Vodafone Ruling – Key Tax Principles

Last month the Supreme Court (SC) pronounced its verdict in the case of Vodafone and pulled a lid over the most debated tax controversy of the recent history. The bone of contention was whether transfer of shares of a foreign company which indirectly held shares of an Indian company was taxable in India. The matter took 26 days of final hearing, battery of 'Superstar' lawyers assembled by either side, hundreds of paralegals assisting the lawyers and thousands of pages of briefs to culminate in this widely awaited ruling. For those 26 days, Senior Counsel Harish Salve, representing Vodafone and Solicitor General of India, Rohinton Nariman representing the Revenue Department set the courtroom alight with their reasoned and exhaustive arguments and counter-arguments; the Supreme Court's courtroom became the battleground for the two gladiators.

(Contributed by the Committee on International Taxation of the ICAI. Comments can be sent to citax@icai.org)

The three member bench of Supreme Court led by the Chief Justice of India himself eventually ruled that the transaction of transfer of one share of a Cayman Island company which indirectly held shares in Indian company by Hutchison group to Vodafone group was not taxable in India. Therefore, no tax was recoverable from Vodafone for failure on its part to deduct tax at source while making payment to Hutchison. In the process, the Supreme Court reiterated the well-established principle - tax planning within the framework of law is permissible as well as provided some new concepts for consideration viz. the 'look at' test,

situs of shares, 'participative' *vis-à-vis* 'persuasive' interest etc.

In this article, we have tried to shed some light on the key principles emanating from the Supreme Court's ruling.

'Timeline' of Vodafone Ruling

1992 – Hong Kong based Hutchison group ('to be called as Hutch') acquired interest in Indian mobile telecommunication business through a joint venture, Hutchison Max Telecom Limited ('HMTL') which was subsequently renamed as Hutchison Essar Limited ('HEL').

1998 – Hutch group, through Hutchison Telecommunications Ltd., Hong Kong ('HTL') incorporated CGP Investments (Holding) Ltd. ('CGP') in Cayman Islands with a single share equity capital.

2004 – Hutchison Telecommunication International Limited (CI), ('HTIL') was incorporated and listed on New York and Hong Kong stock exchanges.

– HTL transferred the single equity share of CGP to HTI (BVI) Holdings Limited ('HTI BVI') which was a wholly owned subsidiary of HTIL.

2005 – Consolidation of Hutch's Indian telecom business under a single entity, HEL.

– Ownership of HEL was consolidated under tier I companies based in Mauritius which were held by CGP. Thus, CGP became the indirect owner of HTIL's share of approx. 52% interest in HEL.

– Out of the balance 48%, 15% interest was held by companies headed by Asim Ghosh ('AG') & Analjit Singh ('AS') and remaining 33% was held by the Essar group.

2006 – In December 2006, HTIL issued a press statement stating that it had been approached by various interested parties for acquisition of its equity interest in HEL.

– On the same date, an open offer was made by Vodafone Group Plc on behalf of Vodafone group for a non-binding bid of $ 11.055 billion for the enterprise value of HTIL's 67% interest in HEL by acquiring the one share equity of CGP.

67% represented HTIL's direct and indirect interest in HEL of 52% and call options to acquire the remaining stake in the companies headed by AG & AS which would allow Vodafone to control another 15% stake in HEL.

2007 – In February 2007, Vodafone group submitted a revised offer of $ 11.076 billion for HTIL's interest in HEL.

– In May, FIPB consents to Vodafone-Hutch deal under the extant FDI regulations subject to other applicable laws. Accordingly, Vodafone acquired the one share of CGP which entitled it to 52% direct and indirect controlling interest in HEL and an option to acquire shares in the companies headed by AG and AS. The same is depicted by way of a diagram as Exhibit 1 and Exhibit 2.

– In August, the revenue department issued a show-cause notice to Vodafone Essar Limited ('VEL'), prior to acquisition called as HEL, seeking to treat it as representative assessee for Hutch.

– In September, another show-cause notice issued to VEL for failure to deduct taxes at source while making payment to Hutch and therefore, considering it to be an 'assessee-in-default'.

