

THE VODAFONE SAGA: TAX PLANNING AND CORPORATE VEIL PIERCING

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ABSTRACT

Corporate veil piercing in taxation matters had until recently been a well-defined subject with settled judicial precedents. A fine line had been struck between the need to tax transactions while still allowing scope for tax planning. This said distinction was based, *inter alia*, on the meaning of ‘colorable device’. However, the Vodafone Judgment in 2009 completely changed the scope of standards by expanding them further without, as some suggest- proper justification. The matter was placed before the Supreme Court, which came out with its judgment earlier this year, restoring clarity to the basic principles of tax jurisprudence that had been arrived at after years of litigation. While the decision in favor of Vodafone has come as a welcome relief to many, it is also interesting to note that there are other similar transactions in the offing and thus the *Vodafone* case has wider ramifications. Furthermore, with the Government not ready to let the Vodafone deal pass by, this controversy still remains alive after years of litigation and adjudication by the highest judicial authority of the country. This paper, analyzes the judicial developments as a result of the case along with set precedents on corporate tax planning in other common law jurisdictions such as Canada and the United Kingdom. The author thus tries to ascertain the changing contours of the Indian investment climate and its implications for the near future.

INTRODUCTION

Tax reduction is not evil if you do not do it evilly.

- Murphy Logging Co. v. United States¹

One of the basic characteristics of a corporate entity is its separate legal identity. It is one of the most recognized concepts in corporate law across several jurisdictions. Especially in common law countries, as witnessed in the case of *Solomon v. Solomon*² as well as other cases under the Indian³ and even in the US⁴ jurisdictions, the corporate personality is usually upheld and courts refrain from interfering. However, in certain cases, the court may look beyond the legal fiction involved, and into the reality or the root of the matter.⁵ The corporate veil may be pierced in matters where there has been

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1 Murphy Logging Co. v. United States, 378 F.2d 222 (1967).

2 [1897] AC 22 (HL). Also see, generally Lee v Lee's Air Farming Ltd [1961] AC 12 (PC).

3 Meenakshi Mills, Madurai v. The Commissioner of Income Tax, Madras, AIR 1957 SC 49.

4 Berkey v. Third Avenue Railway, 244 N.Y. 602, 155 N.E. 914 (1927).

5 3 N. Vija Kumar, *Income from Other Sources, Lifting of Veil and Section 57 (iii) of the Income Tax Act, 1961*, 199 TAXMAN 12 (MAG) (2011).

under utilization of capital, or failure to fulfill corporate formalities, frauds, alter ego etc.⁶ In addition, where the willful conduct of the directors etc. itself causes for the corporate veil to be pierced in instances where their actions are *mala fide* on the face of it.

Being one of the most litigated issues in corporate law in different jurisdictions, and with the *Vodafone* case having just reached its conclusion, it becomes imperative to look at the present legal position on this subject. One is compelled to question as to whether the nexus of a transaction with India, even if the nexus is only in the form of the assets being located in India is in itself reason enough to pierce the corporate veil in order to look into the intention of the parties. With other such deals also having been completed either prior to or at the same time as the Vodafone deal, the whole corporate world is following the implications of the judgment very closely. With the Finance Bill having received the presidential assent, new aspects of the problem have now emerged. The retrospective amendments to definitions under Section 2 and Section 9 of the Income Tax Act, 1961 not only make sure that any deals à la Vodafone entered into from now would fall under the tax net, but also keeping in mind the statements made by the Finance Minister in his Budget speech, could also pose problems to Vodafone as well. Thus, the Vodafone affair continues to be the controversy that refuses to die down.

This paper while beginning with a discussion on the general principles of corporate veil piercing with reference to tax planning contradistinguishes the same in other common law jurisdictions of the United Kingdom and Canada before entering into the development of the Vodafone controversy, as we know it today. The author, while giving a brief idea of what panned out before the High Court, focuses more on the Supreme Court decisions and the ramifications that the budget could have on deals such as Vodafone, and more importantly, the economy of the country itself. One must make sure that by trying to stop India from being perceived as a tax haven, it should not become overtly excessive, when it comes to exercising its tax jurisdiction. For the same to happen, the controversy needs to bury itself, but with the recent renewed efforts by the Government, the same does not seem to be happening in the near future. With the Direct Taxes Code⁷ perpetually changing form even before implementation and with new changes being suggested perennially, the author would not delve into the subject of how the judgment would stand under the DTC.

I. CORPORATE VEIL PIERCING: THE POSITION IN OTHER JURISDICTIONS

Against the general rule and legal fiction of separate legal personality, sometimes, especially in cases of fraud and tax evasion, the corporate veil is pierced, and those behind the subject matter of the transaction are held responsible. Corporate veil piercing is no longer restricted to a few jurisdictions. Yet, as is usually the case with power, it must

6 CIT V. Associate Clothiers Ltd. AIR 1963 Cal. 629; Juggilal Kamlatpat v. CIT, AIR 1969 SC 932.

7 Hereinafter DTC.

be used responsibly and thus veil piercing must not be done indiscriminately. Nevertheless, the 2008 version of OECD Model Convention commentary also specifically acknowledges that the purpose of tax conventions, inter alia, is to prevent tax avoidance and evasion. This is seen as one of the main reasons for veil piercing. In other common law jurisdictions such as Canada and the United Kingdom's, similar parameters for veil piercing such as ours are followed. Let us have a brief perusal of the same:

A. Canada

In tax matters, in addition to being granted the status of a taxpayer, a corporation derives several advantages from its being so. But where such an advantage persists, there also exists scope for abuse. Hence, the legislators and courts have developed various techniques to “pierce the corporate veil”, so that in certain matters, the shareholders, officers and/or directors may be jointly held or severally liable for the obligations of the corporation. The Supreme Court of Canada in *OPSEU v. Ontario (Attorney General)*⁸ while stating that the case of *Solomon v. Solomon*⁹ had become a major part of their law, also stated that in certain cases the veil can be lifted in the interest of third parties. Though there have been contradictions to the same, the Civil Code of Quebec Art. 317 specifically provides for no defense of juridical personality in matters where it [Corporation] is being set up solely for the purpose of dissembling fraud or abuse of rights or contravention of a rule of public order etc.

