A Case Study

VODAFONE V/S INCOME TAX AUTHORITY OF INDIA – A PANDORA'S BOX

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ABSTRACT

The case examines one of the largest merger and acquisition deals in India, how, Vodafone, one of the world's largest mobile telecommunications company gained control over Indian Telecom Company Hutch Essar through intermediate companies situated in Mauritius and Cayman Islands. It discusses the rationale for Vodafone's acquisition of 67% stake in Hutch Essar and also examines the acquisition route adopted by Vodafone in order to avoid payment of capital gains tax to the extent of two billion dollars which was accrued to the Indian Tax Authorities. The company refused to pay the capital gains tax arguing that the transaction has taken place offshore and hence it is not due in India. The case critically examines the arguments and counter arguments of Vodafone and Indian Tax Authorities as to whether the tax is due to be paid in India or not. The purpose of this case study is to understand the tax laws of India which are applicable to such kind of transactions. The study of the case is done purely on the secondary data and it is analysed according to the sections and regulations laid down by the Indian Tax Act. The case also ponders over an important aspect of mergers and acquisitions, whether investment through tax havens routes are genuine or are resorted to avoid taxes in home jurisdictions. The study is presented in a form of case to elaborate it further and to use it by the students as well as the academicians.

Keywords: Mergers and Acquisition, Income Tax Act, Capital Gains, Withholding Tax, Tax Havens

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Introduction:

Vodafone Essar Limited, formerly known as Hutchison Essar is a telecom service provider in India that covers twenty three telecom circles in India and is based in Mumbai. Vodafone holds sixty seven percentage stake in Vodafone Essar Limited and Essar holds the rest thirty three percentage stake. It is the second largest mobile phone operator in terms of revenue after Bharti Airtel, and third largest in terms of customers. It has around ten thousand employees across India. It has a subscriber base of approximately one hundred and six million and commands a market share of twenty four percent in India.

On February 11, 2007, Vodafone agreed to acquire the controlling interest of sixty seven percentage held by Li Ka Shing Holdings in Hutch-Essar for US$11.1 billion. The company was valued at USD 18.8 billion. The transaction closed on May 8, 2007. Despite the official name being Vodafone Essar, its products are simply branded '**Vodafone**'. It offers both prepaid and postpaid GSM cellular phone coverage throughout India.

Background:

Vodafone Group Plc:

Vodafone Group Plc incorporated in England is the world's leading mobile telecommunications company. It is world's second largest mobile operator in terms of subscribers and largest in terms of revenue. It has a significant presence in Europe, the Middle East, Africa, Asia Pacific and the United States through the Company's subsidiary undertakings, joint ventures, associated undertakings and investments. It has approximately 347 million customers as on 31 March 2010. Currently, India is the third largest market after Germany and the United States for Vodafone. The Company's ordinary shares are listed on the London Stock Exchange and the Company's American Depositary Shares ('ADSs') are listed on the NASDAQ Stock Market. The Company had a total market capitalisation of approximately £71.2 billion at 12 November 2009.

Vodafone Group has entered into arrangements with network operators in countries where the Group does not hold an equity stake. Under the terms of these Partner Market Agreements, Vodafone and its partner operators co-operate in the marketing of global products and services with varying levels of brand association. This strategy enables Vodafone to implement services in new territories and to create additional value to their partners' customers and to Vodafone's travelling customers without the need for equity investment in these countries. Similar agreements also exist with a number of the Group's joint ventures, associated undertakings and investments (the affiliates).

Hutchison Whampoa:

Hutchison Whampoa Limited (HWL) of Hong Kong is a Fortune 500 company and one of the largest companies listed on the Hong Kong Stock Exchange. HWL is an international corporation formed in 1863 with a diverse array of holdings which includes the world's biggest port and telecommunication operations in 54 countries. WL reports turnover of approximately HKD301 billion (USD39 billion) for the year ended 31st December 2009. Hutchison deals in the businesses of ports and related services, property and hotels, retail, energy, infrastructure, investments and telecommunications. It belongs to the Cheung Kong Group and employs around 2, 20,000 people worldwide.

Hutchison Whampoa Limited based in Hong Kong is among the largest companies listed on the main board of the Hong Kong Stock Exchange. Flagship companies include Hutchison Port Holdings, Hutchison Whampoa Properties, A S Watson, Cheung Kong Infrastructure and Hutchison Telecommunications International Ltd.

