An Analysis of the Supreme Court Judgment in the Vodafone Case

The authors analyse the Supreme Court’s ruling in the Vodafone case, in which the Court held that an offshore share transfer between two non-residents was not subject to tax in India.

1. Introduction

In a landmark judgment, the Supreme Court of India in Vodafone (2012) set aside the judgment of the Bombay High Court (High Court) and allowed the appeal of Vodafone International Holdings B.V. (VIHB). The Supreme Court approved of the ownership structure of Vodafone through various holding and subsidiary companies. The offshore transaction involving the transfer of shares of CGP Investments (CGP, a company incorporated in the Cayman Islands) by Hutchison Telecommunications International Limited (HTIL) to VIHB (a company incorporated in the Netherlands) was held to be a bona fide structured foreign direct investment into India which fell outside India’s territorial tax jurisdiction, and thus was not taxable. This offshore transaction evidences participative investment and was held not to be a sham or planned tax avoidance transaction.

The Court concluded that certainty and stability are an integral and basic foundation of any fiscal system. Legal doctrines such as limitation of benefits and look-through are matters of policy, and it is for the government of any country to have them incorporated in its treaties and domestic law to avoid conflicting views.

The Supreme Court rejected the conclusion of the High Court that the transfer of a single CGP share (which was the entire shareholding of CGP) by HTIL to VIHB would amount to the transfer of any capital assets in India attracting capital gains tax in India. The Supreme Court emphasised that it is the task of the Court to ascertain the legal nature of the transaction, and when doing so it must look at the entire transaction as a whole and not adopt any dissecting approach. As regards tax avoidance or evasion, the Court went through jurisprudence laid down in various English court cases and in two Indian cases, McDowell and Azadi Bachao Andolan, and observed that all tax planning is not illegal, illegitimate or impermissible.

2. Facts of the Case

Vodafone International Holdings B.V. (VIHB), a Dutch-based Vodafone entity, acquired a controlling stake in Hutchison Essar Limited (VEL), an Indian company, from a Mauritius-based Hutchison Telecommunications International Limited (HTIL) by acquiring shares of CGP Investment (CGP), a Cayman Islands company (which belonged to HTIL) in February 2007. CGP held various Mauritian companies, which in turn held a majority stake in HEL. In September 2007, the Income Tax Department of India (the tax authorities) issued a show-cause notice to VIHB for failure to withhold tax on the amount paid for acquiring the stake in CGP, as the tax authorities believed that HTIL was subject to tax in India on capital gains it earned from the transfer of shares of CGP, as CGP indirectly held the stake in HEL. The holding structure of this transaction can be illustrated as in Figure 1.

VIHB filed a writ petition to the Bombay High Court challenging the notice, contending that the tax authorities had no jurisdiction over the transaction, as the transfer of shares had taken place outside India between two companies incorporated outside India, and the subject of the transfer was shares, the situs of which was outside India. However, the High Court dismissed the writ petition of VIHB. On appeal, the Supreme Court remanded the matter to the tax authorities. Accordingly, the tax authorities passed the order which was challenged by VIHB with a writ petition, which was then dismissed by the High Court.

3. Main Contentions of the Tax Authorities

The tax authorities made the following arguments in this case.

There is a conflict between the Supreme Court’s decisions in Azadi Bachao Andolan (2003) and McDowell (1985) and thus Azadi Bachao Andolan and McDowell must be overruled to the extent that it departs from McDowell. This is in the context of determining whether all tax planning is illegal and impermissible, and thus a transaction carried out for tax purposes must be dissected and evaluated.

Income from the sale of the CGP share would fall within section 9 of the Income Tax Act, 1961 (the ITA) as that section provides for look-through. The word “through”...
in section 9 means “in consequence of”. It was argued that if the transfer of a “capital asset situate [sic] in India” happens “in consequence of” something which has taken place overseas (including the transfer of a capital asset), all income derived – even indirectly, even abroad – from such transfer becomes taxable in India. Even if control over HEL were to be transferred in consequence of the transfer of the CGP share outside India, it would still be covered by section 9. Under section 9(1)(i), it is permissible to look through the transfer of shares of a foreign company holding shares in an Indian company and treat the transfer of shares of the foreign company as equivalent to the transfer of the shares of the Indian company, on the premise that section 9(1)(i) covers direct and indirect transfers of capital assets.

