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The Indian Tax authorities call on Vodafone

How much tax can India levy on a Foreign Company (FC)? This one simple question has many conflicting answers. The tax authorities could reason out that all the transactions undertaken by FC with reference to India would entitle India to levy tax. FC could, on other hand, reason out that unless it has undertaken any activities or has any presence in India, no tax can be levied on it by India. Both of these answers could be perceived as an extreme view on a given item of income. And, this is where the interpretation of the provisions of the tax laws of India and international jurisprudence on taxing rights of a sovereign state comes into play.

The recent tax controversy over Vodafone case is a classic example of art of interpretation of laws. As per the press reports, counsels of Vodafone & the tax department have overwhelmingly argued the matter. The entire fraternity of tax professionals & tax officers are eagerly awaiting the judgement of Bombay High court on this matter which is expected to be passed in a near future.

Background of Vodafone Case:

Hutchison Telecommunications International invited bids from several investors for auctioning its investments in a Cayman Island Company. Indian Income Tax authorities sought requisite information from Vodafone with regard to the purchase of shares, by it's group company based at Netherlands, of this Cayman Island Company owned by Hutchison, Hong Kong. This purchase referred in this article as 'the share purchase transaction'. The Cayman Island Company owned shares of a Mauritian Company which had invested into the shares of an Indian telecom company. Vodafone challenged this action of Indian tax authorities and sought to obtain injunction over the said action by filing a writ petition with Bombay High court. As per the press reports, the potential tax demand from the share purchase transaction could be US\$ 2 billion!!

The tax propositions and its significance

Summary of several tax propositions applicable to this case and the contentions of Vodafone and tax authorities over the same are reproduced below.

Tax proposition – I: Scope of Indian Income Tax Act ('the Act') over non-resident

- **It's significance under the law**

A non-resident tax payer is liable to tax in India under 'source' tax principle. Income received or accrued or arisen in India in the hands of a non-resident is liable to tax in India. Under specified circumstances, certain items of income are deemed to have been received, accrued or arisen in India. Such circumstances include income arising or accruing, directly or indirectly, through or from any business connection in India, property situate in India or asset or source of income in India or transfer of capital asset situate in India.

- **Contentions of Vodafone**

- Transfer of 'controlling shareholding' was incidental to the share purchase transaction – transfer of 'shareholding' & 'economic interest' in it can not be construed as transfer of 'capital asset'.
- Shares of Indian Telecom Company were not transferred. The share purchase transaction was for transfer of shares of a foreign company and hence not of 'capital asset situate in India'.
- The relevant provision of the Act refers to the income accruing/arising/received *directly or indirectly* and not to the income arising from transfer of capital asset – directly or indirectly. In other words, the transfer has to be direct, but income arising from such transfer could be accruing/arising - directly or indirectly.
- The legal precedent confirms the interpretation that amount of income arising from the share purchase transaction is nothing else but the amount of gains arising from the 'business' or 'transfer of a capital asset' outside of India of Hutchison and it can not be held that the amount of income arising from the share purchase transaction is equivalent to the amount of gains arising out of the sale/transfer of capital asset situate in India.
- Having regard to the judicial precedents in this regard, it can not be concluded that through the share purchase transaction, Vodafone, as one of the shareholders of the Cayman Island Company, has acquired interest in the assets of the Cayman Island Company. As a shareholder

of the Cayman Island Company, Vodafone has acquired merely right to participate in the profits of the Cayman Island Company & Vodafone has acquired no rights/title towards interest in assets of the company.

- **Contentions of Tax authorities**

- The share purchase transaction resulted in transfer of bundle of rights including economic interest and controlling shareholding in Indian Telecom company in favour of Vodafone by Hutchison. Capital asset shall include intangible assets and consequently gain arising from the transfer of economic interest would be subject to tax in India.
- The change to the shareholding pattern of Cayman Island Company through the share purchase transaction falls within the ambit of definition of 'transfer' under the Indian tax laws.
- The share purchase transaction resulted into transfer (in the form of relinquishment of controlling share holding pattern) of capital asset (viz. intangible assets in the form of economic interest and controlling shareholding pattern) situated in India.
- The consideration for the share purchase transaction was determined based on the enterprise value of Indian Telecom company and not of the Cayman Island company.

Tax proposition – II: Assessee-in-default

- **It's significance under the law**

A person who fails to comply with the provisions of the law with regard to deduction/deposit of taxes while making payments under specified circumstances is regarded as 'assessee-in-default'. The tax authorities can recover tax that could arise in the hands of the person (seller for the transaction under consideration) from 'assessee-in-default'. The law was amended vide Finance Act 2008 to widen the powers of the tax authorities under this rule so that it can empower the tax authorities to recover the taxes even from the buyer of the capital assets, the transfer of which could trigger tax liability in India.

