TransPrice Times

Edition: June 2018

Critical Analysis – Google India – AdWord – Royalty Case

1. The case with regard to the Google AdWord by the Bangalore ITAT could be categorised as a judgement that could have far-reaching effects on the digital economy in India. The judgement and the interpretation of business scenario need to be understood simplistically removing all the technical jargons and marrying the facts of the case to the basic principles of taxation.

2. Google India Limited (GIL) is a limited risk distributor of a space where advertisements are showcased, the only difference is that such space appears online and not physically. GIL has a distributorship agreement with Google Ireland for such an activity. Let us call this GIL 1.

3. GIL is also a software development company (back office) of Google Ireland where certain technical work is conducted, which helps in optimising the AdWord program which helps Google Ireland to develop technology to sell, maintain, service the Indian and global market. GIL has a service agreement with Google Ireland for such an activity. This typically would be a cost-plus arrangement. One also needs to note that such a service of software development/ KPO/ ITES is not specifically addressed for the Indian market but for the global market. Let us call this GIL 2.

4. The revenue has taken a stand that as GIL 1 had access to work performed by GIL 2, both the activities could not be fragmented and should be seen as one and therefore GIL 1 is not just selling space but is performing an act of use of the intangible/ intellectual property and hence the payment made by GIL 1 to Google Ireland is considered as royalty and withholding taxes need to be deducted and paid by the payer. Such a stand is backed by the ITAT and the case is decided in favour of the revenue.

5. The core crux of the case is to understand the following:
(1) Meaning of a limited risk distributor and the role of supplier entity (we can say principal entity) in the LRD model; and
(2) Meaning of fragmentation and anti-fragmentation rules in the Income-tax Act, 1961.
In this case, it is assumed that all the transfer pricing models, remuneration are as per the norms and are not violating any transfer pricing principles. Now let us tackle this one by one.

6. Limited Risk Distributor (LRD) - As the name suggests, the distributor in the country of residence (in this case, India) performs limited functions and undertakes limited risks while performing a sales and marketing function. The LRD does not own or develop any intangibles in the country of residence and operates on a resale price minus or market minus model, where the transfer price is determined after considering the market price and reducing it to meet the gross profit percentage. Any additional activity performed by the LRD is remunerated by the Principal entity at an arm's length price. Any losses suffered are also remunerated by the Principal entity and the LRD is assured of minimum returns in percentage terms. The LRD can make higher profits in absolute terms by increasing volume of the business. Typically, all intangibles to support the business is provided by the Principal entity (in this case, which gets transferred to Principle entity by work done by GIL 2) and is embedded in the transfer price. No payment is generally made against royalty or license fees as the purchase price is considered inclusive of royalty element which artificially could not be segregated. In the instant case, GIL 1 is an LRD and Google Ireland is the Principal entity. The Indian customers contract with GIL 1 for the provision of space, which is contracted back by GIL to Google Ireland. The function undertaken by GIL 1 is marketing and sales.

Various aids are used by GIL 1, which are services by GIL 2 to make its marketing and sales effective. The IPs for such aids remains with Google Ireland.

7. Meaning of fragmentation and anti-fragmentation rules in the Income-tax Act, 1961 - Fragmentation of activities means, artificially breaking activities in a single supply chain to two different activities of a profit centre. In the current context, an anti-fragmentation rule could only be invoked when the Income-tax office invokes General Anti Avoidance Rules (GAAR), where the revenue has powers to disregard structures and consider them as one. However, deriving a conclusion based on disregarding of the structure without powers of GAAR are not in the legal purview of the Income-tax Act. In the instant case, as GIL 2 and GIL 1 are two separate supply chains with no interconnections with different business objectives, it is not in the legal framework of the Tribunal or the tax authorities to arrive at a conclusion of withholding based on assumed facts. Let us assume for a moment that GIL 2 is based in Singapore and GIL 1 still uses certain work of GIL 2 which is specifically done on the instructions of Google Ireland, then whether GIL 1 would be considered to pay a royalty to Google Ireland?

8. For example, let us consider a sale of the foreign car by an LRD in India. There are several intangibles embedded in the purchase price of the foreign car say the brand, technical know-how, technical know-how passed on to the salesperson to enable a sale, knowledge of manufacturing process by the LRD etc. While an LRD makes a payment against the purchase of a car, one does not bifurcate such purchase price as payment against tangible products and intangible products as purchase payment and royalty payment respectively. The same principle would apply to the case of purchase of online space unless such online space payment is specifically defined to mean royalty or sourced income from India.

9. Whether Royalty is to be paid for selling of digital space? The question is complex, and the Income-tax Act and the tax treaty need to address such issue through a definition change in the royalty or via a specific exclusion. With the changes in the business time, we may have to address specific items of cross-border transactions in the International and domestic taxation law, through the way of treaty changes and domestic law amendments. While a specific test of significant economic presence is incorporated now in the Indian Income-tax Act, 1961 which is applicable for transaction post 1 April 2018, one needs to agree that with an absence of such test earlier in the legislation, similar transactions before 1 April 2018 are not included in the source taxation purview of the Income-tax Act and hence would escape withholding tax due to the want of legislative powers to tax the income. This fact needs to be accepted by the tax authorities until 1 April 2018 and by the taxpayers post 1 April 2018 to get the significant transactions taxed under the source rule post 1 April 2018. If such approach is followed, it would lead to ease of doing business and bringing in the certainty of taxes. This would ultimately lead to a bigger picture for higher investments in India thereby ensuring the growth potential when it comes to the digital economy.