

When Worlds Collide: Indefeasible Rights of Use, Tax and Commercial Reality

James Halliday and Linh Tran

James Halliday (Partner, Baker & McKenzie) and Linh Tran (Associate, Baker & McKenzie) – 24 June 2008. This article was first published in the CAMLA Communications Law Bulletin, (2008) 27(1) CLB 3

1. Introduction

In 1951, Paramount Pictures released the blockbuster hit, "When Worlds Collide". It told of the cataclysmic results of two rogue planets from outer space crashing into Earth, pulverizing the planet and all life on it. The collision of several worlds is a good way to describe the process of drafting an "Indefeasible Right of Use" (IRU) agreement. This process involves the collision of commercial, accounting and tax requirements in a way that requires a very strong understanding of each in order to be reconciled in a workable agreement.

Jumping forward from 1951 to 2008, it is interesting to see that there have been a number of recent announcements regarding the deployment of international submarine cable commission and upgrade projects over the next 18 months.¹ The anticipated growth in the availability of quality high speed transmission capacity is likely to see an increase in commercial arrangements for capacity supply. This is relevant not only to traditional telecommunications infrastructure companies, but also very important to other industry participants such as media and content providers, who are expected to exploit their applications using the capacity on these cables.

When negotiating these capacity supply arrangements, the parties

will undoubtedly consider the various forms of arrangement that are available. In this article we look at what constitutes an IRU arrangement as distinct from other capacity supply arrangements, the key drivers underlying these arrangements and the tax and commercial requirements that are typically important to the contracting parties. It also offers some suggestions as to how best to manage the often competing requirements in the modern environment.

2. Why an IRU?

"Normal" capacity supply arrangements

Participants in the telecommunications industry will be familiar with the "normal" forms of capacity supply arrangements. The contracts which document these arrangements usually describe the capacity to be supplied, the price to be paid, limitations of liability of the supplier, and the rights of the supplier to stop supplying the capacity in the event of the customer's default (e.g. non-payment).

A "normal" capacity supply arrangement will typically have the characteristics shown in the diagram below. (Please refer to Diagram A).

IRUs distinguished

An IRU (that is, an "indefeasible right of use"), in a telecommunications context, is a form of capacity supply arrangement which, as will be seen, exhibits characteristics quite different to those of the "normal" supply arrangements described above. In telecommunications slang, an "IRU" generally refers to a long-term arrangement (e.g. for a term of 10 to 15 years) under which a supplier grants its customer rights to capacity over a fibre optic cable system.² Often the arrangement requires the customer to make an upfront lump sum payment to the supplier to have these rights for the life of the agreement.

The term "IRU" also has a specific and narrow meaning under the *Income Tax Assessment Act 1997* (Cth).³ One consequence of a particular arrangement falling within this narrow meaning is that both the supplier and the customer are entitled to treat the arrangement as capital in nature.⁴ This means, for example, that the customer is able to obtain certain tax depreciation allowances that might not otherwise be possible in connection with a normal supply arrangement – that is, payments for the capacity by the customer are treated as capital payments and are therefore depreciable over the life of the relevant cable (this can often translate to significant tax savings for the customer).

Importantly, the essence of an IRU arrangement is the conferral of economic (but not legal) ownership of the capacity, and/or cable over which the capacity is carried, to the customer. This means that IRU agreements typically require the customer to take the risk of damage to the cable system, even though this is generally not within their control. On the other hand, IRU agreements usually also allow the customer to use the relevant capacity on the same terms and conditions as the supplier.

An IRU agreement will typically have the characteristics shown in the diagram below. (Please refer to Diagram B).

3. Key indicia of IRUs

Overview

There are no criteria which definitively distinguish IRUs from other capacity supply arrangements. When seeking to determine whether a particular arrangement is an IRU (at least for tax purposes), each arrangement is considered on a case by case basis. Broadly, however, there are two essential indicators which, if reflected in the terms of the supply arrangement, assist its characterisation as an IRU. These features are:

- (a) indefeasibility; and
- (b) the customer's right to use the capacity on more or less the same terms as the owner.

