

EY Tax Alert

SC rules discount on prepaid SIM cards and recharge coupon vouchers not liable for withholding as commission or brokerage

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Executive summary

This Tax Alert summarizes the recent Supreme Court (SC) decision in a batch of appeals with lead case being that of Bharti Cellular Ltd. v ACIT¹ (Taxpayer). The issue before the SC was whether discount allowed to distributors on print price of prepaid SIM cards and recharge coupon vouchers by the telecom operators can trigger withholding tax obligation under the provisions of the Indian Tax Laws (ITL). The controversy was dealt with by an array of High Court decisions with divergent views and hence petitions were filed before the SC.

While adjudicating on the issue, the SC has elucidated factors for determining principal-agent and principal-principal relationship. Importantly, it laid down four factor tests to qualify as agent viz. (a) presence of legal power of agent to legally bind the principal with third party, (b) principal exercising certain degree of control over the conduct of agent, (c) fiduciary relationship between them, (d) liability of agent to render accounts to principal and entitlement to receive remuneration from the principal.

On the facts of the lead case, after noting the terms of the distribution agreement in case of prepaid vouchers, the SC ruled that there was no principal-agent relationship between the distributors and the Taxpayer, as the distributors were required to purchase the SIM cards, vouchers at discounted price. The distributors had the right to sell the same at any price below the printed price at their discretion and were also not required to render any accounts to the Taxpayer. Further, there existed no fiduciary relationship between the distributors and the Taxpayer.

Further, the SC held that the withholding tax provision of the ITL is not applicable in the hands of the Taxpayer as it has not credited or paid any income to the distributors in nature of commission. The SC made it clear that profit earned by resale of SIM card cannot be regarded as an event leading to indirect payment by telecom company to the distributors.

¹ (Civil Appeal No. 7257 of 2011)

Further, since the Taxpayer was not privy to contract between distributors and retailers or end customers, it was impossible for the Taxpayer to withhold tax at source. The SC also noted that in absence of a statutory mandate, the Taxpayer cannot be obligated to collect information of discount from distributor which is a far-fetched requirement imposing unfair obligation and inconvenience.

Additionally, the SC observed that in order to reduce litigation, the Central Board of Direct Taxes (CBDT)² should issue appropriate instructions/circulars which are clear and prospective to clarify the doubts on issues arising in withholding tax provision after adopting consultative approach.

Background

- ▶ Under the ITL, a person is required to withhold tax @ 5% on income payable to resident, in the nature of “commission or brokerage”. The term “commission or brokerage” is defined to include any payment received or receivable, directly or indirectly, by a person acting on behalf of another person for services rendered (not being professional services) or for services in relation to buying or selling of goods or in relation to transaction relating to any asset, valuable article, or thing, not being securities.
- ▶ Various telecom companies, engaged in the business of providing cellular telephone services, appoint distributors to sell SIM cards, recharge coupon vouchers to retailers/end customers, wherein the SIM cards/prepaid recharge vouchers are provided at a discounted price (say INR 80). The distributors have the discretion to sell these SIM cards, recharge coupon vouchers to retailers or end customers at a price not exceeding the printed price (say INR 100).
- ▶ On the above arrangement, the tax authority took a view that the agreement between the telecom companies and the distributors was an agency contract in terms of which the distributors acted on behalf of the Taxpayer and that the discount (INR20) was in the nature of “commission”, which was liable to withholding tax under the provisions of the ITL.
- ▶ Over a period of time, the controversy traversed to High Courts (HCs) in various jurisdictions.
 - ▶ One set of HCs³ held that the distribution arrangement for prepaid SIM cards attracts withholding for the telecom company on the discount offered since the distributor merely acts as a link between the telecom company

and the ultimate customer and the distributor is able to bind the two parties.

- ▶ On the contrary, another set of HCs⁴ held that withholding obligation is not attracted since there is a sale of SIM cards to the distributors, who are liable to the risk of loss or damage to such products and there is principal-to-principal relationship between the parties. The HC also held that, although the SIM card, by itself, does not have any value and is integral to the provision of telecom service, nevertheless, it constitutes a right to service which can be sold.
- ▶ In view of the divergent judicial views, petitions were filed before the SC to examine the issue of applicability of withholding tax under the ITL in the hands of the Taxpayer on discount/income earned by distributor on sale of recharge vouchers.

