# Consideration for sale of capacity in the undersea cable system is not considered as royalty but as business income. The sale was concluded outside India on a principal to principal basis and therefore such business income is not taxable in India

**2 March 2015**

## Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Flag Telecom Group Limited[1] (the taxpayer) dealt with the issue relating to taxability of an amount received by the foreign company towards transfer of the capacity in the undersea cable system for providing telecommunication link to the Indian company. The Tribunal held that the Indian company not only had an exclusive ownership over the capacity but also the exclusive right to use the capacity. The Indian company could assign or transfer or sell such capacity to any other party. Accordingly, there was no assignment of 'right to use' but it was 'sale of capacity' in the cable system.

Further, such payment is on account of sale and hence constitutes 'business income' and not 'royalty' under Section 9(1)(vi) of the Income-tax Act, 1961 (the Act). The sale was concluded outside India on a principal to principal basis and therefore, no income is deemed to accrue or arise in India under Section 9(1)(i) of the Act.

The receipt of standby maintenance charges from the Indian company was in the form of fixed annual charge and there was no rendering of any service. Therefore, such receipt is not taxable as Fees for Technical Services (FTS) under Section 9(1)(vii) of the Act.

## Facts of the case

- The taxpayer, a company incorporated in Bermuda, was set up to build a high capacity submarine fibre optic telecommunication link cable system i.e. undersea cable for providing telecommunication link. Such a telecommunication cable was known as 'Fibre Optic link around the Global Cable System' (Flag Cable System).

- The taxpayer had entered into a memorandum of understanding (MOU) with various parties which were mostly national telecommunication companies belonging to different nations, for the purpose of planning and implementing of the 'Submarine Fabric Optic Telecommunication Link Cable System' linking Western Europe (starting from the U.K.), Middle East, South Asia, South East Asia and Far East (ending in Japan). The taxpayer has been termed as 'founding party', whereas the other parties to the MOU have been termed as 'landing parties'.

[1] Flag Telecom Group Limited v. DCIT (ITA Nos. 6254/Mum/2003, 1168 and 6710/Mum/2004 - Assessment Year: 1998-99, 1999-2000 and 2000-01) – Taxsutra.com

- Most part of the cable has been laid down on the sea bed and for the purpose of connection in the terrestrial land, the cable comes ashore in certain countries, connecting with the domestic telecommunication system, which has been termed as 'landing stations'. In India, Videsh Sanchar Nigam Limited (VSNL) was one of the original landing parties to the MOU in the cable system and part of the consortium to the Flag Cable System.
- For the purpose of selling the capacity in the cable system, the parties entered into a Cable Sales Agreement (CSA). On 31 March 1995, the CSA was entered into between the taxpayer and VSNL, which was further amended on 29 April 1998, by which time VSNL had bought the capacity in the said cable system.
- The CSA provided for the ownership rights in the Flag Cable System with all the rights and obligations in the capacity were sold. VSNL can transfer, assign or sell the capacity.
- The entire procedure for ownership of capacity in the cable system and all other terms and conditions has been contained in a separate agreement titled as 'Construction and Maintenance Agreement' (C&MA). As per the terms, once C&MA comes into force, the CSA will come to an end. The C&MA was for a period of 25 years, which coincides with the life of the cable.
- The taxpayer received USD28.94 million from VSNL towards sale of capacity in the cable system. The taxpayer also received separate consideration for standby maintenance activities. The taxpayer claimed that the receipt was on account of sale of goods, from a non-resident to a resident which cannot be taxed in India. CSA and C&MA with VSNL have been executed by the taxpayer outside India on a principal to principal basis and the payment for the sale of capacity has also been made outside India.
- The Assessing Officer (AO) held that the payment was for 'right to use' the cable, hence, taxable as royalty in India under Section 9(i)(vi) of the Act. Further, the AO held that income from standby maintenance activities, which was separately received was taxable as FTS, because the maintenance requires highly skilled and technical personnel.

