Vodafone vs. UOI: One step forward two steps back.

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The article manifests on the rising international disputes related to Bilateral Investment Treaties. They provide a safer channel for other nations to invest in host states. In times of dispute the resolution is governed by the provisions mentioned under Treaty. However, this may not be true to all cases and there still exists problems with enforcement of awards or judgements. One of the profound cases on retrospective taxation in India is still not able to find rescue from ever ongoing process of litigation. Despite the Indian Apex court validly ruling in favor of them. The enforcement of award and judgements are a long way since the Indian legislature using its power of amendments changes the law as it pleases. Therefore, even the hand of judiciary is shortened at the end of legislature, further affecting the investment opportunities in India.

Introduction

On 24thSeptember 2020, Vodafone Group won the most awaited battle against India under International Law. The legal battle involved one of the highest stakes among the foreign investor and Indian State. An Inventor State Dispute Settlement (ISDS) tribunal ruled that imposition of tax liability worth Rs. 22,000 Crore on Vodafone violates India – Netherlands Bilateral Investment Treaty (BIT) obligations. This case highlights the power of Legislature and a Sovereign State to turn events and situations into their court to gain tax. The taxing of nonresidents may be fruitful for a short period, but in the long run, it will prevent Foreign Direct Investments (FDI) due to the 'tax terrorism' or 'phobia' of heavy taxation. One of the significant effects of excessive taxation is disincentive to invest. In the global commercial world, India cannot develop without FDI. Therefore, it is necessary to attract instead ofrepelling economic development. Taxing net shall be limited to a particular parameter because if all the fishes are caught in the trap, there will be none left.

To curb this practice,the Supreme Court in the year 2012 delivered a landmark judgment in the matter of *Vodafone international Holdings Vs. Union of India and Anr*[1]. A three-judge bench declared Vodafone, a Netherlands company, was not liable to be taxed in India. The demand for'capital gains' to be taxed does not applyto indirect transfer. Hence, in J. Radhakrishnan's view, such taxing will amount to imposing capital punishment on capital gains as there is no authority of law.

The controversy pertained to the indirect transfer of capital not situated within the territory of India between two Nonresidents of India. Such capital gains are liable to be taxed as per section 9 of Income Tax Act, 1961(hereinafter referred to as "The Act").

FACTS

In 2007, Vodafone International holding bought 100% shares of a holding company CGP (Cayman Island), for an amount of USD 11.1 billion from a sale by Hutchinson Telecommunication International Limited (HTIL)[2]. CGP,through various organizational courses of action, acquired 67% shares of Hutchinson

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[1]Vodafone International Holdings BV v. Union of India, 2012 (6) SCC 757, at 68 [MANU/SC/0105/2009]

[2]Harsha Agarwal, The Vodafone Case: A critical Analysis, 1 International Sciences of Juridical Studies & Research 22, 21 (2019).

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Essar Ltd (HEL), an Indian company situated in India. Through this transaction, Vodafone gained control over the command of all subsidiaries and downstream of CGP. One of such subsidiaries was Hutchinson Essar Ltd. Hutchinson was a gathering of Hutchinson and Essar. Together, they had a license to provide Indian consumers with telecom communication services among India's various parts. They began operations in 1994.

By the year 2007, India's tax authority issued a show-cause notice to Vodafone why there shall be no imputation of tax on sale of HTIL leading to purchase of shares in HEL. The authority believed that there had been a capital gain by Vodafone after buying the assets located in India. Such transfer of shares of CGP has led to an indirect transfer of HEL in India. The authority felt the tax should have been withheld before making payments to HTIL.

Aggrieved by this, Vodafone approached Bombay High Court, wherein the issue of jurisdiction was remanded to the tax authority to formally decide the matter in addition to the direction that, if the authority affirms there is a tax liability to be fulfilled by Vodafone, they can directly approach the High Court. In the year 2020, the IT authorities, after pertinent scrutinization of documents,concluded that they had jurisdiction to continue against Vodafone to pay tax from installments concerning section 201 of Income Tax Act, 1961. This decision was challenged in High Court challenging it was a seaward transaction, and the nature of transaction has no direct nexus with territory of India. Although, the High Court dismissed the petition stating there was sufficient nexus with the territory of India to tax such transactions. This was later challenged in the Supreme Court by SLP as per Article 136.

Supreme Court rationale

The Supreme dealt meticulously with each issue:

1. Whether an indirect transfer of capital is subject to tax as per section 9 of the Income Tax Act, 1961?

The court in this issue dismissed the rationale of Bombay High Court. The High Court stated there had been a transfer of "rights and entitlements"[3] in addition to the shares. Therefore, such rights fall under the category of capital assets rendering the transaction taxable. In furtherance, the Supreme Court stated a "controlling test" and held itwas a responsibility of the companyand it does not hold the value of an independent capital asset. It is a mere incident of ownership of shares.

The court held that section 9 is a provision where various types of income are deemed to be accrued or arisen in India. Section 9 (1)(i) covers "all income accrued or arising, either directly or indirectly, through form or 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 situate in India."

In order to understand the provision, three criteria are defined for a transfer to be taxable.

i. Presence of a capital asset.
ii. Transfer of such asset.
iii. Position of such asset in India.

