Deloitte.

Tax alert: Interconnectivity utility charges not taxable as royalty under domestic tax law

5 July 2024

The Bangalore Bench of the Income-tax Appellate Tribunal has held that interconnectivity utility charges (IUC) [also referred to as 'interconnectivity usage charges'] received by the taxpayer (non-resident telecom operator) from an Indian entity would not be taxable as royalty under section 9(1)(vi) of the Income-tax Act, 1961.

In a nutshell

The term 'process' used under Explanation 2 of section 9(1)(vi) of the Income-tax Act, 1961 (ITA) in the definition of 'royalty', refers to various species of IPs such as patent, invention, model, design, formula, trademark etc.

As per Explanations 5 and 6 of section 9(1)(vi) of the ITA, the word 'process' includes and shall be deemed to include transmission by satellite (including up-linking, amplification, conversion for downlinking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret. The explanation does not do away with the requirement of successful exclusivity of such right in respect of such process being with the person claiming 'royalty' for granting its usage to a third party.

The possession, dominion and control over property should be fully granted to the user and so long as the non-resident taxpayer have not denuded themselves of utilizing the process, the payment made by the Indian telecom operators to such non-resident could not be held to be the payment for the 'use' or the 'right to use' the process or equipment.

Scroll down to read the detailed alert

Background:

- The taxpayer[1] is a non-resident company registered in Hong Kong. During Financial Years (FYs) 2013-14 and 2016-17, corresponding to Assessment Years (AYs) 2014-15 and 2017-18, the taxpayer received interconnectivity charges from an Indian entity (I Co) in respect of international carriage and connectivity services agreement entered into between the taxpayer and the I Co.
- During the course of reassessment proceedings under section 148 of the Income-tax Act, 1961 (ITA), the Assessing Officer (AO) held that the payment received by the taxpayer from I Co was taxable as royalty under section 9(1)(vi) [relating to income deemed to accrue or arise in India] of the ITA, on the basis that the payment was made to 'use the process' or 'an equipment'.
- Aggrieved, the taxpayer filed an appeal before the Bangalore Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions in brief:

Relevant extract of section 9(1)(vi) of the ITA

"*(1) The following incomes shall be deemed to accrue or arise in India…*

… (vi) income by way of royalty…

… Explanation 2.—For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for—

(i) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trademark or similar property ;

(ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trademark or similar property ;

(iii) the use of any patent, invention, model, design, secret formula or process or trademark or similar property…

… (iva) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB…

… Explanation 5.—For the removal of doubts, it is hereby clarified that the royalty includes and has always included consideration in respect of any right, property or information, whether or not—

(a) the possession or control of such right, property or information is with the payer;

(b) such right, property or information is used directly by the payer;

(c) the location of such right, property or information is in India.

Explanation 6.—For the removal of doubts, it is hereby clarified that the expression "process" includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret"

Decision of the ITAT:

The ITAT noted /observed the following:

Explanation 2 to section 9(1)(vi) of the ITA

[1] Globe Teleservices Ltd v. DCIT [2024] 163 taxmann.com 73 (Bangalore ITAT)

- The term ‘process’ used under Explanation 2 to section 9(1)(vi) of the ITA 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 ITA, refer to various species of intellectual properties (IPs) such as patent, invention, model, design, formula, trademark etc. The expression 'similar property' further fortifies the stand that the terms 'patent, invention, model, design, secret formula or process or trademark' are to be understood as belonging to the same class of properties viz. IPs.

- The term 'Intellectual property' as understood in common parlance meant, knowledge, creative ideas, or expressions of human mind that have commercial value and are protectable under copyright, patent, service mark, trademark, or trade secret laws from imitation, infringement, and dilution. Intellectual property includes brand names, discoveries, formulas, inventions, knowledge, registered designs, software, and works of artistic, literary, or musical nature.

- Thus, the word ‘process’ refer to specie of IP, applying the rule of ejusdem generis or noscitur a sociis, as held by the Supreme Court (SC) in an earlier ruling[2].

- In the case under consideration, there was no transfer of any IP rights or any exclusive rights that had been granted by the taxpayer to the service recipient (I Co) for using such IP. Therefore, Explanation 2 to section 9(1)(vi) of the ITA could not be invoked.

Explanation 5 and 6 to section 9(1)(vi) of the ITA

- By insertion of explanation 5 and 6 to section 9(1)(vi) of the ITA vide Finance Act 2012 (with retrospective effect from 1 June 1976), the meaning of the word ‘process’ had been widened. The word 'process' need not be 'secret', and situs of control and possession of right, property or information had been rendered irrelevant.

- As per Explanation 5 and 6, the word 'process' includes and shall be deemed to include transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret. The Explanation did not do away with the requirement of successful exclusivity of such right in respect of such process being with the person claiming 'royalty' for granting its usage to a third party.

