Ringing in the Vodafone Judgment

Introduction

A precedent-setting case which will lead to a potential impact on cross-border mergers and acquisition activity in India is *Vodafone v. Union of India*. Pursuant to the Mumbai High Court ("**HC**") double bench judgment of September 8, 2010 dismissing the petition of Vodafone, it has ruled that where the underlying asset in a transaction between 2 or more offshore entities is located is India, the transaction should be subject to capital gains tax under income tax laws.

This newsletter assesses issues analyzed by the HC in the extensive 196 page judgment and its implications on cross-border transactions in future.

1.0 Brief facts

Vodafone UK acquired one share and the controlling interest of CGP Investments (Holdings) Limited ("**CGP**") located in Cayman Islands for $11.01bn, by virtue of which it bought a 52% stake in an Indian company, Hutchinson Essar Limited ("**HEL**") in 2007. The tax department issued a notice to Vodafone for failing to deduct tax at source[1] on the HEL transaction, estimated to be $2.6bn. Vodafone claimed that the transaction took place between offshore entities and was outside India's jurisdiction and engaged in a court battle on the taxability of capital gains on the transaction at the HC. The Indian parliament in 2008 also passed an amendment, with retrospective effect, that allows the government to book companies that do not withhold taxes in a transaction. The HC admitted Vodafone's writ petition that challenged the jurisdiction of the Indian tax authorities to recover the tax.

1.1 Contentions of Vodafone

Vodafone did not consider that the transaction was taxable in India and claimed the following:

- The transaction was between 2 non-resident entities, by virtue of a contract executed outside India, wherein consideration was paid outside India for the purchase of a capital asset viz., the share of CGP, an offshore company;

[1] Tax Deducted at Source ("**TDS**") is a mode of collecting advance income tax from assesses in India. In the process of TDS, where any specified type of income arises or accrues to anyone (salary, capital gains, rent etc), the Income Tax Act, 1961 (the "**Act**") enjoins on the payer of such income to deduct a stipulated percentage of such income by way of income tax to be paid to the Central Govt. and pay only the balance amount to the recipient of such income. The TDS from the income of the recipient is deemed to be payment of income tax by the recipient at the time of its assessment. Where income tax is not deducted at source, it becomes payable by the assessee or the recipient himself

- The tax liability was to be borne by Hutchinson Telecom International Ltd. ("**HTIL**"), the seller;

- Vodafone was not liable to withhold tax as the withholding rule in India applied only to Indian residents that the 2008 amendment to the Act of imposing a retrospective interest penalty was unconstitutional.

1.2 Contentions of Tax Authority

The tax authority's arguments were focused on proving that even though the deal was offshore, the transaction was not merely a transfer of a single share but a composite of rights and entitlements[2] of local assets making the transaction taxable in India and contended the following:

- The underlying asset i.e. the joint venture, as asset of capital nature, was situated in India and was central to the valuation of shares;

- It was through the transfer of offshore shares, HTIL sold its rights in the Indian asset including tag along rights, managements rights, goodwill, brand and the right to do business in India;

- The offshore transfer resulted in Vodafone having operational control over the Indian asset and Vodafone also entered into separate agreements with the Indian entities to conduct business in India.

2.0 Liability to tax of non-residents in India

The aspect of whether a transaction between 2 non-residents can be taxed in India was dealt in detail by the HC. The HC held that the jurisdiction of a State to tax a non-resident is based on the nexus connecting the person sought to be taxed with the jurisdiction which seeks to tax. The question as to whether the sum paid to a non-resident or a foreign company pursuant to a transaction is chargeable to tax is determined by Sections 5(2), 9(1) and 195[3] of the Act.

Section 5(2) enunciates that the income of a non-resident from whatever source derived is included in the total income if **(i)** it is received in India; **(ii)** deemed to be received in India; **(iii)** accrues in India; **(iv)** deemed to accrue in India; **(v)** arises in India; or **(vi)** deemed to arise in India.

Section 9(1) explains the circumstances in which income is deemed to accrue or arise in India and includes all income accruing or arising in India, whether directly or indirectly **(a)** through or from any business connection in India; or **(b)** through or from any property in

[2] *Vodafone v. Union of India*, Page 162, Paragraph 125

[3] Section 195 provides for deduction for tax at source upon a payment to a non-resident or foreign company

India; or **(c)** through or from any asset or source of income in India; or **(d)** through the transfer of a capital asset situated in India.

As such, where an asset or source of income is situated in India or where the capital asset is situated in India, all income which accrues or arises, directly or indirectly, through or from it shall be treated as income which is deemed to accrue or arise in India.

The HC noted that the transaction and the agreements executed between the parties indicated that the parties were aware of the composite nature of the transaction and did not limit itself to acquiring one share in CGP but also **(i)** the various assets and liabilities of CGP including a 52% stake in HEL; and **(ii)** stake in control premium, use and rights to the Hutch brand and a non-compete agreement. The HC held that the present case held a significant nexus with India. The essence of the transaction was a change in controlling interest in HEL which constituted a source of income in India.[4] As such, the income accrued in India is chargeable to tax under Section 5(2) of the Act.

Further, the HC held that given a sufficient territorial connection and nexus[5], such person's global income, proportionate to the income chargeable in India, would attract the provisions of Section 195. Effectively, the HC held that in view of the application of Section 5(2), Vodafone was under a statutory obligation to deduct income tax at source under Section 195 of the Act. It, however, left the tax authorities to decide how to apportion the income that has accrued to HTIL as a result of the "nexus with the Indian jurisdiction.[6]"

Conclusion

Effectively, the HC judgment has enumerated that in case of cross-border mergers and acquisitions between 2 non-resident entities wherein **(i)** a controlling interest in rights and entitlements is situated in India, **(ii)** whether a wholly-owned subsidiary or a group company is transferred to a new company, then such transaction will come under the purview of tax laws. While carrying out such transactions, the buyer will have to withhold tax, make contractual provisions to this effect with the seller, or be deemed an assessee in default[7]. However, since the HC has left it to tax authorities to assess the apportionment, it is not clear how such order shall be enforced since it would be a nightmare to unbundle the value of the rights and entitlements on that part of the transaction which has a nexus with India.

[4] *Vodafone v. Union of India*, Page 193, Paragraph 144

[5] Ibid, Page 192, Paragraph 144

[6] Ibid, Page 183, Paragraph 139

[7] Section 201of the Act broadly provides that any person (referred to in Section 200 of the Act), and in cases referred to in Section 194, the principal officer and the relevant company, who does not deduct the whole or any part of the tax, or after deducting fails to pay the tax as required by or under the Act, he or it shall, without prejudice to any other consequences which he or it may incur, be deemed to be an 'assessee in default' in respect of the tax

The matter is currently under appeal at the Supreme Court ("**SC**"). If SC affirms HC's verdict, foreign investors would need to bear in mind that the cost of such transactions would substantially increase with the additional tax liability.

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