



Payment of inter-connection usage charges by an Indian telecom service provider to a foreign telecom operator is neither FTS nor royalty under the Act or the relevant tax treaties

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Bharti Airtel Limited¹ (the taxpayer) held that the inter-connection facility and the service of the foreign telecom operator (FTO) in picking-up, carrying and successful terminating a call over their respective network is a standard facility, and the FTO does not render any technical services to the taxpayer under the interconnect agreement. Therefore, the payment in the form of inter-connection usage charges (IUC) is not in the nature of fee for technical services (FTS) under Section 9(1)(vii) of the Income-tax Act, 1961 (the Act).

The process of running the network in the cases of all the telecom operators is essentially the same and they do not have any exclusive right over such process to characterise it as royalty. When a process is widely available in the public domain, it cannot constitute a part of the intellectual property (IP) for the purpose of charge of 'royalty' under Section 9(1)(vi) of the Act. There is no 'use' of or 'right to use' of any process in the present case and hence, even under relevant tax treaties, the payment cannot be termed as royalty.

Facts of the case

- The taxpayer is a global telecommunication company having operations in several countries including India.
- The taxpayer, as part of its international long distance (ILD) telecom services business, is responsible for providing services to its subscribers in respect of calls originated/terminated outside India. Thus, for providing ILD services, the taxpayer is required to obtain services of the FTO for the provision of connectivity services over the last leg by the communication channel.
- The taxpayer entered into an agreement with an overseas network corporate to connect the call over the network. The taxpayer provides seamless end-to-end connectivity to the subscribers and the entire revenue from services is paid by the subscribers to the taxpayer. The taxpayer is in turn billed by the FTO in the form of IUC.

¹ Bharti Airtel Limited v. ITO (TDS) [ITA Nos. 3593 TO 3596/Del/2012] – Taxsutra.com

- The AO held that IUC paid by the taxpayer to the FTO, in the course of carrying out its business as an ILD service provider are in the nature of FTS under Section 9(1)(vii) of the Act, or in the alternative, in the nature of royalty under Section 9(1)(vi) of the Act. Accordingly, the income from IUC is deemed to accrue or arise in India in the case of an FTO.
- The AO levied a tax at a higher rate of 20 per cent on the gross amount of payment made to the FTO for all the years² under consideration by applying the provisions of Section 206AA of the Act.

The Tribunal's ruling

Payment of IUC to FTO is not taxable as FTS

- The Delhi High Court in the taxpayer's case³ dealing with a similar issue held that the services rendered qua inter-connection/port access do not involve any human interface and, therefore, the same cannot be regarded as 'technical services' under Section 194J and Section 9(1)(vii) of the Act.
- The Supreme Court⁴ upheld the order of the Delhi High Court. Further all the benches of the Tribunal⁵ are unanimous in their view on this issue. Therefore, the payment cannot be characterised as FTS under Section 9(1)(vii) of the Act.
- In the present case, there is no manual or human intervention during the process of transportation of calls between two networks and it is done automatically. Human intervention is required only for installation of

the network and installation of other necessary equipments/infrastructure. Human intervention is also necessary for maintaining, repairing and monitoring each operator or individual network. Such human intervention cannot be said to be for inter-connection of a call. Human intervention in setting up enhanced capacity has no connection or relation with the traffic of call. Thus, in the process of actual calls, no manual intervention is required.

- The Madras High Court in the case of Skycell Communications Ltd.⁶ held that call charges received for providing cellular mobile services do not come within the definition of technical services under Section 194J read with Explanation 2 to Section 9(1)(vii) of the Act, as it is a mere collection of a fee for the use of a standard facility provided to all.
- The inter-connection facility and the service of the FTO in picking-up, carrying and successful terminating the call over their respective network is a standard facility, and the FTO does not render any technical services to the taxpayer under interconnect agreement. Therefore, the payment cannot be considered as FTS in terms of Section 9(1)(vii) of the Act.

