" in the Statute or in the tax treaty is a matter of policy and has to be expressly provided for. Similarly, Limitation of Benefits (LOB) has to be expressly provided for in the tax treaty. Such clauses cannot be read into the Section by interpretation.

On the applicability of withholding tax (Section 195 of the Act) and representative assessee (Section 163 of the Act) provisions

- The Supreme Court held that:
  - The question of withholding tax at source would not arise as the subject matter of offshore transfer between the two non-residents was not liable to capital gains tax in India.
  - For the purposes of Section 195 of the Act, tax presence has to be viewed in the context of the transaction that is subjected to tax, and not with reference to an entirely unrelated matter.
- The Supreme Court further observed that as there was no incidence of capital gains tax in India, the provisions under Section 163 of the Act, for treating Vodafone as a representative assessee of HTIL, were not applicable.

Highlights of the supplemental concurring judgment passed by Justice K S Radhakrishnan

- Justice Radhakrishnan gave a separate judgment, concurring with the views of the Chief Justice on all major issues.

Some of the key additional observations of Justice Radhakrishnan in his judgment are summarised below:

- On incorporation of a company, the corporate property belongs to the company and members have no direct proprietary rights to it, but merely to their "shares" in the undertaking and these shares constitute items of property which are freely transferrable in the absence of any express provision to the contrary.
- In the absence of LOB Clause and the presence of CBDT Circular No. 789 of 2000 and Tax Residency Certificate (TRC), on the residence and beneficial interest/ownership, the tax department cannot at the time of sale/disinvestment/exit from such Foreign Direct Investments (FDI), deny benefits to such Mauritius companies of the Treaty by stating that FDI was only routed through a Mauritius company.
- LOB and look through provisions cannot be read into a tax treaty but the question may arise as to whether the TRC is so conclusive that the tax department cannot pierce the veil and look at the substance of the transaction. India-Mauritius tax treaty and CBDT Circular No. 789 dated 13 April 2000 would not preclude the Income tax department from denying tax treaty benefits, if it is established, on facts, that the Mauritius company has been interposed as the owner of the shares in India, at the time of disposal of the shares to a third party, solely with a view to avoid tax without any commercial substance.
- The tax authorities, notwithstanding the fact that the Mauritian company is required to be treated as the beneficial owner of the shares under Circular No. 789 and the Treaty, are entitled to look at the entire transaction of sale as a whole and if it is established that the Mauritian company has been interposed as a device, it is open to them to discard the device and take into consideration the real transaction between the parties, and subject the transaction to tax.
- Even though the TRC can be accepted as conclusive evidence for accepting status of residents as well as beneficial ownership for applying the tax treaty, it can be ignored if the treaty is abused for the fraudulent purpose of evasion of tax.
- Revenue's stand that the ratio laid down in the McDowell case is contrary to what has been laid down in Azadi Bachao Andolan case is unsustainable, and therefore, does not call for any reconsideration by a larger Bench.
- In trans-national investments, provisions are usually made for exit route to facilitate an exit on account of good business and commercial reasons such as dispute between partners, uncertain political situations, etc.

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- Transfer of shareholding in CGP, on facts, was not the fall out of an artificial tax avoidance scheme or an artificial device, pre-ordained, or pre-conceived with the sole object of tax avoidance, but was a genuine commercial decision to exit from the Indian Telecom Sector.
- Section 9 of the Act covers only income arising from a transfer of a capital asset situated in India and it does not purport to cover income arising from the indirect transfer of capital asset in India. Section 9 of the Act has no “look through provision” and such a provision cannot be brought through construction or interpretation of a word ‘through’ in Section 9 of the Act. Shifting of situs can be done only by express legislation.
- The facts in the instant case can be distinguished from that of Eli Lily[4] case where services were rendered in India and a portion of salary was received in India.
- Section 195 of the Act would apply only if payments are made from a resident to another non-resident and not between two non-residents situated outside India.

Conclusion

For the reasons discussed above, the Supreme Court held that gains arising from the said transaction were not liable to tax in India, and that therefore there was no obligation on Vodafone to deduct tax at source.

In view of the above, the Supreme Court has directed the tax authorities to return INR 25000 million, which was earlier deposited by Vodafone, along with 4 percent interest and return the bank guarantee.

Our comments

The decision of the Supreme Court is expected to have a far reaching impact on the taxability in India of cross-border transactions. It will also have a significant bearing on several similar transactions which are currently being examined by the income-tax authorities.

While delivering the judgment, the Supreme Court has acknowledged that certainty and stability form the basic foundation of any fiscal system, thereby guiding investors on where they stand and also helping the tax administration in enforcing the provisions of the taxing laws.

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4 CIT v. Eli Lilly and Company (India) P. Ltd. (2009) 15 SCC 1

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