Chapter III: Allowance of Depreciation

3.1 Introduction

Section 32 of the Act provides for allowance of depreciation on assets for tax purposes as deduction to an assessee. Appendix I & IA to the Income Tax Rules, 1962 (Rule), provides for rates of depreciation on different assets, owned and used by the assessee during the course of business. The present chapter deals with audit issues relating to deficiencies in applying the provisions of the Act and relevant Rules/Judicial pronouncements by the Assessing Officers (AOs) during assessments. Category wise details of mistakes in assessment are shown in Table 3.1.

Table 3.1: Nature of mistakes with its tax effect

	Nature of Mistakes and Para Number of the Report	Cases	Tax effect (₹ in crore)
1.	Depreciation claimed and allowed on assets not owned/leased out by the assessee *(Para 3.2)*	20	92.79
2.	Depreciation claimed on assets not used in business *(Para 3.3)*	35	43.96
3.	Mistakes in determination of actual cost or written down value of assets *(Para 3.4)*	29	85.47
4.	Depreciation allowed on assets disposed off *(Para 3.5)*	9	1.99
5.	Capital investment subsidies not deducted from cost *(Para 3.6)*	18	35.65
6.	Mistakes in carrying over the written down value of assets *(Para 3.7)*	6	7.15
7.	Mistakes in adoption of correct figure and errors in computation *(Para 3.8)*	44	212.97
8.	Adoption of incorrect rate of depreciation *(Para 3.9)*	142	107.85
9.	Excess allowance of depreciation on assets used for less than 180 days *(Para 3.10)*	29	25.03
10.	Mistakes in carry forward/set off of depreciation *(Para 3.11)*	87	694.65
11.	Mistake in carry forward and set off of unabsorbed depreciation relating to amalgamating companies *(Para 3.21)*	5	35.45
12.	Irregular claim of capital expenditure as revenue expenditure *(Para 3.13)*	26	344.97
13.	Depreciation allowed on ineligible items *(Para 3.14)*	27	34.29
14.	Irregular Claim of depreciation against income fully exempt from tax *(Para 3.15)*	48	27.28
15.	Mistakes in grant of additional depreciation *(Para 3.19)*	99	656.19
16.	Other mistakes *(Para 3.16 – 3.18, 3.20)*	84	30.82
	Total	**708**	**2436.51**

3.2 Depreciation claimed and allowed on assets not owned/lease out by the assessee

Section 32 of the Act provides for depreciation at prescribed rate on Written Down Value (WDV) of tangible or intangible assets including business or commercial right of similar nature subject to fulfillment of certain conditions. Primary condition is that the asset must be owned, wholly or partly, by the assessee. In case of co-ownership of the asset, co-owners are entitled to claim depreciation to the extent of value of the asset owned by each co-owner. In case of the Partnership firm, only the firm is entitled to claim depreciation on immovable assets brought by the Partners as their capital contribution. As regards ownership in case of finance lease, it has been judicially held[14] that only the lessee can be treated as owner of the asset in case of a finance lease. It is he who is entitled to claim depreciation as per law. No depreciation can be allowed to the lessor in such a case of a genuine finance lease. Where a building is taken on lease, depreciation is allowable only on the capital expenditure incurred on the building by the assessee.

In Chandigarh UT, Chhattisgarh, Gujarat, Karnataka, Kerala, Maharashtra, Rajasthan and Tamil Nadu charges, we found that 20 assessees claimed and were allowed depreciation on assets which were not owned by them at all. Irregular allowance of deprecation on assets not owned by the assessees, resulted in under assessment of income to that extent involving tax effect of ₹ 92.79 crore (See Box 3.1).

Box 3.1: Illustrative cases on assets not owned/leased out by assessees

a. In Gujarat, CIT II Ahmedabad charge, **M/s Mundra International Container Terminal Ltd.**, for AY 08 and AY 09, claimed and was allowed depreciation of ₹ 74.72 crore on 'infrastructure usage facility' @ 25 *per cent* on WDV treating the same as 'intangible asset' which was not in order on the ground that the 'right to use infrastructure facility' was not similar to 'intangible assets' as stated in section 32 of the Act. Instead, it was deemed right to use a tangible asset i.e. infrastructure. Further, the owner of the infrastructure **(Mundra Port & SEZ Ltd.)** also claimed depreciation on the same asset like marine structure and dredging CT for the same AY as seen from their Balance Sheet and as such depreciation claimed by the assessee should have been disallowed. Omission to do so resulted in excess allowance of depreciation of ₹ 74.72 crore involving short levy of tax of ₹ 25.25 crore.

ITD did not accept (February 2013) the audit observation stating that the assessee claimed and was allowed depreciation on the license to use the infrastructure

[14] M/s IndusInd Bank Ltd vs Addl CIT Special Bench of ITAT Mumbai, read with Supreme Court decision in the case of M/s ABB Ltd. The decision was re-affirmed by ITAT Bench Pune in the case of M/s Bajaj Auto finance Ltd vs ACIT.

facility and not as the owner of the infrastructure. Further, the licenses, franchisees etc. are categorized as intangible assets under the block of assets. The reply is not tenable as the assessee had claimed the depreciation on Infrastructure Usage facility as an intangible asset, which is not in the nature of a business or commercial rights as mentioned under the provisions of section 32(1) (ii) of the Act.

b. In Maharashtra, CIT-7, Mumbai charge, **M/s Vizag Seaport Pvt. Ltd.**, for the AY 08, claimed and was allowed depreciation of ₹ 17.53 crore on 'Project berth' at the rate of ten *per cent* treating the same as building which was not in order. The 'Project berth' belonged to **Vishakhapatnam Port Trust** and as such the assessee was not the owner of the berth and therefore not entitled for depreciation. Omission to disallow the depreciation on asset not owned by the assessee resulted in under assessment of income of ₹ 17.53 crore involving potential short levy of tax of ₹ 5.90 crore. ITD accepted the observation and took remedial action (January 2013) under Section 147.

