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Vodafone **SPECIAL FOCUS**

International Tax Review provides you will full coverage of the Vodafone Indian Supreme Court judgment, what it means for your business, key lessons to take from the ruling, and how to avoid becoming the next target of the Indian Tax Department. [Read the full ruling here.](#)

Contents

COVERAGE: Vodafone wins \$2.5 billion India battle

COMMENT: Lessons to learn

STATS: Why Vodafone was destined to win

ANALYSIS: How you can avoid becoming the next Vodafone

INSIGHT: Why the Vodafone ruling leaves China standing alone in the cold

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Vodafone wins \$2.5 billion India battle

By Jack Grocott

Vodafone has won its \$2.5 billion tax battle with the Indian tax authorities.

The Supreme Court ruling marks the end of a much-discussed and widely controversial chapter on the taxation of international transactions.

Chief Justice Kapadia told the court that the tax department has no jurisdiction to tax the telecommunication company's 2007 \$11 billion purchase of a 67% stake in Hutchison.

"[The] judgment shows robustness of the Indian judiciary and will create confidence for foreign investors," said Harish Salve, Vodafone's counsel.

The verdict seems to indicate that Vodafone has won on all counts: jurisdiction, extra territorial nature of withholding provisions, no see through provisions being applicable in absence of a specific GAAR legislation, no judicial driven GAAR as they didn't plan the structure. The court ruled that the transaction was not a device to evade tax. If Vodafone had lost, it would have been hit with a \$2.5 billion tax bill.

THE RULING

1. You cannot look through a transaction under section 9 of the Income Tax Act, 1961;
2. You cannot impute direct or indirect transfer of ownership of assets;
3. No territorial jurisdiction for the Indian tax authorities to proceed;
4. Extinguishment of rights argument of revenue turned down;

5. Vodafone's argument on intermediary location upheld;
6. Azadi correctness upheld – Form over substance. If it is a legitimate transaction, one does not need lift the corporate veil;
7. Hutch is not a fly by night operator;
8. Capital gains not applicable on transactions;
9. Section 195 does not apply; No question of TDS on the transaction;
10. It is a bonafide FDI transaction;
11. Rs2,500 crore (\$500 million) to be returned to Vodafone along with interest. However at an interest rate of 4% and not the usual 6%;
12. Majority court verdict.

REACTION Vodafone

"Vodafone Group (Vodafone) has received the judgment of the Indian Supreme Court. The Court has concluded that Vodafone had no liability to account for withholding tax on its acquisition of interests in Hutchison Essar Limited (now Vodafone India Limited) in 2007."

Mukesh Butani, BMR Advisors – Taxand, India

"The Vodafone verdict will be remembered more as victory of India's fair, impartial and independent judicial system, where rule of law prevails notwithstanding the quantum of tax involved for the treasury. The Supreme Court while rendering its judgment has called upon the tax administration to legislate laws that lend certainty to the investors and something that investors deserve it as a right. This *obiter dicta*, in my view, is the most crucial part of the judgment. The court seems to have held

all grounds in Vodafone's favour virtually rubbishing all arguments of the tax administration. Rest is history."

S Gayathri, head of tax, Essar Group

"The judgment has remarkable clarity on the various thorny issues involved and reinforces the confidence that foreign investor can place in the Indian legislature."

R Mani, head of tax, Tata India

"I am very delighted with this decision. If I was the head of tax at Vodafone and could go back in time then I wouldn't have done anything differently. The government may have lost the battle, but they have won the war as the court has done a great job in saying India is open for investment"

Rupak Saha, head of tax, GE India

"Great outcome. The fact that this matter went up to Supreme Court shows that this was a critical matter for the revenue. It demonstrates the Revenue's tenacity in following up on the matter which they believed was correct. It also shows the vibrancy of India's institutions, especially the judiciary. Given the government's need for revenue collection etc and enormous stakes involved the judiciary remained firm and laid out the law as it deemed fit."

