To Pay or Not to Pay: Vodafone tax imbroglio

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In the summer of 2013, there were some unplanned changes in the cabinet of the Indian central government due to the resignation of two ministers who got embroiled in controversies related to coal-block allocations and railway recruitment. Subsequently, Mr. Kapil Sibal took charge of the Law Ministry. On May 15, 2013, newspapers reported that the new Law Minister had cleared the deck for a conciliation between the income tax department and telecom major Vodafone over the disputed (approximately) Rs. 11,000 crore tax demand, with added penalties and interest payments — arising out of its $ 11-billion purchase of Hutchison's India operations in 2007.[1]

Later on May 26, 2013, the Law Minister further conveyed to the media that notwithstanding its taxation issues, Vodafone is going to invest billions of dollars in India. He also said that investors' renewed confidence in India's telecom sector is due to the new telecom policy that has laid out a clear roadmap for the next 20 years.[2] Though the company had agreed to conciliation (and an out of court settlement) even earlier, the previous Law Minister was of the opinion that there was no scope for conciliation within existing legal framework. In spite of recognizing this problem, Mr. Sibal opined that once a settlement is reached the parliament would ratify it.

The news brought cheer to industrial circles, and obviously relief for Vodafone. Mainstream media and industry, in general, interpreted this as a positive signal for attracting foreign investment. However, there were critics who felt that the government was bending to pressure from multinationals and also panicking unnecessarily in the backdrop of a slowdown in economic growth and a mounting current account deficit. Their viewpoint is that the government is providing undue advantage to Vodafone and setting a bad precedent for future corporate tax evasion.

Legal Tangle as it Happened

Vodafone made an entry into the Indian market in 2007 with more than 20 years of international telecom experience. Subsequently Vodafone became the second largest player in mobile telecom after Bharti Airtel in the Indian market (see Appendix).

In May 2007, Vodafone took over Hutchison Essar India through a deal with Hong Kong based Hutchison, which sold its shares of Hutch India via an indirect offshore transaction. "Vodafone Group owned Vodafone International Holdings, a Dutch company, which paid around $ 11 billion to Hutchison Telecommunications International to acquire CGP Investments, a Cayman Islands based entity. CGP Investments directly owned a Mauritius subsidiary (Maurco) and indirectly owned around 67 per cent interest in Hutchison Essar. In the sale, CGP investments and Maurco assigned inter-company loans that they held to various companies in the Hutchison group."[3]

As a result of the deal, Hutchison Essar changed its name to Vodafone Essar. The Foreign Investment Promotions Board (FIPB) cleared the deal with the caveat that minority shareholders can only sell to resident Indians.[4]

In August 2007 the Income Tax (IT) Department of India issued a show-cause notice to Hutchison Essar, and subsequently in September 2007 slapped Vodafone with a tax demand of around Rs. 11,000 crore. The IT Department believed that even if the transaction was between two non-resident companies, still Vodafone is liable to pay taxes because the transaction involved capital assets deriving revenues from operations in India.

It was also alleged by the tax authorities that the Vodafone transaction involved capital gains for Hutchison. Therefore, Vodafone was supposed to deduct at source the tax due from Hutchison before making the final payment to Hutch. However, Vodafone did not deduct anything and failing to do so the company was held responsible and asked to pay the tax due to the Indian Government.

Vodafone, on the contrary, believed from the beginning that the Indian Government has no jurisdiction to levy taxes on them since the transaction was between two non-resident companies and involved assets that might have been in India but were not under any Indian ownership since CGP (a Cayman Island based Company) controlled 67 per cent stakes in Hutchison Essar Limited and Vodafone, which, in turn, is not an Indian company, had purchased those stakes from CGP. It was Vodafone International Holdings, a Netherlands based company, which bought CGP. And even if taxes have to be paid, Vodafone believed that it should be paid by Hutchison and not by them.

