

# DEPRECIATION

♦ Legal Series Vol. XVI ♦ Issue 9

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## DEPRECIATION UNDER SECTION 11(6) OF INCOME TAX ACT



**Standards & Norms**

Resource support on NGO Governance, Accounting and Regulations



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## DEPRECIATION UNDER SECTION 11(6) OF INCOME TAX ACT

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## OVERVIEW

- 1.01** The term 'depreciation' means a decrease or reduction in the value of an asset over a period of time due to wear and tear or obsolescence. In other words, depreciation is a systematic allocation of the cost of a capital asset over its useful life. Depreciation is a non-cash expenditure to protect an organization against erosion in the value of assets and is generally charged while the finalization of accounts to reflect a true and fair view of the financial result and the financial status of the organization.
- 1.02** In this issue, we shall discuss the allowability of depreciation while computing income subject to application and allowability of depreciation as an application of income.
- 1.03** Depreciation is available to charitable or religious organisations under section 11(1) read with section 11(6) of the Income-tax Act.
- 1.04** Unlike other commercial organisations, charitable organisations need to understand the difference between an asset created out of income (subject to application) and assets created from sources other than income.
- 1.05** Depreciation is claimed in compliance with section 11(6) of the Income-tax Act. This section was inserted by the Finance (No. 2) Act 2014 with effect from 1-4-2015 to disallow the double deduction. This section clearly states that depreciation shall not be allowed while computing income in respect of any asset, acquisition of which has been claimed as an application of income in the same or other previous year.
- 1.06** Before the amendment made by Finance Act, 2014, depreciation was claimed as a charge against income even for those assets which had already been claimed as an application at the time of purchase. It amounts to double deduction; however, such double deduction was permitted based on various judicial pronouncements.

- 1.07** In the case of *CIT v. Karnataka Reddy Janasangha* [2017] 80 taxmann.com 171/247 Taxman 9, the Supreme Court of India declared that Section 11(6), which was introduced by Finance (No. 2) Act, 2014, and pertains to depreciation, will be applicable from the assessment year 2015-16 onwards. Therefore, the amendment has a prospective nature and cannot be applied retrospectively.
- 1.08** Charitable organizations are not bound to follow the depreciation rates prescribed under income tax laws. Hence, they can commercially determine their depreciation rates, considering the fact that Section 14 and Section 32 do not apply to them.
- 1.09** Depreciation which is claimed as application over and above 85% application requirement is academic in nature as it will not result in any additional corpus or fund for the organisation for replacement of asset.
- 1.10** All assets created out of sources other than income shall be eligible for depreciation, including assets created out of restricted grants or legal obligation not treated as income under section 2(24)(iia) or section 2(24)(xviii).
- 1.11** The Finance Act, 2022 has inserted a new explanation after section 11(7), as a result application will be allowed only on a cash basis, which raises the question of whether depreciation (being a non-cash expenditure) will be permissible henceforth. However, the said explanation shall not affect the admissibility of depreciation as application of income subject to the provisions of section 11(6).

## **ALLOWABILITY OF DEPRECIATION UNDER SECTION 11(6)**

- 2.01** Depreciation can be claimed in compliance with section 11(6) of the Income-tax Act. This section was inserted by the Finance (No. 2) Act, 2014 with effect from 1-

4-2015 to disallow the double deduction of depreciation. This section clearly states that depreciation shall not be allowed against those assets which have been treated as application of income in earlier years.

**2.02** The text of section 11(6) with emphasis is reproduced as under:

*“(6) In this section where any income is required to be applied or accumulated or set apart for application, then, for such purposes the income shall be determined without any deduction or allowance by way of depreciation or otherwise in respect of **any asset, acquisition of which has been claimed as an application of income** under this section in the same or any other previous year.”*

**2.03** The explanatory note to the Finance (No. 2) Act, 2014 also clarified that depreciation shall not be allowed if acquisition of assets was claimed as application in the current earlier year. The relevant extract of explanatory note is as under:

*“It is proposed to insert sub-sections (6) and (7) in the said section so as to provide that— (i) where any income is required to be applied or accumulated or set apart for application, then, for such purposes the income shall be determined without any deduction or allowance by way of depreciation or otherwise in respect of any asset, acquisition of which **has been claimed as an application of income under this section in any previous year**, and”*

**2.04** Prior to the amendment introduced by the Finance (No. 2) Act, 2014, depreciation was claimed as a charge against income even for those assets that had already been claimed as an application at the time of acquisition, resulting in a double deduction. However, such double deduction was allowed based on judicial precedents.

