CAPITAL GAINS TAX- A CRITICAL ANALYSIS OF VODAFONE'S CASE

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ABSTRACT

Article 265 of the Indian Constitution provides: "No tax shall be levied or collected except by authority of law[1]". Any compulsory exaction of money by Government amounts to imposition of tax (basically imposed for public purpose for raising the general revenue of the State) which is not permissible except by or under the authority of a statutory provision[2]. The effectiveness of Taxing Statues depends on the means through which interpretation is shrewdly adopted as it imposes unique confrontations to legal interpretations and its technicalities aren't an easy breakthrough.

The *Vodafone* case had been shrouded in uncertainty till 2012.The tale began as early in February 2007 when Vodafone International Holdings (hereinafter *Vodafone* or VIH), a Dutch entity, had acquired 100 percent shares in CGP (Holdings) Limited (hereinafter *CGP*), a Cayman Islands company for USD 11.1 billion from Hutchinson Telecommunications International Limited (hereinafter *HTIL*)[3]. A dramatic turn of events after sometime led to legal battle between the Indian Income Tax Department on the one side and *Vodafone* on the other for the astronomical figure in question: **Rs. 12, 000 Crores** which raised the eyebrows of many business and legal circles in India.

There wasn't any case of much gravity before *Vodafone* pertaining to Tax dispute in India. In this connection, the author would firstly elaborately discuss the meaning and origin of 'Capital Gains Tax' (hereinafter CGT) and its relevancy to *Vodafone*. Secondly, the author would also

[1]The **Constitution of India**, **1950**; Article 265
[2]See Justice G.P. Singh, **Principles of Statutory Interpretation**, LexisNexis, p. 871 (14th ed. 2016)
[3]Refer http://www.cbi.org.uk/media/2145560/making_the_case_july_2013 {*A Claim in Investment Arbitration*, Last visited on 13th August 2017 23:30, IST}

compare the various provisions of CGT (Sections 45-55A) under the "Income Tax Act, 1961" (hereinafter IT Act) by exploring its applicability and intricacies and bringing into limelight the numerous loopholes in *Vodafone* with respect to CGT. Since *Vodafone* is a case of much magnitude from the viewpoint of Corporate Law, Investment Arbitration and Tax Law, the author would additionally focus on these wide interpretations and perspectives on *Vodafone*.

The last leg of this paper would deal with suitable remedies and suggestions for the better application and implementation of CGT under Tax laws and amendments or new incorporations to the relevant provisions of CGT under IT Act if necessary.

CAPITAL GAINS TAX: A NEW TAX PARADIGM?

The origin of CGT in India dates back to 1956 following the recommendations of 'Prof. Kaldor' to levy tax on profits arising on sale/transfer of specified non-inventory asset. As a result of constant evolution, CGT, as it stands today, is levied on transfer of all Capital Assets (other than held as stock-in-trade) with a computation mechanism prescribed under Sections 45 – 55A of the IT Act. Section 2 (14) of the IT Act, defines the term "Capital Assets". It is defined to include property of any kind, whether fixed, circulating, movable, immovable, tangible or intangible and whether or not used for the purpose of his business and profession. However, it also specifies exclusions under Section 2 (14) of the IT Act[4].

Usually, Capital Gains are taxable in the year of transfer of Capital Asset. Section 2 (47) of the IT Act defines the term 'transfer.'"Transfer" in relation to Capital Asset includes sale, exchange, relinquishment, or compulsory acquisition of the asset or extinguishment of any rights therein. However, those transactions under Section 2 (47) of the IT Act are not transfer[5].

[4]Any stock in trade, consumable stores, raw material held for the purposes of Business or Profession; Personal Assets of the assessee, i.e., movable property, including wearing apparels of the assessee & furniture held for his/ other family members personal use, but excludes: Jewellery; Archaeological Collections; Drawings; Paintings; Sculptures; Any work of art; Rural agricultural land in India; 6.5% Gold Bonds, 1977; 7% Gold Bonds, 1980 or National Defense Gold Bonds, 1980 issued by the Central Government; Special Bearer bonds 1991 issued by the Central Government; Gold Deposit bonds issued under Gold Deposit Scheme, 1999.

[5]Distribution of asset in kind by a Company to its shareholders at the time of liquidation; Distribution of Capital Asset on total or partial partition of a Hindu Undivided Family; Transfer of Capital Asset under a gift or will or an irrevocable trust; Transfer of Capital Asset by a Company to its 100% Subsidiary Company; Transfer of Capital Asset by a Subsidiary Company to its 100% Holding Company; Transfer of Capital Asset in a scheme of amalgamation; Transfer of shares of an Indian Company held by a foreign Company to another foreign Company

For the purpose of computation of Income Tax, the Capital Assets are classified under two heads:-

- Short Term Capital Assets; and
- Long Term Capital Assets.

