



## **Global Business Tax Alert** Sharp Insights

### **ITAT Bengaluru reaffirms payment for Adwords program as royalty in case of Google India\***

*\*[2018] 93 taxmann.com 183 (Bangalore - Trib.)*

**Issue no:** GBTA/12/2018

**In this issue:**

[Background](#)  
[Detailed discussion on the  
above issues](#)  
[Conclusion](#)  
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## Background

- Google India Private Limited (GIPL or Appellant) is engaged in the business of providing information technology (IT) and information technology enabled services (ITES) to its group companies. GIPL also acts as a distributor for AdWords programs in India. The main issue in this appeal is the deduction of tax with respect to the payments made by GIPL to Google Ireland Limited (GIL), towards payment for AdWords program.
- In October 2017, in the Appellant's own case, for AYs 2007-08 to 2012-13, the Bengaluru Income tax Appellate Tribunal (ITAT), had adjudicated that the payments made to GIL by GIPL are in the nature of royalty and hence GIPL was liable to withhold tax under section 195 of the Act. As such, the appeal of GIPL was dismissed. The Appellant had filed an appeal against the ITAT order before the Bengaluru High Court. The appeal is currently pending for decision before the High Court (HC). The HC, during the admission hearing of the appeal, made a comment, stating that the ITAT should pass an order for subsequent years, i.e. AY 2013-14 to AY 2015-16, without being influenced by the co-ordinate bench ruling for AY 2007-08 to AY 2012-13.
- The current decision of the ITAT is against the section 201 proceedings for AYs 2013-14 to 2015-16 and for the regular assessment proceedings for AYs 2008-09 to 2012-13. The various appeals clubbed in this judgement are tabulated below -

Issues	AYs	Appellant
Characterization of payments made by GIPL to GIL under the Google AdWords program, consequent liability under section 195 to withhold tax and proceedings under section 201	2013-14 2014-15 2015-16	GIPL
Whether GIL is the 'Beneficial owner' of royalty income	2013-14 2014-15 2015-16	Revenue GIPL GIPL
Rejection of books of accounts	2008-09 to 2012-13	GIPL
Section 40(a)(ia) disallowance on additional profits on the basis of TP adjustments	2008-09	GIPL
Admission of additional grounds on section 10A	2008-09	Revenue
Bona fide claim for TDS non-deduction and section 40(a)(ia) disallowance	2008-09 to 2012-13	GIPL
Rejection of FAR analysis and re-characterizing the activities of GIPL as 'Knowledge Process Outsourcing (KPO)' instead of as 'software services'	2009-10 to 2012-13 2009-10 to 2012-13	GIPL GIPL

Method adopted for computation of arm's length price in respect of IT, ITES and AdWords program Profits attributable to GIL	2009-10 to 2012-13	Revenue
Deduction of telecommunication expenses from the export turnover as well as total turnover	2009-10 to 2010-11	Revenue
Re-opening of assessment under section 148	2007-08	GIL
Characterization of payments received from GIPL	2007-08	GIL

## Detailed discussion on the above issues

### Appeals by GIPL/ Revenue

Issues	Arguments and Conclusion
Characterization of payments made by GIPL to GIL under the Google AdWords program, consequent liability under section 195 to withhold tax and proceedings under section 201	<p>Since HC had directed the ITAT to look into the matter independently, the ITAT has discussed the matter in detail without merely making a reference to the earlier decision in the case of the Appellant. However, the ITAT, like in its earlier decision<sup>1</sup>, has reiterated the payments to be in the nature of royalty, on which TDS is required to be deducted. The arguments on the basis of which the ITAT has thus ruled, are broadly similar to that of the ITAT's earlier ruling.</p> <p>Additional arguments raised in the current appeal –</p> <p><b>Equalization levy</b> - GIPL had claimed that in view of the object of introduction of equalization levy on specific payments, the payments made by GIPL to GIL under the Distributor AdWords Agreement should be considered as 'business profits' in the hands of the Non-Resident (i.e. GIL). The ITAT has however pointed out that equalization levy is only charged on consideration for specified services and not for the services provided in the present case (i.e. use of IPR, copyright, etc.). The ITAT has clarified that since GIPL had acquired license to use IPRs, copyright and other intangibles to provide better services, either to GIL or to the advertisers, the introduction of equalization levy would not convert the nature of payment made by GIPL to GIL.</p> <p><b>Bona fide belief for TDS non-deduction</b> - GIPL's stand on bona fide belief for non-deduction of TDS on payments made to GIL was also quashed by the ITAT, since it was clear that TDS was required to be deducted under section 195 on the basis of the ITAT judgement given in October 2017<sup>2</sup>.</p> <p>The ITAT finally concluded that GIPL was an 'assessee in default' for non-deduction of TDS on payments made to GIL.</p>

