Govt missed four chances in Vodafone tax case

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COULD the Finance Ministry have avoided egg on its face in the Vodafone tax evasion case?

Could it have avoided vitiating the investment climate through retrospective amendment of Income Tax Act under the Finance Act, 2012 to nullify Supreme Court's verdict?

Could it have acted proactively and collected tax revenue in time not only in Vodafone case but also in similar cases?

Could the Finance Minister Pranab Mukherjee have avoided saying that Indians �did not eat lizards� before foreign investment came to the country while defending retrospective legislation in Lok Sabha last month?

The answer to all the four questions is categorical Yes. The Finance Ministry frittered away at least four opportunities including CAG's recommendations to plug loopholes in taxation of capital gains on overseas share transactions between companies for assets located in India.

Vodafone-type cases constitute actual loss of revenue as compared to presumptive loss in 2G scam. The evasion of capital gains tax (CGT) on overseas transactions relating to Indian business operations is scam in itself. It is much more than serious than A.Raja-focused 2G scam. And yet no single person has been held accountable in Vodafone-type revenue loss cases!

None of Mr. Mukherjee's predecessors including Dr. Manmohan Singh had the humility to accept their role in the hopeless situation where the apex court's verdict had to be nullified through retrospective legislation.

The first opportunity or rather the wake-up call came way back in December 1995 when Cellular Communications International (CCI) of the US earned profit (or capital gains tax) of $ 40 million by forsaking its right for 40% equity participation in Sterling Cellular in favour of Swiss Telecom.

It is worth noting that Sterling Cellular, a Delhi cellular licensee now forms part of Vodafone India.

After this story was reported by the Wall Street Journal (WSJ) on 27 December 1995, there were series of reports in Indian media about the mystery of the entity that paid $ 40 million to CCI. As metro cellular licencees were issued at notional prices only a few months earlier, this transaction indicated the money spinning and tax-generating potential of mobile telephony.

This correspondent had forewarned the Government about the risk of losing substantial tax revenue through its nonchalance on such cases that were bound to recur.

In a seven-column story (**Click Foreign JV partners make merry**) splashed on the business page of Pioneer dated 21 May 1996, the correspondent pointed out that the telecom services joint venture guidelines had loopholes that encouraged exiting foreign partners to avoid paying CGT to Income Tax Department (ITD) by resorting to overseas transactions.

As put in that story, �if the new Government does not take a policy stand on this issue, such revenue leakages may acquire serious dimensions as the same problem is expected to recur in the case of other infrastructure projects such as power, road and port projects awarded to joint ventures through competitive bidding or licensing.�

The story also pointed out that �the outgoing Government had failed to plug loopholes in the laws and rules of the land to ensure that the income-tax Department levies a tax on overt or covert premium changing hands abroad including in tax heavens.�

Who was the Finance Minister in the outgoing Government that time? Dr. Manmohan Singh. He owes an explanation to the nation for his inaction. Forget tax heavens such as Cayman Island where Vodafone case arose, take a look at Finance Ministry's pathetic failure to plug loopholes in Indo-Mauritius Double Taxation Avoidance Agreement (DTAA) since the early nineties.

This becomes crystal clear from the report of Joint Parliamentary Committee (JPC) report on the 2 nd Securities Scam submitted in December 2002. This treaty has been misused brazenly by both foreign and Indian companies, foreign institutional investors and high networth investors.

The failure to act on JPC' findings can thus be considered as the second missed opportunity to plug tax revenue-leaking flaws in Indo-Mauritius treaty and certain other DTAAs signed with different countries.

The UK-based Vodafone Group PLC (VGP) had the option to acquire controlling stake in Hutchison Essar Limited (HEL) from Hutchison Telecommunications International Limited (HTIL) either through the tax exempted route of Mauritius or through the Cayman Island route. In the latter case (which is a tax heaven), India does not have a DTAA. Hongkong-based Hutchison Whampoa group was not the first to route its investment through Cayman Island.A few other foreign companies have done that. Even Essar group's ultimate holding company Essar Global Limited (EGL) is registered in Cayman Islands. Why has the Government not signed DTAA with Cayman Island?

Vodafone opted for purchase of Cayman Island-based CGP Investments (Holdings) Limited, the holding company of HEL because it wanted to acquire both direct (42.34%) and indirect stakes (24.65%) aggregating to 66.99%. The indirect stake was held through a clutch of complex under a complex arrangement that has been discussed in detail in the courts and elsewhere.

The Finance Ministry would have just twiddled its fingers in helplessness had Vodafone acquired the direct 42.34% equity stake in HEL by purchasing shares of CGP's 100% owned subsidiaries in Mauritius through which it invested in HEL (which was later renamed as Vodafone India Limited).

In Mumbai High Court, VGP had contended that if any of the shares held by the Mauritian Companies were sold in India, there would be no capital gains tax payable in India in view of the Convention on avoidance of double taxation between Mauritius and India. Hence, on a transfer of shares of HEL which are admittedly an asset situated in India, there would have been no capital gain tax chargeable in India.

Vodafone's stance has been that if tax avoidance was the motive, it could have directly bought the shares of a slew of Mauritian companies through which Hutchison Whampoa invested in HEL.