On top of that, there was legal ambiguity in this case because at that time IT Act did not cover "failure to deduct tax at source" with clarity. "Under section 201, a person is deemed to be an assessee in default if there is a failure to deduct tax at source or for failure to deposit the tax deducted at source after such tax has been deducted. The persons covered under the ambit of section 201 included persons referred to in section 200. Sub-section (1) of section 200 provided that any person deducting any tax at source on payments other than salary shall pay the sum so deducted to the Central Government or as the Board directs within the prescribed time. A view had been expressed that the provisions of sub-section (1) of section 201 did not cover failure to deduct tax at source."[5] As a result of this absence of "failure to deduct tax" clause in section 200, there was always a legal possibility of exploiting that in section 201 by corporate entities. Though such an interpretation was contrary to the intent of the legislation, it could be always used as a legal defense. Vodafone exactly did that.

On the basis of these arguments, Vodafone went to the Bombay High Court (HC) in October 2007 challenging the IT Department's notice. It seems that Vodafone's strategy was to stall the claim process legally and then later use the above mentioned anomalies in the tax act to make its case viable and stronger.

However, in February 2008 the parliament amended Section 201 of IT Act. "The sub-section (1) of section 201 had been amended to clarify that where a person, including the principal officer of a company who is required to deduct any sum in accordance with the provisions of Income-tax Act does not deduct, or does not pay, or after so deducting fails to pay, the whole or any part of the tax, as required by or under the Income-tax Act, he shall be deemed to be an assessee in default under section 201." The amendments to consequences of non-deduction of tax at source were made applicable with retrospective effect from June 1, 2002.[6] The move (as seen cynically by some so-called industry watchers) was ostensibly meant to boost the sagging revenues of the government.[7]

Later in 2012, retrospective amendments were made in Income Tax Act (1961) – "intended to clarify and restate the legislative intent of the source rule of taxation for nonresidents in India. In particular, they addressed situations where transfers took place exclusively between such non-residents—hence indirectly — of underlying assets in India. The relevant section 9(1)(i) of the Act became effective retrospectively as of 01 April 1962."[8]

Finance Act 2012 also "brought out certain clarificatory amendments with retrospective effect which would have its application in taxation of capital gains in an offshore transaction by inserting explanations to the terms "transfer", "property", "through" and "capital asset situated in India."[9]

By those retrospective amendments, disposing of/parting with/creating assets (or interest in an asset) through direct or indirect transfer of shares of a company (irrespective of its place of incorporation) were brought into Indian tax jurisdiction, provided the transaction finally culminates in or relates to transfers in any company operating in India. The amendments also explained that definition of property "includes and shall be deemed to have always included any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever."[10] Sometimes transfer of shares does not necessarily imply simultaneous transfer of control and management of a company. This amendment was meant to plug that loophole.

To explain the phrase "capital asset situated in India," the 2012 amendment clearly stated that "For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India."[11]

As mentioned earlier, the IT Department's contention in the case was that final ownership of the company lies with Vodafone and though Hutch was supposed to pay the taxes Vodafone also cannot run away from their responsibility because Vodafone was supposed to deduct the tax at source and then pay the balance amount of the deal to Hutch. To the IT Department, this amounted to a case of tax evasion – more so given these "retrospective" amendments in 2008 and 2012.

In December 2008, the Bombay High Court rejected the plea of Vodafone and pronounced its judgment in favour of the Government of India, stating that Vodafone was liable to pay the taxes since the 2007 transaction with Hutchison Essar Limited involved purchase of capital assets of an Indian company. So, the Court rejected Vodafone's petition and said that IT Department has the right to investigate the case. Vodafone was not satisfied with the decision of the Bombay High Court and decided to challenge it in the Supreme Court (SC).