HTIL, under the share purchase agreement, had extinguished its rights of control and management over HEL and, consequent upon such extinguishment, there was a transfer of a capital asset situated in India. In fact, it was the primary argument advanced by the tax authorities that the share purchase agreement, commercially construed, evidences a transfer of HTIL’s property rights by their extinguishment. Under the share purchase agreement, HTIL had directly extinguished its rights of control and management, which are property rights, over HEL and its subsidiaries and, consequent upon such extinguishment, there was a transfer of a capital asset situated in India.

In support of these arguments, the tax authorities highlighted various features of the share purchase agreement. HTIL ignored its subsidiaries and was exercising the voting rights over the CGP and the HEL shares directly, ignoring all the intermediate subsidiaries which are wholly owned and non-operational. Extinguishment took place without the CGP share, and by virtue of various clauses in the share purchase agreement, as HTIL itself disregarded the corporate structure it had set up.

CGP was introduced only with the intention to avoid tax, and it had no business or commercial purpose.

CGP was a mere holding company and because it could not conduct business in the Cayman Islands, the situs of the CGP share existed where the underlying assets are situated, namely in India.

The transfer of the CGP share was not adequate in itself to achieve the object of consummating the transaction between HTIL and VIHB; there was a transfer of other rights and entitlements, and these rights and entitlements constituted, in themselves, capital assets.

As the transfer of a controlling interest is taxable in India, VIHB should have deducted tax at source under section 195 of the ITA. VIHB can be held liable as a representative assessee under section 163 of the ITA.
4. Decision of the Supreme Court

In delivering its judgment, the Supreme Court made certain observations on important international business practices apart from the domestic tax provisions. These observations can have far-reaching impact not only in India but also in international tax jurisprudence. The observations could impact not only existing pending matters before various judicial authorities, but also the structuring of future transactions. The observations of the Supreme Court are briefly summarized below.

4.1. Separate-entity principle and basis of holding structure

The Court observed that corporate structures are primarily created for business and commercial purposes, and multinational companies that make offshore investments always aim at better returns to their shareholders and the growth of their companies. Corporations created for such purpose are legal entities distinct from their shareholders, and are capable of enjoying rights and being subject to duties that are not the same as those enjoyed or borne by their shareholders.

Corporate and tax laws, particularly as regards corporate taxation, generally are based on the separate-entity principle, i.e. a company is treated as a separate person. The ITA, in the matter of corporate taxation, is based on the principle of the independence of companies and other entities subject to income tax. Companies and other entities are viewed as economic entities with legal independence vis-à-vis their shareholders or participants. Upon incorporation, the corporate property belongs to the company, and shareholders have no direct property rights thereto, but merely to their shares in the undertaking. These shares constitute items of property which are freely transferable in the absence of any express provision to the contrary.

It is well accepted that a subsidiary and its parent are totally distinct taxpayers. Consequently, entities subject to income tax are taxed on profit derived by them on a stand-alone basis, irrespective of their actual degree of economic independence and regardless of whether profit is reserved or distributed to the shareholders or participants. The shareholders or participants that are subject to income tax are generally taxed on profit derived in consideration of their shareholding or participation (e.g. capital gains). It is also fairly well settled that for tax treaty purposes a subsidiary and its parent are also totally separate and distinct taxpayers.

However, the fact that a parent company exercises its influence as a shareholder on its subsidiary does not generally imply that the subsidiary is to be treated as a resident of the state in which the parent company resides.

Where the expertise of a subsidiary’s directors is transferred to other persons or bodies or where the decision making of a subsidiary’s directors has become fully subordinate to the holding company such that the subsidiary’s directors are mere puppets, the subsidiary may be deemed to have become resident in the same country as the holding company.

Similarly, if a controlling non-resident enterprise makes an indirect transfer through an abuse of organizational form or legal form and without a reasonable business purpose, so as to result in tax avoidance or avoidance of withholding tax, the tax authorities may disregard the form of the arrangement. Where a transaction is used principally as a colourable device for the distribution of earnings, profit or gain, it is possible to review all the facts and circumstances surrounding the transaction. It is in such cases that the principles of piercing the corporate veil, substantive over form or beneficial ownership arise.

It is a common practice in international law (which is the basis of international taxation) for foreign investors to invest in Indian companies through an interposed foreign holding or operating company, for both tax and business purposes. In doing so, foreign investors are able to avoid the lengthy approval and registration processes required for a direct transfer (i.e. without a foreign holding or operating company) of an equity interest in a foreign-invested Indian company.

