Vodafone: predicament of Income Tax in India- an analysis

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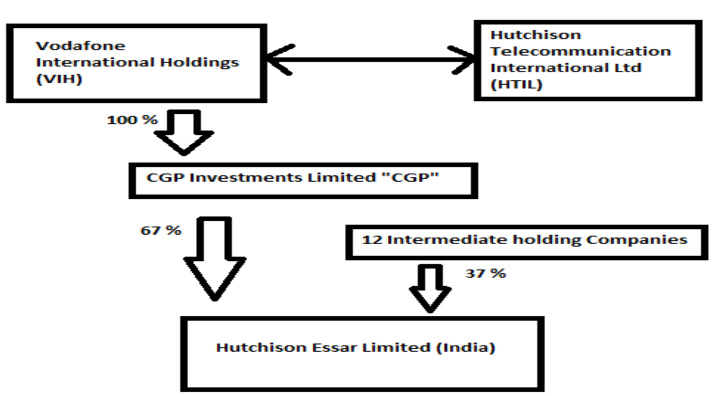
Abstract

India is fourth of the largest Asian economies, part of BRICs, seen as emerging economy and hence attracting investments through Foreign Direct Investments and Foreign Institutional Investments. This requires legal environment which is conductive for attracting foreign players and any policy which negatively impact the investments made by foreign companies and their operations is bound to be criticised for being anti people and politics.

The research paper is an analysis of a tax dispute involving the Vodafone Group with the Indian Tax Authorities. Vodafone had acquired, International Holdings BV (VIH), a company resident for tax purposes in the Netherlands, of the entire share capital of CGP Investments (Holdings) Ltd., a company resident for tax purposes in the Cayman Islands, through transaction dated February 11, 2007. According to the Indian Tax Authorities their, Revenue Department, the aim of this acquisition was to obtain 67% controlling interest in Hutchison Essar Limited (HEL), which was a company resident for tax purposes in India. This was contented by Vodafone wherein according to them, VIH had agreed to acquire companies, which in turn controlled a 67% interest, but not controlling interest, in Hutchison Essar Limited. According to Vodafone, CGP held indirectly through other company's 52% shareholding interest in HEL as well as options to acquire a further 15% shareholding interest in HEL, subject to relaxation of Foreign Direct Investment norms in India. Hence, the Indian Income Tax Authorities sought to tax the capital gains arising from the sale of the share capital of CGP on the basis that CGP, whereas not a tax resident in India held the underlying Indian assets.



It provides a legal prospective of doing business in emerging economies like India wherein there is inherent over controlled regulatory environment under the lens of taxation laws. It attempts to study the different aspects of legal environment in which the foreign companies operate in the India hence having an essential emphasis on the taxability provisions in India of cross- border transactions. The judgment by Hon'ble Supreme Court in this case will be a precedent for cases of same or similar nature in Indian courts and hence will be guiding force for the foreign companies operating in India. It further consolidates the point that certainty and stability from any fiscal system is critical to expect investors through FDI or FII routes.

Introduction

In legal fiction theory, first propounded in the thirteenth century by Pope Innocent IV, it was stated that corporate bodies could not be ex-communicated because they only exist in abstract. This diction is the foundation of the separate entity principle. The approach of both the corporate and tax laws, particularly in the matter of corporate taxation, generally is founded on the above mentioned separate entity principle, i.e., treat a company as a separate person. The Indian Income Tax Act, 1961, in the matter of corporate taxation, is founded on the principle of the independence of companies and other entities subject to income-tax. This is in alignment to common practice of International Taxation Law, where a foreign investor operates through an interposed foreign holding or operating companies such as Cayman Islands or Mauritius based company for both tax and business purposes as was done in the present case. However, if a Non- Resident company makes a disguised or circuitous transfer which violates the spirit of organization or legal form, without a commercial objective and thereby results in tax avoidance or avoidance of tax payment, then the Tax Authorities may go behind the form of arrangement or the contentious act through the use of holding company and may re-characterize the equity transfer according to its economic substance and impose tax. According to Peter Drucker says "Even within transnational economic units, national politics still overrule economic rationality".

