Vodafone's Supreme Court Victory in India[1]

By Nikhil Mehta and Gareth Miles[2]

1. Introduction

On 20 January 2012, the Supreme Court of India delivered its eagerly anticipated decision in *Vodafone International Holdings BV v. Union of India* [2012] 17 taxmann.com 202 (SC). In a full reversal of the earlier decision against Vodafone in the Bombay High Court, Vodafone's appeal was unanimously allowed by the 3-judge bench in the Supreme Court. This is a landmark decision for the foreign investment community, particularly given that numerous other transactions are affected, and is of even wider significance given what the judges said about tax avoidance.

The facts in *Vodafone* are both complex in detail and well-known. But the tax issue is relatively simple. When Vodafone International Holdings BV ("VIH"), bought a single share constituting the whole of the issued share capital of CGP, a Cayman company, from a British Virgin Islands subsidiary in the Hutchison Telecom Group, did the seller realise a capital gain which was subject to tax in India, with the result that VIH should have withheld Indian tax from the sale consideration? The Indian nexus arose because CGP, through a complex corporate structure and indirect rights to certain equity options held in that structure, effectively had a 67% interest in Hutchison Essar Limited ("HEL"), which carried on one of India's largest mobile telecommunications businesses. For that reason, the sale price of CGP was @ US$11.1bn. If VIH was found liable, its tax bill from the Indian Government would have exceeded US$2bn.

The transaction was ostensibly the sale by one non-resident to another non-resident of a share in a non-resident company and, as such, was thought to be outside the Indian tax jurisdiction. Moreover, none of seller, purchaser or target had a presence in India. Since Indian capital gains tax (strictly, income tax as capital gains is a separate head of income in the Income Tax Act 1961, but referred to as "CGT" in this article) is only payable by a non-resident on the transfer of a capital asset situated in India, that ought to have been the end of the matter given the Cayman situs of the share in CGP. But the Indian tax authorities ("the Revenue") thought otherwise and, on the basis of various arguments, looked through the share sale and contended that the parties had effectively transferred a controlling interest in a significant Indian company which was an Indian asset or a bundle of Indian assets. So they claimed CGT. Since withholding by the purchaser was a convenient method of collecting the tax, particularly since the seller group had divested its Indian interests whereas the Vodafone group had a growing Indian presence, the Revenue pursued VIH.

2. The Bombay High Court

The dispute threw into focus issues of tax avoidance such as what was legitimate tax planning and what should be struck down as artificial or colourable devices designed for no reason other than to avoid tax. For many years, the Indian courts have carefully followed the development of judicial anti-avoidance doctrines in UK tax law and have used, as persuasive authority, decisions of the English courts. In the Bombay High Court, a large part of the decision approved legitimate tax planning and disapproved shams and other devices. That court also found nothing objectionable about the tax planning in the *Vodafone* facts. It upheld the general principle that the courts would not pierce corporate veils unless something objectionable had occurred, be it artificial tax avoidance or, even worse, tax evasion. The logic of its thought process should have meant success for VIH at that stage. However, the Bombay High Court then proceeded to look at the facts and to interpret the transaction documents in ways which led them to conclude that the real bargain between the parties was not a simple share sale and must have included other assets, which were in all likelihood mostly Indian assets for CGT purposes. This was the worst of all worlds since it effectively applied tax avoidance principles to an acknowledged non-tax avoidance scenario. Moreover, the way in which the Bombay High Court interpreted documents set off alarm bells not just for tax advisers, but also for commercial lawyers involved in drafting contracts and related documents.

3. The Supreme Court

There were two judgments delivered in the Supreme Court: the leading judgment of Chief Justice S.H. Kapadia (with whom Swatanter Kumar J agreed), and a concurring (but much longer) judgment of K.S. Radhakrishnan J. In deciding for VIH, the Supreme Court restored much-needed clarity. Key features of the decision are:

- Legitimate tax planning remains a valid exercise which the Courts will respect. In particular, the principle in *Duke of Westminster v. CIR* [1935] 19 TC 490 is alive and well in India: this point was particularly important as it cleared up some confusion arising from two earlier Supreme Court decisions: *McDowell v CTO* [1985] 3 SCC 230 and *Union of India v. Azadi Bachao Andolan* [2004] 10 SCC 1. The *McDowell* decision was delivered soon after *Furniss v Dawson* [1984] STC 153 in the UK and was the first instance of the "modern" English judicial anti-avoidance doctrine being considered by the Indian Supreme Court. One of the judges indicated that the *Westminster* principle was dead in England, and should be afforded the same status in India. It was not wholly clear if the other judges agreed with him. The judges in the *Azadi Bachao* decision disagreed: in *Vodafone*, the survival of the principle was confirmed.