VEL and Vodafone challenged the said notices by filing writ petition in the Bombay High Court.

2008 – The Bombay High Court dismisses the petition filed by Vodafone. The Bombay High Court held that the transaction of sale of one share of CGP can be picked up for scrutiny by the revenue department as the inherent intention behind the transaction was to acquire the controlling interest in HEL. The High Court additionally commented that as all the relevant papers were not filed before it, it was not in position to analyse the nature of the transaction and hence, not comment on it.

2009 – January. Vodafone files Special Leave Petition against the Bombay High Court's order which is dismissed by the Supreme Court. Further, the Supreme Court directed the tax authority to first determine whether the revenue department has jurisdiction over the said transaction. If the same was found to be prejudicial to Vodafone, Vodafone could directly appeal before the Bombay High Court.

2010 – May. Order passed by the revenue authorities asserting their jurisdiction to tax the said transaction in the hands of Vodafone as a 'taxpayer in default'.

– September. Vodafone filed an appeal with the Bombay High Court against the revenue authorities' decision. The Bombay High Court

The control of a company resides in the voting power of its shareholders and shares represent an interest of shareholder which is made up of various rights contained in the contract embedded in the Articles of Association.

dismissed Vodafone's writ and confirmed the order of the revenue authorities.

– October & November. Vodafone files SLP before the Supreme Court against the Bombay High Court's decision. Supreme Court orders Vodafone to deposit ₹2,500 crores and balance tax amount involved of ₹8,500 crores by way of a bank guarantee.

2011 – August to October. Hearings took place over a period of 28 days.

2012 – 20th January 2012. Supreme Court delivers its verdict.

Exhibit 1

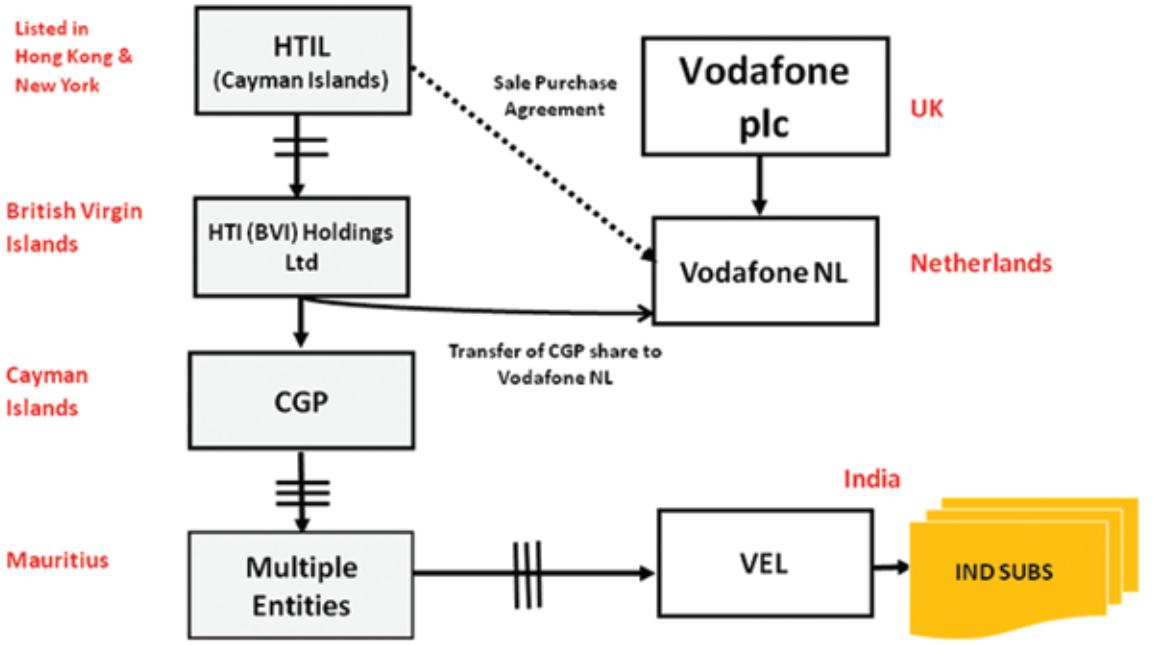
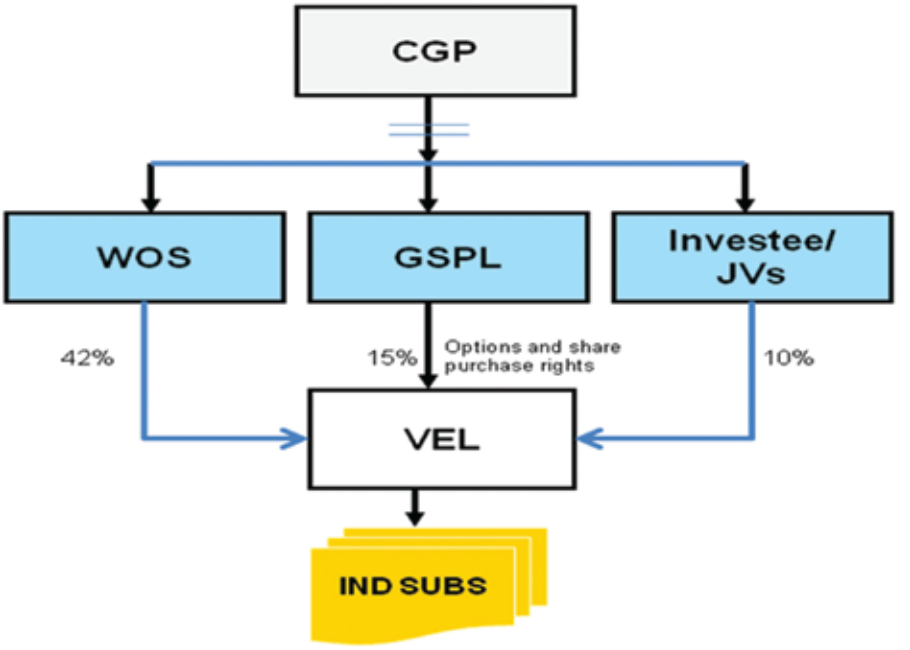