## Tribunal's ruling

### *Sale of capacity in the cable system*

- Tax Management Foreign Income Portfolio US International Taxation of Telecom, for the treatment of tax in an undersea fibre optic cable system, clarified that the transfer of asset in the agreements must be somewhat metaphysically identified as an amount of digital capacity.
- The cable has been identified in terms of its capacity to transmit, and not as an independent asset *de-hors* its capacity. This entire concept of 'capacity' used in the agreement by the parties to a telecom network cable has to be understood from the terms of the contract and not solely on a scientific term or technical angle.
- The main characteristic of the cable is transmission of capacity only for which rights or Indefeasible Right to Use (IRUs) are granted to the users of the telecom network.
- As per clauses given in CSA and C&MA, VSNL had all the ownership rights and obligations in respect of the capacity purchased in the cable system. Further the management committee which included VSNL shall make all decisions on behalf of signatories to implement the purpose of the agreement. VSNL can transfer capacity to any other signatory or any other international telecommunication entity.
- In case of termination of C&MA, the net asset of the entire cable system will be disposed off and any proceeds of cost will be distributed among signatories in proportion to each signatory's shares.
- VSNL had all the risks and rewards of ownership which was unaffected by the taxpayer, inasmuch as VSNL not only had the exclusive domain on the rights to use but also right to resale or transfer its interest in the capacity in the cable system to the exclusion of the taxpayer.
- The intention of the parties and their conduct can also be gauged by the accounting treatment given by the parties. The taxpayer recognised its revenue from sale of capacity on the date on which the risks and rewards of ownership have been transferred to the purchaser. The capacity has been treated as 'stock-in-trade' and the capacity which has been left or available in the balance sheet is a part of 'current asset' under the head 'capacity available for sale'. It has not been treated as a fixed asset. VSNL had also treated it as purchase of fixed assets and not as an item of expenditure.
- The Tribunal agreed with the contention of the tax department that cable is only a medium, however, disagreed with the tax department's conclusion that capacity is not capable of sale. It is the capacity alone which is the subject matter of either 'agreement to sale', 'agreement for 'right to use' or 'indefeasible right to use', 'agreement for lease' or 'agreement for service', etc.

- Either by looking at the form or looking through the substance, the only picture which emerges is that, parties intended to 'sell' and not to give or get 'right to use'.
- In the present case, in all the agreements the word 'capacity' has been defined in terms of saleable units which can be sold/purchased amongst the parties. The asset is to be identified as an amount of digital capacity in the cable, which is the subject matter of transfer.
- The capacity in a particular segment has an exclusive right *qua* the owner which can be used in the manner in which the owner proposes. There can be several owners of capacity in a particular length of the cable.
- If VSNL had bought 51 Minimum Investment Units (MIUs) in the Flag cable system, which was running across in all the segments, it had not only the exclusive ownership of 51 MIUs, but also the exclusive right to use the said capacity in the manner in which it likes i.e. it could assign or transfer or sale to any other party.
- In case had there been only right to use to be given, then the ownership right to the exclusion of the taxpayer could not have been given to VSNL.
- Based on the apparent terms and conditions of the agreement between the parties, there was no assignment of 'right to use' but 'sale of capacity' in the cable system.

### *Consideration is not royalty*

- The taxpayer right from the stage of entering the MOU with the parties, signing of capacity sales agreement and C&MA agreement, intended to sale the capacity with transfer of complete ownership, risks and rights. The entire agreement was for the period of 25 years which coincided with the life of the cable.
- Accordingly, the signatory becomes the owner of the capacity in the cable system after the purchase, that is, VSNL in the instant case. This fact further establishes that there was no payment for simply the use of the capacity.
- In case of a 'royalty', agreement, the complete ownership is never transferred to the other party. The concept of transfer of ownership to the exclusion of the other party is denuded in the case of 'royalty'.
- If the consideration has been received for transferring the ownership with all rights and obligations then such a consideration cannot be taxed under the head 'royalty'. Thus, the characterisation of the transfer, in the terms of the contract and agreement entered by the parties, is for sale and not for simple use.
- The payment received by the taxpayer from VSNL was on account of sales and hence constitutes business income and not royalty under Section 9(1)(vi) of the Act.

