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DETAILED ANALYSIS OF VODAFONE CASE

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FACTS

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 situated 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. 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.

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.

JUDGMENT

The judgment of the court has been decided and studied issue wise, which are hereunder.

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[1] 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.

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.

[1] Hutchison Asia Telecommunications.

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.

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 summarized 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.

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 SC, while deciding on the matter, took a holistic view of the entire transaction, and also commented on the effects of this controversy in matters relating to public policy in taxation. Interestingly, while this case was with respect to the controversy regarding India"s jurisdiction to tax offshore transfers, other important aspects like eligibility of benefits under the India- Mauritius tax treaty, international corporate law principles, etc. were also dealt with comprehensively in this judgment. The SC ultimately decided the case in Vodafone"s favor based on extensive reliance to the facts of its case, while laying down important legal principles with respect to inter alia tax avoidance, tax planning, situs of capital assets and Indian withholding tax provisions.

Based on facts of the case, the SC decided that the legal form of the Cayman entity could not be disregarded simply because it was a holding company. Under international corporate law, holding company structures ordinarily need to be respected. Such a structure can be collapsed or looked through only in the event that the holding structure abuses the legal form without any reasonable business purpose. There is a difference between a pre-ordained transaction and one which has been in existence for a substantial period of time. In the given facts the Cayman structure had been in place for more than a decade, and hence there was no reason to ignore the holding structure.

A more important principle which has been laid down by the SC is that the burden to prove that there has been an abuse of the legal form of the transaction, or that the transaction is a sham, would lie on the tax authorities. This principle gains relevance in the Indian context whereby it may not be feasible for a taxpayer to discharge the negative burden of proving that no abuse of the legal form exists.

The SC ruled that the Indian tax law does not contain any specific „„look through"" provisions, and to read such a provision into the law would transform the entire concept of chargeability to tax under the Indian law. The SC also put its stamp of approval for the Parliament to prospectively enact statutory general anti-avoidance rules („„GAAR"") in the Indian context. It stated that tax avoidance is a problem faced by almost all countries following civil and common law systems and all share a common broad aim, i.e. to combat it. Many countries are taking various legislative measures to increase the scrutiny of transactions conducted by non-resident enterprises. The judgment co-authored by the Chief Justice of India, while propounding the rule of law, stated that the Vodafone

Case is an eye-opener of what India lacks in regulatory laws and what measures India has to take to meet the various unprecedented situations, that too without

sacrificing national interest. In this context, certainty is integral to the rule of law.[2]

Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial for taxpayers (including foreign investors) to make rational economic choices in the most efficient manner.

In all, the Vodafone decision is not limited to taxation aspects of offshore transfers. The SC has really expounded a „„look at"" approach by delving into matters concerning national interest, stability to foreign investors, and above all, certainty in law – which is the ultimate principle of the rule of law. The judicial principles should help allay concerns of the several investors who have been troubled in relation to taxation of their overseas transfer of share involving downstream Indian entities.[3]

Moreover, as the taxman has been unable to succeed with the judiciary in upholding his claim to tax offshore transactions, it is quite likely that he will seek instead to amend the tax laws. Three possible amendments present themselves – firstly the proposal in the Direct Taxes Code („„DTC"") to bring taxing rights on defined offshore transfers could be enacted in the Union Budget of 2012 itself.

Secondly, the withholding tax provisions are likely to be explicitly widened to include compliance by non-residents and thirdly, anti-avoidance rules, popularly known as General Anti-Avoidance Regulations, are likely to be rapidly legislated.

The Supreme Court concluded that:

"FDI flows towards location with a strong governance Infrastructure which includes enactment of laws and how well the legal system works. Certainty is integral to rule of law. Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial for taxpayers (including foreign investors) to make rational economic choices in the most efficient manner."[4]

The judicial logic is just a categorical syllogism. The major premise is: that which promotes the economic policy of FDI promotion is good. The minor premise is that the Department"s view of the tax law, as adopted in the Vodafone Case, does not (or is unlikely) to promote the economic policy of FDI promotion. The conclusion follows: the Department"s view is not good.

