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[2019] 104 taxmann.com 145 (Article)/[2019] 44 CPT 665 (Article)

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Date of Publishing: March 19, 2019

## Telecom Industry - Income-tax perspective



**SURABHI BANSAL**

Director-Taxation, S.S. Kothari Mehta & Co.



**AGGARTA GUPTA**

Manager - Taxation, S.S. Kothari Mehta & Co.

### Introduction

1. Telecommunication has been one of the fastest growing sectors of the Indian economy, driven by affordable smart phones with high end technology, low price telephone, mobile and internet services and emergence of 4G networks. With the population of over a billion and growing, India is the second largest internet user base in world. No doubt, India is seen as key force for global business by various foreign telecommunication operators.

The fastest-growing industry is not left untouched by the hassles of income-tax litigations. In this article we aim to discuss on some of the resolved and unresolved income-tax facts affecting the industry.

### Characterisation of payment of Connectivity Charges

2. Connectivity charges are the charges received by a telecommunication operator towards telecom services which include transmission of data and voice, interconnection services, roaming facility, airtime charges, call charges, internet services, etc. The telecommunication provider renders such services with the help of the network/circuits which enable a user to transmit voice and data through telecommunication bandwidth. All forms of data services involve transmission of data through optic fibre cables or satellites or undersea cables and thereby entail payment of bandwidth charges.

There has been litigation on the issue as to whether connectivity charges are in the nature of Royalty, especially after insertion of the *Explanations* 5 and 6 in section [9\(1\)\(vi\)](#) and, therefore, liable for TDS. There are various judicial pronouncements where different views have been taken.

The AAR in ruling given in the case of *Dell International Services India (P.) Ltd.*, In re [2008] 172 Taxman 418/[2009] 305 ITR 37 (AAR) held that by availing of facility provided by foreign company through its network/circuits, there is no usage of equipment by the assessee. It is a case of the foreign company utilising

its own network and providing a service that enables the assessee to transmit voice and data through telecommunications bandwidth and, therefore, payment made by assessee to foreign company cannot be taxed as 'royalty' under the *Explanation 2* to section 9(1)(vi).

While a contrary view was taken by the Hon'ble Madras High Court in the case of *Verizon Communications Singapore Pte. Ltd v. ITO (International Taxation)* [2013] 39 taxmann.com 70/[2014] 224 Taxman 237 (Mad.) (Mag.) that the consideration received by the non-resident taxpayer from the Indian customers for provision of bandwidth/telecommunications services outside India was for the 'use of, or the right to use equipment' and, therefore, royalty under section 9(1)(vi) of the Act. Alternatively, the payments can also be considered for the use of process provided by the taxpayer and therefore, royalty under the Act.

A reference is also required to be drawn to the OECD commentary on Model Convention. It has been mentioned in the commentary that payments made under a typical roaming agreement will not constitute royalty since these payments are not made in consideration for the use of, or right to use property or for information as they cannot be viewed as payments for the use of or right to use a secret process since no secret technology is used or transferred to the operator. Therefore, the tax treaty does not consider payments made to foreign telecommunications operators towards connectivity charges as Royalty as per Article 12 of the tax treaty.

The Mumbai Tribunal in the decision of *B4U International Holdings Ltd. v. Dy. CIT (IT)* [2012] 21 taxmann.com 529/52 SOT 545 has held that payment of transponder hire charges paid to a foreign entity in India cannot be regarded as royalty under India-USA tax treaty. The Tribunal placed reliance on the Delhi High Court's decision in *Asia Satellite Communications Co. Ltd. v. DIT* [2011] 332 ITR 340/197 Taxman 263/9 taxmann.com 168. Further, the Delhi High Court in the decision of *DIT v. New Skies Satellite BV* [2016] 68 taxmann.com 8/238 Taxman 577/382 ITR 114 has held that insertion of the *Explanations 4, 5 and 6* to section 9(1)(vi) by the Finance Act, 2012 by itself would not affect the meaning of the term 'royalties' as mentioned in article 12 of India-Thailand DTAA.

