The Vodafone Essar Dispute: Inadequate Tax Principles Create Difficult Choices for India

Geoffrey T. Loomer*

Although the international taxation system is not new to problems and crises, economic liberalization and the increasing integration of world markets has intensified its difficulties, with MNEs being at the forefront of tax avoidance by taking advantage of loosely co-ordinated international tax treaties. The threat is worrisome enough for emerging economies such as India and China to take notice, despite their earlier stance of regarding foreign investment as a boom, regardless of tax contributions. This article takes a specific example in the case of the Vodafone Essar tax dispute regarding the payment of capital gains tax on the transfer of a controlling interest in an Indian entity from one foreign company to another, in order to illustrate the loopholes in Indian tax law, the choice that is present before Indian courts - a choice between abiding by the principles of international taxation or changing Indian tax policy altogether, and a view on the way international taxation agreements are to be read in light of the norms of international taxation.

* Research Fellow, Oxford University Centre for Business Taxation, Saïd Business School, Oxford.

I. Introduction

A. The Form and Flexibility of the International Tax System

It hardly needs repeating that the existing international tax system, designed to allocate countries' taxing rights over income from bilateral trade and investment, struggles under the weight of global economic integration. The evolution of transnational trade and investment, particularly within multinational enterprises [hereinafter "MNEs"], raises difficult tax policy issues that sovereign States have attempted to address through their domestic tax regimes and their respective networks of double taxation conventions [hereinafter "DTCs" or "tax treaties"]. This collection of policy responses has produced an international tax consensus which Avi-Yonah aptly describes as a "*flawed miracle*".[1] The system functioned reasonably well in an economic environment characterized by independent, single-state enterprises carrying on business abroad through branch operations or carrying out transactions with unrelated foreign enterprises – to the extent that such an environment ever existed. However, recent liberalization of State economies and transnational integration of businesses, assisted by advances in communication and transportation, disturb the foundations upon which the international tax system is based.[2] It is increasingly evident that the fractures in the system are felt by both developed and developing nations.

There is a tendency to think of the problems related to international taxation, and particularly international corporate taxation, as being recent. However, they have troubled policy-makers since at least the late 19th century. The period between the World Wars in particular saw an unprecedented expansion of international business and a corresponding crisis in international taxation, to which the initial model DTCs were a response.[3] In 1992, several years before electronic commerce became a worldwide norm, Picciotto described the state of the then-current international tax regime as an "*increasing crisis*" which was in need of a "*new approach*".[4] As he observed at the time, much of this crisis has to do with the creation and manipulation of offshore Statehood by internationally integrated firms; the well-advised MNE is able to exploit the loosely coordinated tax treaty system, often through the use of tax haven intermediaries, in order to

1 R. S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Tex. L. Rev. 1301, 1303 (1996).

2 Two of the best critiques, addressed in further detail in § IV below, are: K. Vogel, *Worldwide vs Source Taxation of Income – A Review and Re-Evaluation of Arguments* (Parts I-III), 8-9 Intertax 216 (1988), 10 Intertax 310 (1988), 11 Intertax 393 (1988), and M.J. Graetz, *The David R Tillinghast Lecture – Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax. L. Rev. 261 (2001).

3 E. Seligman, Essays In Taxation ch 4 (MacMillan 1925), H. Wurzel, *Foreign Investment and Extraterritorial Taxation*, 38 Colum. L. Rev. 809 (1938).

4 S. Picciotto, International Business Taxation: A Study in the Internationalization of Business Regulation 67-68 (Quorum Books, 1992).

minimize its worldwide tax burden.[5] This behaviour, although considered by some to be unethical or at least undesirable, is entirely legal in the context of prevailing international tax principles – what might be called the customary norms of international taxation. These principles or norms include residence-based taxation, source-based taxation, permanent establishment, separate entity accounting and, more fundamentally, separate corporate personality.[6]

Various tax administrations are nonetheless continuing to mount aggressive challenges to international tax minimization structures that rely upon, or stretch the boundaries of, these principles or norms. It is fair to say that, while issues related to selective establishment in tax havens and selective reliance on treaty networks are not new, it is only recently that governments have come to regard such issues as socio-political rather than merely technical.[7] Efforts to thwart international tax avoidance are by no means restricted to highly developed States, including the member States of the Organisation for Economic Co-operation and Development [hereinafter "OECD"]. Large emerging economies such as India, China and Brazil, who may have previously welcomed the benefits of foreign investment without regard to tax contribution, are now rightly concerned that profitable investments by non-residents should bear a "*fair share*" of taxation in the host country.[8] The difficulty faced by any State is ascertaining and pursuing the fair and legally appropriate tax burden within the constraints imposed by the international tax system.

B. The Indian Experience

It is well known that India has experienced remarkable economic growth in the last decade. Massive increases in foreign investment, with the associated corporate restructuring activity, have forced the Indian Income Tax Department [hereinafter "ITD"] to grapple with and respond to complex international tax issues. The theme of recent challenges brought by the ITD is the preservation or amplification of India's tax jurisdiction as a source/host State.[9] Among other claims, the ITD has argued that low thresholds should apply for treating local activities of non-resident enterprises – including liaison offices and business process

5 *Id*., at 134-39. For a more recent exposition, *see* S. Picciotto, *Tackling Tax Havens and "Offshore" Finance*, (Transnational Institute Conference Paper, Money Laundering, Tax Evasion and Financial Regulation 2007), *available at* http://www.tni.org/crime-docs/picciotto.pdf.

6 R.S. Avi-Yonah, International Tax as International Law: An Analysis of the International Tax Regime (Cambridge University Press 2007).

7 Picciotto 2007, *supra* note 5, at 1-2; The report by G. B. Oxfam, *Tax Havens: Releasing The Hidden Billions For Poverty Eradication* (Oxfam Policy Paper, 2000), *available at* http://www.taxjustice.net/cms/upload/pdf/oxfam_paper_-_final_version__06_00.pdf has helped raise the visibility of these issues in the United Kingdom.

8 A. Schindel & A. Atchabahian, *Source and Residence: New Configuration of Their Principles* 90a CDFI (Int'l Fiscal Association Congress, General Report, 2005).

9 S. Chakrabarti & R. Joseph, *Permanent Establishment and Income Attribution in India*, Tax Notes Int'l 517 (2008); K.A. Parillo, *Will Bureaucracy Hinder India's Rise?*, Tax Notes Int'l 886 (2008).

outsourcing – as taxable permanent establishments under domestic law and applicable tax treaties, that certain profits arising in India should attract withholding tax as royalties or "*fees for technical services*", and that changes in ownership of Indian companies should attract capital gains taxation.

This article discusses a recent challenge falling into the last of those categories. The dispute turns on the proposition that Indian capital gains tax was exigible on a transaction which in broad terms involved one non-resident company, Hong Kong-based Hutchison Telecommunications International Limited [hereinafter "HTI"], transferring to a second non-resident company, UK-based Vodafone Group plc [hereinafter "Vodafone"], an indirect controlling interest in the Indian company Hutchison Essar Limited[10] [hereinafter "TelCo"]. The relevant TelCo shares were held *via* a corporate structure designed to benefit from the tax treaty between India and Mauritius.[11] The ITD alleges that Vodafone should have withheld approximately US$ 2 billion in capital gains tax from the consideration paid to HTI and further alleges that Vodafone is liable for US$ 2 billion in penalties, plus interest, for its failure to withhold and remit such tax. The case proceeded to the Bombay High Court and was heard in June and July 2008. At the time this article was written (October-November, 2008) the High Court had not yet issued its decision. After writing but prior to publication, the High Court dismissed Vodafone's petition, primarily on procedural grounds.[12] The Court also made various wide-ranging comments adopted from the respondents' submissions, all of which must be considered *obiter dicta*, suggesting that the transaction was taxable in India because it represented a transfer of a "*controlling interest*" in an Indian enterprise from one "*group of companies*" to another.[13] While the author sympathizes with this suggestion, he considers it legally untenable for the reasons discussed herein. In any event, the dispute is expected to be appealed to the Supreme Court of India.[14]

10 Hutchison Essar Limited was marketed as "Hutch". The name has been changed to Vodafone Essar Limited. To avoid confusion among the shareholders it is referred to herein as TelCo.

11 Convention Between The Government of The Republic of India and The Government of Mauritius for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains, India-Mauritius, 1983 [hereinafter the "India-Mauritius DTC"].