International Chamber of Commerce

"Our major fear has been that other jurisdictions might follow the novel approach of the Indian tax authorities in the Vodafone case. Today's judgment should be read as a clear endorsement of the view that countries don't have jurisdiction to tax international transactions based on the location of underlying assets."

Pallav Gupta, head of India tax, ITC

"It is obvious that the Indian parliament, if they wish to tax such transactions, should specifically provide for such legislation after considering the impact on foreign investments. Without a specific provision, there cannot be any tax on such bona fide international transactions."

Navin Jain, head of tax, Cairn Energy India

"In my very quick reading of the judgement, it is absolutely positive where the structure exists for good time. However, if the entity has been created just before exit for tax avoidance/treaty shopping or round tripping or fraud or illegal purposes then tax authorities will continue to litigate. However, if the corporate can justify that there was business rationale for entity creation and not solely tax avoidance, the chances for success increases."

Krister Andersson, chairman of the tax policy group at Business Europe

"I think it is a good decision not only for businesses but also for the Indian government. The Vodafone tax case has negatively impacted foreign direct investment and economic activity in India, and with the independent tax ruling of the court, tax uncertainty is reduced. This is likely to boost investment in India. There is of course also a lesson to be learned for governments that we need internationally acceptable rules of how to split the tax cake between governments."

Isabel Verlinden, PwC, Belgium

"Tax systems are already complex enough to grapple with from a technical side without having to factor in what tax authorities "wished to have" based on more subjective criteria."

Ian Brimicombe, group head of tax, AstraZeneca, UK

“Clearly Vodafone’s judgment has been vindicated so arguably they would not do anything differently. However, there were lessons for all businesses from this case including the need to ensure that potential tax liabilities arising from corporate transactions are clearly allocated for the account of one or other party, even if the probability of the tax arising is remote. Alternative structures for similar commercial transactions could also be considered to increase certainty of the post-tax outcome. These considerations are especially important in the context of dealing with emerging markets where tax law is rapidly evolving.”

Andrew Loan, Macfarlanes, UK

“The decision gives the Indian tax authorities a bloody nose but I think most Indian tax advisers thought their approach was incorrect in this case and expected this result. Vodafone must be very relieved.”

Chris Sanger, head of global tax policy, Ernst & Young

“The question of taxing indirect disposals has now been considered by other countries and many will be hoping that this decision will result in those countries reconsidering their approaches. The prospect of tax on indirect disposals can undermine certainty and deter foreign direct investment.”

Sanjay Sanghvi of Khaitan & Co - India

“This is indeed a great relief for taxpayers and international investors community. This ruling now brings much needed clarity and certainty on cross-border transactions that have an impact on the change of ownership in a third jurisdiction,”

Sandy Bhogal of Mayer Brown, UK

“The decision will be greeted with relief by those who have used similar offshore holding structures for inbound investments and hopefully puts an end to the uncertainty over particular territorial tax issues which threatened to undermine foreign investment into India. It will be helpful if the Indian tax authorities fully abide by this decision with an immediate change in attitude to allow taxpayers with such structures to finalise open enquiries and disputes.”

Pranav Sayta, Ernst & Young, India

“It’s a good judgment and vindicates the position taken by Vodafone. I think it will give a lot of confidence to foreign investors and businesses in general about the Indian legal system. It should help business confidence in general.”

Bill Dodwell, head of tax, Deloitte UK

“The question India now faces is whether it thinks its market is so attractive that it can levy a capital gains tax on indirect sales. Many would think this would be poor economics and that it is better to look harder at the taxes levied directly on the local activities.”

Gagan Kumar of Archer & Angel, India

“It’s not only a respite for taxpayers but for the economy as well. FDI may not be challenged now.”



