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Bombay High Court Rules on Vodafone's Petition:
Taxation of Off-Shore Transaction Upheld

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This article summarizes a recent decision of the Bombay High Court ("High Court") in the case of Vodafone International Holdings B.V.[1] (Order dated September 8, 2010). The issue before the High Court was whether the Indian tax authorities (the "tax authorities") had the jurisdiction under the Indian Income tax Act, 1961 (the "Act") to tax the gains arising from the transfer of shares in an offshore jurisdiction between two non-resident entities.

The High Court held that the transaction must be viewed from a commercial perspective and that it was crucial to determine the place or the source from which the profts had been generated. The High Court observed that the price paid for the acquisition included controlling rights and other entitlements of the Indian business. Moreover, the divestment of the seller 's interests comprised of many components and, therefore, the tax authorities had the jurisdiction to tax the transaction.

Further, the High Court noted that there were multiple arrangements involved

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in the transaction, and held that there should be an apportionment of the income based on the part of the capital gains that has a nexus with India. Having said that, the High Court has not ruled on the manner in which the consideration should be apportioned. This will be determined by the tax authorities. Vodafone has appealed to the Supreme Court of India and the frst preliminary hearing commenced on September 27, 2010. The matter will now be heard on October 25, 2010.

Background

Vodafone International Holdings B.V ("Vodafone") is an entity based in Netherlands. Vodafone acquired 100 percent shares in CGP (Holdings) Limited ("CGP"), which is an entity based in Cayman Islands, from Hutchinson Telecommunications International Limited ("HTIL"). See fgure 1 on page 9.

CGP had controlling stake in Hutchison Essar Limited ("HEL"), an Indian entity. HEL was a joint venture between the Hutchinson group and the Essar group.

The acquisition resulted in Vodafone acquiring control over CGP and its subsidiaries, including HEL.

The tax authorities issued a show cause notice to Vodafone to explain why tax was not withheld

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on payments made to HTIL in relation to the above transaction. Vodafone fled a writ petition in the High Court challenging the jurisdiction of the tax authorities in the matter. The High Court held that the tax authorities had a prima facie case that the transaction involved the transfer of a capital asset in India. Vodafone challenged the order of the High Court before the Supreme Court. The Supreme Court directed the tax authorities to determine the jurisdiction issue and also permitted Vodafone to challenge the decision of the tax authorities on the preliminary issue of jurisdiction before the High Court.

The issue before the high Court was whether the Indian tax authorities had the jurisdiction under the Indian Income tax Act, 1961 to tax the gains arising from the transfer of shares in an offshore jurisdiction between two non-resident entities.

The tax authorities held that they had the jurisdiction to proceed against Vodafone for their failure to withhold tax from payments made under the Act provisions. This order of the tax authorities was challenged by Vodafone before the High Court.

Statutory Provisions

Firstly, India does not have a double taxation avoidance agreement with Cayman Islands. Therefore, the taxability of the capital gain in the hands of HTIL, the Cayman holding company which sold the shares of CGP to Vodafone BV, will be determined solely in accordance with Indian law.

Secondly, Indian tax law requires any "person" making any payment to any other "person" to withhold tax at applicable rates if such payment is chargeable to tax under Indian law. (Section 195 of the Act.) Further, the defnition of the word "person" includes a foreign company. (Section 2(31)(iii) read with Section 2(17)(ii) of the Act.)

Thirdly, any income which accrues or arises in India, or is deemed to accrue or arise in the hands of a non-resident, is taxable in India. (Section 5 of the Act.) Additionally, any income which a non-resident receives from the transfer of a capital asset situated in India is deemed to accrue or arise in India. (Section 9(1) of the Act.)

Vodafone's Contentions

(i) The transaction represents only the transfer of shares in CGP and not the rights. The transfer is not taxable in India because the asset is not situated in India.

(ii) There is no income which arises or accrues in India since the right to receive money was outside India. The contracts were entered outside India, and the payment was also made outside India.

(iii) The Act does not contain a look-through provision which justifes the levy of tax in India. A look-through provision imposes tax on gains from the transfer of shares outside the country, if it results in the transfer of control in a company that holds substantial immovable property in the country.

(iv) The location of the asset does not notionally shift to India because the agreement pursuant to which it is transferred has also led to certain related agreements which have a nexus with India.

