Depreciation Concepts & Case Studies

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Nature of Depreciation

- It is well recognized that value of any capital asset depreciates due to wear and tear, efflux of time and obsolescence
- It is for this reason that an estimated amount is required to be provided for such depreciation in order to arrive at the correct profit or loss for the period
- The underlying principle of tax law is to tax profits without making allowance for capital expenditure unless provided for
- Depreciation is a main deduction in the capital field

Nature of Depreciation

- What is depreciation – expenditure, loss or allowance
- Depreciation treated as allowance – section 32(2), 72A
- Depreciation is part of PGBP – when does the loss split between unabsorbed depreciation and business loss – Bangalore ITAT in case of KPIT Cummins
- Whether depreciation allowance can be set-off against salary income – impact of restriction u/s 71(2A)
- Depreciation in case of cash basis of accounting

Section 32 - Conditions

The grant of depreciation is subject to the following rules:

- The depreciation allowance is granted only in <u>respect of certain specified assets</u>
- The assets should be <u>owned</u> by the assessee who claims the depreciation
- The assets should be <u>used for the purpose of a business or profession</u> carried on by the assessee
- The depreciation is <u>computed for block of assets on the basis of WDV at prescribed rate</u>

NNMS

Block of Asset - concept

- Section 2(11) defines the term "block of assets" to mean a group of assets falling within a class of assets comprising -
  - Tangible assets being buildings, machinery, plant or furniture;
  - Intangible assets, being know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of a similar nature,

  in respect of which the same percentage of depreciation is prescribed
- Accordingly, two assets can form part of the same block, if they are of same class and the same rate of depreciation is provided with respect to the two assets

Block of Asset - Concept

Whether a single asset can constitute "block of assets"

- Section 2(11) defines the term "block of assets" to mean a group of assets
- Group in general parlance means more than one
- If this view is adopted, there would be difficulty in claiming depreciation in cases where there is only one asset in the block
- Special Bench in the case of *Chhabria Trust v ACIT 87 ITD 181 (Mum) (SB)* has held that even a single asset would be entitled to depreciation

WDV - concept

Depreciation under Section 32 is on the written down value (WDV) of the block of assets. Section 43(6) defines WDV in the case of block of assets to mean the WDV of that block of assets in the immediately preceding previous year as reduced by the depreciation *actually allowed* in respect of that block of assets in relation to the said preceding previous year and as further adjusted by:

- Increased by the *actual cost* of any asset falling within that block, acquired during the previous year
- Reduced by the *money payable in respect of any asset falling within that block, which is sold or discarded or demolished or destroyed* during that previous year together with the amount of the scrap value

User Test - Concept

- The basic condition u/s 32 is that asset should be used for the purpose of business or profession
- Active use v passive use (ready to use)
- The section 32 used the word <u>used</u>
- How the test applies under the block concept
- Whether the user test should be satisfied vis-à-vis the block of assets or it should be satisfied vis-à-vis the individual asset
- User for the whole year or part of the year is sufficient

Capital Gains on sale of assets – Sec 50

- With the introduction of block of assets concept, section 50 has been introduced whereby in the case of a block ceasing to exist on account of there being no asset in the block or the sale proceeds of an asset exceeds the WDV at the beginning of the previous year plus addition, the shortfall/excess realized is treated as short term capital gain/loss under section 50

Capital Gains – Middle of the year

CASE STUDY

- Block consists single asset
- Opening WDV – Rs. 500
- Asset sold for Rs. 750 on April 30th
- New Asset purchased on Oct 1st
- Value of new asset – Rs. 450
- Is excess of Rs. 250 on April 30 taxable
- What is the depreciation allowable
- *Everest Wollen Mills 3 SOT 521*

180 day Rule and User test

CASE STUDY

- Opening WDV Rs. 1,000 (Rate – 10%)
- New asset purchased Rs. 500 on April 10, 2009
- For some reason same asset is sold on May 30 after using for 50 days for Rs. 250. Loss of Rs. 250 on the asset
- Asset used for less than 180 days
- What will be the rate of depreciation and what will be the block value

