	Rs.
Gross annual value	
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]	62,500
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy	60,000
Step III - Amount computed in *Step I or Step II*, whichever is higher	62,500
Step IV - Loss due to vacancy	*Nil*
Step V - Gross annual value is *Step III minus Step IV*	62,500
Gross annual value	62,500
Less: Municipal tax (50% of 12% of Rs. 1,30,000)	7,800
Net annual value	54,700
Less: Deductions under section 24	
Standard deduction (30% of Rs. 54,700)	16,410
Interest on borrowed capital (50% of Rs. 63,000)	31,500
Income of Unit 2	6,790
Computation of income of X	
Income from house property	
Unit 1: Rs. (-) 30,000	
Unit 2: Rs. 6,790	(-) 23,210
Other income	1,80,000
Net income	1,56,790

91.1-4 ***WHERE A HOUSE IS SELF-OCCUPIED FOR A PART OF THE YEAR AND LET OUT FOR REMAINING PART OF THE YEAR*** - In this case, the benefit of section 23(2)(*a*) [*see* para 91.1-1] is not available and income will be computed as if the property is let out.

91.1-4P1 *X owns a property at Delhi (municipal value: Rs. 1,64,000, fair rent: Rs. 2,16,000, standard rent: Rs.1, 80,000). The house is let out up to January 31, 2009 (monthly rent being Rs. 14,000). From February 1, 2009, the property is self-occupied for own residential purposes. Expenses incurred by X are: municipal tax: Rs. 6,000 (actually paid), repairs: Rs. 2,100, insurance: Rs. 1,100, interest on capital borrowed (date of borrowing being June 10, 1991) for acquiring the property: Rs. 1,23,000. Assuming that the income of X from other sources is Rs. 1,86,000, find out the net income of X for the assessment year 2009-10. Does it make any difference if the property is let out up to January 31, 2009 @ Rs. 19,000 per month. There is no unrealised rent.*

SOLUTION :

	If rent is Rs. 14,000 per month Rs.	If rent is Rs. 19,000 per month Rs.
Municipal valuation (MV)	1,64,000	1,64,000
Fair rent (FR)	2,16,000	2,16,000
Standard rent (SR)	1,80,000	1,80,000
Actual rent	1,40,000	1,90,000
Gross annual value		
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]	1,80,000	1,80,000
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy	1,40,000	1,90,000
Step III - Amount computed in *Step I or Step II*, whichever is higher	1,80,000	1,90,000
Step IV - Loss due to vacancy	*Nil*	*Nil*
Step V - Gross annual value is *Step III minus Step IV*	1,80,000	1,90,000

	If rent is Rs. 14,000 per month Rs.	If rent is Rs. 15,000 per month Rs.
Less: Municipal tax	6,000	6,000
Net annual value	1,74,000	1,84,000
Less : Deductions under section 24		
Standard deduction (30% of Rs. 1,74,000 or Rs. 1,84,000)	52,200	55,200
Interest on borrowed capital	1,23,000	1,23,000
Income from property	(–)1,200	5,800
Other income	1,86,000	1,86,000
Net income	1,84,800	1,91,800

91.2 ***Provisions in brief*** - The provisions governing tax incidence on self-occupied house property may be summarized as follows—

Self-occupied property	*Tax treatment*
1. If such property is used by the owner for the purpose of carrying on his business or profession	Income is not taxable under the head "Income from house property". Any income and expenditure in respect of such property will be considered while calculating income from business or profession under section 28
2. If such property is used for the residence of the owner and his family members	
2.1 If only one property is used for such purpose	
2.1-1 If such property is used throughout the previous year for own residential purposes, it is not let out or put to any other use	Nothing is taxable. Only interest on borrowed capital is deductible subject to a maximum of Rs. 30,000/1,50,000 [*see* para 91.1-1]
2.1-2 If such property could not be occupied throughout the previous year because employment, business or profession of the owner is situated at some other place	Same as above [*see* para 91.1-2]
2.1-3 When a part of the property (being independent residential unit) is self-occupied and the other part is let out	Income from the independent unit, which is self-occupied, will not be taxable. Interest on borrowed capital is deductible up to Rs. 30,000/Rs. 1,50,000. Income from the unit which is let out is to be computed as if the unit is let out [*see* para 90]
2.1-4 When such property is self-occupied for a part of the year and let out for the other part of the year	No concession is available. The house will be taken as let out property
2.2 If more than one property is used for residential purpose	Only one property selected by the taxpayer will be treated as self-occupied [for how to make selection, *see* problem 95-P6]. Other remaining properties will be deemed as let out [*see* para 90].

91.3 ***Other points for consideration*** - The aforesaid rule (*i.e.*, provision mentioned in paras 91.1-1, 91.1-2 and 91.1-3) is applicable only in the case of natural persons. In other words, limited liability companies, firms, associations and clubs cannot claim the benefit of steps mentioned above as they cannot occupy a house for residential purposes. The karta of a Hindu undivided family (being a natural person) is, however, entitled to the aforesaid benefit.

■ *When owner occupies a house in some other capacity* - The aforesaid provisions cannot be applied to cases where the owner of the house is not occupying his own house in his capacity as "owner" for residential purposes. If the assessee lets out his house to his employer-company which, in turn, allots the same to him as rent-free quarter, the assessee is not entitled to the aforesaid benefits, as he occupies the house not as owner but only in his capacity as sub-tenant of the employer-company—*D.R. Sunder Raj* v. *CIT* [1979] 2 Taxman 458 (AP).

Special provisions when unrealised rent is realised subsequently [Secs. 25A and 25AA]

92. In the following two situations unrealised rent is collected:

92.1 ***Unrealised rent was allowed as deduction in the assessment year 2001-02 (or earlier) [Sec. 25A]*** - Where a deduction has been allowed under section 24(1)(*x*) [in the assessment year 2001-02 or earlier years] in respect of unrealised rent and subsequently during any previous year [relevant for the assessment year 2002-03 or subsequent year] the assessee has realised any amount in respect of such rent, the amount so realised will be chargeable to tax under the head "Income from house property" (without making any deduction under sections 23 and 24).

- The amount so recovered is taxable in the previous year in which it is recovered.
- It is taxable even if the house is not owned (or deemed to be owned) by the assessee in the year of recovery.

92.1-P1 *For the assessment year 2001-02, X claims a deduction of Rs. 86,000 on account of unrealised rent pertaining to the previous year 1999-2000 and the same is allowed by the Assessing Officer. On December 20, 2008, he recovers Rs. 6,000 from the defaulting tenant (expenses on recovery are Rs. 500). What will be the tax treatment?*

SOLUTION : Rs. 6,000 recovered from the defaulting tenant is chargeable to tax as income under the head "Income from house property" in the year of recovery (*i.e.*, the previous year 2008-09 or assessment year 2009-10). Expenditure of Rs.500 is not deductible. Rs. 6,000 is chargeable to tax as property income of the previous year 2008-09 even if X is not the owner of any house property.

It may be noted that normally income is taxable under the head "Income from house property" only if the taxpayer is the owner or "deemed owner" of a house property during the previous year. In the case of recovery of unrealised rent, property income is taxable even if no house is owned (or deemed to be owned) by the taxpayer.

92.1-P2 *X owns a house property which is given on rent. For the previous year 2000-01, he claims a deduction of Rs.78,000 on account of unrealised rent, out of which the Assessing Officer allows only Rs. 62,000 as deduction. What are the tax consequences if X recovers on June 19, 2008 from the defaulting tenant (a) Rs.10,000, (b) Rs.16,000 or (c) Rs.35,000 as full and final payment.*

SOLUTION :

Amount recovered during 2008-09 Rs.	*Amount of bad debt (i.e., Rs. 78,000 minus the amount of recovery)* Rs.	*Deduction allowed in 2001-02* Rs.	*Balance*
(a) 10,000	68,000	62,000	Loss of Rs. 6,000
(b) 16,000	62,000	62,000	*Nil*
(c) 35,000	43,000	62,000	Income of Rs. 19,000

In situation (a), X cannot claim deduction of Rs. 6,000 in the year of recovery (*i.e.*, previous year relevant for the assessment year 2009-10). From the assessment year 2002-03, unrealised rent of the earlier year cannot be deducted.

In situation (c), the excess recovery of Rs.19,000 is chargeable to tax under the head "Income from house property" for the previous year 2008-09 (*i.e.*, assessment year 2009-10).

It may be noted that in the either of the two cases :

a. expenditure on recovery is not taken into consideration ; and

b. the tax treatment will remain the same, even if the house property is not owned by X during 2008-09.

92.2 ***Unrealised rent of the previous year 2001-02 (or subsequent year) is collected subsequently [Sec. 25AA]*** - Where the assessee cannot realise rent during the previous year 2001-02 (or in any subsequent year) from a property let to a tenant and, subsequently, the assessee has realised any amount in respect of such rent, the amount so realised (to the extent it has not been included in annual value earlier†), shall be deemed to be income chargeable under the head "Income from house

†Circular No. 14/2001.

property" and accordingly charged to income-tax as the income of that previous year in which such rent is realised whether or not the assessee is the owner of that property in that previous year.

92.2-P1 *From the information given below, find out the income under the head "Income from house property" for the assessment years 2009-10 and 2010-11.*

Municipal valuation (MV)	*1,90,000*	*1,90,000*
Fair rent (FR)	*1,85,000*	*1,95,000*
Standard rent (SR)	*1,70,000*	*1,70,000*
Annual rent	*2,16,000*	*1,75,000*
Unrealised rent during the previous year 2008-09 [all condition of rule 4 are satisfied]	*30,000*	*30,000*
Unrealised rent during the previous year 2009-10	*Nil*	*Nil*
Unrealised rent of 2008-09 realised during the previous year 2009-10	*28,000*	*28,000*
Interest on borrowed capital (per annum)	*36,000*	*36,000*

The above stated properties are let out throughout the previous years 2008-09 and 2009-10. Municipal tax (paid) is at the rate of 20 per cent.

SOLUTION :

Rs. in thousands

	Previous year 2008-09		Assessment year 2009-10	
	X	Y	X	Y
Gross annual value				
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]	170	170	170	170
Step II - Rent received/receivable after deducting unrealized rent of the current previous year but before adjusting loss due to vacancy	186	145	216	175
Step III - Amount computed in *Step I* or *Step II*, whichever is higher	186	170	216	175
Step IV - Loss due to vacancy	*Nil*	*Nil*	*Nil*	*Nil*
Step V - Gross annual value is *Step III minus Step IV*	186	170	216	175
Less: Municipal tax paid [20% of (a)]	38	38	38	38
Net annual value	148	132	178	137
Less: Deductions under section 24				
Standard deduction (@ 30%)	44.40	39.60	53.40	41.10
Interest on borrowed capital	36	36	36	36
Income under the head "Income from house property".	67.60	56.40	88.60	59.90

Tax treatment when unrealised rent of the previous year 2008-09 is collected in the previous year 2009-10

Recomputation of gross annual value of the previous year 2008-09

Rs. in thousand

	X	Y
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]	170	170
Step II - Rent received/receivable after deducting effective unrealized rent of Rs. 2,000 but before adjusting loss due to vacancy	214	173
Step III - Amount computed in *Step I* or *Step II*, whichever is higher	214	173
Step IV - Loss due to vacancy	*Nil*	*Nil*
Step V - Recomputed gross annual value is *Step III minus Step IV*	214	173

Less: Gross annual value (original)	186	170
Unrealised rent not taxed earlier	28	3
Less: Deductions under section 24		
Standard deduction [it is 30% of net annual value and the amount computed above is not part of "annual value" of the house property, although it is income chargeable under the head "Income from house property" by virtue of section 25AA]	*Nil*	*Nil*
Interest on borrowed capital (already deducted)	*Nil*	*Nil*
Income	28	3
Income under the head "Income from house property"		
Assessment year 2009-10	67.60	56.40
Assessment year 2010-11	116.60	62.90

Mode of taxation of arrears of rent in the year of receipt [Sec. 25B]

93. Section 25B provides as follows—

1. The taxpayer is (or was) the owner of any property consisting of any buildings or lands appurtenant thereto which has (or had) been let to a tenant.

2. He has received any amount, by way of arrears of rent from such property, not charged to income-tax for any previous year.

3. The amount so received (after deducting a sum equal to 30 per cent of such amount) shall be deemed to be the income chargeable under the head "Income from house property".

4. It is taxable in the previous year in which it is received.

5. It is taxable even if the assessee is not the owner of that property in the year in which he has received arrears of rent.

93-P1 *X owns a property. It is given on rent (rent being Rs. 11,000 per month) to a bank. Municipal value of the property is Rs. 1,30,000, fair rent is Rs. 1,40,000 and standard rent is Rs. 1,34,000. Municipal tax paid by X is as follows—Rs. 26,000 on March 3, 2009 and Rs. 30,000 on May 10, 2009. On May 1, 2009, rent is increased from Rs. 11,000 per month to Rs. 14,000 per month with retrospective effect from April 1, 2008. Arrears of rent 2008-09 are paid on May 1, 2009. Find out the income chargeable to tax for the assessment years 2009-10 and 2010-11.*

SOLUTION :

	Assessment year	
	2009-10	2010-11
	Rs.	Rs.
Gross annual value (on the assumption that rent is Rs. 11,000 per month for the previous year 2007-08 and Rs.14,000 per month for the previous year 2009-10)		
Municipal value (MV)	1,30,000	1,30,000
Fair rent (FR)	1,40,000	1,40,000
Standard rent (SR)	1,34,000	1,34,000
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]	1,34,000	1,34,000
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy	1,32,000	1,68,000
Step III - Amount computed in *Step I* or *Step II*, whichever is higher	1,34,000	1,68,000
Step IV - Loss due to vacancy	*Nil*	*Nil*
Step V - Gross annual value is *Step III minus Step IV*	1,34,000	1,68,000
Less: Municipal tax	26,000	30,000
Net annual value	1,08,000	1,38,000
Less: Standard deduction under section 24 (*i.e.*, 30% of net annual value)	32,400	41,400
Income from property	75,600	96,600

Arrears of rent of the previous year 2008-09 paid on May 1, 2009	*Rs.*
Gross annual value of previous year 2008-09 if rent is Rs. 14,000 per month	1,68,000
Less: Gross annual value considered earlier	1,34,000
Arrear of rent	34,000
Less: 30% of Rs. 34,000	10,200
Amount taxable	23,800
Income from house property	
Assessment year 2009-10	75,600
Assessment year 2010-11 (*i.e.*, Rs. 96,600 + Rs. 23,800)	1,20,400

Hints for tax planning

94. For the purpose of tax planning, the following broad propositions should be borne in mind. However, these propositions would hold good in the context in which they have been made :

■ If a person has occupied more than one house for his own residence, only one house of his own choice is treated as self-occupied and all the other houses are deemed to be let out. The tax exemption applies only in the case of one self-occupied house and not in the case of deemed to be let out properties. Care should, therefore, be taken while selecting the house to be treated as self-occupied in order to minimise the tax liability. The same is explained in problem 95-P5.

■ As interest payable out of India is not deductible if tax is not deducted at source (and in respect of which there is no person who may be treated as an agent under section 163), care should be taken to deduct tax at source in order to avail exemption under section 24(*b*).

■ As amount of municipal tax is deductible on "payment" basis and not on "due" or "accrual" basis, it should be ensured that municipal tax is actually paid during the previous year if the assessee wants to claim deduction.

■ As a member of a co-operative society to whom a building or part thereof is allotted or leased under a house building scheme is the deemed owner of the property, it should be ensured that interest payable (even if not paid) by the assessee, on outstanding instalments of the cost of the building, is claimed as a deduction under section 24.

■ If an individual makes a cash gift to his wife who purchases a house property with the gifted money, the individual will not be deemed as fictional owner of the property under section 27(*i*)—*K.D. Thakar* v. *CIT* [1979] 120 ITR 190 (Guj.). Taxable income of the wife from the property is, however, includible in the income of individual in terms of section 64(1)(*iv*). Such income is to be computed under section 23(2) [*see* para 91.1] if she uses the house property for her own residential purposes. It can, therefore, be advised that if an individual transfers an asset, other than house property, even without adequate consideration, he can escape the deeming provision of section 27(*i*) and the consequent hardship.

■ Under section 27(*i*), if a person transfers a house property without consideration to his/her spouse (not being a transfer in connection with an agreement to live apart), or to his minor child (not being a married daughter), the transferor is deemed to be the owner of the house property. This deeming provision was found necessary in order to bring this situation in line with the provision of section 64. But when the scope of section 64 was extended to cover transfer of assets without adequate consideration to son's wife or minor grandchild by the Taxation Laws (Amendment) Act, 1975, with effect from the assessment year 1976-77 onwards, the scope of section 27(*i*) was not similarly extended. Consequently, if a person transfers house property to his son's wife without adequate consideration, he will not be deemed to be owner of the property under section 27(*i*), but income earned from the property by the transferee will be included in the income of the transferor under

section 64 [*see* para 210]—*see CIT* v. *H.L. Gulati* [1982] 11 Taxman 167 (All.). For the purpose of sections 22 to 27, the transferee will, thus, be treated as an owner of the house property and income computed in his/her hands is included in the income of the transferor under section 64. Such income is to be computed under section 23(2) [*see* para 91.1] if the transferee uses that property for self-occupation. Therefore, in some cases, it is beneficial to transfer the house property without adequate consideration to son's wife or son's minor child.

Problems on computation of property income

95-P1 *X (26 years) owns four houses which are used by him for his residential purposes :*

	House I	House II	House III	House IV
Municipal valuation (MV)	30,000	70,000	92,000	28,000
Fair rent (FR)	40,000	58,000	96,000	37,000
Standard rent (SR)	37,000	74,000	NA	36,000
Municipal tax paid by X	3,000	16,000	29,000	12,000
Insurance premium	1,000	2,000	11,700	2,810
Land revenue (outstanding)	600	—	800	900
Ground rent (outstanding)	1,700	2,110	8,712	516
Interest on capital borrowed to pay municipal tax	600	400	—	300
Interest on capital borrowed for purchase/construction or reconstruction (inclusive of one-fifth of pre-construction period's interest, wherever applicable) (capital is borrowed before April 1, 1999; in the case of House II capital is borrowed on April 10, 2006)	11,060	75,900	54,090	85,300
Interest on capital borrowed for repairs of the property (interest is payable outside India and tax is not deducted at source)	—	—	5,200	12,600
Repayment of loan taken from LIC for acquiring house property	Nil	6,000	17,000	2,000

Find out the net income and tax liability of X for the assessment year 2009-10 taking into consideration the following information :

1. *Income of X from other sources is Rs. 14,75,000.*
2. *X has deposited Rs.8,000 in the public provident fund during the previous year 2008-09.*
3. *For the assessment year 2008-09, House III was considered for the benefit of section 23(2)(a). X would like to change the option if it is permissible under the law and if it is otherwise beneficial for reducing tax bill.*

SOLUTION : Only one house can be treated as self-occupied (hereinafter referred to as SO) for the purpose of section 23(2)(a). It is not necessary that the same house should be treated as self-occupied every year. Other houses will be treated as deemed to be let out (hereinafter referred to as DLO) property.

X has the following four options (income computation is given in *Note 1 infra*) :

House I	(-)11,060 (SO)	12,740 (DLO)	12,740 (DLO)	12,740 (DLO)
House II	(-)38,100 (DLO)	(-)75,900 (SO)	(-)38,100 (DLO)	(-)38,100 (DLO)
House III	(-)7,190 (DLO)	(-)7,190 (DLO)	(-)30,000 (SO)	(-)7,190 (DLO)
House IV	(-)68,500 (DLO)	(-)68,500 (DLO)	(-)68,500 (DLO)	(-)30,000 (SO)

	Option 1 Rs.	Option 2 Rs.	Option 3 Rs.	Option 4 Rs.
Income from house property	(-)1,24,850	(-)1,38,850	(-)1,23,850	(-)62,550
Income from other sources	14,75,000	14,75,000	14,75,000	14,75,000
Gross total income	13,50,150	13,36,150	13,51,140	14,12,450
Less : Deduction under section 80C [See Note 2]	33,000	33,000	33,000	33,000
Net income	13,17,150	13,03,150	13,18,140	13,79,450

	Rs.
X should, therefore, opt for Option 2	
Tax on Rs. 13,03,150	2,95,945
Add : Surcharge (not applicable in case net income does not exceed Rs. 10 lakh)	29,595
Tax and surcharge	3,25,540
Add : Education cess (2% of tax and surcharge)	6,511
Add : Secondary and higher education cess (1% of tax and surcharge)	3,255
Tax liability	3,35,310

Notes :

1. Computation of income under different options

	House I Rs.	House II Rs.	House III Rs.	House IV Rs.
If it is SO				
Net annual value under section 23(2)(*a*)	*Nil*	*Nil*	*Nil*	*Nil*
Less : Interest on capital borrowed for acquiring house property but subject to maximum of Rs. 30,000/ Rs. 1,50,000	11,060	75,900	30,000	30,000
Income if the house is treated as SO	(-)11,060	(-)75,900	(-)30,000	(-)30,000
If these houses are DLO				
Municipal valuation (MV)	30,000	70,000	92,000	28,000
Fair rent (FR)	40,000	58,000	96,000	37,000
Standard rent (SR)	37,000	74,000	NA	36,000
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]	37,000	70,000	96,000	36,000
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy	*Nil*	*Nil*	*Nil*	*Nil*
Step III - Amount computed in *Step I* or *Step II*, whichever is higher	37,000	70,000	96,000	36,000
Step IV - Loss due to vacancy	*Nil*	*Nil*	*Nil*	*Nil*
Step V - Gross annual value is *Step III minus Step IV*	37,000	70,000	96,000	36,000
Less : Municipal taxes	3,000	16,000	29,000	12,000
Net annual value	34,000	54,000	67,000	24,000
Less : Deductions under section 24				
Standard deduction [30% of net annual value]	10,200	16,200	20,100	7,200
Interest on capital borrowed	11,060	75,900	54,090*	85,300
Income if these houses are DLO	12,740	(-)38,100	(-)7,190	(-)68,500

*If money is borrowed for financing, acquisition, construction, repair, renewal or reconstruction of house property, interest thereon is deductible under section 24(*b*). It is deductible even if interest is due but unpaid during the relevant previous year. If, however, interest is payable abroad and there is no person in India who may be treated as an agent of the lender, section 25 imposes an additional condition that interest is not deductible unless tax is deducted at source. In the given case, interest is not deductible as tax is not actually deducted during the previous year. It is,

however, not necessary that tax should be deducted only at the time of actual payment. To claim the benefit of deduction under section 24(b), interest payable may be transferred to the personal account of the lender and tax may be deducted at the time of credit.

2. Deduction under section 80C is available with respect to PPF deposit and repayment of loan taken from LIC for purchasing houses.

3. No deduction is available in respect of insurance premium, land revenue and ground rent.

95-P2 *X owns a big house (erection completed on September 14, 2004) which is partly self-occupied and partly let out. Unit 1 (fifty per cent of the floor area) is let out for commercial purposes on a monthly rent of Rs. 6,000 (rent of 2 months could not be realised). Unit 2 (25 per cent of the floor area) is used by X for the purpose of his profession, while Unit 3 (the remaining 25 per cent), is utilised for the purpose of his residence. Other particulars of the house are as follows : municipal valuation : Rs. 80,000, standard rent under the Delhi Rent Control Act : Rs. 1,40,000, municipal tax : Rs. 10,812 (levied during the year), Rs. 10,000 (actually paid during the year 2008-09, Rs. 812 is, however, paid on April 30, 2009), repairs : Rs. 8,000, ground rent : Rs. 16,800, annual charge created by will by father in favour of Mrs. X : Rs. 14,000 and insurance premium : Rs. 12,000. Income of X from profession is Rs. 62,000 (without debiting house rent and other incidental expenditure) ; cost of construction of the house : Rs. 8,00,000 ; rate of depreciation : 10 per cent.*

X has a substantial interest in ABC Ltd., a closely-held company. For financing the construction of the house property he has borrowed : Rs. 2,00,000 @ 6 per cent from ABC Ltd. The amount of loan was treated as dividend under section 2(22)(e) in the assessment of X for the assessment year 2002-03. However, as per contract with the company, he is liable to pay interest on January 1 every year.

Determine the taxable income of X for the assessment year 2009-10, on the assumption that he maintains books of account on the basis of mercantile system.

SOLUTION : *Income from Unit 1*		*Rs.*
Municipal value (50% of Rs. 80,000) (MV)		40,000
Annual rent (Rs. 6,000 × 12)		72,000
Standard rent (50% of Rs. 1,40,000) (SR)		70,000
Unrealised rent		12,000
Computation of gross annual value		
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]		40,000
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy		60,000
Step III - Amount computed in *Step I* or *Step II*, whichever is higher		60,000
Step IV - Loss due to vacancy		*Nil*
Step V - Gross annual value is *Step III minus Step IV*		60,000
Less : Municipal taxes (50% of Rs. 10,000, being the amount actually paid during 2008-09)		5,000
Net annual value		55,000
Less : Deductions under section 24	*Rs.*	
Standard deduction [30% of Rs. 55,000]	16,500	
Interest on borrowed capital (50% of Rs. 2,00,000 × 6 ÷ 100)	6,000	22,500
Income from Unit 1		32,500
Computation of professional income		
Income		62,000

	Rs.	Rs.
Less :		
Municipal taxes (¼ of Rs. 10,812)	2,703	
Repairs (¼ of Rs. 8,000)	2,000	
Ground rent (¼ of Rs. 16,800)	4,200	
Annual charge (*personal expenditure not deductible)	*Nil**	
Insurance premium (¼ of Rs. 12,000)	3,000	
Depreciation [see Note 1]	13,122	
Interest on capital borrowed (*i.e.*, ¼ of Rs. 2,00,000 × 6 ÷ 100)	3,000	28,025
Taxable income from profession		33,975
Calculation of total income		
Income from house property		
Unit 1	32,500	
Unit 2	*Nil*	
Unit 3 [25% of Rs. 2,00,000 × 6 ÷ 100]	(-)3,000	29,500
Income from profession		33,975
Income from dividend [*see Note 2]		*Nil**
Gross total income		63,475
Less : Deductions under sections 80C to 80U		*Nil*
Net income (rounded off)		63,480

Notes :

1. If property is used for the purpose of own business or profession, depreciation can be claimed under section 32 [see para 109]. For the assessment year 2009-10 depreciation is calculated as under :

	Rs.
Cost of construction of the property on September 14, 2004	8,00,000
25% of cost of construction, as 25% of the area is used for the purpose of profession	2,00,000
Depreciation of the previous year 2004-05 (*i.e.*, 10% of Rs. 2,00,000)	20,000
Written down value on April 1, 2005	1,80,000
Depreciation of the previous year 2005-06 (*i.e.*, 10% of Rs. 1,80,000)	18,000
Written down value on April 1, 2006	1,62,000
Depreciation of the previous year 2006-07 (*i.e.*, 10% of Rs. 1,62,000)	16,200
Written down value on April 1, 2007	1,45,800
Depreciation of the previous year 2007-08 (*i.e.*, 10% of Rs. 1,45,800)	14,580
Written down value on April 1, 2008	1,31,220
Depreciation of the previous year 2008-09	13,122

2. Under section 2(22)(e), any payment of loan or advance by a closely-held company to a shareholder, holding at least 10% equity share capital is treated as deemed dividend to the extent of accumulated profits of the company [see para 193.2 for details]. It is taxable for the assessment year 2002-03.

3. Interest on capital borrowed for the purpose of construction of house property is deductible under section 24. The rule is equally applicable even if loan raised by a person is treated as deemed dividend under section 2(22)(e).

4. In computing house property income, no deduction is available in respect of ground rent, annual charge and insurance premium.

95-P3 *X is a cost accountant in ABC Ltd., Bombay and gets Rs. 24,000 per month as salary. He owns two houses, one of which is let out to the employer-company which in turn provided the same to X as rent-free accommodation. Determine the net income of X for the assessment year 2009-10 taking into account the following information relating property income :*

Fair rent (FR)	60,000	1,82,000
Annual rent	63,000	1,84,000
Municipal valuation (MV)	61,000	1,85,000
Standard rent (SR)	NA	NA
Municipal taxes paid	14,000	40,000
Repairs	3,500	7,700
Insurance	3,000	33,000
Land revenue	7,500	24,000
Ground rent	4,000	7,800
Interest on capital borrowed by mortgaging House I (funds are used for construction of House II)	18,000	—
Unrealised rent of the previous year 2002-03	—	1,60,000
Unrealised rent of 2008-09	—	55,000
Nature of occupation	*Let out to ABC Ltd.*	*Let out to Y for business*
Date of completion of construction	*March 1999*	*April 2001*

SOLUTION : SALARY INCOME

		Rs.
Basic salary (*i.e.*, Rs. 24,000 × 12)		2,88,000
Perquisite in respect of rent-free house [see Note *1 infra*]		43,200
Gross salary		3,31,200
Less : Standard deduction		—
Income from salary		3,31,200
PROPERTY INCOME		
House I (let out for residence)		
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]		61,000
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy		63,000
Step III - Amount computed in *Step I* or *Step II*, whichever is higher		63,000
Step IV - Loss due to vacancy		*Nil*
Step V - Gross annual value is *Step III minus Step IV*		63,000
Less : Municipal taxes		14,000
Net annual value		49,000
Less : Deductions under section 24	*Rs.*	
Standard deduction (30% of Rs. 49,000)	14,700	
Interest (*as the funds are utilised for the construction of House II, it is not deductible from the income of House I)	*Nil**	14,700
Income from House I		34,300
House II		
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]		1,85,000

	Rs.	Rs.
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy		1,84,000
Step III - Amount computed in *Step I* or *Step II*, whichever is higher		1,85,000
Step IV - Loss due to vacancy		*Nil*
Step V - Gross annual value is *Step III minus Step IV*		1,85,000
Less : Municipal taxes		40,000
Net annual value		1,45,000
Less : Deductions under section 24		
Standard deduction (30% of Rs. 1,45,000)	43,500	
Interest on capital (*as the capital is borrowed for construction of House II it is deductible even if House I is mortgaged by X for this purpose)	18,000*	61,500
Loss from House II		83,500
Computation of net income of X		
Salary income		3,31,200
Income from house property		
House I	34,300	
House II	83,500	1,17,800
Net income		4,49,000

Notes :

1. X has let out House I to the employer company which provides the same to X as a rent-free accommodation. Rental income received by X, as owner of House I from the tenant, is taxable under the head "Income from house property" under section 23(1). Besides, the value of perquisite in respect of rent free house is taxable under the head "Salaries". X is not entitled to the benefits permissible under section 23(2), as he occupies the house not as owner but in his capacity as sub-tenant of the employer company—*D.R. Sunder Raj.* v. *CIT* [1979] 2 Taxman 458 (AP).

Perquisite value of rent-free accommodation is computed as under :

While salary is Rs. 2,88,000, lease rent of House I is Rs. 63,000. As lease rent of the house exceeds 15% of salary, 15% of salary is taxable [see para 52.1-2].

