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TAX FLASH NEWS

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Restructuring related specific provisions under the Income-tax Act do not apply while allowing depreciation on goodwill in the scheme of amalgamation

Background

Recently, the Ahmedabad Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Urmin Marketing P. Ltd.[1] (the taxpayer) dealt with the claim of depreciation on goodwill arising in the scheme of amalgamation. The Tribunal held that the goodwill arising in the scheme of amalgamation is a part and parcel of intangible assets. Hence, the taxpayer is eligible for depreciation on the goodwill. The taxpayer had not acquired any goodwill from the amalgamating/transferor company and hence 6th proviso to Section 32[2], Explanation 7 to Section 43(1) and Explanation 2 to Section 43(6)(c)[3] of the Income-tax Act, 1961 (the Act) do not apply in the present case. Further the transaction cannot be regarded as a colorable device merely because the taxpayer had claimed depreciation on goodwill in the scheme of amalgamation.

Facts of the case

Unicorn Packers Private Limited (amalgamating company/UPPL) got amalgamated with the taxpayer [Urmin Marketing Pvt Ltd. (amalgamated company)/UMPL] in the scheme of amalgamation with effect from 1 April 2014. The scheme was approved by the Gujarat High Court. All the assets and liabilities of the amalgamating company as on 31 March 2014 became the assets and liabilities of the taxpayer (amalgamated company) with effect from 1 April 2014.

The net value of assets of UPPL was at INR 870.14 million as on the date of amalgamation. However, the purchase consideration of amalgamating company i.e. UPPL was valued at INR 5557.50 million. The purchase consideration was paid by the taxpayer by issuing its fresh equity shares to the shareholder of UPPL resulting the excess payment of INR 4867.36 million[4] over the assets and liabilities taken over by it. This excess payment was treated as goodwill by the taxpayer in the books of accounts. Further, the taxpayer in the return of income claimed depreciation at 25 per cent on such goodwill, treating the same as intangible asset.

The Assessing Officer (AO) observed that both the amalgamating and amalgamated company i.e. UMPL and UPPL belong to the same group of companies. Both the companies were owned, controlled and managed by the same promoters/directors. There was no business in amalgamated company i.e. taxpayer (UMPL) on the date of amalgamation as there was no vendor or customers in its books of accounts. Similarly, there was no goodwill recorded in the books of accounts of both the companies prior to the amalgamation. Accordingly, there should not be any question of goodwill owing to close connection between both the companies in the scheme of amalgamation.

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[1] Urmin Marketing P. Ltd. v. DCIT (ITA.No.1806/Ahd/2019) – Taxsutra.com

Note – This decision deals with a few issues. However, this flash news captures the issue with respect to depreciation on goodwill.

[2] Proviso 6 to Section 32(1) provides that the depreciation in case of amalgamation should be allowed to the amalgamated company to the extent what should have been allowed in case if amalgamating company.

[3] The provisions of Section 43(1) and 43(6) provide that the actual cost of the transferred assets and WDV should remain the same as it was there in the books of amalgamating company prior to the amalgamation.

[4] INR 5557.50 million – INR 870.14 million

Neither amalgamated company nor amalgamating company incurred any cost in acquiring such intangible assets. Therefore, depreciation was not available for any asset created in the books of accounts due to valuation and revaluation of assets and liabilities. Accordingly, the AO treated the value of goodwill as nil and denied the claim of depreciation in the year under consideration and also in the subsequent year.

The AO also observed that proviso 6 to Section 32(1) requires that the depreciation in the case of amalgamation should be allowed to the amalgamated company to the extent what should have been allowed in the case of amalgamating company. Similarly the provisions of Section 43(1)[5] and (6)[6] require that the 4actual cost of the transferred assets and WDV should remain the same as it was there in the books of amalgamating company prior to the amalgamation. Accordingly, the AO was of the opinion that as there was no goodwill in the books of amalgamating company prior to amalgamation, the value of goodwill in the books of amalgamated company should also be nil for the purpose of taxation.

The AO was of the view that intangible asset in the form of goodwill emerging in the books of resulting company (amalgamated company) was on account of valuation of business and revaluation of assets and liabilities which was not available in the books of accounts of the amalgamating company. As such neither amalgamated company nor amalgamating company incurred any cost in acquiring such intangible assets. Therefore, under the provisions of Section 32 depreciation is not available on any asset created in the books of accounts due to valuation and revaluation of assets and liabilities.

