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GLOBALIZATION, TAXATION AND ETHICAL DILEMMAS - THE VODAFONE CASE

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ABSTRACT

The case based on the experiences of Vodafone in India, presents perspectives on international taxation and tax planning in multiple tax jurisdictions. Followed widely by accountants, tax and legal professionals globally, the Vodafone case brings together a range of issues, from legal to ethical, that transcends the immediate legislative and technical tax questions to highlight the impact of global market forces on ethical issues, such as tax competition from multi-stakeholder perspectives. The case also highlights the complex role of the accountant and tax practitioners who need to distinguish legitimate tax planning from tax evasion, distinctions with moral, financial and reputational implications for multi-national enterprises and professionals involved. Overall, the case brings out several themes suitable for a global course in accounting.

Key words: Globalization, tax havens, tax planning, withholding taxes, ethics

INTRODUCTION

After years of government control and inefficient management, the telecom industry in India was to enter into a new global era with the liberalization of the early 1990s. Telecom was a key industry that could increase communication and market efficiency, paving the way to a modern and more inclusive India. However, there was increased need for investments in infrastructure and technology. While many local players entered the industry, this new environment of openness also attracted global firms with financial and technical resources. An early entrant was Hutchison Whampoa, a Hong Kong based firm, led by the legendary Li Ka-Shing. Seeking local partners, Hutchison first partnered with Max India in 1992 to form Hutchison Max. To further expand operations, they acquired Essar Communications, the telecom subsidiary of the Indian Ruia family firm in 1999, to form Hutchison Essar (HEL).

The global telecom giant, Vodafone, was watching for an opportunity to enter the Indian market. Unlike family-owned and managed firms (Ruias and Ka-Shing's Hutchison Whampoa), operating largely as conglomerates, Vodafone specialized in telecom. In recent years, Vodafone's global strategy had shifted to emerging markets, such as Turkey, South Africa, India and Egypt, as Vodafone began facing saturation in European telecom markets. The CEO Arun Sarin, an astute strategist of Indian origin with a flair for global business, led Vodafone in this phase of globalization.

THE ACQUISITION TRANSACTION

Li Ka-Shing decided to exit the Indian market in 2006. He had prepared the way for such an event, having consolidated all shares of HEL under one financial holding company, CGP Investments (Holdings) Ltd (Cayman Islands)[1], controlled by Hutchison Telecom International Limited (HTIL), also incorporated in Cayman Islands and listed on New York and Hong Kong Stock Exchanges. Arun Sarin joined other suitors including the Ambanis, India's richest family and the Ruias themselves, finally managing to clinch the deal at a stupendous $11.1 billion. The acquisition exposed the complex nature of global financing (Figure 1). The basic transaction consisted of Vodafone International Holdings (VIH) BV (Netherlands), a wholly owned subsidiary of Vodafone (U.K.), acquiring CGP Investments (Holdings) (Cayman Islands) (hereafter referred to as CGP) from Hutchison Telecom International Limited (HTIL), also from Cayman Islands. However, the transaction unveiled a labyrinth of holding companies and subsidiaries spanning Europe (Netherlands and UK), the islands in the Caribbean (Cayman Islands, British Virgin Islands) and Indian Ocean (Mauritius) widely recognized as tax havens, culminating in the transfer of the controlling interest in Hutchison Essar Limited (HEL) to VIH.[2] Figure 1 presents a transaction overview.[3]

ENTER TAX AUTHORITIES AND THE COURTS: A NEW SAGA BEGINS

Before Vodafone had time to celebrate, the Indian Revenue Service (INRS)[4] came calling. Had VIH set aside the taxes due from the seller, HTIL? On September 19, 2007, the INRS issued Vodafone a show-cause notice to explain why Vodafone should not be treated as a taxpayer-in-default for not withholding capital gains tax for what it had paid HTIL. They contended that Li Ka-Shing had made a substantial profit from investments in India. Surely, it was only appropriate that VIH set aside the taxman's share. The tax bill, calculated at the rate of 22 percent on HTIL's capital gain of $9.6 billion on the transaction, was over $2.1 billion.

