

## Vodafone-All is Not Lost-A Mixed Verdict

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*Bombay High Court on 8<sup>th</sup> September, 2010 ruled that Income tax authorities in India have the jurisdiction to tax transactions, even though the transaction took place outside India as the underlying assets were in India. The Court held that the transfer of these rights and entitlements constitute capital, which can be taxed as part of non-resident income. This upholds the contention of the tax authorities which argued that Vodafone (non-resident buyer) should have deducted tax before making payment to the non-resident seller. The Court also remarked that only that part of income will be taxed in India which can be attributable to India and not on the foreign source income. (MANU/MH/1040/2010)*

### **Background**

Vodafone (VIH BV) purchased Hutchison Telecommunications International Ltd.'s (HTIL) 66.98 per cent shares in Hutch Essar Ltd. for USD 11.2 billion during May 2007. Hutchison controlled its Indian entity through a company called CGP Investment (Holding) Ltd. (CGP) domiciled in Cayman Island. CGP's shares were sold by Hutchison.

AS per IT authorities HTIL's sale of majority in its Indian company to Vodafone attracted capital gains tax, therefore, under the IT Act, Vodafone should have deducted tax at source. IT authorities issued Vodafone a Show Cause Notice in September 2007 asking why the company did not deduct tax at source as the underlying assets are based in India. Vodafone contested this notice by way of a writ in the Bombay High Court saying as the Indian Tax authorities do not have the jurisdiction over a foreign entity according to existing law. In December 2008, HC dismissed the writ (MANU/MH/1147/2008).

In a Special Leave Petition filed before the Supreme Court, by an order dated, 23<sup>rd</sup> January, 2009, the IT authorities were directed to determine the jurisdictional challenge raised by the Vodafone. The order passed by the Supreme Court reserved the right of Vodafone to challenge the decision of the IT Authorities, if determined against Vodafone, before this Court leaving all questions of law open. Thereafter, a second notice to show cause was issued to Vodafone on 30<sup>th</sup> October, 2009 to which Vodafone filed a reply dated, 28<sup>th</sup> January, 2010. On 31<sup>st</sup> May, 2010, the order was passed by IT Authorities under Section 201 upholding jurisdiction.

Vodafone once again approached the Bombay High Court against this order.

Relevant extracts of the Judgment (MANU/MH/1040/2010). (Para numbers indicate the para number of the Judgment).

### **The Issue of Substance versus form**

**56.** Indian Law recognises that an Assessee, who engages in legitimate business activity and organizes business around accepted legal structures is entitled to plan his transactions in a manner that would reduce the incidence of tax. An Assessee who does so, does not tread upon a moral dilemma or risk a legal invalidation. There is a recognition in our law of the principle that lawful forms of activity can legitimately be arranged by those who transact business to plan for tax implications. So long as the legal structures that are put into place and the instruments of law that are utilised, have been utilised *bona fide* for a business purpose, fiscal law—absent statutory provisions to the contrary—does not permit an enquiry into the motives of the Assessee or an investigation into the underlying economic interest. But a transaction which is sham or, what the law describes as a colourable device, stands on an entirely different foundation.

**63.** The following principles are now firmly embedded in our jurisprudence:

- (i) A transaction or arrangement which is permissible under: law which has the effect of reducing the tax burden of an Assessee does not incur the wrath of the law;

- (ii) Citizens and business entities are entitled to structure or plan their affairs with circumspection and within the framework of law with a view to reduce the incidence of tax;
- (iii) A transaction which is sham or which is a colourable device cannot be countenanced. A transaction which is sham or a colourable device is one in which the parties while ostensibly seeking to cloth the transaction with a legal form, actually engage in a different transaction altogether. A transaction which serves no business purpose other than the avoidance of tax is not a legitimate business transaction and in the application of fiscal legislation can be disregarded. Such transactions involve only a pretence and a facade to avoid compliance with tax obligations;
- (iv) Absent a case of a transaction which is sham or a colourable device, an Assessee is entitled to structure business through the instrument of genuine legal frameworks. An act which is otherwise valid in law cannot be disregarded merely on the basis of some underlying motive resulting in some economic detriment or prejudice. In interpreting a fiscal statute, it is not the economic result sought to be obtained by making the provision which is of relevance and the duty of the Court is to follow the plain and unambiguous language of the statute.