Exhibit 2



Key Principles Emanating from Supreme Court Ruling

1. *McDowell* Vs. *Azadi Bachao Andalon*

- It was the contention of the Revenue authorities that SC decision in the case of Azadi Bachao Andolan [263 ITR 706] needed to be overruled as it had adopted a divergent view from the principles laid down by the five member bench in the case of McDowell [154 ITR 148].
- The Supreme Court dismissing the contention of the revenue authorities held that the majority ruling (four member ruling) in McDowell had clearly laid down that legitimate tax planning within the framework of law was permissible. However, resorting to colorable devices to avoid tax cannot be considered to be a part of tax planning.

  The Supreme Court further went on to explain that separate ruling given by Justice Chinnappa Reddy in McDowell's case was in relation to tax evasion through use of colorable devices and by resorting to dubious methods and subterfuges. However, Justice Reddy has not mentioned that tax planning is illegitimate or impermissible. Further, it was to be noted that Justice Reddy himself agreed with the four member ruling.
- The Supreme Court further explained the McDowell's ruling and the context in which Justice Reddy held that the principle laid down in the case of Duke of Westminster was not applicable and that the subsequent ruling in the case of Ramsay was to be considered as way forward.

  The Supreme Court explained that as per the principle laid down by House of Lords in the case of *CIR Vs. Duke of Westminster [1935 All E.R. 259]*, a taxpayer can arrange his affairs so as to reduce the liability of tax and the fact that the motive for a transaction is to avoid tax does no invalidate it unless a particular enactment so provides.

  However, in a subsequent ruling in the case of WT Ramsay [1981 1 All E.R. 865], a new approach to artificial tax avoidance schemes was laid down wherein an assessee could be held liable to tax only if there was a clear intention of tax avoidance. Further, the intention to evade taxes ought to be proved based on facts and the same should not be concluded on a mere literal interpretation.