Kevin Phillips, Baker Tilly, UK

“If the Indian Supreme Court had upheld India’s right to tax an indirect disposal of shares in an Indian company in this way, it could have cast doubt on the treatment of similar transactions in other territories. Foreign investors in such territories can breathe a little easier as a result.”

Marc Sanders, VMW Taxand, Netherlands

“The decision shows that the use of tax haven companies in the (acquisition) structure attracts interest from tax authorities. Hopefully this decision will influence other tax authorities not to pursue similar proceedings.”

Keith O’Donnell, head of Taxand Luxembourg

“The Vodafone case brings welcome closure to a high profile example of a common problem. Challenges by tax authorities to perceived or real cases of tax avoidance are understandable; however the challenges need to follow the rule of law. If the law isn’t sufficient, then the legislators need to intervene. It should not be the role of the tax authorities to stretch the law to achieve a stated or implicit policy objective. This tendency to “stretch” has been all too common recently and the uncertainty it creates reduces the credibility of the tax system. Credit is due to the Indian Supreme Court for reaffirming the rule of law.”

COMMENT Lessons to learn

By Jack Grocott

The Supreme Court's Vodafone judgment is a momentous decision not only for India but also for a large number of foreign investors anxious to be a part of India's growth story.

From the outset, by ruling that the Indian tax authorities have no jurisdiction in the case, the Supreme Court has held that transfers of shares outside India that indirectly transfers Indian shares are not eligible to be taxed in India.

This is especially significant as a number of indirect transfers of Indian shares between non-residents were drawn into tax litigation in India in the days after the [Bombay High Court's](#) decision in Vodafone from October 2010. Additionally, the tax department was looking to re-open a number of cross-border mergers on the strength of the decision of the high court, including the Kraft-Cadbury and GE-Genpact deals. The decision brings much needed certainty to the taxation of such deals in India which will go a long way to attracting more foreign investment.

The verdict also dispels the fears about not just the legality of tax planning but the use of intermediate jurisdictions and treaty shopping. The ruling shows that the use of holding companies and investment structures in this instance was primarily driven by business/commercial purpose and that the use of these elements in international structuring should not always imply tax avoidance.

The decision will give taxpayers certainty and will enable multinationals to more efficiently plan their Indian operations.

As far as the government is concerned, the next step is the draft Direct Taxes Code (DTC) Bill 2010. One element of the DTC focuses on the topic of the taxation of off-shore transactions that involve an indirect transfer of Indian asset (Indian shares or Indian businesses). But as the DTC is unlikely to come into effect from April 1 this year, it is quite possible that the government might introduce such provisions in the forthcoming Finance Bill which will be presented by the finance minister to Parliament on March 16.

KEY LESSONS

- Taxpayers need to be careful of their obligations in India. Far from putting one's guard down, one should note from this protracted litigation, the government's aggression on revenue collection, and the extent they would go to claim it.
- India is a heavily source-driven country and its withholding regime is a crucial element of its tax collection tool. Taxpayers need to be aware that interest and penalties for failing to comply withholding obligations can be very large. A key point to remember is that Vodafone was a buyer in this case, and not the party who made the gains.
- One concern is that the concurring judgment states that when a non-resident pays to



another non-resident, the withholding provisions are not applicable unless the payer has some kind of presence in India. But a quick read of the law contrasts with this and taxpayers should expect the revenue to continue to argue this point.

- The tax department will continue to be aggressive and will continue its investigations into non-resident companies. This will lead to an increase, and not a reduction in litigation.

- When planning transactions, you need to think about how a court would view the structure. Taxpayers should consider the fact that most of the judges at the higher courts are not tax trained. This means you cannot rely on technical defences but instead rely on strong arguments that a judge could understand.
- Taxpayers need to control how much information on a transaction is made public. The revenue is not scared to use any little bit of information to support their argument.

Stats reveal Vodafone was destined to win

By Jack Grocott

Strong legal arguments were not the only thing on Vodafone's side in their triumph at the Indian Supreme Court, statistics show that a victory was inevitable.