SC ruling:

The SC ruled that the Taxpayer is not required to withhold tax at source on discount earned by the distributors as they earn profits on their own account and not in the capacity of an agent of the Taxpayer and that the income is not paid/payable by Taxpayer to the distributors. The SC also elucidated on principles governing principal-agent and principal-principal relationship and has set aside the decision of Delhi and Calcutta HCs and dismissed the petition challenging decisions of Rajasthan, Karnataka and Bombay HCs. Briefly, the SC has provided below reasoning:

Features of agency relationship

- ▶ The SC noted that the phrase “acting on behalf of other person” postulates the existence of legal relationship of agent and principal and same is required to be determined based on law of agency under the Indian Contract Act, 1872 (ICA).
- ▶ An agent creates triangular relationship between principal and third party. To create agency relationship, the SC held that following four principles are relevant (four-factor test):
 - ▶ An agent has legal power to alter principal’s legal relationship with a third party.
 - ▶ The principal exercises certain degree of control over the conduct of the activities of the agent.
 - ▶ The task entrusted by the principal to the agent should result in a fiduciary relationship.
 - ▶ The agent is liable to render accounts to the principal and is entitled to remuneration from the principal for the work the agent performs for the principal.
- ▶ Further, the SC adopted substance-based approach to identify agency relationship rather than the

² The apex administration body for direct taxes in India

³ CIT vs. Idea Cellular Ltd. (2010) (325 ITR 148)(Del.), Vodafone Essar Cellular Ltd. vs. ACIT (2011) (332 ITR 255) (Ker.); Bharti Cellular Ltd. vs. ACIT (2011) (200 Taxman 254)(Cal.), Vodafone Essar Ltd. [IT Appeal No.291 of 2013] (AP)

⁴ Bharti Cellular Ltd. v. DCIT (372 ITR 33)(Kar); CIT vs. Vodafone Cellular Ltd. (TS-59-HC-2020(Bom)); Reliance Communication Infrastructure Ltd. (ITA No.702/2017)

nomenclature and also observed that there are complexities in determining the legal relationship between a principal and an agent given the multi-dimensional nature of contract.

Features of principal-to-principal relationship or independent contractor arrangement

The SC elucidated below principles to determine principal-to-principal relationship:

- ▶ The money earned from customer under a normal contract of sale belongs to independent contractor and it shall be part of the contractor's assets in the event of bankruptcy or liquidation.
- ▶ An independent contractor earns profits for itself in the course of business, even where the manner in which business is conducted is specified in contract. It is not required to render accounts of the business.
- ▶ An independent contractor is not subject to control of contracting party and work for themselves, though subject to the terms of the contract. As against that, an agent acts in fiduciary capacity and works under the control of principal.
- ▶ An independent contractor may seem to act as an agent in view of control exercised over it. However, the independent contractor may not satisfy the four factors test as explained above.

Principal-to-principal relationship between Taxpayer and distributors in the facts of the case

- ▶ The SC noted the terms of the distributor/franchise agreement with the Taxpayer and ruled that the relationship between taxpayer and the distributor was one of principal to principal. Briefly, the illustrative features of the agreement which led to such conclusion were the fact that:
 - ▶ distributors entered into exclusive arrangement with the Taxpayer for marketing/promotion of prepaid cards, vouchers;
 - ▶ distributors should possess necessary documents, permits and comply with laws for conduct of business;
 - ▶ distributors were required to purchase the prepaid cards at discounted price but had right to sell the same at any price below the printed price at their discretion;
 - ▶ distributors were required to maintain the establishment or infrastructure as required by the Taxpayer;
 - ▶ distributors were not entitled to any compensation on termination of the contract
- ▶ The terms though suggest that the right, title or interest in SIM cards, vouchers, etc. remain with the Taxpayer and are not transferred to the distributor, the SC held that such feature is due to the mandate of license issued by statutory authority.

- ▶ Under the regulatory mandate, the franchisee/distributor is required to collect documents from prepaid and postpaid SIM card users. However, the contractual terms do not reflect any fiduciary character of relationship.
- ▶ The distributors earn their income when they sell the prepaid products to the retailer, or the end-user/customer and the sale price received by the distributors is within their sole discretion.