It is essential that the method of computation of Income chargeable to tax and rates of taxes are different for both the types of Capital Gains. "Short Term Capital Assets" means any Capital Asset held by an assessee for not more than 36 months, immediately prior to its date of transfer[6]. On the other hand, "Long Term Capital Assets" means any Capital Asset held by an assessee for more than 36 months, immediately prior to its date of transfer[7].However, the above rule of 36 months has certain exceptional situations wherein such period is taken as 12 months:

- ✓ Equity / Preference Shares in a Company, which may be quoted or unquoted;
- ✓ Securities like Debentures, Govt. Securities etc., which should be listed on a recognized Stock Exchange;
- ✓ Units of UTI [Unit Trust of India] which may be quoted or unquoted;
- ✓ Units of a Mutual fund, which may be quoted or unquoted;
- ✓ Zero Coupon Bonds, which may be quoted or unquoted.

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in scheme of amalgamation of two foreign companies; Transfer of Capital Asset in a scheme of amalgamation of banking Company with a banking institution; Transfer in a demerger of a Capital Asset by the demerged Company to resulting Company; Transfer of shares held in an Indian Company by a demerged foreign Company to the resulting foreign Company; Transfer or issue of shares by the resulting Company in a scheme of demerger to the shareholders of the demerged Company; Allotment of shares in an amalgamated Company in lieu of shares held in amalgamating Company; Transfer of Capital Asset (being foreign currency convertible bonds or GDR) by a non-resident to another non-resident; Transfer of Agricultural Land in India before March 1st, 1970; Transfer of Capital Asset (being work of art, manuscript, painting etc.) to Govt. / University/ National Museum, etc.; Transfer by way of Conversion of Bonds or Debentures into Shares; Transfer by way of exchange of a Capital Asset being membership of a recognized stock exchange for shares of a Company; Transfer of land by a sick Industrial Company which is managed by its workers cooperative; Transfer of a Capital Asset by a firm to a Company in case of conversion of firm into a Company; Transfer of Capital Asset, being a membership right held by a member of a recognized Stock Exchange in India; Transfer of Capital Asset to Company in the case of conversion of a proprietary concern into a Company; Transfer involved in a scheme of lending securities.

[6]See Rutvik Sanghvi's, **Taxation of Capital Gains earned by Non-Residents**, The Chamber's Journal, SS. Vol. 50 (2014), p. 1031

[7]*Ibid*, p. 1032

VODAFONE CASE: THE DESTRUCTION OF A NEW APPROACH?

In February 2007, *VIH*, a Dutch entity, had acquired 100 percent shares in *CGP*, a Cayman Islands Company for USD 11.1 billion from *HTIL*. *CGP*, through various intermediate companies/ contractual arrangements controlled 67 percent of Hutchison Essar Limited (hereinafter *HEL*), an Indian Company. The acquisition resulted in *Vodafone* acquiring control over *CGP* and its downstream subsidiaries including ultimately *HEL*. *HEL* was a joint venture between the Hutchinson group and the Essar group. It had obtained telecom licenses to provide cellular telephony in different circles in India from November 1994[8].

In September 2007, the Indian Tax department issued a show-cause notice to *Vodafone* to explain why tax was not withheld on payments made to *HTIL* in relation to the above transaction. The Tax department contended that the transaction of transfer of shares in *CGP* had the effect of indirect transfer of assets situated in India. *Vodafone* filed a writ petition in the Bombay High Court, inter alia, challenging the jurisdiction of the tax authorities in the matter. By its order dated 3 December 2008, the Bombay High Court held that the Indian Income Tax authorities had jurisdiction over the matter. *Vodafone* challenged the order of the Bombay High Court before the Supreme Court. In its ruling dated 23 January 2009, the Supreme Court directed the tax authorities to first determine the jurisdictional challenge raised by *Vodafone*.

In May 2010, the Tax authorities held that they had jurisdiction to proceed against *Vodafone* for their alleged failure to withhold tax from payments made under Section 201 of the IT Act[9]. This order of the tax authorities was challenged by *Vodafone* before the Bombay High Court. By its order dated 8 September 2010, the Bombay High Court dismissed *Vodafone*'s challenge to the order passed by the tax authorities. *Vodafone* filed a Special Leave Petition (SLP) against the High Court order before the Supreme Court. On 26 November 2010, SLP was admitted and the Supreme Court directed *Vodafone* to deposit a sum of INR 25000 million within three weeks and provide a bank guarantee of INR 85000 million within eight weeks from the date of its order.

