Tribunal's ruling in Google – Can the googly be read better?

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Rahul Mitra (Partner, Dhruva Advisors LLP)

Ajay Rotti (Partner, Dhruva Advisors LLP)

The Bangalore Tribunal recently delivered the much-awaited ruling in the case of Google India on the issue relating to taxability of payments made by Google India in favour of Google Ireland for the purchase of advertisement space for resale, under a distribution arrangement, entered between the said parties. The Tribunal was pleased to hold that such receipt in the hands of Google Ireland constituted royalty under the India-Ireland tax treaty; and also under the domestic tax laws of India; and accordingly attracted withholding tax (WHT) under the source rule basis of taxation followed in India. An analysis is made of the said ruling of the Bangalore Tribunal.

1. The transfer pricing (TP) policy for the distribution segment has not been highlighted by the Tribunal in its ruling, however, one would assume, based on industry knowledge and experience, that the policy would have most probably been one of resale minus, applying either Resale Price Method; or Transaction Net Margin Method, depending upon the functional profile of the distributor.

2. It was noted from the ruling that Google India had also provided IT services and ITeS in favour of Google Ireland under a contract service provider model, i.e. cost plus mark up.

3. The Tribunal concluded that the ITeS and distribution segments were inseparable, to understand the character of payment made by Google India in favour of Google Ireland for purchase of advertisement space, in the sense that several services, as part of distribution functions, e.g. post-sale services to customers and other assistances to customers in the matter of hosting of advertisement on the website of Google Ireland, were forming part of the ITeS segment.

4. The Tribunal inferred from the above conclusion that what Google India had paid in favour of Google Ireland under the distribution segment, was not just for purchase of advertisement space, but also included consideration for user of intangible property (IP), e.g. trademark, software, etc., both as part of distribution agreement; and also as part of ITeS segment; and accordingly proceeded to coin the payment as royalty under the India-Ireland tax treaty.

5. We take the opportunity of eyeing the issue from a different perspective, with a combination of principles relating to TP and interpretation of tax treaties, which are inseparably blended, to examine whether any other view is possible to be taken in this regard –

a. It is typical under any distribution arrangement, where the trademark is licensed by the same entity, which supplies goods/ services (in the present case, being advertisement space), that the principal provides a royalty free license for distribution rights; and the user of trademark of goods, which are supplied for resale, as the return for all intangibles, including trademark, are embedded in the price of the goods.

b. Thus, when a car manufacturer sells a finished car (CBU) to its overseas distributor for resale under distribution arrangement, no separate royalty is charged by the car manufacturer, as the import price of a CBU includes all types of returns flowing to the principal, including returns for IPs in the form of technology and trademark. When a customer buys a car from any dealer, he pays one single amount for the price of the car; and not separate amounts, namely one for the tangible property, i.e. body of the car; and the other for IP embedded in the car, in the form of technology and trademark.

c. Similar is the case where a principal appoints a contract manufacturer or contract service provider for rendering services, where the goods manufactured or services generated, are sold back to the principal; and not to any third-party customer. In such case, the principal company, owning valuable IP, *interalia* in the form of technology or patent, grants a royalty free license in favour of the contract manufacturer or contract service provider, for using the IP for rendition of services in favour of the principal; and not for exploiting the same through sale of goods/ services to third parties.

d. The above are common business models prevalent amongst MNCs globally; and one would assume that it might not have been any different in the case of Google India.

e. Thus, for the purposes of providing ITeS in favour of Google Ireland under a contract service provider model, with a cost plus form of remuneration, Google India might have used certain software platforms, etc., provided by Google Ireland under the arrangement of supplying advertisement space to customers in India through Google India as the buy-sell distributor, however, since the services were essentially rendered for the benefit of Google Ireland, albeit some part might have been consumed by customers in India, who were buying the advertisement space, but at the instance and behest of Google Ireland in the capacity of the principal, Google India can be said not to have exploited such IP for its business.