Both indicators stem from the idea that, under an IRU arrangement, economic ownership of the relevant capacity/cable is conferred to the customer. It is therefore helpful when approaching IRU agreements to think of an IRU as giving effect to the transfer of a tangible asset, such as a car, and thinking about how certain situations might be dealt with if the agreement were

for the sale and purchase of that asset rather than for the supply of a service.

The following sections describe how capacity supply arrangements are often structured, and the provisions often included, so as to reflect the above indicators. Generally speaking, the greater the number of these provisions in an agreement, the more likely it is that the arrangement will be regarded as an IRU.

Indefeasibility

The first key indicator of an IRU is that it is indefeasible. In order to be indefeasible, it is usually necessary that the relevant capacity is:

- **Identifiable.** If a supplier sells a tangible physical asset to a customer (e.g. a car), then the asset must obviously be identified and known. In the case of an IRU, the arrangement should ideally be for capacity over specific wavelengths within a specific fibre strand, or over specific fibre strands within a specific cable, or at the very least, over a specific route or routes.
- **Fixed.** As part of the requirement that the asset be identifiable, the amount of capacity must also be fixed.
- **For the customer's exclusive use.** If a person owns a car, they usually have the exclusive right to use that car. Similarly, the capacity or infrastructure must be exclusively made available to the customer, and not shared with any third person.

To evidence indefeasibility, IRU agreements typically:

- do **not** include a right to terminate by either party; and
- do **not** allow for the customer to receive refunds of any

payments made upfront for the capacity.

Rights more or less similar to that of the owner

The second key indicator of an IRU is that the customer must have a right to use the capacity on the same terms, more or less, as those on which the owner is entitled to use that capacity.

To reflect this idea of quasi-ownership, IRU agreements typically contain the following types of clauses:

- **No obligation to maintain.** The purchaser of a car has the entire obligation to service that car. Similarly for an IRU, the supplier cannot have an obligation to maintain the cable system or relevant service to any particular level.⁵
- **No compensation for defective service.** Unless there is a separate warranty arrangement, the purchaser of a car has no general law right to receive compensation if the car breaks down. Similarly, the customer in an IRU arrangement is not entitled to receive any kind of compensation (such as service credits or rebates) if the cable system fails or otherwise becomes inoperative, or for interruption to the supply of capacity.
- **Customer must meet share of the costs of uninstalling the cable system.** The purchaser of a car must pay to meet the cost of disposing of it when it reaches the end of its life. Similarly, the customer in an IRU arrangement must contribute its proportional share of the cost of uninstalling the cable system, if the cable system is liquidated.
- **Customer receives share of proceeds of disposal.** The

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customer in an IRU arrangement is entitled to a proportional share of any proceeds which arise from the installation of the cable system or from claims against third parties in respect of it.

Again, because of this indicator, the agreement will generally not include a right for the customer to terminate the agreement, even where there is failure by the supplier to make the relevant capacity available.

4. Drafting IRU agreements for typical commercial arrangements

Perhaps not surprisingly, the indicators of IRU agreements and the ideal "IRU provisions" rarely match the actual commercial requirements of the parties to them. For example, customers of telecommunications services usually expect to have the right to terminate the services arrangement where the supplier fails to supply that service. As discussed, this is not usually permitted in a true IRU agreement. Similarly, customers do not typically expect to have to meet the cost of repairing cable cuts, as this is usually the obligation of the supplier.

The key challenge with IRU agreements is, therefore, to structure the arrangement so that it incorporates the key IRU indicators, but still meets the commercial requirements of the parties. This section looks at some of the ways in which this might be achieved. Some of these requirements go purely to form,⁶ whereas others go to substance.

Where there are strong tax objectives driving the IRU arrangement, it is important that the parties be mindful of the anti-avoidance provisions of applicable tax legislation and ensure that they structure the arrangement in a manner that does not contravene any relevant prohibitions. Specialist tax advice should

obviously be sought in such circumstances.

Operations and maintenance services

Under a normal capacity supply arrangement, the customer will usually want the service to be supplied to a certain standard or "service level" (for example, the supplier may promise to supply the service to a certain availability target). The customer will usually also ask for some kind of liquidated damages or "service credit" if the service is not provided to the contracted level.

