

Fees paid to overseas group entity for advertisement space characterised as ‘royalty’: Bangalore ITAT

Summary

The Hon’ble Bangalore Bench of the Income Tax Appellate Tribunal (ITAT) in a recent ruling¹ of Google India Pvt Ltd (Google India) has held that payments made by Google India to its overseas company, viz Google Ireland Limited (Google Ireland), towards the distribution of the advertising space under the AdWords programme qualify as ‘royalty’ under both the Income-tax Act, 1961 (Act) and the India–Ireland Double Tax Avoidance Agreement (DTAA) as it had access to the overseas company’s patent, technical know-how, trademark, process, brand etc.

The ITAT held that introduction of ‘equalisation levy’ does not change the character of the payment. It also made far-reaching observations on the concept of ‘beneficial ownership’ and other important concepts.

Background

- In October 2017, the ITAT (for the past years) had held that the payments by Google India to Google Ireland are taxable as ‘royalty’ on the following grounds:
 - The IPR of the Google search engine technology vests in Google India and the payments made to Google Ireland falls within the ambit of ‘royalty’.
 - Under the AdWords Agreement, Google India is permitted to use the trademark, service mark, domain etc., which are essential and pivotal for the business of selling advertisement space. Therefore, payments under the AdWords Agreement are not only for marketing and promoting the AdWords programme but also for use of Google brand features.
 - The entire search engine technology on which the license has been granted to Google India for selling advertisement space to the advertisers is a ‘process’. Hence, the payment towards the license to use the ‘process’ would qualify as ‘royalty’.
 - Google India is obliged to provide pre-sales and post-sales Information Technology Enabled Services (ITES) to the Indian advertisers under a separate service agreement

¹ Google India Private Limited v DCIT [2018] [IT(IT)A No.1190/Bang/2014 2013-14]

wherein Google India has access to Google Ireland’s customer data and confidential information licensed to Google India. The ITAT held that the AdWords Agreement is dependent on and connected to the agreement for ITES for discharge of obligations to advertisers and together these services qualify as ‘royalty’.

- Google India appealed against the ITAT order before the Karnataka High Court (HC). For the subsequent years, Google India requested the court to transfer the proceedings to another bench of the ITAT. However, the HC directed the ITAT to examine afresh the first appellate authority’s order based on Google India’s and Revenue’s contentions, without being influenced by the earlier order.
- The ITAT, upon fresh examination, reached the same conclusion as in its earlier order² and held that Google India has access to patent, technical know-how, IPRs, trade mark, process, derivative works, brand features etc of Google Ireland, and reconfirmed that payment of advertisement fees to Google Ireland is a payment of royalty within the provision of the Act and the DTAA. Google India was held in default for not withholding tax on such payments.
- Additional arguments presented in the recent decision and the ITAT’s views on those are discussed below:

Additional arguments

Issue	Arguments	ITAT’s ruling
<p>1. Equalisation levy</p>	<ul style="list-style-type: none"> • Google India contended that in assessment years 2017-18 and 2018-19, Revenue has taken a position that equalisation levy is applicable on payments made to non-residents for the purchase of online advertisement space. • Therefore, in view of the object of introduction of equalisation levy on payment for online advertisement to non-residents, the payment made to Google Ireland under the AdWords Agreement should be considered as ‘business profit’ in the hands of Google Ireland and not as ‘royalty’. 	<ul style="list-style-type: none"> • ITAT examined the applicability of equalisation levy³, introduced in the Finance Bill 2016, to the advertisement fees paid by Google India and held as under: <ul style="list-style-type: none"> – Equalisation levy does not determine the classification of payment between royalty and business income. – Equalisation levy is only a charge on consideration for specified services and not others where there is use of IPR, copyright and other intangibles. – Under Google’s AdWords Agreement, Google India had acquired the license to use IPRs, copyright and other intangibles to provide better services to Google Ireland or to advertisers in India,

² Refer our [Alert](#) dated 01 November 2017 for a detailed discussion.

