

SC opines that annual license fees paid by telecom operators is capital in nature

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Summary

The issue before the Supreme Court (SC) in this case¹ was whether the variable licence fee paid by telecommunication companies (Taxpayers) to the Department of Telecommunications under the New Telecom Policy (NTP) of 1999 is revenue in nature and is to be allowed as deduction under Section 37 of the Income-tax Act, 1961 (the Act) **or** whether the same is capital in nature, and accordingly, amortisation is required to be done in accordance with Section 35ABB of the Act.

The SC has, vide its order dated 16 October 2023, settled this controversy and held that variable license fee is capital in nature. The rationale being that consequence of non-payment would result in cancellation of license, which is intrinsic to the taxpayer's trade. The SC held that the nomenclature and manner of payment is irrelevant for deciding whether an expenditure is capital in nature.

Facts of the case

- The taxpayer, engaged in the business of telecommunication services, procured a licence to maintain and operate cellular mobile services under the Indian Telegraph Act, 1885. The agreement for such license was executed under NTP 1994.
- **NTP 1999:** This policy substituted the NTP 1994 w.e.f. 22 July 1999 and provided that:
 - Existing operators (i.e. licensee) need to pay a one-time entry fee (payable upto 31 July 1999).
 - Subsequently, w.e.f. 1 August 1999, a yearly licence fee was payable on a percentage of AGR (percentage was to be decided by the TRAI²). Meanwhile, the GOI³ fixed 15% of AGR as provisional license fee.
- As per NTP 1994, fixed amount of license fee was payable for the first three years, and from the fourth year, the fees was based on the number of subscribers⁴.
- The taxpayer had treated the license fee paid as per NTP 1994 as capital expenditure.
- Migration to NTP 1999 was on the condition that all legal proceedings shall be withdrawn and no dispute relating to the period up to 31 July 1999, will be raised in future.
- The taxpayer paid the entry fee up to 31 July 1999, and treated such entry fee as capital expenditure.
- For assessment year (AY) 2003-04, taxpayer filed ROI⁵ declaring 'Nil' income. It claimed yearly license fee of INR 11.88 crore as revenue expenditure.

¹ In the case of Bharti Hexacom Ltd. and others vide Civil Appeal No(S). 11128 of 2016 (batch of appeals)

² Telecom Regulatory Authority of India

³ Government of India

⁴ irrespective of the revenue, subject to the prescribed minimum

⁵ Return of income

- On scrutiny, the assessing officer (AO) treated such license fee as capital expenditure and allowed it to be amortised over the licence period as per Section 35ABB of the Act. Accordingly, the AO allowed INR 0.99 crore as expense (i.e. amortised portion) and disallowed the balance amount.
- On appeal, CIT(A)⁶ held that annual licence fee calculated on the basis of AGR would be deductible as revenue expenditure under Section 37 of the Act.
- Further, the tribunal upheld the CIT(A)'s order. The Tribunal placed reliance on its earlier order in the case of Bharti Cellular Ltd⁷ wherein the facts were identical to the present case.

Delhi HC's verdict

The Delhi HC held that:

- Section 35ABB of the Act applies when expenditure of capital nature is incurred for acquiring a right for operating telecommunication services and it is not a deeming provision.
 - It observed that the aforesaid section does not help in determining whether the license fee is capital or revenue in nature.
 - Licencees require a licence to start or commence business as cellular telephone operators. Accordingly, the payment of a licence fee was a precondition for the licensee to commence or set up the business.
 - Delhi HC held that license fee payable for the period up to 31 July 1999 should be treated as capital expenditure and is eligible for deduction under Section 35ABB of the Act.
- However, it held that license fee payable on AGR basis is revenue expenditure incurred for continuing to operate and run the business. The matter then travelled to the SC.

Issue before the SC:

Whether the variable annual licence fee is capital or revenue in nature.