An IRU arrangement, however, requires the customer to take on the risks and benefits of ownership of the cable system. Theoretically, this means that the customer must also take on the obligation to maintain that system. Accordingly, a requirement that the supplier satisfy defined service level requirements cannot (strictly speaking) form part of an IRU agreement. This is potentially problematic in that, as a matter of practice, it is rarely feasible for the customer to assume the cable operations and maintenance obligations itself.

This issue is typically resolved by the customer outsourcing operations and maintenance obligations back to the supplier. Thus, an IRU agreement is usually accompanied by a separate operations and maintenance agreement which governs the provision of these services.

A further and related complexity is that, because the customer (theoretically) must bear risks in respect of the cable (or relevant part), such as the risk of damage and obsolescence, the customer should bear its proportion of the costs of repairs and upgrades of the cable. Commercially, however, the customer may be unwilling to pay additional amounts to the supplier in the event of damage to the cable or other circumstances

which require the cable to be upgraded.

One way to address this issue could be to include a provision in the operations and maintenance agreement which requires the supplier to indemnify the customer for any repair and upgrade costs in consideration of the customer paying a specified premium. The premium would then be drafted as being an amount that is included in the total IRU fees under the IRU agreement so that the customer would not, in practice, pay any additional amounts to the supplier.

Flexibility of capacity requirements

As discussed above, the requirement of indefeasibility generally means that the IRU agreement needs to identify the relevant capacity, ideally, by identifying specific fibre strands or routes. In some cases, however, it is not always desirable or even possible to include these details at the time of entering into the agreement. In other cases, the parties may simply wish to preserve some flexibility as to the capacity over which they have rights during the term of the arrangement.

Of course, to expressly include a right for either party to specify the fibre strands or routes at a later time, or to change those fibre strands or routes during the term, would be inconsistent with the idea of an IRU being a defined asset. Indeed, the inclusion of such rights would quite clearly make the arrangement one for the supply of services.

In these situations, the agreement should be drafted to include as much detail as possible in respect of the capacity requirements that are not expected to change over the term of the arrangement. It should then also include provisions which allow flexibility for the other requirements to change as necessary during the term. Some

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examples of how this might be done in different scenarios are as follows:

- A customer will generally require continuity of capacity supply notwithstanding faults affecting the relevant fibre strands. To ensure this is possible, the agreement should allow for the customer to exercise its rights of use in relation to capacity on alternative fibre strands where there is a fault on the specific fibre strands over which the customer normally obtains the capacity, until the fault is remedied. In this scenario, it might be sufficient to simply identify the amount of capacity to be supplied and the cable over which it is to be supplied. This would mean that in the event that the supplier needs to provide the customer with capacity over fibre strands that are different to those contemplated at the commencement of the arrangement, it is able to do so and still be within the terms of the agreement.
- A customer may require the capacity on different routes during the term to accommodate its changing business needs and the demands of its own customers. This scenario can be accommodated to some extent by specifying upfront the fixed capacity requirements (which are likely to be the aggregate amount of required capacity, and the possible routes over which that capacity may be required), and including a provision stating that the IRU is to be activated progressively in accordance with the terms of a separate agreement (e.g. the operations and maintenance agreement). That other agreement would then include a mechanism

under which the customer can, from time to time, direct activation of rights to capacity over the various routes specified in the IRU agreement.

- A supplier, while able to undertake to provide an IRU for capacity between specified points, might not be able to specify the fibre strands, or even the routes, over which rights to capacity will be granted because the relevant cables are not yet built. In this scenario, it would only be possible to specify the aggregate amount of capacity required and the physical locations between which the capacity is required. The flexibility would need to be built in by way of a provision stating that the IRU is granted for the specified amounts of capacity between the specified locations along routes which are to be determined pursuant to a design process. The design process would then need to be set out in a separate agreement (typically referred to as a "design and construct" agreement).

Termination rights

It is reasonable, and usual, for a customer to expect a right to terminate a capacity supply arrangement where the supplier fails to provide the relevant capacity. The customer might also expect a right to a refund of any amounts paid upfront for that capacity. Similarly, it is usual and reasonable for a supplier to expect a right to terminate the arrangement where the customer defaults in payment. As discussed above, however, a true IRU agreement generally cannot be terminated and cannot allow for refunds of upfront payments.