1. **The notice from India's Income Tax Department in September 2007 to Vodafone-** In September 2007, Income Tax Department issued the notice to Vodafone asking why their transaction of payments to HTIL not be taxed, as the transfer of shares in CGP had the effect of indirect transfer of assets situated in India. The Income Tax Department has the authority to issue a show cause for all the capital transaction which is direct or indirect transfer of assets situated in India. In reply to this notice, Vodafone challenged the jurisdiction of Income Tax Department and filled a writ petition in the Bombay High Court. The High Court categorically held that Income Tax authorities had a jurisdiction as the transaction was one of transfer of a capital asset situated in India, though the Supreme Court later set aside the order of the Bombay High Court.

In May 2012 under Section 201 of the Income Tax Act, 1961 the tax authorities held that they have the jurisdiction to proceed against Vodafone for their failure to withhold tax from payments. The contention was upheld by Bombay High Court against which the company preferred a Special Leave Petition (SLP) in the Supreme Court.

The Supreme Court interpreted Section **9(1) in the Income Tax Act, 1995** as under

i. There are three elements of charge on capital gains under Section 9(1)(i)
    a. Transfer
    b. Existence of a capital asset

c. And situation of such asset in India

ii. The words "indirect transfer" has not been defined in Section 9(1)(i), and hence if the word indirect is read into Section 9(1)(i) then the phrase 'Capital asset situate in India' would be turn into an effective preposition.
iii. Section 9(1)(i) hence cannot cover or be extended to cover indirect transfers of capital assets/property situated in India. It is also not a look through provision.
iv. Even the proposed provisions contained in the Direct Taxes Code Bill, 2010 on taxation of off-shore share transactions indicate that indirect transfers are not covered by Section9(1)(i) of the Act.
v. Companies and other entities are viewed as economic entities with legal independence vis-a-vis their shareholders/participants. The court further iterated that it is well established preposition of tax laws that a subsidiary and its parent are totally distinct tax payers. Consequently, the entities subject to income-tax are taxed on profits derived by them on standalone basis, irrespective of their actual degree of economic independence and regardless of whether profits are reserved or distributed to the shareholders/ participants. Hence, shareholders/ participants, that are subject to (personal or corporate) income-tax, are generally taxed on profits derived in consideration of their shareholding/participations, such as capital gains which settles the contention that for tax treaty purposes a subsidiary and its parent are also totally separate and distinct tax payers.

Hence the Supreme Court set aside the orders of the Bombay High Court and concluded that the transfer of share in CGP did not result in the transfer of a capital asset situated in India and hence cannot be subjected to taxation under Indian laws.

2. CGP was though introduced at a late stage in the transaction but it was holding company which was involved only in "share sale" and not "asset sale". There were two possible routes for transaction of sale so that the buyer acquired the same degree of control as was previously exercised by HTIL.
1. The CGP route
2. The Mauritius route

The transaction was preferred through CGP route and under The Indian Companies Act, 1956, the situs of the shares would be where the company is incorporated and where its shares can be transferred. In the present context, it was affirmed that transfer of CGP shares were recorded in Cayman Island and this was not disputed by the tax authorities.
Hence CGP was established for smooth conversion of business and not only to hold shares in subsidiary companies whereby one can conclude that CGP not undertaken a colourable or artificial device. It was merely a holding company whose shares were situated in India where its underlying assets were located. A controlling interest is an incident of ownership of shares of a company which flows out of the holding of shares and hence an identifiable or distinct capital asset independent of the holding of shares.

3. **The applicability of Section 195 (withholding tax) and Section 163 (representative assesses)-** According to Section 195 of the Income Tax Act

(1) Any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest (not being interest on securities) or any other sum chargeable under the provisions of this Act (not being income chargeable under the head "Salaries" shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force :

Provided that in the case of interest payable by the Government or a public sector bank within the meaning of clause (23D) of section 10 or a public financial institution within the meaning of that clause, deduction of tax shall be made only at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode:

Provided further that no such deduction shall be made in respect of any dividends referred to in section 115-O.

Explanation: For the purposes of this section, where any interest or other sum as aforesaid is credited to any account, whether called "Interest payable account" or "Suspense account" or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be credit of such income to the account of the payee and the provisions of this section shall apply accordingly.

