India

Beyond Vodafone – The Ripple Effect

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Issue: Asia-Pacific Tax Bulletin, 2016 (Volume 22), No. 1
Published online: 15 March 2016

This article analyses the aftermath of the now famous Vodafone judgment and the resultant changes in tax law and policy internationally and in India. The article analyses the current ongoing debate around “tax ethics” and “morality” that has led to a slew of tax policy changes around the globe.

1. Introduction

India, with its burgeoning middle class and its rapid pace of industrialization, is one of the fastest growing economies in the world. With the rapid growth of its business and its attendant complexity in relation to tax issues, Indian tax authorities are fast earning a reputation as being one of the most aggressive in the world. Additionally, India during the past few years has played an increasingly active role as a member of G20 and was one of the early proponents of the Base Erosion and Profit Shifting (BEPS) concerns. Naturally, India has also been a strong advocate of transparency and Exchange of Information for tax purposes and has pushed the G20 forum to exert pressures on countries that do not conform to international standards of transparency. This has led to the recently promulgated law called the “Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015” which aims to curb black money, or undisclosed foreign assets and income and imposes tax and penalty on such income.

The starting point of India’s tilt towards an aggressive tax policy and an active role in global tax policy reforms can possibly be attributed to what is now famously (or infamously) called the Vodafone judgment, which put the Indian tax authorities, the Indian judiciary and Indian government at cross roads.

This article traces the aftermath of the Vodafone judgment and its effect on India’s tax policy including its significant influence on the debate around “tax ethics” and “morality” in today’s global economy.

2. The Vodafone Judgment

Unlike the Chinese tax authorities who had a mechanism in the domestic tax law to tax indirect transfers,[1] the Vodafone ruling signified the first time an Indian judicial authority (Indian Supreme Court) arbitrated on a transaction involving the indirect transfer of shares of an Indian company through an offshore entity. The main controversy surrounding the transaction was whether there was an indirect transfer of shares of the Indian entity due to the transfer of shares of a holding entity based outside India, thereby triggering the provisions of section 9(1)(i) of the Indian tax law (IT Act).[2] The complexity of the case was compounded by the fact that there was no enabling provisions under the IT Act to actually tax such transactions.

The matter was adjudicated by the India Supreme Court (SC) and the SC made the following crucial observations[3] in favour of the taxpayer:

- There is a distinction between “look through” approach and “look at” approach. It was held that the IT Act does not have “look through” provisions and it cannot be extended to cover indirect transfers of capital assets/property situated outside India. The Revenue or the Courts must “look at” a document or a transaction in a context to which property belongs.
- The Revenue/the Courts have to “look at” the entire transaction as a whole, and not adopt a dissecting approach.

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2. Section 9(1)(i) of the IT Act provides a deeming fiction to treat certain incomes to be deemed to accrue or arise in India.
In case of indirect transfers, the situs of the assets is located outside India and hence the transaction was not taxable in India.

During the course of delivering the verdict, the SC had also made certain other observations, particularly that such transactions could only be brought under the tax net through an express legislation.

The judgment of the SC signified a seismic shift in the Indian judiciary’s approach to tax planning vis-à-vis tax avoidance and overturned previous rulings of the SC\(^4\) which propounded a principle of “substance over form” in comparison to a “form over substance” principle which it upheld in the Vodafone ruling. Further, the SC dismissed the Indian tax authority’s jurisdiction over the offshore transaction and concluded that the Indian tax authorities did not have any right to levy tax on the “offshore share sale”.

### 3. Vodafone Judgment – The Aftermath

The government of India immediately filed a review petition against the SC judgment in the Vodafone tax case, and termed the judgment as one that suffered from many errors apparent on record and which failed to consider the case submitted by the Indian tax authorities. The SC dismissed the petition filed by the Indian government as without merit and needing no reconsideration.

The dismissal of the review petition signified the end of judicial options for the Indian government on the Vodafone transaction and led to a slew of tax policy changes resulting in retrospective amendments, domestic anti avoidance rules, new regulations to combat black money and culminating in India’s active role in global tax policy reform.