The AO observed that the valuation of UPPL was managed by the directors of the companies which was nothing but a colourable device in order to reduce taxable profit by claiming huge depreciation. The Commissioner of Income-tax (Appeals) [CIT(A)] confirmed the order of the AO.

Tribunal decision

Accounting aspects

The purchase consideration paid by the amalgamated company to the shareholders of the amalgamating company may be in excess of the value of the net assets taken over or some time it may be lower than the net assets taken over. As such purchase consideration to be paid to the amalgamating company by the amalgamated company is determined after considering various internal and external factors which may affect future profitability and growth. Such factors include previous earnings, future possible earnings, location, technical knowhow, customer base, marketing network, etc. Thus, it leads to difference between net value of assets taken over and purchase consideration paid.

Further, Accounting Standard (AS) -14 issued by the ICAI[7] prescribes two methods of accounting for the transaction carried out in the scheme of amalgamation namely pooling of interest method and purchase method. In the present case, the taxpayer by following the pooling of interest method of AS-14 recognised the difference as Goodwill in the books of account. The purchase consideration was paid by the taxpayer to the shareholders of the transferor/ amalgamating company as evident from the scheme of amalgamation. Hence, the purchase consideration exceeds the book value of net asset acquired by it. The excess amount was recorded as goodwill in the books of the taxpayer. Admittedly, the taxpayer incurred the cost more than the net book value of assets acquired by it in the scheme of amalgamation which has also been approved by the Gujarat High Court (vide order dated 24 July 2015) with effect from 1 April 2014.

Furthermore, it was mentioned in the scheme of amalgamation that the difference if any between the value of the assets acquired by the amalgamated company and the consideration paid shall be recorded either as capital reserve or goodwill as the case may be. It has been observed that the scheme for the amalgamation was presented before the Gujarat High Court for the approval in pursuance to the provisions of Section 391 to 394A of the Companies Act.

No objection from tax department on the amalgamation scheme

The Tribunal observed that the Ministry of Corporate Affairs (MCA) had filed an affidavit stating that as per the Circular[8], it has sent letter to the tax department to invite objection if any in the scheme of amalgamation. The tax department did not raise any objection within the time allowed by MCA or subsequently. It indicates that there was no grievance in the scheme of amalgamation.

The Mumbai Bench of NCLT in one of the petitions for amalgamation in the case of Gabs Investment Pvt Ltd (Transferor) and Ajanta Pharma limited (Transferee)[9] has not approved the scheme of amalgamation on the objection raised by the tax department.

Accordingly, in the present case the scheme was approved by the Gujarat High Court after receiving no objection from the tax department. It is implied that the tax department has given its consent in the present scheme of amalgamation by raising no objection in response to the letter issued by the regional director of MCA. Further, there was no dispute in the amount of the purchase consideration and the Net Asset Value (NAV) determined between the companies, as available in the scheme of amalgamation, which was approved by the Gujarat High Court as well.

[5] Explanation 6
[6] Explanation 2

[7] The Institute of Chartered Accountants of India
[8] MCA Circular No. 1/2014, dated 15 January 2014
[9] In CPS No 995 and 996/2017

Valuation of Goodwill and Eligibility of Claim of Depreciation

On a combined reading of Section 32, Section 43 and certain other provisions , it would appear that the intent of the Legislature is to make amalgamation a tax neutral scheme for companies as well as for the shareholders and not to provide a tax planning mechanism to either of them. However, a conjoint reading of the above provisions reveal that the assets which were transferred by the amalgamating company to the amalgamated company in the process of amalgamation were not made subject to the capital gain tax.

Furthermore, 6th proviso to Section 32 has limited the amount of depreciation available to the amalgamated company post amalgamation to the extent of the amount of depreciation which would have been available to the amalgamating company, had there not been any amalgamation.

Indeed, there was no entry in the books of the transferor/amalgamating company for the intangible assets/ goodwill being self-generated assets. However, it has been observed that all the relevant provisions of the Act deal with the assets available/recorded in the books of the transferor/amalgamating company. In other words, the assets which have been acquired by the taxpayer in the scheme of amalgamation would continue at the book value in the books of the amalgamated company.

The question arises whether the goodwill shown by the taxpayer was acquired in the scheme of amalgamation from the amalgamating company. The answer stands in negative. It is because there was no entry in the books of accounts of the amalgamating/transferor company reflecting the value of the goodwill. As such, the amount of goodwill as claimed by the taxpayer represents the difference between the purchase consideration and the NAV acquired by it. The purchase consideration paid by the taxpayer was based on the valuation report after considering various factors.

