

Loss incurred in course of e-commerce trade cannot be recharacterised as expenditure incurred for creation of intangible asset: Bangalore ITAT

Summary

E-commerce companies in India have resorted to deep discounting of their products in order to capture market share and gain trust of the buyers. This has resulted in their wholesale trade entities incurring huge losses. The revenue department challenged incurrence of such losses and treated it as expenditure for creation of an intangible asset in the nature of 'brand' by generating consumer goodwill. Bangalore Income Tax Appellate Tribunal (ITAT), in a recent case¹, has held that a genuine business loss cannot be disregarded in absence of a specific provision in the Income-tax Act. The ITAT further held that the action of the Tax Officer in assuming that expenditure has been incurred by the taxpayer for creation of intangible asset i.e. brand/goodwill is without any basis.

Facts of the case

- The taxpayer is a company engaged in the business of wholesale trade. It sold goods to retailers at a discount and incurred a loss of 2.52 per cent at gross level.
- The Tax Officer held that the action of the taxpayer of selling goods at less than cost price was not a normal business practice and held that it was a strategy for generating customer goodwill and brand value.
- The Tax Officer relied upon the fact that the taxpayer has sold its shares at a huge premium, which was argued to be on account of value of business, marketing intangible and consumer goodwill.
- The Tax Officer also referred to approaches towards valuation of intangibles prescribed by OECD in connection with Base Erosion and Profit Splitting (BEPS)

¹ Flipkart India Private Limited vs. ACIT [2018] 92 taxmann.com 387 (Bangalore - Trib.)

and adopted the 'cost approach' to attribute a reasonable profit margin to the cost of purchases and valued the intangible to the extent profit is foregone by the taxpayer.

- The taxpayer preferred an appeal to Commissioner of Income-tax (Appeals), who upheld the assessment order and also enhanced the assessed income by denying depreciation allowed by the Tax Officer.
- Aggrieved by the order of Commissioner of Income-tax (Appeals), the taxpayer filed an appeal before the Bangalore bench of ITAT.

Taxpayer's submissions

- Genuineness of the numbers of sales and purchase is not under challenge. Hence, the Tax Officer cannot disregard the books of accounts.
- Amount of income not accrued to the taxpayer cannot be brought to tax, even if the taxpayer incurs loss of the sale transaction.
- Domestic transfer pricing provisions under the Act are not applicable since the taxpayer has not undertaken any transaction with a related party as laid down in relevant section² of the Act.
- The legislature has introduced specific deeming provisions³ in the Act for imputing specified sales consideration. In the absence of such a specific deeming provision, the revenue authorities did not have the power to consider revenue not earned as income of taxpayer.
- Shares at high premium are acquired by the holding company. It is one way of funding subsidiary. Therefore, the fact that huge share premium is paid does not in any way help the case of the revenue.

Revenue's submissions

- The taxpayer, by sacrificing its profits due to predatory pricing, intended to develop brand for its business and this was a business strategy knowingly employed by it.
- Despite losses incurred, the taxpayer's shares were purchased by investors at a high premium. Such high share premium was justified only because of the asset base created by the taxpayer in the form of brand value.
- Revenue drew attention towards Profit and Loss Account (P&L) submitting that promotion expenses were paltry as compared to the turnover, proving that predatory pricing was taxpayer's main advertising and sales promotion.

² Sec.40A(2)(b) of Income-tax Act, 1961

³ Section 43CA and Section 50C of Income-tax Act,1961

- Indulging in predatory pricing expands the profit making apparatus and therefore the profits foregone can be regarded as capital expenditure.

Held by the ITAT

- The Tax Officer cannot disregard the profit or loss as disclosed in the profit and loss account, unless it falls under deeming provisions⁴ of the Act.
- Where a trader transfers his goods to another trader at a price less than the market price and the transaction is a bona-fide one, the taxing authority cannot take into account the market price of those goods, ignoring the real price fetched to ascertain the profit from the transaction. In this regard, ITAT relied on Karnataka High Court's decision⁵.
- ITAT rejected the Tax Officer's conclusion that the profit foregone was an expenditure incurred, and further that the expenditure so incurred was for acquiring intangible assets like brand, goodwill, etc.
- ITAT further rejected revenue's argument regarding high premium on issue of shares collected by Taxpayer opining that such argument was not substantiated by any material on record. It was also noted that valuation of shares as per the Tax Officer was on Discounted Cash Flow method and there was no mention in the order of assessment regarding values being ascribed to goodwill/ brand or intangibles.
- Based on above observations, ITAT held that the loss declared by the taxpayer in its Return of Income should be accepted by the Tax Officer and his action in arriving at a positive total income by assuming that there was an expenditure of a capital nature was without any basis and not in accordance with law.

Our comments

The ITAT has gone by strict interpretation of law and disregarded ingenious re-characterisation of the transaction by the Tax Officer. The ruling provides a welcome relief for e-commerce companies and reaffirms the long established principle that income cannot be imputed in the hands of a taxpayer, unless specifically provided for under the law.

⁴ Sec.145(3) of Income-tax Act, 1961

⁵ A.Khadar Basha Vs. ACIT (2015) 232 Taxman 434(Kar)



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