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VODAFONE, HYDRA AND HERCULES' SECOND LABOUR REVISITED

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INTRODUCTION

Who said only two things in life are certain? I doubt if it was the Indian Government. Indeed, the Government appears to have gone out of its way to disprove this proposition in relation to taxes. The *Vodafone* saga in India has turned into an incarnation of the serpent Hydra. In Greek mythology, the Hydra had innumerable heads, so many in fact that painters of vases had difficulty capturing its portrait(s) fully. For each head which was cut off, it grew two more. It seemed impossible to defeat. That was until it met Hercules, whose Second Labour was the task of killing it. Hercules hatched a cunning plan, which involved cauterising each stump left behind after a head rolled, so that the Hydra finally became headless and perished.

A new Hydra has arisen out of the *Vodafone* tax litigation in India. Enough attempts have been made to kill this Hydra (both by the taxpayer and by the tax authorities), but today it still continues to grow heads. There is, however, some prospect that Hercules may have arrived in the form of India's latest Finance Minister, Mr P Chidambaram. But there is still the "labour" to be performed.

A look at the twists and turns in 2012 alone shows the serpent-like nature of the beast and its formidable powers of regeneration:

- 20th January: Supreme Court of India decides unanimously in favour of Vodafone.
- 17th February: Indian Government files a review petition requiring the Supreme Court to review its own judgment.

- 9th March: Parliamentary Standing Committee on Finance publishes it Report on the Direct Taxes Code Bill ("DTC") including relaxations to the proposed *Vodafone* tax charge.
- 16th March: Indian Budget contains provisions to bring Vodafone-type offshore share sales within the Indian tax net with retrospective effect from 1st April 1962, thereby taking the charge out of the DTC and accelerating its introduction. The Standing Committee's recommendations are ignored.
- 20th March: The Supreme Court dismisses the review petition.
- 28th May: The Finance Act 2012 is enacted, containing provisions to tax indirect transfers of Indian assets through offshore sales of shares in foreign companies and imposing withholding tax obligations on offshore purchasers, irrespective of whether or not they have an Indian presence. These provisions are described as "clarificatory" and introduced with retrospective effect from 1st April 1962. They effectively negate the Supreme Court's judgment.
- 17th July: the Government appoint an Expert Committee to look at India's new general anti-avoidance rule, also introduced in the Finance Act but with effect from next April. This committee is known as the Shome Committee after its Chairman, Mr Parthasarathi Shome.
- 22nd July: Mr Pranab Mukherjee, the Finance Minister responsible for the Finance Act changes, becomes President of India.
- 30th July: the Shome Committee's remit is extended to review the *Vodafone* provisions in the Finance Act, but only from the viewpoint of foreign institutional investors who invest in India on a portfolio basis: this was clearly a direct response to international institutional pressure.
- 31st July: Mr P Chidambaram leaves the Home Ministry to become Finance Minister for the third time. Since he was one of the original architects of liberalisation in 1991, his appointment is welcomed by the foreign investment community.

- 1st September: the Shome Committee's remit is further extended to review the *Vodafone* provisions in the context of all non-residents.
- 9th October: the Shome Committee's draft report is published, recommending radical changes to the *Vodafone* provisions, particularly regarding their retrospective effect.

So, what has all the Finance Act fuss been all about? I do not intend to go over all the *Vodafone* history up to the Supreme Court decision, which was covered in the last edition of the GITC Review. The Government decided to negate the *Vodafone* decision by introducing the following changes to the Indian Income Tax Act 1961 ("ITA"):

- Amending Section 9 (which, inter alia, is the principal charging provision for charging tax on capital gains made by non-residents) so that it expressly extends to sales of shares in foreign companies by non-residents where the underlying assets are in India;
- Amending the definition of "capital asset" to include management and controlling rights over an Indian company;
- Amending the definition of "transfer" in relation to a capital asset to include rights created by agreement which are dependent upon an offshore share transfer;
- Imposing a withholding tax obligation on a non-resident purchaser of offshore shares irrespective of whether the purchaser has any presence in India.

