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DOUBLE DEDUCTION OF DEPRECIATION FOR TRUSTS & NGOs



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INTRODUCTION

1.01 In this issue we shall discuss the law relating to depreciation for charitable organisations. This issue has always remained contentious, confusing and controversial. There are various issues which require clarity including the following :

- Whether depreciation is further permissible when the entire cost of the asset has already been allowed as application of income.
- Whether the depreciation rates provided under the income tax laws will apply or not.

- Whether section 32 will apply to charitable organisations.
- Whether depreciation can be claimed if the cost of acquisition is nil.
- Whether income from house property would be computed under provisions of section 22 to 25 or depreciation should be provided in the normal course.
- Whether nature of receipt for acquisition of assets will have any bearing on depreciation.

WHETHER DOUBLE DEDUCTION OF DEPRECIATION IS PERMISSIBLE

1.02 In the past in many cases it was held that NGOs can claim double depreciation even if the entire cost of the asset was treated as application/expenditure in the year of purchase. The issue of allowing further depreciation, even if the entire cost of the asset has been allowed as application in the year of purchase, has become a matter of further debate in the light of the recent case laws. In the case of *Commissioner of Income-tax, Hisar v. Market Committee, Pipli* [2011] 238 CTR 103 (Punj. & Har.) [2011] was held that such deduction was permissible. The court was of the view that depreciation in case of trusts was not a double deduction as it was not an expenditure; it only reduced the percentage of funds available for charitable or religious purposes. The court declined to accept the applicability of the Supreme Court ruling in *Escorts Ltd. v. Union of India* [1993] 199 ITR 43(SC). It may be noted that in *Escorts case*, Supreme Court held that double depreciation was not permissible. However, this ruling was in context of a commercial organisation where the facts and circumstances are different from an NGO. The *Escorts case* has been discussed later. In the *Market Committee case (supra)* it was held that allowing depreciation on the capital assets was legitimate, even when capital expenditure on acquisition of the corresponding assets had already been allowed as 'application of income' for the purpose of allowing exemption under section 11 of the income-tax Act.

1.03 Almost simultaneously in another case, the Cochin Tribunal in *DDIT(E), Range-II, Ernakulam vs. Adi Sankara Trust*, [2011] 12 taxmann.com105(Cochin), [2011] 46 SOT 230(Cochin) has given a decision contrary to the aforesaid Punjab & Haryana High Court ruling. The Tribunal applied the Supreme Court ruling in *Escorts case (supra)* and held that the additional deduction towards depreciation was not permissible as the WDV (Written Down Value) of the asset was nil by virtue of treating it as an expense. Therefore, any further depreciation would amount to double deduction which is prohibited. The Tribunal further observed that if a grant is received for purchase of an asset, then such grant is in any case exempted U/s. 11(1)(d) as corpus donation. In other words, there would be no need to claim the capital expenditure as application of fund because the source of fund itself is not considered as income. The

Tribunal was of the view that an asset can be charged against the income only once. If the asset was created out of capital receipt, then such receipts are exempted and therefore, no case for double depreciation should arise.

- 1.04** The observations of the Cochin Tribunal provide insight into the issue. However, both the Punjab & Haryana High Court or the Cochin Tribunal should be seen from the perspective they bring into light.
- 1.05** As has been rightly pointed out that a capital asset if purchased from capital receipts then such receipts should be treated as corpus donation. Therefore, there would be no necessity to claim the initial deduction regarding the cost of the asset, because the corpus donations are exempted. In other words, any assets which are not purchased from the income during the year shall only be eligible for depreciation in the normal course as its cost of acquisition is not nil. However, controversy is only with regard to those assets which are purchased for charitable purposes out of current year's income become zero value assets and the question arises whether such assets should be allowed further depreciation.
- 1.06** The Punjab High Court has ruled that even in case of those assets which are purchased for charitable purposes out of current year's income, further depreciation shall be permissible. The possible rationale being : application towards charitable purposes is not a chargeable expenditure. Therefore, any asset created continues to be a resource available for charitable purposes. In such circumstances, it is legitimate to allow diminution in the value of the available resources and assets in future.
- 1.07** The Market Committee case *supra* held that such deduction was permissible because depreciation in case of trusts was not a double deduction as it was not an expenditure; it only reduced the percentage of funds available for charitable or religious purposes. The issue here is that any reduction in the available funds for charitable or religious purposes enhance the corpus. The current law allow only 15% towards corpus every year and any additional accumulation of similar nature is certainly a subject matter of debate. This issue needs to be debated from the point of view of whether the asset was created out of an income, deemed income, legal obligation or a capital receipt. In case of NGOs, when legal obligations and capital receipts are artificially treated as income, then the need for double deduction becomes relevant.
- 1.08** The debate of double deduction of depreciation is not of recent origin in *Director of Income-tax (Exemption) v. Framjee Cawasjee Institute* [1993] 109 CTR (Bom.) 463, it was held that depreciation on depreciable assets had to be taken into account in computing the income of the trust although the amount spent on acquiring such assets had been treated as application of income of the trust in the year in which assets were acquired. In this case the following question was placed before the Bombay High Court :