- **Contentions of Vodafone**

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- Amendment to the law is unconstitutional.
 - The tax authorities can not apply these provisions of the Indian law to a 'non-resident' not having any presence in India. These provisions could not grant extra territorial jurisdiction to the Tax authorities.
 - The tax authorities can not extend the scope of the Indian law to the transaction undertaken on foreign shores.
 - Vodafone can be held to be liable to tax claim only if the seller fails to pay the same. In other words, primary tax liability was on the seller. If no proceedings for recovery or collection are pending before the seller, Vodafone can not be regarded as 'assessee-in-default' and be called upon to pay the taxes due in India of the seller.
 - **Contentions of Tax authorities**
 - Amendment was merely clarificatory in nature.
 - Amendment was not for Vodafone case alone.
 - The machinery provision of the Indian Income Tax Act (viz. the obligation of deduction of tax while making payment to a non-resident) should not be interpreted strictly. In other words if the plain reading of the relevant provisions leads to an interpretation that Vodafone was to be regarded as 'assessee-in-default' then the provision should not be held as unconstitutional or illegal.
 - Once the share purchase transaction falls within the scope of the Indian tax laws, Vodafone could be regarded as 'assessee-in-default'.

Tax proposition – III: Transfer of a 'capital asset'

- **It's significance under the law**

Gains arising from transfer of a capital asset situate at India by a non-resident will attract income tax in India. The deeming fiction laid down under section 9 of the Act empowers Indian tax authorities to tax the gains arising from share purchase transaction executed by Vodafone if it can be concluded that Vodafone has effectively acquired 'capital asset' situated in India from a non-resident. To determine the 'situs' of the shares, as per the judicial precedents and commentaries, the jurisdiction of the registered office of the company shall be relevant.

- **Contentions of Vodafone**

- ‘Situs’ for the purpose of determination of the source principle of gains arising from the transfer of shares is the registered office of the company. The shares are of a foreign company and hence can not be regarded as ‘capital asset’ for the purposes of section 9.
- Transaction was between two foreign companies who are ‘non-residents’.
- ‘Capital asset’ for the purpose of section 9 of the Act should be tangible asset situated in India. Transfer of controlling/economic interest of Indian company can not be regarded as ‘capital asset’ for the purposes of Indian tax laws. Also, the share purchase transaction was for capital asset situated outside India.
- Acquisition of economic interest of Indian Telecom company by Vodafone through the share purchase transaction can not be regarded as ‘transfer of capital asset’ situated in India.

- **Contentions of Tax authorities**

- Section 9 should be given widest application.
- Referring to the principle of ‘Effects Law’ embedded under US tax laws, Vodafone acquired economic interest in an Indian company by consummating the share purchase transaction.
- Transfer of economic interest of the Indian telecom company would entitle the tax authorities to tax the gains arising on the same.

Tax proposition – IV: Show cause notice

- **It’s significance under the law**

The process of gathering information and explanations from the tax payer on the identified transactions/activities. At the end of the said process, the tax authorities, after affording sufficient opportunity to the tax payer, could levy tax/penalty on the tax payer on the identified transactions/activities.

- **Contentions of Vodafone**

- The tax authorities can not inquire about the share purchase transaction since the same has taken place outside of India between two non-residents.
- The tax authorities will have no jurisdiction over transaction taken at foreign shore. No inquiries can be raised by the tax authorities.
- The writ petition is necessary to quash such *ultra vires* proceedings.
- Show cause notice is premature since the taxability of the gain arising from the share purchase transaction has not been established.

- **Contentions of Tax authorities**

- Vodafone has other remedy under the law and hence writ petition can not be preferred against the proceedings to seek injunction.
- The proceeding is merely to gather information and not for assessment. Vodafone will have ample opportunities to challenge the conclusions of the tax authorities.

Tax proposition – V: Territorial jurisdiction of Indian Tax laws and authorities

- **It's significance under the law**

Indian Income Tax Act can have its applicability only to the territory of India and to the identified transactions related to India. Indian tax authorities must respect the international jurisprudence on taxing rights of a sovereign state.

- **Contentions of Vodafone**

- Indian income tax laws can not be applied to the share purchase transaction since the provisions of the law do not provide any *nexus* between Indian territory and the share purchase transaction.
- Indian tax authorities can not have extra-territorial jurisdiction.

- **Contentions of Tax authorities**

- Income arises on account of business transaction of India.
- Transfer of capital asset situated at India would empower the tax authorities to levy tax in India on gains arising from the same.
- Vodafone had admittedly acquired controlling interest in Indian Telecom company. The Indian tax authorities would have jurisdiction over the share purchase transaction that enables Vodafone to acquire controlling interest in Indian Telecom Company.

Concluding remarks:

The contentions of both the sides are quite plausible.

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