(2) Where the person responsible for paying any such sum chargeable under this Act other than interest on securities, and salary to a non-resident considers that the whole of such sum would not be income chargeable in the case of the recipient, he may make an application to the Assessing Officer to determine, by general or special order, the appropriate proportion of such sum so chargeable, and upon such determination, tax shall be deducted under sub-section (1) only on that proportion of the sum which is so chargeable :

(3) Subject to rules 1754a made under sub-section (5), any person entitled to receive any interest or other sum on which income-tax has to be deducted under sub-section (1) may make an application in the prescribed form 1754a to the Assessing Officer for the grant of a certificate authorising him to receive such interest or other sum without deduction of tax under that sub-section, and where any such certificate 1754a is granted, every person responsible for paying such interest or other sum to the person to whom such certificate is granted shall, so long as the certificate is in force, make payment of such interest or other sum without deducting tax thereon under sub-section (1).

(4) A certificate granted under sub-section (3) shall remain in force till the expiry of period specified therein or, if it is cancelled by the Assessing Officer before the expiry of such period, till such cancellation.

(5) The Board may, having regard to the convenience of assesses and the interests of revenue, by notification in the Official Gazette, make rules specifying the cases in which, and the

circumstances under which, an application may be made for the grant of a certificate under sub-section (3) and the conditions subject to which such certificate may be granted and providing for all other matters connected therewith.

The above provision was not applicable on the Vodafone transaction as Section 195 is not applicable to subject matters of offshore transfer between the two non-residents as in this case there was no capital gain in India. There may be other related matters but in context of this transaction there was no incidence of liability of tax.

Section 163 of the Income Tax Act , the above provision is not applicable to the Vodafone transaction as there was incidence of capital gains tax in India as it was not a (Vodafone) was not a representative assesses of HTIL.

4. **The democratically elected government which is the legitimate representative of people of country takes a decision to make retrospective amendments in Taxation laws to bring the transactions like of Vodafone within its ambit contrary to the Judgment of the Supreme Court-** Retrospective legislation refers to any law that is passed and is to be treated as if it has always had effect, and hence holds a person to be in contravention of the law when that law did not exist when the alleged contravention occurred. There is no provision prohibiting the enactment of retrospective legislation in the Indian Constitution. However the validity of such retrospective amendments are to be tested in light of Article 14 (equality before law) and Article 19 (1)(g) (right to carry business) of the Constitution of India. Though the legislature can pass a law and make its provisions retrospective, it would be relevant to consider the effect of the said retroactive operation of the law both in respect of the legislative competence of the legislature and the reasonableness of the restrictions imposed by it. Further in case the legislation is introduced to overcome a judicial decision, the power cannot be used to subvert the decision without removing the statutory basis of the decision.

Retrospective Legislation – Legislative Vs Judicial

The legislative power to make law with retrospective effect is well recognized. It is also well settled that though the legislature has no power to sit over Court's judgment or usurp judicial power, but, it has, subject to the competence to make law, power to remove the basis which led to the Court's decision, Thereby the legislature has power to enact laws with retrospective effect but has no power to change a judgment of court of law either retrospectively or prospectively. The constitution clearly defines the limits of legislative power and judicial power. None can encroach upon the field covered by the other.

The Finance Minister (FM) to the surprise of many has unfolded on the Budget day a number of amendments in Direct tax law with retrospective effect to offset many of the Court and Tribunal rulings. One issue which has been in the spotlight and has been widely debated is the retrospective amendments introduced in the name of clarificatory amendments though the real nature appears to amend retrospectively the charging sections with a clear intent to neutralize the landmark ruling of the Apex Court in the case of Vodafone and other Court/Tribunal decisions which are rendered in favor of the taxpayer. Even in the past there have been retrospective clarificatory amendments being introduced in fiscal statues to set straight erroneous laws and to nullify Court Rulings which have been rendered without understanding the legislative intent. However the frequency in which the legislature is resorting to retrospective amendments with primary motive to offset a Court ruling is alarming. When the Finance Bill is introduced in the Parliament, usually a memorandum is issued by the Finance Minister explaining the rationale behind the introduction of changes in the provisions and indicating the legislative intent. However, the legislative intent to tax indirect transfers as early as from 1962 when India did not even liberalize the economy for foreign investments is surprising.

