VODAFONE TAX CASE: AN UNENDING TALE OF LESSONS

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ABSTRACT

In the recent decades, the globalization has led to advent of companies operating in more than one nation. Such companies for long time have been hailed as the torchbearer of development of nations as they bring technological advancements, foreign investment etc. However, at the same time the rising concern for the governments is the persisting nature of companies to avoid paying the taxes. The situation is of such nature, that President of United states of America Joe Biden had to publicly admit that MNCs contribution to tax is negligible or zero.

The MNCs have the privilege of having companies in more than one nations, thereby it becomes easy for companies to route their finance through companies and it is general to carry out transaction between or amongst the different subsidiary company present in different countries. The consistency of such transactions upset the tax authorities of being unable to tax such transactions because of legal impediments.

The Vodafone tax case is a classic case study involving rounds of litigation, negotiations and arbitration. The present paper examines the relevance of Vodafone tax case in three sections, *firstly* it delves upon the litigation and ruling of Hon'ble Supreme court, *secondly* it examines the legislative response to the judgment in the form of amendment and test it on the basis of earlier precedent, *thirdly,* it delves upon the arbitrability of tax dispute as Vodafone invoked the arbitration clause existing bilateral investment treaty (BIT). The paper concludes by highlighting certain lessons that are taught by the conundrum of Vodafone tax case.

Keywords: Retrospective tax, Arbitrability, Investment Treaty.

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INTRODUCTION

Due to emergence of globalization, it has become possible for the companies to conduct business operations in multiple countries. The ability to conduct trade and business in multiple countries has contributed enormously to global economy. From decades, MNCs have been hailed to bring employment opportunities, technological advancements and, needless to mention, the enormous tax for the government. However, the MNCs having extreme resources manages their revenue so well that their tax liability computed is either negligible or zero. President Joe Biden initiated the debate on 'corporations not paying taxes' and informed that 55 of the largest corporations of the country pays zero tax[4]. The insolence behavior of MNCs of 'not paying tax' offends the tax authorities, thus propelling them to look at their transactions in great depth along with the presumption of tax avoidance and thereby the tax authorities even with slightest possibility imposes tax liability on the corporations.

The tax liability of big corporations is of huge value, thus neither government will leave the tax straightforwardly nor the corporations will pay the tax straightforwardly. This results into the litigation in domestic courts, and if needed, even in international courts.

The preceding paragraphs reflects the gist as to what happened in the landmark case of ***Vodafone International Holdings vs Union of India[5],*** and the succeeding paragraphs dwells into detailed factual and legal analysis of the judgement.

- **FACTS OF THE CASE**

The case arises out of an acquisition by Vodafone International holdings of the entire share capital of CGP Investments (Holdings) Ltd. For tax purposes, Vodafone International Holdings is a tax resident of Netherlands and CGP Investments (Holdings) Ltd. is a tax resident of Cayman Islands. Furthermore, CGP Investments (Holdings) Ltd. indirectly held 67 percent shareholding in Hutchison essar Ltd., a tax resident of India. This brings to the conclusion that the acquisition of CGP Investments (Holdings) Ltd. by Vodafone International holdings has indirectly transferred the shareholding of Hutchison essar Ltd. According to the tax authorities,

[4] President Joe Biden, *Remarks by President Biden on the economy,* THE WHITE HOUSE (Dec. 8, 2021 6.00 PM IST) https://www.whitehouse.gov/briefing-room/speeches-remarks/2021/09/16/remarks-by-president-biden-on-the-economy-4/.

[5] Vodafone International Holdings vs Union of India, (2012) 6 SCC 613 (India) [Hereinafter "Vodafone"].

the acquisition has led to the indirect transfer of capital assets situated in India which makes it liable to be taxed in India.

- **PROVISION INVOLVED IN THE CASE [6]**

Section 9 of the Income Tax Act is the principal provision that was involved in the case. Section 9 of the act provides for the taxation of income deemed to accrue or arise in India. Section 9 (1) (i) says that all income will be deemed to be accrued or arise in India, if that income is 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[7].

