KPMG

#KPMG josh

TAX FLASH NEWS

20 August 2021

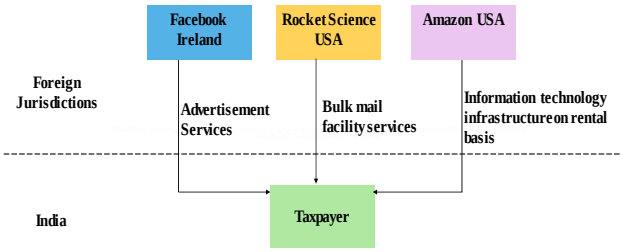
Payments for online advertising, marketing and IT facilities to non-resident entities are not taxable as royalty

Executive summary

Recently, the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Urban Ladder Home Decor Solutions Pvt. Ltd.[1] (the taxpayer) dealt with the issue of taxability of payments for online advertising, marketing and information technology (IT) facilities to non-resident entities under India-Ireland and India-US tax treaties.

The Tribunal observed that non-resident entities only allow the taxpayer to use their facilities for the purpose of creating advertisement content. Further, the payment made to another non-resident entity was only for using the IT facilities provided by it. These non-resident entities do not give any specific license for use or right of any of the facilities (which include software). Hence, the question of transferring the copyright over those facilities did not arise at all. Accordingly, the payments made to such non-resident entities do not fall within the meaning of 'royalty' as defined in the relevant tax treaties. Consequently, there was no requirement to deduct tax at source from those payments under Section 195 of the Income-tax Act, 1961 (the Act). Hence, the taxpayer cannot be considered as an 'assessee in default' under Section 201(1).

Facts of the case



The taxpayer is engaged in the business of dealing in home decor products. It sells its products mainly through online marketing. Hence, the taxpayer had placed its advertisement on the platform of Facebook, Ireland. It had also used bulk mail facility offered by Rocket Science group, USA. The taxpayer had also used AWS offered by Amazon Inc., USA, which is in the nature of providing IT infrastructure on rental basis.

The taxpayer uses Facebook platform to display its products on the wall of Facebook users. Hence the taxpayer makes payments to Facebook for the advertisements hosted on the web for seeking attention of Facebook users. Rocket Science group LLC has got 'Mail Chimp' platform, which allows its users to send bulk email advertisements/marketing content to their customers using its marketing automation tools. The taxpayer has also availed cloud computing services from Amazon for its online business needs.

---

[1] Urban Ladder Home Décor Solutions Pvt. Ltd. v. ACIT (ITA No.615 to 620/Bang/2020) – Taxsutra.com

The Assessing Officer (AO) noticed that the taxpayer made payments to non-residents towards advertisement and marketing expenses without deducting tax at source. The AO observed that Facebook advertisements are nothing but the usage of Facebook technology and process to advance the business in the e-commerce era. Similarly, the payments made to Rocket Science Group was for email advertisement through Mail Chimp's Market automation tool and it was for the usage of technology, model or process and/or equipment. Accordingly, the payments made to Facebook as well as Rocket Science Group, LLC were taxable as royalty under the provision of Explanation 2(iii)[2] to Section 9(1)(vi) and also under the provisions of Explanation 2(iva)[3] to Section 9(1)(vi). Hence, tax was required to be deducted under Section 195 at the time of payment/credit of royalty.

With respect to the payment to Amazon, the AO observed that there were sites of the taxpayer where the data connectivity and networking was provided. Generally, every site has a 'router' being placed in the premises for the data communication purposes. Therefore, it was clear that the services provided by Amazon also includes providing the routers and the data connectivity and networking. The AO held that even if the cloud computing services are taking the character of Fees for Technical Services (FTS), it was chargeable to tax in India as per the Act and also under the tax treaty. However, the taxpayer has failed to deduct tax at source. Hence, taxpayer was liable for the default for non-deduction on the payments made and consequential interest leviable under Section 201(1A).

Since there was a failure to deduct tax at source by the taxpayer, the AO treated the taxpayer as 'assessee in default' in all the three years under consideration.