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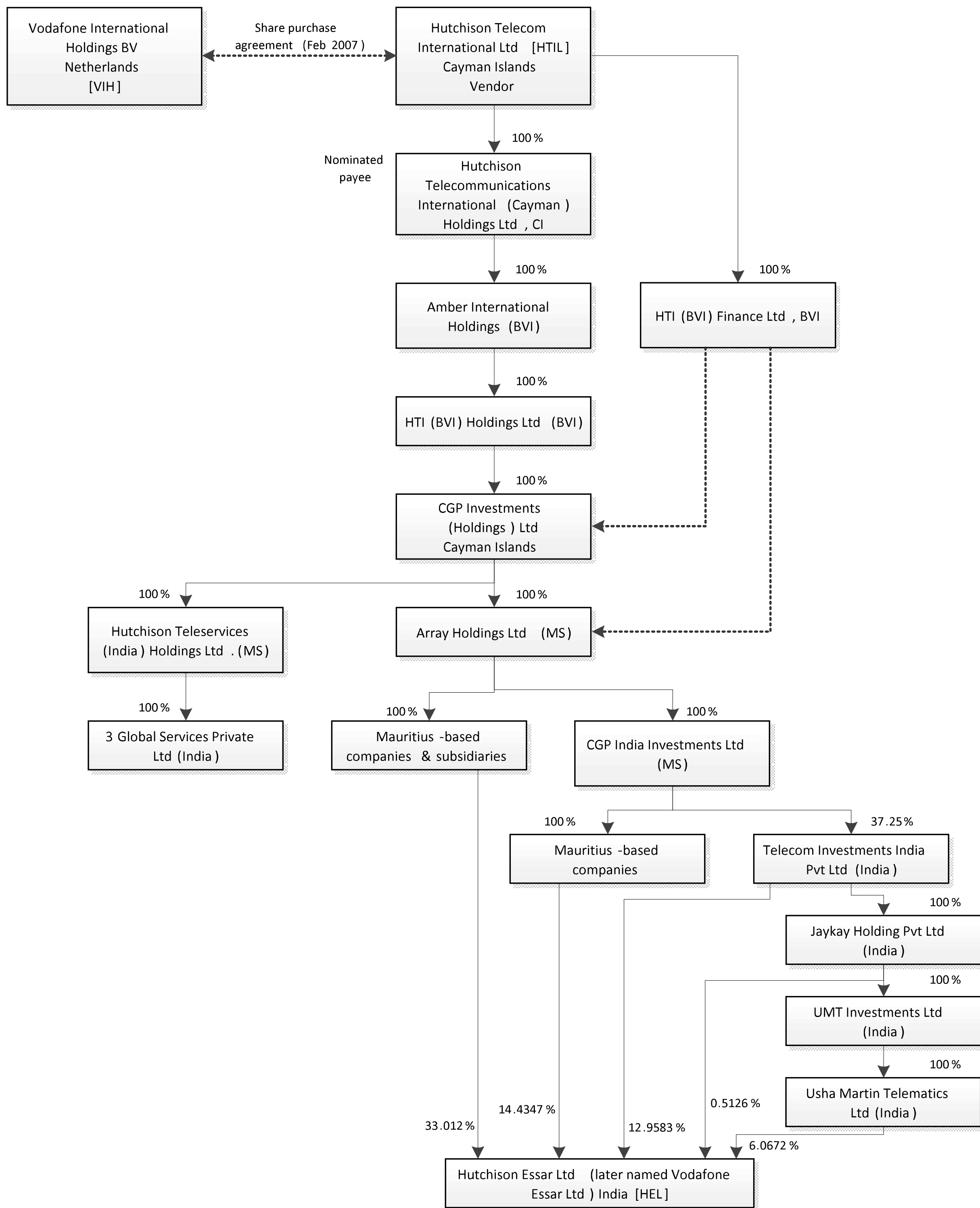
[1]This financial holding company was a Special Purpose Vehicle to consolidate and separate risk from the parent and reallocate them to investors. This form of holding company was recognized in Indian corporate and tax law.

