DEPRECIATION – AN OPTION TO CLAIM OR NOT – A STUDY

By

Ms.Bhavya Rangarajan, Advocate

Ms.B.Mala, Associate

M/s Subbaraya Aiyar, Padmanabhan & Ramamani Advocates

SYNOPSIS

- Depreciation
- Depreciation – An option to claim or not – A Study
    - a) Introduction
    - b) Definition
    - c) Depreciation – as it was
    - d) Reason behind not claiming depreciation
    - e) Depreciation – as it is
- Is Explanation 5 Retrospective?
- Conclusion

DEPRECIATION

Depreciation is the allocation of the cost of an asset over its useful life. There are different methods of computing depreciation. For income tax purposes, the method to be adopted by all assessees is the written down value (WDV) method, unless it is an asset of an undertaking engaged in generation or generation and distribution of power, in which case, the actual cost method is used.

DEPRECIATION – AN OPTION TO CLAIM OR NOT – A STUDY

Introduction:

Sec. 32 of the Income Tax Act (the Act) provides for depreciation on assets used for the purposes of business. There are a plethora of cases, the ***Mahendra Mills***[1] case probably being the most prominent one, which hold that the assessee has an option to claim depreciation. In other words, if the assessee does not wish to avail of the benefit of depreciation for some reason, it cannot be forced upon him. To remedy this situation, the Act was amended and Explanation 5 to Section 32(1) was inserted by the Finance Act 2001 w.e.f. 1 April 2002, which lays down that depreciation shall be granted whether or not the assessee claims the same i.e: the assessee does not have an option to claim depreciation.

This article seeks to cover the original position regarding the depreciation claim, the various judgments giving the assessee an option to claim depreciation, the subsequent *prospective* amendment to the Act and the repercussions thereof.

[1] 243 ITR 56 (SC)

Definition:

Depreciation is a method of allocating the cost of an asset over its useful life. It is provided to account for the decrease in the value of an asset due to wear and tear on account of use or commercial exploitation of the asset. Sec 32 of the Act reads as follows:

> *"32. Depreciation – (1) In respect of depreciation of –*
>
> *(i) buildings, machinery, plant or furniture, being tangible assets;*
>
> *(ii) know-how, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets acquired on or after the 1st day of April, 1998, owned, wholly or partly, by the assessee and used for the purposes of the business or profession, the following deductions* ***shall be allowed*** *-*
>
> ……………………
>
> …………………… "

Depreciation : as it was

While Section 32 dealt with depreciation, Section 34 laid down the conditions for the depreciation allowance. The relevant part of this Section 34 reads as under:

> *"34. Conditions for depreciation allowance and development rebate – (1) The deductions referred to in sub-section (1) [or sub-section (1A)[2]] of section 32* ***shall be allowed only if*** *the prescribed particulars have been furnished ; and the deduction referred to in section 33 ………………*
>
> *(2) For the purposes of Sec 32 –*
>
> *(i) the aggregate of all deductions in respect of depreciation made under sub-section (1) [or sub-section (1A)] of section 32 or under the Indian Income Tax Act 1922 ……………………… shall, in no case, exceed the*

[2] Inserted by TLA Act 1970 w.e.f 1/04/71.

actual cost to the assessee of the building, machinery, [plant, furniture, structure or work,] as the case may be."

We see from the above that Section 32 allows depreciation as a deduction subject to the provisions of Section 34 and section 34 lays down that deduction under section. 32 shall be allowed only if the prescribed particulars have been furnished.

