Taxation and Accounting Aspects of Sales Return

Sales return is a situation when customers are not satisfied with a product, and return the product, expecting to receive the full amount (against its return) at which that product had been purchased. Situations of sales return come up due to a variety of reasons. Also known as *returns inwards*, these situations are a normal part of business. Goods are returned when these have defects or when these are not up to the expectations of buyers, as perceived at the time of purchase. Such situations are not as simple as they appear to buyers or customers. There is a need to account for sale returns, as it appears that there has not been any sale at all, in the first place. Factors, like sale on credit or by cash, affect the accounting and taxation aspects of this process. Read the article to understand these aspects in details…

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Sales return is a part of business. Situation occasioning return of sale may arise for variety of reasons. If we dissect the word 'return', it consists of two words, i.e. *re* and *turn*. Return as verb means *to come back to a former place or state,* or, *to give, take, or carry back.* Existence of same goods which were subject matter of original sale is a pre-requisite to call second movement as transaction of sales return. Even if goods which are sent back are of same variety or make as of original sale, yet if the goods are different, this will not be return but barter. For taxation purposes, this would be regarded as two separate transactions involving transfer of property in goods, wherein the parties, by mutual consent, only have agreed to adjust the price of goods to settle accounts. Kerala High Court in *Grasim Industries Limited vs. State of Kerala [1995] 96 STC 285* considered the concept of sales return and observed:

> *…a sales return means a return of the very goods purchased by the buyer in whole or in part. It*

is a reversal of the sale, as if the sale had not taken place in respect of the returned goods, and therefore contemplates a return before the goods are appropriated and used by the buyer. A return of the left overs after use cannot be equated with a sales return. The return should be of goods of the same nature and quality as those supplied.

However, in case of transaction for loan of goods, parties, by virtue of express agreement, may agree to accept the goods other than that of same variety or make. It is common in trade to borrow speciality chemicals, etc., from fellow manufacturers for use by way of consumption with a promise of return of goods of same variety, make and properties but of different batch. Each of such transactions will have to be examined in the light of peculiar facts and circumstances of each case, to ascertain whether it was a single transaction of loan or two inter-linked transactions of sale and purchase. In a transaction of sales return, it is not necessary that goods must come back to the place from where the sale originated. Madras High Court in *Madras Petro-Chem Limited vs. State of Tamil Nadu [1998] 109 STC 233 (Madras)* held that, there is nothing in Section 8A of the Central Sales Tax Act, 1956 (the CST Act) warranting that the goods must be returned to the State from which the sale originated. The section does not in any way contemplate that the goods must be returned to the place of despatch.

Difference between Sales Return and Unfructified Sale

All discussions about sales return presuppose that there was a sale at some earlier point of time. If there was no sale, movement of goods in return journey may be anything but sale return. It is necessary to understand when sales get complete. As per Section 4(3) of the Sale of Goods Act, 1930 (the Act*), where under a contract of sale the property in the goods is transferred from the seller to the buyer, the contract is called a sale.* Section 19 of the Act further provides that property passes when intended to pass. Parties to the contract of sale, through express provision in the contract, may agree to a point of time when the property in goods will pass. To constitute a valid sale, there must be a concurrence of the following:

1. parties competent to contract;
2. mutual assent;
3. a thing the absolute or general property in which is transferred from the seller to the buyer; and
4. price in money paid or promised.

In *Metal Alloy Company Private Limited vs. Commercial Tax Officer reported in [1977] 39 STC 404,* a learned single member bench of the Calcutta High Court succinctly brought out the difference between *return of goods and rejection of goods.* The headnote of the case reads:

Return of goods and rejection of goods stand on different footings. Return of goods is a bilateral transaction brought about by the consent of the seller and the purchaser, which consent may have been effected either prior to the delivery of the goods or subsequent to such delivery. Rejection of goods, on the other hand, is a unilateral transaction governed by the provisions of the Contract Act or the Sale of Goods Act, open only to the purchaser.

Transaction in this case was for the supply of stirrup pumps to Governments of Madhya Pradesh and Rajasthan. The contract stipulated that the pumps so supplied would be checked at unit level and payments would be made if they were according to specifications and were perfectly in order. Some of the pumps so supplied by the selling company were rejected by the buyers on the ground that they were not according to the stipulated specifications. The assesse argued that there was no completed sale in view of the admitted rejection of the goods, so the authorities concerned were not empowered to impose a levy of the tax. Concurring with the contention of the assesee, it was held that the very act of rejection gave a go-by to the transactions which were in furtherance of a supposed sale.