12 Vodafone International Holdings BV v. Union of India and another, Writ Petition No. 2550 of 2007 (Dec. 3, 2008) [hereinafter the "Petition Judgment"]. The High Court held that Vodafone was required to follow a prescribed dispute resolution procedure for challenging the Show Cause Notice issued by the ITD, rather than attacking the legality of the Notice via petition. It held that the alleged chargeability of the transaction to tax and the alleged duty to deduct tax at source involved difficult questions of fact and law which could only be resolved through the proper administrative framework (¶ 170-85).

13 Vodafone International Holdings BV v. Union of India and another, Writ Petition No. 2550 of 2007 (Dec. 3, 2008), at ¶ 152-68.

14 If the Supreme Court overrules the High Court and concludes that the Notice was patently illegal, that is likely to be the end of the matter. Alternatively, if the Supreme

This is widely regarded as a landmark case for two reasons. First, the decision will influence, if not determine, the outcome in a number of related disputes, said to involve dispositions of Indian interests by the likes of AT&T and General Electric.[15] In each case, the ITD is advancing the view that a change in the ultimate ownership of an Indian company by virtue of a transfer of shares in an offshore holding entity is a disposition giving rise to a taxable capital gain in India. More generally, the decision is significant because it will shape the legal environment for foreign corporate investment in India.

C. Outline of Article

This article begins by briefly reviewing the economic and legal context in which the Vodafone Essar tax dispute arose. It then focuses on the central feature of the dispute, which has practical and theoretical implications within and beyond India. This is the contention that a State's jurisdiction to tax capital gains might be framed in such a way that a gain from a disposition, which is formally an alienation of shares situated in a foreign State, is nonetheless taxable as a gain arising or accruing from the underlying shares or assets in the source/host State (in this case, India). An associated proposition is that tax treaty benefits relieving a foreign enterprise from source-State taxation, specifically capital gains taxation, may be denied where the treaty is considered to have been abused by residents of third States. Acceding to either contention requires a State to "*pierce the corporate veil*", disregarding the separate personality and distinct residence of companies in a corporate group.

The author is not an expert in the domestic tax law of India. Accordingly, the intent of this article is not to investigate what the Indian Supreme Court will decide based on a thorough analysis of the Income Tax Act, 1961 [hereinafter the "Act"] and the relevant judicial precedents. Instead, the focus is on the relevant principles of international tax law that are engaged. Some insights are offered on the apparent scope of the Act, notably section 9, and the relevant provisions of the India-Mauritius DTC, notably Article 13. In the author's opinion, while it is highly unlikely that an Indian Court, having regard to these provisions, would conclude the transaction was taxable in India, it is worth recognizing that this dispute presents a broader policy choice for India. The overall question is whether the judiciary will endorse and abide by international tax norms, thereby vindicating certain international tax minimization structures, or will deviate from such norms in order to counter what the ITD sees as unacceptable tax avoidance. This is a choice between: on the one hand, legal certainty and international coherence, perhaps at the expense of an equitable allocation of

Court agrees that Vodafone is required to follow a prescribed dispute resolution procedure, it may be some time before either Court rules definitively on the merits of the dispute.

15 *See* J. Leahy, *Vodafone Tax Battle Set to Reach Supreme Court*, FINANCIAL TIMES, July 10, 2008, B. Reynolds, *Indian Tax Authority Focuses on Cross-Border Deals*, 19 INT'L TAX Rev. 7 (2008).

taxing rights; and on the other, judicial activism and international divergence, perhaps leading to a more equitable balance of taxing rights. Clearly the approach taken will affect, positively or negatively, the attitude of MNEs and other investors towards future investment in India.

II. The Economic and Legal Context of the Dispute

A. Indian Economic Expansion, Tax Treaties and the Role of Mauritius

Since the early 1990s India has undergone ambitious reforms to liberate its economy, including the relaxation of exchange controls and restrictions on foreign ownership. This reform process has generated substantial foreign direct investment [hereinafter "FDI"] in India by MNEs based in the United States [hereinafter "US"], Europe, Japan and elsewhere. Net FDI in India has been estimated at US$ 4.7 billion for the 2005-06 fiscal year, increasing to US$ 8.5 billion for the 2006/07 fiscal year.[16] Gross investment inflows were much higher. The growth of multinational activity in India has inevitably been accompanied by mergers, acquisitions, divestments and other corporate restructurings, giving rise to complex tax and commercial issues.[17] How these tax issues are resolved depends, of course, on the domestic tax laws of India, the domestic tax laws of the investor's State of residence, and the provisions of any tax treaty between the two States.

The States providing the greatest amount of FDI into India in recent years are, beginning with the largest source, Mauritius, the US and the United Kingdom [hereinafter "UK"].[18] The primacy in this list of the relatively small island nation of Mauritius is initially surprising. The position is explained by a series of features that make Mauritius an attractive jurisdiction in which to establish holding companies or other investment vehicles. *First*, the relaxation of India's foreign investment restrictions in the early 1990s coincided with the development of the Mauritian Financial Services Centre. Under this regime a company resident in Mauritius is subject to a very low rate of tax on investment income and faces no Mauritian capital gains tax, while its foreign shareholders face no Mauritian withholding tax on dividends or interest paid by the company. *Second*, the India-Mauritius DTC is one of the most generous of India's tax treaties in allocating tax jurisdiction to the resident/home State. The advantages include: (a) a reduction of withholding tax on dividend payments made by an Indian company in which a Mauritian company is a shareholder, from 20% to 5% where the shareholder has

16 Ministry of Finance, Government of India, Economic Survey 128 (2006–2007), Ministry of Finance, Government of India, Economic Survey 126 (2007–2008), Office of Industries, *Competitive Conditions for Foreign Direct Investment in India* 1-1, 2-1 (USITC Staff Research Study 30, 2007).

17 *See* generally K. Dalal, *International Restructurings: Tax Consequences for Operations in India*, 53 Bull. Int'l Fiscal Doc. 560 (1999).

18 USITC, *supra* note 16, at 1-2, 2-11.

a participating interest; (b) a reduction of withholding tax on royalty payments made by an Indian company to a Mauritian company, from 20% to 15%; (c) the absence of a "*fees for technical services*" article, which exists in various Indian tax treaties; and (d) a complete exemption from capital gains tax on the alienation by a Mauritian company of property in India, unless the property is immovable property or is part of a permanent establishment that the Mauritian company has in India.[19] In this last respect the treaty is more akin to the OECD model tax convention [hereinafter the "OECD Model"][20] than are most other Indian tax treaties, which tend to incorporate elements of the United Nations model tax convention [hereinafter the "UN Model"].[21] In broad terms, most of India's tax treaties place a greater emphasis on source-based taxation, reflecting India's historic position as a net importer of capital and technology.[22]

The India-Mauritius DTC has been controversial in India for some time. Some feel that the treaty has been manipulated by third-country residents to route investments into India and to extract income at reduced or nil rates of tax.[23] The treaty has even been used by Indian residents setting up wholly-owned companies in Mauritius to route investments into India, a scheme known as "*round tripping*" or "*mirroring*". Nevertheless, the Central Government has continued to support the India-Mauritius DTC and has yet to renegotiate it. Official pronouncements regarding the application of the treaty have served to *induce* foreign investors to establish residence in Mauritius, rather than deterring such behaviour. In 1994, the Finance Ministry issued a circular[24] which clarified that capital gains, derived by a Mauritius resident from the transfer of shares of an Indian company, are only taxable under Mauritian tax law (which, in effect, means such gains will not be taxed). In 2000, apparently in response to investor concerns

19 Article 13 of the India-Mauritius DTC. This provision is discussed in more detail in section III.C below.

20 OECD Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital (Paris, 2008). The OECD Model is accompanied by detailed commentary [hereinafter "OECD Commentary"], which includes reservations expressed by various OECD member and non-member States. India is not a member of the OECD but was granted observer status in 2006. The extent of the country's engagement with the OECD is apparent from the inclusion of India's views in the current OECD Commentary.

21 U.N. *Articles of the United Nations Model Double Taxation Convention Between Developed and Developing Countries*, U.N. Doc. ST/ESA/102 (2001). The UN Model is accompanied by detailed Commentary [hereinafter "UN Commentary"], building upon and sometimes differing from the OECD Commentary.