In **Ascharajlal Ram Parkash Vs CIT**[3]**,** the Allahabad High Court held that :

> "*Sec. 34 provides that deductions under s. 32 on account of depreciation shall be allowed only if the prescribed particulars have been furnished. In **what form the prescribed particulars must be furnished**, or in what document, **is not mentioned in s. 34**. There is no requirement in that section that the prescribed particulars must be furnished in any particular document….. In the form of return there is a section which refers to the various particulars required under s. 34(1) when a claim is made for depreciation. Now, merely because the form of the return provides for a place where the statement of such particulars should be set out does not mean that in the absence of such statement the ITO has no power to allow the depreciation. A deduction by way of depreciation is necessary in order <u>to arrive at the true profits or gains of the business or profession</u>. The ITO is bound to arrive at the true figure of such profits and gains and if in the course of assessment proceedings **he comes to know of the relevant particulars necessary for the grant of deduction, he is bound to give effect to it***"

Similarly, in **Dasaprakash Bottling Co Vs CIT**[4]**,** the Madras High Court held that:

[3] 90 ITR 477 (ALL)
[4] 122 ITR 9 (MAD)

"It is a far cry from s. 34 to state that, unless the prescribed particulars had been furnished by the assessee, the allowance for depreciation could not under the law be granted. Reading ss. 32 and 34 together, one considers that the allowance of depreciation is available to the assessee in all cases. The ITO can disallow the claim, if the assessee did not furnish the prescribed particulars. However, it would be ***open to the ITO to grant depreciation even if the assessee had not furnished the prescribed particulars****, as the computation of income under the Act is* <u>*the computation of the real or proper statutory income.*</u>"

Subsequently, section 34(1) was deleted by the Taxation Laws (Amendment and Miscellaneous Provisions) Act 1986 w.e.f 1st April 1988. This gave rise to the question of <u>**option of claiming depreciation**</u>: i.e., does the assessee have an option to claim depreciation or should the depreciation be compulsorily allowed even when the assessee does not claim or withdraws the claim made.

The High Courts were divided on this issue.

In **CIT Vs Arun Textile**[5], the Gujarat High Court held that:

"The assessee-firm, in the original return of income for the asst. yr. 1973-74 filed on 14th June, 1973, had claimed depreciation on machinery. In its revised return filed on 13th March, 1975, the said claim of depreciation was withdrawn. The ***ITO*** *had, under an assessment order made under s. 143(3) of the IT Act, 1961****, while noticing that in the revised return of income the assessee had not claimed depreciation, allowed the depreciation which was claimed in the original return*** *on the ground that it was not necessary for allowing the depreciation that the factory should work full-fledged and further that the assessee had provided for the depreciation in the books of account. The assessee challenged this order in appeal on the ground that it was*

[5] 192 ITR 700 (GUJ)

open to the assessee not to claim the deduction, and since the deduction was not claimed in the revised return, there was no occasion for the ITO to allow the same…………

"The argument of learned counsel for the Revenue was that, unless the depreciation is taken into account, the ITO cannot arrive at the correct taxable income of the assessee… It is difficult to accept this argument…. It may appear intriguing on the part of the assessee as to why it does not claim the benefit of deduction from its taxable income, but the choice is clearly its. ***Where the assessee does not want the benefit, it cannot be thrust upon it****…If it were incumbent on the ITO to make compulsory deductions irrespective of whether the assessee claimed or not, the statutory requirement of making the claim along with necessary particulars and the provision for "allowing" it would be unnecessary. There is intrinsic evidence under* ***s. 43(6)(b)*** *of the Act in the expression "less all depreciation* ***actually allowed****" to show that it is not as if all allowable deductions are to be granted by the ITO even when the assessee does not want the same. In this context, we may also refer to the Circular of the Central Board of Revenue, 29D(XIX-14) of 1965, (F. No. 45/239/65-ITJ dt. 31st Aug., 1965), which directed that, "where the required particulars have not been furnished by the assessee and no claim for depreciation has been made in the return, the ITO should estimate the income without allowing depreciation allowance." Thus, as the assessee had not claimed depreciation allowance and had made clear its intention not to claim the same, no necessary particulars were furnished and it is obvious that the ITO has no occasion to allow any deductions… "*

