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Multinationals Brace for India Ruling on Vodafone

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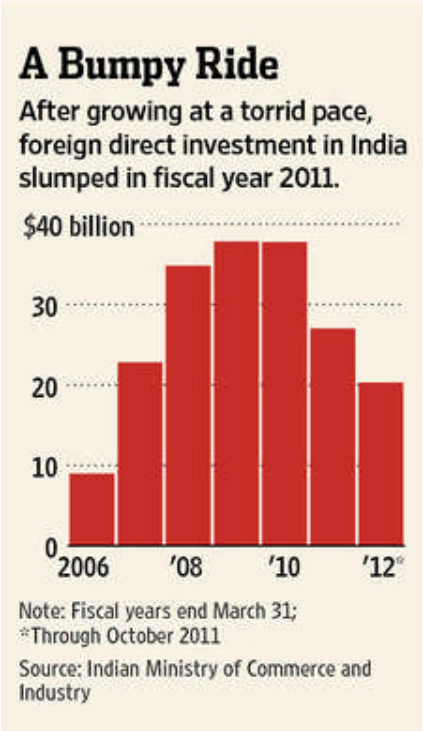
NEW DELHI—It wasn't long ago that India was hailed as one of the world's most promising growth markets. But mercurial regulation, stifling bureaucracy and slower economic growth have shaken foreign companies' confidence about making big investments here.



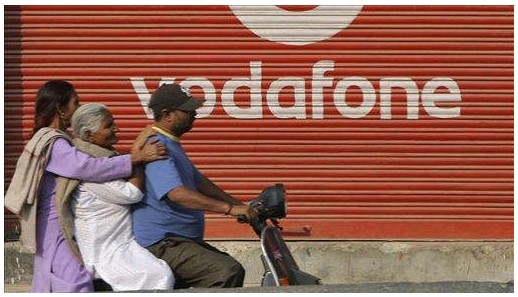
Now a case at the country's highest court threatens to make the climate chillier still.

India's Supreme Court is preparing to issue its decision on whether U.K.-based Vodafone Group PLC must pay about $2.6 billion in taxes on an $11.1 billion deal it struck in 2007 with a unit of Hong Kong's Hutchison Whampoa Ltd. to enter India.

A Vodafone loss would damp cross-border mergers and acquisitions here, many deal experts say, rendering standard transaction structures too risky and forcing foreign companies to weigh potentially new litigation and insurance costs. Some companies might simply decide that India isn't worth the headache. A ruling is expected in weeks.

If the decision goes against Vodafone, investors will "think twice before going for opportunities in India," says Mahesh Kumar, an M&A lawyer at Nishith Desai Associates who advises foreign clients. "It could severely damage the entire investment scene." His firm provided advice to Vodafone at the lower-court level.

Vodafone has said India doesn't have jurisdiction to tax the Hutchison deal because it was structured as a transaction between two overseas entities. The government says it has authority because the underlying asset was Indian.



WSJ's Amol Sharma has details of a pending decision from India's Supreme Court regarding Vodafone's tax liability stemming from a 2007 deal. REUTERS/Mukesh Gupta

Several other companies, including AT&T Inc. of the U.S. and Britain's SABMiller PLC, are fighting similar tax claims and Indian authorities have been handing out tax notices to other companies, deal lawyers say.

A tough stance on corporate taxes would add to a passel of developments that have caused many companies to sour on India.

Opinion

New Delhi's Reformettes: India's Prime Minister Thinks Small

The government last month reversed its decision to allow multibrand foreign retailers, such as U.S.-based Wal-Mart Stores Inc. and the U.K.'s Tesco PLC to invest in India. The flip-flop quashed what would have been a turning point in business here and left many foreign companies questioning whether they can trust New Delhi's future promises. (Single-brand retailers, such as Nike Inc. and IKEA, are permitted to invest, and New Delhi on Tuesday removed a 51% ownership cap for them.)

Meanwhile, exiting investments in unlisted businesses is getting tougher for foreign companies. India's central bank is threatening to block deals in which closely held Indian businesses are contractually required to buy back shares from foreign investors, usually because the Indian companies haven't met performance benchmarks. The Reserve Bank of India says such arrangements amount to equity-derivative transactions, from which foreign firms are barred.

Agence France-Presse/Getty Images

Germany's Fraport AG has a stake in Delhi's airport, above, but has been stymied elsewhere in the country

That comes against the backdrop of an economy that has lost some steam. Gross domestic product, once projected to increase 9% in the fiscal year ending March 31, is now expected to rise at a 7% pace or slower. And interest-rate increases are crimping corporate investment. Corruption scandals also have left bureaucrats afraid of making decisions for fear of being investigated later.

After a net inflow of $29 billion from foreign investors in Indian stocks in 2010, there was a $540 million net outflow last year, one reason the country's benchmark index sank 25% last year.

