THE *VODAFONE* JUDGMENT-WIDER CONCERNS OF WITHHOLDING TAX UNDER THE INCOME TAX ACT

*Anisha Keyal and Pritika Rai Advani**

The decision of the Bombay High Court in Vodafone's challenge to a $1.7-billion tax notice served on the company related with the acquisition of majority stake in Hutchison Essar Limited has wide ramifications for large, cross-border transactions. The ruling states that the Income Tax Department has the jurisdiction to send notice to Vodafone to pay Rs 12,297 crore as tax liability for its 2007 Hutch-Vodafone deal. It based its ruling on the reason that Vodafone's transaction with Hutchison Telecommunications International has a nexus with India which is enough to hold its payments subject to withholding tax under § 195 of the Income Tax Act, 1961. It is the aim of this article to analyze the ruling of the Court with regard to § 195. The article seeks to prove, firstly, how the Vodafone transaction did not have any nexus with India enough in the eyes of law to tax it under the Act. Subsequently, the authors will attempt to draw attention towards the much ignored test of nationality which should be utilized in interpreting § 195 and its provisions dealing with withholding tax on payments made to non-residents.

I. INTRODUCTION

The recent decision by the Bombay High Court in the case of *Vodafone International v Union of India*[1] (Vodafone) is significant because of the rulings made with respect to various provisions of the Income Tax Act, 1961 (the Act). With due respect to the ruling by the Hon'ble High Court, the present article disagrees with the ruling on §195 (1)[2] of the Act which deals with deducting tax at source when payments are made to non-residents.

In the *Vodafone* judgment, the Court made an attempt to make §195 of the Act applicable extraterritorially. The Court held that when payments are made to non-residents, if the payments are shown to be chargeable under the charging

* 3rd and 2nd year students respectively, the W.B. National University of Juridical Sciences.

[1] Writ Petition No.1325 of 2010 (Bombay H.C.) (Unreported).

[2] The Income Tax Act, 1961, § 195: OTHER SUMS (1) Any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest (not being interest on securities) or any other sum chargeable under the provisions of this Act (not being income chargeable under the head "Salaries") shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force...

provisions of the Act, §195 can be made extraterritorial in its operation. This means that the *only* requirement for attracting §195 is to show that some payment was made to a non-resident and such payment was chargeable under the other provisions of the Act.

However, the authors believe that the judgment is flawed in its holding that chargeability of payments under the Act is enough to establish nexus. This is because the case at hand is unique to the extent that payments made are in relation to a transaction involving the sale of shares of a non-resident company by a non-resident to another non-resident, through an agreement executed outside India, subject to the laws of England, and for which payment was made outside India.[3]

The Petitioner had contended in this case that two tests must be satisfied before §195 can be invoked, the first of which is express and the second implicit: (i) the sum must be chargeable under the Act. If there is a dispute on quantum, an obligation still arises, but if it is not chargeable at all then the Section does not apply and this would raise a jurisdictional issue; (ii) The person is one on whom the Revenue can legitimately, consistent with the principles of the conflict of laws cast an obligation.

It is humbly submitted that the court's interpretation is flawed on both these tests. In applying the first test of chargeability, the court erred in holding that a nexus existed with regard to the payment. Further, the Court refused to even apply the second test stating that the first test is determinative enough. The judgment of the Court wherein §195 was held to apply to *"any person"*, is incorrect. The authors believe that the second test of residence, domicile or nationality[4] should have been used as well.

---

[3] *See* KANGA, PALKHIVALA & VYAS, THE LAW AND PRACTICE OF INCOME TAX 2105 (Dinesh Vyas ed., 2004).

[4] §411 Restatement (Third) Foreign Relations Law, (1987): *Jurisdiction to Tax: The Basic Rule*

(1) A state may exercise jurisdiction to tax a person, natural or juridical, on the basis of
  (a) nationality,
  (b) domicile, or
  (c) residence.

(2) A state may exercise limited jurisdiction to tax a person, natural or juridical, on the basis of
  (a) presence or doing business in its territory, or
  (b) ownership of property located in its territory.

(3) A state may exercise jurisdiction to tax
  (a) property located in its territory, or
  (b) a transaction that occurs, originates, or terminates in its territory or has some other substantial connection to the state.

The main argument of the authors is that the transaction in question should not have been held as one which would be subject to tax deduction under §195. In order to prove the argument, the authors will first show that the presumption of territoriality holds well with regard to §195 and that there are no reasons logical enough to hold it otherwise. Further, on the basis of the transaction and contracts, the payments should not have been deemed chargeable under the charging provisions of the Act, which in this case are §§ 5 and 9. The observation of the Court that the various entitlements flowing from the transfer of share were capital assets is flawed because such rights were only incidental in nature.