Thus, this section is a codification of the fact that there can be a transgression on the immunity that has been given to corporation in this regard. But, the three main elements evidenced through case laws that are being used to constitute the basis for the piercing of the corporate veil are:

1. The shareholders must themselves be involved in the transaction at issue;
2. They must have acted in bad faith when the transaction was entered into; and
3. The transaction entered into in bad faith by the shareholders must have the effect of confusing (in a tacit or explicit manner) the patrimony of the shareholders with that of the corporation, and thus of contravening the principle of patrimonial division.

The courts have applied such principles for veil piercing in landmark cases relating to tax such as *Toronto (City) v Famous Players Canadian Corp*¹⁰ and *Aluminum Co of Canada v Toronto (City)*.¹¹ While the former related to the inclusion of the income of the subsidiary into the income of the parent for taxation purposes, the latter applied the ruling of the former wherein it was stated that “in a way the subsidiary was a puppet in the hands of

8 [1987] 1 SCR 2, at 26.

9 *Supra* note 2.

10 [1936] 2 DLR 129 (SC).

11 [1944] 3 DLR 609 (SC).

the parent company as it had no independent functioning of its own.”

These ruling were further applied to cases such as *Conseil de la Santé (Montréal) v. City of Montréal*¹² and *Smith, Stone & Knight and Aluminum Co.*¹³ However, this test has proved to be very stringent as for it to take place there needs to be no independent functioning of the subsidiary. However, these cases are now considered the exception to the general rule; the basic rule remains that taxation is by itself very burdensome on the individuals and corporations¹⁴ and veil piercing for taxation purposes is to be applied in exceptional circumstances only.

One of the main reasons to justify infringement on the legal personality of the corporation in relation to taxation is *via* fraud. Nevertheless, the mere using of a corporation for reduction of tax liability is not the sole reason for piercing of the corporate veil.¹⁵ Instead, there should be a convincing proof of fraud. It is true that the controlling shareholder must structure a false transaction or some other actions with the specific intention of committing fraud. Thus, chiefly two situations may arise where fraud can lead to piercing of the corporate veil:

*On the one hand if a company is formed for the purpose of evading legal obligations or concealing fraud, the court will look behind the corporate veil.[On the other hand] if, after incorporation, those in control of the company direct it to commit a wrong, courts can pierce the veil.*¹⁶

Thus, in both the situations, a person who knowingly uses the company’s separate legal identity as a means to commit fraud is not protected on that count.

B. United Kingdom

In the UK, a landmark judgment on similar issues was propounded back in 1936, in *IRC v. Duke of Westminster*¹⁷, wherein it was stated that “given a document of transaction is genuine the court cannot go behind it to some supposed underlying substance.” The above rulings being applied in Canada that talk about extensive control have not been applied strictly in the United Kingdom. In *Adams v Cape Industries PLC*,¹⁸ the Court refused to pierce the veil even though it was proven that the parent company exercised considerable control over the subsidiary. According to them, true veil piercing can only occur in matters where the company has been set up for fraudulent purposes and thus

12 [1994] 3 SCR 29.

13 [1939] 4 All ER 116 (KB).

14 Inland Revenue Commissioners v. Westminster (Duke), [1936] AC 1 (H.L.).

15 R. v. Keylsen, 96 DTC 6265 (Man. QB).

16 HOWARD J. KELLOUGH AND PETER E. MCQUILLAN, TAXATION OF PRIVATE CORPORATIONS AND THEIR SHAREHOLDERS 245, (3d ed. 1999).

17 [1936] AC 1, at 19-20 (HL).

18 [1990] Ch 433 (CA).

did not envisage other situations where the same can be put to use. Under UK Law, veil piercing is seldom done. The Adams case also rejected the single economic unit theory propounded by Lord Denning in the matter of *DNH Food Distributors v. Tower Hamlets*.¹⁹

Lifting of corporate veil is definitely recognized under English Law,²⁰ however it is rarely used. It is another recognized principle in the United Kingdom, that justice alone would not warrant lifting of the corporate veil and unless there is a clear intent of mala fide included, the court will not employ equitable discretion.²¹ Fraud has thus been recognized through many judicial precedents as a legitimate ground for invoking this doctrine.²²

Thus, while there have been certain variations in piercing of the veil, the basic principle still remains that if a transaction is genuine, the court should not interfere. The court should look at the form and not the substance, as focus on the latter would not only be onerous to the court but the organizations as well. However, in cases of fraud etc., the substance of the transaction can be looked into.

