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JUST IN - TAX UPDATE

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THE EXTRATERRITORIAL REACH OF INDIAN INCOME TAX LAW - A BRIEF ON THE LATEST TURN IN THE VODAFONE MATTER

In a 196 page judgment delivered by the Division Bench of the Bombay High Court on 8 September 2010, it was asserted that Indian Income Tax Authorities have the jurisdiction to levy tax on offshore transactions in certain cases. This opens up taxability issues of earlier foreign transactions similarly structured, as also raises questions on appropriate structuring of future transactions under the Indian Income Tax Act. (However, the new Direct Tax Code, which has been circulated and is proposed to be effective from 1 April 2012, deals with such transactions in a distinct and clear manner.)

The Court has held that there was a bundle of rights that were transferred by the offshore transaction, and that some of those rights had a nexus with India. The Indian Income Tax Authorities therefore, had jurisdiction.

The focus will now shift to the Supreme Court as it will hear the entire matter, both relating to jurisdiction as also liability (for withholding tax as also capital gains tax) , as set out below.

BACKGROUND

Sir Winston Churchill once remarked - "There is no such thing as a good tax." It seems that the Indian Government (**'UOI'**) would beg to differ, while on the other hand, Vodafone International Holdings B.V. (**'Vodafone Int.'**) would have no trouble agreeing.

In a first of its kind case before the Indian judiciary, Vodafone Int. challenged the Income Tax Authority of India (**'ITA'**) against the assessment that certain Capital Gains Tax that ought to have been paid on a transaction entered into by Vodafone Int.

Not only is this matter unique in its facts, but also the amounts involved are substantial. More significantly, it leads to a basic question on structuring foreign investments into India.

Per the assessment of the ITA, Vodafone Int. should make the UOI richer by about Rs. 12,000 crores, being the assessment as Capital Gains Tax on the transaction. The transaction in question is estimated to be for a consideration of

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Your View

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By The Way

* "The difference between death and taxes is death doesn't get worse every time Congress meets." **- Late American Comedian – Will Rogers**

* While filing his tax returns, **Albert Einstein** observed - "This is too difficult for a mathematician. It takes a philosopher."

about US$ 11.2 billion (about Rs. 53,000 crores).

For understanding as to what led to this dispute, we need to understand the basic transaction involved and the stand taken by both sides to the dispute. The tax dispute pertains to the England-based Vodafone Group's acquisition of 67% stake in Hutchison Essar from the Hong Kong-based Hutchison Telecommunications International in February 2007. The transaction was a transfer of a Cayman Island based company, a subsidiary of Hutchison, for which payment was made outside India. The ITA alleged that Vodafone Int. had failed to withhold Indian tax on the payment of consideration made to Hutch for acquiring the controlling interest.

The ITA is attempting to tax capital gains arising on transfer of controlling interest (through majority shares) of a foreign holding company of an Indian subsidiary as such transfer involves an indirect change in controlling interest of the Indian subsidiary. Pursuant to this, the ITA had issued a show-cause notice to Vodafone Int., asking it why it should not be treated as an Assessee in Default for failing to withhold tax at source and credit such tax to the UOI, based on the transaction.

Simply put, Capital Gains can be defined as any surplus generated by selling a capital investment. A capital investment can include business stocks (shares), paintings, houses, family businesses and the like.

The main provision being relied upon here by the ITA is Section 9(1) of the Income Tax Act which says that where a non-resident earns any income by a transfer of capital asset in India (whether direct or indirect), the capital gains tax would apply. Although the transaction has taken place between two international entities, here the underlying capital asset, which Vodafone indirectly acquired, is in India.

The ITA was of the opinion that the transaction in question was designed to pull the wool over the eyes of the ITA by showing it had taken place abroad so as to claim that the ITA had no jurisdiction hear or decide this matter.

Through a Writ Petition before the Bombay High Court[1] , Vodafone Int. challenged the show-cause notice arguing that the concerned transaction was a mere and simple transfer of shares between two foreign companies and there was no transfer of any capital asset in India and therefore, such transaction would not attract the provisions of Income Tax Act, and hence Vodafone Int. is not liable to pay any tax to the UOI or ITA. Further, it was submitted that the ITA lacked jurisdiction to entertain such a transaction involving two foreign companies.

The main question of dispute involved here was as to whether the transfer of shares between two foreign companies, resulting in extinguishment of controlling interest in the Indian company held by a foreign company in favour of another foreign company, amounts to transfer of capital assets in India and whether this transaction would then be chargeable to tax? The ITA concluded that the income is chargeable to tax in India, and that Vodafone Int. was obligated to deduct tax at source at the time of making payment of sale consideration to Hutch Telecom.

After detailed and lengthy arguments from both sides, involving senior counsels considered as some of the stalwarts of the profession, the Bombay High Court in its first judgment held that

> *"…A divestment or extinguishment of right, title or interest must necessarily precede the divestment of the controlling interest and it would be impossible to*

dissociate one from the other and any divestment by one of any interest of enormous value in shares of such high intensity would certainly amount to acquisition of enduring benefit to the other, resulting in acquisition of a capital asset in India."

"...Under the aforesaid facts and circumstances, Revenue has made out a strong prima facie case that the transaction entered upon by the Petitioner (Vodafone Int.) amounts to transfer of a capital asset and not merely a transfer simplicitor of controlling interest ipso facto in a corporate entity

Vodafone Int. went before the Supreme Court, in January 2009, through a Special Leave Petition[2] (SLP) challenging the jurisdiction of the ITA with regard to this matter, arguing that the ITA has no jurisdiction to tax it over the transaction. However, the Apex Court refused to intervene in the matter and directed the ITA to revert on its jurisdiction. The Supreme Court dismissed the SLP stating that

"the Petitioner (Vodafone Int.) shall be entitled to question the decision of the authority on the preliminary issue before the High Court, in the event the same is decided against it, the question of law to that extent shall remain open"

Pursuant to the Supreme Court decision, the ITA asserted its jurisdiction and passed order dated 31 May 2010 rejecting the challenge of jurisdiction by Vodafone Int. Being adverse to its interest, Vodafone Int. challenged the order of the ITA through a Writ Petition[3] before the High Court.

The ITA, in its arguments, concurred that acquiring shares in the Cayman Islands entity was not really taxable. However, the ITA contended that what was taxable was the transfer of majority and controlling interest in the Indian entity thereby passing on the right to do telecom business, brand acquisition and the transfer in goodwill.

Vodafone Int. in fact obtained and complied with the approvals from the Indian Exchange Regulation Authorities and the Foreign Investment Promotion Board (FIPB). It was argued that the fact that Vodafone Int. felt the necessity of obtaining such approvals prior and during the course of the transaction itself showed the presence of a territorial nexus in India.

CONCLUSION

While dismissing the Writ Petition, the Court has held that the ITA has jurisdiction in the matter. Though the Court held that the transfer of shareholding by the entities abroad was a valid transaction, and not a sham, certain other contractual rights with Indian parties were also a part of the transaction and that the nexus with India was established. The question as to whether the transaction involved the extinguishment of controlling interest in the underlying capital asset located in India through an indirect transfer of shares of an Indian company would unequivocally attract capital gains tax under the Income Tax laws of India has not been conclusively decided.

Click here for a copy of the full judgment dated 8 September 2010

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1. 2009(4)BomCR258 decided on 3 December 2008
2. [2009]179TAXMAN129(SC)
3. Writ Petition No. 1325 of 2010

Editor **: Rahul Kothari**

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