[2]The final ownership percentages pointing to HEL, as in Figure 1, indicates the controlling interest HTIL transferred to VIH that added up to 67%. The remaining 33% interest were held primarily by the Essar group.

[3]A complete presentation of the structure of the transaction is available on page 28 of the judgment of the Supreme Court at http://supremecourtofindia.nic.in/outtoday/sc2652910.pdf.

[4]The Indian Revenue Service uses the abbreviation "IRS"; however, the abbreviation "INRS" is used in this case to differentiate the Indian Revenue Service from the United States Internal Revenue Service.



BVI - British Virgin Islands; MS - Mauritius; CI - Cayman Islands
Figure adapted from publicly available reports.

Figure 1. An Overview of the Indirect Share Transfer

Vodafone first responded to the INRS show-cause notice with a writ petition in December 2008 in the Bombay High Court, contending that INRS did not have jurisdiction over the sale as the transaction had no nexus with the territory of India.[5] Rather, the transfer was between two non-resident entities of a capital asset situated outside India. The Bombay High Court dismissed the writ petition, ruling that INRS had the right to determine tax liability. The INRS then charged that, considering the Share Purchase Agreement (SPA) between the entities, the Vodafone transaction was not merely a transfer of shares but a composite agreement transferring a bundle of intangible rights, such as control premium, non-compete agreements, and put/call arrangements to Vodafone. Further, the INRS also contended that Vodafone structured the transaction to avoid Indian tax, given that the intervening holding companies lacked commercial substance. Citing the applicable sections of the Indian Income Tax Act, the INRS alleged that Vodafone should be held responsible for not withholding the capital gains tax of $2.1 billion.[6] Vodafone appealed again to the Bombay High Court. The court issued a judgment on September 8, 2010 concurring with the INRS that, given the "nexus between the person sought to be charged and the country seeking to tax him, income tax may extend to that person in respect of his foreign income…once the nexus is shown to exist, provisions of Section 195 would operate."[7]

The mood at Vodafone head office had turned somber. Three years of painstaking work and there appeared little to show for it. Nevertheless, Vodafone had a trump card in their legal team, particularly star counsel, Harish Salve. Vodafone had recruited Harish Salve, a highly reputed counsel for the August 2010 hearings in the Bombay High Court. While Salve could not convince the Bombay High Court to drop the case, he did improve Vodafone's position. The judges could not conclude the transaction to be a sham, set up to avoid taxes.[8] Increasingly optimistic, Vodafone now appealed the Bombay High Court's decision to the Supreme Court of India (SC) on September 14, 2010. Salve set aside all major engagements to concentrate on the Vodafone case, spending months in his Mayfair London apartment preparing for the final court hearings. Aided by a large contingent of associates and assistants, the consuls appeared before the Supreme Court over several weeks of long and grueling court proceedings. Finally, in their ruling on January 20, 2012, the Supreme Court

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[5]The highest court in the Indian judicial system is the Supreme Court. Below the Supreme Court are 21 High Courts in different states and below the High Courts are the District and Sessions Courts within each state.

[6]The INRS cited sections §5(2), §9(1)(i), and §195(1) of the Income Tax Act (ITA). Provisions of ITA can be accessed at http://www.incometaxindia.gov.in/Pages/acts/income-tax-act.aspx. The applicable sections of the Indian Tax Law include Sections 5(2) and 9(1). Under Section 5(2), total income of any previous year of a person who is a nonresident... (b) accrues or arises or is deemed to accrue or arise to him in India during such year. This section is connected with Section (9)(1), that such income is deemed to accrue or arise in India "through the transfer of a capital asset situate in India" (Section 9(1)). If the transaction is taxable, the buyer is liable for withholding taxes from the non-resident seller under Section 195 of the Income Tax Act (see also Court Rulings in Appendix). Provisions of Section 195 are available at: http://indiankanoon.org/doc/1329583/ [Accessed November 13, 2015].

