Milbank

February 23, 2012

Tax Group Client Alert

Beijing Frankfurt Hong Kong London Los Angeles Munich New York São Paulo Singapore Tokyo Washington, DC

INDIAN TAX DEPARTMENT CHALLENGES RECENT SUPREME COURT HOLDING THAT OFFSHORE INDIRECT INVESTMENT TRANSACTION IS NOT SUBJECT TO WITHHOLDING TAX

The hottest tax case in India has not been resolved just yet. On February 17, 2012, the Indian Tax Department ("ITD") filed a review petition challenging the very recent Supreme Court of India decision in *Vodafone International Holdings B.V ("Vodafone BV") v. Union of India & Anr.*[1] The Supreme Court will rehear the case on February 27th.

On January 20, 2012, the Supreme Court overruled the Bombay High Court's holding in *Vodafone* that the buyer of an indirect investment in an Indian Company was liable for failing to withhold $2.2 billion of the seller's capital gains taxes.[2] *See* Milbank Client Alert, Sept. 28, 2010. The Indian Supreme Court reversed and held that the transaction fell outside India's territorial tax jurisdiction, thereby relieving Vodafone BV of any Indian tax liability. The Supreme Court's holding reaffirmed foreigners' long-held understanding, disturbed by the High Court in 2010, that they could structure bona fide offshore transactions that *indirectly* transfer assets situated in India without accruing capital gains taxes in India. Whereas, when shares in an Indian company are purchased *directly*, the buyer must withhold 20% of the purchase price.[3]

The ITD's claim arose from an $11.08 billion[4] share sale that took place in 2007, in which Vodafone BV, a Dutch subsidiary of the British telecom company Vodafone Group Plc, bought CGP Investments (Holdings) Ltd. ("CGP"), a Cayman Islands company, from

[1] *Vodafone International Holding B.V. v. Union of India & Anr.,* Civil Appeal No. 733 of 2012, Supreme Court of India, Jan. 20, 2012 *[hereinafter* Supreme Court Decision].

[2] *Vodafone International Holdings B.V. v. Union of India & Anr.,* Writ Petition No. 1325 of 2010, The High Court of Judicature at Bombay O.O.C.J., Sept. 8, 2010 *[hereinafter* High Court Decision].

[3] Section 115E of the Indian Income Tax Act ("Act") requires investment income of non-residents to be taxed at a rate of 20%. This tax is to be withheld by the buyer under Section 195 of the Act.

[4] Supreme Court Decision at 78.

For more information regarding this Client Alert, please contact any of the attorneys listed below.

Dale Ponikvar
212-530-5296
dponikvar@milbank.com

Drew Batkin
212-530-5122
dbatkin@milbank.com

Lysondra Ludwig
212-530-5068
lludwig@milbank.com

This Client Alert is a source of general information for clients and friends of Milbank. Its content should not be construed as legal advice, and readers should not act upon the information in this Client Alert without consulting counsel.
© 2012 Milbank, Tweed, Hadley & McCloy LLP. All rights reserved.

Attorney Advertising. Prior results do not guarantee a similar outcome.

www.milbank.com

Hutchison Whampoa Ltd. ("Hutchison"), a Hong Kong company. CGP had effective control of 67% of Hutchison Essar Ltd. ("HEL"), an Indian telecom company.[5]

The High Court had held the buyer, Vodafone BV, liable to the ITD for the 20% withholding tax ($2.2 billion) on the sales proceeds.[6] The court maintained that CGP's shareholdings created a sufficient territorial nexus to India to require the transaction to be taxed under Section 195 of the Indian Income Tax Act (the "Act").[7] A 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.[8] Although the CGP share sale occurred offshore, the court held the transaction indirectly shifted ownership of assets situated in India—meeting the nexus requirement—and was thus subject to taxation.

The Indian Supreme Court disagreed with the High Court. The Supreme Court held that no Indian nexus existed, because the transfer of assets had been structured as a sale of the shares of a foreign subsidiary between two foreign entities. The Court ordered the ITD to refund Vodafone's $496 million deposit on the $2.2 billion tax liability, plus 4% interest.

The reversal was based on two key findings. First, the Court found the offshore transaction employed a "bona fide" structure. In making its first finding, the Supreme Court applied the "look at" test, which determines the legal nature of a transaction by taking a holistic approach.[9] The Court looked at the history of the holding structure to determine whether it had been created as an "investment to participate in India," specifically looking at: (i) the time period for which the holding structure existed, (ii) the period for which the holding structure was operating in India, (iii) the generation of taxable revenue in India, (iv) the timing of the exit, and (v) the continuity of business on such exit.[9] The Hutchinson structure was created as an "investment to participate in India." Created in 1994, it had companies operating in India since its inception, which paid Indian income tax, and upon the exit of Hutchinson,13 years later, the structure continues to operate in the Indian telecom sector in the hands of the buyer.[10] The Court deemed the form of the transaction legitimate.