  The Supreme Court further explained that ruling in the case of Ramsay did not overrule the principle laid down in the case of Westminster but merely provided a proper context as per which any arrangement which was colorable in nature and intended primarily to evade taxes had to be ignored. Thus, the Ramsay ruling only lays down the principle of statutory interpretation rather than providing an anti-avoidance mechanism in the interpretation of tax laws.
- The Supreme Court further relied on the ruling of House of Lords in the case of *Craven Vs. White [1988 3 All E.R. 495]*, wherein it was held that the Tax Authority cannot question every transaction as to whether it is a tax deferment/or tax avoiding device but the Tax Authority should apply the 'look at' test to ascertain its true legal nature. If the arrangement is a genuine tax planning, then the taxpayer cannot be refused benefit of the same.

  Applying the Westminster principle in the said case, it was held that the Tax Authority cannot tax a subject without a specific provision to support and every tax payer is entitled to arrange his affairs so that his taxes shall be as low as possible and that he is not bound to choose that pattern which will replenish the treasury.
- Given the same, the Supreme Court explained that there is no conflict between principles laid down in the ruling of McDowell and in the case of Azadi Bachao and that there was no requirement to reconsider the decision of Azadi Bachao Andolan.

2. Separate Entity Principle and 'Look At' Test

- The Supreme Court quoting Pope Innocent IV explained the principle of separate entity applicable to companies. In nutshell, the separate entity principle states that the company is to be treated as a person separate from its shareholders. The said principle is also reflected in the both Indian corporate and tax laws. Companies and other entities are viewed as economic entities with legal independence *vis-à-vis* their shareholders/ participants.
- Further, generally as well as for the purposes of tax treaties, a subsidiary and its parent are considered as totally distinct tax payers. Also, given the fact that parent company exercises shareholder's influence on its subsidiaries does not generally imply that the subsidiaries are to be deemed to be resident of the country in which the parent company resides.
- However, if the controlling foreign enterprise makes an indirect transfer through "abuse of organisation form/legal form and without reasonable business purpose" resulting in tax avoidance, then the revenue authorities can disregard the form of the arrangement, re-characterise the equity transfer according to the economic substance and impose tax on the actual controlling foreign enterprise. This would need to be determined by review of all facts and circumstances surrounding the transaction.
- However, when it comes to taxation of a holding structure, at the threshold, the burden is on the

The Supreme Court explained that under the "look at" test, the Revenue authorities need to ascertain the true legal nature of the transaction by looking at the entire transaction holistically and not by adopting the dissecting approach.

Revenue authorities to allege and establish the abuse, in the sense of tax avoidance in the creation/ and or use of such structures. The Revenue may invoke "substance over form" principle or "piercing the corporate veil test" only after it is able to establish on the basis of facts and circumstances surrounding the transaction that the transaction is sham or tax avoidant. One of such example could be a structure for circular trading or round tripping or to pay bribes which should be disregarded applying the principle of fiscal nullity.

- Thus, if revenue authorities finds that in a holding structure that an entity has not commercial/business substance and has been interposed only to avoid tax then in such cases, applying the test of fiscal nullity it would be open to the Revenue to discard such inter-positioning of that entity.
- The SC reiterated the "look at" principle enunciated in Ramsay (supra) and Craven *Vs.* White 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 to. 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 to adopt a dissecting approach. The Revenue cannot start with the question as to whether the impugned transaction is a tax deferment/saving device but that it should apply the "look at" test to ascertain its true legal nature.
- The SC further observed that every strategic foreign direct investment coming to India, as an investment destination, should be seen in a holistic manner. While doing so, the Revenue/Courts should keep in mind the following factors:
  - o the concept of participation in investment,
  - o the duration of time during which the Holding Structure exists;
  - o the period of business operations in India;
  - o the generation of taxable revenues in India;
  - o the timing of the exit;
  - o the continuity of business on such exit.

  In short, the onus will be on the Revenue to identify the scheme and its dominant purpose.

  The SC also held that merely because at the time of exit, capital gains tax does not become payable, the entire share sale transaction would not become sham or tax avoidant.