Whereas, in **CIT Vs Southern Petrochemical Industrial Corporation Ltd**[6], the Madras High Court did not accept the withdrawal of claim by the assessee and held that:

> *"The assessee had furnished the particulars regarding the claim of depreciation in the original return and a revised return was filed. The revised return is not a revised return within the meaning of s. 139(5) as it cannot be stated that the assessee had discovered any omission or wrong statement in the original return filed.* ***It is not open to the assessee to deliberately withdraw the claim for depreciation*** *and such a deliberate withdrawal of the claim can neither be regarded as an omission nor furnishing a wrong statement in the original return. It cannot, therefore, be stated that the revised return has taken the place of the original return. That apart, even assuming that the assessee withdrew the original return by filing a revised return,* ***it is not open to the assessee to withdraw the particulars regarding the grant of depreciation by filing a revised return…***"

The **Supreme Court** then settled the issue in ***Mahendra Mills***[7], by holding that in the absence of particulars of depreciation, it was not mandatory for the ITO to compute the income by allowing depreciation u/s 32 and that if the assessee does not wish to avail of the benefit of depreciation for some reason, it cannot be forced upon him. In this case, the Supreme Court **approved the judgment given by the High Court in *CIT vs Arun Textiles* (supra).**

From the above, it is clear that:

a) The phrase 'depreciation allowed' does not include 'depreciation deemed to be allowed'. The depreciation should be actually allowed.

---

[6] 233 ITR 400 (Mad)
[7] 243 ITR 56 (SC)

b) The assessee has an *'option to claim'* and an option cannot become an obligation.

c) Therefore, until a claim is made, the ITO need not allow depreciation.

Reason behind not claiming depreciation or withdrawing the claim for depreciation

Depreciation being an expense item, it reduces the profit and thereby leads to a lesser tax amount. Thus, one question to be looked into is why the assessees would want to withdraw a claim which is actually beneficial.

The main reason for **not claiming depreciation** was to enable the set off of carried forward losses. Section 72 deals with the carry forward and set-off of business loss. The section reads as under:

> *"**72. Carry forward and set-off of business losses**.*
>
> *(1) Where for any assessment year, the net result of the computation under the head" Profits and gains of business or profession" is a loss to the assessee, not being a loss sustained in a speculation business, and such loss cannot be or is not wholly set off against income under any head of income in accordance with the provisions of section 71, so much of the loss as has not been so set off or, where he has no income under any other head, the whole loss shall, subject to the other provisions of this Chapter, be carried forward to the following assessment year, and-*
>
> *(i) it shall be set off against the profits and gains, if any, of any business or profession carried on by him and assessable for that assessment year; and*
>
> *(ii) if the loss cannot be wholly so set off, the amount of loss not so set off shall be carried forward to the following assessment year and so on:*
>
> ………………………

……………………

(2) Where any allowance or part thereof is, under sub-section ***(2) of section 32*** *or sub-section (4) of section 35, to be carried forward,* ***effect shall first be given to the provisions of this section****.*

(3) No loss (other than the loss referred to in the proviso to sub-section (1) of this section) shall be carried forward under this section for more than ***eight assessment years*** *immediately succeeding the assessment year for which the loss was first computed."*

Section 32(2) lays down that:

"Where, in the assessment of the assessee, ***full effect cannot be given to any allowance under sub-section (1)*** *in any previous year, 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, then, subject to the provisions of sub-section (2) of section 72 and sub-section (3) of section 73, the allowance or the part of the allowance to which effect has not been given, as the case may be, 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****."*

The Section 72 provides that NO loss shall be carried forward under the section for more than **eight assessment years** immediately succeeding the assessment year for which the loss was first computed. The losses would lapse if not set off within the specified period.

However, the allowance or the part of the allowance of depreciation to which effect has not been given shall be added to the amount of the allowance for depreciation for the following previous year and deemed to be part of that allowance. Allowance for depreciation does not therefore lapse.

