

SUPREME COURT OF JUSTICE

# TAX DEDUCTION OF GOODWILL AMORTIZATION IS ALLOWED FOR INCOME TAX PURPOSES

## BACKGROUND

By means of a ruling dated July 15th, 2020, the Third Chamber of the Supreme Court of Justice decided in a legal dispute that a tax deduction of: (i) an amortization of goodwill applied by the taxpayer company in its Income Tax return for the 2007 tax period, generated as a result of a merger by absorption carried out after the share control's acquisition of Supermercados, S.A. (Grupo Romero) (Acquired company) by Inmobiliaria Don Antonio, S.A. (Grupo Rey) (Surviving company) by the order of B/.13,197,065.00; and (ii) the deduction of an amount from an accounting reserve for customer loyalty in the amount of B/.815,000.00.

In this case, through the Resolution TAT-RF-073 of November 20, 2015, the Administrative Tax Tribunal (TAT, as per the Spanish acronym) had: (i) ordered the General Revenue Directorate (DGI, as per the Spanish acronym) to verify the amount of the impairment suffered in the accounting goodwill determined upon completion of the merger, in order to determine the amount of the amortization that could have been considered as deductible for the tax period in dispute; and (ii) confirmed the objection to the deduction of the amount of the accounting reserve for customer loyalty.

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### DGI'S POSITION

The DGI stated in its analysis that the taxpayer Inmobiliaria Don Antonio, S.A. claimed as a deductible expense an amount equivalent to the amount of the purchase of shares issued by the company Supermercados, S.A. under the concept of goodwill, a position that was rejected by the DGI because (i) the purchase or acquisition of shares should be classified as an investment and therefore, (ii) the profit or loss related to such investment should not be considered as an amortizable expense, but as a gain or loss on the sale of the instruments and under the special regime of capital gains.

### POSITION OF THE STATE COUNSEL

On the other hand, the State Counsel, upon participating in the process as a member representing the interests of the State (i.e., the DGI), concludes that (i) the administrative acts being challenged do not violate the provisions of article 60 of the Income Tax Regulations (Executive Decree No. 170 of 1993), nor other rules cited as having been infringed; and (ii) that in the governmental proceedings, before the DGI and the TAT, it was possible to evaluate, explain and overcome the matter in dispute, and the State Counsel concurred with the second instance ruling.

## RULING OF THE THIRD CHAMBER

The Third Chamber of the Supreme Court of Justice refers separately to each of the objections that gave rise to the additional liquidation issued by the DGI against Inmobiliaria Don Antonio, S.A.

Firstly, with respect to the deduction of an amount from an accounting reserve for customer loyalty in the order of B/.815,000. 00, the Third Chamber agreed with the TAT, considering that according to the definitions and provisions in force, the provisions for a customer loyalty program constitute a contingent liability and as such, they are not deductible, so it was not feasible to include as a deductible expense this amount of provisions, considering that the tax regulations only admit for purposes of income tax deductions the reserves for non-collectible accounts and the reserve for seniority premiums, as provided in the articles of the Income Tax Regulations.

Secondly, with respect to the deduction of the amortization of goodwill by the taxpayer company in its income tax return for the 2007 tax period, generated as a result of a merger by absorption carried out after the acquisition of the share control of Supermercados, S.A. (Grupo Romero) (Acquired company) by Inmobiliaria Don Antonio, S.A. (Grupo Rey) (Surviving company) by the order of B/. 13,197,065.00, the Third Chamber revokes the decision of the TAT and instead decides to admit the deduction made by the taxpayer.

To reach this conclusion, the Third Chamber decided to accept the conclusions of the reports presented both by the taxpayer's experts and by the expert appointed by the Third Chamber itself, where great emphasis is placed on the definition of business combinations and intangible assets provided for in IFRS 3 and IAS 38, respectively.

In summary, the accounting standards can be summarized as follows: The intangible asset, for the purpose of separating it from the goodwill generated in the business combination, must be (i) identifiable, i.e., divisible and capable of being sold, transferred, licensed, leased or exchanged, either individually or jointly with another contract, asset or liability with which it is related or (ii) arising from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

On the other hand, the experts quote IAS 38, which defines intangible assets as follows: "Entities often employ resources, or incur liabilities, in the acquisition, development, maintenance or enhancement of intangible resources, such as scientific or technological knowledge, design and implementation of new processes or new systems, licenses or concessions, intellectual property, know-how or trademarks (including trade names and publishing rights), other common examples of items that fall under this broad heading are software, patents, copyrights, films, customer lists, mortgage service rights, fishing licenses, import quotas, franchises, business relationships with customers or suppliers, customer loyalty, market shares and marketing rights".

