



## Tax alert: SC says TDS not applicable on sale of prepaid SIM cards to distributors, by telecom companies

6 March 2024

The Supreme Court of India has held that telecom companies selling prepaid SIM cards to distributors/franchisees at discounted prices, would not attract TDS under section 194H of the Income-tax Act, 1961, in the absence of principal-agent relationship.

### In a nutshell



The obligation of TDS under section 194H of the ITA arises when the legal relationship of principal-agent is established.

TDS under section 194H of the ITA is not to be extended and widened in ambit, to apply to true/genuine business transactions, where the taxpayer is not the 'person responsible for paying or crediting income'.

When the obligation, and the time and manner in which the tax is mandated by law to be deducted at source, is fixed by the statute, the same cannot be shifted/alterd/modified or postponed on a concession in the Court by the Revenue.



Following aspects should be considered for a principal-agent relationship:

- The essential characteristic of an agent is the legal power vested with the agent to alter his principal's legal relationship with a third party and the principal's co-relative liability to have his relations altered.
- As the agent acts on behalf of the principal, one of the prime elements of the relationship is the exercise of a degree of control by the principal over the conduct of the activities of the agent.
- The task entrusted by the principal to the agent, should result in a fiduciary relationship.
- As the business done by the agent is on the principal's account, the agent is liable to render accounts thereof, to the principal. An agent is entitled to remuneration from the principal for the work he performs for the principal.



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## Background:

- The taxpayers<sup>1</sup> are cellular mobile telephone service providers in different circles as per the licence granted to them under section 4 of the Indian Telegraph Act, 1885, by the Department of Telecommunications (DoT), Government of India.
- To carry on business, the taxpayers have to comply with the licence conditions and the rules and regulations of the DoT and the Telecom Regulatory Authority of India (TRAI).
- Amongst others, under the prepaid business model, the end-users, or customers, are required to pay for services in advance, which can be done by purchasing recharge vouchers or top-up cards from the retailers. For a new prepaid connection, the customers, or end-users, purchase a kit, called a start-up pack, which contains a Subscriber Identification Mobile card (SIM card), and a coupon of the specified value as advance payment to avail the telecom services.
- The taxpayer had entered into franchise or distribution agreements with several parties.
- The case under consideration revolved around the question of whether the sale of prepaid SIM cards by the taxpayers to distributors at discounted prices (below MRP), which was ultimately sold by such distributors at MRP or below MRP, but above the purchase price, would attract tax deduction at source (TDS) under section 194H of the Income-tax Act, 1961 (ITA), [relating to tax deduction at source on commission/brokerage income of payee]?
- In the course of appellate proceedings, the matter reached before the High Courts (HCs). The HCs of Delhi and Calcutta held that the taxpayers were liable to deduct TDS under section 194H of the ITA, whereas the HCs of Rajasthan, Karnataka and Bombay held that section 194H of the ITA was not attracted to the circumstances under consideration. The matter was now before the Supreme Court (SC).

## Relevant provisions in brief:

- **Extracts of section 194H of the ITA:**

### ***“194-H. Commission or brokerage.—***

*Any person, not being an individual or a Hindu undivided family, who is responsible for paying, on or after the 1st day of June, 2001, to a resident, any income by way of commission (not being insurance commission referred to in Section 194-D) or brokerage, shall, at the time of credit of such income to the account of the payee or at the time of payment of such income in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income tax thereon at the rate of five per cent...*

*...Explanation.—For the purposes of this section,—*

*(i) "commission or brokerage" includes any payment received or receivable, directly or indirectly, by a person acting on behalf of another person for services rendered (not being professional services) or for any services in the course of buying or selling of goods or in relation to any transaction relating to any asset, valuable article, or thing, not being securities..."*

## Decision of the SC:

The observations of the SC were as follows:

### Section 194H of the ITA

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<sup>1</sup> Bharti Cellular Ltd (Now Bharti Airtel Ltd) vs. ACIT, Kolkata [2024] Civil Appeal No. 7257 of 2011 along with batch of other appeals (SC)