Next, the implicit test of nationality should have been considered and evaluated. In this regard, it is submitted that payments made by non-residents to another non-resident should not be included. The authors will show through judgments prior to the Vodafone case itself that the principle of law is itself undecided. Also, an analysis of provisions in other countries will reveal that internationally too, provisions similar to §195 are limited in their scope. The use of principles of interpretation of statutes will be made to prove conclusively that §195 is inapplicable in a case such as *Vodafone*. Finally, it is the our argument that the presence of penal provisions support the conclusion that a narrow and reasonable interpretation must be given to the scope of §195.

II. PRESUMPTION OF TERRITORIALITY OF §195

It is a universally recognized presumption that laws made by any country are intended to be applicable to its own territory and are aimed at governing their domestic conditions. However, certain deviations from this principle of State sovereignty are permitted when the intention of making certain laws applicable extraterritorially is manifestly stated.[5] In India, Art. 245[6] of the Constitution gives the Parliament authority to make laws which are extra territorial in application. However, Indian laws are presumed to be territorial unless it can be proved that a particular Statute or provision is directed towards being applied extraterritorially and that such application is based on the existence of a clear nexus with the country.

---

[5] *See* S.D. Sharma, *Applicability Of The Doctrine Of Extra-Territoriality To Legislation By The Indian Legislature*, 28 J.C.L. & I.L. 91-95 (1946); Pamela Karten Bookman, *Solving The Extraterritoriality Problem: Lessons From The Honest Services Statute,* 92 Va. L. Rev. 749 (2006); Bradley W.Joondeph, *The Meaning of Fair Apportionment and the Prohibition on Extraterritorial State Taxation*, 71 Fordham L. Rev. 149 (2002-2003).

[6] The Constitution of India, Art. 245: Extent of laws made by Parliament and by the Legislatures of States –

(1) Subject to the provisions of this Constitution, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State

(2) No law made by Parliament shall be deemed to be invalid on the ground that it would have extra territorial operation.

The relevant part of §195 reads as follows:

> *Any person* responsible for paying to a non-resident, not being a company, or to a foreign company, any interest (not being interest on securities) or *any other sum chargeable* under the provisions of this Act (not being income chargeable under the head "Salaries") shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force.

§1[7] of the Act clearly states that the Act shall be applicable to India. Thus, it will be argued that §195 in light of the facts of the *Vodafone* case should not have been deemed to operate extraterritorially.

In order to assess the scope of §195 and territoriality, it is helpful to seek reliance from tests laid down in other jurisdictions, such as the United States of America. The Restatement (Third) of Foreign Relations Law[8] has established five tests for determining whether or not a statutory provision is extra territorial in its application. Each of these five tests[9] is followed in all jurisdictions of the world as justifications for diluting the presumption of territoriality. We will attempt to prove that §195 as per the *Vodafone* case does not satisfy any of these tests and hence is only territorial in operation.

A. TEST OF NATIONALITY

The first and often the most widely used test is that of nationality.[10] This states that when payment, as in a taxing statute, is made to or by a person who holds nationality of the country which seeks to tax it, irrespective of whether the person resides in or outside the country and where the payment was received, the taxing provision can be extraterritorial.

---

7 The Income Tax Act, 1961, §1: SHORT TITLE, EXTENT AND COMMENCEMENT. (2) It extends to the whole of India.

8 William S. Dodge, *Understanding the Presumption Against Extraterritoriality*, 16 BERKELEY J. INT'L L. 85 (1998), V. Rock Grundman, *The New Imperialism: The Extraterritorial Application of United States Law*, 14 INT'L LAW. 257 (1980); David H. Armstrong, *Canons of Construction: Presumption of Territoriality*, 47 MICH. L. REV. 1230-1232 (1949).

9 §402 read with § 403 of Restatement (Third) Foreign Relations Law, (1987). *See also* Wade Estey, *The Five Bases of Extraterritorial Jurisdiction and the Failure of the Presumption against Extraterritoriality,* 21 HASTINGS INT'L & COMP. L. REV. 177 (1997-1998).

10 §402(2) of Restatement (Third) Foreign Relations Law, (1987).

In the instant case, the payment was made by Vodafone International Holdings BV, (VIH) a company incorporated in Netherlands and controlled by Vodafone Group Plc, U.K. This payment was made to Hutchison Telecommunication International Ltd, Cayman Islands (HTIL). Thus, evidently neither of them holds the Indian nationality which serves as a very persuasive factor in extending §195 beyond Indian boundary. We believe that this is a very strong factor in mitigating the argument of establishing nexus with India.

B. EFFECTS TEST

The effects test[11] was first laid down by Justice Bork, in *Zoelsch v. Arthur Anderson & Co.*[12] J.Bork had held that acts of Congress should presumptively apply only to conduct that causes effects in the United States regardless of where the conduct occurs. The effects test in essence states that a state has jurisdiction to prescribe law with respect to conduct outside its territory which has or is intended to have substantial effect within its territory. In fact, the most recent case in this regard is *Morrisson v. National Australia Bank Ltd.*,[13] where the U.S. Courts have further narrowed down the effects tests to hold that only when the effects are substantial enough should the law be given extraterritorial operation.