c. In Maharashtra, CIT-3, Mumbai charge, **M/s Reliance Corporate IT Park Ltd.** for the AY 11, received total lease rent of ₹ 37.14 crore comprising of principal amount of ₹ 15.69 crore and finance charge of ₹ 21.45 crore during relevant previous year. The assessee had offered entire lease rent for taxation and had claimed depreciation of ₹ 34.75 crore on Plant and Machinery given on finance lease. As per provisions ibid, the assessee, being lessor, was not entitled for depreciation and as a corollary to this, the principal amount of ₹ 15.69 crore was not taxable. Omission to disallow the depreciation on assets not owned by the assessee resulted in under assessment of income of ₹ 19.06 crore with consequent potential short levy of tax of ₹ 5.89 crore.

d. In Karnataka, CIT-I Bangalore charge, **M/s Cisco Systems Capital (India) Pvt. Ltd.** for AY 09, claimed depreciation of ₹ 68.32 crore on networking equipment given on 'Finance Lease' by categorising them under 'computers including software'. AO while finalizing the assessments disallowed excess claim of depreciation of ₹ 51.24 crore categorising the same as Plant and Machinery. However, no depreciation was allowable on the 'Finance Lease' assets since the assessee being lessor would not be considered as owner in view of the decision cited above. Omission to disallow the depreciation resulted in excess allowance of ₹ 17.08 crore involving short levy of tax of ₹ 9 crore.

The audit observations indicate that certain AOs are allowing depreciation on assets without examining the element of ownership of the assets, as per one of the requirements for claiming the depreciation.

3.3 Depreciation claimed on assets not used in business

Where the asset is not used for the purpose of business, depreciation under section 32 of the Act shall not be allowed. Further, where the asset is not

used exclusively for the purpose of business, depreciation shall be allowed proportionately with regard to such usage of the asset.

In Andhra Pradesh, Chandigarh UT, Delhi, Gujarat, Jharkhand, Madhya Pradesh, Maharashtra, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal charges, 35 assessees claimed and were allowed depreciation on assets which were not used in the business. Irregular allowance of deprecation on assets not used in the business resulted in under assessment of income to that extent involving tax effect of ₹ 43.96 crore (See Box 3.2).

Box 3.2: Illustrative cases on depreciation claimed on assets not used in business

a. In Maharashtra, CIT-5, Mumbai charge, **M/s Maharashtra State Road Development Corp. Ltd.** for AY 08, was allowed depreciation of ₹ 333.93 crore which included depreciation of ₹ 46.31 crore on three incomplete projects viz ₹ 9.15 crore on Bandra Worli Sealink Project, ₹ 35.23 crore on Nagpur Ahmedabad Sinnar Ghoti Mumbai Project, and ₹ 1.93 crore on Kalyan Bhiwandi Shilphata. Since these projects were not completed by the end of FY 07, allowance of depreciation on these projects was irregular. Irregular allowance of depreciation aggregating ₹ 46.31 crore involved potential short levy of tax of ₹ 15.59 crore. ITD accepted (July 2013) the observation and took remedial action under Section 147 of the Act.

b. In West Bengal region, CIT-IV charge, Kolkata, in respect of **M/s Durgapur Chemicals Ltd.** for AY 10, depreciation of ₹12.83 crore was allowed during assessment (December 2011) on new assets which were installed but not put to use for production. This resulted in excess allowance of depreciation of identical amount involving potential tax effect of ₹ 4.36 crore.

Illustrations above indicate that ITD is allowing depreciation on assets without examining of the fact whether the asset was used by the assessee during the course of business on which depreciation was claimed.

3.4 Mistakes in determination of actual cost or written down value of assets

Under section 43(1) of the Act, "Actual Cost" of an asset means its actual cost to the assessee including the expenses on installation etc, if the part of the cost is met directly or indirectly by the third person, the cost to the assessee will be reduced by such amount borne by that person.

We noticed mistakes in 29 cases in determination of actual cost or written down value of assets in Andhra Pradesh, Chandigarh, Chhattisgarh, Delhi, Karnataka, Madhya Pradesh, Maharashtra, Orissa, Tamil Nadu, Uttar Pradesh, Uttarakhand and West Bengal charges, which resulted in excess allowance of depreciation involving tax effect of ₹ 85.47 crore (See Box 3.3).

Box 3.3: Illustrative case on Mistakes in determination of actual cost or written down value of assets

a. In Madhya Pradesh, CIT Bhopal charge, **M/s Madhya Kshetra Vidyut Vitaran Co. Ltd.** added twice the assets available at the beginning of the year to the new assets added during the previous year relevant to AY 11. Thus excess claim of depreciation amounting to ₹ 121.48 crore after setting off the current year's losses resulted in short levy of tax of ₹ 38.82 crore.

b. In Karnataka, CIT Mysore charge, AO finalized the assessment of **M/s Chamundeshwari Electricity Supply Company Ltd.**, for AY 10, at loss of ₹ 239.39 crore after disallowing depreciation of ₹ 12.49 crore claimed on capital subsidy / grant received on account of fixed assets. The assessee filed revised depreciation statements for AY 09, showing closing WDV at ₹ 231.33 crore and accordingly the depreciation claim pertaining to AY 10 worked out to ₹ 35.97 crore against which depreciation of ₹ 56.64 crore was allowed in assessment. The omission resulted in over assessment of loss by ₹ 20.66 crore involving potential tax effect of ₹ 7.02 crore.

From the above, it is evident that AOs while finalizing the assessment committed mistakes in determining the actual cost of WDV of assets which resulted in excess allowance of depreciation.

3.5 Depreciation allowed on assets disposed of

As per Section 43(6) of the Act, WDV of any block of assets in respect of any previous year means aggregate of the WDV of all the assets falling within that block of assets at the beginning of the previous year and adjusted by increase in the actual cost of any asset falling within that block, acquired during the previous year and by the reduction of the moneys 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 scrap value, so that amount of such reduction does not exceed the WDV as so increased. Further, as per explanation below Sub-Section 4 of Section 41, moneys payable in respect of any building, machinery, plant or furniture include any insurance, salvage or compensation moneys payable or the price for which such assets are sold.

In Bihar, Chandigarh UT, Gujarat, Jharkhand, Maharashtra, Kerala, Tamil Nadu and Uttar Pradesh charges, nine assessees claimed and were allowed depreciation on assets disposed of. Irregular allowance of depreciation on assets disposed of resulted in under assessment of income to that extent involving tax effect of ₹ 1.99 crore (See Box 3.4).