II. THE POSITION IN INDIA

A company, as stated before is capable of enjoying rights and duties that are different from its members due to it being an artificial person having a separate legal identity.²³ It has a separate personality and identity from that of its shareholders.²⁴ This separation is qualified in nature i.e. in certain conditions such as when it is used for unjust and inequitable purposes, and then this veil is lifted.²⁵ These qualifications are in other words an exception to the general rule, the general rule being that of separate legal personality. These exceptions also include tax evasion and circumvention of tax obligations.²⁶

Tax planning is permissible as seen by the fact that companies routinely chose to follow the path of routing investments through Mauritius or the Cayman islands solely for the benefits, tax or otherwise that accrue out of such transactions. Furthermore, until glaring loopholes in our Double Tax Avoidance Agreements with Mauritius that allow for capital gains to not be taxed at all are removed, the revenue department cannot expect the courts to decide against what is clearly the letter of the Law. Thus, evidently,

19 [1976] 1 WLR 852 (CA).

20 *Creasey v. Breachwood*, [1993] BCLC 480 (CA) though later overruled by *Ord v Belhaven Pubs Ltd* [1998] 2 BCLC 447 (CA).

21 *Trustor v. Smallbone*. [2001] 2 BCLC 436 (Ch. D).

22 *Jones v. Lipman*, [1962] 1 WLR 832 (HC); *Gilford Motor Co. Ltd. V. Home*. [1933] Ch. 936 (CA).

23 PAUL L. DAVIES, GOWER AND DAVIES, *PRINCIPLES OF MODERN COMPANY LAW* 22 (8th ed., 2008).

24 *Salomon v. A Salomon & Co. Ltd.*, [1897] AC 22 (HL); *Guzdar v. CIT*, AIR 1955 SC 74.

25 KAREN VADERKERCKOVE, *PIERCING THE CORPORATE VEIL* 249 (2007).

26 *C.I.T., Madras v. Meenakshi Mills Ltd.*, (1967) 63 ITR 609 (SC).

courts in India have also upheld tax planning as a legitimate practice. However, the planning should not form a colorable device. What this means is that it should not have been used specifically as a means to evade tax. So if one manages to order their affairs in a manner, which enables them to pay a lesser tax under the appropriate act than they otherwise would have, then they cannot be compelled to pay more than that amount.²⁷

Thus, if an entity is made solely as a facade for the purpose of evading taxes, then it cannot be held to be a separate entity as such.²⁸ Thus, the form of the transaction may be ignored, if its substance evidences the use of a colorable device.²⁹ As a corollary to the same, if the transaction is plain and unambiguous, then the form and not the substance should be looked into.³⁰

The landmark case of *McDowell v. CTO*³¹, laid down the basic framework at the time on the issue of tax planning. In this matter, Justice Rangnath Mishra had observed that:

Tax planning may be legitimate provided it is within the framework of law, colorable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honorable to avoid payment of tax by resorting to dubious methods.

For example, one may cause income to be diverted before it accrues to him, thus exempting himself from tax on that amount. These devices, as stated by the Court do not depend upon considerations of morality.³² This has been reiterated by the Supreme Court in later decisions as well.³³ Thus the *McDowell v. CTO* case was nothing more than an exception to the hitherto settled law which allowed for tax planning. This jurisprudence was furthered in the matter of *Shiv Kant Jha v. Union of India*.³⁴ tax planning was deemed permissible in later cases such as *Commissioner of Income Tax v. Punjab State Electricity Board*.³⁵ Thus, even the courts have specifically upheld tax planning as legitimate, unless of course the same can be shown to be a colorable device. Hence, tax planning finds itself in relation to economic planning, and while the latter is for the state the former is for the subject.³⁶ It would not serve the economy well to tax the ingenuity of the individual in understanding the complicated maze of tax laws and positioning themselves in a manner to incur the least tax burden and hence benefit most out of their income. Therefore, if

27 *Supra* note 13.

28 *Barber-Greene Americas Inc. v. Commissioner of Internal Revenue*, (1960) 35 TC 36, *Union of India v. Azadi Bachao Andolan*, (2003) 263 ITR 707 (SC).

29 *Id.*

30 *CWT v. Arvind Narottam*, (1988) 173 ITR 479 (SC).

31 AIR 1986 SC 649.

32 *Madhuram Agarwal v. State of Madhya Pradesh* (1999) 8 SCC 667.

33 *Supra* note 27.

34 Review Petition (Civil) No. 1917-1918/2003 & Curative Petition No. 10569/2004.

35 1980 124 ITR 894 (P.H.).

36 INSTITUTE OF CHARTERED ACCOUNTANTS IN INDIA, *DIRECT TAX LAWS*, Volume I, 14.1.

tax planning not involving colorable devices is legitimate in its nature, its denial to an individual refuses to make economic or legal sense.

III. VODAFONE DECISION AND TAX PLANNING

*Vodafone International Holdings BV v. Union of India*³⁷ involved four major players. Hutchinson International³⁸ (non-resident company) held 100 percent shares in CGP Investment Holdings Ltd (non-resident company registered in the Cayman Islands) which in turn held 67 percent shares in Hutchison Essar (Indian company). Vodafone International, another non-resident company acquired, the entire shareholding of CGP Investments, thus indirectly also acquiring 67 percent share in Hutchison Essar. Thus not only were the buyer and the seller, positioned outside India, the transfer itself took place beyond the territory of India, and the only connection of the entire transaction to India was the indirect transfer of Hutchison Essar whose assets were situated in India.