<p>Whether GIL is beneficial owner of royalty income?</p>	<p>The Revenue held that as GIL is not the beneficial owner of royalty, the same would be taxed at the rate of 10.56%, as per the provisions of Act and not at the rate of 10%, as per Article 12 of the DTAA between India and Ireland. ITAT noted that the Google AdWords program was owned by Google Inc. USA and it was licensed by Google Inc. to Google Ireland Holdings, which in turn was further licensed to Google Netherlands Holdings BV and in turn to GIL.</p> <p>ITAT noted that since there are four layers of holdings, it is not clear exactly how much right in license is conferred to different holdings and how the revenue is distributed amongst the above holdings. Also, GIL could not bring evidence on record that major share of the revenue collected on account of AdWords program comes to it. GIL also failed to produce various agreements executed among the above entities.</p> <p>Accordingly, this matter has been remanded by the ITAT to the Assessing Officer (AO) for fresh adjudication.</p>
<p>Rejection of books of accounts</p>	<p>The AO had rejected the audited books of accounts of GIPL by revoking provisions of section 145 (3) of the Act, since it had not credited the gross receipts from the sale of AdWords program to its Profit and Loss account, but credited only the share of advertisement revenue.</p> <p>The ITAT held that the difference in method of accounting adopted by the AO and GIPL is only a matter of presentation and does not change the profit originally reported by GIPL.</p> <p>ITAT thus accepted the books of accounts prepared by GIPL.</p>
<p>Admission of Additional grounds on section 10A</p>	<p>Before the ITAT, the Revenue raised an additional ground challenging section 10A deduction claimed by GIPL on amount received from GIL for rendering services in India to the advertisers, on the argument that it was not 'export of article or thing or computer software'.</p> <p>The ITAT noted that in view of the fact that the AO had already accepted GIPL's claim of deduction on such amount, the Revenue cannot raise additional ground and improve upon the case made out by the AO. Thus the appeal filed by Revenue was dismissed.</p>
<p>Bona fide claim for TDS non-deduction and section 40(a)(ia) disallowance</p>	<p>Disallowance made under section 40(a)(ia) on payments made to GIL was challenged by GIPL. The ITAT has held that in the impugned year, i.e. AY 2008-09, payments made to GIPL was held as royalty. As far as the claim for bona fide belief for non-deduction of TDS was concerned, the same was also addressed in the foregoing appeals. Therefore this ground of appeal by GIPL was dismissed by the ITAT.</p>
<p>Deduction of telecommunication expenses from the export turnover as well as total turnover</p>	<p>The Revenue had challenged the deduction of telecommunication expenses incurred in foreign currency from both export as well as total turnover.</p> <p>The ITAT held that the issue was squarely covered by the Hon'ble Apex Court in case of HCL Technologies Ltd<sup>3</sup>, and hence the said expenses should be deducted not only from the export turnover but also from the total turnover.</p>

## Appeals by GIL

Issues	Arguments and Conclusion
Re-opening of assessment under section 148	GIL had challenged the opening of assessment on two grounds viz. (i) the assessment was reopened without forming a belief that income chargeable to tax had escaped assessment; and (ii) notice under section 143(2) was not issued within the prescribed period. The ITAT rejected GIL's contention on the former ground, stating that the AO had formed a <i>prima facie</i> belief that income has escaped assessment, based on the reasons recorded for reopening. With regard to the latter issue as well, the ITAT, relying on the provisions under section 143 and 147 has stated that the notice under section 143(2) was issued within the prescribed time limit. Hence, the appeal by GIL was dismissed.
Characterization of payments received from GIPL	The same issued was already adjudicated by the ITAT in the aforesaid appeals filed by GIPL, where payments have been held as royalty. Therefore, the ITAT held that assessment of business profits in the hands of GIL, by treating GIPL as a Permanent Establishment of GIL, as assessed by the Revenue, is not proper.