We have to take Vodafone's contention at the face value because it had earlier availed of capital gains tax exemption on certain Indian disinvestments made via the Mauritius route.

VGP's American subsidiary, Vodafone International Inc (VII), had divested its share holding in favour of two Indian companies through its 100% subsidiary, M/s Air Touch International Mauritius Ltd. (AIML) in Mauritius. AIML earned long-term capital gain amounting to Rs.79.59 crore and short-term capital gain of Rs.42.69 crore for the assessment year 2001-02 from the above transaction. AIML claimed exemption from capital gain tax under Indo-Mauritius DTAA, which ITD allowed after scrutiny in January 2004.

As pointed out by CAG in its report numbered 13 of 2005, VII saved capital gain tax of Rs.20.77 crore by taking shelter of Indo-Mauritius DTAA. �Had the shares been directly sold by VII USA, the entire capital gain would have been subjected to tax in India under Indo-US DTAA,� the report says.

CAG report, in fact, came as third opportunity for the Finance Ministry to put its act together on capital gains tax leakages resulting from tax-planned overseas transactions relating to Indian assets.

In a chapter on DTAAs, running into 39 pages, CAG recommended:

�Ministry may, therefore, have to put in place an effective mechanism to ensure that the benefit of residency and taxation of capital gains are availed of only by bonafide residents of the countries with which DTAAs have been concluded and not extended to residents of third countries as a matter of course in a routine manner. Ministry may undertake a transparent cost benefit analysis of extension of such benefits through �treaty shopping' so that it would become a recognized and clearly thought out policy of the Government to permit the same.�

CAG also advised the Government to �take urgent action to include specific clause for enforcing �limitation of treaty benefits' in all identified �problem DTAAs' so that the consequential benefits are not availed by default�

The report says: �Audit recommends that DTAAs may be examined critically through a phased and well monitored programme so that interests of revenue are safeguarded and one sided concessions are avoided. Audit recommends that the Board may assess the costs and benefits from each DTAA transparently and objectively, especially as DTAAs are not placed before Parliament.�

The fourth and real opportunity to levy CGT on HTIL arose in early 2007 when VGP's Dutch subsidiary approached Foreign Investment Promotion Board (FIPB) to take note and grant approval for the indirect acquisition of a 51.96% stake in HEL through an overseas acquisition of the entire share capital of CGP from HTIL.

Before FIPB cleared Vodafone International Holdings B.V's (VIH) application, Central Board of Direct taxes (CBDT)/ITD swung into action.

On 15 March 2007, ITD sought from HEL seeking information regarding the sale of the stake by Hutchison group in HEL to VGP, including in relation to the shareholders agreements and details of the transaction for acquisition of the share capital of CGP.

After receipt of an indifferent reply form HEL, ITD shot off another letter HEL on 23 March 2007. In this, ITD pointed out that both VGP's and Hutchison's announcements evidenced that HTIL had made substantial gains. It advised HEL to impress upon HTIL to discharge tax liability on gains, before ceasing its Indian operations.

CBDT apparently also turned the heat on Hutch-Voda deal through the media. A story in financial daily published on 26 April 2007, for instance, revealed that CBDT had urged finance ministry to ask HTIL to first pay capital gains tax on the sale of its 52 per cent stake in Hutchison-Essar to Vodafone for .1 billion before the Foreign Investment Promotion Board (FIPB) clears the Vodafone acquisition.

The story appeared a day before the decisive FIPB meeting. It is here also pertinent to note the fact that FIPB is under the administrative control of Finance Ministry. So is CBDT. The Ministry should have thus lent its ear to CBDT's plea.

On the eve of FIPB meeting, a Mumbai-based general daily quoted Secretary (Industrial Promotion & Policy) Ajay Dua as claiming that FIPB members had not received any advice from CBDT that HTIL must first pay capital gains tax before getting FIPB clearance.

Shorting after FIPB cleared VGP application on 27 April 2007, Mr. Dua told a business daily that none of the tax issues raised by ITD were discussed at the FIPB meeting.

On 9 May 2007, an official announcement stated: �On the recommendation of the FIPB Meeting held on 27th April, 2007, Finance Minister, Shri P. Chidambaram has approved the proposal of M/s. Vodafone International Holdings B.V. to take note of the transaction by which Vodofone is acquiring or has acquired effective shareholding of 51.96% in M/s. Hutchison Essar Limited. The proposal pertain to the Department of Telecommunications.�

The approval, if investigated, can open a can of worms. The obvious questions that arise are: why did Mr. Chidambaram not reconcile the conflicting interest of FIPB and CBDT? Why he did not ask FIPB to reconsider its recommendation in the light of issues raised by CBDT? Why did FIPB, in the first place, not discuss the CBDT's capital gains tax demand? Did FIPB pass on to CBDT tonnes of information that it asked Vodafone and Hutchison groups to submit?

One can hope some RTI activist would force the Government to make public all documents relating to FIPB's failure to act on CBDT's advice.

The White Paper on Black released by Finance Ministry is an eyewash at least as for as the black money generation potential of defective DTAAs are is concerned.

The Government must come out one with a white paper on a comparative analysis of DTAAs and give a time-frame for plugging the revenue leakages from the of defective ones.

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