#### 3.1. Retrospective amendment to the law governing “indirect transfers”

The erstwhile government of India in order to negate the SC’s decision brought in amendments to the IT Act in its Budget for the year 2012, to tax such indirect transfers. The amendments provided that any share or interest of a foreign company is deemed to be situated in India if it derives directly or indirectly its value “substantially” from assets located in India. The ambit of the terms “property” and “transfer” were also widened. Therefore, transactions involving transfer of shares of entities based outside India with substantial assets in India were sought to be taxed in India.

The said provisions were made retroactively applicable with effect from Fiscal Year 1961-62 and this did not augur well with the investor community raising several questions in the minds of the investor community about the certainty of tax regime in India.

The Indian tax administrative body, Central Board of Direct Taxes (CBDT), subsequently came up with a clarification\(^5\) that cases which have already been concluded and for which no tax notices on the cases being reopened had been issued, would not be reopened on account of the said retroactive amendment. This managed to bring some respite to the investors and other stakeholders. However, the Indian tax authorities notwithstanding the clarification issued, continue to hound Vodafone India in relation to the transaction till date. A case in a point is the recent reminder issued by the Indian tax authorities to Vodafone reminding them about the tax dues on the transaction.\(^6\)

Vodafone also issued a notice to the Indian government signifying their intent to pursue the matter with the International Court of Arbitration based in London under the Indian-Netherlands bilateral investment promotion agreement.

#### 3.2. Retrospective amendment – Review committee and changes in the Budget 2015

The government in view of severe criticism on account of retrospective amendments constituted a committee\(^7\) to recommend on the feasibility of such amendments. The Committee recommended that the provisions relating to the taxation of indirect transfers are not clarifications and thus should apply prospectively. Further, the Committee opined that retrospective amendments in relation to the indirect transfer are neither clarifications nor in accordance with global practice and, based on the principles of equity and probity in taxation, such amendments should be applied prospectively.

\(^4\) SC’s ruling in McDowell and Co. Ltd.’s case.

\(^5\) Clarification issued by the CBDT on 29 May 2012.


\(^7\) The then Prime Minister of India constituted an Expert Committee on General Anti Avoidance Rules (GAAR) under the chairmanship of Dr Parthasarathi Shome to undertake stakeholder consultations and finalize guidelines. Subsequently, the Prime Minister referred vide Notification dated 30 July 2012 and 1 September 2012 an additional issue to the Committee, on the implications of the amendment made to the IT Act relating to the taxation of overseas transfer of assets where the underlying asset is in India, in the context of all non-resident taxpayers. The report was published in the year 2012.
The new government led by Mr Narendra Modi dealt with the issue of retrospective amendments and provided clarity on concept and taxability of indirect transfers in India through an amendment in the Budget 2015.

4. Vodafone and Its Impact on India’s Tax Policy

The impact of the Vodafone judgment and its effect on India’s tax policy can be understood in the slew of tax policy measures introduced post-judgment. Some of the significant tax policy measures include:

4.1. Introduction of General Anti-Avoidance Rules

The government of India introduced the General Anti-Avoidance Rules (GAAR) in the year 2012 that provided the tax authorities with a wide range of powers to the tax authorities to deny tax benefits if a transaction was entered into without commercial substance. The GAAR in India provides the tax authorities with substantial powers to recharacterize transactions in case they are entered into with the sole object of tax avoidance. The GAAR in India will be operative from 1 April 2016.

4.2. The “Black Money” Law

The government of India introduced the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act 2015 popularly known as the “Black Money” Law which aims to curb black money, or undisclosed foreign assets and income and imposes tax and penalty on such income.

The Black Money law was effective from 1 July 2015 and provides stringent penalty on individuals stashing illegal money outside India.