## SECTION 11(6) CANNOT BE APPLIED RETROSPECTIVELY

- 3.01** The Supreme Court of India in the case of *CIT v. Karnataka Reddy Janasangha* [2017] 80 taxmann.com 171/247 Taxman 9 held that section 11(6) inserted by Finance (No. 2) Act, 2014 pertaining to depreciation would apply from assessment year 2015-16 onwards, in other words, the amendment is prospective in nature; it cannot be applied retrospectively. As a result, organisations who had claimed double deduction prior to the enactment of section 11(6) can sustain such a claim.

## CAN A PART OF THE ASSET BE CLAIMED AS AN APPLICATION UNDER SECTION 11(6)

- 4.01** Section 11 of the Income Tax Act restricts trusts to claim the application of income only to the extent of income available, unlike commercial organizations. *For example*, if the income is Rs. 100 then the application cannot be Rs. 120, unlike a commercial organisation where the profit and loss account can reflect losses. In case of a Trust even if the application is Rs. 120 it will only imply that Rs. 20 was spent from sources other than income and shall remain as an unabsorbed expense to be set off against future income. This view also draws authority from the fact that there is a fundamental difference between:
- (a) Charge against income
  - (b) Application of income
- 4.02** Under the scheme of section 11, in order to arrive at the income available for application, all charges have to be deducted. *For example*, if the trust has incurred fundraising expenses, such expenses will first be deducted from the fund raised to determine the income subject to 85% application. Similarly, if any NGO has income from house property, then the expenses against such property will first be deducted from the property income to determine the income subject to 85% application. In

other words, fundraising expenses or expenses against property are a charge against income and cannot be treated as applied toward charitable purposes.

- 4.03** In light of the above, organizations can only claim applications to the extent of available income, including both revenue and capital applications. Any asset, in whole or in part, can only be claimed if income is available. If income is insufficient to cover the entire cost of the asset, only the portion financed from income should be recognized as an application of income under section 11(1)(a) in the Income and Expenditure Account. It is recommended that organizations segregate assets into two schedules: (i) assets acquired from income subject to application, and (ii) assets acquired from sources other than income. Depreciation can be claimed against assets acquired from sources other than income, which is permitted under section 11(6). Some assets may appear in both schedules.

## **RATE OF DEPRECIATION AND APPLICABILITY OF SECTION 32**

- 5.01** The income of a charitable trust is not required to be computed in accordance with the provisions of the Act. It should be computed in accordance with the normal rules of accountancy in a commercial sense. Therefore, the heads of income under section 14 and the depreciation rates provided under the Income-tax laws should not necessarily apply to a charitable or religious organisation. In *CIT v. Sheth Manilal Ranchhoddas Vishram Bhavan Trust* [1993] 70 Taxman 228/[1992] 198 ITR 598 (Guj.), the court held that the amount of depreciation debited to the accounts of the charitable institution had to be deducted to arrive at the income available for application to charitable and religious purposes. It further observed that the income from the properties held under trust would have to be arrived at in the normal commercial manner without classification under the various heads set out in section 14. It held that the expression 'income' had to be understood in the popular or general sense and not in the sense in which the income was arrived at for the purpose of assessment to tax by application of some artificial provisions either

giving or denying deduction and, therefore, there was no reason why depreciation should not be allowed as a deduction in order to determine the real income of the organisation.

**5.02** In the case of *CIT v. Rao Bahadur Calavala Cunnan Chetty Charities* [1982] 135 ITR 485, the Madras High Court held that the income from the properties held under trust would have to be arrived at in the normal commercial manner without classification under the various heads set out in section 14.

**5.03** In *CIT v. Institute of Banking Personnel Selection (IBPS)* [2003] 131 Taxman 386/264 ITR 110 (Bom.) the Court held that the provisions of section 32 were not relevant for charitable organisations. Therefore, the conditions specified in section 34 were also not applicable and the assessee was entitled to depreciation, which could be considered as legitimate in order to compute the real income of the assessee on commercial principles. Therefore, it is not necessary to strictly apply the provisions of section 32 or the rate of depreciation provided under the Act. However, there is nothing which prevents the organisation from applying the same rates or the provisions under the normal commercial principle in a realistic sense.

**5.04** The Karnataka High Court in the case of *Principal Commissioner of Income-Tax (Exemptions) v. Shushrutha Educational Trust* [I.T.A. No. 862 of 2017, dated 21-8-2018], held that the income of the trust is required to be computed under section 11 on commercial principles after providing for allowance for normal depreciation and deduction thereof from gross income of the trust.

