

# The Vodafone Controversy in India

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## "I-T Department issues show cause notice to Vodafone Essar"

Hindu Business Line (5 September 2007)

## "CBDT reopens 400 PE, M&A deals"

Economic Times (9 December 2007)

## "Vodafone verdict may cast shadow on other deals"

Economic Times (4 December 2008)

## "Vodafone plea against \$1.7 b tax dismissed"

The Financial Express (8 December 2008)

These are just a few of the headlines on the "Vodafone Saga" which have hit the front pages of leading Indian pink dailies over the past one and a half years. Touted by leading tax experts as a landmark ruling in Indian tax litigation history (and definitely one of the largest revenue generating litigation), the Vodafone-Hutchison transaction has been amongst the most talked about international transactions, and one that could potentially re-define the cost of doing M&A deals for companies with an Indian footprint.

This article discusses the background and facts of the Vodafone controversy, as well as some key issues that could arise for other India-based M&A deals, that is until this case is conclusively settled by the Indian Revenue Authorities ("IRA") or the Supreme Court<sup>1</sup>.

### The transaction

The transaction is essentially focused around the transfer of controlling interest in an Indian company, Hutchison Essar Ltd ("HEL"), between two non-Indian

companies – Hutchison and Vodafone. HEL is in the telecommunications business in India.

Prior to the transfer, HEL was a 67:33 joint venture between Hutchison Telecom (based in Cayman Islands) and Essar Group, India, wherein Hutchison held 67% equity stake. In terms of the holding structure, Hutchison Telecom (Cayman Islands) set up a series of wholly owned subsidiaries, including one CGP Investments in Cayman Islands (referred to as first level holding companies), which in turn invested in second level holding companies based in Cayman Islands, Mauritius and India. These second level holding companies held equity stakes in HEL.

In May 2007, Hutchison exited from the Indian telecommunications market by way of transfer of its rights and interest to Vodafone, after getting requisite approvals. The transaction was structured as a sale of equity stake of CGP Investments (Cayman Islands), from Hutchison Telecom (Cayman Islands) to Vodafone, and the consideration received by Hutchison was ~US\$11.1 billion. This acquisition was widely publicised as Hutchison's exit from the Indian telecommunications market and Vodafone's corresponding entry, and press releases carried statements that Vodafone had gained management control of HEL as part of the acquisition of controlling interest from Hutchison. Taking a step further, Vodafone in fact made disclosures to SEC on its acquisition of HEL stock. As is the case in such transactions, HEL was rechristened Vodafone Essar Limited ("VEL") to reflect Vodafone's entry into the company and Hutchison's exit.

While making this consideration payout, Vodafone did not withhold any Indian taxes, on the basis that the acquisition of the shares

of CGP Investments, being an offshore transaction (not directly involving Indian stock) was not liable to tax in India. Neither did Vodafone seek an advance administrative ruling ordering "Nil" withholding on a bona fide belief that such transfer was outside the purview of the Indian taxman.

### The start of a debate –

#### Where is IRA's share of the pie?

Vodafone's acquisition of the stake in HEL is indisputably the largest Indian acquisition by a foreign company, executed outside India. However, it comes as no surprise that the 'no India tax' position on such a large deal did not find favour with the Indian tax administration.

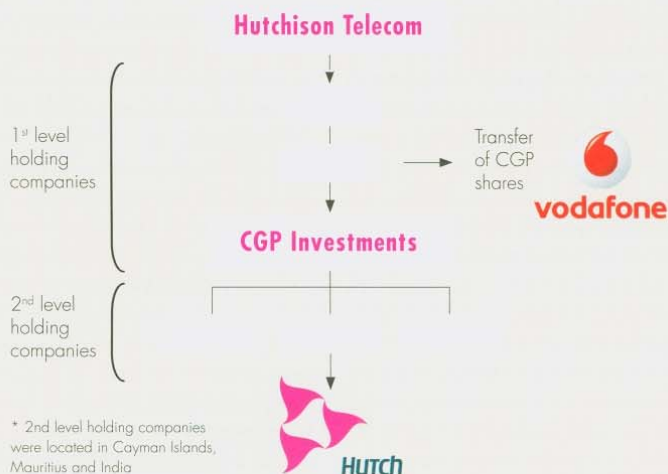
Following this transaction, the IRA issued a notice<sup>2</sup> to Vodafone asking it to show cause for non-withholding of tax<sup>3</sup> by it from payments made to Hutchison, ostensibly towards acquisition of Indian assets. The IRA also estimated a withholding tax shortfall of US\$1.7 billion, which Vodafone was asked to compensate. Interest and penalty was to be levied separately on this amount.

