Tax Alert – ITAT held that profit foregone cannot be termed as expenditure incurred for acquiring intangible assets like brand/goodwill

Tax Alert
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Dear All,

Recently, the Income Tax Appellate Tribunal, Bangalore ("**ITAT**") in the case of Flipkart India Private Limited vs. ACIT[1] ("**Assessee**"), has held that one cannot proceed on the presumption that profit forgone is expenditure incurred and further that expenditure incurred was for acquiring intangible assets like brand, goodwill etc.

The issue for consideration before the ITAT was whether under the facts and circumstances of the case, sales made by the Assessee at losses by allowing discount, were for creation of intangibles / goodwill and hence whether loss incurred by the Assessee be disallowed as capital expenditure.

The ruling of the ITAT is discussed below:

BRIEF FACTS:

1. The Assessee is engaged in the business of wholesale trade/ distributor of books, mobiles, computers and related accessories. It primarily acquires goods from various persons and immediately sells the goods to retail sellers such as M/s WS Retail Services Pvt Ltd and others, who would subsequently sell the goods as sellers on the internet platform under the name *'Flipkart.com'.*

2. The Assessee sells these goods at a price which is lower than its purchase price thereby incurring huge losses. The reasoning provided by the Assessee was that the strategy of selling at a price lower (predatory pricing) than the cost price is to capture market share and to earn profits in the long run.

3. However, the Income-tax department ('**Revenue**') concluded that the strategy was to establish customer goodwill and brand value in the long run. The Revenue contended that selling goods at less than cost price is not a normal practice, specially when the share price of the Assessee was valued at a much higher price. Accordingly, held that the losses incurred by the Assessee was to create intangible assets and therefore the loss to the extent created due to predatory pricing was in fact a capital expenditure and was disallowed. However, the AO granted an allowance of depreciation on such intangible asset @ 25%.

4. For computing the amount of expenditure towards creation of intangibles, the Revenue adopted cost approach method, whereby the reasonable profit margin to the cost of purchases earned by other wholesalers in the market was determined and to the extent profit was forgone by the taxpayer, was considered as the value of intangibles.

5. On appeal, the Commissioner of Income Tax [Appeals] ('**CIT(A)**'), confirmed the order of AO and in addition, exercised his powers of enhancement to withdraw depreciation allowance on the basis that the Assessee was not owner of the intangibles.

ARGUMENTS BEFORE ITAT:

Arguments of the Assessee

1. The Assessee contended that the starting point of computation of income from business has to be the sales as recorded in the books of accounts. It contended that since the books of accounts were not rejected by the revenue, it cannot resort to a process of estimating income of the Assessee. The Revenue cannot bring to tax "hypothetical income" by assuming that the Assessee incurred expenses on creation of intangible assets.

2. The Assessee relied on the decision of the Hon'ble Supreme Court in the case of CIT vs. Calcutta Discount Co Ltd[2] wherein it

[1] ITA No 202/Bang/2018

held that, it is well accepted principle of law that an assessee can so arrange his affairs as to minimize his tax burden.

3. The Assessee relied on the decision of the Hon'ble Supreme Court in the case of CIT vs. A.Raman & Co[3], wherein it was held that "*income which accrues to a trader is taxable in his hands, income which he could have, but has not earned, is not taxable as income accrued to him*".

4. The Assessee by relying on various judicial pronouncements has contended that what can be taxed is only income that accrues or arises as laid down under Section 5 of the Income-tax Act, 1961 ("**IT Act**"). Nothing beyond Section 5 of the IT Act can be brought to tax. It was also contended that there is nothing to show accrual of income so as to disregard the loss declared. It was further contended that the revenue indirectly applied the transfer pricing provisions to compute the value of intangibles, without considering that the same can be made applicable only to transactions between related parties and where one of the party is a non-resident.

5. The Assessee also contended that wherever the legislature wanted to tax income not earned, it had made specific provisions in the IT Act by way of a deeming fiction [such as section 43CA, 45(4), 50C (1)]. Hence, 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 an assessee.

6. The Assessee contended that the expenses incurred in creating intangibles/brands, is allowable as revenue expenses and such expenses cannot be regarded as capital expenditure, which cannot be claimed as a deduction.

7. The Assessee also contended that a business expenditure should be allowed on the basis of commercial expediency.

Arguments of the Revenue

1. The Revenue contended that the Assessee by sacrificing its profits by indulging in predatory pricing intends to develop brand for its business and hence, profits foregone to the extent it is below the cost of purchases, should be regarded as expenditure incurred for building brand for its business.

2. Despite of making losses, the shares of the Assessee are being purchased by investors at a high premium and such high premium is justified only because of the asset base created by the Assessee in the form of brand value.

DECISION OF ITAT:

1. The ITAT held that the starting point for computing of income from business is the profit or loss as per the profit and loss account of the Assessee, which cannot be disregarded unless certain provisions (Section 145(3)) of the IT Act are invoked. Since the AO has not invoked such provisions, the AO is not empowered to go beyond the book results.

2. The ITAT held that, it is settled law that "*where a trader transfers his goods to another trader at a price less than the market price and the transaction is a bonafide 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"* and "*income which has accrued or arisen can only be subject matter of total income and not income which could have been earned but not earned*".

3. The ITAT held that "*the AO was not right in proceeding to ignore the books results of the Assessee and resorting to a process of estimating total income of the Assessee in the manner in which he did, what can be taxed is only income that accrues or arises as laid down in Sec.5 of the Act. Nothing beyond Sec.5 of the Act can be brought to tax".*

4. The ITAT held that there is no provision to disregard the loss declared by the Assessee and also there is no provision by which the Revenue can ignore the sale price declared by an Assessee and proceed to enhance the sale price without any material before him to show that the Assessee has in fact realized higher sale price. In fact, whenever, the Legislature intended to tax income not earned, they have made a provision to this effect.

5. The ITAT also held that there was no expenditure which was incurred by the Assessee and one cannot proceed on the

[2] 91 ITR 8 (SC)
[3] 67 ITR 11 (SC)

presumption that profit forgone is expenditure incurred and further that expenditure incurred was for acquiring intangible assets like brand, goodwill etc.

6. The ITAT did not go into the valuation methodology, since it rejected the basic position adopted by the Revenue and held that the Assessing Officer should accept the loss declared by the Assessee.

7. The ITAT concluded that the action of the Revenue in disregarding the books results cannot be sustained and the further conclusion that the action of the Revenue in presuming that the Assessee had incurred expenditure for creating intangible assets/brand or goodwill is without any basis. Accordingly, the loss declared by the Assessee in the return of income should be accepted by the AO and the action of disallowing the expenses in without any basis.

ELP COMMENTS:

The decision of the ITAT has upheld the settled principle of law that unless there is a provision in the IT Act for taxing certain income whether earned or not earned, the same cannot be taxed. This will certainly help those transactions which are being questioned by the Revenue on the basis of being undertaken at a value which is less than fair market value and accordingly bringing those transactions within the tax net. The scope of Section 56 has been widened in 2010 and 2012, however, transactions undertaken prior to this date are being questioned on the basis of a provision which was to apply for future years.

The IT Act does not function on presumptions and there should be material to place on record that the transaction has been held at a higher price. As a matter of fact, the IT Act does contain many provisions where income which has not been earned or transactions which have been undertaken at a value which is less the fair market value have been brought to tax at fair market value.

The ITAT has also upheld the commercial expediency of a business person and any expenditure incurred by a business person cannot be questioned, if was undertaken on account of commercial expediency.

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