Govt challenges Vodafone ruling, ball back with SC

Given that Vodafone was expected to pay Rs 11,000 crore of taxes, and several more cases like AT&T/SabMiller/E*Trade depend on it (even Essar has asked for a refund on the tax paid on its Vodafone sale based on the Supreme Court judgment), it's not surprising the government has decided to ask the SC to review its ruling. This is the ruling where, while concurring with the majority judgment that the taxman did not have the right to tax Vodafone on its $11.1 bn purchase of Hutch's India operations, Justice KS Radhakrishnan had said that imposing capital gains taxes on this was tantamount to imposing capital punishment on capital investment in the country—indeed, if taxes had to be paid, they should have been paid by Hutch, not Vodafone. Since the bench headed by Chief Justice of India SH Kapadia had invoked the need to keep tax laws stable for foreign investors, the government's review petition has said the SC has erred in invoking FDI since there was no FDI in this case as Vodafone paid Hutch in an overseas deal! While that sounds neat, given that Vodafone has invested another $15 bn in India (it made profits of $400 mn), including $2.5 bn in the 3G bids that are currently the subject of another legislative battle with the government, it is obvious Justice Kapadia was making a larger point.

Whether the SC accepts or rejects the government's review petition remains to be seen, but one of the crucial points made is that the transaction wasn't just an overseas sale since it had a substantial Indian leg as well, apart from the fact that the underlying assets were based in India – this is the essence of the ruling by the Bombay High Court that the SC had overruled. The fact that the deal needed an FIPB approval is cited as further evidence of this. The government also says the existing Income Tax Act, and not just the Direct Tax Code which is yet to be introduced, gives it enough powers to look at the 'substance' of a transaction instead of just its 'form'.

Till the SC decides on the review, and there is the possibility the government could go in for a retrospective change in the law, this means continued uncertainty for investors. The larger point made by SC was that, since the Indian law doesn't have any General Anti-Avoidance Rules (GARR), investors are taken by surprise when the taxman re-examines transactions using the GARR window. Interestingly, while the SC drew attention to the fact that India didn't have GARR in the Azadi Bachao Andolan case in 2004, the government did precious little about it. What's more confusing is that the government wants investors in physical assets to pay capital gains taxes while financial investors are exempted if they come in through Mauritius or pay the relatively miniscule securities tax in India. And even in this case, tax experts point out, those who invest in physical assets while being based out of Mauritius and Singapore won't have to pay capital gains even after GARR provisions are brought in. Presumably the Budget will bring some clarity on the tax treatment for different classes of investors especially since investors in physical assets are supposed to be the more preferred.