Many of the offshore holdings and arrangements are undertaken for sound commercial and legitimate tax planning reasons, without any intent to conceal income or assets from the home country tax jurisdiction, and India has always encouraged such arrangements, unless the arrangement is fraudulent or fictitious.

Holding structures are recognized in both corporate and tax law. Special purpose vehicles and holding companies are recognized in company law; in the Takeover Code promulgated by the Securities Exchange Board of India; and in income tax law. When it comes to taxation of a holding structure, at the threshold, the burden is on the tax authorities to allege and establish abuse.

The tax authorities may invoke the substance-over-form principle or attempt to pierce the corporate veil only after it is established, based on the facts and circumstances surrounding the transaction, that the challenged transaction is a sham or constitutes tax avoidance. If a structure is used for circular trading, round-tripping or to pay bribes, the relevant transactions, although having a legal form, should be disregarded by applying the test of fiscal nullity.

Similarly, where the tax authorities find that an entity which has no commercial or business substance has been interposed in a holding structure only to avoid tax, by applying the test of fiscal nullity it would be possible for the tax authorities to disregard the interposed entity.

However, this must be done at the threshold. In such cases the “look-at” principle may be applied. Under this principle, the tax authorities or the court must look at a document or a transaction in the context to which it properly belongs. It is the task of the tax authorities or the court to ascertain the legal nature of a transaction, and in doing so the tax authorities or the court must look at the entire transaction holistically (i.e. as a whole) and not take the approach of dissecting the transaction.
The tax authorities cannot start with the question as to whether the challenged transaction is a tax deferral or saving device. Rather, they should apply the look-at test to ascertain the true legal nature of the transaction. To date, genuine strategic tax planning has not been rejected by the decision of any English courts. Every strategic foreign direct investment coming to India, as an investment destination, should be regarded in a holistic manner. The following factors are determinative and should be borne in mind: the concept of participation in investment, the duration of time during which the holding structure exists; the period of business operations in India; the generation of taxable revenue in India; the timing of the exit; and the continuity of business upon such exit.

The burden is on the tax authorities to identify the scheme and its dominant purpose. The corporate business purpose of a transaction is evidence of the fact that the challenged transaction is not undertaken as a colourable or artificial device. The stronger the evidence of a device, the stronger must be the corporate business purpose to overcome the evidence of a device.

A corporate structure created for genuine business purposes is one that is generally created or acquired at the time when (1) the investment is being made, (2) further investments are being made, (3) the group is undergoing financial or other overall restructuring or (4) operations such as consolidation are carried out. The tax authorities or courts can always examine whether these corporate structures are genuine and set up legally for a sound and genuine commercial purpose. The burden is entirely on the tax authorities to show that the incorporation, consolidation, restructuring etc. has been effected to achieve a fraudulent, dishonest purpose, so as to defeat the law.

4.2. Whether section 9 is a look-through provision

Sections 5 and 9 of the ITA, 1961 are reproduced hereunder for the ease of understanding the observations of the Supreme Court.

Scope of total income:

5. [...] (2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which:
(a) is received or is deemed to be received in India in such year by or on behalf of such person; or
(b) accrues or arises or is deemed to accrue or arise to him in India during such year.

Income deemed to accrue or arise in India:

9. (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, or through the transfer of a capital asset situate in India.[...]

In the present case, the Court was concerned with the last sub-clause of section 9(1)(i), which refers to income arising from the transfer of a capital asset situate in India. The charge to capital gains tax arises upon the transfer of a capital asset situate in India. The above-mentioned sub-clause consists of three elements, namely transfer, existence of a capital asset and location of such asset in India. All three elements must exist in order for the last sub-clause to be applicable.

The income accruing or arising to a non-resident outside India upon the transfer of a capital asset situated in India is fictionally deemed to accrue or arise in India, and such income is made liable to tax in India. Indeed, this is the main purpose behind the enactment of section 9(1)(i) of the ITA. The courts must give effect to the language of a provision when it is unambiguous and admits of no doubt regarding its interpretation, particularly when a legal fiction is embedded in the relevant provision. A legal fiction has a limited scope; it cannot be expanded by giving purposive interpretation, particularly if the result of such interpretation is to transform the concept of chargeability which is also there in section 9(1)(i), particularly when one reads section 9(1)(i) with section 5(2)(b) of the ITA.