Thus, whenever any conduct causes or is intended to cause substantial effects in the country, it can be taxed irrespective of where the conduct occurred.

Incidentally, even the Bombay High Court utilised this effects test to hold that the transaction has substantial effects in the country. However, it is submitted that this transaction is not one which has effects in the country, and effects if any are not substantial enough to attract § 195.

1. Establishment of nexus under §9(1)(i) of the Act

The judgment accepted the principle that income generated by a non-resident from an offshore transaction is not subject to tax in India unless the assets transferred have sufficient nexus with the territory of India.[14] In order to establish a nexus between the person sought to be taxed and the jurisdiction which seeks to tax, the Court examined §5 (2) and §9(1) (i) of the Act.

---

[11] §402(1)(c) of Restatement (Third) Foreign Relations Law, (1987). *See also,* Am. Banana Co. v. United Fruit Co., 213 U.S. 347, 356–57 (1909) and EEOC v. Arabian Am. Oil Co. (Aramco), 499 U.S. 244, 246, 248 (1991).

[12] Zoelsch v. Arthur Anderson & Co. 24 F.2d 27 (DC Cir. 1987).

[13] Morrisson v. National Australia Bank Ltd., Supreme Court of the United States, decided on June 24, 2010.

[14] *See supra* note 1, ¶ 77-78.

§5(2)[15] pertains to the total income of non-resident that is chargeable to tax. The Court simplified §5(2) stating that "it covers income of a non-resident which (i) is received in India; (ii) accrues in India; (iii) arises in India; (iv) is deemed to be received in India; (v) is deemed to accrue in India; or (vi) is deemed to arise in India."[16] Therefore, in essence, §5(2) relates to income which actually accrues or arises in India, or deems to accrue or arise in India.[17] However, the Court implicitly rejected the applicability of §5(2) as it promptly proceeded to consider the law on the scope of the deeming provision, §9(1)(i),[18] which outlines the circumstances in which income is deemed to accrue or arise in India By directly taking into consideration the conditions by which income shall be deemed to accrue or arise in India, as provided in §9(1)(i), the Court rejected that aspect of §5(2) which deals with income that has actually accrued or arisen in India. Thus, at most, the income can only have said to be deemed to accrue or arise, and not to have actually accrued or arisen in India.

In this regard, the case of *CIT v. Toshuku Ltd*[19] can be helpful. Here, a non-resident assessee had acted as selling agent outside India and did not carry on business operations in the taxable territory. The commission received by the non-resident for service rendered outside India was held not to have accrued or arisen in India and the mere making of a book entry by the statutory agent was held not to amount to a receipt in India. The Court held that: *"If no operations of business are carried out in the taxable territories, it follows that the income accruing or arising abroad through or from any business connection in India cannot be deemed to accrue or arise in India"*.[20]

---

[15] The Income Tax Act, 1961, §5(2): Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which—

(a) is received or is deemed to be received in India in such year by or on behalf of such person; or

(b) accrues or arises or is deemed to accrue or arise to him in India during such year.

Explanation 1.—Income accruing or arising outside India shall not be deemed to be received in India within the meaning of this section by reason only of the fact that it is taken into account in a balance sheet prepared in India.

Explanation 2.—For the removal of doubts, it is hereby declared that income which has been included in the total income of a person on the basis that it has accrued or arisen or is deemed to have accrued or arisen to him shall not again be so included on the basis that it is received or deemed to be received by him in India.

[16] *See supra* note 1, ¶80.

[17] The part of §5(2) that deals with income which is received in India or deemed to receive in India is not relevant for this article.

[18] *See supra* note 1, ¶78-79.

[19] CIT v. Toshuku Ltd, (1980) 125 ITR 525 (SC).

[20] *See also* CIT, Punjab v. R. D. Aggarwal & Co. (1965) 56 ITR 20 (SC); M/s. Carborandum Co. v. C.I.T., (1977) 108 ITR 335 (SC) which are decided on the basis of §42 of the Indian Income-Tax Act, 1922, which corresponds to §9(1)(i) of the Act.

In the Vodafone case, prima facie *the transaction is between two non-resident entities, through a contract executed outside India for the purchase of a capital asset, which is one share of CGP Investments (Holdings) Limited (CGP) and for which consideration was also paid outside India. Thus, it is evident from the transaction and the ruling above that the income could not have accrued or deemed to accrue in India.*

2. Failure of the nexus test with respect to the share transfer

The Court divided §9(1)(i) into four categories which "cover income accruing or arising, whether directly or indirectly: (i) through or from any business connection in India; (ii) through or from any property in India; (iii) through or from any asset or source of income in India; or (iv) through the transfer of a *capital asset situated in India*."[21] Since this transaction involved transfer of shares and certain other rights and interests, the Court specifically focused on income accruing or arising through the transfer of a capital asset. The only avenue that remained open to establish a nexus was to prove that a 'capital asset' was transferred and this capital asset was 'situated' in India.