The Finance Bill, 2012 laid down before the Parliament seeks to tax indirect transfer of capital assets in India by inserting clarificatory explanations to Sections 2(14), 2(47), 9(1) and 195 of the ITA. The Bill further proposes to clarify 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'.

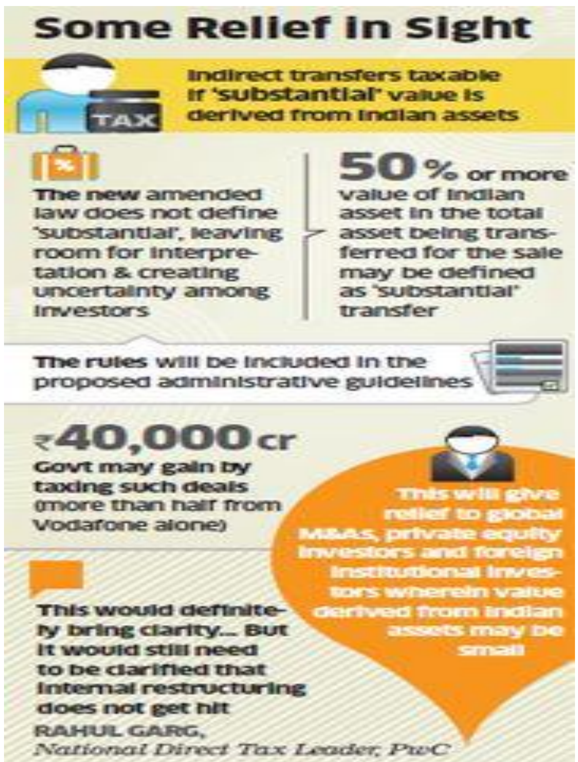
5. **The retrospective amendments – can they be Clarificatory or Substantive.** The Supreme Court has held that retrospective amendment which brings in substantive law and is not clarifying in nature is unconstitutional. Therefore, the Government to overcome the instant ruling of the Supreme Court has introduced the new law on taxability of indirect transfers by way of an explanation to section 9(1) of the Income tax Act. Section 9(1) of the Income tax Act provides that income arising from any asset or source of income in India is chargeable to tax in India. Now the Finance Bill, 2012 has inserted an explanation to section 9 clarifying that in case the share or interest of company incorporated outside Indian derives substantial value from assets located in India then share or interest shall be deemed to be situated in India and on transfer of the same is taxable in India. Further this clarification is applicable from the date when the section was originally enacted.

The Supreme Court in the case of Vodafone had observed that the Legislature wherever wanted to tax income which arises indirectly from the assets had specifically provided so in the statute itself. The Court had drawn reference to section 64 of the Income tax Act which deals with clubbing of income of minor and spouse with the individual to drive its point. It had further observed that on a comparison of section 64 and section 9(1)(i) what is discernible is that the legislature has not chosen to extend section 9(1)(i) to "indirect transfers". The Supreme Court in the case of Vodafone has brought out various defects in the contentions of the Revenue and has clearly communicated by reference to section 64 of the Income tax Act that indirect transfers are not within the purview of section 9(1)(i). However the Finance Minister has brought out amendment to section 9(1)(i) in the disguise of clarification without pointing out the lacuna and how is it contrary to the legislative intent.

Conclusion

To conclude, there are two points of contention regarding the amendments with in retrospective applicability as to whether they boost up investor sentiment and shield the economy from global headwinds or do they discourage further investment in emerging economy like India- "I think the government is committed to promote investments in India, I see lots of signs of that," Midha said. "But, that said, proof is in the pudding." The Finance Minister in his speech in Parliament on May 7, 2012 in order to give some solace to the international business community has clarified in the Parliament that retrospective amendments in the Finance Bill, 2012 with regard to indirect transfer abroad of assets located in India do not override the provisions of the Double Taxation Avoidance Agreements which India has entered into. Further, the Minister has clarified that the clarificatory amendments would not be used to reopen any assessments where assessment orders have already been completed.

