

Will Mergers & Acquisitions become tax – expensive?

Depreciation of goodwill has always been a contentious issue between taxpayers & the department.

Clause (11) of s. 2 of the Income Tax Act 1961 (ITA) defines 'block of assets' to mean a group of assets falling within a class of assets comprising of *Tangible assets, being buildings, machinery, plant or furniture* and *Intangible assets, being know – how, patents, copyrights, trade – marks, licenses, franchises or any other businesses or commercial rights*

s. 32(1) of the ITA provides for deduction on account of depreciation on *tangible assets (building, machinery, plant & furniture) and intangible assets (know – how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature) acquired on or after 1st April 1998.*

Thus, ITA does not specifically include 'goodwill' within the definition of s. 2(11) or even s. 32.

The question as to whether goodwill of a business is an asset within the meaning of s. 32 of the ITA & depreciation on goodwill should be allowed came up before the **Hon'ble Supreme Court** in the case of **Smiff Securities Limited [(2012) 348 ITR 302 (SC)]** wherein it was held that *goodwill acquired on amalgamation (being difference between the net book value of assets & consideration paid) was a capital right which fell within the expression 'any other business or commercial right of a similar nature' and hence eligible for depreciation while computing business income.* Thereafter, the **Apex Court** in the case of **PCIT V/s Zydus Wellness Ltd. (2020)** has dismissed the Special Leave Petition (SLP) *against the order of the High Court which upheld the decision of the Tribunal allowing the taxpayers claim for depreciation of goodwill.*

Thus, the Supreme Court has regarded goodwill as a commercial/business right eligible for depreciation under s. 32(1)(ii). Infact, the decision of the Apex Court in the case of Smiff Securities has been widely relied on Courts & Tribunals around the country to decide identical issues. However, this is still a matter of litigation before various courts.



The recent amendment by the Finance Bill 2021 to prohibit depreciation on goodwill has put the above controversy to rest. Below are the highlights of the amendment made:

“

Amendment by Finance Bill 2021

S. 2(11) provides that 'block of assets' shall not include the 'goodwill of a business or profession'.

S. 32(1)(iii) shall be amended to provide that 'goodwill of a business or profession' shall not be eligible for depreciation.

Explanation 3 to s. 32(1) defines 'asset'. However, it has been proposed that 'goodwill of a business or profession' shall not be treated as an 'intangible asset' for purpose of s. 32(1).

”

Definition of Witten Down Value ('WDV')

The definition of WDV under s. 43(6)(c)(ii) of the ITA has been amended. WDV in the case of block of assets would now be further reduced by the actual cost of goodwill failing within the block as follows:

In respect of FY 2020 – 21, relevant to AY 2021 – 22, where goodwill of a business or profession was part of block of assets on which depreciation was claimed by the taxpayer in FY 2019 – 2020, the amount of depreciation reduced by the actual cost of goodwill would be decreased by:

- a. Actual amount of depreciation on such goodwill allowed before AY 1988 – 89
- b. Amount of depreciation allowable to the taxpayer on such goodwill from AY 1988 – 89 onwards as if goodwill was the only asset in the relevant block.

The amount of reduction cannot exceed the WDV of the block of assets.

Rationale for making the amendment explained by the Memorandum

The term 'intangible asset' has been defined in s. 2(11) and Explanation 3 to s. 32 of the ITA. After the aforesaid amendments become effective, intangible assets will be defined as *intangible assets being know-how, patents, copyrights, trade – marks, licenses, franchises or any other business or commercial rights of similar nature **not being goodwill of a business or profession.***

The rationale behind exclusion of goodwill from the ambit of intangible assets is that *actual calculation of depreciation of goodwill is required to be carried out as per provisions of the Income Tax Act 1961. Once the relevant provisions are applicable, in some situations (like business re-organization) there could be no depreciation on account of actual cost being zero. It is further stated that goodwill, in general, is not a depreciable asset & it depends upon how the business runs, goodwill may see appreciation and in the alternative no depreciation to its value. Hence,*

The aforementioned amendments make it explicitly clear that 'goodwill' cannot be regarded as an 'asset' or cannot fall within the definition of 'block of assets' for the purpose of depreciation under s. 32(1).

Additionally, the following sections are also proposed to be amended:

- A new provision is proposed to be inserted into s. 50(2) that the CBDT may prescribe a manner to compute written Down Value ('WDV') of an asset & short term capital gain (if any) if goodwill is forming part of the block of assets and depreciation has been claimed on it.
- Consequential amendments are also proposed to be made to s. 55 which provide meaning of various terms including 'cost of acquisition' for the purpose of computation of capital gains.

The Bill which was introduced in 2021 did not amend s. 43(1) which defines WDV of block of assets. Consequently, the Finance Bill as passed by the Lok Sabha made the following amendments:

for the said reasons there is no justification of depreciation in the manner there is a need to provide for depreciation incase of other intangible assets or plant & machinery.

Points to Ponder –

1. The decision of the Apex Court in the case of Smiffs Securities Limited was delivered in the year 2012. More than 8 years after the pronouncement, the Government has decided to overturn it. Several organizations have taken the benefit of the depreciation on goodwill arising out of amalgamation or a business re - organization. An example of this would be Hindustan Unilever's acquisition of Horlicks in December 2018 from GlaxoSmithKline PLC, which had claimed high goodwill as depreciation and will now be impacted by this amendment as, tax experts said, goodwill claims are still pending of the previous years. Unilever had expected around 1.3 billion euros of the goodwill to be deductible for tax purposes from the Horlicks deal.¹
2. As per the memorandum, the said amendments will take effect from 1st April 2021 and will be effective AY 2020 – 2021 onwards. Since this is a substantive amendment, it would not be possible to deny taxpayers benefits of depreciation accruing for the previous years.
3. The newly proposed amendment will open up new avenues for litigation. What constitutes 'goodwill' and what doesn't, would be possible be a matter of debate. The economy of M&A transactions would be altered a great deal in the future especially where intangible assets form a substantial chunk of the transaction.
4. The effects of the amendment are two fold on big ticket mergers and acquisitions – it would greatly bring down the negotiating power of the seller & also substantially increase the tax outflow as in the hands of the acquirer company considering that no benefit of depreciation shall be available.

Conclusion

How businesses deal with this amendment as well as the impact on large value mergers & acquisitions would be seen in the long run. The rationale of the Government that the value of goodwill appreciates in the long run & therefore depreciation claim on this cannot be allowed holds valid. However, there are instances like Jet Airways India Ltd. which went into bankruptcy as well as Nokia (the number one mobile company during 2005 – 2010) which also highlight cases of goodwill losing its value. Under such situations, what could be the Government's stand – time to wait & watch.

¹ https://www.business-standard.com/budget/article/m-a-costs-to-go-up-after-budget-2021-axes-tax-depreciation-on-goodwill-121020300252_1.html