### *No business connection in India – business income not taxable*

- The taxpayer does not have any capital asset or property in India, which has been transferred to VSNL. The sale of capacity in the cable system does not arise through and from business connection in India, because sale has been made to VSNL which is unconnected to the taxpayer. The landing station is owned by the landing parties of the respective countries.
- The taxpayer was not earning income through any aid or assistance of VSNL as VSNL was not carrying out any business for the taxpayer in India and therefore, in this case there was no income accruing or arising from business connection in India.
- Neither the landing station nor the capacity in the cable is an asset of the taxpayer in India, hence there is no income accruing or arising through or from an asset of the taxpayer in India. Regarding source from India, the source of income must lie in India so as to be deemed to be income in India. The source must flow from an asset, whereas in this case there is no asset belonging to the taxpayer through or from which the taxpayer is having income.
- No income had accrued or arisen in India within the deeming provision of Section 9(1)(i) of the Act, as the sale had concluded outside India on a principal to principal basis. The CBDT circular[2] would be squarely applicable in the case of the taxpayer for the relevant year.
- Further, as there is no deemed income accruing or arising to the taxpayer in India within the ambit of Section 9(1)(i), there is no attribution of income to operations in India.
- Consequently, the payment received by the taxpayer from sales of capacity made to VSNL was not taxable either as 'royalty' under Section 9(1)(vi) of the Act or 'business income' accruing or arising in India within the deeming provision of Section 9(1)(i) of the Act.

[2] CBDT Circular No. 23, dated 23 July 1969 which has subsequently been withdrawn by a Circular No 7, dated 22 October 2009 and that the later Circular does not have a retrospective effect

***Taxability of standby maintenance charges and repair and maintenance charges***

- The entire cable system is to be operated and maintained by founding signatory in co-ordination with relevant landing party signatory. Flag Network Operation Centre (FNOC) has to provide overall network service surveillance and over all co-ordination of maintenance and repair operations of Flag cable system.

- The taxpayer has to co-ordinate the deployment of the vessels for repairs and maintenance operation in accordance with the procedure defined. The maintenance activities undertaken by the taxpayer for the purpose of standby maintenance was for the arrangement for standby cover and maintenance and operation of FNOC.

- Standby maintenance charges were not in respect of any actual rendering of services but to maintain infrastructure for co-ordination and setting up conditions for efficient rendering of services in relation to maintenance and repairs of cable system.

- There was a separate charge for repair and maintenance under the C&MA whereby, the taxpayer was actually required to undertake repair and maintenance. The standby maintenance was a fixed annual charge which was payable, not for providing services but for arranging standby maintenance arrangement which was required for a situation whenever some repair work in the undersea cable or terrestrial cable is actually performed.

- In relation to the standby maintenance, the payment made by VSNL is not in the nature of 'managerial service' or 'consultancy services'.

- If the taxpayer was providing some kind of repair services in the cable system, then it can be termed as 'technical services'. However, if there was no actual rendering of services, but mere collection of annual charge to recover the cost of standby facility, agreed by all the members of the consortium on proportionate cost basis, then the taxpayer was not providing any kind of 'technical services'.

- In the present case, the standby maintenance charges were in the form of fixed annual charge which was in the nature of reimbursement. Only actual cost incurred had been recovered from VSNL in providing the standby maintenance services.

- Accordingly, the receipts on account of standby maintenance charges cannot be taxed as FTS, under Section 9(1)(vii) as there was no rendering of services.

- However, whenever payment is received on account of actual repair or maintenance carried out, then same would definitely fall within the ambit of FTS chargeable to tax under Section 9(1)(vii) of the Act.

## Our comments

This is a welcome ruling of the Mumbai Tribunal where it has been observed that the buyer of the capacity in a particular segment of the cable network has exclusive rights of the owner which can be used in the manner the owner proposes. Therefore, it is a 'sale of capacity' and consideration for sale of such capacity is not taxable as royalty. Further, the sale of capacity does not arise through and from business connection in India and therefore, the income is not deemed to accrue or arise in India.

The Tribunal also held that the standby maintenance charges are not taxable as FTS since there is no rendering of services. However, when payment is received on account of actual repair or maintenance carried out, it would be chargeable to tax as FTS.

This case was decided under the provisions of the Act because India does not have a tax treaty with Bermuda.

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