Judicial precedents

- The Authority for Advance Ruling (AAR) in earlier rulings[3] noted that in order to satisfy ‘use or right to use’, the control and possession of the right, property or information should be with service recipient.

- The Karnataka High Court (HC) in an earlier ruling[4] had observed the following:
  - The payment to non-resident telecom operator (NTO) for providing interconnect services and transfer of capacity in foreign countries could not be charged as royalty as there was no ‘use’ or ‘right to use’ process, equipment.
  - The granter of the right (non-resident taxpayer in the present case) to be denuded from the property, and it should vest completely with the recipient (I Co in the present case).
  - The possession, dominion and control over such property should be fully granted to the user and so long as the NTOs (non-resident taxpayer in the present case) have not denuded themselves of utilizing the

[2] CIT v. Bharti Cellular [2010] 193 Taxman 97 (SC)

[3] Cable & Wireless Networks India (P.) Ltd. [2009] 182 Taxman 76 (AAR), ISRO Satellite Centre [2008] 175 Taxman 97 (AAR) and Dell International Services India (P.) Ltd. [2008] 172 Taxman 418 (AAR)

[4] Vodafone Idea Ltd. v. DDIT [2023] 152 taxmann.com 575 (Karnataka HC)

process, the payment made by the Indian telecom operators to such NTOs could not be held to be the payment for the 'use' or the 'right to use' the process or equipment.

Conclusion

- There was no treaty between India and Hong Kong, the country of which the taxpayer was a tax resident. Therefore, the payment received by taxpayer had to be analysed under ITA alone.
- In earlier cases[5], the ITAT had analysed the taxability of identical payment received by the taxpayer for similar services, under the ITA, having regards to section 9(1)(vi) of the ITA; Explanation 2, 5 and 6. The ITAT in these cases had held that payments made by an Indian telecom company for telecom services, as rendered by the taxpayer in the case under consideration would not fall within the ambit of royalty under section 9(1)(vi) read with Explanation 2, 5 and 6 of section 9(1)(vi) of the ITA.
- Further, the Revenue had not made out a case that there was a permanent establishment of the taxpayer in India in order to tax the receipt by the taxpayer in India as it was arising from extra territorial sources. Accordingly, the payments received by the taxpayer amounted to business profits of the taxpayer taxable in the recipient country.

In view of the above, the ITAT held that the payments received by the taxpayer could not be held to be royalty under section 9(1)(vi) of the ITA.

Comments:

This ruling has held / upheld the following:

- The term 'process' used under Explanation 2 to section 9(1)(vi) of the ITA in the definition of 'royalty' refers to various species of IPs such as patent, invention, model, design, formula, trademark etc.
- As per Explanation 5 and 6 of section 9(1)(vi) of the ITA, the word 'process' includes and shall be deemed to include transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret. The Explanation does not do away with the requirement of successful exclusivity of such right in respect of such process being with the person claiming 'royalty' for granting its usage to a third party.
- The possession, dominion and control over such property should be fully granted to the user and so long as the NTOs (non-resident taxpayer in the present case) have not denuded themselves of utilizing the process, the payment made by the Indian telecom operators to such NTOs could not be held to be the payment for the 'use' or the 'right to use' the process or equipment.

It may be pertinent to note that the Delhi Bench of the ITAT in case of *B.T. Global Communications India Pvt. Ltd v. DCIT* had held that payment made for network connectivity services outside India were not in the nature of royalty in terms of Article 13 of India-UK tax treaty.

https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/Global%20Business%20Tax%20Alert/in-taxgbt-alert-network-connectivity-charges-not-in-the-nature-of-royalty-noexp.pdf

Further it may be pertinent to note that India has entered into a tax treaty with Hong Kong which has entered into force on 30 November 2018 and a notification[6] in respect of the same has been issued on 21 December 2018.

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

---

[5] Telefonica De Espana SA v. ACIT/DCIT [2023] 154 taxmann.com 436 (Bangalore -Trib.); Telefonica De Espana SA v. DCIT in IT(IT)A Nos. 215 & 216/Bang/2023 by order dated 17 August 2023; Al Telekom Austria Aktiengesellschaft v. DCIT in IT(IT)A Nos. 336, 338 & 339/Bang/2023 by order dated 25 August 2023; Telecom Italia Sparkle Singapore Pte. Ltd. v. DCIT in IT(IT)A Nos. 579 & 580/Bang/2020 &IT(IT)A No. 1138/Bang/2022 by order dated 31 August 2023

[6] Notification No. S.O. 6247(E) [NO.89/2018/F.NO.500/124/97-FTD-II], dated 21 December 2018

Deloitte.