

Chapter II: Systemic issues on Depreciation

2.1 Introduction

Income Tax Act, 1961 (Act) deals with various provisions relating to allowance of depreciation. We have come across cases where unintended benefits were given to the assessee due to certain provisions of the Act being deficient, unclear and ambiguous. This has also led to contradictory judicial pronouncements. The present chapter deals with systemic issues relating to allowance of depreciation.

Rates of depreciation on different assets/ block of assets as provided in the Income Tax Rules 1962, differ from those prescribed under the Companies Act 1956 for the same assets. While computing the taxable income, additional efforts are made by disallowing depreciation as per Companies Act and then allowing depreciation as per the Act. Accelerated depreciation under Income Tax Act does not guarantee conservation of funds to replace plant and machinery as intended, in the absence of any monitoring mechanism.

2.2 Harmonisation of rates of depreciation

The rates of depreciation prescribed under the Income Tax Rules, 1962 for various assets/block of assets are different from those prescribed under the Companies Act, 1956⁴. The depreciation worked out at the rates prescribed under the Companies Act, 1956 is debited to the Profit and Loss account of a company to determine the true profit or loss of the business or the true cost of production etc. and ultimately is available for replacement of capital assets.

It has been judicially held⁵ that depreciation is allowed to replace the value of an asset to the extent it has depreciated during the relevant period of accounting and as the value has, to that extent, been lost, the corresponding allowance for depreciation takes place. CBDT has also clarified⁶ that the depreciation is provided to enable the industry to conserve sufficient funds to replace plant and machinery at the expiry of its useful life.

The Kelkar Task Force⁷, in its Report (December 2002), *inter alia*, recommended that depreciation claims under the Act be restricted to those charged to the Profit and Loss account in accordance with the provisions of

⁴ The Companies Act 1956 was repealed by the Companies Act 2013 but during course of audit, the Companies Act, 1956 was effective.

⁵ P.K. Badiani Vs. Commissioner of Income Tax, Bomb (1976) 4SCC562,

⁶ CBDT Circular No. 14/2001

⁷ Constituted by Government of India for the study of 'Direct Taxes Reforms including rationalization of tax structure'.

the Companies Act. This was intended to minimize the divergence between the depreciation amounts charged to the Profit and Loss account and those claimed for tax purposes. Though the recommendation was partly implemented by way of revision of the rates of depreciation under the Act, effective from AY 07, the disparity between the two Acts continued.

We compared the data compiled from various charges on the depreciation debited to Profit and Loss accounts as per the Companies Act vis-à-vis the depreciation allowed by ITD. The comparison revealed that depreciation as per the Income Tax Act was higher in 6,267 cases and was lower in 5,926 cases by a difference aggregating ₹ 57,665.41 crore and ₹ 11,754.80 crore respectively. The depreciation allowed was at par in 10,441 cases in both as per Companies Act and the Income Tax Act. The details of depreciation allowed as per both the Acts vis-a-vis difference between them are shown at **Appendix 3A, Appendix 3B and Appendix 3C.**

While computing the taxable income, additional efforts are made by disallowing depreciation as per Companies Act and then allowing depreciation as per the Act. There is a need to synchronize the rates prescribed under the Income Tax Rules with the objectives of providing depreciation with a condition that it is restricted to the corresponding amount debited in the Profit & Loss account available for replacement of a specific asset.

CBDT may consider providing the rates of depreciation under the Act in conformity with the rates of depreciation applicable as per the Companies Act. If any incentive is intended by way of depreciation, it may be expressly given by way of incentive instead of depreciation. ITD may carry out a cost benefit analysis on the issue to ascertain the effectiveness of this incentive mechanism and decide on harmonizing the depreciation rates with those under the Companies Act.

Income Tax Act, 1961, does not provide for allowance of depreciation on pro rata basis depending on the usage of assets. This led to unintended benefits of deduction to the assesseees for the period for which asset was not used.

2.3 Unintended benefit of depreciation for the period when asset is not used

Section 32 of the Act provides for depreciation on actual value or written down value (WDV) of assets at the rates prescribed in Appendix I of Income Tax Rules, 1962, if the asset is used for 180 days or more and at 50 per cent of

the normal rate if the asset is used for one day or more but less than 180 days during the relevant previous year.

We observed from compilation of 986 cases from various charges as shown in **Appendix 4** that assessee made additions of various assets worth ₹ 1,41,725.45 crore in the month of March in different FYs and claimed depreciation of ₹ 15,617.86 crore instead of allowable depreciation of ₹ 2,602.61 crore on *pro rata* basis for the month of March only, the assets being purchased in the month of March itself.

Similarly, additions worth ₹ 31,621.10 crore were made in 450 cases as shown in **Appendix 4A**, in the month of September in different FYs, on which depreciation was allowed for the whole year.

Thus, the assessee got unintended benefit of deduction even for the period for which asset was not used.