In January 2009, the SC dismissed Vodafone's appeal. The Court left the decision on jurisdiction of the deal to the IT department. It also referred the case back to the Bombay High Court. Subsequently in October 2009 the IT Department issued a fresh show-cause notice and Vodafone replied once again, in January 2010, saying that the

IT Department had no jurisdiction. Next in this never-ending tussle in May 2010, the IT Department issued an order emphasizing that it has jurisdiction; and Vodafone filed a petition in the Bombay High Court challenging this order in June 2010.[12]

In September 2010, the Bombay HC turned down Vodafone's petition and asked the company to pay up. "The Bombay High Court's ruling stated that the transaction involved not only the transfer of shares of CGP Investments but the transfer of other assets, such as control premium, the right to use the Hutchison brand in India, a non-compete agreement with the Hutchison group, the assignment of intra-group loan obligations, and certain option rights in relation to specific Indian entities. The court also stated that these diverse rights and entitlements had sufficient nexus with India. As a result, the court concluded that Vodafone Holdings was liable for up to $ 2.6 billion for failing to withhold on capital gains in connection with its purchase of CGP Investments."[13]

Vodafone appealed to the Supreme Court once again against the court order. After directing the IT Department to quantify the tax liability, SC asked Vodafone to deposit Rs. 2,500 crore and provide bank guarantees of Rs. 8,500 crore, pending final verdict in November 2010.

Meanwhile Vodafone had built a 100 million customer base in India by 2010 and had started making profits from its India operations by 2011. It also paid Rs. 11,618 crore for 3G spectrum in nine circles in 2010. The legal seesaw battle continued in 2011 and 2012. By this time, Vodafone paid and bought out its 33 per cent partner Essar and later sold 5.5 per cent stake to Piramal Healthcare for $ 640 million (around Rs. 2,890 Crore), apparently to comply with existing FDI limits.[14] Currently the limit is pegged at 74 per cent with provision of 49 per cent through automatic route (however, the inter-ministerial body, the Telecom Commission approved the limit to be increased to 100 per cent, as on July 2, 2013).[15]

The Supreme Court, in January 2012, decided in favour of Vodafone – stating that the transactions were made between two non-resident companies outside India and involved assets that were not part of an Indian entity. It also asked the IT Department to return Rs. 2,500 crore to Vodafone with 4 per cent interest. The IT Department still was not satisfied with the verdict and filed a review petition at the apex court which is currently pending.[16]

Senior lawyer Arvind P. Datar wrote in defense of Vodafone – "This was not the result of any devious tax planning scheme but the consequences of the growth of Hutchison Essar Ltd. by acquiring several telecom companies over the years. Hutchison International decided to exit its Indian operations and a public announcement was made to this effect."[17]

"The Government of India has no jurisdiction over Vodafone's purchase of mobile assets in India as the transaction took place in Cayman Islands between HTIL and Vodafone," Chief Justice S. H. Kapadia said in the judgment. He also said that Hutchison Essar, whose Indian operations were acquired by Vodafone, "was not a fly-by-night operator and was in India since 1994 and had contributed Rs. 20,242 crore by way of direct and indirect taxes."[18]

On the face of it, the Supreme Court believed that Vodafone had acquired Indian telecom giant Hutchison Essar's 67 per cent stake through CGP (Cayman Islands

Company) primarily for their expansion and growth reasons and not to evade taxes. The Supreme Court also expressed the view that the transaction by Vodafone (the off-shore transaction) is bona fide FDI into India which fell outside India's territorial tax jurisdiction, and hence is not taxable.

However, noted Supreme Court advocate and social activist Prashant Bhushan felt that "In the Vodafone case, the Supreme Court has again made a wrong call on tax avoidance, setting a precedent that jeopardises thousands of crores of potential revenue for the exchequer… With such welcoming winks towards tax avoidance devices, it is unlikely that any foreign company would be called upon to pay tax or at least capital gains tax in future in India. Thousands of crores of tax revenue, and the future attitude of the courts towards innovative tax avoidance devices, will be shaped by these two judgments (referring to another 2003 SC judgment on a Central Board of Direct Taxes (CBDT) circular related to alleged tax evasion by using Double Taxation Treaty)."[19]

Anti-Avoidance and High Powered Shome Panel

Earlier in a separate development, Finance Minister P. Chidambaram stated that there would be no rash action on Vodafone by the tax authorities and the issue would be decided after considering all aspects of the case. He also said that a decision on the Vodafone case would also be based on the recommendations of the Parthasarathi Shome Committee, which was constituted by Indian Government after this incident.