Box 3.4: Illustrative cases on depreciation allowed on assets disposed of

a. In Tamil Nadu, CIT-II, Chennai charge, **M/s Indowind Energy Ltd**, for AY 11, had sold energy saving devices for a consideration of ₹ 3.13 crore during the relevant previous year and irregularly claimed and was allowed depreciation of ₹ 1.25 crore thereon. Irregular allowance of depreciation involved potential tax effect of ₹ 1.06 crore.

b. In Maharashtra, CIT-1, Mumbai charge, in the case of a company **M/s Spenta International Ltd.**, for AY 07, a fire broke out at company premises at Palghar in December 2004 damaging 38 knitting machines and stock in hand. The company filed a claim of ₹ 4.39 crore with insurance company. Initially the company got ₹ 1 crore as advance in FY 06 and thereafter the block of 'Plant and machinery' was credited by ₹ 3.19 crore in the books of account. However, while calculating depreciation, no reduction was made from the WDV of Plant and Machinery destroyed by fire. Irregular allowance of depreciation of ₹ 87.23 lakh in FY 06 and ₹ 44.35 lakh in FY 07 resulted in short levy of tax of ₹ 55.31 lakh including interest.

The cases mentioned above indicate that the AOs allowed depreciation on the assets which were already disposed of and the assessees were no longer in possession thereof.

3.6 Capital investment subsidies not deducted from cost

As per Explanation 10 to Section 43(1) of the Act, where a portion of the cost of an asset acquired by the assessee has been met directly or indirectly by the Central Government or a State Government or any authority established under any law or by any other person, in the form of a subsidy or grant or reimbursement (by whatever name called), then, so much of the cost as is relatable to such subsidy or grant or reimbursement shall not be included in the actual cost of the asset to the assessee.

In Andhra Pradesh, Bihar, Chhattisgarh, Maharashtra, Karnataka, Tamil Nadu, Uttar Pradesh and West Bengal charges, we noticed that 18 assessees while calculating the depreciation did not deduct capital investment subsidies received from the cost of the assets. Non deduction of capital investment subsidies from the cost of the asset resulted in under assessment of income to that extent involving tax effect of ₹ 35.65 crore (See Box 3.5).

Box 3.5: Illustrative cases on Capital investment subsidies not deducted from cost

a. In Uttar Pradesh, Lucknow charge, AO for AY 11, wrongly allowed depreciation of ₹ 86.57 crore to **M/s Madhyanchal Vidyut Vitran Nigam Ltd.**, as against ₹ 9.38 crore admissible under the Act. We noticed that the depreciation allowed of ₹ 86.57 crore included depreciation on the cost of assets, which was

directly met out of the grants received from the Government/APDRP and Public contributions. The omission to disallow such claim resulted in excess computation of loss of ₹ 77.19 crore involving potential tax effect of ₹ 23.85 crore.

b. In Maharashtra, CIT-10 Mumbai charge, **M/s Maharashtra State Electricity Transmission Company Ltd.**, for AY 08, received capital subsidy of ₹ 101.03 crore towards cost of fixed assets comprising of ₹ 32.45 crore as outright contribution and grant of ₹ 68.58 crore. However, the AO did not reduce capital subsidy so received from the cost of asset and allowed depreciation on full value. The omission resulted in excess allowance of depreciation of ₹ 15.15 crore involving short levy of potential tax of ₹ 5.15 crore. ITD took remedial action (March 2013) under Section 143(3) read with Section 263 of the Act.

In above cases, capital subsidy/grants/contributions received by the assessee from different sources reduced the actual cost/WDV of the assets, even then the AOs allowed depreciation on full value of the assets.

3.7 Mistakes in carrying over the written down value of assets

Written Down Value of an asset or block of assets as worked out as per provision of Section 43(6) of the Act is required to be carried over correctly to the next year as opening WDV to give a true and fair view of the accounts.

We observed in Andhra Pradesh, Bihar, Maharashtra and Tamil Nadu charges that six assessees committed mistakes in carrying over the WDV of assets to the next year as opening WDV which resulted in excess allowance of depreciation involving tax effect of ₹ 7.15 crore (See Box 3.6).

Box 3.6: Illustrative case on mistakes in carrying over the WDV of assets

In Andhra Pradesh, CIT-III Hyderabad charge, **M/s Salivahana Green Energy Ltd.**, for AY 11, adopted opening WDV of the block of assets at ₹ 69.70 crore in the depreciation schedule for AY 11 as against closing WDV of ₹ 53.39 crore of the assets as on 31 March 2009. Excess carry over of WDV of ₹ 16.31 crore involved short levy of tax of ₹ 5.95 crore.

AOs omitted to check the correctness of the written down value of assets carried over to the next year by the assessees in above cases.

3.8 Mistakes in adoption of correct figure and errors in computation

Section 143(3) of the Act provides that in a scrutiny assessment, the AO is required to make a correct assessment of the total income or loss of the assessee and determine the correct sum payable by him or refundable to him on the basis of such assessment.

We found in Andhra Pradesh, Madhya Pradesh, Delhi, Chandigarh, Kerala, Gujarat, Uttar Pradesh, Maharashtra, Orissa, West Bengal and Tamil Nadu charges that 44 assessees committed mistakes in adoption of correct figure of depreciation in computation of income involving tax effect of ₹ 212.97 crore (See Box 3.7).

