

Taxation

Reaffirming Tax Principles

by abhishek goenka

THE Supreme Court in its landmark ruling in the Vodafone case has reaffirmed long established principles of taxation under the Indian income tax laws. The London-headquartered giant litigated the matter to the apex court as the country's revenue and lower courts refused to grant Vodafone relief from a tax obligation on a transaction that concerned offshore transfer of shares of a foreign company between two non-residents.

Detailed facts relating to the case are complex — and a classic pointer that business structures are getting overly intricate. Having said that, simply put, the case concerned Vodafone Netherlands's tax withholding obligation on payment to Hutch Cayman Island for purchase of the latter's shareholding in another Cayman Island company. This firm indirectly held shares in the Indian company that housed Hutch's telecom business in India.

The Indian Revenue Department alleged that the sale of shares of the Cayman company by Hutch to Vodafone was liable to tax in India. It said the deal resulted in the effective transfer of the ownership of the Indian telecom business. The revenue department, hence, alleged that under Indian tax laws, Vodafone was responsible for withholding taxes on the payment to Hutch and for depositing such withheld taxes to the government. Since it failed to do so, a staggering amount of \$2.5 billion was sought to be recovered.

Similar to the path that most litigations take, Vodafone was fighting the case in the Bombay High Court as well as the Supreme Court on aspects such as whether the revenue department had the jurisdiction to attack such a transaction. After many setbacks and, often, harsh comments by both courts, the case reached the apex court once again on the final merits of the matter.

Contrary to expectations, the Supreme Court recently issued an unequivocally favourable ruling to Vodafone holding that the purchase of the Cayman company's shares was a transfer of capital assets situated outside India. And, hence, no part of the gains made by Hutch had arisen or deemed to



The Vodafone ruling reinforces the faith of the investor community in the Indian judicial system

have arisen in India.

Specifically, the court observed that the shares of a foreign company are assets situated outside India, much like the shares of an Indian company are situated in India. It also said that the corporate structure was setup by Hutch over a significant length of time to serve its commercial investment objectives.

The court also painstakingly pored over all the contractual agreements and held that the transaction, in essence, was for the transfer of the shares of the Cayman company and that other ancillary arrangements for certain options and rights were executed merely to safeguard the rights of Vodafone. The court effectively debunked the dual theory that the Bombay High Court had come up with.

The ruling also stands out for reinforcing several first principles in the interpretation of tax laws and will serve as the Bible and dossier of sorts. Both businesses and administrators grapple with not only increasingly higher stakes in tax matters, but also — and more worryingly — a global tax environment where a debate rages on balancing the need for tax revenues with allowing companies some leeway in tax planning.

It will be useful to trace some of the important findings made by the apex court since these are quite all-encompassing and can be used increasingly even in international jurisprudence:

- Tax rules have to be interpreted as they exist and a purposive interpretation cannot be permitted to be made to deeming provisions of the law

- It is the responsibility of the government to outline a clear set of tax rules that minimise

any room for ambiguity because clarity of tax incidence is integral to investors

- Large businesses are typically held and operated through multiple entities in multiple jurisdictions for legitimate commercial considerations

- Existence of a corporate entity needs to be respected so long as its operation or conduct is not seen as a mere device for tax purposes

- The revenue department has the ability to question corporate structure or form of an arrangement when facts suggest that the intent is to merely avoid payment of taxes

- India has had judicial anti-avoidance rules and there is no infirmity in the principles laid down by the court in previous judgments

- The burden of proof for tax avoidance is on the revenue department and it needs to establish that a structure or a transaction is effected in a manner purely to abuse provisions of



WALK FREE: The Supreme Court ruling has vindicated Vodafone's stand on the Hutch deal

law for the avoidance of tax.

Yet, much like most things in our country, the court ruling has had its share of controversy. The honourable justices have made several observations related to foreign direct investment (FDI) and how it is important to the country. These remarks have stirred a discussion on whether tax matters should be ruled upon wearing a capitalistic or socialistic hat.

Oddly, while the ruling has been issued by a three-member bench of the court, two members (lead by the honourable Chief Justice) have expressed their judgment in one order, and the third member has expressed his judgment separately.

Fortunately, although the two orders do not dissent from each other in their conclusions, the legally binding authority of the third member's judgment and the principles discussed in it are unclear. As a case in point, there appears to be some divergence on the need for non-residents to comply with the withholding tax provisions in India in the absence of a nexus

The ruling has certainly jolted the government's spirit for taxing offshore share sale transactions

with India, and this will continue to create uncertainty in global mergers and acquisitions deals involving an Indian footprint.

On the side of the government, the ruling has certainly jolted its spirit for taxing offshore share sale transactions. It appears unlikely that the government will request a review of the court order. But there are enough indications in the ruling — and discussions after the issuance of the ruling — for the government to legislate appropriate laws to streamline its tax policy by introducing specific anti-abuse rules and look through provisions.

Therefore, while the ruling on the Vodafone tax dispute may not stand out as the one that will continue to benefit investors in the years to come, it will — no doubt — stand out as the one that reaffirmed the basic principles of taxation and, more importantly, one that reinforced the faith of the investor community in the Indian judicial system.

Goenka is partner with BMR Advisors. Sumeet Hemkar, director, BMR Advisors, has contributed to the column