When FTS clause is missing in the tax treaty

- When FTS clause is not available in the tax treaty, the income would be assessable as business income and it can be brought to tax in India, only if the FTO has a Permanent Establishment (PE) in India and the earning of income is attributable to activities or functions performed by such PE. This view is supported by various decisions⁷.

² Assessment Year 2008-09 to 2011-12

³ CIT v. Bharti Cellular Ltd. [2009] 319 ITR 139 (Del)

⁴ CIT v. Bharti Cellular Ltd. [2011] 330 ITR 239 (SC)

⁵ Vodafone East Ltd. v. Addl. CIT [ITA No. 243/Kol/2014], Bharti Hexacom Ltd. v. ITO (TDS) [ITA 656/JP/2010], Dishnet Wireless Ltd. v. DCIT (ITA No. 320 to 329/Mad/2014)

⁶ Skycell Communications Ltd. v. DCIT [2001] 251 ITR 53 (Mad)

⁷ ACIT v. Paradigm Geophysical Pty. Ltd. [2010] 122 ITD 155 (Del), CIT v. Siemens Aktiengesellschaft [2009] 310 ITR 320 (Bom)

Payment of IUC to FTO is not taxable as royalty under the Act

- Perusal of certain clauses of the agreement between the taxpayer and the FTO, demonstrate the following:
 - The telecom operator provides connecting, transit and termination services to each other on a reciprocal basis and neither of the parties shall have any rights in the equipments or in the network of other parties.
 - The taxpayer merely delivers the call that originates on its network to one of the inter-connection locations of the FTO, and FTO carries and terminates the call on its network.
 - The taxpayer is nowhere concerned with the route, equipment, process or network elements used by the FTO in the course of rendering such services.
- The term 'process' used in the Explanation 2 to Section 9(1)(vi) of the Act in the definition of 'royalty' does not imply any 'process' which is publicly available. The words, which surround the word 'process' in clauses (i) to (iii) of Explanation 2 to Section 9(1)(vi) of the Act refer to various species of IPs such as patent, invention, model, design, formula, trade mark, etc. Thus, the word 'process' must also refer to a species of IP applying the rule of '*ejusdem generis*' or '*noscitur a sociis*' as held by the Supreme Court in the case of Bharti Cellular Ltd.
- Based on the above and certain decisions⁸, it was held that the term 'royalty' connotes exclusivity and the exclusive right in relation to the thing (be it physical or IP) for which royalty is paid should be with the grantor of that right.

There is a clear distinction between a 'process' and the physical equipments and resources deployed in the execution of a 'process'. While the former is an intangible asset, the latter is tangible and has a physical existence.

- The owner of the 'process' might grant the 'use' or 'right to sue' to different persons at the same time, but the exclusivity of the ownership should be with the grantor.
- If the IP is used by the owner himself and he bears the risk of exploitation or liabilities for the use, then as the owner makes own entrepreneurial use of the IP the income would fall under the scope of 'business income' and not 'royalty'. The 'royalty' in respect of the use of a 'process' would imply that the grantor of the right has an exclusive right over such 'process' and allows the 'use' thereof to the grantee in return for a 'royalty'. It is necessary that grantee must 'use' the 'process' on its own and bear the risk of exploitation.
- The 'process' of running the network in the cases of all the telecom operators is essentially the same and they do not have any exclusive right over such 'process' so as to be in a position to charge a 'royalty'. For allowing the use of such process, the term 'use' in the context of royalty connotes use by the grantee and not by the grantor.
- Explanation 6 to Section 9(1)(vi) of the Act, does not eliminate the requirement of successful exclusivity of the right in respect of such process being with the person claiming 'royalty' for granting its usage to a third party. None of the FTOs has any exclusive ownership or rights in respect of such process, and hence, the payment cannot be considered as royalty.