The Respondents argued that apart from the shares, the 'controlling interest' constitutes an independent capital asset. However, this contention was struck down by the Court. The Court, relying on numerous decisions by various courts,[22] clearly held that: "A controlling interest is an incident of the ownership of the shares in a Company; something which flows out of the holding of shares. A controlling interest is, therefore, not an identifiable or distinct capital asset independent of the holding of shares."[23] This meant that the share transfer of CGP failed to establish the nexus with India.

However, the Court believed that out of the public representation made of 66% equity interest being transferred, the CGP share accounts for only 42% direct interest and some indirect, making the share holding 51% and that 15% was still unaccounted for.[24] The Court arrived at a conclusion that there was a transfer of contractual rights in India, namely the transactions with Analjit Singh and the Asim Ghosh and these rights are a capital asset, assigned with a certain value. This, according to the judges, establishes the nexus with India. It is submitted with great humility that this is a flawed deduction on the part of the Court.

3. Establishment of nexus relating to transfer of rights and entitlements

---

[21] C.I.T., Punjab v. R. D. Aggarwal & Co, (1965) 56 ITR 20 (SC), ¶81.

[22] Smt.Maharani Usha Devi v. C.I.T, (1981) 131 ITR 445; Baijnath Chaturbhuj v. CIT, (1957) 31 ITR 643; Commissioner of Wealth Tax v. Mahadeo Jalan, (1972) 86 ITR 621; Inland Revenue Commissioners v. Bibby & Sons Ltd, (1946) 14 ITR (Supp) 7.

[23] *See supra* note 1, ¶70.

[24] *See supra* note 1, ¶124-126.

Firstly, in establishing a nexus, the legal nature of the transaction must be examined, and not its consequence or effect.[25] In this case, the legal nature of the transaction was simply a transfer of a share, and a share has certain accompanying rights. With the transfer of the share, the rights associated with it were also transferred. This, i.e., the transfer of rights, was a consequence of the transaction, distinct from the transfer of a share, which actually was the legal nature of the transaction. This in effect means that the Court made an attempt to derive the nexus from incidental rights and entitlements which we argue is not relevant enough. In order to successfully establish a nexus, the legal nature of the transaction should have been examined and not the indirectly related aspects. Such indirect or incidental rights would move with any kind of transaction related to the shares in question. Thus, it is the share transfer which should be examined and not the indirect effects if it. Therefore, Vodafone's contention that the transaction involved a transfer of a share and not individual rights should stand.

Secondly, the Court recognised that an assessee who is engaged in legitimate business activity can plan his transactions in a manner which would reduce his tax burden, provided that the transaction is neither sham, nor colourable, nor fraudulent in nature.[26] So, in order to assess the legal nature of the transaction, a court can probe into the substance of the transaction and does not have to limit itself to the form. The order of the Revenue dated 23 January, 2009, as contended by the Petitioner, proceeded on the basis that the transaction by itself is not a sham.[27] The Court has not, in any expression disproved of this assertion of the Petitioner and hence in view of this, Vodafone is entitled to structure its business and plan the transaction in a manner which would reduce its tax burden.

---

[25] This can be inferred from Lord Diplock's judgment in Snook v. London and West Riding Investments, [1967] 2 QB 786 (CA), where he stated:

I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create … *for acts or documents to be a "sham," with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating. No unexpressed intentions of a "sham" affect the rights of a party whom he deceived* (Emphasis supplied). This was re-iterated in *Hitch's Executors v Stone* [2001] STC 214 (CA). The court cannot simply look at the consequence of the transaction, to make the transaction taxable. Lord Cairns in Partington v. Attorney-General, L. R. 4 H. L. 100, said that "if the crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be."

[26] *See supra* note 1, ¶56.

[27] *Id.*, ¶53(1).

Finally, the Court has stated that these contractual rights passed by virtue of the fresh agreements that were entered into, and these rights moved separately from the transfer of shares. *However, in actuality, the contractual rights were pre-existing rights with the downstream subsidiary of CGP, so they moved by themselves and hence, the transfer of the contractual rights did not form part of the consideration.*[28]

In cases where composite consideration is paid, a separate capital asset can be proven only if there are two distinct assets each capable of being acquired or transferred separately. It is hard to believe that these contractual rights could have been transferred independent of CGP.

Thus, the nexus cannot be established on the basis of the transfer of these rights and entitlements.

4. The provisions of the Direct Tax Code

Furthermore, even if it agreed that there are effects pertinent to India, these effects are not substantial enough to allow an extra-territorial operation of a provision of law. This is strengthened by the fact that the proposal in the Direct Tax Code which at least for the future makes an attempt to clarify the situation under which indirect transfers can be subject to tax. It clearly states that in the case of a business of which all the operations are not carried out in India, the income of the business deemed to accrue in India shall be only such part of the income as is reasonably attributable to those operations carried out in India. It further states that only where the dominant fair market value of more than 50% of the assets is present in India, those cases are the ones which the revenue would seek to tax.[29]

Thus, accepting this as a proposal, a mere 16% of interest in India should not have classified as having nexus enough and more to be taxable in India.

