THE ECONOMIC TIMES

Can't pay tax on fictional income: Flipkart to Income Tax Appellate Tribunal

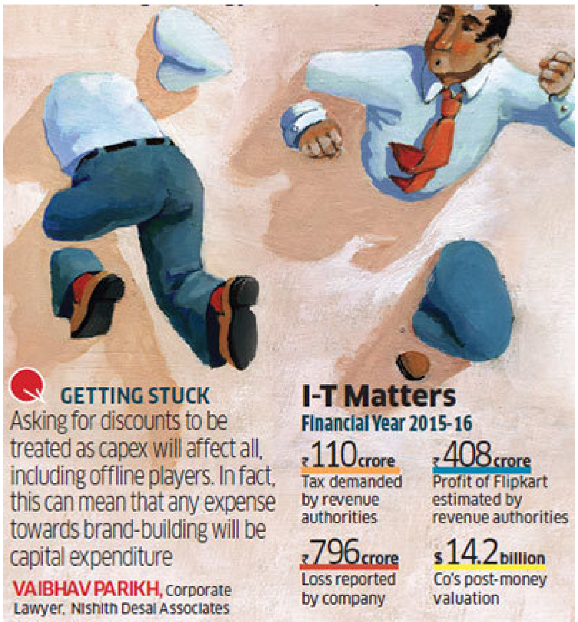
BY VARSHA BANSAL & MUGDHA VARIYAR, ET BUREAU | APR 12, 2018, 06.44 AM IST

BENGALURU: Flipkart has challenged the income-tax department's demand that it reclassify marketing expenses and discounts as capital expenditure, arguing before the Income Tax Appellate Tribunal (ITAT) that tax cannot be levied on "fictional income".

If discounts are classified as capital expenditure, Flipkart, which otherwise incurs a loss, could become a profit-making entity and would be liable to pay domestic taxes.

The panel was hearing Flipkart's appeal against a Rs 110 crore tax demand for the financial year 2015-16 following the tax department's reclassification order that could impact how other consumer internet startups, too, are taxed.

"Nothing in the IT Act mandates that a product has to be sold at a particular price, and revenue not earned (by virtue of giving discounts) cannot be treated as capital expenditure," said Percy Pardiwala, senior advocate appearing for Flipkart, according to a summary of the hearing sourced from Taxsutra, a website focused on tax-related matters. The revenue department's rationale for requiring Flipkart India's marketing expenses and discounts to be capitalised is that the company enjoys high valuations driven by its marketing intangibles despite its recurring losses and low fixed-assets base.



Revenue counsel CH Sundar Rao said Flipkart India, despite being a wholesaler selling popular goods, reported losses at the gross-profit level. He argued that the company's motive was to capture market by creating marketing intangibles in terms of customer base, brands and trademarks, which, in turn, resulted in its high valuations.

"Flipkart received an enduring benefit by incurring losses because of aggressive discounts (cash discounts to the extent of 3% of the turnover)," said Rao, leading to one of the judges on the tribunal bench asking if this was a case of "predatory pricing".

Flipkart's counsel argued that the company's strategy was to earn profits in the long-run and the discounts were required as part of its marketing strategy. Flipkart did not immediately respond to queries from ET.

Currently, companies categorise discounts and marketing costs as revenue expenses, while spending on a patent, machinery or building, among others, is categorised as capital expenditure. If discounts are classified as capital expenditure, Flipkart, which otherwise incurs a loss, could become a profit-making entity and would be liable to pay domestic taxes. Revenue authorities have demanded tax of about Rs 110 crore on an estimated profit of Rs 408 crore for the financial year 2015-16, whereas Flipkart reported a loss of Rs 796 crore for that period. The online marketplace currently has a post-money valuation of $14.2 billion. The tribunal has reserved its judgement in the case.

Tax and startup industry experts say a verdict against Flipkart could fundamentally change how internet and other companies in India are taxed.

"Asking for significant discounts to be treated as capital expenditure because it helps in building the brand, will affect anyone who offers discounts, even infrequently, including offline players. In fact, this can mean that any expense towards brand-building will be capital expenditure," said Vaibhav Parikh, corporate lawyer at Nishith Desai Associates. "In the past, there were such cases made against some companies over advertisements, but several have been ruled in favour of the company."

Another issue brought by the revenue counsel was of transfer pricing — which is the price at which divisions of a company transact with each other. Rao said the discounts by Flipkart India benefitted another party — Flipkart Internet, to which the Flipkart brand and internet platform were transferred from Flipkart India. "In the absence of any specific provision to counter such seeming transactions, it could be difficult to bring them under the transfer pricing net," said Amit Maheshwari, partner at Ashok Maheshwary & Associates LLP.