

# TAX FLASH NEWS

13 January 2022

## Goodwill recognised due to revaluation of debtors and inventory post slump sale is not eligible for depreciation

Recently, the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Middleby Celfrost Innovations Pvt. Ltd.<sup>1</sup> (the taxpayer) dealt with the allowability of depreciation on the increased amount of goodwill due to revaluation of debtors and inventory post slump sale. The Tribunal observed that the taxpayer can claim depreciation on goodwill only on the difference between the consideration paid at the time of slump sale and the net value of assets that the taxpayer acquired under the slump sale. The taxpayer cannot vary the quantum of goodwill based on an exercise carried out subsequent to the slump sale and by passing book entries towards reduction in the value of sundry debtors and inventory even though there may be valid reasons for doing so.

Further, the Tribunal observed that both the sundry debtors and inventory items were part of the business that the taxpayer acquired on slump sale, and they will retain the same character as they had with the seller. The taxpayer only steps into the shoes of the seller in so far as the business was transferred on a going concern basis. Therefore, the taxpayer is entitled to claim bad debts and reduction in the value of inventory as a business deduction subject to the satisfaction of conditions under the Income-tax Act, 1961 (the Act).

### Facts of the case

During the Financial Year 2013-14, the taxpayer acquired the assets and liabilities of the refrigeration business of an Indian company as a going concern on a slump sale basis for a total consideration of INR 746 million through a Business Transfer Agreement (BTA) dated 15 October 2013.

After the conclusion of the slump sale, the taxpayer obtained a valuation report from an independent valuer for the allocation of the purchase price towards various assets (Purchase Price Allocation report or PPA report). As per the PPA report, all assets were recorded at a fair value and an allocation was made towards the brand value. The resultant excess purchase consideration paid was recognised towards goodwill.

The taxpayer carried out the adjustments to the values of sundry debtors and inventory took over from an Indian entity at the year-end, during the closing of the books of accounts. The book value of sundry debtors was reduced by INR 42.13 million and the book value of inventories was reduced by INR 86.11 million, totaling to Rs. 128.25 million, on account of which the goodwill was recognised. Apart from the above, adjustments were also made for certain liability (INR 15 million) and to the purchase consideration (INR 33 million). Consequently, the revised goodwill valued and recorded in the books by the taxpayer was at INR 527.05 million.

During the Assessment Year 2014-15, the taxpayer claimed depreciation on the said revalued goodwill. Alternatively, the taxpayer claimed deductions with respect to inventory and debtor's adjustment from the business profits.

The Assessing Officer (AO) accepted that the difference between the purchase consideration and the net value of the assets was goodwill entitled for depreciation under Section 32. However, the AO observed that to the extent of the amount which had arisen on account of adjustments to debtors and inventory, the same was not in terms of the valuation report. Therefore, depreciation was not allowed on the same. The Commissioner of Income-tax (Appeals) upheld the order of the AO.

<sup>1</sup> Middleby Celfrost Innovations Pvt. Ltd. v. DCIT (I.T.A. Nos.953 to 955/Bang/2019) – Taxsutra.com

## Tribunal's decision

### **Depreciation on Goodwill**

There is no provision in the Act as to how the purchaser in a slump sale has to record the value of assets/rights acquired in a slump sale when the value of assets/rights would be available and agreed by the parties. As per the agreement between the parties, the taxpayer acquired the refrigeration business on a slump sale basis for a particular sale consideration. In terms of the business purchase agreement, the cost/consideration allocated to various assets has to be recorded as bargained between the taxpayer and the seller of the refrigeration business.

In the present case, the taxpayer got the valuation done by an independent valuer. It was noticed that the debtor's account and inventory had been valued higher at the time of the slump sale. In terms of the decision of the Supreme Court in the case of *Smifs Securities*<sup>2</sup>, the taxpayer could claim goodwill only on the difference between the consideration paid at the time of slump sale and the net value of the assets that the taxpayer acquired by virtue of the slump sale.

The taxpayer cannot vary the quantum of goodwill based on an exercise carried out subsequent to the slump sale and by passing entries in the books of accounts towards the end of the financial year, even though there may be valid reasons for doing so. The tax department was justified in rejecting the taxpayer's claim for depreciation on the enhanced value of goodwill to the extent of INR 128.26 million.

Where the quantum of consideration attributable to various assets in a slump sale is sought to be varied from what was bargained between the parties, like in this case towards unrealisable debts/bad debts or reduction in the value of inventory, the claim can be made only by way of either a write-off of bad debt under Section 36(1)(vii) or diminution in the value of inventory by necessary entries in the books of account.

### **Allowability of debtor's adjustment from business profits**

The taxpayer had debited the entire provision related to debtors to the goodwill account and the same was not debited to the Profit & Loss account. Accordingly, no amount in this respect was claimed as a deduction in the return of income.

The taxpayer had disclosed the amount recovered from debtors in the subsequent years as income and offered the same to tax. Moreover, the taxpayer had not claimed any deduction in the P&L account or tax return when the same was written off in the books of accounts at a later point of time. If the goodwill adjustment was dismissed and the Tribunal disallowed the depreciation claim, the taxpayer would suffer a loss as it would perpetually lose its right to claim a deduction to which it is legally entitled.

The plea in this regard in principle is supported by the decision of the Supreme Court in the case of *T. Veerabhadra Rao*<sup>3</sup> where it was held that even if a debt is transferred from one owner to another, the transferee should be entitled to the same treatment as in the hands of the predecessor with respect to the debt transaction.

Accordingly, the plea raised in the alternative was accepted. The AO has been asked to examine the taxpayer's claim in this regard and allow the deduction in accordance with the law in the year of write-off in the light of the additional evidence.

## Our comments

The allowability of depreciation on goodwill has been a subject matter of debate before the Courts. The Supreme Court, in the case of *Smifs Securities Ltd*, had held that the goodwill of a business is an intangible asset eligible for depreciation. Subsequently, some of the Courts/Tribunal have allowed depreciation on goodwill.

In the present case, the issue was with respect to the allowability of depreciation on the increased amount of goodwill due to revaluation of debtors and inventory post slump sale.

The Bangalore Tribunal, in the present case, has held that the taxpayer is not eligible for depreciation on goodwill arrived at after the fair value adjustment made to the debtors and inventory in the book of accounts. However, for AY 2014-15, the taxpayer could claim depreciation on goodwill only on the difference between the consideration paid at the time of slump sale and the net value of the assets that the taxpayer acquired by virtue of the slump sale.

The Finance Act, 2021 has introduced various amendments to exclude 'goodwill of a business or profession' from being classified as a depreciable asset with effect from 1 April 2021.

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<sup>2</sup> CIT v. Smifs Securities Ltd. [2012] 348 ITR 302 (SC)

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<sup>3</sup> CIT v. T. Veerabhadra Rao [1985] 22 Taxman 45 (SC)

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