In response to a query on whether the tax authorities would send a notice to Vodafone for collection of dues following amendment the in the Income Tax Act to bring in the retrospective provisions, Mr.Chidambaram said, "There is section 119.There is a Supreme Court judgment. There is the opinion of the Attorney General. All this have to be studied by the assessing officer and his supervising officers… They will study all that. In the meantime, we will get the Shome Committee's report also."[20]

The government's tax demand from Vodafone in this case (and in other similar cases) is essentially on the basis of general anti-avoidance rules (GAAR). The discussion on GAAR started immediately after release of the draft Direct Taxes Code Bill (DTC) in August 2009. GAAR or similar anti-avoidance legislation was mooted because the difference among tax planning, tax mitigation, tax avoidance and tax evasion often gets blurred in India like in many other countries.

For example, the Income Tax Act in India states that even non-residents have to pay tax on incomes earned in India, but many foreign institutional investors (FIIs) avoided paying taxes citing the Double Taxation Treaty with Mauritius. This treaty allows a company to be taxed only in the country where it is domiciled. All these FIIs are based in other countries and are operating exclusively in India, but simultaneously claim Mauritian domicile on the legal ground of being registered there under the Mauritius Offshore Business Activities Act (MOBA). Interestingly, companies registered under MOBA are not allowed to acquire property, invest or conduct business in Mauritius. As mentioned earlier, the effort to get these entities into the tax net through a CBDT circular was foiled by the 2003 SC judgment favouring such companies. GAAR was specifically proposed to block these kinds of tax avoidance and evasions.[21]

Since the issue of anti-avoidance created a flutter in the stock market and foreign investment was apprehensive about the retrospective nature of GAAR, the Government of India decided to set up a high powered expert committee to look into the issues of GAAR and indirect transfer. The formation of the committee was expedited, to a great extent, because of this tax issue with Vodafone. The committee consisted of three members and was headed by Parthasarathi Shome. The Shome panel's primary objective was to investigate indirect transfers and submit its recommendations to the Government of India for advisory purposes.

The Shome Panel in its draft report submitted in 2012 recommended that any taxation involving indirect transfer of assets located in India should be prospective and not retrospective. The committee also said that retrospective application of law should happen in exceptional or the rarest of rare cases.The panel said that if the government opts for retrospective taxation of indirect transfers, no burden should be fixed on the payer for non-deduction of tax at source. Most importantly, the Committee had recommended that the implementation of GAAR be postponed by three years. Earlier, the Statute Book provided that GAAR would come into force from April 1, 2013.

As expected, major recommendations of the Shome panel were accepted and GAAR is now postponed till financial year 2016-17. Since GAAR is postponed now, obviously the "retrospective" nature of such anti-avoidance rules is also under a deep cloud.[22]

Slippery Past

Historically, this is not the first time that Vodafone has tried evading and dodging tax liabilities. "It acquired German company Mannesmann in 2000 using offshore holding company structures so as to avoid paying tax but ended up paying $ 1.7 billion as a negotiated settlement with the British government in 2010. This was about $ 1.3 billion lower than the tax liability it had provided for, thanks to the good sense of hiring as its negotiator the same man who had been pursuing the tax demand as an official of the British government."[23] This dispute was over Vodafone's activities in its Luxembourg arm, Vodafone Investment Luxembourg Sarl. This was established to utilize the low tax jurisdiction of the country.