3. Scope of Section 9 – Whether a Look Through Provision so as to Cover Indirect Transfer of Capital Assets?

- The Revenue authorities primarily contended that any gain arising to a foreign company in consequence of indirect transfer of capital asset situated in India would be taxable under Section 9 in India. Thus, in the instant case, even if control over HEL were to get transferred in consequence of transfer of the CGP Share outside India, it would yet be covered by Section 9.
- The Supreme Court while explaining the scope of provisions of Section 9(1)(i) of the Act explained that income dealt with in each sub-clause is distinct and independent of the other. In the instant case, the applicable clause is last sub-clause of Section 9(1)(i) which refers to income arising from "transfer of a capital asset situate in India'.
- The said sub-clause consists of three elements, namely,
  - o transfer,
  - o existence of a capital asset, and
  - o situation of such asset in India.

  All above three elements should exist in order to make the last sub-clause applicable. Therefore, if such a transfer does not exist in the previous year no charge is attracted. Further, Section 45 also states that such income shall be deemed to be the income of the previous year in which transfer took place. Hence, transfer in the previous year should exist in order to attract the said sub-clause.

  Thus, income accruing or arising to a nonresident outside India on transfer of a capital asset situate in India is fictionally deemed to accrue or arise in India by virtue of above sub-clause of Section 9(1)(i) of the Act.
- The Revenue authorities contended that under Section 9(1)(i) it can "look through" the transfer of shares of a foreign company holding shares in an Indian company and treat the transfer of shares of the foreign company as equivalent to the transfer of the shares of the Indian company on the premise that Section 9(1)(i) covers direct and indirect transfers of capital assets.
- However, based on unambiguous language of Section 9(1)(i) of the Act and the fact that the legislature has not used the words indirect transfer in Section 9(1)(i), the SC held that Section 9(1)(i) cannot be extended to cover indirect transfers of capital assets/property situate in India. It further

held that the words directly or indirectly in Section 9(1)(i) go with the income and not with the transfer of a capital asset (property).

- Further, the SC also relied on the provisions of proposed Direct Taxes Code Bill which expressly proposes to tax indirect transfers. This proposal indicates that indirect transfers are not covered by the existing Section 9(1)(i) of the Act. The question of providing "look through" in the statute or in the treaty is a matter of policy. It is to be expressly provided for in the statute or in the treaty. Similarly, limitation of benefits has to be expressly provided for in the treaty. Such clauses cannot be read into the section by interpretation. Thus, the SC held that that Section 9(1)(i) is not a "look through" provision.

4. Other Property Rights – Whether Constitute a Separate Asset?

- The revenue authorities contended that HTIL had certain rights like rights of control and management over HEL and its subsidiaries, which were extinguished under the share purchase agreement entered with Vodafone for transfer of share of CGP. Thus, the defacto control over subsidiaries which was extinguished amounted to transfer of capital asset situated in India.
- The Supreme Court based on the facts held that the instant case involved selling shares of CGP and not with sale of assets, item-wise. The Supreme Court explained that under the "look at" test, the Revenue authorities need to ascertain the true legal nature of the transaction by looking at the entire transaction holistically and not by adopting the dissecting approach.
- Accordingly, SC observed that if one applies the "look at" test, they would find that the entire Hutchison structure had been in place since 1994 to 2007. Hence, it could not be said that the structure was created or used as a sham or tax avoidant. Hence, applying the "look at" test and without invoking the dissecting approach, the SC held that extinguishment of above mentioned rights occurred because of the transfer of CGP share and not by virtue of various clauses of SPA.
- Further, the SC also held rights such as right to control a subsidiary or to appoint a director or to direct a downstream subsidiary to vote in a particular manner fall within the category of persuasive position/influence. Hence, as these rights cannot be enforced in the court of law, they cannot be construed as a right in the legal sense.
- With regards, to call and put options to buy additional shares, the SC held that these are

contractual rights and in absence of any statutory stipulation, they cannot be considered as capital assets. At best, they may be regarded as potential shares till they are exercised.

