

Court rules Google India's payments to Google Ireland for AdWords program are subject to withholding tax, requires profit split

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An Indian appellate court has ruled that payments made by Google's Indian subsidiary to Google's Irish subsidiary to operate the Google AdWords program in India were royalties subject to withholding tax and not payments to obtain advertising space for resale, as Google has claimed.

Moreover, in its May 11 judgment, the Bengaluru Income Tax Appellate Tribunal said the reduced withholding tax rate negotiated in the Ireland-India tax treaty may not be applicable to these payments because Google Ireland may not be the beneficial owner of the royalties.

The court also considered transfer pricing issues, mandating the use of the profit split method for some related-party transactions and requiring a reexamination of all transactions by reference to the conduct of the parties rather than their contracts.

Google said it will challenge the judgment.

"We will file an appeal in the High Court as this ruling is an inaccurate representation of our business operations in India. The order is also a clear departure from previous judgments on the issues and is not in line with India's double taxation avoidance agreement," a Google spokesperson told MNE Tax in a May 14 emailed statement.

The court's decision disposed of 6 joined appeals and pertains to Google's tax years 2007-2008 through 2015-2016.

During those years, Google's Indian subsidiary, Google India Pvt. Ltd (Google India) was granted marketing and distribution rights to Google's AdWords program under a distribution agreement. AdWords is an automated system where advertisers purchase sponsored links on Google search results pages.

Under the 2005 agreement, Google India obtained advertisement space under the AdWords distribution system and marketed and resold it to advertisers in India. Google India collected advertising revenue from customers, retained part of the collection on a cost plus profit basis, and remitted the balance to Google Ireland.

Google India and Google Ireland also entered into a services agreement which required Google India to render information technology enabled services (ITES) and software development related services to Google Ireland for which it was remunerated at cost plus 15.5 percent. This fee was also deducted from advertising receipts remitted to Google Ireland. The service agreement also granted Google India the right to use intellectual property owned by Google Ireland.

Google India characterized the payments to Google Ireland as the purchase of advertising space for resale to advertisers under the Google AdWords program. The payments were thus business profits in the hands of Google Ireland that were not taxable in India because Google Ireland did not have a permanent establishment in India, Google argued.

India Revenue and, later, the Bengaluru Income Tax Appellate Tribunal, disagreed, treating the payments made by Google India to Google Ireland as payments of royalties that are deemed to accrue or arise in India and are thus chargeable to tax.

The appellate court concluded that the distribution/reseller agreement and service agreements were interconnected and interdependent agreements. It said the payments to Google Ireland were made on account of the usage of Google Ireland's trademark, intellectual property rights, process, and derivative works, and were thus in the nature of a royalty.

Equalization levy

The court also said that India's equalization levy on amounts paid to a nonresident for digital advertising would not apply to the Google India payments because the tax, introduced in 2016, is prospective only.

Meyyappan Nagappan, Leader, Taxation of Digital Economy, at Nishith Desai Associates, noted that the equalization levy might apply to Google India and similar transactions in later years, though.

“This ruling has resulted in an unforeseen situation where a company may have to pay both a 6% equalization levy and a royalty tax on the same transaction when, theoretically, it can only be either business income, and be subject to equalization levy, or be only royalty, and be subject to taxes as royalty, but not both,” Nagappan said.

India-Ireland tax treaty

The court also ruled that Google India failed to prove that Google Ireland was the beneficial owner of the royalties and thus entitled to the reduced, 10 percent rate of withholding tax provided under the India-Ireland tax treaty. The court remanded issue back the Indian tax authority to adjudicate the issue of beneficial ownership.

During the period at issue, Google used a “double Irish” sandwich structure to transfer advertising profits from India and elsewhere through Ireland to low-tax Bermuda, where the Google India is managed and controlled.

“It is also undisputed fact that Google Inc. has licensed the Adwords program and other intangibles to Google Ireland Holdings (GIH), who in turn licensed to Google Netherlands Holdings B.V. (GNHBV) and in turn GNHBV further licensed the Adwords program and intangibles to Google Ireland Ltd. (GIL), who finally has given the distributor rights of the assessee for selling the Adwords space to advertisers, meaning thereby, whatever revenue is generated on account of sale of Adwords space to different advertisers, the revenue is to be distributed amongst all the holdings as they have some beneficial interests therein,” the court noted.

The court said, that Google Ireland has not led with the court license agreements executed between Google Inc. USA and Google Ireland or Google Ireland and GNHBV and other relevant agreements and thus the issue of beneficial ownership could not be resolved.

Transfer pricing issues

The Court also addressed transfer pricing disputes between Google India and the tax authority.

In addition to the agreement between Google India and Google Ireland for ITES services, Google India had entered into an agreement with Google Inc to render software development (IT) services. Google India’s research and development units at Bangalore, Hyderabad, and Gurgaon provided the IT services, which included application development, maintenance, and testing services. For these services, Google India was remunerated at cost plus 17.5%.

The Indian tax authority had rejected Google’s analysis of functions assets and risks, though, recharacterizing the activities, functions, and performance of Google India as knowledge process outsourcing (KPO) services instead of IT services and thus commanding a greater allocation of profit. The tax authority argued that Bengaluru and Hyderabad units of Google India act as R&D centers, which are in the nature of product development, product upgrades, product support, testing of products and product improvement.

The appellate court concluded, though, that neither the Indian tax authority nor Google properly analyzed the actual conduct of the transacting parties in their transfer pricing analyses and therefore remanded this issue along with the rest of the transfer pricing file to the tax department for a review.

The characterization of functions in a transfer pricing analysis cannot be based merely on the terms of contract or description of the services given by the assessee-company, the court said.

The court also concluded that the profit split method is the best method for related party transactions between Google India and Google Ireland that have a nexus with the Google AdWords program. Thus, that method should be used in the tax department’s review, the court said. This conclusion will surely be challenged by Google in High Court.

Further, the court said that the tax authority should examine whether the Google India’s functions resulted in the creation of intangibles such as marketing intangibles or technological intangibles and whether a compensable transfer of any such intangibles to Google Ireland has occurred.

KPO services

Nagappan said that the High Court may, through this case, resolve profit attribution and value creation issues that are the subject of fierce disagreement between the tax department and multinational taxpayers operating in India.

In this case, the tax authorities have argued that data collection and data analysis is being conducted in India which creates significant value. They have argued that the services performed by Google India are not mere information technology services but rather KPO and therefore require a higher attribution of income to India," Nagappan said.

The department has also sought to increase profit attribution in India by stating that there are valuable human intangibles and customer-related intangible assets such as customer lists, customer contracts, customer relationship, open purchase orders, he said.

"This is significant since, internationally, there is a lack of consensus on how much value is created by such intangibles, which have previously not been recognized as assets and therefore could not be used for functions, assets, and risks analysis under the OECD transfer pricing analysis, Nagappan said.

Without consensus on value creation, the number of transfer pricing disputes in India will increase, and they are already amongst the highest in the world, Nagappan said.