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Payment towards online advertising, bulk mailing and cloud computing not taxable as royalty

The Bangalore Bench of the Income-tax Appellate Tribunal (ITAT), based on the facts of the case, has rendered its decision that, payments made for placing advertisement on an online platform were not taxable as royalty under the India-Ireland tax treaty. The ITAT further held that bulk mailing and cloud computing facility availed were also not taxable as royalty under the India-USA tax treaty.

Background:

- The taxpayer[1] is engaged in the business of dealing in home décor products, and it sells its products mainly through online marketing.
- During the Financial Years (FY) 2014-15 to 2016-17, corresponding to Assessment Years (AY) 2015-16 to 2017-18 the taxpayer:
  - Placed its advertisement on the online platform of an Irish entity (say ABC): The taxpayer used the online platform to display its products on the wall of ABC's platform users.
  - Availed bulk mail facility offered by a USA entity (say LMN): LMN has a platform (say LMN platform), which allows its users to send bulk email, advertisements / marketing content to their customers, using its marketing automation tools.
  - Availed services of another USA entity (say XYZ), which were in the nature of providing information technology (IT) infrastructure on rental basis: The taxpayer availed cloud computing services from XYZ for its online business needs.
- During the course of survey proceedings conducted on the taxpayer, the Assessing Officer (AO) noticed that the taxpayer had made payments to non-residents towards advertising and marketing expenses without deducting tax at source (TDS).

  The AO took a view that the payments made by the taxpayer to these non-residents was taxable as 'Royalty' on the following basis:

  #### Payment to ABC for advertisement on the online platform

  - The payments made to ABC were for advertisements hosted on the web, for seeking attention of ABC's platform users.
  - The advertisements were nothing but the usage of ABC's technology and process to advance the business in the e-commerce era.

[1]Urban Ladder Home Décor Solutions Pvt Ltd. v. ACIT (IT), Bangalore [2021] ITA No. 615 to620/Bang/2020 (Bang-Trib.)

- The technology, and/or design, and/or process, and/or equipment of ABC that enabled the advertisers to reach their target audience in the most efficient way was the crux of the business.
- The taxpayer had been using the same to develop its business. Accordingly, the payments made to ABC were squarely covered under explanation 2(iii) of section 9(1)(vi) of the Income-tax Act, 1961 (ITA) i.e. the use of any patent, invention, model, design, secret formula or process or trade mark or similar property, and also under explanation 2(iva) of section 9(1)(vi) of the ITA i.e. the use or right to use any industrial, commercial or scientific equipment.

Payment to LMN for bulk mail facility

- The services availed by the taxpayer was in the nature of usage of technology, model or process, and/or equipment, and the same was covered under explanation 2(iii) of section 9(1)(vi) of ITA i.e. the use of any patent, invention, model, design, secret formula or process or trade mark or similar property, and also under explanation 2(iva) of section 9(1)(vi) of the ITA i.e. the use or right to use any industrial, commercial or scientific equipment and the payments so made amount to royalty payments.

Payment to XYZ for cloud computing

- Cloud computing was an arrangement in which the cloud provider hosts the shared computing resources such as hardware, software applications etc., and the cloud user accesses them for storage, data processing etc., via internet on a need basis. In view of cloud computing technology, enterprises need not make investment in IT infrastructure (i.e. hardware, storage space, application softwares, other IT resources etc.) and they can use the required IT resources on payment of charges.
- There would be sites of the taxpayer, wherein data connectivity and networking are provided by XYZ. Typically, every site had a 'router' being placed in the premises for the purposes of data communication. The services provided by XYZ also included providing the routers, and data connectivity along with networking.
- The payment made to XYZ was chargeable to tax in India as per the provisions of the ITA as well as the provisions of the India-USA tax treaty.

- Thus, the AO held that since there was a failure to deduct TDS, the taxpayer was 'assessee-in-default' in all the three years under consideration, and raised demand under section 201(1) of the ITA (relating to consequences of failure to deduct or pay tax) and also charged interest.
- In the course of appeal proceedings, the matter reached before the Bangalore Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions in brief:

- Extract of explanation 2 to section 9(1)(vi) of the ITA which defines the term "royalty":

"For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for -

...(iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;…

…(iva) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;…

- Extract of Article 12(3) of the India-USA tax treaty which defines the term "royalties":
  "The term "royalties" as used in this Article means:
  (a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematograph films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof ; and
  (b) payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial, or scientific equipment, other than payments derived by an enterprise described in paragraph 1 of Article 8 (Shipping and Air Transport) from activities described in paragraph 2(c) or 3 of Article 8."
- Extract of Article 12(3)(a) of the India-Ireland tax treaty which defines the term "royalties":
  "The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph film or films or tapes for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process or for the use of or the right to use industrial, commercial or scientific equipment, other than an aircraft, or for information concerning industrial, commercial or scientific experience".

Decision of the ITAT:

- With respect to the applicability of respective tax treaty provisions, the ITAT noted / observed the following:
  - While the AO referred to the provisions of the India-USA tax treaty, the AO had held that the payments were in the natrure of 'royalty', mainly considering the provisions of section 9(1)(vi) of the ITA.
  - ABC was located in Ireland, whereas LMN and XYZ were located in the USA.
  - The Supreme Court in an earlier case[2] (rendered in the context of taxability of royalties) while examining whether the provisions of the ITA could be referred to, ignoring tax treaty provisions had

[2]Engineering Analysis Centre of Excellence Private Limited vs. CIT (Civil Appeal Nos. 8733-8734 of 2018 dated March 02, 2021) (SC)

held that, the provisions contained in the ITA which dealt with royalty, not being more beneficial to the taxpayer, had no application based on the facts.