Latest reports suggest that this settlement was preceded by another multi-million pound deal with Her Majesty's Revenue and Customs (HMRC) as part of a settlement linked to its Irish unit in 2009. Though the exact amount of the settlement has never been made public, the accounts of Vodafone's Irish subsidiary (Vodafone Ireland Marketing) show that Vodafone reclaimed € 67million of tax from the Irish government, which was then paid to the Treasury as part of the settlement.

This Dublin based subsidiary was started by Vodafone in 2002 to collect royalties and brand management fees from operating companies and joint venture partners doing business under the British flagship brand. It made collections from countries around the world – except the UK and Italy. "By 2007, Vodafone Ireland Marketing Ltd, a company employing no staff and registered to an industrial estate in the Dublin suburb of Leopardstown, reported a turnover of € 380million (£ 325million) a year."[24]

The Irish subsidiary was established to exploit tax incentives. If Vodafone could show evidences of "carrying out trading activities" from Dublin then the corporation tax rate would get halved. Having no staff and amassing such kind of turnover in 2007 forced Vodafone to relocate some of its employees in London to Dublin. “It was decided the Dublin team would oversee international advertising accounts, and Vodafone's big sponsorship deals including Formula One, the Champions League and the Ashes cricket Test series… In October 2011, Vodafone made an about-turn… The Irish brand subsidiary was wound down… Before it closed, the Dublin office paid more than € 1.04 billion (£ 900million) in dividends during a four-year period to a parent company, Vodafone Investments Luxembourg Sarl.”[25]

Ironically, all these out-of-country financial escapades of Vodafone are coming into light after the company disclosed that it had not paid any corporation tax in Britain for two years due to tough operating conditions in its home market.[26]

Coming back to the Indian experience, when Vodafone struck the deal with Hutchison in 2007, the FIPB cleared the deal with the caveat that thereafter minority shareholders could only sell to resident Indians. Contrary to this caveat, by October 2009 minority shareholders Analjit Singh and Asim Ghosh expressed their interest to sell their stakes back to Vodafone and later in December that year FIPB approved their stake sales. This was made possible by a new rule made in 2009, which said that indirect foreign investment would be treated as domestic equity, if it is routed through a company owned and controlled by Indians.

Singh and Ghosh held effectively 7.58 per cent and 4.68 per cent interest in Vodafone Essar respectively. They held those shares through three domestic holding companies each. While Analjit Singh was one of the promoters of Hutchison Max, Asim Ghosh served in Hong Kong based Hutchison Whampoa and later in Vodafone. “The shareholdings of the two individuals in Vodafone Essar (then Hutchison Essar) became a bone of contention in 2007 when Vodafone bought Hutchison Telecom's 67 per cent economic interest in the Indian mobile phone firm for $ 11.1 billion. At that time, it had been alleged that Mr. Singh and Mr. Ghosh were acting as 'fronts' for Hutch and Vodafone, but both of them were able to convince the government that this was not the case. Both vehemently denied these allegations, insisting that the stakes had been purchased through funds arranged through loans on commercial terms, though the loans were guaranteed by Hutchison.”[27]

Later in 2011, Ghosh sold his remaining equities to Analjit Singh and by that time had left Vodafone to join Husky Energy Inc. – one of Canada’s largest integrated oil and natural gas companies – as its President and CEO. Vodafone officially clarified that the transaction would not affect the holding pattern and there would no problem as the company is very much within the threshold of FDI ownership.[28]

Bad Precedent, Unresolved Issues and Panic Reaction

The Vodafone judgment is important for the company, but it has greater ramifications for the country as a whole. Many of the issues involved are yet to be resolved conclusively. Vodafone is naturally happy because they don’t have to pay $ 2.6 billion in taxes. The Supreme Court verdict also apparently soothed a lot of nerves in foreign companies which had acquired stakes and interests through holding companies based in countries outside India.