The basic question arose whether the income has accrued or has arisen in India under Section 9 of the Income Tax Act. The Income Tax Department (of the view that it does), issued Vodafone a show cause notice asking why no action should be taken against Vodafone under the Act for not deducting tax at source while making payments to Hutch and thereby sought to recover USD 2.1 billion from Vodafone as alleged withholding liability. Its validity was challenged before High Court which stated that the petition challenging the show cause notice was premature as there was an alternative remedy available to the petitioner. The Supreme Court also dismissed the same with the direction to re-agitate the issue of jurisdiction with the concerned Assessing Officer.³⁹

The High Court, in its endeavor to decide on the validity of the show cause notice, inadvertently answered all the other issues against Vodafone, without really providing final and concrete conclusions. Thus, the judgment was understood to exist more for the academic interests rather than for conclusive determination. The High Court in this matter, tried to lift the veil over the intermediary by reasoning that the transfer of the intermediary in effect led to the transfer of a controlling stake in Hutchison Essar, which was the only Indian company involved. Even though the Additional Solicitor General on behalf of the state categorically stated that they did not believe the said transaction to be an illegal act or a colorable device, the Court decided the case as a fit one to pierce the veil, thus making the exception to the general rule. Thus, not only was the requirement of the transaction being structured as a colorable device not fulfilled, the judicial precedents over the years that had come to settle the principles of when piercing can occur were also largely ignored. Therefore, if such reasoning was to be accepted by the courts in India, then the same would be on faulty ground and would seriously jeopardize

37 [2009] 311 ITR 46 (Bom).

38 Hereinafter HTIL.

39 *Vodafone International Holdings BV v. Union of India*, [2009] 179 TAXMAN (Bom).

other mergers and acquisitions that had happened around the same time, as notices had been sent to others as well, along with the fact that companies would be wary of the tumultuous conditions in the market and would put their future investment plans on hold.

In the same year as the Vodafone Judgment, there also existed the *E*Trade Mauritius case*,⁴⁰ where the Advance Ruling Authority had given a different opinion on similar facts and circumstances. The facts in this matter involved a Mauritian Company, which was a subsidiary of a US Company. The subsidiary received capital contribution and loans from the parent and bought shares in ILFS, an Indian company. When these shares were subsequently sold, capital gains accrued in favor of the applicant (the Mauritian Company), which were exempt from tax under Article 13(4) of the Indo Mauritian Direct Tax Avoidance Agreement. According to the Income Tax Department, the company in Mauritius was only a facade and its sole purpose was to avoid taxes that would otherwise be incident on the US Company. The Court rejected this contention and held there to be no legal taboo against treaty shopping. It held that if an entity, for the purpose of mitigating its tax liability sets up another entity in a tax friendly zone, then the conduit entity cannot be simply declared invalid. It also opined that the Court, as stated before should not look into the matter or substance to judge validity or legality transaction. Instead, if less than honest means are applied by parties to escape tax liability, then the same is to be covered within the ambit of circumstances when the veil can be pierced. Where the documents themselves are a sham and only used to cover up the real transaction, only then would the circumstance be apt for veil piercing. Sham transactions are one where legal rights and obligations are only for the purpose of fooling the regulatory authorities involved; and even when the parties do not intend to have legal obligations, but do so only to portray the same to third parties, it would be a fit case to be called as a sham transaction. Thus if all the legal formalities are completed, there is no reason to consider the transaction as a sham. In the absence of compelling reasons, there is no reason to even consider piercing the corporate veil, let alone actually undertake the act.

IV. WHY THE REASONING BEHIND THE VODAFONE [HC] DECISION CANNOT BE DEEMED CORRECT IN LAW

The revenue department stated that the transaction of the petitioner amounted to a transfer of the capital asset situated in India and not merely “*transfer simplicitor*” of controlling interest *ipso facto* in a corporate entity. The Court felt it was inconceivable how Hutchinson could transfer its controlling interest in Hutchinson Essar without extinguishing its right in the shares of the Indian group. Further, the Court concluded that the purpose of transfer was to acquire controlling interest in Hutchinson Essar. The Court felt that the shares were merely a mode or a vehicle to transfer some other assets. This “other asset” was deemed to be situated in India. In addition, referring to CGP and HTIL as

40 A.A.R. No.826 of 2009.

similar entities or part of group companies is akin to lifting corporate veil between the entities of the same group, which is not in accordance with common law doctrine on group companies.⁴¹ Similarly, considering both to be the same is rife with inadequacies as then a company can hold just 49.9 percent stake with no chargeability to tax.⁴²

The Court instead of bringing forth an in-depth analysis of the merits should have just stated that the notice was not *non est* in law and thus could be maintained on that ground. The Court eventually stated that the transfer of capital asset situated in India and the capital gains arising therefrom is chargeable under Section 9(1) (i) of the Income Tax Act. As seen in *Gulzar v. CIT*,⁴³ nothing under Indian law fuels the assumption that the shareholder has any interest in the property of the company. In *Carrasco Investments v. Special Director, Enforcement Directorate*,⁴⁴ the Court refused to categorize the sale of the shares of a parent company outside India as a sale of shares of the subsidiary company within India.⁴⁵ The only exception to this would be if the corporate veil were lifted over the intermediate company. However, the facts in the Vodafone case do not warrant the same.⁴⁶ The existence of group companies or fully owned subsidiary itself would not entitle piercing of the corporate veil.⁴⁷ The doctrine of looking at the substance and not the form of the transaction applies when there is a colorable or illegal transaction, which has to be ignored. Thus in other circumstances, the substance should be ignored and only the form looked at. Further, subsequent transactions cannot be looked into in order to envision the prior transaction in a different light. Thus, the Court, though correct in maintaining the validity of the show cause notice, seemed to fault when it came to the merits of the dispute by overlooking judicial precedents, legal principles and adequate reasoning to the contrary.

