Article

Introduction to Indefeasible Right to Use

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Introduction:

Indefeasible right to use (IRUs) is an off-spring of leasing; has been in existence for long and has been effective for a distinct industry and asset class, largely telecom. While the concept of IRUs has been known to all however owing to its unique applicability, there are several elements of IRUs which are distinct from a classic case of lease. This paper below is an attempt to understand IRUs and the legal and accounting aspects in which IRUs operate.

The word *indefeasible* means something that cannot be annulled or revoked. Indefeasible right to use is an *irrevocable* right conveyed to the user by the owner. Hence, indefeasible right to use (IRU) is a contractual grant of usage rights or a contractual agreement between the user and the owner for an exclusive, unrestricted and indefeasible right to use the relevant facility for any legal purpose for a defined period of time.

An IRU is one of the most common methods of conveying right to use in assets in the telecommunication industry. IRU is granted by the company or consortium of companies (grantor) that builds the cable (usually optical fibre). The fibre optic networks or communication cables are largely capital intensive and involve huge capital expenditure. IRUs facilitate sharing of the expenditure by conveying the excess capacity to another service provider and sometimes swapping network capacities as well.

The grantor pays the fees associated with installing the optic network/ cable and other fees and incentives to jurisdictions through which the network will run. The grantor also pays for up-front labour costs of installing and testing and other costs for getting it into the ground. Once installation is complete or even before the completion of the same, the grantor enters into agreements with other long-haul fibre network owners, ISPs and telcos that need the network to get services to customers. These leaseholders who take such services are known as grantees. In consideration of acquiring the ownership of a portion of the network, the grantee pays to the grantor fees for availing the IRU.

As per a Consultation Paper on "*Access Facilitation Charges and Co-location Charges at Cable Landing Stations*[1]," issued by Telecom Regulatory Authority of India, IRU means the right to use the reference capacity[2]:

a. On long term lease for the period for which the submarine cable remains in effective use;

[1] Paper Issues on 22nd March, 2012, http://www.trai.gov.in/WriteReaddata/ConsultationPaper/Document/Consultation_paper_on_CLS.pdf

[2] Reference Capacity is the submarine cable capacity which is to be purchased by the operator either on lease or ownership basis

b. acquired (including equipment, fibers or capacity) under an agreement entered into between the capacity owner and an eligible Indian International Telecommunication Entity;

c. in respect of which maintenance cost incurred becomes payable in any circumstances during the period of validity of the agreement.

Difference between Right to Use and IRUs

Lease as a specie of bailment transfers right to use to the lessee for a specified period of time and retains reversionary rights at the end of the term. The most obvious question that may arise in case of IRUs is that IRUs confer right to use as well but strictly speaking they are not conventional leases.

There are 3 elements that make a lease transaction; a) transfer of right to use, b) transfer of possession and c) surrender of control. Where all the three elements are present in a transaction it is construed to be lease. Where a) and b) are present and c) is missing the transaction is construed to be making a provision of right to use rather than a transfer of right to use and is a license contract[3].

IRUs are based on the concept of network sharing. The cables are subdivided into parts and indefeasible right to use a part is given as a whole. The part remains an independent part from usage perspective but is not independent on the whole. Hence there is sharing of capacity on the whole and independent usage of the part, yet the control over the entire asset is not passed to each of the users. Some of the features of IRU are:

- Grant of right to use
- Indicia of ownership is conveyed not actual control of the facility
- Useful life of the asset is generally the economic life of the asset
- Irrevocable and exclusive right is being conferred

Like conventional leases in IRUs there is a transfer of right to use and there is transfer of possession – actual or constructive. With regard to surrender of control in case of leases, right to physically control the use of the underlying asset is conveyed to the lessee and others' control over the asset is excluded is a case of conventional right to use transactions. IRU is a typical case where, it confers only exclusive usage rights on the purchaser on the part and the rights of title and control of the entire facility remains with the grantor of IRU. In case of IRUs there is technology enabled sharing of right to

[3] The distinction between lease and license contracts has been established over the years by series of rulings. Reliance may be placed in the matter of *Premlata Bhatia vs. Union of India and Others*, 2004 IAD Delhi 186, 108 (2003) DLT 346, *Associated Hotels of India Ltd.* v. *R.N. Kapoor*, 1959 AIR 1262, *Konchanda Ramamurty Subudhi vs. Gopinath Naik and Ors.*, AIR 1968 SC 919 and more.

use by several users, hence it does not result in handing over the possession of the entire facility.

Hence, IRU is a combination of the features of a lease and a service contract but not clearly into the domain of either lease or service contract.