Therefore, we see that the option to claim depreciation can be used as leverage. By opting out of claiming depreciation for a particular year, the profits of the assessee would be that much higher; enabling the set off of carry forward business losses which might otherwise lapse. In the subsequent years, the depreciation can be claimed on the higher written down value as brought forward, when there are sufficient profits after the set off of business losses. Sub-section (2) of section 72 clearly lays down that effect shall first be given to that section and then, if sufficient profits are available, effect shall be given to section 32.

Another reason would be the claim for deduction under Chapter VIA. If in a particular year, the gross total income is not sufficient to absorb the deduction available under Chapter VIA, by not claiming depreciation for that year, the assessee would be able to absorb the deduction. However, with the introduction of explanation 5 to section 32(1), assessees would have to compute the gross total income after allowance for depreciation as laid down in section 80AB. Section 80AB lays down that:

> "**Deductions to be made with reference to the income included in the gross total income** *: Where any deduction is required to be made or allowed under any section included in this Chapter under the heading "C.- Deductions in respect of certain incomes" in respect of any income of the nature specified in that section which is included in the gross total income of the assessee, then, notwithstanding anything contained in that section, for the purpose of computing the deduction under that section, the amount of income of that nature as computed in accordance with the provisions of this Act (**before making any deduction under this Chapter**) shall alone be deemed to be the amount of income of that nature which is derived or received by the assessee and which is included in his gross total income.*"

The above section makes it clear that depreciation should be provided for before any deduction is allowed under this chapter. There are also various judgments to this effect.

In ***CIT vs. Viswas Footwear Co. Ltd.***[8]***,*** the Madras High Court held that deduction under Section 80HHC should be granted after set-off of unabsorbed depreciation, unabsorbed business losses and unabsorbed investment allowance of earlier years.

Similarly, in ***Scoop Industries (P) Ltd. & Ors. Vs. ITO & Ors***[9]***,*** the Bombay High Court held that if the assessee is claiming any deduction under Chapter VI-A as a "newly established undertaking", it will have to claim depreciation first and thereafter only the total income is to be computed to enable it to claim the benefit of deduction. If the depreciation is not reduced while computing the income, the assessee would be claiming deduction on gross amount of income which would be more than that what the assessee is entitled to, ***and at the same time*** keeping WDV of its assets high resulting in higher claim of depreciation in subsequent years. Therefore, the assessee claims a double advantage[10].

One other point to be noted with respect to Chapter VI-A is that as some of the deductions under this chapter like that under Sections 80IA to 80IE are for a ***limited period***, the assessee can exercise the option of not claiming additional depreciation in order to claim the Chapter VI-A deductions. In this context, it is important to note that Explanation 5 governs only subsection (1) (i) of Section 32, and not Section 32(1)(iia). Therefore, the option to claim additional depreciation is available to the assessees, who can consider whether deduction Chapter VIA is more beneficial than additional depreciation.

---

[8] 304 ITR 127 (Mad)
[9] 289 ITR 195 (Bom)
[10] also see Vahid Paper Converters vs. ITO 98 ITD 165 (Ahd)(SB)

<u>Depreciation : as it is</u>

Before the amendment, there was a question as to whether depreciation was optional or mandatory. The department's claim was that the provision was mandatory while the assessees claimed that it was optional and that depreciation was not to be allowed unless claimed. Ultimately, the Supreme Court in the case of ***Mahendra Mills*** (supra) settled the controversy by holding that depreciation claim is optional and the assessing officer cannot thrust the depreciation allowance when it is not claimed by the assessee.

To remedy this situation and to get over this judgment, Explanation 5 to Section 32 (1) was inserted vide the Finance Act 2001 with effect from 1st April 2002. The said explanation reads as under:

> *"**Explanation 5** – For the removal of doubts, it is hereby declared that the provisions of this sub-section shall apply whether or not the assessee has claimed the deduction in respect of depreciation in computing his total income;"*

Pursuant to the insertion of the said Explanation, **depreciation** has become **mandatory** **<u>whether or not</u>** the assessee has claimed a deduction for depreciation in computing total income.

