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# Client Alert

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## FOREIGN BUYER OF INDIRECT INTEREST IN INDIAN COMPANY MUST WITHHOLD AND REMIT SELLER'S CAPITAL GAINS TAX TO INDIAN TAXING AUTHORITY

In a surprising decision, an Indian court has held a foreign buyer liable for as much as \$2.6 billion of a foreign seller's capital gains on the indirect sale to buyer of shares in an Indian company with Indian assets. In *Vodafone International Holdings B.V. ("Vodafone") v. Union of India and Anr.*,<sup>1</sup> the High Court of Judicature at Bombay recently dismissed Vodafone's appeal of the Indian Tax Department's (the "Department") decision to tax Vodafone on its approximately \$11.1 billion acquisition of a controlling stake in Hutchison Essar Ltd ("HEL"), an Indian company with some of its assets located in India.<sup>2</sup>

In February 2007, Vodafone, a cellular operator, purchased a 100% share interest in CGP Investments (Holdings) Ltd. ("CGP"), a Cayman Islands corporation wholly owned by the Hutchison Group, a Hong Kong company. CGP directly and indirectly owned a 67% share interest in the Indian company, HEL, also a cellular operator.

The Bombay court notes the Department primarily argues that Vodafone's acquisition of CGP generated Indian capital gains tax because the transaction has "sufficient territorial nexus to India."<sup>3</sup> The Department determined that nexus exists because Vodafone purchased CGP, which holds a share interest and associated rights in HEL, an Indian company with assets located in India.<sup>4</sup> Thus, the capital gains seller realized on the transaction are subject to Indian tax in the same proportion that HEL's Indian assets bear to HEL's total assets. The Department asserts that Vodafone, as buyer, should have withheld these taxes when seller Hutchison credited Vodafone's payment for the acquisition of CGP, under section 195 of the Indian Income Tax Act (the "Act"). Further, under section 200 of the Act, once Vodafone withheld the taxes, Vodafone had the responsibility to remit the withholding to the Indian government.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with either of the attorneys listed below, whose names and contact information are provided herein.

Dale Ponikvar  
212.530.5296  
dponikvar@milbank.com

Robert Finkel  
212.530.5271  
rfinkel@milbank.com

Thallen Brassel  
212.530.5892  
tbrassel@milbank.com

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<sup>1</sup> *Vodafone International Holdings B.V. v. Union of India and Anr.*, Writ Petition No. 1325 of 2010, The High Court of Judicature at Bombay O.O.C.J.

<sup>2</sup> The court gave Vodafone eight weeks in which to appeal the decision to the Supreme Court of India, after which the estimated bill of \$2.6 billion becomes due. Vodafone filed an appeal to this decision on September 14, 2010.

<sup>3</sup> *Id.* at 36.

<sup>4</sup> *Id.* at 35.

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Vodafone countered that Vodafone, the Hutchison Group and CGP are all non-Indian companies, and that the Department has no authority to tax such a transaction between offshore corporations with no nexus to India.<sup>5</sup> Vodafone's position is that the transfer of CGP to Vodafone represents a transfer of a capital asset between two foreign entities, and any gain arising out of this transfer is not taxable in India because the asset is not situated in India.<sup>6</sup> Accordingly, Vodafone maintained that it had no obligation to withhold or remit any capital gains tax to Indian tax authorities because section 195 of the Act is inapplicable to offshore transactions without nexus to India.<sup>7</sup>

The court states that under section 195 of the Act, there are two conditions to be met in order to hold a taxpayer responsible for withholding capital gains tax on its offshore acquisition of CGP. The first requirement is that the taxpayer pay interest or any other sum to an Indian non-resident. The second requirement is that the interest or other sum be taxable under the provisions of the Act. If both the first and second requirements are met, then tax must be deducted at the rates in force "at the time of credit of such income to the account of the payee or at the time of payment thereof," whichever is earlier.<sup>8</sup>

Moreover, the court found that the transaction had sufficient territorial nexus to India to be taxable under section 195 of the Act.<sup>9</sup> The jurisdiction of the Department to tax any Indian non-resident is based on the existence of a nexus between that party and India. This nexus is established if the party to be taxed has a physical presence in India, **or** if the source of the taxable income originates in India.<sup>10</sup> Specifically, tax may be imposed on income which (i) is received in India; (ii) accrues in India; or (iii) is deemed to accrue or arise in India.<sup>11</sup> In this case, proceeds of the share sale are income deemed to arise in India. Hence, they have an Indian source, and therefore, sufficient nexus to India to be subject to Indian tax.

Even where a payment is formally structured so that it has no element which could be made subject to tax in India, if the payer does not withhold any tax, and the Department thereafter makes a demand for tax which allegedly should have been withheld under section 195 of the Act, the burden is on the taxpayer to contend that his failure to withhold was justified on the ground that there was no taxable amount under the provisions of the Act. This is obviously a heavy burden, particularly on a foreign person unfamiliar with Indian tax law.

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<sup>5</sup> *Vodafone International Holdings B.V. v. Union of India and Anr.* at 23.

<sup>6</sup> *Id.* at 25.

<sup>7</sup> *Id.* at 32.

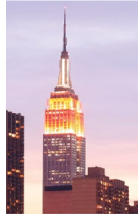
<sup>8</sup> *Vodafone International Holdings B.V. v. Union of India and Anr.* at 127.

<sup>9</sup> *Id.* at 36.

<sup>10</sup> *Vodafone International Holdings B.V. v. Union of India and Anr.* at 91.

<sup>11</sup> *Id.* at 182.

## WORLDWIDE OFFICES



### **New York**

One Chase Manhattan Plaza  
New York, NY 10005  
+1-212-530-5000



### **Beijing**

Units 05-06, 15th Floor, Tower 2  
China Central Place  
79 Jianguo Road, Chaoyang District  
Beijing 100025, China  
+8610-5969-2700



### **Munich**

Maximilianstrasse 15  
(Maximilianhoefer)  
80539 Munich  
Germany  
+49-89-25559-3600



### **Frankfurt**

Taunusanlage 15  
60325 Frankfurt am Main  
Germany  
+49-69-71914-3400



### **São Paulo**

Av. Paulista, 1079  
São Paulo, SP Brazil  
+55-11-2787-6282



### **Hong Kong**

3007 Alexandra House  
18 Chater Road  
Central, Hong Kong  
+852-2971-4888



### **Singapore**

30 Raffles Place  
#14-00 Chevron House  
Singapore 048622  
+65-6428-2400



### **London**

10 Gresham Street  
London EC2V 7JD  
England  
+44-20-7615-3000



### **Tokyo**

21F Midtown Tower  
9-7-1 Akasaka  
Minato-ku, Tokyo 107-6221  
+813-5410-2801



### **Los Angeles**

601 South Figueroa Street  
30th Floor  
Los Angeles, CA 90017  
+1-213-892-4000



### **Washington, DC**

International Square Building  
1850 K Street, NW  
Suite 1100  
Washington, DC 20006  
+1-202-835-7500