Box 3.7: Illustrative cases on mistakes in adoption of correct figure and errors in computation

a. In Madhya Pradesh, CIT Bhopal charge, in the case of **M/s MPMKVVNL**, AO adopted depreciation for the AY 10 at ₹ 613.81 crore instead of correct amount of ₹ 99.07 crore as per the Act. The mistake resulted in excess allowance of depreciation of ₹ 514.74 crore involving tax effect of ₹ 154.42 crore.

b. In Delhi, CIT- IV Delhi charge, **M/s Idea Cellular Towers Infrastructure Ltd.** for AY 11 claimed depreciation @15 *per cent* on passive infrastructure assets treating them as "Plant and Machinery". AO considered Plant and Machinery as building and allowed depreciation @10 *per cent* and added back ₹ 11.21 crore only in the income which was correctly worked out to ₹ 74.72 crore towards 5 *per cent* excess claimed. The mistake resulted in excess allowance of depreciation of ₹ 63.51 crore involving potential tax effect of ₹ 21.59 crore.

c. In Tamil Nadu, CIT-I Chennai charge, while finalising the assessment of **M/s Dhanus Technologies Ltd.**, for the AY 11, AO disallowed interest payment of ₹ 2.85 crore instead of depreciation of ₹ 28.10 crore which was required to be disallowed. The mistake resulted in excess allowance of depreciation to the extent of ₹ 25.25 crore, involving short levy of tax of ₹ 11.58 crore including interest under section 234B.

Therefore, AOs committed mistakes in adoption of correct figure of depreciation in computation of income which resulted in under assessments.

3.9 Adoption of incorrect rate of depreciation

Depreciation on any block of assets shall be calculated at the rates specified in Appendix I and in respect of any class of assets relating to power generation undertakings at the rates indicated in Appendix I A to the Income Tax Rules, 1962.

We observed in Andhra Pradesh, Bihar, Chandigarh, Delhi, Gujarat, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Rajasthan, Tamil Nadu, Uttar Pradesh, Uttarakhand and West Bengal charges that 142 assessees claimed and were allowed depreciation at rates which were higher than the rates admissible under the Act. The mistake resulted in excess allowance of depreciation involving tax effect of ₹ 107.85 crore (See Box 3.8).

Box 3.8: Illustrative cases on adoption of incorrect rate of depreciation

a. In Andhra Pradesh, CIT-IV Hyderabad charge, **M/s Ushodaya Enterprises**, for the AY 08 and AY 09, claimed and was allowed depreciation on Cinematographic films/TV serials at 25 *per cent* treating them as intangible assets. Since the film library is not in the form of technical knowhow or copyrights but merely TV programs contained in CDs/storage media which were being used as tools in the business activity and hence the same should have been treated as Plant and Machinery, attracting depreciation at 15 *per cent*. The mistake resulted in short computation of income aggregating ₹ 116.78 crore involving tax effect of ₹ 52.79 crore. ITD took remedial action (May 2011) under section 263 of the Act for the AY 08.

b. In Kerala, CIT-Trivandrum charge, in the case of **M/s Asianet Satcom Ltd.** for AY 09, AO allowed depreciation on set top boxes and modems supplied to Cable TV/Internet subscribers at the rate of 60 *per cent* applicable to computers instead of 15 *per cent* treating them as Plant and Machinery. Omission resulted in excess allowance of depreciation of ₹ 6.16 crore involving potential tax effect of ₹.2.09 crore. ITD accepted and rectified (August 2013) the mistake under section 263 of the Act.

The above cases indicate that AOs allowed depreciation at rates which were higher than the rates admissible under the Act. This resulted in excess allowance of depreciation.

3.10 Excess allowance of depreciation on assets used for less than 180 days

Proviso to section 32(1) of the Act provides for depreciation @ 50 *per cent* of the normal rate on asset which is acquired and put to use during the relevant previous year for the purposes of business or profession for a period of less than 180 days.

In Andhra Pradesh, Bihar, Chandigarh, Karnataka, Maharashtra, Rajasthan, Tamil Nadu and West Bengal charges, we observed that 29 assessees while calculating business income claimed depreciation at normal rate of depreciation though the assets were used less than 180 days. Excess allowance of depreciation resulted in under assessment of income to that extent involving tax effect of ₹ 25.03 crore (See Box 3.9).

Box 3.9: Illustrative cases on excess allowance of depreciation on assets used for less than 180 days

a. In Andhra Pradesh, CIT-III Hyderabad charge, AO, in the case of **M/s Sagar Cements Pvt. Ltd.**, for AY 10, allowed depreciation on Plant and Machinery at normal rate though the same were put to use for less than 180 days for the

purpose of business. The mistake resulted in excess allowance of depreciation of ₹ 37.64 crore involving potential tax effect of ₹ 12.79 crore.

b. In Karnataka, CIT LTU Bengaluru charge, AO, in the case of **M/s IBM India (P) Ltd.,** for the AY 07, disallowed software expenses of ₹ 99.36 crore treating the same as capital asset, and thereafter allowed depreciation of ₹ 59.62 crore thereon at full rate of 60 *per cent.* We observed that the amount on which AO allowed depreciation was required to be bifurcated depending upon the use of assets for more than 180 days and the lesser period. Consequently, the allowable depreciation worked out to ₹ 47.40 crore, as against ₹ 59.62 crore allowed by AO. The mistake resulted in excess allowance of depreciation of ₹ 12.22 crore, involving short levy of tax of ₹ 6.38 crore.

The above cases indicate that AOs allowed normal rate of depreciation though the assets were used less than 180 days.

3.11 Mistakes in carry forward/set off of depreciation

As per provisions of the Act, where for any AY, depreciation/unabsorbed depreciation cannot be set off against business income or any other income in the relevant previous year, it shall be carried forward indefinitely and set off against any income taxable in the succeeding assessment years. Further, section 72A(4)(b) of the Act provides that in the case of a demerger where the loss and unabsorbed depreciation is not directly relatable to the undertakings transferred, the accumulated loss and unabsorbed depreciation shall be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings are retained by the demerged company and resulting company and be allowed to be carried forward and set off in the hands of the demerged company or the resulting company as the case may be.

In Andhra Pradesh, Chandigarh, Delhi, Gujarat, Karnataka, Kerala, Maharashtra, Rajasthan, Tamil Nadu and West Bengal charges, we observed mistakes in carry forward/set off of depreciation in 87 cases which resulted in under assessment of income to that extent involving tax effect of ₹ 694.65 crore (See Box 3.10).

