



GOODWILL – IF THE TAX DEPARTMENT HAS ITS WILL THEN IT WILL NOT BE GOOD ANYMORE

The Finance Bill, 2021 proposes to amend various sections of the Income tax Act, 1961 (the Act) to deny depreciation on goodwill. In any acquisition or merger/amalgamation, payment over and above the aggregate value of net assets acquired of the target company is a common practice. The acquisition price which is based on the fair value of the business being acquired is calculated on either of the two methods i.e. the discounted cashflow or the market multiple method. The excess price paid by the acquirer is towards a bundle of intangible rights which is not recorded in the books of account by the target and is commonly known as goodwill.

Existing position under the Act

Section 32 of the Act which provides for allowance of depreciation deals with both tangible and intangible assets. In respect of intangible assets, the section provides an inclusive definition of intangibles that are covered for the purpose of depreciation. The section covers *Intangible assets, being know-how, patents copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature*. On perusal it would be noted that goodwill is not explicitly covered in the aforesaid definition of intangibles and therefore there was a controversy which was put to rest by the Hon'ble Supreme Court in the case of **CIT v Smifs Securities Ltd. (2012) 348 ITR 302 (SC)** wherein it was held that goodwill arising at the time of merger is an intangible asset and is entitled to be depreciated u/s 32 of the Act.

The facts of the case were that YSN Shares and Securities Pvt Ltd (YSN) amalgamated with the assessee company in accordance with a scheme of amalgamation sanctioned by both the Bombay and Calcutta High Court. The excess consideration paid over the net assets acquired was treated as goodwill arising on amalgamation and depreciation was claimed by the assessee. The AO denied the depreciation holding that goodwill is not an asset by referring to explanation 3 to section 32.

The question before the Apex Court was whether goodwill is an asset under section 32 and whether depreciation is allowable or not. The findings of the Apex Court were:

"The Commissioner of Income Tax (Appeals) [CIT(A)', for short] has come to the conclusion that the authorised representatives had filed copies of the Orders of the High Court ordering amalgamation of the above two Companies; that the assets and liabilities of M/s. YSN Shares and Securities Private Limited were transferred to the assessee for a consideration; that the difference between the cost of an asset and the amount paid constituted goodwill and that the assessee-Company in the process of amalgamation had acquired a capital right in the form of goodwill because of which the market worth of the assessee-Company stood increased. This finding has also been upheld by Income Tax Appellate Tribunal [ITAT', for short]. We see no reason to interfere with the factual finding.

The Hon'ble Court further held that Explanation 3 states that the expression 'asset' shall mean an intangible asset, being know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature. A reading the words 'any other business or commercial rights of similar nature' in clause (b) of Explanation 3 indicates that goodwill would fall under the expression 'any other business or commercial right of a similar nature'. The principle of ejusdem generis would strictly apply while interpreting the said expression which finds place in Explanation 3(b). In the circumstances, we are of the view that 'Goodwill' is an asset under Explanation 3(b) to Section 32(1) of the Act."

Subsequent to this decision there have been plethora of judgements by various Courts wherein the decision of the Hon'ble Supreme Court has been followed. In a few cases and notable amongst them is the case of **United Breweries Ltd. Vs. Addl. CIT (ITA No. 722, 801 & 1065/Bang/2014 dated 30.9.2016)**, wherein a different view was taken. This view was however based on the peculiar facts of the case and is not in divergence with the view of the Apex Court. The ITAT in the said matter denied depreciation on goodwill by applying the 6th proviso to section 32(1) of the Act and Explanation 3 to section 43(1) of the Act.