SC's verdict

- The SC observed that the following conditions are cumulatively required to fulfilled in order to apply provisions of Section 35ABB of the Act:
 - Expenditure must be capital in nature.
 - Expenditure must be incurred by a taxpayer for the purpose of acquisition of the right to operate telecom services.
 - Expenditure must represent the payment actually made to obtain a licence.
- Indian Telegraph Act, 1885, is the parent legislation, which *inter alia* provide that:
 - The central government (CG) may grant a licence to establish, maintain or work a telegraph by granting a licence on the payment of a licence fee.
 - The CG may revoke the licence issued on grounds of default in payment of consideration.
- The SC also discussed the qualitative changes effected in the license agreement due to migration from NTP 1994 to NTP 1999.

⁶ Commissioner of Income-tax (Appeal)

⁷ ITA No. 5335 (Del)/2003 dated 29 May 2009

- The SC upheld and reiterated the principles laid down by various courts regarding the aspects that need to be considered for determining whether an expenditure is capital in nature.
- It also observed that the following factors are not relevant for determining the nature of a transaction:
 - Periodic expense or a lump-sum payment is immaterial for determining the nature of transaction. A lumpsum payment can be revenue in nature and a recurring periodic payment (i.e. installments of capital sum) can be capital in nature.
 - The magnitude of a disbursement is immaterial for determining the nature.
 - Whether an expenditure is debited in the revenue account or not, would not determine the transactions' nature.
- The SC observed that the taxpayer has placed reliance on various SC decisions⁸ wherein the SC has apportioned the payment as partly revenue and partly capital in nature. However, those decisions did not pertain to the expenditure towards license fees, and hence, such decisions were distinguished on the facts.
- It observed that failure to pay the annual licence fee will lead to revocation of licence⁹. Also, the operators will be disabled from carrying on telecom business. The continuation of such right is contingent on the payment of entry fee and licence fee. Accordingly, the apportionment made by the Delhi HC is not sustainable.
- The SC held that single transaction cannot be split up in artificial manner into a capital and revenue payments by simply considering the mode of payment, since it is a settled position that payment in installments does not change the nature of the transaction.
- In the instant case, the successive installments relate to the same obligation, (i.e. right to establish, maintain and operate telecom business), and hence, the cumulative payment is capital in nature.
- The composite right conveyed to the taxpayer cannot be bifurcated in an artificial manner into right to establish telecommunication services and right to maintain and operate telecommunication services.
- Since the taxpayer had accepted that both components (fixed and variable) of the licence fee paid under NTP 1994 was to be amortised, there was no basis to reclassify the variable license fee under NTP 1999 as revenue in nature.
- The nomenclature and manner of payment is irrelevant. Non-payment would result in cancellation of license, and hence, the payment is intrinsic to the existence of licensee and its trade.
- Accordingly, the SC held that the license fee should be treated as a capital expenditure.

⁸ Jonas Woodhead and Sons. India Ltd. vs. CIT, (1997) (224 ITR 342) (SC); CIT vs. Best and Co. (Pvt.) Ltd. (1966) (60 ITR 11) (SC); Southern Switch Gear Ltd. vs. CIT, (1998) (232 ITR 35) (SC); CIT vs. Sarada Binding Works, (1976) (102 ITR 187)

(Madras HC) and Mewar Sugar Mills Ltd. vs. CIT, (1973) (3 SCC 143) (SC)

⁹ Under Section 8 of the Indian Telegraph Act, 1885

Our comments

This verdict will have ramifications for all telecom companies which will now have to amortise variable license fees over the remaining period of the license agreement. The impacted taxpayers may need to evaluate, basis the facts of their case, the tax impact, penalty exposure, impact on cash outflows and if at all there is an accounting implication. However, it is expected that the overall tax impact could even out to a large extent due to the amortisation provisions.

Considering the SC has not debarred any retrospective operation of this judgement, it remains to be seen how this is implemented by the tax authorities.

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