Discount or commission is not payable/paid by the Taxpayer

- ▶ After determining that the relationship between the distributor and the taxpayer was one of principal-to-principal, the SC also examined withholding tax provisions under the ITL and noted that the person responsible for withholding tax at source is the principal on whose behalf the agent provides services. The words "direct" and "indirect" employed in the definition of commission or brokerage are with reference to act of payment. The term "indirect" payment ensures that any other mode of payment by principal is also covered and there is no tax evasion.
- ▶ Since withholding tax obligation arises when any payment is received or receivable in the form of commission/ brokerage, it noted that the distributor earns income from retailers/ end customers, being the difference between the sale price received and the discounted price paid. The sale price and accordingly the income of the distributor is determined by the distributor and the third parties. Accordingly, 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 is required to be withheld.
- ▶ The Court also held that the tax authority cannot insist to withhold tax on the Taxpayer, who is not privy to the transaction between distributor and third parties and same results in impossibility of performance on the Taxpayer to withhold tax in absence of privity.
- ▶ The SC held that the scope of indirect payment in withholding tax provision cannot be interpreted in a wide manner to cover bonafide transactions where commercially, the principal is not liable to pay income to the agent. Accordingly, the liability to withhold tax at source cannot be fastened on the Taxpayer.
- ▶ Further, the SC distinguished the case of Singapore Airlines Ltd vs. CIT⁵ on facts because in that case the Taxpayer, being an airline operator, possessed information of supplementary commission payable to travel agent basis the billing settlement system and also noted that the terms of contract suggested that there was principal-agent relationship between airline companies and the travel agent.
- ▶ On the argument of the tax authority that Taxpayer should periodically collect information from the distributor about the discount earned for the

⁵ (2023) (449 ITR 203) (SC) Refer EY Tax Alert dated 21 November 2022 titled "Supreme Court rules supplementary

commission earned by travel agents from customers on sale of air tickets is subject to withholding taxes"

purpose of withholding tax, the SC observed that such a mechanism is not a statutory mandate and is a far-fetched requirement which imposes unfair obligation and inconveniences on the Taxpayer.

- ▶ The SC held that provisions of the ITL determine the time and manner in which tax is required to be withheld and it cannot be modified by the Court. The concession in provision of law, if any, may be granted by the CBDT basis its powers conferred under provisions of ITL.

Issue of instructions or circulars to avoid litigation

- ▶ The SC observed that withholding tax is a substantial source of revenue to the treasury. It checks tax evasion and non-payment of tax and expands the tax base. The deductor collects tax on income earned by third party and is subject to penal consequences on failure to comply with the provisions. The withholding tax provisions should be construed programmatically and realistically and not as enmeshes or catch-as-catch-can basis.
- ▶ It held that withholding provisions being substantial source of revenue should be interpreted in a realistic manner and in case of legal or factual doubt, the provision may not be interpreted basis doctrine of doubtful penalization.
- ▶ In case of apparent divergence of opinion, the CBDT should issue appropriate instructions/circulars clearly and on prospective basis to clarify the doubts after adopting consultative approach. Apart from enhancing tax revenue and ensuring tax compliance, it is important objective of the tax authority to reduce litigation.

Comments

In its landmark ruling, the SC has put to rest the controversy of withholding tax obligation on income earned under distribution arrangements prevalent in telecom industry. The SC has provided good exposition of the factors relevant for determining and distinguishing principal-agent relationship vs principal-principal or independent contractor relationship. The exposition can be used as a guiding principle for categorizing distribution arrangements employed in other industries like consumer goods, digital good and services, pharmaceuticals, etc.

The SC has made it clear that withholding obligation is triggered only in respect of payment made to an agent. To be an agent, a person represents, acts on behalf of and binds the principal while also establishing fiduciary duty to the principal. As against that, a distributor is a person who undertakes functions on its own and earns profits having regard to his own rights, risks and obligations. The fact that a distributor arrangement is implemented as a franchise arrangement such that the franchisee is subject to certain restrictions including commitment to act exclusively does not dilute the fact that the franchisee acts as a principal and takes the risk of loss or non-recovery from the end customer. The fact that franchisee has to undertake certain compliances in the name of telecom company for meeting regulatory requirements does not dilute principal-to- principal relationship.

The SC also advised that CBDT should issue appropriate instructions/circulars to clarify the doubts on issues arising in withholding tax provision after adopting consultative approach and also ruled that withholding provisions, being substantial source of revenue, should be interpreted in a realistic manner and in case of legal or factual doubt, the provision may not be interpreted basis doctrine of doubtful penalization.

The exposition of the SC for evaluating agency or independent contractor relationship may be relevant for various other aspects including determination of agency permanent establishment vis-à-vis non-residents, corresponding representative assessee of non-residents, principal officer of company liable to withhold tax, etc.

The decision of the SC constitutes the law of the land and is binding on all and may apply to all pending litigations at different levels. The taxpayers impacted by the ruling may need to evaluate the way forward and the strategy depending on the terms of their distributor arrangement.

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