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18 March 2024

**Supreme Court Holds Distributors of Telecom Companies
are not Agents and there is no Obligation to Withhold Tax**

INTRODUCTION

In a recent ruling, the Supreme Court of India has granted significant relief to telecom companies by absolving them from the obligation to deduct tax on the discount provided to a distributor of pre-paid coupons and starter-kits (hereinafter referred to as **prepaid products**). The Court delivered its judgment in a batch of tax appeals reported as *Bharti Airtel Ltd v Asst CIT*, 2024 SCC OnLine SC 198.

The ruling finally settles an issue on which various High Courts expressed divergent views. While the Calcutta High Court and Delhi High Court took a view that a telecom company had an obligation to deduct tax at source under section 194H of the Income-tax Act, 1961 (IT Act), the Karnataka High Court and other High Courts took a view that there was no obligation to deduct tax at source.

FACTUAL BACKGROUND

The Appellant is a cellular mobile telephone service provider. The Appellant offers both prepaid and postpaid connections to the end user. The judgement of the Supreme Court concerns the "prepaid connection" business model.

Under the prepaid business model, an end user pays for the services in advance by purchasing a prepaid product from a distributor. The mechanics are set out below:

- i. The Appellant enters into a franchise or distribution agreements with a distributor.
- ii. The Appellant sells the prepaid products to a distributor at a discount over the printed price.
- iii. The distributor subsequently sells the prepaid products to customers or end user at any price not exceeding the printed price.

The tax authorities viewed the income of a distributor (i.e., the difference between the discounted price paid to the Appellant and the final sale consideration received from end user) as "commission" paid by the Appellant to a distributor in the capacity of an agent. As a result, it was alleged that the Appellant

failed to deduct tax on such commission under section 194H of the IT Act.

Section 194H of the IT Act casts an obligation on the payer to deduct tax at the rate of 5% on payment or credit of any income by way of commission or brokerage to a resident. The provision defines 'commission' or 'brokerage' to include payments received or receivable, directly or indirectly, by persons acting on behalf of another person and rendering services in the course of buying or selling any asset (excluding securities).

Due to the divergent views expressed by the High Courts, various petitions were filed before the Supreme Court.

RULING OF THE SUPREME COURT

The Court emphasised that the obligation to deduct tax under section 194H hinges on the existence of a principal-agent relationship between the Appellant and a distributor.

The Court examined several judicial precedents and the law on agency to define the essentials of a principal-agent relationship and differentiate it from a principal-principal relationship.

Essentials of a principal-agent relationship

The following essentials were laid down to identify a principal-agent relationship:

- i. **Legal Power:** The agent must have the legal power to alter the principal's legal relationship with third parties.
- ii. **Degree of Control:** As the agent acts on behalf of the principal, the principal exercises a degree of control over the agent. The degree of control is lesser than the control exercised in a 'master servant' relationship and is different from the rights and obligations in case of a principal-to-principal relationship.
- iii. **Fiduciary relationship:** The task entrusted by the principal to the agent should result in a fiduciary relationship.
- iv. **Rendering account:** The agent is liable to render accounts to the principal and is entitled to remuneration for the work performed for the principal.

The Court stressed that the substance of the relationship should be assessed to determine its true nature, rather than the nomenclature adopted by the parties.

Essentials of a principal-principal relationship

The Court considered the following principles to distinguish an agent from an independent contractor:

- i. **Sale on own account:** An agent transacts in goods on behalf of the principal, whereas an independent contractor sells goods as his own. In an agency relationship, the transferee would be a debtor to the principal and not the agent. The sale proceeds received by an independent distributor belong to him exclusively.
- ii. **Liability:** As an independent distributor sell goods on his own account, the end customer may only hold the independent distributor liable for any breach of contractual obligations. In an agency relationship, however, the end customer can hold the agent as well as the principal liable. Liability of the manufacturer under tort law towards the end-users is not sufficient to constitute a contractual relationship between them.
- iii. **Remuneration:** An independent contractor generally works towards maximizing his profits, whereas an agent is generally entitled to a prearranged remuneration.
- iv. **Control:** A distributor's obligations to the principal is only limited to the specific contractual terms, whereas an agent has additional obligations due to a fiduciary relationship (for example, obligation to render accounts).

Distributors are not agents and the obligation to deduct tax does not arise

The Court held that a distributor was not acting as an agent of the Appellant but rather as an independent contractor. In reaching this conclusion, the Court considered several factors:

- i. A distributor paid for the purchase of prepaid products upfront, even before selling them to the end user.

- ii. A distributor had the discretion to sell the prepaid products at a given price (ie below the printed price).
- iii. Although the Appellant retained the right, title, and interest in the pre-paid SIM cards, the same was retained only due to certain regulations of the Department of Telecommunication. Merely retaining the title in SIM cards could not constitute an agency relationship with a distributor.
- iv. A distributor receives payment when the end user makes the payment and does not receive any remuneration from the Appellant.
- v. A distributor is not a trustee accountable to the Appellant for the payment received. The payment received represents the gross income / profit earned by a distributor, not a remuneration paid by the Appellant.

Having established that a distributor was not an agent of the Appellant, the Court also examined the provisions of section 194H of the IT Act and ruled it to be inapplicable for the following reasons:

- i. The Appellant does not pay or credit the distributor's account with any commission.
- ii. The distributor's income cannot be construed as an 'indirect payment' of commission as the payments made by the end customer cannot be said to be payments made on behalf of the Appellant.
- iii. The Court also acknowledged the practical difficulty of deducting tax and complying with tax deduction provisions, given that the Appellant is not privy to a transaction between a distributor and an end customer.

The Court distinguished its earlier ruling in *CIT v Singapore Airlines Ltd.*, [2022] 449 ITR 203 (SC) by observing that the existence of an agency relationship was not disputed in the facts of that case as the Airlines company (assessee) possessed information regarding the quantum of commission payable to a travel agent which was subject to tax deduction.

The Court stressed pragmatic application of withholding tax provisions and advised the CBDT to promptly clarify doubts in cases of differing opinions.

COMMENT

The decision of the Supreme Court is important as the Court decided an issue on which there were divergent views from various High Courts. The ruling is of relevance to taxpayers with similar business models, who may need to review and reassess their strategy depending on the terms of their arrangements with distributors.

Similarly, the ruling is also of relevance to foreign companies with distributors / agents

in India who would also need to review and reassess their arrangements to examine whether a taxable presence is created in India in light of the principles laid down by the Supreme Court.

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