

## News Analysis: The *Vodafone* Effect

by Anurag Jain and Parul Jain

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# HIGHLIGHTS

## News Analysis: The *Vodafone* Effect

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For the past four years or so the investing community all over the world has been following the developments in the high-profile *Vodafone* case,<sup>1</sup> which went through two rounds of litigation up to the highest court in India. Speculation over the case resulted in broken merger and acquisition deals and strongly negotiated indemnities. Uncertainty was rife, especially with the Bombay High Court accepting the Revenue Department's argument that it had jurisdiction to tax the transaction in question.

The Supreme Court on January 20 ruled in favor of the U.K.-based global telecommunications company, overturning a High Court order and setting to rest a prevalent controversy for similar offshore transactions. With almost \$2.1 billion at stake, the Supreme Court's decision is a win not only for Vodafone, but for the entire country. (For prior coverage, see *Doc 2012-1191* or *2012 WTD 14-1*.)

### The Transaction

The main issue in the case was the taxability of the offshore sale by Hutchison Telecom International Ltd. (HTI) to Vodafone of a solitary share, representing the entire share capital in an Indian mobile phone company held by a Cayman Islands company.

The Revenue Department had alleged that because the Cayman Islands company had direct and indirect control over the shares in the mobile phone company registered in India, the transaction gave rise to capital gains in India for HTI and consequently, a withholding tax obligation on Vodafone.

The High Court dismissed Vodafone's petition of appeal, observing that a controlling interest in an Indian entity had been transferred. Further, other rights had been transferred and could be subject to tax in India if a nexus was found with Indian territory, it said.

<sup>1</sup>*Vodafone International Holdings B.V. v. Union of India*; Civil Appeal No. 733 of 2012; S.L.P. (C) No. 26529 of 2010 (Jan. 20, 2012).

Vodafone's counsel argued the matter for a few weeks before the Supreme Court. The arguments covered various complex issues surrounding international taxation, such as:

- the situs of an asset;
- substance over form;
- the lifting of the corporate veil;
- legitimate tax planning versus unacceptable tax avoidance;
- the sanctity of cross-border holding structures for tax purposes;
- the concept of controlling interest;
- treaty benefits; and
- the interpretation of share purchase agreements and related transactions, and so on.

The counsel for the appellant made extensive references to U.K. decisions on tax avoidance and sham devices.

### The Supreme Court's Decision

The Supreme Court held that in the absence of a specific look-through provision in India's domestic tax laws, an overseas share sale cannot be taxed in India on the basis of underlying assets. The Court, recognizing the practical aspects of holding structures in the current business environment, observed that a corporate structure cannot be disregarded for tax purposes merely because a subsidiary may work under the guidance of its parent or because a parent company exercises shareholder influence and there may be a restriction on the autonomy of the directors of the subsidiary because of that influence.

Elaborating on situations in which tax abuse can be alleged, the Court observed that the Revenue Department bears the burden of proving tax abuse, and that a transaction was aimed at avoiding taxes.

The Court also held that the transaction between HTI and Vodafone could not be dissected into various components (that is, incidental control rights and other rights envisaged to vest in the purchaser through the strategic partnership agreement) for tax purposes. The Court distinguished between the legal rights of a group holding company and the de facto control it may exercise over its downstream subsidiaries. De facto control, the Court held, cannot be transferred in the same way

as a legal right so as to result in the transfer of a capital asset giving rise to taxable gains.

The Court also examined the territorial applicability of Indian withholding tax and held that withholding tax obligations cannot be imposed on nonresidents that have no tax presence in India. It observed that the withholding tax provisions should apply only to Indian resident payers.

### The Effects

The Court has established an important principle: that tax can be levied only on a transaction, and not on its effects. While this ruling deals with important aspects of international tax and corporate law, what is even more interesting is the fact that the judiciary has reinforced the position that the legislature needs to step in and enact proper regulatory laws.

The Court also seems to be advocating the enactment of a statutory general antiavoidance rule in India's domestic legislation. However, while such legislation may help keep tabs on unchecked antiavoidance transactions, its success in India would depend entirely on its effective and balanced implementation.

The Indian judiciary has demonstrated its understanding of foreign investors' need for certainty in tax laws. The Court says such clarity would not only help the taxpayer, but would also assist the Revenue Department and curb unnecessary litigation. This endorsement by the Court will go a long way, and hopefully the legislature will keep it in mind when enacting new laws — for example, the upcoming Direct Taxes Code, which is awaiting parliamentary approval.

A word of caution to investors: This ruling may not be binding for all offshore transactions. While the

Court ruled favorably for the taxpayer in *Vodafone*, its decision was based largely on the facts of that case.

While holding company structures are to be respected in ordinary circumstances, they can still be pulled down in the case of a sham or tax fraud. Therefore, foreign investors may still need to be wary of a "Vodafone risk" and be ready to negotiate indemnities in deals involving India.

Another observation of note involves the availability of an India-Mauritius tax treaty benefit to a Mauritius entity holding a valid tax residency certificate (TRC). While upholding eligibility for tax treaty benefits on the basis of a TRC, the Court observed that the mere holding of a TRC does not prevent the Revenue Department from denying treaty benefits in cases of tax abuse or in matters of tax evasion and illegality. The takeaway for foreign investors is that they should probably reexamine their structures to determine the level of substance in a Mauritius investing entity.

In summary, India's highest judicial authority has reinforced the importance of commercial and business purpose in transactions and acknowledged the movement from form to substance. At the same time, it has reiterated that the Revenue Department does not have the prerogative to challenge every transaction on the basis of some perceived tax benefit to the taxpayer. This ruling will clearly go down in history as one of India's most effective rulings on tax avoidance and will provide guidance for the analysis of transactions even after a general avoidance rule is finally implemented in India. ♦

♦ *Anurag Jain is a partner and Parul Jain is a director with BMR & Associates.*

*The views expressed in this article are those of the authors, and do not necessarily reflect the views of BMR & Associates.*