C. TEST OF PROTECTIVENESS, UNIVERSALITY AND PASSIVE PERSONALITY

The other three tests prescribed by the Restatement are the tests of protectiveness, universality and passive personality.

---

[28] *Supra* note, ¶53.

[29] *See* §5 of the Direct Tax Code Bill, 2009. *See also* Deloitte, *Direct Tax Code Bill -2010 Proposed Changes*, available at http://www.deloitte.com/assets/Dcom-India/Local%20 Assets/Documents/Direct%20Tax%20alerts/DTX-17a-2010.pdf (Last visited on October 2, 2010).

The test of protectiveness[30] aims at giving primary importance to national security. This is used when there are transactions of the government which are related to governance, security and international relations. Hence, this case which is essentially a cross-border merger and acquisition does not attract the test of protectiveness.

The test of universality[31] speaks of universal crimes against humanity or universal offences against which a State can enforce jurisdiction outside its territories as well. However, this too, evidently has no application in the case at hand.

The last test of passive personality[32] aims to protect victims of the country's nationality from effects of acts done outside the country's boundaries. Like the tests of protectiveness and universality, this too is not of much meaning in the present context.

III. INDIAN JUDICIAL PRONOUNCEMENTS UNDER §195 OF THE ACT

According to the Revenue's argument in the *Vodafone* case, once chargeability is established, no further requirements of nexus need to be satisfied for attracting Tax Deducted at Source (TDS) provisions. As such, there is no ground for not giving the words "any person" in §195 their natural and ordinary meaning. The Revenue's stand can be countered by arguing that *"any person"* can only refer to residents, and the provision must be given a contextual meaning. The case law on the point is not entirely clear. However, the authors believe that in light of these conflicting positions and principles of statutory interpretation, "any person" should be interpreted to mean only residents.

The Revenue's arguments in the *Vodafone* case were hinged upon two cases which the Hon'ble Court accepted after finding considerable force in them. These two cases are *Satellite TV v. DCIT* [33] (Satellite TV) and *CIT v. Eli Lilly*[34] (Eli Lilly). It is important to first explain these two cases and prove how they are far from conclusive on the point of law in question.

The phrase "any person responsible for paying to a non-resident" was held in the *Satellite TV* case as inclusive of non-residents and thus payments made outside India were within the scope of the Section. The assessee in the *Satellite TV* case had relied on an earlier decision of a co-ordinate Bench of the

30 §402(3) of Restatement (Third) Foreign Relations Law, (1987).

31 §404 of Restatement (Third) Foreign Relations Law, (1987).

32 §402 of Restatement (Third) Foreign Relations Law, (1987).

33 Satellite TV v. DCIT, (2006) 99 TTJ (Mum) 1025.

34 CIT v. Eli Lilly, [2009] 178 Taxman 505 (SC).

Tribunal in *Shrikumar Poddar v. DCIT*[35] (Shrikumar Poddar) but the Tribunal refused to follow *Shrikumar Poddar*, saying that a decision is authority only for what it decides, and not for everything that may logically follow from it.

However, in order to fully appreciate the position of law, due regard must be given to the *Shrikumar Poddar* case. The assessee in this case was a non-resident who raised loans outside India from Educational Subscription Service Inc. and East Lansing State Bank of East Lansing, Michigan. The borrowed money was transferred to his account in India and from that account the payment was made outside India. Noticeably, the Tribunal held that if the payment is not made in India and the same is made out of India, provisions of §195 cannot be applied and consequently *there would be no liability to deduct tax by a non-resident out of the payment made to a non-resident outside India*. These observations in *Shrikumar Poddar* were treated as obiter and not conclusive of the issue. Accordingly, the Tribunal in *Satellite TV* took a view different from that in *Shrikumar Poddar*.

It is however pertinent to note that this decision by the Tribunal in the *Shrikumar Poddar* case is the *only* case where it has been categorically pointed out that payment by a non-resident to another non-resident precludes §195 in the very first instance.

Another case that arguably favours the Revenue's argument of §195 being independent of the residence, nationality or domicile of the payer and the payee is the Supreme Court judgment in the *Eli Lilly* case.

The facts of the *Eli Lily* case are important to understand the extent of the judgment. In this case, Eli Lilly Netherlands seconded expatriates to work in India for an Indian-incorporated joint venture (JV) between Eli Lilly Netherlands and another Indian company. The expatriates rendered services only to the JV and received a portion of their salary from the JV. The JV withheld taxes on the salary actually paid in India. However, the salary costs paid by Eli Lilly Netherlands were not borne by the JV and that portion of the income was not subject to withholding tax by Eli Lilly or the overseas entity. It was this portion of the income that came under the scanner of §192 of the Act which dealt with withholding tax on payment made as salaries to non-residents. The Apex Court suggested that chargeability under §9 would constitute sufficient nexus on the basis of which any payment made to non-residents as salaries would come under the scanner of §192. However, the Court did not rule clearly on a situation where salaries were paid by non-residents to another non-resident as in this case, Eli Lily was a part of the JV and services were clearly rendered within India, for the JV.

