

Payments by Google India were royalties subject to withholding tax, tribunal rules

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An Indian tax tribunal has concluded that payments made by Google India to Google Ireland under a contract for marketing and distribution of online advertisement space through Google's AdWords program should be treated as royalty payments. As such, the payments were subject to withholding tax, the tribunal concluded, in an October 24 decision.

The tribunal's rationale was that the payments were made in return for a license to use Google's patented technology and confidential data. India levies a withholding tax on royalty income.

The dispute first arose when the Indian tax authorities sought to tax about INR 1457 crores (approx. USD 225 million, at today's exchange rates) paid to Google Ireland between financial years 2006-07 to 2011-12 under a marketing and distribution services contract for AdWords without deduction of tax at source as royalty income.

Unlike an advertisement in traditional media, AdWords enables an advertiser to change and monitor the performance of an advertisement and to adjust the content of the advertisement accordingly.

Distribution rights: commercial rights or license of intellectual property?

Although the marketing and distribution contract did not involve transfer or license or right to use any of Google Ireland's intellectual property, the tax authorities argued that Google India had access to Google's proprietary technology and confidential data under the services agreement.

Google argued that the IT/ITeS services provided by Google India were not linked in any manner to its distribution function and that its AdWords division and ITeS division operated separately with no overlap of activities or responsibilities.

However, the Tribunal held that Google India could perform its distribution functions only due to the license to use Google's proprietary technology and confidential data under the services agreement. Thus, the Tribunal concluded the services agreement could not be divorced from the distribution agreement. The bifurcation of agreements was only a design / structure prepared by Google India to avoid the payment of taxes.

Google also argued that the payments to Google Ireland were merely for purchase of ad space for onward sale to advertisers in India, akin payments made by advertising agencies to newspapers, magazines or television channels for ad space to publish their customer's advertisements, and should be treated as business profits falling under Article 7 of the OECD Model Tax Convention, rather than royalties.

Google placed reliance on a [2001 report by the Technical Advisory Group on Treaty Characterization of Electronic Commerce Payments](#) and a 1999 report of a High-Powered Committee on Electronic Commerce Taxation constituted by India's Central Board of Direct Taxes.

Both reports had concluded that payments for online advertising space should be treated as business income and had been relied in other Tribunal decisions as well. Google further argued that in the absence of a permanent establishment in India, its business income should not be subject to tax in India under the Income Tax Act read with the India-Ireland tax treaty.

However, the Tribunal, relying on its understanding of the AdWords Program, distinguished the rulings and reports on the ground that the fact pattern dealt with therein was vastly different from the fact pattern in the present case, which involved the license of proprietary technology and confidential data.

Use of trademark: essential or incidental?

The tax authorities also argued that the payments to Google Ireland were for use of Google's trademarks and brand features.

While Google relied on past rulings of the Delhi High Court (*Sheraton International Inc v DDIT [2009]* and *Formula One World Championship Ltd. v. CIT, [2016]*) to argue that the use of trademarks and brand features granted to Google India was merely incidental to its distribution and marketing functions, the tribunal held that such use was essential and pivotal for Google India to market and distribute the AdWords Program.

Confidentiality clauses: routine?

The tax authorities relied on a non-disclosure agreement and a confidentiality clause forming part of the contract for distribution and marketing services to support the argument Google India had access to Google's proprietary technology and confidential data.

Google argued that the confidentiality clause is intended only to protect confidentiality of the information, if any, which either party gathers during the course of the business. Such clauses are generic to most agreements and cannot per se establish that there is a right to use Google's intellectual property.

The tribunal accepted the argument of the tax authorities that the confidentiality and non-disclosure obligations on Google India were indicative of Google's India's right to use Google's proprietary data and confidential information.

Proceedings barred by limitation?

Google also challenged the proceedings with respect to FY07 and FY08 on the ground that they were barred by limitation.

Under Section 201, the tax authorities may commence proceedings against a taxpayer who has failed to discharge their withholding obligation. Section 201 did not prescribe a limitation period. Courts have held (*CIT vs. NHK Japan Broadcasting Corporation [2011]*) that a reasonable limitation period should be read in based on a holistic read on of other relevant provisions of the Income Tax Act and the Finance Act, 2012 introduced a six-year limitation period for residents.

Google argued that the judicial four-year limitation period should continue to apply to it, but the tribunal held that a 'reasonable' limitation period for non-residents should be taken as six years in light of the amendment to section 201, as any other period would amount to discrimination between residents and non-residents.

Royalties: Taxable only on receipt?

Google India had not actually paid Google Ireland, but rather had credited the amounts to Google Ireland's account in its books. Google sought to rely on the Ireland-India tax treaty to argue that the royalty income would be taxable only in the event of actual receipt.

However, the tribunal rejected this argument. It held that the benefit of the treaty is only available to Google Ireland and would not impact Google India's withholding obligations under the Income Tax Act (which required deduction even upon credit of income to account of the payee in the books of the payer).

The tribunal was also of the view that while the treaty can provide for the characterization of the income, the country where it is to be paid and at what rate the said income is to be taxed, it cannot prescribe when (i.e., year of accrual or receipt), the income is required to be taxed.

Takeaways

The tribunal's judgment was based in large part on its understanding of the Google AdWords Program. Based on information regarding the AdWords Platform provided by the parties, information available on Google's website, and in books available in the public domain,

The tribunal concluded that the distribution agreement was not merely an agreement to sell ad space but rather is an agreement to provide services to facilitate the display and publication of an advertisement to targeted customers with the help of technology.

The AdWords Program gives an advertiser a variety of tools to enable it to maximize attention, engagement, delivery and conversion of its advertisements.

The tools are provided using Google's proprietary technology and confidential data (including data on numerous individual web-users, such as their name, age, gender, location, phone number, IP address, habits, preferences, online behavior, search history, etc.) with Google India acting as a gateway.

The tribunal concluded that it is through use of Google's intellectual property that the AdWords tools for performing various activities are made available to Google India and the advertisers. Therefore, payments made to Google Ireland would be in the nature of royalties.

The tribunal's ruling is unique, considering the subject matter and fact pattern involved. The Tribunal's ruling is also of interest for its clear break with positions taken by other tribunals. Various tribunals have held that income from sale of online advertising space is business profits which are not taxable in the absence of a permanent establishment in India.

In fact, it was for this very reason that the equalization levy was introduced to capture advertising fees within the Indian tax net. It will be interesting to see how this decision reconciles with the new international tax rules being developed for the taxation of the digital economy.

The tribunal's ruling has aggressively sought to bring the payments to tax in India by clubbing two independent agreements entered for different services provided by two different units of Google India to show that there was utilization of IP by the Indian entity and recharacterizing the income as royalties.

The ruling is also aggressive in holding that the use of customer data and confidential information to provide advertisement services could be seen as a license of IP.