180 day Rule and User test

CASE STUDY - continued

- Does asset form part of Block? When does an asset form part of the block – on acquisition, on being ready to use or on actually being put to use or at the year end
- Once asset merged into block it does not have separate identity
- Impact of Proviso to section 32 prescribing 180 days rule – does it mean in the year of purchase identity of the asset should be maintained separately or it only restricts the quantum of depreciation
- What happens if there is a gain will it eat into the opening WDV
- Will the position change if more than one asset is added
- What happens if asset is not used and not ready to use – gain or loss in such situation
- Asset purchased on April 2009, but put to use on Dec 2010 – used less than 180 days in next year

Capital Gains – STCG V LTCG

CASE STUDY

- Block consists single asset being building
- Asset is more than 3 years old
- Opening WDV – Rs. 50,000
- Asset sold at Rs. 10 lakhs
- Gain is taxable as STCG
- Can exemption u/s 54EC or 54F be claimed
- *CIT v Ace Builders P Ltd 195 CTR 1 (Bom), CIT v Assam Petroleum Industries P Ltd 262 ITR 587 (Gauh*

Capital Gains – Building Demolished

CASE STUDY

- Building purchased with land
- Building value Rs. 10 lakh
- Building demolished during the year
- Scrap value realized – Rs. 50K
- New construction started
- At the end of the year new building is under construction
- Not ready to occupy
- Can WDV be c/f or it will be STCL
- Will the answer vary based on stage of construction

Gift of Asset

CASE STUDY

- Single asset in the block WDV Rs. 1,000
- Asset gifted
- Actual cost to donee as per Explanation 2 to section 43(1) shall be actual cost to previous owner minus depreciation actually allowed
- Therefore donee can add Rs. 1,000 to his block
- In case of Donor, no money paid – what is to be reduced
- Block ceases to exist
- Can he claim STCL of Rs. 1,000
- As per section 47(iii), gift is not transfer
- Will it make difference in case there is more than one asset in the block of donor

Restructuring - Concept

- 5^{th} Proviso to section 32 provides that depreciation would be apportioned between transferor and transferee based on the number of days – situations covered are 47(xiii), 47(xiv), 170, amalgamation and demerger
- Section 43(1) r/w section 43(6) provide for actual cost minus depreciation actually allowed to be cost in the hands of transferee in certain cases and not all cases
- What is to be reduced in the hands of transferor generally not provided except in case of demerger

Transfer from Holding to Subsidiary

CASE STUDY

- Single asset in the block WDV Rs. 1,000 on April 1
- Transfer between holding company and subsidiary company
- Transferred at Rs. 100 to subsidiary
- Actual cost or WDV to subsidiary
- As per Explanation 6 to section 43(1) r/w Explanation 2 to section 43(6) actual cost to previous owner minus depreciation actually allowed shall be WDV in the hands of subsidiary
- What is to be reduced in the hands of holding company
- Block ceases to exist
- Can he claim STCL of Rs. 900
- As per section 47(iv), transfer by Holding Co to Subsidiary is not transfer
- Will it make difference in case there is more than one asset
- What happens if conditions of section 47A are not fulfilled in succeeding years

Transfer from Holding to Subsidiary

CASE STUDY

- WDV of the block (1^{st} Apr 08) – Rs. 5,000 with 2 assets
- During FY 08-09 new asset worth Rs. 2,000 purchased and old asset sold for Rs. 6,000
- After depreciation of Rs. 100, Block value becomes Rs. 900
- During FY 09-10, asset purchased last year for Rs. 2,000 is transferred by holding company to subsidiary company
- Transferred at Rs. 100 to subsidiary
- Actual cost or WDV in the hands of subsidiary
- As per Explanation 6 to section 43(1) r/w Explanation 2 to section 43(6) actual cost to previous owner minus depreciation actually allowed shall be WDV in the hands of sub
- What is to be reduced in the hands of holding company

Restructuring - Case Study

CASE STUDY

- Conversion of Prop concern into company on Oct 1, 2009
- Block of Asset WDV Rs. 1,000
- Revalued and taken over at Rs. 1,500
- All conditions of section 47(xiii) satisfied
- Depreciation to be apportioned in the ratio of no. of. days – Section 32, 5th proviso
- What will be WDV in the hands of company a) Rs. 1,000 – Dep or b) Rs. 1,500 – Dep