“Whether, on the facts and in the circumstances of the case, the Tribunal was right in law directing the ITO to take

depreciation into account in computing the income from depreciable assets when in fact the full capital expenditure had been allowed in the year of acquisition of these assets ?”

- 1.09** In this case the Tribunal had explained the position by stating that when the ITO says that full expenditure has been allowed in the year of the acquisition of the assets, what he really means is that the amount spent on acquiring these assets had been treated as application of income of the trust in the year in which the income was spent in acquiring these assets. This does not mean that in computing income from those assets in subsequent years, depreciation in respect of those assets cannot be taken into account. The matter was held in favour of the assessee and depreciation was held to be deductible when the cost of the asset was already fully allowed as application.
- 1.10** In the above case, the assessee also placed before the court the CBDT circular No. 5-P(LXX-6) of 1968, dated 19-6-1968. In the circular, it is clarified that in the case of a business undertaking held under trust, its income will be income as shown in the accounts of the undertaking and that, where the trust derives income from house property, interest on securities, capital gains or other sources, the income should be understood in its commercial sense.
- 1.11** Similar issues were debated in *CIT v. Institute of Banking* [2003] 264 ITR 110 (Bom.). The two issues which were debated in this case were :
- (1) Whether depreciation was deductible when the cost of the asset was already fully allowed as application.
 - (2) Whether depreciation was deductible when the cost of acquisition to the assessee was *nil*.
- 1.12** Both the above issues were decided in favour of the assessee, thus, upholding the deductibility of depreciation in both the above-mentioned circumstances. 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.
- 1.13** In the light of the above discussion, it seems that there is a strong case for allowing depreciation on those assets which was created out of income as application. The reason is that if depreciation is not permitted, then such assets cannot be replaced and the corpus will be eroded. However, such rational should apply only to those assets which can be considered as application of funds towards charitable purposes. For example, if an NGO constructs a building for dispensary then such building should be eligible for further depreciation. On the contrary, if the NGO creates any commercial assets for generating income, then in the first place such assets cannot be treated as application for charitable purposes. Therefore, the issue of double depreciation would not arise.

DEPRECIATION AS A DEDUCTION BEFORE OR AFTER DETERMINING INCOME AVAILABLE FOR CHARITABLE PURPOSES

1.14 The income of charitable organisations is required to be computed as per the normal commercial principles and the rules of accountancy. The emphasis is also on the real income which cannot be determined without allowing depreciation as expenditure. In *CIT v. Society of the Sisters of St. Anne* [1984] 146 ITR 28 (Kar.), it was debated whether Tribunal was correct in holding that the amount of depreciation debited to accounts of a charitable institution is to be deducted to arrive at the income available for application to charitable and religious purposes. The Court held that depreciation was nothing but decrease in value of property through wear, deterioration or obsolescence and allowance is made for this purpose in book keeping and accountancy. If depreciation is not allowed as a necessary deduction for computing the income from the charitable institutions, then there is no way to preserve the corpus of the trust for deriving the income. In the same case, it was observed that the income within the meaning of section 11(1) should be the income in the real sense which can be applied to charitable purposes and from which surplus can arise if a part thereof is not applied to the objects of the trust. Viewed from this angle, the Court took the considered opinion that the provisions of depreciation was not only prudent but was essential for the purpose of arriving at income available for distribution for application to charity and the amount of depreciation was not the income available for application with the assessee.

