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DEPRECIATION OF GOODWILL

AUTHORED BY - TAMILSELVI D

INTRODUCTION

Goodwill essentially represents a company's reputation and plays a crucial role when one buys a business. It reflects not just the personal value of the company but also its business value, including its assets, contacts, and goodwill itself. Previously, goodwill was considered a depreciable asset, meaning it provided economic benefits over multiple reporting periods. The Income Tax Act, 1961, defines two types of assets tangible and intangible but does not explicitly include goodwill in either category. Although the judiciary had recognized goodwill as a depreciable asset, this status was short-lived. The 2021 Union Budget clarified that goodwill is not a depreciable asset.

The Union Budget 2021 amended the Income Tax Act, 1961, to prohibit depreciation on the goodwill of a company. The Act disallows depreciation on self-generated goodwill, and from 01 February 2021, no depreciation is permitted on the exercise of goodwill related to ownership interests. Goodwill is explicitly excluded from the 'extraordinary assets' category. However, deductions for payments made for the acquisition of goodwill are legally permissible upon its sale. This raises the question of whether depreciation is allowable on acquired goodwill, which we will explore in detail.

CONCEPT OF GOODWILL AND DEPRECIATION

GOODWILL MEANING

Goodwill is an invisible force, hard to earn and takes years to build, but once earned, its benefits can be reaped for years and generations. The importance of goodwill transcends the limited scope of a business and actually permeates an individual's life.

In business terms, goodwill is the amount of value that a company's reputation adds to its overall value. Goodwill is the sum total of what a business has done in the past, what it is doing in the present, and what it plans for the future. A company's reputation primarily depends on its behavior with customers, society and the environment, development of trust in its brand, transparency in its processes and ethical behavior of the company. If a business manages all these, it will automatically gain goodwill for the company or brand.

Goodwill is the reputation of a business. Goodwill is considered as an intangible asset for any organization or business. Goodwill generally reflects the value of intangible assets such as a strong brand name, good customer relationships and good employee relations. Goodwill is calculated on the difference between the total value of the company and the value of its net tangible assets.

VARIOUS FEATURES OF GOODWILL

In a business context, "goodwill"[1] refers to the intangible value of a company's reputation, brand name, customer loyalty, and other factors that contribute to its overall positive perception in the market. Goodwill is often associated with the excess of the purchase price of a company over its net tangible assets when another company acquires it. Here are some key features and aspects of goodwill:

Intangible Asset: Goodwill is an intangible asset, meaning it does not have a physical

[1] Goodwill meaning - *available at:* https://www.vedantu.com/commerce/goodwill / (visited on 05 May 2024)

 ISSN: 2582-6433

existence but represents the value of non-material elements of a business.

Brand Value: One of the primary components of goodwill is a company's brand value. A strong brand name, positive brand recognition, and customer loyalty can significantly contribute to the goodwill of a company.

Customer Loyalty: Companies with a loyal customer base tend to have higher goodwill. The positive relationship with customers can lead to repeat business, referrals, and increased sales.

Reputation: A company's reputation in the market, among customers, suppliers, and other stakeholders, can impact its goodwill. A positive reputation can attract more business opportunities and support growth.

Employee Skills and Experience: The skills, experience, and expertise of the employees can contribute to a company's goodwill. Highly skilled and motivated employees can positively influence the company's performance and reputation.

Favorable Supplier Relationships: Goodwill can also be influenced by strong and favorable relationships with suppliers, ensuring a steady supply of quality materials or services.

Patents and Intellectual Property: Owning valuable patents or intellectual property can enhance a company's goodwill, as it provides a competitive advantage and potential for future growth.
Customer Base and Market Share: Companies with a large and diverse customer base or a significant market share tend to have higher goodwill due to their established position in

the market.

Market Presence: The strength of a company's presence in various markets and geographic locations can impact its goodwill.

Financial Performance: A company's consistent and strong financial performance over time can contribute to its goodwill, as it indicates stability and profitability.

Strategic Advantage: Goodwill can arise from having a unique strategic advantage, such as proprietary technology, exclusive licenses, or a dominant market position.

It's important to note that goodwill is subject to impairment testing, and if there is a decline in the factors contributing to goodwill, the company may need to write down its value on the balance sheet. Additionally, the accounting treatment of goodwill varies based on accounting standards, such as Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS).

TYPES OF GOODWILL

There are two distinct types of goodwill: acquired and inherent.[2]

1. **PURCHASED GOODWILL**

Purchased goodwill arises when a business concern is purchased for an amount greater than the fair value of the separable acquired net assets. As a result, it is shown as an asset on the balance sheet—a type of goodwill that is recognized in a company's accounts.