Unabsorbed Depreciation Allowance

- Section 32(2) provides for two situations
- Full effect cannot be given owing to there being no profits or gains chargeable for that previous year or owing to the profits or gains chargeable being less than the allowance,
- Subject to section 72 or 73,
- Unabsorbed allowance shall be added to the amount of the allowance for depreciation for the following previous year and deemed to be part of that allowance
- or if there is no such allowance for that previous year, be deemed to be the allowance for that previous year, and so on for the succeeding previous years.
- What would be the situation if the same business is not carried on by the assessee
- What happens if the assessee has no business income and has only income under the head other sources (the assessee would therefore not enter computation under section 28 to 44DA)

Actually Allowed - Concept

- Section 43(6) provides for reduction of depreciation actually allowed
- In case of a concern carrying on partly agricultural activities and non-agricultural activities, what is actually allowed – CIT v Doom Dooma India Ltd, CIT v Suman Tea & Plywood Industries P Ltd 204 ITR 719 (Cal)
- Amendment to section 43(6) – Explanation 7 inserted by Finance Act (No. 2), 2009
- Can the same analogy be applied in case of disallowance of depreciation with respect to personal use of asset under section 38(2)
- Is depreciation first allowed u/s 32 and then disallowed?
- Venkadam Laxminarayan 43 ITR 526, Allied Publishers P.Ltd 68 ITR 546 (Bom)

Intangible Asset - Concept

- Depreciation on Intangible assets introduced by the Finance Act (No 2), 1998. As per the provisions of section 32(1)(ii), the intangible assets entitled for depreciation are know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of a similar nature.
- The assets specified are exhaustive followed by a general category - *any other business or commercial rights of a similar nature*
- The specific assets mentioned in section 32 have certain similarities, common traits and characteristics such as definite life, protection of rights under statue, controllable, measurable and identifiable.
- Unless, any other business or commercial rights of a similar nature are similar to the above specific rights, they cannot be considered as intangible assets for the purpose of section 32 of the Act
- Recent judgment of Mumbai HC in case of Techno Shares – Rule of *noscitur a sociis and ejusdem generis*

Intangible Asset - US Regulations Section 197

- Types of Intangibles as per US Regulations
  - goodwill and going concern value,
  - workforce in place,
  - information base,
  - know-how,
  - customer-based intangibles,
  - supplier-based intangibles,
  - franchises, trademarks and trade names,
  - insurance policy expirations,
  - bank deposit base.
  - Section 197 intangibles also include any other item that is similar to work force in place, information base, know-how, customer-based intangibles or supplier-based intangibles

Intangible Asset - US Regulations Section 197

In case of sale of business - Allocation between assets as per US Regs

- Class I assets, which include cash and cash equivalents,
- Class II assets, which include certificate of deposit, government securities,
- Class III assets, which include generally all furniture, fixtures, land, buildings, equipment, other tangible property, accounts receivable, covenants not to compete and intangible assets other than goodwill and going concern value and
- Class IV assets which include intangible assets in the nature of goodwill or going concern value

Indian Judicial Decisions

Goodwill whether eligible for depreciation

- Skyline Caterers 20 SOT 266 - favourable
- Kotak Forex 2009-TIOL-711-ITAT-MUM – favourable
- R.G.Keshwani vs ACIT (2009) 116 ITD 133 -Against
- Bharatbhai J Vyas Vs ITO 97 ITD 248 (Ahd)-Against peculiar facts payment to retiring partner

Non-compete Fees

- ACIT vs Real Image Technology Pvt. Ltd 120 TTJ 983
- Medicrop Technologies India Pvt Ltd 2009-TIOL-203-ITAT-MAD

Intangible – Purchase of Software

- Purchase of software – when Intangible (25% depreciation) or Plant (Computer including software – 60% depreciation)
- Revenue v Capital
- Tests laid down in the case of Amway Enterprises
  - Ownership test;
  - Enduring benefit to assessee; and
  - Functional test.

Thank You

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