Vodafone Judgement: Guide To Law Laid Down By The Supreme Court

In **Vodafone International Holdings B.V. vs. UOI** the Supreme Court has laid down several important and far-reaching principles of law on tax planning vs. tax avoidance, interpretation of s. 9, applicability of s. 163, TDS obligations u/s 195, interpretation of statutes, policy towards foreign investment, etc. Our expert editorial team has carefully analyzed the entire judgement and identified all the core principles therein.

(A) Tax planning vs. Tax Evasion:

(1) The cardinal principle is that if a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. A document or a transaction cannot be looked at isolated from the context to which it properly belonged. It is the task of the Court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a whole and not to adopt a dissecting approach. This is the "Look At" principle. The Revenue cannot start with the question as to whether the transaction was a tax deferment/saving device but that the Revenue should apply the "look at" test to ascertain its true legal nature. Genuine strategic planning had not been abandoned and it cannot be said that all tax planning is illegal/ illegitimate/ impermissible. Tax planning may be legitimate provided it is within the framework of law. However, a colourable device cannot be a part of tax planning. There is no conflict between **McDowell** 154 ITR 148 (SC) and **Azadi Bachao Andolan** 263 ITR 706 (SC).

(2) While it has been a cornerstone of law that a tax payer is enabled to arrange his affairs so as to reduce the liability of tax and the fact that the motive for a transaction is to avoid tax does not invalidate it unless a particular enactment so provides, for the arrangement to be effective, it is essential that the transaction has some economic or commercial substance.

(3) The principle of "fiscal nullity" cannot be applied so as disregard a transaction and treat it as a fiscal nullity if it has enduring legal consequences. For the principle to apply there should be a pre-ordained series of transactions and there should be steps inserted that have no commercial purpose. The inserted steps can be disregarded for fiscal purpose and one can look at the end result and tax the end result by applying the terms of the taxing statute sought to be applied.

(B) Tax Planning in the context of Holding – Subsidiary structure:

(4) The law of corporate taxation is founded on the "separate entity principle" by which a company is treated as a separate person capable of legal independence vis-à-vis its shareholders/participants. The fact that a parent company exercises shareholder's influence on its subsidiaries does not imply that the subsidiaries are to be deemed residents of the State in which the parent company resides. Also, the fact that there is a restriction on the autonomy of the subsidiary's Board of directors is acceptable as an inevitable consequence of the group structure. However, if the subsidiary become a

"puppet" of the holding company, then the turning point in respect of the subsidiary's place of residence comes about.

(5) It is a common practice for foreign investors to invest in Indian companies through an interposed foreign holding or operating company, such as Cayman Islands or Mauritius based company for both tax and business purposes. This is to avoid lengthy approval and registration processes required for a direct transfer of an equity interest in a foreign invested Indian company.

(6) The question whether a transaction is used principally as a colourable device for the distribution of earnings, profits and gains, has to be determined by a review of all the facts and circumstances surrounding the transaction. It is in the above cases that the principle of lifting the corporate veil or the doctrine of substance over form or the concept of beneficial ownership or the concept of alter ego arises. There are many circumstances where separate existence of different companies, that are part of the same group, will be totally or partly ignored as a device or a conduit (in the pejorative sense).

(7) **Examples of "colourable devices" where tax planning schemes can be ignored**:

(i) **Example 1**: If an actual controlling Non-Resident Enterprise (NRE) makes an indirect transfer through "abuse of organisation form/legal form and without reasonable business purpose" which results in tax avoidance or avoidance of withholding tax, the Revenue may disregard the form of the arrangement through use of Non-Resident Holding Company, recharacterize the equity transfer according to its economic substance and impose the tax on the actual controlling Non-Resident Enterprise.

(ii) **Example 2**: If a structure is used for circular trading or round tripping or to pay bribes then such transactions, though having a legal form, should be discarded by applying the test of fiscal nullity.

(iii) **Example 3**: In a case where the Revenue finds that in a Holding Structure an entity which has no commercial/business substance has been interposed only to avoid tax then in such cases applying the test of fiscal nullity it would be open to the Revenue to discard such inter-positioning of that entity. However, this has to be done at the threshold.

(C) How to determine whether the investment is a "preordained transaction" created for tax avoidance purposes or one which evidences "investment to participate" in India:

(8) There is a conceptual difference between a "preordained transaction" created for tax avoidance purposes or one which evidences "investment to participate" in India. Strategic Foreign Direct Investment coming to India as an investment destination should be seen in a holistic manner. While doing so, the Revenue/Courts should keep in mind the following factors:

(i) the concept of participation in investment;
(ii) the duration of time during which the Holding Structure exists;
(iii) the period of business operations in India;
(iv) the generation of taxable revenues in India;
(v) the timing of the exit;
(vi) the continuity of business on such exit.