[2] Goodwill types, *available at:* https://www.holded.com/blog/goodwill-meaning-features-types (visited on 07 May 2024)

2. **INHERENT GOODWILL**

Inherent goodwill is the opposite of purchased goodwill and represents the value of the business rather than the fair value of its separable net assets. This type of goodwill is internally generated and arises over time due to reputation, and can be positive or negative.

Inherent goodwill is, of course, better to have. Best of all, it costs you nothing and you can get a lot out of it. Intrinsic goodwill takes a lot of time to build, however, certain factors have a major impact on it.

DEPRECIATION MEANING

Depreciation refers to the accounting method used to allocate the cost of a tangible or intangible asset over its useful life. Depreciation refers to how much an asset's value has been used up. It allows companies to generate revenue from assets they own by making payments over a period of time.

Since companies do not have to fully account for assets in the year they are acquired, the immediate cost of ownership is significantly reduced. Not accounting for depreciation can greatly affect a company's profitability. Companies may depreciate long-term assets for tax and accounting purposes.[3]

Depreciation can be compared to depreciation, which accounts for the change in value of intangible assets over time
Section 32 of the Income Tax Act 1961 talks about depreciation.

Depreciation means that over time, any asset deteriorates and loses its original value. Depreciation is when a purchased asset loses its monetary value due to wear and tear, time and daily use.[4]

The monetary value of an asset decreases over time due to use, wear and tear or

[3]What is depreciation- *available at:* https://www.investopedia.com/terms/d/depreciation.asp (visited on 08 May 2024)
[4] Sec 139 of depreciation - *available at*: Income tax act,1961.

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obsolescence. This decrease is measured as depreciation.[5]

VARIOUS FEATURES OF DEPRECIATION

Depreciation is an accounting method used to allocate the cost of tangible assets over their useful life. This process allows businesses to spread the cost of acquiring an asset over its expected lifetime, matching the expense with the revenue generated from using the asset. Here are some key features of depreciation:

Cost Allocation: Depreciation helps allocate the cost of an asset over its useful life rather than expensing the entire cost in the year of purchase. This is more representative of the asset's actual contribution to revenue generation over time.

Non-Cash Expense: Depreciation is a non-cash expense, meaning no actual cash outflow occurs when recording depreciation. It only affects the book value of the asset and reduces the company's net income.

Useful Life: Assets have a limited useful life, which is the estimated period they can be effectively utilized by the business. Depreciation is calculated based on this useful life.

Residual Value: The residual value (also known as salvage value or scrap value) is the estimated value of the asset at the end of its useful life. It is subtracted from the original cost when calculating depreciation.

Depreciation Expense: This is the amount of depreciation recorded on the company's income statement for a specific accounting period. It reflects the portion of the asset's cost

[5]Definition of depreciation- *available at :* https://m.economictimes.com/definition/depreciation/amp (visited on 08 May 2024)

 ISSN: 2582-6433

that has been allocated as an expense during that period.

Accumulated Depreciation: This is the total depreciation expense recorded for an asset since its acquisition. It is a contra-asset account and reduces the asset's book value on the balance sheet.

Book Value: The book value of an asset is its original cost minus its accumulated depreciation. It represents the asset's net carrying value on the balance sheet.

Impacts on Taxes: Depreciation is often tax-deductible, allowing businesses to lower their taxable income and reduce tax liabilities.

Depreciation Policies: Companies must choose a consistent depreciation policy for each class of assets, adhering to generally accepted accounting principles (GAAP) or international financial reporting standards (IFRS).

Depreciation Schedule: A depreciation schedule outlines the depreciation expense for each accounting period over an asset's useful life.

Depreciation for Different Asset Classes: Different types of assets (e.g., buildings, machinery, vehicles) have different depreciation rates and useful lives, depending on their nature and expected longevity.

Overall, depreciation plays a crucial role in financial reporting, as it accurately reflects the wear and tear of assets and their diminishing value over time. Properly accounting for depreciation is essential for presenting a company's financial position accurately and making informed business decisions.

 ISSN: 2582-6433

TYPES OF DEPRECIATION

There are four common methods of calculating depreciation for an asset, each with its own advantages and disadvantages. Here's a brief overview of each method:

1. **Straight line depreciation:** This method evenly spreads the cost of an asset over its useful life, with the same amount of depreciation being recorded each year. This is a simple and straightforward method, but it may not reflect the actual decline in an asset's value over time.

2. **Units of production depreciation:** This method bases the depreciation on how much the asset is used or produces. The more an asset is used, the more depreciation is recorded. This method is useful for assets that wear out faster with use, such as machinery or vehicles.