[7]A copy of the Order of the Bombay High Court can be accessed at: http://bombayhighcourt.nic.in/data/judgements/2010/OSWP130810.pdf.

[8]Http://forbesindia.com/article/boardroom/a-salve-for-a-taxing-moment-the-vodafone-inside-story/32186/0 [Accessed June 2, 2015].

of India (SC) reversed the verdict of the High Court in a unanimous judgment (see Timeline in Figure 2 for events).[9]

The SC judgment was significant for the depth and breadth of issues addressed, from tax planning and evasion, to tax havens, indirect share transfers and Foreign Direct Investments (FDIs). At the core, the question was whether the income arose in India, given that the share transfer took place outside India. Considering the entirety of the facts of the case, the SC held that the purpose of CGP was not solely to hold shares in subsidiary companies but also to enable a smooth transition of business that included consolidating Mauritius based companies with 3 Global Services Pvt Ltd (3GSPL).[10] Therefore, it could not be said that CGP had no business or commercial substance. Hence, the nexus with India did not exist in this case, unless the INRS looked beyond the transaction and the entities involved, applying a "look through" provision or "piercing the corporate veil." Applying the Ramsay case, the evidence did not warrant "look through" because there were no "colourable devices" or evidence of fraudulent acts.[11] Rather, the long-standing Westminster principle held that "every tax payer is entitled to arrange his affairs so that his taxes shall be as low as possible and that he is not bound to choose that pattern which will replenish the treasury" (the Appendix consolidates key excerpts from the High Court and Supreme Court rulings).

Clearly, ethical questions also loomed large, particularly given the use of holding companies located in areas widely recognized as tax shelters (Figure 3 presents excerpts on tax havens from recent Citizens for Tax Justice (CTJ) online publications).[12] Quoting from the Tax Justice Network Project (U.K.), the SC recognized that "(t)he role played by tax havens in encouraging and profiteering from tax avoidance, tax evasion and capital flight from developed and developing countries is a scandal of gigantic proportions." Nevertheless, the court emphasized the need to uphold tax treaties. Specifically, in the light of the *Azadi Bachao* precedent, the court pointed out that Mauritius was another legitimate route that HTIL could have used without incurring taxes given that the downstream companies held Tax Residency Certificates (TRC) from Mauritius.

Once it was determined that "tax avoidance" was not the motive for the structure of the transaction, the court based their final verdict on the "rule of law." They emphasized that the provisions for "deemed income" under Section 5(2) of the Income Tax Act 1961 applied to income from transfer of capital assets situated specifically in India (Section 9(1)(i)). The justices' strict adherence to the letter of the law was evident in the final verdict. As one justice summarized the outcome in the light of tax law, INRS had "failed to establish both resident test as well as the source test." In arriving at the verdict, the SC emphasized the need that certainty and stability form the