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[8]Raag Yadava, Shiva Santosh Yelamanchili et.al, **Vodafone & India: *A Review of Claims in Investment Arbitration***, 43 NLS L.J. (2012); p. 12
[9]*Supra note* 6, p. 1041

Under Section 9 (1) (i) {*Income deemed to accrue or arise in India*} of the IT Act, *inter alia*, income accruing or arising directly or indirectly from the transfer of a Capital Asset situated in India is deemed to accrue/ arise in India in the hands of a non-resident[10]. In this connection, the Supreme Court observed that:

- Charge to Capital Gains under Section 9 (1) (i) of the Act arises on existence of three elements, namely transfer, existence of a Capital Asset and situation of such asset in India.
- The Legislature has not used the words ‘indirect transfer’ in Section 9 (1) (i) of the Act. If the word ‘indirect’ is read into Section 9 (1) (i) of the Act, then the phrase ‘Capital Asset situate in India’ would be rendered nugatory.
- Section 9 (1) (i) of the Act does not have ‘look through’ provisions and it cannot be extended to cover indirect transfers of capital assets/ property situated in India.
- The proposals contained in the *Direct Taxes Code Bill*, *2010*; on taxation of off-shore share transactions indicate that indirect transfers are not covered by Section 9 (1)(i) of the Act.
- A legal fiction has a limited scope and it cannot be expanded by giving purposive interpretation, particularly if the result of such interpretation is to transform the concept of chargeability which is present in Section 9 (1)(i) of the Act.

Accordingly, the Supreme Court concluded that the transfer of the share in *CGP* did not result in the transfer of a Capital Asset situated in India and gains from such transfer could not be subject to Indian Tax[11].

The Tax authorities further argued that the rights of *HTIL* over the control and management of *HEL* constituted “property” in the hands of *HTIL*. Accordingly, the extinguishment of such rights under the Share Purchase Agreement (SPA) resulted in a taxable transfer of a Capital Asset situated in India. It held that extinguishment took place because of the transfer of the *CGP* share and not by virtue of various clauses of SPA[12].

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[10]The *Income Tax Act*, *1961*; Section 9 (1) (i)
[11]See Para 999 of *Vodafone* Judgment, Supreme Court of India, [SCC 2012]
[12]*Ibid*, Para 765

Additionally, the Supreme Court held that the sole purpose of *CGP* was not only to hold shares in subsidiary companies but also to enable a smooth transition of business. Therefore, it could not be said that *CGP* had no business or commercial substance. But the Tax authorities had contended that the transfer of the *CGP* share was not adequate in itself to achieve the object of consummating the transaction between *HTIL* and *VIH* and that intrinsic to the transaction was a transfer of other 'rights and entitlements'. It was further contended that such "rights and entitlements" constituted 'Capital Assets' and gains from the transfer of which were liable to Indian Tax.

The Supreme Court also observed that if a Non-Resident makes an indirect transfer through abuse of the organization form/ legal form and without a reasonable business purpose, which results in tax avoidance or avoidance of withholding tax, then the Tax authorities may disregard the form of the arrangement or the impugned action through use of holding companies and may re-characterize the equity transfer according to its economic substance and impose tax. "The Corporate business purpose of a transaction is evidence of the fact that the impugned transaction is not undertaken as a colourable or artificial device[13]".

In finality, the Supreme Court held that:

- The question of withholding tax at source would not arise as the subject matter of offshore transfer between the two non-residents was not liable for CGT in India.
- For the purposes of Section 195 {*Other Sums*} under the IT Act, tax presence has to be viewed in the context of the transaction that is subjected to tax, and not with reference to an entirely unrelated matter. As there was no incidence of CGT in India, the provisions under Section 163 of the IT Act for treating *Vodafone* as a representative assessee of *HTIL*, were not applicable. Section 195 of the Act would apply only if payments are made from a resident to another non-resident and not between two non-residents situated outside India[14].

Countries are guided by either the source or resident rule to tax income. An important question discussed by the parties in *Vodafone* was whether the Revenue could establish a nexus to tax the transfer of *CGP* Investments share. Under Section 5 (1) of the IT Act, the worldwide

[13]Sutherland, Cambridge University Press, **Statutory Construction**, (2d Vol., 3d ed. 2011), p. 165
[14]*Supra* note 6, p. 1048

income (including any income that is actually or deemed to accrue or arise, or is received) of a person resident in India is brought within the ambit of total income. Under subsection (2) of the IT Act, for a non-resident, the only income that is taxable is income that is received or deemed to have been received, or income that has accrued or arisen or has been deemed to have accrued or arisen in India.

