Vodafone's Indian fate delayed...again

By Pauline Renaud

For months now, the sword of Damocles has been hanging above Vodafone. It was hoped, that by mid-November the Indian tax bill case would come to an end. But with the final appeal hearing set for 24 February, many questions about the impact on foreign investment hang in the balance.

In early September, the Bombay High Court ruled that authorities were allowed to levy a US$2.5bn tax bill from Vodafone International, a Dutch subsidiary of the British mobile operator, on its US$11.2bn purchase of Hutchinson Essar in 2007.

The Indian Income Tax department argued that the deal not only involved the transfer of shares but also a transfer of rights such as management control, brands and rights to conduct business in India - pointing towards an "Indian nexus", allowing the country to claim tax.

Vodafone rejected those arguments, saying that its subsidiaries in Mauritius and the Cayman Islands, where the stake changed hands, were fully functional companies. A Vodafone lawyer was quoted saying at the time that because India has a double taxation treaty with Mauritius, investments made from there into India are not subject to tax.

Questions were also asked about why the Dutch company, as a buyer, should be liable to a tax since it made no gain. "In this 'test case', the tax authority is attempting to interpret Indian law as it has never been interpreted for the past 50 years, and this interpretation also goes against internationally recognised tax norms," Vodafone stated.

The judgment has also left tax law experts somewhat puzzled. "Capital gains tax is usually paid by the seller – who is the transferor of a capital asset – and not the buyer. Thus, we will have to wait till the next hearing on 24 February, when the Supreme Court will decide on the 'jurisdiction issue' and the merits of the case, and who will finally be liable for the tax bill," explained Ravishankar Raghavan, a principal in the Tax Group at Indian law firm Majmudar.

"Indian tax law is sometimes a bit of a mystery for foreign tax experts," said Dale L. Ponikvar, a tax partner in charge of outsourcing and intellectual property matters at Milbank. "But the Indian legislator has, in the past, shown an awareness of the value of foreign investments in the country," he added.

Vodafone CEO Vittorio Colao complained in late September that the tax bill sent a negative message about the country for foreign investors who created jobs and deployed assets in India. He was later quoted saying that he would need a positive outcome to the tax case and a stable regulatory environment to continue investing in the country.

"In the short term, this will definitely impact Vodafone's investment plans but I believe that they view India as a long-term strategic market so it will be more a question of how they absorb the tax bill to reduce impact on earnings," explained Shiv Putcha, a principal analyst, emerging markets, at Ovum Telecoms.

On 15 November, the Supreme Court asked Vodafone to pay a Rs 25bn (US$554m) down payment on its tax bill within three weeks. The company was also told to submit bank guarantees worth Rs 85bn (US$1.9bn) within eight weeks. "This should not be interpreted as Vodafone having lost its case and therefore liable to pay tax in India," qualified Raghavan.

"If Vodafone is not found to be liable to pay tax in India, which might be the outcome although the Indian tax authorities have built strong arguments in this 'fact specific case', all the money will be refunded to Vodafone by the Indian tax authorities along with a payment of interest," he added.

But beyond the impact on Vodafone itself is whether this case will substantially change the face of the Indian regulatory environment and the willingness of foreign companies to conduct deals.

"The Vodafone case will definitely be a test case for future transactions. Press reports suggest that there are around 400 similar deals under the spotlight, with some of these being examined by tax authorities and others being litigated at various levels. The judgment may provide fillip to tax authorities' investigations," said Raghavan.

Some experts in the industry even fear that if the Supreme Court decides to go ahead with the tax bill, other foreign firms might also be deterred from investing in the country. With 14 mobile operators in India, the sector is considered overcrowded. But local tax regulations are often seen as the main hurdle since buyers have no clarity as to how regulations will change.

"On a larger scale, I think foreign investors will be increasingly wary of tax jurisdiction and will look to structure their deals to offset any possible tax implications. This should definitely have an impact on valuations of companies looking to sell," added Putcha.

But most analysts agree to say that ultimately, it should not halt deals. "There are of course hurdles, including the regulatory and tax environment, but these factors are not likely to stop companies, including foreign firms, from seeking M&A opportunities.

"Looking ahead, we expect consolidation towards triple and quad plays as well with fewer players in these markets," concluded Jonathan Dharmapalan, global deputy telecommunications leader at Ernst & Young.