- **ARGUMENTS ADVANCED IN THE CASE**

1. **Look at *v/s* Look through:** *Look at* means that the authority must look at a document or a transaction to assess the context to which it properly belongs to. *Look through* means 'in consequence of'. In this the whole intention and aim behind the transaction is looked to come to conclusion that 'whether the income was taxable or not'? The contention of the department was that section 9(1)(i) provides for look through approach as it heavily uses the word 'through'. As in the transaction of the case, there is indirect transfer of capital asset situated in India (assets of HEL) to VIH. Even if the transactions took overseas it would come under the ambit of Section 9.
2. **Extinguishment of Rights *v/s* Transfer of capital assets:** The tax authority contended that after the acquisition by Vodafone International Holdings. The HTIL (parent company of Hutchinson Essar Ltd.) has *extinguished* its property rights on Hutchinson Essar Ltd. This acquisition implies that now that the property of Hutchinson Essar Ltd has been moved from the *control and management* of Hutchinson Essar Ltd to *control and management of* Vodafone International Holdings. This will mean that the acquisition has led the transfer of capital assets situated in India.
3. **Acquisition is a preordained transaction:** Preordained Transaction are those transactions which are pre decided to avoid tax liability. The tax authority contended that this acquisition is a façade to avoid tax liability under the Indian law and Supreme court in many cases has held that transactions made to avoid tax can be made to pay the taxes. It further contended

[6] As it was existing during the case i.e., before the amendment through Finance act, 2012.
[7] The Income Tax Act, 1961, § 9(1)(i), No. 43 OF 1961, Acts of Parliament [Hereinafter "ITA"].

that CGP was inserted in transaction at a later stage. HTIL explored the possibility through its Mauritius entities, but it was found that it would be taxable. Thus, HTIL created the tax avoidance scheme through CGP and indirectly sold its property rights in HEL through the acquisition of CGP.

- **RATIO DECIDENDI OF THE JUDGEMENT**

1. **Look at test to be applied:** The apex court opined that Section 9 of the act cannot be extended by way of purposive interpretation to include indirect transfers of capital asset situate in India. As the legislature has not used the word 'indirect transfer'. The court noted about the Direct Taxes code (DTC) Bill, 2010 which proposes to tax income from transfer of shares of a foreign company by a non-resident, where at any time during 12 months preceding the transfer, the fair market value of the assets in India, directly or indirectly, owned by company is at least 50 percent. Thus, when a bill is being proposed for the same situation, then there is no point in extending the meaning of already existing statute.
2. **The transaction was not preordained:** The court mentioned factors that should be considered while determining a preordained transaction like Duration of time for which the structure existed, period of business operation in India, Generation of taxable revenue in India, Timing of exit and any other relevant factor, on case-to case basis. The court highlighted that Hutchinson structure existed since 1994 and is operating in India since 1994 to 2007. During their operating period, they paid tax ranging from 3 crores to 250 crores and even after acquisition it has paid tax ranging from 394 crores to 962 crores. CGP (Investments) Ltd. was incorporated in 1998 and thus, it cannot be presumed that it was specifically created for the purpose of acquisition. By relying on these factors, the court concluded that structure was not made to avoid tax.

The case illustrates the importance of careful interpretation of the tax statutes. Originally, The Bombay High court ruled in the favour of tax authorities. The High court approached the case through '*nature and character of transaction approach'*. It observed that apart from the fact that CGP has been acquired by VIH, the fact that there was a transfer of other 'rights and entitlements', these rights and entitlements are the true nature and character of transactions. Further, these rights and entitlements are capital assets within the meaning of Section 2(14) of Income tax act. On the contrary, Supreme court approached the case through the '*look at test'.* The court further made a distinction between ***share sale*** and ***asset sale.*** In the present case, the share sale happened, not asset sale. Thus, it would not be taxable under the ambit of the Section

9 of Income tax act.

