Funding the Future

The Vodafone India decision - and what we can learn fro...

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I wrote the following article for the Indian tax website Taxsutra, but I'll share it here. It does, of course, consider India's recent loss in its case against Vodafone:

The Supreme Court decision in the recent Vodafone case must be considered a body blow for Indian taxation, India as a whole and the necessary onslaught on tax haven abuse that I and many others are involved in.

First, it is important to note that this was always an unusual case: Vodafone was being sued for tax which it was said it should have withheld from a payment it made to Hutchison Essar Limited for a stake in that company's Cayman subsidiary that in turn owned its Indian mobile phone operations. Vodafone did not, as a result, ever make a profit in this matter: it was being sued for tax that might have been due by a third party if that third party had made its gains in India. It did not make that gain in India for what might (to simplify matters) be considered a straightforward reason, and that was because it had ensured that ownership of the Hutchison Essar mobile phone network in India was not recorded in India at all, but in the Cayman Islands. The claim was Vodafone should have withheld the tax due on the capital gain as a result.

The ruling on this case is over 250 pages long and cannot all be considered in detail here. What is interesting to me is the discussion on whether the structure used by Hutchison was reasonable tax planning or an unreasonable arrangement subject to challenge by India. The principles on which this decision was made where all defined in English taxation law and effectively required comparison of three cases and the principles within them. Everything effectively turned on whether the legal form of the transaction in Cayman should prevail or its substance in India should be taxed.

The first critical case considered was, as a result, the 1936 decision in what has become known as the Duke of Westminster case. In this now notorious decision the House of Lords defended the right of a person to arrange their affairs howsoever they wished so long as it was legal and there was, they said, nothing the tax authorities could do to challenge the outcome in that case. This is in turn built on an 1869 decision which confirmed that tax in the UK has to be charged in accordance with "law"[1] as a result of it being said in the House of Lards that:

If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, 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. In other words, if there be admissible, in any statute what is called an equitable construction, certainly such a construction is not admissible in a taxing statute.

This was the issue at stake in the Westminster case, and this was the matter also at stake in the Ramsey and Dawson cases from the 1980s also discussed in the decision on Vodafone, both of which were considered to have to some degree over-turned the Westminster ruling (although with subsequent restrictions also being applied in the UK, it should be noted). The unfortunate fact is that the judge in this case has, I think, clearly favoured Westminster over Ramsey, calling the latter a simple ruling on interpretation and treating the former as being law. Given the facts of this case, and their relative similarity with Dawson, that is surprising, but it seems he refused to see beyond the law of contract and address the underlying issue as both Ramsey and Dawson allowed.

In that case his failure to interpret the law in what seems to me to be the correct way leads us straight into consideration of whether India now has need for a general anti-avoidance rule (GAAR).

If all tax were about one action and one consequence then tax law would be easy, and determining if tax law applied or not would generally be relatively straightforward. But some tax is not like that at all. Aggressive tax planning is about putting together a string of transactions, each legal in their own right (or they would not be tax avoidance but would become tax evasion) but with the series, in combination, achieving a result quite different from that which parliament might ever have intended. It is this unintended outcome in combination that a GAAR is designed to tackle, especially in those cases where, despite the best will of judges, there is nothing at all to make the resulting tax avoidance illegal.

Graham Aaranson QC has suggested the UK should have a limited form of GAAR. Personally, I would have liked him to go further: stopping the most egregious schemes a he suggests such a GAAR should be limited to is not, in my opinion, enough. I was consulted by Graham Aaronson during the course of his review.

What is more worrying is that I am not sure as yet that Aaranson's tackled the biggest problem, internationally, with these GAARs, and that's simply whether or not the judges will embrace them or not. In Australia they by and large have and so they've made some gains. In Canada the judges virtually refused to operate a GAAR. The result has been a GAAR that's failed to deliver. All of which has always left me thinking that an essential component of a GAAR is a change to the basis on which tax law is interpreted from a legal (literal) basis to an equitable (common law) basis.

The Australians almost got there (but not for tax) a long time ago with their law of 1901 [2] *on legal interpretation which said:*

In the interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object.

This seems to get to the very core of the problem in the Vodafone case. It seems to me that what we want our judges to do when looking at tax law is to assess the substance of the transaction and to ignore its form. The result has a massive advantage: it is about as comprehensible as most law can ever be. If the man on the Clapham Omnibus could see that the substance and form of the transaction were the same (an asset in India is sold and tax is payable in India) then they'd know they would have complied with the law. If the substance and form do not coincide i.e. an asset is sold in India and tax is payable, if at all, in Cayman, they'd know they were in trouble. What can be more certain that that?

Ancient law, designed in an age of steam ships, is crippling India as it is crippling other countries in the age of the internet. It's time we changed these laws now. Only that way can we get tax justice — and that's a situation where the right amount of tax (but no more) is paid in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes.

[1] *Partington v. Attorney-General* (1869), L.R. 4 E. & I. App. 100, *per* Lord Cairns at p. 122.

[2] *Section 15 AA of the Acts Interpretation Act, 1901 downloaded from http://www.austlii.edu.au/au/legis/cth/consol_act/aia1901230/s15aa.html*