The Commissioner of Income-tax (Appeals) [CIT(A)] observed that the taxpayer was given privilege of accessing/using various components of advertisement program created by Facebook in its website. With regard to payments made to 'MailChimp', CIT(A) observed that it involves payments made for the use of, or the right to use of patented software processes. Further, with regard to the payments made to 'Amazon Web Services', CIT(A) observed that it involves payments for the use of, or the right to use of patented software processes. Consequently, the CIT(A) while upholding the order of the AO held that the consideration paid by the taxpayer for the use of, or the right to use of the software was taxable as royalty under various tax treaties and need to be taxed in India.

[2] The use of any patent, invention, model, design, secret formula or process or trademark or similar property
[3] The use or right to use any industrial, commercial or scientific equipment

Tribunal's decision

Applicability of tax treaty provisions

The Tribunal relied on the Supreme Court's decision in the case of Engineering Analysis Centre of Excellence Private Limited[4] and observed that the relevant tax treaty provisions should be considered in the instant case for determining the question whether the payments made by the taxpayer to three non-resident entities (i.e. Facebook, Rocket Science group, Amazaon) are in the nature of royalty or not. Hence, there is no necessity to refer to the provisions of Section 9(1)(vi) for the payments made to such non-resident entities.

Agreement between the taxpayer and non-residents

A careful perusal of the relevant provisions of the agreement entered by the taxpayer with Facebook and Rocket Science Group, indicates that both these non-resident entities are allowing the taxpayer to use the facilities provided on their sites, which includes, inter alia, software facilities also.

The purpose of compelling the taxpayer to use those facilities is to create an environment of ease in creating the 'advertisement content' to suit the platforms of Facebook or Rocket Science. The environment of ease is beneficial and time saving to both the advertiser and the advertising platform. Thus, the facilities have been created by the non-resident entities for mutual benefit. However, a person shall get the right to use those facilities only when he enters into an agreement with them for hosting his advertisement or for sending bulk mails, meaning thereby, the use of facilities is intertwined with the activity of placing advertisement in web portal of Facebook or sending bulk mails. In case of web hosting charges paid to AWS, the taxpayer is allowed to use the IT infrastructure facilities.

Judicial precedents

The Kolkata Tribunal in the case of Right Florists[5] referred to various decisions[6] and held that the receipts in respect of online advertising on Google and Yahoo cannot be brought to tax in India under the provisions of the Act, as also under the provisions of India US and India Ireland tax treaty.

[4] Engineering Analysis Centre of Excellence Private Limited v. CIT [2021] 125 taxmann.com 42 (SC)
[5] ITO v. Right Florists [2013] 32 taxmann.com 99 (Kol)
[6] Pinstorm Technologies (P) Ltd v. ITO 24 taxmann.com 345 (Mum), Yahoo India (P) Ltd v. DCIT [2011] 11 taxmann.com 431 (Mum

Reference was also made to the decision of the Madras High Court in the case of Skycell Communications Ltd[7] wherein it was observed that the point that mere usage of a facility does not give rise to the provision of any technical service. Under the same analogy, mere usage of facility provided by the aforesaid non-residents to taxpayer does not render the payments as 'royalty', since the core point of parting of any 'copyright' attached to the said facilities does not arise at all.

In the case of Engineering Analysis Centre of Excellence Private Limited, the issue related to 'issuing of license to use software', i.e., the software purchased by a person shall be used by the buyer for his own business purposes. Since the license was granted without parting the copyrights attached to the software, the Supreme Court held that the payments received by the non-resident software companies cannot be taxed as 'royalty' under the provisions of the relevant tax treaties[8] and hence there is no requirement to deduct tax at source from the payment made to them by a resident taxpayer.

Taxability of income as royalty

In the instant case, the recipients, i.e. Facebook and Rocket Science group only allow the taxpayer to use their facilities for the purpose of creating advertisement content. The payment made to Amazon Web Services (AWS) is only for using the IT facilities provided by it, that too the billing would depend upon the extent of usage of those facilities. In fact, these non-resident entities do not give any specific license for use or right of any of the facilities (which include software).

The right to use those facilities was intertwined with the main objective of placing advertisements. In the case of Amazon, the payment was made only for using of IT infrastructure facilities on rental basis. Hence, the question of transferring the copyright over those facilities does not arise at all.

