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FEBRUARY 2021

Depreciation on Goodwill
The road ahead

The controversy as to whether "Goodwill" of a business is an "intangible asset" eligible for depreciation was settled by the Hon'ble Supreme Court ('SC') in the case of Smifs Securities Ltd[1]. The SC in this case affirmed that goodwill acquired pursuant to amalgamation of a business is an intangible asset eligible for depreciation under section 32 of the Income-tax Act, 1961 ('Act'). Several subsequent judicial precedents which have relied upon the aforesaid SC decision and granted the benefit of depreciation on goodwill to the taxpayer.

However, the Finance Bill, 2021 ('FB 2021') has proposed certain significant changes in this regard. As per the proposals contained in FB 2021, 'goodwill' is not considered to be a part of block of assets and hence is not eligible for depreciation.

The amendments proposed[2] vide FB 2021 are listed below:

a.	Section 2(11)	Definition of 'block of assets' amended to exclude 'goodwill' from its ambit
b.	Section 32	Goodwill also excluded from list of qualifying intangible assets eligible for depreciation
c.	Proviso to section 50(2)	Manner to determine Written Down Value and Short Term Capital Gains to be prescribed (in a case where block of assets comprising of goodwill ceases to exist)
d.	Determination of cost of acquisition of goodwill as per section 55	Purchase price to be reduced by depreciation already obtained till Assessment Year ('AY') 2020-21

Practical issues and challenges

Given the proposed amendment, depreciation on goodwill will not be allowed as a deduction henceforth. However, the following issues merit consideration:

- **a** Treatment of goodwill already existing in the block of intangibles? Should it be reduced from the block of intangible assets to compute depreciation for future years?
- **b** Assuming that the existing block of intangibles also has other intangible assets other than goodwill, how would the depreciation be computed?
- **c** Will the past years depreciation claim on goodwill get impacted?
- **d** Treatment of unabsorbed depreciation on goodwill which is brought forward from earlier years?
- **e** Usually in a business acquisition/merger/demerger, there might be many intangible assets/rights with goodwill being a residual figure. How should a taxpayer approach allocation towards other intangibles and the basis to determine whether any of these qualify for depreciation? Could the Revenue question such detailed allocation by asserting that these are nothing but actually a part of goodwill?
- **f** Was a robust and a scientific Purchase Price Allocation ('PPA') towards intangible assets carried out in the past? Any need or ability to revisit the PPA basis the disclosures in tax audit report, etc.
- **g** Ability to revise the tax return to reflect the appropriate allocation towards various components of intangible assets or a fresh claim during assessment/appellate proceedings
- **h** Optimal mode of business acquisition for new M&A transactions – slump purchase, amalgamation, demerger, share acquisition?
- **i** Eligibility of other intangible assets (customer contracts, distribution network, etc.) to claim depreciation in cases where such intangibles are acquired through (i) slump sale (ii) amalgamation / demerger

[1] *[2012] 348 ITR 302 (SC)*
[2] *Slated to be effective from AY 2021-22 i.e. for FY 2020-21 and onwards*

Plausible alternatives to claim depreciation on goodwill in a case where goodwill forms part of block of assets as on April 1, 2020

a) Continue claiming depreciation on the entire block of intangibles

- Once an asset enters a block, it loses its identity – several favorable judicial precedents on this count
- No mechanism provided in law or in FB 2021 to compute value of goodwill which needs to be reduced from existing WDV (unlike specific provisions for slump sale, etc.)
- May not be workable if goodwill is the only asset in the block of intangible assets; in which case bifurcating the goodwill into various other components may be explored on a case-to-case basis

b) Purchase Price Allocation

- Depending upon the level of PPA done in the past and disclosures around such intangibles in the block, explore whether reallocation of higher amounts to non-goodwill intangibles is possible (Trade marks, license, customer contracts, knowhow, distribution network, etc)
- Revising the tax return for AY 2020-21 (if already filed) by March 31, 2021 basis the revised PPA
- Claim depreciation only on reallocated non-goodwill items
- Filing the original return for AY 2020-21 by February 15, 2021 basis the revised PPA

c) Restructuring of business / other intangibles[3]

- Exploring whether the business / other intangibles lying in the block of intangibles need to be restructured to maximise the tax efficiency due the budget proposals
- Any such restructuring of the business or other intangibles to be considered basis the business and commercial justification and overall regulatory implications arising therefrom including direct and indirect taxes.

