CAPITAL GAINS TAX- LEGAL STRUCTURING

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ABSTRACT

The effectiveness of Taxing Statues depends on the means through which interpretation is shrewdly adopted as it imposes unique confrontations to legal interpretations and its technicalities are not an easy breakthrough.

The Vodafone case had been shrouded in uncertainty until 2012.The tale began as early in February 2007 when Vodafone International Holdings (hereinafter Vodafone or VIH), a Dutch entity, had acquired 100 percent shares in CGP (Holdings) Limited (hereinafter CGP), a Cayman Islands company for USD 11.1 billion from Hutchinson Telecommunications International Limited (hereinafter HTIL). A dramatic turn of events after sometime led to legal battle between the Indian Income Tax Department on the one side and Vodafone on the other.

There was not any case of much gravity before Vodafone pertaining to Tax dispute in India. The paper firstly elaborately discuss the meaning and origin of 'Capital Gains Tax' (hereinafter CGT) and its relevancy to Vodafone. Secondly, compare the various provisions of CGT (Sections 45-55A) under the "Income Tax Act, 1961" (hereinafter IT Act). Since Vodafone is a case of much magnitude from the viewpoint of Corporate Law, Investment Arbitration and Tax Law, the focus on these wide interpretations and perspectives on Vodafone.

The last leg of this paper would deal with suitable remedies and suggestions for the better application and implementation of Capital Gain Tax under Tax laws.

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***Keywords**: Constitution, Capital Gain, Loopholes, Vodafone case.*

1. VODAFONE CASE INTRODUCTION

In the light of the case of *Vodafone v. Union of India* [1], the petitioner Vodafone (based in Netherlands) acquired Cayman Islands-based Company CGP Holdings Limited from Hutchinson Telecommunications International Limited. The deal was concluded at 11.1 billion dollars, as CGP Holdings controlled 52 % of Hutchison-Essar Limited (based in India) and had the option to buy 15 % more hence because of this acquisition Vodafone had effective control of 67% over Hutchison-Essar. The Indian Income Tax Authorities claimed that Vodafone was to pay capital gains tax on capital gains accrued due to the consequent control of Hutchison-Essar Limited. The amount of tax payable was estimated at 2.5 billion dollars.

1.1. Bombay High Court

The Tax Authorities filed a case against Vodafone in the Bombay High Court. The court held that a prima facie case was made out by the Tax Authorities of transfer of Capital Assets, and therefore accrual of Capital Gains and hence was liable to pay the Capital Gains tax. Hutchison- Essar being a company situated in India was seen by the Income Tax Authorities as the Target Company, and they contended that the purpose of the acquisition of CGP was to acquire effective control in Hutchison- Essar. Vodafone contended that the Tax Authorities had no territorial jurisdiction over the transaction as the acquiring company as well as the company acquired was not based in India.

1.2 Supreme Court

Vodafone in its turn filed a Special Leave Petition before the Supreme Court. The Apex Court held that the Bombay High Court had erred in its decision and should have employed a "look at" approach instead of a "look through" approach. They emphasized on the theory of Corporate personality wherein the identity of the shareholder is distinct from that of the company. The Court said that the authorities must look at the transaction at its face value rather than the hidden intent behind it. The acquisition of CGP Holdings was not solely to gain control over Hutchison-Essar, but the gain in control was a corollary of the acquisition, which was not the purpose of the acquisition

1.3Capital Gains

Capital Gains Tax [2] under the Income Tax Act is tax payable on the *"transfer of a capital asset situated in India."*[3] *Capital Assets according to the Income Tax Act, 1961 are "property of any kind held by an assessee, whether or not connected with his business or profession."*

According to Section 9 (1)(i) of the Act, which forms the heart of the controversy, income accruing indirectly or directly out of transfer of Capital Assets situated in India is deemed to accrue in India out of the hand of a Non-Resident. The Supreme Court expressed its view in this regard stating that the transfer of shares of CGP did not result in a transfer of Capital Assets

1.4 Structuring

According to the views expressed by the Supreme Court, there were two possible structures available for such a transaction to include a tax-free entity, to either include CGP or route the deal through Mauritius. Therefore, by structuring the deal through CGP, they have transitioned the business in a smooth manner. Thus, the sole purpose of the CGP acquisition was not to control Hutchison-Essar. This smart structuring through layers of Investment subsidiaries in tax-free jurisdictions saved Vodafone the payment of an exorbitant tax. In addition, fanning the control through multiple companies and not a nodal structure helped Vodafone.