The agreements entered by respective parties indicates that the copyright over those facilitating software was not shared with the taxpayer. In any case, the main purpose of making payment was to place advertisements only and not to use the facilities provided by the non-resident entities. Thus, the facilities provided by the non-resident entities were only enabling facilities, which help a person to place his advertisement contents on the platform of Facebook or to use MailChimp facility of Rocket Science. In case of Amazon, the payment was in the nature of rent payments for use of infrastructure facilities.

Accordingly, these non-resident recipients stand on a better footing than those taxpayers which were before the Supreme Court in the case of Engineering Analysis Centre of Excellence Private Limited Accordingly, following the ratio laid down by the Supreme Court, the payments made to such non-resident entities do not fall within the meaning of 'royalty' as defined under relevant tax treaties.

The AO has not made out an alternative case that these payments were taxable as business income in India. Hence, there is no necessity for us to deal with that aspect.

Samsung's case distinguished

The lower authority had followed the Karnataka High Court decision in the case of Samsung Electronics Co Ltd.[9] However, in the case of Engineering Analysis Centre of Excellence Private Ltd, the decision rendered by the Karnataka High Court was overruled by the Supreme Court.

Conclusion

In view of the above, it was held that the payments made by the taxpayer to such non-resident entities cannot be considered as 'royalty payments' under the relevant tax treaties. Therefore, it is not chargeable to tax in India. Consequently, there was no requirement to deduct tax at source from those payments under Section 195 and the taxpayer was considered as an 'assessee in default' under Section 201(1).

Our comments

Online advertising on website/search engines like Google, etc. has become an important advertising and marketing tool for present day businesses. In some of the cases taxability of income from such services has been dealt under the 'royalty' provisions while in few cases the taxability of such income has been examined from a 'Permanent Establishment' (PE) perspective.

Normally, advertisement /marketing fees paid to a foreign web-based search company (Google, Yahoo, etc.) may not be taxable as 'royalty' where the uploading and display of advertisement on the portal is the responsibility of the foreign company. The taxpayer is only required to provide the banner advertisement to the foreign company for uploading the same on its portal. The taxpayer thus has no right to access the portal of the foreign company. Further such income may also not be taxable as business income in India if foreign technology companies do not have a PE in India. A search engine which has its presence only through its website cannot be held as a PE unless its web servers are also located in the same jurisdiction. These principles have been upheld in various decisions[10].

---

[7] Skycell Communications Ltd [2001] 251 ITR 53 (Mad)
[8] India-Australia, Canada, China, Cyprus, Finland, France, Germany, Hong Kong, Ireland, Italy, Japan, Korea, Netherlands, Singapore, Sweden, Taiwan, USA, UK tax treaties

[9] CIT v. Samsung Electronics Co Ltd [2011] 16 taxmann.com 141 (Kar)
[10] ITO v. Right Florists [2013] 143 ITD 445 (Kol), Pinstorm Technologies (P) Ltd v. ITO [2012] 54 SOT 78 (Mum), Yahoo India (P) Ltd v. DCIT [2011] 140 TTJ 195 (Mum)

However, in some of the cases, the agreement could be for facilitating the display and publishing of an advertisement for the targeted customer with the help of various patented tools and software. In such cases, the taxpayer has the access to various data and it is using the information for the purposes of selecting the ad campaign and for maximising the impression and conversion of the customers to the ads of the advertisers. In such cases, the taxpayer has a licence to use the confidential information, technical know-how, trademark, brand features, etc. Therefore, in such cases, it has been held that the payment is taxable as royalty[11].

Interestingly the Supreme Court in the case of Engineering Analysis Centre of Excellence Private Limited held that the amounts paid by resident Indian end-users/distributors to non-resident computer software manufacturers/suppliers, as a consideration for the resale/use of the computer software through distribution agreements, is not a payment of royalty for the use of copyright in the computer software. It does not give rise to any income taxable in India under the tax treaty. Consequently, the taxpayer was not liable to deduct any tax under Section 195.