Lastly, the Third Chamber concludes by stating that from the administrative file in question, it was possible to prove that the amortization of generated goodwill or intangible asset was the result of the merger between Supermercados, S.A. and Inmobiliaria Don Antonio, S.A. and, as indicated by both expert reports above, that it was constituted as net taxable income for the sellers and, therefore, the corresponding tax was levied and paid.

## OUR COMMENTS

In the ruling analyzed, the Third Chamber, in our opinion, in a rather superficial and automatic manner, concludes the viability of a tax deduction related to goodwill generated by a business combination, which was formalized through a merger between companies. We have several comments and observations to make for all those business groups that consider this kind of transactions:

**1)** After reviewing the expert reports and the analysis of such reports on the above mentioned accounting standards, it is relevant to note that, the Third Chamber states that "The experts point out that goodwill is an intangible asset, which can be deducted as an expense, since it is identifiable, has control and can generate future economic benefits ". This statement is questionable because goodwill is not an individual or individualizable asset, but rather a residual classification in which the value assigned in the acquisition of a business is assigned, when there are no longer individual assets to which that value could be assigned.

A capital gain should not be confused with an individual or individualizable intangible asset. This is relevant because Article 60 refers to a listing -which is not closed- but refers to individualized or individualizable intangible assets, not to a residual value as corresponds to goodwill.

**2)** Goodwill should be understood as an asset generated as a result of a business combination, not as an accounting or financial expense, nor as a deductible expense. The discussion of the goodwill deduction, given the rules cited in the ruling itself, should revolve around whether an impairment loss on goodwill could be considered as deductible for income tax purposes. Without an accounting depreciation of goodwill, resulting from the contractual conditions in each case, there is no accounting item to be taken to expense, or to a deductible expense as concluded in the ruling analyzed. Unless we consider the aforementioned article 60 of Executive Decree No. 170 of 1990, this provides a tax incentive for this purpose, which is not evident from a reading of the text of the same.

**3)** On the other hand, the Third Chamber concludes that the goodwill must be considered as an intangible asset subject to the provisions of Article 60 of the Income Tax Regulations. However, the text of the aforementioned regulation indicates the following: "Article 60: The taxpayer will have the option to deduct the organization and pre-operation expenses in the fiscal year in which they are incurred or paid or a maximum period of 5 years. Also deductible, according to the contractual conditions of each case, are the amortizations for rights of keys, concessions, trademarks, manufacturing procedures, industrial patents, formulas and other similar intangible assets, when such rights or procedures have constituted taxable income for the assignors of the same". In other words, amortization is applied to the extent that the contractual condition of each case involves the use or gradual exhaustion of the right to exploit the intangible asset, with which its value is amortized considering a contractually defined time horizon for its exploitation by the concessionaire or user of the intangible asset.

**4)** Even if it were concluded that article 60 of Executive Decree No. 170 of 1993 allows the recognition of goodwill as one of the intangible assets subject to the possibility of a deduction corresponding to its amortization, it is necessary to determine and demonstrate the amount

of such amortization, that is, how the impairment of the intangible asset is calculated, in this case the goodwill. Otherwise, it would result that the aforementioned article 60 authorizes the deduction of amortization for tax purposes of an asset, without it having been demonstrated that amortization due to a reduction in the value of said asset actually took place.

**5)** On the other hand, according to full IFRS, the goodwill qualify for non-finite lives with very specific exceptions. For non-finite lives, IAS 36 requires impairment testing on a minimum annual basis or when there are events that may affect the amount recorded. For purposes of calculating impairment of goodwill, it must be allocated to the different cash-generating units with some exceptions, since goodwill alone does not generate future economic benefits.

**6)** Currently, under full IFRS, goodwill is not amortized, only one impairment test is performed once a year. It is worth mentioning that this regulation has been submitted to the consideration of a project for the revision of the goodwill accounting that would include the possible amortization of the same. In this sense, the complete IFRS will allow the amortization or charging of the goodwill, without requiring it to be always maintained in the statement of financial position.

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