- Section 194H of the ITA (imposes the obligation to deduct TDS) states that any person responsible for paying at the time of credit or at the time of payment, whichever is earlier, to a resident any income by way of commission or brokerage, shall deduct income tax at the prescribed rate. As per section 204(iii) of the ITA, in the case of credit or in the case of payment in certain cases, 'the person responsible for paying' is the payer himself, or if the payer is a company, the company itself and the principal officer thereof.
- Explanation (i) to section 194H of the ITA, defines the expressions 'commission' or 'brokerage' and with respect to the same, amongst others:
  - The payment received or receivable should be to a person acting on behalf of 'another person'.
  - The words 'another person', refers to 'the person responsible for paying'.
  - The words 'direct' or 'indirect' are with reference to the act of payment. The legislative intent to include 'indirect' payment ensures that the net cast by the section is plugged and not avoided or escaped; albeit it does not dilute the requirement that the payment must be on behalf of 'the person responsible for paying'. The payment/credit in the account should arise from the obligation of 'the person responsible for paying'.
  - The payee should be the person who has the right to receive the payment from 'the person responsible for paying'. When this condition is satisfied, it does not matter if the payment is made 'indirectly'.
  - It is restricted to the services rendered by the agent to the principal in the course of buying and selling of goods, or in relation to any transaction relating to any asset, valuable article, or thing, not being securities.

### Relationship between principal and agent

- It was settled by a series of earlier rulings<sup>2</sup> of the SC that the expression, 'acting on behalf of another person' postulated the existence of a legal relationship of principal and agent, between the payer and the recipient/payee.
- The law of agency was technical. Whether in law, the relationship between the parties is that of principal-agent, is by applying section 182 of the Contract Act, 1872 (CA, 1872). Therefore, the obligation of TDS under section 194H of the ITA arises when the legal relationship of principal-agent is established.

Agency in terms of section 182 of CA, 1872 exists when the principal employs another person, who is not his employee, to act or represent him in dealings with a third person.

- Whether a legal relationship of a principal and agent exists, the following factors/aspects should be taken into consideration:
  - a. The essential characteristic of an agent is the legal power vested with the agent to alter his principal's legal relationship with a third party and the principal's co-relative liability to have his relations altered<sup>3</sup>.
  - b. As the agent acts on behalf of the principal, one of the prime elements of the relationship is the exercise of a degree of control by the principal over the conduct of the activities of the agent. This degree of control is less than the control exercised by a master on a servant and is different from the rights and obligations in case of principal to principal and independent contractor relationship.
  - c. The task entrusted by the principal to the agent should result in a fiduciary relationship. The fiduciary relationship is the manifestation of consent by one person to another, to act on his or her behalf and subject to his or her control, and the reciprocal consent by the other to do so<sup>4</sup>.
  - d. As the business done by the agent is on the principal's account, the agent is liable to render accounts thereof to the principal. An agent is entitled to remuneration from the principal for the work he performs for the principal.

<sup>2</sup> Singapore Airlines Ltd. and Another v. CIT [2023] 1 SCC 497 (SC)

<sup>3</sup> F.E. Dowrick, The Relationship of Principal and Agent, 17 MLR 24, 37 (1954)

<sup>4</sup> RESTATEMENT (THIRD) OF AGENCY (AMERICAN LAW INSTITUTE PUBLISHERS 2007)

- e. The term ‘agent’ should be restricted to one who has the power of affecting the legal position of his principal by the making of contracts, or the disposition of the principal’s property; viz. an independent contractor who may, incidentally, also affect the legal position of his principal in other ways. It is in the restricted sense in which the term agent is used in explanation (i) to section 194-H of the ITA.

### Earlier SC rulings on Principal-Agent relationship

- In an earlier ruling<sup>5</sup>, the SC, in the context of distinction between a contract of sale and contract of agency, observed that:
  - The agent is authorised to sell or buy on behalf of the principal, whereas the essence of contract of sale is the transfer of title of goods for the price paid or promised to be paid.
  - In case of an agency to sell, the agent who sells them to the third parties, sells them not as his own property, but as a property of the principal, who continues to be the owner of the goods till the sale. The transferee is the debtor and liable to account for the price to be paid to the principal, and not to the agent for the proceeds of the sale. An agent is entitled to his fee or commission from the principal.
- The SC in another ruling<sup>6</sup> held that:
  - All kinds of interactions with third parties or interested parties, resulting from the introduction of the third parties with one who wishes a particular undertaking to be performed, may not be a result of an agency.
  - An agent renders service to the principal, who he/she represents, and therefore the principal, and not the agent, is liable to the third parties.
  - The money received by an independent contractor from his customers, will belong to the independent contractor and not to the party who sold to him. The money will be a part of such independent contractor’s property in the event of his bankruptcy or liquidation.