3. **Double declining balance depreciation:** This method records more depreciation in the early years of an asset's life, and less in later years. This reflects the fact that many assets lose value more quickly when they are newer. However, this method can be more complex to calculate and may not be suitable for all assets.

4. **Sum of years' digits depreciation:** This method also front-loads more depreciation in the early years, but it uses a formula based on the number of years in the asset's useful life to determine the rate of depreciation. This method may be useful for assets that have a predictable pattern of decline in value over time.

Ultimately, the choice of depreciation method will depend on the nature of the asset, the company's accounting policies, and other factors such as tax implications.[6]

DEPRECIATION OF GOOD WILL

[6] *Supra* note 2.

 ISSN: 2582-6433

Goodwill is easy to describe but difficult to define. Goodwill is an intangible asset that represents the value of a company's reputation, customer relationships, and other non-physical assets. It consists of an established business apart from a new business any excess of the net value of the asset taken in liquidation is called goodwill.[7] Depreciation of goodwill is now disallowed but continues to apply to other intangible assets such as trademark; copyright etc. section 32 of income tax rules provides provisions relating it depreciation. [8]We know that the value of machinery, land etc. may decrease over time and this decrease is called depreciation. Goodwill was considered a depreciable asset because it fell into the category of intangible assets and was believed to depreciation over time like any other asset. But the Memorandum to the Finance Bill, 2021 states that goodwill is not a depreciation asset as it can be appreciated rather than depreciated. This phenomenon of depreciation helped a tax payer to pay taxes but now with the new law, a Pandora of new rulings will surely open. Unlike physical assets such as machinery or equipment, goodwill does not have a definite useful life and is not subject to wear and tear. As a result, goodwill cannot be depreciated using the traditional methods of depreciation.

However, accounting standards require that companies test goodwill for impairment at least annually or more frequently if certain events occur that suggest that the fair value of the asset may be impaired. Impairment testing involves comparing the carrying value of the goodwill (i.e., the amount recorded on the company's balance sheet) to its fair value. If the carrying value exceeds the fair value, an impairment loss must be recognized to reduce the carrying value to its fair value. This impairment loss is reported as a non-operating expense in the company's income statement.

[7] Depreciation of goodwill, *available at:* https://taxguru.in/income-tax/depreciation-acquired-goodwill-allowable-provisions-income-tax-act-1961.html
[8]Depreciation relating provision – *available at:* Income tax Act, 1961.

In summary, while goodwill cannot be depreciated using traditional methods, it is subject to impairment testing to ensure that its value on the balance sheet is not overstated. If an impairment loss is recognized, it will reduce the carrying value of the goodwill on the balance sheet and result in a non-operating expense in the income statement.

COURT DECISION

The ambiguity about whether goodwill is depreciable led to the question of whether it could be treated as "any other similar commercial or business rights." In the early 1980s, the Supreme Court of India defined the term goodwill as follows:

Goodwill refers to the benefit arising from association and reputation. A variety of elements go into its manufacture, and its composition varies in different trades and in different trades within the same trade, and one element may predominate in one trade, while another may predominate in another. Its value may fluctuate from one moment to another depending on changes in the reputation of the business. It is affected by the business, the personality and business integrity of the owners, the nature and character of the business, its name and reputation, its location, its impact on the contemporary market, the prevailing socio-economic ecology, and introduction. To older customers and acknowledged non-competition.[9]

The court did not address whether goodwill is depreciable, which created much controversy, and was aggravated by conflicting decisions rendered by various Indian courts and tribunals. Finally, in a judgment issued on August 22, 2012, the Supreme Court settled

[9]Court decision, *available at:* https://www.bdo.global/en-gb/microsites/tax-newsletters/corporate-tax-news/issue-59-july-2021/india-certain-goodwill-no-longer-eligible-for-depreciation#:~:text=Finance%20Act%2C%202021,-Finance%20Act%2C%202021&text=Effective%201%20April%202021%2C%20the,an%20asset%20for%20depreciation%20purposes

the issue, ruling that goodwill arising in a joint venture fall within the ambit of the phrase "any other similar commercial or business rights." An intangible asset is eligible for depreciation as per Explanation 3(b) to section 32(1) of the Income Tax Act.

The Supreme Court decision held that taxpayers were able to depreciate goodwill over a period of years, particularly in the context of acquisition and/or restructuring transactions, thereby reducing their taxable income and tax liabilities. For about 10 years following the Supreme Court's decision, taxpayers have been claiming depreciation of goodwill arising from business acquisitions and other business reorganizations.