- The Supreme Court recognised that multinationals used SPVs and holding companies in cross-border structures for tax planning and other (e.g. regulatory) reasons. There was nothing in principle objectionable about this.

- The corporate veil could not be pierced except in exceptional circumstances where companies were used as tax avoidance devices or to perpetrate tax evasion such as round tripping of funds back into India.

- In looking at structures, the courts and the tax authorities should look at transactions as a whole and not dissect them at the outset in search of an unacceptable tax motive. If the exercise of looking at the overall transaction disclosed artificial steps, then it was permissible to ignore these on the basis of the House of Lords decision in *W.T. Ramsay Ltd. v. IRC* [1981] STC 174. In *Vodafone*, the Indian tax authorities had approached the transaction the wrong way in presuming tax avoidance and then taking apart the transaction to look for it. Relevant factors in examining international sales included: (i) the concept of participation in investment (as opposed to participation in a mere tax avoidance exercise); (ii) the duration of time during which the holding structure exists; (iii) the period of business operations in India; (iv) the generation of taxable revenues in India; (v) the timing of the exit; (vi) the continuity of business on such exit.

- The onus is on the Revenue to identify the scheme and its dominant purpose.

- It was not possible to read the tax legislation dealing with transfers of capital assets situated in India as extending to indirect transfers: that would amount to reading words into the provision (Income Tax Act 1961 s.9(1)) which were not there.

- Even though "transfer" for CGT purposes includes extinguishment, the transaction did not involve the extinguishment of any property rights in India by any entity in the selling group.

- The corporate veil could only be pierced if it could be shown that CGP's ultimate parent had usurped its authority (and that of lower companies in the chain). That had not happened.

Following its holistic approach, the Supreme Court found that the transaction was exactly as the parties contemplated: an offshore sale between offshore parties of an offshore asset. This was not subject to CGT. *A fortiori*, VIH had no withholding obligation.

K S Radhakrishnan J also discussed the use of the India/Mauritius tax treaty in foreign investment structures. Since the treaty was not relevant to the facts, other than by way of hypothesis if the sale had occurred out of Mauritian sub-subsidiaries below CGP, his comments are obiter dicta.

4. The Impact of the Decision

The decision means that a number of similar share sales which have been challenged by the Indian tax authorities should escape Indian taxation. Some, may, however, still be vulnerable if, for example, SPVs were inserted in the structure as part of the sale planning. The disapproval by the Supreme Court of the Bombay High Court's approach to recharacterising transactions where there is no tax avoidance is welcome. But care will still need to be exercised in structuring and documenting international sales, having particular regard to the factors which the Supreme Court regarded as important in showing a commercial transaction.

The Indian Direct Taxes Code Bill ("DTC") will reverse some of the impact of *Vodafone* for transactions implemented after it comes into force (currently 1 April 2012, although there is an expectation that it will be delayed). The DTC purports to tax offshore sales of this nature where at least 50% of the fair market value of an offshore SPV consists of Indian assets. In the light of the Supreme Court decision, the current wording in the DTC appears inoperative and will need amendment.

The new charge will throw a greater focus on sellers acting out of treaty countries like Mauritius which enjoy capital gains exemptions. But treaty relief will itself be subject to the new statutory GAAR-also contained in the DTC. While the practical interaction between treaties and the GAAR remains to be seen, the Supreme Court's comments on acceptable foreign investment planning should serve as a marker for the Revenue to exercise prudence in invoking the GAAR where treaty relief is claimed.

[1] This article was first published in *Tax Journal* on 3rd February 2012.
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