22 For a detailed comparison *see* S. Rao & R. Nayak, *India and International Community Split over Treaty*, 19 Int'l Tax Rev. 32 (2008).

23 USITC, *supra* note 16, at 2-13, 6-6.

24 Circular 682, *Clarification regarding agreement for avoidance of double taxation with Mauritius* (30 March, 1994), *available at* www.incometaxindia.gov.in (last visited November, 2008).

that the ITD was disputing the "*beneficial ownership*" of dividends paid to Mauritian investment vehicles, the Finance Ministry issued a further circular.[25] It stated that a tax residency certificate issued by the Mauritius government constituted "*sufficient evidence*" of the tax residence of a company in Mauritius as well as the beneficial ownership of dividends which the Mauritian company received from Indian companies. It also reiterated that capital gains derived by a Mauritius resident from the transfer of shares of an Indian company are not taxable in India.

A host of challenges to the validity and impact of the 2000 circular were made via public interest litigation in the case of *Union of India v. Azadi Bachao Andolan*.[26] In that decision, the Supreme Court of India made it abundantly clear that the circular constituted a legitimate exercise of the Central Government's authority under the Act. The Court also made wide-ranging comments on the validity of international tax planning, which are certain to be highly influential in the current dispute.

B. Description of the Vodafone Essar Transaction

Given the obvious advantages of structuring foreign investments in India through a Mauritian holding entity, it is not surprising that the controlling interest in TelCo was held by HTI in this manner. Nor is it surprising that Vodafone's acquisition of that controlling interest, which was the largest foreign direct investment in India to date,[27] maintains the Mauritius connection. Before considering the merits of the challenges mounted by the ITD, it is helpful to examine the mechanics of the acquisition.

The transaction has been casually described by some commentators as a sale of shares in TelCo from HTI, based in Hong Kong, to Vodafone, based in the UK. This description is merely an approximation as it condenses the relevant corporate structures and legal relationships. Unfortunately, the details of the actual arrangement are somewhat obscure. Documents available from HTI indicate that the overall transaction was agreed upon in February, 2007 and completed in May, 2007.[28] The author understands from these documents, from the Petition Judgment, and from parties familiar with the case, that the formal

25 Circular 789, *Clarification regarding taxation of income from dividends and capital gains under the Indo-Mauritius Double Tax Avoidance Convention (DTAC)* (13 April, 2000), *available at* www.incometaxindia.gov.in/ (last visited November, 2008).

26 [2003] 263 I. T. R. 706 [S. C.], reversing [2002] 256 I. T. R. 563 [Delhi High Court].

27 A. Heyward *et al.*, *Brand India – Where Next? A Panel Discussion*, 20 J. Applied Corp. Fin. 8, 16 (2008).

28 H. T. I. press releases are *available at* http://www.htil.com.hk/eng/media/press.htm.

transaction involved Vodafone International Holdings BV [hereinafter "Vodafone BV"], a Dutch subsidiary of Vodafone, acquiring all of the shares of CGP Investments (Holdings) Ltd [hereinafter "CGP"], a Cayman Islands subsidiary of HTI, from HTI for $11 billion cash. CGP in turn owned directly or indirectly one or more entities based in Mauritius, which in turn owned 52% of TelCo plus a further 15% interest in the form of options.[29] The remaining 33% of TelCo was and remains owned by the India-based Essar Group. It should also be noted that, while HTI has its headquarters in Hong Kong, it is incorporated (and presumably resident) in the Cayman Islands, being a subsidiary of Hong-Kong based Hutchison Whampoa Limited. It is plain from the above description of the arrangement that the formal capital gain arose where the transferred shares were located, which was Cayman, or where the vendor was located, which was either Hong Kong or Cayman.[30] On either view of the transaction there would seem to be no taxable nexus with India or even with Mauritius.

The ITD nevertheless advances the bold proposition that the gain on the disposition of the CGP shares by HTI was within India's domestic tax jurisdiction. It argues that the profit on the transaction – approximately US$ 9 billion – was chargeable to tax in the amount of US$ 2 billion. Although the primary liability would rest with the vendor, the ITD argues that Vodafone BV is jointly liable for failing to withhold tax from the consideration paid to the vendor.[31] It further argues that TelCo itself may legitimately be assessed for Vodafone's purported tax liability as a "*representative assessee*" based in India.[32]

C. Summary of the Main Issues in Dispute[33]

The case presented to the High Court involves several issues and it is not feasible to address all of them here. As mentioned above, the central question is whether India's jurisdiction to tax can be interpreted in such a way that the gain on the disposition by HTI, which was formally an alienation of shares situated offshore, is nonetheless taxable as a gain arising or accruing from the underlying shares or assets in India. Doing so would seem to require an expansive reading of

29 The indirect acquisition of the additional 15% of TelCo was subject to dispute because of Indian regulatory restrictions on foreign ownership. The acquisition was eventually approved by the Foreign Investment Promotion Board.

30 If the vendor were resident in Hong Kong, then, in the absence of a tax treaty between Hong Kong and Cayman, both States might seek to tax the gain. The transaction was of course structured this way because neither of those jurisdictions taxes capital gains.

31 Income Tax Act, 1961, § 195, 200 [hereinafter "Act"].

32 Act, § 160-163.

33 The Petition Judgment, *supra* note 12 sets out in great detail the positions of the parties with respect to the issues summarized here.

the already broad ambit of section 9 of the Act, disregarding the separate legal personality of companies in a multinational corporate group. Even if it were accepted as a matter of domestic law that section 9 applied, the Indian Courts would next have to consider whether the deemed income of the enterprise would be exempt from Indian taxation by virtue of the India-Mauritius DTC. That determination would depend upon whether the treaty was considered to have any relevance to the disposition by HTI and, assuming the treaty was relevant, whether the benefits of the treaty should be denied in any event.

There are other supplementary issues that would need to be decided if the Indian Courts concluded the transaction was taxable in India. One question is whether Vodafone, as purchaser, should or should not be treated as a "*person*" liable to withhold tax on payments to non-residents within the meaning of section 195 of the Act, given that Vodafone BV had no taxable presence in India.[34] Another question is the constitutional validity of a retroactive/retrospective amendment to the Act, introduced by the February 2008 Budget, providing that a failure to withhold tax at source by a withholding agent may be subject to penalties and interest.[35] While these questions are fascinating in their own right, they are unlikely to require answers given the analysis of the substantive issues below.

III. What is the Apparent Extent of India's Jurisdiction to Tax Capital Gains?

A. General Comments on Jurisdiction to Tax

As a matter of public international law, each country has the sovereign right to legislate within its territorial jurisdiction. A pivotal aspect of legislative sovereignty is the jurisdiction to tax.[36] There is a difference of academic opinion regarding the power of States to legislate extraterritorially when there is no right to enforcement. One school of thought maintains that a State's right to tax is in

[34] *See,* Clark v. Oceanic Contractors Inc, [1983] 2 A. C. 130 (H. L.).

[35] The combined effect of sections 195, 200, 201 and 221 of the Act is that a person who fails to withhold or remit tax from payments to non-residents is deemed an 'assessee in default' and may face penalties and interest on amounts not withheld or remitted. Section 201 was amended by the Finance Act, 2008, retroactive to June 2002. The amendment could thus affect Vodafone and TelCo notwithstanding that the acquisition occurred in May 2007. For a discussion of challenges to retroactive tax legislation in the UK and Canada *see,* G. T. Loomer, *Taxing Out of Time: Parliamentary Supremacy and Retroactive Tax Legislation*, B. T. R. 64 (2006).

