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Analysis of the Vodafone Supreme Court Order

In a landmark judgment passed on 20th January 2012, a three Judge *Bench* of the *Supreme Court comprising of Chief Justice of India Hon'ble Justice S. H. Kapadia, Hon'ble Justice Swatanter Kumar and Hon'ble Justice K. S. Radhakrishnan vide 2 concurring judgments, set aside the controversial Bombay High Court judgment dated 8th September 2010 in the tax liability matter of " Vodafone International Holdings B.V. VS Union of India & Another " and absolved Vodafone of any tax liability under their acquisition of the "Hutch" brand in India.*

Background:

1. Through several agreements, the primary of which being a Share Purchase Agreement dated 11th February 2007 ("**SPA**"), Vodafone International Holdings BV ("**VIH**"), a Netherlands company and subsidiary of Vodafone Plc, acquired the entire share capital of CGP Investments (Holdings) Ltd. ("**CGP**"), a Cayman Islands company, for a consideration of US$ 11.08 billion from Hutchinson Telecom International Limited (" **HTIL**"), both CGP and HTIL being subsidiaries of the Hong-Kong based Hutchison Telecommunications International.
2. Consequently VIH acquired a group of companies which in turn collectively controlled a 67% interest in Hutchinson Essar Limited (" **HEL**"). HEL was an Indian joint-venture telecommunication company between HTIL and Essar Group Limited, involved in providing telecommunications services under the brand name "Hutch".
3. Pursuant to the SPA, on 31st May 2010 the Income Tax Department passed an order declaring that the IT authorities had jurisdiction to tax the SPA transaction. Being aggrieved, VIH filed Writ Petition No. 1325 of 2010 before the Bombay High Court which was dismissed on 8 th September 2010, and hence VIH filed this Civil Appeal.

Key Issue:

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- The Unresolved Controversy In Indian Corporate Law, "Right Of First Refusal"

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IT Department seeks to tax the capital gains arising from the sale of the share capital of CGP on the basis that CGP, while not a tax resident in India, holds the underlying Indian assets.

Key Issues and Observations:

1. Whether Section 9(1)(i) of the Income Tax Act, 1963 ("**Act**") **is a "look through" provision?**

Section 9 of the Act reads *"(1) The following incomes shall be deemed to accrue or arise in India :-*

*(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or **through** the transfer of a capital asset situate in India."*

The IT Department contended that under the aforementioned 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 the aforementioned Section 9(1)(i) covers direct, indirect and consequent transfers of capital assets. Thus, they alleged that the income from the sale of CGP shares would amount to the transfer of a capital asset in India.

The Court observed that in this case, the last sub-clause of the aforementioned Section 9(1)(i) referring to income arising from "transfer of a capital asset situate in India" is the only relevant one. The Court held that the said sub-clause consists of three elements, namely, transfer, existence of a capital asset, and situation of such asset (and not an underlying asset as alleged by the IT Department) in India and all three elements should exist in order to make the last sub-clause applicable. It also held that "consequent or indirect" transfer of assets or "transfer of underlying assets" was not contemplated in the said Section by its Legislators, and considering the same would amount to altering the law. The Court supported this view with its comments on the proposed Direct Taxes Code Bill 2010 ("**DTC**"), which contains a specific clause for taxation of non-residents for foreign assets with underlying Indian assets. The Court observed that since this was a change to be brought about by the IT Department in the proposed bill, it could not be envisaged under Section 9(1)(i) of the Act.

Reference to "direct or indirectly" at the beginning of the Section mean income and not relate to the transfer of a capital asset.

The Court further cited Section 5(2) of the Act which reads "5.(2) *Subject to the provisions of this Act, the total income of any previous year of a person who is a nonresident includes all income from whatever source derived which-*

(a)is received or is deemed to be received in India in such year by or on behalf of such person; or

(b)accrues or arises or is deemed to accrue or arise to him in India during such year. "

Reading the 2 Sections together, the Court held that Section 9(1)(i) is not a "look through" provision and does not entitle the IT department to tax the transfer of capital assets outside India (whether or not it happens underlying assets in India), nor can it tax any income of non-residents which accrues outside India.

