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Tax alert: Goodwill created on amalgamation not genuine, not eligible for depreciation

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The Hyderabad Bench of the Income-tax Appellate Tribunal (ITAT) has held that based on the facts of the case, the goodwill created on account of amalgamation of the taxpayer with its wholly-owned subsidiary, was not real or genuine. Hence, the taxpayer was not entitled to depreciation on the same.

Background:

- The taxpayer[1] is a company engaged in the business of providing IT enabled services along with disaster recovery solutions, real-time data protection, and business continuity planning and offsite data storage solutions to its group companies.
- During the Financial Year (FY) 2016-17 corresponding to Assessment Year (AY) 2017-18:
  - The taxpayer acquired entire shareholding of an Indian company (S Co) on 1 August 2016 from its fellow subsidiary in Mauritius (F Co). S Co became a wholly-owned subsidiary of the taxpayer on acquisition. The valuation of the shares was done based on a valuation report (dated 16 June 2016) prepared on the basis of the Discounted Cash Flow (DCF) Method. As per the report, the fair value of S Co's share as on 31 March 2016, was valued at approximately INR 190 per share.
  - S Co amalgamated with the taxpayer by an order of NCLT[2] dated 15 May 2017, with the appointed date for amalgamation being 1 April 2016. The net asset value of S Co as on 1 April 2016, which was worked out at about INR 1 million, was supported by the valuation report dated 11 March 2017 – the intrinsic value worked out to approximately INR 80 per share.
  - The excess cost of investment, over the value of net tangible asset, was determined as 'goodwill' and the taxpayer claimed depreciation on the same under section 32(1)(ii) of the Income-tax Act, 1961 (ITA).
- During the course of audit proceedings, the Assessing Officer (AO) observed the following:
  - The amalgamation of S Co with the taxpayer was not on commercial or business exigencies, but it was a business combination within the intra-group, so as to create an ordinary intangible asset in the form of huge goodwill and, thereby, claim depreciation on it to lower the tax liability of the taxpayer.
  - The creation of an artificial intangible asset by the taxpayer in the intra-group companies without proper justification was, in the nature of employing a device of avoidance of tax.

  Accordingly, the AO disallowed the depreciation claimed on goodwill.
- Aggrieved, the taxpayer filed an appeal before the Hyderabad Bench of the Income-tax Appellate Tribunal

[1] Invesco India Private Limited v. DCIT Circle-2(1), Hyderabad [ITA No. 111/Hyd/2022] (Hyderabad ITAT)

[2] National Company Law Tribunal

(ITAT) against the final order of the AO.

Relevant provisions in brief:

Relevant extract of section 32[3] of the ITA

"(1) In respect of depreciation of—

(i) buildings, machinery, plant or furniture, being tangible assets;

(ii) know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature, being intangible assets acquired on or after the 1st day of April, 1998,

owned, wholly or partly, by the assesse and used for the purposes of the business or profession, the following deductions shall be allowed…"

Decision of the ITAT:

The ITAT noted/observed the following:

- The taxpayer had paid about INR 190 per share on 1 April 2016 and the same was determined by adopting DCF method. At the same time, the taxpayer had determined the net assets value at about INR 1 million and the intrinsic value of each share at about INR 80.
  - For showing investment in shares, the taxpayer had adopted DCF method of valuation of shares and in order to record 'goodwill', the taxpayer had adopted fair market value (FMV) of assets, both on the same date.
  - As per the AO, the valuer considered DCF method for the FY 2016-2017 to FY 2020-2021, even though, it was aware of the fact that S Co had been amalgamated w.e.f. 1 April 2016. Therefore, the method adopted for arriving at FMV of shares as on 31 March 2016 under DCF method was not acceptable.

    In view of the above, the method adopted for arriving at fair market value of shares as on 31 March 2016 under DCF method lost its sanctity and it was not acceptable.
- The fact that the taxpayer had made investment on 1 August 2016 and the Board of Directors adopted resolution for acquisition of S Co on 2 August 2016, clearly showed that, affairs of amalgamation were created with a view to create goodwill by adopting different valuation methods for investment and recording the value of assets for amalgamation.

