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TAX FLASH NEWS

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Payment for international private leased circuit and connectivity charges for use of private bandwidth in underwater sea cable are not taxable as royalty or FTS

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Geo Connect Ltd.[1] (the taxpayer) held that payment in respect of International Private Leased Circuit (IPLC) charges and connectivity charges paid to the U.S. entities are not taxable as royalty since the payment was made for transmission of call data and did not involve the use or right to use any industrial commercial or scientific equipment. The control of equipment (i.e. the undersea cable etc.) was with the non-resident parties and was not leased to the taxpayer. The service in substance was for providing connectivity facility to the taxpayer to generate and cater to outbound Public Switch Telephone Network (PSTN) calls within the U.S.A., hence the same did not amount to 'royalty' under the Income-tax Act, 1961 (the Act) or under India-USA tax treaty (tax treaty).

The Tribunal held that the aforesaid payment is not taxable as Fees for Technical Service (FTS) in the absence of human intervention in the services involved. The 'make available' test under Article 13 of the tax treaty is not satisfied and therefore, it is not taxable as FTS under the tax treaty. Accordingly, deduction of tax under Section 195 of the Act is not applicable.

Facts of the case

- The taxpayer was operating an outbound call centre and was engaged in telemarketing services on behalf of its clients based at U.S.A. The call centre executive sitting in the premises of the taxpayer makes an outbound call to the U.S.A. on telephone numbers of potential buyers of clients in real-time. In the process of calling by the executive to the person located in the U.S.A., the voice data is converted into electronic data and is carried over by multiple entities.

- From Delhi to Mumbai the call is carried over line provided by the Videsh Sanchar Nigam Ltd. (VSNL) and Mumbai onwards this call is carried over an underwater sea cable maintained by the VSNL and AT & T, U.S.A. upto the shores of the U.S.A. From another end of underwater see cables at the U.S.A., the call is connected to basic telephone service provider of the U.S.A. by IGTL Solutions (USA) Inc (IGTL Solutions). This underwater sea cable is jointly maintained by the VSNL and AT & T, U.S.A.

- For running the call centre, the taxpayer acquired dedicated private bandwidth[2] in the underwater sea cable from VSNL and AT&T USA. In terms of the agreement, the taxpayer paid the IPLC

[1] Geo Connect Ltd. v. DCIT (ITA Nos. 1927/Del/2008 & 127/Del/2011) – Taxsutra.com

Note – The Delhi Tribunal has dealt with several other issues in this case. However, this flash news deals with the issue of taxability of IPLC and connectivity charges for use of dedicated private bandwidth in underwater sea cable.

[2] The dedicated 'private bandwidth' means a certain portion of total data carrying capacity of the cable would be available to the taxpayer.

charges to VSNL and to 'Kick Communication' for the use of dedicated private bandwidth in underwater sea cable. The taxpayer deducted tax on payments made to VSNL. However, no tax was deducted on payments made to 'Kick Communication'.

- The Assessing Officer (AO) held that the right to use the bandwidth and technical services is in the nature of maintenance and it fall within the definition of royalty. The AO held that income deemed to accrue or arise in India within the meaning of Section 9 of the Act and the tax treaty and hence tax was to be deducted on this amount before making payments. Accordingly, he disallowed the payment in terms of Section 40(a)(i) of the Act for non-deduction of tax.

- The Commissioner of Income-tax (Appeals) [CIT(A)] concurred with the finding of the AO that payments made to the two parties were in the nature of royalty.

Tribunal's decision

Business connection

- On perusal of the Explanation 2 to Section 9(1)(i) of the Act as well as the illustrative examples of business connection given by Central Board of Direct Taxes (CBDT) in Circular No. 23/1969[3], it has been observed that non-resident parties in the case of the taxpayer are not having any business connection in India since no such facts of business activity carried out through a person acting on behalf of the non-resident or through a broker or agent have been brought by the tax department.

- The Delhi High Court in the case of Asia Satellite Telecommunication Company Limited[4] has held that Section 9(1)(i) of the Act is not applicable since all the operations are not carried out in India. In the present case also, the undersea cable for providing dedicated bandwidth to the taxpayer was installed beyond the territory of India and no operations were carried out by the non-resident in India. It was responsible for restoring connectivity and managing faults in connectivity etc., in respect of data transmitted through undersea cable only.