[36] The Public International Law of Taxation: Texts, Cases and Materials 1-9 (A. H. Qureshi ed., Graham & Trotman, 1994), R. S. J. Martha, The Jurisdiction to Tax in International Law 12-18 (Kluwer, 1989).

principle unlimited: a State may enact legislation taxing the income of persons having no connection to the country, whether or not such a law could be enforced as a practical matter.[37] In the UK, India and other Commonwealth countries, this view of tax jurisdiction is buttressed by the constitutional argument that extraterritorial lawmaking of any nature is within Parliamentary competence. The other school asserts that purporting to tax the foreign income of non-residents is not only impractical, but contrary to international law.[38] While this matter remains contentious, both theories accept that a State enjoys a right to tax where there exist legally relevant "*connecting factors*" with that State. The generally accepted connecting factors, and thus the accepted bases for tax jurisdiction, are residence and source. Income tax legislation usually reflects these limits even if as a matter of constitutional theory it need not do so. Lord Herschell famously summarized the extent of UK tax jurisdiction in the following terms, "*The Income Tax Acts, however, themselves impose a territorial limit; either that from which the taxable income is derived must be situate in the United Kingdom or the person whose income is to be taxed must be resident there*".[39]

India is like most States in that it exercises both residence-based and source-based taxation in respect of income, including capital gains. For residents of India, section 4 of the Act, in conjunction with subsection 5(1), provides that a person's total income subject to tax includes all income derived from any source which is received or deemed to be received in India by him, which accrues or arises or is deemed to accrue or arise to him in India, or which accrues or arises to him outside India. Subsection 5(2) provides that the total income of a person who is non-resident includes all income derived from any source which is received or deemed to be received in India by the non-resident, or which accrues or arises or is deemed to accrue or arise to the non-resident in India. Thus, a gain that "*arises in*" India from a transfer of capital property, and which "*arises to*" a non-resident, is included in the non-resident's Indian income and taxed accordingly.[40] The non-resident may also face taxation in the residence/home State in respect of the same

[37] Wurzel, *supra* note 3, A. Knechtle, Basic Problems in International Fiscal Law 37-41 (Kluwer, 1979), A. H. Qureshi, *The Freedom of a State to Legislate in Fiscal Matters under General International Law*, 41 Bull. Int'l Fiscal Doc 14 (1987).

[38] A. R. Albrecht, *The Taxation of Aliens under International Law*, 29 B. Y. I. L. 145 (1952), Avi-Yonah 2007, *supra* note 6. For a detailed discussion *see* Qureshi 1994, *supra* note 36, at 22-125.

[39] Colquhoun v. Brooks, (1889) 14 App. Cas. 493, 504 (H. L.), approved in Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v. National Bank of Greece, [1971] A. C. 945, 954 (H. L.). *See also,* Electronics Corporation of India Ltd v. C. I. T. [1990], 183 I. T. R. 43, 52 [S. C.].

[40] Act, § 45.

[41] O. E. C. D. Model, Article 13; U. N. Model, Article 13.

capital gain, leading to double taxation. This problem may be alleviated by unilateral relief in the domestic legislation of the residence/home State or, more commonly, by the capital gains article of a tax treaty negotiated between the two States.[41]

The framework of section 5 of the Act seems workable until one begins to explore the question of where capital gains or other income "*arise*". For many forms of income the answer to that question will be far from obvious. In the context of capital gains on company shares, the prevailing (yet arbitrary) rule is that such gains "*arise*" in the country where the company is resident, regardless of where the company or its operating subsidiaries carry on business. The critical question in the Vodafone Essar dispute is whether India's source jurisdiction goes further than this.

B. Deemed Income of Non-Residents under Indian Domestic Law

1. Section 9 of the Act

As noted above, subsections 5(1) and 5(2) of the Act include in a person's total income, all amounts deemed to be received by him in India or deemed to accrue or arise to him in India. This brings into play section 9 of the Act, which deems certain types of income to accrue or arise in India. Paragraph 9(1)(i) reads as follows:

> (1) The following incomes shall be deemed to accrue or arise in India:-
>
> (i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India.

Clause (a) of the first Explanation to this provision quite sensibly provides that, where the operations of a business are carried out partly in India and partly elsewhere, the income of the business deemed by section 9 to accrue or arise in India is only such part of the income as is reasonably attributable to the operations in India. The other clauses of the first Explanation are not relevant here.

There are two fundamental observations to make regarding the scope of section 9. *First*, it is not contentious that the provision applies to both residents and non-residents. Therefore non-residents, who are beyond Indian tax jurisdiction in respect of income accruing or arising abroad, are chargeable under subsection 5(2) in respect of income deemed by section 9 to accrue or arise in India. *Second*, the term "*deemed*" creates a statutory fiction: it brings within the scope of taxation income not *actually* arising in India but which is *legally considered*

to have arisen in India.[42] It is said that the word "*deemed*" is apt to include the obvious, the uncertain and the impossible.[43] Thus, section 9 enlarges India's tax jurisdiction by deeming certain types of income which, in principle, would be considered to arise elsewhere, to arise in India for tax purposes. The potentially extraterritorial reach of this and other provisions of the Act do not render such provisions unconstitutional.[44]

One can imagine that the ITD might invoke section 9 to advance a number of arguments that HTI's disposition of its controlling interest in TelCo was within India's source jurisdiction. Specifically, it could allege that income was deemed to accrue or arise to HTI in India by virtue of "*the transfer of a capital asset situate in India*". A slightly more tenable argument would be that income was deemed to accrue or arise to HTI in India through or from a "*business connection*" in India.

2. Transfer of a Capital Asset Situate in India

An argument under this branch of section 9 of the Act would begin from the recognition that what occurred in the Vodafone Essar transaction was indisputably a capital disposition rather than a transaction producing trading income. HTI disposed of its ultimate controlling interest in a telecom enterprise, while Vodafone BV acquired that controlling interest through an isolated payment. There is no evidence that HTI was carrying on an active business of buying and selling shares in telecom companies, as a securities dealer might do. Although the legal distinction between capital and income can be vexing, it is quite difficult to see how this transaction could be characterized as anything other than a transaction on capital account, from both the vendor's perspective and the purchaser's perspective. This should be true even if one ignores the separate identity of companies in the corporate group and postulates that HTI "*sold the telecom business*" to Vodafone.

The recognition that this was a capital transaction inevitably leads to difficulties in maintaining that the transaction was taxable in accordance with this branch of section 9. The provision deems income to accrue or arise through "*the transfer of a capital asset situate in India*". The expression "*transfer of property*" may

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42 C. I. T./C. E. P. T. v. Bhogilal Laherchand, [1954] 25 I. T. R. 50 [S. C.], C. I. T. v. R. D. Aggarwal & Co, [1965] 56 I. T. R. 20 [S. C.], N. A. Palkhivala & B.A. Palkhivala, Kanga and Palkhivala's Law and Practice of Income Tax 256 (8th edn., Tripathi, 1990).

43 C. I. T. v. Vina, [1965] 58 I. T. R. 100 [Gujarat High Court], citing Public Trustee v. I. R. C., [1960] A. C. 398, 407 (H. L.).

44 A. W. Wadia v. C. I. T., [1949] 17 I. T. R. 63 [Privy Council], Abdul Azeez v. C. I. T., [1958] 33 I. T. R. 154 [Madras High Court], Electronics Corporation of India Ltd v. C. I. T. [1990] 183 I. T. R. 43, 52 [S. C.].

be very broad, including voluntary and involuntary transfers as well as full and partial transfers, yet in all cases it denotes the passing of rights in property from one person to another. The legal form of the Vodafone Essar transaction was such that there was no passing of rights in any capital asset situate in India. The assets of TelCo were and continue to be owned by TelCo. The shares of TelCo were and continue to be owned 67% by the Mauritian entities and 33% by the Essar Group. Even the ownership of the Mauritian entities has not changed. Formally, the only passing of rights from one person to another was in respect of the shares of CGP, which are situated in the Cayman Islands, not India.

The only means of sustaining an argument based on this branch of section 9 is to pierce the corporate veil, ignoring the separate personality of the companies in the HTI corporate group. Two variations seem possible. The Indian Courts could adopt the position that, for tax purposes, one should ignore the separate personality of all the intermediate holding entities and of TelCo itself. On this basis one would posit that HTI disposed of telecom assets situated in India. Maintaining such a view would be challenging to say the least; TelCo presumably has paid income tax over the years as a company resident in India; and TelCo presumably has distributed dividends on which its domestic shareholders have paid tax and on which its Mauritian shareholders have suffered withholding tax.[45] A less extreme position would be to accept the corporate status of TelCo but to ignore the separate personality of all the intermediate companies, deeming HTI to have disposed of shares of TelCo. On either view, there would be a notional disposal by a non-resident of capital property situated in India, rendering the gain taxable in India pursuant to sections 4, 5(2) and 9. This taxing right, if it exists, would not be mitigated by treaty because there is no tax treaty between India and the Cayman Islands.