It would be relevant to mention here that earlier Department has considered the payment of connectivity charges being in the nature of Fee for Technical Services (FTS). However, Courts have held that transmission of data does not involve any human intervention and services rendered with the help of machines cannot be termed as technical in nature. It is a standard facility and does not involve any technical services. However, a recent AAR ruling in case of *MasterCard Asia Pacific Pte. Ltd. in re* [2018] 406 ITR 43/94 taxmann.com 195 (AAR-New Delhi) cannot be overlooked wherein it has been held that even an automatic Master Card Interface Processor placed at customers' locations in India for processing of electronic payment transactions using Master Cards global network and infrastructure can constitute a PE of foreign company in India. It re-generates the question of taxability in such cases.

### **Taxability of charges paid for international interconnectivity through use of submarine cable system**

**3.** Under submarine cable system, a cable is laid on the seabed between land-based stations to transmit signals across stretches of ocean. The set-up cost involved in submarine cable system is huge. Therefore, generally such business is created as consortium by companies located in different countries. The telecom company located in a country owns the submarine cable network laid in that particular country.

The income-tax issues that arises under such systems is whether the consideration paid to foreign companies for acquiring submarine cable system capacity is taxable as capital gains or royalty?

In a ruling given by the AAR in the case of *Dishnet Wireless Ltd., In re* [2012] 24 taxmann.com 298/210 Taxman 644/353 ITR 646 (AAR - New Delhi) where payments were made to the foreign company for

acquisition of the cable capacity, it was held that as per the clarificatory amendment to Section 9(1)(vi) of the Income Tax Act (ITA), such payments made were for a right to use a process and a right to use commercial or scientific equipment and would, therefore, be taxable in India as "royalty" under the ITA. However, the Authority does not comment upon the taxability under tax treaty.

### **Clarification on nature of distributor's margin on SIM cards and prepaid vouchers**

4. The telecommunication operators appoint independent retailers/distributors for sale of SIM cards and prepaid vouchers. These retailers/distributors are generally small and operate in an unorganised sector. Telecom operators provide such SIM cards and prepaid vouchers to the retailers/distributors at a discount. There has been continuous debate and litigation going on the issue as to whether such discount is in the nature of commission income to retailer's distributors and, therefore, liable for TDS?

The Karnataka High Court in the case of *Bharti Airtel Ltd. v. Dy. CIT* [[2014](#)].[52 taxmann.com 31](#)/[[2015](#)] [228 Taxman 219 \(Mag.\)](#)/372 [ITR 33](#) has rendered the decision in favour of assessee. The Court held that discount being profit margin given to the distributors was to be realised by them on resale of such SIM cards to the ultimate customers. It was observed that the income of the distributor was the difference between sale price and MRP (as fixed by the service provider), which accrues to them only when they sell the services to the ultimate customers and not when they purchase the right to service. Thus, at the time of sale of a prepaid card by the assessee, no income had accrued to the distributor that was chargeable to tax. Accordingly, telecommunication service provider was not liable to TDS under section 194H on the amount of discount given to the distributor.

Similar view was taken in the following cases-

- ◆ *Bharti Hexacom Ltd. v. Asstt. CIT* [[2016](#)].[68 taxmann.com 357](#) (Delhi - Trib.)
- ◆ *Vodafone Cellular Ltd. v. Addl. CIT* [[2017](#)].[88 taxmann.com 917](#) (Pune-Trib.)
- ◆ *Vodafone Essar Gujarat Ltd. v. Asstt. CIT* [[2015](#)].[60 taxmann.com 214](#) (Ahd.-Trib.)