4.3. Tax Information Exchange Agreements

The government of India has been very aggressive in pursuing Tax Information Exchange Agreements (TIEA) with various countries which has led to voluminous sharing of information between India and these various jurisdictions.

India has already signed around 15 TIEAs and is in negotiations with around another 30 jurisdictions to enter into new TIEAs. Further, India is also pursuing to include articles on “Information exchange” in some of the existing tax treaties it has signed with other countries.

4.4. Base Erosion and Profit Shifting

While India is not a member of the OECD and is only an observer, it has played a pivotal role in providing its views on the BEPS action plans. Some of the significant points emerging out of the action plans like CBC Reporting (Country by Country Reporting – Action Plan 13), issues around Digital economy (Action Plan 1), Preferential tax regimes (Intangibles/Intellectual Property) (Countering Harmful tax practices more effectively – Action Plan 5) have already been acted on by India in its Budget 2016.

India is also aggressively pursuing changes to its domestic tax law and its tax treaties in line with recommendations of BEPS action plans.

From the above, it is quite evident that India is experiencing a radical shift in tax policy and the Indian government is keen to adopt every tool available to counter tax avoidance and aggressive tax planning. The government of India as a step in this direction has in February 2016 constituted a Tax Policy Research Unit (TPRU) and Tax Policy Council which would drive the government’s tax policy to reflect the changing economic needs in a global economy.

Interestingly, India has and continues to position itself at the forefront of the global debate on tax avoidance and its effect on the developing economies, possibly as an attempt to exert some influence on such matters.

5. Vodafone Judgment; Tax Ethics and Tax Morality

While the Vodafone transaction itself was viewed as being within the confines of India’s tax law, the past few years have seen a renewed debate on the aggressive tax planning structures adopted by global corporations and the resultant loss of revenue to the tax exchequer around the world. Further, while the structures adopted by these corporations exploited the loopholes around the domestic laws of countries and the beneficial provisions available under the various international tax treaties, tax economists around the world have questioned the morality of such structures particularly the revenue loss to
the developing countries which base their economic development around increasing tax revenues and widening the tax base.

Governments across the world, especially in the European Union, have aggressively pursued corporations indulging in aggressive tax planning leading to a spate of bad publicity for these corporations in those countries.

The government of the United Kingdom and HMRC have questioned the tax structure adopted by Starbucks which had sales of up to GBP 400 million in the UK but paid virtually no taxes in the UK. The subsequent publicity resulted in a significant drop in sales for Starbucks in the UK which resulted in Starbucks reaching an agreement with the UK government and remitting additional taxes during the fiscal year 2015. The UK government has also aggressively pursued corporations like Amazon and Google which have adopted similar structures resulting in minimal tax revenues for the British exchequer.

We have also seen similar stances to the one adopted by the British government in countries like France and Italy on similar structures adopted by other corporations.

Though aggressive tax planning by itself is not unlawful, it has acquired a moral and ethical tint in view of the huge public backlash during the past few years. Governments across the world have denounced such aggressive tax planning as “immoral”[8] especially when Revenue coffers across the world have substantially dried up in view of the global downturn.

The crying need of the hour may be an open debate between the various stakeholders (corporations, governments, public) on the boundaries of tax planning and its effect on the global economy.

6. Conclusion

The global downturn of 2008 including the staggered pace of recovery of global economy till date has renewed the debate around the ethical basis of aggressive tax structures adopted by corporations and the loss of crucial tax revenue due to such aggressive tax planning measures. Global multinational corporations like Starbucks, Google and Apple which have set up creative and aggressive tax structures resulting in minimal or low tax payments in the income earning “source” countries are facing increasing scrutiny from governments across the world.

While, the Vodafone ruling has not directly initiated the above debate around the aggressive tax structures, the extent of publicity that the transaction garnered and the aggressive posturing adopted by the Indian government, has set a precedent for governments around the globe on similar structures. As the Vodafone controversy rages on in spite of the Indian SC’s order, it would seem that countries across the world have taken a cue from the Indian government on the treatment of such transactions.