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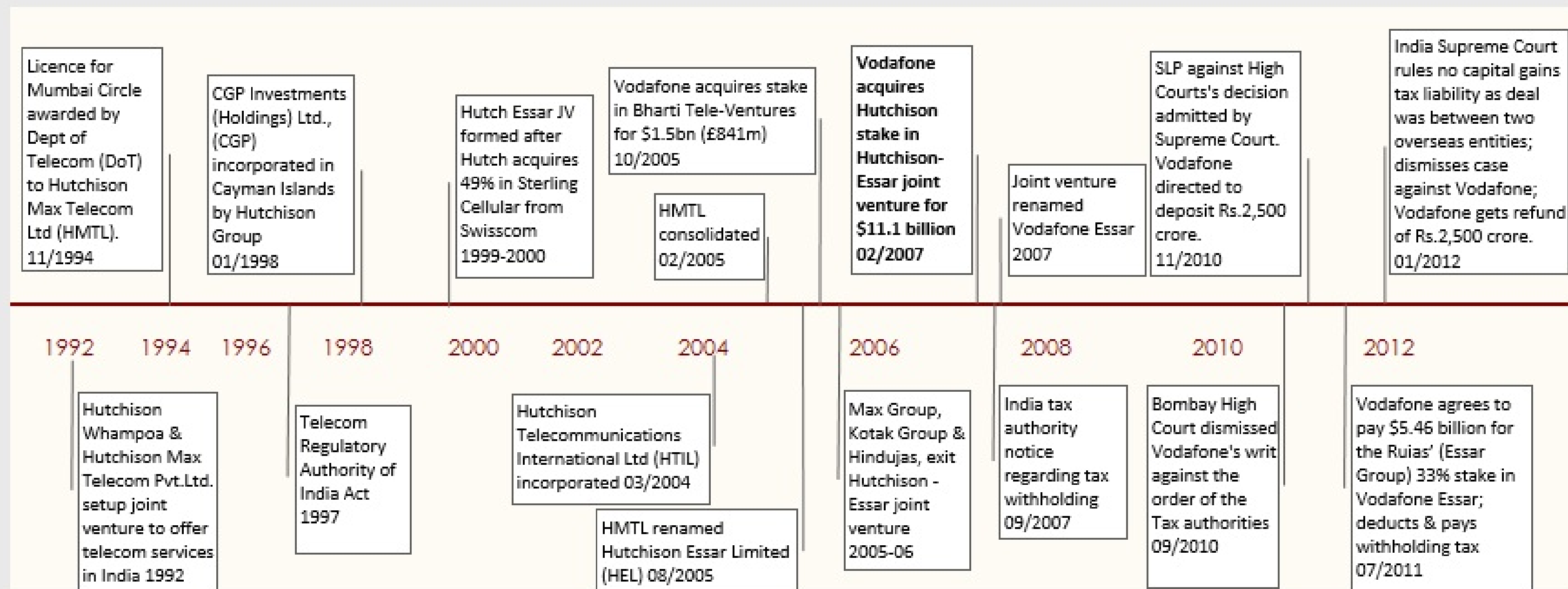
[9]A copy of the Supreme Court judgment can be accessed at: http://supremecourtofindia.nic.in/outtoday/sc2652910.pdf [Accessed June 2, 2015].

[10]3 Global Services Pvt Ltd (3GSPL or 3 Global), a 100% subsidiary of Hutchison Whampoa, was incorporated in the year 1999 in India. 3GSPL was a global pioneer of 3G (3rd Generation) telecommunication technology.

[11]The Ramsay principle (Ramsay case of 1982) held that courts were to look into the genuineness and legality of the case in determining the taxability of the transactions. If the transaction had artificial steps with no commercial substance, the proper approach was to tax the consequence of the composite transaction, ignoring "circular" transactions, called "fiscal nullity." See http://www.oecd.org/ctp/glossaryoftaxterms.htm for Tax Glossary.

[12]Citizens for Tax Justice (CTJ): "Offshore Shell Games," CTJ, 2014; pp. 7-8; Retrieved from: http://ctj.org/pdf/offshoreshell2014.pdf [Accessed May 5, 2015].



Compiled from publicly available news reports and other online sources.