RETROSPECTIVE APPLICATION OF TAX STATUTES

- **LEGISLATIVE RESPONSE TO VODAFONE JUDGEMENT**

After the judgement of Hon'ble Supreme Court against the Government and in favour of the Vodafone International Holdings. The dispute didn't end here, and the legislators proceeded with overturning the judgement of the apex court and introduced amendment bill namely "Finance bill, 2012" on 16 March 2012, which implies that amendment was introduced in less than two months of judgement and was later passed by Lok Sabha on 8 May 2012 and was passed by Rajya Sabha on 16 March 2012.

Ordinarily, the amendment would not have any effect on the Vodafone case as the matter was in finality decided by the apex court, however, the amendment again reinvigorated the Tax dispute with by seeking retrospective applicability of the provisions. Retrospective application of an act means that act would be deemed to come into force from the past date. Illustratively, if an act is passed on 1 January 2019, however, the act says that the act is retrospective applicable from the date of 1 January 2018, it will mean that the proceedings between the period of 1 January 2018 to 31 December 2018 would now be governed by an act passed on 1 January 2019.

In the instant case, the tax authorities heavily debated on Section 9 of Income Tax act and asserted that it provides for '**look through'** test which means that "**consequence of the transaction".** However, the apex court rejected the argument and held that Section 9 only provides for "**look at"** test which means that **"transaction should be seen from the view as it exists on paper".** Thus, to make the Vodafone to pay the tax, the amendment of the Section 9 can be easily anticipated. The amendment bill provided for the same. The section 4(a) of the Finance bill, 2012 provided that the amendment to Section 9 would be retrospectively applicable from the 1st day of April 1962.

Section 4(a) of the Finance bill, 2012 added two *explanations* after Explanation 3, in the following words:

> ***Explanation 4***. *—For the removal of doubts, it is hereby clarified that the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of".*
>
> ***Explanation 5.*** *—For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India."*[8]

Explanation 4 introduced the '**look through test'** in the ambit of Section 9, which was earlier rejected by Supreme court. **Explanation 5** further widened the meaning of 'capital asset' to include share. This was also contended by the tax authorities that transfer of share would mean transfer of capital share and which came to be rejected by Supreme court.

In toto, the motive behind amending the Section 9 was to annul the reasoning tendered by Supreme court and to further provide a legal foundation to arguments of the tax authorities.

- **JUDICIAL VIEW ON RETROSPECTIVE APPLICATION OF TAX STATUTES**

The Hon'ble Supreme court in case of ***Chhotabhai Jethabhai Patel and Co. v. Union of India***[9]***,*** was approached to consider the constitutional validity of retrospective application of tax statutes. The case was concerning the levy of excise (an indirect tax). The primary contention raised in the case was the following:

> *An "excise" was basically an indirect tax i.e. a tax or duty not intended by the taxing authority to be borne by the person on whom it is imposed and from whom it is collected but is intended to be passed on to those who purchased the goods on which the duty was collected; but when such a tax was imposed with retrospective effect it could not be passed on, so such a levy deprived the tax of its essential characteristic of being indirect. It therefore ceased to be a "duty of excise" and became a personal tax of a category quite distinct from "excise".*[10]

[8] Finance bill, 2012, § 4(A).
[9] Chhotabhai Jethabhai Patel and Co. v. Union of India, 1962 Supp (2) SCR 1 (India) [Hereinafter "chhotabhai"].
[10] *Id.,* at ¶ 5.