The facts of the case were that during the year under consideration the assessee inter alia amalgamated its wholly owned subsidiary KBDL. The assessee acquired the entire shareholding of the company from the shareholders for consideration of Rs. 180.52 crores. In the books of account, the assessee had recorded the value of the assets on the basis of revaluation done by the valuer and thereby shown the goodwill at Rs.62.30 crores. The Assessing Officer did not accept the claim of depreciation on goodwill by holding that the assessee had not acquired any intangible assets in pursuant to the amalgamation of its subsidiary with the assessee and therefore as per the Assessing Officer the goodwill was not at all in existence. The Assessing Officer invoked the provisions of Explanation 3 to section 43(1) which confers a power on the AO to determine the cost if the Assessing Officer is satisfied that the main purpose of the transfer of such assets was the reduction of liability to income tax by claiming depreciation on the enhanced cost. As this was an amalgamation of the subsidiary with the assessee therefore all the assets which came to the assessee were already in use by the subsidiary and consequently the valuation of all the assets was subjected to the verification of the Assessing Officer as per Explanation 3 of section 43(1). The value of the goodwill shown in the books of KBDL was Rs.7.45 crores which was enhanced in the books of account of the assessee to Rs.62.30 crores.

The Assessing Officer also invoked the 6th proviso to Section 32 which restricts the depreciation in the hands of the successor or amalgamated company to the extent as apportioned between the amalgamating and amalgamated company in the ratio of number of days for which the assets are used by them as if no amalgamation had taken place. According to the Assessing Officer as goodwill was appearing in the books of the amalgamating company, no depreciation on the enhanced value of goodwill was permissible considering the said proviso.

The ITAT held and rightly so that the Assessing Officer has full powers to examine the value of goodwill under the existing provisions of the Act. It is important to note that the ITAT did not hold that goodwill is not a depreciable asset. As a matter of fact, the ITAT held that '*there is no quarrel on the issue that goodwill is eligible for depreciation*'. The point being made here is that the existing provisions were sufficient to check the alleged abuse of inflating the value of goodwill by taxpayers and there was no need to amend the Act.

Usually there is no goodwill appearing in the books of the amalgamating company as there is no cost of such self-generated goodwill and therefore goodwill arises only on account of the amalgamation/merger and in such cases the aforesaid provisions of the Act as relied upon by the Hon'ble ITAT in the case of United Breweries (supra) would not be applicable. Accordingly, in a case where goodwill arises on account of amalgamation/ merger the goodwill is eligible for depreciation in accordance with the judgement of the Apex Court.

Position as per Indian GAAP and Ind-AS

As per Accounting Standard (AS-26) on 'Intangible assets' goodwill is an intangible asset which has to be tested for impairment on an annual basis. Similar is the treatment under Ind-AS 38. Thus, it would be seen that under the accounting principles goodwill is a recognized as an intangible asset which is though not to be amortized/depreciated over a period of time but to be tested annually for impairment. In case on an annual test of impairment, if no such impairment condition exists then it needs to be carried at same value in the books of accounts and not be amortized or depreciated.

Amendments proposed

Finance Bill 2021 seeks to amend the law by making amendments to the concept of block of assets and section 32 of the Act which deals with depreciation. It is proposed to provide that the block of assets shall not include goodwill and likewise in section 32 it is proposed to provide that depreciation on goodwill will not be allowed. It is also proposed to amend section 50 of the Act to provide that in a case where goodwill of a business or profession formed part of block of assets for the assessment year beginning from 1st April 2020 and depreciation has been obtained by the assessee under the Act, the written down value of block of asset and short- term capital gain, if any, shall be determined in the manner as may be prescribed. Section 55 of the Act is also proposed to be amended to provide that in case of goodwill of business or provision acquired by the assessee by way of purchase from a previous owner and any deduction on account of depreciation under section 32 of the Act has been obtained by the assessee in any previous year preceding the previous year relevant to the assessment year commencing on or after the 1st April, 2021, then the cost of acquisition will be the purchase price as reduced by the depreciation so obtained by the assessee before the previous year relevant to assessment year commencing on 1st April, 2021. The said amendments shall take effect from 1st April, 2021 and will accordingly apply to the assessment year 2021-22 and subsequent assessment years.

Why the Finance Bill proposals need a reconsideration?