### Agreement between the taxpayer and the franchisee/distributor

- The franchisee/distributor was appointed for marketing of prepaid services and for appointing the retailer or outlets for sale promotion. It was pertinent to note that the retailers or outlets for sale promotion are appointed by the franchisee/ distributor and not the taxpayer.
- The franchisees/distributors, amongst others:
  - Had agreed not to undertake activities mentioned in the agreement for any other competitive cellular mobile telephone service provider in the business.
  - Had to comply with statutory, regulatory, and municipal permissions while conducting the business.
  - Had agreed to indemnify and keep indemnified, the taxpayer against any and all costs, expenses and charges imposed on the taxpayer because of any action by a statutory, regulatory, or municipal authority due to non-compliance by the franchisee/distributor.
  - Had to maintain a suitable establishment for the conduct of business and performance of obligations. While doing so, the franchisee / distributor had to conform and adhere to the policies communicated to it from time to time by the taxpayer.
  - Had to maintain proper and sufficient quantities of prepaid start-up packs and recharge coupons, to meet market requirements. At no point in time, are the right, title, or interest in the prepaid cards passed on to the franchisee/distributor. All rights, title ownership and property rights in the cards rested with the taxpayer.

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<sup>5</sup> Bhopal Sugar Industries Limited v. Sales Tax Officer, Bhopal (1977) 3 SCC 147

<sup>6</sup> Labreche v. Harasymiw [1992] 89 DLR (4<sup>th</sup>) 95 at 107 (SC)

- Was solely responsible and liable for safety and storage of prepaid start-up kits, recharge cards and other material. The taxpayer was not liable for any loss, pilferage, or damage to the pre-paid coupons/starter-kits.
  - Had to indemnify the taxpayer for any loss caused on this account. The franchisee/distributor was to insure the prepaid start-up kits/ recharge coupons; the liability for any loss or damage due to fire, burglary, theft etc. was that of the franchisee/distributor.
  - Had to employ a fully trained service staff, who had undergone training in accordance with the standards set out by the taxpayer.
  - Was responsible to collect all necessary agreement/contract Forms and other related Forms, after obtaining signatures of the customers on the said Forms. These Forms, duly completed in all respects and signed by the customers, were to be forwarded to the taxpayer for verifications and for record keeping.
- The franchisee's/distributor's price and payment for services was to be specified by the taxpayer from time to time. The rates could be varied during the terms of the agreement at the discretion of the taxpayer and such variation was to be intimated to the franchisee/distributor.
  - All tax liabilities in connection with, or arising out of, the transactions pertaining to the agreement, was the responsibility of the franchisee/distributor.
  - The franchisees/distributors were required to pay in advance, the price of the welcome kit containing the SIM card, recharge vouchers, top-up cards, e-tops, etc. The above-mentioned price was a discounted one. Such discounts were given on the price printed on the pack of the prepaid service products. The franchisee/distributor paid the discounted price, regardless of, and even before, the prepaid products being sold and transferred to the retailers or the actual consumer. The franchisee/distributor was free to sell the prepaid products at any price below the price printed on the pack. The franchisee/distributor determined his profits/income.

#### **Mandate given by DoT to the taxpayer**

- The Revenue highlighted that the prepaid SIM cards were not the property of franchisee/distribution, and no right, title or interest was transferred to them. These were always to remain the property of the taxpayer. This was correct, but this was a mandate and requirement of the licence issued to the taxpayer by the DoT. In actual practice, the right to use the SIM card and its possession was handed over and given to the end-user, that is, the customer who installed the SIM card in his phone to avail the telecommunication services.
- The contractual obligations of the distributors/franchisees did not reflect a fiduciary character of the relationship, or the business being done on the principal's account.

#### **Applicability of 194H in the case under consideration**

- TDS under section 194H of the ITA was not to be extended and widened in ambit to apply to true/genuine business transactions, where the taxpayer was not the person responsible for paying or crediting income.
- In the present case, the taxpayer neither paid nor credited any income to the person with whom he had contracted.
- Explanation (i) to section 194H of the ITA, by using the word 'indirectly', does not regulate or curtail the manner in which the taxpayer can conduct business and enter into commercial relationships; neither does the word 'indirectly' create an obligation where the main provision does not apply.
- The tax legislation recognises diverse relationships and the modes in which commerce and trade are conducted, albeit obligation to tax at source arises only if the conditions as mentioned in section 194H of the ITA, are met and not otherwise. This principle does not negate the compliance required by law.