By such a ruling, India may actually have added more complication to its existing taxation structure.⁴⁸ The Court chose its reasoning knowing that, a controlling interest alone under the Act does not constitute a separate or distinct capital asset.⁴⁹ So, even for composite consideration, there should be distinct assets.⁵⁰

41 *Supra* note 17.

42 T.N. Pandey, *Bombay High Court's decision concerning tax deduction at source where transacting parties are non-residents*, International Taxation, [2009] 176 TAXMAN 65(MAG).

43 1986 SCR (1) 164.

44 [1992] 2 Comp LJ 339 (Del.).

45 *Bombay HC Vodafone decision, Some Insights*, available at <http://legaldevelopments.blogspot.com/2008/12/bombay-hcvodafone-decision-some.html>.

46 *Supra* note 17.

47 In Re Acer Computers, (2004) 189 CTR 498 (AAR).

48 Rano Jain, *An Analysis of Bombay High Court's Decision in Vodafone Case*, International Taxation, [2009] 176 TAXMAN 75 (MAG).

49 Baijnath Chaturbhuj v. CIT [1957] 31 ITR 643 (Bom.).

50 R.P. Garg, *Bombay High Court on Vodafone*, International Taxation, [2011] 198 TAXMAN 12 (MAG).

Further in *Carew and Co. Ltd v. Union of India*,⁵¹ it had been stated that by way of acquisition of all the shares of a company, the shareholder could only acquire control and the right to manage and would not as a result acquire the undertaking. Further, the words “directly and indirectly” under Section 9 (1) (i) appear before “accruing and arising”, so the same interpretation cannot be given to “transfer’ under this sub-section.⁵²

V. ANALYSIS OF THE VODAFONE CASE: SUPREME COURT

The difference between tax avoidance and tax evasion is the thickness of a prison wall.

- Denis Healey

The culmination of the dispute on the 20th of January this year in favor of Vodafone in the multi-billion dollar dispute has caused a ripple of the favorable kind in the international market. The Court has brought back clarity to the issue of cross border investment after years of turbulence. The Revenue department, *inter alia* contended that the capital gains arising out of the transaction as a result of transferring the shareholding of CGP would amount to transfer of a capital asset situated in India and hence it would be liable to tax. The Supreme Court, while rejecting the above contention held that no part of the transaction was amenable to taxation in India.

A. FORM OF TRANSACTION OVER SUBSTANCE OF TRANSACTION: SECTION 9 IS A ‘LOOK AT’ AND NOT A ‘LOOK THROUGH’ PROVISION

The Supreme Court stated that a document or a transaction ought to be looked at in order to construe the facts of the case. Further, one must look at a corporate holding structure with a view to uphold the basis of corporate law, which provides for the separate legal entity doctrine.

It also opined that, Section 9 of the Income Tax Act, 1961 is not a look through provision through which one can look at the substance of the transaction even if the subject matter is outside of one’s jurisdiction. It is instead a legal fiction with a limited scope which ought not to be further extrapolated. The incomes that are deemed to accrue or arise in India include:

*all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, [***] or through the transfer of a capital asset situated in India.*

Thus, clearly, the capital asset needs to be situated in India and if the *situs* of the capital asset was ignored, then the letter and the spirit of the provision would be rendered ineffective. The Court cannot blatantly ignore the words of a provision and hold them

51 *Carew & Co. Ltd. v. Union of India* AIR 1975 SC 2260.

52 Chaitanya K.K., *Vodafone Decision – Why it requires a review?*, International Taxation [2011] 200 TAXMAN 51 (MAG).

for no real value. Without going into the substance of the transaction, the Court stated that the *situs* of the shares of CGP was the Cayman Islands and not India and hence there was nothing connecting the transaction with the latter. Further, the Court stated that the controlling interest and other shareholders rights cannot be seen as distinct assets from the shares themselves and thus cannot be called as “assets” under Section 9 of the Act for the purpose of application of the said provision. Thus, a “share sale” is not an asset sale. Both differ in their genesis and implications.

Therefore, one could not adopt a dissecting approach to treat the “property rights” emanating from the shareholding pattern in CGP as a distinct capital assets situated in India. Therefore, on this aspect, the view of the Bombay High Court was set aside. The Court held that the substance of the transaction should take a backseat when the form of the transaction is clear enough. Thus, Section 9(1) (i) cannot be rewritten to include an indirect transfer of capital assets/property situated in India. The legislature has not used the words “indirect transfer” in Section 9(1) (i) and therefore there is nothing to presume that the section covers direct as well as indirect transfers of capital assets. A view to the contrary would be absurd as neither literal, nor purposive interpretation leads to a contrary result.

The Court also stated that the DTC Bill, 2010 proposes taxation of offshore share transactions and thus this proposal indicates in a way that indirect transfers are not covered by the existing Section 9(1)(ii) of the Act. In fact the DTC Bill, 2009 expressly stated that income accruing even from the indirect transfer of a capital asset situated in India would be covered under a deemed sale accruing in India. Absence of such a provision in the present Act would mean that Section 9 is not a look through provision.