Interestingly, the counsel further contended in respect of the 'direct tax'. That, the retrospective application of the tax statute can be in legislative competence *"if the tax in its altered form — i.e., a tax direct and personal"*.[11]

The apex court propounded that "*mere retrospectivity in the imposition of the tax cannot per se render the Law unconstitutional"*[12]

- **COMMITTEE RECOMMENDATIONS ON RETROSPECTIVITY OF TAX STATUTES**

After the retrospective amendments to the Income tax act, the tax regime of India was questioned and criticised nationally as well as internationally. A committee was under the chairmanship of Dr. Parthasarathi shome, the committee submitted its first report on **'GAAR'** and in its second report, it worked on "**indirect transfers".**

The committee made several recommendations about implementation of retrospective tax statues. At the very outset, the committee recognises that there can be retrospective application of tax statues, however, it can be in exception or rarest of rare cases. The illustrations of these rarest of rare case includes to correct apparent mistakes/anomalies in the statue, to apply matters that are genuinely clarificatory in nature, i.e. to remove technical defects, particularly in procedure, which have vitiated the substantive law; or, third, to "protect" the tax base from highly abusive tax planning schemes that have the main purpose of avoiding tax, without economic substance, but not to "expand" the tax base And even if need is felt to retrospectively implement the tax statutes. Then, it propounds a far more democratic and equitable way, by consultations with stakeholders.[13]

ARBITRABILITY OF TAX DISPUTES

- **VODAFONE'S RESPONSE TO RETROSPECTIVE TAX AMENDMENTS**

After the retrospective amendments, Vodafone was again demanded the tax liability. To which Vodafone issued a notice of dispute under Article 9 of India-Netherlands BIT. Article 9 of the

[11] *Id.,* at ¶ 7.
[12] *Id.,* at ¶ 39.
[13] Committee of Experts under the Chairmanship of Dr. Parthasarthi Shome, Report on Retrospective amendments relating to capital transfers 34 (2012) [Hereinafter "shome"].

BIT provides for multi-tiered dispute resolution. The first tier of dispute resolution under Article 9(1) is negotiation.

> "*Any dispute between an investor of one Contracting Party and the other Contracting Party in connection with an investment in the territory of the other Contracting Party shall, as far as possible, be settled amicably through negotiations between the parties to the dispute. The party intending to resolve such dispute through* ***negotiation*** *shall give notice to the other of its intentions."*[14]

However, negotiation between Vodafone and Union of India failed to meet halfway in the dispute. The next tier of dispute resolution suggested under Article 9(2) is discretionary. Article 9(2) provides for conciliation. In the instant case, the Vodafone company skipped the conciliation and initiated Arbitration against Union of India under Article 9(3) of BIT.

In the meantime, Vodafone repeated the procedure under the India – United Kingdom BIT. And issued a second notice of dispute under Article 9(1) in June 2015 and initiated second arbitration proceedings under Article 9(3) of BIT in January 2017[15].

The course taken by Vodafone was challenged in Delhi High court. The Union of India contended that the second arbitration proceedings under India- United Kingdom BIT and amounted to an election of remedy under the India-Netherlands BIPA by Defendants and the consequence of such election was that Vodafone International Holdings B.V had to limit its remedy to the one available under the India-Netherlands BIT[16].

The Delhi High court ruled that Union of India can raise the issue of abuse of process before India- United Kingdom BIT and the tribunal will have the authority to decide this issue on its own merit. And further suggested that if Plaintiff-Union of India consents, then two arbitration proceedings can be consolidated. [17]

[14] India-Netherlands Bilateral Investment Treaty, 1995, art. 9(1).
[15] Union of India vs Vodafone Group Plc United Kingdom, 2018 SCC Online Del 8842 ¶ 23,24 (India).
[16] *Id.,* ¶ 22.
[17] *Id.,* ¶ 149.

- **IS TAX DISPUTE A PUBLIC POLICY ISSUE AND THUS NOT ARBITRABLE?**

Arbitration being a private forum of dispute resolution, thus issues of public policy is considered to be out of the scope of arbitration. The New York convention on the recognition and enforcement of foreign Arbitral Awards is one of the key instruments in the field of Arbitration. The convention is crucial for determining the validity of arbitral awards. Article V(2)(b) of the New York convention says that recognition and enforcement of an arbitral award may be refused if it would be contrary to public policy.[18] However, the convention don't define the definition of 'public policy'. Thus, the scope of 'public policy' would be depending upon the domestic laws of the contracting state. Similar provision is also provided in the Arbitration and conciliation act, 1996 under section 34 that gives authority to the court to not recognise and enforce arbitral awards that conflict with the public policy in India. **Explanation 1** deliberates a list on what can be called as 'in conflict with the public policy of India. They are as follows, if:

i. *The making of the award was induced or affected by fraud or corruption or was in violation of section 75 or 81; or*
ii. *It is in contravention with the fundamental policy of Indian law; or*
iii. *It is in conflict with the most basic notions of morality or justice*[19]