1.5 Conclusion

Thus, smart investment structures such as the one created by Vodafone help in avoiding large tax amounts in jurisdictions such as India where the taxation rates are high and taxation laws are extremely stringent despite measures like Double Taxation Avoidance and Advance Pricing.

2. CAPITAL GAINS TAX: A NEW TAX APPROACH?

The beginning of Capital Gains Tax in India dates back to year 1956 on the recommendations of 'Prof. Kaldor' to levy a tax on profits arising on sale or transfer of specified non-inventory asset. As a result of constant and continuous development, Capital Gains Tax, as it is today, is levied on transfer of all Capital Assets (except those which are held as stock-in-trade) with a computation aspects which are prescribed under Sections 45 to section 55A of the Income Tax Act. Section 2 (14) of the IT Act, defines and clarifies the term "Capital Assets". It is defined to include property of any kind, whether fixed, circulating, movable, immovable, tangible or intangible and whether or not used for the purpose of his business and profession. However, it also specifies exclusions under Section 2 (14) of the IT Act [4].

Normally, Capital Gains are taxable in the year of in which transfer of Capital Asset takes place. Section 2 (47) of the IT Act defines the term 'transfer.'"Transfer" in relation to Capital Asset includes sale, exchange, relinquishment, or compulsory acquisition of the asset or extinguishment of any rights therein. However, those transactions under Section 2 (47) of the IT Act are not transfer [5].

For the purpose of computation of Income Tax, the Capital Assets are classified under two heads:-

1) Short Term Capital Assets; and
2) Long Term Capital Assets.

It is required that the method of computation of Income chargeable to tax and rates of taxes are different for both the types of Capital Gains. "Short Term Capital Assets" means any Capital Asset held by an assesse for not more than 36 months, immediately prior to its date of transfer [6]. The criteria of 36 months have been reduced to 24 months in the case of immovable property being land, building, and house property, from FY 2017-18. For instance, if you sell house property after holding it for a period of 24 months, any income arising will be treated as long-term capital gain provided that property is sold after 31st March 2017. On the other hand, "Long Term Capital Assets" means any Capital Asset held by an assessee for more than 36 months, immediately prior to its date of transfer [7].However, the above rule of 36 months has certain exceptional situations wherein such period is taken as 12 months:

1) Equity / Preference Shares in a Company, which may be quoted or unquoted;
2) Securities like Debentures, Govt. Securities etc., which should be listed on a recognized Stock Exchange;
3) Units of UTI [Unit Trust of India] which may be quoted or unquoted;
4) Units of a Mutual fund, which may be quoted or unquoted;
5) Zero Coupon Bonds, which may be quoted or unquoted.

When the above-listed assets are held for a period of more than 12 months, they are considered as long-term capital asset. In case an asset is acquired by gift, will, succession or inheritance**,** the period this asset was held by the previous owner is also included when determining whether it is a short term or a long-term capital asset. In the case of bonus shares or rights shares, the period of holding is counted from the date of allotment of bonus shares or rights shares respectively.

3. VODAFONE CASE: THE DIMOLITION OF A NEW APPROACH?

In February 2007, Vodafone International Holdings (VIH), a Dutch entity, had acquired 100 percent shares in CGP, a Cayman Islands Company for USD 11.1 billion from Hutchinson Telecommunications International Limited HTIL. CGP, through various intermediate companies/ contractual arrangements controlled 67 percent of Hutchison Essar Limited (hereinafter HEL), an Indian Company. The acquisition resulted in Vodafone acquiring control over CGP and its downstream subsidiaries including ultimately HEL. HEL was a joint venture between the Hutchinson group and the Essar group. It had obtained telecom licenses to provide cellular telephony in different circles in India from November 1994[8].

In September 2007, the Indian Tax department issued a SCN to Vodafone to explain why tax was not withheld on payments made to HTIL in relation to the above transaction. The Tax department contended that the transaction of transfer of shares in CGP had the effect of indirect transfer of assets situated in India. Vodafone filed a writ petition in the Bombay High Court, inter alia, challenging the jurisdiction of the tax authorities in the matter. By its order dated 3 December 2008, the Bombay High Court held that the Indian Income Tax authorities had jurisdiction over the matter. Vodafone challenged the order of the Bombay High Court before the Supreme Court. In its ruling dated 23 January 2009, the Supreme Court directed the tax authorities to first determine the jurisdictional challenge raised by Vodafone.