The IRA's basic argument was that in addition to the transfer of shares of CGP Investments, Vodafone had acquired certain Indian assets i.e. Hutchison's controlling interest in HEL and other related intangible rights. Further, the consideration paid by Vodafone was effectively towards 'economic interest' in VEL rather than towards shares of CGP Investments which was a 'shell company'.

<sup>1</sup> The Apex Court of India

<sup>2</sup> Under Indian tax laws, the IRA can issue a notice to any person who fails to withhold tax from taxable payments made to a non-resident.

<sup>3</sup> Indian tax laws provide that the payer is liable to withhold tax at "appropriate rates" in respect of any transaction involving payment to a non-resident.



### Vodafone's response to the IRA notice

As expected, Vodafone sought to challenge this notice issued by the IRA. As a first step, Vodafone filed a writ petition before the jurisdictional High Court<sup>4</sup>, and then a special leave petition before the Supreme Court, for quashing the notice issued by the IRA, by seeking a decision inter alia on the following issues:

- Extra-territorial jurisdiction of the IRA over non-residents for enforcing compliance with Indian withholding tax requirements, where the transaction involved non-Indian parties and assets;
- India taxability of transfer of foreign assets (which may hold underlying Indian assets); and
- Unconstitutional retrospective amendment in tax withholding laws<sup>5</sup>.

#### Extra-territorial jurisdiction of IRA over non-residents

At the outset, Vodafone argued that Indian tax laws could not be enforced upon it, citing a two-fold argument – First, the transaction was an offshore sale which did not have any direct nexus with India. Second, machinery provisions such as tax withholding could not be enforced upon non-residents, since it would then expose non-residents to arduous compliance obligations in India.

On the other hand, the IRA was of the view that tax withholding provisions apply equally to all persons (residents and non-

residents), as long as the subject transaction is taxable in India. It also argued that the lack of machinery provisions for enforcement of obligations could not be a valid ground for 'reading down' the provisions or for holding such provisions as inapplicable to non-residents.

#### Taxability of foreign transfers

Vodafone argued that the gains on the transfer of CGP Investments' shares were outside the purview of Indian tax since such shares were technically located outside India (i.e. Cayman Islands), and hence, the IRA could not seek to tax the transaction in India.

In response, the IRA referred to the filings made by Vodafone and Hutchison with Indian and overseas regulators, so as to emphasise their 'intent' to transfer the controlling interest in HEL. It was argued that the shares of CGP Investments were merely a vehicle to transfer a bundle of assets to Vodafone, such that the real asset being transferred was the controlling interest in HEL.

The IRA also relied on the American principle of 'Effects doctrine'. Per the 'Effects Doctrine', a state has the right to impose liability upon persons beyond its jurisdiction, for any activity that has consequences within its borders.

The IRA concluded that income earned by Hutchison from the said sale accrued in India, and the show cause notice issued

to Vodafone was valid on grounds of extra territoriality.

#### Retrospective amendment in tax withholding laws

Tax withholding provisions, as they read (or are so interpreted) at the time of issuance of the show cause notice covered only such cases where tax withheld by the payer was not deposited with the Government. These provisions were later amended retrospectively to cover cases where no tax was withheld by the payer, with the government claiming that the amendment is clarificatory in nature. Vodafone challenged the constitutional validity of the amendment, since it had the effect of imposing a financial burden on it, while the old provisions did not.

#### The verdict

**A Myth...** Vodafone lost Indian capital gains litigation.

**The Reality...** Courts have only upheld the validity of the show cause notice issued by the IRA to Vodafone and made adverse remarks on Vodafone's failure to file crucial documents with the IRA and the High Court.

**What now...** The IRA now needs to demonstrate taxability of transactions in India and its jurisdiction over Vodafone.

A critical point to note here is that the Indian Courts (the High Court and subsequently the Supreme Court) have not specifically addressed and concluded on the moot question regarding taxability of Hutchison's gains in India, and Vodafone's liability to withhold tax on the consideration paid. While the judgments appear to tilt towards the position taken by the IRA, there are quite a number of disclaimers in these judgments which can be attributed to the lack of availability of factual information.

The High Court, in its detailed order,

<sup>4</sup> Under normal procedure, such notices can be first disputed only before the IRA, after which the assessee may approach the appellate authorities (including the High Court and the Supreme Court at a later stage) should it be aggrieved by the IRA's decision. Only in exceptional circumstances can the assessee approach the High Court directly by way of a writ.