Vodafone urged the Court to adopt a contextual interpretation of Section 195 according to the established principles of conflict of laws and legislative intent as it believed that Section 195 was inapplicable to offshore entities making offshore payments but the Revenue argued that the expression ‘‘person’’ as used in the Section is not restricted to a person resident in India[15]. The Court concluded that chargeability and enforceability are distinct legal concepts and that the following factors are guiding rules based on which Section 195 is to be interpreted:

- Section 195(1) provides for a tentative deduction subject to regular assessment;
- The Section postulates two prerequisites — there must be a payment made to a nonresident, and such payment must be a sum chargeable under the IT Act;
- The obligation to deduct tax arises when the sum (the entire sum need not be chargeable) payable to a nonresident is chargeable to tax under the IT Act;
- The liability to deduct tax arises if the tax is assessable in India;
- Fiscal Legislation is based on the principle that a sufficient territorial connection or nexus is required between the person sought to be charged and the country seeking to tax them;
- Provisions dealing with ‘Tax Deduction at Source’ (TDS) are in the nature of machinery provisions and constitute an integrated code, not independent of the charging provisions that determine assessability to tax; and
- The Parliament, while imposing a liability to deduct tax, has imposed it on a person responsible for paying tax without limiting the same to a person resident in India.

[15]Aditi Mukundan & Bijal Ajinkya, **The Vodafone Decision: *All is not lost***, Tax Notes International, 2nd Issue, Tax India Analysts (2010), p. 103

Therefore, the Court decided that there is no limitation of extraterritoriality involved although the Parliament is aware that the law can be enforced within the territory to which the ITAct extends[16].

CHANGING DIMENSIONS OF TAXATION LAWS

Parties are free to choose whatever lawful arrangement which will suit their business and commercial purpose, but the true nature of the transaction can be ascertained only by looking at the legal arrangement actually entered in to and carried out. One of the tests to examine the genuineness of the structure is the 'timing test' i.e., the timing of the incorporation of the entities or transfer of the shares etc. Structures created for genuine business reasons are those which are generally created or acquired when investment is first made, or further made at the time of consolidation[17]. It cannot be said that *HTIL* or *Vodafone* was a 'fly by night' operator or short time investor, as the *HTIL* operated from 1994 and only in 2007 was the divestment made.

If the 'look at' test is applied and not the 'dissecting' approach, then the extinguishment took place because of transfer of *CGP* Investments share and not by virtue of various clauses in the SPA (wherein the rights of the HEL-controlling interest were factored in). Therefore, sale of *CGP* Investments share, for exiting from the Indian telecom sector, cannot be considered as a pre-ordained transaction, with no commercial purpose other than tax avoidance. Sale of *CGP* Investments share was a genuine business transaction and not a fraudulent or dubious method to avoid CGT[18].

The legal principle on which *situs* of an asset, such as share of a company, is determined, is well settled. As per Indian Company Law, *situs* of shares would be where the Company is incorporated and where its shares can be transferred. Considering that the transfer of *CGP* Investments shares was recorded in Cayman Islands, where the register of members of *CGP* Investments is maintained, it could not be accepted that the *situs* of the Cayman Islands

[16]*Supra note* 12, Para 861
[17]See http://www.vodafone.com/content/dam/sustainability/pdfs/vodafone_tax_risk_management_strategy (Last visited on 16th August 2017 at 2:30 P.M. {IST})
[18]*Supra note* 12, Para 967

company shares was where the underlying assets were situated (India). Therefore, *situs* of *CGP* Investments is situated in Cayman Islands, and on transfer in Cayman Islands, the *situs* would not shift to India.

In other words, a ‘Controlling Interest’ is an incident of ownership of shares of the Company and is not an identifiable or distinct Capital Asset independent of holding of shares. Transfer of the *CGP* Investments share automatically results in a host of consequences including transfer of controlling interest and that Controlling Interest as such, cannot be dissected from *CGP* Investments share without a specific legislative intervention. Accordingly, this Controlling Interest cannot be dissected so as to percolate and be treated as transfer of Controlling Interest of the downstream entities, and ultimately to that of *HEL*. Controlling interest, which stood transferred to *Vodafone* from *HTIL* accompanies the *CGP* Investments share and cannot be dissected. It is a case of sale of shares and not an asset sale[19].