In this regard, the CBDT has issued a Clarification that in case where assessment proceedings had been completed under section 143(3) of the Act before the first day of April 2012 and no notice for reassessment had been issued prior to that date, then such cases shall not be opened under sections 147 / 148 of the Act on account of the above mentioned clarificatory amendments in Finance Act, 2012.



Source-http://articles.economictimes.indiatimes.com/2012-06-04/news/32031652_1_direct-taxes-code-indian-assets-general-anti-avoidance-rules

National Direct Tax Leader, PwC: "This would bring clarity and also exclude cases where substantial assets are not in India. But it would still need to be clarified that internal restructuring does not get hit even if value of asset derived from India is more than 50%."
Once internal discussions are over, a detailed circular will be issued by the Central Board of Direct Taxes, the apex body in charge of direct taxes. Government officials say the circular will provide certainty to foreign investors on the kind of transactions that could become taxable. The rule will apply to deals in which income tax assessment is not complete. The law does not apply to cases where assessment has been concluded.

A dozen such deals could fetch the government as much as 40,000 crore - more than half of it from Vodafone alone, finance ministry officials say. Vodafone, which is being pursued by Indian authorities for not withholding tax on a 2007 deal in which it bought the local telecom business of Hutchison, is likely to challenge the validity of the tax demand before an international arbitration tribunal.

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Section 201. CONSEQUENCES OF FAILURE TO DEDUCT OR PAY.

(1) If any such person and in the cases referred to in section 194, the principal officer and the company of which he is the principal officer does not deduct or after deducting fails to pay the tax as required by or under this 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:

Provided that no penalty shall be charged under section 221 from such person, principal officer or company, unless the Assessing Officer is satisfied that such person or principal officer or company, as the case may be, has without good and sufficient reasons failed to deduct and pay the tax.

(1A) Without prejudice to the provisions of sub-section (1), if any such person, principal officer or company, as is referred to in that sub-section does not deduct or after deducting fails to pay the tax as required by or under this Act, he or it shall be liable to pay simple interest at eighteen per cent per annum on the amount of such tax from the date on which such tax was deductible to the date on which such tax is actually paid.

(2) Where the tax has not been paid as aforesaid after it is deducted, the amount of the tax together with the amount of simple interest thereon referred to in sub-section (1A) shall be a charge upon all the assets of the person, or the company, as the case may be, referred to in sub-section (1).

Section 9(1) in The Income- Tax Act, 1995. [online] Available at http://www.indiankanoon.org/doc/492579/ [Accessed on 23 Aug. 12] (1) The following incomes shall be deemed to accrue or arise in India-

(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India 4[or through the transfer of a capital asset situate in India. Explanation.- For the purposes of this clause-

(a) in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India;

(b) in the case of a non- resident, no income shall be deemed to accrue or arise in India to him through or from operation,., which are confined to the purchase of goods in India for the purpose of export; 5[ ]

(c) 6[in the case of a non- resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to

accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India;]

(d) 7[in the case of a non- resident, being-

(1) an individual who is not a citizen of India; or

(2) a firm which does not have any partner who is a citizen of India or who is resident in India; or

(3) a company which does not have any shareholder who is a citizen of India or who is resident in India,

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(1) For the purposes of this Act, 'agent', in relation to a non-resident, includes any person in India -

(a) Who is employed by or on behalf of the non-resident; or

(b) Who has any business connection with the non-resident; or

(c) From or through whom the non-resident is in receipt of any income, whether directly or indirectly; or

(d) Who is the trustee of the non-resident; and includes also any other person who, whether a resident or non-resident, has acquired by means of a transfer, a capital asset in India:

Provided that a broker in India who, in respect of any transactions, does not deal directly with or on behalf of a non-resident principal but deals with or through a non-resident broker shall not be deemed to be an agent under this section in respect of such transactions, if the following conditions are fulfilled, namely:-

(i) the transactions are carried on in the ordinary course of business through the first-mentioned broker; and

(ii) The non-resident broker is carrying on such transactions in the ordinary course of his business and not as a principal.

(2) No person shall be treated as the agent of a non-resident unless he has had an opportunity of being heard by the Assessing Officer as to his liability to be treated as such.

Amit Midha, president of Asia Pacific and Japan for Dell,
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