NEW DELHI—India's Supreme Court on Friday ruled that Vodafone Group PLC isn't liable to pay taxes on the deal it struck to enter India in 2007, delivering a major victory to the British telecommunications giant and providing some encouragement to foreign companies that are concerned about the country's investment climate.

The court's decision means that Vodafone won't have to pay more than $2 billion in taxes on its $11.2 billion acquisition of a controlling stake in an Indian cellphone company from Hong Kong's Hutchison Whampoa Ltd. Indian authorities don't have jurisdiction to tax the deal because it was structured as a transaction between two foreign entities, a three-judge panel of the court said.

The verdict, which overturns a ruling by a lower court in Mumbai, comes after a four-year legal fight by Vodafone in India. The tax case became a symbol for many foreign investors of the uncertainty of doing business in India, the unpredictability of regulators and the risks foreign firms face if they decide to make big bets on Indian growth.

In a statement, Vodafone Chief Executive Vittorio Colao said: "We are a committed long-term investor in India and we have made clear all along that we have faith in the Indian judicial system. We welcome the Supreme Court's decision, which underpins our confidence in India. We will continue to grow our
India's Supreme Court ruled Vodafone doesn't have to pay more than $2 billion in taxes for its acquisition of a controlling stake in an Indian cellphone company. Above, a man leaves a Vodafone store in Mumbai on Friday.

Indian business."

The court directed the tax department to refund the 25 billion rupees ($500 million) that Vodafone, the world's biggest wireless-service provider by sales, had deposited, along with 4% interest.

Indian tax authorities can file what is known as a "review petition" to seek clarifications from the court on some aspects of the case, but haven't decided whether to do so, said Mohan Parasaran, counsel for the tax department.

The Vodafone case took on heightened significance amid a broadly grim climate for foreign investment in India. The ruling will be a boost for India as it tries to convince companies to pour more money into the country. Still, foreign companies will want to see New Delhi take other steps, such as following through on promises to further open the retail sector to foreign investment and speed up permits and approvals for big projects.

Vodafone's rapid-fire expansion into emerging markets, which former CEO Arun Sarin engineered over half a decade before stepping down in 2008, has become a cautionary tale for European companies chasing growth in the developing world. Vodafone plunged quickly into India, Egypt, Ghana and Turkey—alluring high-growth markets whose unpredictability has turned out to pose deep challenges for the company.

Cyril Shroff, managing partner of Indian law firm Amarchand Mangaldas, said the Vodafone decision was a surprise in the Indian business world, where many people had assumed that the Supreme Court would uphold the Mumbai High Court's earlier decision and side with Indian tax authorities. "It's a strong indication of an independent judiciary, despite all the noise on the street and the fact Vodafone had lost in the High Court," Mr. Shroff said.

Mr. Shroff said the verdict provides much-needed clarity for foreign investors who had become skittish about doing major deals in India with so much tax uncertainty. "It was becoming a big issue—just the fact that something could hit you like a bolt from the blue in India," Mr. Shroff said. Vodafone has said the legal advice it received in India indicated it wouldn't be taxed on the Hutchison deal.

Mukesh Butani, chairman of consulting firm BMR Advisors, said the decision delivered an important critique of India's murky laws in areas such as taxes. "Certainty is an integral part of the rule of law and the government needs to make laws that give a clear picture to investors," Mr. Butani said. BMR said Vodafone is one of its clients but it didn't provide advice to the firm on the Supreme Court case.

The Vodafone case comes as the government of Prime Minister Manmohan Singh is trying to reverse a worrying slowdown in economic growth by boosting both domestic and foreign investment. Growth in gross domestic product, once expected to be 9% in the year ending March 31, is now forecast to be about 7%, still high by international standards but not enough to accomplish major objectives like rapid infrastructure development and programs to alleviate poverty. Mr. Singh is planning a range of measures to jump-start growth, including encouraging state-run firms to make major infrastructure investments and streamlining regulations in the power sector. The government is also expected to consider opening up the aviation sector to investment by foreign airlines.

And it will likely reconsider a move to allow in foreign retailers like Wal-Mart Stores Inc. Late last year, the
government approved a change that would allow 51% foreign ownership in Indian supermarkets and department stores, but then reversed itself days later under pressure from a major coalition ally.