The Hon"ble Court overlooked both our Constitution and the Income-tax Act in adopting its core reasons which appears to be at the heart of the judgment. There is a miscarriage of justice because the effect of the Judgment is to promote extraneous purpose. Justice Radhakrishnan, in his concurrent

[2] GokulChaudri, The Rule of Law isthe Law of the Land, TPIR, Vol.2 (2012).

[3] Shiva Kant Jha, The Reasons For Which The Vodafone Need Not Be Accepted: Remedies Against The Decision To Be Explored, available at http://www.shivakantjha.org/critiquevodafone.pdf, last accessed on 20th August 2015.

[4] Vodafone International Holdings v. Union of India (2008) 220 CTR (Bom) 649.

judgment has reiterated the need for FDI, and the propriety for promoting that through corporate structuring from the Off-shore centres.

Throughout the main and the concurrent Judgments the most dominant concern is to facilitate FDI. Whatever promotes it is good. Off-shores centres are good, corporate structuring is good, minimal government supervision is good; everything is good that that facilitates FDI. The Vodafone Judgment clearly states that our Government knows full well wherefrom investment is coming to India, and how it is coming.

The Hon"ble Judges cast aside their judicial robe of detachment, and virtually turned to play the role of economic advisors with the neoliberal commitments. They did not realize that inviting FDI is not a judicial quest. They judges are seldom competent to decide the legality and propriety of policy-loaded issues. Joseph Stiglitz is of opinion is that FDI is often not good for the country. He said in his Globalization and its Discontents:

"There is more to the list of legitimate complaints against foreign direct investment. Such investment often flourishes only because of special privileges extracted from the government. While standard economics focuses on the distortions of incentives that result from such privileges, there is a far more insidious aspect: often those privileges are the result of corruption, the bribery of government officials.[5]

The foreign direct investment comes only at the price of undermining democratic processes. This is particularly true for investments in mining, oil, and other natural resources, where foreigners have a real incentive to obtain the concessions at low prices."

In conclusion, the court has grossly overstepped its jurisdiction by entering into the field of policy making, which is the field of the legislature.

CONCLUSION

Cross-border acquisition of Indian companies has been a focus of the Tax Authority over the last couple of years. It is fairly well-established that if the acquisition involved a direct transfer of shares of an Indian company, the same would trigger taxable capital gains under the ITL. However, there have not been precedents in the past where Tax Authority has attempted to tax capital gains arising on transfer of shares of a foreign holding company of an Indian subsidiary on the basis that such transfer involves an indirect transfer of the underlying Indian assets. The ruling of the SC would set a binding precedent for other similar transactions, as well for those transactions which are currently being investigated by the Tax Authority or are in various stages of litigation.

An issue that was extensively argued before the SC was on the concept of tax avoidance and an attempt was made by the Tax Authority to dilute the principle laid down in the SC"s Azadi Bachao

[5] Joseph Stiglitz, Globalization and its Discontents, Edn. 1, 2001 pp. 71-72.

ruling on an alleged ground that the said ruling was inconsistent with the decision of the larger bench of the SC in the McDowell‟s case. The SC has clarified that there is no conflict in the decisions and has sought to reiterate that while tax planning is legitimate, structures thatare subterfuges or colorable devices, need not be respected for tax purposes.

The ruling also acknowledges that use of holding companies and investment structures as well as use of offshore financial centers, can often be driven by business/commercial purpose and the use of these elements in international structures, does not imply tax avoidance.

One of the concerns expressed by several foreign investors in the context of the Vodafone case is the uncertainty created by the approach of the Tax Authority. The SC order echoes these concerns of theinvestor community. The SC has observed that certainty and stability form the basic foundation of any fiscal system and they are integral to the rule of law. One would hope that the Government gives due consideration to these observations while framing its tax policy and legislative proposals.

The decision of the SC is a milestone development in the taxation of international transactions and on the judicial approach to tax avoidance. This case is, perhaps, the first in the world where the issue of taxation on indirect transfer of shares was being litigated before a country‟s highest judicial forum. The principles emanating from this ruling could, therefore, have ramifications beyond India. It could also be of relevance in shaping India's tax policy on international taxation and tax avoidance in the future.

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