PROVISION OF IT ACT DEALING WITH DEPRECIATION

The Indian Income Tax Act, 1961 provides for the deduction of depreciation in determining the taxable income of an assesses.

SECTION 32: DEPRECIATION

Section 32 of the IT Act lays down the concept and procedure for depreciation.[10] First, it classifies assets into two categories- tangible assets such as buildings, machinery, plant or furniture and intangible assets such as technical know-how, right, license etc. In the case of tangible assets such as machinery, plant or furniture, depreciation can be carried out by reducing the value of the asset if it exceeds a certain value. It says that a car used for tourism purposes and used outside India cannot be exempted. It also states that depreciation cannot be allowed for new machinery in case of price reduction as per central government norms. Section 32 of the Income Tax Act, 1961 deals with the provisions related to the deduction of depreciation. Depreciation is a reduction in the value of an asset over time due

[10]Section 32 – *available at:* https://incometaxindia.gov.in/Acts/Finance%20Acts/1998/102120000000009269.htm#:~:text=(a)%20tangible%20assets%2C%20being,commercial%20rights%20of%20similar%20nature (visited on 23 Feb 2023)

to wear and tear, obsolescence, or other factors. The section provides for the calculation of depreciation on various assets used for business or profession, such as buildings, plant and machinery, furniture, vehicles, etc. Depreciation is allowed as a deduction from the income of the taxpayer, which reduces the tax liability.

Section 32 of the Income Tax Act, 1961 deals with the provisions related to the deduction of depreciation. Depreciation is a reduction in the value of an asset over time due to wear and tear, obsolescence, or other factors. The section provides for the calculation of depreciation on various assets used for business or profession, such as buildings, plant and machinery, furniture, vehicles, etc. Depreciation is allowed as a deduction from the income of the taxpayer, which reduces the tax liability.

SECTION 45: CAPITAL GAINS

Section 45 of the Income Tax Act, 1961 deals with the provisions related to capital gains. Capital gains arise when an asset is sold or transferred and the sale price is higher than the cost of acquisition. The section provides for the calculation of capital gains on various assets such as stocks, bonds, mutual funds, real estate, etc. The capital gains are classified as long-term or short-term, based on the holding period of the asset. The tax rate for long-term capital gains is lower than that of short-term capital gains.[11]

SECTION 50: SPECIAL PROVISION FOR COMPUTATION OF CAPITAL GAINS IN CASE OF DEPRECIABLE ASSETS

Section 50 of the Income Tax Act, 1961[12] deals with the special provision for the

[11]Section 45-capital gain - *available at:* Income tax department (visited on 23 Feb 2023)
[12]Section 50: Special provision for computation of capital gains in case of depreciable assets –*available at:* https://indiankanoon.org/doc/1705981/#:~:text=%2D%20Where%20the%20capital%20asset%20is,issued%

computation of capital gains in case of depreciable assets. Depreciable assets are those assets on which depreciation is allowed as a deduction from the income of the taxpayer. The section provides for the calculation of capital gains on the sale of such assets, taking into account the depreciation claimed on the asset during the period of ownership. The capital gains are calculated by reducing the cost of acquisition of the asset by the amount of depreciation claimed on the asset. The resulting amount is then taxed as capital gains.

RECENT AMENDMENTS IN THE IT ACT REGARDING GOODWILL-AN ANALYSIS

The decision to write off goodwill from depreciable assets has received a mixed reaction from the tax community. Some of the fears (or we can say negative side) of revision are-

This will increase the tax burden. All recent contracts will have to be reviewed as taxes will now be reversed as depreciation is no longer allowed. The memorandum to the Finance Bill says that goodwill cannot be reduced but that is not true. Goodwill can be impaired if a merger or acquisition goes wrong. There are of course other instances where goodwill may be impaired. The proposal does not differentiate between depreciation and amortization on wholesale in a merger and acquisition agreement as goodwill has a different definition in the two cases. The proposal would lead to double taxation, in which neither the buyer nor the seller would benefit.

Depreciation on goodwill is always an essential component in calculating the after-tax returns of an acquisition proposal and can strongly influence the pay-back calculations of every M&A deal and the associated negotiations in an auction or offer price for an asset.

