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Supreme Court confirms validation of demerger of passive infrastructure assets by Vodafone Essar Gujarat Limited

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Executive Summary

Supreme Court (SC) has dismissed the Special Leave Petition (SLP) filed by Income tax authorities (Revenue) against the Gujarat High Court (HC) ruling in Vodafone Essar Gujarat Limited. (Taxpayer)

- The issue under contention was whether a scheme of demerger of infrastructure assets (Scheme) between group companies for 'nil' consideration could be sanctioned under the provisions of the Income Tax Act.
 - The scheme was initially rejected by a single bench member of Gujarat HC based on the arguments put forth by Revenue that the scheme was framed as an attempt to evade tax and defraud Revenue by way of demerger to a conduit company.
 - On appeal by the Taxpayer, the divisional bench of Gujarat HC approved the scheme considering the commercial rationale and global practice followed in the industry.
 - On further appeal by Revenue to the SC for a reconsideration of the issue SC dismissed the SLP.

Facts

- The Taxpayer along with other group companies (collectively referred to as the Taxpayers), proposed to transfer their passive infrastructure assets without corresponding liabilities to Vodafone Essar Infrastructure Limited (Transferee) by way of demerger for nil consideration.
- Post demerger, the Transferee company was proposed to be amalgamated into Indus Tower Limited (ITL).
- Petitions were filed with the High Courts of Bombay, Madras, Calcutta, Delhi and Gujarat for approval of scheme and the same were approved by the High Courts of Bombay, Madras, Delhi and Calcutta.
- Revenue had filed objections to the demerger scheme before Gujarat HC wherein Gujarat HC rejected the scheme on the grounds that the sole objective of the scheme was tax evasion and the assets were demerged to a conduit company.
- Aggrieved by the decision of Gujarat HC, the Taxpayer appealed before the Divisional Bench of the Gujarat HC.

Issues before the Gujarat HC

- Whether the proposed scheme for demerger of assets was formulated with the sole objective of tax avoidance

Gujarat HC (Divisional Bench) Ruling

- The HC noted that the segregation of telecommunication services and telecommunication infrastructure business reflects the global trend and has been adopted by telecommunication companies in India without objection.
- The HC also noted that similar schemes were sanctioned by other High Courts and that the power of Revenue in respect of assessment, recovery of taxes and pending proceedings were not affected.
- HC acknowledged that even if the ultimate effect of the Scheme may result into some tax benefit/ saving, it cannot be said that the sole object of the Scheme is tax avoidance.
- Separately, in the instant case, it cannot be said that the majority of the shareholders wanted to confiscate the rights of the minority shareholders as no shareholder has raised any objection regarding such an arrangement. Therefore there is no question that the scheme is against public interest.
- In lieu of the above arguments and placing reliance on SC decisions in case of Vodafone International Holdings BV¹ and Azadi Bachao Andolan², HC concluded that since the scheme was approved by the shareholders, creditors and other regulatory authorities, the same stands approved under the provisions of Companies Act, 1956 while protecting the right of the Revenue to recover its outstanding dues irrespective of the sanction of the scheme. Accordingly it also observed that the pending proceedings against the Taxpayer shall not be affected in view of the scheme being sanctioned.

¹ 341 ITR 1

² 10 SCC 1

SC Ruling

- Revenue filed a SLP with the SC against the Gujarat HC ruling for it being referred to a larger bench. Revenue argued that the reasoning of the Gujarat HC was similar to that of the SC ruling in Vodafone tax matter which needed reconsideration, as it had not considered all the grounds filed by the Government in its review petition.
- SC dismissed Revenue's SLP against Gujarat HC. SC has, however, ordered that the Revenue is entitled to take appropriate proceedings for recovery of any tax statutorily due from the Taxpayers.

Comments

- The above ruling provides that exemption provision or tax savings forming part of any scheme of arrangement shall prevail provided it is supported by strong commercial and business rationale.
- It may be pertinent to note that the HC has reserved the right of the Revenue to initiate any proceedings with regard to any tax liabilities from the Taxpayers.
- Separately, it may not be appropriate to conclude on the validity of the scheme based on monetary consideration. The HC held that there is no bar which restrains a transaction being dealt with differently under separate statutes (viz under Companies Act 1956 and Income tax Act 1961).

Way forward

The aforesaid ruling has highlighted that the approval of a scheme of arrangement resides on its core ground of argument being a strong commercial and business rationale. In absence of the same, any exemption provision or tax benefit forming part of the scheme may result in challenges to obtain an approval for the scheme as the Revenue could raise objections with regard to the sole intention of the scheme being tax evasion.

Source: Vodafone Essar Gujarat Limited vs Department of Income tax [2012] 24 taxmann.com 323 (Guj.)
Department of Income tax vs Vodafone Essar Gujarat Ltd SLP No 29819/2012 (SC)

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