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Client acquisition cost held to be an intangible asset being “business and commercial rights of similar nature”, eligible for depreciation allowance under section 32(1)(ii) of the Income-tax Act

In brief

The Income-tax Appellate Tribunal (Tribunal), Hyderabad has recently delivered a judgment in the case of M/s SKS Micro Finance Limited¹, (the assessee or the Company) on the issue of allowability of depreciation on the acquisition of the customer base of the seller pursuant to a slump sale agreement. In this case, the Tribunal held that the payment made by the assessee for acquiring the customer base is towards acquiring an intangible asset being “business and commercial rights of similar nature” and hence eligible for the allowance of depreciation under section 32(1)(ii) of the Income-tax Act, 1961 (the Act).

Facts

- The assessee, a micro finance lender (Company), acquired Swayam Krishi Sangam Society (SKSS) through a business transfer agreement by way of slump sale during the Assessment Year (AY) 2006-07.
- The total consideration under the business transfer agreement was assigned towards physical/actual assets and for value creation of the customer base or customer acquisition cost.
- The assessee claimed depreciation allowance at the rate of 25% on such a cost, it being an intangible asset under the provisions of section 32(1)(ii) of the Act.

¹ SKS Micro Finance Ltd. v. DCIT [TS-283-ITAT-2013(Hyd)]

- The assessing officer (AO) denied assessee's claim on the ground that the intangible asset, as claimed to be acquired by the assessee, does not fall under any of the identified intangible assets appearing in the Income-tax Rules, 1962 (the Rules).
- On appeal, the Commissioner of Income-tax (Appeals) (CIT(A)) referring to section 32(1)(ii) of the Act, observed that depreciation allowance was intended to be allowed to a limited category of intangible assets and held that the customer base acquired cannot be termed as know-how, patent, copyright or trade mark or franchise. Furthermore, CIT(A) also took such expenditure out of the purview of the residuary category of "business and commercial right or similar property" as it does not relate to intellectual property whereas section 32(1)(ii) of the Act contemplates depreciation allowance in respect of those licenses or rights which relate to intellectual property.
- Aggrieved by the order of the CIT(A), the assessee filed an appeal before the Tribunal.

Issues before the Tribunal

Whether the payment made for client acquisition cost/right to access the customer base of SKSS was an intangible asset within the meaning of the definition of intangible asset as laid down in section 32(1)(ii) of the Act?

Revenue's contentions

- The AO contended that the assessee had acquired part of the already existing business of SKSS and hence, the said asset had not been created during the course of the business of the assessee and cannot be considered to be a business or commercial rights of similar nature.
- It was observed that the benefits from business gains were enjoyed by SKSS, whereas, the assessee had only acquired the clientele available on the rolls of

SKSS by making a lump sum payment.

- The AO also opined that mere collections of installments in respect of finances already made by SKSS cannot be said to amount to the user for the purpose of its business.
- Furthermore, the assessee made the lump sum payment in lieu of foregoing a future business relationship with the transferor company. Hence, the expenditure incurred was capital in nature.
- Lump sum payment by the assessee did not bring any durable asset into existence and for claiming depreciation allowance, ownership and use of the asset are the pre-requisites which are not fulfilled in the present case.
- In view of the above, the AO held that the right over the clients cannot be said to be an intangible right as defined under section 32(1)(ii) of the Act read with Rule 5 of the Rules.

Assessee's contentions

- The right to access the customers of SKSS is an intangible asset used for the purpose of the business of the Company.
- Definition of intangible asset under section 32 of the Act is an inclusive definition and hence for any other asset to fall within the purview of a depreciable asset, it should partake the character of "any other business or commercial rights of similar nature" which has not been defined in the Act and hence should be assigned the meaning as assigned in various judicial precedents.
- The assessee has the capacity to control the future benefits from the customers which arises from legal rights enforceable in a court of law.

- Customers once acquired would have business relationship with the assessee for a period of 3 to 5 years. Also, the association was reasonably secured and assured and the cost was also measured reliably as those have been separately identified and paid for.
- The assessee owns/possesses the right to access the customers of SKSS, thus satisfying the condition for acquisition in respect of an intangible asset and the said asset has been used in the business/profession of the assessee.
- To fall within the definition of intangible asset as mentioned in Rule 5 of the rules, the intangible asset can either be created or acquired from outside for consideration.
- As per section 32(1)(ii) of the Act, the client acquisition cost paid is a license in the nature of business or commercial rights. By payment of the consideration towards acquiring the customer base, the assessee acquired the right over more than 1 lakh clients and hence, it acquired a right for the purpose of business of its business which being a commercial right is eligible for depreciation allowance.

Tribunal Ruling

- Tribunal held that the client acquisition cost paid by the assessee was towards acquiring an intangible asset and therefore eligible for depreciation allowance under section 32(1)(ii) of the Act.
- Tribunal noted that the assessee fulfilled the necessary conditions required for claiming depreciation allowance under section 32 of the Act and went to determine that whether the cost paid for acquisition of clients could be considered an intangible asset under section 32 (1)(ii) of the Act.
- Tribunal referred to the Memorandum of Understanding between the assessee and SKSS and observed that the customer base acquired by the

assessee was an assured source of economic benefit and provided impetus to the business of the assessee as the customers acquired had a proven track record since they had already been trained, motivated, credit checked and risk filtered.

- To interpret the meaning of the expression “business or commercial right of similar nature” Tribunal relied on the judgment of *Smifs Securities Limited*² and various other judgments of the High Court/Tribunal and distinguished the judgment of the Delhi High Court in the case of *Sharp Business Systems*³ observing that the words ‘similar’ or ‘commercial rights’ necessarily result in an intangible asset against the entire world which can be asserted as such to qualify for depreciation allowance under section 32(1)(ii) of the Act.
- Hence, Tribunal held that by acquiring the customer base, the assessee has acquired business and commercial rights of similar nature and hence it was eligible to claim depreciation allowance under section 32(1)(ii) of the Act.

Conclusion

The Tribunal ruling provides a useful precedent for claiming depreciation allowance for residuary/other category of intangible assets. While the Supreme Court judgment in the case of *Smifs Securities Limited* has clarified the position regarding depreciation allowance on goodwill, the ITAT ruling is a welcome decision to support the claim of depreciation allowance on other items of intangible assets which could be classified under the heading “business and commercial rights of a similar nature” and eligible for a depreciation allowance under section 32(1)(ii) of the Act.

² CIT v. SMIFS securities Limited (SC)(348 ITR 302)

³ Sharp Business Systems India Ltd. v. DCIT (ITAT Delhi)(140 TTJ 607)

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