However, it is crucial to note that the Apex Court specifically confined its decision to TDS under §192 (TDS in case of salaries); and on the facts of that

---

[35] Shrikumar Poddar v. DCIT, (1997) 59 TTJ (Mum) 304.

case, the issue of payments by non-residents did not even arise as Eli Lilly Netherlands was part of the JV anyway. The Court took the position that the withholding tax provisions relating to salary and the charging provisions form an integrated part of the Act and, where the payment of salary is taxable in India, that payment falls within the scope of the withholding tax provisions. Thus, it can be safely concluded that this decision is pertinent to its own facts and §192 of the Act. Since §192 deals with salary payments, it is conceptually different from §195. In cases of §192, when services are rendered within India, it is easy to establish the territorial and nationality link. However, other payments, which are the subject-matter of §195 by their varied nature cannot be called similar to §192.

Thus, payments under §195 from a non-resident to another non-resident outside India cannot be based on the *Eli Lily* case, as this case specifically confined itself to only §192 and not all TDS provisions uniformly.

Given this state of the case law, the question of the extraterritorial application of the words "any person" in §195 cannot be regarded as settled. Further, an analysis of case laws utilized by the Court in determining the scope of §195 would reveal that never before has a fact situation arisen where payments are made from a non-resident to another non-resident.[36] Thus, the applicability of such principles to the unique case at hand is in serious doubt.

Keeping this approach of the court in mind, in the present case, since VIH, a non- resident that has neither any office in India nor has any sum chargeable in India, should not have been included within "any person" under §195.

IV. INTERNATIONAL PERSPECTIVE ON REQUIREMENT OF NATIONALITY

The argument of the authors that the words "any person" must be read to mean "any residents" is also supported by many countries and their statutes. The authors would first give examples of a few countries with similar provisions and then deal extensively with U.K. decisions which provide effective guidelines in the Indian situations.

A. WITHHOLDING TAX PROVISIONS IN STATUTES OF VARIOUS COUNTRIES

In various countries, withholding tax in case of non-residents applies only when payments are made by residents to non-residents.

[36] Vijay Ship Breaking Corporation v. Commissioner of Income Tax, (2009) 314 ITR 309 (S.C.); A.H. Wadia v. Commissioner of Income Tax, (1949) 17 ITR 63 (FC); Kanchanganga Sea Foods Ltd. v. Commissioner of Income Tax, 2010 (6) SCALE 442; Transmission Corporation of A.P. Limited v. CIT, [2008] 239 ITR 587.

According to the Japanese Income Tax Act and its withholding provisions, withholding tax applies only if they are paid in Japan or if they are paid abroad and the payer also has an office, residence within Japan.[37]

As per the French Tax Code, only that interest paid by a French debtor to a non-French tax resident is subject to French withholding tax.[38] A similar provision exists in the Russian and Singaporean system as well.[39]

Thus, these examples from a few other countries suggest that it is generally followed that withholding tax is applicable only when payments of whatever nature are made from a resident, either a person or a corporation to a non-resident. Although the authors agree that this would vary from statute to statute, examples of these countries should serve as effective guidelines to the Indian legislature and judiciary in resolving certain confusions regarding application of §195.

B. U.K. CASE LAWS ON TEST OF NATIONALITY

In a decision of the House of Lords in *Clark v. Oceanic Contractors*,[40] followed in *Andre Agassi v. Robinson*,[41] their Lordships had to directly consider the question of whether chargeability is *ipso facto* sufficient nexus to attract TDS provisions. A TDS provision for payments made outside England, was not given extraterritorial application, based on principles of statutory interpretation.[42]

In these English cases, the provisions in question were §§ 18 and 555 of their taxing Act called Corporation Taxes Act, 1988. §18 read as clearly as to say that it applies "*to any person, whether a Commonwealth citizen or not,* although not resident in the United Kingdom …from any trade profession or vocation exercised within the United Kingdom." Further, even §555 was apparent enough to state that "where a payment is made (*to whatever person*) and it has a connection

---

[37] Japan, Income Tax Act, Act No. 33 of March 31, 1965, Chapter V: Withholding at Source of Income of Nonresidents or Corporation, Art. 212. *See also* Japan External Trade Organization, *Investing in Japan*, available at http://www.jetro.go.jp/en/invest/setting_up/laws/section3/page4.html (Last visited on October 2, 2010).

[38] *See* Tax Directorate, *The French Tax System*, available at http://www.impots.gouv.fr/portal/ deploiement/p1/fichedescriptive_1006/fichedescriptive_1006.pdf (Last visited on October 2, 2010).