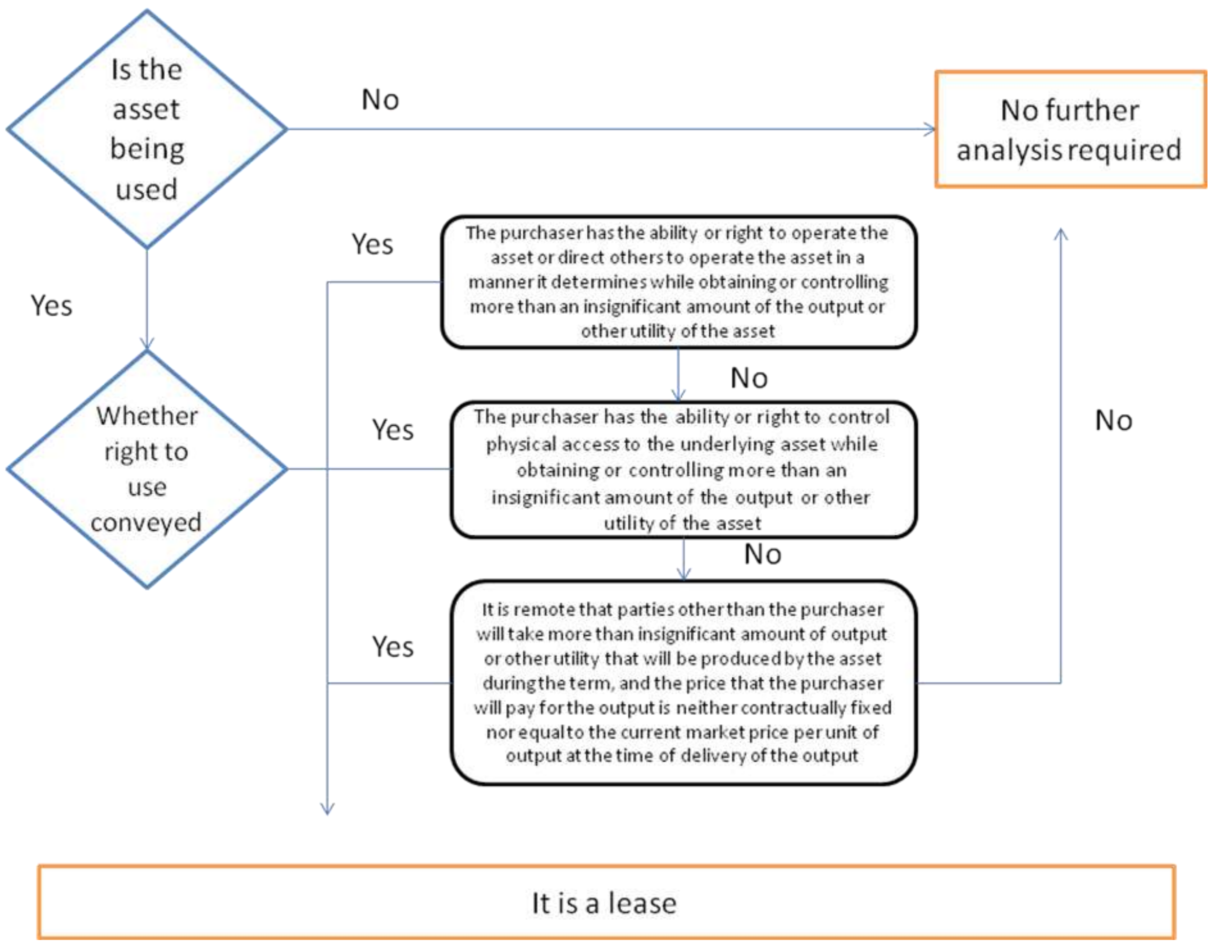
Is IRU a lease arrangement?

The International Financial Reporting Interpretation Committee (IFRIC) in its interpretation IFRIC 4 on *Determining whether an arrangements contains a lease* provides for few parameters to determine whether or not a transaction qualifies for a lease or not. The interpretation does not provide guidance for determining how a lease should be classified under the standard instead it helps to determine whether a particular transaction has features of a lease embedded in it, then the lease accounting principles under IAS 17 shall apply.

In case of IRU's the right to use the capacity is an asset which is separate from the underlying asset which is the cable/ optic fibre. Thus in case a separate identifiable asset is being leased out and exclusive right to use is being assigned to the lessee, then it would qualify as a lease, otherwise the contract must be accounted for as a revenue contracted under International Accounting Standard (IAS) 18. In IRU contracts, typically, the capacity utilization facility is provided for as long as the life of the asset/ facility.

A contract may not be lease arrangement apparently, but may have features embedded of lease wherein the right to use is conveyed in return of series of payments.