While there is no concept of allowance of depreciation on *pro rata* basis in proportion to actual period of usage (as prescribed under Companies Act) in the Act, the provisions of the Act allow assessee to claim depreciation even for those periods during which the assets were neither acquired/kept ready for use nor put to actual use. Consequently, the purpose of amending the Act to reduce the allowance of depreciation and increase the taxable profits remained largely unachieved, as the anomaly continued to exist with the allowance of depreciation at 50 *per cent* even if the asset is purchased on the last day of the relevant previous year and put to use only for a day.

CBDT may consider providing for depreciation on pro-rata basis in the Act depending upon usage of the assets during the relevant previous year subject to the condition that depreciation at 50 *per cent* of the normal depreciation may be allowed only when asset is put to use at least for a certain fixed period.

There were inconsistencies in allowance of depreciation on assets owned by Charitable/Religious Trust and Association of Persons due to ambiguity in law and conflicting judicial decisions which had adverse impact on tax revenues

2.4 Inconsistencies in allowance of depreciation on assets owned by Charitable/ Religious Trusts and Association of Persons

Section 11 of the Act provides for exemption to a Charitable or Religious Trust, subject to certain conditions, in respect of income from property held thereunder, to the extent such income is applied or accumulated for

charitable or religious purposes. CBDT has clarified⁸ that for the purpose of such exemption, the income of a trust is to be taken in the commercial sense, and not as computed under the provisions of the Act. In other words, the income that is eligible for exemption is the one that has been determined as per the books of account.

While the Bombay⁹, Punjab and Haryana¹⁰ and Delhi¹¹ High Courts held that depreciation would be allowable as a deduction even in such cases where the capital expenditure had been allowed as an application of income for charitable purposes, Kerala High Court¹² had taken a contrary view holding that such depreciation should be added back to the income of the trust as disclosed in its books of account in view of Apex court's decision¹³ that under general principles of taxation, double deduction was not intended, unless clearly expressed.

In Karnataka charge, the application of law/court rulings was not uniformly followed during assessments of Trusts/AOPs. While some AOs disallowed the depreciation claims on the cost of assets already allowed as application of income, others allowed the depreciation claims of the assessee, on the strength of varied judicial decisions (including Appellate/Tribunal orders). Para 3.15 on 'Irregular claim of depreciation against income fully exempt from tax' of this report also describes such cases of double deductions.

Absence of enabling provisions and often conflicting judicial decisions on similar issues had adverse impact on tax revenues as noticed in allowance of depreciation in addition to capital expenditure on assets towards application of income in the case of Charitable / Religious Trusts.

Ambiguities in law and contradictory stand taken by judicial authorities on the application of significant provisions relating to assessment of the Charitable Trusts need to be resolved so as to clarify whether depreciation to Trusts is to be allowed or not. This issue having already been highlighted vide *para 5.2 on 'Inconsistencies in allowance of depreciation' of Report No.20 of 2013 of the Comptroller and Auditor General of India on 'Exemptions to Charitable Trusts and Institutions'* still requires clarification from the Ministry.

⁸ CBDT Circular dated 19 June 1968

⁹ CIT vs Institute of Banking Personnel Selection (264 ITR 110)

¹⁰ CIT vs Market Committee, Pipli (330 ITR 16)

¹¹ DIT vs. Vishwa Jagriti Mission (73 DTR (Del) 195)

¹² Lissie Medical Institutions vs. CIT (76 DTR (Ker) 372)

¹³ Escorts Ltd vs. Union of India (199 ITR 43)

Carry forward and set-off of unabsorbed depreciation for the AY 98 to AY 02 as per the Act and amendment made in the Act for AY 03 onwards led to conflicting judicial decisions. The issue has not yet been settled.

2.5 Incorrect set off of unabsorbed depreciation

According to section 32(2) as applicable for the AY 98 to AY 02, unabsorbed depreciation could be carried forward and set off against business income for a period of eight years only. The brought forward unabsorbed depreciation relating to the period prior to AY 98, if any, was to be aggregated with the unabsorbed depreciation of AY 98 and was required to be treated as unabsorbed depreciation of AY 98. With effect from AY 03, Section 32(2) was amended to allow the carry forward and set off of the unabsorbed depreciation for an indefinite period.

In the case of DCIT vs. Times Guaranty, the ITAT, Mumbai Special Bench held that unabsorbed depreciation of AY 98 to AY 02 is not eligible for relief granted by amendment to Section 32(2) in AY 03 and the same could be set off only against the business income and for eight years only. However, the Gujarat High Court in the case of General Motors India Pvt. Ltd. Vs DCIT 2010 Taxman 20 (Gujarat) has given ruling that any unabsorbed depreciation available to an assessee on 01 April 2002 will be dealt with in accordance with the provisions of Section 32(2) as amended by the Finance Act, 2001.

