

TAX FLASH NEWS

Restoration services relating to transmission of data and telecommunication traffic are not taxable as FTS. Income reasonably attributable to business operations carried out in India in relation to such services shall be taxable as business income

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Flag Telecom Group Limited¹ (the taxpayer) held that consideration received from restoration activities is not taxable as Fees for Technical Services (FTS) under Section 9(1)(vii) of the Income-tax Act, 1961 (the Act). Standard facility for transmission of data and telecommunication traffic by cable operators cannot be termed as rendering of technical services.

The Tribunal held that the portion of the asset i.e. 'cable' through which restoration activity has been provided, has connection in India in as much as it lies within the territorial waters of India. The income has accrued to the taxpayer from an asset in India and hence it is deemed to be business income arising in India. All the business operations of the taxpayer are not carried out in India therefore, reasonable attribution of income from such operations has to be made under Section 9(1)(i) of the Act.

Further the Tribunal held that payments for standby maintenance services are not taxable as FTS under the Act.

Facts of the case

- The taxpayer is a company incorporated in Bermuda. The taxpayer had built a submarine fiber optic telecommunication cable to link telecom traffic amongst Western Europe, Middle East, South Asia, South East Asia and Far East. The capacity in the

said cable system had been sold to various landing parties, which are mostly national telecommunication companies belonging to different nations.

- In India, Videsh Sanchar Nigam Limited (VSNL) was one of the original landing parties in the FLAG cable system. For the purpose of selling the capacity in the cable system to various landing parties, including VSNL, a Capacity Sales Agreement (CSA) was entered into amongst Landing Parties. Subsequently, the CSA was amended by which, VSNL has bought the capacity in the said cable system.
- The entire procedure for the ownership of capacity in the cable system and also for providing standby maintenance activities contained in the Construction and Maintenance Agreement (C&MA) separately entered between the parties.
- Under the terms of the C&MA, the FLAG cable system is to be jointly operated and maintained for an efficient working condition along with the taxpayer and landing parties signatories. During the year under consideration, the taxpayer had received the payment from VSNL on account of provision of standby maintenance activities, as in the earlier years.
- The Assessing Officer (AO) held that receipts from standby maintenance services/charges were in the nature of FTS within the meaning of Section 9(1)(vii) and hence it was to be taxed in India.
- Further during the year under consideration the taxpayer had entered into an arrangement with certain telecom cable operators to provide restoration of traffic to their customers in the

¹ Flag Telecom Group Limited v. DDIT (ITA No. 2255/Mum/2006 & 14 other Group Appeals) - Taxsutra.com

event of disruption in the traffic on their cable system. Under these arrangements, if there is disruption in the traffic on a particular segment of the cable operator, the taxpayer provides the alternative telecommunication link route through its own capacity in the cable.

- In India, VSNL had an arrangement with SEA-ME-WE3 (SMW3), for carrying its telecommunications traffic on segments to and from India and between the segments not connected to India. In case of a disruption in the traffic on a particular segment on SMW3 cable, the operator SMW3 approaches the taxpayer for restoration of the traffic on a particular segment through its cable.
- For this purpose, the taxpayer had entered into a 'Restoration Agreement' with SMW3 Cable Network. The taxpayer agreed to provide for restoration of traffic to VSNL through its cable in case of disruption in the SMW3 cable on various segments. In such a case of restoration activity, the taxpayer invoices the restoration calling party i.e. VSNL, directly for the restoration activity. Thus, the taxpayer provides an alternative route of telecommunication which is end to end connectivity to VSNL, in case there is a disruption in the SMW3 cable system.
- During the year under consideration, the taxpayer received payment for restoration services. The Assessing Officer (AO) held that restoration services were technical in nature and therefore such services were taxable as FTS under Section 9(1)(vii) of the Act.
- The Commissioner of Income-tax (Appeals) [CIT(A)] held that payment for restoration activities was to be assessed as business income and was taxable in India under Section 9(1)(i) of the Act. The CIT(A) estimated the Indian income from restoration activity at 10 per cent of the global receipts.

