A Realist's account of the Bombay High Court's Decision in the Vodafone Case

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The authors here present a realist's view of the decision of the Bombay High Court in Vodafone International Holdings B.V. *v.* UOI. *The authors argue that, although the Court appeared to rely on legal reasoning, the decision ultimately turned on pragmatic considerations of the interests of the parties. While finding the legal explanations of the Bombay High Court unconvincing, the authors raise questions as to the implications of such an approach in future.*

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I. Introduction

Much has been said about the Vodafone case, especially on the legitimacy of India's right to tax the Hutchison gains. This paper steers clear of that debate. Its

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contribution is rather simple. It presents a realist's[1] account of the Bombay High Court's recent decision in *Vodafone International Holdings B.V* v. *Union of India*.[2]

Incontrovertibly, the Vodafone case presents the Indian Courts with a choice – to either tax the Hutchison gains or to declare the transaction tax free in India. The only statutory provision to assist the court is section 9 of the [Indian] Income Tax Act 1961 (hereinafter referred to as "the Act") that taxes capital gains in India if they arise from the transfer of a capital asset situate in India. The Bombay High Court has held that Hutchison gains are chargeable to tax in India. The paper does not seek to reach a normative conclusion or purport to comment on the legal correctness of the Bombay High Court's decision. To do so would be a submission to the formalist view[3] that "*every legal question has a right answer that a properly trained lawyer or judge can deduce by correctly applying the canonical legal materials*[4] *to the facts of the case*", much like in the case of a structured doctrinal science.[5] Rather, it stands by the realist's belief that the Vodafone case presents hard questions to which 'canonical legal materials' do not supply a determinate answer and that the court must resolve these questions by "*balancing, the interests of the parties and ultimately drawing an arbitrary line on one side of the dispute.*"[6]

In realist fashion, the paper moves on the premise that the Bombay High Court cares about the practical outcomes of the Vodafone case and its impact on the real world of fact. While the Bombay High Court chooses its preferred outcome, it feels the need to justify its decision according to "*accepted modes of*

1 The theoretical underpinning of this paper is the understanding of realism advanced in Matthew C. Stephenson, *Legal Realism for Economists*, 23(2) J. Econ. Persp.191(2009). Stephenson refers to the writings of prominent legal realists, to name a few, Karl Llewellyn, Jerome Frank, Max Radin, Herman Oliphant and Walter Wheeler Cook. He also refers to scholars associated with Critical Legal Studies such as Duncan Kennedy, Joseph Singer and Mark Tushnet.

2 Vodafone International Holdings B.V v. Union of India, [2010] 329 ITR 126 (Bombay High Court) [hereinafter *"the Judicial Opinion"*].

3 The "formalist view" here, refers to the pure formalist view described in Stephenson, *supra, n.* 1, at 193–194.

4 Stephenson, *supra, n.* 1, at 193–194. He uses the expression "canonical legal materials"to comprise of principally statutes, regulations, contracts, and prior judicial decisions—along with a relatively small number of fundamental legal concepts.

5 Legal Information Institute, Cornell U. L. Sch., Jurisprudence: an overview *available at* http://topics.law.cornell.edu/wex/Jurisprudence.

6 *Id.*

7 Stephenson, *supra, n.* 1, at 205.

legitimate legal reasoning"– " the arguments from precedent, the careful parsing of statutory or regulatory language, and the analogies to other areas of law."[7] As the court engages in this judicial craft, a "significant gap" arises between "the real reasons" behind its decision and "the legalistic explanations" advanced in its written opinion.[8] The paper highlights this gap and cautions *"against trying to draw conclusions about the nature and effects of law by taking"* Vodafone's written judicial opinion at face value.[9]

The paper seeks to discern the 'real law' arising from the Vodafone case which is more context-sensitive and pragmatic.[10] More simply, the paper perceives this case as an effective context to analyse the predicament of an Indian tax judge, who, while operating in an area of 'legal formalism', must engage with a complex factual matrix and tax policy.

II. The Issue before the Court

India taxes non-residents on their income sourced in India. Section 9 of the Act provides the source rules. It states that capital gains would be taxed if they arise from the transfer of a capital asset situate in India.[11]

Hutchison Telecommunications International Limited (HTIL), a tax resident of Hong Kong, owned 67% equity interests in India's leading telecom company Hutchison Essar Limited (HEL) through its wholly owned subsidiary in Cayman Islands, CGP Investments Ltd (CGP).[12] Seeking to enter the Indian

8 Stephenson, *supra, n.* 1, at 197.

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9 Stephenson, *supra, n.* 1, at 198.