[39] *See* Anonymous, *Withholding Tax on Interest on Corporate Debt*, available at http://us.practicallaw.com/7-385-8420 (Last visited on October 2, 2010).

[40] Clark v. Oceanic Contractors, [1983] 2 WLR 94.

[41] Andre Agassi v. Robinson, (2006) 1 W.L.R. 1380.

[42] Lord Scarman held: "unless the contrary is expressly enacted or so plainly implied that the courts must give effect to it, United Kingdom legislation is applicable only to British subjects or to foreigners who by coming to the United Kingdom, whether for a short or a long time, have made themselves subject to British jurisdiction."

of a prescribed kind with the relevant activity, the person by whom it is made shall on making it *deduct out of it a sum* representing income tax and shall account to the Board for the sum".

Even in light of these clearly worded provisions which indicate the scope of the provisions, the Court in the *Agassi* case applied the principles mentioned above to hold it inapplicable outside the territorial boundary. *They held this on the basis of the fact that transaction was entered into between non-resident companies; the provisions could not be attracted.*[43] §555 (2) is a TDS provision and this was held inapplicable extraterritorially. If this case is to be followed, clearly, the High Court should have excluded the applicability of §195 as well in the *Vodafone* case.

In the above cases, the famous ruling in *Ex parte Blain*[44] was quoted to say that "[i]f a foreigner remains abroad, if he has never come into this country at all, it seems impossible to imagine that the English legislature could ever have intended to make such a man subject to particular English legislation."[45] It lay down, categorically that the dilemma of extraterritoriality of a provision is a series of questions, of statutory construction.

These principles are that:

- The meaning adopted should be that which advances the overall purpose of the legislation. This is to say that the words of an Act are to be read in their entire context and in harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament. Further, results that would lead to absurdity or to frustration of the objective of the legislation should be avoided.

- If the words are ambiguous and open to two interpretations, the benefit of interpretation is given to the subject. Nothing must be implied in a taxing statute.

The authors shall now use each of these principles to prove the inapplicability of §195 of the Indian Act in cases where payments are made from non-resident to another non-resident.

V. INTERPRETATION OF §195 OF THE INCOME TAX ACT, 1961

The first principle to be analyzed is the purpose and intention behind §195 and its applicability in the *Vodafone* case.

---

43 *Supra* note 41, ¶31.

44 Ex Parte Blain, 12 Ch. D. 522. (C. A. I879).

45 *Supra* note 41, ¶10.

A. OBJECT AND PURPOSE OF TDS PROVISIONS

The rationale behind TDS provisions seems to require a contextual interpretation of "persons" to mean only "residents". TDS provisions are useful in two ways. They ensure that the Revenue Department can collect taxes in advance, that is, before the final assessment and this is helpful in meeting their urgent requirement for money. However, TDS provisions are essentially meant to ensure easier collection of taxes. The logic is that certain sums, though taxable in the hands of the payee, might escape tax because of problems in enforcement machinery in the case of non-resident payees.[46] Hence, those sums should be deducted by the payer, from whom they can be recovered more easily. The purpose of TDS provisions in Chapter XVII B is thus, to see that the sum which is chargeable under §4 for levy and collection of income-tax, the payer should deduct tax thereon at the rates in force, if the amount is to be paid to a non-resident. The said TDS provisions are meant for tentative deduction of income-tax subject to regular assessment.[47]

For this purpose to materialize, it is essential that the payer must be in a better position than the payee, that is, it must be easier to collect from the payer than from the payee. This will be true only in cases where the payer is a resident and the payee is a non-resident. In case both parties are non-residents, it will be as easy or as difficult to collect the sums due from the payee as the payer. In that case, the rationale behind application of TDS provisions is not attracted.

B. BENEFIT TO THE PAYER IN CASES OF AMBIGUITY

The next principle utilized by courts in interpreting any taxing provision is that whenever there are two conclusions possible after a reasonable enquiry, the one which favours the payer must be endorsed.[48]

As is evident, on a reading based on the above mentioned principle, there can be ambiguity in interpreting §195. One interpretation is based on the ordinary meaning which would include payments made from non-residents as well. However, another interpretation based on a contextual interpretation is one where only payments made from residents to non-residents should be included. Thus, there is confusion and the conclusion benefitting the payer must be adopted. §195 should then be made applicable only in payments made from resident to another non-resident.

---

[46] Transmission Corporation of A.P. Ltd. and Anr. v. CIT, [1999] 239 ITR 587 at 594.

[47] *Id.*

[48] IRC v. Duke of Westminister, 1936 AC 1; CIT v. M K Vaidya, [1997] 224 ITR 186 (Kar.); CIT v. New Shorrock Spinning & Manufacturing, (1956) 030 ITR 038 (Bom); CIT v. Naga Hills Tea Co. Ltd., 89 ITR 236, 240 (SC); CIT v. Kanakasabai, 89 ITR 251, 257 (SC).