Tribunal's ruling

Taxability of standby maintenance services/charges

- The issue had come up for consideration before the Tribunal earlier, wherein, it was held that standby maintenance charges do not fall within the realm of 'technical services' under Section 9(1)(vii) of the Act.
- It was not in dispute that the standby charges is a fixed annual charge, which is payable not for providing or rendering services albeit for arranging standby maintenance arrangement, which is required for a situation whenever some repair work on the under-sea cable or terrestrial cable is actually required to be performed or rendered.

- It is a facility or infrastructure maintained for ready to use for rendering technical services or for repairing services, if required. There is no actual rendering of the services qua the standby maintenance charges.
- Accordingly, following the earlier years' precedence, it was held that the receipt on account of standby maintenance charges was not chargeable as FTS within the scope of Section 9(1)(vii) of the Act.

Taxability of restoration services

- In the present case restoration activity does not fall within the nature of 'managerial' or 'consultancy services', because there was no rendering or managing by direction, regulation, administration or supervision of activities by the taxpayer to VSNL.
- The taxpayer does not provide any advisory services for arranging of restoration activities to VSNL. The taxpayer already had a cable system network in which it had spare capacity, which was provided to VSNL on behalf of SMW3 in case of disruption in SMW3 cable network.
- It is a kind of providing a standard facility for carrying telecommunication traffic to other telecommunication provider. When a restoration calling party like VSNL avails the network link in the cable of the taxpayer, no transfer of technology is involved nor have any technical services been rendered.
- VSNL only receives end to end connectivity for a temporary period till the cable of SMW3 is restored for the traffic. In the present case, the existing cable with its spare capacity with the taxpayer was being allowed to be used for transmitting data.
- Simple use of sophisticated technical equipment for providing the capacity in the cable to VSNL *ipso facto*² does not lead to any inference that any technical service was being provided by the taxpayer to VSNL.
- As per the requirement, the taxpayer was providing its network to VSNL as an alternate route to the SMW3 cable for the temporary period.
- Therefore, it cannot be held that for providing such a standard facility through its cable system, the taxpayer is rendering any kind of technical services to VSNL, so as to fall within the ambit of FTS under Section 9(1)(vii) of the Act.

² by that very fact or act

- For rendering of technical services there has to be delivery of technical skills through human element or there is a constant human endeavour in providing technical service or advice or make available such a technical skills or services.
- But if any technical equipment developed by a human has been put to operation automatically, then usage of such technology *per se* cannot be held as rendering of technical services. Transmission of data or telecommunication through a cable is not rendering of a technical service but use of a technical device. This proposition has been laid down by the Madras High Court in the case of Skycell Communications Ltd.³
- On perusal of the restoration agreement, it cannot be inferred that there was any actual rendering of technical services by the taxpayer. Nothing was suggestive of the fact that under the restoration agreement some kind of technical skill, technical services are being provided, except for the kinds of restorations which can be undertaken and terms thereof for the connectivity and payment.
- Accordingly, such a standard facility for transmission of data and telecommunication traffic by cable operators cannot be termed as rendering of technical services and therefore it was held that consideration received from restoration activities was not taxable as FTS under Section 9(1)(vii) of the Act.

Taxability as business income

- A portion of the cable length falls within the territorial waters of India from where it connects to Mumbai and from there it again goes to other countries. In case of sale of the capacity, the landing parties become the complete owner of the capacity to the exclusion of the taxpayer as held in earlier years. However, the spare capacity which lies in the cable belongs to the taxpayer, through which it had provided the restoration network to VSNL.
- The portion of the asset i.e. cable, through which restoration activity was provided also had connection in India in as much as it lies within the territorial waters of India. Accordingly, it can be held that income had accrued to the taxpayer from an asset in India and hence it was deemed to be business income arising in India.
- However, all the business operations of the taxpayer were not carried out in India, therefore reasonable attribution of income from such operations has to be done. In such a situation, Explanation 1A to Section 9(1)(i) provides that, in case of a business of which

all operations are not carried out in India, then the income of the business shall be deemed to accrue or arise in India only such part of the income, which can be reasonably attributable to the operations carried out in India.