<sup>5</sup> Indian tax laws were retrospectively amended to provide that a person would be considered to be an 'assessee in default' ('AID') if it failed to withhold tax from any taxable sums payable to a non-resident. Prior to this amendment, a person was considered as an AID where it failed to deposit withheld taxes with the government (or so was the interpretation of the law).

had highlighted the 'non-cooperation' by Vodafone during proceedings, and opined that vital documentation and information (including the primary share transfer agreement) was willfully concealed from the court. Based on the limited information available on record, the court upheld the prima facie issuance of notice by the IRA on following grounds:

- The dominant purpose of the transaction was a transfer of "controlling interest" in HEL, the Indian company, which should be subject to laws of India, unless proved otherwise based on evidence. Since Vodafone was unable to present sufficient evidence to substantiate its statements, the notice could not be said to be prima facie invalid.
- The taxability (or otherwise) of the transaction could be determined by the IRA only upon examination of all relevant facts and agreements connected with the transaction.

The court also pointed out that the writ proceedings initiated by Vodafone against the notice were premature since a show cause notice would not harm Vodafone's interests, and is only a pre-cursor to investigation into the case. The court opined that ordinarily, a show cause notice could be quashed directly by the High Court only where no case can be made against the recipient of notice, even if the facts challenged against it are proved to be correct.

The Supreme Court endorsed a similar view and rejected Vodafone's plea, while opining that the question of the IRA's jurisdiction over Vodafone in the subject matter could be decided only when a detailed scrutiny of documents and information had been undertaken. Accordingly, the matter was referred back to the IRA for a detailed scrutiny of documents to be furnished by Vodafone.

### **This was yesterday? So what's today?**

As of today, the Indian courts have **not** opined on the taxability of the Hutchison-Vodafone transaction. In fact, the IRA has been directed to undertake a detailed scrutiny of the transaction, and based on its scrutiny,

substantiate its prima-facie jurisdiction over Vodafone for enforcing the tax withholding provisions.

Of course, the entire debate around taxability of the said transaction in India and the *prima facie* observations of the Indian courts appear to be tilted in favour of the position being adopted by the IRA, and might have given the IRA more confidence to include overseas transactions in its tax net. However, a mere observation should not lead us to answer this extremely litigative position either way at this point in time.

Apropos, in a recent case of *Eli Lilly & Co.*,<sup>6</sup> the Supreme Court has interestingly upheld extra-territorial application of Indian tax laws on foreign companies which have been held responsible for withholding tax from overseas salary taxable in India. While the said judgment was specifically held to apply to tax withholding from salary income, it could still add weight to the IRA's claim of extra-territorial jurisdiction over Vodafone.

In another case *Electronic Corporation*,<sup>7</sup> the division bench of the Supreme Court expressed an opinion that Indian income tax law has extra-territorial jurisdiction, while referring the matter to the Constitution bench. However, since the appeal was later withdrawn by Electronic Corporation, the law on this aspect is not settled yet.

Moving ahead, in March 2009, the IRA has further tightened the noose over tax withholding from overseas payments through the issue of additional tax withholding compliances. Given the manner and form of such compliances, it would be interesting to see if the same would apply to payments by non-residents to non-residents.

The current "Vodafone situation" could potentially have deeper ramifications on certain issues which we have attempted to deliberate below (in brief):

#### **Uncertainty around 'underlying assets'**

The position adopted by the IRA, coupled with the observations of the court are significant in so far as they generally strengthen the IRA's stand on taxability of off-shore transactions between non-residents, especially where the target has a footprint in India. This perhaps runs counter to the legal principle that a company

is a separate legal entity, even in the absence of conditions necessitating piercing of the corporate veil. The Court has not debated on the theory of 'lifting the corporate veil' or on this transaction structure being one for "tax avoidance".

On similar lines as those of Vodafone, the IRA has already challenged other big international acquisitions of Indian operations, e.g. the sale of Genpact by GE to large PE funds and the acquisition of AT&T's stake in Idea Cellular by the Tata Group. These matters are currently *sub judice*, either with the courts or the Revenue department, but they could potentially move in the same direction as Vodafone<sup>8</sup>.

Such a view on underlying assets, if upheld, can lead to absurd results, besides casting the tax net over a vast number of transactions. The current litigation leads to a number of questions, which remain unanswered as of today:

- The impact of sale of shares by a foreign investor in a foreign listed company which has an Indian subsidiary – Is that a transfer of "underlying" Indian assets by a foreign investor?
- Given that current debate is in respect of the transfer of the "controlling interest" of HEL, what would be the India tax position in the case of a transfer of a minority stake? Alternatively, what about a situation where the controlling interest is transferred out in various tranches of minority shareholding?
- Would the situation be the same in the case of a sale and purchase of Participatory Notes, where the ultimate underlying assets are the shares of Indian companies?
- Does India have the legal basis to tax such offshore transactions in the absence of controlled foreign company ("CFC") legislation?

As we have said, there is no answer "now", but hopefully, the courts would soon give "certainty and clarity" on this difficult subject.