f. Similarly, Google India, as part of the distribution arrangement, would have enjoyed a license for distribution rights; and to use the trademark, however, obviously without any consideration, as returns for all IPs would have been engulfed in the price of the advertisement space, being a consolidated price for supply of goods.

g. Thus, both as contract service provider under ITeS segment; and distributor under distributor agreement, Google India might have been allowed access to IPs of Google Ireland, being the principal, who was both the owner of IPs; and also the supplier of goods, namely advertisement space, however, without any consideration, as not being required under models of contract service provider and distribution.

h. The above view point finds support from the Commentary to Article 12 of OECD Model Convention (MC), where the definition of royalty is similar to that contained in India-

Ireland tax treaty, *to the extent relevant for the present discussions*. The OECD Commentary provides that if a distributor pays fees separately for exclusive distribution rights to sell branded products manufacturer by the non-resident principal, the consideration does not partake of payment for user of trademark, but merely for an exclusive right to resell branded products of the manufacturer, thus constituting business profits for the purposes of Article 7 of MC; and not royalty under Article 12 of MC.

i. In the case of Google, the facts may be conceived to be even better, as Google India does not appear to have paid any separate consideration for the exclusive right to distribute advertisement space owned by Google Ireland, as any such return was engulfed in the price of the goods, i.e. advertisement space.

j. Similarly, in case Google India would have been allowed user of some IP, including software, by Google Ireland, being the mother platform, as part of ITeS segment, the same would have been in the course of rendering services for the benefit of Google Ireland under a contract service provider model with a cost plus form of remuneration, even though the customers of advertisement space might have been benefitted by such services, but at the instance and behest of Google Ireland; and Google India would have never had the occasion to pay any consideration for the user of such IP in favour of Google Ireland, being the principal in the overall supply chain.

k. Thus, it may be contended that no part of the payment made for purchase of goods, in the form of advertisement space, by Google India in favour of Google Ireland, under the distribution arrangement, could constitute royalty, for subjecting the same to WHT.

l. Further, as a buy-sell distributor; and not agent, Google India is anyway subject to tax for the profits relating to the distribution model, where moderation thereof is possible by application of the principles of TP, thus not posing any threat for loss of revenue for the government exchequer.

Apart from deciding upon the issue WHT, as above, the Tribunal also went on to hold that he business segment of Google India for distribution of advertisement space, was subject to residual profit split method (RPSM) under TP. We take the opportunity to append our views in this regard :

1. Generally, PSM is applied either where both parties to the transaction contribute unique/ non-routine intangibles; or there are multiple transactions, which are so interrelated that they cannot be evaluated separately for the purposes of determining the arm's length price of any one transaction.

2. It is noted that the Tribunal has restored the issue relating to TP to the file of the TPO to examine whether Google India, as per the functional, asset and risk analysis, actually contributed any unique or non-routine intangible; and thereafter apply the correct TP method.

3. However, having said that, the Tribunal proceeded to hold that the TPO would need to apply RPSM for the distribution segment on the logic that several entities across the world were involved in the overall supply chain, by relying upon the Delhi Tribunal's ruling in the case of Orange (Global One), which later got affirmed by the Delhi High Court.

4. One of authors of this article had the privilege of arguing the case of Orange (Global One) before the Delhi Tribunal, being the first substantial case on RPSM in India, where the Tribunal approved profit (loss) split in the case of the taxpayer, not because there were other entities in the overall supply chain, but because the Indian entity, as one of the key elements of the overall global supply chain, actually exploited intangibles in the capacity of an entrepreneurial licensee; and was not simply a plain vanilla service provider or distributor of services.

5. Now, in the case of Google, since the Tribunal had itself asked the TPO to carry out a de novo FAR analysis to identify the contribution of intangibles, if any, by Google India, there could not have been any material available before the Tribunal to conclude that Google India contributed unique intangibles for its distribution segment, so as to be subjected to RPSM.

One would eagerly await to see as to how the High Court would deal with the issues, when the matter may be taken up before such forum.