- Similarly, the operations carried out by IGTL Solutions are also in the U.S.A. and not in India. Since operations by both the non-resident parties are carried out beyond the territory of India, it has been held that Section 9(1)(i) of the Act is not attracted in the case of two non-resident parties.

Taxability of royalty under the Act

- In the present case, it has been observed that under the agreements with Kick Communication, the consideration was not for the use or right to use any equipment. On reference to the terms and conditions of the agreement it is evident that Kick Communication agreed for rendering services of transmission of call data and its effective management and there was no agreement for use or right to use any industrial commercial or scientific equipment between the non-resident and the taxpayer. Thus, Explanation 2 to Section 9(1)(vi) of the Act was not applicable to the facts of the instant case.

- It has been observed that the service in substance is for providing connectivity facility to the taxpayer to generate and cater to outbound PSTN calls within the U.S.A. Thus, the clause (iii)[5], (iv)[6] or (iva)[7] of Section 9(1)(vi) of the Act are not applicable for consideration paid to IGTL Solutions by the taxpayer. Accordingly, consideration paid to the non-resident parties does not fall under the term 'royalty' in terms of Section 9(1)(vi) of the Act.

Taxability of royalty under the tax treaty

- The Tribunal's decision in the case of Asia Satellite Telecommunication Company Limited[8] has been reversed by the

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[3] CBDT Circular No. 23/1969, dated 23 July 1969
[4] Asia Satellite Telecommunication Company Limited v. CIT [2011] 332 ITR 340 (Del)

[5] The use of any patent, invention, model, design, secret formula or process or trade mark or similar property
[6] The imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill
[7] The use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in Section 44BB of the Act
[8] Asia Satellite Telecommunication Company Limited v. ACIT [2003] 85 ITD 478 (Del)

Delhi High Court. The Delhi High Court held that consideration paid for bandwidth used for up-linking and down-linking of the television signals cannot be termed as royalty either under Section 9(1)(vi) of the Act or under the terms defined in the tax treaty. The High Court discussed in detail the use or right to use the process, information or equipment. However, in the instant case, the control of equipment was with the non-resident parties, and they have not leased the equipment, i.e. the undersea cable etc. to the taxpayer. The equipments were owned and used by the non-resident parties only, and therefore it cannot be said that the consideration paid was for the use of equipment by the taxpayer. Similarly, the non-resident parties have not provided use of any process to the taxpayer, which are of patentable nature having exclusive ownership rights.

- The taxpayer was not concerned with any of the process involved in transmission or connectivity of call data. The only concern of the taxpayer was the transmission of call data beyond the boundaries of India to the person in the U.S.A. to whom the call was made.

- The Explanation 5 and 6 of Section 9(1)(vi) of the Act and Memorandum of Explanation does not apply to the facts of the present case since there has not been any corresponding change in the definition of the term royalty in the tax treaty. Accordingly, the restricted meaning of the royalty under the tax treaty shall continue to operate despite the amendment in the Act. Accordingly, it has been held that the payments made by the taxpayer are not in the nature of royalty either under the Act or relevant tax treaty.

Withholding of tax

- The obligation under Section 195 of the Act to deduct tax is at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of cheque or draft or any other mode, whichever is earlier. Therefore, it is relevant to see the obligation of the payer at the time of credit or actual payment and any subsequent amendment through retrospective effect, cannot create any obligation upon the payer which did not exist at the time of crediting or actual payment of the sum.

- Thus, it has been held that disallowance cannot be made under Section 40(a)(i) of the Act for non-deduction of tax on the payments to non-resident parties.

Taxability of FTS

- The Delhi High Court in the case of Bharti Cellular Ltd.[9] held that technical services must be rendered by human element and it does not include any service provided by machine or robots. The call connectivity and transmission services have been held as not involving human element by the Tribunal in the case of Bharti Airtel Ltd.[10]. Similarly, in the instant case, the tax department has not brought out any evidences that human element was involved in call transmission services through dedicated bandwidth.

- We find that in the case of Bharti Airtel Ltd. the Delhi Tribunal decided the identical issue of payment made for carrying calls from outside India and terminating such calls in India. In the instant case also identical service of transmission of call data from the end of the Indian Territory to the person in the U.S.A. to whom the call is made, is involved. Accordingly, the payment in question cannot be considered as FTS in terms of Section 9(1)(vii) read with Explanation 2 of Section 9(1)(iv) of the Act.

