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Experts at a loss to explain taxmen's Flipkart 'paradoxical' math

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BENGALURU: Flipkart's paradoxical status as India's most-valuable but loss-making internet company may have landed it in the tax soup it is in now.

Flipkart is currently valued at about $11.6 billion, down from a peak of $15.2 billion in 2016 after a series of markdowns by mutual funds.

The income-tax department views Flipkart as an anomaly since the company has been making losses while its valuation has been rising, said a senior tax official familiar with the details of the department's case against Flipkart. "The valuation going up is the problem," the official told ET, requesting anonymity.

"Flipkart wants to build its brand and create long-term value. But they want to show (expenses towards this) under revenues. They are claiming losses year after year but their valuation is going up." The country's largest online marketplace in December lost an appeal against the tax department's ruling that it reclassify its marketing expenditure and discounts as capital expenditure. Flipkart, Amazon India and many other ecommerce marketplaces deduct marketing expenditure and discounts from revenue, inevitably resulting in losses that aren't liable to be taxed.

"For Flipkart, the whole survival is on the marketplace, where they make commissions from sellers. If they make a commission of Rs 1 on a Rs 100 mug, they spend Rs 2 or Rs 3 to advertise that product and build their brand," the tax official said.

The tax department contends that this is not a cost but capital expenditure that should be spread over 4-10 years, which could result in online marketplaces being deemed profitable and liable to pay 30% tax, ET reported on Monday. Flipkart is currently valued at about $11.6 billion, down from a peak of $15.2 billion in 2016 after a series of markdowns by mutual funds.

The company registered marketing expenses of Rs 1,086 crore and a loss of Rs 5,223 crore in fiscal year 2015-16. An ET analysis of marketing costs and losses of leading internet companies in India shows that most of them have losses much higher than the costs incurred on marketing and discounting. This means that even if the expenses are not deducted from revenues, the companies will not be immediately profitable.

Only One97 Communications, the parent company of Paytm, had its marketing costs almost similar to that of its losses for fiscal 2016-17. Flipkart did not respond to queries on the matter. Other ecommerce entrepreneurs ET reached out to declined comment.

Ecommerce industry members and tax experts have termed the tax department's ruling as unconstitutional, stating that the law does not provide for marketing expenses to be considered as capital expenditure. "There is no precedent to this case," said Vaibhav Parikh, corporate lawyer at law firm Nishith Desai Associates. "If the I-T department is bringing a new provision, it will impact not only Flipkart but all retail companies. This may also impact investor interest."

The software industry body Nasscom had raised this issue as part of its recommendation for the 2017-18 Union Budget, seeking for marketing costs to be classified as deductible expenses in the year in which they are incurred. The issue was not considered in the Budget.

"It is possible the income tax department is eyeing a portion of the billion+ dollars in funding that comes into this sector, but let's not kill the golden goose before it grows up," said Prasanto K Roy, vice president, Nasscom Internet Council.

The ruling could potentially affect ecommerce companies investing in marketing and customer acquisition via discounts, cashbacks and other promotions, or via discounted logistics or services to their seller partners, Roy said.

Tax experts say the ruling is likely to fall through in a higher court. Flipkart is likely to challenge the order at the Income Tax Appellate Tribunal (ITAT), ET reported on Monday. "The stand of the tax department to treat the discounts and marketing expenses as capital expenditure is not right from a business prudence and accounting perspective," said TC Meenakshisundaram, MD, IDG Ventures India Advisors, an investor in Flipkart. "Such treatment can't be done for every retail organisation that gives 70% off (as discounts)."