In May 2010, the Tax authorities held that they had jurisdiction to proceed against Vodafone for their alleged failure to withhold tax from payments made under Section 201 of the IT Act [9]. Vodafone before the Bombay High Court challenged this order of the tax authorities. By its order dated 8 September 2010, the Bombay High Court dismissed Vodafone's challenge to the order passed by the tax authorities. Vodafone filed a Special Leave Petition (SLP) against the High Court order before the Supreme Court. On 26 November 2010, SLP was admitted and the Supreme Court directed Vodafone to deposit a sum of INR 25,000 million within three weeks and provide a bank guarantee of INR 85,000 million within eight weeks from the date of its order.

Under Section 9 (1) (i) {Income deemed to accrue or arise in India} of the IT Act, inter alia, income accruing or arising directly or indirectly from the transfer of a Capital Asset situated in India is deemed to accrue/ arise in India in the hands of a non-resident[10]. In this connection, the Supreme Court observed that:

1. Charge to Capital Gains under Section 9 (1) (i) of the Act arises on existence of three elements, namely transfer, existence of a Capital Asset and situation of such asset in India.
2. The Legislature has not used the words 'indirect transfer' in Section 9 (1) (i) of the Act. If the word 'indirect' is read into Section 9 (1) (i) of the Act, then the phrase 'Capital Asset situate in India' would be rendered nugatory.
3. Section 9 (1) (i) of the Act does not have 'look through' provisions and it cannot be extended to cover indirect transfers of capital assets/ property situated in India.
4. The proposals contained in the Direct Taxes Code Bill, 2010; on taxation of off-shore share transactions indicate that indirect transfers are not covered by Section 9 (1)(i) of the Act.

5. A legal fiction has a limited scope and it cannot be expanded by giving purposive interpretation, particularly if the result of such interpretation is to transform the concept of chargeability which is present in Section 9 (1)(i) of the Act.

   Accordingly, the Supreme Court concluded that the transfer of the share in CGP did not result in the transfer of a Capital Asset situated in India and gains from such transfer could not be subject to Indian Tax [11].

   The Tax authorities further argued that the rights of HTIL over the control and management of HEL constituted "property" in the hands of HTIL. Accordingly, the extinguishment of such rights under the Share Purchase Agreement (SPA) resulted in a taxable transfer of a Capital Asset situated in India. It held that extinguishment took place because of the transfer of the CGP share and not by virtue of various clauses of SPA [12].

   Additionally, the Supreme Court held that the sole purpose of CGP was not only to hold shares in subsidiary companies but also to enable a smooth transition of business. Therefore, it could not be said that CGP had no business or commercial substance. However, the Tax authorities had contended that the transfer of the CGP share was not adequate in itself to achieve the object of consummating the transaction between HTIL and VIH and intrinsic to the transaction was a transfer of other 'rights and entitlements'. It was further contended that such "rights and entitlements" constituted 'Capital Assets' and gains from the transfer of which were liable to Indian Tax.

   The Supreme Court also observed that if a Non-Resident makes an indirect transfer through abuse of the organization form/ legal form and without a reasonable business purpose, which results in tax avoidance or avoidance of withholding tax, then the Tax authorities may disregard the form of the arrangement or the impugned action through use of holding companies and may re-characterize the equity transfer according to its economic substance and impose tax. "The Corporate business purpose of a transaction is evidence of the fact that the impugned transaction is not undertaken as a colorable or artificial device [13]".

   In finality, the Supreme Court held that:

1. The question of withholding tax at source would not arise, as the subject matter of offshore transfer between the two non-residents was not liable for CGT in India.
2. For the purposes of Section 195 {Other Sums} under the IT Act, tax presence has to be viewed in the context of the transaction that is subjected to tax, and not with reference to an entirely unrelated matter. As there was no incidence of CGT in India, the provisions under Section 163 of the IT Act for treating Vodafone as a representative assessee of HTIL, were not applicable. Section 195 of the Act would apply only if payments are made from a resident to another non-resident and not between two non-residents situated outside India [14].

Countries are guided by either the source or resident rule to tax income. An important question discussed by the parties in Vodafone was whether the Revenue could establish a nexus to tax the transfer of CGP Investments share.

Under Section 5 (1) of the IT Act, the worldwide income (including any income that is actually or deemed to accrue or arise, or is received) of a person resident in India is brought within the ambit of total income. Under Section 5 (2) of the IT Act, for a non-resident, the only income that is taxable is income that is received or deemed to have been received, or income that has accrued or arisen or has been deemed to have accrued or arisen in India.