For the above reasons, section 9(1)(i) cannot by a process of interpretation be extended to cover indirect transfers of capital assets or property situated in India. To do so would amount to changing the content and ambit of section 9(1)(i). In the Vodafone case, the Court refused to rewrite section 9(1)(i), noting that the legislature did not use the words “indirect transfer” in section 9(1)(i).

The words “directly or indirectly” in section 9(1)(i) refer to the income, and not the transfer of a capital asset (property).

For these reasons, the Supreme Court held that section 9(1)(i) is not a look-through provision.

4.3. Whether there was extinguishment of the property rights of HTIL

The Supreme Court reiterated that in this case the Court is concerned with the sale of shares and not with the sale of assets, item-wise. It is evident from the facts that this case involves the sale of the entire investment made by HTIL through a company, namely CGP, in the Hutchison structure. Here, the Supreme Court applied the look-at test.

The tax authorities vacillated before the High Court in their arguments. The Court noted that such vacillation was due to the adoption of a dissecting approach by the tax authorities in the course of their arguments. According to the look-at test, it was the task of the tax authorities to ascertain the legal nature of the transaction and, in doing so, the tax authorities must look at the entire transaction holistically and not adopt a dissecting approach.

The Supreme Court remarked that there is a conceptual difference between a preordained transaction which is created for tax avoidance purposes on the one hand, and a transaction which evidences investment to participate in India on the other.

The Supreme Court observed that the structure in this case was not created or used as a sham or a means of tax avoidance. Neither HTIL nor VIHB was a fly-by-night opera-
tor or short-term investor. If one applies the look-at test, without invoking a dissecting approach, the extinguishment took place because of the transfer of the CGP share and not by virtue of various clauses of the share purchase agreement. Where the structure has existed for a considerable length of time, as in this case generating taxable revenue since 1994, and the Supreme Court was satisfied that the transaction satisfied all the parameters of participation in investment, then the Court need not address questions such as de facto control vs. legal control or legal rights vs. practical rights.

The fact that the parent company exercises influence as a shareholder on its subsidiaries cannot obliterate the decision-making power or authority of the subsidiary’s directors. The subsidiary’s directors cannot be reduced to mere puppets. The decisive criterion is always whether the parent company’s management has such direct interference with the subsidiary’s core activities that the subsidiary can no longer be regarded as performing those activities on the authority of its own executive directors.

In an international investment, exit coupled with continuity of business is one of the important circumstances that indicates the commercial or business substance of a transaction. In this case, the share purchase agreement was needed to readjust the outstanding loans between the companies; to provide for standstill arrangements in the period between the date of signing the share purchase agreement on 11 February 2007 and its completion on 8 April 2007; to provide for a seamless transfer; and to provide for fundamental terms of price, indemnities, warranties etc.

On the facts and circumstances of the case, the right of HTIL, if at all it is a right, to direct a downstream subsidiary as to the manner in which it should vote, would fall under the category of a persuasive position or influence rather than having power over the subsidiary.

The Supreme Court held that under the HTIL structure, as it existed in 1994, HTIL occupied only a persuasive position or influence over the downstream companies as regards manner of voting, nomination of directors and management rights. The minority shareholders or investors had participative and protective rights (including right of first refusal or tag-along rights, as well as call and put options which provided for exit) which flowed from the CGP share. The entire investment was sold to VIHB through the investment vehicle (CGP). Consequently, there was no extinguishment of rights as alleged by the tax authorities.

4.4. Role of CGP in the transaction

There is a fundamental difference in cross-border investments made overseas and domestic investments. Domestic investments are made in the home country and are meant to remain as they were. When a cross-border investment is made overseas, away from the natural residence of the investing company, provisions are usually made for an exit route to facilitate an end to the investment as and when necessary for sound business and commercial reasons, which is generally outside the scope of judicial review.

The Supreme Court noted that CGP was incorporated in 1998 in the Cayman Islands, and it was in the Hutchison structure from 1998. The current transaction was of divestment and, therefore, the transaction of sale was structured at an appropriate level so that the buyer really acquired the same degree of control as was previously exercised by HTIL. VIHB agreed to acquire companies, and the companies that it acquired controlled a 67% interest in HEL.