⁸ CIT v. Neyveli Lignite Corporation Ltd. [2000] 243 ITR 0459 (Mad), N.V. Philips Gloeilampenfabrieken Eindhoven v. CIT [1988] 172 ITR 521 (Cal)

- Explanation 5 to Section 9(1)(vi) of the Act applies only in case of royalty falling within the ambit of Explanation 2 of Section 9(1)(vi) of the Act. When a process is widely available in the public domain and is not exclusively owned by anyone, then it cannot constitute an item of IP for the purpose of charge of 'royalty' under clauses (i), (ii) and (iii) of Explanation 2 to Section 9(1)(vi) of the Act. Hence, Explanation 5 has no effect in the instant case.
- Applying the decision of the jurisdictional High Court, it was held that the payment cannot be termed as royalty under Section 9(1)(vi) of the Act.

Payment of IUC to FTO is not taxable as royalty under the tax treaties

- The definition of 'royalty' provided in the relevant tax treaties use the expression 'secret formula or process' and it is separated by a comma before and after the expression. This implies that 'formula/process' is a part of the same group and the adjective 'secret' governs both. Only payments received as consideration for the 'use of', or 'the right to use' is necessary for the payment to be termed as royalty. This is much narrower to the definition of 'royalty' under the Act.
- Thus, under the treaties, in order to constitute royalty for use of or the right to use of a process, the process has to be 'secret'. In the case of the telecom industry, however, telecommunication services are rendered through standard facilities and no 'secret process' is involved.
- There is no 'use of' or 'right to use' of any process in the present case and hence, even under the tax treaties, the payment cannot be termed as royalty. Based on various decisions⁹, it was held that the payment was not 'royalty' under the tax treaties.

⁹ Asia Satellite Telecommunications Co. Ltd. v. DIT [2011] 332 ITR 340 (Del), DCIT v. PanAmSat International Systems Inc. [2006] 103 TTJ 861 (Del), Cable & Wireless Networks India (P) Ltd. [2009] 315 ITR 72 (AAR)

Position subsequent to the retrospective amendment by the Finance Act, 2012

- There would not be any change in the above position, even subsequent to the retrospective amendments¹⁰ introduced by way of Explanation 5 and 6 to Section 9(1)(vi) of the Act, since changes in the Act cannot be read into the tax treaties as long as there is no change in the tax treaties.
- Following the jurisdictional High Court decisions¹¹ as well as decisions of other Courts, it was held that the amendments introduced by the Finance Act 2012 cannot be read into the tax treaties.

Whether the payment made by the taxpayer to the FTO is deemed to accrue or arise in India

- The payments were neither received nor deemed to have been received by the FTOs in India. The payment does not accrue or arise to the FTOs, through or from any property of the FTOs in India or from any asset or source of income of the FTOs in India or through the transfer of any capital asset of the FTOs in India. The entire business operations of the FTOs have taken place outside India.
- Under these circumstances and applying the decision in the case of Asia Satellite Communication Company Ltd., no income is deemed to accrue or arise to the FTOs in India.
- Alternatively, no part of such income can be said to be reasonably attributable to the business connection of the FTOs in India. Reliance is placed on the decision of Goodyear Tyre & Rubber Co.¹²

¹⁰ Introduced by the Finance Act 2012 with effect from 1 June 1976

¹¹ DIT v. Nokia Networks [2013] 358 ITR 259 (Del), DIT v. New Skies Satellite BV & Ors. (ITA No. 473/2012)

¹² CIT v. Goodyear Tyre & Rubber Co. [1989] 184 ITR 369 (Del)

- Even under the tax treaties, the payments being in the nature of business income of the FTOs, Article 7 of the relevant tax treaties governs the same. The FTOs do not have any PE in India and therefore, the income cannot be brought to tax in India.

Beneficial rate provided under the tax treaty overrides the provisions of Section 206AA of the Act

- The Tribunal observed that Section 206AA of the Act is prospective in nature. However, following various decisions¹³, it was held that the beneficial rate provided in the tax treaty overrides the provisions of Section 206AA of the Act.

