

# WNTS Insight

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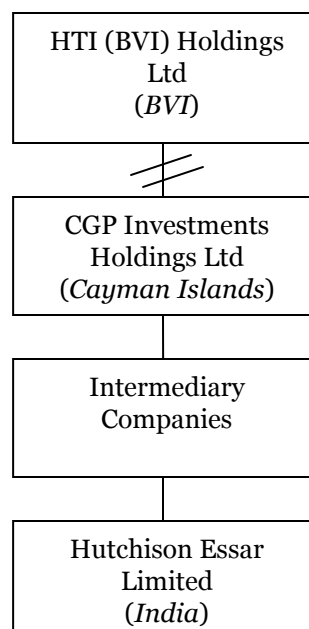
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## Vodafone's Indian tax case win has important implications for US multinationals

The Indian Supreme Court issued its decision in the landmark *Vodafone* case on January 20, concluding that India should not tax Vodafone on the sale of a foreign company's shares outside that country, even though the transaction involved an indirect transfer of an underlying Indian company. The Court considered, and opined on, various arguments relating to strategic tax planning as opposed to tax avoidance, substance over form, and -- most importantly for U.S. multinationals -- the ability of Indian tax authorities to "look through" structures with the objective of taxing transactions in India.

### Key facts

Beginning in 1992, the Hutchison Group acquired significant direct and indirect interests in Hutchison Essar Limited (HEL), an Indian operating company. A simplified version of the ownership structure is depicted below.



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Pursuant to an agreement between the parties in February 2007, HTI (BVI) Holdings Ltd (HTI) sold the sole share of CGP Investments (Holdings) Ltd (CGP) to Vodafone.

In August 2007, the Indian tax authorities issued a notice to Vodafone seeking to hold it as an "assessee-in-default" for its failure to withhold Indian taxes on payment of the sale consideration to HTI.

Vodafone challenged the notice before the Bombay High Court and thereafter before the Supreme Court. The Supreme Court directed Vodafone to submit all documents to the tax office, which would then pass an order relating to the preliminary issue of whether it had jurisdiction over Vodafone in this matter.

The tax office passed an order on May 31, 2010, asserting its jurisdiction over Vodafone in the case. Subsequently, Vodafone approached the Bombay High Court to oppose this order of the tax office.

The Bombay High Court dismissed Vodafone's petition and opined that the transfer of the sole share of CGP reflected only a part of an overall arrangement that was aimed at transferring control of HEL to Vodafone. Furthermore, it ruled that the Indian tax authorities had jurisdiction to proceed against Vodafone for the recovery of taxes on the transaction. Vodafone appealed the Bombay High Court's order to the Supreme Court.

## *Supreme Court findings and conclusions*

### **Use of holding company structures for Indian investments and the application of anti-avoidance rules**

Holding company structures are recognized in both Indian corporate law and tax law, and the use of special purpose vehicles and holding companies is common in Indian legal structures.

The burden of establishing that a structure is abusive lies with the Revenue authorities. While the Revenue authorities may invoke the "substance over form" principle, or may "pierce the corporate veil," they can do so only after establishing, based on the facts and circumstances, that a transaction is a sham or results in tax avoidance.

The Revenue must ascertain the transaction's legal nature and, while doing so, must consider the transaction holistically and not adopt a "dissecting" approach.

Some factors that must be considered while examining transactions include the duration of the holding structure's existence, the period of business operations in India, the generation of taxable revenues in India, the timing of the exit, and the continuity of the business upon an exit.

In this case, the transaction's business purpose provides evidence that the transaction undertaken by Vodafone is not an "artificial device."

### **Location of capital asset**

Indian domestic law (Section 9(1)(i) of the Income-tax Act, 1961) provides for nonresident taxation upon the transfer of a capital asset situated in India. Therefore, all three elements -- transfer, existence of a capital asset, and the situation of such asset in India -- must be present for the transaction to be taxed in India.

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The legislature has not used the word "indirect" in the law. Therefore, it is not possible to read this into the applicable provisions.

The fact that the draft Direct Taxes Code, 2010 proposes to introduce specific law to tax indirect transfers in India further supports the position that current law does not permit such taxation.

The question of applying a "look through" provision under domestic law or "limitation of benefits" under tax treaty is a matter of government policy. Absent specific provisions to such effect, a "look through" or "limitation of benefits" provision cannot be invoked.

Under Indian corporate law, the situs of shares is where the company is incorporated and where its shares can be transferred. In *Vodafone*, shares of a Cayman Islands entity were transferred and the transfer was recorded in the Cayman Islands, where the Register of Members of the company was maintained. The Indian Revenue authorities did not rebut this assertion.

Therefore, the Tax authorities cannot conclude that the situs of the capital asset (the shares) was in India.

### **Supreme Court's conclusion**

The Court concluded that the transaction in this case was a bona fide foreign investment transaction that fell outside India's territorial jurisdiction.

The transaction evidences participative investment; it was not a sham or a tax-avoidant transaction.

The subject matter of the transaction was the transfer of a Cayman Islands company's shares. Consequently, the Indian Revenue authorities have no territorial jurisdiction to tax the transaction.

Therefore, there was no requirement to withhold taxes on the payment of consideration by Vodafone.

### ***Actionable Insights***

The *Vodafone* case should be encouraging for many U.S. multinationals with Indian interests. Previously, third-party transactions and global tax structuring involving underlying Indian companies were significantly affected by the uncertainty surrounding the outcome of the *Vodafone* case. The principles in the Supreme Court's decision should clarify matters for U.S. multinationals.

Of course, demonstrating commercial substance will continue to be key with respect to planning that involves India. Companies should continue to monitor the proposed Direct Taxes Code (earlier proposed to be effective on April 1, 2012) and any Indian Government attempts to introduce general anti-avoidance rules or rules to tax indirect transfers of Indian companies in its annual budgetary exercise. The new Indian budget is expected to be released in mid-March.

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