The court emphasized the term 'directly or indirectly' does not refer to the transfer of capital asset situated in India. This would amount to changing the content of

[3]Vodafone Supra note 1.

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section 9(1) (i). If 'indirect' is read with section 9(1)(i), it will lead to a nullifying effect of sub-clause 4.

In this regard, the court held that section 9(1)(i) is not a 'look through' provision and did not allow for such interpretation, rejecting the contention by IT department that 'through' under clause (i) means 'in consequence of,' stating it is aproscribed use of the statue[4]. It was also suggested that *situs*[5]of share could not be ascertained where the underlying asset is located but, on the basis, where the share is itself located. The court also made a passing reference to Direct Taxes Code Bill 2010, which is in furtherance to propose seaward share transactions. Therefore, it can be inferred section 9(1)(i) does not cover indirect transactions.

2. The court also differentiated between tax planning and tax avoidance.

The court supported the taxpayer by distinguishing between tax planning and tax avoidance. It is not necessary every tax planning is illegal or verboten. By departing from rule laid down in *Mc Dowell case,* where the court held tax planning is legitimate only if it is under the framework of law and no artificial or colorable route has been used in tax planning[6]. The Supreme Court in the present case followed the *Union of India vs. Azadi Bachao Andolan*, 2014, where there is a clear demarcation made between tax planning and avoidance is used to settle issues in the present case by the judges[7]. In the Vodafone case, the court settled that the sale of CGP was not an example of tax evasion as a similar purpose could be achieved by selling the shares of HEL by downstream subsidiaries in Mauritius for businesspurposes. It also observed that the FDI and FII could not be limited to be generating from Mauritius solely and not from other investors residing in other countries holding a company in Mauritius. The court viewed the Mauritius route of investing as clean and not sham or colorable device to evade taxing statutes in India. Therefore, the transfer of HEL through CGP to Vodafone is not a sham transaction.

The court ruled in favor of Vodafone protecting the FDI and FII for coming years and restrained from applying a draconian provision to tamper with the ease of doing business in India.

Further amendment

Soon after the judicial respite to Vodafone, the Finance Minister amended the Act with a retrospective effect. As per the legislature, the amendment intended to 'clarify' and not for 'removal of doubts.' The amendment's purpose was to settle the apparent mistakes in the judicial decisions concerning interpretation of section 9[8]. The Amendment made changes in the interpretation cause and included within section 2(14), capital asset the rights of management and control[9]. Section 2(47) amended to include transfers from a non -resident. Under section 9, the term 'through' included 'in consequence of' permitting indirect transfer taxation. The second change is the provision stating that if a capital asset is deriving value from

[4]Vodafone supra note 3.
[5]Vodafone supra note 5.
[6]Nishith Desai Associates, Victory for Vodafone in Indian Supreme Court: the final conclusion or another twist in the tale? THOMSON REUTERS PRACTICAL LAW (1 March,2012),https://content.next.westlaw.com/7-519-1524?__lrTS=20200910213538155&transitionType=Default&contextData=(sc.Default)&firstPage=true
[7]*Id.*

[8] Explanatory Memorandum, Finance Bill, 2012. The language used to expel for amendment was simply: " Certain judicial pronouncements have created the scope and purpose of section 9.

[9] Section 4(a), Finance Act, 2012.

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assets substantially located in India, it shall be deemed to be a capital asset situated in India[10].

Way forward

After the amendment, the issue was further challenged as per BIT between Netherlands and India ISDS decided on BIT provisions. The court, in this case, emphasized the 'fair &just' aspect. Such retrospective taxation imposed by India was against BIT's obligations, and therefore the Vodafone again was prevented from succumbing to India's tax liability. Although India can still challenge the award at the Seat of Arbitration and go down that road, it might create a repelling effect on other investors worldwide, limiting FDI possibilities in the long run.

Conclusion

In my opinion, article 245 (2) of the constitution, the powerhouse of the amendment, can be challenged. In order to satisfy an extraterritorial nexus, two criteria must be fulfilled:

i. Real or rationale territorial nexus
ii. The liability imposed shall be pertinent to the object.

In the present case, there is no real territorial nexus as it is a deliberate attempt to tax the services provided outside India by enterprises. With a similar analogy as per Nani Palkhiwala, one may even tax a foreigner ascertaining a hotel room service in India. In the present case, two nonresidentstransact outside India's territory over a company when there is indirect control over an Indian Enterprise.

In order to develop the country economically, the government keeps increasing the tax base. Amendment forming a significant part of taxation statutes shall only be applied with a prospective nature. Indeed, the amendments are ultimate to increase the tax base, but it can create a draconian effect in the long run on foreign investors. As visible in the present case, the liability of Rs.22,000 crores were a capital punishment by monetary means. Such laws will not attract foreign investment and instead act as a disincentive. For a developing country to develop, FDI & FII is necessary to generate employment and earn revenue from sales or manufacturing. If all such activities are circumscribed under the tax net, it will tamperwith commercial gains and investments. Apart from commercial gains, an investor also considers the ease of doing business and consistency of legal provisions reigning their investments. Concerning this, the taxation structure and law is essential to provide ease of doing business. I believe the legislature recognizes their fallacies and weighs the long-term effects of their actions before making such decisions, scramming international investors.

[10] *Id.*

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