The 2007 Vodafone deal was structured as a transaction between the firm's Dutch subsidiary and a Cayman Islands-based company that held Hutchison Whampoa's India assets.

The Supreme Court agreed with Vodafone that the deal isn't subject to capital gains tax—and Vodafone therefore had no obligation to withhold tax—even though the main asset changing hands was a controlling interest in an Indian cellphone company. The court's decision said taxing Vodafone "would amount to imposing capital punishment for capital investment."

The offshore transaction is a "bona fide" structure, Chief Justice S.H. Kapadia said while issuing the verdict. The judge said the fact that Hutchison's Cayman Islands unit was in place for several years before the deal suggested that the deal structure wasn't created with the purpose of sidestepping taxes.

The landmark ruling is a defining moment for Chief Justice Kapadia, who has guided the court through a tumultuous time in India since taking over in May 2010, asserting the court's role to oversee investigations into corruption and large-scale tax evasion. He brought to the case an expertise in tax and finance law honed through handling many corporate cases as a judge over the years. "He is someone who understands how the law affects businesses," said Nick Robinson, a visiting fellow at the Center for Policy Research, a think tank in New Delhi.

Lawyers said the ruling upheld a principle that many countries follow but that India didn't—that tax authorities should concern themselves only with the corporate structure or "form" of a merger deal, not the substance of what assets are changing hands. The upshot of that approach is that India doesn't have jurisdiction in tax deals like the Vodafone one.

"It really clears the air for a number of foreign direct investors whose deals are pending because they had similar structures to Vodafone and were concerned about this," said Akhil Hirani, managing partner of law firm Majmudar & Co.

Dinesh Kanabar, chairman of the tax practice at KPMG India, said the verdict will also help many other companies that are facing Indian tax demands similar to Vodafone's, including AT&T Inc. and SABMiller PLC. "It's a significant precedent for every single case," he said.

Vodafone, which bought out Indian joint venture partner Essar Group last year, has had a rough time in the country. Of Vodafone's 391 million mobile phone customers globally, more than 146 million are in India, but that hasn't translated into huge profits. For the fiscal year ended last March, Vodafone's India operation generated $3.86 billion in revenue but just $15 million in operating profit.

The company was forced to book a $3.4 billion impairment charge on its Indian operations in May 2010 due to tough competition from more than a dozen mobile rivals. Meanwhile, Vodafone has been pouring cash into India. Between the 2007 acquisition and its investments in mobile-phone spectrum and cellular-network infrastructure, the company has invested more than $26 billion.

Though its Supreme Court victory on Friday represents a major success, Vodafone has spent sizable sums fighting the case and has also brushed up against other serious challenges there since entering the Indian market in 2007. Not long after Vodafone entered, a major Indian regulatory shift led to the sudden entry of six new competitors in the mobile market, triggering a price war that caused Vodafone to write down its initial $11.1 billion investment by about a third.

Vodafone has also suffered serious write-downs on its businesses in Turkey and Ghana due to adverse changes in the macroeconomic assumptions the company made when sizing up acquisitions in the markets. Investors eventually became fatigued with Vodafone's rapid global expansion. Its CEO, Mr. Colao, has taken the hint and announced plans to concentrate the company in Europe, India and sub-Saharan Africa rather than expanding elsewhere.
The challenges posed by emerging markets haven't been limited to Vodafone's balance sheet. In Egypt, for example, Vodafone took heat last year when government forces shut down its operations during the Arab Spring and later used its mobile network to send out pro-regime propaganda messages via text.

Despite the volatility, however, Vodafone's emerging-markets exposure has soothed investors as European markets such as Spain, Italy and Portugal have become a drag on the company amid the European debt crisis and sluggish economic climate.

In the year ended March 31, 2011, Asia, the Middle East and Africa region—which does not include Turkey—comprised almost a third of Vodafone's global service revenue of £42.7 billion ($66.1 billion). As service revenue in Europe dropped 3.4% on a reported basis during the fiscal year, revenue in Asia, the Middle East and Africa skyrocketed 20%. In India alone, service revenue surged by 23.9% on a reported basis.

—Lilly Vitorovich, Romit Guha, Shefali Anand and Paul Sonne contributed to this article.

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