
Hutch Vodafone Merger

An Issue of Tax Planning Under Income Tax Act, 1961

It is a landmark case that will severely impact the Mergers & Acquisitions (M&A) landscape in India. No matter which way it goes, the Vodafone versus IT department tax case will have an indelible impact on the M&A landscape of India. Last year British Telecom giant Vodafone paid Hong Kong based Hutchison International over USD 11 billion to buy Hutchison's 67% stake in Indian telecom company Hutchison Essar. The transaction was done through the sale and purchase of shares of CGP, a Mauritius based company that owned that 67% stake in Hutch Essar

Since the deal was offshore, neither party thought it was taxable in India. But the tax department disagreed. It claimed that capital gains tax most people paid on the transaction and that tax should have been deducted by Vodafone whilst paying Hutch. The matter went to court and was heard over by the court.

Vodafone argued that the deal was not taxable in India as the funds were paid outside India for the purchase of shares in an offshore company that the tax liability should be borne by Hutch; that Vodafone was not liable to withhold tax as the withholding rule in India applied only to Indian residence that the recent amendment to the IT act of imposing a retrospective interest penalty for withholding lapses was unconstitutional.

Now the taxman's argument was focused on proving that even though the Vodafone-Hutch deal was offshore, it was taxable as the underlying asset was in India and so it pointed out that the capital asset; that is the Hutch-Essar or now Vodafone-Essar joint venture is situated here and was central to the valuation of the offshore shares; that through the sale of offshore shares, Hutch had sold Vodafone valuable rights - in that the Indian asset including tag along rights, management rights and the right to do business in India and that the offshore transaction had resulted in Vodafone having operational control over that Indian asset. The

Department also argued that the withholding tax liability always existed and the amendment was just a clarification.

The tax officers are saying that Hutch is taxable on the profit they made from the sale - that is one aspect. The second aspect is that Vodafone as a payer was liable to deduct tax at source because they paid income to Hutch. Those are the two different issues. The case was mainly about the second issue where the Vodafone was liable or not and in principle; it is possible that the department is right on the first and yet not right on the second.

To give you an example, assuming for a moment that Hutch is taxable, the question would be - was Vodafone liable to deduct tax and the arguments made on behalf of Vodafone were that the Section 195, which is dealing with this duty to deduct, does not apply outside India.

The taxability of Hutch would probably arise only after Hutch, if at all, decides to file a tax return in India. In all probability, it appears that the tax office may issue a notice to them to file a tax return in which case Hutch would have to decide whether it is taxable or not. In all probability, reading the law and considering the fact that shares of a foreign company have been sold outside India by another foreign company, the tax return that they would file only show nil income. Therefore a different battle will start once that tax return is filed or if a notice is issued and Hutch decides to challenge the jurisdiction of the notice itself.

If the tax return is filed then it will have to probably go through the entire realm of the appellate process that we have, which is the commissioner appeals at the first stage of tribunal and then the courts. But if they decide to challenge the notice itself, then probably the dispute will definitely go on the virus of the notice if that challenges to the courts itself.

The provisions of Section 195, they came into force in 1939 in the old act. One never intended to cover payments outside India and that was on assumption of the legislature - that was the enquiry committee report, which said that it is not intended to apply outside India. Not only that that, it was the assumption of the Department, they had issued circulars on that basis, that tax deduction provisions do not apply outside India, even if overseas income were taxable in India

Vodafone has very vehemently argued that even if Section 195 were to be interpreted the way the Department wants; to interpret to mean that a person would include a non-resident, it has to be read contextually and the territorial limitation has to be read into that section. It cannot apply to any and every transaction that may happen outside India in relation to any goods or any services or any other assets that may happen outside India. Unless the Act specifically provides so and in the Act as it is standing today, I do not think there is any specific provision in the law.

The interpretation of Section 91, where they have said that the direct and the indirect aspect of the income is applicable only to the accruing; it does not apply when there is a transfer of a capital asset situated in India. So that I think is the main argument and in any case I think the issue really is whether the capital asset which is really transferred situated in India, the Indian asset may have the bearing on the value of the foreign asset. But is it really a capital asset which was in India. That is really the issue, which will have to be sort of dealt with when one has to give a verdict on the taxability of the transaction

It is always self-evident, that if I buy shares of a company, in effect the shares are valued based on the underlying asset that is contained in the company - so that is self evident. For example, let us say today the Suzuki company was sold to Toyota overseas. Is there an argument to say that the sale consideration that was paid-obviously what Suzuki will be paid by Toyota; it will include the value of the business in India, it will include the value of the business everywhere the Suzuki operates - so is there going to be an argument now that consideration should be split and to the extent the consideration relates to Suzuki's Indian business that is taxable in India. So I think we have got a huge broader issue that we are dealing with here and therefore I do not think these arguments about value being the underlying value are anything significant. These are self evident in any transaction where you buy shares of a company that has assets. So I think that there is a huge overall perspective here.

