SC Decision in Vodafone Case – Jan 30, 2012

SC Decision in Vodafone Case – A Litany of After-Effects
JANUARY 30, 2012
By S Sivakumar, CA

NO other case has, perhaps, generated the kind of extraordinary interest that the Vodafone International Holdings BV case **(**2012-TII-01-SC-INTL**)** has, in recent months. It would probably take time for the tax practitioners and the other stakeholders to fully digest the full extent of the implications that would arise out of this important decision.

Here is an attempt to try and look at certain macro implications … But, before that, let's try to have a synopsis of this case.

As we know, Section 9(1)(i) of the Income tax Act states that, 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 situate in India, shall be taxable in India. It was largely this issue with the Apex Court was concerned with, while dealing with the Vodafone case. The question that arose was whether, the transferor company, which is a holding company incorporated offshore and which was effectively controlling its Indian subsidiary company through a maze of fully owned foreign subsidiaries could be said to be liable for capital gains tax, in respect of its transaction involving divesting of control in its Indian subsidiary, by transferring shares in a foreign subsidiary company to another foreign subsidiary company, in a transaction that took place outside India. The issue was whether this transaction amounted to an indirect transfer of a capital asset situated in India and whether, the provisions of Section 9(1)(i), referred to above and consequently, taxable in India.

The Apex Court, while deciding this case, has held that, the word 'indirectly' appearing in Section 9(1)(i) would not cover "indirect transfers" of capital assets situated in India and that, the said Section 9(1)(i) does not contain 'look through' provisions. The Apex Court had held, the legislature has not used the words "indirect transfer" in Section 9(1)(i) and that, if the word 'indirect' is read into this Section, it would render the express statutory requirement of the fourth clause in Section 9(1)(i) nugatory and has further held that, Section 9(1)(i) applies only to transfers of capital assets situated in India. Further, the Supreme Court has categorically held in Paras 183,184 and 185 that, Section 195, which mandates tax to be deducted at source on payments to non-residents, cannot cover payments made by a non-resident (to another non-resident). In other words, Section 195 does not have an extra-territorial jurisdiction, as per the Apex Court.

In terms of the issue as to whether, this particular transaction is to be treated as a 'transfer' in terms of Section 2(47) of the Income tax Act, the Apex Court has held that, there is no transfer of shares of the Indian Company, in respect of the transfer of shares of a foreign company (in this case, the shares were transferred by one non-resident to another non-resident) as it cannot be said that there is an extinguishment of the control and the transfer of an asset situated in India and neither is a transfer of an asset or management and control of property situated in India, in the instant case.

On whether and to what extent, the Revenue is entitled to lift the corporate veil in respect of transactions between the holding company and subsidiary company in taxation matters and apply the well-recognized tax principle of substance over form, the Apex Court has, in effect held, this concept cannot be applied in a case where, interalia, transactions are organized in a manner to take advantage of tax planning devices, as contrasted to tax evasion.

This judgement makes a great reading material for all those interested in issues concerning non-resident taxation. What are the possible after-effects arising out of this judgement?

Here's my take:

++ The Government, despite the huge loss of revenue arising out of this judgement and certain other similar cases which are pending, is unlikely to bring in a retrospective statutory amendment in the coming Budget, as this would severely dent its credibility amongst the foreign investors.

++ Of course, we can expect certain amendments to deal with the implications arising out of this case, on a prospective basis. Of course, that the Direct Tax Code Bill already contains a provision that the income from the transfer, outside India, of a share in a foreign company, shall be deemed to arise in India, if the FMV of the assets by the foreign company is at least, 50% of its total assets. This fact has been recorded in the Vodafone judgement by the Apex Court. In the instant case, it would seem that, the transaction would be taxable under the DTC. The Government could go for a prospective amendment in the Income tax Act, especially as it seems that the DTC is not likely to getimplemented from April 1, 2012.

++ This decision would have a major impact on the tax deductibility in respect of transactions involving non-residents which get conducted outside of India. Since the Apex Court has not approved the extra-territorial applicability of Section 195, it would now seem that, no tax can be levied on transactions entered into with non-residents outside of India. Though, there have been judicial pronouncements that, Section 195 requiring tax to be deducted at source in respect of payments to non-residents is not applicable when the services are rendered by the non-residents outside India and are utilized outside India, this judgement would seal the issue once and for all. Going forward, in my view, Section 195 requiring tax to be deducted at source can be invoked only in cases where the services have been fully or partly performed by the non-resident in India. Typical examples where tax cannot be levied in India are services performed by foreign selling and marketing agents, off shore professional services, services rendered for organizing exhibitions and fairs held abroad, etc.

++ This judgement would have a major impact, vis-à-vis the contentious issue regarding the applicability of Section 206AA of the Income tax Act, to transactions involving payments by residents to non-residents. As is known, Section 206AA requires tax to be deducted at 20%, when the payee has not provided details of his PAN. The Department has been taking a stand that, Section 206AA read with Section 195, has applicability to payments to non-residents also, leading to a rather absurd situation requiring non-residents who might not have ever visited India, to apply for PAN. With the Apex court holding that Section 195 has no extra-territorial applicability, Indian importers of services can now heave a huge sigh of relief.

++ Any implications arising out of this judgement on service tax? Though this decision has been given in the context of the income tax law, its reverberations would surely be felt in the area of levy of service tax under the reverse charge mechanism, under Section 66A of the Finance Act, 1994. In my strong view, post the Vodafone judgement, service tax cannot be levied on the services importers in respect of transactions which get concluded outside of India. A typical example would be that of commission paid to overseas selling agents. In other words, the reverse charge mechanism can work only when the non-resident renders services while being in India.

Before concluding …

++ More than anything else….. the decision is a great step forward in the dependability of India's great judicial system and will go a long way in reassuring foreign investors, especially, given the fact that, this high profile case has been decided in about five years' time.

++ The judgement reaffirms that tax planning, as contrasted to tax evasion, is a sustainable tax related strategy. Obviously, this would not be to the liking of the Revenue, which would want to see all international transactions from the evasion point of view.

++ Certain highly relevant observations have been made by the Hon'ble Judges in this judgement. For instance, the Hon'ble CJI has observed that, that foreign direct investment flows towards locations with a strong governance infrastructure, good laws, efficacious enforcement of laws by the legal systemand that, certainty is integral to the rule of law. One hopes that, these words are given serious thought by the present Government, in matters of tax administration involving both direct and indirect taxation.

++ This is a rather voluminous judgement, running into about 280-odd pages. Given my obvious lack of understanding of the finer issues, I could try to write another piece on this historic judgement.

(The Author is Director, S3 Solutions Pvt Ltd, Bangalore)