#### **Impossibility of deducting TDS by the taxpayer**

- The taxpayers were not privy to the transactions between distributors/franchisees and third parties. It was, therefore, impossible for the taxpayer to deduct TDS and comply with section 194H of the ITA, on the difference between the total/sum consideration received by the distributors/ franchisees from third parties and the amount paid by the distributors/ franchisees to them.
- Further, it was willy-nilly impossible to deduct, as well as make payment of the tax deducted, within the timelines prescribed by law, as these begin when the amount is credited in the account of the payee by the payer or when payment is received by the payee, whichever is earlier. The payee receives payment when the third party makes the payment.
- This payment was not the payment received or payable by the taxpayer as the principal. The distributor/franchisee was not the trustee who was to account for this payment to the taxpayer as the principal. The payment received was the gross income or profit earned by the distributor/franchisee. It was the income earned by distributor/ franchisee as a result of its efforts and work, and not a remuneration paid by the taxpayer as a cellular mobile telephone service provider.
- When the obligation, and the time and manner in which the tax is mandated by law to be deducted at source, is fixed by the statute, the same cannot be shifted/altered/modified or postponed on a concession in the Court by the Revenue. The concession may be granted, when permissible, by way of a circular issued in accordance with section 119 of the ITA.

### Conclusion

- In view of the above, the taxpayer would not be under a legal obligation to deduct tax at source on the income/profit component in the payments received by the distributors/franchisees from the third parties/customers, or while selling/transferring the pre-paid coupons or starter-kits to the distributors under section 194H of the ITA.
- Accordingly, the appeals filed by the taxpayers (cellular mobile service providers) were allowed.

### Comments:

Whether a particular business relationship would consist of principal-agent or principal-principal or franchisor/franchisee, is a fact-based exercise. There was an ongoing litigation as to whether prepaid SIM cards sold by telecom companies to distributors/franchisees, at discounted prices, would attract TDS under section 194H of the ITA.

The SC, in this ruling, while holding that such telecom companies would not be liable for TDS under section 194H of the ITA, has amongst others, upheld the following principles:

- The expression 'acting on behalf of another person' postulates the existence of a legal relationship of principal and agent, between the payer and the recipient/payee.
- The obligation of TDS under section 194H of the ITA arises when the legal relationship of principal-agent is established.
- Whether a legal relationship of a principal and agent exists, the following factors/aspects should be taken into consideration:
  - a. The essential characteristic of an agent is the legal power vested with the agent to alter his principal's legal relationship with a third party and the principal's co-relative liability to have his relations altered.
  - b. As the agent acts on behalf of the principal, one of the prime elements of the relationship is the exercise of a degree of control by the principal over the conduct of the activities of the agent. This degree of control is less than the control exercised by a master on a servant and is different from the rights and obligations in case of principal to principal and independent contractor relationship.

- c. The task entrusted by the principal to the agent should result in a fiduciary relationship. The fiduciary relationship is the manifestation of consent by one person to another, to act on his or her behalf, and subject to his or her control, and the reciprocal consent by the other to do so.
  - d. As the business done by the agent is on the principal's account, the agent is liable to render accounts thereof to the principal. An agent is entitled to remuneration from the principal for the work he performs for the principal.
- TDS under section 194H of the ITA is not to be extended and widened in ambit to apply to true/genuine business transactions, where the taxpayer is not the 'person responsible for paying or crediting income'.
  - Explanation (i) to section 194H of the ITA, by using the word 'indirectly', does not regulate or curtail the manner in which the taxpayer can conduct business and enter into commercial relationships. Neither does the word 'indirectly' create an obligation where the main provision does not apply.
  - When the obligation, and the time and manner in which the tax is mandated by law, to be deducted at source, is fixed by the statute, the same cannot be shifted/altered/modified or postponed on a concession in the Court by the Revenue. The concession may be granted, when permissible, by way of a circular issued in accordance with section 119 of the ITA.

In addition, the SC has also considered its recent ruling<sup>7</sup> (which was also relied upon by the Revenue) while pronouncing the said ruling and highlighted the distinguishing features of the same. Our tax alert on the same can be accessed in the link below:

<https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/Global%20Business%20Tax%20Alert/in-tax-gbt-Airlines-liable-to%20deduct-TDS-on-supplementary-commission-earned-by-air-travel-agents-noexp.pdf>

Further, the SC has also considered various aspects while pronouncing its ruling, such as:

- Distinction between agent and servant;
- Distinction between a contract of sale and contract of agency;
- Legal position of distributor, franchisee and independent contractor as compared to that of an agent.

Taxpayers may evaluate the impact of this ruling to the facts of their cases.

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<sup>7</sup> Singapore Airlines Ltd. and Another v. Commissioner of Income Tax, (2023) 1 SCC 497

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