

# SC settles controversy regarding withholding tax by telecom companies under distribution model for their prepaid business

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## Summary

The Supreme Court (SC), in a batch of appeals<sup>1</sup>, has settled the controversy regarding taxpayers' (telecom companies) obligation to deduct tax at source<sup>2</sup>, on the income component in the payments received by their franchisees / distributors from the third parties<sup>3</sup>, on sale of starter-kits / recharge vouchers.

The income of franchisees / distributors, in this case, is the difference between the purchase price of the starter-kits / recharge vouchers which is paid to the taxpayer and the price at which these were sold to third parties. This amount was being construed by the tax department as being commission or brokerage, requiring tax deduction at source by the taxpayer.

The SC held that the distributors / franchisees in such cases were independent contractors, and as the taxpayers are not privy to the transactions between the distributors / franchisees and third parties, it is impossible for them to deduct tax.

## Facts of the case

- The taxpayers are engaged in the business of telecommunication services.
- For their prepaid business, taxpayers entered into franchise or distribution agreements with several parties, wherein the starter-kits<sup>4</sup> (for new pre-paid connection) and recharge vouchers were sold to franchisees / distributors at a 'discounted price'. The discounts were given on the printed price of the packs.
- The profit of franchisees / distributors was the difference between the 'discounted price' and sale price of starter-kits / recharge vouchers sold to retailers / customers / end users.
- On scrutiny, the Revenue held that the taxpayers were liable to deduct tax under Section 194H of the Act on the difference amount (i.e. difference between the discounted price and sale price) being in the nature of 'commission or brokerage'. Further, the Revenue held that the relationship between the taxpayers and franchisee / distributor was in the nature of principal and agent.
- The Revenue was of the view that prepaid SIM cards were the property of the taxpayers and no right, title or interest was transferred to the franchisees /distributors.

<sup>1</sup> In the case of Bharti Cellular Limited (now Bharti Airtel Limited) - Civil Appeal No(S). 7257 of 2011 (with others Civil Appeal nos. 2652-2653, 4949-4950 and 4947-4948 of 2015; 7455 of 2018; 111 and 2860 of 2021; 8902 of 2022; 7729, 7735, 7736, 7737, 7738, 7739, 7740, 7741, 7742, 7743, 7679, 7680, 7681, 7682, 7744, 7745, 7746, 7747, 7748, 7848, 7849, 7852, 7853, 7854, 7855, 7856, 7857 and 7859 of 2023; and 3514, 3515, 3516 and 3517 of 2024)

<sup>2</sup> Under section 194H of the Income tax Act, 1961 (section 194H the Act)

<sup>3</sup> Third parties / customers / retailers

<sup>4</sup> The kit contains a SIM card and a coupon of the specified value as advance payment to avail the telecom services

## Contrary rulings by the High Courts (HCs)

- The Delhi HC and Calcutta HC held that the taxpayers were liable to deduct tax at source under Section 194H of the Act. Whereas, a contrary view was expressed by the Rajasthan HC, Karnataka HC and Bombay HC.

## Issue before the SC:

Whether the taxpayers (i.e. telecom companies) were liable to deduct tax under Section 194H of the Act on income component in the payments received by the distributors / franchisees from the third parties / customers / retailers on sale of starter-kits / recharge vouchers.

## Key observations of SC

Key observations of the SC are as under:

- As per Section 194H of the Act, the term 'commission' or 'brokerage' *inter alia* 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). This postulates a legal relationship of principal and agent.
- Based on Section 182 of the Contract Act, 1872, agency exists when the principal employs another person, who is not his employee, to act or represent him in dealings with a third person.
- 'Agency' is a triangular relationship between the principal, agent and the third party. As per the SC, the following factors

are relevant for determining principal and agent relationship:

- a) Whether legal power is vested with the agent to alter principal's legal relationship with third party and principal's co-relative liability to have his relations altered.
  - b) An agent acts on behalf of the principal. One of the key elements is the exercise of a degree of control by the principal over the conduct of agent's activities.
  - c) Task entrusted by the principal to the agent must result in a fiduciary relationship.
  - d) Business done by the agent is on the principal's account, the agent is liable to render accounts thereof to the principal and is entitled to remuneration for the work performed.
- The SC also observed that substance of the relationship between the parties is of primary importance, notwithstanding the nomenclature given by the parties to the relationship. This is examined by reference to the functions, responsibility and obligations of the so-called agent.

