Budget 2023: Proposal to deem nil cost of acquisition and improvement for intangible assets

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In a development likely to have widespread impact on routine business transactions, the Finance Bill, 2023 (**Bill**) has proposed that the cost of acquisition and improvement of self-generated intangible assets should be deemed to be NIL. Courts have earlier held such costs as unascertainable and therefore, it was not possible to compute the amount of capital gains income subject to tax (i.e., *sale consideration* as reduced by the *cost of acquisition* and *cost of improvement* of the capital asset). However, with this proposed deeming provision, such a calculation will be possible. This may have unintended consequences – for instance, certain routine business transactions may be subject to capital gains tax.

> The Finance Bill, 2023 proposes to deem the cost of acquisition and improvement for self-generated intangible assets to be NIL (zero).

1 Background

As per the provisions of the Income Tax Act, 1961 (**ITA**), any income arising from the transfer of a capital asset is chargeable to tax under the head '*capital gains*'. The ITA provides a mechanism to compute such capital gains income. Broadly, the amount of capital gains income subject to tax is computed as the '*sale consideration*' as reduced by the '*cost of acquisition*' and '*cost of improvement*' of the capital asset.

The terms '*cost of acquisition*' and '*cost of improvement*' have been defined in the ITA. Generally, these terms refer to the cost actually incurred by the taxpayer towards acquiring or improving the capital asset. The ITA also prescribes the '*cost of acquisition*' and '*cost of improvement*' for certain assets that have not been purchased by the taxpayer – for instance, capital assets acquired by way of gift, or through transmission.

On similar lines, the ITA also specifies the '*cost of acquisition*' and '*cost of improvement*' for certain self-generated intangible assets, since for such assets, the cost is often not readily identifiable or ascertainable. To elaborate, under the ITA, the cost of acquisition of goodwill of a business or profession, a trade mark or brand name associated with a business or profession, a right to manufacture, produce or process any article or thing, a right to carry on any business or profession, tenancy rights, etc., acquired through a mode other than purchase (or specified modes such as transmission from a previous owner) is deemed to be '*NIL*'. Similarly, deeming provisions also prescribe a NIL cost of improvement for goodwill and certain rights. As mentioned above, these provisions broadly seek to prescribe NIL cost of acquisition and improvement for specified self-generated intangible assets. In such a scenario, the entire sale consideration received from the transfer of these assets is subject to tax as capital gains income.

However, the deeming fiction under the ITA which prescribes a NIL cost as discussed above is currently restricted to specified intangible assets. For other self-generated intangible assets, the ITA does not provide for a similar deeming fiction. This has led to many legal disputes and interpretational debates.

2 Court decisions on computation of capital gains income for intangible assets

In this context, the decision of the Supreme Court in the case of *B.C. Srinivasa Setty* in 1981 was a landmark ruling. The Supreme Court held that for the purposes of computing capital gains income, the charging section and computation provisions constitute an integrated code. In a case where the cost of acquisition of an asset cannot be ascertained, the machinery provision for computation of capital gains income would fail. Therefore, no capital gains tax can be levied in a case where the cost of acquisition is unascertainable.

Following this decision, various Indian courts, while adjudicating on the taxability of capital gains income arising from the transfer of self-generated intangible assets (other than those for which the ITA deems NIL cost of acquisition and improvement), have consistently held that there would be no capital gains income since the computation mechanism fails where the cost of acquisition is not ascertainable. Such assets include copyright, know-how, patents, etc.

For instance, the Mumbai bench of the Income Tax Appellate Tribunal (ITAT) in the case of *Bharat Serums and Vaccines Ltd.* held that the deeming provisions of the ITA did not have any reference to '*know-how*' which was the asset under consideration in that case. The cost of acquisition of such know-how under development (being a self-generated asset) was unascertainable and therefore no capital gains income would arise. As recently as 2022, the Bangalore and Mumbai benches of the ITAT in the cases of *Sasken Technologies Ltd.* and *Kirit Raojibhai Patel*, respectively, held that the capital gains income arising on the transfer of intellectual property rights and transferable development rights cannot be brought to tax as it is not possible to compute capital gains income when the cost of acquisition is not ascertainable.

3 Proposals under the Finance Bill, 2023

The Bill proposes to codify that the '*cost of acquisition*' and '*cost of improvement*' of any other intangible asset or a right (that is not already mentioned in the restricted list of intangible assets under the deeming provisions discussed above) for which no consideration has been paid, shall be considered as '*NIL*' for the purpose of computing capital gains income.

The Bill however does not define the term '*intangible asset*' for the purposes of the deeming provision. Section 32 of the ITA, which pertains to depreciation, contains a limited definition of intangible assets. As per Explanation 3 to Section 32(1) of the ITA, the expression '*assets*' includes intangible assets being *know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature not being goodwill of a business or profession*. That said, this definition only has application for the purposes of Section 32 of the ITA. It cannot be strictly applied to the capital gains tax provisions and would therefore only have persuasive value.

In the absence of a definition of '*intangible asset*' for the purpose of the capital gains tax provisions, the tax authorities are likely to construe the term '*intangible asset*' widely. As a result, the proposed amendment may have extensive implications, including for situations that were not intended by the legislature to be governed by this new provision.

For instance, the transfer of data between group companies in the course of routine operations may be covered within the ambit of this new provision as self-generated data, and may be viewed as an intangible asset. Under the new provision, the cost of acquisition of such self-generated data would be NIL. Where the transfer is made by an Indian entity to a non-resident group company, the tax office may seek to impute

consideration to the transfer by invoking transfer pricing provisions. This could result in the entire imputed consideration being subject to capital gains tax (since the cost of acquisition is now deemed NIL as opposed to unascertainable, making the computation of capital gains income possible) in the hands of the transferring entity, in a situation wherein routine business information has been sent to a group entity abroad.

4 Conclusion

While the intent of the legislature may be to pull the plug on the non-taxability of certain intangibles that were not specifically covered under the deeming provisions (such as know-how, copyrights, patents, etc.), codifying the proposed amendment without a specific definition of intangible assets or a restriction on the applicability of the provision has the potential to lead to more litigation. Going forward, taxpayers would need to be mindful of the applicability of this amendment, and its impact on routine business transactions.