Here again based on the interpretation there are several questions to be answered and detailed below:



Is the asset being used, if yes,

a) whether the right to use has been conveyed or not. This means that if the fulfilment of the arrangement is dependent upon the use of the asset, the contract is an embedded lease.

b) The arrangement will be considered to be a lease if the right to control the underlying asset has been conveyed, i.e

i. The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

ii. The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

iii. Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

In case of IRUs, the user has the right to operate, access, control the part of the entire capacity. So based on the parameters above, it can be established that an IRU has qualities of lease for the part of the entire capacity.

Once we have been able to determine whether the IRU is a lease or not, the question of whether an operating lease or finance lease arises. As is the case in finance lease, most of the IRUs extend the contract to the major part of the economic life of the asset, thus the appropriate test for determining whether the IRU would qualify for operating lease or finance lease would depend on the transfer of risks and rewards. Typically while drafting these agreements an option is provided to the lessee to purchase the network at a nominal price at the end of the lease term, so much that there is reasonable certainty that the option to purchase would be exercised at the end of the lease period to be clearly termed as finance lease.

In case the substantial risks and rewards are retained by the lessor, the IRU agreement shall be an operating lease. In case the substantial risks and rewards are not retained by the lessor the agreement shall be that of finance lease. However this would be contract specific determination and classification. For instance, in case the lessee-user makes lump sum payment for the purchase of the capacity, it will be a sale whereas in case of payment made over a period of time if would be operating lease. In case an IRU includes an operating and maintenance components along with the lease component, in such a case for accounting purposes the two must be recorded separately. In case the operation and maintenance contract is separate from the IRU agreement, then the maintenance contract would be a contract of service provided by the lessor. Also one cannot with utmost certainty state that all IRUs will be specie of lease. The contractual substance of the transaction will determine if it is inclined towards lease, license or a service contract.

Service element of an IRU agreement

In some contracts, the grantee is not utilising the capacity purchased and the grantor can allocate the unused capacity to a third party and retain the rewards associated with the utilization of the capacity then it can be said that the grantor is providing nothing but a service for delivery of traffic on its network, then the arrangement would qualify as contract for service for the grantor.

Whether or not the IRU is a service contract or a lease contract would depend on the substance of the arrangement. It is pertinent to understand that a service contract is one which does nor transfer the right to use the asset but uses the same for the benefit of the other party, whereas in case of leases, the lessor transfers the right to use the asset in favor of the lessee.

In case of the purchaser of IRU, the capacity purchased in recorded as an asset and is amortized over the period of benefit as a charge against income. In case of the IRU provider, the question of revenue recognition is based on whether the IRU qualifies as a lease arrangement or a service contract.

Legal Issues:

Most IRUs grant indicia of ownership while not conveying the control over the asset/ facility. The key legal issues that arise in most IRU contracts are whether the contract is eventually conveying the right, title and interest in the asset or is a mere contractual right to access the asset. In the landmark judgement of *WorldCom Inc. and MCI WorldCom Network Services, Inc. v. PPLPrism, LLC*[4], from the US Bankruptcy Court for the Southern District of New York, the legal issues of the enforceability of IRUs was examined.

MCI WorldCom Network Services purchased IRUs from Cambrian which involved an upfront payment and a separate maintenance contract and a right to purchase the asset at the end of the useful life for a nominal fee. Cambrian subsequently filed for bankruptcy and sold the fibres to PPL Prism which gave rise to dispute over the right in the fibres between WorldCom and PPLPrism.

The Court held that even though the grantee on whom the IRU is conveyed, though is the beneficial owner and the not the legal owner but the former's equity as owner of IRU was recognized as the right to use and the title belong to the grantee. The Court concluded that IRU is a property interest and not a mere contractual right to access. The Court held that WorldCom's IRU was an easement by necessity but the right to access the fibres was enforceable against PPLPrism for the limited purpose of enjoyment of the IRU.