In view of the above, the ITAT held that the relevant provisions of the respective tax treaties were to be considered for determining the question on whether the payments made by the taxpayer to the aforesaid non-resident entities (viz. ABC, LMN and XYZ) were in the nature of royalty or not. Hence, the provisions of section 9(1)(vi) of the ITA were not required to be referred.

- The ITAT on perusal of the relevant agreements between the taxpayer and the non-resident entities observed the following:

Payment to ABC and LMN

- The agreements showed that both ABC and LMN were allowing the taxpayer to use the facilities provided on their sites, which included, inter alia, software facilities also.
- The purpose of compelling the taxpayer to use those facilities, was to create an environment of ease in creating the "advertisement content" to suit the platforms of ABC or LMN. The environment of ease was beneficial and time saving, to both the advertiser and the advertising platform. Thus, the facilities were created by the non-resident companies for mutual benefit.
- However, a person got such right to use those facilities only when he entered into an agreement for hosting advertisement or for sending bulk mails, meaning thereby, the use of facilities was intertwined with the activity of placing advertisement on the web portal of ABC or sending bulk mails.
- The co-ordinate Benches of the ITAT in earlier rulings[3], had held that the amount paid by the taxpayer to the non-resident for the services rendered for uploading and display of banner advertisement on non-resident's portal was in the nature of business profit on which no tax was deductible at source, since the same was not chargeable to tax in India in the absence of a permanent establishment of the non-resident in India.
- ABC and LMN had only allowed the taxpayer to use their facilities for the purpose of creating advertisement content. The main purpose of making payment was to place advertisements only, and not to use the facilities provided by the non-resident companies. Thus, the facilities provided by the non-resident companies were only enabling facilities, which helped a person to place his advertisement contents on the platform of ABC, or to use LMN platform facility, effectively.

Payment to XYZ for cloud computing

- The taxability of web hosting charges was examined in an earlier case by the co-ordinate Bench of the ITAT[4], wherein on a detailed perusal of the terms of the agreement it was held, inter-alia, as follows:

[3]Pinstorm Technologies (P) Ltd vs. ITO [2012] 24 taxmann.com 345 (Mum-Trib) and Yahoo India (P) Ltd vs. DCIT [2011] 11 taxmann.com 431 (Mum-Trib)

[4]EPRSS Prepaid Recharge Services India P Ltd v. ITO [2018] 100 taxmann.com 52 (Pune-Trib)

"In case of provision of royalty to a person, then as seen from the terms and conditions of various agreements, there is fixation of price to be paid and there may be variation on account of use of certain services but first there has to be basic price fixed. However, in the facts of present case, looking at the documentation, the billing is segregated into various services i.e. AWS services, storage services, etc.

The fees paid by assessee was for use of technology cannot be said to be for use of royalty, which stands proved by the factum of charges being not fixed but variable i.e. it varies with the use of technology driven services and also use of such services does not give rise to any right in property".

- The decision rendered by the Madras High Court[5] in the context of "fees for technical services" had clarified that mere usage of a facility did not give rise to provision of any technical service.
- Under the same analogy, mere usage of facility provided by the above said non-residents (viz. ABC, LMN and XYZ) did not render the payments as "royalty payments", since the core point of parting of any "copyright" attached to the said facilities did not arise at all.
- The Supreme Court in an earlier case[6] (rendered in the context of taxability of royalties) had held that, since the license was granted without parting the copyrights attached to the software, the payments received by the non-resident software companies could not be taxed as "royalty" under the relevant tax treaty provisions. Hence, there was no requirement to deduct TDS from the payment made to them by a resident taxpayer.
- The payment made to XYZ was only for using the IT facilities provided by it, that too the billing would depend upon the extent of usage of those facilities.
- The payment was made only for using the IT infrastructure facilities on rental basis. Hence, the question of transferring the copyright over those facilities did not arise at all.

- In view of the above, the ITAT held that:
  - The non-resident companies (viz. ABC, LMN and XYZ) did not give any specific license for use, or right to use any of the facilities (which include software), and those facilities were not going to be used in the business of the taxpayer. Hence the question of transferring the copyright over those facilities did not arise at all.
  - The relevant agreements made it clear that the copyright over those facilitating software was not shared with the taxpayer.

  Accordingly, the payments made to these non-resident entities did not fall within the ambit of the term "Royalty" as defined in the relevant tax treaties (viz. India-Ireland and India-USA tax treaty).

[5]Skycell Communications Ltd v. DCIT [2001] 251 ITR 53 (Del-HC)

[6]Engineering Analysis Centre of Excellence Private Limited vs. CIT (Civil Appeal Nos. 8733-8734 of 2018 dated March 02, 2021) (SC)

Comment:

This ruling, based on the facts of the case, establishes the principle that, payment made towards - (i) placing advertisements on websites / platforms, (ii) bulk mailing facility, and (iii) cloud computing services, do not constitute 'Royalty' under the provisions of the relevant tax treaties (viz. India-Ireland and India-USA tax treaty).

One should also evaluate the applicability of equalisation levy provisions in case of such arrangements.

Taxpayers with similar facts may wish to evaluate the impact of this ruling to the specific facts of their cases.

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