The Bangalore Tribunal, in the instant case, reiterated some of the principles laid down by the above-referred decisions and held that the payment made to Amazon was only for using the IT facilities provided by the non-resident entities. Hence, the question of transferring the copyright over those facilities does not arise at all. Thus, the payment made to non-resident entities was not taxable as royalty. In the instant case, the AO had not made out an alternative case that these payments were taxable as business income in India. Hence, the Tribunal did not deal with the PE aspect.

In 2016, Equalisation Levy (EL) was introduced at 6 per cent on online advertisement, digital advertising space or any other facility or service. Subsequently, the Finance Act, 2020 broadened the scope of the equalisation levy and introduced a 2 per cent levy on the consideration received or receivable by an ecommerce operator from an e-commerce supply or services. It would be interesting to analyse the provisions of EL with respect to services provided by the non-resident entities in the instant case. However, if the transaction is taxable under the provisions of EL the same would be exempt under the provisions of the Act.

Recently, the Central Board of Direct Taxes (CBDT) notified thresholds[12] for the provisions of Significant Economic Presence (SEP). SEP provisions have been introduced to inter alia tax digital transactions which were otherwise not taxable due to absence of physical presence in India (cases like Right Florist and Pinstorm discussed above). While the SEP is broadly defined, these provisions are part of India's domestic law. Consequently, it will not prevail over the beneficial tax treaty provisions, wherever applicable. A non-resident may avail the benefit under the relevant tax treaty since Indian tax treaties contain the conventional concept of PE for taxing business profits of a non-resident and the inclusion of SEP in the Act will not be read into the tax treaties unless they are amended. However, in case of non-residents from a non-tax treaty country / jurisdiction, their business income earned from India may become taxable in India. Accordingly, such non-residents will need to comply with various relevant provisions of the Act.

In view of the above, the taxpayers may evaluate taxability of their transactions relating to online advertisement, marketing, etc., under the above-referred relevant provisions.

[11] Google India Pvt Ltd v. ACIT [2017] 190 TTJ 409 (Bang), Google India Private Limited v. DCIT [2017] 167 ITD 567 (Bang)

[12] CBDT Notification No. 41/2021, dated 3 May 2021 - The amount of aggregate of payments arising from transaction or transactions in respect of any goods, services or property carried out by a non-resident with any person in India, including provision of download of data or software in India during the previous year, shall be INR 2 crores. The number of users with whom systematic and continuous business activities are solicited or who are engaged in interaction shall be 3 lakhs.

KPMG in India addresses:

Ahmedabad
Commerce House V, 9th Floor,
902, Near Vodafone House, Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Bengaluru
Embassy Golf Links Business Park,
Pebble Beach, 'B' Block,
1st & 2nd Floor,
Off Intermediate Ring Road, Bengaluru – 560071
Tel: +91 80 6833 5000

Chandigarh
SCO 22-23 (1st Floor),
Sector 8C, Madhya Marg,
Chandigarh – 160 009.
Tel: +91 172 664 4000

Chennai
KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road,
Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Gurugram
Building No.10, 8th Floor,
DLF Cyber City, Phase II,
Gurugram, Haryana – 122 002.
Tel: +91 124 307 4000

Hyderabad
Salarpuria Knowledge City,
6th Floor, Unit 3, Phase III,
Sy No. 83/1, Plot No 2, Serilingampally Mandal,
Ranga Reddy District,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Jaipur
Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road,
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi
Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682 019.
Tel: +91 484 302 5600

Kolkata
Unit No. 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai
1st Floor, Lodha Excelus,
Apollo Mills,
N. M. Joshi Marg,
Mahalaxmi,
Mumbai – 400 011.
Tel: +91 22 3989 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business Park,
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305.
Tel: +91 0120 386 8000

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex,
Mundhwa Road, Ghorpadi,
Pune – 411 001.
Tel: +91 20 6747 7000

Vadodara
Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada
Door No. 54-15-18E,
Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District,
Andhra Pradesh – 520 008.
Tel: +91 0866 669 1000

---

home.kpmg/in

#KPMG josh

home.kpmg/in/socialmedia

KPMG Assurance and Consulting Services LLP, Lodha Excelus, Apollo Mills Compound, NM Joshi Marg, Mahalaxmi, Mumbai - 400 011
Phone: +91 22 3989 6000, Fax: +91 22 3983 6000