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Direct Tax Alert

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Supreme Court's judgment on deductibility of variable licence fee payable to establish, maintain and operate cellular mobile services

In a recent significant ruling[1] impacting the telecom sector, the Supreme Court has reversed the judgment of various High Courts and held that annual variable licence fees paid by the assessee under the New Telecom Policy, 1999 is a capital expenditure and not deductible as a revenue expenditure under the Income-tax Act, 1961 (the Act). It also held that such variable licence fees paid may be amortised over the balance licence period in accordance with section 35ABB of the Act.

Background and facts of the case

- The National Telecom Policy of 1994 (1994 Policy) was substituted by the New Telecom Policy of 1999 dated 22 July 1999 (1999 Policy). Under the 1999 Policy, a licensee needs to pay to the Department of Telecommunication (DoT), a one-time entry fee and additionally, annual variable licence fees calculated at a certain percentage of annual gross revenue earned by the licensee.
- The respondent assessee company in this case[2], an existing telecom operator under the 1994 Policy, is engaged in the business of telecommunication services. Since 1994, it was granted a non-transferable and non-assignable licence to establish, maintain and operate cellular mobile services.
- The assessee migrated to the 1999 Policy, and the fees paid up to 31 July 1999 by the assessee was treated as one-time entry fee under the 1999 Policy. Such entry fee was

[1] CIT v. Bharti Hexacom Ltd (Civil Appeal No. 11128 of 2016 and others, judgment dated 16 October 2023)(SC)
[2] Lead assessee – Bharti Hexamcom Ltd

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considered by the assessee as capital expenditure for the purposes of the Act. With effect from 1 August 1999, the assessee is required to pay annual variable licence fees which is calculated at 15% of annual gross revenue earned by the assessee viz. on revenue sharing basis.

- During the scrutiny by the Revenue for assessment year 2003-04, it was noted that the annual variable licence fees paid was claimed by the assessee as revenue expenditure. According to the Revenue, such annual licence fees was capital expenditure, and hence was to be amortised in accordance with section 35ABB over the remainder licence period of twelve years. Hence, in the assessment order, only $1/12^{th}$ of such annual variable licence fees was allowed as a deduction under section 35ABB of the Act, and the remaining amount was disallowed and added back to the income of the assessee.
- Upon appeal by the assessee, the Commissioner of Income Tax (Appeal) had held that such annual variable licence fee was revenue expenditure deductible under section 37 of the Act. The Revenue's appeal before the Tribunal was dismissed. Upon further appeal by the Revenue, the High Court of Delhi held that while the licence fee payable up to 31 July 1999 should be treated as capital expenditure that will qualify for deduction as per section 35ABB, the variable licence fees paid after 1 August 1999 on revenue sharing basis should be treated as revenue expenditure and accordingly deductible under section 37.
- Thus, the issues before the Supreme Court were whether the variable annual licence fee paid by the respondent assessee/s to DoT under the 1999 Policy is revenue in nature and is deductible under section 37, or whether the same is capital in nature and is accordingly required to be amortised as per section 35ABB, and whether the High Courts were right in apportioning the licence fee as partly revenue and partly capital.

Revenue's contentions

- The payments towards the same purpose, i.e., payment of licence fee for acquisition of a licence, cannot be characterised partly as capital expenditure to the extent of entry fee and partly as revenue in nature to the extent payable annually, when both types of payment were towards acquisition of a licence.
- When the assessee had duly amortised the licence fee paid annually as capital expenditure under the 1994 Policy as well as the entry fee under the 1999 Policy, there was no basis to reclassify the same as revenue expenditure in so far as variable licence fee is concerned for the subsequent years.
- The payments made, either of entry fee or annual licence fee, is in essence only towards securing a licence to establish, maintain and operate a telegraph system. Further, section 4 of the Telegraph Act authorises the Government to grant the licence against a consideration. Hence, both the entry fee and annual variable payments are covered within the ambit of 'consideration' chargeable under section 4 of the said Act. Hence, the split namely, entry fee for acquiring the licence and variable licence fee for operating the licence has no legal basis.
- Reliance placed by the High Court on certain decisions of the Supreme Court[3] was inappropriate as cases did not deal with single source/ purpose for which the payments in different forms had been made. Since

[3] *Jonas Woodland and Sons. India Ltd.* v. *CIT* [1997] 224 ITR 342 (SC), *Southern Switch Gear Ltd.* v. *CIT* [1998] 232 ITR 35 (SC), *CIT* v. *Best and Co. (Pvt.) Ltd.* [1966] 60 ITR 11 (SC)

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payments were traceable to different subject matters, the Supreme Court decisions which held that the payments could be apportioned partly as capital and partly as revenue were distinguishable.