10 Stephenson, *supra, n.* 1, at 198.

11 Income Tax Act, 1961 (43 of 1961), S. 9.

12 *See,* ¶¶ 2–4 of the Judicial Opinion; CGP owned directly, through its subsidiaries in Mauritius, 42 % of HEL. CGP also owned 37.25% in an Indian company Telecom Investments India Pvt. Ltd. (hereinafter referred to as TII). TII in turn held, directly and through its wholly owned subsidiaries in India, 20% of HEL. Consequently, through this route CGP held 7.45 % of HEL. In addition, CGP held through a Mauritian entity 45.79% of an Indian Company Omega Telecom Holdings Private Limited (hereinafter referred to as Omega). Omega in turn held 5.1108% in HEL. Through this route CGP owned 2.34%. As such, CGP owned 52% of equity interests in HEL.

Mr. Asim Ghosh, through his controlled companies, owned 23.97% of TII. Since TII owned 20% of HEL, Mr. Asim Ghosh owned an indirect equity interest of 4.79 % in HEL. Mr. Analjit Singh, through his controlled companies, owned 38.78% of TII. Since TII owned 20% of HEL, Mr. Analjit Singh owned an indirect equity interest of 7.75 % in HEL. SMMS Investments Private Limited (an Indian company) owned the remaining 54.21% of Omega. Since Omega owned 5.1108% of HEL, SMMS owned an

Telecommunications Industry, Vodafone bid to acquire HTIL's equity interests in HEL.[13] HTIL transferred its equity interests in HEL by selling the single share of CGP to Vodafone's acquisition vehicle, Vodafone International Holdings B.V Netherlands (hereinafter "VIH BV").[14] The parties acknowledged that the consideration received by Hutchison for the sale of the CGP share was ascertained on the basis of 67% of the economic value of HEL.[15]

The Income Tax Department took the view that the Hutchison gains were chargeable to tax in India. With Hutchison's exit from India, the Income Tax Department issued a notice to VIH BV for not deducting tax at source as required under the Act.[16] S. 195 of the Act requires any person making a payment to a non-resident of a sum 'chargeable to tax in India' to deduct tax at source from such payment.[17] Vodafone argued as follows: S. 9 of the Act embodies the formal source rule, which provides for taxing the gains arising from the transfer of capital assets that are situate in India; Hutchison's gain arose from the sale of shares of CGP, a capital asset located in the Cayman Islands; Hutchison's gain was hence not chargeable to tax in India; therefore VIH B.V was not obliged to deduct tax at source under the Act.

The dispute came before the Bombay High Court. In reaching a decision on the chargeability of Hutchison gains in India, the Bombay High court had to decide whether Hutchison gains arose from a capital asset situated in India. What was the capital asset giving rise to the Hutchison gains?

III. Competing Outcomes of the Vodafone case

Before *"hard grappling with the facts of the case and inner working of the statute"*,[18] the Bombay High Court's principal concern in resolving these questions was apparently the *"practical outcome of the* [Vodafone] *case - who wins and who loses and its*

indirect equity interest of 2.77%. It is understood that SMMS was owned by IDFC. Together, Asim Ghosh, Analjit Singh and SMMS owned 15% of HEL. CGP had call options over these 15 % shares via its 100 % owned subsidiary 3 Global Services Private Limited, an Indian Company.

13 *See*, ¶¶ 15–31 of the Judicial Opinion.

14 *See*, ¶ 42 of the Judicial Opinion.

15 *Supra*, n. 11.

16 *See*, ¶¶ 47–51 of the Judicial Opinion.

17 Income Tax Act of 1961 (43 of 1961), s. 195.

18 Joseph Isenberg, *Musings on Form and Substance in Taxation*, 49 U. Chi. L. Rev. 859

effect on the real world."[19] The context for evaluating the two outcomes were broad policy considerations, such as the objectives of source based taxation and the certainty of India's income tax law.

If the Hutchison gains were held taxable in India it would fortify India's taxing rights as a source country – if you earn value from India, you shall be taxed in India. The entire value earned by HTIL *"was only on account of the fruits of the investment made by HTIL in India, goodwill/ brand value generated by HTIL for the Hutch brand in India, the telecom licences granted in India, customer base in India and the prospect of future development and expansion in India."*[20] Nonetheless, the formal source rule for capital gains income prescribed that capital gains are taxable in India only if the capital asset situated in India is transferred. In the context of capital gains on company's shares, the settled legal principle is that shares are located where the company's share register is maintained, normally the place of its incorporation.[21] Rendering the Hutchison gains taxable in India would entail imposing *"substantial tax liabilities, after the fact, on entities that would avoid such liabilities according to this formal rule"*.[22]

If the Hutchison gains were held not taxable in India, India would forfeit its right to tax as the country of source, warranting tax payers to exploit the unintended loopholes in India's tax statute and jurisprudence. Hutchison like legal structures could be deployed for avoiding tax liability in India. Any legislative intervention would only take care of prospective transactions. Given the broad policy considerations and factual matrix, the Bombay High Court's apparent preferred outcome was to declare that the Hutchison gains are taxable in India.