In general sense, the Hon'ble Supreme court of India defined '**contrary to public policy'** in ***Central Inland water transport corporation ltd. vs Brojo Nath Ganguly*** [20] as follows:

> *"Public policy connotes some matter which concerns the public good and the public interest. The concept of what is for the public good or in the public interest or what would be injurious or harmful to the public good or the public interest has varied from time to time*[21]"

From the arbitration point of view, Supreme court examined the scope of public policy in ***Renusagar Power Co. Ltd. vs General Electric co.*** [22] and held that enforcement of a foreign award would be refused on the ground that it is contrary to public policy if such enforcement

[18] New York Convention on the recognition and enforcement of foreign Arbitral Awards, 1958 art. V(2)(b), June 7, 1959.
[19] The Arbitration and conciliation act, 1996, § 34, No. 26 OF 1996, Acts of Parliament.
[20] Central Inland water transport corporation ltd. vs Brojo Nath Ganguly, (1986) 3 SCC 156 (India).
[21] *Id.*, ¶ 92.
[22] Renusagar Power Co. Ltd. vs General Electric co, 1994 Supp (1) SCC 644. (India).

would be contrary to (i) fundamental policy of Indian law; or (ii) the interests of India; or (iii) justice or morality."[23]

Furthermore, under Article 25 of Model Tax Convention on Income and on Capital 2017 by OECD, it provides for arbitration on tax disputes. However, it provides that if a decision has been rendered by court or administrative tribunal of the state, then the dispute cannot be submitted for arbitration. [24]

In toto, tax disputes are no more unfamiliar with arbitration proceedings. Further, it is yet to be clarified as to "whether tax is a public policy issue or not? *Prima facie,* public policy is from the perspective of direct implication on public or in which there is direct involvement of public in it. However, in tax disputes, the public good is subliminal and not very apparent. Thus, tax policy must be considered an arbitrable issue and not barred owing to public policy.

The tax disputes being an arbitrable issue would also bring good for nations as well as corporates. The corporates would be more inclining towards getting the dispute adjudicating the dispute in an 'closed private forum', then in 'open court system'. The flexibility in the system will be appreciated by the companies, thus entrusting their investment in a country allowing tax disputes to be arbitrable.

GUIDING LESSONS AND CONCLUSION

The Vodafone tax case, infamously known as 'retrospective taxation case', with several rounds of litigation, negotiation and then arbitration, exposes the very need of tax administration. It reveals how a chaotic taxation system could prove fatal to foreign investment. The emergence of globalisation and increased trade between and among countries has in fact heightened the onus on the government to maintain cordial international relations. To maintain those relations, the countries become parties to several treaties, these treaties are entered with the *bona fide* belief that if other party is abstaining from doing something, then the remaining parties must also abstain from doing it, as being the foundation of the principle of *pacta sunt servanda*.

The lessons that the case provides is that parliament having the sole authority to enact laws, doesn't mean that stakeholders will adopt those laws, as they are enacted. Thus, instead of

[23] *Id.*, ¶ 39.
[24] Model Tax convention on Income and on capital, 2017, art. 25 (OECD).

entertaining those objections after the enactment of law, it is better that a stakeholder analysis is practiced prior to enactment of law.

The next lesson that the case provides is that arbitration as being the widely recognised dispute resolution at international level is an emerging dispute resolution forum. Thus, by incorporating the tax arbitration as an alternative to litigation at domestic level would also reduce tax litigation in the country. As a model, OECD has been working in the field since 2017 and result of it can be expected in the coming time.