2. Scope of Section 195 of the Act?

Section 195(1) of the Act reads " *Any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest or any other sum chargeable under the provisions of this Act (not being income chargeable under the head "Salaries" shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force* "

Thus, Section 195 of the Act casts an obligation on the payer to deduct Tax at Source ("**TDS**") from payments made to non-residents, which payments are chargeable to tax. If the sum credited by the payer is not chargeable to tax then no obligation to deduct the tax would arise. Shareholding in companies incorporated outside India (in this case CGP) is property located outside India. Where such shares become subject matter of offshore transfer between two non-residents, there is no liability for capital gains tax. The Court thus held that the present case concerns the transaction of "outright sale" between two non-residents of a capital asset (share) outside India. Further, the said transaction was entered into on principal to principal basis. Therefore, no liability to deduct TDS arose.

3. Other Contentions

The Court also went on to quash certain further allegations of the IT Department such as:

a) **The use of CGP as a tax avoiding/masking vehicle** - the IT Department alleged that CGP was interposed by HTIL at the last minute to avoid taxation. It further alleged that tax planning was a violation of the Act. The Court held that the use of multiple step-up and step-down subsidiaries is perfectly legitimate. To investigate allegations of fraud through complex corporate set-ups (as alleged by the IT Department), the law provides for lifting/piercing the corporate veil. Further, the burden of proof lies on the party alleging such fraud. As per the SPA mechanism, the Court did not observe or find any instance of fraud or tax concealment and relied on the McDowell(1) and the Azadi Bachao(2) case to ascertain the same. It further clarified that there is no conflict between McDowell and Azadi Bachao. Tax planning is permissible and legitimate if is within the four corners of law;

b) **Nature and character of Transaction vs Dissecting approach** - The Court held that the SPA transaction was not a sale of assets on itemized basis, as alleged by the IT Department and upheld by the Bombay High Court, but instead was a single share sale. The Court held that the transaction should be "*looked at*" as a whole. Thus the contention of the IT Department to tax the individual aspects of the transaction was held invalid;

c) **Role of a Representative Assessee u/s 163 of the Act** - The IT Department alleged that Vodafone could be treated as a "representative assessee" of HTIL on account of its minor investments in Bharti Airtel. The Court held that merely because a person is an agent or is to be treated as an agent, would not lead to an automatic conclusion that he becomes liable to pay taxes on behalf of the non-resident. It would only mean that he is to be treated as a "representative assessee". Section 161 of the Act makes a "representative assessee" liable only as regards the income in respect of which he is a "representative assessee". The

Court held that since there is no transfer of a capital asset situated in India, Vodafone cannot be a representative assessee;

d) **Taxation on Valuation -** The IT Department alleged that Vodafone paid US $11.08 billion for 67% of the enterprise value of HEL plus its down-stream companies having operational licences. It bought an upstream company with the intention that rights flowing from the CGP share would enable it to gain control over the cluster of Indian operations or operating companies which owned telecom licences and other business assets. The Court that valuation cannot be the basis of taxation. The basis of taxation is profits or income or receipt which in this situation is capital gains from transfer of a capital asset;

Order

The Court set aside of the Bombay High Court order dated 8th September 2010 and allowed this Appeal. It further directed the IT Department to return the sum of Rs.2,500 crores, the amount deposited by VIH pursuant to the Court's interim orders along with interest at the rate of 4% per annum. The Registry of the Supreme Court was directed to return the Bank Guarantee (for Rs.8500 crores) given by VIH within four weeks.

Conclusion

Applying the "look through" and "look at" test in order to ascertain the true nature and character of the transaction, the Supreme Court held, that the offshore transaction was a bonafide structured FDI investment into India which fell outside India's territorial tax Jurisdiction, and hence was not taxable.

The Supreme Court judgment provides the much needed certainty around deals/M&A activity in India. The judgment settles a long-pending controversy and at the same time it boosts investor confidence in the Indian Judiciary and reinforces the belief that the Judiciary would ultimately correctly interpret and uphold the law.

However the DTC proposes to tax off-shore transactions between non-residents, subject triggering certain conditions. Therefore this judgment may have limited relevance post implementation of the present form of the DTC.

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(1) McDowell and Co Ltd v CTO (1985) 3 SCC 230

(2) Union of India v. Azadi Bachao Andolan and Another (2004) 10 SCC 1

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