Thus, the taxpayer has not acquired any goodwill from the amalgamating/transferor company and hence the provisions of the Act i.e. 6th proviso to Section 32, Explanation 7 to Section 43(1), Explanation 2 to Section 43(6)(c) does not apply in the present case.

In the depreciation related provisions, the word goodwill has nowhere been mentioned. However, the Supreme Court in the case of Smifs Securities Ltd1 has held that the goodwill falls within the definition of the assets under the category of any other business or commercial rights of similar nature. Therefore, there remains no ambiguity that the goodwill is a part and parcel of intangible assets. Hence, the taxpayer is eligible for depreciation on the goodwill. The goodwill generated in the scheme of amalgamation was acquired by the taxpayer. Thus, the taxpayer had complied with all the conditions provided under Section 32 to claim the depreciation.

Inconsistency in valuation report and colourable device

The valuation of the business being a technical matter, the assistance of the expert is required. The AO himself cannot determine such value. If he was not satisfied with the valuation report, then the only recourse available to the AO is to refer the matter to the technical person. The Tribunal relied on the decision of Synbiotics Ltd[11].

It has been observed that both the companies namely UMPL and UPPL were registered on 28 August 2007 and 16 March 2010 respectively with the MCA. These 2 companies were filing separate income tax returns. Both the companies being body corporate have a separate legal identity. All these details were duly disclosed in the scheme of amalgamation which was duly approved by the Gujarat High Court vide order dated 24 July 2015.

It has been observed that vide letter dated 8 May 2015, the regional director of MCA has also invited comment or objection from the tax department, but the tax department did not raise any objection with respect to scheme of amalgamation.

The scheme contained all the information related to purchase consideration, its valuation, mode of payment and accounting treatment. The High Court approved such scheme after inviting comment from Registrar of Companies (ROC), MCA, and official liquidator including the income tax department. Thus, the reasonableness of the scheme cannot be doubted. Accordingly, an inference cannot be drawn that the taxpayer had employed colorable device in order to record high value of purchase consideration which has resulted into goodwill.

The Tribunal observed that the tax department has to consider certain facts before arriving at a finding whether a particular series of the transactions is a colourable device or not as the primary onus is on the AO to find out whether the parties to the transactions have concealed or hidden any fact and/or whether what is shown to be done could have actually happened in different time or at a different place.

The activity of amalgamation is very common and prevailing in the corporate world for synergizing resources, control, eliminate the competition, etc. In the present case, there was no reference made by the lower authorities suggesting that the transaction was carried out illegally. Moreover, the transaction in the instant case were within the ambit of the law.

There is no prohibition under the Act for disallowing the depreciation on the goodwill generated in the scheme of amalgamation. The provisions of General Anti-Avoidance rule (GAAR), POEM, and BEPS are not applicable for the year under consideration[12].

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

[11] Synbiotics Ltd v. ACIT reported in [2016] 48 ITR(T) 210 (Ahd)

[12] The present case pertains to the assessment year 2015-16 and GAAR, POEM, and BEPS provisions were introduced subsequently

There is no dispute to the fact that the payment was made by the taxpayer to the shareholders of the amalgamating company in the form of shares and not through the cash payment. The payment through the shares is valid mode of payment. The Tribunal relied on the decision of the Delhi High Court in the case of Mira Exim Ltd[13] to support its case.

Thus, the present transaction cannot be regarded as a colorable device merely on the reasoning that the taxpayer claimed the depreciation on the goodwill in the scheme of amalgamation.

Our comments

Allowability of depreciation on goodwill has been a matter of debate before the Courts/Tribunal.

In some of the cases, the Courts/Tribunal[14] have held that depreciation is not allowable on goodwill because it is not of similar nature to that of intangible assets viz. know-how, patents, trademarks, licences, franchise, etc. as specified under Section 32. In other words, it will not get covered under the expression 'any other business or commercial rights of similar nature'.

