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THE VODAFONE JUDGMENT –What Every Foreign Company with Indian Business Operations Must Know

BACKGROUND

On 7 September 2010, High Court of Mumbai ordered Vodafone International Holdings BV (Vodafone) to pay approximately USD $2.1 billion in tax in relation to its acquisition of shares from Hutchinson Telecommunications International Limited (Hutch) in the foreign holding company of an Indian entity (Essar) in May 2007. This is the first case which has been litigated before the High Court where the Indian Tax Authorities have successfully sought to tax capital gains arising on a share transfer from a foreign holding company to another foreign company on the basis that such a transfer results in an indirect change in controlling interest of a subsidiary Indian company.

Vodafone has appealed this decision before the Supreme Court and whilst there remains the possibility of changes, it is important for foreign companies to heed the key issues summarised in this note. In particular, this note serves as an overview of the pitfalls for foreign companies that have thus far been highlighted as a result of this case.

FACTS

Vodafone acquired the shares of CGP, a company registered in the Cayman Islands, indirectly from Hutch. In doing so, Vodafone acquired more than 50% controlling stake in Essar. Vodafone paid USD $11.2 billion for the shares of CGP.

A simplified structure of the acquisition is shown in the diagram below:
In September 2007, very shortly after the acquisition of CGP had been completed, the Indian Revenue Department attempted to recover USD $2.1 billion in tax from Vodafone. According to the Department, under the Income Tax Act 1961 (ITA) Vodafone was under a responsibility for the withholding of tax on the payments made to Hutch. The Department deemed Vodafone to be an assessee in default for failing to withhold tax and requested Vodafone pay tax on behalf of Essar.

Various hearings of the case took place in the High Court and Supreme Court which culminated in the High Court's most recent decision. The key legal issues which were argued by the Indian Revenue Department and need to be considered by any foreign company with Indian business operations are as follows:

1. Under s195 ITA, any income or capital gain payment accruing or deemed accruing in India to a non-resident is subject to withholding tax.
2. Under s201 ITA the responsibility to withhold tax is on the payee. If the payee does not withhold sufficient amounts or if they do not pay the necessary amount at the appropriate time,

then the payee is an assessee in default and liable to pay all the relevant tax.

3. Whilst the main assets sold were shares of a foreign holding company namely CGP and the transaction took place between foreign entities outside of India, the effect and purpose of the transaction was to sell controlling interest in an Indian entity namely Essar. This, it was argued supported the contention that the payment could be deemed to accrue in India for the purposes of s195 ITA.

4. In addition to the sale of the shares there was also a transfer of other ancillary and related rights in India such as the assignment of various inter-company loans, a telecoms licence, right to the brand name (which was royalty free) and an option to purchase a further 15% of Essar's shares, consideration for which was also factored into the amount of USD $11.2 billion paid by Vodafone to Hutch. It was argued that many of these entitlements were unrelated to CGP, indicating therefore that the transfer of such rights were not incidental or consequential to the transfer of shares of CGP. These transfers of entitlements in Hutch were viewed as independent from the transfer of shares in CGP. This, it was argued further supported the contention that the payment was made towards the transfer of rights in India and therefore the payment could be deemed to accrue in India.

5. The structuring of the transaction through acquisitions outside of India and the manner in which the transaction was documented was a sham to avoid tax as the main and key purpose of the acquisition of CGP was for the discontinuation of Hutch's interests in the Indian mobile telecommunications sector and for these interests to be taken over ultimately by Vodafone.

THE JUDGMENT

The High Court ruled in favour of the Revenue Department. They acknowledged that the transfer of shares of a foreign company is not taxable in India unless the transaction had what Judges Devadhar and Chandrachud described as a "significant nexus with India". Determining whether such a nexus exists would require an investigation into the entire substance of a transaction. The High Court pointed to Australia and China as examples of jurisdictions which would tax transactions of a similar nature to Vodafone's acquisition of Essar. The key observations and general principles which were set out in the High Court judgments are instructive for future transactions are as follows:

1. Tax planning and off-shore structuring by foreign businesses is permitted and can be used to reduce the tax liability of business entities in India where there is a legitimate business transaction. However, where the sole purpose of a business transaction is to avoid tax this is a sham and the transaction can be disregarded.