In *Peico Electronics & Electricals vs. State of Tamil Nadu [1990] 78 STC 88 (Madras),* purchaser failed to retire the documents from the bank to enable him to take delivery of the goods from carrier. Revenue rejected the claim of *unfructified* sale, taking a view that once the ascertained goods had already moved to the customers as a result of an earlier contract of sale, and invoices raised therefore, and the accounts of the customers debited, there will be transfer of goods, notwithstanding the rejection of the goods by the customers. Therefore, it will be only a case of sales return and not *unfructified sale.* Division bench of Madras High Court applied Judgement of Calcutta High Court in *Metal Alloy Company Private Limited vs. Commercial Tax Officer (supra)* to hold that there was nothing to suggest that there was any understanding or a term of contract which might be construed that the property in the goods passed to the purchaser as soon as the goods were put in common carrier. The High Court allowed appeal of the assesse and held that the

turnover in question represented the unfructified sales and, therefore, the tax paid on those 'unfructified sales' was liable to be returned.

In *K Mohan & Co vs. State of Tamil Nadu [2002] 128 STC 279 (Madras HC),* goods were dispatched from Madras to the buyer in Calcutta. The buyer failed to take delivery of the goods by retiring the documents. Goods sold to another buyer in Calcutta was held to be an interstate sale, as goods were sold before termination of interstate movement, as the first buyer did not take delivery from the carrier.

In *Consolidated Coffee Limited and Another vs. Coffee Board, Bangalore 1980 AIR 1468; [1980] 46 STC 164 (SC); 2002-TIOL-678-SC-Misc,* it was argued that the word *sale* means an agreement to sell for which reliance was placed upon Section 4 of the Sale of Goods Act, 1930 wherein a contract of sale of goods is defined as contract, whereby the seller either transfers or agrees to transfer the property in goods to the buyer for a price. Rejecting the argument, the Supreme Court held that wherever the word sale occurs in the CST Act, it is the definition given in Section 2(g) of the CST Act that will be applicable and therefore the sale in Section 5(3) of the CST Act must mean transfer of the goods by one person to another for cash or for deferred payment or for any other valuable considerations; it cannot mean *agreement to sell*.

In *Nagarjuna Construction Company Limited, Bangalore vs. State of Karnataka and Others* reported in *2010(69) Kar.L.J. 97 (HC),* the Division Bench of the Karnataka High Court struck down Section 7 of the Karnataka VAT Act and held:

> *...this section, which creates a legal fiction that a transaction of sale is completed for the purposes of the Act when payment is received as advance is akin to bringing to tax, an agreement to sell goods, even before the property in the goods passes to the buyer.*

While delivering this decision, the Karnataka High Court also went into the validity of the Explanation to Section 3 of the Karnataka VAT Act, 2003, which requires the works contract to include any amount received as advance, as part of the consideration for transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract, in the month, in which execution of such works contract commences and has held this Explanation to be unconstitutional.

In *Sales tax Officer, Pilibhit vs. Budh Prakash Jai Prakash 1954 AIR 459,* a Constitution Bench of the Supreme Court held that the liability to be assessed to sales tax can arise only if there is a completed sale under which price is paid or is payable and not when there is only an agreement to sell, which can only result in a claim for damages. Definition of sale in Uttar Pradesh Sales Tax Act, to the extent it treated forward contracts as completed transaction of sale, was held to be *ultra vires*. In *State Of Rajasthan And Anr vs. Rajasthan Chemist Association [2006] 147 STC 542 (SC)*, levy of sales tax on the basis of MRP printed on packaging *dehors* of actual price charged or chargeable was under challenge. The Court emphasised that the tax on sale or purchase must be on occurrence of taxing event of sale transaction. Entry 54 in List II of Seventh Schedule, empowers the State Legislature to impose and collect taxes on sale of goods. The measure to which tax rate is to be applied must have a nexus to taxable event of sale and not divorced from it. It was held that every transaction of sale is independent and can be subject to levy of tax and the components and the measure which can make the tax levy effective must have nexus with the taxable event. By devising a methodology in the matter of levy of tax on sale of goods, law prohibits taxing of a transaction which is not a completed sale and also confine *sale of goods* to mean sale as defined under the Act. This cannot be overridden by devising a measure of tax which relates to an event which has not come into existence when tax is *ex-hypothesi* determined, much less which can be said a completed sale and which cannot be subject of legislation providing tax on sale of goods, by transplanting a sum related to as *likely price* to be charged for subsequent sale to be taxed by the devise of measuring tax for the completed transaction which has become subject of tax.