Box 3.10: Illustrative cases on mistakes in carry forward/set off of depreciation

a. In Maharashtra, CIT-3 Mumbai charge, in the case of **M/s Idea Cellular Ltd.** for the AY 10, the AO allowed set off of brought forward unabsorbed depreciation of ₹ 740.51 crore as against available brought forward unabsorbed depreciation of ₹ 137.24 crore. During the year, demerger of the company took place and 13.98 *per cent* of the total asset was transferred to **Idea Cellular Tower Infrastructure Ltd. (ICTIL)** i.e. resulting company. Therefore, ₹ 19.19 crore (being 13.98 *per cent* of ₹ 137.24 crore) was required to be transferred to the resulting company and as such

only 86.02 *per cent* of unabsorbed depreciation was available for set off. Excess set off of unabsorbed depreciation of ₹ 622.46 crore resulted in under assessment of income to that extent involving short levy of tax of ₹ 266.08 crore including interest.

b. In Rajasthan, CIT-2 Jaipur charge, while finalising the assessment of **M/s Rajasthan Rajya Vidyut Utpadan Nigam Ltd.**, for AY 11, AO set off brought forward unabsorbed depreciation of ₹ 101.57 crore out of ₹ 958.06 crore pertaining to the period up to AY 03 and the balance of ₹ 856.49 crore was allowed to carry forward to subsequent years. We observed that the unabsorbed depreciation of ₹ 958.06 crore was reduced to ₹ 733.08 crore during scrutiny assessment for AY 10. Thus, there was excess carry forward of unabsorbed depreciation of ₹ 224.98 crore pertaining to earlier periods. Further, while completing scrutiny assessment for the AY 11, the unabsorbed depreciation of ₹ 134.81 crore pertaining to AY 10 was allowed to be carried forward to subsequent years which was not available at all. Excess carry forward of ₹ 359.80 crore involved potential tax effect of ₹ 122.29 crore. ITD accepted the observation and issued notice under Section 154 on 24 September 2013.

c. In Tamil Nadu CIT-III Chennai charge, in the case of **M/s Thiru Arooran Sugars Ltd**, for AY 11, AO set off entire income of ₹ 97.78 crore towards brought forward business loss and unabsorbed depreciation pertaining to earlier years as against the available amount of ₹ 7.04 crore relating to unabsorbed business loss and ₹ 34.24 crore pertaining to unabsorbed depreciation. The mistake resulted in excess set off of unabsorbed depreciation of ₹ 56.50 crore involving a tax effect of ₹ 26.42 crore.

d. In West Bengal, CIT-I Kolkata charge, in the case of **M/s West Bengal State Electricity Transmission Company Ltd.,** for AY 10 and AY 11, AO allowed carry forward of unabsorbed depreciation of ₹ 155.37 crore pertaining to AY 08 whereas the actual amount of unabsorbed depreciation was ₹ 79.00 crore. The mistake resulted in excess allowance of carry forward of unabsorbed depreciation of ₹ 76.37 crore involving potential tax effect of ₹ 25.96 crore

The above cases indicate that AOs committed mistakes in carry forward/set off of depreciation which resulted in under assessment of income.

3.12 Mistake in carry forward and set off of unabsorbed depreciation relating to amalgamating companies

As per the provisions of section 72A, the brought forward losses of amalgamated company will be eligible for set off against the income of the amalgamating company subject to fulfillment of certain conditions.

We found mistakes in carry forward/set off of unabsorbed depreciation relating to amalgamating companies in five cases in Andhra Pradesh, Kerala, Orissa and Tamil Nadu charges which resulted in under assessment of income to that extent involving tax effect of ₹ 35.45 crore (See Box 3.11).

Box 3.11: Illustrative case on mistake in carry forward and set off of unabsorbed depreciation relating to amalgamating companies

In Andhra Pradesh, CIT-III Hyderabad charge, in the case of **M/s SHV Energy Pvt. Ltd**, for AY 10, AO allowed carry forward and set off of unabsorbed depreciation of ₹ 49.51 crore relating to amalgamated company (M/s SHB Energy LPG Infrastructure Pvt. Ltd.) instead of correct amount of ₹ 17.64 crore. Besides, brought forward business loss of ₹ 14.18 crore (pertaining to AY 01) was also set off though no such loss was available for set off. Excess set off of ₹ 46.05 crore of unabsorbed depreciation/ brought forward business loss resulted in understatement of income to that extent involving potential tax effect of ₹ 15.65 crore.

The above cases indicate that AOs committed mistakes in carry forward/set off of depreciation relating to amalgamating companies which resulted in under assessment of income.

3.13 Irregular claim of capital expenditure as revenue expenditure

Capital expenditure is not allowable while computing taxable income, unless the law expressly so provides. It has been judicially held[15] that payment of non-compete fees falls within the capital field and therefore deduction cannot be allowed as a revenue expenditure. Instead, depreciation is allowed on Know-how, Patents, Copyrights, Trade marks, Licences, franchise or Commercial rights of similar nature.

During test check in Andhra Pradesh, Chandigarh, Delhi, Gujarat, Karnataka, Kerala, Maharashtra, Orissa, Rajasthan and Tamil Nadu charges, we found that 26 assessees irregularly claimed and were allowed capital expenditure as revenue expenditure which resulted in under assessment of income to that extent involving tax effect of ₹ 344.97 crore (See Box 3.12).

Box 3.12: Illustrative cases on irregular claim of capital expenditure as revenue expenditure

a. In Maharashtra, CIT-3 Mumbai charge, in the case of **M/s Idea Cellular Ltd.** for the AY 10, AO allowed deduction of ₹ 543.98 crore on account of non-compete fee which was not allowable as revenue expenditure in terms of judicial pronouncement. Omission to disallow non-compete fee as revenue expenditure resulted in under assessment of income of ₹ 543.98 crore involving tax effect of ₹ 245.91 crore including interest. Further, during the year under consideration, the assessee had received fixed assets under finance lease. The assessee in his books of accounts had capitalized ₹ 147.62 crore being principal component paid to the

[15] Sharp Business System vs Commissioner Of Income Tax (Special Bench I of Delhi High Court – 05 November 2012)

lessor under finance lease and claimed as revenue expenditure which was reduced to ₹ 142.76 crore in the revised return and allowed accordingly. The assessee was entitled for depreciation on this amount and was not entitled for deduction of the amount as revenue expenditure. This omission resulted in under assessment of income of ₹ 121.35 crore with consequent short levy of tax of ₹ 54.86 crore including interest. Total short levy of tax worked out to ₹ 300.77 crore including interest.