2. No deduction is available in respect of insurance, land revenue and ground rent.

95-P4 *X owns two houses—House I and House II. While House I is let out throughout the previous year, House II is used by him for the residential purposes for the first 8 months (i.e., from April 1, 2008 to November 30, 2008) and let out on monthly rent of Rs. 35,000 for remaining part of the year. His business income is Rs. 7,86,000. Determine the taxable income of X for the assessment year 2009-10 on the basis of the following information in respect of property income :*

	House I Rs.	House II Rs.
Municipal valuation (MV)	*2,42,000*	*4,10,000*
Fair rent (FR)	*2,51,000*	*4,00,000*
Standard rent (SR)	NA	NA
Composite rent payable by the tenants for house and amenities	*3,20,000*	—
Municipal taxes		
- paid by X	—	*65,000*
- due but not paid	*47,000*	—
Repairs (met by the tenant)	*18,000*	—
Insurance	*14,700*	*16,000*
Collection charges	*6,300*	—
Unadjusted unrealised rent of the previous years 2000-01 and 2001-02	*2,90,000*	—

	Rs.
The composite rent of Rs. 3,20,000 has been fixed on the basis of computation given below :	
Rent of the building	2,60,000
Electricity charges	12,000
Water charges	8,000
Lift charges	16,000
Guard and security charges	24,000
Total	3,20,000

For providing the aforesaid services to the tenants of House I, the following expenses are incurred by X :

Expenses/depreciation	Rs.
Electricity bills	10,870
Water bills	9,100
Lift maintenance (including salary paid to lift operator)	12,740
Depreciation on lift (according to section 32)	9,000
Salary of guard	8,000
Expenses on providing security	4,570

SOLUTION :

Income from House II		
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]		4,10,000
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy		1,40,000
Step III - Amount computed in *Step I* or *Step II*, whichever is higher		4,10,000
Step IV - Loss due to vacancy		*Nil*
Step V - Gross annual value is *Step III minus Step IV*		4,10,000
Less : Municipal taxes paid by X		65,000
Net annual value		3,45,000
Less : Deductions under section 24		
Standard deduction (30% of Rs. 3,45,000)		1,03,500
Insurance		*Nil*
Income from House II		2,41,500
Income from House I		
Composite rent		3,20,000
Less : Charges for providing amenities	*Rs.*	
Electricity charges	12,000	
Water charges	8,000	
Lift charges	16,000	
Guard security	24,000	60,000
Rent of property		2,60,000
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]		2,51,000
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy		2,60,000
Step III - Amount computed in *Step I* or *Step II*, whichever is higher		2,60,000
Step IV - Loss due to vacancy		*Nil*
Step V - Gross annual value is *Step III minus Step IV*		2,60,000
Less : Municipal taxes (*deductible only if actually paid during the previous year)		*Nil**
Net annual value		2,60,000
Less : Deduction under section 24 (standard deduction)		78,000
Income from House I		1,82,000

		Rs.
Statement of net income of X for the assessment year 2009-10		
Property income		
House I		1,82,000
House II		2,41,500
Income from house property (a)		4,23,500
Profits and gains of business or profession (b)		7,86,000
Income from other sources		
Amount collected from tenants of House I for providing different amenities	60,000	
Less : Expenses and depreciation (*i.e.*, Rs. 10,870 + Rs. 9,100 + Rs. 12,740 + Rs. 9,000 + Rs. 8,000 + Rs. 4,570)	54,280	
Income from other sources (c)		5,720
Gross total income [(a) + (b) + (c)]		12,15,220
Less : Deductions under sections 80C to 80U		*Nil*
Net income		12,15,220

Notes :

1. Unrealised rent of earlier years is not deductible.

2. Service charges received separately in excess of rent, by owner of building as value of service rendered by him to his tenants should be considered as income from other sources and not as income from house property—*Tarapore & Co. v. CIT* [2002] 125 Taxman 446 (Mad.).

3. No deduction is available in respect of insurance and collection charges while computing house property income.

95-P5 *Mrs. X owns a house property (comprising eight let out residential units) at Bombay. Fair rent of the property is Rs. 61,000, while standard rent is Rs. 60,500. The property is let out on annual rent of Rs. 62,000, while net rateable value according to municipal records is Rs. 50,000. The following other particulars are available in respect of the house : general tax : 25.5 per cent ; water tax : 9 per cent ; sewerage (Halalkhore) tax : 5 per cent ; education cess : 5 per cent ; water benefit tax : 6 per cent ; sewerage benefit tax : 4 per cent ; state education cess : 6 per cent ; repairs expenditure paid by the tenants : Rs. 6,000 ; insurance premium due but outstanding : Rs. 2,000; annual charges created by Mrs. X : Rs. 2,000 ; interest on borrowed capital for construction (inclusive of brokerage of Rs. 1,000 for arranging loan) : Rs. 17,000 ; legal charges for notice sent to three tenants for arrears of rent : Rs. 400 ; collection charges payable : Rs. 219 ; one flat (rent Rs. 600 per month) remained vacant for four months ; unrealised rent of 2001-02 (defaulting tenant has vacated the property) : Rs. 3,000 ; unrealised rent of 2008-09 : Rs. 1,590; date of commencement of construction : June 1994; and date of completion of construction : January 15, 1998.*

During the year 1998-99, Mrs. X was allowed a deduction of Rs. 17,860 on account of unrealised rent. During the previous year 2008-09, she recovers Rs. 2,100 (out of Rs. 17,860) after incurring expenditure of Rs. 700.

During the previous year 2008-09, Mrs. X receives Rs. 85,000 (gross) as interest on company deposits, Rs. 2,48,000 (gross) as salary. Compute the taxable income of Mrs. X for the assessment year 2009-10.

SOLUTION :

Income from salary	Rs.	Rs.
Basic pay		2,48,000
Less : Standard deduction		—
Taxable salary (a)		2,48,000
Income from let out property		
Fair rent (FR)		61,000
Net rateable value	50,000	
Add :		
1/9 for grossing (repairs)	5,556	
Water tax @ 9% of NRV	4,500	
Sewerage (Halalkhore) tax @ 5% of NRV	2,500	

		Rs.	Rs.
Income from salary			
Municipal valuation (MV)			62,556
Standard rent (SR)			60,500
Annual rent			62,000
Unrealised rent			1,590
Loss due to vacancy (Rs. 600 × 4)			2,400
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]			60,500
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy (*i.e.*, Rs. 62,000 - Rs. 1,590)			60,410
Step III - Amount computed in *Step I* or *Step II*, whichever is higher			60,500
Step IV - Loss due to vacancy			2,400
Step V - Gross annual value is *Step III minus Step IV*			58,100
Less : Municipal taxes			
❑ General tax @ 25.5% of NRV	Rs. 12,750		
❑ Water tax @ 9% of NRV	Rs. 4,500		
❑ Sewerage tax @ 5% of NRV	Rs. 2,500		
❑ Education cess @ 5% of NRV	Rs. 2,500		22,250
Net annual value			35,850
Less : Deductions under section 24			
Standard deduction [30% of Rs. 35,850]			10,755
Interest on borrowed capital			16,000
Brokerage paid for arranging loan (not deductible)			*Nil*
Income from let out property (*b*)			9,095
Recovery of unrealised rent [expenditure incurred is not deductible by virtue of section 25A—see para 92] (*c*)			2,100
Income from house property [(*b*) + (*c*)]			11,195

Income from salary	
Computation of income	
Salaries	2,48,000
Income from house property	11,195
Interest income	85,000
Gross total income	3,44,195
Less : Deduction under sections 80C to 80U	*Nil*
Net income (rounded off)	3,44,200

Note - No deduction is available in respect of insurance premium and annual charges while computing house property income.

95-P6 *X has the following properties :*

1. *Flat in Bombay purchased on June 1, 2008 which is let out on a monthly rent of Rs. 2,000. The building in which the flat is located was completed on May 1, 2008. The flat was let out from August 1, 2008.*
2. *Flat in Delhi (construction completed on May 10, 2005), which is self-occupied.*
3. *Godown in Calcutta constructed in 2005 which is let out on a monthly rent of Rs. 8,000 (it remains vacant for ½ month). The expenses actually incurred during the year against rental income are :*

Municipal taxes actually paid during the previous year ending March 31, 2009	*7,000*	*2,400*	*11,000*
Building co-operative maintenance charges	*2,000*	*900*	—

	Bombay Rs.	Delhi Rs.	Calcutta Rs.
Electricity charges	—	*4,200*	*6,800*
Fire insurance premium	—	—	*2,600*
Collection charges	*750*	—	*1,400*
Repairs	*320*	*1,900*	*14,000*

The following further informations are given :

1. *The flat in Delhi, if let out, would fetch a monthly rent of Rs. 7,000 ; however, standard rent of the house according to the Delhi Rent Control Act is Rs. 6,000 per month.*

2. *Other data regarding flat in Bombay and godown in Calcutta is as follows:*

	Bombay flat Rs.	Calcutta godown Rs.
Municipal valuation (annual)	*21,600*	*70,000*
Fair rent (annual)	*22,000*	*75,000*
Standard rent (annual)	*22,500*	*74,000*
Unrealised rent	*200*	*4,000*

3. *X carries on a business in which he suffered a loss of Rs. 600 during the year ended on March 31, 2009.*

4. *X received a consolidated salary of Rs. 14,000 per month during the year from a part-time employment which he holds.*

5. *X took a loan of Rs. 1,80,000 on March 31, 2000 from a bank at 24 per cent per annum to construct the house in Delhi. However, on May 15, 2005 it is repaid along with interest.*

Compute X's total income for the year ending March 31, 2009.

SOLUTION :	*Rs.*	*Rs.*
Income from salary		
Pay	1,68,000	
Less : Standard deduction	—	1,68,000
Income from flat of Bombay of the previous year June 1, 2008 - March 31, 2009		
Municipal valuation (from June 1, 2008 to March 31, 2009) (MV)		18,000
Fair rent (from June 1, 2008 to March 31, 2009) (FR)		18,333
Standard rent (from June 1, 2008 to March 31, 2009) (SR)		18,750
Actual rent from June 1, 2008 to March 31, 2009 (*i.e.*, after excluding unrealised rent but before deducting rent of vacant period) [*i.e.*, Rs. 2,000 × 10 - Rs. 200]		19,800
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]		18,333
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy (*i.e.*, Rs. 2,000 x 10 - Rs. 200)		19,800
Step III - Amount computed in *Step I* or *Step II*, whichever is higher		19,800
Step IV - Loss due to vacancy		4,000
Step V - Gross annual value is *Step III minus Step IV*		15,800
Less : Municipal taxes		7,000
Net annual value		8,800
Less : Deduction under section 24, *i.e.*, standard deduction (30% of Rs. 8,800)		2,640
Income from flat at Bombay		6,160
Income from let out godown at Calcutta		
Municipal valuation (MV)		70,000
Fair rent (FR)		75,000
Standard rent (SR)		74,000

		Rs.
Actual rent after deducting unrealized rent but before loss due to vacancy (Rs. 8,000 x 12 - Rs. 4,000)		92,000
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]		74,000
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy		92,000
Step III - Amount computed in *Step I* or *Step II*, whichever is higher		92,000
Step IV - Loss due to vacancy		4,000
Step V - Gross annual value is *Step III minus Step IV*		88,000
Less : Municipal taxes		11,000
Net annual value		77,000
Less : Deduction under section 24, *i.e.*, standard deduction (30% of Rs. 77,000)		23,100
Income from godown at Calcutta		53,900
Income from self-occupied property in Delhi		
Annual value		
Less : Deductions under section 24		*Nil*
Interest of 5 years (*i.e.*, 2000-01 to 2004-05, being preconstruction period) deductible in 5 equal instalments for the previous years 2005-06 to 2009-10 : Rs. 1,80,000 × 24/100 × 5 ÷ 5 [Rs. 43,200 ; deduction cannot, however, exceed Rs. 30,000]		30,000
Income of self-occupied property		(-)30,000
Computation of taxable income of X		
Salary		1,68,000
Income from house property		
Flat at Bombay	6,160	
Flat at Delhi	(-)30,000	
Godown at Calcutta	53,900	30,060
Business loss		(-)600
Gross total income		1,97,460
Less : Deductions under sections 80C to 80U		*Nil*
Net income (rounded off)		1,97,460

Note : No deduction is available in respect of building co-operative maintenance charges, electricity charges, fire insurance premium and collection charges.

95-P7 *X Ltd. was registered in 1972 under the Companies Act, 1956 and started business of letting properties on rent for commercial and residential purposes. It acquired some old properties in late 1972, while it constructed 4 properties till March 31, 2009, details are given as under :*

	Date of completion of construction	Number of flats	
		Residential	Commercial
Property A	*March 13, 1991*	*14*	*6*
Property B	*March 31, 1998*	*10*	*3*
Property C	*March 31, 1998*	*15*	*10*
Property D	*March 10, 1998*	*7*	*8*

For the previous year 2008-09, rent is Rs. 6,80,000 on accrual basis. Fair rent is Rs. 5,85,000. The company pays one-third of the municipal taxes imposed by the local authority, while the balance two-thirds is paid by tenants (total municipal tax imposed @ 12% by the local authority for the previous year amounts to Rs. 70,720). For the previous year, the company gives the following information :

❑ *Maintenance of lift (*including depreciation)*	*6,000**	*9,000*
❑ *Water supply*	*8,000*	*12,000*
❑ *Maintenance of swimming pool*	*10,000*	*6,000*
❑ *Lighting of stairs*	*12,000*	*5,000*
❑ *Extension of water connection (*including depreciation)*	*21,000**	*38,000*
❑ *Interest on capital borrowed for the purpose of construction of house properties*	*48,000*	—
❑ *Ground rent (unpaid)*	*22,000*	—
❑ *Land revenue (unpaid)*	*17,000*	—
❑ *Fire insurance premium for the houses owned by the company*	*4,000*	*2,000*

	Rs.
Unrealised rent (defaulting tenant has not vacated, nor steps have been taken to vacate the property)	*7,000*
Depreciation @10% on written down value of Rs. 60,10,500	*6,01,050*
Salary of managing director and staff (including salary of Rs. 4,000 paid to a clerk for collecting rent)	*21,000*
Collection charges (including bank commission, legal expenses and expenditure on stamp and stationery)	*37,820*

3 flats of rental value of Rs. 3,000 and 6 flats of rental value (inclusive of cost of amenities) of Rs. 1,800 remained vacant for 6 months and 7 months respectively during the previous year 2008-09

All the properties are outside the jurisdiction of the Rent Control Acts.

Determine the income of the company for the assessment year 2009-10.

SOLUTION : As the company is carrying on the business of letting properties on rent, its income is chargeable to tax under the head "Income from house property" :

Income from house property

	Rs.	*Rs.*	*Rs.*
Rent receivable		6,80,000	
Less : Amount charged from tenants for providing different amenities			
Maintenance of lift	9,000		
Water supply	12,000		
Maintenance of swimming pool	6,000		
Lighting	5,000		
Extension of water connection	38,000		
Insurance	2,000	72,000	6,08,000
Municipal value (*i.e.*, Rs. 70,720 × 100 ÷ 12) (MV)			5,89,333
Fair rent (FR)			5,85,000
Standard rent (SR)			NA
Annual rent			6,08,000

	Rs.	Rs.
Unrealised rent (not deductible, as the tenant has not vacated the property, nor steps have been taken to compel him to vacate the property)		*Nil*
Loss due to vacancy [*i.e.*, Rs. 6,08,000 ÷ Rs. 6,80,000 (3 × Rs. 3,000 × 6 + 6 × Rs. 1,800 × 7)]		1,15,878
Computation of gross annual value		
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]		5,89,333
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy		6,08,000
Step III - Amount computed in *Step I* or *Step II*, whichever is higher		6,08,000
Step IV - Loss due to vacancy		1,15,878
Step V - Gross annual value is *Step III minus Step IV*		4,92,122
Gross annual value		4,92,122
Less : Municipal taxes (borne by the company), *i.e.*, 1/3 of Rs. 70,720		23,573
Net annual value (a)		4,68,549
Less : Deductions under section 24 :		
Standard deduction [@30% of Rs. 4,68,549]		1,40,565
Interest on capital		48,000
Income from house property		2,79,984
Income from other sources		
Amount receivable from the tenants for providing different amenities (*i.e.*, Rs. 9,000 + Rs. 12,000 + Rs. 6,000 + Rs. 5,000 + Rs. 38,000 + Rs. 2,000)	72,000	
Less :		
Unrealised amount [Rs. 7,000 × Rs. 72,000 ÷ Rs. 6,80,000]	741	
Loss due to vacancy [(3 × Rs. 3,000 × 6 + 6 × Rs. 1,800 × 7) × Rs. 72,000 ÷ Rs. 6,80,000]	13,722	
Expenses incurred and depreciation (*i.e.*, Rs. 6,000 + Rs. 8,000 + Rs. 10,000 + Rs. 12,000 + Rs. 21,000 + 4,000)	61,000	
Income from other sources		(–)3,463
Gross total income		2,76,521
Less : Deductions under sections 80C to 80U		*Nil*
Net income (rounded off)		2,76,520

Note : No deduction is available in respect of ground rent and land revenue while computing house property income.

FREQUENTLY ASKED QUESTIONS (FAQs) ABOUT MODE OF COMPUTATION OF ANNUAL VALUE

FAQ 1 - *According to section 23(1), gross annual value shall be determined as follows—*

Section 23(1)(a)	*Reasonable expected rent of the property is taken as annual value, if clauses* (b)/(c) *of section 23(1) are not applicable*
Section 23(1)(b)	*If rent received or receivable (after deducting unrealized rent and loss due to vacancy) is higher than reasonable expected rent, then such rent shall be taken as annual value*
Section 23(1)(c)	*If rent received or receivable (after deducting unrealized rent and loss due to vacancy) is lower than reasonable expected rent and lower collection is only because of vacancy, then such rent shall be taken as annual value*

However, it appears that the mode of computation of annual value, given in the current edition, is different from the scheme of section 23 given above.

Answer - The mode of computation of annual value given in the current edition is simpler and different from the computation mode given in earlier editions (*i.e.*, up to 40th edition). However, the amount of annual value of a property in any given case will be the same whether one follows the method given in this edition or one goes by the method given in earlier editions or one calculates annual value according to the scheme of section 23(1)(*a*)/(*b*)/(*c*). Take for instance the following cases—

(Rs. in thousand)

	X	Y
Municipal value (MV)	96	215
Fair rent (FR)	110	210
Standard rent (SR)	95	217
Annual rent	156	192
Unrealized rent	60	10
Loss due to vacancy (property remains vacant for one month because of non-availability of suitable tenant)	13	16
Computation of annual value according to the method given in the current edition		
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]	95	215
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy	96	182
Step III - Amount computed in *Step I* or *Step II*, whichever is higher	96	215
Step IV - Loss due to vacancy	13	16
Step V - Gross annual value is *Step III minus Step IV*	83	199
Computation of annual value according to the method given in earlier editions		
Section 23(1)(*a*) - Reasonable expected rent of the property is taken	95	215
Section 23(1)(*b*) - Find out rent received/receivable after deducting unrealized rent and loss due to vacancy, if it is higher, it will be taken as annual value, otherwise section 23(1)(*b*) is not applicable.	NA	NA

	X	Y
Section 23(1)(*c*) - If rent received/receivable (after deducting unrealized rent and vacancy loss) is lower and lower collection only because of vacancy, then such lower collection shall be taken as annual value.	83	NA
If lower collection is partly because of vacancy and partly because of other factors, then loss due to vacancy shall be deducted from reasonable expected rent.	NA	199
If lower collection is because of factors other than vacancy, then reasonable expected rent shall be taken as annual value.	NA	NA

FAQ 2 - *According to section 23(1)*(c)*, if rent actually received/receivable (after excluding unrealized rent and loss pertaining to vacancy) is lower than the reasonable expected rent of the property, then rent received/receivable is taken as annual value if lower collection is only because of vacancy. In other words, if lower collection of rent is partly because of vacancy and partly because of other factors, then section 23(1)*(c) *is not applicable. In such a situation, reasonable expected rent shall be taken as annual value under section 23(1)*(a)*. However, in this book loss due to vacancy is deducted from reasonable expected rent of the property when lower collection of rent is partly because of vacancy and partly because of other factors.*

Answer - If due to vacancy, actual rent received or receivable is lower than the reasonable expected rent, then such rent is taken as gross annual value. However, this rule is applicable only if decline is only because of vacancy. If the shortfall is partly because of vacancy and partly because of some other factors (like letting out at lower rent, unrealised rent, etc.), then mode of computation is not provided by the Act.

It is a settled legal position that when there is a doubt about the meaning of any statutory provision, the provision is to be understood in the sense in which it can harmonise with the subject of the enactment and the object which the Legislature has in view—*CIT* v. *Chandanben Maganlal* [2002] 120 Taxman 38 (Guj.).

The Legislature has desired to give relief to an assessee whose property remains vacant. One may also refer to the mode of computation of annual value given in income-tax return forms [*i.e.*, the formula of computation of annual value given in Item 1(*a*) of Schedule HP in ITR-1 to ITR-6, wherein rent received after deducting vacancy loss is taken as annual value if it is lower than reasonable expected rent regardless of the fact whether lower collection is only because of vacancy or otherwise].

If decline in rent collection is partly because of vacancy and partly due to other factors, then loss due to vacancy shall be deducted from the amount of the reasonable expected rent, otherwise illogical results will come. Examine the case given below—

	(Rs. in thousand)
Municipal value (MV)	62
Fair rent (FR)	66
Standard rent (SR)	61
Annual rent (property is actually let out at Rs. 5,000 per month)	60
Loss due to vacancy	10
Unrealized rent	*Nil*
Computation of gross annual value as per formula given in the book	
Step I - Reasonable expected rent of the property [MV or FR, whichever is higher, but subject to maximum of SR]	61
Step II - Rent received/receivable after deducting unrealized rent but before adjusting loss due to vacancy	60
Step III - Amount computed in *Step I* or *Step II*, whichever is higher	61
Step IV - Loss due to vacancy	10
Step V - Gross annual value is *Step III minus Step IV*	51

In this case, rent actually collected is Rs. 50,000 which is lower than reasonable expected rent of Rs. 61,000. The lower collection is because of the following reasons—

a. loss due to vacancy (*i.e.*, 2 months rent: Rs. 10,000); and

b. loss due to letting out of property at less than reasonable expected rent (*i.e.*, Rs. 1,000)

Rs. 10,000 is deducted to find out annual value of the property, although lower collection of rent is partly because of vacancy and partly because of other factors.

Opinion that section 23(1)(c) *is not applicable when lower collection of rent is partly because of vacancy* - There is a view that Rs. 10,000 should not be deducted in the aforesaid situation and annual value should be Rs. 61,000 [simply because of the fact that clause (*c*) of section 23(1) is not applicable when lower collection is partly because of vacancy and under clause (*a*) vacancy loss is not deductible]. If Rs. 61,000 is taken as annual value, then the taxpayer can reduce his tax liability by declaring that property is given on annual rent of Rs. 61,000 (and not on Rs. 60,000). Consequently, the rent actually collected is Rs. 51,000 (which is lower than reasonable expected rent only because of vacancy) and Rs. 51,000 will become annual value under section 23(1)(*c*).

If vacancy loss is not adjusted in a case where lower collection of rent is partly because of vacancy, illogical results will come—

	When it is declared that property is given on annual rent of Rs. 60,000	*When the landlord declares that annual rent is Rs. 61,000*
Annual value under section 23(1)(*a*)	Rs. 61,000	Not applicable
Annual value under section 23(1)(*c*)	—	Rs. 51,000

Annual value would be higher (Rs. 61,000) if annual rent is Rs. 60,000. Conversely, annual value will be lower (Rs. 51,000) if it is declared that annual rent is not Rs. 60,000 but Rs. 61,000. Where the plain literal interpretation of a statutory provision produces a manifestly unjust result, which could never have been intended by the Legislature, the language used by the Legislature may be fine-tuned so as to achieve the intention of the Legislature and produce a rational construction — *K.P. Varghese* v. *ITO*[1981]7 Taxman 13 (SC), ***Narang Overseas (P.) Ltd.*** v. ***ITAT*** [2007] 165 Taxman 558 (Bom.). Therefore, in this book loss due to vacancy is deducted from reasonable expected rent whenever lower collection of rent is partly because of vacancy and partly because of other factors.

FAQ 3 - *In this book, loss due to vacancy is deducted under* Step V *while calculating annual value. For instance, in FAQ 1, the two properties remain vacant for one month. One month's rent is equal to Rs. 13,000 in the case of X and Rs. 16,000 in the case of Y. Rs. 13,000 and Rs. 16,000 are deducted to calculate the figure of gross annual value in the cases of X and Y respectively. It appears to be incorrect. The correct approach should be to reduce the value on proportionate basis (i.e., 1/12 of the amount immediately before adjusting vacancy loss shall be deducted) as shown in the table below—*

(Rs. in thousand)

	Computation of annual value (on the basis of method given in this book) after deducting an amount equal to one month's rent		**Computation of annual value (if vacancy loss is taken as equal to 1/12 of the amount before adjusting of vacancy loss)**	
	X	**Y**	**X**	**Y**
Step III - *Value before adjusting vacancy loss*	*96*	*215*	*96*	*215*
Step IV - *Vacancy loss - if one month's rent is deducted*	*13*	*16*	—	—
Step IV - *Vacancy loss - if loss is taken on proportionate basis* (i.e., *1/12 of Rs. 96,000 or Rs. 2,15,000)*	—	—	*8*	*17.92*
Step V - *Gross annual value (Step III - Step IV)*	*83*	*199*	*88*	*197.08*

Answer - Adjustment of vacancy loss on proportionate basis was possible under the old scheme of section 24(1)(*ix*) [*i.e.*, before the amendment made by the Finance Act, 2001]. Now section 24(1)(*ix*) has been omitted. Under the new scheme of computation of property income, vacancy loss can be adjusted only under clause (*c*) of section 23(1). The present format of section 23(1) is as follows—

Clause (*a*) of section 23(1)	Under this clause, reasonable expected rent is determined to find out annual value. It is a notional figure.
Clause (*b*) of section 23(1)	Under this clause, actual rent received/receivable is calculated. It is on the basis of actual inflow of cash. It is not a notional figure. If actual rent received/receivable is higher than reasonable expected rent, it is taken as annual value.
Clause (*c*) of section 23(1)	Under this clause, actual rent received/receivable is calculated. It is on the basis of actual inflow of cash. It is not a notional figure. If actual rent received/receivable is lower than reasonable expected rent and lower collection is only because of vacancy, actual rent will be taken as annual value.

From the above discussion, one can forcefully argue that clause (*c*) which considers actual loss due to vacancy, does not permit adjustment of loss on proportionate basis. Consequently, in this book, actual loss due to vacancy is deducted in *Step V* and vacancy loss is not adjusted on proportionate basis.

FAQ 4 - *In this book unrealized rent is deducted under Step II. If the amount computed in Step I is higher than Step II, one may not be able to avail full deduction of unrealized rent. However, in new income-tax return Forms (i.e., ITR-2 to ITR-6) unrealized rent is fully deducted from annual value [for instance, see Schedule HP, Items 1(a) and 1(b) in different ITRs]. There appears to be some mismatch between the mode of computation of income from house property given in this book and the computation mode of property income given in income-tax return Forms.*

Answer - The formula of computation of annual value given in income-tax return Forms (*i.e.*, ITR-2 to ITR-6) is not correct and it is not based upon the provisions of section 23(1). A schedule given in a Form cannot supersede provisions of the Income-tax Act. If there is a clash between Income-tax Act and income-tax return Forms, one has to follow what is given in the Income-tax Act. There are many discrepancies in the income-tax return Forms. In ITR-5, a partnership firm can be resident but not ordinarily resident, whereas section 6 does not permit it. Exemption under section 54EC is not available in the case of short-term capital gain. ITR-4 gives a different version. Provisions of section 44BBB are not applicable in the case of partnership firm, whereas ITR-5 (which is applicable in the case of a partnership firm) contains a provision for the same. The Central Board of Direct Taxes has done a remarkable work in preparation of these forms. The Board will eventually correct a few shortcomings that are there in the return Forms. Return Forms cannot supersede provisions of the Act. An incorrect calculation of income (even if it is because of a defect in the format of return form) can now be corrected by the Assessing Officers under section 143(1).

CHAPTER SIX

Profits and gains of business or profession

Chargeability [Sec. 28]

101. Under section 28, the following nine types of income are chargeable to tax under the head "Profits and gains of business or profession" :

a. profits and gains of any business or profession [*see* paras 101.1 to 101.7] ;

b. any compensation or other payments due to or received by any person specified in section 28(*ii*) [*see* para 101.8] ;

c. income derived by a trade, professional or similar association from specific services performed for its members [*see* para 101.9] ;

d. profit on sale of import entitlement licences, incentive by way of cash compensatory support and drawback of duty [*see* para 101.10] ;

e. any profit on transfer of the Duty Entitlement Pass Book Scheme;

f. any profit on the transfer of the Duty Free Replenishment Certificate;

g. the value of any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession [*see* para 101.11] ;

h. any interest, salary, bonus, commission or remuneration received by a partner of firm from such firm [*see* para 322.2] ;

i. any sum whether received or receivable, in cash or kind, under an agreement for not carrying out any activity in relation to any business or not to share any know-how, patent, copyright, trade-mark, licence, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for service [*see* para 101.12];

j. any sum received under a keyman insurance policy (including bonus);

k. profits and gains of managing agency; and

l. income from speculative transaction [*see* para 101.13].

Income from the aforesaid activities is computed in accordance with the provisions laid down in sections 29 to 44DB.

101.1 ***Business - Meaning of*** - In view of section 2(*13*), business includes any (*a*) trade, (*b*) commerce, (*c*) manufacture, or (*d*) any adventure or concern in the nature of trade, commerce or manufacture.

101.1-1 *DEFINITION OF "BUSINESS" IN SECTION 2(13) IS NOT EXHAUSTIVE* - The definition of the term "business" in section 2(*13*) is not exhaustive, it covers every facet of an occupation carried on by a person with a view to earning profits. Thus, the word "business" under section 28 has a very broad meaning and may be used in many different connotations.

Production of goods from raw material, buying and selling of goods to make profits and providing services to others are different forms of "business". Profits arising therefrom are, therefore, chargeable to tax under the head "Profits and gains of business or profession". The term "business" is a word of wide import and in fiscal statutes it must be construed in a broad rather than a restricted sense—*Mazagaon Dock Ltd.* v. *CIT* [1958] 34 ITR 368 (SC).

101.1-2 *SIGNIFICANCE OF PROFIT MOTIVE* - Though profit motive is one of the primary requisites of business, it is not an essential ingredient of business. For instance, mutual concerns and societies do

carry on business, but they seldom have profit motive—*General Family Pension Fund* v. *CIT* [1946] 14 ITR 488 (Cal.).

101.1-3 *CONTROL AND PROFIT MOTIVES ARE TWO CRUCIAL TESTS* - If there is neither control over the actual conduct of the day-to-day business nor is there any direct nexus with the profits or losses of a business, there can be no question of a business or profession carried on by the assessee in terms of section 28 and the case, therefore, must fall within the ambit of section 56 as income from other sources—*CIT* v. *S.K. Sahana & Sons Ltd.* [1987] 33 Taxman 62 (Pat.).

101.1-4 *RISK, UNCERTAINTY, FORESIGHTEDNESS TO VISUALISE THE IMPONDERABLES AND CAPACITY TO OVERCOME THE UNFORESEEN HURDLES ARE ESSENTIAL REQUISITES FOR BUSINESS ACTIVITIES* - When a person decides to invest his savings for a purpose other than business or trade, he ordinarily looks for safety of the principal amount. The other object would be to receive regular and certain return on amount invested. If there is no safety of the capital invested and if there is no certainty of regular return, it is difficult to say that such a transaction can be said to be in the nature of investment. As against this, an adventure means an enterprise or undertaking involving some risk in the transaction. The very word "venture" connotes chance *plus* risk—*CIT* v. *Minal Rameshchandra* [1987] 167 ITR 507 (Guj.).

101.1-5 *BUSINESS AND RENDERING SERVICES TO OTHERS* - It is not necessary that business should always consist of activities of trade, commerce or manufacture. Even activities of rendering services to others fall within the four corners of the expression "business".