In trade, generally, goods subject to sale are unascertained goods. When contract of sale is made on the basis of description of goods, without identifying particular piece physically, goods subject to sale remain unascertained goods. As per Section 23(1) of the Sale of Goods Act, 1930 in a contract for the sale of unascertained or future goods by description, property in goods passes when the goods of that description and in a deliverable state are unconditionally appropriated to the contract. Section 4(2)(b) of the CST Act provides that a sale or purchase of goods shall be deemed to take place inside a State if the goods are within the State, in the case of unascertained or future goods, at the time of their appropriation to the contract of sale by the seller or by the buyer. Section 4(2)(b) of the CST Act unlike the Section 23(1) of the Sale of Goods Act does not talk of unconditional appropriation with the assent of the other party or of passing of property. It is, therefore, not necessary for application of Section

4(2)(b) that the goods should be unconditionally appropriated to the contract,with the assent of the other party or that the property should have passed at the time of appropriation. It is sufficient for Section 4(2) (b) if the goods are appropriated by the seller and the other party assents to it later. However, the above position of Section 4(2) (b) of the CST Act need not be confused with the point of time when sale completes. Section 4 of the CST Act has a limited role of deciding *situs* of sale, i.e., naming the State, which would be competent to collect tax on such sale. The point of time when sale gets completed, will be decided on the basis of the Sales of Goods Act, 1930. Section 23(1) of the Sale of Goods Act is subject to Section 19(3) of that Act. Section 19(3) provides that rules contained in Sections 20 to 24 of that Act, are subject to a different intention of the parties to the contract. Thus, parties to a contract can very well agree to a particular point of time, when sale will get completed.

Intention is a state of mind. Intention is an inference to be drawn from the relevant facts[1]. No person can make out the state of mind of another person. State of a person's mind can only be determined by deducing the facts of a case. Section 14 of the Indian Evidence Act, 1872 provides:

> *Facts showing the existence of any state of mind, such as intention, knowledge, good faith, negligence, rashness, ill-will or goodwill towards any particular person, or showing the existence of any state of body or bodily feeling, are relevant, when the existence of any such state of mind or body or bodily feeling is in issue or relevant.*

Explanation 1 of the Section provides that a *fact relevant as showing the existence of a relevant state of mind must show that the state of mind exists, not generally but in reference to the particular matter in question.* It is thus necessary that intention of the parties, as to the point of time when property in goods will pass, to call a transaction to be a completed transaction of sale, must be clearly discernible from the terms of the contract.

In the modern style of business, such as e-commerce, where majority or significant percentage of sale happen on *cash on delivery* (COD) basis, understanding the difference between sale return and unfructified sale is very important. In *Prem Payari Aggarwal vs. Punjab State AIR 1967 P H 130; [1966] 18 STC 150 (P H) Division Bench* judgment dated 16-02-1966, it was observed that in a sale by V. P. P., there is an order placed by the buyer on the seller. The seller despatches the goods by postal parcel and the goods are to be delivered by the postal authorities to the buyer on payment of their price. In some cases, goods may even be sent by V. P. P. without an order. Property in the goods would pass and the sale would be complete on the buyer paying the price of the goods and not before that. Therefore, where the buyer does not accept the goods and returns them, there is no sale and the question of levying any sales tax thereon does not arise. The question of levy of sales tax only arises in those cases where the goods have been accepted by the buyer and the postal parcel has been paid for. It was held that the goods sent by V. P. P. from Punjab to Uttar Pradesh are liable to Central sales tax and such tax is leviable by the Punjab authorities. In *Agrim Sampada Ltd And Another vs. Union of India And Others [2004] 168 ELT 15 (Delhi HC)*, it was held that when importer of the goods in India fails to pay for the goods which were dispatched to him on *cash against delivery* basis and abandons them, the ownership of the goods continue to vest in the foreign supplier, unless he is proved to be a party to any fraud or the payment for the goods stands guaranteed to him by virtue of a letter of credit or otherwise. Reliance was placed on *Union of India vs. Sampat Rai Dugar [1992] 58 ELT 163 (SC)*, wherein the Apex court observed that it might be that for such act of abandonment, action might be taken against the importer for suspension/cancellation of license or might be, some other proceedings could also be taken against him, but certainly he could not be treated as the owner of the goods.

