Google India vs. ACIT: shifting the digital tax landscape

Kluwer International Tax Blog
December 12, 2017

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Please refer to this post as: Shilpa Goel (Editor), 'Google India vs. ACIT: shifting the digital tax landscape', Kluwer International Tax Blog, December 12 2017, http://kluwertaxblog.com/2017/12/12/google-india-vs-acit-shifting-digital-tax-landscape/

Much has been said and written globally about Google's tax affairs. The way the company carries on its business operations and how much tax it pays on income generated from such operations has been a subject of recent, heated debate in both France and the UK. In India too, international tax experts are discussing an important ruling handed down by the Bangalore Income Tax Appellate Tribunal, in October, in favour of the Revenue and against the networking giant. There is much to be said about the 134-page judgment but, in this blog, I will restrict myself to the royalty aspect of the decision, which is, whether or not the INR 14.57 billion remitted by Google India to Google Ireland under a Distribution Agreement constitute royalty payments, and accordingly, subject to Indian withholding tax.

Two agreements

In 2004, Google India and Google Ireland entered into an ITeS Agreement (Service Agreement), pursuant to which Google India was to ensure that the advertisements placed by global advertisers adhere to Google's editorial guidelines and local regulations of countries from where such advertisements originate. Certain intellectual property rights were granted to Google India under this Agreement; however, no amount was paid or payable to Google Ireland under the Agreement.

A year later, in 2005, Google India and Google Ireland executed a Distribution Agreement, under which Google India was to market, distribute, and resell advertising space (through AdWords Program) to Indian advertisers. Google India

also agreed to provide certain customer support services to the Indian advertisers.

Google India remitted INR 14.57 billion, 2007-08 through 2012-13, to Google Ireland under the Distribution Agreement without deducting tax at source. Naturally, the Income Tax Department did not like it and asked Google India to show cause why it did not deduct withholding tax on the INR 14.57 billion in royalties as per the provisions of the Income Tax Act. For its part, Google India maintained that the amounts did not constitute royalty income but instead were in the form of business income and were not taxable in India given that Google Ireland did not have a permanent establishment in India.

The Assessing Officer rejected the company's position. Google India appealed to Commissioner of Income but was unsuccessful. Hence, a second, yet unsuccessful, appeal to the Tax Tribunal.

Google India versus Revenue

Google India's main argument was that it entered into two separate and distinct agreements with its Irish affiliate – the Distribution Agreement (2005) and the Service Agreement (2004). The INR 14.57 billion that was remitted to Google Ireland, the company contended, was in furtherance of the Distribution Agreement under which no intellectual property rights whatsoever were granted to it by Google Ireland. It further argued that the intellectual property rights that the Revenue was alleging to have been transferred by Google Ireland were in fact transferred under the Service Agreement – which existed even prior to the Distribution Agreement and would continue even if the Distribution Agreement expires or is terminated (and *vice versa*).

In short, Google India argued that the Revenue is alleging transfer of intellectual property rights (and hence raising the question of royalty income) without actually tracing that right to the text of the Distribution Agreement, under which the disputed amount was remitted to Google Ireland. In contrast, Google India cited a range of leading judicial precedents (which the Tribunal distinguished), the Indian High Power Committee Report on E-commerce, and the views of OECD's Technical Advisory Group to stress that payments arising from advertisements are necessarily in the form of business profits and, therefore, not taxable in the source country, namely, India in the absence of a permanent establishment in India.

Revenue's position too was quite clear and convincing: Google Ireland granted

Google India certain intellectual property rights and consideration was paid by Google India to use the copyright in the AdWords program. The Revenue read the Service Agreement together with the Distribution Agreement to argue that Google Ireland allowed Google India access to intellectual property rights for activities related to the Distribution Agreement. In other words, the intellectual property rights were granted to Google India for the purpose of marketing and distribution activities. Accordingly, the payments made to Google Ireland were in the nature of royalty as per the provisions of section 9(1)(vi) of the Income Tax Act read with the India-Ireland tax treaty.

The Tribunal's ruling

The Tribunal agreed with the submissions set out by the Revenue and rejected Google India's argument that the service component was independent of the distribution of advertising space to Indian advertisers. In the opinion of the Tribunal, inputs from the Service Agreement are always required in the business model of the company, without which there cannot be any targeted marketing for advertisements and promotion of sales to advertisers. Therefore, it concluded, the services rendered under Service Agreement cannot be divorced with the activities undertaken under the Distribution Agreement. The Tribunal went further to hold that the transaction was "only a design/structure prepared by the taxpayer to avoid the payment of taxes."

On the taxpayer's point of sales being in the form of business income, the Tribunal held that there was no sale of space, rather a continuous targeted advertisement campaign to targeted customers (in a particular language and to a particular region) with the help of digital data and other confidential information. In other words, it is not merely selling of space but rendering of services by making available intellectual property. Thus, the payments fell within the ambit of royalty income as per the Income Tax Act and the tax treaty.

Some observations

The definition of royalty under Explanation 2 to section 9(1)(vi) means consideration for transfer of all or any rights (including the granting of a license) in respect of use of a patent, invention, model, design, secret formula, process, trademark, similar intellectual property or in relation to imparting of any information concerning technical, industrial, commercial or scientific knowledge,

experience or skill. Clearly, the amount payable to Google Ireland was for purchase of advertisement space under the AdWords Program and not in relation to any transfer of any right or any right to use any copyright, patent, invention etc. The Distribution Agreement did not involve any use of patents, invention, model, design, secret formula or process or trademark by Google India.

There are several question marks in the Tribunal's decision: Did Google Ireland provide to Google India right to use intellectual property in return for the payments that it received? Is the amount payable under the Distribution Agreement in relation to any knowledge concerning a patent or invention, or is it in relation to use of any scientific equipment? Does grant of a non-exclusive right to distribute advertisement space constitute grant of an intellectual property right or is merely granting a commercial right? Was the Tribunal right in assuming that the right to use the intellectual property granted under the Service Agreement was so used by Google India for the purpose of distribution of advertisement space? Finally, should the Tribunal not have, for the sake of completeness, gone into an analysis of whether Google India constituted a permanent establishment of Google Ireland?

At the time of writing this blog, I am informed that Google India is appealing the Tribunal's decision in the High Court. No doubt, the High Court will go deeper into these questions and we will soon see if the High Court appreciates the facts of the case differently and, as a result, comes to a different conclusion. One thing is clear though: tax tribunals in India have begun to take a purposive look at transactions, especially digital transactions such as this and the one we saw in ABB FZ LLC's case, and companies must be well-informed of the risks and uncertainties associated with such structures.