101.1-6 *BUSINESS CANNOT BE CARRIED ON WITH ONESELF* - Business arises out of commercial transactions between two or more persons.

One cannot enter into a business transaction with oneself. However, there can be a business transaction between partnership and a limited company in which all the partners of the firm are shareholders as the firm is a legal entity distinct from company under the general law—*CIT* v. *B.M. Kharwar* [1969] 72 ITR 603 (SC).

101.1-7 *BUSINESS VIS-A-VIS COMPANY* - The capacity of a joint stock company to carry on business is controlled and guided by its memorandum and articles of association. In deciding whether (or not) a particular activity of a company constitutes business in its hands, it is necessary to examine the memorandum and articles of association of the company. However, existence (or non-existence) of power in the memorandum of association of a company to carry on a particular activity is not the only decisive factor to ascertain whether the activity constituted business activity and profit arising therefrom is chargeable to tax as business profit. The final decision depends upon the facts of each case.

101.2 ***Business includes trade*** - In view of section 2(*13*) business, *inter alia*, includes trade. Therefore, it is essential to deal with it separately. Shah, J. observed in *State of Punjab* v. *Bajaj Electricals Ltd.* [1968] 70 ITR 730 (SC) that trade in its primary meaning is the exchanging of goods for goods or goods for money; in its secondary meaning it is repeated activity in the nature of business carried on with a profit motive, the activity being manual or mercantile, as distinguished from the liberal arts or learned professions or agriculture.

101.3 ***Business includes commerce*** - If a person purchases goods with a view to selling them at a profit, it is an ordinary case of trade. If such transactions are repeated on a large scale, it is called commerce. In determining a case of trade or commerce, in contradiction to investment, one has to take into account the nature of the assets, the occupation of assessee, and the frequency and volume of transactions—*W.L. Knopp* v. *CIT* [1948] 16 ITR 398 (Mad.).

101.4 ***Business includes manufacture*** - The word "manufacture" is defined by the *Oxford English Dictionary* as making of articles or materials by physical labour or mechanical power. ". . . The essence of manufacturing is that something is produced or brought into existence which is different from that out of which it is made, in the sense that the thing produced is by itself commercial commodity which is capable as such of being sold or supplied."

101.5 ***Business includes any adventure in the nature of trade, commerce or manufacture*** - When section 2(*13*) refers to an adventure in the nature of trade, it clearly suggests that the transaction

cannot properly be regarded as trade or business. It is allied to transactions that constitute trade or business, but may not be trade or business itself. It is characterised by some of the essential features that make up trade business but not by all of them—*See G. Venkataswami Naidu & Co.* v. *CIT* [1959] 35 ITR 594 (SC).

101.5-1 *WHAT MAKES A TRANSACTION AN ADVENTURE IN THE NATURE OF TRADE* - R.R. Rastogi, J. in *ITO* v. *Rani Ratnesh Kumari* [1980] 123 ITR 343 (All.) observed :

"In order to find whether a transaction of purchase and subsequent sale amounts to an adventure in the nature of trade, the initial intention is an important factor but not a conclusive one. The subsequent events and the assessee's conduct are also important factors and the facts to be considered are : first, whether the transaction was in the line of the assessee's business and, secondly, whether it was an isolated transaction or there was a series of similar transactions."

101.5-2 *ISOLATED TRANSACTION WHEN CAN CONSTITUTE ADVENTURE IN NATURE OF TRADE* - It is not necessary that in order to constitute trade there should be a series of transactions, both of purchase and of sale.

Even a single and isolated transaction can be held to be capable of falling within the definition of "business" if it bears clear *indicia* of trade. However, a stray activity of a non-businessman would not be business—*CIT* v. *Prabhu Dayal* [1971] 82 ITR 804 (SC). A single transaction of purchase and sale of an antique car by the assessee cannot be regarded as an adventure in nature of trade—***CIT*** v. ***Narendra I. Bhuva*** [2004] 90 ITD 174 (Mum.).

101.5-3 *DEALER IN LAND* - A transaction of purchase of land cannot be assumed, without more, to be a venture in the nature of trade. Transaction in land where there is scheming and organisation on the part of the assessee, constitutes an adventure in nature of trade—*P.M. Mohammed Meerakhan* v. *CIT* [1969] 73 ITR 735 (SC).

101.5-4 *DEALER IN SHARES* - The fact that purchase of shares was motivated by a possibility of enhanced value, will not necessarily render the investment a transaction in the nature of trade—*CIT* v. *H. Holck Larsen* [1986] 160 ITR 67 (SC). Where, however, from the very beginning, purchase of shares is made with the intention of selling them, at a profit, it is an adventure in the nature of trade—*Rajputana Textiles (Agencies) Ltd.* v. *CIT* [1961] 42 ITR 743 (SC).

■ *Frequency of dealings* - Purchase and sale of shares for substantial amounts at frequent intervals cannot be treated as change in investments but have to be treated as dealings in shares—*Raja Bahadur Visheshwara Singh* v. *CIT* [1961] 41 ITR 685 (SC).

■ *Borrowal of money* - In a given set of circumstances, borrowal of money for purchase of shares would be a strong circumstance that the dealing in the shares was in a commercial spirit—*CIT* v. *Godavari Corpn. Ltd.* [1985] 156 ITR 835 (MP). Where most of investments made by assessee in shares are retained, transactions in shares can be held to be in nature of trade if assessee has borrowed funds for such transactions—***Pushpaben H. Koticha*** v. ***CIT*** [2004] 2 SOT 904 (Rajkot).

■ *Broad conclusions* - The following broad conclusions should be noted—

1. Where a company purchases and sells shares, it must be shown that they were held as stock-in-trade and that existence of the power to purchase and sell shares in the memorandum of association is not decisive of the nature of transaction.

2. The substantial nature of transactions, the manner of maintaining books of account, the magnitude or purchases and sales and the ratio between purchases and sales and the holding would furnish a good guide to determine the nature of transactions.

3. Ordinarily the purchase and sale of shares with the motive of earning a profit, would result in the transaction being in the nature of trade/adventure in the nature of trade; but where the object of the investment in shares of a company is to derive income by way of dividend, etc., then the profits accruing by change in such investment (by sale of shares) will yield capital gain and not revenue receipt—**Circular No. 4/2007**, dated June 15, 2007.

101.5-5 *MONEY LENDER* - It is a question of fact in each case whether property purchased by a money-lender in discharge of loans advanced by him forms part of the stock-in-trade of his business. It

depends on whether, after purchase, he treats the property as part of the stock-in-trade of his business by such acts, *e.g.*, including the value of the property in the accounts or charging the expenditure incurred in respect of the property to the business or treating the income derived therefrom as income of the business. The burden is upon the department to prove that such property forms part of the stock-in-trade of his business—*Alapati Ramaswami* v. *CIT* [1959] 35 ITR 73 (AP). However, purchase of property out of income derived from money-lending business cannot be regarded as a transaction made in furtherance of money-lending business—*Ram Chandra Munna Lal* v. *CIT* [1949] 17 ITR 394 (Punj.).

101.5-6 *DEALING IN ACTIONABLE CLAIMS/DECREE* - Purchase of money decree and realisation of money therefrom by a money-lender cannot be termed anything but an adventure in the nature of trade, since money decree is not an asset which one would acquire for keeping it for his enjoyment—*Rukmani Co. (P.) Ltd.* v. *CIT* [1964] 52 ITR 599 (Mad.).

101.5-7 *SALE OF FOREIGN EXCHANGE* - Where a property-owning company acquires foreign exchange but, without taking delivery of it on the date fixed for delivery, resells the foreign exchange at a later date on profit, it the object or purpose for which the assessee acquired the foreign exchange is to make the profit by sale and, therefore, the transaction is an adventure in the nature of trade—*Regent Estates Ltd.* v. *CIT* [1963] 48 ITR 162 (Cal.).

101.5-8 *DISPOSING ASSETS IN PIECES* - Disposing of asset in pieces when buyer is not available for whole of asset, cannot be considered as adventure in nature of trade—***Vinod Kumar*** v. ***CIT*** [2004] 1 SOT 937 (Asr.).

101.5-9 *EMERGING PRINCIPLES* - On a resume of different judicial pronouncements, the following principles emerge :

1. An adventure in the nature of trade need not be business itself. Any activity akin to business may be taken to be an adventure in the nature of trade.

2. A single transaction may also constitute an adventure in the nature of trade. There need not be regularity or repetitiveness in the activity.

3. Whether a transaction is in the nature of trade and commerce must be decided on the facts and circumstances of each case.

4. The activity alleged/claimed to be an adventure in the nature of trade need not be allied to the already existing activity of the assessee.

5. The activity or the transaction said to be an adventure in the nature of trade must be with the object of earning profit—*Eclat Construction (P.) Ltd.* v. *CIT* [1988] 172 ITR 84 (Pat.).

■ *No single test is conclusive* - The aforesaid considerations are set out and discussed in judicial decisions which deal with the character of transactions alleged to be in the nature of trade. In considering these decisions it would be necessary to remember that they do not purport to lay down any general or universal test. The presence of all the relevant circumstances may help to draw a similar inference ; but it is not a matter of merely counting the number of facts and circumstances *pro* and *con* ; what is important is to consider their distinctive character. Thus, the decision about the character of a transaction cannot be based solely on the application of any abstract rule, principle or test and it must, in every case, depend upon all the relevant facts and circumstances.

101.5-10 *ONUS TO PROVE* - It is for the revenue to establish that the profit earned in a transaction is within the taxing provision and is on that account liable to be taxed as income—*Janki Ram Bahadur Ram* v. *CIT* [1965] 57 ITR 21 (SC). Where a transaction is not in the line of the business of the assessee and is an isolated or single instance of transaction, the onus is on the income-tax department to prove that the transaction is an adventure in the nature of trade—*Saroj Kumar Mazumdar* v. *CIT* [1959] 37 ITR 242 (SC).

101.6 ***Business income not taxable under the head "Profits and gains of business or profession"*** - In the following cases, income from trading or business is not taxable under section 28, under the head "Profits and gains of business or profession" :

Nature of income	Head under which it is chargeable to tax
Rental income in the case of dealer in property	Rent of house property is taxable under section 22 under the head "Income from house property", even if property constitutes stock-in-trade of recipient of rent or the recipient of rent is engaged in the business of letting properties on rent—*Salisbury House Estate Ltd.* v. *Fry* [1930] AC 432 (HL).
Dividend on shares in the case of a dealer in shares	Dividend received from an Indian company is not chargeable to tax in the hands of shareholders. If dividend is received from a foreign company or if deemed dividend under section 2(22)(*e*) is received from a domestic company, it is taxable and when dividend is taxable, it is always taxable under section 56(2)(*i*), under the head "Income from other sources", even if it is derived from shares held as stock-in-trade or the recipient of dividends is dealer in shares.
Winning from lotteries, etc.	Winnings from lotteries, races, etc., are taxable under the head "Income from other sources" (even if derived as a regular business activity).

Profits derived from the aforesaid business activities are not taxable under section 28, under the head "Profits and gains of business or profession". Profits and gains of any other business are taxable under section 28, unless such profits are exempt under sections 10 to 13A.

101.7 ***Meaning of "profession" and "vocation"*** - Section 2(*36*), profession includes vocation. The word "profession" implies professed attainments in special knowledge as distinguished from mere skill; "special knowledge" which is "to be acquired only after patient study and application"—*United States* v. *Laws* [1896] 163 US 258. Many vocations may fall within the ordinary and accepted use of the word "profession"; for instance, as those of tax experts, financial accountants, cost accountants, management accountants, architects, engineers, journalists, and so forth. However, whether a person in any given case carries on a profession is a question of degree and always of facts—*Robbins Herbal Institute* v. *Federal Taxation Commissioner* [1923] 32 CLR 457.

A company being an artificial person cannot be said to possess any personal skills. A company (being an artificial person) does not have a mind and body and, therefore, cannot be engaged in profession. It can neither have an intellectual skill or any manual skill—*ITO* v. *Ashalok Nursing Home (P.) Ltd.* [2006] 9 SOT 61 (Delhi) (URO).

101.7-1 ***DISTINCTION BETWEEN BUSINESS, PROFESSION OR VOCATION, NOT SIGNIFICANT*** - As profits and gains of a business, profession or vocation are chargeable to tax under the head "Profits and gains of business or profession", distinction between "business", "profession" and "vocation" does not have any material significance while computing taxable income. What does not amount to "profession" may amount to "business" and what does not amount to "business" may amount to "vocation"—*Upper India Chamber of Commerce* v. *CIT* [1947] 15 ITR 263 (All.).

101.8 ***Compensation or other payments due to or received by any person specified in section 28(ii)*** - Under section 28(*ii*), compensation or payment due to or received by the following persons, by whatever name called, is chargeable to tax under the head "Profits and gains of business or profession":

a. any person managing the whole (or substantially the whole) of affairs of an Indian company, at (or in connection with) the termination of his management (or the modification of the terms and conditions relating thereto);

b. any person managing the whole (or substantially the whole) of the affairs in India of any other company, at or (in connection with) the termination of his office (or the modification of the terms and conditions relating thereto);

c. any person, holding an agency in India for any part of the activities relating to the business of any other person, at (or in connection with) the termination of the agency (or the modification of the terms and conditions relating thereto);

d. any person, for (or in connection with) the vesting in the Government (or in any corporation owned or controlled by the Government), under any law for the time being in force, of the management of any property or business.

101.9 ***Income of trade or professional associations from specific services [Sec. 28(iii)]*** - It is a settled principle that excess of income over expenditure accruing to a mutual association is not income and, consequently, it is not liable to tax. The principle is based upon the fact that in the case of surplus, the contributors are to receive back a part of their own contributions; the complete identity between the contributors to common fund and the participants in the surplus negatives the idea of any income, as no one can make a profit out of himself—*Harris* v. *Corporation of Burgh of Irvine* 4 TC 221.

To this rule, an exception is provided in the case of insurance business carried on by a mutual insurance company or co-operative society under section 2(*24*)(*vii*) [*see* para 6]. Another exception to the general principle is provided by section 28(*iii*) which provides that income of a trade, professional or similar association from specific service performed for its members is taxable as business income, even though the association enjoys a mutual character. In order to bring an income within section 28(*iii*), two essential conditions have to be satisfied, namely, (*a*) income is derived by a trade, professional or similar association, and (*b*) income is derived by specific services performed for its members [*see* para 161].

The following points should be noted—

1. Trade association v. *Trading association* - Section 28(*iii*) is applicable in the case of "trade association". Trade association is not the same thing as trading association. A "trade association" is an association of tradesmen, businessmen or manufacturers for the protection and advancement of their common interest — *CIT* v. *Royal Western India Turf Club Ltd.* [1953] 24 ITR 551 (SC). Thus, an association carrying on business is undoubtedly a trading association but not a "trade association".

2. Social clubs are not trade associations - Social clubs are not "trade associations". Therefore, surplus or income derived by a club, even from rendering specific services to its members, is not taxable under section 28(*iii*) it would be governed by general principles applicable to mutual associations. Likewise, entrance fees received by a club (not being a trade association) is not taxable under section 28(*iii*). It is governed by general principles applicable to mutual associations.

3. The words "specific services rendered by an association to its members" mean "conferring particular benefits", *i.e.*, conferring on the members some tangible benefits which would not be available to them unless they pay the specific fees charged for such special benefits — *CIT* v. *Calcutta Stock Exchange Association Ltd.* [1959] 36 ITR 222 (SC).

101.10 ***Export incentives*** - Exporters are given export incentives by way of cash compensatory support (CCS), drawback of duty and import entitlement licences. Profit on sale of import entitlement licences cash assistance and drawback of duty is taxable as business income.

101.11 ***Value of any benefits or perquisites [Sec. 28(iv)]*** - The value of any benefit or perquisite, whether convertible into money or not, arising from the business or the exercise of a profession, is taxable as income from business or profession. This rule is applicable, irrespective of whether the benefits or perquisites are contractual or gratuitous. For instance, sum received by a lawyer from various liquor dealers who are not his clients, but are benefited by his professional services in a case against prohibition, is chargeable to tax under section 28(*iv*), as the benefit arises in the exercise of profession.

- Where partner is allowed by firm to use of residential premises, car and telephone, value of such perquisites is includible in income of assessee under section 28(*iv*)—*V.P. Warrier* v. *CIT* [1990] 181 ITR 303 (MP).
- For determination of perquisite value of vehicle provided to a director of company for his free use, rule 3† can be applied even though he is not an employee of the said company—*CIT* v. *Sir Padampat Singhania* [2000] 111 Taxman 223 (All.).

†Now rule 3 does not provide perquisite valuation rule in respect of car.

■ Foreign trips granted free by a company whose product the assessee is selling, to the assessee and his family in appreciation of business done by the assessee, constitutes benefit assessable under section 28(*iv*)—***R. Imbavalli*** v. ***ITO*** [2004] 83 TTJ (Chennai) 352.

■ Expenses borne by a film producer, on the family members of the assessee, a film director, travelling to shooting locations in Europe, where he was temporarily relocated to perform his professional work at instance of producer, cannot be said to be a benefit or perquisite in hands of the assessee within meaning of section 28(*iv*)—***David Dhawan*** v. ***CIT*** [2005] 2 SOT 311 (Mum.).

101.12 ***Receipts in the nature of non-compete fees and exclusivity rights [Sec. 28(va)]*** - The following sums received (or receivable) in cash or in kind under an agreement shall be taxable under section 28 as income from business :

a. any sum for not carrying out any activity in relation to any business ; or

b. any sum for not sharing any know-how, patent, copyright, trademark, licence, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services.

Exception - The aforesaid (*a*) is not applicable in respect of the following :

a. any sum received on account of transfer of the right to manufacture, produce or process any article or thing which is chargeable as capital gains;

b. any sum received on account of transfer of a right to carry on any business, which is chargeable as capital gains;

c. any sum received as compensation from the multilateral fund of the Montreal Environment Programme, in accordance with the terms of agreement entered into with the Government of India.

As a consequence, the aforesaid receipt shall not be taxable as business income under section 28(*va*).

101.12-1 *MEANING OF AGREEMENT* - For the aforesaid purpose, "agreement" includes any arrangement or understanding or action in concert. Such arrangement, understanding or action may (or may not) be formal or in writing. Moreover, such arrangement, understanding or action may (or may not) be intended to be enforceable by legal proceedings.

101.12-2 *MEANING OF SERVICE* - For the aforesaid purpose, the following are the salient features of "service"—

1. It means service of any description.

2. It is made available to potential users.

3. It includes the provision of services in connection with business of any industrial or commercial nature such as accounting, banking, communication, conveying of news or information, advertising, entertainment, amusement, education, financing, insurance, chit funds, real estate, construction, transport, storage, processing, supply of electrical or other energy, boarding and lodging.

101.12-3 *TAX TREATMENT IN THE HANDS OF PAYER NOT RELEVANT* - In the hands of recipient, the aforesaid receipts are taxable under section 28(*va*), even if these are capital receipt and the payer does not claim any deduction.

101.12-4 *RECEIPTS IN THE NATURE OF NON-COMPETE FEES FOR A PROFESSION* - The aforesaid provisions are applicable only in respect of any sum received for not carrying out any business. If a sum is received for not carrying out any profession, it is not covered by section 28(*va*)—*see* Circular No. 495, dated September 22, 1987.

101.13 ***Speculation business [Explanation 2 to sec. 28]*** - If an assessee carries on a speculative transaction of such a nature as to constitute a business, such business should be deemed distinct and separate from any other business. This provision has been incorporated to make the operation of section 73 effective which lays down that loss in a speculative business can be set-off only against profits from speculative business.

101.13-1 *MEANING OF SPECULATIVE TRANSACTION* - In view of section 43(*5*), "speculative transaction" means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled, otherwise than by the actual delivery or transfer of the commodity or scrips. There are three basic ingredients of speculative transactions :

a. the contract is for the purchase or sale of stock, share or commodity ;

b. that the contract for the purchase or sale of any stock, share or commodity is periodically or ultimately settled ; and

c. the settlement would be otherwise than by actual delivery or transfer of commodity or scrips.

If, therefore, a contract is for purchase or sale of what is not stock, share or commodity, it would not be a speculative transaction. If a contract is ultimately settled otherwise than by actual delivery or transfer of commodity, it would be speculative transaction even if at the time of entering into the contract there was no intention to gamble. On the other hand, if actual delivery of commodity takes place, the transaction would be a non-speculative transaction even if it is highly speculative otherwise—*see Davenport & Co. (P.) Ltd.* v. *CIT* [1975] 100 ITR 715 (SC).

■ *What is delivery* - The following points should be noted—

1. Even 'blank transfer' of shares amounts to 'actual delivery' within the meaning of the term used in section 43(*5*) if shares are delivered along with blank transfer forms—*CIT* v. *Mangal Chand Bhanwarlal & Co.* [2001] 119 Taxman 614 (Raj.).

2. Where a middleman purchases goods and after taking delivery thereof sells them to another party, merely because railways receipt shows seller as both consignor and consignee, it cannot be said that transaction is a speculative transaction—***Makhan Lal Suresh Kumar*** v. ***ITO*** [2004] 1 SOT 323 (Delhi) (SMC).

3. The 'delivery' contemplated by section 43(*5*) need not be actual but even constructive or implied. The Assessing Officer may have to accept the case of constructive or implied delivery as the actual delivery within the meaning of the aforesaid provisions—***C. Bharath Kumar*** v. ***CIT*** [2005] 4 SOT 593 (Bang.).

4. The words 'actual delivery or transfer' in section 43(*5*) are not restricted to delivery or transfer to the assessee; it can be to his agent—***Jayasree Roychowdhury*** v. ***CIT*** [2005] 92 ITD 400 (Kol.).

101.13-2 *SPECULATIVE TRANSACTION* v. *BREACH OF CONTRACT* - A transaction is considered to be speculative if it is settled without actual delivery. It does not follow that all contracts which are settled or adjusted without delivery are speculative. What the section visualises is a contract which is settled by means of a cross-contract, *i.e.*, there is a purchase contract which is settled by a sale contract. If the contract is settled, for some other reasons, by payment of damages, or even without payment of damages, it may or may not be a speculative transaction dependent on the circumstances of the case. If the contract is broken, *i.e.*, for any reason one party is unable to give delivery or the other party is unable to take delivery, it is a case of breach of contract. It depends, therefore, on the facts and circumstances of the case as to whether there has actually been a "breach" of the contract or a "settlement" of the contract. The material question is : why is the contract settled? If it is settled by mutual consent to avoid delivery, then it will be speculative. If it is settled because of inability of the assessee to supply or on account of the fact that it does not have the necessary resources to give the delivery, then it will be a breach of contract—*CIT* v. *Bhagwan Dass Rameshwar Dayal* [1984] 149 ITR 387 (Delhi). Section 43(*5*) covers only cases where a contract is settled without breach and not cases where there is a breach followed by settlement of quantum of damages—*CIT* v. *Hans Machoo & Co.* [2000] 113 Taxman 427 (Delhi).

101.13-3 *EXCEPTIONS* - The following are exceptions to the aforesaid provisions—

101.13-3a HEDGING CONTRACTS - The following hedging contracts, entered into by merchants in the course of business, to guard against future business losses through price fluctuations are excluded by proviso to section 43(*5*) :

❑ A contract in respect of raw material (or merchandise) entered into by a person in the course of his manufacturing (or merchanting) business to guard against loss through future price

fluctuations in respect of his contract for actual delivery of goods, manufactured by him (or merchandise sold by him).

- A contract in respect of stocks and shares entered into by a dealer (or investor) therein to guard against loss in the holdings of stocks and shares through price fluctuations.
- A contract entered into by a member of a forward market or stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss which may arise in the ordinary course of his business as such member.

The burden of proof is upon the assessee to show that transactions are merely hedging transactions—*CIT* v. *Joseph John* [1968] 67 ITR 74 (SC).

■ In the case of a trader, the following position emerges in regard to scope of hedging contracts—

1. Hedging contracts can be both for purchase and sale.

2. In order to be genuine and valid hedging contract of sales, the total of such transactions should not exceed the total stock of the raw material or merchandise on hand.

3. In order to be genuine and valid hedging contract of purchase, there should be an existing forward contract of sale by actual delivery.

4. The hedging contracts need not necessarily be in the same variety of the commodity. They could be in connected commodities *e.g.*, one type of cotton against another type of cotton—***Sopropha S.A., In re*** [2004] 138 Taxman 75 (AAR - New Delhi).

101.13-3b DERIVATIVE TRANSACTIONS - Section 43(*5*) has been amended with effect from the assessment year 2006-07. After the amendment, any eligible transaction in respect of trading in derivative will not be treated as a speculative business transaction if a few conditions are satisfied.

■ *Conditions* - The above exception is applicable only if the following conditions are satisfied —

1. The transaction is carried out in a recognised stock exchange.

2. The transaction is in respect of trading in derivating referred to in section 2(*aa*) of the Securities Contracts (Regulation) Act, 1956. According to this section "derivative" includes —

a. a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;

b. a contract which derives its value from the prices, or index of prices, of underlying securities.

3. The eligible transaction is carried out electronically on screen-based systems through a stock broker/sub-broker/other registered intermediary in accordance with the provisions (including bye-laws/directions) of the Securities Contracts (Regulation) Act, 1956/SEBI Act, 1992/Depositories Act, 1996 or by banks or mutual funds.

4. The eligible transaction is supported by a time stamped contract note issued by such stock broker, etc., to every client. It should indicate in the contract note —

a. the unique client identity number allotted under any Act referred to in *point 3* above; and

b. permanent account number (PAN) allotted under the Income-tax Act.

5. Further, the stock exchange should fulfil the following conditions—

a. the stock exchange shall have the approval† of the Securities and Exchange Board of India in respect of trading in derivatives and shall function in accordance with the guidelines or conditions laid down by the Securities and Exchange Board of India;

b. the stock exchange shall ensure that the particulars of the client (including unique client identity number and PAN) are duly recorded and stored in its databases;

c. the stock exchange shall maintain a complete audit trail of all transactions (in respect of cash and derivative market) for a period of seven years on its system;

d. the stock exchange shall ensure that transactions once registered in the system cannot be erased or modified.

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†For this purpose, approval is given to (*a*) the National Stock Exchange of India, and (*b*) the Bombay Stock Exchange.

101.14 ***Judicial pronouncements on the scope of section 28*** - The following judicial pronouncements should also be kept in view :

101.14-1 *AMOUNT CREDITED IN BOOKS* - When an amount is credited in business books, it is not an unreasonable inference to draw that it is a receipt from business—*Lakhmichand Baijnath* v. *CIT* [1959] 35 ITR 416 (SC).

101.14-2 *COMPENSATION FOR LOSS OF EARNING* - Where godowns, being used for storing business goods, were requisitioned by Government and thereafter business was carried on a smaller scale, compensation paid for loss of earning was held to be taxable as business income—*CIT* v. *Manna Ramji & Co.* [1972] 86 ITR 29 (SC).

101.14-3 *DEPOSITS* - If deposits received in the course of a business, in substance, partake more of the nature of trading receipts than of security deposits, such deposits, if unreturned, would be taxable as trading receipt—*Punjab Distilling Industries Ltd.* v. *CIT* [1959] 35 ITR 519 (SC).

101.14-4 *EXCHANGE FLUCTUATION ON ACCOUNT OF TRADE* - Where as a result of the devaluation, the assessee became entitled to receive a larger price in terms of rupees for the exported goods, the price of which was fixed in foreign currency, it was *held* that the profits constituted a trading profit since the transaction took place in the course of trade—*M. Shamsuddin & Co.* v. *CIT* [1973] 90 ITR 323 (Ker.).

101.14-5 *DHARMADA* - *"Dharmada", "mandir"* and *"gaushala"* are customary levies by traders for charitable purposes and the amounts received under these heads are not trading receipts. The fact that the amounts collected under these heads are spent for other purposes, though amounts to breach of trust, would not affect the initial nature and character of the receipt—*CIT* v. *Channoo Lal Damodar Dass* [1978] 113 ITR 759 (All.), *CIT* v. *Manoo Ram Ram Karan Dass* [1979] 116 ITR 606 (All.).

101.14-6 *FORFEITURE OF MARGIN MONEY BY BANK* - Where the assessee-bank in the course of its business, purchased securities for its constituents on receiving certain percentage of face value called 'margin money in deposit' and as constituents failed to pay balance amount of purchase value of securities at stipulated date fixed therefor, margin money was forfeited and securities became property of the assessee, the margin money so forfeited shall be assessed as business income of the assessee—*CIT* v. *Lakshmi Vilas Bank Ltd.* [1996] 86 Taxman 231/220 ITR 305 (SC).

101.14-7 *WRITING BACK TO PROFIT AND LOSS ACCOUNT* - Where the assessee received deposits in the course of trade transactions, amounts of such credit balances which were barred by limitation and which were written back by assessee to profit and loss account, were to be assessed as the assessee's income—*CIT* v. *T.V. Sundaram Iyengar & Sons Ltd.* [1996] 86 Taxman 429/222 ITR 344 (SC).

101.14-8 *VALUE OF STOCK DECLARED TO BANK* - The difference between the value of stocks declared to the bank and that found in the account books can be brought to tax if the information furnished by the bank contains not only items of stock but also their quantity and the assessee is not in a position to prove that apparent is not real—*Kaila Sweet Supplier* v. *CIT* [1998] 100 Taxman 59 (All.).

101.14-9 *LEASING OF BUSINESS ASSETS* - The Apex Court in *Universal Plast Ltd.* v. *CIT* [1999] 237 ITR 454 laid down the following general principles relating to income from leasing out the assets of the business by an assessee :

1. No precise test can be laid down to ascertain whether income (referred to by whatever nomenclature—lease amount, rent or license fee) received by an assessee from leasing or letting out of assets would fall under the head "Profits and gains of business or profession".

2. It is a mixed question of law and fact and has to be determined from the point of view of a businessman in that business on the facts and in the circumstances of each case, including true interpretation of the agreement under which the assets are let out.

3. Where all the assets of the business are let out, the period for which the assets are let out is a relevant factor to find out whether the intention of the assessee is to go out of business altogether or to come back and restart the same.

4. If only a few of the business assets are let out temporarily, while the assessee is carrying on his other business activities, then it is a case of exploiting the business assets otherwise than employing them for his own use for making profit for that business; but if the business never started or has started but ceased with no intention to be resumed, the assets also will cease to be business assets and the transaction will only be exploitation of property by an owner thereof, but not exploitation of business assets.

Where the assessee-company leased its colliery to the managing contractor and the assessee was to be paid the profit at a certain rate on the amount of coal raised, as income arose out of a contractual relationship between the principal and the agent, the assessee's income from leasing of its business was to be assessed as business income and not as income from other sources—*S.K. Sahana & Sons Ltd.* v. *CIT* [1999] 104 Taxman 86/236 ITR 432 (SC).

■ *Other judicial pronouncements* - One should also note the following—

1. When a company gives its house as residence to its director, income from that property must be assessed as only income from business—*CIT* v. *New India Maritime Agencies (P.) Ltd.* [2002] 124 Taxman 801/253 ITR 732 (Mad.).

2. Where the assessee had closed its oil mill long back, rental income derived by letting out quarters attached to mill premises cannot be treated as business income—*CIT* v. *Ramdas & Sons* [1999] 103 Taxman 267/236 ITR 786 (Pat.).

3. Where for a prescribed fee, the assessee charitable institution was letting out its building for specified periods for marriages, etc., along with chairs, mikes, income from letting would be assessable as business income—*CIT* v. *Halai Nemon Association* [2000] 111 Taxman 326/243 ITR 439 (Mad.).