B. AMENDMENTS UNDER THE FINANCE ACT, 2012

Vide the Finance Act, 2012, Section 9(1)(i) of the Income Tax Act was amended to *inter alia* levy tax on a “transfer of a capital asset situated in India”. Explanations were inserted, with retrospective effect from April 1 1962, to clarify the meaning of the terms “transfer”, “capital asset”, and further expand the scope of Section 9 (1) (i) of the Income Tax Act, thereby bringing within the ambit of the Act, capital gains arising from the off-shore transfer of assets/shares, outside India. Hence, according to the Finance Act, 2012:

- (i) Section 9(1)(i) was amended to clarify that the expression “through” shall mean and include and shall be deemed to have always meant and included “by means of”, “in consequence of” or “by reason of”.

This would greatly widen the scope of the provision as compared to what it stands at present. Amending the same retrospectively could cause a lot more companies to fall in the tax net.

- (ii) Section 9 (1) (i) was amended to clarify 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.

This is clearly an effort to nullify what had been stated in Vodafone. The basis of the Supreme Court reasoning in relation to Section 9 had been that the provision does not provide to look through the transaction and does not allow indirect transfer of capital assets to be taxed. For all transactions that have not culminated as of now, it could spell doom as they could very well be brought under the ambit of this provision for any such transaction they may have entered into. The word “substantial value” remains to be defined in order to determine the tax implication arising out of transfer of a capital asset situated in India. This leaves open a window for litigation on the exact meaning of the words “substantial value”. Since the same is open for interpretation, there could be substantial litigation leading to conflicting decisions among the lower authorities and the Supreme Court might need to be called in again to ascertain the correct position. The liability to tax the indirect transfer also brings with it a corresponding tax-withholding obligation on the purchaser of shares.

Further, the retrospective amendment means that every transaction, which had been undertaken in the past, but for which assessment is not yet complete, could be brought under the tax net. According to the former Finance Minister, the retrospective clarificatory amendments will not be used to reopen any cases wherein the assessment order has already been finalized. It is clear that the orders u/s 201 are considered to be assessment orders or akin to assessment orders and appealable orders under Section 246A of the Act.⁵³ Thus, one would need to determine, when an order could be said to have achieved finality to decide where the Vodafone issue is finally going to go to.

- (iii) Section 2(14) was amended to clarify that ‘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.

This is another change that seems specific to the Vodafone decision to solidify the argument that property rights were being transferred, which had been used by the revenue department before the High Court.

- (iv) Another major amendment is in relation to section 2(47) of the Act to clarify that “transfer” includes and shall be deemed to have always included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in

53 Mahindra & Mahindra Ltd. v. Dy. CIT [2009] 313 ITR 263 (Mum) (SB), Delhi Development Authority v. ITO (1998) 230 ITR 9 (Del) ,District Excise Officer, Muzaffarnagar v. ITO (2000) 68 TTJ (Del)(TM) 436, ITO v. Delhi Development Authority (2001) 252 ITR 772 (SC).

any manner (directly or indirectly, absolutely or conditionally, voluntarily or involuntarily by way of an agreement whether entered into in India or outside India) or otherwise. This is notwithstanding that such transfer of rights has been characterized as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India.

- (v) Section 195(1) was amended to clarify that the obligation to comply with subsection (1) and to make deduction there under applies extends and shall be deemed to have always applied or extended to all persons, resident or non-resident, whether or not the non-resident has:-
 - (a) a residence or place of business or business connection in India; or
 - (b) any other presence in any manner whatsoever in India.

All the above amendments have been made retrospectively and therefore it remains to be seen whether they can bring some finality to the Vodafone issue.

C. ISSUE RELATING TO CORPORATE VEIL

With respect to the piercing of the corporate veil, the judgment of the Supreme Court did not imply that the principles as laid down in *Solomon case* were sacrosanct and could never be disregarded. It also observed that the General Anti Avoidance Rules have been judicially recognized and was not new to India. However, this would not mean that the separate legal identity of corporations could be disregarded. Thus, the corporate veil, as stated before can only be lifted if the transaction is a sham or a colorable device. Further, the Supreme Court stated that the burden of proof for whether a transaction was sham lay with the Revenue Department. Therefore, the Revenue Department has to prove the same, and only if it establishes a *prima facie* case in its favor would the other party need to rebut the same. Thus, if genuine business is the purpose of a transaction, that in itself would be evidence that it was not undertaken as a colorable and artificial device. Therefore, if the “corporate business” purpose exceeds the evidence of it being a colorable device, then the transaction is not a sham.

The Court also drew a distinction between a *mala fide* transaction to avoid tax, and a *bona fide* transaction, by way of tax planning required in order to participate more effectively in the Indian Economy. The structure in the present matter had remained the same for the better part of the decade i.e. from 1998 and thus no presumption could be drawn that the transaction was a sham.

Had the structure been set up immediately prior to the transaction happening, a perverse presumption could have been drawn against it. Thus, because the twin tests of business purpose and continuity were being satisfied, no illegality could be imputed to the same.

D. CORPORATE HOLDING STRUCTURES BACKED BY IMPORTANT BUSINESS CONSIDERATIONS

The Court also upheld the validity of the Mauritian route for investing in India. Under Article 13 of the India-Mauritius Double Tax Avoidance Treaty, the capital gains arising out of a transaction would only be taxed in the country of the alienator. Applying the facts of the present case, to the requirements of the above provision, one realizes that the jurisdiction where the capital gains should ideally be taxed is Mauritius. But, in Mauritius, taxes on capital gains are exempt. Thus, the capital gains arising out of the subject matter of the transaction do not get taxed at all.