- In the present case the most appropriate basis for identifying the income, which can be reasonably attributable to India would be on the basis of fraction of the length of the entire cable system in the cases where restoration services have been provided in respect of the cable segments connected to India in its territorial waters.
- The territorial waters extend upto 12 nautical miles in India and hence only 12 nautical miles of the cable system ought to be considered for attributing the income to India. The taxpayer had provided the chart of segments on which the restoration activities have been undertaken by way of connection to the cable landing station in the territorial waters in India, which was from Fujairah to Mumbai, Miura to Mumbai and Mumbai to Singapore.
- The taxpayer had also filed a statement showing the details of restoration charges over the years giving the details of segments on which the restoration had been provided; length of the segment, length of the cable in territorial waters of India and apportionment of revenue to India.
- In principle, the Tribunal upheld the method of attribution of revenue as given in the said statement, however the AO is directed to determine the income of the taxpayer which is to be taxed in India after apportioning the revenue on the basis of length of the cable in the territorial waters in India on the segments on which restoration has been provided.
- The working given in the chart submitted by the taxpayer shall be verified by the AO, so as to determine the correct business income which is to be taxed in India.

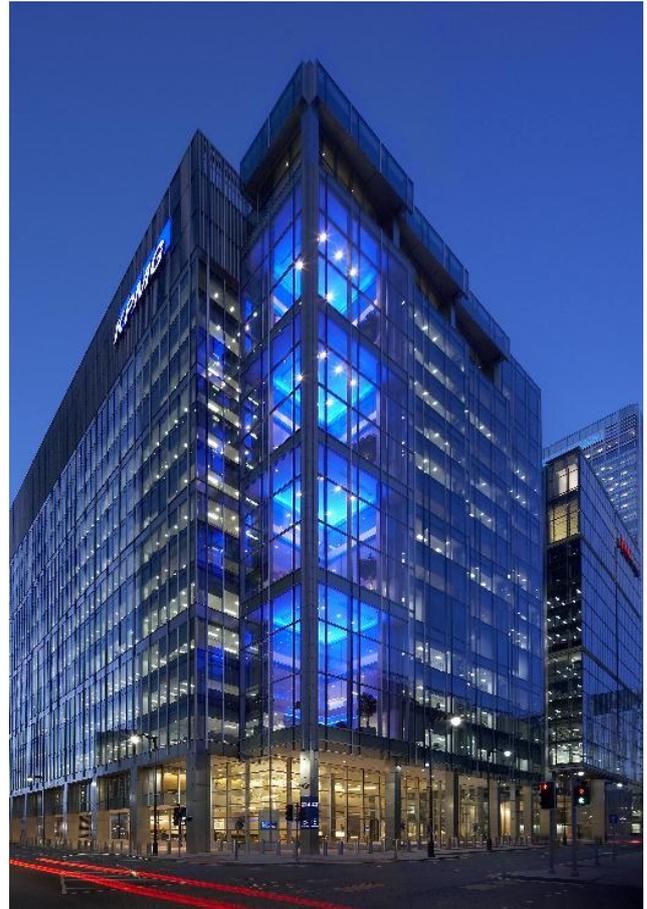
Our comments

The Mumbai Tribunal in the present case dealt with the issue of taxability of restoration services relating to transmission of data and telecommunication traffic. The Tribunal held that a standard facility for transmission of data and telecommunication traffic by cable operators cannot be termed as rendering of technical services. Accordingly, consideration for restoration services is not taxable as FTS. The Tribunal observed that transmission of data through a cable is not rendering of a technical service but use of a technical device. Further, usage of such technology which has been put to use automatically *per se* cannot be held as rendering of technical services.

³ Skycell Communications Ltd. v. DCIT [2001] 119 Taxman 496 (Mad)

The Tribunal held that the portion of the 'cable' through which restoration activity has been provided lies within the territorial waters of India and therefore, the business income has arisen in India. Further, the most appropriate basis for identifying the income, which can be reasonably attributable to operations in India would be on the basis of fraction of the length of the entire cable system.

In the present case the taxpayer is a resident of Bermuda with which India does not have a tax treaty. If a taxpayer is a resident of a tax treaty country, the taxability of business income in the hands of the taxpayer would depend on the presence of its Permanent Establishment in India.



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