The two other aspects that I did want to touch upon because that might be one bizarre outcome -Let us say that the Bombay High Court holds that there may be an argument that the capital asset is actually situated in India but they hold that the provisions of Section 195, that is the obligation to withhold tax being a procedural obligation does not apply

amongst to non-residents. I am not certain but I think that there could be another argument where the Department may say that the Vodafone paying entity becomes what is called representative assessee of Hutchison. It is a very technical issue; normally a representative assessee can only be a person in India. But if a foreign entity buys a capital asset from another foreign entity, which is situated in India, then it becomes a representative assessee, in which case it becomes primarily liable for the tax liability not for withholding tax.

So that is not the issue before the court. But if the court came up with some distinction of this kind that we do not believe Section 195 applies because of extraterritoriality then that does not necessarily mean that the avenues for the tax department are shut out. It depends a bit on what the court holds when it deals with the taxability at least in a prima facie level.

In so far as the arguments mentioned, I am not sure it was taken up-it came up at some stage. One of the things that is important to consider is that we have a decision of the Supreme Court in the case of Mauritius companies - the famous decision of Azadi Bachao-which basically said that if you have a Mauritian special purpose entity with no substance but to hold shares, you cannot pierce its corporate veil and go upward because the tax residency certificate protects the substance of the Mauritian entity. So in other words, you cannot pierce the corporate veil upwards.

Now what we are doing is piercing the corporate veil backwards. We are saying the Mauritius Company had it sold the shares, it would not have been taxable and you could not look beyond the Mauritius company to see who actually made the money because ultimately the money from the Mauritius Company went to the beneficial owner who was a resident in a non-treaty jurisdiction. But the argument put on its head is you could not pierce the corporate veil upwards. But when the shareholder of the Mauritian entity sold the shares, you could pierce the corporate veil downwards, which I think is a bit bizarre because if you cannot pierce the corporate veil of the Mauritian entity; because that is what the Supreme Court said in Azadi Bachao, then I am not terribly sure on how you can pierce the corporate veil downwards.

The department has itself signalled that other M&A deals will be looked at by them and I believe they have issued notices to other

companies on similar lines, I believe they are also pursuing cases of participatory notes.

But leaving that aside, everyone has talked about M&A deals. But if the logic of the Department were to prevail, then every transaction on the New York Stock Exchange in a US company which has shares in the Indian company would have some part of its value derived from the Indian assets. Then they would say that the New York buyer by their logic under Section 195 should be deducting tax on that proportion. I think it's completely laughable but it necessarily follows from the stand the department has taken. So either their stand is right in which case it should work the way I am saying, or their stand is wrong and I do believe their stand is wrong.

Second and the surprising part for me is the macro perspective, other deals over the past -overseas deals or an overseas company, who are owning assets in India, is not new to us. We had the Sterling Tea Companies for example; we had Calcutta Tramways which was a company whose only asset was by its name suggested the tramways in Calcutta. If you had a sale of those shares on the stock market in London, who never sought to tax that. There were many companies with those features in the past we had other sales like CEAT, Dunlop, Shaw Wallace, which happened overseas it has never been sought, to be taxed by the department on the sales for public knowledge. So why did the department change its stand.

The issue really is that it will definitely open up a lot of issues for Indian investors investing abroad if a similar transaction was sought to be taxed by the tax authorities in other countries; we had a situation where in the context of some other provision, particular position was taken by the tax authorities and some other country decided to tax the software companies abroad and that issue had to be resolved ultimately through mutual bilateral talks and to bring an end to that. So I do agree that yes, if such a thing happens then we can have responding actions and there could be pressure from other countries also to do something similar. So one needs to be very careful when one deals with such issues.

Taxability apart, I don't want to get into that but I think this applying, withholding tax or tax deduction obligations in offshore transactions is going to have a huge element of uncertainty when you do transactions, two foreign companies sitting in New York are selling businesses or

companies to each other and they are now going to have to wonder how much tax they should withhold- should they apply to the Indian Tax Authorities. I think it creates a great degree of uncertainty and even if the Tax Department wants to go after taxability of these transactions, I think we need to divorce the procedural issue of tax deduction at source from the arguments on whether or not the transaction is taxable and be a little more realistic and rational to bring in certainty to transactions rather than bring in an element of uncertainty here.

Today we are doing transactions offshore, what do we tell people? You are buying shares of an offshore company but by the way you may have withholding tax obligations; should you apply to the Tax Department to deduct taxes? So it becomes very complicated.