I refer to these as "the *Vodafone* changes". The *Vodafone* changes are deemed to have had effect from 1st April 1962. In addition, there is a "validation clause" which effectively blesses all actions taken by the tax authorities in the context of offshore share sales irrespective of judgments like *Vodafone*. So, any action taken in other cases prior to the Supreme Court's decision in favour of *Vodafone* is deemed to be valid, and does not require the tax authorities to start again following the enactment of the *Vodafone* changes.

The other major controversial area in the Finance Act is the introduction of the general anti-avoidance rule. That has nothing as such to do with *Vodafone*, other than perhaps as a visceral reaction by the Government to what it regards as unacceptable tax avoidance. The *Vodafone* changes in the Finance Act operate independently of the GAAR. Although the GAAR has been enacted and is due to come into operation from 1st April 2013, the Shome Committee has recommended a 3-year moratorium. The Government's response is awaited.

I ought to explain why the proposed retrospection goes back fifty years. India's first Prime Minister, Jawaharlal Nehru, still held office on 1st April 1962 and President Kennedy was in the White House. That was the date when the Income Tax Act 1961 came into force. With the magic and flourish of a draftsman's pen, the provisions are deemed always to have been there in the legislation. Somewhat disingenuously, the Government of India justified this as no more than a matter of clarification of legislative intent and for the removal of doubt. If clarification is all that was needed, one cannot help wondering why the Hydra got as big as it did.

I now turn to consider the *Vodafone* changes.

SECTION 9

So far as is relevant to capital gains, Section 9 currently brings the following into the tax charge:

> "all income accruing or arising, whether directly or indirectly, through the transfer of a capital asset situate in India".

The *Vodafone* judgment made it clear that the words "directly or indirectly" qualified the accrual of income, not the transfer of a capital asset. To counter this, the Finance Act has introduced two "Explanations" of this wording. The first says:

> "For the removal of doubts, it is hereby clarified that the

> expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of"".

> The second one says:

> "For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India."

It is difficult to see how the first Explanation affects *Vodafone* since, whether something is done through, by means of, in consequence of, or by reason of, it must at the least involve the transfer of a capital asset situated in India. If there is no actual transfer, this Explanation certainly does not deem one to have occurred. The second Explanation hits the target, however. This deems the offending foreign share to have an Indian situs. So perhaps that is where the first Explanation gets its teeth. Once the foreign shares are deemed to be Indian, anything arising "through" their transfer as expanded by the first Explanation, is caught.

The DTC contains materially different wording to deal with the *Vodafone* effect. It purports to expand the territorial net to offshore share sales, but to exempt those where the fair market value of the underlying Indian assets is less than 50% of the value of all the underlying assets. The 50% threshold has gone. Instead, if the value of the underlying assets is "substantially" derived from Indian assets, then the offshore shares have an Indian situs. There is no guidance on how to measure "substantially". As we know, it means different things in different contexts. But if the expression is satisfied, then the transfer of the offshore shares will be fully taxable in India even if part of the underlying value – i.e. the part other than the substantial part, is derived from non-Indian assets. This seems, frankly, bizarre.

CHANGING THE DEFINITION OF "CAPITAL ASSET"

The expression "capital asset" is defined as meaning "property of any kind…" : section 2(14) ITA. A new Explanation introduced by the Finance Act states, again "for the removal of doubts", that the word "property" includes and shall be deemed always to have included:

> "any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever".

This change appears to relate back to the tax authorities' contention in *Vodafone* that the share sale in fact involved the sale of a bundle of rights including rights to run the Indian business. So, if a control premium is being paid on a share sale, the authorities may try and allocate that premium to rights outside the shares. If they do, that would be deeply disappointing as it revives the confusion of the Bombay High Court as to identifying what assets were sold and how to construe sale documentation.

EXTENDING THE MEANING OF "TRANSFER"

Perhaps the most disturbing change is a new Explanation to Section 2(47), which contains the definition of "transfer" for capital gains purposes. The language of the new Explanation is so remarkable that it deserves reproduction *verbatim*:

> "For the removal of doubts, it is hereby clarified that "transfer" includes and shall be deemed always to have included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely

> or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights has been characterised as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India."