5. Role of CGP and Situs of Shares of CGP

- The Supreme Court also made interesting observations on efficiencies of a holding structure. It observed that subsidiaries are often created for tax or regulatory reasons. Further, based on facts of the case, it held that it cannot be said that the intervened entity CGP had no business or commercial purpose.
- Also, the Revenue authorities contended that as CGP was a mere holding company, situs of CGP's shares existed where its underlying assets were situated, which was India. However, the SC held that under the Indian Companies Act, 1956, the situs of the shares is wehre the company is incorporated and the place, where shares can be transferred.
- In the instant case, as transfer of the CGP shares were recorded in the register of members kept in Cayman Island, the situs of the shares was in

Cayman and not in India were underlying assets are situated.

6. Transfer of Controlling Interest – Whether A Separate Capital Asset ?

- The Supreme Court held that controlling interest is an incident of ownership of shares in a company and it flows from holding of shares. Controlling interest is not an identifiable or distinct capital asset independent of holding of shares. The control of a company resides in the voting power of its shareholders and shares represent an interest of shareholder which is made up of various rights contained in the contract embedded in the Articles of Association.
- Shares, and the rights which emanate from them, flow together and cannot be dissected. Thus, it held that control and management is facet of holding of the shares. Thus, the instant case covered only a straight forward share sale which Vodafone purchased along with various rights flowing from the CGP share, including the right to gain control over three layers of companies.
- The SC also as a general rule held that where a transaction involved transfer of shares it transaction cannot be broken up into separate individual components, assets or rights such as right to vote, right to participate in company meetings, management rights, controlling rights, control premium, brand licences and so on as shares constitute a bundle of rights.
- The SC also held that it was not open for the revenue authorities to split the payment for share sale into variety of different rights transferred due to share sale.
- The essential character of the transaction cannot be altered by the form of the consideration, the payment or the basis of consideration. The transaction in the instant case remained a contract of outright sale of the entire investment for a lump sum consideration.

7. Scope and Applicability of Sections 195 and 163 of the Act

- The SC held that withholding provisions under Section 195 of the Act would apply only if the transaction is subject to tax in India. In the present case, the transaction was of transfer of capital assets between two non-resident entities on a principal to principal basis, through a contract situated outside India and for which consideration was also paid outside India. Hence, as the transaction was not taxable in India, no liability to deduct tax at source arose on Vodafone.

Applying the Westminster principle in the said case, it was held that the Tax Authority cannot tax a subject without a specific provision to support and every tax payer is entitled to arrange his affairs so that his taxes shall be as low as possible and that he is not bound to choose that pattern which will replenish the treasury.

- Further, tax presence in India has to be viewed in context of the transaction and hence, Vodafone's investment in Bharti Airtel cannot make all entities of Vodafone group subject to the Indian Income-tax Act, 1961. Tax presence has to be construed in a manner that brings the non-resident assessee under jurisdiction of Indian tax authorities.
- With regards to applicability of provisions of Section 163 of the Act pertaining to representative assessee, the SC held that Section 163 of the Act does not relate to deduction of tax. Further, Section 163(1)(c) as well as Section 9(1)(i) of the Act state that income should be deemed to accrue or arise in India. In the instant case, as there is no transfer of capital asset situated in India, Section 163(1)(c) of the Act is not attracted and hence, no proceedings can be initiated on Vodafone as representative assessee even under provisions of Section 163 of the Act.

Conclusion

While concluding, the SC made some interesting observations on the legal and judicial system. It observed that 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.

Further, legal doctrines like "Limitation of Benefits" and "look through" are matters of policy. It is for the Government to have them incorporated in the Treaties and in the laws so as to avoid conflicting views. This would help both investors as well as the tax administration in enforcing the provisions of the taxing laws.

Thus, the judgment of SC in Vodafone case has given many key principles for interpretation of legal statutes and tax treaties and which would serve as a guiding principle in all future cases.

The revenue authorities have recently filed a review petition against the above judgment with the Supreme Court, so it seems that the Vodafone controversy has not yet been laid down to rest. ■