India

India's Flipkart Tax Ruling May Ripple to Digital Giants

By Siri Bulusu

E-commerce giants like Amazon.com Inc. could be at risk of larger tax bills in the future after an Indian tax tribunal demanded $17.1 million from Flipkart.

The Feb. 6 Income Tax Appellate Tribunal decision declining a suspension of the tax bill is just the latest sign that India is taking a no-holds-barred approach when it comes to taxing the digital economy, practitioners told Bloomberg Tax.

Snapshot

- Tax tribunal deems "discounts" to be taxable
- Flipkart claimed financial situation meant it couldn't pay

Flipkart India Private Ltd.'s tax bill for the 2105-16 tax year is based on reclassifying discounts as capital expenditures. Any digital companies, such as Amazon, that offer discounts to customers could soon face a similar tax demand. And while Flipkart will likely appeal the order, other digital companies could see tax adjustments before a precedent is set by India's higher courts, practitioners said.

The dispute centers on whether companies using discounts constitutes brand promotion. Because Flipkart offered discounts to "build up brand value, monopoly or primacy in the online market," the tax authority increased the company's taxable income, according to the court document.

The decision is "very absurd and illogical" and could impact any corner store or digital giant that offers discounts, loyalty programs or seasonal promotions, Amar Ghalot, tax partner at Lakshmikumaran and Sridharan Attorneys, said Feb. 15.

Flipkart and Amazon didn't return requests for comment.

Flipkart Claims 'Financial Hardship'

Flipkart must deposit half of the amount and provide tax authorities with the remainder by Feb. 28, according to the court document.

The tax department's demand reverses a taxation principle that says expenses incurred on a short-term basis to generate income should be deductible—and instead states that such expenses create long-term profitability and should be taxed.

The original tax adjustment was an addition of $219.2 million to the company's taxable income from assessment year 2015-16. The tax authority claimed that the company was deducting expenses that were related to building and promoting their brand, according to the court document.

Upon appeal by Flipkart, the commissioner of income-tax appeals upheld that the expenses were taxable but reduced the adjustment for assessment year 2015-16 to $208.5 million, which gave rise to the $17.1 million tax bill, according to the court document.

Flipkart said the tax demand would cause "financial hardship" and its "liquidity position" meant it couldn't afford to pay the amount, according to the court document. But the ITAT said in its judgment Flipkart didn't provide any evidence of the claim.

Characterizing Expenses

Indian tax law deems brand promotional expenses to be revenue expenses, which aren't deductible because they generate profit in the long term. But capital expenses, such as the purchase of an asset, can't be taxed, according to Section 37 of the Income Tax Act, 1961.

Revenue expenses are meant to enhance business, “but legally there can be a thin line when determining what is an expenditure on a capital asset and what is expenditure to drive income,” Ashish Sodhani, associate at Nishith Desai Associates, said Feb. 15.

Tax authorities could be characterizing the discounts as capital expenditure by labeling customers a capital asset, Sodhani said, adding that the details of the revenue office's position aren't publicly available.

“Currently there are thousands of online marketplaces using discounts to offer the most competitive price—you will find that any given product will be offered at a similar price by all these retailers,” Sodhani said.

Risks for Digital Giants

Practitioners warn that the case should be carefully litigated due to the sweeping impacts it could have on all online retailers, which are already facing new challenges from changes coming to the Income Tax Act, 1961.

India's Finance Bill 2018-19 proposed to amend the definition of a “business connection” to include “significant economic presence,” a change that could embolden the tax authority's argument in litigation where permanent establishment is contested. The change could also move that could impose a 40 percent tax on any foreign company rendering digital goods or services to India.

“The scene is bad for digital companies in India, first with the draconian amendment to the Finance Bill and then with the Central Board of Direct Taxes driving tax officers to come down hard when taxing e-commerce companies,” Ghalot said.

Flipkart officials will appear again before the Bangalore Income Tax Appellate Tribunal on May 17 to argue the company's case.

In the meantime, Sodhani said, Amazon may get a tax bill “any minute.”

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