## Transfer Pricing (TP) Issues

Issues	Arguments and Conclusion
FAR Analysis in case of provision of software services	<p>GIPL had challenged the TPO's order rejecting GIPL's TP study, as no separate FAR analysis was carried out by GIPL for each function performed with the Associate Enterprises (AEs).</p> <p>The ITAT has held that the TP analysis should ideally be made on a 'transaction by transaction' basis, except in cases where transactions are so closely inter-related or continuous that application of arm's length principle on a 'transaction by transaction' basis would be unreliable or cumbersome. Only in such case, the transactions are to be aggregated.</p> <p>However, noting that even TPO had made the TP analysis without referring to any evidence or actual conduct of parties and therefore comparability of international transaction could not be judged, ITAT has remanded the entire TP issue to the AO/TPO for undertaking the exercise of TP analysis afresh.</p> <p>Further, the ITAT has also directed the TPO to aggregate functions which have a direct nexus with the core business activity (AdWords distribution program) and also examine whether GIPL's functions resulted in creation of intangibles i.e. marketing or technological intangibles.</p> <p>The matter has been remanded to AO/TPO for <i>de-novo</i> adjudication.</p>
Re-characterizing the activities of GIPL as 'Knowledge Process	The TPO had re-characterized the functions of GIPL as KPO services instead of as software services. The ITAT stated that characterization of functions cannot be based merely on terms of contract or description of the services given by GIPL. It has to be determined having regard to the actual conduct of the parties. The

Outsourcing' (KPO) instead of as 'software services'	ITAT also directed to consider CBDT Circular 6/2013 in deciding GIPL's functional profile. This matter has been remanded to the AO/TPO for <i>de-novo</i> adjudication.
Method adopted for computation of arm's length price in respect of IT, ITES and AdWords program.	GIPL had adopted Transactional Net Margin Method as the most appropriate method (MAM) in respect of IT, ITES and AdWords program. The ITAT has adjudicated that the TPO shall benchmark the transaction by adopting Profit Split Method (PSM) as the MAM, relying on the decision in the case of <sup>4</sup> Orange Business Services India Networks, <sup>5</sup> Global One India, where it was held that in cases involving multiple interrelated international transactions which cannot be evaluated separately, PSM can be adopted as the MAM. This matter was remanded to the AO/TPO for <i>de-novo</i> adjudication.
Section 40(a)(ia) disallowance on additional profits on the basis of TP adjustments	The AO had made disallowance under section 40(a) (ia) on the basis of additions made by TP adjustment. The ITAT opined that since the issue of computation of arm's length price under TP has been remanded to the AO/TP officer, disallowance under section 40(a)(ia) could not be made.
Profits attributable to GIL	The Revenue had challenged the DRRP's deletion of adjustment made by the AO on account of attribution of profits to GIL, on the basis that GIPL was an 'agent' of GIL. The ITAT, relying on the decisions of <sup>6</sup> Morgan Stanley and <sup>7</sup> E-Funds IT Solutions, held that there would be a need to attribute profit to PE if TP analysis does not adequately reflect the functions performed and risks assumed by the enterprise. The issue was remanded to the AO/TPO for <i>de-novo</i> assessment.

<sup>1</sup>[2017] 86 taxmann.com 237 (Bengaluru – Trib)

<sup>2</sup>GBT News Alert No GBTA/61/2017 dated October 28, 2017 was released by Deloitte for the said ITAT judgment.

<sup>3</sup>CIT vs. HCL Technologies Ltd. [(2018)(93 taxmann.com 33)(SC)]

<sup>4</sup>Orange Business Services India Networks (P) Ltd. Vs. Dy.CIT (2015) 63 taxmann.com 304 (Delhi-Trib)

<sup>5</sup>Global One India (P.) Ltd. Vs. Asst. CIT (2014) 44 taxmann.com 100(Delhi-Trib)

<sup>6</sup>Director of Income-tax (International Taxation) v. Morgan Stanley &Co.(292 ITR 416)

<sup>7</sup>Asst.DIT vs. E-funds IT Solution Inc .(399 ITR 34)(SC)

## Conclusion

The ITAT, in the current case has reaffirmed the position taken by the co-ordinate bench in the Appellant's own case pertaining to AYS 2007-08 to 2012-13 adjudicating that the payments made to GIL by GIPL under the AdWords program are in the nature of royalty.

Various other grounds of appeal as raised by GIPL have also been dismissed by the ITAT. However, the additional grounds raised by the Revenue were not admitted by the ITAT. With regard to TP issues, all matters are remanded to the TPO/ AO for adjudication.

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