2. Where on a true construction of the commercial and legal relationship the tax authorities find that a legal device is being used to conceal the true character of the transaction then the tax authorities are entitled to look beyond the legal device.

3. Shares are a capital asset and the holding of a controlling interest does not for the purpose of Indian tax law constitute an asset independent from such shares. Such controlling interest is an incident of ownership of sufficient shares in a company.

4. The obligation of the taxpayer to withhold tax is limited to the appropriate portion of income chargeable to tax under the ITA.

5. In order to attract chargeability to tax in India from the transfer of a capital asset, the place where an asset is situated is crucial to establish Indian tax jurisdiction. The ITA recognises the principle that income from a transfer arises in the place where the asset is situated.

6. The ITA defines the circumstances in which income is deemed to accrue or arise in India. The essential ingredient in order for income to be accrued or deemed accruing in India is that there must exist a nexus with India.

7. In cases where there is a multiplicity of activities that gives rise to income, then apportionment of income is appropriate so that it can be taxed in separate jurisdictions according to the proportion of income deriving in that jurisdiction. The entire income need not be income chargeable under the ITA. In this case, the High court has left it to the Indian Revenue Department to apportion which elements of income are taxable in India.

8. The High Court and indeed the Indian Revenue Department is entitled to probe into the actual nature of the transaction and in this case it was clear that intrinsic to the transaction was not simply the transfer of shares in a foreign entity but the assignment of interests and entitlements which also constituted capital assets in their own right and these fell within the remit of the ITA.

IMPLICATIONS FOR FOREIGN COMPANIES

The High Court's decision will have implications on foreign companies participating in merger and acquisition transactions with links to India. Such transactions may be liable to taxation in India and so it will be a point for negotiation between buyers and sellers as to who should bare the risk of this.

Whilst the Vodafone case confirms that tax planning through off-shore structures is permitted there needs to be more vigilance when structuring investments into India through offshore intermediary companies located in jurisdictions such as Mauritius, Singapore and Cyprus. These jurisdictions have in the past been used because of the tax efficiencies they can provide upon a disposal of those investments and it may be that on the disposal of those investments there is deemed to be sufficient nexus with India so as to make any income arising on the disposal subject to tax in India.

The High Court's decision does however still allow participants in merger and acquisition transactions with links to India to argue that such transactions are not wholly taxable in India and to challenge the India Revenue Department on any apportionment matters.

Unfortunately for now there remains an ambiguity on how apportionment should be dealt with. In the future, the revised Direct Taxes Code 2010. Will provide greater clarity on when "foreign transactions" can be taxed in India. The Code, which is currently in the process of being passed into law, states that the transfer of a foreign company's shares would be liable to taxation in India where the foreign company own at least 50% of its underlying assets in India. It is anticipated that the Code will come into force on 1 April 2012.

PRACTICAL TIPS

Whilst there remains a degree of uncertainty and an apparently more aggressive approach being adopted by the Indian tax authorities there are certain steps foreign companies can take to ensure they mitigate their risks. The disappointment suffered by Vodafone need not necessarily put off businesses from pursuing their India strategies.

Rather, it should act as a warning to businesses who have or wish to acquire interests in India to take certain precautionary steps. For example, as early as the negotiation phase or indeed when a target has been identified where there is an acquisition involving underlying Indian assets, foreign companies should factor in the potential of large tax bills landing on their doorsteps. They should consider Vodafone's experiences and try to identify potential risks and measures which they can take to safeguard their position as best possible before signing-off on acquisitions. For companies who are about to participate in an acquisition which has links to India, it is possible seek the opinion of the Authority on Advance Rulings as to the taxability of the transaction in India.

Contractual documents should be drafted with the risks posed by the Vodafone case very much in mind. Mechanisms to be considered include indemnities for future tax liabilities. Additionally, a proportion of the transaction purchase monies may be held in escrow for appropriate periods or the acquirer may consider the ability to recover monies from the seller for the relevant period to cover for the statutory limitation period for the Indian Revenue Department to recover overdue taxes.

Where possible, companies who have acquired or are intending to acquire interests in India should seek to distinguish their scenario from the Vodafone case. There are cases where other State High Courts have ruled that tax planning routes through acquisition of offshore companies was legitimate and no tax liability like the Vodafone case arose. These cases can be distinguished on the facts. For example, this was seen in the recent case of GE India Technology Centre Private Ltd v. CIT.