Indian domestic law, like the law of many other States, contemplates the disregard of corporate personality in various circumstances, including situations involving aggressive tax avoidance.[46] There will be no attempt to investigate or reconcile those circumstances here, other than to say that the Act does not easily lend itself to interpretations of international legal relationships that disregard separate corporate personality. Among other things, the Act provides that "*person*" includes a company,[47] accepts that "*company*" includes any "*any body corporate*

45 Reduced to 5% pursuant to Article 10 of the India-Mauritius DTC.

46 S. R. Wadhwa & P. K. Sahu, *Form and Substance in Tax Law* 87a CDFI 337 (Int'l Fiscal Association Congress, India Branch Report, 2002), R. Jain, *Conflicts in the Attribution of Income to a Person*, 92B CDFI 291 (Int'l Fiscal Association Congress, India Branch Report, 2007).

47 Act, § 2(31).

incorporated by or under the laws of a country outside India",[48] and does not contain a controlled foreign company [hereinafter "CFC"] regime. The Act seeks to counteract international tax avoidance in certain specific situations[49] but contains no general rule that would apply here. Moreover, the Supreme Court, in *Azadi Bachao Andolan*, observed that, while Courts are empowered to pierce the corporate veil when applying domestic law, such an approach "*can hardly apply*" to entities resident in a State with which India has concluded a tax treaty.[50] Whether the Indian Courts should, in the present case, retreat from a legalistic approach for the purpose of determining the scope of the Act is discussed in section IV below.

3. Business Connection in India

An alternative position would be to accept – or claim to accept – the separate personality of all companies involved in the transaction, but argue that deemed income arose directly or indirectly through or from a "*business connection*" in India.

The term "*business connection*" has been described as "*one of the most nebulous and elastic terms used in this Act*".[51] The term was not defined prior to April, 2004. The Finance Act, 2003 inserted two additional Explanations after the then existing Explanation in section 9. The second Explanation, which is relevant for present purposes, elaborates on the term "*business connection*" as follows:

> For the removal of doubts, it is hereby declared that "*business connection*" shall include any business activity carried out through a person who, acting on behalf of the non-resident, -
>
> (a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or
>
> (b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or
>
> (c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident …

48 Act, § 2(17).

49 Act, § 92-92F, 93.

50 Azadi Bachao Andolan v. Union of India, [2003] 263 I. T. R. 706 [S. C.] at ¶ 116.

51 Palkhivala, *supra* note 42, at 18.

Put simply, business connection includes any integral business activity carried out through a dependent agent in India. The second Explanation goes on to exclude most independent agents acting in the ordinary course of business from the scope of business connection, provided such an agent does not work "*mainly or wholly*" on behalf of the non-resident or on behalf of the non-resident and certain associated non-residents. The cumulative effect of the second Explanation bears some resemblance to paragraphs 5 and 7 of Article 5 of the UN Model, listing certain agency activities which do or do not constitute a permanent establishment. For example, paragraphs 5(4)(a), 5(4)(b) and 5(5) of the India-Mauritius DTC, which seem to be based on paragraphs 5(5)(a), 5(5)(b) and 5(7) of the UN Model, illustrate the similarity between the business connection rules and relevant treaty provisions.

The above-mentioned Explanation does not purport to define business connection exhaustively, thus one must consider how the term is more generally understood in Indian law. The essential features of a business connection appear to be the following: a real and intimate relation must exist between the business activities carried on beyond India and the business activities carried on within India; that relation must somehow contribute to the earning of income by the non-resident in the overall business; and there must be a course of dealing or continuity of relationship, rather than an isolated transaction, between the person in India who helps earn the profits and the non-resident who realizes those profits.[52] The concept of "*business connection*" is thus similar to, but wider than, the treaty concept of permanent establishment. The crucial point is that both concepts are founded upon an underlying premise that *the* business of *the* non-resident is carried on partly in the source/host country, whether through an agent or otherwise. In other words, the determination whether the local activities of the business meet the threshold of business connection or permanent establishment is subsequent to the question whether a unitary business exists.

Is it correct to aggregate the economic activities of a multinational corporate group and treat them as a single business? Again we come up against the legal principle that the business of a company cannot automatically be subsumed within the business of a controlling shareholder, as each is a separate juridical person. This principle is recognized in the treaty context by paragraph 5(7) of the OECD Model and paragraph 5(8) of the UN Model, dealing with permanent establishments. Paragraph 5(6) of the India-Mauritius DTC is typical:

52 Anglo-French Textile Co. Ltd. v. C. I. T., [1953] 23 I. T. R. 101 [S. C.], C. I. T. v. R. D. Aggarwal & Co., [1965] 56 I. T. R. 20 [S. C.].

> The fact that a company, which is a resident of a Contracting State, controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other Contracting State (whether through a permanent establishment or otherwise) shall not, of itself, constitute either company a permanent establishment of the other.

The relevant part of the OECD Commentary, which is reiterated in the UN Commentary, states that the substance of the above provision is generally accepted, as it stems from the principle that a subsidiary company constitutes an independent legal entity. The Commentaries state that even the fact that a subsidiary's business is managed by the parent company "*does not constitute the subsidiary company a permanent establishment of the parent company*".[53] It is recognized, of course, that a subsidiary can constitute a permanent establishment of its parent company according to the same conditions stipulated with respect to unrelated enterprises. For example, a subsidiary would be considered a permanent establishment of its parent (or of another related company) if it was a dependent agent of that company which had and habitually exercised authority to conclude contracts in that company's name.

The same logic would seem to apply in the context of Indian domestic law; if an Indian subsidiary acted as a dependent agent of its parent in the course of the parent's business, a business connection would exist in accordance with section 9. The general principle of separate corporate personality nevertheless retains its force. In the absence of some unitary business carried on by the parent and the subsidiary, there appears to be no basis on which to characterize an Indian subsidiary or its activities as a business connection of the parent. In the present case, it is difficult to see how the business of TelCo, namely the provision of telecommunications services to Indian customers, is intimately related to the business of the Mauritian holding entities, which presumably consists of holding shares (and possibly carrying out other investment or treasury functions). The only way to reach the alternative conclusion would be to disregard the separate corporate personality of the various entities in the group, effectively treating TelCo as a branch of the non-resident enterprise. Whether the Indian Courts should adopt that approach is discussed in section IV below.

One further point is worth noting with respect to section 9 of the Act. Even if the Indian Courts were to view TelCo or its activities as a business connection in relation to HTI, it is difficult to see how the profit on the disposition of HTI's interest could be described as trading income arising "*through or from*" that business connection. The profit would surely constitute a gain arising from the alienation

53 O. E. C. D. Commentary, Article 5 ¶ 40, U. N. Commentary, Article 5 ¶ 32.

of the entire business connection. The deemed profit would thus represent a capital receipt rather than trading income. Accordingly, in the author's view, an argument based on the "*business connection*" element of section 9 would not be not substantially different from an argument that deemed income arose through the transfer of a capital asset situate in India. The success of either variation of the argument depends on the Courts' willingness to disregard the separate existence of non-resident corporations and thereby expand India's source jurisdiction under the Act.

C. Potential Application of the India-Mauritius DTC

If the Indian Courts were to accept that deemed income arose to HTI pursuant to subsection 5(2) and section 9 of the Act, the next consideration *might be* how to classify that income for tax treaty purposes. It is not evident that this *would be* a consideration because, if the entire HTI enterprise were treated as a single economic unit (disregarding the Cayman and Mauritian entities), there would be no applicable tax treaty to consider.[54] Yet, if the conclusion were reached, contrary to the suggestions made in section III.B above, that the corporate structure could be respected while at the same time deeming income to arise through or from a business connection in India, the effect of the India-Mauritius DTC would have to be addressed. This would be necessary because, as in other countries, Indian tax treaties have priority over Indian domestic tax law.[55]

1. Treatment of Deemed Income under the Treaty

It has been held that section 9 of the Act does not characterize or alter the nature of the relevant income for tax treaty purposes.[56] Presumably, deemed income would retain its underlying character, meaning that deemed income from business activity would be classified as business profits under Article 7, deemed royalty income would be classified as royalties under Article 12, deemed income from capital dispositions would be classified as capital gains under Article 13, and so on for the other named income types. Where the nature of the income was uncertain it would likely fall within Article 22 – 'Other Income'.

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54 It is noteworthy that this issue is not mentioned in the Petition Judgment.

