

PIERCING THE CORPORATE VEIL: THE INDIAN SCENARIO POST VODAFONE



While the Supreme Court's ruling in ***Vodafone International Holdings B.V. V/S Union of India*** has been greeted with relief by foreign investors, it has left plenty of room for revenue authorities to pierce the corporate veil in the future.

In Good Company

The company is presently one of the most widely preferred modes of business organisation due to several advantages that it has enjoyed over other forms such as sole proprietorship and partnership. One of the major attractions of incorporation is the limitation of liability of a shareholder to a pre-determined amount, namely contribution to the company's capital. This has been given effect by recognizing the company as a juristic person in its own right, having an identity distinct and separate from that of its shareholders.

The Doctrine Of The Corporate Veil

Among the best illustrations of the principle of the

corporate veil, wherein the legal fiction of the company as a juristic person is recognized so as to separate the actions, rights and liabilities of the company from its shareholders or officers, is that of the seminal English case of ***Saloman V/s A. Saloman & Company Limited*** decided by the House of Lords in 1897. By refusing to permit the primary shareholder to be made liable for the debts of the insolvent company, thereby overturning the decision passed by the Court of Appeals, it gave judicial recognition to the proposition that incorporation bestows upon the company a separate personality independent of its shareholders, which cannot be considered as acting as an agent for them. The **Salomon** principle has been duly recognized as a basic canon of company law in India, both by the judiciary as well as legislators, with the doctrine of the corporate veil enshrined in the Companies Act, 1956.

Piercing The Corporate Veil

The ramifications of this doctrine are far reaching and, over time, a need was felt to curb its scope. This was due to the fact that the company form was increasingly being deployed in complex structures and transactions to avail various benefits intrinsic to this structure. For example, if the recognition of a separate corporate personality was absolute, a specific obligation placed on an individual could be overcome by the incorporation of a company having such person as the majority shareholder. Further, companies could then restrict their liability to a bare minimum by forming a series of shell companies having little or no assets or use subsidiaries to indulge in illegal or prohibited activity.

Courts sought to remedy this by making carve outs to the **Salomon** principle whereby, in certain circumstances, it is permissible for the corporate veil to be 'pierced'. That is, the artificial persona enjoyed by the company in the eyes of the law would be disregarded and the shareholders or directors/ officers behind the company could be imputed with the actions of the company and be obliged to share the burden of obligations and liabilities of the company. However, it is important to emphasize the fact that courts across jurisdictions have always regarded the doctrine of piercing the corporate veil as an exception rather than the norm.

Looking Through The Artificial Persona

The Indian Supreme Court in **Kapila Hingorani V/s State of Bihar** held that the corporate veil which separates an entity vis-à-vis its shareholders could be lifted when the corporate personality was found to be 'opposed to justice, convenience and interest of the revenue or workman or against public interest'. The apex court in **State of Uttar Pradesh V/s. Renusagar Power Company**, in observing the difficulty of confining the scope and



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applicability of this doctrine within predetermined boundaries, stated that it was neither necessary nor desirable to enumerate the classes of cases where lifting the veil is permissible, since that would necessarily depend on a host of disparate factors including the relevant provisions of the applicable statute/ regulation, the object sought to be achieved, the impugned conduct of the company, the involvement of public interest and its effect on parties.

Although this doctrine has been invoked across a wide spectrum of legal fields spanning tortious liability, contractual, criminal and even constitutional law, it is most frequently cited in the realm of taxation. While the Income Tax Act, 1961 does not contain any statutory provision for lifting the corporate veil, Indian courts have in the past permitted revenue authorities to look through the legal structure adopted by an assessee company to reveal whether the economic reality of such a facade amounts to tax evasion.

The Vodafone Controversy

A recent instance of drawing back the corporate veil in the context of tax assessment was **Vodafone International Holdings B.V. V/s Union of India** where the company challenged a show cause notice issued by the revenue authorities who claimed that the indirect transfer of 67% of shares of Indian entity Hutchinson-Essar caused by purchase of 100% shares of another offshore company would attract payment of capital gains tax in India to the tune of rupees twelve thousand crores. Vodafone argued that as all the concerned parties—namely the purchaser, the seller and the target of acquisition were companies incorporated abroad, the Indian revenue authorities had no jurisdiction to demand tax on the same. By ignoring the existence of multiple entities separating the parties and ascribing the motive for purchase of shares of one company as being the acquisition of another, the authorities

had undertaken a large scale exercise of lifting the corporate veil.