(v) Vodafone does not have any income chargeable to tax under the Act as it does not have a business presence in India. Therefore, Vodafone does not have an obligation to deduct taxes under section 195 of the Act.

The Tax Authorities Contentions

(i) The Vodafone transaction involved a transfer of 67% stake in HEL, which includes a transfer of the composite rights/interests of HTIL in HEL.

(ii) The transaction involved the right to the telecom license which allows Vodafone to conduct business in India, the transfer of management rights, the right to seek loans through intermediaries, the acquisition of the Hutch brand, etc., which are independent of the CGP shares.

(iii) The consideration paid by Vodafone was for a compendium of rights including effective control and management of HEL in India.

(iv) All these rights constitute a capital asset situated in India and the price paid to HTIL was based on the underlying value of the property situated in India.

(v) The expressions "person" in section 195 of the Act is not restricted to a person resident in India. It can also be applied to a non-resident. The obligation to deduct tax is not extinguished merely because the payment is made by a non-resident to another non-resident outside India.

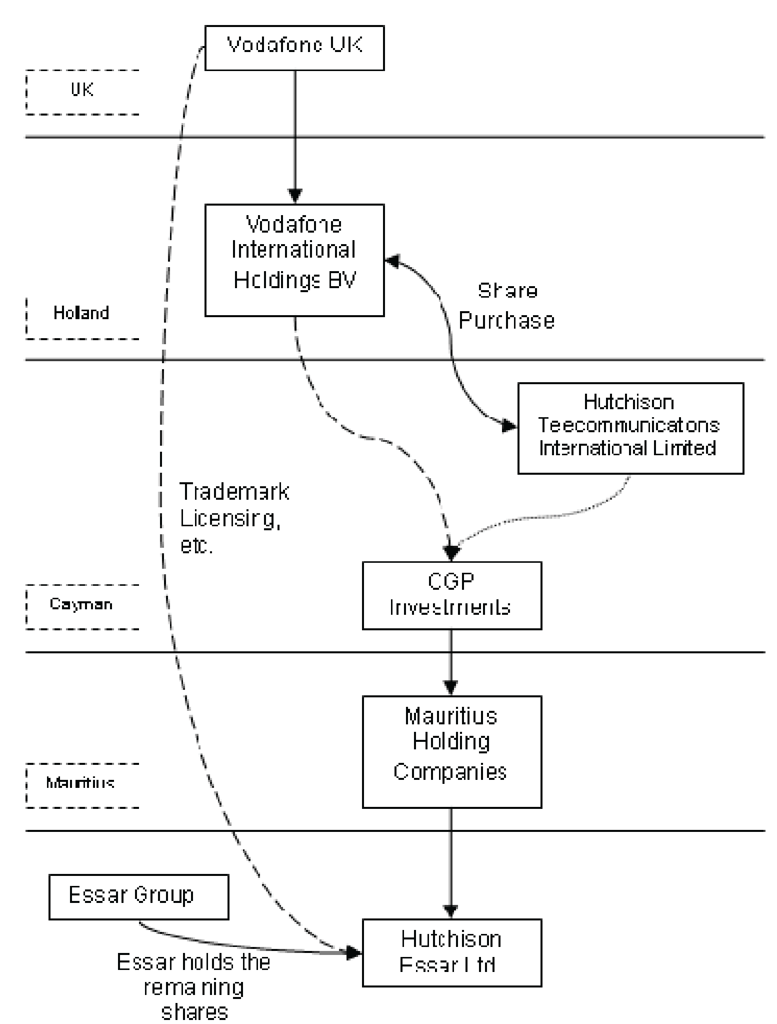

Figure 1

High Court's Findings

Structuring Business for Tax Planning

The Act recognizes the right of a taxpayer to plan his transactions to reduce the incidence of tax. Additionally, instruments and legal structures which are utilized for a bona fde business purpose do not permit an enquiry by the tax authorities into the underlying economic interest, more so because the Act does not permit the tax authorities to make such an examination. However, the parties cannot conceal the nature of their legal relationship by adopting a structure which is different from the legal character assumed by them.

Shares and Rights of Shareholders

Ownership of shares may in certain cases result in the shareholder acquiring a controlling interest in the company. A controlling interest is derived due to ownership of the shares of the company. Therefore, shares and rights which emanate from them fow together and cannot be separated.