The sale of the CGP share, for exiting from the Indian telecommunication sector, cannot be considered as a preordained transaction, with no commercial purpose other than tax avoidance. The sale of the CGP share was a genuine business transaction, not a fraudulent or dubious means of avoiding capital gains tax.

4.5. Acquisition of the CGP share with “other rights and entitlement”

The Court reiterated that a controlling interest is an incident of ownership of shares in a company, something which flows out of the holding of shares. A controlling interest, therefore, is not an identifiable or distinct capital asset independent of the holding of shares, and the nature of the transaction must be ascertained from the terms of the contract and the surrounding circumstances. A controlling interest is inherently a contractual right and not a property right, and its transfer cannot be considered as transfer of property and thus a capital asset unless the statute stipulates otherwise. The acquisition of shares may carry the acquisition of a controlling interest (which is
purely a commercial concept), and tax is levied on the transaction, not on its effect.

Control of a company resides in the voting power of its shareholders, and shares represent an interest of a shareholder which is made up of various rights contained in the contract embedded 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. Shares, and the rights which emanate therefrom, flow together and cannot be dissected. Thus, control and management is a facet of the holding of the shares.

The acquisition of the CGP share that gave VIHB an indirect control over three levels of companies evidences a straightforward share sale and not an asset sale. The Supreme Court concluded that the High Court erred in holding that VIHB acquired 67% of the equity capital of HEL; the High Court was confused because it adopted a dissecting approach to examine each individual asset.

The High Court should have applied the look-at test under which the entire Hutchison structure, as it existed, would have been looked at holistically. The facts clearly revealed that the case concerns investment into India by a holding company (parent company), HTIL, through a maze of subsidiaries. When one applies the nature- and character-of-the-transaction test, confusion arises if a dissecting approach to examining each individual asset is adopted. As stated, CGP was treated in the Hutchison structure as an investment vehicle. As a general rule, where a transaction involves a transfer of shares lock, stock and barrel, so to speak, such a transaction cannot be broken up into separate individual components, assets or rights (such as the right to vote, the right to participate in company meetings, management rights, controlling rights, control premium, brand licences), as shares constitute a bundle of rights.

On the facts, the Supreme Court believed that the High Court should have examined the entire transaction holistically. VIHB rightly asserted that the transaction in question should be looked at as an entire package. The items mentioned above, such as control premium, non-competitive agreement, consultancy support, customer base, brand licences and operating licences, were all an integral part of the holding subsidiary structure that existed for almost 13 years, generating huge revenues.

The Supreme Court emphasized that the mere fact that, at the time of exit, capital gains tax is not payable or exigible to tax would not render the entire “share sale” (investment) a sham or a means of tax avoidance. According to the Supreme Court, the High Court has failed to appreciate that the payment of USD 11.08 billion was for the purchase of the entire investment made by HTIL in India. The payment was for the entire package. The parties to the transaction did not agree upon a separate price for the CGP share and for what the High Court calls “other rights and entitlements” (including options, right to non-competitive, control premium, customer base etc.).

Thus, it was not for the tax authorities to split the payment and consider a part of such payment for each of the above items. The transaction remained a contract of outright sale of the entire investment for a lump-sum consideration. What is needed is to look at the entire ownership structure set up by Hutchison as a single consolidated bargain and to interpret the transactional documents, while examining an offshore transaction of the nature involved in this case.

4.6. India–Mauritius Income Tax Treaty and tax residency certificate

Neither the India–Mauritius Income Tax Treaty (1982) (hereinafter the Treaty) nor Circular 789 of 13 April 2000 issued by the Central Board of Direct Taxes, would preclude the tax authorities from denying treaty benefits, if it is established, on facts, that the Mauritius company was interposed as the owner of the shares in India, at the time of disposal of the shares to a third party, solely with a view to avoiding tax without any commercial substance.

The Supreme Court emphasized that a sham transaction, a colourable device or the adoption of a dubious method to evade tax cannot be recognized. But to say that the Treaty will recognize foreign direct investment and foreign indirect investment only if it originates from Mauritius, and not from investors from third countries, incorporating a company in Mauritius, is pitching it too high, especially when statistics reveal that for the last decade foreign direct investment in India was USD 178 billion and, of this, 42% (USD 74.56 billion) was through the Mauritian route.