101.14-10 *GRANT MADE BY GOVERNMENT* - Grant made by Government to a 100 per cent Government company for its functioning is treated as revenue receipt in the hands of the recipient company—***CIT*** v. ***Steel Authority of India Ltd.*** [2003] 133 Taxman 659 (Delhi).

101.14-11 *INTEREST ON NON-REFUNDABLE DEPOSITS* - Interest received by the assessee-co-operative sugar factory on non-refundable deposits made by cane-growers, is treated as trading receipts of the assessee—*CIT* v. *Panchaganga Sahakari Sakhar Karkhana Ltd.* [2001] 250 ITR 772/118 Taxman 122 (Bom.).

101.14-12 *PRIZE RECEIVED BY LOTTERY AGENT* - Sum received by lottery agent as his share of percentage of first prize money is taxable as business income—*CIT* v. *Bikram Singh Sood* [2001] 115 Taxman 140/249 ITR 454 (Delhi).

101.14-13 *MAINTAINING RACE HORSES* - Where there is a regular and systematic activity carried on by the assessee in maintenance of race horses and dominant intention of the assessee in maintaining race horses is to earn income from horses either by allowing them to run in races and to earn profit by way of sale or lease of horses and thereby to earn income, such income from horses is assessable as business income—***Kamala Muthia*** v. ***CIT*** [2003] 259 ITR 184/129 Taxman 803 (Mad.).

101.14-14 *INTEREST EARNED ON APPLICATION MONEY* - As the amount of interest earned on the application money to the extent to which it is not required for being paid to the applicants to whom money have become refundable by reason of delay in making the refund will belong to the company, only when allotment process is over. It is only at that point of time, it can be said that amount has accrued to the company as its income—***CIT*** v. ***Henkel Spic India Ltd.*** [2004] 139 Taxman 40 (Mad.).

101.14-15 *SUBSCRIPTION WHICH IS NOT REFUNDED* - Life membership subscription for a magazine received by a publisher over last 15 years and not refunded to customers at all at any time during these 15 years, is a revenue receipt in the assessee's hands—***ITO*** v. ***Mritunjay Sharma*** [2003] SOT 635 (Agra).

General principles governing assessment of business income

102. One has to keep in mind the following general principles while computing income taxable under the head "Profits and gains of business or profession" :

102.1 ***Business or profession carried on by the assessee*** - Business or profession should be carried on by the assessee. Under section 28, it is the person, carrying on a business or profession, who is chargeable to tax. What is emphasised is not the ownership of business but the fact that business is being carried on by the assessee.

102.2 ***Business or profession should be carried on during the previous year*** - Income from business or profession is chargeable to tax under this head only if the business or profession is carried on by the assessee at any time during the previous year—*Bombay Steam Navigation Co. (1953) (P.) Ltd.* v. *CIT* [1965] 56 ITR 52 (SC). It is, therefore, not essential that business or profession should be carried on throughout the previous year or up to the end of the previous year—*CIT* v. *Bangalore Transport Co. Ltd.* [1967] 66 ITR 373 (SC). However, the following receipts are taxable even if no business or profession is carried on by the assessee during the previous year :

- Recovery or excess recovery against a deduction [sec. 41(1)—*see* para 156.1].
- Sale of depreciable assets by power generating unit [sec. 41(2)—*see* para 109.11].
- Sale of an asset used for scientific research [sec. 41(3)—*see* para 114.4-3].
- Recovery or excess recovery against bad debts [sec. 41(4)—*see* para 132.5].
- Amount withdrawn from special reserve [sec. 41(4A)—*see* para 134.4].
- Sum received after discontinuance of a business or profession [sec. 176(3A), (4)—*see* para 156.7].
- Sum received for restrictive covenant [sec. 28(*va*)—*see* para 101.12].

102.3 ***Income of previous year is taxable during the following assessment year*** - Income of business or profession carried on by the assessee during the previous year is chargeable to tax in the next following assessment year. There are, however, certain exceptions to the rule laid down by sections 172, 174, 174A, 175 and 176(1) [*see* para 2.2].

102.4 ***Tax incidence arises in respect of all businesses or professions*** - Profits and gains of different businesses or professions carried on by the assessee are not separately chargeable to tax. Tax incidence arises on aggregate income from all businesses or professions carried on by the assessee.

102.5 ***Legal ownership* v. *Beneficial ownership*** - Under section 28, it is not only the legal ownership but also the beneficial ownership that has to be considered. For instance, if business is acquired for the benefit and on behalf of a company which is going to be incorporated and the promoters earn profits during pre-incorporation period, the company would be assessable to tax in respect of pre-incorporation profit, if it ratifies the action of the promoters and receives profit made by them. In this regard the following observations of the Supreme Court in *CIT* v. *City Mills Distributors (P.) Ltd.* [1996] 85 Taxman 352 one should note —

> "In our view, the Tribunal was right in saying that the relevant question was : what was the legal entity that had carried on the business before the assessee-company was incorporated and earned the income at the time of its accrual. A company becomes a legal entity in the eye of the law only when it is incorporated. Prior to its incorporation, it simply does not exist. The assessee-company did not exist when the income with which we are here concerned was earned. It is, therefore, not the assessee-company which earned the income when it accrued and it is not liable to pay tax thereon.
>
> The same result is reached by a somewhat different process of reasoning. A company can enter into an agreement only after its incorporation. It is only after incorporation that a company may decide to accept that its promoters have carried on business on its behalf and appropriate the income thereof to itself. The question as to who is liable to pay tax on such income cannot depend upon whether or not the company after incorporation so decides. It is he who carried on the business and received the income when it accrued who is liable to bear the burden of tax thereon.

It may be that the transaction of appropriation by a company to itself of income earned by its promoters before its incorporation is also subject to tax ; that is not an issue before us and we do not express any view in that behalf."

102.6 ***Profits in the case of winding up*** - Profits made by an assessee in winding up of a business or profession are not taxable under section 28, as no business is carried on in that case. However, such profits may be taxable as capital gains under section 45 [*see* para 166] or as business income under section 28 if the process of winding up is such as to involve the carrying on of a trade.

102.7 ***Real profit*** **v.** ***Anticipated profit*** -As accounting year is a self-contained year, taxable profit is the profit accrued or arising in that year. Anticipated or potential profits or losses, which may occur in future, are not considered for arriving at taxable income of a previous year. This rule is, however, subject to one exception, *i.e.*, stock-in-trade may be valued on the basis of cost or market value, whichever is lower.

102.8 ***Real profit*** **v.** ***Notional profit*** - The profits, which are taxed under section 28, are the real profits and not notional profits—*Kedarnath Jute Mfg. Co. Ltd.* v. *CIT* [1971] 82 ITR 363 (SC), *Keshkal Co-operative Marketing Society Ltd.* v. *CIT* [1987] 165 ITR 437 (MP). No person can make profit by trading with himself in another capacity. If the owner of business withdraws stock-in-trade for his personal use, profit does not arise—*Sir Kikabhai Premchand* v. *CIT* [1953] 24 ITR 506 (SC).

102.9 ***Income from exploiting a commercial asset is business income*** - If a commercial asset is not capable of being used as such, then its being let out to others does not result in an income which is the income of the business, but it cannot be said that an asset which was acquired and used for the purpose of the business ceased to be a commercial asset of that business as soon as it is temporarily put out of use or let out to another person for use in his business or trade. The yield of income by a commercial asset is the profit of the business irrespective of the manner in which that asset is exploited by the owner of the business. He is entitled to exploit it to his best advantage and he may do so either by using it himself personally or by letting it out to somebody else.

Though in the case of letting of commercial assets no general principles can be laid down which would be applicable in all cases, the following broad propositions emerge from decided cases :

In *CEPT* v. *Shri Lakshmi Silk Mills Ltd.* [1951] 20 ITR 451 (SC) the assessee owned a dyeing plant which could not be used by it personally owing to non-availability of yarn. It, therefore, let out the plant to another company on rental basis. The question for consideration was whether the rental income was assessable as profits from business. The Court *held* that it was a part of the normal activities of the assessee's business to earn money by making use of its machinery by either employing it in its own manufacturing concern or temporarily letting it to others for making profit for that business when for the time being it could not itself run it.

■ *Discontinuance of venture* - If the assessee discontinues commercial nature of the venture and seeks to make income from mere letting out of its assets, then income will not be business income—*see CIT* v. *Rajindra Flour & Allied Industries (P.) Ltd.* [1981] 128 ITR 402, 412 (Delhi).

■ *Intention of the assessee* - Where the intention of the assessee is to part with entire machinery of factory and premises with the obvious purpose of earning rental income and to treat factory and machinery not as a commercial asset during subsistence of lease, rental income is not to be assessed under section 28, but is liable to be assessed under section 56—*New Savan Sugar & Gur Refining Co. Ltd.* v. *CIT* [1969] 74 ITR 7 (SC).

■ *When letting out is incidental to assessee's business* - Rent of residential quarters given to workers or rent of office accommodation given to Post Office/excise department, to run the business smoothly, is business income—*CIT* v. *National Newsprint & Paper Mills Ltd.* [1978] 114 ITR 388 (MP), *CIT* v. *National Newsprint & Paper Mills Ltd.* [1978] 114 ITR 398 (MP).

102.10 ***Recovery of sum already allowed as deduction*** - Any sum recovered by the assessee during the previous year, in respect of an amount or expenditure which was earlier allowed as deduction, is taxable as business income of the year in which it is recovered [sec. 41(1)—*see* para 156].

102.11 ***Mode of book entries generally not relevant*** - It is now well settled that the way in which entries are made by an assessee in his books of account is not determinative of the question whether the assessee has earned any profit or suffered any loss. The assessee may, by making entries which are not in conformity with the proper accountancy principles, conceal profit or show loss and the entries made by him cannot, therefore, be regarded as conclusive one way or the other. What is necessary to be considered is the true nature of the transaction and whether in fact it has resulted in profit or loss to the assessee—*Sutlej Cotton Mills Ltd.* v. *CIT* [1979] 116 ITR 1 (SC). For instance, a trading receipt will remain a trading receipt even if it is not shown as trading receipt in the books of account kept by assessee.

102.12 ***Illegal business*** - The income-tax law is not concerned with the legality or illegality of a business or profession. It can, therefore, be said that income of illegal business or profession is not exempt from tax—*Mann* v. *Nash* [1932] 1 KB 752 [*see* also para 105.11].

102.13 ***Insurance receipts*** - The Courts have maintained a distinction between insurance against loss of goods and insurance against loss of profits. The latter is undoubtedly taxable. But what happens where the insurance company pays any amount against loss of goods. Result may be the same where the payment is made for goods in which the assessee carried on business. Any payment being accretion from business, the excess or surplus accruing for any reason may be nothing but profits.

However, insurance compensation which is capital in nature may be taxed under section 45(1A). If section 45(1A) is not applicable, then insurance compensation being a capital receipt is not chargeable to tax.

102.14 ***Losses incidental to trade - Commercial principles for computing business income*** - One has to keep in view the general commercial principles while determining real and true profits of a business or profession—*Calcutta Co. Ltd.* v. *CIT* [1959] 37 ITR 1 (SC).

There may be an expenditure or there may be a loss which may not be an admissible loss under any of the provisions of the Act and yet such loss would have to be allowed in order to determine what are the true profits of a business, and it is the duty of everyone who has anything to do with taxing business-people to understand what are the principles of commercial expediency. Unless, therefore, one understands these principles, it is difficult to make a proper assessment on a business or businessman.

102.14-1 *TRADING LOSS* - Trading losses of revenue nature incurred in carrying out the business are deductible, if they are incidental to the operation of business. This rule is applicable even if it is not specially coded anywhere under the Act. A trading loss is allowable as deduction while computing business income only in the year in which it is incurred. Moreover, in order to avail deduction of trading loss, it should have been incurred by the assessee in the character of a trader and the same should fall on him in that character—*CIT* v. *K.T.M.S. Mahmood* [1969] 74 ITR 100 (Mad.). As capital receipts are not chargeable to tax as business income, capital losses are not deductible while computing income under the head "Profits and gains of business or profession".

In other words, business losses can be allowed as deduction only if the following conditions are satisfied :

Condition 1	Losses should be revenue in nature.
Condition 2	Losses should be incurred during the previous year.
Condition 3	Losses should be incidental to the business or profession carried on by the assessee.
Condition 4	It should not be notional or fictitious.
Condition 5	It should have been actually incurred and not merely anticipated to incur in future.
Condition 6	There should not be any, direct or indirect, restriction under the Act against the deductibility of such loss.

102.14-1a LOSS SHOULD BE REVENUE IN NATURE - Loss of capital nature is not deductible while calculating business income—*CIT* v. *Mysore Sugar Co. Ltd.* [1962] 46 ITR 649 (SC).

102.14-1b IT SHOULD BE INCURRED DURING THE PREVIOUS YEAR - Loss should be incurred during the previous year. If the loss is not known, and it comes to light later during a particular assessment year, the adjustment can be claimed in that assessment year—*Punjab Steel Stockholders Syndicate Ltd.* v. *CIT*[1980] 125 ITR 519 (Punj. & Har.). To allow deduction, business must be carried on during the relevant previous year—*Bombay Steam Navigation Co. (1953) (P.) Ltd.* v. *CIT*[1965] 56 ITR 52 (SC), *D.P. Wadia & Sons* v. *CIT*[1975] 100 ITR 79 (Bom.), *Kedarnath Jute Mfg. Co.* v. *CIT*[1971] 82 ITR 363 (SC), *Ashoka Viniyoga Ltd.* v. *CIT*[1972] 84 ITR 264 (SC).

102.14-1c LOSS SHOULD BE INCIDENTAL TO BUSINESS OR PROFESSION CARRIED ON BY THE ASSESSEE - The loss becomes allowable if it "springs directly from and is incidental" to the business of the assessee—*CIT* v. *Abdullabhai Abdulkadar*[1961] 41 ITR 545 (SC). If there is a direct and proximate nexus between the business operation and the loss, or it is incidental to it, then the loss is deductible since without the business operation and doing all that is incidental to it, no profit can be earned—*Commonwealth Trust (India) Ltd.* v. *CIT*[2000] 242 ITR 593/110 Taxman 507 (Ker.).

One should also keep in view the following points :

■ *Money-lending business through agent* - Where the assessee was carrying on money-lending business through an agent who held a power of attorney which conferred on him large powers of management, including authority to operate bank accounts, it was held that the loss sustained by the assessee due to the agent's action of withdrawing money from bank and misappropriating the same, was deductible—*Badridas Daga* v. *CIT*[1958] 34 ITR 10 (SC).

■ *Loss owing to mistake committed by businessman or his employees* - The losses which arise owing to mistake committed by a businessman in the course of his transacting business or owing to a mistake of his servants, etc., in the course of their employment must be regarded as an allowable business loss since they would be very much incidental to the business.

■ *Question of fact* - Whether loss is incidental to the operation of business is a question of fact to be decided on the facts of each case, having regard to the nature of the operations carried on and the nature of the risk involved in carrying them out.

102.14-2 *INSTANCES OF LOSSES DEDUCTIBLE FROM BUSINESS INCOME* - Such instances are as follows :

- Loss of stock-in-trade as a result of enemy action or arising under similar circumstances—*CIT* v. *S.N.A.S.A. Annamalai Chettiar*[1972] 86 ITR 607 (SC).
- Loss of stock-in-trade due to destruction by fire—*Motamal Jethumal* v. *CIT*[1947] 15 ITR 155 (Pat.).
- Loss of stock-in-trade by ravages of white ants—*Hira Lal Phoolchand* v. *CIT*[1947] 15 ITR 205 (All.).
- Loss of stock-in-trade by an act of God.
- Loss arising on account of failure on the part of the assessee to accept delivery of goods—*R.C. Jain* v. *CIT*[1973] 91 ITR 557 (Delhi).
- Loss of stock-in-trade due to theft—*Hopkin & Williams (Travancore) Ltd.* v. *CIT*[1967] 64 ITR 76 (Ker.)
- Loss on account of advances given to employee's welfare co-operative stores which become irrecoverable—*CIT* v. *Deccan Sugars & Abkhani & Co. Ltd.* [1985] Tax 79(3) 77 (Mad.).
- Loss of cash, retained for business purposes, incurred due to theft after business hours—*Chhotulal Ajitsingh* v. *CIT*[1973] 89 ITR 178 (Raj.), *Basantlal Sanwar Prasad* v. *CIT*[1968] 67 ITR 380 (Pat.), *CIT* v. *Sarya Sugar Mills (P.) Ltd.* [1968] 70 ITR 109 (All.).
- Loss of currency notes in transit during the course of operation of business through highway robbery—*Harnath Rai Lakhi Prasad* v. *CIT*[1966] 61 ITR 308 (Pat.).
- Depreciation in funds kept in foreign country for purchase of stock-in-trade.
- Depreciation due to devaluation of foreign currency in the exchange value of the unpaid price in foreign currency of goods exported—***CIT*** v. ***Taiko Chander Nagar Chemicals (P.) Ltd.*** [2008] 171 Taxman 266 (Delhi).

- Loss incurred due to devaluation of rupee in foreign country which is being utilised in the course of business—*CIT* v. *Mehboob Productions (P.) Ltd.* [1969] 74 ITR 676 (Bom.).
- Loss incurred by a financial corporation, established for advancing loans to industrial concerns, on account of sale of securities purchased with surplus funds—*Rajasthan Financial Corpn.* v. *CIT* [1967] 65 ITR 112 (Raj.).
- Loss arising from sale of securities held in the regular course of business—*CIT* v. *Dalmia Jain & Co. Ltd.* [1972] 83 ITR 438 (SC).
- Loss arising due to non-realisation of the loan advanced to the importer—*T.J. Lalvani* v. *CIT* [1970] 78 ITR 176 (Bom.).
- Loss of cash and securities in a banking company on account of dacoity after banking hours—*CIT* v. *Nainital Bank Ltd.* [1965] 55 ITR 707 (SC).
- Loss due to forfeiture of a deposit made by the assessee for properly carrying out of contract for supply of commodities—*Narandas Mathuradas & Co.* v. *CIT* [1959] 35 ITR 461 (Bom.).
- Loss on account of embezzlement by an employee—*Badridas Daga* v. *CIT* [1958] 34 ITR 10 (SC). It is not necessary to prove that embezzlement was done by a particular employee —*Punjab Steel Stockholders Syndicate Ltd.* v. *CIT* [1980] 125 ITR 519 (Punj. & Har.).
- Loss incurred due to theft or burglary in factory premises during or after working hours—*CIT* v. *Sarya Sugar Mills (P.) Ltd.* [1968] 70 ITR 109 (All.).
- Loss of precious stones or watches of a dealer while bringing them from business premises to his house—*CIT* v. *K.T.M.S. Mahmood* [1969] 74 ITR 100 (Mad.).
- Loss arising from negligence or dishonesty of employees who have been given specified duties in the course of business—*Curtis* v. *J.G. Oldfield Ltd.* [1925] 9 TC 319.
- Loss incurred on account of insolvency of banker with which current account is maintained by the assessee—*CIT* v. *Hajee Abdul Gani Ayoob* [1941] 9 ITR 339 (Rangoon).
- Loss incurred by a banking company on account of sale of securities under an arrangement sanctioned by the court—*CIT* v. *Simla Banking & Industrial Co. Ltd.* [1961] 41 ITR 332 (Punj.).
- Loss incurred due to sale of lands acquired from a business-debtor in satisfaction of debt—*CIT* v. *A.K.A.R. Family* [1941] 9 ITR 347 (Rangoon).
- Loss incurred due to freezing of the stock-in-trade by enemy action—*Pohoomal Brothers Silk Shops* v. *CIT* [1965] 55 ITR 112 (Bom.).
- Loss on account of non-recovery of advances given by the assessee-company (engaged in the business of financing its subsidiaries) to its 100 per cent subsidiary company—*CIT* v. *Gillanders Arbuthnot & Co. Ltd.* [1982] 9 Taxman 76 (Cal.).
- Loss incurred due to forfeiture of deposits made (as per certain licencing scheme, on account of assessee's failure to avail itself of import entitlements)—*CIT* v. *Textool Co. Ltd.* [1982] 135 ITR 200 (Mad.).
- Loss due to forfeiture of deposited security with a statutory corporation in connection with a contract—*Thackers H.P. & Co.* v. *CIT* [1982] 134 ITR 21 (MP).
- Assessee-company, subscribing to a chit fund, bid the chit after paying a few instalments. It was *held* that the difference of chit amount and price paid for which it was bid as business loss, was deductible—*CIT* v. *Kovur Textiles & Co.* [1982] 136 ITR 61 (AP).
- Where a stranger obtained a draft from the assessee's current account on the basis of a forged letter under signature of secretary of company, loss due to such embezzlement is allowable as a business loss—*G.G. Dandekar Machine Works Ltd.* v. *CIT* [1993] 202 ITR 161 (Bom.).
- Where the assessee-company has guaranteed the loan taken by its subsidiary in the course of carrying on its own business and on that account it suffers loss on subsidiary going into liquidation, loss is to be allowed in the year in which the assessee-company receives last of the payments from the liquidator—*CIT* v. *Amalgamations (P.) Ltd.* [1997] 92 Taxman 132/226 ITR 188 (SC).

- Where the assessee is forced to subscribe to certain securities by the Government department with which it is doing business and it has no option but to subscribe to securities, the investments are necessarily by way of commercial expediency for the purpose of carrying on business as a contractor and, therefore, loss suffered on sale of such securities by the assessee is allowable as a revenue loss—*CIT* v. *D.S. Bist & Sons* [2001] 117 Taxman 642 (Delhi).
- The issue regarding allowance of illegal expenditure/loss has been elucidated upon in the light of the recent Supreme Court's decision in the case of ***Dr. T.A. Quereshi*** v. ***CIT*** [2006] 157 Taxman 514 and in the background of *Explanation* to section 37. After the introduction of this *Explanation*, a view emerged that the decision of the Supreme Court in the case of *CIT* v. *Piara Singh* [1980] 3 Taxman 67 has been superseded. This view has been negatived by the Apex Court in *Dr. T. A. Quereshi's* decision (*supra*), where it has been held that the *Explanation* to section 37(1) applies only to 'business expenditure' and not to 'business loss' and, hence, loss arising as a result of seizure and confiscation of illegal stock-in-trade is allowable as a business loss against income from illegal business.

102.14-3 *INSTANCES OF LOSSES NOT DEDUCTIBLE FOR BUSINESS INCOME* - These are :

- Loss of advances made for setting up a new business which ultimately could not be started—*Narang Industries Ltd.* v. *CIT* [1967] 66 ITR 316 (Delhi).
- Depreciation of funds kept in foreign currency for capital purposes—*CIT* v. *Tata Locomotive & Engg. Co. Ltd.* [1966] 60 ITR 405 (SC).
- Loss arising from non-recovery of tax paid by an agent on behalf of the non-resident—*CIT* v. *Abdullabhai Abdulkadar* [1961] 41 ITR 545 (SC).
- Loss suffered by the assessee-firm doing business in distribution of films, of amount advanced by it to film producer for acquiring distribution rights—*CIT* v. *Sembi Traders* [1996] 221 ITR 410/89 Taxman 21 (Mad.).
- Anticipated future losses.
- Loss relating to any business or profession discontinued before the commencement of previous year—*CIT* v. *Lahore Electric Supply Co. Ltd.* [1966] 60 ITR 1 (SC).
- Loss incurred by the assessee in encashment of cash certificate with bank prematurely for paying off of its debt to said bank in order to reduce quantum of bank interest—*Krishna Chandra Dutta (Cookme) Pvt. Ltd.* v. *CIT* [1993] 204 ITR 23 (Cal.).
- Loss incurred due to devaluation of Indian rupee in respect of unremitted profits earned in past on which income-tax had already been levied—*CIT* v. *Vicks Products Inc.* [1989] 177 ITR 556 (Bom.).
- Where the assessee had constructed a bridge over a river to facilitate laying of water pipes leading to its benefication plant and the said bridge was washed away in heavy floods, it was held that loss ensuing from the said floods was not a business loss—*Gujarat Mineral Development Corporation Ltd.* v. *CIT* [1983] 143 ITR 822 (Guj.).
- Loss of security deposit made to obtain selling agency—*CIT* v. *Motiram Nandram* [1940] 8 ITR 132 (PC).
- Where the assessee, a retired partner of a firm, wrote off an amount owed by the firm to it several years after the dissolution of the firm, it was *held* that the amount so written off was not deductible in computing the assessee's income since the amount represented capital contributed to the firm as a result of which the assessee had become entitled to the share of profits and, that if at all it was a loss, it was a capital loss—*Fatehchand Moonat* v. *CIT* [1983] 13 Taxman 18 (MP).
- Where a deposit was made by the assessee-company with another company in connection with a leave and license agreement to work in a mill owned by the latter company, loss due to irrecoverability of deposit would be a capital loss and not a business loss—*Hasimara Industries Ltd.* v. *CIT* [1998] 98 Taxman 303/230 ITR 927 (SC).

Method of accounting [Sec. 145]

103. Income under the heads "Profits and gains of business or profession" and "Income from other sources" shall be computed in accordance with method of accounting regularly employed by the assessee. There are two methods of accounting—mercantile system and cash system. For details *see* para 18.2.

In order to further clarify the same principle, section 43(*2*) defines the word "paid" to mean "actually paid or incurred" according to the method of accounting upon the basis of which the profits or gains are computed under the head "Profits and gains of business or profession".

Scheme of deductions and allowances

104. Section 28 defines various incomes which are chargeable to tax under the head "Profits and gains of business or profession". Section 29 permits deductions and allowances laid down by sections 30 to 37 while computing profits or gains of a business or profession. Section 29 is to be read with reference to other provisions of the Act. Sections 40, 40A and 43B give a list of expenses which are not deductible.

Basic principles governing admissibility of deduction under sections 30 to 44DB

105. Before studying the nature and amount of permissible and non-permissible deductions under sections 30 to 44DB, it will be useful if one keeps in view the following principles :

105.1 ***Onus to prove admissibility of an expenditure*** - It is the responsibility of the assessee to prove that a particular deduction is admissible in his case.

105.2 ***Allowances are cumulative*** - The allowances laid down under sections 30 to 37 are cumulative and not alternative. For instance, if a particular expense is expressly dealt with by a particular section, its admissibility under the residual section 37 cannot be denied unless the particular section prohibits any allowance under any other provision.

105.3 ***Expenditure should relate to the previous year*** - It is necessary to claim deduction that the expenditure should relate to the previous year. In order to ascertain whether the expenditure relates to the relevant previous year or not, one has to examine the method of accounting generally adopted by the assessee. This rule is, however, subject to a few exceptions. Sections 41, 176 [*see* para 156] and also section 28(*va*) [*see* para 101.12] bring into charge certain receipts relating to a business or profession not in existence during the previous year. Expenditure laid out to earn such receipts are allowable as deductions in the year in which these receipts are charged to tax.

105.4 ***Business should be carried on during the previous year*** - In order to avail deduction of expenditure, it is necessary that the business, in respect of which expenses are incurred, should be carried on by the assessee during the previous year. If the business has been closed or discontinued before the commencement of the previous year, no deduction in respect of such discontinued business is permissible while computing the taxable income of the previous year from other sources—*L. M. Chhabda & Sons* v. *CIT* [1967] 65 ITR 638 (SC). For instance, if the assessee carries on two businesses : A and B, expenditure of business A is not deductible from profits of business B, if business A was not carried on during the previous year or was discontinued before the commencement of relevant previous year. However, sections 41 and 176 bring into charge certain receipts relating to a business or profession, not in existence during the previous year.

105.5 ***Expenditure should have been incurred in connection with assessee's own business*** - An expenditure is allowable as deduction in computation of taxable income only if it is incurred for the purpose of assessee's own business.

105.6 ***Benefit of expenditure may extend to somebody else*** - If the expenditure is incurred primarily in connection with the assessee's own business, it would still be allowed as deduction even if it enures to the benefits of someone else—***CIT*** v. ***Indian Express (Madurai) (P.) Ltd.*** [2003] 126 Taxman 33 (Mad.).

105.7 ***Benefit of expenditure may extend beyond the relevant previous year*** - It is not necessary that benefit of the expenditure should be limited to the previous year in which the expenditure is incurred. A revenue expenditure incurred during the previous year is deductible even if benefit of expenditure is extended beyond the year of expenditure.

105.8 ***No allowance in respect of exhaustion of wasting assets*** - No deduction is admissible in respect of diminution or exhaustion of the capital asset from which income is derived. Wasting assets such as mines and quarries, timber-bearing land, leasehold interest are capital assets and their diminution or exhaustion in value represents capital loss which is not allowable as deduction, as the Act permits deduction of revenue losses only. To the principle that no deduction is permissible in respect of diminution or exhaustion of wasting capital assets, a few exceptions are provided under the Act (*e.g.*, section 42 authorises under certain circumstances deduction in respect of depletion of mineral oil and section 35A permits capital expenditure on acquisition of patent rights or copyright to be written off over a period of years, subject to certain conditions).

105.9 ***No allowance in respect of a business set-up after the date of expenditure*** - In the case of a new business, the first previous year commences on the date when the business or profession is set-up. Expenditure incurred prior to setting up of a business falls outside the previous year. Section 28 applies only in respect of business carried on during the previous year. As a consequence, expenditure incurred before setting up of a business would not be deductible while computing income of the previous year.

105.9-1 *EXCEPTION* - To the aforesaid general rule that expenditure incurred before setting up of a business is not permissible as deduction, some exceptions are provided [some instances where expenditure incurred before setting up of a business is allowable as deduction are found in sections 35 (*see* para 114), 35A (*see* para 115), 35D (*see* para 121) and 35E (*see* para 122)].

105.9-2 *EXPENSES INCURRED AFTER SETTING UP BUT BEFORE COMMENCEMENT* - There is sometimes a time lag between setting up of a business and its actual commencement. Expenditure incurred after setting up of a business may be allowed as deduction under sections 30 to 37, even if it is incurred before the actual commencement of business—*CIT* v. *Ralliwolf Ltd.* [1980] 121 ITR 262 (Bom.). To put it differently, expenses incurred during the preparatory stage prior to setting up of business will not qualify for deduction. However, the expenses incurred during the intervening period between setting up of the business and the commencement of the business would be permissible deductions however long the intervening period may be—***CIT*** v. ***Sardar Sarovar Narmada Nigam Ltd.*** [2005] 93 ITD 321 (Ahd.).

105.10 ***No allowance in respect of non-assessable business*** - Section 28 applies only in respect of business, profits of which are assessable under the Income-tax Act. Therefore, the question of deduction of expenditure under sections 30 to 37 arises only if profits of a business are assessable to tax under the Act. On the other hand, if business is assessable, expenditure is deductible, though it is immaterial whether any taxable profits have been earned or not. For instance, expenditure would be deductible even if the business has sustained loss or earned profit which is less than the maximum amount of income chargeable at *nil* rate, *i.e.*, Rs. 1,10,000 in the case of an individual† or Hindu undivided family for the assessment year 2008-09.

■ *Indivisible business* - When the assessee carries on an *indivisible* business and a part of income is liable to tax or is exempt from tax under any provision of the Act, the entire expenditure incurred for the purpose of the business is allowable as deduction, although a part of expense may have been incurred for earning profit which is exempt from tax. In other words, if an assessee carries on an *indivisible* business, it is not permissible to disallow proportionate part of expenditure attributed to income exempt from tax or not liable to tax. Section 14A does not cover a case where expenditure is in respect of one indivisible business which yields taxable as well as exempt income. On the other hand, if an assessee carries on several distinct businesses, expenditure relating to non-taxable business(es) cannot be claimed against the profits of taxable business(es).

†Rs. 1,45,000 in case of a resident woman and Rs. 1,95,000 in case of a resident senior citizen.

