



Depreciation on the inflated value of an intangible asset is disallowed by invoking Explanation 3 to Section 43(1) of the Income-tax Act dealing with ‘actual cost’

Background

Recently, the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Sanyo BPL Pvt. Ltd.¹ (the taxpayer) held that the Assessing Officer (AO) is justified in denying a depreciation claim on the inflated value of an intangible asset namely ‘distribution network’ upon transfer by way of slump sale. This has been done by invoking Explanation 3 to Section 43(1) of the Income-tax Act, 1961 (the Act) dealing with ‘actual cost’. The Tribunal observed that it is an ingenious attempt by the taxpayer to claim higher depreciation and avoid payment of tax. It is nothing but a colourful device adopted with the intention of tax avoidance.

Facts of the case

- The taxpayer is an Indian company engaged in the business of manufacturing and trading of colour television and accessories.
- The taxpayer was formed as a joint venture of Sanyo Electric Company Ltd., Japan and BPL Sanyo Ltd., on a 50:50 basis. The taxpayer acquired a business of manufacturing and trading of colour televisions from BPL Ltd., on a slump purchase basis in terms of business transfer agreement dated 14 December 2005 for a consideration of INR360 crore.
- This purchase consideration was accounted in the books of the taxpayer as per values assigned by Chowdhary & Associates, an independent registered valuer, among various assets including the distribution network on the basis of market value.

- As per a depreciation schedule, the total value of intangible assets was INR188 crore and addition of INR268 crore is shown. The break-up of intangible assets includes the value of distribution network of INR44 crore. The taxpayer had claimed depreciation at 25 per cent on the value of distribution network.
- During the Assessment Year, the Assessing Officer (AO) disallowed the claim for depreciation on the value of intangible asset known as ‘distribution network’ and depreciation on other fixed assets invoking the provision of Explanation 3 to Section 43(1) of the Act.
- The AO observed that the valuation of the distribution network is on the higher side and has been done to claim depreciation. What is transferred is only CTV division and BPL continues to do other divisions on its own.
- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO.

Tribunal’s ruling

Depreciation on intangible assets

- Even assuming that there is no intangible assets as distribution network as claimed by the taxpayer, excess of consideration paid over assets taken over constitutes goodwill as per judicial precedents in the light of the decision of the Delhi High Court in the case of Triune Energy Services (P) Ltd.².

¹ Sanyo BPL Pvt. Ltd. v. DCIT (ITA No. 1395/Bang/2014) – Taxsutra.com

² Triune Energy Services (P) Ltd. (ITA Nos.40 & 189 of 2015)

- Intangible assets qualifying for depreciation in terms of the law laid down by the Supreme Court in the case of Smifs Securities Ltd³.
- But the matter does not end there. Valuation of goodwill is also the bone of contention between the taxpayer and the revenue. Depreciation is admissible on the actual cost as the actual cost is required to be determined.
- The legislature has prefixed the word 'actual' to the word 'cost' in Section 43(1) of the Act which suggests that the intention of the Legislature was to curb the malpractices and tendencies to inflate capital costs for obtaining higher depreciation while not burdening the other with any material tax liability and to exclude collusive, inflated and fictitious cost.
- In this connection, observation made by the Delhi High Court in the case of Dalmia Dadri Cement Ltd.⁴ are apt. The AO has ample power to determine the 'actual cost' of the asset which is eligible for depreciation as the circumstances of the case would justify.
- In the present case, the very fact that the seller of the business had 50 per cent interest in the company and the taxpayer had failed to controvert the misgivings of the AO as to the inflation of the actual cost of the asset.
- These circumstances would certainly justify the AO to infer that a fictitious price has been set on the asset in order to avail higher depreciation under the Act.
- In any event, right to use distribution network does not result in creation of any intangible asset as neither the transferor company or the taxpayer had paid any money to the distributors for giving them distributorship of dealing in the products of the taxpayer.
- The AO is justified in denying a depreciation claim on the intangible asset of the distribution network on the inflated value of the asset. It is an ingenious attempt by the taxpayer to claim higher depreciation and avoid payment of tax.

- It is nothing but a colourful device adopted with the intention of tax avoidance and the principles enunciated by the Supreme Court in the case of McDowell & Co. Ltd.⁵ are squarely applicable.

Depreciation on other assets

- With respect to depreciation of other assets, the taxpayer claimed that the claim for depreciation was made on the basis of valuation done by an independent valuer among various assets.
- Though the AO accepted in principle, the method of apportionment of values to fixed assets based on the valuation of the independent valuer, the AO found fault in the method of valuation utilised by the valuer as, according to him, the immovable property owned by the taxpayer at Noida, was undervalued compared to the value as per the stamp duty.
- This raised the suspicion of the AO that the methodology adopted by the valuer is not free from doubt and therefore, the AO had not accepted the values assigned by the taxpayer to the assets and felt that the assets were overvalued in order to claim depreciation with the intention of avoiding tax liability and therefore, invoked the provisions of Explanation 3 to Section 43(1) of the Act.
- In this case, the assets were already depreciated in the hands of the seller i.e. BPL Ltd. and higher values were assigned by the taxpayer in order to avoid tax liability. Thus, ingredients which are necessary for invoking Explanation 3 to Section 43(1) are satisfied and the AO is justified in his action in restricting the allowance of depreciation.
- The findings given in respect of depreciation on the distribution network equally holds good even in respect of valuation of depreciable assets.

³ CIT v. Smifs Securities Ltd [2012] 348 ITR 302 (SC)

⁴ CIT v. Dalmia Dadri Cement Ltd. [1980] 125 ITR 510 (Del)

⁵ McDowell & Co. Ltd v. CTO [1984] 154 ITR 148 (SC)

Our comments

The Bangalore Tribunal in the instant case has applied the Supreme Court's decision in the case of McDowell & Co. Ltd and held that the taxpayer has adopted a colourable device with an intention to avoid tax. The observation of the Tribunal with respect to inflated figures of tangible and intangible assets in the transaction of slump sale between the related entities is far reaching. It would be interesting to see how tax authorities will deal with such transactions once the provisions of GAAR come into effect from Financial Year 2017-18.

Taxpayers should take necessary caution *inter alia* involving restructuring transactions to avoid application of anti-avoidance measures against them especially after GAAR provisions come into effect.



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