Large amounts can be routed back to India using the tax residency certificate as a defence, but once it is established that such an investment is black money or capital that is hidden, it is nothing but circular movement of capital known as round-tripping. In such cases, the tax residency certificate may be ignored, as the transaction is deemed to be fraudulent and against national interests. However, the tax residency certificate may be accepted as conclusive evidence for purposes of accepting the status of residents, as well as beneficial ownership for purposes of applying the Treaty; the certificate may be ignored if the Treaty is abused for the fraudulent purpose of tax evasion.

The tax authorities may not tax a subject without statutory support, and in this case the Supreme Court also acknowledged that every taxpayer is entitled to arrange its affairs so that its taxes will be as low as possible, and that the taxpayer is not bound to choose that pattern that will most replenish the treasury. The tax authorities’ argument that the rationale laid down in McDowell is contrary to what was laid down in Azadi Bachao Andolan, in the view of Supreme Court was unsustainable and, therefore, calls for no reconsideration by a larger bench. (The McDowell case was delivered by a larger bench of the Court than the decision delivered in the Azadi Bachao Andolan case.)

4.7. Concept of source

According to the Supreme Court, the source of an item of income has been construed to be where the transaction of sale takes place, and not where the item of value that was the subject of the transaction, was acquired or derived.
HTIL and Vodafone are offshore companies, and because the sale took place outside India, applying the source test, the source of the related income is also outside India, unless legislation ropes in such transactions.

The Supreme Court emphasized that substantial territorial nexus between the income and the territory which seeks to tax that income is of prime importance to levy tax. The expression used in section 9(1)(i) is “source of income in India”, which implies that income arises from that source; there is no question of income arising indirectly from a source in India. The expression used is “source of income in India” and not “from a source in India”.

4.8. Applicability of sections 195 and 163 of the ITA

For the ease of understanding the observations of the Supreme Court, the relevant portion of sections 163 and 195 of the ITA is reproduced below:

C. Representative assesses – Special cases

Who may be regarded as agent:

163.

(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 [...]

195.

(1) Any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest [...] 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 [...]

Section 195 imposes an obligation on the payer to deduct tax at source from payments made to non-residents which payments are chargeable to tax. Such payment(s) must have an element of income embedded therein which is chargeable to tax in India. If the amount paid or credited by the payer is not chargeable to tax, no obligation to deduct tax would arise.

The expression "any person", as used in section 195, in the view of the Court looking at the context in which section 195 has been placed, would mean any person who is resident in India.

The Supreme Court observed that a shareholding in companies incorporated outside India (in this case, CGP) is property located outside India. Where such shares become the subject matter of an offshore transfer between two non-residents, there is no liability to capital gains tax. In such a case, no question of deducting tax would arise.

The object of section 195 is to ensure that tax due from non-resident persons is secured at the earliest point in time so that there is no difficulty in collecting the tax subsequently at the time of regular assessment. The Vodafone case concerns the transaction of an “outright sale” between two non-residents of a capital asset (share) outside India. Further, this transaction was entered into on a principal-to-principal basis. Therefore, there is no liability to deduct tax at source.

The tax presence of the person responsible for deduction must be viewed in the context of the transaction that is subject to tax, and not with reference to an entirely unrelated matter. The investment made by Vodafone Group companies in Bharti did not make Vodafone’s presence such that it is subject to the ITA and the jurisdiction of the tax authorities for deduction of tax. Tax presence must be construed in context, and in a manner that brings the non-resident assessee under the jurisdiction of the Indian tax authorities. Lastly, in the Vodafone case, the tax authorities failed to establish any connection with section 9(1)(i). Under the circumstances, section 195 is not applicable.

Section 163 does not relate to the deduction of tax. It relates to the treatment of a purchaser of an asset as a representative assessee. A reading of section 163 of the ITA shows that, under the given circumstances, certain persons may be treated as a representative assessee on behalf of a non-resident specified in section 9(1). This would include an agent of a non-resident who is also treated as an agent under section 163 of the ITA, which in turn deals with special cases where a person may be regarded as an agent. Once a person comes within any of the clauses of section 163(1), such a person will be deemed to be the “agent” of the non-resident for purposes of the ITA. However, the mere fact that a person is an agent or is to be treated as an agent, would not lead to the automatic conclusion that such person becomes liable to pay taxes on behalf of the non-resident. It would only mean that such person is to be treated as a representative assessee. Section 161 of the ITA makes a representative assessee liable only as regards the income in respect of which such person is a representative assessee.