Vodafone urged the Court to adopt a contextual interpretation of Section 195 according to the established principles of conflict of laws and legislative intent as it believed that Section 195 was inapplicable to offshore entities making offshore payments but the Revenue argued that the expression ‘‘person’’ as used in the Section is not restricted to a person resident in India[15]. The Court concluded that chargeability and enforceability are distinct legal concepts and that the following factors are guiding rules based on which Section 195 is to be interpreted:

1. Section 195(1) provides for a tentative deduction subject to regular assessment;
2. the Section necessitate two prerequisites — there must be a payment made to a nonresident, and such payment must be a sum chargeable under the IT Act;
3. The obligation to deduct tax arises when the sum (the entire sum need not be chargeable) payable to a nonresident is chargeable to tax under the IT Act;
4. The liability to deduct tax arises if the tax is assessable in India;
5. Fiscal Legislation is based on the principle that a sufficient territorial connection or nexus is required between the person sought to be charged and the country seeking to tax them;
6. Provisions dealing with ‘Tax Deduction at Source’ (TDS) are in the nature of machinery provisions and constitute an integrated code, not independent of the charging provisions that determine assessability to tax; and
7. The Parliament, while imposing a liability to deduct tax, has imposed it on a person responsible for paying tax without limiting the same to a person resident in India.

Therefore, the Court decided that there is no limitation of extraterritoriality involved although the Parliament is aware that the law can be enforced within the territory to which the IT Act extends [16].

4. DYNAMIC DIMENSIONS OF TAXATION LAWS

Parties are free to choose whatever lawful arrangement, which will suit their business and commercial purpose, but the true nature of the transaction can be ascertained only by looking at the legal arrangement actually entered in to and carried out. One of the tests to examine the genuineness of the structure is the ‘timing test’ i.e., the timing of the incorporation of the entities or transfer of the shares etc. Structures created for genuine business reasons are those which are generally created or acquired when investment is first made, or further made at the time of consolidation [17]. It cannot be said that HTIL or Vodafone was a ‘fly by night’ operator or short time investor, as the HTIL operated from 1994 and only in 2007 was the divestment made.

If the ‘look at’ test is applied and not the ‘dissecting’ approach, then the extinguishment took place because of transfer of CGP Investments share and not by virtue of various clauses in the SPA (wherein the rights of the

HEL-controlling interest were factored in). Therefore, sale of CGP Investments share, for exiting from the Indian telecom sector, cannot be considered as a pre-ordained transaction, with no commercial purpose other than tax avoidance. Sale of CGP Investments share was a genuine business transaction and not a fraudulent or dubious method to avoid Capital Gain Tax [18].

The legal principle on which situs of an asset, such as share of a company, is determined, is well settled. As per Indian Company Law, situs of shares would be where the Company is incorporated and where its shares can be transferred. Considering that the transfer of CGP Investments shares was recorded in Cayman Islands, where the register of members of CGP Investments is maintained, it could not be accepted that the situs of the Cayman Islands company shares was where the underlying assets were situated (India). Therefore, situs of CGP Investments is situated in Cayman Islands, and on transfer in Cayman Islands, the situs would not shift to India.

In other words, a 'Controlling Interest' is an incident of ownership of shares of the Company and is not an identifiable or distinct Capital Asset independent of holding of shares. Transfer of the CGP Investments share automatically results in a host of consequences including transfer of controlling interest and that Controlling Interest as such, cannot be dissected from CGP Investments share without a specific legislative intervention. Accordingly, this Controlling Interest cannot be dissected to percolate and be treated as transfer of Controlling Interest of the downstream entities, and ultimately to that of HEL. Controlling interest, which stood transferred to Vodafone from HTIL accompanies the CGP Investments share and cannot be dissected. It is a case of sale of shares and not an asset sale [19].

When a transaction involves transfer of shares including everything, it cannot be broken down into individual components, assets or rights. Withholding tax provisions would apply only if payments are made from a resident to another non-resident, and not between two non-residents situated outside India. In Vodafone, the transaction was the transfer of a Capital Asset between two nonresident entities, through a contract executed outside India and it was entered into on a principal-to-principal basis. The consideration was also paid outside India. The SC similarly ruled in the case of Eli Lily [20] and was distinguished on the ground that services were rendered in India by the employees, and a portion of salary was received from an entity situated in India. Therefore, there is no liability to withhold tax, which is triggered only when there is income chargeable to tax in India.

