Losses incurred on account of predatory pricing could not be construed as capital expenditure

May 8, 2018

In brief

In a recent ruling[1], the Bangalore Bench of the Income-tax Appellate Tribunal (Tribunal) held that the loss incurred by a taxpayer by selling goods to retailers at a price less than the cost price could not be construed as capital expenditure on building brand image or goodwill, as there was no accrual of liability or actual outflow in the form of payment. Further, it held that unless the revenue authorities rejected the books of accounts as provided under section 145(3) of the Income-tax Act, 1961 (the Act) they could not resort to a process of estimating the total income of the taxpayer on a notional/ hypothetical basis, except in certain situations where the Act specifically provides for taxing the income not earned by way of deeming fiction.

In detail

Facts

- The taxpayer was a private limited company in the business of wholesale trading/ distribution of books, mobiles, computers and related accessories.
- The taxpayer purchased goods from unrelated parties and sold them to unrelated retailers, who in turn, sold them on an internet platform.
- During assessment the tax officer (TO) observed that the taxpayer had sold the goods at a price less than the cost price at gross level and incurred losses.
- The TO took the view that the loss incurred by the taxpayer created marketing intangible assets, hence, the extent of loss on account of predatory pricing was regarded as capital expenditure incurred by the taxpayer and the loss claimed by the taxpayer was disallowed.
- The difference between the price at which other similar wholesalers would have sold the goods and the price at which the goods had been sold by the taxpayer was considered as expenditure incurred on goodwill for which depreciation at 25% was granted.
- On appeal, the Commissioner of Income-tax (Appeals) upheld the TO's order and withdrew the depreciation as the taxpayer was not the owner of the intangible assets, although it had incurred the expense in creating such assets.

Issues before the Tribunal

- Whether the TO had the power to estimate income without rejecting the books of account and computing the total income on a hypothetical/ notional basis?
- Whether the TO was justified in holding that the strategy of selling goods at a price less than the cost price would give rise to goodwill and brand value?

Taxpayer's contentions

- The TO had not stated that the figures reported/ disclosed by the taxpayer in the books of accounts was not true or correct. Therefore, the TO erred in disregarding the books

[1] ITA No. 202/ Bang/ 2018 order dated

of account and resorted to a process of estimating income.

- Only income that accrued or arose could be taxed, as laid down in section 5 of the Act. There was nothing to show accrual of income to disregard the loss declared by the taxpayer in the return of income filed.
- The TO had attempted to apply the provisions of section 92 of the Act without appreciating that the taxpayer had entered into transactions of buying and selling goods with unrelated parties.
- Wherever the legislature wanted to tax income not earned it had made specific provisions in the Act by way of deeming fiction. In the absence of such a specific deeming provision, the action taken by the TO was without the authority of law.
- To say expenditure had been incurred or accrued to the taxpayer, there should have been either outflow of funds or liability incurred. There was no such outflow or accrual of liability during the previous year.
- Even assuming that the taxpayer incurred expenditure in creating marketing intangible, the same was allowable as revenue expenditure, as held in various judicial precedents[2] as such expenditure merely facilitated the taxpayer in carrying on his business and could not be said to be of enduring nature.
- Commercial expediency in the given facts and circumstances of a case was the sole discretion of the taxpayer and not of the Revenue.
- Predatory pricing was a business strategy and it did not result in generation of goodwill or brand or any other intangible.

Tribunal's ruling

- The Tribunal observed that the TO had not invoked the provisions of section 145(3) of the Act, hence, the TO could not disregard the profit or loss as disclosed in the profit and loss account.
- Based on various decisions,[3] the Tribunal held that the TO was not right in proceeding to ignore the books result of the taxpayer and resorting to a process of estimating the total income of the taxpayer.
- Only the income that accrued or arose as laid down in section 5 of the Act could be taxed, except for certain situations as per sections 43CA, 45(4) and 50C(1) of the Act.
- To opine that the taxpayer had incurred expenditure, there should have been either accrual of liability or actual outflow in the form of payment. In the present case, admittedly there was no such accrual of liability or actual outflow.
- Relying upon the decision of the Supreme Court[4], the Tribunal held that for creation of intangibles such as goodwill was not possible.
- It was difficult to ascertain the cost of acquisition, cost of addition or alteration of goodwill that led to the increase in its value in terms of money.
- It was not possible to say that the profits foregone created goodwill or any other intangibles or brand for the taxpayer.
- The TO was unable to bring any material on record to substantiate that the high valuation of shares was done only because of being ascribed to brand or goodwill or any intangibles.
- Therefore, the Tribunal held that loss as declared by the taxpayer in the return of income should have been accepted by the TO.

The takeaways

- This is a welcome ruling by the Tribunal, as it clarifies that profit foregone by giving discount cannot be held to be expenditure on marketing intangible or for building brand or goodwill, as there is no outflow of funds or incurring of liability.
- This ruling also reaffirms that Revenue cannot invoke the provisions of section 145(3) without rejecting the books of account of the taxpayer.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

[2] CIT *v.* Indo Nissin Foods Limited [2013] 217 Taxman 95 (Karnataka); DCIT *v.* Core Healthcare Limited [2009] 308 ITR 263 (Gujarat); CIT *v.* Modi Revlon Private Limited [2012] 210 Taxman 161(Delhi)(Mag.)

[3] CIT *v.* Calcutta Discount Co. Limited [1973] 91 ITR 8 (SC); CIT *v.* A.Raman & Co. [1968] 67 ITR 11 (SC); CIT *v.* Shoorji Vallabhdas & Co. [1962] 46 ITR 144 (SC)

[4] CIT *v.* B.C.Srinivasa Setty [1981] 128 ITR 294 (SC)

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