

Tax Hotline

January 30, 2008

AN UPDATE ON THE RECENT INTERNATIONAL TAX RULINGS IN INDIA

1. *The Supreme Court rejects the review petition of the revenue in the case of Morgan Stanley*

The Supreme Court of India ("Supreme Court") dismissed the review petition filed by the Income-Tax Department ("Revenue Authority") in the case of Morgan Stanley & Co. U.S ("Morgan Stanley")^[1], relating to taxation of back office operations of foreign companies in India. Thus, the favourable ruling in the case of the outsourcing industry has become the law of the land in India.

The Revenue Authority by means of a special leave petition ("SLP") had initially challenged the ruling of the Authority for Advance Rulings ("AAR")^[2], wherein the AAR had ruled that captive service provider would not form a permanent establishment ("PE") of Morgan Stanley.

The SLP filed by the Revenue Authority was disposed off by the Supreme Court^[3]. While disposing the SLP, the Supreme Court held that services rendered by personnel of the parent company on deputation to the captive service provider would constitute a PE. However, if the personnel of the parent company were engaged in stewardship activities in the captive group company, then the same would not constitute a PE in India. Further, the Supreme Court also held that an arm's length relationship between a non-resident enterprise and its PE in India absolved the non-resident enterprise from any further profit attribution.

The SC entertains review petitions against its own rulings in very rare cases. The dismissal of the Revenue Authority's review petition brings with it the much need certainty that was required in relation to taxation of back office operations of foreign companies in India.

2. *The Vodafone Saga!*

The Writ Petition filed by Vodafone Essar Limited ("Company") before the Bombay High Court Division Bench ("High Court") against the show cause notice issued by the Revenue Authority is currently sub-judice. The Revenue Authority via the show cause notice had raised a tax demand of approximately US\$ 2.1 billion from the Company.

Hutchison had sold shares of its Cayman Islands holding company to Vodafone International Holdings BV ("Vodafone International"), a Dutch Company. The Revenue Authority alleged that Vodafone International had indirectly acquired the beneficial interest in the Company and it would get ownership and control of assets in India. The Revenue Authority also alleged that the Company had a Business Connection with the seller i.e. Hutchison and hence gains earned by Hutchison would be subject to capital gains tax in India. Since Vodafone International had failed to withhold the tax at source, its Indian subsidiary was held to be its 'agent' and an 'assessee (taxpayer) in default'.

The Revenue Authority raised a preliminary objection on the ground of maintainability of the Writ Petition. Writ Petitions are normally entertained inter alia only if all alternative remedies are exhausted or there is prejudice in the minds of revenue. Presently, the High Court has put a stay on the the tax demand raised from the Company and fixed the matter for final hearing on March 10, 2008. A similar case has also been initiated by the Revenue Authority in the case of Genpact, which was the captive outsourcing subsidiary of GE. GE sold a part of its stake to private equity investors. Genpact has filed a Writ Petition which is scheduled to be heard by the Delhi High Court in early February.

This case will have a significant bearing on many inbound investment structures where shares of overseas holding companies are transferred.

- Vivek Mimani, Dhruv Sanghavi & Bijal Ajinkya

[1] (2007) 7 SCC 1

[2] <http://www.nishithdesai.com/tax-hotline/2006/Tax-hotline-Feb22-2006.htm>

[3] <http://www.nishithdesai.com/tax-hotline/2007/Tax-hotline-Jul-9-2007.html>

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