Essar Group:

The Essar Group is a multinational conglomerate corporation in the sectors of Steel, Energy, Power, Communications, Shipping Ports & Logistics as well as Construction headquartered at Mumbai, India. The Group's annual revenues were over USD 15 billion in Financial Year 2008-09. Essar began as a construction company in 1969 and diversified into manufacturing, services and retail. Essar is managed by Shri.Shashi Ruia, Chairman – Essar Group and Shri.Ravi Ruia, Vice Chairman Essar Group. Essar has its foot print over Asia, Africa, Europe and the America, and employs more than 50,000 people across the globe.

Hutchison Essar:

Hutchison Essar Ltd. ("Hutch India"), a company incorporated in India in 1994, was a joint venture of the Hong Kong-based Hutchison Telecommunications International Ltd ("Hutch Hong Kong") and the India-based Essar Group. Hutch India was in the business of providing telecommunications service in India. Hutch Hong Kong held sixty seven percent of the shares of Hutch India through CGP Investments Holdings Ltd ("the Cayman Islands Special Purpose Vehicle"), an SPV registered in Cayman Islands, and some other shareholders.

The Event:

Vodafone Holdings International ("Vodafone"), a Dutch company, purchased shares of a Cayman Company – CGP Investments (Holdings) Ltd from a foreign company Hutchinson Telecommunications International Limited – HTIL for a total consideration of $11.2 billion. CGP Investments in turn held 67% stake of an Indian Telecom company (Hutch Essar) through intermediate companies situated in Mauritius. The sale ultimately resulted in the ownership of Hutch Essar by Vodafone Holdings International.

The Indian Foreign Investment Promotion Board (FIPB) approved the said transaction on the condition that Vodafone would comply with all Indian municipal laws. Pursuant to the consent of Essar Group, a new joint venture called the Vodafone Essar Ltd. (the new name of Hutch Essar Ltd.) came into existence.

As a result of this sale, capital gains, estimated at $ 2 billion, accrued to the Cayman Islands SPV. Considered from the point of view of jurisdictions, it is clear that the sale transaction took place between the Dutch SPV (owned by a UK group) and the Cayman Islands SPV (owned by a Hong Kong company). The ultimate effect however was the transfer of controlling shares of an Indian company.

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 Income Tax Department has claimed capital gains under Section 9(1) (i) of the Income Tax Act as it is of the view that the transaction involved transfer of an Indian Asset and that the profit made by HTIL from the sale of shares to Vodafone was generated in India. Therefore, Vodafone had an obligation to pay withholding tax in India before making payment of purchase price to HTIL. The matter went to court.

Arguments of Vodafone:

Vodafone argued that the transaction took place between offshore entities owned by itself and Hutchison and was outside India's jurisdiction and moreover the deal was not taxable in India as the funds were paid outside India for the purchase of shares in an offshore company.

Vodafone's contention was that the provisions were not applicable as the primary obligation to discharge the tax was with the payee i.e. HTIL. Moreover withholding tax provisions cannot have extra-territorial application and is applied to companies of Indian residence only.

Arguments of Tax Authority:

But the tax department seeks to show that since most of the assets were in India, the deal was liable to Indian capital gains tax. Hutch had sold Vodafone valuable rights - 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 the Indian asset, which is the second largest telecom service provider in India.

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. It also argues that under Indian law, the buyer in a deal is required to withhold any capital gains tax liability and to pay it to the treasury.

Treatment of Capital Gains on extra territorial transaction:

The Indian Parliament, under the provisions of the Constitution, has the competence to enact a legislation having an extraterritorial application. But it is unsure whether the Income Tax Act has such powers. According to Section 9 of the Income Tax Act, where a non-resident earns any income by a transfer of capital asset in India (whether direct or indirect), the capital gains tax would apply. But Section 9 does not state that the transfer of the capital asset can be direct or indirect. It is only income which can be direct or indirect.

Pursuant to Section 195 of the Act, every person paying any sum, which is chargeable to tax in India to a non-resident, must deduct income tax at source at the time of payment or credit. This applies to both residents as well as non-residents.

