India Inc has been surging ahead audaciously with the support of its Information Technology developments with its repertoire of resources. Global players have been eying the Indian market, owing to immense opportunities that the continent provides; both in terms of expansion and profit. Investment patterns in India have shown positive growth over the years with significant process on the de-regulation front. India has been greatly involved with the G-8 and G-20, including signing of the Double Taxations Avoidance Agreements/Treaties (DTAA) with various tax-haven countries. This has boosted the image of India as a 'lookout destination' for investment and an emerging hub for economical activities. World Report 2010 ranked India as the 9th most attractive investment destination, while Bloomberg Global Poll conducted in September 2010 put India in the third position, above the United States of America (US).

However, the very same image is said to have taken a beating with the recent Vodafone Tax case, which has been revolving in courts since 2009. With clear signs of the court ruling in favour of the tax authorities, many global companies are said to be rethinking their investment plans in India, keeping in mind the impact of the judgment on the taxation front. The Doing Business Report 2011 of World Bank has ranked India at 134, below neighbouring countries like Pakistan and Bhutan. This is a result of procedural difficulties for start-up companies and investment companies, in India and abroad.

Tax regulations play a major role in cross border transactions and investments in a country. Tax havens, open borders and DTAA countries are major destinations for investment through Foreign Direct Investment (FDI) or other routes. The Vodafone tax case throws an interesting question on the taxability of a non resident company acquiring shares of a resident company through an indirect route. This is a landmark case, as it is for the first time that the tax departments have sought to tax a company through a mechanism of tracing the source of acquisition. While we have heard about lifting the 'corporate veil', this instance has set a rare example wherein the Indian tax authorities have gone to length to interpret the existing tax laws, to bring a global company like Vodafone to its tax ambit.

Facts

Vodafone International Holdings BV, based in Netherlands and controlled by Vodafone UK, obtained the controlling interest and share of CGP Investments Holdings Ltd (CGP) located in Cayman Island for a value of $11.01 billion from Hutchinson Telecommunications International Ltd (HTIL), which had stake in Hutchinson Essar Ltd (HEL) that handled the company's mobile operations in India. HEL had its stake in CGP Holdings, from which Vodafone bought 52 per cent of HEL's stake in 2007, thereby vesting controlling interest over them. The Bombay High Court, on September 8, ruled that where the underlying assets of the transaction between two or more offshore entities lies in India, it is subject to capital gains tax under relevant income tax laws in India. The Court invoked the nexus rule wherein a state can tax by connecting a person sought to be taxed with the jurisdiction, which seeks to tax. The treatment of the company as an Assessee in Default (AID) under Section 201(1)(1) of the Income Tax Act and reading Sections 5(2), 9(1)(3) and 195, the court came to the conclusion that Vodafone was liable to deduct tax at source (TDS). Vodafone has now appealed before the Supreme Court to revisit the judgment, which makes them liable for a record amount of Rs 12,000 crores going to the tax authorities' kitty.

Impact

Vodafone raises pertinent questions on the issue of taxation of non-resident entities. The judgment will have direct impact on transactions of major acquisitions like SABMiller-Foster and Sanofi Aventis-Shanta Biotech. Similar transactions that existed earlier are Sesa Goa, AT&T and General Electric. British firm Cairn Energy has already agreed to pay tax in India as well as the UK on selling its stake in Cairn India to Vedanta Resources from $6.65 billion to $8.48 billion. Depending upon the size of the stake sale, the tax liability could range between $868 million and $1.1 billion. The judgment would definitely throw a cautious note to major investors and M&As in India; however, it does not have
that great an impact to curtail the investment flow to an emerging destination like India. The judicial propriety of the case is still to be settled when the matter comes for final stages in the Supreme Court. Going by the events in the lower courts, the Supreme Court is unlikely to disturb the Bombay High Court ruling.

The global community is keenly watching the current trends happening in the Indian subcontinent, especially since it has become an emerging player at the socio-economic and political levels. United Nations Conference on Trade and Development (UNCTAD) has reported that India is set to dislodge the US by December 2012 to become the second best destination for FDIs, the major component of which is M&As. India is also set to revamp its taxaions norms with significant changes at the regulatory level. The proposed Direct Tax Code contains key provisions, which will have a major impact on investments in India. India has improved its rankings in the WB 'Doing Business' Report on the number of regulatory changes taken in the existing year. This shows that the country is set to make a global footprint by branding itself as a 'Must Invest' destination.

The Vodafone tax case has given India the opportunity to create a model for other countries, which follow source-based taxation principles. It is an opportune time to bask in the glory of India, which is said to have had one third share of the world market in ancient times, as pointed out by economist Amartya Sen in his book The Argumentative Indian. Let's hope that we can revive the 'Real India' soon.

Notes:

1. Section 201 of the Act broadly provides that any person (referred to in Section 200 of the Act), and in cases referred to in Section 194, the principal officer and the relevant company, who does not deduct the whole or any part of the tax, or after deducting fails to pay the tax as required by or under the Act, he or it shall, without prejudice to any other consequences which he or it may incur, be deemed to be an 'assessee in default' in respect of the tax.

2. Section 5(2) enunciates that the income of a non-resident from whatever source derived is included in the total income if (i) it is received in India; (ii) deemed to be received in India; (iii) accrues in India; (iv) deemed to accrue in India; (v) arises in India; or (vi) deemed to arise in India.

3. Section 9(1) explains the circumstances in which income is deemed to accrue or arise in India and includes all income accruing or arising in India, whether directly or indirectly (a) through or from any business connection in India; or (b) through or from any property in India; or (c) through or from any asset or source of income in India; or (d) through the transfer of a capital asset situated in India.

4. Section 195 provides for deduction for tax at source upon a payment to a non-resident or foreign company.

5. The proposed DTC says that if 50 per cent of the value of the shares being transferred is derived from assets situated in India, it is deemed to be taxable in India.

6. Countries like India have been following resident-based taxation mechanism, wherein whoever is the resident of India is taxed. Source-based taxation provides for a taxation regime which goes into the source of the asset which is liable for tax.

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