³ Under Chapter VIII of the Finance Act 2016 read with Rules

		<p>and this payment qualified as 'royalty'.</p> <ul style="list-style-type: none"> – Therefore, the introduction of equalisation levy would not convert the nature of payments made to Google Ireland.
<p>2. Beneficial ownership</p>	<ul style="list-style-type: none"> • Revenue contended that Google Ireland was not the beneficial owner of the fees received under the AdWords Agreement on account of the following: <ul style="list-style-type: none"> – The trademark/copyright of the AdWords programme is owned by Google Inc, USA. – Google Ireland has received the right to use the AdWords programme from Google Netherland Holdings under a license agreement against payment of royalty. Profits derived by Google Ireland are transferred to an entity which is controlled and managed from Bermuda, with whom India has not entered into a DTAA. In reaching this conclusion, the Revenue was guided by the statements made before the Public Accounts Committee, House of Commons, British Parliament, by a senior employee of Google UK Ltd. – Google Ireland is in turn held by a chain of multi-level holding companies under the Google Group. – The Tax Residency Certificate (TRC) merely establishes the residential status but does not establish beneficial ownership. – Based on the above, Revenue contended that tax at the rate of 10.556 per cent under the Act⁴ would be applicable on royalty paid/payable by Google India and the benefit of 10per cent tax rate on royalty under the DTAA would not be available. 	<ul style="list-style-type: none"> • Examining the TRC submitted by Google India, the ITAT held that the certificate has no mention of the beneficial ownership of the Google AdWords programme, of which distributorship was given to Google India. • The ITAT also observed that multi-layered holdings may mean that Google Ireland is a conduit. It also observed that there was no information on how the revenue was shared amongst the holding companies and the level of control on revenues by Google Ireland. • ITAT directed Google India to submit the agreements between the various holding companies in support of its contention that Google Ireland is the beneficial owner of the distribution fees. However, in view of Google India's inability to submit such agreements to support Google Ireland's status as the beneficial owner, the ITAT directed Revenue to examine the matter afresh based on facts.

⁴ Under section 115A of the Income-tax Act, 1961

<p>3. Taxability of royalty under DTAA</p>	<ul style="list-style-type: none"> • Relying on judicial precedents, Google India submitted that under the DTAA, royalty can only be taxed on receipt basis in the hands of the non-resident and that the tax liability under the DTAA can arise only at the point of payment and not at the time of crediting the amount. Therefore, there cannot be an occasion for deduction or withholding the tax on such income at the time of crediting the amount. • However, Revenue contended that the words ‘payments of any kind received as a consideration for ...’ in the definition of ‘royalty’ under the DTAA would only mean the classification of the income and not the method of accounting. Therefore, the royalty would be deemed income on an accrual basis under the DTAA as well as under the Act. 	<ul style="list-style-type: none"> • The ITAT examined the judgments referred to by the parties and found that royalty has to be taxed on receipt basis. • However, the ITAT observed that the nature of the AdWords Agreement and the ITES agreement is quite complex and, based on the facts of the case, held that payments towards royalty would be liable to tax withholding on accrual basis.
<p>4. Bona fide Belief</p>	<ul style="list-style-type: none"> • Google India submitted that it held a bona fide belief that it was not under obligation to withhold tax on the advertisement fees paid to Google Ireland as: <ul style="list-style-type: none"> – there was no disallowance in earlier years. – Google Ireland does not have a Permanent Establishment in India and the payments are business receipts in its hands. – it had relied on the Bombay HC decision in the case of Kotak Securities⁵, to contend that payments should not be disallowed under the provisions⁶ of the Act. 	<ul style="list-style-type: none"> • The ITAT rejected Google India’s plea of bona fide belief for non-deduction of tax in view of the following: <ul style="list-style-type: none"> – Google India was aware of the nature of services being provided to Google Ireland and the payments being made under the Google AdWords programme. Also, Revenue has disputed the nature of claims raised since the beginning. – Disallowance for non-deduction of tax falls under a non-obstante provision⁷ of the Act, and as such the disallowance shall prevail over any other provision under the Act. – Plea of bona fide belief can only be considered while adjudicating the issue of penalty⁸ to be levied under the Act.

⁵ CIT v Kotak Securities Ltd. (340 ITR 333)

⁶ Under section 40(a)(ia) of the Income-tax Act, 1961

⁷ Section 40(a)(ia) of the Income-tax Act, 1961

⁸ Section 271C of the Income-tax Act, 1961

Our comments

The characterisation of payments in the digital and online space continues to be a vexed issue. The ITAT appears to have gone beyond the distribution function performed by Google India and relied on the intensity of technology used in the process of providing online advertising, thereby linking the distribution agreement with Google India's ITES agreement, for which there is a separate revenue stream.

Further, the ITAT's detailed observations on Google Ireland's 'beneficial ownership' test are far-reaching and encompass a wide field of enquiry. It could have a significant impact on companies employing step-down subsidiary/holding structures. The interplay of charging equalisation levy vis-à-vis tax withholding on royalty payments is another issue that may be subject to litigation in the online advertising space.



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