According to newspaper reports, the government is examining the possibility of putting in place a formal framework for resolving tax disputes, possibly keeping in mind the dispute with Vodafone. The mechanism is speculated to be similar to the advance pricing agreements used to resolve transfer pricing cases. This is "to provide for a negotiated settlement mechanism on the lines of advance pricing arrangements (APAs), a recently introduced route to resolve transfer pricing disputes that has become very popular with multinationals."[29]

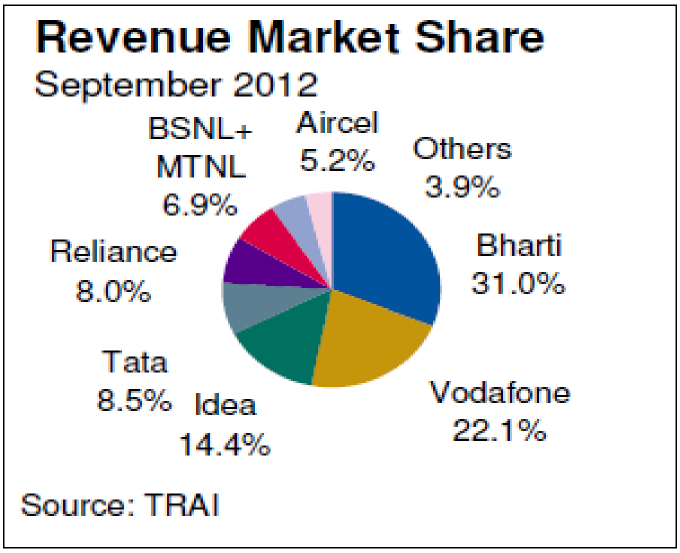
As if the talk of out-of-court negotiation was not a bad enough precedent to set – now we have a possible scenario where foreign corporate companies will be incentivized to start evading tax liabilities by acquiring Indian capital assets through tax-haven based holding companies. They will do so with impunity, and then they will be given a legal platform where they will bargain to pay less in terms of tax liabilities. Things cannot possibly be better for foreign multinationals and if this really happens then it will be lauded as a "huge improvement in business environment."

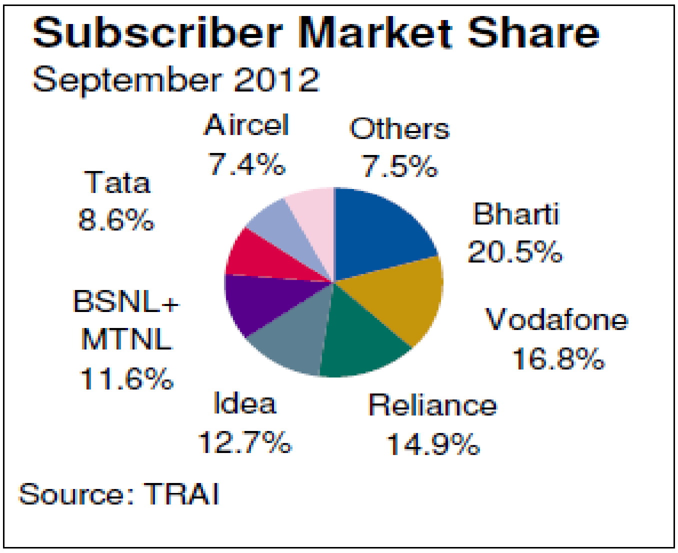
However, this chain of events involving Vodafone, Hutchison Essar and the Government of India has brought out the contradiction between policies attracting foreign investment and sound public finance policies. For the time being, status quo is maintained as far as anti-avoidance is concerned, but unlike in issues related to fiscal deficit, the "loss to the exchequer" argument is hugely missing from mainstream debate and discussion of the Vodafone case till now.