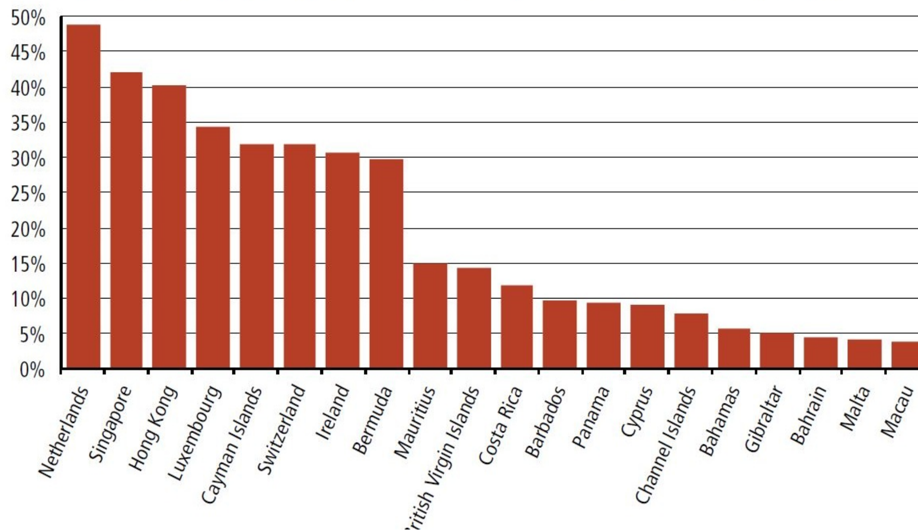
Figure 2: The Transaction Timeline

FIGURE 2

Top Companies with the Most Tax Haven Subsidiaries (from Table 1, p. 8)

Company	Number of Tax Haven Subsidiaries	Locations of Subsidiaries
Bank of America Corp.	264	Bahamas (2), Bermuda (3), Cayman Islands (143), Channel Islands (17), Costa Rica (1), Gibraltar (4), Hong Kong, (8), Ireland (11), Luxembourg (18), Mauritius (6), Netherlands (32), Panama (1), Singapore (10), Switzerland (4), Turks and Caicos (1), U.S. Virgin Islands (3)
AES	226	Bahamas (1), Barbados (1), Bermuda (6), British Virgin Islands (12), Cayman Islands (99), Channel Islands (1), Costa Rica (1), Cyprus (2), Hong Kong (1), Ireland (2), Jordan (2), Luxembourg (1), Mauritius (2), Netherlands (82), Panama (7), Singapore (6)
Morgan Stanley	226	Bermuda (4), Cayman Islands (107), Channel Islands (10), Cyprus (3), Gibraltar (4), Hong Kong (11), Ireland (6), Luxembourg (37), Malta (1), Mauritius (5), Netherlands (27), Singapore (8), Switzerland (3)
KKR	157	Cayman Islands (131), Channel Islands (3), Cyprus (1), Hong Kong (2), Ireland (8), Luxembourg (5), Mauritius (4), Singapore (3)
Thermo Fischer Scientific	144	Barbados (3), Bermuda (4), British Virgin Islands (1), Cayman Islands (10), Channel Islands (1), Costa Rica (1), Gibraltar (2), Hong Kong (11), Ireland (7), Luxembourg (19), Malta (3), Netherlands (54), Singapore (11), Switzerland (17)
PepsiCo	137	Barbados (1), Bermuda (16), British Virgin Islands (1), Cayman Islands (5), Costa Rica (2), Cyprus (15), Gibralter (3), Hong Kong (10), Ireland (13), Jordan (1), Liechtenstein (1), Luxembourg (25), Mauritius (2), Netherlands (33), Panama (1), Singapore (2), Switzerland (6)

Figure 1: Percent of Fortune 500 Companies with 2013 Subsidiaries in Twenty Top Tax Havens



Source: "Offshore Shell Games," CTJ, 2014; pp. 8-9; Retrieved from: http://ctj.org/pdf/offshoreshell2014.pdf (accessed on May 5, 2015)

foundation of any fiscal system. Investors should know where they stand and tax administrators should understand their role in enforcing the provisions of tax laws.

POSTSCRIPT: THE JUDGEMENT AND ITS AFTERMATH

The case drew global attention from accounting firms and seasoned tax professionals. Vodafone and HTIL had structured the transaction based on current laws in India. The rule of law was tested and found to hold. Would the verdict have been different elsewhere? Salve quipped that if the Chinese tax office said that this was not genuine tax planning, Vodafone would have to reach for their checkbooks. In fact, China had passed Circular 698 in 2009 that allowed tax authorities to disregard intermediary companies if they were set up to avoid taxes rather than for business purposes.

