

TAX FLASH NEWS

The Delhi High Court accepts various factors like product monopoly, duration of business functioning and volume of orders to be executed as sufficient basis for goodwill evaluation

Background

Recently, the Delhi High Court (High Court) in the case of *Motherson Auto P. Ltd.*¹ (the taxpayer) dealt with the issue of goodwill valuation. The High Court held that the monopoly enjoyed by the taxpayer in respect of the product manufactured, the continuous functioning of its business and the large volume of orders at hand when the collaboration transaction took place, were sufficient basis for valuation of goodwill. There is no stipulated matrix of factors which are to be taken into consideration for such valuation.

Facts of the case

- The taxpayer, an Indian company was taken over by a new company i.e. Motherson Sumi Systems Pvt. Ltd. in terms of a collaboration agreement dated 3 December 1986. The new company was promoted by the taxpayer and two Japanese companies.
- As per the collaboration agreement which was approved by the Central Government, the consideration of the unit as a going concern could be adjusted against the goodwill of the taxpayer.
- The valuation of the goodwill was based on 'assumptions and projections' approved by the investing/purchasing Japanese Companies, and evaluated by a chartered accountant nominated with the concurrence of the Japanese companies. The total consideration (including the goodwill) agreed upon by the parties was INR6.09 million.

¹ CIT v. Motherson Auto P. Ltd. (ITA 178/2001) – Taxsutra.com

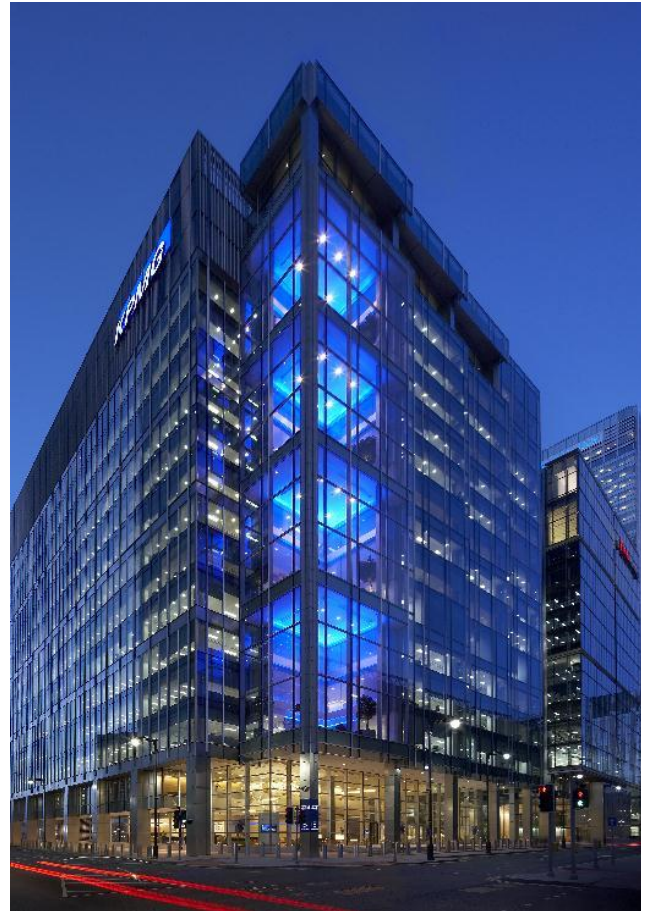
- During assessment proceedings for the assessment year (AY) 1987-88, the taxpayer claimed the value of goodwill transferred was INR5.13 million. However, the AO was of the opinion that valuation of the goodwill was not based on any established principle and therefore, the AO did not accept such goodwill valuation.
- The Assessing Officer (AO) also concluded that the taxpayer had incurred a loss during the previous year and further the goodwill claimed was founded on the expertise drawn from the collaborating company.
- The Delhi Tribunal observed that the report of the chartered accountant, supported the taxpayer's stand. Though the taxpayer was incorporated in 1984, it had taken over the business of an existing firm, Sehgal Cables.
- Though the taxpayer had incurred losses during the first year of its operation, those losses were wiped out during the next year. Also, the taxpayer had orders worth INR48.7 million in its hand when the takeover transaction had taken place and that it had a manufacturing monopoly over the product i.e. wireless harness. Accordingly, the Tribunal allowed the taxpayer's appeal.

High Court's ruling

- The High Court referred to the Tribunal's order and observed the following basis for valuation of goodwill:
 - The taxpayer, though established in 1984, was continuously engaged in the business since 1975, when Sehgal Cables started functioning.

- The taxpayer had unexecuted orders worth INR48.7 crore on hand, when the collaboration agreement was signed and its profit for one year offset the loss for the previous year.
- The taxpayer had a manufacturing monopoly over one product, i.e. wireless harness.
- The Supreme Court's decision in the case of S. C. Cambatta², indicates that there is no stipulated matrix of factors which are to be taken into consideration for valuation of goodwill. The length of time for which a business might operate, its profitability, etc. are relevant. Equally relevant is whether, and to what extent it has competition in respect of the business activities it undertakes, the market acceptability and demand for the product or services in question, capital employed, unique expertise developed, etc.
- The weight attached by the Tribunal to the monopoly enjoyed by the taxpayer in respect of the product manufactured, the continuous functioning since the business of Sehgal Cables had been taken over by the taxpayer and the large volume of orders at hand when the collaboration transaction took place, were sufficient basis for valuation. The Tribunal's view therefore has some basis in law.
- The AO and Commissioner of Income-tax (Appeals) did not refer to the report of the Chartered Accountant firm nor cared to call that firm.
- In the circumstances, it cannot be held that the valuation of goodwill made by the taxpayer was unreasonable or untenable in law.
- Accordingly, the sum of INR5.13 million received by the company from its collaborators was on account of goodwill and was not exigible to tax.

However, this decision is relevant from the goodwill valuation perspective where the High Court has observed that in relation to goodwill valuation, the length of time for which a business might operate, its profitability, extent of competition in respect of the business activities undertaken, the market acceptability, demand for the product or services, capital employed, unique expertise developed, etc. are relevant and sufficient factors for valuation of goodwill.



Our comments

This decision is pertaining to AY 1987-88. Subsequently, Section 55(2) has been amended with effect from AY 1988-89 to provide that for the purpose of computing capital gains, the 'cost of acquisition' in relation to the self-generated goodwill shall be 'nil'. Accordingly, in relation to the self-generated goodwill, capital gains are levied on the consideration received from the sale of such goodwill.

² S. C. Cambatta and Co. Private Limited v. Commissioner of Excess Profits Tax, Bombay [1961] 41

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