## DEPRECIATION BEYOND 85% IS ACADEMIC IN NATURE

**6.01** In the case of *ITO v. Krishi Upaj Mandi Samiti* [2012] 24 taxmann.com 342/53 SOT 500 (Jp. - Trib.), it was held that the income which is required to be considered applied in excess of 85% receipts is to be ascertained on commercial principles



and depreciation is to be allowed. In case without depreciation, the receipts applied are in excess of statutory percentage, then issue of allowability of depreciation is academic.

The relevant extract is as under:

*“Hence in the case of trust the income which is required to be considered applied in excess of 85% receipts is to be ascertained on commercial principles and depreciation is to be allowed. In case without depreciation, the receipts applied are in excess of statutory percentage then issue of allowability of depreciation is academic. In absence of details not filed before us, we are unable to see as in what case of Samiti and in which year, the issue of depreciation is academic.”*

## **DEPRECIATION ON ASSETS CREATED OUT OF LEGAL OBLIGATIONS AND RESTRICTED GRANTS**

**7.01** The law is unambiguous regarding the admissibility of depreciation as depreciation is not allowed against income in cases where acquisition is claimed as application of income. In other words, all assets created out of sources other than income subject to application shall be eligible for depreciation. For the sake of clarity, the assets which shall be entitled for depreciation are as under:

- (a) Assets purchased out of the general fund, corpus fund and other free reserves of the trust.
- (b) Assets purchased out of restricted grants explicitly received to purchase assets. It may be noted that such grant should not be covered under the definition of voluntary contribution under section 2(24)(ia) or a Government grant under section 2(24)(xviii).
- (c) Assets created out of loan which has not been claimed as application either in the year of purchase or in the year of repayment of loan.

## ALLOWABILITY OF DEPRECIATION WHERE THE COST OF ACQUISITION IS NIL

- 8.01** The Bombay High Court has confirmed in the case of *CIT v. Institute of Banking Personnel Selection (IBPS)* [2003] 264 ITR 110/131 Taxman 386 that depreciation can be claimed on assets received as a contribution without any cost. The court relied on the decision in *DIT (Exemption) v. Framjee Cawasjee Institute* [2014] 49 taxmann.com 22/227 Taxman 266 (Bom.)(Mag.), which held that the Assessing Officer should allow depreciation on assets received on transfer when the assessee did not incur the cost of acquiring the assets. It should be noted, however, that these cases relate to a period before the enactment of section 11(6). After insertion of section 11(6) though it is permissible to claim depreciation on asset which was created out of income, however in the absence of any cost of acquisition it seems that such assets will not be eligible for depreciation.

## JUDICIAL PRECEDENCE ON THE ALLOWABILITY OF DOUBLE DEDUCTION BEFORE 01-04-2015

- 9.01** The Supreme Court of India in the case of *CIT v. Rajasthan & Gujarati Charitable Foundation Poona* [2018] 89 taxmann.com 127/253 Taxman 165/402 ITR 441 held that in case of assessee-charitable institution registered under section 12A, even though expenditure incurred for acquisition of capital assets was treated as application of income for charitable purposes under section 11(1)(a), yet depreciation would be allowed on assets so purchased (Position prior to 1-4-2015). The following cases were referred: *CIT v. Institute of Banking Personnel Selection (IBPS)* [2003] 131 Taxman 386 (Bom.) (para 1) and *Lissie Medical Institutions v. CIT* [2012] 24 taxmann.com 9/209 Taxman 19 (Mag.)/348 ITR 344 (Ker.).

## CLAIM OF DEPRECIATION EVEN THOUGH APPLICATION IS ALLOWED ON CASH BASIS ONLY

**10.01** The Finance Act 2022 has inserted a new explanation after section 11(7), as a result, the application will be allowed only on a cash basis, which raises the question of whether depreciation (being a non-cash expenditure) will be permissible henceforth.

**10.02** The explanation is reproduced as under:

*“Explanation.—For the purposes of this section, any sum payable by any trust or institution shall be considered as application of income in the previous year in which such sum is actually paid by it (irrespective of the previous year in which the liability to pay such sum was incurred by the trust or institution according to the method of accounting regularly employed by it):*

*Provided that where during any previous year, any sum has been claimed to have been applied by the trust or institution, such sum shall not be allowed as application in any subsequent previous year.”*

**10.03** A plain reading of the above explanation suggests that it applies only to any expenditure which has become payable but has not been paid. Depreciation is a non-cash expenditure and is not payable to anybody. Therefore, the depreciation shall be considered an application subject to section 11(6) provisions even after the newly inserted explanation.

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