However, the Vodafone saga and its aftermath were not over. Indian tax authorities raced to plug tax loopholes and restrain tax haven activity. Soon after the Vodafone verdict, the Indian Government passed legislation (the 'Finance Bill 2012') inserting new provisions in interpreting Section 9(1), bringing capital gains from indirect share transfers into the tax ambit.[13] Other legislative changes to curb errant tax haven activity were also in the offing. The Mauritian tax treaty also came on the tax radar screen, with increased efforts to re-negotiate the Mauritian DTAA. Mauritius for their part understood the need to improve the image of the country as a clean and well-regulated international financial center by providing guidelines for global business.[14] However, there were legitimate fears that the proposed Limitation of Benefits (LoB) coupled with other anti-avoidance measures may well create an air of uncertainty and dampen inbound flow of investments.

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[13]On April 17, 2012, Vodafone filed an intent to arbitrate under Dutch-India Bilateral Investment Treaty ('BIT') should the new laws be enacted retrospectively (from contingencies in the 2014 Annual Report of Vodafone).

[14]Khanna, Anshu, "Limitation of benefits clause: Indo-Mauritius tax treaty", posted by: Grant Thornton India LLP, January 6, 2014; Retrieved from http://www.grantthornton.in/en/press/press-releases-2014/limitation-of-benefits-clause-indo-mauritius-tax-treaty/ [Accessed Dec. 26, 2016].

Mauritius had recently changed its slogan to "gateway to Africa," reflecting the impact on future Indian FDI through the island nation.[15] However, Indian tax officials appeared confident that India's ability to continue to attract FDIs was not merely dependent on the benefits of tax havens to potential investors.

Vodafone Suggested Questions

1. Briefly describe key aspects of the Vodafone case. Specifically consider the actual transaction that led to the fallout with the INRS, the main entities involved in this transaction, and their relationships in light of Figures 1 and 2.
2. The courts discussed a range of topics to arrive at their decision.
    a) Briefly describe indirect share transfers. Why did the two courts have conflicting verdicts on the taxability of indirect share transfers? What did justices mean by the statement "the courts are to interpret the law and not create it" in the light of the Vodafone case verdict? (see also Cope and Jain, 2015).
    b) Attorney Salve observed that the outcome would have been different in China. The Indian courts used the common law system, in contrast to code law in many other countries including China. Discuss the possible difference if the case had been adjudicated in China, particularly in the light of Circular 698 issued by Chinese tax authorities (see also Cui, 2014; pages 113-124).
3. The case highlights some areas important to the accounting professional.
    a) Briefly discuss some of these tax concepts, including tax codes and jurisdictions, law and substance of transactions, and scope of income.
    b) Assume that you are a tax partner of a large audit firm. What advice would you provide to a client who is seeking to invest in Asia, specifically China and India? Consider the tax issues that emerge from an FDI strategy, including tax planning in setting up the entity, operations including avoiding double taxation, and exit strategies, considering such areas as indirect share transfers, risk mitigation, and tax treaties.
4. Treaty shopping also leads to countries competing to lower taxes (called tax competition). This leads to erosion of the tax base, according to the OECD.
    a) Contrast the viewpoints of the state, corporations, citizens and the courts regarding treaty shopping.
    b) How should accountants approach this situation (see Alexander et al., 2003)? Consider the recent rule (IRSRRA (Section 7525)) on confidentiality provisions for public accountants. Could this influence the credibility of the profession? Comment.

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[15]Resulting from the new focus on Africa, India's share of global investments through Mauritius shrank to 15% in contrast to that of Africa, which increased to 50% (see The Hindu Business Line, December 8, 2013: http://www.thehindubusinessline.com/industry-and-economy/mauritius-india-agree-to-limitation-of-benefit-clause/article5436404.ece).