b. In Tamil Nadu, CIT Salem charge, AO allowed **M/s Rasi Seeds (P) Ltd.**, for AY 10, ₹ 76.16 crore as sub-license fee debited to the Profit and Loss account. Audit observed that the assessee had incurred expenditure of ₹ 76.16 crore for entering into sub-licence agreement with **M/s Mahyco Monsanto Biotech (I) Ltd.** for employing the technology for BT Genes and for transfer of technology and use of trademark, which was in the nature of capital expenditure qualifying for depreciation @ 25 *per cent* only. Omission to treat the same as capital expenditure and restricting the deduction to the extent of eligible depreciation resulted in excess allowance of deduction of ₹ 57.12 crore involving tax effect of ₹ 19.41 crore. The ITD did not accept (August 2013) the audit observation stating that it was allowable as revenue expenditure. The reply is not tenable in view of codal provisions of the Act.

c. In Karnataka, CIT-LTU, Bangalore charge, in the case of **M/s Canara Bank,** for AY 09, AO allowed expenditure of ₹ 15.89 crore, charged to its Profit and Loss account, towards creation of new logo under brand building initiative undertaken with the objective of increasing the customer base. As the expenditure incurred involved enduring benefit to the assessee, it should have been treated as capital attracting depreciation admissible to an intangible asset. Omission resulted in under assessment of income of ₹ 11.91 crore involving short levy of tax of ₹ 5.35 crore.

The above cases indicate that AOs irregularly allowed claim of capital expenditure as revenue expenditure which resulted in under assessment of income.

3.14 Depreciation claimed and allowed on ineligible items

Depreciation is allowable on capital assets used for the purpose of business. However, no depreciation is allowable on land though it is a capital asset. Likewise, goodwill is not an intangible asset and hence will not qualify for depreciation allowance, as held by the Supreme Court[16].

We observed in Andhra Pradesh, Chandigarh, Delhi, Gujarat, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Rajasthan, Tamil Nadu and West Bengal charges that 27 assessees claimed and were allowed depreciation on items which were not eligible for depreciation. Irregular allowance of

[16] M/s B.C. Srinivas Setty vs CIT (128 ITR 294)

depreciation resulted in under assessment of income to that extent involving tax effect of ₹ 34.29 crore (See Box 3.13).

Box 3.13: Illustrative cases on depreciation claimed and allowed on ineligible items

a. In West Bengal region, CIT-I Kolkata charge, **M/s Infinity InfoTech Parks Ltd.,** for AYs 08, AY 10 and AY 11, engaged in the business of 'development of IT Park and providing services relating thereto' was allowed depreciation on the unsold buildings built by them leading to allowance of depreciation on 'trading stock' and not on 'capital asset' used for the purpose of business. This resulted in total excess allowance of depreciation ₹ 16.19 crore involving tax effect of ₹ 5.50 crore. ITD did not accept (October 2013) the observation on the ground that the business of the assessee was to provide services and the said assets were being used for that purpose. This is not tenable as the business of the assessee was 'development of IT Park and providing services relating thereto' which included developing, constructing and selling of building 'unit wise' and 'floor space basis'. Hence, the assessee was not eligible for depreciation as the constructed building had no use for the purpose of the business of the assessee.

b. In Karnataka, CIT-I, Bangalore charge, in the case of **M/s Fibres and Fabrics International Pvt. Ltd.**, for AY 07 and AY 08, revealed that the assessee was allowed depreciation aggregating to ₹ 8.61 crore, claimed on goodwill, though it did not qualify as an intangible asset. The mistake resulted in under assessment of ₹ 8.61 crore, involving a total tax effect of ₹ 4.06 crore.

The above cases indicate that AOs allowed depreciation on ineligible items which resulted in under assessment of income.

3.15 Irregular claim of depreciation against income fully exempt from tax

No deduction is allowable against the income which is exempt from tax. Further, in the case of trust/ society whose income is claimed as exempt by application of income under Section 10 or 11, no depreciation is admissible as it will amount to allowance of double deduction.

We observed in Bihar, Haryana, Karnataka, Tamil Nadu, Uttar Pradesh and Uttarakhand charges that 48 assessees claimed and were allowed depreciation against income fully exempt from tax which resulted in under assessment of income to that extent involving tax effect of ₹ 27.28 crore (See Box 3.14).

Box 3.14: Illustrative cases on Irregular claim of depreciation against income fully exempt from tax

a. In Uttarakhand, CIT Dehradun charge, **M/s Institute of Management Studies** was registered under the Societies Registration Act 1960 and availed exemption for AY 11 under Section 12AA of the Act wherein the income of the assessee was exempt. However, AO while finalising the assessment irregularly

allowed depreciation of ₹ 10.67 crore which resulted in double deduction to that extent involving tax effect of ₹ 3.30 crore.

b. In Tamil Nadu, CIT-II Madurai charge, in the case of **M/s Govel Trust,** for AY 11, AO allowed depreciation of ₹ 6.75 crore on assets whose cost was already claimed as application of income which resulted in allowance of double deduction involving tax effect of ₹ 2.07 crore. ITD did not accept (August 2013) the observation stating that the scheme of taxation of Charitable Trust was different from taxation of other taxable entities. The deduction of depreciation did not amount to double benefit/ double deduction. The reply is not tenable as the case law reported in 328 ITR 421 (P&H) mainly dealt with granting of exemption for the Profits and Gains from business incidental to the objectives of the Trust u/s 11(1), (2) and (3) when the exemption contemplated u/s 11(4A) was not applicable, and not about the allowing of depreciation to the Trust.

Thus, AOs irregularly allowed depreciation against income fully exempt from tax which resulted in under assessment of income.

3.16 Allowance of depreciation on non-commercial vehicle

In case of new commercial vehicles, acquired on or after the 01 January, 2009 but before the 01 October 2009 and put to use before the 01 October 2009 for the purposes of business or profession, depreciation is allowable at the rate of 50 per cent.