<sup>6</sup> CIT vs Eli Lilly and Co. India (P) Ltd. (2009) 312 ITR 225 (SC)

<sup>7</sup> Electronics Corporation of India Ltd. vs CIT (1990) 183 ITR 43 (SC)

<sup>8</sup> Based on information available in the public domain.

### Impact on global M&A activities

Companies have become more cautious with respect to global M&A activities which involve transfer of Indian 'underlying assets'. Owing to the uncertainty around taxability of overseas transfers in India, price negotiations are bound to reflect the impact of possible tax costs which might arise in India or at least, one could expect to have even more complex documentation for such transfers, specifically clauses pertaining to warranties and indemnities, which until now have been customary.

Pending the outcome of this litigation, certain acquirers are also insisting on withholding tax at the maximum marginal Indian tax rate (42%) applicable to foreign companies. This is a near impossibility for the seller, who would then need to file tax returns in India and claim a refund of tax from the IRA (which in itself is a marathon procedure). Other than having a drastic impact on the net consideration received and timelines, efforts involved in getting the refund would also need to be factored in.

Some other protective covenants being insisted upon by buyers in recent international M&A deals involving Indian assets include:

- **Seller to obtain a withholding order from the IRA, specifying the rate at which tax is to be withheld.** Given that such transactions are currently *sub judice*, obtaining a withholding order from the IRA for similar transactions would be a herculean task for any seller and the IRA would be very reluctant to issue any such orders, more so where "non-taxability" is contended for seeking a "Nil" withholding order. Recently, a "Nil" withholding order was denied in case of *E-Trade Mauritius Ltd*, which sought shelter under the India-Mauritius treaty for the sale of shares of an Indian company. Interestingly, the writ petition challenging the order was also dismissed by the High Court on technical grounds and E-Trade was directed to follow the normal course of litigation.
- **Escrow mechanisms for Indian tax.** This is another area of contention between the parties, given the lack of clarity on various factors such as the applicable tax rate, acquisition cost to be considered and the possibility of a dual tax hit for the seller

(in India and the country of residence) in the case of 'Vodafone-like' transactions. In fact, in the abovementioned case of *E-Trade*, while directing the matter back to the Revenue Department, the High Court ordered the deposit of withholding taxes with the High Court. Subsequently, it appears that the sum has been released to the Revenue Department post completion of assessment by the authorities.

### Impact on FDI

While Indian revenue authorities may have a reason to rejoice, like everything else, the current situation also has a flip side to it. The Indian economy is already feeling the effect of the global slowdown, which in turn has negatively affected foreign direct investment ("FDI") into the country. This negative impact could deepen, owing to growing apprehensions of overseas investors about the uncertainty surrounding the Indian tax regime, which understandably has an impact on their investment decision in India.

### Investments through tax havens

A moot point to be considered in the Vodafone case is the presence of a Cayman Islands company as the seller company, and the fact that India does not have a Double Taxation Avoidance Agreement ("DTAA") with Cayman Islands. In the absence of a DTAA, any capital gains from the transfer of a capital asset of an Indian company would be taxable in India, as per domestic tax laws. India's business connection laws and the use of the word 'direct or indirect' tend to cast the net very wide and are extra-territorial.

Accordingly, a key question that arises is the impact on taxability. Would the result be different if the seller company is a resident of a tax efficient jurisdiction such as Mauritius, Singapore or Cyprus, and the sale of the Indian company's shares has been affected directly by this company?

A reasonable interpretation of Indian tax provisions would suggest that the protection of the DTAA should continue to be available despite the current Vodafone litigation and any direct sale of an Indian company's shares by a resident of a "tax friendly" country should continue to be non-taxable in India. Of course, it would be tough to predict the

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mindset of the IRA, and there is a possibility that it might look through such 'tax efficient' holding companies and attempt to tax the ultimate parent company (as ultimate beneficiary). The IRA may also put forth the argument that "controlling interest" is a separate asset from shares and hence, no beneficial tax treatment (as in case of shares) is available under the DTAA.

### Conclusion

In summary, the current scenario is laden with uncertainty, pending the outcome of the Vodafone litigation. Developments are being consistently monitored, and buyers/sellers are exploring various 'low risk' acquisition structures for concluding deals in this environment. The attempt is really to develop a structure, which could classify the entire transaction as a "non-taxable transfer" for Indian tax purposes in order to mitigate the risk of challenge by the IRA.

Meanwhile, from an India perspective, the IRA should also consider a long term legal solution to this controversy. Given that India has been the centre stage of large deals and this trend is expected to continue, clarity on such issues would be a positive signal for investors.

Let's continue with our trend of "welcoming" foreign investment, not only for the benefit of the investors, but also our economy and country at large. "Clarity and certainty", both in the tax and regulatory framework is the mantra for attracting and retaining foreign investors in India. ●