**66.** The governing principle therefore is that tax planning is legitimate so long as the Assessee does not resort to a colourable device or a sham transaction with a view to evade taxes. A genuine transaction within the framework of law will not be impeached.

### **Shares as Capital Assets**

**69.** Ownership of shares may in certain situations result in the assumption of an interest which has the character of a controlling interest in the management of the Company. The extent of shareholding which is sufficient to vest in the holder of shares an interest which assumes the character of a controlling interest may again vary from case to case.

**70.** A controlling interest does not for the purpose of the Income Tax Act, 1961 constitute a distinct capital asset. That is simply because the assumption of control is a right which emanates from the acquisition of a sufficient number of shares in the Company as would enable the holder of the shares to exercise a voting power of a degree and nature as would result in a control of the management. A controlling interest is an incident of the ownership of the shares in a Company, something which flows out of the holding of shares. A controlling interest is therefore, not an identifiable or distinct capital asset independent of the holding of shares.

**71.** A share is not a sum of money, but is an interest measured by a sum of money made up of various rights contained in the articles of association.

**72.** That a shareholder acquires a right to participate in the profits of the company may be readily conceded but it is not possible to accept the contention that the shareholder acquires any interest in the assets of the company. A shareholder has got no interest in the property of the company though he has undoubtedly a right to participate in the profits if and when the company decides to divide them. The company is a juristic person and is distinct from the shareholders. It is the company which owns the property and not the shareholders.

**76.** The position of law which has consistently held the field for over a hundred years in the UK and for well over five decades in India, is that the business of a corporation is not the business of its shareholders. The undertaking and the assets of a corporation are not the undertaking and assets of its shareholders. A corporation as an entity incorporated under legislation governing companies has a distinct juristic personality. A shareholder has during the subsistence of the corporate personality, no interest in the assets owned by the corporation. The right of the shareholder is to participate in the profits by receiving the dividend that may be declared by the corporation. A share represents an interest of a shareholder which is made up of various rights contained in the contract embodied in the Articles of Association. The right of a shareholder may assume the character of a controlling interest where the extent of the shareholding enables the shareholder to control the management. A controlling interest which a shareholder acquires is an incident of the holding of shares and has no separate or identifiable existence distinct from the

shareholding. The extent of the power of the shareholder would depend upon the magnitude of the holding but the nature of the power is not altered by it. Shares and the rights which emanate from them, flow together and cannot be dissected.

### **Taxation of Non-residents**

**77.** The jurisdiction of a State to tax non-residents is based on the existence of a nexus connecting the person sought to be taxed with the jurisdiction which seeks to tax. The nexus may arise as a result of the physical presence of the non-resident. The nexus of a non-resident with the taxing jurisdiction arises where the source of income originates in the jurisdiction. The source of income is determined in accordance with source rules. The source of income may be relevant in a number of ways. For example, the source enables the taxing jurisdiction to determine whether a country may tax a particular item of income under the source principle of taxation or to determine whether the income has a foreign source so as to be eligible for a foreign tax credit. The source principle of taxation is also used to refer to the category of income from which a particular item of income originates. The source principle of taxation is a principle for allocating taxing jurisdiction over income, according to which a country may tax income having its source in that country, regardless of the residence of the tax payer. Nations recognize that both the country of residence and the country of source have a valid claim to tax income.

### **Apportionment**

**82.** In certain instances which are known to tax legislation, a need for apportioning income arises when the source rule applies and the income can be taxed in more than one jurisdiction. Judicial precedent emanating from the Supreme Court and the High Courts has analysed situations where a person has earned profits on the sale and purchase of goods abroad or where an Assessee engages in a composite activity—such as manufacture and sale—and one component takes place within the jurisdiction of the taxing territory, while another has occurred outside the taxing jurisdiction.

### **Transnational Law**

**93.** Transnational law recognises that the jurisdiction of a State to tax non-residents is based on the existence of a nexus of the person sought to be taxed or his activities with the taxing jurisdiction. Such nexus may exist either as a result of physical presence or, in relation to the source rule, where the income earned by the non-resident has a source in the taxing jurisdiction.

