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Payment for distribution of AdWords Program cannot be characterised as 'royalty'; in absence of a PE of the non-resident in India, the same cannot be brought to tax in India and consequently, no withholding tax obligation can be attached – Bangalore bench of the Tribunal

In brief

The Bangalore bench of the Income-tax Appellate Tribunal (Tribunal)[1] observed that the AdWords Program, a computerised advertising program is essentially a computer program or software, and the issue regarding the use of computer software being tantamount to royalty now stands resolved by the Supreme Court[2]. It also observed that there was no consideration flowing for the use of brand features and that the use of such features was incidental and ancillary for achieving the main purpose of marketing and distribution. The Tribunal also noted that the Technical Advisory Group (TAG) set up by the Organisation for Economic Co-operation and Development (OECD) has recommended the taxability of such payments under Article 7 – Business Profits of the relevant Double Taxation Avoidance Agreement (DTAA). The Supreme Court has considered the OECD commentary as a necessary aid for the interpretation of provisions contained in the DTAA.

The Tribunal concluded that the payment for distribution of AdWords Program is not 'royalty', and in the absence of a permanent establishment (PE) of the non-resident in India, the same cannot be brought to tax in India. Accordingly, no withholding tax obligations can be attached on the payer for the same.

In detail

Facts

The taxpayer provided marketing as well as distribution of online advertisement space under AdWords Program to a non-resident. The taxpayer also provided support for certain Information Technology (IT) and Information Technology Enabled Services (ITES) for software development as well as administration of the online advertisement space under AdWords Program to the non-resident.

The taxpayer, an Indian company, did not withhold any tax at source while making payment to the non-resident entity for the purchase and distribution of the online advertisement space under AdWords Program, considering

[1] IT(TP)A No(s). 1513 to 1516/Bang/2013 : Asst. Years 2009-10 to 2012-13

[2] Engineering Analysis Centre of Excellence Private Limited *v.* CIT & Anr. reported in [2021] 432 ITR 471 (SC)

that the said amount was not royalty, and in the absence of a PE of the non-resident entity in India, the same was not taxable in India.

The Tax Officer (TO) initiated proceedings under section 201 of the Income-tax Act, 1961 (the Act) as a taxpayer-in-default for non-deduction of tax at source considering the payment to be 'royalty' under the Act as well as the DTAA. The TO inter-linked the Service Agreement for ITES services and the distribution agreement and concluded that the non-resident actually granted access to confidential information (i.e. customer information), tools and software [i.e. Intellectual Property Rights (IPRs)] for activities related to Distribution Agreement (and not merely for the ITES agreement).

Tribunal's ruling

The Tribunal observed that the TO has heavily relied on interlinking of the Distribution Agreement and Service Agreement to hold that the right to use the IPRs was provided by the non-resident entity to the taxpayer, payment for which would constitute as royalty. The Tribunal took note of the fact that the ITES services provided under the Service Agreement are enabling the overall business and are not directly related to generating revenue from the sale of online advertisement space in India. Such revenues are generated by end customers post clicking on the online advertisement link and not because of the ITES services. Thus, it was not necessary to decide whether these agreements are interlinked or complementary to each other.

The Tribunal observed that the definition of the term 'royalty' under the DTAA overrides the definition of 'royalty' as provided in the Act, the former being more beneficial. The Tribunal restricted its discussions to the DTAA. It analysed the agreements between the parties in detail and made the following observations and conclusions while analysing the definition of royalty in the DTAA:

- The non-resident entity owns all rights, titles and interests in and to all information and data including the user data collected by it in connection with the provision of online advertisement space. As regards the ownership of IPRs, all IPRs remain the exclusive property of the non-resident entity. The confidential information provided was also the sole property of the non-resident entity and was to be used by the taxpayer merely in the performance of its services under the Service Agreement. Thus, it concluded that none of the rights as per section(s) 14(a) or (b) and 30 of the Copyright Act, 1957 have been transferred to the taxpayer in the present case. Hence, the payment cannot be characterised as royalty in terms of the decision of the Supreme Court[2].

- There is no consideration payable to the non-resident entity for the use of brand features, and the use of such tools was also incidental and ancillary for achieving the main purpose of marketing and distribution. Therefore, the payments made towards the purchase of online advertisement space are not in the nature of royalty. Reliance is placed on the Delhi High Court ruling in the case of Sheraton International Inc[3].

- Since the non-resident entity has not parted with the copyright it holds, the taxpayer cannot be said to have gained the right to use any scientific equipment.

The Tribunal noted that TAG, set up by the OECD, also recommended the taxability of transaction of sale of online advertisement space under Article 7 (business profits) and not under Article 12 (royalty). It further observed that the Supreme Court has recently upheld that the OECD commentary is a necessary aid for interpreting the provisions contained in the DTAA. It was also noted that the High-Powered Committee on electronic commerce set up by the Central Board of Direct Taxes has also accepted TAG's view.

The Tribunal observed that the emergence of Equalisation Levy (EL) on online advertising can be traced to the dynamic business models as that of the taxpayer, that have the ability to transcend the link between an income producing activity and a specific location. The present definition of PE is based upon physical presence criteria, which created challenges in characterising the nature of payment as royalty, fees for technical service or business profit. Accordingly, online advertisement space is now covered under EL. The Tribunal noted that if the same was already covered under the definition of royalty, then the question of bringing it as part of the EL scheme would not arise.

The takeaways

This is a welcome decision from the Bangalore bench of the Tribunal. It reaffirms the view that the online transaction of the sale of online advertisement space under the AdWords Program does not entail providing of

[3] DIT *v.* Sheraton International Inc [2009] 313 ITR 267 (Delhi)

any rights in any IPRs to customers and hence is not taxable as royalty. It further confirms the position that incidental use of trademarks in a distribution arrangement for the purpose of marketing and distribution cannot trigger royalty, without a specific consideration being assigned to the same. These findings could also be helpful for other online automated services which are provided under a reseller arrangement subject to factual similarities.

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