This wording is so wide that it deserves to be struck down for uncertainty. Further, to suggest that it is there for the removal of doubts as if everyone ought to have known (from 1962!) about this extended meaning of "transfer" is disingenuous in the extreme. It again seems to reserve the tax authorities' right to tax the transfer of something other than the sale of foreign shares. For example, does involuntary parting of an asset (or even voluntary for that matter) catch the right to carry on a business, which inevitably disappears when a seller sells shares in the company owning the business? And even if it does, why should that matter if the sale of the foreign shares is deemed to have an Indian *situs*?

The most worrying aspect of both this amendment and the earlier one regarding the meaning of "property" is that it could negate the implicit exemption in the second Explanation to Section 9. To illustrate this by an example: suppose a multinational group transfers a global business division by selling shares in an intermediate holding company. There is an Indian business carried on by an Indian company which forms a very small part of the division to be sold. It is so small that it cannot on any rational basis result in the offshore holding company shares being deemed to have an Indian *situs* under the second Explanation. But, under the extended definition of "property", the rights of management or control of the Indian company might be said to be a separate capital asset. Even though there is no actual transfer of the shares in the Indian company, there is undoubtedly a parting with the Indian asset *viz.* the right of management or control, which is characterised as being effected by the offshore share sale.

Taking this through to its logical conclusion, in such a share sale, the Indian tax authorities could seek to assert that part of the transaction is taxable in India.

If this is right, then there can be no situation involving the sale of an Indian business, however small, which falls outside the Indian tax net-even if the subject-matter of the sale is "substantially" of non-Indian assets. This is an alarming conclusion. It is cold comfort that if the Indian tax authorities insist on this sort of approach, they will make an enormous rod for their own backs on valuation matters.

THE VALIDATION PROVISION

For reasons I cannot explain, the validation provision (Section 119) appears in the Finance Act at the end of a section entitled "Wealth-tax". It has only one sentence as follows:

> "Notwithstanding anything contained in any judgment, decree or order of any Court or Tribunal or any authority, all notices sent or purporting to have been sent, or taxes levied, demanded, assessed, imposed, collected or recovered or purporting to have been levied, demanded, assessed, imposed, collected or recovered under the provisions of Income-tax Act, 1961 (43 of 1961), in respect of income accruing or arising through or from the transfer of a capital asset situate in India in consequence of the transfer of a share or shares of a company registered or incorporated outside India or in consequence of an agreement, or otherwise, outside India, shall be deemed to have been validly made, and the notice, levy, demand, assessment, imposition, collection or recovery of tax shall be valid and shall be deemed always to have been valid and shall not be called in question on the ground that the tax was not chargeable or any ground including that it is a tax on capital gains arising out of transactions

> which have taken place outside India, and accordingly, any tax levied, demanded, assessed, imposed or deposited before the commencement of this Act and chargeable for a period prior to such commencement but not collected or recovered before such commencement, may be collected or recovered and appropriated in accordance with the provisions of the Income-tax Act, 1961 as amended by this Act, and the rules made thereunder and there shall be no liability or obligation to make any refund whatsoever."

The draftsman deserves a "long sentence" award! This provision essentially validates all assessment, collection and enforcement action taken by the tax authorities in relation to capital gains on offshore share sales. This is irrespective of any judicial decision to the contrary, such as *Vodafone* itself. It precludes any technical challenge on the merits or otherwise. Despite the retrospection back to 1962, the tax authorities have to observe statutory time limits. But any action taken within those limits is validated. It effectively means that the tax authorities may proceed to collect tax not just from Vodafone, but all the other taxpayers whose cases are pending and which have the same controversy.

WITHHOLDING TAX ON PAYMENTS TO NON-RESIDENTS

One of the points argued in *Vodafone* was the extent to which a non-resident payer could be subject to Indian withholding tax obligations where the payment is made to a non-resident outside India. The general rule in Section 195 ITA is that withholding is required from amounts chargeable to tax where the recipient is a non-resident. The provision says nothing about the status of the payer. The Supreme Court cited with approval English cases like *Clark v Oceanic Contractors Inc* [1983] STC 35, and *Agassi v Robinson* [2006] STC 1056 in holding that the withholding obligation under Section 195 required the payer to have a relevant presence in India.

Section 195 was duly amended by the Finance Act 2012. It now says that a payer has a withholding obligation in relation to amounts chargeable to tax irrespective of whether the payer has a residence, place of business, business connection or any other presence in India.