(D) Onus Is On The Revenue:

(9) When it comes to taxation of a Holding Structure, at the threshold, the burden is on the Revenue to allege and establish abuse, in the sense of tax avoidance in the creation and/or use of such structure(s). In the application of a judicial anti-avoidance rule, the Revenue may invoke the "substance over form" principle or "piercing the corporate veil" test only after it is able to establish on the basis of the facts and circumstances surrounding the transaction that the impugned transaction is a sham or tax avoidant.

(10) The onus is on the Revenue to identify the scheme and its dominant purpose. 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. The stronger the evidence of a device, the stronger the corporate business purpose must exist to overcome the evidence of a device.

(E) Whether gains on transfer of foreign company's shares can be assessed u/s 9 (1)(i) on the basis that it owns Indian assets and there is an "indirect transfer" of those assets?

(11) The Revenue's argument is that even if the shares of the foreign company are situated in the Cayman Islands, its' transfer attracts Indian tax because the foreign company owns Indian assets and there is an "indirect transfer" of the Indian assets which is assessable u/s 9(1)(i) is not acceptable because u/s 9(1)(i), income arising from "transfer of a capital asset situate in India" is deemed to accrue or arise in India. Three elements must exist for the section to apply, namely, "transfer", "existence of a capital asset" and "situation in India". This is a legal fiction and cannot be expanded by giving "purposive interpretation". The Revenue's argument that u/s 9(1)(i) it can "look through" the transfer of shares of a foreign company holding shares in an Indian company and treat the transfer of shares of the foreign company as equivalent to the transfer of the Indian assets on the premise that s. 9(1)(i) covers direct and indirect transfers of capital assets is not acceptable. S. 9(1)(i) does not cover indirect transfers of capital assets/ property situate in India.

(12) However, such "indirect transfers" are made taxable under the proposed Direct Tax Code (DTC) Bill, 2010 which provides that income from transfer of shares of a foreign company by a non-resident shall be taxed if at any time during 12 months preceding the transfer, the fair market value of the assets in India, owned directly or indirectly, by the company, represents at least 50% of the fair market value of all assets owned by the company.

(F) Where is the "source" of the gains?

(13) The argument that as the transaction had a deep connection with India, i.e. ultimately to transfer control over the Indian company, the "source" of the gain is India is not acceptable. "Source" in relation to an income means where the transaction of sale takes place and not where the item of value, which was the subject of the transaction, was acquired or derived from. As the purchaser and vendor are offshore companies and since the sale took place outside India, applying the source test, the source is also outside India.

(14) Substantial territorial nexus between the income and the territory which seeks to tax that income is of prime importance to levy tax. S. 9(1)(i) uses the expression "source of income in India" which implies that income arises from that source and there is no question of income arising indirectly from a source in India. The expression used is "source of income in India" and not "from a source in India".

(G) Whether valuation of the shares of the foreign company on the basis of the underlying Indian assets has a bearing?

(15) Though the purchaser paid consideration to the vendor based on the enterprise value of the Indian assets, valuation cannot be the basis of taxation. The basis of taxation is profits or income or receipt. In a case of tax on transfer of a capital asset (as opposed to a case of tax on profits arising from business operations), one has to see the conditions in which the tax becomes payable under the Act. In valuation, one has to take into consideration the business realities like the business model, the duration of its operations, concepts such as cash flow, discounting factors, assets and liabilities, intangibles, etc. Valuation is a matter of opinion. When the entire business or investment is sold, for valuation purposes, one may take into account the economic interest or realities. S. 9 cannot be applied only on the basis that the value of foreign company's shares was made up by the underlying Indian assets.

(H) Whether a transaction of sale of "shares" can be dissected so as to tax other underlying "rights and entitlements"?

(16) A transaction has to be viewed from a commercial and realistic perspective and it has to be determined whether it is a "share sale" or an "asset sale" because the tax consequences of a share sale would be different from the tax consequences of an asset sale. A slump sale involves tax consequences which could be different from the tax consequences of a sale of assets on itemized basis.

(17) A transaction involving transfer of shares lock, stock and barrel cannot be broken up into separate individual components, assets or rights such as right to vote, right to participate in company meetings, management rights, controlling rights, control premium, brand licences and so on as shares constitute a "bundle of rights".

(18) The character of a slump transaction cannot be altered by the form of the consideration, the payment of the consideration in installments or on the basis that the payment is related to a contingency particularly when the transaction does not contemplate such a split up.

(19) Merely because separate values in respect of the lump sum consideration has been indicated does not mean that the parties had agreed for the price payable for each separate item.

(I) Scope of section 195:

(20) S. 195 applies only when the payment made to the non-resident has an element of income embedded in it which is chargeable to tax in India. If the sum paid or credited by the payer is not chargeable to tax then no obligation to deduct the tax arises.

(21) If the sum is assessable in India, the payer has a duty to deduct tax at source u/s 195 unless such payer is himself liable to pay income-tax thereon as an agent of the payee.