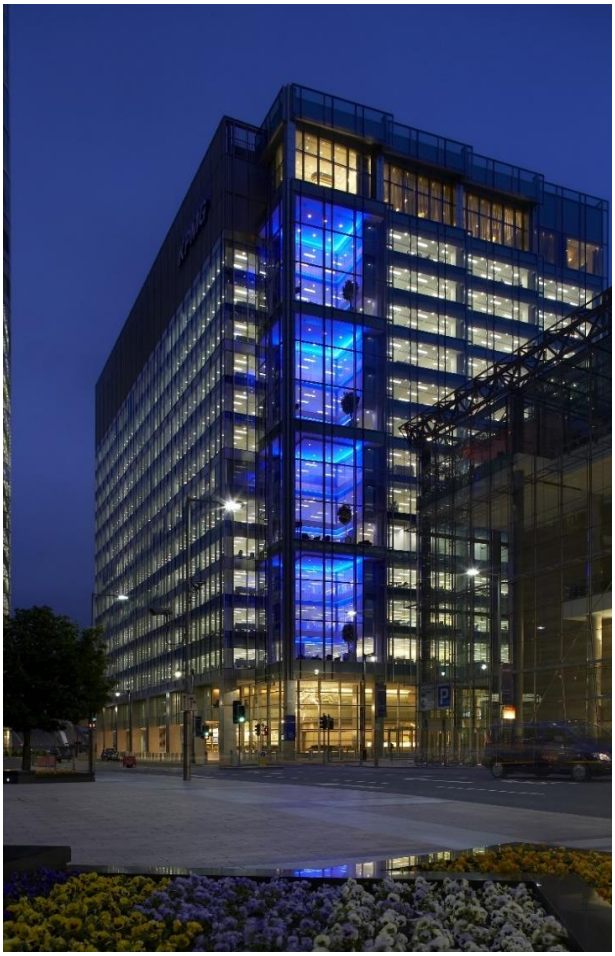
On the other hand, the Courts/Tribunal[15] have held that all the intangible rights mentioned under Section 32 are similar to the rights under goodwill and hence eligible for depreciation. Section 32 allows depreciation on both tangible and intangible assets. All these rights are similar to the rights under goodwill.

The Supreme Court in the case of Smifs Securities Ltd.[16] held that the goodwill being a difference between the amount paid and cost of shares in case of amalgamation scheme, was an asset eligible for depreciation under Section 32. The Supreme Court has applied the principle of ejusdem generis and held that the expression 'any other business or commercial rights of a similar nature' includes goodwill for the purpose of allowability of depreciation.

However, the Panaji Tribunal in the case of Chowgule & Co. (P.) Ltd.[17] invoked Explanation 7 to Section 43(1) and observed that in making the assessment of amalgamated company, such company could be allowed the depreciation on the depreciable assets of the amalgamating company or on the assets on which it has incurred actual cost. There was no such asset under the head goodwill (intangible asset) on which amalgamating company has ever claimed any depreciation or held as an asset is shown to have vested in the amalgamated company. Further no actual cost shown to have been incurred subsequently by the amalgamated company. Mere accounting entries do not give right to the amalgamated company to claim depreciation on goodwill (intangible asset) contrary to the provisions of law.

In the present case, the Tribunal has held that the goodwill generated in the scheme of amalgamation is a part and parcel of intangible assets. Hence, the taxpayer is eligible for depreciation on the goodwill. The taxpayer had not acquired any goodwill from the amalgamating/transferor company and hence 6th proviso to Section 32, Explanation 7 to Section 43(1) and Explanation 2 to Section 43(6)(c) cannot be applied in the present case.

The Tribunal has also held that the transaction cannot be regarded as a colorable device merely on the reasoning that the taxpayer claimed the depreciation on the goodwill in the scheme of amalgamation.



[13] CIT v. Mira Exim Ltd [2013] 359 ITR 70 (SC)
[14] Bharatbhai J. Vyas v. ITO [2005] 97 ITD 248 (Ahd), R.G. Keswani v. ACIT [2009] 116 ITD 133 (Mum), Borkar Packaging (P.) Ltd. v. ACIT [2010] 131 TTJ 99 (Panaji), CIT v. Mangalore Ganesh Beedi Works [2003] 128 Taxman 351 (Kar)
[15] CIT v. Hindustan Coca Cola Beverages (P) Ltd. [2011] 198 Taxman 104 (Del), B. Raveendran Pillai v. CIT [2010] 194 Taxman 477 (Ker), KEC International Ltd. v. ACIT [2010] 41 SOT 43 (Mum), India Capital Markets P Ltd v. DCIT (ITA.No.2948/Mum/2010)
[16] CIT v. Smifs Securities Ltd. [2012] 348 ITR 302 (SC)
[17] Chowgule & Co. (P.) Ltd. v. ACIT [2011] 10 taxmann.com 224 (Panaji)

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