The judgment from Chief Justice SH Kapadia was just the latest tax decision he has made that favoured the taxpayer.

As the table shows, over the past four years Kapadia has found 76% of tax cases in favour of the taxpayer. This is by far and above the percentages of his colleagues.



Chief Justice Kapadia

INCOME TAX JUDGMENTS PASSED BY SUPREME COURT JUDGES*

Name of Supreme Court judge	Assessee	Revenue	Assessee in percentage	Revenue in percentage	Ratio
Justice SH Kapadia **	65	29	76	24	
Justice SP Bharucha	72	101	42	58	
Justice Suhas Sen	13	27	33	67	
Justice Ranganathan	18	12	60	40	
Justice Sabyasachi Mukherjee	22	15	59	41	
Justice Jeevan Reddy	12	14	46	54	
Justice YV Chandrachud	10	12	45	55	
Justice K Venkataswami	4	3	57	43	
Justice YK Sabharwal	1	5	17	83	
Justice Arijit Pasayat	14	13	52	48	
Justice GB Pattanaik	8	16	33	67	
Justice RC Lahoti	15	14	52	48	
Justice BN Kirpal	5	5	50	50	

* In favour of

** Jan 1 2008 - Jan 24 2012

Source: Taxmann/Taxsutra

Further reading on

www.internationaltaxreview.com

[PROFILE: Chief Justice Kapadia](#)

[Read all 10 weeks of the Supreme Court hearing](#)

[Listen to a free archived webcast on the ruling](#)

How you can avoid becoming the next Vodafone

By Jack Grocott

If things hadn't gone Vodafone's then the company would now be looking at a \$2.5 billion tax bill. Here are a few tips on how to avoid becoming the next target for the Indian Tax Department.

Trust

"There is a huge trust deficit between the taxpayer and the tax administration, a consequence of which are cases like Vodafone. Taxpayers need to engage the tax authorities to undertake measures to reduce this trust deficit and work towards a healthy relationship between them. A demand for an enhanced taxpayer relationship programme should be made." – **Bela Mao, head of India tax, Shell**

Focus on risk

"A focus on tax risk is very critical for companies and can significantly impact the bottom line of a transaction. Taxpayers should factor this risk into significant acquisitions considering the litigation risk profile of India. Significant value can get eroded and most importantly companies can get stripped out of cash in tax litigations." – **Navin Jain, head of tax and treasury, Cairn Energy India**

Compliance

"In India, we have taxes at the federal level – for example, income tax, customs duty, service tax, and excise duty – the state level (VAT) and the municipal level (for example, entry tax and purchase tax). Each type of tax has its own monthly/quarterly/yearly compliance requirements and penalties for non-compliance. Any foreign entity coming to India should find out in detail

all taxes and compliance procedure applicable to it, to avoid penalties for non-compliance." – **Jitendra Grover, head of India tax, Nokia**

Perform a health check

"Perform a health check on your existing structures to see that they meet the tests laid down by the Supreme Court. Do not interpose an investment vehicle as an afterthought or at the time of exit of investment in India to avoid denial of tax benefit in India. The offshore investment vehicle or the SPV must be introduced since inception of the structure or as early as possible having regard to commercial requirements of the group and not merely at the time of exit from India to claim tax benefit, without any commercial substance for such vehicle. See that the legal documentation is robust in the sense that they should reflect the true business requirements of the group and the concerned transaction." – **Sanjay Sanghvi, Khaitan & Co, India**

Prepare and strategise

"Taxpayers should actively identify, prepare and strategise areas in their business that are likely to be under scrutiny from the authorities such as permanent establishments and attribution of income. This strategy is critical as it will benefit you in the long run. The earlier you start, the better. In India we like paper. The more documents you maintain at an early stage the easier you will be able to manage a dispute because you can't win without documents." – **Porus Kaka, senior advocate, India**