105.11 ***Expenditure tainted with illegality*** - Expenses tainted with illegality, such as penalty levied for evading provisions of FEMA, cannot be claimed as deduction under the Act [*Expln.* to sec. 37(1)].

105.12 ***No allowance in respect of a non-existent liability*** - The Income-tax Act makes a distinction between an existing liability and a contingent liability. While a payment in respect of the former is deductible, a payment in respect of the latter is not deductible.

105.13 ***No allowance in respect of anticipated losses*** - Under the present scheme of the Act, anticipated loss cannot be deducted, though the loss is certain. In other words, a loss which is neither suffered nor incurred in the previous year is not deductible against the actual receipts of the year—*Edward Collins & Sons Ltd.* v. *IRC* [1924] 12 TC 773. The only exception to this rule is that stock-in-trade may be valued at cost or market value, whichever is lower.

105.14 ***No deduction in respect of depreciation of investment*** - A deduction in respect of depreciation of investment in shares and securities is not allowable.

105.15 ***Relevance of distinction between capital and revenue expenditure*** - The question whether the expenditure is capital expenditure or revenue expenditure is relevant only in the case of expenditure falling under sections 30, 31 and 37(1). These sections expressly exclude the items of the nature of "capital expenditure" from being allowed as permissible deduction. However, expenditure falling under other sections may fall either under the category of capital expenditure or revenue expenditure—*Nathmal Bankatlal Parikh & Co.* v. *CIT* [1980] 3 Taxman 97 (AP), *Mohan Meakin Breweries Ltd.* v. *CIT* [1979] 118 ITR 101 (HP).

Deductions expressly allowed in respect of expenses/allowances

106. Sections 30 to 37 enumerate deductions expressly allowed in respect of expenses and allowances. Sections 40, 40A and 43B cover expenses which are not deductible. Provisions of these sections are discussed in paras 107 to 141. While studying the provisions of these sections, one should keep in view the basic principles governing the admissibility of deductions as mentioned in para 105 above.

Rent, rates, taxes, repairs and insurance of building [Sec. 30]

107. Under section 30, the following deductions are allowed in respect of rent, rates, taxes, repairs and insurance for premises used for the purpose of business or profession :

a. the rent of premises, if the assessee has occupied the premises as tenant and the amount of repairs (not being capital expenditure), if he has undertaken to bear the cost of repairs ;

b. the amount of current repairs (not being capital expenditure), if the assessee has occupied the premises otherwise than as a tenant ;

c. any sum on account of land revenue, local rates or municipal taxes ; and

d. amount of any premium in respect of insurance against risk of damage or destruction of the premises.

107.1 ***Rent*** - If the assessee has occupied the property otherwise than as a tenant (for instance, when the assessee uses his own property for the purpose of his own business), nothing would be deductible on account of rent of the property [*see* also para 91].

107.1-1 *WHERE RENT IS PAYABLE BY A FIRM TO A PARTNER* - If a firm has taken on rent premises belonging to one of its partners and pays rent to the landlord-partner, rent would be deductible under section 30—*Heastie* v. *Veitch & Co.* [1934] 2 ITR 456 (CA). In such a case the landlord-partner is chargeable to tax under section 22 read with section 23(1) in respect of the annual value of the property as if the property is let out. The Gujarat High Court in *CIT* v. *Rasiklal Balabhai* [1979] 119 ITR 303 has, however, *held* that in such case rent received by the landlord-partner is not taxable under section 22.

107.1-2 *PARTLY USED FOR BUSINESS PURPOSES* - Where a part of the business premises taken on rent is used and occupied by the assessee as his dwelling house, a proportion of rent attributable towards the use of the premises as dwelling house is not allowed as deduction [sec. 38].

107.1-3 *RENT OF PREVIOUS TENANT* - If an assessee takes premises on lease for carrying on a business or profession and agrees to pay arrears of rent of previous tenant, such arrears of rent cannot be deducted, whether arrears of rent are paid under legal obligation or voluntarily—*CIT* v. *Maharajadhiraja Kameshwar Singh of Darbhanga* [1933] 1 ITR 94 (PC).

107.1-4 *RENT v. PREMIUM* - Section 105 of the Transfer of Property Act makes a distinction between rent and premium. While price paid for obtaining a lease is "premium", money paid periodically or at specified occasion is "rent". The consideration for lease may consist of rent and/or premium. Amount allowed as deduction under this section is rent for premises taken on lease and not premium payable at the time of commencement of the first lease, or on renewal or termination of lease; such premium is generally regarded as capital expenditure. If, however, premium merely consists of advance payment of rent, it would be allowed as deduction in the relevent years.

107.1-5 *PREMISES NOT PUT TO USE* - Where a premises is taken on lease by the assessee for expansion of business but the premises is not actually used and there is no evidence that the lease agreement is bogus or the premises has been used for other purposes, the rent paid is deductible—*Vijay International* v. *CIT* [2002] 253 ITR 26 (Cal.-Trib.). Where, however, the assessee has taken a building on rent but building is not even ready to be put to use for the business of the assessee as it is under renovation, deduction of rent paid is not permissible under section 30—*Jainsons SS* v. *CIT* [2001] 76 ITD 51 (Delhi).

107.2 ***Repairs*** - If an assessee has occupied the property as a tenant and has undertaken to bear cost of repairs (not being capital expenditure), the amount of such repairs is allowable as deduction. If, however, the person occupies the property otherwise than as a tenant, the amount paid by him on account of current repairs (not being capital expenditure) is allowable as deduction.

107.3 ***Land revenue, local rates and municipal taxes*** - Any sum paid on account of land revenue, local rates or municipal tax is deductible subject to the provision of section 43B [*see* para 155].

■ *Only on premises* - Local rates levied upon the owner of a mine in respect of the annual output or the annual despatches of the mineral abstracted are not covered by section 30 which only deals with revenue, rate or tax on premises—*K.M. Selected Coal Co. of Manbhum, In re.* 1 ITC 281 (Pat.).

107.4 ***Insurance premium*** - Any premium paid in respect of insurance against risk of damage or destruction of premises is deductible.

Repairs and insurance of machinery, plant and furniture [Sec. 31]

108. Under section 31, the following expenditures are allowed as deduction in respect of machinery, plant or furnitures used for the purpose of the business or profession : (*a*) amount paid on account of current repairs (not being capital repairs), and (*b*) amount of insurance premium paid in respect of insurance against risk of damage or destruction.

108.1 ***Used for the purpose of the business or profession - Meaning of*** - The expression "used for the purpose of the business or profession" implies that current repairs and insurance in respect of machinery, plant or furniture are allowed as deduction only if these assets are used for the purpose of assessee's own business, the profits of which are subject to tax. If the owner of plant, machinery and furniture uses them for his own business, he can avail deduction on current repairs and insurance under section 31. If, however, the owner lets out plant, machinery or furniture, the lessee would be entitled for deduction in respect of current repairs and insurance under section 31. Lessee's claim in respect of expenditure in excess of "current repairs" would not be sustainable even though it is specially provided in the lease deed. In such case, if lessor makes expenditure on current repairs and such expenditure is necessary for earning of income from letting out, the lessor would be entitled for deduction under section 57(*iii*).

108.2 ***Period of use*** - In order to avail deduction under section 31, it is necessary that plant, machinery or furniture must be used for the purpose of assessee's business during the previous year. It is, however, not necessary that these assets should be used throughout the previous year—*CIT* v. *National Syndicate* [1961] 41 ITR 225 (SC). In other words, even if these assets are worked for only a part of the year, the assessee can avail full allowance permissible under this section and not merely an amount proportionate to the period of user. The word "used" in the section should be understood in a wide sense so as to embrace passive as well as active user ; when machinery is kept ready for use at any moment in a particular factory under an express agreement from which taxable profits are earned, the machinery can be said to be "used" for the purpose of the business which earned the profits, even though the machinery had not actually worked—*Whittle Anderson Ltd.* v. *CIT* [1971] 79 ITR 613 (Bom.).

108.3 ***Current repairs*** - The expression "current repairs" connotes repairs which are attended to when the need for them arises from the assessee's point of view and which are not allowed to be accumulated. The simple test that must be constantly borne in mind is whether as a result of expenditure which is claimed as an expenditure for current repairs, what is really being done is to preserve and maintain an already existing asset. The object of expenditure is not to bring a new asset into existence, nor is its object the obtaining of a new or fresh advantage. The basic test to find out as to what would constitute current repairs is that the expenditure must have been incurred to 'preserve and maintain' an already existing asset, and the object of the expenditure must not be to bring a new asset into existence or to obtain a new advantage—***CIT*** v. ***Saravana Spg. Mills (P.) Ltd.*** [2007] 163 Taxman 196 (SC).

If the amount spent is for the purpose of bringing into existence a new asset or obtaining a new advantage, then such an expenditure would not be an expenditure of a revenue nature. It has been clarified that capital expenditure on repairs is not deductible from assessment year 2004-05.

Depreciation

109. "Depreciation" usually means loss or decline in value which occurs gradually over useful life of a material thing, due to physical wear, tear and decay, and is generally limited to losses or decline in value which cannot be restored by current repairs and maintenance.

109.1 ***Conditions for claiming depreciation*** - In order to avail depreciation, one should satisfy the following conditions :

Condition 1	Asset must be owned by the assessee.
Condition 2	It must be used for the purpose of business or profession.
Condition 3	It should be used during the relevant previous year.
Condition 4	Depreciation is available on tangible as well as intangible assets.

109.1-1 ASSET MUST BE OWNED BY THE ASSESSEE - In order to be entitled to depreciation allowance, the assessee has to show that the asset is owned by him or the assessee is the co-owner of the asset. It is only the owner of the assets who is entitled to claim depreciation on them. In *R. B. Jodha Mal Kuthiala* v. *CIT* [1971] 82 ITR 570, the Supreme Court, *inter alia, held* that the real test was to ascertain whether the assessee was entitled to the income from the property and, hence, the owner must be the person who can exercise the rights of the owner not on behalf of the owner but in his own right. If this criteria is satisfied, registration of building, car, ship, etc., is not relevant.

109.1-1a REGISTERED OWNER v. BENEFICIAL OWNER - The emphasis in the statutory provision contained in section 32 is that in order to claim depreciation asset should be "owned by the assessee".

■ *Registered ownership is not necessary* - It is not necessary that the assessee should be the registered owner of the asset. Exclusive possession rights, to exclude others from enjoyment of the assets, full control over the assets, right to retain possession and defend the same are but some of the characteristics of the ownership which would entitle a person to claim the benefit of the depreciation allowance under section 32 (if such asset is used for the purpose of carrying on a business/ profession)—*Mysore Minerals Ltd.* v. *CIT* [1999] 106 Taxman 166 (SC).

■ *Section 53A of the Transfer of Property Act* vis-a-vis *concept of ownership* - Section 53A comes into operation only if the following conditions are satisfied :

- There should be a contract for consideration. Transfer by way of gift is not covered by section 53A.
- The contract should be in writing. An oral agreement is not sufficient.
- It should be signed by the transferor or on his behalf.
- The contract should be to transfer immovable property. Section 53A is not applicable in the case of transfer of movable property—*Bhabhi Dutt* v. *Ramlalbyamal* [1934] 152 IC 431.
- The transferee should have taken possession of the property or any part thereof. Section 53A is not applicable if the transferee has not taken possession of the property.
- The transferee has performed or is willing to perform his part of the contract.

If the above conditions of section 53A of the Transfer of Properties Act are satisfied, the purchaser can claim depreciation even though no registered sale deed is executed in his favour—*Mysore Minerals Ltd.* v. *CIT* [1999] 106 Taxman 166 (SC), *CIT* v. *Poddar Cement (P.) Ltd.* [1997] 92 Taxman 541 (SC), *CIT* v. *UP State Agro Industrial Corpn. Ltd.* [1981] 127 ITR 97 (All.)

109.1-1b PROPERTY TAKEN ON LEASE - The following points should be noted—

109.1-1b[1] *Capital expenditure on construction of any structure in a building taken on lease [Expln. 1 to sec. 32(1)]* - If an assessee carries on business or profession in a building not owned by him but in respect of which he holds a lease or other right of occupancy, he is entitled to depreciation in respect of capital expenditure* incurred by him on construction of any structure or any work in relation to the building by way of improvement, renovation or extension.

109.1-1b[2] *Circular No. 2/2001* - Except the case noted above, if the asset is owned by the lessor, depreciation is available to the lessor (not to lessee). The Accounting Standard on 'Leases' (AS-19) issued by the Institute of Chartered Accountants of India, requires capitalization of the asset by the lessees in a financial lease transaction. For tax purposes, only the "owner" is entitled for depreciation. Mere capitalisation according to AS-19 will have no implication on the allowance of depreciation on assets under the provisions of the Income-tax Act—*Circular No. 2 of 2001*, dated February 9, 2001.

■ Normally, the ownership of the asset is to be determined by the terms of contract between the lessor and the lessee. If the lessor in terms of the agreement provides only the right to use to the lessee during the periods of lease, retaining the rights as an 'owner' with itself, in such a case the lessor would be regarded as the owner for the purposes of claim of depreciation. However, if the leasing arrangement is a mere financing arrangement whereby lessor, in reality, is only providing funds for acquisition of the asset and the asset leased out, for all intents and purposes becomes property of the lessee, then in such a situation the benefit of depreciation would not be available in the hands of the lessor but in the hands of lessee—***Industrial Finance Coprn. of India*** v. ***CIT*** [2005] 4 SOT 223 (Delhi). In other words it cannot be concluded that after Circular 2/2001, lessee cannot claim depreciation in the case of financial lease. If lessee (in the case of financial lease) can exercise the rights of the owner not behalf of lessor but in his own right, depreciation is available to the lessee.

109.1-1c PROPERTY OF PARTNERSHIP FIRM - In the case of partnership firm, the firm is entitled to claim depreciation on immovable assets brought by partners as their capital contribution, even if such assets are not registered in the name of the firm under the Transfer of Property Act.

109.1-1d PROPERTY TAKEN ON HIRE-PURCHASE - In a hire-purchase contract the rentals paid by the hire-purchaser enable him to exercise an option in his favour to acquire the assets at the end of the term. Thus, in a hire-purchase contract the economic ownership of the asset rests with the hire-purchaser and not the lessor. A circular of the Board issued in 1943 governs the tax treatment in such cases. The amount of rentals paid by the hire-purchaser is apportioned between the capital amounts paid to obtain the ownership of the assets; and income payments in respect of its hire. The asset is deemed to belong to the hire-purchaser at the inception of the arrangement and is entitled to depreciation.

*But if it is found that the expenditure *per se* is revenue in nature, then the same shall be allowable as per provisions of section 30/37(1)—***CIT*** v. ***Star India (P.) Ltd.*** [2008] 22 SOT 444 (Mum.).

The hire vendor is to treat the transaction as a financial transaction and show only the interest part of the instalment as taxable income. This situation is prevailing notwithstanding the fact that under civil law the ownership does not pass to the hire-purchaser until the last instalment is received.

■ *Can hirer claim depreciation before payment of last instalment* - Both in the cases of *CIT* v. *General Industries Corpn.* [1985] 155 ITR 430 as well as *CIT* v. *Nagpur Golden Transport Co.* [1998] 233 ITR 389 the Delhi High Court had held that in a hire purchase scheme, the person taking an asset on hire (*i.e.*, hirer) would be entitled to claim depreciation. These judgments clearly go against the contention that until the last instalment is paid the ownership vests in the seller and not in the hirer—***VLS Finance Ltd.*** v. ***CIT*** [2006] 5 SOT 363 (Delhi). A similar ruling is given in ***Karimjee (P.) Ltd.*** v. ***ITO*** [2007] 15 SOT 128 (Mum.).

Consequently, if the following conditions are satisfied, depreciation can be claimed by hirer—

1. The hire purchase agreement must show that as long as hirer discharges his obligation, he has an uninterrupted right over the asset for all practical purposes.

2. The seller will eventually lose all rights, title and interest in the asset if the hirer discharges his obligation (*i.e.*, payment of all instalments).

If the above conditions are satisfied, depreciation will be available to the hirer (and not seller) from the year in which the asset is taken on hire. It is incorrect to state that in such a case depreciation is available to the seller until the last instalment is paid.

109.1-1e DEPRECIATION ON FRACTIONAL OWNERSHIP - After the amendment in section 32(1) by the Finance (No. 2) Act, 1996, depreciation is admissible even in respect of fractional ownership of an asset.

109.1-2 *ASSET MUST BE USED FOR THE BUSINESS OR PROFESSION* - The asset, in respect of which depreciation is claimed, must have been used for the purpose of business or profession. If it is found that during that year, the machinery cannot be said to have been used for the purpose of the assessee's business, then depreciation cannot be allowed.

109.1-2a PASSIVE VERSUS ACTIVE USER - The user of the asset should be understood in a wide sense so as to embrace passive as well as active user. An asset can be said to be in use when it is kept ready for use—*CIT* v. *Geo Tech Construction Corpn.* [2000] 244 ITR 452/112 Taxman 373 (Ker.). If a machine is kept ready for use at any moment in a particular factory, under an express agreement, from which taxable profits are earned, the machinery can be said to be "used" for the purpose of the business which earns profits, although in fact it has not worked during the year—*Whittle Anderson Ltd.* v. *CIT* [1971] 79 ITR 613 (Bom.), *Capital Bus Service (P.) Ltd.* v. *CIT* [1980] 123 ITR 404 (Delhi), *CIT* v. *Viswanath Bhaskar Sathe* [1937] 5 ITR 621 (Bom.). However, for the grant of depreciation on the principle of passive user, the assessee has to prove that the passive user is also for business purposes—***Hydel Constructions Ltd.*** v. ***CIT*** [2005] 146 Taxman 80 (Delhi) (Mag.).

Moreover, any forced idleness of the machinery cannot disentitle the assessee from getting the benefit of allowance—***CIT*** v. ***National Peroxide Ltd.*** [2003] SOT 321 (Mum.). Depreciation claimed by a transport undertaking on spare engines kept in store for use in case of need, cannot be disallowed on ground that they were not used by assessee—*CIT* v. *Pepsu Road Transport Corpn.* [2002] 121 Taxman 232/253 ITR 303 (Punj. & Har.).

109.1-2b ASSETS USED PARTLY FOR BUSINESS PURPOSES - Under section 38(2) where any building, machinery, plant or furniture is not exclusively used for the purposes of the business or profession, the deduction under section 32(1)(*ii*) shall be restricted to a fair proportionate part thereof which the Assessing Officer may determine, having regard to the user of such building, machinery, plant or furniture for the purposes of the business or profession.

109.1-2c OTHER JUDICIAL PRONOUNCEMENTS - One should also keep in view the following judicial pronouncements :

■ *Other business activity* - If assets are used in the assessee's business, income from which is subject to tax, the mere fact that some other business activity of the assessee which does not bring taxable

income has also the benefit of such assets would not mean that the assessee could not get depreciation *qua* such asset—*Waterfall Estates Ltd.* v. *CIT* [1981] 131 ITR 223 (Mad.).

■ *Residential quarters* - When occupation of residential quarters by the assessee's employees is subservient to and necessary for the business, the property is considered as occupied by owner for the purpose of his business—*CIT* v. *Delhi Cloth & General Mills Co. Ltd.* [1966] 59 ITR 152 (Punj.). Depreciation is, therefore, allowable on such buildings—Letter F. No. 9/26/IT/60, dated March 21, 1960. Similarly, fans, air-conditioners, refrigerators, furniture, etc., provided by the assessee employer at the quarters of employees is considered to have been used wholly for the purpose of employer's business and depreciation is admissible.

■ *Trial run* - Even trial run of a machinery would fall within the ambit of used for the purpose of business; further, the assessee cannot be denied the benefit of depreciation on the ground that the machinery was used for a very short duration for trial run—*CIT* v. *Ashima Syntax Ltd.* [2001] 251 ITR 133 (Guj.), *CIT* v. *Union Carbide (I) Ltd.* [2002] 124 Taxman 859 (Cal.), ***Aurofood Ltd.*** v. ***CIT*** [2005] 4 SOT 346 (Chennai).

109.1-3 ***ASSET MUST BE USED DURING THE RELEVANT ACCOUNTING YEAR*** - Depreciation is allowed only if the asset is used for the purpose of business or profession at least for sometime during (not necessarily throughout) the previous year. It is not necessary that the asset should have been used for the purpose of business or profession throughout the previous year. Even use during any part of the year would be sufficient to enable the assessee to claim depreciation for the whole year. Once an asset is part of a block of assets and depreciation is granted on that block, it cannot be denied in its subsequent year on the ground that one of the assets is not used by the assessee in some of years; user of assets has to apply upon block as a whole instead of an individual asset—***Unitex Products Ltd.*** v. ***ITO*** [2008] 22 SOT 430 (Mum.).

■ *Exception* - Where an asset is acquired and put to use for the purpose of business or profession for less than 180 days during the previous year in which it is acquired, depreciation thereon shall be allowed at 50 per cent of the depreciation allowable according to the percentage prescribed in respect of the block of assets comprising such asset [*see* para 109.7-2e for detailed discussion].

109.2 ***Assets which are qualified for depreciation*** - Under the Income-tax Act, one can claim depreciation in respect of the following assets —

■ *Tangible assets*	Building, machinery, plant or furniture
■ *Intangible assets acquired after March 31, 1998*	Know-how, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature

109.2-1 ***BUILDING*** - *See* para 86.1-1.

109.2-1a BUILDING DOES NOT INCLUDE LAND - Building means superstructure only and does not include land. In other words, value of building on which depreciation is allowed does not include the cost of land or site on which the superstructure stands because there cannot be any question of the destruction of the site—*CIT* v. *London Hotel* [1968] 68 ITR 62 (Bom.) and *CIT* v. *Alps Theatre* [1967] 65 ITR 377 (SC).

■ The following points should be noted —

1. Depreciation on building constructed on leased land is admissible even if the agreement provides that after the expiry of lease, the building would be handed over to the lessor without compensation—*Y.V. Srinivasamurthy* v. *CIT* [1967] 64 ITR 292 (Mys.).

2. Where the assessee purchases a building and the purchase price (as per sale deed) is a composite one (sale deed does not indicate the prices of land and building separately), then no distinction at least in the consideration paid to the vendor can be made and the entire amount is qualified for depreciation. However, if there is a clear-cut identity in respect of price paid to the land and building (*i.e.*, sale deed indicates price of land and building separately), then depreciation is available only on the building—***CIT*** v. ***Rajesh Exports Ltd.*** [2006] 9 SOT 28 (Bang.) (URO).

109.2-1b 'BUILDINGS' INCLUDES ROADS - The word 'buildings' includes roads, bridges culverts, wells and tube-wells. This is clear from Note 1 to Appendix I to the Income-tax Rules, 1962.

109.2-2 *MACHINERY* - Like "building", the word "machinery" has not been defined anywhere in the Act. Therefore, one has to depend upon natural meaning and decided cases. The Privy Council in *Corporation of Calcutta* v. *Chairman, Cossipore & Chitpore Municipality* AIR 1922 PC 27 defined the word "machinery" as :

"... some mechanical contrivances which, by themselves or in combination with one or more other mechanical contrivances, by the combined movement and interdependent operation of their respective parts generate power, or evoke, modify, apply or direct natural forces with the object in each case of effecting so definite or specific a result..." (p. 32)

According to this definition, machinery need not be self-contained unit capable of being put to use by itself and may be part of a bigger machinery. In other words, machinery would not be ceased to be machinery simply because it is a part of manufacturing plant.

109.2-3 *PLANT* - The word "plant" is defined under section 43(*3*) to include ships, vehicles, books, scientific apparatus and surgical equipment used for the purpose of the business or profession but does not include tea bushes or livestock or "buildings or furniture and fittings".

As the definition is inclusive and not exhaustive, the word "plant" includes anything which can be comprehended within its ordinary meaning, such as fixtures, machinery, tools, apparatus or appliances, etc., necessary to carry on any trade or mechanical business or any mechanical operation or process, the machinery, apparatus or fixtures by which a business is carried on or the fixtures and tools necessary to carry on any trade or mechanical business.

109.2-3a BUILDING, FURNITURE OR FITTINGS CANNOT BE TAKEN AS PLANT - With effect from the assessment year 2004-05, building, furniture or fittings cannot be taken as plant.

109.2-3b WHETHER BOOKS ARE PLANT - Section 43(*3*) expressly declares that "books" used for the purposes of the business or profession of the assessee (that is, used for the purpose of enabling the assessee to carry on his business or profession and earn income therefrom) are "plant" within the meaning of section 32.

109.2-3d INSTANCES OF ARTICLES HELD AS PLANT - The following are held as plant :

Designs ; drawings ; plans and technical data ; fencing around the refinery process unit ; safe deposit lockers cabinets ; coal tubs ; cast iron pipes ; winding and guiding ropes ; knives and lasts used in the manufacture of shoes ; aircraft engines (which were being dismantled) ; electrical fans and other office appliances ; poles ; cables, conductors and switch-boards for distribution of electricity ; mains, service lines and switchgears in the case of electric supply company ; light fittings, ceiling and pedestal fans ; air-conditioning equipment installed in safe deposit vault by a bank ; electric stoves used for the purpose of business ; dry dock for the use of ship builders and ship repairers and marine engineers ; railway siding used for the purposes of goods manufactured by the factory ; cylinders used for storing of oxygen gas by a concern manufacturing oxygen gas ; winding and guiding ropes; internal telephone system ; cooling coils installed by a sugar manufacturer to facilitate more rapid formation of sugar crystals ; technical know-how in the form of blueprints, technical manuals, research experience, workshop drawings, clearance tables, part lists, manufacturing instruction ; specification for materials, bottles and shells (belonging to soft drink manufacturer) ; tubewell ; weighing machine (used in production of paper) ; wall clock installed in factory; bins/racks/shelves kept in workshop ; shuttering material in construction; lockers, counters, guns, steel equipment, electrical fitting; cooling equipment; bamboo used in business of hiring to customers, underground cables used by the assessee having communication network and exchanges as main apparatus, etc.

109.2-4 *FURNITURE* - As the word "furniture" is not defined in the Act, its meaning in common parlance has to be ascertained. According to *Webster's New International English Dictionary,* the word "furniture" means "articles of convenience or decoration used to furnish a house, apartment, place of business or of accommodation". The *Shorter Oxford English Dictionary* defines furniture "as movable articles in a dwelling house, place of business, or public building". All articles of decoration or convenience used for the purpose of furnishing an office or place of trade or manufacturing would, therefore, be covered by the word "furniture".

109.3 ***Disallowance of depreciation*** - Depreciation is not allowed in respect of the following :

- Where a car is used otherwise than in a business of running it on hire for tourists :

a. depreciation is not allowed on the excess of the actual cost over Rs. 25,000 if car is acquired between April 1, 1967 and February 28, 1975 [proviso to section 43(*1*)] ; and

b. depreciation (including terminal depreciation) is wholly disallowed if car is a foreign car and has been acquired after February 28, 1975 but before April 1, 2001 [first proviso to sec. 32(1)(*ii*)].

Depreciation is available in the case of foreign made car in the following cases—

1. Where a foreign made motor car is used outside India in business or profession carried on by the assessee in another country.

2. Where foreign made car is used in India in the business of running it on hire for tourists.

3. Where a foreign made is acquired after March 31, 2001, and used for business purposes in India.

■ Any machinery or plant if actual cost thereof is allowed as a deduction in one or more years under an agreement entered into by the Central Government under section 42.

109.4 ***Basic concepts for computation of depreciation allowance*** - To understand method of computation of depreciation, one must know the following :

Terms	*Section/Rule*	*Reference*
Method of depreciation	32	Written down value method ["straight line method" in the case of generation or generation and distribution of power - *see* para 109.11]
Rates of depreciation	Appendix 1 & 1A to the Income-tax Rules	*See* Annex 2
Block of assets	2(*11*)	*See* para 109.5
Actual cost	43(*1*)	*See* para 109.10
Written down value	43(*6*)	*See* para 109.6

109.5 ***Block of assets [Sec. 2(11)]*** - The term "block of assets" means a group of assets falling within a class of assets comprising —

a. tangible assets, being buildings, machinery, plant or furniture ;

b. intangible assets, being know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature,

in respect of which the same percentage of depreciation is prescribed.

Under section 2(*11*), it is not necessary that asset should be used for purpose of business during the year under consideration. The user of the asset is important for the purpose of actual allowability of depreciation, but not for determining whether the asset falls within the block of assets or not— ***Chhabria Trust*** v. ***CIT*** [2003] 87 ITD 181 (Mum.) (SB).

A taxpayer may have 13 different block of assets as given below :

Number	*Nature of asset*	*Rate of depreciation*
Block 1	*Buildings* - Residential buildings other than hotels and boarding houses	5%
Block 2	*Buildings* - Office, factory, godowns or buildings which are not mainly used for residential purpose [it covers hotels* and boarding houses but does not cover those which are covered under Blocks 1 and 3]	10%
Block 3	*Buildings* - The following buildings : *a.* buildings acquired on or after September 1, 2002 for installing machinery and plant forming part of water supply project or water treatment system and which is put to use for the purpose of business of providing infrastructure facilities under clause (*i*) of sub-section (4) of section 80-IA; *b.* temporary erections such as wooden structures	100%

* Depreciation at the rate of 10 per cent available in respect of hotel building even if the building is also used for providing residence of employees, letting out to bank and shops—***CIT*** v. ***Sangu Chakra Hotels (P.) Ltd.*** [2007] 161 Taxman 257 (Mad.).

Number	*Nature of asset*	*Rate of depreciation*
Block 4	*Furniture* - Any furniture/fittings including electrical fittings	10%
Block 5	*Plant and machinery* - Any plant or machinery (not covered by Block 6, 7, 8, 9, 10, 11 or 12) and motor cars (other than those used in a business of running them on hire) acquired or put to use on or after April 1, 1990	15%
Block 6	Ocean-going ships, vessels ordinarily operating on inland waters including speed boats	20%
Block 7	*Plant and machinery* - Buses‡, lorries@ and taxies used in the business of running them on hire**, machinery used in semi-conductor industry, moulds used in rubber and plastic goods factories.	30%
Block 8	*Plant and machinery* - *Aeroplanes* - Besides, it includes commercial vehicle which is acquired after September 30, 1998 but before April 1, 1999 and it is put to use for any period prior to April 1, 1999, life saving medical equipment	40%
Block 9	*Plant and machinery* - Containers made of glass or plastic used as refills and plant and machinery which satisfy conditions of rule 5(2) - *see Note infra.* and the following— *a.* new commercial vehicle** acquired during 2001-02 and put to use before March 31, 2002 for the purpose of business or profession; and *b.* machinery/plant used in weaving, processing and garment sector of textile industry which is purchased under Technology Upgradation Fund Scheme during April 1, 2001 and March 31, 2004 and put to use up to March 31, 2004	50%
Block 10	*Plant and machinery* - Computers including computer software. Besides, it includes new commercial vehicles acquired in replacement of condemned vehicle of 15 years of age and put to use before April 1, 1999 (if acquired after September 30, 1998 but before April 1, 1999) or put to use before April 1, 2000 (if acquired during the financial year 1999-2000). It also includes books (other than annual publication) owned by a professional. It also includes gas cylinders ; plant used in field operations by mineral oil concerns; direct fire glass melting furnaces	60%
Block 11	*Plant and machinery* - Energy saving devices ; renewal energy devices ; rollers in flour mills, sugar works and steel industry.	80%
Block 12	*Plant and machinery* - Air pollution control equipments; water pollution control equipments; solid waste control equipments, recycling and resource recovery systems; machinery acquired and installed on or after September 1, 2002 in a water	

‡Air-conditioning plant is an integral part of a bus and, therefore, depreciation on air-conditioner fixed in a bus is allowable at the rate applicable to the bus, instead of the rate applicable to air-conditioner—*CIT* v. *Delhi Airport Service* [2001] 170 CTR (Delhi) 534.