This of course begs the question how the obligation can be enforced where a payer really has absolutely no connection in India. Nevertheless, the territorial extension is on the statute book.

THE SHOME COMMITTEE

The last entry on my timeline is the "Draft Report on Retrospective Amendments Relating to Indirect Transfer", published by the Shome Committee. As the title states, this report is still in draft and, after some consultation, will be finalised and submitted to the Indian Government. The Shome Committee was appointed to review the *Vodafone* changes in response to the huge outcry amongst the foreign investment community. The Committee has not disappointed with its recommendations. These include:

- Retrospective legislation should only be introduced in exceptional circumstances for genuine clarification or to attack highly abusive schemes (the *Vodafone* changes did neither);
- The *Vodafone* changes should be prospective, not retrospective;
- If they remain retrospective, then no-one should be subject to interest or penalties for not complying with the provisions prior to their introduction;
- Shares in a foreign company should be deemed to have an Indian *situs* only if more than 50% of the underlying assets are situated in India: this does away with the rather nebulous concept of "substantially"; further, the tax charge should only be by reference to the consideration payable for the Indian assets;

- The tax charge should not extend to minority shareholders in offshore companies even where the underlying assets are predominantly Indian; "minority" here means having 26% or less of the voting power or share capital;
- Listed companies whose shares are "freely traded" on "recognised" stock exchanges should not be within the tax charge on indirect transfers, so shares in such companies can trade without sellers worrying about Indian tax liabilities and purchasers wondering whether to withhold. Recognised stock exchanges and freely traded will be defined by reference to regulatory laws;
- Intra-group transactions should be tax neutral;
- Non-residents investing in Indian equities through foreign institutional investors should not be exposed to the tax charge;
- Private equity investors should similarly be excluded;
- The effect of saying that shares in a foreign company have an Indian *situs* is that dividends paid by those companies have an Indian source. It should be made clear that such dividends should not be subject to Indian taxation;
- The application of the wide definition of "transfer" in Section 2(47) should be curtailed;
- It should be clarified that a non-resident seller entitled to capital gains treaty exemptions in relation to sales of shares in Indian companies should also get treaty relief when selling shares in an offshore company with underlying Indian assets.

At the time of writing, the consultation period has just ended. The hope, of course, is that the Government will respond to the final Report by making significant relaxations to the *Vodafone* changes, probably in next year's Finance Act.

CONCLUSION

As I hope is clear, the new Hydra continues to survive, although the most recent developments suggest that it is under threat.

If Mr Chidambaram accepts the recommendations of the Shome Committee, that would result in an extraordinary *volte face* by the Indian Government. One can only speculate as to what effect that will have on the attitude of the Indian tax authorities to foreign investors. They have already expressed great displeasure at the Committee's conclusions, and are vehemently opposed to the 3-year GAAR moratorium proposal. Meanwhile, other challenges to the retrospective changes are pending in the courts.

But we do know that the charge on indirect transfers is here to stay at least on a prospective basis with effect from 1st April 2012, as is the obligation to withhold taxes irrespective of an Indian presence. There may be a horse trade done on the length of the GAAR moratorium to appease the tax administration while not provoking the private sector.

Earlier this year, when the Budget proposals containing the *Vodafone* changes were announced, the uncertainty related to whether draft legislation would in fact become law. Now, with the enactment of the Finance Act followed by the two reports of the Shome Committee on the GAAR and on indirect transfers, the uncertainty lies in whether existing legislation will be unwound. This is a curious paradox for the legislature.

For those foreign investors looking at potential investments, much can be done on the planning front as we know broadly what the prospective parameters are, even though there is still ambiguity in the detail. The key is the efficient use of tax treaties with entities which have substance (and substance should of course be proportionate to the activity). Establishing beneficial ownership of assets in the treaty entity is another important consideration.

For those investors who own Indian assets, a careful review of current structures is important, particularly for those contemplating an exit in the not-too-distant future, particularly with a view to doing so before the GAAR becomes operational next year (as currently enacted!).

So, I do not know when the Hydra will finally perish, but the one piece of comfort I can give is that there are ways of living with it!