Section 195 would apply only if payments are made from a resident to a non-resident, and not between two non-residents situated outside India. In the present case, the transaction was between two non-resident entities through a contract executed outside India. Consideration was also passed outside India. That transaction has no nexus with the underlying assets in India. In order to establish a nexus, the legal nature of the transaction must be examined, rather than the indirect transfer of rights and entitlements in India. Consequently, Vodafone was not legally obliged to respond to the section 163 notice which relates to the treatment of a purchaser of an asset as a representative assessee. On the facts, it was held that section 163(1)(c) is not applicable, as there is no transfer of a capital asset situated in India.
4.9. Transfer pricing provisions

Under the heading "Computation of income from international transaction having regard to arm’s length price", section 92 of the ITA, which deals with the transfer pricing provision, provides as follows:

92

(1) Any income arising from an international transaction shall be computed having regard to the arm’s length price [...]

Explanation. For the removal of doubts, it is hereby clarified that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm’s length price.

4.9.1. Taxability

Under the ITA, transfer pricing provisions apply when the parties are associated enterprises. In the current transaction, the parties thereto (HTIL and VIHB) are not associated enterprises, and thus transfer pricing provisions are not applicable. However, a question that can arise when the income is not chargeable to tax in India, concerns whether the transfer pricing provisions may be applicable even if such transaction is between two associated enterprises.

The Authority for Advance Ruling (AAR) had occasion to deal with similar issues in the DANA Corporation (2009)5 and Amiantit6 cases. These cases involved the capital gains provisions, and on the facts it was held that the transaction was not subject to capital gains tax in India. In all these cases the relevant transactions were between two associated enterprises.

However, the AAR observed as follows:

It must be noted that the [transfer pricing] provision is not an independent charging provision. As the section heading itself shows, it is a provision dealing with "Computation of income from international transactions". The opening part of the relevant Section says that "any income arising from an international transaction shall be computed having regard to the arm’s length price". The expression 'income arising' postulates that the income has arisen under the substantive charging provisions of the Act. In other words, the income referred to in the Section is nothing but the income captured by one or the other charging provision of the Act. In such a case, the computation aspect is taken care of by the relevant Section.

The income is traceable to 'Capital gains' which is one of the heads of income. If, the income cannot be said to arise, the [transfer pricing] provision of the Act does not come to the aid of Revenue Authorities, even though it is an international transaction between two associated enterprises. The expression 'income arising' in [transfer pricing] provisions is not used in a sense wider than or different from its scope and connotation elsewhere in the Act. [Transfer pricing] provisions obviously are not intended to bring in a new head of income or to charge the tax on income which is not otherwise chargeable under the Act.

In the case of In re. Vanenburg Group B.V. (2007),7 the AAR, in referring to the provisions in Chapter X, noted:

"These are again machinery provisions which would not apply in the absence of liability to pay tax".

Thus, in the case of controlled transactions between associated enterprises, if no income is chargeable under the ITA, the question of evaluating such transactions under the transfer pricing provisions of the ITA does not arise.

Further, some observations of the Supreme Court could also have an effect on the interpretation of the transfer pricing provisions.

4.9.2. Concept of control

The Supreme Court dealt with the question of the nature of the "control" that a parent company has over its subsidiary. It observed that in appropriate cases of piercing the corporate veil, the parent and the subsidiary may be deemed to form one entity. However, barring such circumstances, a subsidiary has its own power, functions and responsibilities and those are governed by the laws of the place of its incorporation. Thus, even though a subsidiary may normally comply with a request of its parent company, it is not simply as a puppet of the parent company. The distinction is between having power and being in a persuasive position. In the case of multinationals, subsidiaries enjoy a great deal of autonomy in the country of incorporation except where a subsidiary is created or used as a sham.

The directors of a subsidiary owe their duties to the subsidiary and not to the parent company. One must distinguish between (1) the influence of the parent company as a shareholder of the subsidiary and (2) the decision-making power or authority of the subsidiary’s directors. Where the parent company’s management has direct interference in the subsidiary’s core activity, that subsidiary cannot be regarded as performing the activities on the authority of its executive directors. Although the parent and the subsidiary work as a group, each subsidiary must protect its own separate commercial interests. Considering the facts of the Vodafone case, the Court was of the view that HTIL’s right to direct a downstream subsidiary as to the manner in which it should vote fell under the category of persuasive position, rather than having a power over the subsidiary.

