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## Payment for acquisition of capacity in undersea cables taxable as royalty

### In brief

In a recent decision<sup>1</sup>, the Authority for Advance Rulings (the AAR) held that the amount received by Saudi Telecom Limited (STC) from Dishnet Wireless Ltd. (Applicant) under the terms of the Europe India Gateway submarine cable (EIG cable system) Capacity Transfer Agreement towards the transfer of the EIG capacity is taxable in India. The AAR held that the payment was consideration for the right to access and use the EIG cable system. The transaction did not constitute a transfer of ownership. It was accordingly held that the payment qualified as 'Royalty' both under the Income-tax Act, 1961 (the Act) as well as the Double Taxation Avoidance Agreement between India and Saudi Arabia (tax treaty).

<sup>1</sup>Dishnet Wireless Ltd., *In re* [2012] 24 taxman.com 298 (AAR)

### Facts

- The Applicant is a company incorporated in India and is engaged in the business of providing telecommunication services in India.
- A consortium, of which STC is a part, entered into a Construction and Maintenance Agreement (CMA) on 6 May 2008 to plan and lay the EIG cable system, linking the Indian subcontinent and the UK through underground submarine cables. STC acquired 7.1265% stake in the EIG cable system through an initial investment of 50 million USD.
- The members of the consortium were entitled to capacity allocation in portions of the EIG cable system based on the proximity to the country to which the

consortium member belonged. The members were entitled to transfer their share of capacity to other telecommunication entities privately, provided the transferee complied with the conditions laid down in the CMA.

- STC entered into a Capacity Transfer Agreement (CTA) with the Applicant for transfer of the right to use 40% of its allocated capacity in the EIG cable system for a consideration of 20 million USD.

### Issues for consideration

- Whether payment by the Applicant to STC for transfer of right to use 40% of its allocated capacity constitute payment in the nature of 'royalty'?
- Whether payment by the Applicant to STC towards annual operation and maintenance charges of the EIG cable system would be in the nature of fees for technical services (FTS)?
- Whether the above payment would suffer tax withholding under section 195 of the Act?

### Applicant's contentions

- The Applicant contended that the capacity acquired in the EIG cable system should qualify as a 'capital asset' situated completely outside India. Accordingly, such capital gains should not be taxable in India.
- It was also contended that since the consideration paid to acquire 40% of the allocated capacity of STC was in the nature of transfer of rights acquired by STC under the CMA, the corresponding 40% recoupment of the liability or obligation by STC (i.e. 40% of 50 million USD) was in the nature of cost reimbursement for STC.

### Revenue's contentions

- The stake held in the EIG cable system by STC is not an independent asset which can be transferred independent of the CMA.
- The sum paid by the Applicant was in consideration for the right to exclusively use a specific segment of the EIG cable system and hence would qualify as 'royalty' within the Act and the tax treaty.

### AAR ruling

- The following observations were made by the AAR on the CMA:
  - The members were to hold the allocated capacity on an ownership basis and were free to designate a portion of it to other telecommunication entities.
  - Such transfer would mean making available to a non-EIG party the right to use the capacity.
  - The transferor would ultimately be liable for any amounts due under the CTA.
  - With the prior written consent of the Management Committee constituted under the CMA, a party could assign, sell or transfer all its rights and obligations under the CMA. The transfer would be subject to the transferee acceding to the CMA.
- The following observations were made by the AAR on the CTA:
  - It does not purport to transfer all the rights and obligations of STC under the CMA.
  - No right of ownership, property in or title to the capacity, facilities or network infrastructure, equipment or software was conveyed to or vested in the Applicant.

- The right to use the transferred capacity is exclusive to the Applicant and is non-transferable to any third party.
- In the event of termination of the CTA, all rights of capacity that had been transferred to the Applicant shall revert to STC immediately unless mutually agreed otherwise.

### **Not capital expenditure**

- The AAR held that the CTA is not an agreement to transfer the ownership in the EIG cable system. It merely grants the Applicant the right to participate in the use of the EIG cable system.
- The AAR held that the contention of ownership rights transfer were vitiated by the fact that the Applicant was restrained from transferring the capacity to any third party, and the fact that all the rights on the Applicant would revert to STC on termination of the CTA.

### **Not a reimbursement**

- The AAR rejected the contention of cost reimbursement since the obligation of STC under CMA is independent of the obligation of the Applicant to STC. Accordingly, the AAR held that the payment to STC was for the right to use the equipment or capacity in the EIG cable system.

### **Royalty**

- The AAR considered the recent insertion of Explanations (5) and (6) to section 9(1)(vi) of the Act which seeks to clarify the scope of the definition of 'royalty'. The AAR held that under the scope of the recently amended definition, the payments to STC would qualify as consideration for use of a process and a right to use commercial or scientific equipment. Hence, it was held that the payment would suffer tax withholding under section 195 of the Act.

### **Annual maintenance charges**

- With regard to the payment of annual operations and maintenance charges, it was held that they were towards a share for maintaining the entire EIG cable system and hence would not qualify as FTS. Accordingly, the same would not suffer tax withholding under section 195 of the Act.

### **Conclusion**

The AAR, based on the facts and circumstances of the case, held that the transfer of a right to exclusively use a specific segment of the submarine cable system would qualify as royalty.

This ruling appears distinguishable from the issue of taxability of connectivity services provided by telecom service providers to businesses. However, this judgment may be of relevance and have persuasive value in cases where a telecom service provider, as a consortium member, transfers its share in a cable to another telecom operator.

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