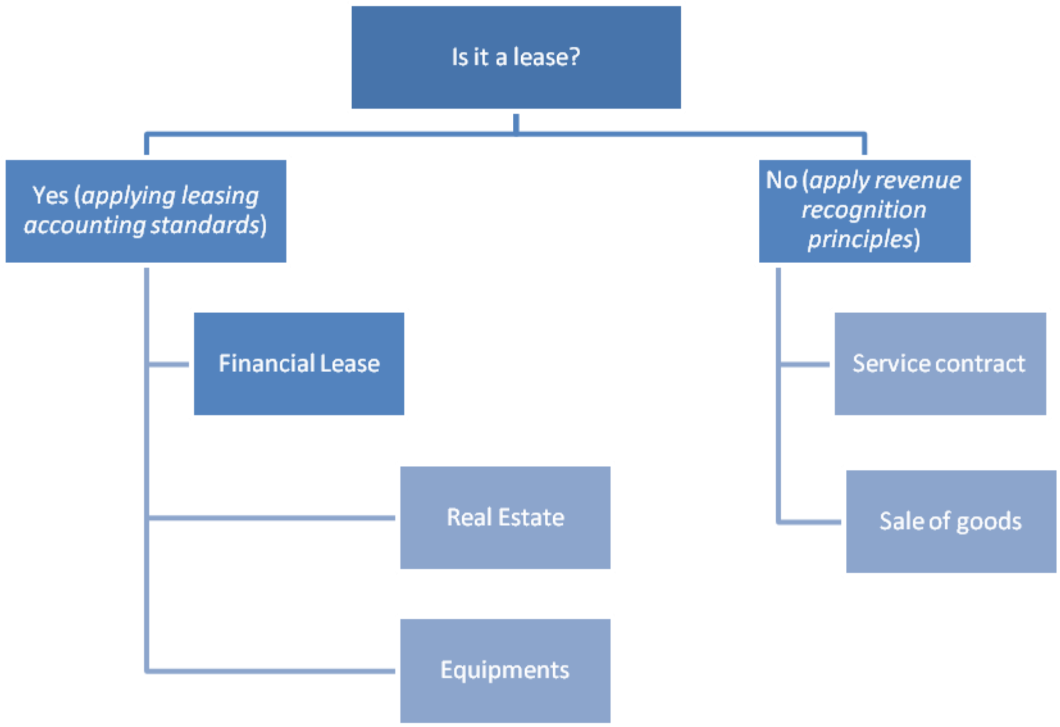
In substance the way the IRU's are structured would determine the color of the agreement, while some IRU contracts would be structured such that the grantor retains the ownership of the asset, others would convey the ownership of the asset at the end of the term by way of a nominal fee.

Accounting Issues:

Since IRUs have features of lease, sale and service, there exists a lot of ambiguity for accounting for IRUs, it is therefore pertinent to understand the substance of the

[4] http://www.nysb.uscourts.gov/opinions/ajg/101099_40_opinion.pdf

structure to be able to render clarity for accounting purposes as depicted in the chart below:



The questions to answer while looking at the substance of the IRU contract are does the transaction have features of a lease? If yes, then what type of lease needs to be determined and AS 19 shall be applicable likewise. If no, then revenue recognition principles will be applicable.

Where the IRU is a sale type contract, it is recognised as an intangible asset and are amortised over the useful life of the asset or term of the contract.
The research committee of ICAI had issued an exposure draft on the '*Technical Guide on Revenue Recognition for Telecommunication Operators*[5]' which was put for public comments till January, 2010. The exposure draft defined IRU as *an exclusive, unrestricted, and indefeasible right to use the relevant capacity (including equipment, fibres or capacity) for any legal purpose.*

In some cases where there is a capacity swap taking place, the excess capacity is swapped with another grantor/ owner of fibre cables, the assets may be treated as fixed assets as per AS 10. Para 22 of AS 10 on Accounting for Fixed Assets provides clarity on the issue, relevant extract is as below –

> *22. When a fixed asset is acquired in exchange or in part exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the*

[5] http://www.icai.org/resource_file/17693announ9401a.pdf

net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. For these purposes fair market value may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident.

Taxation Issues:

In case IRUs are considered to be leases, taxes as applicable in case of financial leases or operating leases will become applicable. With regard to claiming depreciation on these assets u/s 32 of the Income Tax Act, 1961, the eligibility to claim depreciation is dependent on the beneficial ownership of the asset (in case of leases) and that the asset is put to use.

In a case of *Videsh Sanchar Nigam Ltd.*[6], the Income Tax Appellate Tribunal, Mumbai evaluated the question whether the user of IRU could claim depreciation on the asset which was owned by another party. In the present case Videsh Sanchar Nigam was granted the right to use and was claiming depreciation on the beneficial ownership of the asset. The agreement between the grantor and the user was for a term of 25 years and stated that the beneficial owner had the right to the extent of its investment in cable network, had complete right as the owner of the part and possessed such rights to the exclusion of the others.

ITAT, Mumbai stated that eligibility for depreciation was '*governed by the factum of beneficial owners*hip of the depreciable assets notwithstanding the absence of legal title thereto.' Reliance was placed on the ruling of on the decision of Hon'ble Supreme Court in the case of Mysore Minerals Ltd. Vs. CIT[7], *wherein ownership was defined as a collection of rights to use and enjoy property, including right to transmit it to other......*' ITAT held that the user was the *de facto* owner of the network and depreciation was allowed therein.

The rental income received will also be subject to tax for the grantor. In case the IRU is a service type or sale type contract tax will be applicable on the services rendered or sale proceeds. In case where the services are separately contracted for and are not incidental to the purchase of IRUs, payment made on such services shall be identified and shall be subject to service tax.

[6] http://www.indiankanoon.org/doc/133765634/

[7] 239 ITR 775