- So long as the payment is towards licence fee, the expenditure will be in the nature of capital expenditure.

Taxpayer's contentions

- For attracting provisions of section 35ABB, it is necessary that the expenditure must be capital in nature.
- The payment of licence fee under the 1994 Policy i.e., prior to migration to the 1999 Policy was for obtaining the licence. But, the variable licence fee payable with effect from 1 August 1999 as a percentage of annual gross revenue was not in the nature of capital expenditure as it is not incurred with a view to acquire the right to operate telecommunication services, but was for continuing the right to operate telecommunication services, given that the said services were already being operated by the assessee by virtue of a licence which had been obtained in 1994.
- Since the restriction of the number of players or operators in each region was completely lifted under the 1999 Policy, coupled with the fact that variable licence fee was to be paid on an annual basis to continue with the right to operate telecommunication services, no enduring benefit was accruing to the respondent assessee/s.
- When the provisions of section 35ABB were introduced, the concept of variable licence fee did not exist. Application of the said provision to variable licence fee would give rise to absurd results, not intended by the Legislature.
- The annual licence fee, even though termed as a licence fee, is in essence expenditure incurred to operate the telecommunication services from year to year. Such expenditure is incurred annually to earn revenue, is also paid as percentage of revenue and hence is an annual revenue expenditure.
- The payment of annual licence fee is similar to the payment of royalty as it relates to the annual turnover and would therefore be revenue in nature.
- Merely because the DoT can rescind the licence owing to non-payment of the variable licence fee, it does not mean that the payment is towards acquisition of the licence. The benefit of the variable licence fee is only restricted to one year to which the payment pertains. Hence, the same could not be held to be capital expenditure or expenditure for acquisition of a capital asset.
- Varius judgments of the Supreme Court and other Courts including judgments where a percentage of annual profits / revenue were to be shared, were cited to bring home the argument that the variable annual payments were revenue in nature and therefore deductible.

Supreme Court ruling

- The Supreme Court, in its judgment considered a large number of judicial precedents including those from foreign jurisdiction and attempted to list down (in para 19 of the judgment) the broad principles/ tests that have been forged and adopted by Courts from time to time, while determining whether a given expenditure is capital or revenue in nature.
- The Supreme Court, in its analysis also attempted to distinguish payment made to acquire a right from the payment of royalty for right to use. The Court explained that where a

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payment is not referable to the acquisition of a capital asset but only secures a right to use the asset, the same would be a royalty and hence, it would be classified as a revenue expenditure.

- The Supreme Court also explained that, in determining the question as to whether a payment is a capital disbursement or in the nature of a revenue expenditure, the fact whether the payment is periodic or a lump sum, the magnitude of a disbursement and the entries in books of accounts, are immaterial. According to the Supreme Court, to answer the said question, one must consider the nature of the concern, the ordinary course of business usually adopted in that concern and the object with which the expenditure is incurred. The Supreme Court further observed that attention must be paid not only to the form of the transaction, but also its substance. The Supreme Court also highlighted that what is material is the nature of right sought to be secured through the payment, and the structure or form of the transaction or the payment schedule is hardly suggestive of the nature of the transaction.
- After highlighting the aforesaid principles, the Supreme Court concluded that in the case before it, since the annual payment of variable licence fee is only towards licence fees and merely because it is paid in annual instalments based on the annual gross revenue, the payment cannot be construed as revenue in nature.
- The Supreme Court further explained that the annual payments of licence fee as also the entry fee relate to the single purpose, i.e., the acquisition of the right to carry on the business of rendering telecommunication services. Since this right is a capital asset, the payments made towards the acquisition of the right, whether in lump-sum or in annual instalments based on annual gross revenue, would be in the nature of capital disbursements.
- Thus, the Supreme Court also held that the High Courts were not right in apportioning the licence fee as partly revenue and partly capital. Supreme Court explained that the licence issued under section 4 of the Telegraph Act is a single licence to establish, maintain and operate telecommunication services. Since it is not a licence for divisible rights that conceive of divisible payments, apportionment of payment of the licence fee as partly capital and partly revenue expenditure is without any legal basis.
- According to the Supreme Court the fact that failure to pay the annual variable licence fee leads to revocation or cancellation of the licence, vindicates the legal position that the annual variable licence fee is paid towards the right to operate telecom services.
- Supreme Court also pointed out that a composite right by way of licence cannot be split up, in an artificial manner, into a right to establish telecommunication services on the one hand and the right to maintain and operate the telecommunication services on the other. Such bifurcation is contrary to the terms of the licensing agreement and the 1999 Policy.
- Supreme Court also reiterated basis its earlier decision that an annual payment based on profit sharing towards right to carry on business would be capital in nature. If the expenditure in its core is capital in nature, neither the fact that the same was paid in instalments nor that it was dependent on revenue or profit of the assessee would warrant a change in classification of the transaction.
- Supreme Court also held that since the entry fee and the variable licence fees are traceable to the same source, i.e., acquisition of a

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licence, they both would have to be held to be capital in nature. This is even though the variable licence fee is paid in a staggered manner.