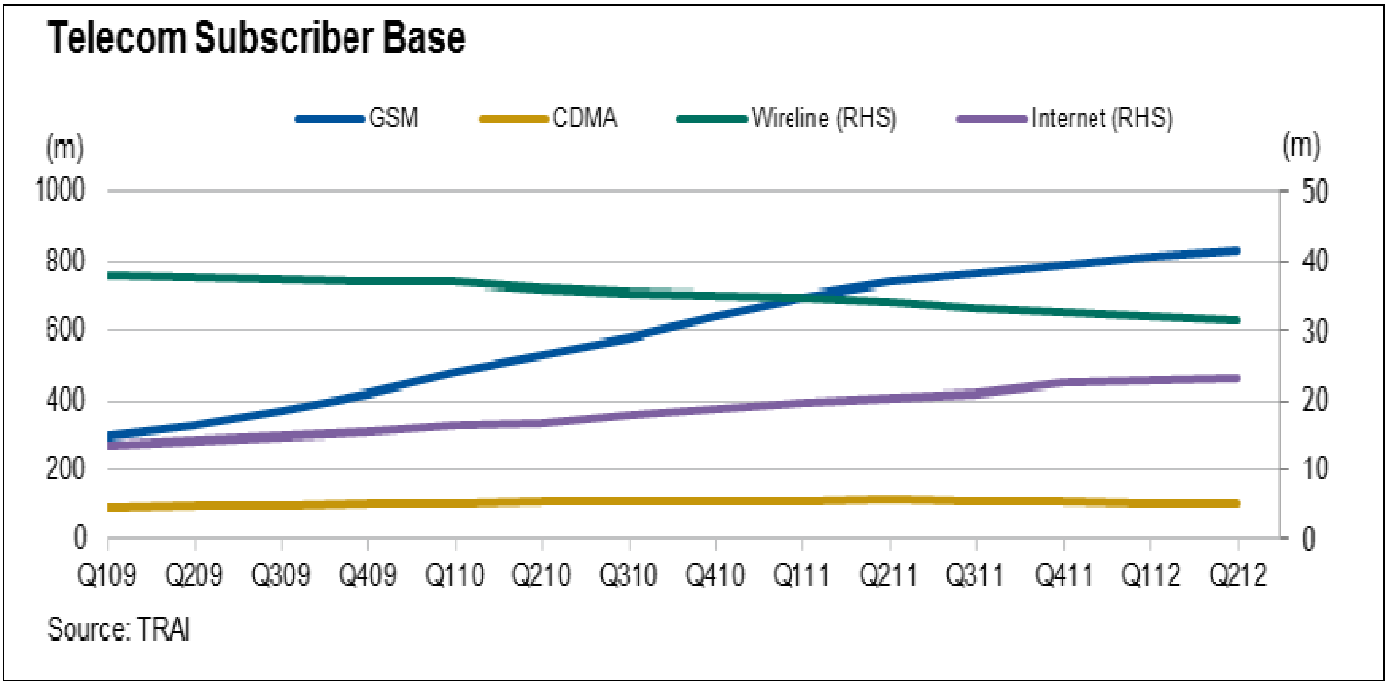
The entire issue of capital gains in this case is currently being posed such that at the end of the day any government in India has to make a distinct choice between attracting foreign investment and plugging loopholes in its financial and tax laws through anti-avoidance rules. This is definitely not so. On the contrary, the resultant measures adopted by the government have the potential to create a vitiated and lopsided business environment in favour of erring foreign companies and tax dodgers. The government and the country will also gain nothing in the bargain.

A prolonged slowdown in the economy and a mounting current account deficit have created panic among policy makers, who always see the ghost of the 1991 balance of payments crisis in everything, but fail to understand the efficacy of simple import control, capital control and exchange rate control mechanisms. As a result, today the country may face some bad public finance policy making for blanket appeasement of foreign investment. This appeasement, as we can see in this particular case also, invariably takes the form of creating new policies to clear all legal hurdles in favour of foreign investments. Even if we forget the legalities for a moment, it is impossible to find any sound economic logic behind such waivers as far as public finance is concerned. Less said about the normative and ethical parts of this fiasco, is better.

Appendix







Source: [2013 Outlook: Indian Telecommunication Services] prepared by India Ratings & Research