India's Supreme Court treats telecom licence fees as a capital expense – major pain ahead

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Overview

In the *Bharti Hexacom* case, India's Supreme Court (the "**SC**") has held that the variable licence fee that was paid annually by telecommunication companies (the "**Taxpayers**") to the Department of Telecommunications (the "**DoT**") under the New Telecom Policy, 1999 dated July 22, 1999 (the "**1999 Policy**") is a capital expenditure to be amortised over a period of years under the Income-tax Act, 1961 (the "**IT Act**") and not a deductible business expenditure. The SC dismissed the decision of the Division Bench of the Delhi High Court (the "**DHC**") passed on December 19, 2013, in ITA No. 1336 of 2010, in which the DHC had held that the expenditure incurred towards establishing, operating and maintaining telecom services should be apportioned as part capital and part revenue.

Background

The National Telecom Policy, 1994, was substituted by the 1999 Policy, which stipulated that the licensee should pay a one-time entry fee as well as a licence fee (being a percentage of the annual gross revenue). The entry fee chargeable would be the fee payable by the Taxpayers up to July 31, 1999, calculated up to this date and adjusted after the quantum of revenue share to be charged as licence fee was finally decided upon obtaining the recommendation of the Telecom Regulatory Authority of India (the revenue share was fixed at 15% of the annual gross revenue of the licensee by the Indian government in the interim period).

With effect from August 1, 1999, the licence fee was payable on a percentage of the annual gross revenue earned. The 1999 Policy stipulated that, upon migration, the Taxpayers would have to forego the right of operating in a regime of a limited number of operators as per the existing licensing agreement and operate in a multiple licence regime, i.e., additional licences without any limit could be issued in any given service area. The licence period was twenty years from the effective date of the existing licence agreement, i.e., the agreement executed in 1994. Migration to the 1999 Policy was on the stipulation that all conditions should be accepted as a package in their entirety and all legal proceedings be withdrawn, with no dispute relating to the period up to July 31, 1999, to be raised in the future. The Taxpayers migrated to the 1999 Policy and paid the licence fee up to July 31, 1999, and treated this one-time licence fee payment as a capital expenditure, but treated the fee paid thereafter as revenue expenditure.

On this basis, Bharti Hexacom claimed approximately INR12 crores in the tax assessment year 2003-04 as a revenue expenditure. The Indian tax authority (the "**ITA**") allowed approximately INR1 crore as a business deduction under Section 35ABB of the IT Act but disallowed the remaining INR11 crore, treating it as a capital expenditure to be amortised over the remaining licence period. The Commissioner of Income-tax (Appeals) reversed the

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ITA's assessment order, and the ITA's appeal against this reversal was also dismissed by the Delhi Income-tax Appellate Tribunal. The DHC, in its ruling, held that the licence fee paid prior to July 31, 1999 was a capital expense and the licence fee paid thereafter was a revenue expense.

The issue before the SC and its key observations

Whether the variable licence fee paid by the Taxpayers to the DoT under the 1999 Policy is a revenue expenditure allowable as a business deduction under Section 37 of the IT Act or whether it is capital in nature?

The SC made the following key observations.

1. Referring to about thirty tax cases (both English and Indian), the SC stated that an expense towards "acquisition of a concern" is capital in nature while an expense for "carrying on a concern" is revenue in nature. The real test is whether the expenditure incurred is to meet a continuous demand or made once and for all with a view to bring into existence an asset or advantage of an enduring nature.

2. If there is no enlargement of the permanent structure or capital assets, and the expenditure essentially relates to the operation or working of the existing apparatus, such an expenditure will be revenue in nature.

3. The SC noted that the prior regime required a fixed payment for the first three years of the licence followed by a variable payment from the fourth year onwards, based on the number of subscribers. The SC observed that the Taxpayers had amortised their expenses in the old regime and, thus, there was no basis to reclassify the same expense under the 1999 Policy as a revenue expenditure. Mere payment of an amount in instalments does not convert or change a capital payment into a revenue payment.

4. In the present case, the licence was issued under Section 4 of the Telegraph Act as a single licence to establish, maintain and operate telecommunication services, and not a licence for divisible rights conceiving divisible payments. Therefore, the apportionment of payment of the licence fee as partly capital and partly revenue expenditure was without any legal basis. Failure to pay the annual variable licence fee would lead to revocation or cancellation of the licence, which vindicated the legal position that the annual variable licence fee was paid towards the right to operate telecom services. As such, a single transaction could not be split up in an artificial manner into capital and revenue payments by simply considering the mode of payment.

Based on the foregoing, the SC held that the payments made by the Taxpayers post-July 31, 1999, are a continuation of the payments pre-July 31, 1999, and although in an altered format, they do not take away the essence of the payments. These are mandatory payments traceable to the foundational document, i.e., the license agreement as modified post migration to the 1999 policy. Thus, the entry fee and the variable annual licence fee paid by the Taxpayers to the DoT under the 1999 Policy are capital in nature and should be

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amortised in accordance with Section 35ABB of the IT Act.

Our comments

Section 37(1) of the IT Act is the residuary section that allows deduction of expenses to determine the taxable business profits. For a taxable deduction, expenditure has to be incurred wholly and exclusively for the purposes of the business, and it should not be in the nature of capital expenditure. Thus, capital expenditure is not an allowable expenditure.

The term "capital expenditure" is not defined under the IT Act, and as a result, the controversy over what is capital and revenue expenditure has been raging for decades. The dividing line between the two is so thin that the ITA and courts alike face a tough balancing task. To summarise, whether a particular expenditure is revenue or capital in nature must be determined on a consideration of all the facts and circumstances of the case and by applying the principles upheld in various decided rulings.

The SC ruling has set aside the DHC judgment and connected matters. In addition, judgments passed by the High Courts of Delhi, Bombay and Karnataka, following the foregoing judgment of the DHC, have also been consequently set aside. This decision will create significant tax litigation as many completed tax assessments involving more than thirty or forty tax cases are likely to be reopened. This ruling will not only impact the telecommunication sector but also many other sectors where entities have claimed a business expense on pay outs to the government for licenses, mining rights, etc., which should have been amortised. Press reports suggest that telecommunication companies are likely to seek a review of the SC ruling.

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