55 This principle is recognized in various cases, including Azadi Bachao Andolan, [2003] 263 I. T. R. 706 [S. C.] and C. I. T. v. PVAL Kulandagan Chettiar, [2004] 267 I. T. R. 654 [S. C.]. Subsection 90(2) of the Act states that, in cases where the Central Government has entered into a tax treaty, the provisions of the Act shall apply only to the extent they are more beneficial to the particular assessee to whom the treaty applies. This means that the Act does not apply to such an assessee in other circumstances.

56 Asia Satellite Telecommunications Co. Ltd. v. Dy. C. I. T., [2003] 85 I. T. D. 478 [Delhi ITAT].

It is difficult to escape the conclusion that, if the India-Mauritius DTC were applicable to the disposition by HTI, the only appropriate treaty article would be Article 13. One arrives at this conclusion primarily by recognizing that the underlying character of the income in question, whether deemed to arise through the transfer of a capital asset situate in India or through a business connection in India, is that of a capital receipt. Even if the underlying nature of the deemed income were considered ambiguous, reflecting elements of both capital gain and business profits, one would have to consider paragraph 6 of Article 7, which provides: "*Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article*". What this means is that Articles which deal expressly with specific types of income, such as Article 13, have priority over the business profits Article in the case of overlap.[57] The contrary argument – that the deemed income represents profits of a Mauritian enterprise carrying on business in India through a permanent establishment (Article 7) or represents other income that is effectively connected with such permanent establishment (Article 22) – requires one to postulate that the Mauritian enterprise "*carries on business*" in India through a permanent establishment. As discussed above with respect to the meaning of business connection, that hypothesis involves disregarding the separate personality of the relevant companies and treating them as operating a unitary business, contrary to paragraph 6 of Article 5. Surely it is untenable in the current dispute to ignore the separate existence of TelCo while respecting the existence of the Cayman and Mauritian entities. Yet, if the personhood of a Mauritian entity is ignored, it cannot be a Mauritius resident entitled to treaty benefits, in which case the India-Mauritius DTC becomes wholly irrelevant. All of this suggests that the only potentially applicable Article is Article 13.

Simplifying somewhat, Article 13 of the India-Mauritius DTC grants jurisdiction to the source/host State in respect of gains from the alienation of immoveable property situated in the host State, gains from the alienation of moveable property that is part of the business property of a permanent establishment in the host State, and gains from the alienation of such a permanent establishment[58] (with the standard exclusion for ships and aircraft operated in international traffic). Paragraph 4 of Article 13 provides that gains derived by a resident of a contracting State from the alienation of any other property shall be taxable only in the residence State. Notably, the India-Mauritius DTC does *not*

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57 O. E. C. D. Commentary, Article 7 ¶ 59-62; U. N. Commentary, Article 7 ¶ 24.

58 An argument that any deemed income in this case represents a gain from the alienation of a permanent establishment (¶ 13(2)) would be plagued by the same problems noted previously: it necessitates disregarding the separate personality of the relevant companies and treating them as operating a unitary business.

grant jurisdiction to the host State in respect of gains from shares in a company which is resident in the host State, even where the value of such shares is derived principally from immoveable property or other specified assets situated in the host country.

This is unlike the UN Model and various other DTCs to which India is a party. In most of India's tax treaties, a non-resident alienator of shares of an Indian company could be subject to tax in India. The provisions often contain some variation of the following language:[59]

> Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State.
>
> Gains from the alienation of shares other than those mentioned in [the paragraph above] representing a participation of at least 10% in a company which is a resident of a Contracting State may be taxed in that Contracting State.

Some treaties negotiated by India are even broader, allowing both contracting States to tax gains from the alienation of any property other than ships and aircraft operated in international traffic.[60] Under any of these treaties a disposition by a non-resident of shares of an Indian company would be taxable in India, limited in some cases to participating shareholdings.

This is in stark contrast to the India-Mauritius DTC. Article 13 of this treaty ensures that capital gains derived by a Mauritius resident from the transfer of shares of an Indian company are taxable only in Mauritius, as confirmed by the government circulars issued in 1994 and 2000.[61] A similar approach is taken in India's tax treaty with Cyprus.[62] Each of these treaties reflects an exclusive allocation of tax jurisdiction to the shareholder's residence State in respect of capital gains on the transfer of shares. Source jurisdiction in respect of such gains,

59 *E.g*. India-France Income and Capital Tax Treaty, India-Fr., 1992, Article 14 ¶ 4-5; India-Japan Income Tax Treaty, India-Japan, 1989 (as amended by 2006 Protocol), Article 13 ¶ 3.

60 *E.g*. India-United States Income Tax Treaty, India-U.S., 1989, Article 13; India-United Kingdom Income Tax Treaty, India-U.K., 1993, Article 14; India-Canada Income and Capital Tax Treaty, India-Can., 1996, Article 13 ¶ 2.

61 *Supra* notes 24 and 25.

62 India-Cyprus Income and Capital Tax Treaty, India-Cyprus, 1994, Article 14.

even if it exists under domestic law, is eliminated by the treaty.

2. Denial of Treaty Benefits

There is a corollary issue that might arise in the course of the Vodafone Essar dispute, depending upon how the transaction is ultimately characterized. Assuming that deemed income is considered to have arisen under section 9 of the Act and that such income would, in principle, be classified as a gain in accordance with Article 13 of the India-Mauritius DTC, the ITD could assert that the benefit of the treaty should be denied in any event. The arguments advanced by the ITD in this regard would undoubtedly resemble arguments that have been made by various tax administrations around the world in response to perceived "*treaty abuse*". The challenges faced by any tax administration are delineating which arrangements are abusive and responding to perceived abuses without flouting the tax treaty in question.

As with other international treaties, a tax treaty reflects a balance of advantages that is agreed to by the contracting States when the treaty is negotiated. There are two principal purposes of tax treaties. The *first* is the reduction or elimination of double taxation on transnational trade and investment; the *second* is the prevention of tax evasion through an open exchange of information between the contracting States.[63] Treaty abuse, and in particular "*treaty shopping*", is considered to occur where the balance inherent in a treaty is undermined by persons who are not resident in either contracting State accessing treaty benefits.

In 1987, the OECD published an influential report [hereinafter "OECD Conduit Report"] which addressed the exploitation of tax treaties by a person "*acting through a legal entity created in a State with the main or sole purpose of obtaining treaty benefits which would not be available directly to such person*".[64] The OECD suggested that treaty shopping should be discouraged because it violates reciprocity between the contracting States, it can result in transnational income being subject to "*inadequate taxation*", and it destroys the incentive for countries to negotiate and conclude new treaties.[65] The UN, in 1988, published its own report on treaty shopping [hereinafter "UN Treaty Shopping Report"], in which the term "*abuse of*

63 P. Baker, Double Taxation Conventions B.06-B.12 (Sweet & Maxwell, 2007),O. E. C. D. Commentary, Article 1 ¶ 7.

64 O. E. C. D. Committee on Fiscal Affairs, *Double Taxation Conventions and the Use of Conduit Companies*, *in* International Tax Avoidance and Evasion: Four Related Studies 88 (O. E. C. D., 1987). The key points from this report are reiterated in the O. E. C. D. Commentary, especially at Article 1 ¶ 11-21.

65 *Id*., at 90.

66 U. N. Department of International Economic and Social Affairs, *Contributions to International Co-operation in Tax Matters: Treaty Shopping, Thin Capitalization, Co-operation between Tax Authorities, Resolving International Tax Disputes* 2 (1988).

tax treaties" was defined loosely as "*the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits the treaties were not designed to give them*".[66] The authors admit that this definition begs a number of questions, notably: can we identify the persons whom a tax treaty is designed to benefit? This report differs from the OECD Conduit Report in that it recognizes there may be advantages to allowing enterprises to structure their affairs so as to take advantage of tax treaties. For example, developing countries that are keen to attract inward investment may actively desire that dividends or interest paid to a recipient in a treaty jurisdiction be subject to low or no withholding tax, even if the recipient is a holding company for shareholders based elsewhere.[67]

On comparing the OECD Conduit Report and the UN Conduit Report it becomes evident that verbs such as "*abuse*" and "*exploit*" when applied to tax treaties express value judgements – they are words of conclusion rather than analysis. A prominent US commentator has stated that "*abuse*" is a heavily loaded term:

> Not only is it derogatory; it implies that the proper use of tax treaties can be identified. Yet differences over precisely that point lie at the heart of the current discussion. Because the term suggests what is being discussed is a point of common understanding and agreement, when plainly it is not, the usefulness of the term is questionable.[68]

Assuming that it is possible to identify situations of tax treaty abuse, the next question is how to counteract it. This might be done through purposive interpretation of the relevant treaty provisions, invocation of inherent treaty anti-abuse principles or application of domestic anti-avoidance rules.[69] A variety of approaches have been used to determine whether an intermediate entity is the

[67] *Id*., at 6-7.