The Memorandum explaining the provisions of the Finance Bill lists down various reasons for proposing this amendment. These reasons are dealt clause by clause in the table below:

Sl. No.	Rationale given in the Memorandum	Remarks
1	Goodwill of a business or a profession has not been specifically provided as an asset either in the definition under clause (11) of section 2 of the Act or in section 32 of the Act.	<p>The question whether goodwill of a business is an asset and whether depreciation on goodwill is allowable has been decided by the Supreme Court in the case Smifs Securities Limited (<i>supra</i>). Once the Apex court has laid down a view then that becomes law of the land and whether it has been specifically provided for in the Act or not is irrelevant. A case in point is the procedure to be followed u/s 147 of the Act which was laid down by the Apex Court in the GKN Driveshaft case which procedure has been followed by the department since the time the decision was laid down by the Supreme Court.</p> <p>Therefore, this argument being put forth by the department has no merit.</p>

2	<p>Sixth proviso to section 32 of the Act mandates that in a case of succession/ amalgamation/demerger during the previous year, depreciation is to be calculated as if the succession or amalgamation or demerger has not taken place during the previous year and apportioned between the predecessor and the successor, or the amalgamating company and the amalgamated company, or the demerged company and the resulting company, as the case may be, in the ratio of the number of days for which the assets were used by them.</p>	<p>This proviso would be applicable only and only if goodwill is appearing in the books of the amalgamating company (Refer the United Breweries Case). If goodwill arises at the time of amalgamation or demerger then this proviso is not applicable.</p> <p>Therefore, recourse to this proviso to change the law is misplaced.</p>
3	<p>Sub-section (1) of section 43 of the Act which defines actual cost of the assets to the assessee. Explanation 7 to this section covers a situation where in a scheme of amalgamation, any capital asset is transferred by the amalgamating company to the amalgamated company and the amalgamated company is an Indian company. It clarifies that in this situation, the actual cost of the transferred capital asset to the amalgamated company shall be taken to be the same as it would have been if the amalgamating company had continued to hold the capital asset for the purposes of its own business.</p>	<p>This explanation is also applicable only if goodwill is already appearing in the books of the amalgamating/ demerged company.</p> <p>This would have no application where goodwill is arising on account of amalgamation/ merger/demerger as the amount paid over and above the net assets acquired would be the cost of the goodwill.</p>
4	<p>Thus, while Hon'ble Supreme Court has held that the Goodwill of a business or profession is a depreciable asset, the actual calculation of depreciation on goodwill is required to be carried out in accordance with various other provisions of the Act, including the ones listed above. Once we apply these provisions, in some situations there could be no depreciation on account of actual cost being zero and the written down value of that assets in the hand of predecessor/ amalgamating company being zero.</p>	<p>This argument is not a valid justification for amending the law. In fact, the department could have carved out cases considering the existing provision of the Act where depreciation on goodwill would not be allowed. The point that is being missed by the authorities is that in business combinations more often than not the amount paid (<i>even if consideration is discharged only by issuance of shares</i>) is higher than the aggregate value of net assets taken over. In such a case the difference paid is nothing but an amount which represents a bundle of intangible assets/rights which is collectively known as goodwill.</p>
5	<p>It is seen that Goodwill, in general, is not a depreciable asset and in fact depending upon how the business runs, goodwill may see appreciation or in the alternative no depreciation to its value</p>	<p>This argument being out fourth by the authorities is illogical. The fact that it is being acknowledged in the memorandum that this aspect depends on how 'business runs' in itself implies the goodwill may see an erosion in value as well. Further if one were to compare the case of a "brand" which is an intangible asset duly mentioned in section 32 of the Act, a similar argument can also be put forth that brands may generally see an appreciation in value.</p> <p>But the fact that brand is recognized as an intangible asset on which depreciation is</p>

	<p>allowed shows how illogical is the argument of the department.</p> <p>Instead of giving the argument as mentioned in the memorandum the authorities could have simply amended the law by giving clarity to the concept of the block of assets that this would include goodwill and provide for exceptions where depreciation would not be allowed.</p>
--	---

Way going forward

The proposal to deny depreciation on goodwill is likely to hurt the M&A activity in the Country. It would also result in more litigation as the taxpayer would now seek to apportion the excess amount paid over the net assets acquired on other tangible/intangible assets so as to claim depreciation on the excess amount paid. Given the fact that this Budget was supposed to be a growth-oriented budget, the proposal to deny depreciation on goodwill requires a definite reconsideration.

Sachin Vasudeva
 Partner
 SCV & Co. LLP
 Chartered Accountants