## Difference between contract of sale and contract of agency

- In this regard, the SC relied on its earlier decision<sup>5</sup>, wherein it was held that the agent is authorised to sell / buy on the behalf of the principal, whereas the essence of contract of sale is to transfer the title of goods for the price paid. It also

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

observed that in agency, the agent sells the property of the principal. Further, in such case, the debtor is liable to pay to the principal and the agent receives its commission from the principal.

- The SC observed that merely on account of the fact that SIM card remained the property of the taxpayer till it is sold to the end-user, it cannot be held that there is a agency relationship, since the same was mandated by the Department of Telecom's requirement, and contractual obligations of the franchisees /distributors does not reflect a fiduciary character of the relationship.

### **Independent contractor**

- In order to check whether a contracting party acts as an independent contractor, it needs to be examined whether in the course of work, the person intends to make profits for self, or is entitled to receive pre-arranged remuneration.
- An independent contractor is not required to render accounts of the business, as it belongs to him and not his employer.
- Typically, a distributor buys goods on his account and sells them in his territory and earns profit on account of difference between purchase price and the sale price.
- In this case, the sale price received by the franchisees / distributors is as per their sole discretion, and hence, franchisees / distributors determine their profits.

- In view of this, the SC held that the distributors / franchisees in this case were independent contractors.

### **Obligation to deduct tax at source**

- The obligation to deduct tax is on the date of actual payment or credit, whichever is earlier.
- The SC observed that the income of the franchisee / distributor is paid or credited to their account on sale to the retailer / end-user / customer.
- The taxpayer does not, at any stage, either pay or credit the account of the franchisee / distributor with the income by way of commission or brokerage on which tax at source under Section 194H of the Act is to be deducted.
- With respect to the Revenue's argument regarding requirement to deduct tax since payment is indirectly received or receivable, SC was of the view that Section 194H of the Act must not be extended to apply to genuine business transactions, where the taxpayer is not the "person responsible for paying or crediting the income".
- As per the SC, the word 'indirectly' does not create an obligation to deduct tax where the main provision (i.e. Section 194H of the Act) does not apply.
- The SC held that reliance cannot be placed on its earlier decision in the case of Singapore Airlines Limited<sup>6</sup>. The SC observed that in the present case, taxpayers are not privy to the transactions between the distributors /

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<sup>6</sup> Singapore Airlines Ltd. and Another v. Commissioner of Income Tax, (2023) (1 SCC 497)

franchisees and third parties, and hence, it is impossible to deduct tax in such case.

- Further, the SC rejected the Revenue's argument that taxpayers must periodically obtain information and then deduct tax, since it would lead to imposing an unfair obligation, beyond the statutory mandate.

### **Other / general observations**

- In case of a legal or factual doubt, taxpayers can rely on the 'doctrine of presumption' against doubtful penalisation. The application of this doctrine will depend on facts of each case, including the past practice followed by the taxpayer and accepted by the department.

- Tax deduction provisions should be pragmatically and realistically construed.

### **SC's conclusion**

The SC concluded as follows:

- Taxpayers were not under a legal obligation to deduct tax at source on the income component in the payments received by franchisees / distributors from the third parties / customers / retailers on sale of starter-kits / recharge vouchers. (i.e. on difference between the purchase price and sale price of starter-kits and recharge vouchers).

### **Our comments**

This ruling will provide much needed clarity and certainty to telecom service providers on the liability to deduct tax in case of distribution models for their prepaid businesses.

In this verdict, the SC has enumerated in detail the guiding principles for determining the 'principal-agent' relationship and the basis to distinguish 'agency' and 'independent contractor' agreements. This guidance will be useful to analyse withholding tax liability in case of similar arrangements in other sectors.

While delivering this judgement, the SC has also observed that where divergence opinions exists, it may be advisable for the Central Board of Direct Taxes to issue clarifications to avoid litigation. These clarifications, if and when issued, should be clear, and made prospective when justified. It also observed that in addition to enhancing revenue and ensuring tax compliance, an equally important objective of the Revenue is to reduce litigation.

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