APPENDIX

Court Ruling Excerpts

Item # and Page #	Key Concepts
High Court Ruling Excerpts	
Item 54, part xvii, page 51	Section 9 (1) of ITA: Deemed income of non-resident - should have sufficient territorial nexus with state.
Item 78, page 94	Section 5 (2) of ITA provides criteria for taxing non-resident, i.e., nexus for the purpose of chargeability to income tax - receipt or accrual of income in India.
Item 81, pages 97-98	Section 9 (1) defines circumstances in which income is deemed to accrue or arise in India.
Item 93, page 109	International Double Taxation Concepts and Issues 1, 3: Criteria for determining jurisdiction to impose income tax. Source principle - relationship of State to that income. Residency principle - relationship of State to the person deriving that income.
Item 98, page 114	Transnational law criteria for recognizing jurisdiction of a State to tax nonresidents.
Item 100, page 116	Source Rules limitations (situation of property) and related OECD initiatives.
Item 108 and 109, pages 125 and 126	Section 195 of the ITA: Responsibilities of person paying a nonresident to withhold taxes; payee (beneficiary) is beyond the reach of Indian law. Thus, obligation rests with payer, who has nexus with or is subject to Indian law.
Item 132, pages 177-178	Description of facts of transaction between HTIL and VIH, BV appears to show that essence of transaction was transfer of conrol over HEL (situated in India); includes excerpts from due diligence report by Ernst and Young.
Item 144, pages 191-192	Basic test under Section 195 - payment made to non-resident taxable under the Act; connection with person based on business connection with state or situation within the State of an asset or source of income from which the taxable income is derived.
Item 146, page 195	Open to Petitioner to debate the deductibility of tax at source before the tax authority.

Source: http://bombayhighcourt.nic.in/data/judgements/2010/OSWP130810.pdf

(continued)

APPENDIX (continued)

Supreme Court Ruling Excerpts

Item 3, page 2	Presents description of "Evolution of the Hutchison structure and the Transaction."
Item 59, page 31	Westminster Principle - cardinal principle on "look at" versus "look through" concepts.
Item 68, pages 38-41	Principles underlying Holding Structures and legitimacy of such holding companies where there is evidence of business purpose (indicates that the transaction is not undertaken as a colorable device).
Item 69, pages 41-42	Does Section 9 of the Income Tax Act, 1961 as that Section provides for a "look through", i.e., going behind the corporate veil to determine the ulterior motive for the transaction?
Item 70, pages 42-43	Evaluation of the merits of this interpretation that "look through" is permissible. Applies Section 5 (total taxable income of an individual including income deemed to accrue or arise in India) and particularly Section 9 (1) wich describes income deemed to accrue or arise in India.
Item 71, pages 43-48	Detailed assessment of Section 9 (1) of the ITA and whether it covers indirect transfer of capital assets/property; This item presents the key arguments for applying the specific provisions of the law related to interpreting indirect share transfers.
Item 80, pages 68-69	Was the Mauritian route available to HTIL? The Mauritian companies were not liable to pay capital gains tax under the Indo-Mauritian Double-Tax Avoidance Agreement (DTAA).
Item 104, pages 187-188	Tax Justice Network project (U.K.) in its report published in September 2005, stated as follows: "The role played by tax havens in encouraging and profiteering from tax avoidance, tax evasion and capital flight from developed and developing countries is a scandal of gigantic proportions."
Item 106, pages 189-190	Adequate legislative measures have to be taken to plug the loopholes, but genuine corporate structure set up for purely commercial purpose and indulging in genuine investment must be recognized as such.
Item 107, pages 190-191	Tax planning is legitimate when within the framework of law (Latilla vs. INRS)
Item 108, page 191	In Jiyajeerao (supra) also, this Court made the following observation: "Every person is entitled so to arrange his affairs as to avoid taxation, but the arrangement must be real and genuine and not a sham or make believe."

Source: http://supremecourtofindia.nic.in/outtoday/sc2652910.pdf