When a transaction involves transfer of shares lock, stock and barrel, it cannot be broken down into individual components, assets or rights. Withholding tax provisions would apply only if payments are made from a resident to another non-resident, and not between two non-residents situated outside India. In *Vodafone*, the transaction was the transfer of a Capital Asset between two nonresident entities, through a contract executed outside India and it was entered into on a principal-to-principal basis. The consideration was also paid outside India. The SC similarly ruled in the case of *Eli Lily*[20] and was distinguished on the ground that services were rendered in India by the employees, and a portion of salary was received from an entity situated in India. Therefore, there is no liability to withhold tax, which gets triggered only when there is income chargeable to tax in India.

Vodafone Group’s earlier investment in Airtel cannot be regarded as a presence in India to bring Vodafone under the jurisdiction of the *ITL*. *Vodafone* cannot be regarded as a representative taxpayer on behalf of the non-resident which requires that income should have deemed to accrue in India as there is no transfer of Capital Asset situated in India. “Call and Put options” are contractual rights and in the absence of a statutory stipulation, they cannot be

[19]*Ibid*, Para 971
[20]See *Eli Lily* Case [(2009) 15 SCC 1]

considered as Capital Assets; at best, they may be regarded as potential shares, till they are exercised.

VODAFONE & TAX AVOIDANCE: THE RE-EMERGENCE OF A NEW DICHOTOMY?

Vodafone contended that retrospective tax amendments result in a denial of justice under the India-Netherlands BIT (Bilateral Treaty [Article 9]) obligations[21].Publicists differ on the interpretation of the term "Denial of Justice[22]". A person is free to arrange his business in such a way so that he is able to avoid a law and its evil consequences so long as he does not break that or any other law. The major question under International Taxation is: Does retrospective taxation amount to substantial interference with *Vodafone*'s shareholding? It is understood that the Government of India at that point gave assurance that retrospective taxation wouldn't be applicable to *Vodafone* and no Indian Court will take access to it.All businesses depend on tax policy predictability and certainty in order to plan investments for the long term. Retrospective taxing rules should be introduced only in the 'rarest of rare' cases and that, if applied to CGT, the authorities should pursue the seller, not the buyer (*Vodafone* being the latter not the former in the case at issue).

Also, a taxing Statute is to be strictly construed. The source of power which doesn't speak of taxation specifically cannot be interpreted by expanding its width as to include therein the power to tax by implication or by necessary inference. A subject will be liable to tax and will be entitled for exemption from tax according to "*strict language of the statute*[23]". In case of a doubt or a dispute, it is a well settled rule that the construction has to be made in favour of the tax payer and against the revenue department. The rule of Strict Construction has been vehemently diluted by the Supreme Court for the simple and obvious reason that *Vodafone* being a foreign Company is not subject to Indian jurisdiction thereby hampering the sound interpretation of taxing laws.

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[21]*Supra note* 8, p. 07
[22]Lissitzyn, **The Meaning of the term 'Denial of Justice' in International Law**, 30 AM. J. INT'L L. 633-635 (1936)
[23]*Supra note* 2, p. 873

Multinational Companies such as *Vodafone* therefore operate in an international taxation environment which is determined by governments working individually and collectively shaped by voters in democracies. Larger businesses are more complex, which in turn means a greater level of complexity in applying the rules. Governments generally also require multinational companies to apply 'transfer pricing' rules to inter-company activities to ensure that profits are allocated to the countries where the relevant economic activity takes place.

CONCLUSION & SUGGESTIONS

Cross-border acquisition of Indian Companies has had been a focus of the Tax Authority over the last couple of years. It is fairly well-established that if the acquisition involved a direct transfer of shares of an Indian Company, the same would trigger taxable Capital Gains under the ITL. However, there have not been precedents in the past where Tax Authority has attempted to tax Capital Gains arising on transfer of shares of a foreign holding Company of an Indian subsidiary on the basis that such transfer involves an indirect transfer of the underlying Indian assets.

Vodafone is a milestone in Indian Tax history which brought into limelight the true 'Parliamentary Intention' and the practical difficulty in application of CGT under Taxing Laws. Parliamentary Intention can be best expressed only through the text of the Statute, albeit read in context. Obviously, the best way to give effect to Parliamentary Intention in Tax will be to express policy clearly in the specific legislation by having a coherent underlying framework for the Tax System. On the other hand, provisions dealing with CGT especially Sections 45-55A and Sections 2 (14) and 2 (47) need to be revisited and given wider scope to its meaning in the ambit of International Taxation. It would only then increase Clarity, Transparency and Legitimacy by giving full effect to Parliamentary Intention without overriding it.