@Rigs and compressor used for drilling borewells though mounted on a lorry cannot be held to fall under category 'motor lorry' —***CIT*** v. ***National Boring Co.*** [2003] 129 Taxman 860 (Raj.).

Leasing of vehicles amounts to running it on hire—*CIT* v. *Madan & Co.* [2002] 254 ITR 445 (Mad.), ***CIT* v. ***Suidu Trade Links Ltd.*** [2003] 131 Taxman 302 (Delhi), Contrary ruling—***Kotak Mahindra Finance Ltd.*** v. ***CIT*** [2003] 130 Taxman 422 (Bom.). On the basis of the CBDT Circulars, the decision of the Tribunal and other decisions of the High Courts, the following principles emerge :

(*i*) The assessee will be entitled to deduction on account of depreciation at higher rate if the vehicles are used by the assessee in the business of running them on hire.

(*ii*) If the assessee is engaged in business other than the business of running the vehicles on hire and has used the vehicles in the course of such business, the mere fact that some recovery has been made from the customers on account of spot delivery of goods may not be a sole determinative factor to come to the conclusion that the vehicles were used for the business of running them on hire.

(*iii*) The mere recovery of transport charges from the customers is not the sole factor to determine as to whether the vehicles have been used in the business of running them on hire.

(*iv*) An assessee may have diverse activities of business and the business of running the vehicles on hire may be one of such activities in which case higher depreciation would be permissible—***CIT*** v. ***B.P. Agarwalla & Sons Ltd.*** [2003] 86 ITD 219 (Kol.) (TM) (Mag.).

Number	Nature of asset	Rate of depreciation
	supply project or water treatment system or for the purpose of providing infra-structure facility; wooden parts used in artificial silk manufacturing machinery ; cinematograph films, bulbs of studio lights ; wooden match frames ; some plants used in mines, quarries and salt works ; and books (being annual publications) owned by assessees carrying on a profession or books (may or may not be annual publications) carrying on business in running lending libraries	100%
Block 13	*Know-how* - Know-how acquired after March 31, 1998 ["Know-how" means any industrial information or technique likely to assist in the manufacture or processing of goods or in the working of a mine, oil-well or other sources of mineral deposits (including searching for discovery or testing of deposits for the winning of access thereto)	25%
Block 13	*Intangible assets (acquired after March 31, 1998)* - Know-how, patents, copyrights, trade marks, licences, franchises and any other business or commercial rights of similar nature.*	25%

Note : If the following conditions are satisfied, then plant and machinery shall be treated as a part of block of assets qualifying for depreciation at the rate of 40 per cent by virtue of rule 5(2) :

1. New machinery or plant is installed during the previous year relevant to the assessment year 1988-89 (or any subsequent year), for the purposes of business of manufacture or production of any article or thing (not being any article specified in the Eleventh Schedule).

2. Such article or thing is manufactured or produced by using any technology (including any process) or other know-how developed in (or is an article or thing invented in) a laboratory owned or financed by the Government or a laboratory owned by a public sector company or a University or an Institution recognised in this behalf by the Secretary, Department of Scientific and Industrial Research, Government of India.

3. The right to use such technology (including any process) or other than know-how or to manufacture or produce such article or thing has been acquired from the owner of such laboratory or any person deriving title from such owner.

4. The return, furnished by the assessee for any previous year in which the said machinery or plant is acquired, shall be accompanied by a certificate from the Secretary, Department of Scientific and Industrial Research, Government of India, to the effect that such article or thing is manufactured or produced by using such technology (including any process) or other know-how developed in such laboratory or is an article or thing invented in such laboratory.

109.6 ***Written down value [Sec. 43(6)]*** - Written down value for the assessment year 2009-10 will be determined as under :

Step 1	Find out the depreciated value of the block on April 1, 2008.
Step 2	To this value, add "actual cost" [*see* para 109.10] of the asset (falling in the block) acquired during the previous year 2008-09.
Step 3	From the resultant figure, deduct money received/receivable (together with scrap value) in respect of that asset (falling within the block of assets) which is sold, discarded, demolished or destroyed during the previous year 2008-09.

■ *Other points* - The following points should be noted—

1. The resulting amount is the written down value of the block of assets on March 31, 2009 relevant for the assessment year 2009-10.

2. The amount of reduction under *Step 3* cannot exceed the value of assets computed under *Step 1* and *Step 2*.

3. One may determine written down value for other assessment years on similar basis.

4. In some cases, computation of written down value is based upon notional figures [*see* para 109.6-5].

*The expression 'any other business or commercial rights of similar nature' would include such rights which can be used as a tool to carry on the business—***Skyline Caterers (P.) Ltd. v. ITO** [2008] 20 SOT 269 (Mum.). In ***Peninsular Capital Market Ltd. v. CIT*** [2008] 19 SOT 421 (Cochin), it was held that membership card of a stock exchange is an intangible asset eligible for depreciation under section 32.

5. Even in case of assets acquired before previous year where in past no depreciation was computed, actually allowed or carried forward for no fault of assessee, depreciated value under *Step 1* shall include actual cost of assets to the assessee — ***Kandla Port Trust*** v. ***CIT*** [2006] 8 SOT 429/104 TTJ 396 (Rajkot).

6. For *Step 3* it is not the gross consideration received by an assessee on the sale of its assets. All expenses incidental to a sale would reduce the consideration to that extent and, therefore, are permitted to be deducted from the gross consideration — ***CIT*** v. ***Essar Shipping Ltd.*** [2006] 5 SOT 70/102 ITD 71 (Mum.).

109.6-1 *WRITTEN DOWN VALUE IN THE SLUMP SALE* - *See* para 520.2.

109.6-2 *MONEY PAYABLE IN RESPECT OF ASSETS SOLD, DISCARDED OR DESTROYED - MEANING OF* - By virtue of *Explanation* to section 41, "money payable" in respect of any building, machinery, plant or furniture includes :

a. any insurance, salvage or compensation money, payable in respect thereof ;

b. where the building, machinery, plant or furniture is sold, the price for which it is sold.

The expression "money payable" has to interpreted only as actual money payable in cash or by cheque/draft and not any other thing or benefit which can be converted in money—*CIT* v. *Kasturi & Sons Ltd.* [1999] 103 Taxman 342 (SC).

109.6-3 *"SCRAP" VALUE IS DEDUCTIBLE ONLY WHEN THE DISCARDED ASSET IS NOT SOLD* - There are two different cases —

Case 1- When the discarded asset is sold	Sale consideration shall be deducted from the value of block of assets
Case 2 - When the asset is discarded, demolished or destroyed (but not sold) [*see* note]	Scrap value shall be deducted from the value of block of assets

If the assessee does not want to convert that scrap into money by selling that scrap or if the assessees decide to give away that scrap (in whole or in part) to others without realising anything in return from them, it does not have the effect of depriving the scrap of the value it otherwise has and, consequently, in such case value of scrap shall be deducted — *CIT* v. *Ashoka Betelnut Co. (P.) Ltd.* [2002] 125 Taxman 321 (Mad.).

109.6-4 *WHEN COMPUTATION OF WRITTEN DOWN VALUE IS BASED UPON NOTIONAL FIGURES* - In the following cases written down value is based upon notional figures :

- *Succession in business or profession [Expln. 1 to sec. 43(6)]* - When in the case of succession in business or profession, the predecessor cannot be found and the assessment is to be made on successor under section 170(2), the written down value of any block of assets shall be the amount which would have been taken as its written down value if the assessment had been made directly on the person succeeded to. To put it differently, depreciation is to be calculated taking the written down value of block of assets as if there had been no change in the ownership at all.
- *Transfer between holding and subsidiary company [Expln. 2 to sec. 43(6)]* - *See* para 521.2.
- *Transfer in the scheme of amalgamation [Expln. 2 to sec. 43(6)]* - *See* para 516.2.
- *Written down value when assets are transferred in demerger [Expln. 2A to sec. 43(6)]* - *See* para 517.2-2.
- *Written down value in the hands of resulting company [Expln. 2B to sec. 43(6)]* - *See* para 517.2-2.
- *Written down value in the case of corporatisation of recognised stock exchange in India [Expln. 5 to sec. 43(6), applicable from the assessment year 2002-03]* - Where in a previous year, any asset forming part of a block of assets is transferred by a recognised stock exchange in India to a company under a scheme for corporatisation (approved by SEBI), the written down value of the block of assets in the case of such a company shall be the written down value of the transferred assets immediately before such a transfer.

▪ *Written down value in respect of assets acquired during the period when income was exempt [Expln. 6 to sec. 43(6), applicable from the assessment year 2003-04 onwards] - Explanation* 6 is applicable if the following conditions are satisfied—

Condition 1	The assessee was not required to compute his total income for the purposes of the Income-tax Act for any previous year or years preceding the previous year (hereinafter referred to as "preceding previous year") relevant to the assessment year under consideration.
Condition 2	The assessee maintains books of account in respect of such preceding previous year(s).
Condition 3	The assessee provides depreciation in the books of account pertaining to such preceding previous year(s).

Consequences if the above three conditions are satisfied - If the above three conditions are satisfied, then—

1. Actual cost of an asset shall be adjusted by the amount attributable to the revaluation of such asset, if any, in the books of account.

2. The total amount of depreciation on such asset provided in the books of account of the assessee in respect of such preceding previous year(s) shall be deemed to be the depreciation actually allowed under the Income-tax Act for the purposes of section 43(6).

3. The depreciation actually allowed as above shall be adjusted by the amount of depreciation attributable to such revaluation.

Provisions illustrated - Consider the following cases—

1. X, a salaried employee, purchased a computer on May 13, 2007 for Rs. 40,000 for his personal purposes. He resigns from his service on December 14, 2008 to set up a business of trading in books and stationery. The computer, which was purchased in May 2007, is transferred to the office for being used in the business of trading in books and stationery.

Actual cost of computer for the purposes of calculating depreciation of the business for the previous year 2009-10 will be Rs. 40,000. Depreciation from May 13, 2007 to December 14, 2009 shall not be deducted from Rs. 40,000. Amount of depreciation will be 60 per cent of Rs. 40,000. The amended provision is not applicable in this case, as X does not maintain books of account and provide depreciation for the period commencing from May 13, 2007 and ending on December 14, 2009.

2. A plant was purchased by X & Co. (a partnership firm) on September 1, 2007 for Rs. 20 lakh. The income of the firm was exempt up to March 31, 2009. The firm maintains books of account but does not provide depreciation in respect of the plant purchased on September 1, 2007.

In the previous year 2009-10 (when the income of the firm becomes chargeable to tax), depreciation will be available on the actual cost of Rs. 20 lakh. The notional depreciation from September 1, 2007 to March 31, 2009 shall not be deducted from the actual cost even under the new provisions, as the firm has not claimed any depreciation in respect of the plant in its books of account.

3. Income of X Ltd. is exempt up to March 31, 2008. The following information is taken from the books of account of the company in respect of a plant purchased by it on June 10, 2005—

Date	Transaction	Amount Rs.
June 10, 2005	Cost of plant	1,00,000
March 31, 2006	Depreciation for the year ending March 31, 2006 @ 15.33%	15,330
April 1, 2006	Written down value	84,670
April 1, 2006	Revaluation of the asset (amount transferred to revaluation reserve account)	20,000
March 31, 2007	Written down value before depreciation	1,04,670
March 31, 2007	Depreciation for the year ending March 31, 2007 @ 15.33%	16,045

Date	Transaction	Amount Rs.
April 1, 2007	Written down value	88,625
March 31, 2008	Depreciation for the year ending March 31, 2008 @ 15.33%	13,586
April 1, 2008	Written down value	75,038

In the above case, depreciation would be available for the previous year 2008-09 (*i.e.*, assessment year 2009-10) as follows—

Date	Transaction	Amount Rs.
June 10, 2005	Cost of plant	1,00,000
March 31, 2006	*Less:* Notional depreciation for the year ending March 31, 2006 @ 15.33% as provided in the books of account	15,330
April 1, 2006	Written down value	84,670
April 1, 2006	Revaluation of the asset (ignore it)	*Nil*
March 31, 2007	Written down value before depreciation	84,670
March 31, 2007	*Less:* Notional depreciation for the year ending March 31, 2007 @ 15.33% as provided in the books of account but after ignoring the effect of revaluation	12,980
April 1, 2007	Written down value	71,690
March 31, 2008	*Less:* Notional depreciation for the year ending March 31, 2008 @ 15.33% as provided in the books of account but after ignoring the effect of revaluation	10,990
April 1, 2008	Written down value for the purpose of section 43(6)	60,700
March 31, 2009	Depreciation under section 32 for the previous year 2008-09 on the assumption that rate of depreciation is 15% and there is no other asset in the block of assets (15% of Rs. 60,700, no additional depreciation)	9,105

109.6-5 *JUDICIAL PRONOUNCEMENTS* - One should also keep in view the following judicial pronouncements :

1. The assessee purchased sugar mills from the branch of a HUF to which the mills were allotted in a partition. The assessee claimed depreciation on the basis of written down value in the HUF's assessment, but later, when the Supreme Court *held* in the HUF's case that the value given in the partition deed represented the real value, claimed further depreciation on the enhanced value of the assets in its appeal before the Commissioner (Appeals). It was *held* that the assessee was entitled to the claim for further depreciation on the enhanced value—*Jaora Sugar Mills (P.) Ltd.* v. *CIT* [1980] 124 ITR 482 (MP).

2. In case of change of constitution of assessee-firm, depreciation would be allowable on written down value of assets and not on enhanced cost at which assets are taken over by new firm—*CIT* v. *Alagappa Cotton Mills* [2002] 253 ITR 100/124 Taxman 526 (Mad.).

109.7 ***Computation of normal depreciation† allowance*** - From the assessment year 1988-89, depreciation is admissible on the basis of block of assets [*see* para 109.5]. To ascertain the amount of depreciation, one should find out the following :

- Written down value of block of assets [*see* para 109.6][1].
- Rate of depreciation [*see* Annex 2].

1. In a few cases, one has to take actual cost in the case of an undertaking engaged in generation or generation and distribution of power - *see* para 109.10.

†Para 109.7 covers normal depreciation. Besides one can claim additional depreciation [*see* para 109.8].

109.7-1 ***RULE OF COMPUTATION*** - The product of aforesaid two is the amount of depreciation. For instance, if written down value of a block of assets [*i.e.*, buildings, rate of depreciation : 10 per cent] is Rs. 3,19,400 for the previous year 2008-09, depreciation will be Rs. 31,940 [being 10 per cent of Rs. 3,19,400] for the said previous year and the depreciated value of the block on April 1, 2009 will be Rs. 2,87,460 (*i.e.*, Rs. 3,19,400 — Rs. 31,940).

The aforesaid rule is, however, not applicable in the cases mentioned in para 109.7-2.

109.7-2 ***EXCEPTIONS TO THE RULE*** - In the cases given below, the abovementioned rule is not applicable :

Exception one	If written down value of the block of asset is reduced to zero, though the block is not empty	*See* para 109.7-2a
Exception two	If the block of assets is empty or ceases to exist on the last day of the previous year (though the written down value is not zero)	*See* para 109.7-2b
Exception three	In the case of imported cars	*See* para 109.7-2c
Exception four	In the case of succession or amalgamation or business re-organisation or demerger	*See* para 109.7-2d
Exception five	If in the first year in which an asset is acquired, it is put to use for less than 180 days	*See* para 109.7-2e

109.7-2a WHEN THE WRITTEN DOWN VALUE OF A BLOCK OF ASSET IS REDUCED TO ZERO - No depreciation is admissible where written down value has been reduced to zero, though the block of asset does not cease to exist on the last day of the previous year.

Provision illustrated - On April 1, 2008, depreciated value of a block of asset (rate of depreciation : 15 per cent) is Rs. 80,000. It consists of Plants A and B. The assessee purchases Plant C (rate of depreciation : 15 per cent) on December 28, 2008 for Rs. 30,000 and sells Plant A on May 3, 2008 for Rs. 1,80,000. In this case on March 31, 2009, the assessee has Plant B and Plant C in the block of the asset, though the written down value of the block is zero. No depreciation will be admissible for the previous year 2008-09 (*i.e.*, the assessment year 2009-10) as is evident from the computations given below :

	Rs.
Depreciated value of the block consisting of plants A and B	80,000
Add : Actual cost of plant C	30,000
Total	1,10,000
Less : Sale consideration of plant A [though the plant is sold for Rs. 1,80,000, the amount of reduction cannot exceed Rs. 1,10,000 ; the difference of Rs. 70,000 is short-term capital gain under section 50(1)]†	1,10,000
Written down value of the block consisting of plants B and C	*Nil*
Less : Depreciation for the previous year 2008-09	*Nil*
Depreciated value of the block consisting of plants B and C on April 1, 2009	*Nil*

109.7-2b IF BLOCK OF ASSET CEASES TO EXIST - If a block of asset ceases to exist or if all assets of the block have been transferred and the block of asset is empty on the last day of the previous year, no depreciation is admissible in such case.

Provision illustrated - X Ltd. owns two plants — Plant A and Plant B — on April 1, 2008 (rate of depreciation : 15 per cent, depreciated value on April 1, 2008 : Rs. 2,37,000). The company purchases Plant C on May 31, 2008 for Rs. 20,000 and sells Plant A (on April 10, 2008), Plant B (on December 12, 2008) and Plant C (on March 1, 2009) for Rs. 10,000, Rs. 15,000 and Rs. 24,000 respectively.

†*See* para 173.1-3.

Written down value of the block of assets will be determined as under :	Rs.
Depreciated value of the block consisting of Plants A and B	2,37,000
Add : Cost of Plant C	20,000
Total	2,57,000
Less : Sale proceeds of Plants A, B and C	49,000
Written down value of the block (which is empty)	2,08,000

In the aforesaid case, no depreciation is admissible, as the block of asset ceases to exist on the last day of the previous year. Rs. 2,08,000 will be treated as short-term capital loss on sale of Plants A, B and C under section 50(2)†. Depreciated value of the block on the first day of the next previous year (*i.e.*, on April 1, 2009) will be taken as *nil* (*i.e.*, written down value on March 31, 2009 : Rs. 2,08,000 *minus* short-term capital loss : Rs. 2,08,000).

In the case study given above, if Plants A, B and C are transferred for a consideration which is higher than Rs. 2,57,000 (say, Rs. 3,57,000), then no depreciation will be available and Rs. 1,00,000 shall be taken as short-term capital gain on sale of Plants A, B and C.

On the basis of case studies given in paras 109.7-2a and 109.7-2b, one can draw the following conclusions—

1. Depreciation is available in the following cases —

a. if the block, having written down value, is not empty on the last day of the previous year ;

b. if no asset is sold in the block which has written down value ;

c. if some of the assets have been sold, the block is not empty and it has written down value.

There will not be any capital gain/loss in these situations.

2. Depreciation is not available in the following cases —

a. if the block, having a written down value, is empty on the last day of the previous year (there will be short-term capital loss) ;

b. if some of the assets have been sold (the block is not empty) but it has no written down value (it will happen when sale consideration is more than the value of the block and there will be short-term capital gain) ;

c. if all the assets have been sold and it has no written down value (there will be short-term capital gain).

109.7-2c IMPORTED CARS - If an imported car was acquired during March 1, 1975 and March 31, 2001, depreciation is not admissible. If, however, such imported car is used in the business of running it on hire for tourists or for the purpose of business or profession outside India then depreciation is admissible at the usual rate.

The table given below, highlights the aforesaid provisions—

	Imported car acquired after February 28, 1975 but before April 1, 2001	*Imported car acquired after March 31, 2001*
Imported car is used for		
❑ the business of running it on hire for tourist	Depreciation available	Depreciation available
❑ the purpose of business or profession outside India	Depreciation available	Depreciation available
❑ the purpose of business or profession in India	Depreciation not available	Depreciation available

†For section 50, one may refer to para 173.1-3.

109.7-2d DEPRECIATION IN CASE OF SUCCESSION, AMALGAMATION, BUSINESS RE-ORGANISATION OR DEMERGER [FIFTH PROVISO TO SEC. 32(1) AND SEC. 44DB] - Fifth proviso to section 32 and section 44DB are applicable while determining depreciation if there is a change of ownership of assets because of the following —

a. conversion of firm or sole proprietary concern into company;

b. succession to business other than on death — business of HUF taken over by a member, business of a firm taken over by a partner, conversion of HUF concern into company;

c. amalgamation of a company; and

d. demerger of a company; and

e. amalgamation or demerger of co-operative banks.

■ In the year in which change of ownership takes place because of the aforesaid reasons, depreciation shall be calculated as under —

1. Find out the amount of depreciation of the previous year in which ownership of assets changes (because of the aforesaid reasons) on the assumption that the succession, amalgamation or demerger has not taken place.

2. The amount of depreciation so determined shall be apportioned between the (*a*) predecessor and successor, or (*b*) amalgamating company and amalgamated company, or (*c*) demerged and resulting company, as the case may be, in the ratio of number of days for which the assets are used by them during the previous year in which ownership changes.

■ Depreciation will be available to the predecessor and successor in the aforesaid ratio. There is no option available to the Assessing Officer. Depreciation cannot be denied to the successor on the plea that full depreciation was allowed to the predecessor.

109.7-2dP1 *X owns a block of assets consisting of plants A and B, depreciation rate 15 per cent. On April 1, 2008, depreciated value of the block is Rs. 10,40,000 (it is not qualified for additional depreciation). On July 7, 2008, the block of assets is transferred by X to Y for Rs. 30,70,000. Find out the tax consequences under the following situations—*

1. X is amalgamating company and Y, being an Indian company, is the amalgamated company and the block of assets is transferred by X to Y in a scheme of amalgamation. Y does not own any other asset.

2. Suppose in (1)(supra) Y is a foreign company.

3. Suppose in (1) Y owns a block of assets (consisting of plants C and D, depreciation rate 15 per cent) on April 1, 2008. Depreciated value of the block of asset being Rs. 6,40,000. Y purchases plant E (rate of depreciation 15 per cent) on March 10, 2009 for Rs. 2,90,000. It is put to use on the same day.

4. X is a partnership firm. It is converted into Y company. The conversion satisfies the conditions of section 47(xiii). Y does not own any other asset.

5. X is a firm. The business of X is taken over by Y, a partner in the firm. On April 1, 2008, Y owns plants C and D (depreciation rate 15 per cent, depreciated value of the block Rs. 60,78,000). Y purchases plant E on December 5, 2008 (depreciation rate 15 per cent, actual cost Rs. 36,000). It is put to use on the same day. On March 13, 2009, Y sells plant C for Rs. 26,40,000.

SOLUTION :

Computation of depreciation allowance on Plants A and B	*Rs.*
Depreciated value of the block on April 1, 2008	10,40,000
Depreciation @ 15%	1,56,000
Apportionment between X and Y	
Number of days when the assets are held by X (from April 1, 2008 to July 6, 2008)	97 days
Number of days when assets are held by Y (365 days – 97 days)	268 days
Depreciation available to X (Rs. 1,56,000 × 97 ÷ 365)	41,458
Depreciation available to Y (Rs. 1,56,000 × 268 ÷ 365)	1,14,542

Tax consequences in the hands of X and Y

	Situation 1 Rs.	Situation 2 Rs.	Situation 3 Rs.	Situation 4 Rs.	Situation 5 Rs.
Tax consequences in the hands of X					
Depreciation	41,458	41,458	41,458	41,458	41,458
Short term capital gain under section 48 read with section 45	*Nil*[1]	20,30,000[2]	*Nil*[1]	*Nil*[3]	20,30,000
Depreciation in the hands of Y					
Depreciated value of the block on April 1, 2008	*Nil*	*Nil*	6,40,000	*Nil*	60,78,000
Add: "Actual cost" of assets acquired from X	10,40,000	30,70,000	10,40,000	30,70,000	30,70,000
Add : Actual cost of plant E acquired by Y	-	-	2,90,000	-	36,000
Less: Assets sold during the year	-	-	-	-	26,40,000
Written down value of the block	10,40,000	30,70,000	19,70,000	30,70,000	65,44,000
Depreciation					
❑ On assets acquired from X	1,14,542	1,14,542	1,14,542	1,14,542	1,14,542
❑ On Plant E	-	-	21,750[4]	-	2,700[6]
❑ On other assets	-	-	96,000[5]	-	5,15,700[7]
Total depreciation	1,14,542	1,14,542	2,32,292	1,14,542	6,32,942
Written down value of the block on April 1, 2009	9,25,458	29,55,458	17,37,708	29,55,458	59,11,058

Notes :

1. It is exempt under section 47(*vi*).

2. As the amalgamated company is not an Indian company, the provisions of section 47(*vi*) are not applicable.

3. It is exempt under section 47(*xiii*).

4. It is 15% of 1/2 of Rs. 2,90,000 as Plant E is put to use for less than 180 days during the previous year.

5. It is 15% of (Rs. 19,70,000 – Rs. 10,40,000 – Rs. 2,90,000).

6. It is 15% of 1/2 of Rs. 36,000.

7. It is 15% of (Rs. 65,44,000 – Rs. 30,70,000 – Rs. 36,000).

8. In the above problem, situation 4 covers the case if a firm is converted into company by satisfying conditions of section 47(*xiii*). The tax treatment will be same in the following cases [except exemption under section 47(*xiii*)]—

a. if X is a firm and the business is taken over by Y a partner in the firm;

b. if X is HUF and the business is taken over by Y a member of the family;

c. if X is a sole proprietor and business is taken over by Y, a firm in which X is one of the partners.

d. if X is a sole proprietor and business is taken over by a company in which X is one of the shareholders.

In (*d*) if conditions of section 47(*xiv*) are satisfied, exemption will be available to X under that section.

9. In situations 2, 4 and 5 if the Assessing Officer is satisfied that fair market value of Plants A and B is less than Rs. 30,70,000 (being the consideration paid by Y), then he can take action under *Explanation 3* to section 43(*1*).

109.7-2e WHEN AN ASSET IS PUT TO USE FOR LESS THAN 180 DAYS IN THE YEAR OF ACQUISITION - If any asset falling within a block of asset is acquired by the assessee during the previous year and it is put to use for the purposes of business or profession for a period of less than 180 days in that previous year, the deduction in respect of such asset shall be restricted to 50 per cent of the amount calculated at the percentage prescribed in the case of block of asset comprising such asset.

■ The aforesaid provision is applicable if the following conditions are satisfied :

Condition one	If the asset is "acquired" during the previous year.
Condition two	It is *put to use* for a period of less than 180 days.

When the two conditions are satisfied, depreciation shall be restricted to *50 per cent of the amount calculated at the percentage* prescribed.

■ The aforesaid restriction is applicable only in the year in which an asset is acquired and not in subsequent years.

■ Since in the case of partition of joint Hindu family, dissolution of firm, conversion of firm into company, no asset is "acquired" by the successor, the aforesaid provision is not applicable.

■ If an asset is kept ready for use for more than 180 days before the end of the previous year but actually used for less than 180 days, the aforesaid restriction would not apply. This view is in line with the interpretation of the Courts that "use" includes "ready for use". In other words, the word "used" in this section may be given a wider meaning and embrace passive as well as active user— *Vishwanath Bhaskar Sathe* v. *CIT* 10 ITC 386 (Bom.), ***CIT*** v. ***Vidhyachal Distilleries (P.) Ltd.*** [2005] 147 Taxman 127 (MP).

■ The following table highlights these provisions —

Whether the asset is put to use during the relevant year	*How many days the asset is put to use during the relevant previous year*	*Depreciation if the relevant year is the year in which the asset is "acquired"*	*Depreciation if the relevant year is any subsequent year*
No	—	No depreciation	No depreciation
Yes	Less than 180 days	Half of usual depreciation	Usual depreciation
Yes	180 days or more	Usual depreciation	Usual depreciation

For the aforesaid table the following conclusions can be drawn —

1. If an asset is not used at all, no depreciation in respect of that asset is available. This rule is applicable in the first year in which the asset is acquired as well as in the subsequent years.

2. If in the first year, in which an asset is acquired, it is put to use for less than 180 days, 50 per cent of the normal depreciation is available.

3. In the subsequent year if the asset is put to use for sometime (maybe for less than 180 days), usual depreciation is available.

Provisions illustrated - The above provisions are explained in the following examples —

1. X Ltd. purchases a plant (rate of depreciation : 15 per cent) on May 10, 2008. It is put to use on January 10, 2009. In this case, the plant is acquired during 2008-09 and in 2008-09, it is put to use for less than 180 days. It is, therefore, qualified for half of the usual depreciation (i.e., 7.5 per cent).

2. Y Ltd. purchases a plant (rate of depreciation : 15 per cent) on May 10, 2008. It is put to use on January 10, 2010. In this case, the plant is acquired during 2008-09 and in the year 2008-09 it is not put to use at all. Therefore, for the previous year 2008-09 no depreciation will be available. It is put to use in the previous year 2009-10. For the previous year 2009-10, the usual depreciation will be available, as the asset is not acquired during 2009-10, although it is put to use for less than 180 days.

3. X Ltd. owns two buildings A and B on April 1, 2008 (rate of depreciation : 10 per cent, depreciated value: Rs. 14,15,700). It purchases on December 1, 2008 building C for Rs. 3,10,000 (rate of depreciation : 10 per cent) and sells building A during the previous year 2008-09 (say on January 10, 2009) for Rs. 8,70,000, then depreciation for the previous year 2008-09 shall be determined as under :

	Rs.
Depreciated value of the block (*i.e.*, buildings A and B) on April 1, 2008	14,15,700
Add : Cost of building C (purchased on December 1, 2008)	3,10,000
Total	17,25,700
Less : Sale proceeds of building A	8,70,000
Written down value of the block	8,55,700
Depreciation [as building C is purchased in the year 2008-09 and it is put to use for less than 180 days, depreciation on Rs. 3,10,000 will be 50% of 10% of Rs. 3,10,000 and on the remaining amount depreciation will be 10% of (Rs. 8,55,700—Rs. 3,10,000)]	70,070
Depreciated value of the block on April 1, 2009	7,85,630

If in the aforesaid case, building A is sold for Rs. 15,87,000, depreciation will be determined as under :

Depreciated value on April 1, 2008	14,15,700
Add : Cost of building C	3,10,000
Total	17,25,700
Less : Sale proceeds of building A	15,87,000
Written down value	1,38,700
Depreciation [as the written down value is lower than the cost of building C which is put to use for less than 180 days, depreciation shall be 50% of 10% of Rs. 1,38,700]	6,935
Depreciated value of the block on April 1, 2009	1,31,765

4. The depreciated value of a block of assets (consisting of Plants A and B) (rate of depreciation 30 per cent) owned by a trading company is Rs. 1,17,000 on April 1, 2008 [Plant A : Rs. 1,00,000 + Plant B : Rs. 17,000]. The following information is available —

Asset	Rate of depreciation (per cent)	Date of purchase	When it is put to use	Actual cost Rs.
Plant C	30	March 10, 2008	April 10, 2008	20,000
Plant D	30	March 1, 2008	December 3, 2008	30,000
Plant E	30	May 6, 2008	May 6, 2008	40,000
Plant F	30	May 15, 2008	January 2, 2009	60,000
Plant G	30	June 6, 2009	April 6, 2009	80,000

Plant A is sold on August 16, 2008 for Rs. 86,000. Depreciation shall be determined as under for the previous year 2008-09—

	Rs.
Depreciated value of the block (*i.e.*, Plants A and B) on April 1, 2008	
Plant A : Rs. 1,00,000	
Plant B : Rs. 17,000	
Plant C† : Rs. 20,000	
Plant D† : Rs. 30,000	1,67,000
Add : Cost of Plant E acquired during the year 2008-09 and put to use for more than 180 days [usual depreciation will be available]	(+) 40,000
Add : Cost of Plant F which is acquired during 2008-09 and it is put to use for less than 180 days [it will be qualified for half depreciation]	(+) 60,000

†Plant C and D were purchased during the previous year 2007-08. These will be part of the block on April 1, 2008. This rule is applicable even if these plants were not put to use in the previous year 2007-08 and depreciation will be available for the first-time in the previous year 2008-09.