(22) Also, if in law the responsibility for payment is on a non-resident, the fact that the payment was made, under the instructions of the non-resident, to its Agent/Nominee in India or its PE/Branch Office will not absolve the payer of his liability u/s 195 to deduct tax at source.

(23) Shareholding in companies incorporated outside India is property located outside India. When such shares become the subject matter of offshore transfer between two non-residents, there is no liability for capital gains tax and no obligation to deduct tax at source.

(J) Whether non-residents with no "tax presence" in India are liable u/s 195?

(24) A literal construction of the words "any person responsible for paying" as including non-residents would lead to absurd consequences. A reading of s. 191A, 194B, 194C, 194D, 194E, 194I, 194J read with s. 115BBA, 194I, 194J would show that the intention of the Parliament was first to apply s. 195 only to the residents who have a tax presence in India. It is all the more so, since the person responsible has to comply with various statutory requirements such as compliance of s. 200(3), 203 and 203A. The expression "any person" in s. 195 means any person who is a "resident" in India. S. 195 applies only if payments are made by a resident to another non-resident and not between two non-residents situated outside India. S. 195 did not apply to the present transaction because it was between two non-resident entities, through a contract executed outside India and consideration passed outside India. The transaction had no nexus with the underlying assets in India. In order to establish a nexus, the legal nature of the transaction has to be examined and not the indirect transfer of rights and entitlements in India.

(K) Scope of s. 163:

(25) U/s 160(1)(i), 161(1) & 163, the purchaser of an asset from a non-resident can be treated as an "agent" of the non-resident and can be assessed as a "representative assessee". A "representative assessee" is liable only "as regards the income in respect of which he is a representative assessee". In the context of a purchaser of a capital asset treated as an agent u/s 163(1)(c), the income must be deemed to accrue or srise in India u/s 9(1)(i). On facts, as there was no transfer of a capital asset in India, s. 163(1)(c) did not apply.

(L) On Certainty in Tax Policy:

(26) FDI flows towards location with a strong governance infrastructure which includes enactment of laws and how well the legal system works. Certainty is integral to rule of law. Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial for taxpayers (including foreign investors) to make rational economic choices in the most efficient manner. Legal doctrines like "Limitation of Benefits" and "look through" are matters of policy. It is for the Government of the day to have them incorporated in the Treaties and in the laws so as to avoid conflicting views. Investors should know where they stand. It also helps the tax administration in enforcing the provisions of the taxing laws.

(M) India – Mauritius DTAA: Applicability to Genuine FDI:

(27) In the absence of "Limitation Of Benefits" clause in the DTAA and the presence of Circular No. 789 of 2000 and Tax Residency Certificate, the tax department cannot at the time of sale of the investment, deny benefits to the Mauritius investor by stating that the investment was only routed through a Mauritius company, by a company resident in a third country; or that the Mauritius company had received all its funds from a foreign principal/company; or that the Mauritius subsidiary is controlled/managed by the Foreign Principal; or that the Mauritius company had no assets or business other than holding the investment/shares in the Indian company; or that the Foreign shareholder of Mauritius company had played a dominant role in deciding the time and price of the disinvestment; or that the sale proceeds received by the Mauritius company had ultimately been paid over by it to its 100% shareholder either by way of special dividend or by way of repayment of loans received; or that the real owner/beneficial owner of the shares was the foreign Principal Company. Setting up of a wholly-owned subsidiary in Mauritius by genuine substantial long term FDI in India through Mauritius, pursuant to the DTAA and Circular No. 789 can never be considered to be set up for tax evasion.

(N) India – Mauritius DTAA: Applicability to Non-Genuine FDI:

(28) However, the Tax Residency Certificate is not so conclusive that the Tax Department cannot pierce the veil and look at the substance of the transaction. The DTAA and Circular No. 789 dated 13.4.2000 does not preclude the Department from denying the tax treaty benefits, if it is established that the Mauritius company has been interposed as the owner of the shares in India, at the time of disposal of the shares to a third party, solely with a

view to avoid tax without any commercial substance. The department, in such a situation, notwithstanding the fact that the Mauritian company is required to be treated as the beneficial owner of the shares under Circular No. 789 and the Treaty is entitled to look at the entire transaction of sale as a whole and if it is established that the Mauritian company has been interposed as a device, it is open to the Tax Department to discard the device and take into consideration the real transaction between the parties, and the transaction may be subjected to tax. The Tax Residency Certificate does not prevent enquiry into a tax fraud.

Example: where an OCB is used by an Indian resident for round-tripping or any other illegal activities such as under-invoicing and over-invoicing of exports and imports and routing the same money in the guise of FDI or using black money. As these transactions are fraudulent and against national interest, the Revenue is not prevented from looking into special agreements, contracts or arrangements made or effected by Indian resident or the role of the OCB in the entire transaction.

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