RECENT AMENDMENTS

The most recent amendment to the provisions of depreciation under the Income Tax

20when%20the%20Indian%20Income%2D (visited on 24 Feb 2023)

Act was made by the Finance Act, 2021. The Finance Act, 2021 has introduced certain changes to the provisions of depreciation under Section 32 of the Income Tax Act, which are as follows:

i. Depreciation on goodwill: The Finance Act, 2021 has amended the definition of "block of assets" under Section 2(11) of the Income Tax Act to include "goodwill of a business or profession" as a separate block of assets. This means that the taxpayer can claim depreciation on the goodwill of a business or profession separately, which was not allowed earlier.

ii. Extension of time for claiming depreciation: The Finance Act, 2021 has extended the time limit for claiming depreciation on certain assets, such as buildings, plant and machinery, etc., from the previous limit of 180 days to 270 days from the end of the financial year in which the asset is put to use.

iii. Increase in depreciation rate for motor vehicles: The Finance Act, 2021 has increased the depreciation rate for motor vehicles from 15% to 30% for vehicles purchased between April 1, 2020, and March 31, 2021. This increase in depreciation rate is intended to provide relief to the automobile industry, which has been impacted by the COVID-19 pandemic.

iv. Introduction of new investment-linked deduction: The Finance Act, 2021 has introduced a new investment-linked deduction under Section 32AD of the Income Tax Act, which allows a deduction of 15% of the actual cost of new plant and machinery acquired and installed by a taxpayer engaged in the manufacturing or production of any article or thing. This deduction is available for investments made between October 1, 2020, and March 31, 2023.

These are the recent amendments made to the provisions of depreciation under the Income Tax Act, 1961.

 ISSN: 2582-6433

CIT v. Smifs Securities Ltd.[13]

In the amalgamation between YSN Shares and Smifs Securities Ltd., the company incurred a bad debt and sought a depreciation deduction of Rs. 54,85,430 for goodwill. Initially denied, the company approached the Court, which ruled in its favor, allowing the deduction. The Court recognized goodwill as an intangible asset eligible for depreciation, applying the principle of 'ejusdem generis,' equating it with other business or commercial rights of a similar nature.

Triune Energy Services P. Ltd. v. DCIT[14]

The assessing officer denied the deduction for goodwill. The assessee argued that since the opposing party had goodwill, it should be deducted. The Delhi High Court agreed, noting that goodwill, as an intangible asset, offers a competitive advantage and various benefits when a business is acquired.

Bremko Brake India v. DCIT[15]

The income tax tribunal ruled that acquiring a business includes acquiring intangible assets such as a customer list and know-how, with goodwill being one of them, similar to acquiring machinery and other tangible assets.

[13] *CIT vs Smifs securities Ltd. - available at:* https://itatonline.org/archives/cit-vs-smifs-securities-ltd-supreme-court-goodwill-is-an-intangible-asset-eligible-for-depreciation-us-32/#:~:text=Smifs%20Securities%20Ltd%20(Supreme%20Court),-Posted%20on%20August&text=Pursuant%20to%20an%20amalgamation%20of,goodwill%E2%80%9D%20and%20depreciation%20of%20Rs

[14] *Triune Energy Services P. Ltd. v. DCIT*, ITA 40 of 2015

[15] *Bremko Brake India v. DCIT*, ITA No.1488/PN/2011

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United Breweries v. ACIT[16]

The case differed in that it did not directly support considering goodwill as a depreciable asset. The ruling stated that an amalgamating company is not entitled to goodwill depreciation if it is not claimed by the amalgamated company.

Pitney Bowes India (P) Ltd. v. DDCIT[17]

The company was denied a goodwill deduction as it had not previously claimed it before the High Court and Supreme Court. The Court also rejected the alternative plea to allocate the value of Government Authorizations/Approvals (GAs) towards goodwill, as the taxpayer must adhere to the value assigned by an independent evaluator.

CONCLUSION

Goodwill, once considered a depreciable asset providing economic benefits over multiple reporting periods, has undergone significant reclassification under the Income Tax Act, 1961 (Income Tax Act). The Act generally categorizes assets as either tangible or intangible, with goodwill not explicitly included in either category. Historically, the judiciary recognized goodwill as a depreciable asset, but this status was short-lived. The 2021 budget clarified that goodwill is not a depreciable asset.

Depreciation on goodwill is crucial in calculating the post-tax return of an acquisition proposal, significantly affecting pay-back calculations in M&A deals and influencing bid or offer prices for assets. With the rise of pre-pack solutions for stressed assets and Infrastructure Investment Trusts (InvITs) facilitating the monetization of infrastructure like highways, airports, and railways, the ability to depreciate goodwill could enhance returns for buyers. The government might reconsider allowing depreciation on

[16] *United Breweries v. ACIT,* I.T. A. No.722, 801 & 1065/Bang/2014
[17] *Pitney Bowes India (P) Ltd. v. DDCIT*, ITA Nos. 289 to 293/Del/2013

goodwill from business acquisitions, potentially adjusting the depreciation rate to align with international standards if necessary.