  Further, S Co was a fully owned subsidiary of the taxpayer and F Co from whom shares were acquired was a subsidiary of parent company of taxpayer. Hence, these were intra-group transactions.
- The taxpayer claimed to have reported related party transaction in its transfer pricing study report. It was examined by the transfer pricing officer. Further, the purchase of shares from F Co was also subjected to approvals from NCLT and RBI. These facts did not alter the position that the taxpayer had inflated the enterprise value of the subsidiary, while purchasing the shares from its related party and at the same time, while recording goodwill in terms of amalgamation, had considered real value of the company which resulted in an artificial excess consideration in the nature of goodwill.

  Thus, the two methods adopted for the purpose of valuation of enterprise value i.e., one for the purpose of valuation of acquiring shares (DCF method) and the other for the purpose of recording goodwill (NAV method) could not be accepted.
- The taxpayer in association with its related parties designed a transaction so as to create an artificial intangible asset in the form of 'goodwill' and thereby, claim the depreciation on it, to lower the tax liability of

[3] Prior to amendment vide Finance Act 2021 w.e.f. 1 April 2021

the taxpayer. This creation of artificial intangible asset by the taxpayer in intra-group companies, without proper justification was, in the nature of an implied device to evade taxes.

- As per the transactions between the parties and the location of the entity in Mauritius, as the Mauritius based entity (F Co) was not liable to pay capital gains tax in India on account of tax treaty benefit, the taxpayer designed a plan to transfer the funds to the parent company through the structured transactions via Mauritius based company.

  Amalgamation between two companies is, for the furtherance of their business or consolidation of business for smooth operation for business. However, in the case under consideration, there was no furtherance of business between the two companies because of amalgamation. The taxpayer had failed to prove the benefit derived by creating goodwill in the books of accounts on account of amalgamation.

- When the taxpayer was aware of the enterprise value of S Co as on 31 March 2016 to be at about INR 1 million and the taxpayer had paid INR 2.4 million, then the taxpayer should have accounted the value of goodwill in the books of S Co.

  No goodwill existed in the books of accounts of the amalgamating company and no know-how, patent, copyright, trademark or franchise was acquired. The very fact that, such a goodwill was not valued and was not shown as an asset of the amalgamating company, showed that the taxpayer had not capitalised any value of the goodwill. Hence, the value of such goodwill in the form of intangible, should be taken as NIL.

- The Supreme Court (SC) in an earlier ruling[4], had decided the issue of goodwill as an intangible asset and eligible for depreciation under section 32 (1)(ii) of the ITA, in light of accounting of 'goodwill' on account of amalgamation of two companies. However, the proposition contended by the taxpayer is infructuous, as the 'goodwill' created by the taxpayer on account of amalgamation was not genuine and the taxpayer was not entitled for claiming depreciation on the same goodwill. Where goodwill created by the taxpayer was not a real one or genuine one, the question of considering the ratio laid down by the SC for the purpose of allowing depreciation, did not arise.

In view of the above, the ITAT held that the goodwill created by the taxpayer was not real or genuine, and hence, the taxpayer was not entitled to depreciation on 'goodwill'.

Comments:

This ruling, based on facts, has held that the taxpayer in association with related parties had designed a transaction so as to create an artificial intangible asset in the form of 'goodwill' and thereby, claim the depreciation on it, to lower the tax liability of the taxpayer. This creation of artificial intangible asset by the taxpayer in intra-group companies, without proper justification was, in the nature of an implied device to evade taxes. Hence, the goodwill created on account of amalgamation was not genuine.

It is pertinent to note that section 32(1)(ii) of the ITA has been amended vide Finance Act 2021 w.e.f. 1 April 2021 to exclude 'goodwill of a business or profession' from the purview of depreciation. While depreciation on goodwill is not available now, cost of acquisition in case of acquired goodwill may be available to the taxpayer on its sale by the taxpayer. Accordingly, one may want to examine if the goodwill arising on amalgamation can be considered as acquired goodwill and whether the amalgamated company can claim the cost of acquisition at the time of subsequent sale of business (which includes goodwill created on amalgamation) or on sale of goodwill. Taxpayers may evaluate the impact of this ruling to the specific facts of cases.

[4] Commissioner of Income-tax, Kolkata v. Smifs Securities Ltd. [2012] 24 taxmann.com 222 (SC)

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