Vodafone Group's earlier investment in Airtel cannot be regarded as a presence in India to bring Vodafone under the jurisdiction of the Income Tax Laws. Vodafone cannot be regarded as a representative taxpayer on behalf of the non-resident, which requires that income should have deemed to accrue in India, as there is no transfer of Capital Asset situated in India. "Call and Put options" are contractual rights and in the absence of a statutory stipulation, they cannot be considered as Capital Assets; at best, they may be regarded as potential shares, until they are exercised.

5. VODAFONE & TAX AVOIDANCE: THE RE-EMERGENCE OF A NEW CHASM?

Vodafone contended that retrospective tax amendments result in a denial of justice under the India-Netherlands BIT (Bilateral Treaty [Article 9]) obligations [21].Publicists differ on the interpretation of the term "Denial of

Justice [22]". A person is free to arrange his business in such a way so that he is able to avoid a law and its evil consequences so long as he does not break that or any other law. The major question under International Taxation is: Does retrospective taxation amount to substantial interference with Vodafone's shareholding? It is understood that the Government of India at that point gave assurance that retrospective taxation would not be applicable to Vodafone and no Indian Court will take access to it. All businesses depend on tax policy predictability and certainty in order to plan investments for the long term. Retrospective taxing rules should be introduced only in the 'rarest of rare' cases and that, if applied to CGT, the authorities should pursue the seller, not the buyer (Vodafone being the latter not the former in the case at issue).

In addition, a taxing Statute is to be strictly construed. The source of power, which does not speak of taxation specifically, cannot be interpreted by expanding its width as to include therein the power to tax by implication or by necessary inference. A subject will be liable to tax and will be entitled for exemption from tax according to "strict language of the statute [23]". In case of a doubt or a dispute, it is a well-settled rule that the construction has to be made in favor of the tax payer and against the revenue department. The Supreme Court has vehemently diluted the rule of Strict Construction for the simple and obvious reason that Vodafone being a foreign Company is not subject to Indian jurisdiction thereby hampering the sound interpretation of taxing laws.

Multinational Companies such as Vodafone therefore operate in an international taxation environment, which is determined by governments working individually and collectively shaped by voters in democracies. Larger businesses are more complex, which in turn means a greater level of complexity in applying the rules. Governments generally also require multinational companies to apply 'transfer pricing' rules to inter-company activities to ensure that profits are allocated to the countries where the relevant economic activity takes place.

6. CONCLUSION & SUGGESTIONS

Cross-border acquisition of Indian Companies has had been a focus of the Tax Authority over the last couple of years. It is fairly well established that if the acquisition involved a direct transfer of shares of an Indian Company, the same would trigger taxable Capital Gains under the ITL. However, there have not been case in point in the past where Tax Authority has attempted to tax Capital Gains arising on transfer of shares of a foreign holding Company of an Indian subsidiary on the basis that such transfer involves an indirect transfer of the underlying Indian assets.

Vodafone is a milestone in Indian Tax history, which brought into limelight the true 'Parliamentary Intention', and the practical difficulty in application of Capital Gain Tax under Taxing Laws. Parliamentary Intention can be best expressed only through the text of the Statute, albeit read in context. Obviously, the best way to give effect to Parliamentary Intention in Tax will be to express policy clearly in the specific legislation by having a coherent underlying framework for the Tax System. On the other hand, provisions dealing with Capital Gain Tax especially Sections 45- 55A and Sections 2 (14) and 2 (47) need to be revisited and given wider scope to its meaning in the ambit of International Taxation. It would only then increase Clarity, Transparency and Legitimacy by giving full effect to Parliamentary Intention without overriding it. Thus, smart investment structures such as the one created by Vodafone help in avoiding large tax amounts in jurisdictions such as India

where the taxation rates are high and taxation laws are extremely stringent despite measures like Double Taxation Avoidance and Advance Pricing

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[5] Distribution of asset in kind by a Company to its shareholders at the time of liquidation; Distribution of Capital Asset on total or partial partition of a Hindu Undivided Family; Transfer of Capital Asset under a gift or will or an irrevocable trust; Transfer of Capital Asset by a Company to its 100% Subsidiary Company; Transfer of Capital Asset by a Subsidiary Company to its 100% Holding Company; Transfer of Capital Asset in a scheme of amalgamation; Transfer of shares of an Indian Company held by a foreign Company to another foreign Company
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