While a contrary view was taken by the Delhi High Court in the case of *CIT v. Idea Cellular Ltd.* [[2010](#)].[325 ITR 148/189 Taxman 118](#) wherein it was held by the Court that the essence of the service provided by the distributor is not a sale of any product or goods. The distributors are always acting for and on behalf of the assessee. Commission paid by cellular telephone company to distributors on sale of prepaid sim cards is liable to TDS under section [194H](#).

Similar view was taken in following cases-

- ◆ *Bharati Airtel Ltd. v. Dy. CIT* [[2013](#)].[40 taxmann.com 46](#)/[[2014](#)]. [61 SOT 111](#) (Cochin - Trib.) ([URO](#))
- ◆ *Bharati Cellular Ltd. v. Asstt. CIT* [[2011](#)].[12 taxmann.com 30](#)/200 [Taxman 254](#) (Cal.)
- ◆ *Cellular Mobile Telecommunications Services v. ITO* [[2013](#)].[31 taxmann.com 188](#) (Chennai - Trib.)
- ◆ *Tata Teleservices Ltd. v. ITO* [[2018](#)].[93 taxmann.com 22](#)/171 [ITD 196](#) (Delhi - Trib.)
- ◆ *Vodafone Essar Cellular Ltd. v. Asstt. CIT* [[2010](#)].[194 Taxman 518](#)/[[2011](#)].[332 ITR 255](#) (Ker.)

From above discussion, it is certain that the issue is highly contentious. Any clarification in this regard from the Board would be a welcome step which might bring many litigations to final conclusion.

### **Taxability of supply of software with embedded software**

5. Many telecommunication equipments are imported alongwith software forming an integral part of the equipment. The tax treatment of embedded software into the equipment is a frequently encountered issue with tax authorities as to whether the same could be taxed as 'royalty' in India?

The software embedded equipment imported by telecommunication operators is generally inseparable. The predominant nature is the import of equipment and not the software embedded in it. There are various judicial pronouncements wherein it has been held that purchase of equipment with embedded software cannot be taxed in India in the absence of territorial nexus. Reference in this regard may be made to the Delhi High Courts decision given in the case of *CIT (International Taxation) v. ZTE Corpn.* [2017] 392 ITR 80/245 Taxman 252/77 taxmann.com 304. It was held by the Court that supply of equipment with embedded software cannot be considered in the nature of royalty. Similar view was taken by different High Courts in various cases.

However, in the case of *Nokia Networks OY v. Jt. CIT* [2018] 94 taxmann.com 111/171 ITD 1 (Delhi) (SB), the Special Bench of Delhi ITAT has held that when a subsidiary company is merely an alter ego, or virtual projection of its parent company, in the sense that it has no significant activities of its own or on behalf of persons other than the non-resident parent company, it must be treated as a PE of the parent company in India. The judgment has again placed the issue to future litigation.

### **Expenditure on acquisition of 'right to use spectrum'**

6. The telecommunication operators are required to incur substantial cost towards acquisition of right to use spectrum. The law was not clear on the tax treatment of spectrum fee, whether it is an intangible asset and the spectrum fees paid is eligible for depreciation under section 32 of the Act or whether it is in the nature of a 'license to operate telecommunication business' and eligible for deduction under section 35ABB of the Act?

Vide Finance Act, 2016, new section 35ABA was inserted which provides for amortisation of expenditure incurred for acquisition of 'right to use spectrum' over the tenure of the right. After insertion of the section, the tax position with respect to expenditure incurred on acquisition of spectrum rights stands settled. The provisions of section 35ABA are applicable w.e.f. 1st April 2016. Therefore, the tax position of such an expenditure incurred prior to 1st April 2016 is still not clear.

From above discussions, it is clear that the industry is suffering from income-tax hassles at all levels. Many issues are still unsettled and require interference of the Board. The growth of telecommunication sector is linked to the growth of the country at large. Therefore, it is need of the hour that the Government should take cognizance of various principal income-tax issues and resolve them. This may result into resting of various litigations to peace and deployment of resources in right direction.

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