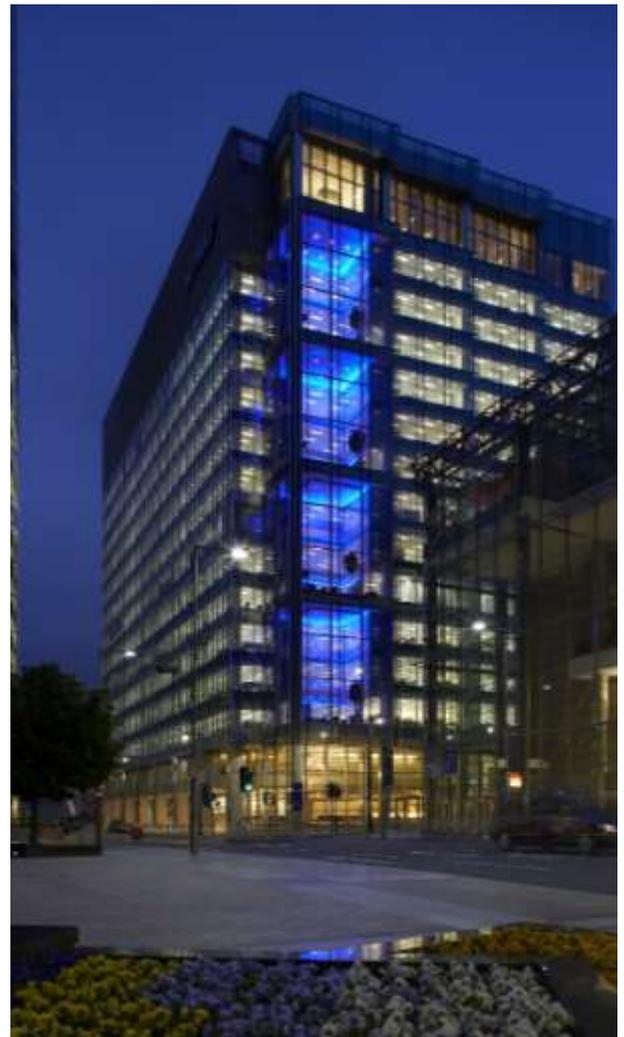
Our comments

The Delhi Tribunal in the instant case has held that when a process is widely available in the public domain, then it cannot constitute an item of IP for the purpose of charge of ‘royalty’ under Explanation 2 to Section 9(1)(vi) of the Act. None of the FTOs have any exclusive ownership or rights in respect of such process, and hence, the payment cannot be considered as royalty. The payment made for inter-connection charges do not fall within the ambit of the definition of ‘royalty’ under Section 9(1)(vi) of the Act or the definition of ‘royalty’ under the treaties. Further, the amendments introduced by the Finance Act 2012 cannot be read into the tax treaties.

The Tribunal also held that inter-connection facility and the service of the FTO in picking-up, carrying and successfully terminating a call over their respective network is a standard facility, and the FTO does not render any technical services to the taxpayer under the interconnect agreement. Therefore, the payment in the form of IUC is not in the nature of FTS under Section 9(1)(vii) of the Act. The Tribunal observed that when an FTS clause is not available in the tax treaty, the income would be assessable as business income and it

can be brought to tax in India, only if the FTO has a PE in India and the earning of income is attributable to activities or functions performed by such PE. Further, the income arising from the payment cannot be deemed to accrue or arise in India.

This decision will help telecom companies whose cases are pending on this issue before different authorities.



¹³ DDIT (IT-II) v. Serum Institute of India Ltd. [2015] 56 taxmann.com 1 (Pune), Wipro Ltd. v. ITO (Int. Taxation) (ITA No. 1544 to 1547/Bang./2013)

www.kpmg.com/in

Ahmedabad

Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru

Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh

SCO 22-23 (1st Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai

No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi

Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad

8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi

Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata

Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai

Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida

6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune

703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

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