A minority investor has what is called as a participative right, which is a subset of protective rights. These participative rights in certain instances restrict the powers of the shareholder with a majority voting interest to control the operations or assets of the investee company. These rights enable the minority to overcome the presumption of consolidation of the operations or assets by the controlling shareholder.

These observations of the Supreme Court on the concept of control and the exercise of protective rights by minority shareholders could have some bearing on the nature of control exercised by two independent parties pooling their resources and doing business together to exploit business opportunities. When the transactions between a joint-venture company and independent parties (joint ventures) are being evaluated under the transfer pricing provisions of the ITA, one must determine whether
control can be said to be exercised in such cases, keeping the above observations of Supreme Court in mind.

4.9.3. Structuring of a multinational organization

The Supreme Court also observed that when a business becomes big enough, it typically reconfigures itself into a corporate group by dividing itself into a multitude of commonly owned subsidiaries, and it also causes various entities in the group to guarantee each other’s debts. Subsidiaries thereby reduce the amount of information that creditors need to gather, and this also promotes the benefits of specialization.

Thus, the structure of parent and subsidiaries is created out of the business exigencies and in order to bring efficiency. It is common to grant intercompany loans and guarantee each other’s debt. Options do not grant any rights until the options are exercised.

In the Vodafone case, certain parties were holding options to acquire the shares in HEL. However, until the option is exercised, it does not grant any management rights. At the most, options can be regarded as potential shares.

Thus, intercompany loans, guarantees, options etc. within a multinational group emanate from business needs, and such grouping is based on the principle of internal correlation. These observations can be useful when evaluating such transactions from a transfer pricing perspective.

4.9.4. Valuation

The Supreme Court observed that valuation cannot be the basis of taxation, as valuation is a matter of opinion. It can be regarded as a science, but not as the law. The basis of taxation is profit, income or receipts. To arrive at a fair value, one must take into consideration the business realities, such as the business model, duration of operations, cash flow, discounting factor, assets and liabilities and intangibles. The exercise of finding an arm’s length price is essentially one of valuation and involves the formation of an opinion. This is why there are the concepts of safe harbour and range of arm’s length prices. Ultimately, it is the income determined on the basis of the arm’s length price that becomes the basis of taxation, and thus the evaluation of the arm’s length price needs to take into account all the characteristics of the controlled transaction. Such evaluation should not be arbitrary or inexact, as this would be against the very charge of tax under the ITA.

4.9.5. Recognition of agreements

The Court observed that where a transaction involves the transfer of shares lock, stock and barrel, so to speak, such a transaction cannot be broken up into separate individual components, assets or rights (such as the right to vote, the right to participate in the company meetings, management rights, controlling rights, a control premium and brand licences), as the shares constitute a bundle of rights. The payment in the Vodafone case was for the entire package. The parties to the transaction did not agree on a separate price for other rights and entitlements in addition to the CGP share. The tax authorities must respect the agreement entered into between the two private parties, and thus it was not for the tax authorities to split the consideration by dissecting the agreement.

Thus, when evaluating a transaction for arm’s length purposes, one would need to give effect to the agreement between the parties, unless the very conduct of the business is completely different from the agreement. If the latter were the case, it would mean that the agreement itself is akin to a sham document.

5. Conclusion

The Supreme Court’s decision in the Vodafone case lays down very important principles relating to tax jurisprudence, which will have a binding judicial effect in India. However, it will also have international impact in the interpretation of tax law. The Court has also dealt with issues relating to corporate law and corporate governance.

The decision has been rendered in the context of the law as prevailing on the date of pronouncement of the judgment. By this decision it is implied that Indian tax law has not kept pace with the changing commercial reality. The Court has reiterated the advice of the Azadi Bachao Andalon case to the government, to incorporate relevant provisions in domestic tax law and in tax treaties if it is their purpose to provide for looking through intermediary companies and taxing indirect transfer of business assets in India, so that investors know where they stand before they conclude a transaction in India.

The Court noted that foreign direct investment flows towards locations with a strong governance infrastructure, simple laws and an efficacious enforcement of laws by the legal system, and that certainty is integral to the rule of law. These observations are noteworthy and should set the tone for the future policy, rules and regulations.