Takeaways From The Vodafone Decision

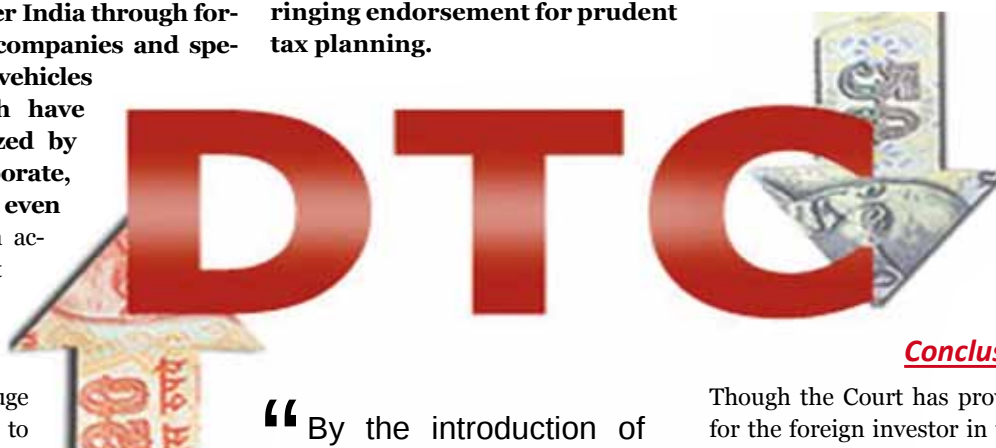
A three judge bench of the Supreme Court ruled in favour of the company, thereby overturning the decision of the Bombay High Court which had pierced the corporate veil in arriving at the conclusion that the transaction of acquisition of shares of the offshore target company amounted to transfer of controlling stake of the Indian entity of Hutchinson-Essar. **In stark contrast, the opinion of Chief Justice Kapadia stated that it is common for foreign investors to enter India through foreign holding companies and special purpose vehicles (SPVs), which have been recognized by Indian corporate, securities and even tax laws.** Such acknowledgement of the legitimacy of this practice will come as a huge source of relief to the foreign investment community as a whole.

As per the majority opinion, the courts would only pierce the corporate veil if the tax authorities could establish that the transaction was not within the four corners of the law but 'sham or tax avoidant' in nature. The Court stated that the approach to be adopted by the department is to determine the dominant purpose of a structure/transaction by paying heed to certain indicators. These include the duration of the holding structure, the period of business operations and generation of taxable revenue in the Indian domestic economy as well as the timing of the exit and continuity of business after exit. By listing the above factors, the Court has reduced the discretion of tax authorities for piercing the corporate veil.

Based on the above mentioned factors and the facts of the case in hand, if the transaction appears to be colourable then revenue authorities can make a case for courts to disregard the form of structure adopted by foreign investors. However, even in such a situation it cannot seek to scrutinise every stage of the transaction in isolation for commercial substance, a threshold which few present day structures would successfully manage to clear. **Tax liability is a major consideration in structuring cross border deals. By recognizing the validity of structures that legitimately enable parties to avail of tax benefits, the Vodafone decision should be read as a ringing endorsement for prudent tax planning.**

a structure/ transaction as an impermissible avoidance arrangement provided it fulfils certain criteria such as not being *bona fide*, lacking commercial substance, abuse of provisions of the DTC and not being conducted at arm's length.

The introduction of GAAR provisions have led to a fair bit of anxiety in corporate circles as it seems to simplify the process of lifting the corporate veil in the context of tax assessment due to the vast variety of transactions which can be construed to fall within its ambit as well as the shifting of the burden of proof to the assessee.



Conclusion

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The Road Ahead - The Spectre Of The DTC

By the introduction of the Direct Taxes Code (DTC), India seeks to overhaul its existing tax laws by making it simpler and more concise. A sea change under the proposed regime would be the introduction of the General Anti-Avoidance Rules (GAAR) which, based on the current draft, would render it legally permissible for tax authorities to pierce the corporate veil and classify

Though the Court has provided relief for the foreign investor in the present instance, it has left plenty of room for revenue authorities in the future to pierce the corporate veil and to look at transactions involving non-residents, with an Indian connection, based on guidelines which are capable of multiple interpretations. With the recent budget proposal to clarify the law as it currently stands and the frequency of seeing through the corporate veil seemingly on the rise, legal counsel will be required to ensure that deals are structured in a manner to safeguard their clients from the scrutiny of the taxman.



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