One way to consider in which the potential inequities arising from

these restrictions can be overcome is by incorporating put and call options in the IRU agreement which would apply in the event of the supplier's and customer's default, respectively. These might work as follows:

- Under the put option, the customer would be entitled to "put" its interest in the IRU to the supplier in the event of the supplier's breach (e.g. failure to provide the capacity). Upon exercise of the put option, the supplier would be required to purchase that interest for a specified amount – for example, the amount paid by the customer for the IRU. This would effectively result in a refund of the amount paid by the customer to the supplier.
- Under the call option, the supplier would be entitled to "call" its interest in the IRU in the event of the customer's breach (e.g. failure to pay for the capacity). Upon exercise of the call option, the customer would be obliged to sell that interest back to the supplier for a specified amount – for example, the amount owed by the customer. This would effectively cancel out the amount owed by the customer to the supplier.

The operation of either the put option or call option would effectively result in the capacity supply arrangement coming to an end, consistent with the commercial intention to allow for termination in the event of default. Given the values involved, the options should be drafted such that they can only be exercised following a significant and comprehensive dispute resolution process, similar to what would apply in connection with termination rights under a services agreement.

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5. Conclusions

As seen from the examples in this article, the commercial requirements of parties to capacity supply arrangements typically do not match the strictures of a true IRU. The means of addressing this dichotomy will depend on the specific arrangement, as the commercial and other objectives will invariably differ in each case. Considerable legal ingenuity incorporating tax, accounting and other advice (as appropriate) is therefore often required to produce an agreement that is reflective of the commercial intent of the parties but which also complies with the requirements of the IRU and its inherent complexities. There are potentially significant benefits to be had by both the supplier and customer (such as tax and accounting effectiveness) where the parties manage to steer a successful collision of the various objectives underlying an IRU arrangement which often travel in different directions.

¹ For example, Telstra and Alcatel-Lucent are currently constructing a Sydney-Hawaii cable; Pipe Networks has recently announced a second cable to New Zealand; and upgrades have recently been completed on the Australia-Japan Cable.

² It may be possible to structure arrangements for the supply of capacity over other fixed transmission technologies, such as microwave and satellite, as IRUs. However, such "IRUs" are unlikely to constitute IRUs for tax purposes.

³ The ITAA defines an "IRU" as "an indefeasible right to use a telecommunications cable system": section 995.1.

⁴ IRUs can in some cases also amount to "finance leases" or "sales type" leases for accounting purposes. A finance or sales lease is also regarded for accounting purposes as a capital asset.

In some cases this can mean that the supplier is entitled to account for the entire upfront payment as revenue in the financial year in which it is received. This article does not examine the accounting treatment in detail of IRUs.

⁵ This is mitigated through the use of operations and maintenance agreements, described below.

⁶ For example, most capacity supply arrangements will, in practice, entail the supplier providing services (i.e. the supply of capacity) to the customer. Notwithstanding this, if the arrangement is to be characterised as an IRU, it must be drafted in a way that does not imply a services arrangement. At the most basic level, this means that the IRU agreement should not refer to the "supply" or "delivery" of capacity or services, or any words or obligations to that effect. Instead, these agreements typically refer to the "grant of an IRU", implying a once-off, upfront provision of an asset (e.g. under a sale agreement), as opposed to an ongoing services arrangement.

DIAGRAM A

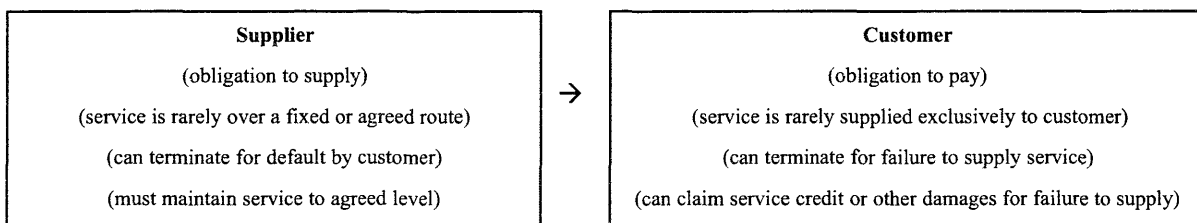


DIAGRAM B