- The Tribunal held that where 'make available' clause is found in the tax treaty, and there is no imparting as contemplated in the tax treaties, the payment cannot be treated as FTS under the tax treaty. It has been observed that make available clause is present in the tax treaty. Since in the call connectivity and transmission from end of the

[9] CIT v. Bharti Cellular Ltd. [2008] 175 Taxman 575 (Del)
[10] Bharti Airtel Limited v. ITO (ITA No. 3593 to 3596/del/2012)

Indian Territory at Mumbai to the termination of call in the U.S.A., no technical knowledge has been made available to the taxpayer, it has been held that payment for the services of call transmission through dedicated bandwidth provided by the non-resident parties cannot be termed as FTS under the tax treaty.

Our comments

The characterisation of contractual payments for services as 'royalty' has been a contentious issue before the courts. Especially in the cases where services involve the use of scientific or technical equipment. Internationally, when payments are made for such services, they are not in the nature of 'royalty' as long as there is no control established over the equipment. This view has been endorsed by the Organisation for Economic Co-operation and Development (OECD) Model Commentaries[11]. This has also been upheld by the Authority of Advance Rulings (AAR) in the case of Cable and Wireless[12] and Dell[13] in light of the definition of 'royalties' under the Act and the relevant tax treaties.

In 2012, a retrospective[14] amendment was introduced to the definition of 'royalty' under the Act whereby it is clarified that such payments would be classified as made for the 'use of equipment' and thus, classified as 'royalty' irrespective of the possession or control of the equipment with the payer or use by the payer or the location of the equipment being in India. Whilst the definition includes payments for the use or the right to use of industrial, commercial or scientific equipment and the use or the right to use of a secret formula or process as 'royalty', internationally OECD commentaries etc., accept that payments for satellite broadcasting services, transponder services, bandwidth services, etc. are not considered as 'royalty'. Further, it is also accepted that bandwidth fees cannot be considered as payments for the 'use of process.'

As per the Article 31 of Vienna Convention, tax treaties are to be interpreted in 'good faith' in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose[15]. However, the Madras High Court in Verizon Communications Singapore Pte Ltd.[16] held that payments made for international connectivity services such as bandwidth services are in the nature of 'royalty' under the Act and India-Singapore tax treaty on the basis that such payments would qualify as payments made for the use of an 'equipment' or a 'process'.

The Delhi Tribunal, in the present case has considered the definition of 'royalty' under the India-USA tax treaty and observed that the control of equipment was with the non-resident parties and they have not leased the equipments to the taxpayer. The equipment's were owned and used by the non-resident parties only, and therefore it cannot be said that the consideration paid was for the use of equipment by the taxpayer. Similarly, the non-resident parties have not provided use of any process to the taxpayer. The taxpayer was not concerned with any of the process involved in transmission or connectivity of call data. Accordingly, the payment was not treated as 'royalty' either under the Act or the tax treaty.

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[11] Para 9.1, OECD Model Commentary provides as follows:

"9.1 Satellite operators and their customers (including broadcasting and telecommunication enterprises) frequently enter into transponder leasing agreements under which the satellite operator allows the customer to utilize the capacity of a satellite transponder to transmit over large geographical areas.Payments made by customers under typical transponder leasing agreements are made for the use of the transponder transmitting capacity and will not constitute royalties under the definition of paragraph 2; these payments are not made in consideration for the use of, or right to use, property, or for information, that is referred to in the definition of paragraph 2 of Article 12; they cannot be viewed, for instance, as payments for information or for the use of, right to use, a secret process since the satellite technology is not transferred to the customer…."

[12] Cable and Wireless Networks India (P) Ltd., In re, [2009] 315 ITR 72 (AAR)

[13] Dell International Services (India) Pvt. Ltd., In re, [2005] 305 ITR 37 (AAR)

[14] With effect from 1 June 1976

[15] Vienna Convention on the Law of Treaties - Principle followed in Hindalco Industries v. ACIT [2005] 2 SOT 528 (Mum), Modern Threads India Ltd. v. DCIT, (1999) 69 ITD 115 (Jaipur)

[16] Verizon Communications Singapore Pte Ltd. v. ITO [2014] 361 ITR 575 (Mad)

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