[68] H. D. Rosenbloom, *Tax Treaty Abuse: Policies and Issues*, 15 Law & Pol'y Int'l Bus. 763, 766 (1983). For further discussion *see*, S. Van Weeghel, The Improper Use of Tax Treaties: With Particular Reference to the Netherlands and the United States (Kluwer Law International, 1998).

[69] O. E. C. D. Commentary, Article 1 ¶ 9.1-22.2.

[70] O. E. C. D. Commentary, Article 10 ¶ 12-12.1 and Article 11 ¶ 9-10. Two of the most important recent cases are Indofood International Finance Ltd. v. JP Morgan Chase Bank, [2006] S. T. C. 1195 (Eng C. A.) (concluding that a proposed Netherlands financing intermediary would not, according to Indonesian law, be the beneficial owner of interest payments under Article 11 of the Indonesia-Netherlands tax treaty) and Prévost Car Inc v. Canada, 2008 T. C. C. 231 (Tax Ct. of Can.) (concluding that a duly constituted Netherlands holding company would, according to Canadian and Dutch law, be the beneficial owner of dividend payments under Article 10 of the Canada-Netherlands tax treaty). For further discussion of this issue *see,* J. D. B. Oliver *et. al.*, *Beneficial Ownership and the O. E. C. D. Model*, B. T. R. 27 [2001].

"*beneficial owner*" of passive income streams (usually dividends or interest) and therefore entitled to reduced withholding tax rates in respect of such payments.[70] Decisions in this area are of little assistance in the present dispute as Article 13 of the India-Mauritius DTC, like the capital gains articles of the O. E. C. D. Model and UN Model, does not incorporate any requirement as to beneficial ownership.

Therefore, it appears that an Indian Court could deny the benefit of Article 13 to an intermediate entity based in Mauritius only if it held that the entity was not a "*person*" or a "*resident*" of Mauritius within the scope of Article 1, perhaps because it was not actually resident there or was not "*liable to taxation*" on the basis of its residence. It is evident from the circulars mentioned previously that the Central Government does not wish to entertain such assertions.[71] More importantly, the Supreme Court in *Azadi Bachao Andolan* made it plain that such assertions are not viable when applied to a company which is duly constituted and resident in Mauritius according to Mauritian law.[72] An alternative approach would be for an Indian Court to fashion some judicial anti-avoidance rule or principle which achieved the same effect, preventing a Mauritian entity from accessing the treaty where the entity was seen as a mere shell for shareholders based elsewhere. It is very doubtful that this approach would be adopted given the observations in *Azadi Bachao Andolan*. The important point is that either of these approaches throws us back to the central issue addressed earlier, namely, whether the separate existence of non-resident companies should be disregarded in order to preserve or expand India's source jurisdiction.

IV. What Should be the Extent of India's Jurisdiction to Tax Capital Gains?

A. Legal Limitations v. Policy Options

The discussion above has demonstrated that section 9 of the Act is expansive but not limitless, that Article 7 of the India-Mauritius DTC (if relevant) is probably not applicable in the face of Article 13, and that the Courts' authority to deny the benefit of Article 13 is not unfettered. Throughout the discussion it has been submitted that any approach which the ITD might employ to assert jurisdiction over the gain arising to HTI displays a common theme. This theme is that India is justified, when delimiting its jurisdiction as a source State, to aggregate the distinct

[71] *Supra* notes 24 and 25.

[72] [2003] 263 I. T. R. 706 [S. C.] at ¶ 62-84.

[73] In the Petition Judgment, the High Court appeared to agree with the respondents' characterization of the transaction in the following terms: "*The subject matter of the present transaction between the Petitioner and HTIL is nothing but transfer of interests,*

entities or activities of a multinational corporate group and treat them as a single enterprise or business.[73] Unfortunately for the ITD, each of the approaches addressed above urges the Courts to interpret and apply the Act or the India-Mauritius DTC in a way that cannot legally be sustained. What the ITD is effectively asking for is a change in India's tax policy and, indeed, a change in the international tax system. It is useful, briefly, to investigate the nature of the change or changes that the ITD appears to be seeking and to consider how feasible such changes might be.

B. Worldwide Formulary Apportionment as a Policy Option

The international tax principles or norms which are reflected in the Act and in the India-Mauritius DTC, and which will likely prevent the arguments of the ITD from succeeding in this dispute, are the principles of corporate residence (and residence-based taxation), permanent establishment (and source-based taxation) and separate entity accounting. Underlying these principles or norms is the recognition that a company is a legal person independent of its shareholders.[74]

Corporate residence in the UK, India and most Commonwealth countries is determined based on place of incorporation, location of central management and control, or both.[75] It is well-known that residence thus defined, is one of the key legal concepts that facilitate international tax avoidance. A well-advised MNE is able to establish offshore residence of its subsidiaries with ease, thus enabling it to shift domestic profits to or retain foreign profits in convenient jurisdictions. This practice is particularly well-suited to reducing or eliminating taxation of capital gains.[76] Nevertheless, most States' domestic tax systems place great emphasis on residence, while treaties based on the OECD Model and (to a lesser extent) the UN Model allocate jurisdiction over various types of income to the State of residence.

The current understanding of source is little better. It has long been

tangible and intangible, in Indian companies of the Hutch Group in favour of the Petitioner and not an innocuous acquisition of shares of some Cayman Islands Company …". Vodafone International Holdings BV v. Union of India and another, Writ Petition No. 2550 of 2007 (Dec. 3, 2008), ¶ 92, 154 [Bombay High Court].

74 Salomon v. A. Salomon and Co. Ltd., [1897] A. C. 22 (H. L.), Andhra Pradesh State Road Transport Corp v. I. T. O., [1964] 52 I. T. R. 524 [S. C.], P. L. Davies, Introduction to Company Law 9 (2002).

75 Act, § 6(3); De Beers Consolidated Mines Ltd. v. Howe, [1906] A. C. 455 (H. L.) 458, Unit Construction Co Ltd. v. Bullock, [1960] A. C. 351 (H. L.) 366.

76 *See*, Lamesa Holdings BV v. COT, [1997] F. C. A. 785 (Aust. F. C.), Wood v. Holden, [2006] S. T. C. 443 (Eng. C. A.), MIL (Investments) SA v. Canada, 2007 F. C. A. 236 (Can. F. C. A.).

recognized that a given item of income may arise from related activities carried on in different countries, making it tremendously difficult to determine what or where the "*source*" of that income is. Some have argued that the concept of income is "*not susceptible to characterization as to source at all*" and that any rules which purport to assign income to a geographic location are necessarily arbitrary.[77] The treaty concept of permanent establishment may be a reasonable guideline for taxing economic activity in a source/host State, yet it currently operates within the restricted context of corporate residence and separate entity accounting.[78]

Tax scholars have argued for decades that prevailing international tax principles, including residence-based taxation, source-based taxation and separate entity accounting, are unsatisfactory. Commentators typically argue in favour of greater source-based taxation or advocate abandonment of these principles in favour of a radically new international tax system, a system which they believe will amplify the tax jurisdiction of developing States, and thus enhance global equity. Among other authors, Graetz has denounced the current system of international taxation as being founded upon and characterized by "*inadequate principles, outdated concepts, and unsatisfactory policies*".[79] Professor Vogel vigorously asserted that the prevailing system of residence-based taxation with credits for foreign income is inequitable, is adverse to "*economic reason*", and amounts to "*fiscal imperialism*".[80] The general reporters at the 2005 congress of the International Fiscal Association repeatedly criticized the "*immobilism*" of the prevailing international tax regime, which in their view exhibits an unacceptable bias towards developed countries.[81] In recognition of these shortcomings, a vast body of literature has arisen arguing that arbitrary residence and source rules should be abandoned in favour of some system of global income apportionment based on multilateral negotiation and agreement.[82]

What must be remembered is that these are *policy* changes recommended by international tax commentators. Their recommendations are aimed at

77 H. J. Ault & D. F. Bradford, *Taxing International Income: An Analysis of the US System and Its Economic Premises*, *in* Taxation in the Global Economy 14, 31 (A. Razin & J. Slemrod ed., Chicago, 1990).