<u>Is Explanation 5 Retrospective?</u>

Another interesting issue that has arisen is whether the Explanation is applicable prospectively or retrospectively. The department has taken the view that since the Explanation begins with 'for the removal of doubts', it is 'declaratory' in nature and hence would be applicable retrospectively. Accordingly, depreciation should be allowed even for the assessment years prior to 2002-2003, irrespective of the ruling in *Mahendra Mills*.

This issue has been dealt with by various courts and they have been unanimous in holding that even after the insertion of Explanation 5, the ruling in the case of *Mahendra Mills* holds good and that depreciation is optional till the amendment, subsequent to which it is mandatory.

Article 141 of the Constitution of India lays down that the decision of the Supreme Court is binding on all courts within the territory of India. However, the legislature can overrule an apex court judgment and give retrospective effect in certain cases. However, if the intention of the legislature is to nullify such decision with retrospective effect, then it should be spelt out in unambiguous words in the proposed amendment.

In ***Ram Nath Jindal Vs CIT***[11], the Punjab & Haryana High Court held that the fact that Expln. 5 to section. 32(1)(ii) has been inserted w.e.f. 1st April, 2002, shows that prior to insertion of the Explanation ***there was no express provision by which depreciation could be fictionally deemed to have been claimed and granted***. Thus, the WDV and profits under section. 41(2) has to be computed on the basis that the depreciation had not been claimed during the relevant years.

The Madras High Court in ***CIT Vs Sree Senhavalli Textiles (P) Ltd***[12] laid down that Expln. 5 to section. 32(1) would apply only from 1st April, 2002. The relevant part of the judgment is as under:

> *"Though after that judgment was rendered by the apex Court, Expln. 5 was inserted in s. 32(1) of the IT Act, 1961, by the Finance Act 2001, w.e.f. 1st April, 2002, declaring that "for the removal of doubts" the provisions of sub-s. (1) will apply whether or not the assessee claims deduction in respect of depreciation in computing his total income, that*

[11] 252 ITR 590 (P&H)
[12] 259 ITR 77 (Mad)

Explanation cannot be regarded as taking away the effect of the judgment of the Supreme Court for the years prior to the date of introduction of the Explanation*. The law declared by the Supreme Court cannot be regarded as having merely raised doubts. The interpretation of the relevant provisions of the Act by the apex Court settles the law, and* ***unless the subsequent amendment to the statute is expressly given retrospective effect, the law laid down by the apex Court will remain the binding law for the period prior to the amendment****. The newly added Explanation takes effect only on and from 1st April, 2002, and will not be applicable for prior years."*

Similarly, the Kerala High Court, in ***CIT Vs Kerala Electric Lamp Works Ltd***[13] did not accept the contention of the learned department counsel and held that:

"As we have noticed that this Explanation was inserted as per the Finance Act, 2001 and the Explanation itself was given effect to only with effect from first day of April, 2002 and when the legislature has expressly given the effect of the Explanation to commence from first day of April, 2002 only, ***we do not see any force in the contention raised by the learned counsel appearing for the Revenue that de hors the express provision the section should be given retrospective effect*** *contrary to the legislative intention."*

Therefore, from the above, we see that Explanation 5 is applicable prospectively and makes it clear that there is no longer an 'option' to claim depreciation. Depreciation is mandatory.

Conclusion

[13] 261 ITR 721 (Ker)

The insertion of Expln 5 to s. 32(1) is to be applied prospectively and it clearly takes away the right of choice of the assessee to make a claim for depreciation or not. It would be open to the ITO to grant depreciation even if the assessee had not furnished the prescribed particulars. This issue now seems well settled by the various judgments of the Courts as enumerated above.