India says it remains committed to attracting foreign investment and that foreigners' confidence will increase as the economy recovers. "They pick up the mood of domestic industry," says Kaushik Basu, India's chief economic adviser. Foreign direct investment plunged in fiscal 2011, but Mr. Basu says he expects a strong rebound for the current year. On Wednesday, a government panel recommended allowing foreign airlines to acquire up to 49% of domestic carriers.

Mixed Messages

Foreign firms have had a variety of experiences in India. Examples:

Huawei Technologies: Chinese telecom-gear maker drops plans to set up factory as demand weakens

Boeing/Pratt & Whitney: Defense Ministry agrees to acquire 10 C-17 cargo aircraft from U.S. firm; U.S.-based Pratt & Whitney wins engine contract on four of the planes

Vedanta Resources: U.K.-based company waits 15 months for approval to buy 30% stake in oiland-gas company Cairn India

Fraport: Frankfurt-based airport operator, which has 10% stake New Delhi's airport, says it may close its New Delhi office as privatization of other Indian airports bogs down

Mr. Basu says foreign multibrand retailing could be reconsidered this year. "It still has a decent chance, but has to be tweaked a bit," he says.

For now, though, many companies are gloomy.

"Two years ago we had high expectations and those have evaporated," says Ansgar Sickert, managing director of Fraport India. Its parent, Frankfurt-based airport operator Fraport AG, has a 10% stake in the joint venture that owns Delhi's airport. But government promises to privatize other existing airports have fizzled.

"There has been a lot of talk—a lot of deadlines come and go—but nothing concrete is happening," Mr. Sickert says. Fraport in response has shifted its focus to Brazil and is likely to close its Delhi office later this year, he says.

The Civil Aviation Ministry didn't respond to requests for comment.

Germany's Würth Elektronik GmbH, which makes circuit boards used in an array of products including cars and cellphone towers, in 2006 set out to build a plant in India's southern state of Karnataka but still hasn't been able

to acquire land.

"There are so many bureaucratic hurdles and procedures—you get muddled and stuck," says Harsha Adya, a Würth executive in India. The company says it refused to use middlemen to pay off bureaucrats to speed matters along—something many Indian entrepreneurs consider a cost of doing business.

Würth, meanwhile, has built a 200-acre industrial park in China, where government officials have sought investment from the company, Mr. Adya says.

The state agency that reviews investment and land-acquisition proposals in Karnataka didn't respond to requests for comment.

Not all companies are losing faith in India.

Ford Motor Co. Chief Executive Alan Mulally says the auto maker remains optimistic about India. Ford in July announced plans to invest nearly $1 billion in a new factory in the western state of Gujarat, the company's second plant in India. "This is about serving Indian customers and we are more bullish about that than ever," says Mr. Mulally, in town for a trade show this month.

But executives at other firms voice frustration. BP PLC in August closed a $7.2 billion deal to acquire stakes in oil-and-gas exploration blocks controlled by India's Reliance Industries Ltd. Last month, however, BP Chief Executive Bob Dudley complained to Indian Petroleum Minister Jaipal Reddy about bureaucratic delays.

"I am deeply concerned that unless we get approvals and permits to begin these seabed surveys this December, we will lose a year in our goal of bringing materially new amounts of gas to the Indian market," Mr. Dudley wrote, according to a copy of a letter reviewed by The Wall Street Journal. It isn't clear whether the U.K.-based company ultimately got the approvals. The company declined to comment for this article. An Oil Ministry spokesman said he couldn't comment.

Coming after such hurdles, the Vodafone tax case has taken on heightened significance.

Corporate lawyer Rajiv Luthra says a Vodafone loss would place India in contrast to most other countries, which don't tax deals involving two overseas entities, and could encourage India to tax deals that hadn't been in its jurisdiction. "It's a slippery path," the Luthra & Luthra managing partner says.

Some deal lawyers say a ruling against Vodafone might not be so dire. "Foreign investments are made not on tax policies, but on long-term prospects for growth," says tax lawyer H.P. Ranina. Others say that even if Vodafone loses, an unambiguous ruling at least will provide clarity.

Even if Vodafone prevails, however, its four-year trek through India's courts can serve as a cautionary note.

The case stems from Vodafone's 2007 purchase of a controlling stake in Indian mobile-phone company Hutchison Essar Ltd. Since a Dutch subsidiary of Vodafone acquired a Cayman Islands company that held Hutchison Whampoa's India assets, Vodafone says India doesn't have tax jurisdiction.

Indian authorities argue that since the underlying asset was an Indian cellphone company, the deal is taxable here.

A Mumbai court sided with Indian tax authorities last year, prompting Vodafone's appeal to the Supreme Court.

A Vodafone spokesman declined to comment. A spokeswoman for India's tax department couldn't be reached.

—Rakesh Sharma contributed to this article.

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