78 O. E. C. D. Commentary, Article 7 ¶ 14-26.

79 *Supra* note 2.

80 K. Vogel, *The Search for Compatible Tax Systems*, *in* Tax Policy in the Twenty-First Century 85-86 (H. Stein ed., 1988). For more detail *see*, *supra* note 2.

81 IFA 2005 Congress, *supra* note 8.

82 Some of the best analyses are: P. B. Musgrave, *International Tax Base Division and the Multinational Corporation*, 27 Pub. Fin. 394 (1972); Picciotto 1992, *supra* note 4, at chapters 8-9; and J Li, *Global Profit Split: An Evolutionary Approach to International Income Allocation*, 50 Can. Tax J. 823 (2002).

legislators and international organizations, including the OECD and UN. It would be incredibly difficult for the legislature of a single country to impose these changes unilaterally. More germane to the present dispute, it would be impossible for the judiciary of a single country to impose these changes through interpretation of existing tax laws.

C. More Modest Policy Options

There are less radical policy options for improving the existing international tax system, some of which could be implemented unilaterally by a State. These options involve amending domestic rules or renegotiating treaty provisions that define and allocate source-based and residence-based jurisdiction.

Various improvements to the allocation of source jurisdiction are possible, including expanded formulations of the permanent establishment concept and enhanced withholding taxes.[83] Many of India's tax treaties already provide relatively low thresholds for finding that a foreign enterprise carries on business in the host State through a permanent establishment. Further, some of its treaties provide for enhanced host State jurisdiction with respect to gains on company shares, as discussed above. India could renegotiate other tax treaties to achieve similar allocations of jurisdiction, as it has done recently in its treaty with the United Arab Emirates [hereinafter "UAE"][84] and as other countries have done in response to perceived treaty flaws.[85] There are indications that India is renegotiating its tax treaty with Cyprus and may be renegotiating its treaty with Mauritius. If it wished to do so, India could even amend section 9 of the Act to expressly deem income to accrue or arise in India where a gain is realized on the transfer of an indirect shareholding in an Indian company. Such a rule would of course be subject to applicable tax treaties.

There is also scope for improvement with respect to the concept of residence, in both treaties and domestic law. Limitation on benefits provisions, like Article 24 of the treaty with the US and the recently adopted Article 29 of the treaty with

83 B. J. Arnold, J. Sasseville & E. M. Zolt, *Invitational Seminar on the Taxation of Business Profits under Tax Treaties*, 57 Bull. Int'l Fiscal Doc. 187 (2003); D. Pinto, *The Need to Reconceptualize the Permanent Establishment Threshold*, 60 Bull. Int'l Fiscal Doc. 266 (2006).

84 The 1992 tax treaty with the UAE had a capital gains provision similar to Article 13 of the India-Mauritius DTC. It was amended by the 2007 Protocol to provide that gains from the alienation of shares of companies resident in the host State may be taxed in that State.

85 For example, Australia responded to the decision in Lamesa Holdings BV v. COT, [1997] F. C. A. 785 (Aust. F. C.), through legislation that purports to modify the scope of the capital gains article in many of its tax treaties.

86 J. Wheeler (Int'l Fiscal Association Congress, General Report, 2007), *supra* note 46, at 40.

the UAE, test the strength of the nexus between the person claiming treaty benefits and the residence State in which he does so.[86] A US-style limitation on benefits article introduces more substantive restrictions on fiscal residence than exist under most States' domestic laws: for example, such a provision may restrict treaty benefits to companies that are ultimately controlled by individuals resident in the other contracting State. The inclusion in treaties of limitation on benefits provisions, or even the redefinition of "*resident*" within treaties, are probably the most effective ways of preventing treaty shopping by residents of third States. In the domestic law context, it might be desirable to implement a more substantive formulation of corporate residence, although of course this would have no effect on the laws of foreign States. A revised domestic residence formulation could be based on location of effective management,[87] location of controlling shareholders, or other criteria indicating that productive human endeavours actually occur in the company's State of residence.[88]

A State can therefore explore a variety of methods for improving its system for taxing international transactions, without having to wait for a globally implemented solution. Yet, as with a multilateral solution, these are changes that would have to be made by legislators and treaty negotiators rather than judges. It is not possible for the judiciary of a State to impose such changes through interpretation of tax laws based on current formulations of source and residence. Nor is it desirable, having regard to legal certainty and predictability, that the judiciary should attempt to do so through boundless application of anti-avoidance rules.

V. Conclusion

In *Azadi Bachao Andolan* the Supreme Court made the following comments regarding the constraints imposed by the international tax system:

> There are many principles in fiscal economy which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long term development. Deficit financing, for example, is one; treaty shopping in our view, is another. Despite the sound and fury of the respondents over the so called 'abuse' of

87 For possible meanings of this term in the treaty context *see* OECD Commentary, Article 4 ¶ 24 (p. 77) as well as India's position thereon (p. 383).

88 B.J. Arnold, *A Tax Policy Perspective on Corporate Residence*, 51 Can. Tax J. 1559 (2003); M.J. Mcintyre, *Determining the Residence of Members of a Corporate Group*, 51 Can. Tax J. 1567 (2003).

'treaty shopping', perhaps, it may have been intended at the time when Indo-Mauritius DTAC was entered into. Whether it should continue, and, if so, for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations. This Court cannot judge the legality of treaty shopping merely because one section of thought considers it improper. A holistic view has to be taken to adjudge what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy.[89]

In the author's view, those observations are apposite, not only to treaty shopping, but also to other phenomena that are endemic to the current international tax regime, including the widespread use of tax haven holding companies to avoid both residence and source taxation. The same observations could also be expressed by developed countries, many of which struggle to deal with tax avoidance in respect of both inbound and outbound investment. Any State that respects prevailing international tax principles or norms, including residence-based taxation, source-based taxation and separate entity accounting, faces difficulties in ensuring that the incomes of MNEs are subject to what that State views as an appropriate domestic tax burden. Nonetheless, a State does not want its tax system to repudiate these principles for fear that it would damage the State's investment climate.

It is perhaps unsurprising that tax administrations may take matters into their own hands, zealously pursuing what they see as the State's fair share of tax on international income. It is unfortunate that specific taxpayers, who have arranged their international affairs in a manner that appears to be legally permissible under prevailing tax rules, are driven to defend those rules in Court at their own expense. The Vodafone Essar dispute is one example of this pattern. In the dispute the ITD may make a variety of arguments under section 9 of the Act and Articles 7 and 13 of the India-Mauritius DTC, all in an effort to achieve some degree of taxation in respect of capital gains that largely derive – ultimately and economically – from a profitable business in India. Yet any such argument must be based on the proposition that separate corporate personality should be disregarded, separate corporate residence should be ignored, and separate entity accounting should be replaced. The ITD thus seeks to dispense with prevailing norms of international taxation and to impose a form of worldwide unitary taxation for MNEs operating in India. It is asking the Courts to do something which they are not empowered to do; make tax policy changes for the betterment of the country.

89 Azadi Bachao Andolan v. Union of India, [2003] 263 I. T. R. 706, [S. C.] at ¶ 137.

GUEST ARTICLE

Constitutional Challenges in the 21st Century

Justice S.B. Sinha*

In this illuminating piece, learned Supreme Court Judge, Justice S.B. Sinha examines the diversity of constitutional challenges facing the Supreme Court in the post-liberalization era. While acknowledging the importance of adhering to the constitutional design of separation of powers, Justice Sinha justifies and elucidates the need for a pro-active judiciary to ensure good governance. He provides an analytical elaboration on the legal dimensions of globalization by critically looking at the judicial approach towards "emerging actors" like multinational corporations. He further illustrates on the impact and influence of globalization on crucial essential public services and the apex court's response to the same. Thus, Justice Sinha argues for a more rights-based approach towards interpreting the Constitution in order to fully realize the social, democratic and human values enshrined therein.

I. Introduction

According to Glanville Austin, it is that institution which is entrusted with interpreting a constitution that has the constitution in its custody.[1] In India, this institution would be the judiciary, and specifically, the Supreme Court, its apex body.

* Judge, Supreme Court of India.

1 Granville Austin, Working a Democratic Constitution: The Indian Experience (2000).