There being no “Limitation of Benefits” provision, the benefits under the India-Mauritius route could not be denied to any corporation. However, this does not mean that the party would be given a clean chit with respect to other aspects of tax evasion such as round tripping, fraud etc. Nevertheless, in the present case, the Supreme Court laid down that CGP cannot be said to have been evading tax as there was a valid business purpose evident in the transaction. In the absence of a business purpose, tax evasion could have been a valid ground.

E. AZADI AND McDOWELL—NOT CONFLICTING

The expressions tax avoidance and tax evasion, while significantly pertinent to the debate at hand, find no definition in either the Companies Act, 1956 or the Income Tax Act, 1961. The cardinal principle of “every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be” still finds favor with the Courts in many jurisdictions. Hence, tax planning *per se* can never be said to be illegitimate or illegal.

Another controversy that had plagued the Indian taxing authorities for the better part of the last decade was reconciling the apparent differences between the *Azadi* and *McDowell* cases. In *McDowell*, the Supreme Court had upheld that tax planning was legitimate as long as it was within the framework of the law; though colorable devices employed to evade tax could not be said to be legitimate. The Court also stated that it was wrong to encourage the belief that it is honorable to avoid payment of tax by resorting to dubious methods. On the other hand, in the matter of *Azadi Bachao Andolan*, it specifically addressed the question of whether using the Mauritian route was tantamount to a colorable device. Seeing no apparent disagreement between the two judgments, the Court did not agree with the Revenue department’s argument that *Azadi* ought to be overruled.

The Court, agreeing with Justice Chinnappa’s separate opinion on the matter stated that the need to depart from the *Westminster Principle* was only in the context of artificial and colorable devices and thus found no conflict between *McDowell* and *Azadi*.

The Court, in order to arrive at this conclusion, looked deeply at the development of the law in United Kingdom. By looking at the *Ramsay* and *Westminster* cases, the Court

came to the conclusion that Ramsay did not discard Westminster but read it in the proper context by which a “device” which was colourable in nature had to be ignored as a fiscal nullity. Thus, Ramsay lays down a principle of statutory interpretation rather than an over-arching anti-avoidance doctrine imposed upon tax laws. Further, the Court also looked at the decision in *Craven (Inspector of Taxes) v. White (Stephen)*⁵⁴, wherein the ‘look at test’ was followed to determine whether there had been genuine strategic planning for tax avoidance.

If one looks at the Westminster principle, one notices that it never did give sanction to a person to order his affairs by any means, whether legitimate or illegitimate to reduce his tax burden. *Azadi*, by restoring the Westminster principle, is only affirming the sanctity of tax planning, as we know it. What *McDowell* goes on to state is also correct as it simply lays down that while tax planning is legitimate, the same must not be done *via* colorable devices. Mauritius, along with the Cayman Islands etc are known tax havens, and there are obviously certain benefits in relation to the capital gains taxes that are incident to a party if it does transact through these routes. Thus, it is only logical that every party would want to set up their businesses in Mauritius to take advantage of the benefits that arise. Merely because there has been a transaction through a Mauritian entity, would not cast a shadow of doubt over the same, fuelling a contention that it is a sham transaction.

One can only look at the form of the transaction to see if there are discrepancies, and if there is none, the substance cannot be gone into. The motive of the transaction being to avoid taxes would not *per se* invalidate it in the absence of a particular enactment that prohibits transactions of that type. The Court can only decide based on the law of the land as it exists at the time of the decision, and if there is nothing to prohibit a transaction of such nature, then irrespective of the economic hardship that is being caused, there could be no liability accruing on the persons involved. It is the task of the Court to ascertain the true legal nature of the transaction and while doing so it has to not adopt a dissecting approach but look at the transaction in question as a whole.

It is true that the same might result in a loss to the exchequer. However, the judiciary is not run by economic considerations and needs to look at the legal scenario before arriving at a conclusion. It could be true that the same is an archaic colonial model that results in a colossal loss of revenue; however, if on the other hand the substance of the transaction were looked at in every transaction that takes place, the same would only result in endless litigation and chaos.

Benefits that are allowed under a particular treaty or a law in force cannot be denied on the ground of economic loss, which can never be the sole consideration to determine the legality of a transaction.

54 (1988) 3 All. E.R. 495

The Court stated that the authorities might invoke the “substance over form” principle or “pierce the corporate veil” only after it is able to establish based on the facts and circumstances surrounding the transaction that the impugned transaction is a sham or specifically structured to be tax avoidant. Every strategic foreign investment flowing into India should be looked at in a holistic manner, bearing in mind factors such as: the concept of participation in investment; the duration of time during which the holding structure exists; the period of business operations in India; the generation of taxable revenues in India; the timing of the exit; and the continuity of business on such exit. As for now, only time will tell where the tussle between the investment favoring and tax favoring approach will reach.

The *McDowell* decision cannot be read as leading to a conclusion that all tax planning is illegal, illegitimate or impermissible. It only related to a specific case situation wherein there were colorable devices present. Furthermore, it is for the judiciary to understand that clauses such as “Limitation of Benefits” have to be incorporated into a treaty and cannot be read into by interpretation. Furthermore, all the references in *McDowell* as regards to departing from the Westminster principle were in the context of artificial and colorable devices.

Thus, there can be no discernible difference of opinion in what was expressed in *Azadi* and *McDowell*. While the latter expressed an opinion in specific circumstances, the former reiterated the general rule to be followed except in the case situation mentioned in the latter.

