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Tough call

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The recent decision by a Mumbai court in the Vodafone case means the role of offshore financial centres in Indian transactions has become a more complex and different animal. By Chetan Nagendra

No international tax case has generated as much controversy and literature in recent times as the September 2010 Mumbai High Court judgment in Vodafone International Holdings BV v Union of India. The judgment, which concerns the use of offshore vehicles on India-bound transactions, has an almost universal bearing on corporate transactions, portfolio and private investments involving India.

In Vodafone, the Coram comprising Mr Justice Chandrachud and Mr Justice Devadhar deemed inadequate the contention by the purchaser, Vodafone International Holdings, that the transfer of a single share of a Cayman Islands company was sufficient to complete the sale of Hutchison Essar (India) by the vendor Hutchison Telecommunications International.

The judges concluded that intrinsic to the transaction was a transfer of other rights and entitlements, constituting capital assets within the framework of India's Income Tax Act 1961 and thus fulfilling the nexus with the taxing jurisdiction and rendering the transaction liable for taxation in India.

The judges also stated that, where a capital asset is situated in India, all income that accrues from it shall be deemed to accrue in India and that the apportionment of income lies within the jurisdiction of the assessing officer during the course of assessment proceedings.

Following the court's ruling, the tax authorities raised a demand of \$2.52bn (£1.57bn) on capital gains due from Vodafone, indicating that the entire offshore transaction was liable to tax in India. The purchaser has preferred an appeal before the Supreme Court of India.

Other offshore developments

The aftermath of the 2008 credit crisis raised scrutiny of both tax-advantaged and tax-neutral offshore jurisdictions, at the Organisation for Economic Cooperation and the G-20 levels, as well as in India.

With respect to tax-advantaged jurisdictions, India has negotiated a 'limitation of benefits clause' denying tax treaty benefits to residents that do not meet strict tests in recent bilateral tax treaties with Singapore and Luxembourg. India has also sought greater scrutiny and/or renegotiation of treaties with Mauritius and Switzerland and tightened capital controls and increased scrutiny of secondary market portfolio investments by foreign investors. In the absence of legislative clarification, administrative and quasi-judicial authorities have attempted to classify corporate transactions as permissible or impermissible tax-avoidance measures.

With respect to tax-neutral jurisdictions, India has announced its intention to negotiate tax information sharing agreements with jurisdictions where no comprehensive tax treaty exists, and has attempted to modify the 'source' rule of taxation to cover transactions where assets are located in India, as opposed to where the transaction was originally sourced, such as an offshore jurisdiction. Finally, the government has also suggested general anti-avoidance and controlled foreign corporation provisions in the forthcoming Direct Taxes Code.

Using offshore structures

Clearly, all these developments will have a bearing on cross-border M&A and private equity investments bound for India, - considering that deals often involve offshore structures in Cayman, the British Virgin Islands (BVI) or other tax-advantaged and tax-neutral jurisdictions. But it is far from clear that offshore structures will no longer be used.

M&A structures and private equity investments are often guided by both tax and non-tax objectives while routing transactions through offshore jurisdictions. For instance, private equity investors may make use of beneficial bilateral tax treaties in tax-advantaged jurisdictions such as Cyprus in order to maximise gains on dividends and on income. In other instances, companies and investors may incorporate structures in multiple offshore jurisdictions to take advantage of local corporate law and tax-neutrality provisions.

There are several other advantages that make BVI and Cayman popular jurisdictions. State-of-the-art corporate legislation caters to the demanding needs of the international investor and the international finance community. For instance, the flexibility in

company legislation makes BVI a perfect jurisdiction for structuring joint ventures and also facilitates reserved matters, drag-along, tag-along and compulsory redemption rights, which are so critical for the smooth operation of joint ventures. The legislation also facilitates easy unwinding and liquidation of corporate structures, and makes it possible to enhance the confidentiality of shareholders, or of the directors of a corporate entity. There is also less restrictive control over capital flows.

Other advantages include familiarity, stability and reputation. Financial services authorities in BVI and Cayman have robust and comprehensive regulation to protect the interests of investors.

regulators are responsive, commercially orientated and take an active interest in the development of these territories as international financial centres. There are also robust anti-money laundering regulations in place derived from Caribbean Financial Action Task Force and Financial Action Task Force recommendations.

Finally, BVI and Cayman are both noted for their professional advisers and the speedy resolution of disputes in courts; the BVI even has a dedicated commercial court.

Conclusion

What this all means for cross-border transactions relating to India is unclear. There is the possibility of even more complex structuring in complicated transactions, and that investors and companies may need to meet increased financial, managerial and operational substance at the offshore level in order to avoid tax controversies. It is also unclear how the interim judgment in Vodafone would apply to a transaction accounted for in a tax-advantaged jurisdiction.

Nevertheless, the utility, flexibility and neutrality afforded by corporate legislation in mature offshore jurisdictions such as BVI and Cayman cannot be ignored. Recent statistics from the Reserve Bank of India, which show that foreign direct investment (FDI) in India from BVI grew by 102 per cent from 2008-09 to 2009-10, indicate that in simplistic FDI terms, the popularity of offshore structures has not diminished.

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