Second, the Court found the transaction in the form adopted did not involve a capital asset "situate" in India as defined by Section 9(1)(i) of the Act. The Court held that the offshore transfer of shares of a foreign Cayman company which held a share interest in an Indian company was not taxable because the stock transferred did not represent an Indian capital asset.[11] A non-resident is taxed on income that is "deemed to accrue or arise in India,"[12] including income from the "transfer of a capital asset situate in India."[13] The Court stated, "Shareholding in companies incorporated outside of India (CGP) is property located outside of India."[14] Thus, the capital assets transferred in this

[5] Foreign Investment Promotion Board, *Press Note 5 (2005 series)* (India). The Foreign Exchange Management Act, 1999, No. 42 of 1999 (Dec. 29, 1999), grants the Foreign Investment Promotion Board ("FIPB") the power to regulate telecom services. The FIPB currently only allows up to 74% equity interest in shares of telecom service companies to be held either directly or indirectly by foreign investors. Twenty-six percent (26%) of HEL shares were held by Indian companies, including the AS (Analjit Singh) Group, the AG (Asim Ghosh) Group, and the IDFC Group, 67% by Hutchinson, and the remaining shares were held by other foreign partners.

[6] Act at §§ 115E, 195 (requiring "Any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest or any other sum chargeable under the provisions of this Act . . . shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force."), 198-199 (the tax deducted and paid is income received by the payee, and such amount is to be deducted by the payor, and credited to the payee).

[7] High Court Decision at 36.

[8] *Id.* at 91.

[9] Supreme Court Decision at 51.

[10] *Id.* at 51-52. The Court noted that the income taxes were paid during two tax periods under Hutchinson ownership (2002-2003 and 2006-2007), and during two tax periods under Vodafone BV ownership (2007-2008 and 2010-2011).

[11] *Id.* at 89.

[12] Act at § 5(2).

[13] Act at § 9(1).

[14] Supreme Court Decision at 89.

case were deemed situated outside of India, even though the sale indirectly led to the transfer of effective control of 67% of an Indian business, and no nexus existed. With no nexus, withholding tax obligations are inapplicable to a non-resident lacking a tax presence in India. Note, however, that the Court specified that the offshore transfer of the stock of an *Indian company* between Indian non-residents *would* be deemed to accrue or arise from India and, thus, be taxable under Section 5(2) of the Act.[15]

Commentators have correctly stated that the Supreme Court's holding may not be the last word. As our lead notes, the ITD has filed a review petition before the Supreme Court. The ITD is challenging the Court's interprertation of Section 9 of the Act and the Court's understanding of the transaction.[16] Even if the Supreme Court reaffirms its holding, press reports suggest that the Indian government may override the decision through legislative means.[17] This matter seems far from closed. This legal uncertainty could impact pricing, and language should be incorporated in deal documents that addresses whether buyer withholding will be made, and if not, how buyer and seller plan to address this tax risk.

[15] *Id.* at 45 (referencing Section 5(2) of the Act, which states that "the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which. . . (b) accrues or arises or is deemed to accrue or arise to him in India during such year.").

[16] India Const., Art. 137 (1949); Arun S., *Vodafone Tax Case: Centre Files Review Petition in Apex Court*, The Hindu, Feb. 17, 2012, http://www.thehindubusinessline.com/industry-and-economy/info-tech/article2903560.ece?homepage=true; Pratap Patanik and Adi Narayan, *India Files Petition in Top Court to Review Vodafone Tax Ruling*, Bloomberg Businessweek, Feb. 17, 2012, http://www.businessweek.com/news/2012-02-17/india-files-petition-in-top-court-to-review-vodafone-tax-ruling.html.

[17] India's drafted Direct Tax Code contains provisions instituting taxation of indirect investment in India; this new code could be released as early as 2013. *As Vodafone Cashes In, India Gov't Wrestles with the Tax Law*, Forbes, Jan. 24, 2012, http://www.forbes.com/sites/kenrapoza/2012/01/24/as-vodafone-cashes-in-india-govt-wrestles-with-the-tax-law/; *India Top Court Says Vodafone is Not Liable for Up to $4.4 Billion in Taxes and Penalties*, Washington Post, Jan. 20, 2012, http://www.washingtonpost.com/business/india-top-court-says-vodafone-is-not-liable-for-up-to-44-billion-in-taxes-and-penalties/2012/01/20/gIQA9EfvCQ_story.html.

------------ o ------------

For more Milbank Client Alerts, please visit our News page at www.milbank.com.

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

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

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

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

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

Munich
Maximilianstrasse 15
80539 Munich, Germany
+49-89-25559-3600

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

São Paulo
Rua Colombia, 325
Jardim América
São Paulo 01438-000 Brazil
+55-11-3927-7701

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

Tokyo
21F Midtown Tower
9-7-1 Akasaka
Minato-ku
Tokyo 107-6221
+81-3-5410-2801

Washington, D.C.
International Square Building
1850 K Street, N.W.
Suite 1100
Washington, D.C. 20006
+1-202-835-7500