F. APPLICABILITY OF S. 195 OF THE INCOME TAX ACT, 1961 ON NON-RESIDENTS

The Court categorically stated that the transaction in the present matter was the outright sale of an asset situated outside Indian by a non-resident to another non-resident. Thus, with no taxable presence in India, it would be naïve to suggest that Section 195 of the Act should apply.

After reviewing cases such as *Clark v. Oceanic Contractors*, and *Eli Lilly*, Justice Radhakrishnan further remarked that withholding tax provisions under Section 195 of the Income Tax Act would apply only in cases where payments are made by a resident to a non-resident. In other words, it has been held that payments between non-residents are not subject to withholding taxes under the Income Tax Act.

Further, the Court also stated that Vodafone couldn't be held as a representative assessee for Hutchinson's tax liability as:

1. Under Section 163 which provides for who may be regarded as a representative assessee, withholding tax is not mentioned.

2. A person ought to be an agent of the recipient of income in order to qualify as a representative assessee. Further, such agency ought to be for the purposes of that income which can be deemed to accrue or arise in India, and not all agents could qualify as representative assessee.

The court observed that neither of the above-mentioned conditions applied in this case and thus Vodafone cannot be called as a representative assessee of Hutch. Thus, in conclusion, for the purposes of determining whether a transaction is sham or bogus, the following considerations need to be kept in mind:

- the concept of participation in investment
- the duration of time during which the Holding Structure exists
- the period of business operations in India
- the generation of taxable revenues in India
- the timing of the exit
- the continuity of business on such exit.

VI. CONCLUSION

Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.

-Judge Learned Hand, U. S. Court of Appeals, *Gregory v. Helvering*⁵⁵

The High Court decision tried fervently to mould theory with practise while trying to assert that assets were transferred in the form of rights. However, the decision failed on many counts and according to many, common sense has prevailed. The Supreme Court, on the other hand, has very clearly laid down the law on many aspects. The Vodafone decision [SC], while being very simple in its terminology has more far reaching consequences than any other judgment in the recent past. Some of the major transactions in recent history in which the government has seen a potential to raise significant tax revenue include Kraft Food's \$19 billion purchase of Cadbury's, Vedanta's \$8.6 billion acquisition of Cairn India, global beer giant Sab Miller's buyout of Foster and Sanofi Aventis' acquisition of Shanta Biotech. Now, as a consequence of this judgment, the

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Revenue is bound to lose out on billions in tax. Thus corporate entities must keep the above decision in mind while going for tax planning and if possible, obtain a nil withholding tax order from the tax authority before going forward with the same.

According to the United Nations Conference on Trade and Development (UNCTAD), India is set to become the second best destination for FDI by Dec. 2012, pushing the U.S. down to fourth best. However, considering the perennial uncertainty surrounding India's tax and regulatory regime, the same seems to be at risk momentarily.⁵⁶ However, as we have seen the tussle between Vodafone and the Indian Government seems set to cross into lands unknown and beyond the power of the Supreme Court itself. If the revenue wants to stem the "loss of revenue", then instead of trying to retrospectively amend the laws to include 'those' that got away, it should instead amend the relevant provision in the Income Tax Act, 1961 and the relevant Double Tax Avoidance Agreements, prospectively.

What is viewed as legitimate tax planning and what is intolerable tax evasion cannot be left to conjecture and surmise. The Supreme Court has thus upheld the rule of law by reading the latter and the spirit of the law instead of the relying on the economic motivations of the Government of India. It needs to be seen whether this retrospective amendment would be challenged or not.

Recent trends show that with the passing of the Budget and Finance Act, 2012 and the additional complications that it has brought to the Indian tax-regulatory environment, British telecom giant- Vodafone will not look to the Indian courts to come to its rescue anymore. It is set to rely on International Arbitration under the India-Netherlands Investment Protection Agreement to state that it has not been afforded 'fair and equitable treatment of investments', thereby violating legal protections granted to the company.⁵⁷ The Indian Government feels that the notice is premature and that tax issues are not covered under India-Netherlands Bilateral Investment Protection Agreement.⁵⁸ Vodafone on the other hand feels that it is being specifically targeted by the retrospective amendments, as there has not been any inkling to tax any other transaction that had happened prior or subsequent to 2007.⁵⁹ Further, while retrospective amendments in tax laws is not unheard of, this is the first time wherein a company despite having emerged victorious as a result of a judgment based on merit from the highest court in

56 *Taxing Times, What Will the Vodafone Case mean for Cross Border M & A* (Dec 21, 2011), available at <http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4529>.

57 Joji Thomas Philip & Vinay Pandey, *Vodafone To Opt For International Arbitration Against Indian Tax Authorities* (May 29, 2012), available at http://articles.economicstimes.indiatimes.com/2012-05-29/news/31888046_1_vodafone-notice-vodafone-plans-indian-tax-authorities.

58 *No Cause of action: Govt tells Vodafone*, Indian Express (May 30, 2012), available at <http://www.indianexpress.com/news/no-cause-of-action-govt-tells-vodafone/955729/0>.

59 *Supra* note 55.

the land is required to cough up tax for the same transaction in question. Thus, the Vodafone case has taken a new turn, wherein the parties now seem bored of conventional litigation and seem ready to try out other means of dispute resolution. Whether arbitration can do what the litigation could not, remains to be seen.

It can only be hoped that after the incessant litigation, and most probably arbitration or settlement as the case may be, the matter and those concerned with it will get the respite that they deserve.