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Global Business Tax Alert
Sharp Insights

In Flipkart India (P) Ltd* case, Bangalore ITAT ruled that Flipkart's discounts are tax deductible

- *92 taxmann.com 387 (Bangalore ITAT)*

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Facts of the case

- Flipkart India (P) Ltd (taxpayer/ Assessee) was engaged as a wholesale trader or distributor of books, mobiles, computers and related accessories. For example, it would purchase goods at INR 100 from unrelated parties and sell to unrelated retailers for INR 80. These retailers would subsequently sell the goods to customers through the online platform of the Assessee, viz. Flipkart.com.
- The Assessee had filed its Return of Income for AY 2015-16 declaring a loss of INR 7,96,34,36,863. The tax officer was of the view that the Assessee was selling goods at lower than the cost price, which was not a normal business practice. The AO also referred to the fact that during the year the Assessee had sold its shares at a huge premium, based on valuation of the shares under the Discounted Cash Flow (DCF) method. Under DCF, future cash flow estimates are used to arrive at the current enterprise value. As such, in his assessment order, the tax officer concluded that selling goods at lower than cost price was nothing but predatory pricing strategy adopted by the Assessee to create brand/ goodwill and the benefit was to reap future profits.
- The tax officer accordingly treated the loss to the extent it is created due to predatory pricing, as capital expenditure, and recalculated the income of the Assessee. In doing so, the tax officer had adopted the cost approach for valuing the intangibles. Thus, he attributed a reasonable profit margin to the cost of purchases and for valuing the intangible, considered the extent of the profit which according to him, was foregone by the Assessee. As a result, the returned loss of the Assessee was converted into a positive income, by disallowing the expenditure as claimed by the Assessee. However, the tax officer allowed depreciation of 25% of such expenditure to the Assessee, as he treated the aforesaid disallowance to be an asset used by the Assessee for the purpose of its business. Similar approach was used by the tax officer for previous years (AYs 2012-13, 2013 -14, and 2014-15 as well).
- On appeal to the Commissioner of Income Tax Appeals (CIT(A)), the order of the tax officer was confirmed. Further, the CIT(A) exercised the powers of enhancement and withdrew the depreciation of 25% allowed by the tax officer, for the reason that the Assessee was not the owner of the intangible so created as the Brand/ Intellectual property was sold by the Assessee in FY 2012-13 to another group company through a slump sale.
- Aggrieved by the order of the CIT(A), the Assessee preferred an appeal with the Hon'ble Bangalore Tribunal (ITAT). The tax officer has also preferred an appeal before the ITAT on the directions given by the CIT(A), to the extent it reduces the profit margin on cost of purchases while working out the intangibles.

Contentions

- The Assessee (represented by its Counsel) placed reliance on numerous decisions and pointed out that the retailers to whom the Assessee sold its goods were unrelated parties and hence the provisions of sec 40A(2)(a) of the Act were not attracted in this case.
- The Assessee also argued that the tax officer can levy tax only on the 'income that accrues or arises' and not on any 'hypothetical income'. He pointed out that the tax

officer had, without authority under the law, taken the approach of bringing to tax as income, revenue that was not earned by the Assessee, by assuming that the expenses incurred by the Assessee were resulting into generation of a capital asset i.e. goodwill, which was capital in nature and hence this was to be disallowed.

- Further, the Assessee argued that the tax officer cannot compute the income in the manner he so desires by disregarding the books of accounts of the Assessee. Assessee relied on judgments wherein it had been held that a tax officer cannot take into consideration the market price of those goods ignoring the real price fetched, if the same is sold at a price lower than the cost price.
- The Assessee also argued that even if it assumed that expenditure were incurred to create a brand/ intangible asset, it merely facilitated the Assessee to carry out its business and hence, cannot be said to be of an enduring nature, to be treated as capital expenditure for tax purposes. Moreover, the test of enduring benefit is not a conclusive test to determine whether such expenditure is capital or revenue in nature. In doing so, the Assessee also placed reliance on numerous judicial pronouncements, wherein it was held that expenditure incurred for developing a brand is not capital expenditure. Also, the Assessee pointed out that there was no outflow towards acquiring intangibles and just the fact that the sale price of the Assessee is less than its cost price, cannot be the basis to conclude that any expenditure was incurred by the Assessee.
- The Revenue (represented by its Counsel) argued that an enduring benefit was created due to the pricing strategy adopted by the Assessee and accordingly, intangible asset was created by the Assessee. It was also argued that the e-commerce model was different from the traditional model of business and hence, Revenue authorities could resort to new model of income assessment.

Issue under consideration

Whether discount offered by Assessee on goods sold to retailers created an intangible asset/ goodwill for the Assessee and accordingly were they not deductible as revenue expenditure?

Ruling of the Bangalore ITAT

- The ITAT has provided relief to the Assessee.
- The ITAT held that Revenue authorities cannot disregard the books of accounts and resort to the process of estimating income of the Assessee, unless provisions of section 145(3) are invoked, which was not the case. Accordingly, the tax officer was not empowered to do so.
- The ITAT also agreed with the submissions put forth by the Assessee and held that there should be a real income which needs to be taxed and not 'income which could have been earned but not earned' and held that the tax return filed by the Assessee needs to be accepted.
- The ITAT further observed that an expenditure can be said to be incurred if there is either an accrual of liability or actual outflow in the form of payment. In the present case, there was neither an accrual of liability nor an actual outflow of payment. The ITAT observed that one cannot go on the assumption that the profit forgone is

expenditure incurred and further, that expenditure so incurred was for acquiring intangible assets like goodwill, brand, etc.

- The ITAT dismissed the Revenue's argument concerning Assessee's shares being purchased at a premium by investors and this in turn creating intangibles/brand/goodwill, by holding that this was an argument without bringing on record any material to substantiate that the valuation of shares was done only because of value being ascribed to such intangibles/brand/goodwill.
- The ITAT further held that even assuming that the expenditure was incurred, the expenditure for building brand or goodwill was revenue expenditure and allowable as deduction.
- ITAT held that loss declared by the Assessee should be accepted and the AO's action in disallowing the loss is not in accordance with the law.

Conclusion

- The Bangalore ITAT concluded the appeals in favour of the Assessee and held that discount offered to retailers is allowable as revenue expenditure.
- The discount offered cannot be construed as an expenditure incurred for acquiring/ creating brand/ intangible.
- Going forward, this judgement should, in particular, help organizations that are currently engaged in retail operations, within the rapidly growing e-commerce sector in our country, to take suitable tax positions, *inter alia*, on predatory pricing strategies and the tax implications arising thereon.

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