Coping strategy

"You need to come up with a coping strategy when preparing for an inevitable dispute with the authorities. The first plan is to maintain documentation for every aspect of your work. It



Jack Grocott, Navin Jain, Bela Mao, Neil Bowen

needs to be made available immediately on request because this will please the authorities and will show a certain amount of diligence from your end. However, this, among other aspects of disputes, requires a lot of work and is often very burdensome. But this is where I advise the liberal use of advisers as they can do a lot of the groundwork. Having said that, as a policy I do not send advisers along to meet the tax authorities. I feel that officials are more comfortable when speaking directly to the taxpayer. I have no evidence to suggest that this works to our advantage but it is something that not many companies take advantage of." – **Neil Bowen, head of India tax, BNP Paribas**

Alternate dispute resolution

"If a dispute has commenced, then a non-resident taxpayer can opt for the alternate dispute resolution mechanism. The advantage of this mechanism is that a potential order of a tax officer can be taken to the income tax tribunal for review, and the tribunal can direct any changes to the order as it deems fit. Such changes are binding on the tax officer, but if they go against the non-resident taxpayer, it still has its appellate remedies available to it, and the tax demand – if any raised – by the tax officer is kept at bay until the income tax tribunal formally decides the issue." – **Akil Hirani, managing partner, Majmudar & Co, India**

Why the Vodafone ruling leaves China standing alone in the cold

By Jack Grocott

With the victory for Vodafone, a message has been sent out to governments around the world that pursuing the taxation of the indirect transfer of shares is an unsustainable policy. But China won't listen.

The decision by the Indian Tax Department to issue an assessment for Vodafone's 2007 purchase of a 67% stake in Hutchison Essar dumbfounded tax professionals around the world, but other jurisdictions liked the move as ambitious and decided to do the same.

The most vocal supporter of this approach was China which introduced Notice 698 in November 2009, in what many believe as a direct response to the Vodafone matter.

Notice 698 states that the authorities will impose a 10% withholding tax on capital gains derived by non-resident enterprises from the transfer of equity interest in Chinese resident enterprises.



Brendan Kelly

Traditional tax planning strategies use an offshore holding company to invest into China and exit from the country by transferring the offshore holding company without paying any China withholding tax. One purpose of 698 is to attack such arrangements.

The circular requires a non-resident seller to disclose an indirect transfer of a resident company to the tax authorities within 30 days after signing the share sale agreement if the tax burden in the intermediate holding company's jurisdiction is less than 12.5%, or if that jurisdiction exempts foreign-sourced income from tax.

To see Vodafone overturned leaves China standing in a potentially very lonely, position in its attempt to extend its taxing jurisdiction beyond its borders in this way.

"The Vodafone decision highlighted the importance of certainty for taxpayers in the tax law, which has been a major issue for companies wrestling with Notice 698 potentially applying to transactions that on their face seem unrelated to China," said Brendan Kelly, of Baker & McKenzie, Shanghai.

While it is difficult to predict how China might react to the decision, it may put additional pressure on the tax authorities there to clarify a number of questions regarding the scope of Notice 698.

"While we have all hoped for changes to Notice 698, China lacks the level of multinational taxpayer access to an independent judiciary that India has shown with this decision. This puts India well-ahead of China, and while India has carried a reputation as the most aggressive taxing jurisdiction in Asia for years, China may quickly stand alone with this unfortunate distinction unless decisive action is taken," said Kelly.



The decision also pointed to the lack of specific general anti-avoidance legislation in India, where in China it could be argued that the combination of GAAR rules and Notice 698 are sufficient to provide jurisdiction in indirect transfer cases.

Therefore, while China might feel some additional pressure to clarify the application of

Notice 698, it is hard to imagine a wholesale repeal.

"If China were to make changes or clarifications to Notice 698, we expect that the focus would be to limit the scope to go after more empty structures, as they have in most of the published cases in China to date," said Kelly.

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