Accounting for Sales Return

Concept of sales return would arise only after the goods are sold. Thus, in a situation of sales return, there are two independent transactions, i.e. that of sale and return. The former involves transfer of property in goods from seller to buyer, whereas the later involves restoration of that property from buyer to seller. Both these independent transactions need to be accounted separately. However, if the nature of business is such where sales returns are inevitable or part of contract of sale, an appropriate provision for impact of future sales return on statement of profit and loss should be made. In an opinion by the Expert Advisory Committee of The Institute of Chartered Accountants of India[2], the querist company was in the business of manufacture of readymade garments. Readymade garment industry is subject to change in trends of fashion and as such, some of the goods were returned and the company as a

[1] CIT vs. Vikram Cotton Mills Ltd [1988] 169 ITR 597 (SC) – *Matter involved taxation under the head 'Income from House Property'.*
[2] *The Chartered Accountant, March, 2012, pp.1355-1357.*

Division bench of Madras High Court applied Judgement of Calcutta High Court in *Metal Alloy Company Private Limited vs. Commercial Tax Officer (supra)* to hold that there was nothing to suggest that there was any understanding or a term of contract which might be construed that the property in the goods passed to the purchaser as soon as the goods were put in common carrier.

matter of contract, accepted them back as sales returns. On the basis of the past trend, sales returns worked out to be approximately 20 to 22% of the sales for the year. The company had a policy of accounting for the sales returns received up to the balance sheet date.

The Committee opined that the existence of right of return by customer would give rise to a present obligation on the company. It noted the definition of the term *provision* as defined in paragraph 10 of Accounting Standard (AS) 29, *Provisions, Contingent Liabilities and Contingent Assets*, and opined that since obligation in respect of sales return can be estimated reliably on the basis of past experience and other relevant factors, such as, fashion trends, etc., in the extant case, a provision in respect of sales returns should be recognised. The Committee opined that the present policy of the company regarding recognising sales returns after the date of the balance sheet in the books of account upon the physical receipt of goods from the customer is not correct. It further opined that the company should recognise a provision in respect of sales returns at the best estimate of the loss expected to be incurred by the company in respect of such returns, including any estimated incremental cost that would be necessary to resell the goods expected to be returned, on the basis of past experience and other relevant factors. Necessary adjustments to the provision should be made for actual sales return, after the balance sheet date up to the date of approval of financial statements.

Deduction/Adjustments for Sales Return under Income-tax Act

In *Bayer Bio Science P Ltd vs. Additional Commissioner of Income Tax [2012] 148 TTJ 73 (ITAT-Mumbai) AY 2007-08*, the assesse, *inter-alia,* claimed deduction of provision for sales return in respect of the sales made in the current year, which were returned by the customers in the subsequent year before the finalisation of books. The Assessing Officer was of the view that since sales returns have actually been made in the subsequent year, the same should have been accounted in the subsequent year itself.

The Tribunal noted that the Section 145 of the Income-tax act, as it stands now, *inter alia,* lays down that business income has to be computed *in accordance with the cash or mercantile system of accounting as regularly employed by the assessee.* The only rider to this statutory requirement regarding method of accounting is that *the Central Government may notify, in the official gazette from time to time, accounting standards* and the applicable accounting standards will have to be followed by the assessee in the method of accounting followed. One of these mandatory accounting standards, notified vide notification no. 9949 dated 25th January, 1996, *inter alia* provides that *provisions should be made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.* This approach requires all anticipated losses to be taken into account in computation of income taxable under the head *profits and gains from business and profession*. Unlike in the pre-amended Section, as it stood before 4th April, 1997, which provided that *in any case where the accounts are correct and complete to the satisfaction of the Assessing Officer but the method employed is such that, in the opinion of the Assessing Officer, the income cannot properly be deduced therefrom, then the computation shall be made upon such basis and in such manner as the Assessing Officer may determine*, there is no enabling provision now which permits the Assessing Officer to tinker with the profits computed, in accordance with the method of accounting so employed under Section 145 and as long as the mandatory accounting standards are duly followed. It is not the case of Assessing Officer that the mandatory accounting standards were not followed.