Chargeability

The transactions between Vodafone and HTIL entail the following rights and entitlements:

(i) controlling rights through the shareholders agreement;

(ii) rights of call and put options on companies directly / indirectly holding shares in HEL;

(iii) right to appoint/remove directors in the board of HEL;

(iv) interest in the form of loans and preference share capital in indirect holding companies of HEL;

(v) use and rights to the Hutch brand in India; and

(vi) non-compete agreement with the Hutch group.

Accordingly, it would not be right to assume that the transaction was merely a transfer of shares of CGP. The transaction includes the transfer of other rights and entitlements mentioned above, and these rights and entitlements constitute in themselves "capital assets" within the meaning of Section 2(14) of the Act.

Apportionment

In certain instances, a need for apportioning income arises when the source rule applies and the

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income can be taxed in more than one jurisdiction. Judicial precedents have analyzed situations where a person has earned profts on the sale and purchase of goods abroad or where a tax payer engages in a composite activity; such as manufacture and sale. One component takes place within the Indian tax jurisdiction while the other has occurred outside the Indian tax jurisdiction.

The high Court held that the transaction must be viewed from a commercial perspective and that it was crucial to determine the place or the source from which the profts had been generated.

In the case of a capital asset, the provisions under the Act provide that the income must accrue or arise by the transfer of a capital asset situated in India. The nexus of the capital asset is the crucial condition. Such a nexus must be fulflled, in order to attract chargeability to tax arising from the transfer and, therefore, the tax authorities are required to apportion (to identify and distribute) the income that has arisen in India, and that which lies outside India.

Section 195 of the Act

(i) Under the provisions of section 195 of the Act, frstly, it is necessary that there should be a person who makes payment to a non-resident, and secondly, the interest or other sum must be chargeable to tax under the provisions of the Act.

(ii) The responsibility for deducting tax at source arises where the sum payable to a non-resident is chargeable to tax, and it is not necessary that the entire sum payable needs to be chargeable under the Act.

(iii) If the sum payable to a non-resident represents income or if income is hidden or otherwise embedded in it, tax is required to be deducted on the sum.

Maimudar & Co's Views

The tax authorities, in recent times, have 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 change in controlling interest of the Indian subsidiary. The case of Vodafone is the frst such matter to be litigated before the High Court and hence, the outcome of this decision was keenly awaited.

While the High Court ruling does seem to suggest that the tax authorities have jurisdiction to tax an alleged offshore transaction, it appears that the conclusion was based having regard to the specifc facts and circumstances of the case and the nature of the specifc legal arrangements put in place for effectuating the transaction. The ruling does not seem to propose a general principle for taxing all offshore share transactions which indirectly involve Indian assets. However, a need does arise for parties to consider the implications of this ruling while structuring their cross-border M&A transactions involving India.

This decision will result in foreign investors adopting a more cautious approach when investing in India. Tax structures will have to be more straightforward and investments will have to be routed through treaty jurisdictions, having more robust substance requirements.

Multinational enterprises hold their operational subsidiaries through a complicated string of holding companies. Depending on the facts, it may be diffcult for them to re-organize their holdings in a manner in which transactions at a global level do not become chargeable to tax in India.

On the merits of the case, our prima facie view is that the transaction ought not to be taxable in India. Such a sensitive view of a transfer of shares abroad leading to the transfer of underlying assets in India is not in line with settled principles of tax law. The Supreme Court has categorically held in the landmark case of Bucha Guzdar that the shareholder only acquires the shares and their consequent rights to dividend, etc. He/she does not acquire any rights per se to the assets held by the company. (See Bacha F. Guzdar v. Commissioner of Income-tax, Bombay, AIR 1955 SC 74)

Such an obscure interpretation of the Act can also lead to double taxation. Assume for a moment that Cayman Islands were to also tax the capital gains in the hands of HTIL. This could lead to double taxation as there would be no credit considering that the taxable events would be different. Such matters may be even more complicated in transactions such as IBM-Lenovo or Royal Bank of Scotland-ABN Amro. o

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1 Vodafone International Holdings B.V. v. Union of India, MANU/MH/1040/2010, decided on September 8, 2010

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