We observed in Gujarat, Karnataka, Kerala and Tamil Nadu charges that 29 assessees was allowed depreciation on non-commercial vehicle at higher rate applicable to commercial vehicles which resulted in under assessment of income to that extent involving tax effect of ₹ 10.91 crore (See Box 3.15).

Box 3.15: Illustrative case on Allowance of depreciation on non-commercial vehicle

In Tamil Nadu, CIT-LTU Chennai charge, **M/s Sundaram Finance Ltd.,** a leasing and finance company having income from lease, rent, bills discounting and service charges, leased out motor vehicles either on operating lease or finance lease only to its customers. For AY 11, the assessee availed depreciation of ₹ 25.72 crore on motor cars at the rate of 50 *per cent* as against ₹ 7.72 crore at the normal rate of 15 *per cent*. Since the company was not using these vehicles in the business and was not running them on hire, the allowance of depreciation thereon at higher rate was not in order. This resulted in excess allowance of depreciation of ₹ 18.01 crore involving short levy of tax of ₹ 8.26 crore.

ITD replied (August 2013) that depreciation at 50% is allowable on new commercial vehicle as per Sl. No.3 (via) of depreciation schedule. The reply is not tenable as the motor cars were not used for the purpose of running them on hire, they are not required to be treated as commercial vehicles for the purpose of allowance at higher rate of depreciation.

Thus, AOs allowed depreciation on non-commercial vehicle at higher rate applicable to commercial vehicles which resulted in under assessment of income.

3.17 Depreciation claimed against let out property

The Act allows 30 *per cent* standard deduction and interest paid on borrowed capital to cover all expenditure related to the income under the head "Income from House Property". Hence, no depreciation is admissible thereon.

In Karnataka, Tamil Nadu, Bihar, Uttarakhand charges, we found that six assessees irregularly claimed depreciation against let out property which resulted in under assessment of income to that extent involving tax effect of ₹ 1.85 crore (See Box 3.16).

Box 3.16: Illustrative case on Depreciation claimed against let out property

In Karnataka, CIT-III Bangalore charge, in the case of **M/s Renaissance Holdings and Developers Pvt. Ltd.** for AY 10, AO allowed depreciation of ₹ 2.02 crore on buildings let out, though its rental income was assessed under the head 'Income from House Property'. Omission resulted in under assessment of income to that extent, involving tax effect of ₹ 85.81 lakh.

3.18 Other mistakes relating to depreciation

While computing tonnage income of a tonnage tax company under section 115VL, provisions of Section 30 to 43B shall apply as if every loss, allowance or deduction had been given full effect to for that previous year itself. Assesses/AOs are also required to comply with certain other provisions relating to depreciation in their claims for depreciation.

In Andhra Pradesh, Chandigarh (UT), Gujarat, Karnataka, Madhya Pradesh, Maharashtra, Orissa, Tamil Nadu and West Bengal, we noticed that 36 assessees had not complied with certain other provisions relating to depreciation in their claims for depreciation which involved tax effect aggregating ₹ 14.73 crore (See Box 3.17).

Box 3.17: Illustrative case relating to Tonnage Tax Scheme

In Andhra Pradesh, CIT-I Vishakhapatnam charge, **M/s Eversun Sparkle Maritime Services Pvt. Ltd.** opted out of Tonnage Tax scheme from AY 11. However, unabsorbed depreciation pertaining to the period of tonnage tax scheme i.e., from AY 06 to AY 10 was allowed to be carried forward which is in contravention to the aforesaid provisions. The mistake resulted in understatement of income of ₹ 5.44 crore involving tax effect of ₹ 1.85 crore. ITD accepted (October 2013) the audit observation and took remedial action.

3.19 Mistakes in grant of additional depreciation

Under the Act[17], an assessee engaged in the business of manufacture or production of any article or thing is entitled to additional depreciation equal to twenty *per cent* of the actual cost of any new machinery or plant (other than ships, land, aircraft etc.), which has been acquired and installed after 31 March 2005 subject to certain conditions prescribed under Section 32(1)(iia) of the Act. From AY 2013-14, assessees engaged in the business of generation or generation and distribution of power are also eligible for additional depreciation.

It was noticed in Andhra Pradesh, Bihar, Chandigarh, Chhattisgarh, Delhi, Gujarat, Karnataka, Kerala, Maharashtra, Rajasthan, Tamil Nadu, Uttarakhand and West Bengal charges that while computing additional depreciation, AOs committed mistakes in grant of additional depreciation in 99 cases resulting in under assessment of income to that extent involving tax effect of ₹ 656.19 crore (See Box 3.18).

Box 3.18: Illustrative cases on mistakes in granting additional depreciation

a. In West Bengal, CIT-I Kolkata charge, in the case of **M/s West Bengal State Electricity Distribution Co Ltd.,** for AY 09 and AY 10, AO allowed additional depreciation of ₹ 362.47 crore and ₹ 46.40 crore respectively on new plant and machinery. The assessee was engaged in the business of 'generation and distribution of electricity' which did not fall in the category of manufacturing of any article and things and as such was not eligible for additional depreciation. Irregular allowance of additional depreciation of ₹ 408.87 crore resulted in under assessment of income to that extent involving short levy of tax aggregating ₹ 138.97 crore.

b. In Tamil Nadu, CIT-LTU Chennai charge, in the case of **M/s Neyveli Lignite Corporation**, for AY 10 and AY 11, AO allowed additional depreciation of ₹ 162.30 crore and ₹ 109.35 crore respectively on dumper, crane, dozer, crawler and pick & carry mobile crane, etc. We noticed that the assessee was engaged in coal mining and power generation which were not manufacturing activity. Thus, the assessee was not eligible for additional depreciation. Omission resulted in short levy of tax aggregating ₹ 92.34 crore for both the AYs.