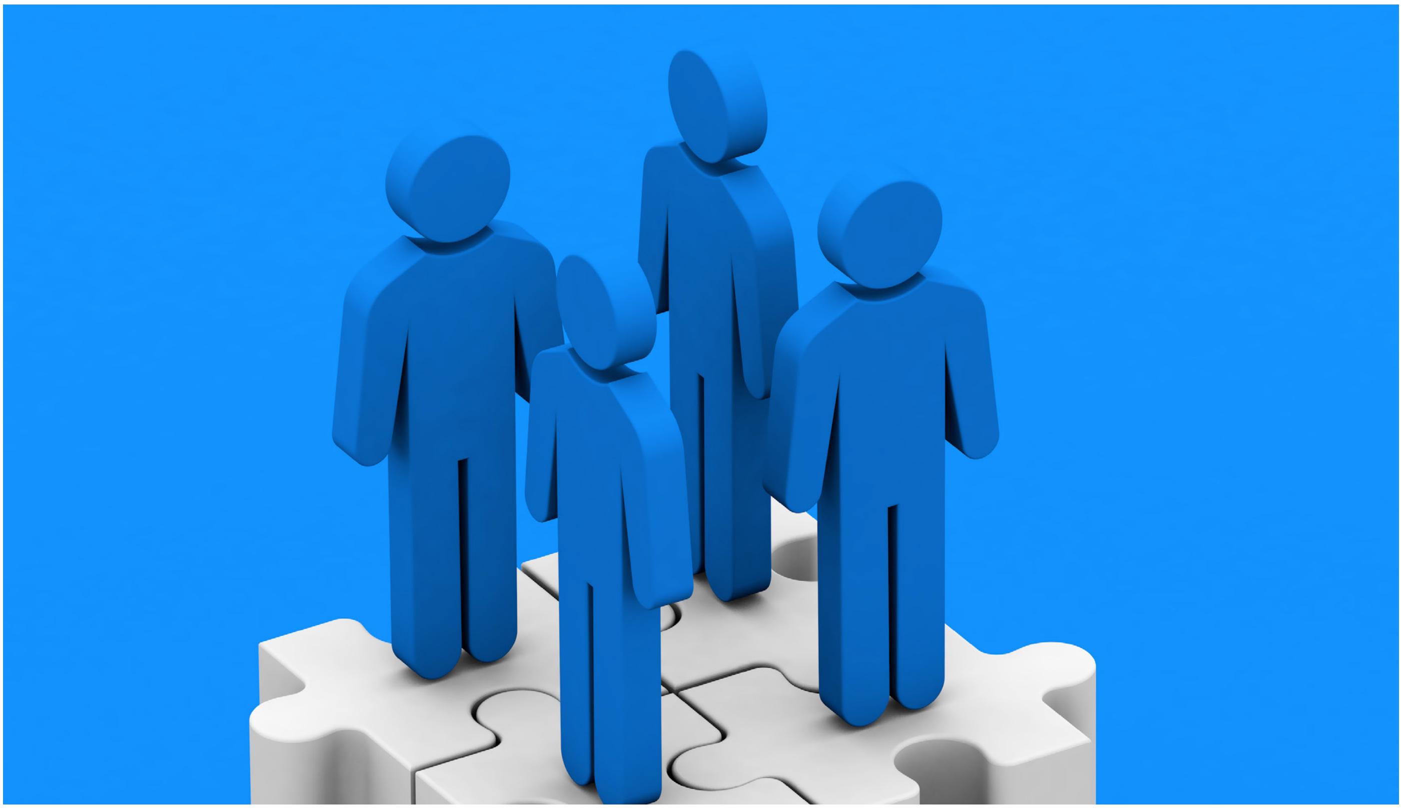
Plausible alternatives for new M&A transactions

a) More scientific and robust PPA into qualifying intangibles other than goodwill

- Detailed analysis of accounting guidelines on recognition of intangibles
- Review of tax case laws on intangibles especially business or commercial rights of a similar nature.
- Balancing between accounting and tax case laws on intangibles.
- Identifying appropriate valuation approach in obtaining valuation reports from technical experts, as applicable

b) Different forms of business acquisition specially if businesses acquired through acquisition of target company's shares

- Consider alternative forms of business consolidation including non-tax neutral mergers / demergers
- Analysing tax implications, if any, in hands of transferor and transferee



[3]*Alternatively, slump sale of entire business undertaking along with goodwill may also be explored. The purchaser in turn will undertake appropriate PPA (including towards goodwill and non-goodwill items). There should be no capital gains tax liability for seller if slump sale done at tax WDV / book value.*

Concluding remarks

The amendment is a significant one and will have a far-reaching impact on future as well as concluded M&A transactions. The fact that depreciation on goodwill is not sought to be allowed even in cases where it is purchased would significantly increase the tax cost of M&A transactions. Hitherto, as a matter of conventional practice, taxpayers generally used to record the difference between the purchase consideration over net assets acquired as 'goodwill' or 'intangible assets' without further bifurcating it into several components. Going forward, a robust and a scientific PPA would assume far more importance to determine the appropriate quantum of goodwill and non-goodwill items. For new M&A transactions, a direct acquisition of a business under a slump sale arrangement may be more preferable as compared to an amalgamation or demerger in order to achieve overall tax efficiencies. Certain other avenues such as liquidation of the target company post acquisition or considering a non-tax neutral merger could also be explored depending upon the fact pattern of each case.

How can Dhruva assist?

1. Analysing whether claim of depreciation on goodwill forming part of existing block is maintainable for future years
2. Assisting and coordinating with a valuer to undertake a PPA
3. Review / restructure existing business models to ensure overall tax efficiencies
4. Advocacy on various aspects where the scope/ applicability is not clear
5. Assistance in review and/or revision of past tax returns to appropriately reflect the value of goodwill and non-goodwill intangibles
6. Evaluate potential opportunities to achieve optimal tax positions for past as well as future transactions
7. Assistance in obtaining opinion from tax counsels on a case-to-case basis

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