

# TransPrice Times

Special Edition: May 2018

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## In the Business of Making Loss

### **The energetic rise of multi-national e-commerce businesses:**

With the advent of internet a few decades ago, the online marketplace has gained an impetus in recent years, thereby revolutionizing the B2B, B2C and C2C transactions. As a consequence, the hassles of physical limitations, investment of time and boundaries among the nations have been eliminated. Such an elimination has effectively brought the world closer than ever before. Information and communication technology ('ICT') has played a vital role in boosting the growth of the global e-commerce industry which has surpassed \$2.3 trillion<sup>1</sup> in revenue as of 2017. Convenient and seamless transactions across countries are no more a distant reality. Amazon, Alibaba, Rakuten are few of the major players in the cyber commerce arena of today.

A steady growth of e-commerce start-ups can be witnessed as more and more people depend upon services of e-businesses. Internet retailers like Amazon and Flipkart; payment systems like PayPal; wholesale markets like Alibaba.com; search engines like Google; commuting services like Uber; online advertising like AdWords; online grocery stores like Bigbasket and Grofers; etc. have created a prominent presence in the cyber commerce arena. The opportunities for greater market reach are boundless. Many countries have governmental regulations in place to protect cyberspace and for smooth operability of cross-border transactions. Although e-commerce accounts for a small portion of total trades that take place, the percentage of e-commerce transactions is on a rise.

### **Valuation of e-commerce businesses:**

At the outset, e-commerce garnered mixed reactions from the masses. These dot com entrepreneurs have tactfully converted their customers' 'apprehensions' into 'increasing confidence'. Resorting to aggressive media tactics, they are in the race to capture today's consumer-driven market. Funding, revenues and valuations are increasing but at the cost of incurring losses themselves. Indeed, it raises the question – how are such businesses valued highly despite sustaining huge cash losses?

Acquisitions of one cyber company by another is a regular news nowadays. Valuations of e-commerce enterprises are not based on the traditional Discounted Cash Flow ('DCF') Valuation Model. Rather, the valuations are being based on multiples of revenue traction and long-term growth prospects. Additionally, reliance on goodwill generation and attractive promises of high returns in the future could also be other factors in the valuation game. It is asserted in the market that such e-commerce start-ups which are knee-deep in losses garner high valuations not because of their profitability; but due to the creation of brand value, market capitalisation, achievement of critical mass, customer base, etc.

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<sup>1</sup> <https://retail.emarketer.com/article/global-ecommerce-topped-23-trillion-2017-emarketer-estimates/5a6f89f5ebd40008bc791221>

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Further, it is a known fact that a cut-throat business model incurs huge Advertising, Marketing and Promotional ('AMP') expenses towards the aim of brand-building and product loyalty. Such e-commerce businesses focus on technology and development of market-facing intangibles – IPRs (Intellectual Property Rights) such as but not limited to trademarks, brand names and very valuable customer databases. These exorbitant outlays are a key cause of the hefty cash burns and losses borne by the e-commerce players. Many e-commerce players tag such expenses as discounts.

## **The Transfer Pricing Fix:**

Marketing intangibles are an area of considerable interest in the Transfer Pricing domain since there are probabilities of manipulative arrangements of operations to avoid taxes. Added to that, the highly circumstantial nature of AMP expenses has led to a multitude of legal cases with attention to this aspect. Diverse methodologies are suggested (Bright Line Test, ABC test, etc.) for determining whether the AMP expenses are linked to brand building (i.e. capital expenses/ non-routine expenses) or linked to revenue building (i.e. revenue expenses/ routine expenses). This determination helps in bringing the just portion of AMP expenses under the tax net.

Despite these efforts, the issues are continuing to grow. Few argue that brand building activities are giving rise to marketing intangibles, thus it is a capital expenditure; while some contend that such activities are a part of daily marketing activities since it follows the logic of 'out of sight, out of mind', thus affecting the period revenue.