C. TERRITORIALITY OF §195 IN LIGHT OF THE PENALTIES UNDER THE INCOME TAX ACT

It is a widely accepted principle that unlike remedial provisions which can be dealt with a little leniently, penal provisions, including civil and criminal tax penalties, are to be strictly construed. This means that if it is not clear whether the language of a penal provision applies to the tax-payer's conduct, then the statute will be interpreted narrowly in favour of the tax-payer.[49] This was quoted with approval by Lord Esher MR in *Tuck v. Priester*[50] where he said that "If there is a reasonable interpretation which will avoid the penalty in any particular case we must adopt that construction. If there are two reasonable constructions we must give the more lenient one. That is the settled rule for penal sections."

The reason is that imposing penalties interferes with the liberty of the subject by taking the subject's money or property by fines or forfeitures. The penal terms must be sufficiently explicit to inform those who are subject to it what conduct on their part will render them liable to its. The citizen cannot be held to answer charges based upon penal statutes whose mandates are so uncertain that they will reasonably admit of different constructions. This is the reason why if the statutory words are ambiguous or obscure, a construction should be placed on them that is least restrictive of the individual's rights.[51]

Under the Act, there are certain penalties enumerated for failure to deduct tax at source under Chapter XVIIB. One of the most significant penalties imposed is that the assessee is treated as an assessee-in-default under §201 in case he defaults on TDS payments. Further, 271C stipulates a penalty of the amount of tax which has not been deducted. Various other sections also impose penalties which are in the nature of civil fines.[52] §276B in particular is extremely stringent as it enforces a penalty of rigorous imprisonment for a term which shall not be less than 3 months but which may extend to 7 years and with fine. This is

---

[49] *See* Saurabh Soparkar, *Interpretation of Penal Provisions under Direct Taxes*, available at http://www.itatonline.org/interpretation/interpretation14.php (Last visited on October 2, 2010). *See also*, *State of West Bengal vs. Kesoram Industries Ltd., (2004) (266 ITR 721); Cape Brandy Syndicate vs. IRC; 1921 (1) KD 64, 71. See also* Somendra Chandra Bose, *Interpretation of Revenue Statutes*, available at http://www.itatonline.org/interpretation/interpretation6.php, (Last visited on October 2, 2010).

[50] Tuck v. Priester, (1887) 19 QBD 638.

[51] *See* John L. Freeze, *Extraterritorial Enforcement of Revenue Laws*, 23 Wash. U. L. Q. 321 (1937-1938); Lawrence Robertson, *Extraterritorial Enforcement of Tax Obligations,* 7 Ariz. L. Rev. 219 (1965-1966); Robert A. Leflar, *Extrastate Enforcement of Penal and Governmental Claims,* 46 Harv. L. Rev.193-225 (1932); B.J. George, *Extraterritorial Application of Penal legislation*, 64 Mich. L. Rev 609-638 (1966).

[52] *See* The Income Tax Act, 1961, §221 read with §§201; 272A(2)(c); 272A(2)(g); 272A(2)(i).

enforced when there is failure to pay the tax deducted at source under Chapter XVII-B to the credit of Central Government. Thus, failure to deduct tax at source under § 195 can lead to such a harsh penalty as well.

Furthermore, another roadblock in this respect is that of enforcement. Enforcing such penal provisions against non-residents can prove to be an area of difficulty for the income tax department as well as the other authorities in question.

Thus, it is observed that in light of these penal provisions, which are both civil and criminal in nature, it would be quite unfair to tax payments made outside India by non-residents to other non-residents. It would attract international denigration and can prove to be harmful to India's growth in the global corporate market.

VI. CONCLUSION

The article aims to present a critique of the Bombay High Court's judgment. Whether it is using the explicit test of chargeability or the implicit test of nationality, the Vodafone transaction should not be subject to taxability in India.

As is argued in this paper, on determining the legal nature of the transaction, the transfer of the contractual rights, do not come within the definition of the transfer of a capital asset in India, and hence, the transaction lacks the necessary territorial nexus with India.

The authors have a more serious concern with the Court's rejection of the second and implicit test of nationality. While interpreting §195, care must be taken to not make it over-inclusive in nature. It is indeed difficult to accept the wide interpretation of the Bombay High Court because this would have seemingly unfavourable consequences for many cross-border mergers and acquisitions. The authors believe that including payments from non-residents to other non-residents is not in tune with the accepted intention and purpose of the statute and principles of interpretation.

Thus, it is suggested that the both tests be utilised in determining the applicability of §195 of the Act. This is a crucial issue for the reason that the Bombay High Court verdict is likely to be a negative for companies like Vedanta, Seas Goa, Idea, AT&T, General Electric, Genpact, Fosters, SAB Miller and other future cross-border merger and acquisitions and private equity deals. Therefore, in light of these practical exigencies and principles of law, it is hoped that the Apex Court verdict will settle doubts on this important area of law.