The ruling of Gujarat High Court has made the statute that existed during the period AY 98 to AY 02 regarding carry forward and set off of unabsorbed depreciation, redundant and non-existent. However, the decision rendered by the Gujarat High Court in the above case was not accepted by the ITD who filed Special Leave Petition (SLP) with the Supreme Court. Supreme Court has dismissed the SLP on 11 March 2013 stating that question of law is kept open.

The issue has not been settled yet. The stand taken by ITAT, Mumbai Special Bench in the case of DCIT vs. Times Guaranty and by Gujarat High Court in the case of General Motors India Pvt. Ltd will still continue to apply.

CBDT may clarify the applicability of Section 32 (2) of the Act relating to carry forward and set-off of unabsorbed depreciation allowance pertaining to the period AY 98 to AY 02 whether depreciation is to be carried forward for set-off beyond 8 years or not.

2.6 Recommendations

We recommend that

- a. The Ministry may consider providing the rates of depreciation under the Act in conformity with the rates of depreciation applicable as per the Companies Act.

The Ministry stated (May 2014) that the Companies Act generally provides depreciation on straight line method based on the estimated life and residual value of the assets. However, the Income Tax Act provides depreciation normally on written down value method to certain specified assets for achieving certain economic and social objectives. Vide IT (Sixth Amendment) Rules, 2005, the rates of depreciation for eligible assets have been rationalised after taking into account estimated life and gradual reduction in rates of income tax over the years. Further, the rates of depreciation specified under the Companies Act are for the purpose of ascertaining the correct amount of commercial profit earned by a company whereas the Income Tax Act prescribes rates of accelerated depreciation which is more than the commercial depreciation for encouraging investment in certain sectors/areas like manufacturing, clean energy, pollution control equipment's etc. As the policy objectives are different, the proposal for aligning the rate of depreciation under the Income Tax Act on the lines of Companies Act is not feasible.

Audit is of the opinion that though the policy objectives are different, there is a need to examine depreciation norms in totality and align the rates under the two Acts wherever possible, as the existing practice involves preparing different sets of accounts and it also deprives the exchequer of its legitimate tax revenue.

The Ministry further replied (June 2014) that if the rates of depreciation are aligned with the Companies Act, the requirement of preparing separate statement of depreciation for income-tax purposes will not be eliminated because of the provisions under the Act.

Audit is of the opinion that the more the alignment of depreciation rates is made, the less will be the chances of errors in calculation of depreciation.

- b. The Ministry may consider providing for depreciation on pro-rata basis in the Act depending upon usage of the assets during the relevant previous year subject to the condition that depreciation at 50 per cent of the normal depreciation may be allowed only when the asset is put to use at least for a certain fixed period.

The Ministry stated (May 2014) that the Act provides 50 per cent of allowable depreciation when the asset is not put to use for not more than 180 days. The existing provision is simple and easy to monitor administratively. Further, the provision for allowing 50 per cent of depreciation on the assets purchased at the fag end of the previous year encourages the tax payer to invest its income in productive asset instead of distributing the same to the owners.

Audit is of the view that the Ministry may make provision for allowance of 50 per cent of allowable depreciation only when asset is put to use at least for three months with a view to minimise the loss to Government exchequer. Further, for easy monitoring the provision on depreciation, the Ministry may use existing IT tools.

The Ministry further stated (June 2014) that in case condition of three months is imposed for claiming depreciation, it is likely that in the last quarter of the year, the assessee would postpone the investment in assets to the next year and this may not be desirable for the growth and development of the country

Audit is of the opinion that the comments of the Ministry are based on presumptions only.

- c. The Ministry may clarify whether the depreciation is to be allowed in addition to capital expenditure on assets towards application of income thereon in the case of Charitable/ Religious Trusts.

The Ministry stated (May 2014) that in the scheme of Trust taxation, first the income has to be computed after deduction of expenses and thereafter, exemption is granted to the extent the income is applied. There are, therefore, two aspects involved:- one of deduction and the other of condition of application. Capital expenditure of the Trust is application of income, and to the extent that it is so applied, the amount applied is excluded from the income. This may, therefore, not be a case of double deduction. Further, the judicial decisions on interpretation of current law relating to taxation of the Trusts has been of varying nature, the claim of depreciation in the case of Trusts in respect of assets for which relief by way of application of income is claimed, can only be denied if the law is specifically amended.

Audit is of the opinion that Ministry may initiate action to make requisite amendment in the Act with a view to avoid the concept of double deduction and contradictory decisions of the Judiciary on the same issue.

The Ministry stated (June 2014) that the matter will be examined by CBDT.

- d.** CBDT may clarify the applicability of Section 32(2) of the Act relating to carry forward and set-off of unabsorbed depreciation allowance pertaining to the period AY 98 to 02.

The Ministry stated (May and June 2014) that the matter has been referred to Central Technical Committee for forming Departmental View and taking further necessary action, if required.

The Ministry's final stand is awaited.