DEPRECIATION RATES AND APPLICATION OF SECTION 32

1.15 It has been clarified by CBDT as well as in various cases that, 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 commercial sense. Therefore, the heads of income u/s. 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* [1992] 198 ITR 598 (Guj.), the following issues were placed before the High Court :

- “1. Whether, on the facts and in the circumstances of the case, the Tribunal was right in law in holding that, while computing income under section 11(1)(a) of the Income-tax Act, 1961, depreciation has to be allowed ?
2. Whether the Tribunal was right in law in holding that, having regard to the scheme of the Act, ‘income’ referred to in section 11(1)(a) of the Act is to be computed not in accordance with the provisions of the Act but in accordance with the normal rules of accountancy under which the

depreciation has to be allowed while computing such income under section 11(1)(a) of the Act?" (p. 599)

- 1.16** 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 deduction in order to determine the real income of the organisation.
- 1.17** In *CIT v. Institute of Banking* [2003] 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 normal commercial principle in a realistic sense.

SUPREME COURT IN ESCORTS CASE

- 1.18** In *Escorts Ltd. v. Union of India* [1993] 199 ITR 43, the Supreme Court held that when deduction under section 35(2)(iv) was allowed in respect of capital expenditure on scientific research, no depreciation was to be allowed under section 32 on the same asset. There is a fundamental axiom that double deduction is not intended unless there is a clear statutory indication to the contrary. The Supreme Court also referred to para 3.29 of the *Choksi Committee Report* (December, 1977), in this context. This para read as follows :

"3.29. Our attention has also been drawn to certain anomalous situations in the matter of allowance of depreciation. In certain cases where a full deduction has been allowed in relation to a capital asset under other sections (as for example, section 35 which permits a deduction in respect of capital expenditure for scientific research), the taxpayers have contended that such deduction is independent of the allowance by way of depreciation. In our view, the intention of the Legislature is not to allow a double deduction (of 200%) in respect of the same asset, once under section 35 and, again by way of depreciation under section 32. If and to the extent that there is any anomaly or contrary view possible on a construction of section 35, we recommend that the law should be

clarified to provide that no depreciation under section 32 shall be allowable in respect of capital expenditure for scientific research qualifying for deduction under section 35.” (p. 59).

- 1.19** The Supreme Court ruling may apply (subject to the specific facts) to charitable organisation as it pertains to claim of depreciation under another section of the act when 100 per cent (or more) depreciation has already been provided u/s. 35. It may be noted that for commercial entities, the taxable income is determined, which may not be the real income. The permissible expenditures also may not be necessarily real. In the case of charitable organisations exempted income and its application for charitable purposes is determined. If one looks carefully at the scheme of determining ‘income’ and ‘application’ of charitable organisations, it can be seen that both capital nature receipts and applications are included. When capital receipts are treated as a part of income, then there is a strong case for double deduction of depreciation for those assets which are purchased out of such capital receipts.

DEPRECIATION WHERE THE COST OF ACQUISITION IS NIL

- 1.20** It has been confirmed the Bombay High Court in *CIT v. Institute of Banking Personnel Selection (IBPS)* [2003] 264 ITR 110/131 Taxman 386 (Bom) that depreciation has to be allowed on assets received as contribution without any cost. The Bombay High Court relied on the decision in *Director of Income-tax (Exemption) v. Framjee Cawasjee Institute* [1993] 109 CTR 463 (Bom.), where it was held that the Tribunal was justified in law in directing the Assessing Officer to allow depreciation on assets received on transfer, when the assessee had not incurred the cost of acquiring the assets. Here again the same logic of preserving the corpus applies. In other words, for example, if an NGO receives a school building in gift it should be allowed to charge any diminution in its value so that it can be maintained in the long run.

DEPRECIATION ON PROPERTY TAXABLE UNDER INCOME FROM HOUSE PROPERTY

- 1.21** The income from house property is not required to be computed under the head “income from house property”. Therefore, the provisions of section 22 to 25 shall not apply. The income from house property should be computed on commercial basis as per normal rules of accounting where depreciation should also be allowed in determining the real income. In the case *CIT v. Society of the Sisters of St. Anne* [1984] 146 ITR 28 (Karn.) it was held that depreciation allowance in respect of the trust property would be allowed. Also notwithstanding

the revenue's contention to the contrary, there is nothing in section 11 which debars a charitable institution from maintaining accounts on mercantile basis. That apart, if depreciation is not allowed as a necessary deduction for computing the income of the charitable institutions, then there is no way to preserve the corpus of the trust for deriving the income. Similar views were taken in the case *CIT v. Bhoruka Public Welfare Trust* [1999] 240 ITR 513 (Cal.).

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