

Legal Analysis of Depreciation on Goodwill under Section 32(1) of the Income Tax Act, 1961

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Abstract: Section 32(1)(ii) of Income Tax Act, 1961 depreciation on specified intangible assets being know how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of a similar nature is allowable expense while determining the profit of the business for income tax purposes. The term goodwill have not been mentioned under section 32(1)(ii). Whether goodwill are in the nature of business and commercial rights of a similar nature under section 32(1)(ii) have been matter of considerable debate. The judgement of the Supreme Court in the case of *Smifs Securities Ltd.* put rests on the conflicting decisions of the High Court and the benches of the Tribunal over the matter. But Supreme Court in the case *Smifs Securities Ltd.* failed to give answer to questions regarding the valuation of the goodwill and inclusion of self generated goodwill under section 32(1)(ii).

Key Words: Goodwill, Depreciation, Amalgamation, Income Tax , Intangible asset

Introduction

According to Income Tax Act, 1961 while determining the income from business and profession only those expenses related to business and profession are allowed to be deducted from the profit. Section 30 to 37 of Income Tax Act laid down expenses which are expressly allowed as deduction from the profit of the business. In case if the expenses are not according to section 30 to 37 , then all those are required to be included in the profit before determining the income tax liability of the assessee. Section 32(1)(ii) of Income Tax Act depreciation is allowable on specified intangible assets being know how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of a similar nature.

Depreciation on goodwill has been matter of considerable debate. The term goodwill have not been mentioned under section 32(1)(ii). Whether goodwill are in the nature of business and commercial rights of a similar nature under section 32(1)(ii) , High Court and the benches of

the Tribunal having conflicting decision over the matter. The Mumbai Tribunal in the case of *Kotak Forex Bokerage Ltd. v. ACIT(2009) 33 SOT 237(Mum)* held that “goodwill” is nothing but a positive reputation built by a person or company business house over a period of time. Thus, goodwill is also business or commercial rights of similar nature and hence, eligible for depreciation under section 32 of the Act. But in the case of *R.G. Keswani v. ACIT(2009) 308 ITR 271(Mum)*, held that goodwill is not an intangible asset and is not eligible for depreciation under section 32. The Kerala High Court in the case of *B. Raveendran Pillai v. CIT(2010) 194 Taxmann(Ker)*, held that goodwill paid for acquiring a hospital with land building, equipment, staff, name, trademarks etc. is certainly for acquiring of business and commercial rights and was certainly comparable with trade mark, franchise, copyright etc. Thus depreciation will be allowed on such goodwill which is similar to business or commercial rights.

The judgement of the Supreme Court in the case of *CIT v. Smifs Securities Ltd., (2012) 13 SCC 488* put rests on the conflicting decisions of the High Court and the benches of the Tribunal over the matter.

Facts of the Case -Pursuant to a scheme of amalgamation, YSN Shares and Securities Private Limited (amalgamating company) was amalgamated into Smifs Securities Ltd.(amalgamated company), assessee Company. Thus the assets and liabilities of YSN Shares and Securities Private Limited were transferred to and vested in the assessee company. The excess consideration paid by the assessee company over the value of net assets acquired of YSN Shares and Securities Private Limited was considered as “goodwill” arising on amalgamation. The assessee company claimed that the extra consideration was paid towards the reputation which the amalgamating company was enjoying in order to retain its existing clientele. Accordingly, the assessee company claimed deduction of Rs. 54,85,430 as depreciation on such goodwill. The assessing officer held that “goodwill” was not an asset falling under explanation 3 to section 32(1) of the Income Tax Act, 1961(the Act) and that no amount was actually paid on account of goodwill.

On appeal, both the Commissioner of Income tax (Appeal) and the ITAT ruled in favour of the assessee. On further appeal, the High Court held no question of law arose in appeal and

dismissed the same. The revenue department appeal to the Supreme Court against the decision of High Court.

Issues before the Supreme Court

- (i) Whether goodwill is an asset within the meaning of Section 32 of the Act?
- (ii) Whether depreciation on goodwill is allowable under the above mentioned section?

Contentions of the revenue authority

No amount was actually paid on account of goodwill and goodwill is not an asset falling under Explanation 3 to Section 32(1) of the Act.

Contention of the assessee

Excess payment made to the transferor, i.e the amalgamating company should be taken as goodwill as it is the excess price paid over the value of net assets of the company for its reputation in front of the clientele.

Judgement

Explanation 3 to s. 32 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. 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). Consequently, “Goodwill” is an asset under Explanation 3(b) to s. 32(1) & eligible for depreciation. Though the AO held that the assessee had not “paid” anything for the goodwill, this cannot be accepted because (a) the CIT (A) & Tribunal (correctly) held that that the difference between the cost of an asset and the amount paid in the process of amalgamation constituted “goodwill” and (b) this aspect was not challenged by the department before the High Court.

Critical Comments

The Delhi Tribunal in the case of *ONGC Videsh Ltd. v. DCIT(2009) 127 TTJ 497 (Del)* held that participating rights acquired by the assessee in a production sharing agreement would be eligible for depreciation under section 32(1)(ii) of the Income Tax Act, as they are in the nature of business and commercial rights. The Supreme Court similarly in the case of *Techno Shares and Stocks Limited v. CIT (2010) 327 ITR 323*, held that –“ by virtue of Explanation 3 to Section 32(1)(ii) the commercial or business right which is similar to a licence or franchise is declared to be an intangible asset. The right to participate in the market has an economic and money value. It is an expense incurred by the assessee which satisfies the test of being a “licence” or any “other business or commercial right of a similar nature” in terms of Section 32(1)(ii). It mean that depreciation is allowable on other kinds of intangible assets which fall within the meaning of the expression “business or commercial rights of similar nature”. The Supreme Court in *Smifs Securities Ltd.* case has followed its earlier position in *Techno Shares*, and by applying the principle of *ejusdem generis* came to the conclusion that goodwill is included in the expression “any other business or commercial right of similar nature” in terms of s. 32(1)(ii). The judgement of the Supreme Court put rests on the conflicting decisions of the High Court and the benches of the Tribunal over the matter. The decision of the Supreme Court in the case of *Smifs Securities Ltd.* will be helpful to the business when they acquire another entity and the consideration of the tax benefit will certainly be factored into by considering the depreciation on goodwill. In this case Supreme Court failed to provide the rules relating to the valuation of “goodwill”. The Supreme Court specifically declined to provide any rule relating to the valuation of goodwill. Supreme Court simply held that the difference between the consideration for amalgamation and the net book value of assets of the amalgamating company constituted ‘ goodwill’. In this case Supreme Court also failed to give answer how to calculate the value of self generated ‘goodwill’ and whether self generated goodwill is also eligible for depreciation.

However in the case of *DCIT v. Toyo Engineering India Ltd., ITA No. 3279/Mum/2008* the ITAT discussed about the valuation of goodwill and held that excess payment made over some of the assets on amalgamation does not show the valuation of the goodwill . The value of all other assets and liabilities , other factors must be taken into consideration while determining the value of goodwill. Goodwill arising on amalgamation represents a payment



made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

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