IV. The Legal Constraints – Costs Associated with Writing a Legally Persuasive Opinion

The Bombay High Court was operating in an essentially formalist area – tax law. It faced the predicament of justifying its preferred outcome in acceptable legal terms. This entailed constructing legal arguments from and consistent with judicial precedent, statute, regulations and fundamental legal concepts. All of which, in this case, seemingly restrained the Bombay High Court from reaching its preferred outcome.

(1982), *quoted in* Richard A. Posner, The Problems of Jurisprudence 58 (1st ed. 1993).

19 Stephenson, *supra, n.* 1, at 200–201.

20 *See,* ¶ 54 of the Judicial Opinion.

21 Brassard v. Smith, 39 (1925) AC 371, cf. ¶ 95 of the Judicial Opinion.

22 David A. Weisbach, *An Economic Analysis of Anti-Tax-Avoidance Doctrines,*4(1) Am. L.

First, the Indian jurisprudence disallowed the court from adopting any legal justification akin to the economic substance doctrine to declare the Hutchison gains taxable in India. Any legal justification advanced by the court would have to adhere to the legal form of the Hutchison Vodafone transaction.[23] Absent a specific statutory provision, Indian judicial precedents had held against importing the doctrine of lifting of corporate veil or other 'look through' provisions in the tax statute.[24] *Second*, thus far, Indian courts had striven to follow interpretive techniques which promoted certainty in the application of fiscal law. *Third*, under the fundamental principles of corporate law, the court could not declare the controlling interest in HEL to be a distinct capital asset.[25]

Thus, the Indian jurisprudence imposed high costs on the Bombay High Court for writing a legally persuasive opinion, requiring a great deal of judicial creativity on the court's end to use the legal source materials for reaching its desired outcome.[26]

V. Legal Arguments Advanced by the Parties

The Parties to the dispute recognized the costs associated with creating a legal justification for each outcome. The Petitioner focused on raising the cost of the opposing view by reinforcing the legal constraints that the Bombay High Court would face in declaring the Hutchison gains taxable in India.[27] It emphasized that the jurisprudence restrained the courts from imposing tax liabilities on the basis of the economic substance of the transaction. The legal form of the transaction was that Hutchison had transferred shares of a Cayman Island company. Indeed these shares represented a bundle of rights. However, in law, what was transferred was a share and not individual rights. Since, the shares were situated in Cayman Islands, the formal source rule failed to capture the Hutchison gains in India's tax net. To sum it up, the Petitioner simply argued that it was not legally tenable to hold that Hutchison gains were taxable in India.

The Revenue proceeded with, specifically, "*legal arguments as a way of lowering the cost to the judge of reaching its preferred outcome by, in essence, doing*

ECON. REV. 88 (2002), *noted in* STEPHENSON, *supra*, *n.* 6, at 192.

23 *See*, ¶¶ 56–57 of the Judicial Opinion.

24 *See*, ¶¶ 58–66 of the Judicial Opinion.

25 *See*, ¶¶ 67–76 of the Judicial Opinion.

26 STEPHENSON, *supra*, *n.* 1, at 201–204.

some of the judge's work."[28] Its focus was on supplying the Bombay High Court with the "*doctrinal bridge over Jordan.*"[29] It assured the court that its submissions could be justified on the basis of the form of the transaction as reflected in the transaction documents. And, that the court would not have to grapple with legal justification entailing the economic substance of the transaction.[30]

The Revenue articulated the Hutchison–Vodafone transaction as a composite one where Vodafone purchased the effective control and management of HEL. It then recounted the other contractual arrangements, such as the brand licence agreement and non-compete agreement between HTIL and VIH B.V, the transfer of management rights to Vodafone and so forth, which were necessary for Vodafone to step into HTIL's shoes. The Revenue contended that all these rights and entitlements acquired by VIH B.V were not mere appendages to the ownership of the one CGP share. It used Vodafone's representations before the Indian Foreign Investment Promotion Board to bolster its argument that the consideration paid by Vodafone compensated HTIL for the compendium of these rights and entitlements. Jumping the gun, the Revenue contended that, since the definition of a capital asset included a proprietary right of every kind, each of these rights and entitlements were a capital asset the transfer of which gave rise to the Hutchison gains. Amiss in the Revenue's arguments was a clear discussion on where these specific 'rights or entitlements' were located.