### **Section 195 of the Income Tax Act, 1961**

**119.** In concluding this portion of the judgment, the principles which should govern the interpretation of Section 195 of the Income Tax Act, 1961 can be formulated as follows:

- (i) Section 195(1) provides for a tentative deduction of income-tax, subject to a regular assessment;
- (ii) Section 195 postulates two requirements—Firstly, there is a person responsible for paying to a non-resident, any interest or other sum. Secondly, the interest or other sum must be chargeable under the provisions of the Act, other than under the head of salaries;
- (iii) The obligation to deduct tax arises where the sum payable to a non-resident is chargeable to tax under the provisions of the Act. For the obligation to deduct to arise, the entire sum payable need not be income chargeable under the Act. If the sum payable to a non-resident represents income or if income is hidden or otherwise embedded in it, tax is required to be deducted on the sum. The obligation of the Assessee in that event is to deduct tax under Section 195 limited to the appropriate portion of income chargeable under the Act;
- (iv) The liability to deduct tax arises if the tax is assessable in India. If the tax is not assessable in India, there is no question of TDS being deducted by an Assessee;
- (v) The general principle of fiscal legislation is that given a sufficient territorial connection or nexus between the person sought to be charged and the country seeking to tax him,

income tax may extend to that person. The connection can be based on the residence of the person or a business connection within the territory of a taxing State or a situation within the State of the money or property from which the taxable income is derived;

- (vi) TDS provisions which are in the nature of machinery provisions constitute an integrated Code under the Act of 1961 together with charging provisions. Hence, those provisions are not independent of the charging provisions which determine assessability to tax;
- (vii) Whether a payment made by a foreign company in foreign currency abroad can be deemed to accrue or arise in India, would depend upon an examination of the facts and circumstances of each case.
- (viii) Parliament, while imposing a liability to deduct tax has designedly imposed it on a person responsible for paying interest or any other sum to a non-resident. Parliament has not restricted the obligation to deduct tax on a resident and the Court will not imply a restriction not imposed by legislation. Section 195 embodies a machinery that would render tax collection effective and must be construed to effectuate the charge of tax. There is no limitation of extra territoriality involved though Parliament is cognisant of the fact that the provisions of the law can be enforced within the territory to which the Act extends.

**132.** The facts clearly establish that it would be simplistic to assume that the entire transaction between HTIL and VIH BV was fulfilled merely upon the transfer of a single share of CGP in the Cayman Islands. The commercial and business understanding between the parties postulated that what was being transferred from HTIL to VIH BV was the controlling interest in HEL. HTIL had through its investments in HEL carried on operations in India which HTIL in its annual report of 2007 represented to be the Indian mobile telecommunication operations. The transaction between HTIL and VIH BV was structured so as to achieve the object of discontinuing the operations of HTIL in relation to the Indian mobile telecommunication operations by transferring the rights and entitlements of HTIL to VIH BV. HEL was at all times intended to be the target company and a transfer of the controlling interest in HEL was the purpose which was achieved by the transaction.

**135.** The transaction between VIH BV and HTIL was a composite transaction which covered a complex web of structures and arrangements, not referable to the transfer of one share of an upstream overseas company alone. The transfer of that one share alone would not have been sufficient to consummate the transaction. The transaction documents are adequate in themselves to establish the untenability of the Petitioner's submissions.

## **Conclusion**

**140.** In assessing the true nature and character of a transaction, the label which parties may ascribe to the transaction is not determinative of its character. The nature of the transaction has to be ascertained from the covenants of the contract and from the surrounding circumstances.

**144.** Chargeability and enforceability are distinct legal conceptions. A mere difficulty in compliance or in enforcement is not a ground to avoid observance. In the present case, the transaction in question had a significant nexus with India. The essence of the transaction was a change in the controlling interest in HEL (Indian entity) which constituted a source of income in India. The transaction between the parties covered within its sweep, diverse rights and entitlements. The Petitioner by the diverse agreements that it entered into has a nexus with Indian jurisdiction. In these circumstances, the proceedings which have been initiated by the Income Tax Authorities cannot be held to lack jurisdiction.

**146.** However, we clarify that it is open to the Petitioner to agitate before the tax authority that the Petitioner had reasonable cause and a genuine belief that it was not liable to deduct tax at source and that no penal liability can be fastened upon the Petitioner.

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