Withholding Tax

Withholding tax is a Government requirement for the payer of an item of income to withhold or deduct tax from the payment, and pay that tax to the government. In most jurisdictions withholding tax applies to employment income. Many jurisdictions also require withholding tax on payments of interest or dividends. In most jurisdictions there are additional withholding tax obligations if the recipient of the income is resident in a different jurisdiction, and in those circumstances withholding tax sometimes applies to royalties, rent or even the sale of real estate. Governments use withholding tax as a means to combat tax evasion, and sometimes impose additional withholding tax requirements if the recipient has been delinquent in filing tax returns, or in industries where tax evasion is perceived to be common.

Typically the withholding tax is treated as a payment on account of the recipient's final tax liability. It may be refunded if it is determined, when a tax return is filed, that the recipient's tax liability to the government which received the withholding tax is less than the tax withheld, or additional tax may be due if it is determined that the recipient's tax liability is more than the withholding tax. In some cases the withholding tax is treated as discharging the recipient's tax liability, and no tax return or additional tax is required.

Stance in favour of Vodafone Essar:

- Since the transaction took place offshore, the Income Tax Act shall not be applicable.
- The transaction was transfer of shares between two entities and as such there was no transfer of capital asset.
- The stake changed hands through a subsidiary in Cayman Islands that held shares in Hutchison Essar, now called as Vodafone Essar, through arms in Mauritius and India. Apart from the transaction being offshore, India has a double taxation tax treaty with Mauritius.
- As per the treaty, investments made in India from Mauritius are not subject to tax. The current tax regime sheds light on indirect tax that clarifies stance unlike the direct code.

Stance in favour of Income Tax Department:

- The routing of the whole transaction between the parties through their subsidiaries in Mauritius and Cayman was with the intention to evade tax.
- As per a precedent set in the Samsung case, where the Karnataka High Court upheld the Department's view that tax must be deducted on all overseas payments, whether or not that income is taxable. But all Courts do not agree.
- The High Court observes that Vodafone be treated as an "Agent" of Hutch, a non-resident, under Section 163 of the Income Tax Act and the said taxes shall be recovered from Vodafone. According to Section 160(1) of the Act, "Agent" of the non-resident is 'representative assessee', and Section 161 discusses the liability of representative assessee. Section 163 defines agent to include a person who has business connection with non-resident.
- The transfer in the current transaction represents a transfer of beneficial interest in the shares of an Indian company and hence, any gain arising from it would attract tax in India.

Observations of the High Court:

- The Court inferred that the subject matter of the transaction between Vodafone and HTIL is nothing but transfer of interest, tangible and intangible, in Indian companies of the Hutch Group, in favour of Vodafone and not just an acquisition of shares of CGP Investments.
- Vodafone had failed to produce the original agreement between Hutchinson Telecommunications International Limited and Vodafone, which makes it difficult to understand the true nature of the transaction between the parties, which leaves scope for various assumptions.
- With the signing of the agreement by Vodafone in February 2007 to acquire the interests in India, a nexus to a source of income in India was clearly established, even before the actual payment in May 2007.
- Representations made before FIPB, shareholders, regulatory authorities in the United States and Hong Kong makes it clear that the Hutch Group was transferring its interest in the Indian Company.
- As there was admittedly a transfer of controlling interest in the Indian company, there was an "extinguishment of rights" and "relinquishment" by the transferor in the shares of the Indian company which constituted a "transfer".
- The shares in the Cayman Company were merely the mode or the vehicle to transfer the assets situated in India. The choice of the assessee in selecting a particular mode of transfer of such assets will not alter or determine the nature or character of the asset.

Conclusion:

This transaction is one of the largest Mergers and Acquisition deals in India and the issues surrounding this case can have wider ramifications on the Mergers and Acquisitions landscape in India. This case raises certain pertinent questions and shows the loopholes of the Indian Tax system like 1) how to access the impact on cross border transactions between two non-resident entities which have Indian assets and whether an Indian Company can be treated as 'agent' of the non-resident purchaser and held liable for deduction of tax. 2) Would there be an adverse effect on the foreign inflows where the foreign investors would think twice before investing in India if they are wary of the hassles involving such issues of tax, jurisdiction and deal structuring. These questions are required to be answered at the earliest as it may raises apprehensions in the minds of the foreign investors who would like to have a long term investment strategy for India.

As a part of corporate strategy companies should give appropriate attention to use of jurisdiction with good treaty networks for implementing global investment structures. Clarity and consistency in disclosures assumes significance in the wake of regulatory compliances and hygienic corporate communications. It is also important that companies should be prudent enough to review and understand the shareholder agreements, references to key business rights and its transferability.

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