- Supreme Court further distinguished the decisions[4] relied by the High Courts on facts largely pointing out that in those cases the payments were traceable to different subject matters and hence an apportionment could be done. In the present case the payments were traceable to a single source and hence no apportionment was permissible.
- Supreme Court also observed that, the assessee/s having accepted that both components, fixed and variable, of the licence fee under the 1994 Policy must be duly amortised, there was no basis to reclassify the same under the 1999 Policy as revenue expenditure, in so far as variable licence fee is concerned.

Dhruva Comments

The Supreme Court in this case has dealt with the issue of deductibility of the variable licence fee paid in relation to the right to establish, operate and maintain telecommunication services. However, the principles discussed and reiterated, and the reasoning considered in this judgment may also be relevant where rights are granted to the assessee, relating to Mining, Oil-exploration, Port and Airport concessions under regulated sectors or those relating to franchise arrangements, collaboration and technical know-how agreements, IPL/ Sports team contracts, marketing, media and broadcasting contracts or other similar business or commercial arrangements, in consideration of an upfront fee together with variable fees charged on revenue sharing basis or on the basis of output. In all such cases, a thorough analysis of the facts and relevant contracts/ documents may be needed to ascertain whether the licence fees payable on a revenue sharing basis can be linked to acquisition of a right being a capital asset. Where such linkage gets established, the deductibility of such licence fee may be affected in light of this judgment of the Supreme Court. In contrast, where a variable licence fee payable can be delinked from the acquisition of a right of capital nature, it may be possible to argue that payment of such licence fees should be treated as revenue expenditure and should be deductible under section 37, subject to fulfilment of other conditions of that section.

Contributors:

Umesh Gala (Partner)

Keyur Rambhia (Principal)

For any queries in relation to this alert, please feel free to contact us.

[4] *Jonas Woodland and Sons. India Ltd.* v. *CIT* [1997] 224 ITR 342 (SC), *Southern Switch Gear Ltd.* v. *CIT* [1998] 232 ITR 35 (SC), *CIT* v. *Best and Co. (Pvt.) Ltd.* [1966] 60 ITR 11 (SC)

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Follow us on:

ADDRESSES

Mumbai
1101, One World Center,
11th floor, Tower 2B,
841 Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai 400 013
Tel: +91 22 6108 1000 / 1900

Ahmedabad
402, 4th Floor, Venus Atlantis,
100 Feet Road,
Prahladnagar,
Ahmedabad 380015
Tel: +91-79-6134 3434

Delhi / NCR
101 & 102, 1st Floor, Tower 4B
DLF Corporate Park
M G Road, Gurgaon
Haryana 122002
Tel: +91-124-668 7000

Pune
305, Pride Gateway,
Near D-Mart, Baner,
Pune 411 045
Tel: +91-20-6730 1000

Kolkata
4th Floor, Unit No 403, Camac Square,
24 Camac Street, Kolkata
West Bengal 700016
Tel: +91-33-66371000

Abu Dhabi
Dhruva Consultants
1905 Addax Tower, City of Lights
Al Reem Island,
Abu Dubai, UAE
Tel: +971 26780054

Dubai
Dhruva Consultants
Emaar Square Building 4, 2nd Floor,
Office 207, Downtown,
Dubai, UAE
Tel: +971 4 240 8477

KEY CONTACTS

Dinesh Kanabar
Chief Executive Officer
dinesh.kanabar@dhruvaadvisors.com

Punit Shah (Mumbai)
punit.shah@dhruvaadvisors.com

Mehul Bheda (Ahmedabad)
mehul.bheda@dhruvaadvisors.com

Vaibhav Gupta (Delhi/ NCR)
vaibhav.gupta@dhruvaadvisors.com

K. Venkatachalam (Pune)
k.venkatachalam@dhruvaadvisors.com

Aditya Hans (Kolkata)
aditya.hans@dhruvaadvisors.com

Nimish Goel (UAE)
nimish.goel@dhruvaadvisors.com

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