It was held that analysis of Section 145, read with applicable accounting standards, apart, even on first principles, deduction in respect of anticipated losses, as a measure of prudent accounting principles, cannot be declined. It is only elementary that the accountancy principle of conservatism, which has been duly recognised by the Courts, mandates that anticipated losses are to be provided for in the computation of income, but it does not permit anticipated profits to be taken into account till the profits actually arise. Even an anticipated loss, even if it may not have crystallised in the relevant previous year, is to be allowed as a deduction in the computation of business profits. As

there was no dispute that sales have been returned in the subsequent year and this fact was known before the date of finalisation of accounts, it was held that there is no point in first taking into account income on sales, which never reached finality, and then accounting for loss on sales return in the subsequent year, i.e. in which sales return did take place. The approach of the assessee was held to be in consonance with the well-settled accountancy principles and provision for sales return was held to be an allowable deduction.

In the same judgement, provision was made for special discount to be passed on to customers against sale made during the year under assessment. There was no dispute about the fact that provision was made by the assesse on a scientific basis and not on an *ad hoc* basis.

Deduction/Adjustments for Sales Returns under Sales Tax/VAT Acts

Section 8A(1)(b)(ii) of the CST Act permits deduction from the turnover of the selling dealer, of the sale price of goods returned within a period of six months from the date of delivery. Facility of adjustment is subject to production of satisfactory evidence of such return of goods and of refund or adjustment in accounts of the sale price thereof. The time-limit of Section 8A(1)(b) has no application in case of rejection of goods, because the very act of rejection gave a go-by to the transactions which were in furtherance of a supposed sale.

Most of the State VAT Acts also provide for deduction for sales return. These State VAT Acts have set their own time limits for return of goods to be eligible for deduction of same from taxable turnover which is generally six months from the date of sale. Andhra Pradesh has a period of 12 months [*Rule 28(3)(a)*] whereas Odisha has a period of three months [*Rule 7(2) &7(3) (d)*]. Another fine distinction to be noted between CST Act and State VAT Acts in this regard is that whereas CST Act counts period of six months from the date of *delivery*, state VAT Acts generally count such period from the date of *sale or purchase*.

State VAT Acts generally treat sale return and unfructified sale as one and the same [see Andhra Pradesh Rule 16(1)(3); Gujarat Section 8(1)(a); Odisha Rule 7(3)(a); Tamil Nadu Section 14(2)] and therefore, time limit for being eligible for adjustment of tax in case of sale return applies to unfructified sale also. Tamil Nadu has prescribed two time-limits, six months for sales return [*Rule 10(6)(b)(i)(B)*] and three months for unfructified sale [*Rule 10(6)(b)(ii)(B)*]. In *Advani Oarlikon (P) Ltd vs. State of Tamil Nadu [2000] 119 STC 25 (STT-Tamil Nadu),* the assesse claimed deduction from turnover on account of unfructified sale. Section 4-D of Tamil Nadu General Sales Tax Act, 1959 at the relevant time provided that, where goods are returned for the reason that they were not taken delivery of by the person for whom they were intended, claim for refund of tax on such unfructified sale should be preferred within a period of thirty days of the receipt of the goods returned. Rejection of claim for adjustment of tax due to unfructified sale, made beyond the period of thirty days, was confirmed by the Tribunal, holding that when the provision contemplates time-limit for claiming sales return or refund or unfructified sale, then necessarily the time limit has to be adhered to while claiming the relief in the relevant assessment year. The position that unless there is completed sale, tax on first event was not chargeable, was not urged with force before the Tribunal.

In *Deputy Commissioner of Sales Tax (Law), Board of Revenue (Taxes), Ernakulam vs. Motor Industries Co. 1983 AIR 370; [1983] 53 STC 48 (SC)*, the apex Court held that deduction in respect of the goods returned by the purchasers must be claimed in the assessment year in which the goods were sold and not in the succeeding year when goods were returned. It was held:

> *...the deduction in respect of sales return has to be allowed in the assessment relating to the financial year in which the sales of the returned goods had taken place and even where assessment for that year is completed, the Department has to comply with the demand for adjustment or refund by making necessary rectification in the order of assessment, provided that other conditions are satisfied.*

Decision in *Motor Industries case (supra)* was followed in *State of Maharashtra vs. BASF (India) Limited [2000] 117 STC 543 (SC)*.

However, the above position applies to sales made in the course of inter-State trade or commerce only for the reason that, most of the State VAT Acts now specifically provide that adjustment on account of sale return or de-escalation of price shall be allowed in the return of tax period in which cause for such adjustment arise, on exchange of debit and credit notes between the buyer and seller [Delhi Section 8(2); Gujarat Section 8(2); Karnataka Section 30(3); Maharashtra Section 63(6)]. However, in absence of specific provision in State VAT Act, the position that adjustment need to be claimed in the year in which original sale took place shall prevail. ■