## **E-commerce Taxation:**

The new business model of e-commerce that relies heavily on deep discounts, is posing peculiar difficulties in applying the source rules for taxing the income derived from digital operations. The inherent cross-border nature of e-commerce could lead to aggressive tax planning measures by such enterprises.

World Governments are struggling to settle the rising issues of global e-commerce taxation while also maintaining fairness to prevent determent of new entrants. Tackling these dilemmas requires a holistic understanding of their modus operandi, communication-based strategies and internet complexities. With a view to maintain a neutral system and avoid double or non-taxation, tax evasion and curb possible malpractices, international taxation laws and treaties have been introduced and are constantly being amended to plug every arising loophole. However, surging litigations are pointing to the glaring ineffectiveness of the existing tax mechanism. As one of the recent initiatives in the face of these challenges, the OECD (The Organisation for Economic Co-operation and Development) came up with the BEPS (Base Erosion and Profit Shifting) project which has laid down Action Plans to address the taxability of digital economy.

Revenue authorities need to look beyond conventional views of consumption and profit origination and analyse the nature of business through a wider lens to encompass the impact on their economic cycle, logistics chain and differences among sectors. If left unchecked, a threat of a parallel e-commerce economy is very real. There is a strengthening movement towards creation of a separate regime for taxing cyber-business owing to its specific features, the framework of value creation and derivation of profits.

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Rather than traditional indicators, relevant factors are to be considered to determine significant economic presence of the concerns in different jurisdictions. Taxability aspects of marketing intangibles, valuation of intangibles, carry forward of losses are to be the prime focus areas which, at present, are inadequate or futile. Concepts of withholding taxes, equalization levy, indirect tax reforms and emergence of an e-government could be prudently designed and implemented for a fair regime. A collaborative effort by world Governments to upgrade their technologies and integrate tax laws can go a long way in monitoring and establishing effective taxation reforms for the rapidly evolving dot com commerce. Focus needs to be given to value creation, value liquidation, transfer of value to impose just taxes.

## **The Flipkart-Walmart Liaison:**

The recently announced Flipkart-Walmart deal has caught the attention of the Revenue authorities in India. The taxability aspects of it will depend on how the deal is structured. Notably, Flipkart also has a history of litigation wherein the Indian Revenue contended that AMP expenses, including the heavy discounts incurred by Flipkart, need to be reclassified as capital expenditure and not be tax-deductible revenue expenses, since these have resulted in creation of brand value and marketing intangibles for the entity. However, the Bangalore Income Tax Appellate Tribunal rejected these arguments and ultimately ruled in favour of the e-tailer allowing discounts to be tax-deductible. The Indian Revenue is contemplating whether Section 9(1) of the Indian Income Tax Act, 1961 relating to indirect transfer provisions and the bilateral tax treaties between India and Singapore, Mauritius can provide some beneficial reliefs to foreign investors transferring their holdings to Walmart.

However, the surfacing of this matter reveals that e-commerce, as an industry, is striving towards increasing wealth through holistic economic growth. This has benefited nations by augmenting of their marketing intangibles base, even though the net tax impact of the entities' operations may be a loss at current levels. Collection of taxes alone is not the indicator of a country's economic growth. Development of intangibles by way of IPRs, employment generation, wealth creation, value generation, technological advancement and development of a highly-skilled entrepreneurial force also enriches the bounty of a nation. The efforts of e-commerce entrepreneurs have been directed towards wealth creation via marketing intangibles, thus leading to the progress of a country's affluence despite reporting tax losses as per prevailing legislations.

## **Concluding Remarks:**

To conclude, although the business of e-commerce has peculiar characteristics where the laws of the land could be challenged and tempted for a complete change, one could take a step back and analyse whether there is indeed a requirement to gauge the taxability of e-commerce businesses with a separate lens. If one may agree to change the way the tax administration looks at a particular situation from a futuristic perspective rather than the current tax losses - by focus on capital as compared to business revenues - in one way or the other, the contribution to the treasury and the nation would be ensured by the booming e-commerce businesses.