	Rs.
Total	2,67,000
Less : Sale proceeds of Plant A	(—) 86,000
Written down value of the block consisting of Plants B, C, D, E and F	1,81,000
Amount of depreciation [*i.e.*, 15 per cent of Rs. 60,000 + 30 per cent of Rs. 1,21,000]	45,300

If, however, in this case Plant A is sold for Rs. 2,12,000, then depreciation shall be determined as under —

Total [as determined above]	2,67,000
Less : Sale proceeds of Plant A	(—) 2,12,000
Written down value	55,000

Since the written down value is less than the cost of Plant F which is eligible for half depreciation, depreciation shall be 15 per cent of Rs. 55,000.

109.7-3 ***PROBLEM ON NORMAL DEPRECIATION*** - To have better understanding of depreciation provisions, the following problems are given :

109.7-P1 *X owns the following assets on April 1, 2008 :*

Assets	Written down value on April 1, 2008 Rs.	Rate of depreciation (per cent)
Furniture	*20,170*	*10*
Building	*9,00,500*	*10*
Building	*2,10,000*	*5*
Plant and machinery	*63,55,000*	*15*
Plant and machinery	*2,05,000*	*40*
Maruti car	*45,000*	*15*

During the previous year 2008-09, the following assets are purchased by X :

Date of purchase	Assets	Cost Rs.	Rate of depreciation (per cent)
September 15, 2008	*Three calculators*	*14,000*	*15*
June 20, 2008	*Plant (second hand)*	*1,90,000*	*15**
November 30, 2008	*Foreign made car*	*1,65,000*	*15*
June 6, 2008	*Patent right*	*2,00,000*	*25*
July 16, 2008	*Trade marks*	*50,000*	*25*

Determine the amount of depreciation for the assessment year 2009-10 assuming that trade marks are put to use after 6 months and other assets are put to use within one week from the date of purchase.

*Admissible rate is 40 per cent if conditions of rule 5(2) are satisfied [for rule 5(2), *see* para 109.5].

SOLUTION : DEPRECIATION WILL BE DETERMINED AS UNDER

	First block Furniture	Second block Building	Third block Building	If assets purchased on June 20, 2008 satisfy conditions of Rule 5(2)		If such conditions are not satisfied		Sixth block Patent rights	Seventh block Trade marks
				Fourth block Plant	Fifth block Plant	Fourth block Plant	Fifth block Plant		
1	2	3	4	5	6	7	8	9	10
Rate of depreciation	10%	10%	5%	15%	40%	15%	40%	25%	25%
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
Depreciated value on April 1, 2008	20,170	9,00,500	2,10,000	64,00,000	2,05,000	64,00,000	2,05,000	—	—
Add : Assets acquired during the previous year	—	—	—	1,79,000	1,90,000	3,69,000	—	2,00,000	50,000
Written down value	20,170	9,00,500	2,10,000	65,79,000	3,95,000	67,69,000	2,05,000	2,00,000	50,000
Depreciation	2,017	90,050	10,500	9,74,475*	1,58,000	10,02,975**	82,000	50,000	6,250†

ADMISSIBLE DEPRECIATION FOR THE ASSESSMENT YEAR 2009-10

	If assets purchased on June 20, 2008 satisfy conditions of Rule 5(2)	If such conditions are not satisfied
	Rs.	Rs.
First block	2,017	2,017
Second block	90,050	90,050
Third block	10,500	10,500
Fourth block	9,74,475	10,02,975
Fifth block	1,58,000	82,000
Sixth block	50,000	50,000
Seventh block	6,250	6,250
Total	12,91,292	12,43,792

109.7-P2 *X Ltd. acquires a plant (additional depreciation is not available) on hire purchase system from Y Ltd. on December 1, 2007 (depreciation rate 15 per cent). Four instalments of Rs. 20,000 are payable quarterly on March 1, 2008, June 1, 2008, September 1, 2008 and December 1, 2008. The cash price of the plant is Rs. 64,000. The depreciated value of the block on April 1, 2007 is Rs. 36,000. X Ltd. pays Rs. 20,000 per quarter up to September 1, 2008. On default by X Ltd. to make further payment, Y Ltd. takes possession of the plant on December 3, 2008.*

SOLUTION :

	Rs.
Hire purchase price (4 × Rs. 20,000)	80,000
Cash down price	64,000
Interest	16,000

*15% of 50% of Rs. 1,65,000 *plus* 15% of Rs. 64,14,000.

†50% of 25% of Rs. 50,000.

**15% of 50% of Rs. 1,65,000 *plus* 15% of Rs. 66,04,000.

Date	Amount outstanding before payment of instalment	Amount outstanding after payment of instalment	Interest* (Rs. 16,000)	Principle (Rs. 64,000)
	Rs.	Rs.	Rs.	Rs.
December 1, 2007	80,000	80,000	-	-
March 1, 2008	80,000	60,000	6,400	13,600
June 1, 2008	60,000	40,000	4,800	15,200
September 1, 2008	40,000	20,000	3,200	16,800
December 1, 2008	20,000	*Nil*	1,600	18,400
Total	-	-	16,000	64,000

Depreciated value of the block on April 1, 2007	36,000
Add : Actual cost of the plant acquired on December 1, 2007	64,000
Written down value on March 31, 2008	1,00,000
Less : Depreciation for 2007-08 (15% of Rs. 36,000 + 7.5% of Rs. 64,000)	10,200
Depreciated value on April 1, 2008	89,800
Less : Sale proceeds of the plant repossessed by Y Ltd. on December 3, 2008	18,400
Written down value on March 31, 2009	71,400
Less : Depreciation @ 15% for the previous year 2008-09	10,710
Deduction in respect of interest	
Previous year 2007-08	6,400
Previous year 2008-09	8,000
Total deduction under section 36	14,400

109.8 ***Computation of additional depreciation*** - The provisions are given below—

109.8-1 CONDITIONS - To claim additional depreciation the following conditions should be satisfied—

Condition one	The assessee must be engaged in manufacture/production of any article or thing.
Condition two	New plant and machinery should be acquired and installed after March 31, 2005.
Condition three	It should be an eligible plant and machinery.

109.8-1a MANUFACTURE/PRODUCTION OF ANY ARTICLE - The assessee should be engaged in the manufacture of production of any article or thing (maybe priority sector item or even non-priority sector item given in the Eleventh Schedule). The words "manufacture" or "production", "article" and "thing" have been interpreted in a number of judicial pronouncements and according to these judgments, a taxpayer engaged in the following activities is not eligible for additional depreciation—

- Cooking food in a hotel—*Indian Hotels Co. Ltd.* v. *ITO* [2000] 112 Taxman 48 (SC).
- Construction of dam, building or contract for civil engineering—*CIT* v. *Buildmet (P.) Ltd.* [1993] 204 ITR 413 (SC), *CIT* v. *N.C. Budharaja & Co.* [1993] 204 ITR 412 (SC).
- Cutting and polishing raw diamonds—*CIT* v. *Gem India Manufacturing Co.* [2001] 249 ITR 307 (SC).
- Hatching of eggs—*CIT* v. *Venkateswara Hatcheries (P.) Ltd.* [1999] 237 ITR 174 (SC).

*Total interest of Rs. 16,000 is divided in the ratio of 80 : 60 : 40 : 20.

- Pressure piling for building—*CIT* v. *Pressure Piling Co. (I) (P.) Ltd.* [1993] 204 ITR 412 (SC).
- Minning of stones—*Lucky Minerals (P.) Ltd.* v. *CIT* [2001] 116 Taxman 1 (SC).

For detailed discussion, *see* para. 254.1-1d[1].

109.8-1b NEW PLANT AND MACHINERY INSTALLED AND ACQUIRED AFTER MARCH 31, 2005 - Additional depreciation is available only in respect of new plant and machinery acquired and installed after March 31, 2005. The following points should be noted—

■ Additional depreciation is not available in respect of building or furniture even if the other conditions are satisfied.

■ Additional depreciation is not available in respect of old plant and machinery. The word "new" is not defined in the Income-tax Act. According to the *Shorter Oxford Dictionary* the word "new" means "not existing before ; now made, or brought into existence, for the first time".

In *Cochin Co.* v. *CIT* [1968] 67 ITR 199, the Supreme Court held that to find out whether (or not) reconditioned machinery can be treated as "new" machinery, the following factors should be taken into consideration—

a. whether the machine after being reconditioned is entirely different from the old machine and whether the latest improvements incorporated into it made the machine substantially new ;

b. the nature and cost of these improvements ;

c. the date on which the machine was manufactured ;

d. for what period it was previously used ;

e. what are the latest available technical improvements which are incorporated therein.

109.8-1c ELIGIBLE PLANT AND MACHINERY - Any plant and machinery which has been acquired and installed after March 31, 2005 by an assessee is qualified for additional depreciation. However, the following assets are not eligible for additional depreciation—

a. ships and aircrafts ; or

b. any machinery or plant which, before its installation by the assessee, was used either within or outside India by any other person ; or

c. any machinery or plant which is installed in any office premises or any residential accommodation, or accommodation in the nature of a guest house ; or

d. any office appliances or road transport vehicles ; or

e. any machinery or plant, the whole of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income chargeable under the head "Profits and gains of business or profession" of any one previous year.

■ Mobile crane used in quarrying operations is not road transport vehicle but an item of machinery and hence the assessee would be entitled to additional depreciation—***CIT*** v. ***Shriram Transport Finance Co. Ltd.*** [2003] 128 Taxman 123 (Mad.).

■ Wireless sets are not office appliances—***CIT*** v. ***Punjab Wireless Systems Ltd.*** [2007] 160 Taxman 118 (Punj. & Har.).

■ In ***CIT*** v. ***Statronics & Enterprises (P.) Ltd*** [2007] 165 Taxman 153/288 ITR 455 (Guj.), the assessee was held entitled to additional depreciation on computers installed for the following functions:

a. data processing;

b. system designing;

c. software development and supply.

The Gujarat High Court held that if office premises are used as industrial premises for carrying out either of the above activities, then the computers installed for either of such purposes would constitute plant and machinery and not just office equipments.

109.8-2 *RATE OF ADDITIONAL DEPRECIATION* - Additional depreciation shall be available @ 20 per cent of the actual cost of new plant and machinery acquired and installed after March 31, 2005. If,

however, the asset is put to use for less than 180 days in the year in which it is acquired, the rate of additional depreciation will be 10 per cent. Additional depreciation is available only in the year in which the new plant and machinery is first put to use.

109.8-P1 *X Ltd. is engaged in the business of manufacture of computer hardware since 1995. During the previous year 2008-09, the following assets are acquired and put to use—*

(Rs. in thousand)

	Block 1	Block 2	Block 3
Rate of depreciation	*15%*	*30%*	*60%*
Number of assets in the block	*11*	*12*	*17*
Depreciated value of the block on April 1, 2008	*18,00*	*25,00*	*5,00*
Additions of plants (new) during the previous year 2008-09			
Plant A	*57,00*	—	—
Plant B	—	*4,00*	—
Plant C	—	—	*17,00*
Sale of old plants (one plant in each block)	*8*	*28,70*	*42,00*

Plants A, B and C are acquired during May 2008 and put to use during September 2008. However, Plant B is put to use in the last week of March 2009. Find out the amount of depreciation, additional depreciation and capital gains.

SOLUTION : *Computation of additional depreciation*

	Plant A	Plant B	Plant C
Whether additional depreciation is available	Yes	Yes	Yes
Rate of additional depreciation	20%	10%	20%
	Rs.	Rs.	Rs.
Actual cost	57,00,000	4,00,000	17,00,000
Additional depreciation (total Rs. 15,20,000)	11,40,000	40,000	3,40,000
Computation of normal depreciation—			
	Block 1	*Block 2*	*Block 3*
Rate of depreciation	15%	30%	60%
	Rs.	Rs.	Rs.
Depreciated value of the block on April 1, 2008	18,00,000	25,00,000	5,00,000
Add : Actual cost of Plants A, B and C acquired during the previous year	57,00,000	4,00,000	17,00,000
Total (a)	75,00,000	29,00,000	22,00,000
Less : Sale proceeds of old plants	(-) 8,000	(-) 28,70,000	(-) 42,00,000
Written down value of the block on March 31, 2009	74,92,000	30,000	*Nil*
Less : Normal depreciation	11,23,800	4,500	*Nil*
Less : Additional depreciation as computed earlier	11,40,000	40,000	3,40,000
Depreciated value of the block on April 1, 2009	52,28,200	*Nil*	*Nil*
Computation of capital gains			
Sale proceeds of old plants	8,000	28,70,000	42,00,000
Whether capital gain is taxable [*the block does not cease to exist, sale proceeds do not exceed the opening balance *plus* new addition, *i.e.*, (a)]	No*	No*	Yes
Less : Cost of acquisition [*i.e.*, (a)]	-	-	22,00,000
Short-term capital gain	*Nil*	*Nil*	20,00,000

Note - X Ltd. can claim normal depreciation of Rs. 11,28,300 [*i.e.*, Rs. 11,23,800 + Rs. 4,500]. Besides, it is also eligible for additional depreciation of Rs. 15,20,000 as computed above.

109.9 *Unabsorbed depreciation* - While dealing with unabsorbed depreciation one should keep in mind the following steps:

[illegible]	Depreciation allowance of the previous year is first deductible from the income chargeable under the head "Profits and gains of business or profession".
[illegible]	If depreciation allowance is not fully deductible under the head "Profits and gains of business or profession" because of absence or inadequacy of profits, it is deductible from income chargeable under other heads of income (except income under the head "Salaries") for the same assessment year.
[illegible]	If depreciation allowance is still unabsorbed, it can be carried forward to the subsequent assessment year(s) by the same assessee [*see* also the points given below]

Notes:

1. No time-limit is fixed for the purpose of carrying forward of unabsorbed depreciation; it can be carried forward for indefinite period, if necessary.

2. In the subsequent year(s), unabsorbed depreciation can be set off against any income whether chargeable under the head "Profits and gains of business or profession" or under any other head (except income under the head "Salaries"). In the matter of set off, the following order of priority is followed in the subsequent year(s) :

a. Current depreciation.

b. Brought forward business loss.

c. Unabsorbed depreciation.

It may be said that if in the subsequent year(s), there is no brought forward business loss, unabsorbed depreciation can be added to current depreciation for the purpose of claiming deduction.

3. Continuity of business is not relevant for the purpose of above set off and carry forward.

4. Depreciation can be carry forward by the same assessee. This rule is, however, not applicable in some cases [for a few exceptions, *see* paras 516.5, 517.5 and 519.3].

5. The unabsorbed depreciation to be carried forward cannot enhanced by an amount equal to income assessed to tax under section 115JB—***CIT*** v. ***Nicco Uco Alliance Credit Ltd.*** [2008] 166 Taxman 250 (Mad.).

109.9-P1 *X submits the following particulars :*

	Previous years	
	2008-09 Rs.	2009-10 Rs.
Income from salary	*1,00,000*	*2,00,000*
Business profits (before depreciation)	*16,000*	*18,000*
Current depreciation	*1,34,000*	*1,32,000*
Income from other sources	*10,000*	*80,000*

Determine the taxable income of X for the assessment years 2009-10 and 2010-11.

SOLUTION : *Assessment year 2009-10 (previous year 2008-09)*

Profits and gains of business or profession :		
Business profits	16,000	
Less : Depreciation	1,34,000	*Nil*
Depreciation not deductible against business profits	1,18,000	
Income from salary		1,00,000
Income from other sources :		
Income	10,000	
Less : Depreciation	10,000	*Nil*
Depreciation to be carried forward to the next year	1,08,000	
Net income		1,00,000

	2008-09 Rs.	2009-10 Rs.
Assessment year 2010-11 (previous year 2009-10)		
Profits and gains of business or profession :		
Business income	18,000	
Less : Depreciation (*i.e.*, current depreciation : Rs. 1,32,000 + un-absorbed depreciation of the previous year 2008-09 : Rs. 1,08,000)	2,40,000	*Nil*
Depreciation not deductible against business income	2,22,000	
Income from salary		2,00,000
Income from other sources :		
Income	80,000	
Less : Depreciation	2,22,000	*Nil*
Net income		2,00,000

Note : As per section 71(2A), an assessee shall not be entitled to set-off of any loss under the head "Profits and gains of business or profession" against income under the head "Salaries". Consequently, unabsorbed depreciation of Rs. 80,000 is set off against income from other sources and remaining unabsorbed depreciation of Rs. 1,42,000 will be carried forward.

109.9-P2 *X submits the following particulars :*

	Previous years 2008-09 Rs.	2009-10 Rs.
Business profits (before depreciation)	*(-) 50,000*	*45,000*
Current depreciation	*18,000*	*20,000*
Income from other sources	*20,000*	*70,000*

Determine the net income of X for the assessment years 2009-10 and 2010-11.

SOLUTION : *Assessment year 2009-10 (previous year 2008-09)* :

Income from other sources	20,000	
Less : Business loss	20,000	
Net income		*Nil*
Amount to be carried forward :		
❑ Business loss Rs. 30,000		
❑ Unabsorbed depreciation Rs. 18,000		
Assessment year 2010-11 (previous year 2009-10)		
Profits and gains of business or profession :		
Business profits	45,000	
Less : Current depreciation	20,000	
Profit after depreciation	25,000	
Less : Brought forward business loss of the previous year 2008-09	30,000	*Nil*
Business loss of previous year 2008-09 to be carried forward to the next year	5,000*	
Income from other sources :		
Income	70,000	
Less : Unabsorbed depreciation of the previous year 2008-09	18,000	52,000
Net Income		52,000

*Brought forward business loss can be set off only against business profits and not against any other income [see also para 229.1]

109.10 ***Meaning of "actual cost" [Sec. 43(1)]*** - It means the actual cost to the assessee as reduced by the proportion of the cost thereof, if any, as has been met, directly or indirectly, by any other person or authority.

For instance, an assessee, who purchases a machine for Rs. 70,000 and gets a cash subsidy of Rs. 10,000 from the Government, "actual cost" will be Rs. 60,000 (*i.e.*, Rs. 70,000 — Rs. 10,000) and he will be entitled for depreciation on Rs. 60,000 and not on Rs. 70,000.

109.10-1 *WHAT IS INCLUDIBLE IN ACTUAL COST* - The expression "actual cost" should be construed in the sense which no man of commerce would misunderstand. For this purpose, it would be necessary to ascertain the connotation of the expression in accordance with the normal rules of accountancy prevailing in commerce and industry. The accepted accounting rule for determining cost of fixed asset is to include all expenses directly relatable to acquisition of the asset (*viz.*, cost price of the asset, interest on money borrowed for the purchase of the asset, bank charges) ; expenses necessary to bring the asset to site, install it and make it fit for use (*viz*, carriage inwards, loading and unloading charges, installation charges, etc.) ; and expenses incurred to facilitate the use of the asset (*viz.*, cost of repairs and modification prior to use of the asset to make it workable, training expenses of the staff before the use of the plant, expenses on essential construction work such as cold storage rooms, cooling towers, etc.) and expenses on insurance, power and fuel, incurred before commencement of business.

109.10-1a INTEREST - If capital is borrowed for acquiring a depreciable asset or capital asset, then the following two specific provisions should be kept in view—

1. Explanation 8 to section 43(1) - If capital is borrowed for acquiring an asset, then interest on such borrowed capital pertaining to the period after such asset is put to use cannot be added to "actual cost". This rule is applicable regardless of the fact whether the assessee is a new concern or an existing concern. Moreover, *Explanation 8* to section 43(*1*) nowhere provides that interest pertaining to a period prior to an asset being first put to use will not be allowed as a deduction under section 36(1)(*iii*)—*CIT* v. *Core Healthcare Ltd.* [2001] 251 ITR 61 (Guj.).

2. Proviso to section 36(1)(iii) - Proviso to section 36(1)(*iii*) is applicable if the following conditions are satisfied—

a. capital is borrowed for acquiring a capital asset;

b. interest is paid (or payable) in respect of the borrowed capital;

c. the capital is borrowed for acquisition of an asset for the purpose of extension of an existing business or profession [it may be noted that because of this condition, proviso to section 36(1)(*iii*) is not applicable in the case of a newly started concern]; and

d. in the books of account, the interest liability may (may not be) capitalised.

If the above conditions are satisfied, then interest liability for the period commencing from the date of borrowing till the date on which such asset was first put to use, shall not be allowed as deduction under section 36(1)(*iii*)†. It may be noted that proviso to section 36(1)(*iii*) is not applicable in the case of a newly started concern.

The cumulative impact of the above two specific provisions is given in the table (*infra*)

Different situations	Stage	Tax treatment
Situation 1 - Business is newly set up in the case of newly started concern	Up to the time of commencement of commercial production	Interest liability up to the stage of commencement of production should be capitalized—*Challapalli Sugars Ltd.* v. *CIT* [1975] 98 ITR 167 (SC).
	After the asset is first put to use	It cannot be capitalised [*Expln.* 8 to sec 43(*1*)]. It may be claimed as deduction under section 36 [*see* also Note 1]

†It can be capitalised for claiming depreciation.

Situation 2 - An existing concern acquiring asset for expanding the same business	Up to the time the asset is put to use	It can be capitalised (*i.e.*, added to the cost of asset). It cannot be claimed as deduction as revenue expenditure under section 36 [proviso to sec. 36(1)(*iii*)]
	After the asset is first put to use	It cannot be capitalised [*Expln.* 8 to sec. 43(*1*)]. It may be claimed as deduction under section 36
Situation 3 - An existing concern acquiring assets to set up a new undertaking which is an extension to existing business	*See* Situation 2	
Situation 4 - An existing concern acquiring asset to set up a new undertaking which is not an extension to the existing business [*see* also Note 2]	*See* Situation 1	

Notes :

1. If certain assets are put to use sometime after the commencement of commercial production, then interest of the period after the commencement of commercial production but before the asset is first put to use, may be capitalised. Alternatively (at the option of the taxpayer) interest can be claimed as deduction under section 36 as revenue expenditure [proviso to sec. 36(1)(*iii*) is not applicable]. It may be noted that this option is available only in *Situations 1* and *4.*

2. In order to determine whether different ventures can be said to constitute the same business or not, what one has to see is whether there is any inter-connection, inter-lacing, inter-dependence, inter-unity embracing the ventures, whether the different ventures are so inter-laced and so dovetailed into each other so as to make them into the same business—***Sterlite Industries (India) Ltd.*** v. ***CIT*** [2006] 6 SOT 504 (Mum.).

109.10-1b GUARANTEE COMMISSION - In *CIT* v. *Fort Gloster Industries Ltd.* [1971] 79 ITR 48 (Cal.) the assessee paid commission to a bank for standing guarantee for the purchase of machinery from a foreign firm. The Court *held* that the commission paid would form part of the actual cost of the machinery.

109.10-1c INCREASE IN LIABILITY ON ACCOUNT OF DEVALUATION - If as a result of devaluation, the liability in respect of repayment of the moneys borrowed for the purchase of machinery increases, it can be legitimately taken into account in determining the actual cost of the machinery. For detailed discussion, *see* para 160.

109.10-1d HOUSE TAX, GROUND RENT, ETC. - In *Kapur Sons & Co.* v. *CIT* [1985] 23 Taxman 66 (Delhi) the assessee capitalised certain expenses including sums spent on ground rent, corporation tax and house tax towards the construction of cinema building on a leasehold plot in the relevant previous year. The Court *held* that, in the instant case, the cinema was built on a leasehold plot for which ground rent was to be paid. This ground rent had to be paid for the entire period of the lease. Similarly, the house tax and corporation tax paid prior to the construction of cinema was a tax charged by the corporation in relation to the plot. These taxes and ground rent had to be paid in any event whether the cinema was built or not and so they could not be treated as part of the cost of the building, *i.e.*, the cinema itself. Also there was no nexus between the ground rent, house tax and the corporation tax and the construction cost of the building. Again, the value of the plot did not go up by the payment of the house tax or the ground rent. Accordingly, these amounts could not be capitalised and did not form part of the cost of the building for the purpose of depreciation allowance.

▪ Where the assessee-company had paid extra ground rent for its land, for its conversion into commercial land and later building was constructed thereon and commercialisation charges were

paid for commercial use of building, commercial charges paid were in respect of building and were to be treated as actual cost of building for allowance of depreciation—*CIT* v. *Hindustan Times Ltd.* [1998] 231 ITR 747 (SC).

109.10-1e SALARIES, GUEST HOUSE EXPENSES FOR ERECTION STAFF, ETC. - In *CIT* v. *Hindustan Polymers Ltd.* [1985] 156 ITR 860 (Bom.), the facts were that the assessee-company was established for manufacturing polystyrene products. In manufacturing these products, three stages were involved : (*a*) manufacture of alcohol, (*b*) manufacture of styrene by using alcohol, and (*c*) manufacture of polystyrene by using styrene. Three different units of plant and machinery were thus required to be installed and during the year under consideration, the assessee was only able to install the alcohol manufacturing plant. During the period of construction of the building and installation of plant the assessee had incurred expenses on salaries, maintenance of guest house for erection staff and vehicle expenses in setting up the plant and general expenses also pertaining to the setting up of the plant. The Court *held* that the entire amount could be claimed by the assessee as part of the actual cost.

Again in *CIT* v. *Rane (Madras) Ltd.* [1978] 112 ITR 241, the Madras High Court *held* that salaries and wages paid to technical staff incharge of the erection of the plant, paid to architects for preparing layout of the plant, and expenditure on re-doing defective foundations for erection of the plant should all be added to the actual cost of plant and machinery.

109.10-1f STAFF TRAINING EXPENSES - If the staff training is relatable to the installation of the machinery, then it would undoubtedly be includible in the actual cost of the assets of the assessee within the meaning of section 43(*1*). But if the training expenditure was incurred in relation to imparting training only in maintenance or operational processes, then it may not constitute part of the fixed assets or actual cost of the machinery — *Sunil Synchem Ltd.* v. *CIT* [1986] 24 Taxman 399 (Raj.).

109.10-1g PRE-PRODUCTION EXPENSES - Pre-production expenditure of a new industry, like salaries, rent, lighting, etc., can be allocated to the various capital assets for eligibility of depreciation allowance — *CIT* v. *Lucas-T.V.S. Ltd. (No. 2)* [1977] 110 ITR 346 (Mad.).

Similarly in *Shree Vallabh Glass Works Ltd.* v. *CIT* [1981] 127 ITR 37 (Guj.) and *CIT* v. *Saurashtra Cement & Chemical Industries Ltd.* [1981] 127 ITR 47 (Guj.), it was *held* that expenses incurred before commencement of production, which are necessary for bringing assets into existence and putting them into working condition, form part of actual cost of plant and machinery. The following points should also be kept in view—

1. Miscellaneous expenses, allocated to technical matters, which are incurred in connection with construction activities and are capitalised would be eligible for depreciation and development rebate—*CIT* v. *South Petro Chemical Industries Corporation Ltd. (No. 1)* [1998] 233 ITR 391 (Mad.).

2. Depreciation would be allowable on horticulture expenditure incurred during the pre-commencement stage and capitalised by the assessee—*CIT* v. *Southern Petro Chemical Industries Corporation Ltd. (No. 1)* [1998] 233 ITR 391 (Mad.).

3. Where during the pre-commencement stage, the assessee-company opened a letter of credit for purchase of machinery for its factory and made fixed deposits in connection therewith, interest earned on such deposits could not be assessed as income from other sources in the assessee's hands but would go to reduce the cost of asset acquired—*Karnal Co-operative Sugar Mills Ltd.* v. *CIT* [1998] 233 ITR 531 (Punj. & Har.).

109.10-1h EXPENDITURE ON TEST RUN OF MACHINERY - Expenses incurred for test runs of plant and machinery before the same are ready to commence commercial production, are part of actual cost of plant and machinery—*CIT* v. *Food Specialities Ltd.* [1982] 136 ITR 203 (Delhi). If, however, any amount is realised on sale of products manufactured in a trial run, then the excess of expenses incurred over amount recovered from sale of products shall be added to cost of plant and machinery. Conversely, if the amount recovered from sale of products generated by such trial run is more than expenses incurred on trial run, then difference shall be deducted from cost of plant and machinery.

Provisions illustrated - X Ltd. purchases two plants – Plant A for Rs. 25 lakh (depreciation rate : 15 per cent) and Plant B for Rs. 40 lakh (depreciation rate : 30 per cent). Before commencement of commercial production, the following expenses are incurred on trial run of two plants—

	[illegible]	[illegible]
Expenses on trial run	25,000	40,000
Amount realised on sale of products generated by trial run	10,000	45,000
Amount to be added to the cost of assets	15,000	-5,000
"Actual cost" of assets for the purpose of section 43(1)	25,15,000	39,95,000

109.10-1i COMPENSATION FOR DELAYED DELIVERY OF MACHINERY - In *Shree Digvijay Cement Co. Ltd.* v. *CIT* [1982] 138 ITR 45 (Guj.) the seller had to pay compensation to the purchaser for delay in delivery of the machinery but the Court *held* that such compensation received by the purchaser could not go to reduce the cost of machinery as it had nothing to do with the cost of machinery but was paid to set off the loss occasioned by the said delay.

109.10-1j REBATE FOR DEFECTIVE MACHINERY - In *CIT* v. *Rohtas Industries Ltd.* [1981] 130 ITR 292 (Cal.) a rebate was allowed by the supplier of a certain machinery to the assessee since the machinery was defective and this amount of rebate was taxed in the assessee's hands as a revenue receipt. The Court *held* that the impugned rebate could not be deducted while determining the actual cost of the machinery.

109.10-1k FOUNDATION STONE LAYING CEREMONY EXPENSES - Expenditure incurred on account of the foundation stone laying ceremony is to be added to the cost of the factory building as the foundation is a part of the construction and forms part of the actual cost of the assets for the grant of depreciation allowance—*CIT* v. *Nirlon Synthetic Fibres & Chemicals Ltd.* [1982] 137 ITR 1 (Bom.).

109.10-1l CONSIDERATION FOR KNOW-HOW FOR ERECTION AND COMMISSIONING OF PLANT - Cost of fixed assets includes all expenditure necessary to bring them into existence and to put them into working condition. Hence, entire lump sum payment made to a foreign company in consideration of supply of technical know-how for erection and commissioning of plant has to be included in the actual cost of plant and machinery—*D. & H. Secheron Electrodes* v. *CIT* [1981] 132 ITR 1 (MP).

However, in *CIT* v. *J. M. A. Industries Ltd.* [1981] 129 ITR 373 the Delhi High Court *held* that expenditure incurred on training of technical advisers, being only to facilitate the working of machinery, could not be included in the actual cost of plant and machinery.

109.10-1m TRAVELLING EXPENDITURE - Expenditure on travelling incurred for acquiring depreciable assets is part of actual cost— *CIT* v. *L. G. Balakrishnan & Bros. (P.) Ltd.* [1974] 95 ITR 284 (Mad.), *CIT* v. *J. M. A. Industries Ltd.* [1981] 129 ITR 373 (Delhi).

109.10-1n INCREASE IN COST DUE TO REVALUATION - If assets are revalued (either upward or downward), it does not have any impact on computation of depreciation under section 32.