On this being pointed out, ITD replied (August 2013) that Supreme Court held[18] that the process of extraction of coal would amount to 'production'. The reply is not tenable as new sub-section (29BA) to Section 2, inserted with effect from 01 April 2009, defined 'Manufacture' to mean a change in non-living physical object or article or thing, resulting in transformation of the object or article or thing into a new and distinct object or article or thing having a different name, character and use; or

[17] As per provision below Section 32(1)(iia) of the Income Tax Act.
[18] CIT vs SESA Goa Ltd., (271 ITR 331)

bringing into existence of a new and distinct object or article or thing with a different chemical composition or integral structure. Since the trade name of coal or physical or chemical properties are not changed in coal mining, the assessee was not entitled to claim additional depreciation on these equipments.

c. In Gujarat, CIT-I Vadodara charge, **M/s Gujarat State Electricity Corporation Ltd** engaged in generation of power, for AY 11, was allowed depreciation of ₹ 642.14 crore which included additional depreciation of ₹ 203.43 crore on new plant and machinery purchased and installed for generation of power by the assessee during the relevant previous year. Since plant and machinery used for generation of power was not covered under clause (ii) of Section 32(1) of the Act, the assessee was not eligible for additional depreciation. The incorrect allowance of additional depreciation of ₹ 203.43 crore resulted in excess allowance of MAT credit of ₹ 69.14 crore.

The AO did not accept (August 2013) the observation stating that by virtue of second proviso to the Rule 5(1A) of the Income Tax Rules, 1962, the company had an option to claim depreciation as if the provision of clause (ii) of section 32(1) of the Act were applicable subject to the conditions that the same rates of depreciation are to be applied for all the subsequent years. Since the assessee has been claiming depreciation as per clause (ii), the assessee had claimed additional depreciation u/s 32(1)(iia) correctly. The reply is not tenable as the Act specifically excluded assets under 'generation of electricity' covered under clause (i) of section 32(1) from availing additional depreciation. Option given under Rule 5(1A) of the Income Tax Rules for units generating electricity is meant for depreciation under section 32(1) and not for additional depreciation covered under section 32(1)(iia) which is a separate provision for promoting manufacturing units. Rules framed under the Act cannot over rule the provisions of the same Act. Further, AO disallowed additional depreciation claimed on power generating equipments by Gujarat Alkalies & Chemicals Limited assessed in the same Circle for AY 11.

d. In Delhi, CIT-V Delhi charge, **M/s NTPC Sail Power Company Pvt. Ltd.**, engaged in the business of power generation, for AY 11, was allowed additional depreciation of ₹ 853.89 crore on plant and machinery partly at 20 *per cent* and partly at 10 *per cent*, though no additional depreciation was allowable. Omission resulted in excess allowance of depreciation of ₹ 203.17 crore involving potential tax effect of ₹ 69.06 crore.

Thus, AOs committed mistakes in grant of additional depreciation resulting in under assessment of income.

3.20 Non claim of additional depreciation during tax holiday

From 2002-03 onwards, depreciation is mandatory and shall be allowed or deemed to have been allowed irrespective of claim made in the Profit & Loss Account or not. In respect of newly established undertakings in Free Trade Zones, units established in Special Economic Zones, newly established 100 *per cent* export-oriented undertakings etc., the Written Down Value (WDV) of the assets used for the purpose of the business of the undertaking shall be computed as if the assessee had claimed and been actually allowed the depreciation for the tax holiday period.

We found in Andhra Pradesh, Chandigarh, Maharashtra and West Bengal charges that in case of 13 assessees, AO did not allow additional depreciation during tax holiday which resulted in over assessment of income to that extent involving tax effect of ₹ 3.33 crore (See Box 3.19).

Box 3.19: Illustrative case on non claim of additional depreciation during tax holiday

In Maharashtra, CIT-Central Circle 3 Mumbai charge, **M/s Elder Pharmaceuticals Ltd.,** for AY 09 and AY 10, engaged in manufacturing of pharmaceutical products having units at Uttarakhand and Himachal Pradesh being in tax holiday, was exempt from tax under section 80IC of the Act. The assessee made additions of ₹ 16.94 crore and ₹ 9.96 crore to the block of asset 'Plant and Machinery' during the relevant previous years on which depreciation admissible was allowed but additional depreciation of ₹ 3.27 crore in AY 09 and ₹ 1.89 crore in AY 10 was not allowed. Omission resulted in overstatement of income to that extent involving potential tax effect of ₹ 1.59 crore.

3.21 Recommendation

We recommend that CBDT may devise a mechanism to improve the quality of assessments and explore the possibility of capacity building for Assessing Officers for reducing the incidence of mistakes.

The Ministry stated (May 2014) that CBDT has taken various administrative steps to improve upon the quality of assessments till now which are as follows:

- *CBDT has laid emphasis on improving the quality of assessments by incorporating the strategy for ensuring quality in scrutiny assessment cases in the Central Action Plan (CAP) document. Post-assessment, practice of review and inspection has been standardized therein. Each CCsIT/DGsIT is required to forward analysis of 50 quality assessments of his charge along with suggestions for improvement to the concerned Zonal Member. Further, quality cases are being compiled and published annually which provides valuable guidance to AOs to*

strive upon to improve quality of orders being framed. These steps have been initiated from FY 2011-12 onwards.

- *To discourage AOs from making high-pitched assessments, Member (IT) issued a communiqué to all CCsIT/DGsIT wherein it was emphasized upon that in cases of deliberate omission or commission on part of AO in making frivolous additions, the supervisory officer may bring the matter to the notice of Competent Authority for administrative action. Supervisory officers were also advised to play effective role in this regard.*
- *Range heads are required to effectively monitor cases during the progress of scrutiny assessment and in appropriate cases, they may invoke provisions of section 144A of the IT Act to issue suitable directions to the AO to enable him to frame a judicious order.*
- *System of Review and Inspection by the supervisory officers, post-assessment, is also used as an effective tool to monitor the quality of scrutiny-assessments, being framed.*

Further regarding initiatives to be taken to enhance capacity building of AOs so as to equip them to handle assessment work, the Ministry (May 2014) also stated that specific inputs may kindly be taken from Director General of Income Tax (HRD) as this issue is being specifically being dealt by that Directorate.

Audit is of the view that the Ministry should pursue the matter regarding enhancement of capacity building with Director General of Income Tax (HRD) so that mistakes in assessments are minimised.

The Ministry while describing the role of Director General of Income Tax (HRD) in imparting various training at all levels, emphasized (June 2014) the implementation of National Judicial Reference System for enhancement on knowledge.