VI. 'Legal Justifications of the Court' v. 'Real Law'

The Bombay High court lapped up the Revenue's submissions.[31] Vodafone had paid Hutchison for a compendium of rights and entitlements, some of which, according to the court, were located in India. Accordingly, it justified the taxation of Hutchison gains on the legal form of the transaction as ascertained from the sale-purchase agreement between HTIL and VIH B.V and Vodafone's disclosures before the Foreign Investment Promotion Board.[32] The court directed for the apportionment of the Hutchison's gains attributable to the transfer of capital assets located in India and those located outside India.[33] For the purpose of

27 *See*, ¶¶ 52–53 of the Judicial Opinion.

28 Stephenson, *supra, n.* 1, at 205.

29 Karl Llewellyn, The Common Law Tradition: Deciding Appeals (1960) *quoted in* Stephenson, *supra, n.* 1, at 205.

30 *See*, ¶ 54 of the Judicial Opinion.

31 *See*, ¶¶132–138 of the Judicial Opinion.

32 *See*, ¶¶ 120–131 of the Judicial Opinion.

Vodafone's particular case, this legal argument sufficed to affix liability on Vodafone to deduct tax at source under the Act.[34]

There are loopholes in the court's legal arguments. Apart from the brand licence agreement and the non-compete agreement between the parties, it is unclear as to which of the rights and entitlements did not flow from the ownership of the CGP share. Moreover, there is no discussion on which of these rights and entitlements were situated in India. Further, how was the Vodafone transaction different from any other merger and acquisition where shares were a mode of transferring ownership of a company?

The Bombay High Court's decision, if taken on face value,[35] would have the following implications. *First*, So long as the transfer of equity interest in any Indian company is accomplished by mere transfer of foreign company's shares, without requiring other contractual arrangements as in the present case, Hutchison-like legal structures could still be deployed for avoiding capital gains tax liability in India. Or, plausibly the other extreme, all international acquisitions that derive value from India, however infinitesimal, but entailing incidental legal arrangements in India (such as interim brand arrangements, management agreements and so forth) would be subject to India's source based taxation to the extent of such value or nexus.[36]

The 'legalistic explanations' advanced by the court differ from the 'real reasons' behind the court's decision,[37] which is source based taxation vis-à-vis the economic substance of the Hutchison-Vodafone transaction. On one hand, the objectives of source rule of taxation would require that transactions deriving value from India should be eligible to tax in India. The court perceived the Hutchison gains as deriving their entire value from the Indian economy and investment environment,[38] and therefore embarked with its preferred outcome that the transaction should be taxed in India. Restrained by the inadequate legal framework, the court took recourse in the Revenue's legal arguments. On the

33 *See*, ¶ 139 of the Judicial Opinion.

34 *See*, ¶ 142 of the Judicial Opinion.

35 *Cf.* STEPHENSON, *supra*, *n.* 1, at 198.

36 This implication should be read in light of ss. 5(4) (g) and 5(6) of the proposed Direct Taxes Code Bill of 2010.

37 STEPHENSON, *supra*, *n.* 1, at 197.

38 Peggy B. Musgrave, *Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union*, *in* TAXING CAPITAL INCOME IN THE EUROPEAN UNION 46, 52-53 (Sjibren Cnossen ed., 2000), *quoted in* Micheal J. Graetz, FOUNDATIONS OF

other hand, the source rule of taxation should not be stretched to illogical limits such that transactions deriving even infinitesimal value from India (presenting practical difficulties in computation) should be taxed in India. This is not intended by the court. The precedential value of the decision should be ascertained as per this "real law".

VII. CONCLUSION

As stated, the Vodafone case presents difficult questions the answers to which require the court to balance the interests of the parties and ultimately draw a subjective line on one side of the dispute. The paper does not disagree with the court's decision to tax the Hutchison gains. However, it finds the legalistic explanations advanced by the court for taxing Hutchison gains questionable on two grounds. The *first* is the persuasiveness of the legal explanation offered by the court to declare that the Hutchison gains were taxable in India. *Second,* it is clear that the court was influenced by its preferred outcome in Vodafone's peculiar case and the costs of writing a plausible legal justification for that outcome. However, it seems that the court failed to consider how its"*[written] opinion will affect the development of the legal doctrine and hence the costs that future judges will face in legally justifying particular results in future cases*".[39] Indeed, the implications arising from the court's opinion taken at its face value are inconsistent with the 'real law'. Perhaps the Vodafone decision can be construed as a makeshift arrangement until the proposed Direct Taxes Code Bill comes into force.

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39 STEPHENSON, *supra, n.* 1, at 206.