109.10-1o TAX LIABILITY OF FOREIGN COLLABORATOR - Amount paid by the assessee in discharge of income-tax liability of a foreign collaborator would form part of consideration for the agreement relating to know-how and would have to be treated as part of the assets of the assessee—*CIT* v. *Standard Polygraph Machines (P.) Ltd.* [2000] 243 ITR 788 (Mad.).

109.10-1p INCOME FROM UTILITIES DIRECTLY CONNECTED WITH SETTING UP OF PLANT AND MACHINERY OR CONSTRUCTION OF BUILDING - TAX TREATMENT - The Supreme Court has given certain guidelines regarding tax treatment of income which is inextricably linked with the process of setting up of plant and machinery or construction of buildings. These guidelines are given in three cases—*CIT* v. *Bokaro Steel (P.) Ltd.* [1999] 102 Taxman 94, *Tuticorin Alkali Chemicals and Fertilizers Ltd.* v. *CIT* [1997] 227 ITR 172 and *CIT* v. *Karnal Co-operative Sugar Mills Ltd.* [2001] 118 Taxman 489. The problem given below is based upon the facts of these cases—

109.10-1pP1 *X Ltd., incorporated on July 11, 2001, started commercial production during April 2009. During 2008-09, the company has borrowed Rs. 25 lakh for purchase of plant and machinery (interest liability for 2008-09 being Rs. 4 lakh). Before making payment to the supplier of the plant and machinery, the borrowed money is kept with Citibank, New Delhi on which the company has earned Rs. 68,000 as interest. The company wants to deduct Rs. 68,000 from the interest liability of Rs. 4,00,000 in order to capitalise the net interest liability of Rs. 3,32,000.*

Besides, during construction of factory building (i.e., during 2008-09) the company has received Rs. 2,64,000 through (i) rent charge (i.e. Rs. 36,000) from its contractors for housing workers and staff employed by contractors for construction work of the assessee, (ii) hire charges (i.e. Rs. 50,000) for plant and machinery given to the contractors for use in construction of factory for the assessee, (iii) interest (i.e., Rs. 86,000) from advances made to the contractors for purpose of facilitating work of construction, and (iv) royalty (i.e., Rs. 92,000) for excavation and use of stones lying on assessee's land for construction work. The company wants to deduct Rs. 2,64,000 from the cost of construction.

In March 2009, the company deposits Rs. 35 lakh to open a letter of credit for the purchase of plant and machinery in terms of agreement with the supplier and earns Rs. 17,600 as interest thereon.

Discuss the tax treatment of the income in the hands of the company.

SOLUTION : In *Tuticorin Alkali Chemicals & Fertilizers Ltd.* v. *CIT* [1997] 227 ITR 172 (SC), it was *held* that if a person borrows money for business purposes, but utilises that money to earn interest (however, temporarily) the interest so generated will be his income. This income can be utilised by the assessee whichever way he likes. Merely because he utilised it to repay the interest on the loan taken will not make the interest income as a capital receipt. For instance, if a company (even before it commences business) invests surplus funds in its hands for purchase of land (or house property) and later sells it at profit, the gain made by the company will be assessable under the head 'Capital gains'.

Take another example, if a company purchases rented house and gets rent, such rent will be assessable to tax under section 22 as income from house property. Likewise, the company may have income from other sources. The company may also keep the surplus funds in short-term deposits in order to earn interest. Such interest will be chargeable under section 56. The Court also emphasised the fact that the company was not bound to utilise the interest so earned to adjust it against the interest paid on borrowed capital. The company was free to use this income in any manner it liked. Therefore, Rs. 68,000 is taxable under section 56(1) under the head "Income from other sources". It cannot be deducted from the interest liability of Rs. 4 lakh. X Ltd. should add Rs. 4,00,000 in the "actual cost" of plant and machinery.

However, while interest earned by investing borrowed capital in short-term deposits is an independent source of income not connected with the construction activities or business activities of the assessee, the same cannot be said for Rs. 2,64,000 which results from the utilisation of various assets of the company and the payments received for such utilisation are directly linked with the activity of setting up the factory of the assessee. These receipts are inextricably linked with the setting up of the capital structure of the assessee-company. They must, therefore, be viewed as capital receipts to reduce the cost of construction. In the case of *Challapalli Sugars Ltd.* v. *CIT* [1975] 98 ITR 167, the Supreme Court *held* that the accepted accountancy rule for determining cost of fixed assets is to include all expenditure necessary to bring such assets into existence and to put them in working condition. In case money is borrowed by a newly started company which is in the process of constructing and erecting its plant, the interest incurred before the commencement of production on such borrowed money can be capitalised and added to the cost of the fixed assets created as a result of such expenditure. By the same reasoning if the assessee receives any amounts which are inextricably linked with the process of setting up its plant and machinery, such receipt will go to reduce the cost of its assets. These are receipts of a capital nature and cannot be taxed as income. The activities of the assessee in connection with the three receipts of Rs. 2,64,000 [*i.e., (i), (ii)* and *(iii)*] are directly connected with or are incidental to the work of construction of its factory undertaken by the assessee. Broadly speaking these pertain to the arrangements made by the assessee with its contractors pertaining to the work of contractors. To facilitate the work of the construction, the assessee permitted the contractor to use the premises of the assessee for housing its staff and workers engaged in the construction activity. This is clearly to facilitate the work of construction. Had this facility not been provided by the assessee, the contractors would have had to make their own arrangements and this would have been reflected in the charges of the contractors for the construction work. Instead, the assessee had provided these facilities. The same reasoning would apply to royalty received by the assessee-company for stones, etc., excavated from the assessee-company's land. The land had been allowed to be utilised by the contractors for the purpose of excavating stones to be used in the construction work of assessee's factory. Therefore, Rs. 2,64,000 shall be deducted from the construction cost of the building and it is not taxable under section 56 under the head "Income from other sources". It is a capital receipt—*CIT* v. *Bokaro Steel (P.) Ltd.* [1999] 102 Taxman 94 (SC).

The assessee deposits money to open a letter of credit for the purchase of the machinery required for setting up its plant in terms of its agreement with supplier. Rs. 17,600, being interest earned thereon, will reduce the cost of the machinery. This is not a case where any surplus share capital money which is lying idle has been deposited in the bank for the purpose of earning interest. The deposit of money in this is directly linked with the purchase of plant and machinery. Hence, any income earned on such deposit is incidental to the acquisition of assets for the setting up of the plant and machinery. Thus, the interest is a capital receipt which would go to reduce the cost of asset—*CIT* v. *Karnal Co-operative Sugar Mills Ltd.* [2001] 118 Taxman 489 (SC).

109.10-2 ***CASES WHEN ACTUAL COST IS TAKEN AT A NOTIONAL FIGURE*** - In the cases given below, actual cost of an asset is taken at a notional figure :

109.10-2a SCIENTIFIC RESEARCH ASSETS [EXPLN. 1 TO SEC. 43(1)] - Where an asset is used in the business after it ceases to be used for scientific research, the actual cost of the asset to the assessee will be the actual cost to the assessee as reduced by the amount of any deduction allowed.

■ For instance, X purchases a plant for Rs. 80,000 on April 22, 1987 for the purpose of carrying on scientific research relating to his business. Rs. 80,000 is allowed as deduction under section 35 for the assessment year 1988-89. On November 11, 2008, the plant is transferred to assessee's factory, after the plant ceases to be used for scientific research. For the purpose of claiming depreciation for the assessment year 2009-10, the actual cost would be *nil* (*i.e.*, Rs. 80,000, being cost price *minus* Rs. 80,000, being the amount of deduction claimed under section 35).

109.10-2b ASSETS ACQUIRED BY GIFT OR INHERITANCE [EXPLN. 2 TO SEC. 43(1)] - Where an asset is acquired by the assessee by way of a gift or inheritance, the actual cost of the asset to the assessee will be actual cost to the previous owner as reduced by the following :

a. depreciation actually allowed in respect of that asset in respect of any previous year relevant to the assessment year commencing before April 1, 1988 ; and

b. depreciation that would have been allowable from the assessment year 1988-89 onwards as if that asset was the only asset in the relevant block of assets [*Expln. 2* to section 43(1)].

■ *Other points* - One should also keep in view the following points—

1. Market value of the asset on the date of acquisition will not be a relevant consideration for determining "actual cost" in such cases.

2. Explanation 2 to section 43(*1*) is applicable only in the case of gift of asset. It does not cover the case of gift or grant of money.

3. Since property taken on partition of a Hindu undivided family does not amount to property inherited by members, *Explanation 2* to section 43(*1*) is not applicable in such a case— *CIT* v. *P.N. Krishna Iyer* [1973] 91 ITR 434 (Ker.).

4. Where certain machinery is gifted by foreign company to the assessee-company, expenditure incurred in bringing machinery to India and installing it is includible in actual cost—*Ciba of India Ltd.* v. *CIT* [1993] 202 ITR 1 (Bom.).

109.10-2bP1 *X owns three plants A, B and C (rate of depreciation : 15%) on April 1, 2006. The depreciated value of the block is as follows :*

	Rs.
Depreciated value of the block consisting of Plants A, B and C on April 1, 2006	*1,55,000*
Add: *Cost of Plant D (second hand) acquired and put to use of November 6, 2006*	*1,00,000*
Less: *Sale proceeds of Plant A sold during 2006-07*	*(-) 1,97,000*
Written down value on March 31, 2007	*58,000*
Less: *Depreciation for the previous year 2006-07 (7.5% of Rs. 58,000)*	*4,350*
Written down value of the block on March 31, 2008 consisting of Plants B, C and D	*53,650*
Less: *Depreciation for the previous year 2007-08*	*8,048*
Depreciated value of the block on April 1, 2008	*45,602*

Plant D is gifted by X to his friend Y on December 20, 2008 (market value of plant : Rs. 86,000).

On April 1, 2008, Y owns two plants (Plants L and M, depreciation rate : 15 per cent). Depreciated value of the block on April 1, 2008 is Rs. 90,000. Plant D is put to use by Y on same day. Find out the amount of depreciation and capital gains in the hands of X and Y for the assessment year 2009-10. What will be cost of acquisition if Plant D is transferred by Y in a subsequent year.

SOLUTION : *Depreciation in the case of X*

	Rs.
Depreciated value of the block consisting of Plants B, C and D on April 1, 2008	45,602
Less: Money payable in respect of asset which is sold, destroyed, demolished or discarded (on gift of Plants D to Y, nothing is received)	*Nil*
Written down value of block consisting of Plants B and C on March 31, 2009	45,602
Less: Depreciation for the previous year 2008-09 @ 15%	6,840
Depreciated value of the block on April 1, 2009	38,762

Capital gain in the hands of X

By virtue of section 47*(iii)*, gift of capital asset is not treated as "transfer". Consequently, nothing is taxable in the hands of X as capital gains.

Depreciation in the case of Y	Rs.
Depreciated value of the block (consisting of Plants L and M) on April 1, 2008	90,000
Add: Actual cost of Plant D acquired by gift from X [see Note]	78,625
Depreciated value of the block (consisting of Plants L, M and D) on March 31, 2009	1,68,625
Less: Depreciation for the previous year 2008-09 (*i.e.*, 7.5% of Rs. 78,625 + 15% of Rs. 90,000)	19,397

Capital gain in the case of Y

During the previous year 2008-09, capital asset is not transferred by Y. Nothing is, therefore, chargeable to tax under the head "Capital gains" for the assessment year 2009-10. If Plant D is transferred by Y in a subsequent year, cost of acquisition will be computed under section 50 [which overrides the provisions of section 49(1)].

Note : Computation of "actual cost" of Plant D in the hands of Y as per *Explanation* 2 to section 43(1)

	Rs.
Actual cost of Plant D to X on November 6, 2006	1,00,000
Less: Depreciation for the previous year 2006-07 (*i.e.*, 7.5% of Rs. 1,00,000)	7,500
Written down value on April 1, 2007	92,500
Less: Depreciation for the previous year 2007-08 (*i.e.*, 15% of Rs. 92,500)	13,875
Written down value on April 1, 2008 which is taken as "actual cost" in the hands of Y irrespective of market value of the asset on the date of gift	78,625

109.10-2c SECOND HAND ASSETS [EXPLN. 3 TO SEC. 43(1)] - *Explanation 3* to section 43(*1*) is applicable if the following conditions are satisfied —

1. Where, before the date of acquisition by the assessee, the assets were at any time used by any other person for the purposes of his business or profession.

2. The Assessing Officer is satisfied that the main purpose of the transfer of such assets, (directly or indirectly) to the assessee, was the reduction of income-tax liability (by claiming depreciation with reference to an enhanced cost).

■ *If the above conditions are satisfied* - If the aforesaid conditions are satisfied, the actual cost of the asset will be such amount as the Assessing Officer may determine having regard to all the circumstances of the case. Before exercising the option, the Assessing Officer is required to take prior approval of the Joint Commissioner.

■ *Judicial pronouncements* - The following judicial rulings should be noted—

1. Merely stating that dissolution has been effected to defraud the revenue by transfer of assets of the firm to the company is not sufficient. What is more material and necessary is that there should be a finding to the effect that the enhanced cost is incurred with the main purpose of reduction of

liability to income-tax by claiming depreciation on the enhanced cost—*Ashwin Vanaspati Industries* v. *CIT* [2002] 125 Taxman 59 (Guj.).

2. Where the reason for transferring of trucks from one entity to another is purely commercial, such as getting national permits within the limits for vehicles or for obtaining advantage of IDBI loans, *Explanation 3* to section 43(*1*) shall not apply as the purpose of transfers is not tax evasion—***G.C. Associates*** v. ***CIT*** [2003] 80 TTJ (Pune) 539.

3. *Explanation 3* to section 43(*1*) can be applied only if the Assessing Officer is of view that fair market value of assets has been inflated to claim excess depreciation. Where fair market value of asset has been certified by a registered valuer and the Assessing Officer has not appointed his own valuer for valuation of disputed assets and even he has not thought it necessary to examine the said valuer, the valuation report submitted by the assessee should be accepted—*United Technologies Ltd.* v. *CIT* [2000] 73 ITD 150 (Ahd.).

109.10-2cP1 *X Ltd. owns two plants (Plant A and Plant B, depreciation rate : 15 per cent‡). The depreciated value of the block on April 1, 2008 is Rs. 6,12,000. On September 20, 2008, Plant B is transferred to Y Ltd. for Rs. 3,50,000 (fair market value : Rs. 90,000).*

On April 1, 2008, Y Ltd. owns two plants (Plant M and Plant N, depreciation rate : 15 per cent‡). Depreciated value of the block on April 1, 2008 is Rs. 1,15,000. Plant B is put to use by Y Ltd. on November 6, 2008. Plant M is sold by Y Ltd. for Rs. 2,45,000 on March 22, 2009.

Find out the amount of depreciation for the assessment year 2009-10 in the hands of X Ltd. and Y Ltd. under following situations—

1. *The Assessing Officer does not want to take action under* Explanation 3 *to section 43(1).*

2. *After taking prior approval of the Joint Commissioner, the Assessing Officer wants to estimate actual cost of Plant B at Rs. 90,000. The main purpose of transfer as recorded by the Assessing Officer is to reduce the tax liability of Y Ltd. by claiming higher depreciation allowance on inflated cost.*

SOLUTION :

	Situation 1 Rs.	Situation 2 Rs.
Depreciation in the hands of X Ltd.		
Depreciated value of the block on April 1, 2008	6,12,000	6,12,000
Less: Money payable in respect of sale of Plant B	3,50,000	3,50,000
Written down value of the block on March 31, 2009	2,62,000	2,62,000
Depreciation for the previous year 2008-09	39,300	39,300
Depreciation in the hands of Y Ltd.		
Depreciated value of the block on April 1, 2008	1,15,000	1,15,000
Add: Actual cost of Plant B [*determined as per *Expln. 3* to section 43(*1*)]	3,50,000	90,000
Less : Money payable in respect of Plant M sold during the year (*cannot exceed Rs. 1,15,000 + Rs. 90,000)	(-) 2,45,000	(-) 2,05,000*
Written down value on March 31, 2009	2,20,000	*Nil*
Depreciation for the previous year [7.5% of Rs. 2,20,000 as Plant B is put to use for less than 180 days]	16,500	*Nil*
Capital gains on sale of Plant M		
Sale proceeds	2,45,000	2,45,000
Less : Cost of acquisition as per section 50 (*section 50† is not applicable, **Rs. 1,15,000 + Rs. 90,000)	—*	2,05,000**
Short-term capital gain	—	40,000

109.10-2cP2 *X owns a house property. It is let out for residential purpose since 1958. He transfers the house property on June 10, 2008 for Rs. 40,00,000 to A Ltd. A Ltd. starts operating its customer care unit from the house*

†Section 50 is not applicable as the block does not cease to exist or written down value of the block is not reduced to zero.

‡25 per cent up to the assessment year 2005-06.

property. Although the house is purchased by A Ltd. for Rs. 40,00,000, the Assessing Officer wants to invoke provisions of Explanation 3 *to section 43(1) to estimate cost at Rs. 25 lakh. Can he do so ?*

SOLUTION :

The Assessing Officer cannot invoke provisions of *Explanation 3* to section 43(*1*) to estimate cost of house at Rs. 25,00,000 even if the purpose of acquiring the house is to claim higher depreciation. The said *Explanation* can be invoked only if prior to acquisition by A Ltd. (*i.e.*, before June 10, 2008), the house was used by the seller (*i.e.*, X) for his business purposes. Before the sale, X does not use the property for his business purpose. *Explanation 3* to section 43(*1*) cannot be invoked.

Therefore, "actual cost" of the house in the hands of A Ltd. for claiming depreciation will be Rs. 40 lakh.

109.10-2d REACQUISITION OF ASSETS [EXPLN. 4 TO SECTION 43(*1*)] - *Explanation 4* to section 43(*1*) is applicable if the following conditions are satisfied—

1. The taxpayer owns an asset.

2. It is used by him for the purpose of his business or profession.

3. The asset ceases to be his property by reason of transfer or otherwise (it may be transferred to any person even to Government or Government undertaking or it may be transferred by an order of court or it may be sold to an outsider or it may transferred by way of gift).

4. Later on the same asset is reacquired by the taxpayer (it may be reacquired from the person to whom it was transferred or it may be reacquired from any other person).

If the aforesaid conditions are satisfied, then "actual cost" of the asset at the time of reacquisition will be as follows—

a. actual cost of the asset to the assessee when he first acquired the asset as reduced by the amount of depreciation (actually allowed up to the assessment year 1987-88 and depreciation that would have been allowable from the assessment year 1988-89 onwards, as if the asset was the only asset in the relevant block of assets); or

b. actual cost at the time of reacquisition,

whichever is less.

109.10-2dP1 *X Ltd. owns two plants (Plant A and Plant B, depreciation rate 15 per cent*). Depreciated value of the block on April 1, 2003 is Rs. 2,30,000. It purchases Plant C on November 3, 2003 for Rs. 1,90,000 and sells Plant A for Rs. 3,50,000 on December 1, 2003. Additional depreciation is not available.*

Plant C is sold to A Ltd. on May 10, 2006 for Rs. 30,000. X Ltd. reacquires Plant C from A Ltd. (or from any other person) on June 6, 2008 for Rs. 2,00,000. Assume that no other asset is acquired/transferred by X Ltd., find out the amount of depreciation from the assessment year 2004-05 onwards.

SOLUTION :

	Rs.
Depreciated value of the block consisting of Plants A and B on April 1, 2003	2,30,000
Add : Actual cost of Plant C	1,90,000
Less : Sale proceeds of Plant A	(-) 3,50,000
Written down value on March 31, 2004	70,000
Less : Depreciation for the previous year 2003-04 (12.5% of Rs. 70,000)	8,750
Depreciated value of the block on April 1, 2004	61,250
Less : Depreciation for the previous year 2004-05 (25% of Rs. 61,250)	15,312
Depreciated value of the block on April 1, 2005	45,938
Less : Depreciation for the previous year 2005-06 (15% of Rs. 45,938)	6,890
Depreciated value of the block on April 1, 2006	39,047
Less : Sale proceeds of Plant C	30,000
Written down value on March 31, 2007	9,047
Less : Depreciation for the previous year 2006-07 (15% of Rs. 9,047)	1,357
Depreciated value of the block on April 1, 2007	7,690

*Up to the assessment year 2005-06, 25 per cent.

	Rs.
Less : Depreciation for the previous year 2007-08 (15% of Rs. 7,690)	1,154
Depreciated value of the block on April 1, 2008	6,536
Add : "Actual cost" of Plant C reacquired on June 6, 2008 [see Note 1]	1,05,984
Written down value of the block on March 31, 2009	1,12,520
Less : Depreciation for the previous year 2008-09 (15% of Rs. 1,12,520)	16,878
Depreciated value of the block on April 1, 2009	95,642

Notes :

1. Actual cost of Plant C at the time of reacquisition on June 6, 2008 is determined as follows—

Cost of Plant C acquired on November 3, 2003	1,90,000
Less : Depreciation for previous year 2003-04 (12.5% of Rs. 1,90,000)	23,750
Depreciated value on April 1, 2004	1,66,250
Less : Depreciation for the previous year 2004-05 (25% of Rs. 1,66,250)	41,562
Depreciated value on April 1, 2005	1,24,688
Less : Depreciation for the previous year 2005-06 (15% of Rs. 1,24,688)	18,703
Depreciated value on April 1, 2006 (*i.e.*, written down value when the Plant C is sold) (*a*)	1,05,984
Cost at the time of reacquisition (*b*)	2,00,000

"Actual cost" under *Explanation 4* to section 43(*1*) shall be Rs. 1,05,984 [(*a*) or (*b*), whichever is lower]. If Plant C is reacquired for less than Rs. 1,05,984 (say Rs. 86,000), cost of acquisition at the time of reacquisition will be Rs. 86,000.

2. Actual cost as determined in (*1*) (*supra*) will remain the same even if X Ltd. sells Plant C to A Ltd. on May 10, 2006, A Ltd. sells it to B Ltd., B Ltd. sells it to C Ltd. and C Ltd. sells it to X Ltd. on June 6, 2008. Moreover, the above calculation will not be affected in the following situations—

a. if Plant C is not eligible for depreciation in the hands of A Ltd., B Ltd. or C Ltd.; or

b. if Plant C is eligible for depreciation but A Ltd., B Ltd. or C Ltd. have not claimed depreciation; or

c. while allowing depreciation in the hands of A Ltd., B Ltd. or C Ltd. the Assessing Officer has invoked the provisions of *Explanation 3* to section 43(*1*).

3. One can reduce tax liability in some cases by transferring asset and reacquiring the same after a few years. For instance, in the given problem if Plant C is not transferred, the quantum of depreciation for the previous year 2007-08 (and subsequent years) will be lower.

109.10-2e SALE AND LEASEBACK [EXPLN. 4A TO SECTION 43(1)] - *Explanation 4A* to section 43(*1*) is applicable if the following conditions are satisfied—

1. S [named as "second person" in *Explanation 4A* to section 43(*1*)] owns an asset.

2. The asset is used by S for the purpose of his business or profession.

3. Depreciation under section 32 is claimed by S.

4. S transfers the asset to F [named as "first person" in *Explanation 4A* to section 43(*1*)].

5. S acquires the same asset from F by lease, hire or otherwise ("otherwise" does not include sale).

If all the aforesaid conditions are satisfied, then, "actual cost" of asset in the hands of F (who is the legal owner) for the purpose of depreciation will be the written down value of the asset in the hands of S at the time of transfer of asset by S to F.

The following points should be noted—

1. Vide Circular No. 762, dated February 18, 1998, if asset forms part of block of assets, individual written down value shall be determined as if the asset was the only asset in the relevant block.

2. Further Circular No. 762, dated February 18, 1998, clarifies that even if there are one or more intermediate sales between the point of first sale and reacquisition by the first seller, the cost will be the written down value at the time of first sale. For instance, in condition No. 5 *supra*, if F transfers the asset to F1, F1 transfer it to F2, F2 gives the asset on lease/hire to S, then also the "actual cost" for F2 will be written down value of the asset in the hands of S.

3. Explanation 4A has an overriding effect over *Explanation 3*. In other words in the case of sale and lease back transactions, *Explanation 4A* is applicable (not *Explanation 3*).

4. The above rule of *Explanation 4A* is not applicable if the asset is not qualified for depreciation allowance in the hands of S or the asset is qualified for depreciation allowance but S has not claimed any depreciation in respect of the asset. In such case the Assessing Officer can invoke *Explanation 3*.

5. Likewise, the above rule of *Explanation 4A* is not applicable if the asset is not used by S for the purpose of business or profession even if after transfer to F it is taken on lease from F. In such a case even *Explanation 3* is not applicable.

6. In *Explanation 3* the Assessing Officer has to record a finding that the main purpose of the transfer of the asset is to claim higher depreciation to reduce tax liability. No such finding is necessary in *Explanation 4A*.

7. The above provisions of *Explanation 4A* to section 43(*1*) applies only to a genuine sale and lease back transaction (SLB). Any transaction in which professed intention and intention gathered from documentation are same, *viz.*, a sale and a lease back, must be considered to be a genuine SLB transaction. If the SLB transaction is established to be non-genuine or a make-believe, it cannot be recognised either as a fact or in law, and in that case, no depreciation would be allowable at all—***Mid East Portfolio Management Ltd.*** *v.* ***CIT*** [2003] 87 ITD 537 (Mum.) (SB).

8. Explanation 4A is applicable only in the case of sale and lease back transactions and not in the case of hire-purchase transactions—***Karimjee (P.) Ltd.*** v. ***ITO*** [2007] 15 SOT 128 (Mum.).

109.10-2eP1 *S owns two Plants (Plant A and Plant B, depreciation rate 15 per cent). Depreciated value of the block on April 1, 2006 is Rs. 2,36,000. He purchases Plant C for Rs. 60,000 on October 31, 2006 (depreciation rate 15 per cent, additional depreciation not available, it is put to use on the same day). He transfers Plant C to F for Rs. 80,000 (fair market value : Rs. 28,000) on June 30, 2008. On July 5, 2008, F gives Plant C on lease to S (lease rent being Rs. 2,000 per month). Find out the "actual cost" of Plant C for purpose of computing depreciation in the hands of F.*

SOLUTION : *Explanation 4A* to section 43(*1*) is applicable. Written down value of the asset in the hands of S on the date of transfer shall be taken as "actual cost" for the purpose of calculating depreciation in the case of F. Written down value of the Plant C shall be separately calculated (even if it is part of block of assets) as follows—

	Rs.
Cost of acquisition Plant C on October 31, 2006	60,000
Less : Depreciation for the previous year 2006-07 (½ of 15% of Rs. 60,000)	4,500
Written down value on April 1, 2007	55,500
Less : Depreciation for the previous year 2007-08 (15% of Rs. 55,500)	8,325
Written down value on April 1, 2008	47,175

"Actual cost" of Plant C in the hands of F will be Rs. 47,175.

109.10-2f BUILDING WHICH WAS USED FOR NON-BUSINESS PURPOSE EARLIER [*EXPLN.* 5 TO SEC. 43(*1*)] - Where a building, previously the property of the assessee, is brought into use for the purpose of business or profession, the actual cost of the asset to the assessee will be the actual cost of the building to the assessee, as reduced by depreciation, calculated at the rates in force on that date, that would have been allowable had the building been used for the purposes of business or profession since the date of its acquisition by the assessee.

Provision illustrated - X purchases a building for Rs. 2,00,000 on April 22, 2005 (suppose the rate of depreciation : 5 per cent). He uses the building for dwelling purposes till December 4, 2006. It is let out on rent from December 10, 2006 to July 10, 2008.

On July 11, 2008, he converts this building into business premises for the purpose of carrying on his business (suppose the admissible rate of depreciation on July 11, 2008 is 10 per cent). For the purpose of claiming depreciation for the previous year 2008-09, the actual cost of the building would be Rs. 1,45,800 as computed below :

	Rs.
Original cost on April 22, 2005	2,00,000
Less : Deemed depreciation for the previous year 2005-06 @ 10 per cent (being the rate applicable on July 11, 2008)	20,000
Balance	1,80,000
Less : Deemed depreciation for the previous year 2006-07 @ 10 per cent	18,000
Balance	1,62,000
Less : Deemed depreciation for the previous year 2007-08 @ 10 per cent	16,200
"Actual cost" on July 11, 2008	1,45,800

The following points should be noted—

1. The provisions of *Explanation 5* are not applicable if the asset is not "building". For instance, if car is purchased for Rs. 2.50 lakh. It is used for personal purposes for 2 years. Afterwards it is used for business purposes. Actual cost for claiming depreciation will be Rs. 2.50 lakh.

2. Explanation 5 to section 43(*1*) is not applicable if a capital asset is converted into stock in trade.

3. Explanation 5 is applicable only if the assessee is the same.

109.10.2g TRANSFER BETWEEN HOLDING AND SUBSIDIARY COMPANY - *See* para 521.1.

109.10-2h TRANSFER IN A SCHEME OF AMALGAMATION - *See* para 516.2.

109.10-2i TRANSFER IN A SCHEME OF DEMERGER - *See* para 517.2-1.

109.10-2j INTEREST [EXPLN. 8 TO SEC. 43(1)] - Any amount paid or payable as interest in connection with the acquisition of an asset and relatable to a period after the asset is first put to use will not form part of actual cost of the asset. *See* also para 109.10-1a.

Explanation 8 has been held in ***CIT*** v. ***Rajasthan Rajya Vidyut Prasaran Nigam Ltd.*** [2007] 161 Taxman 133 (Raj.), not to be attracted when interest is not paid as such but only as a part of cost under the scheme of the IDBI. A similar view has been expressed by the different High Courts in *Widia (India) Ltd.* v. *Chief CIT (Admn.)* [1998] 233 ITR 1 (Kar.), *CIT* v. *Widia (India) Ltd.* [1992] 193 ITR 475 (Kar.) [SLP (C) No. 7272 of 1993 dismissed on April 19, 1993] and *CIT* v. *Tensile Steel Ltd.* [1976] 104 ITR 581 (Guj.).

109.10-2k ADJUSTMENT OF MODVAT [EXPLN. 9 TO SEC. 43(1)] - *Explanation 9* (which is applicable from the assessment year 1994-95) clarifies that in cases where duty of excise or additional duty leviable under the Customs Tariff Act, 1975 and duty leviable under Central Excise Rules, 1944 has been paid and has been included in the actual cost of the asset acquired on or after March 1, 1994, such duty shall be excluded as and when any credit by way of MODVAT is allowed to the assessee under the Central Excise Rules, 1944.

109.10-2l SUBSIDY [EXPLN. 10 TO SEC. 43(1)] - *Explanation 10* provides that where a portion of the cost of an asset acquired by the assessee has been met, directly or indirectly, by the Central Government or State Government, or any Authority established under any law, or by any other person, in the form of subsidy or grant or reimbursement, then in a case where the subsidy is directly relatable to the asset, such subsidy shall not be included in the actual cost of the asset. In a case where such subsidy, or grant or reimbursement, is of such nature that it cannot be directly relatable to any particular asset, so much of the amount which bears to the total subsidy or reimbursement or grant the same proportion as such asset bears to all the assets in respect of which or with reference to which such grant or subsidy or reimbursement is received, shall not be included in the actual cost of the asset to the assessee.

Provisions illustrated - X Ltd. gets a subsidy of Rs. 12 lakh for setting up an industrial undertaking in a backward district in Bihar from the Government of Bihar. The subsidy is calculated @ 10 per cent of cost of the project of Rs. 150 lakh (*i.e.*, plant and machinery : Rs. 80 lakh + cost of plot : Rs. 40 lakh + construction cost of building Rs. 30 lakh) or Rs. 12 lakh, whichever is lower. "Actual cost" of depreciable assets will be determined as under—

(Rs. in lakh)

	Cost	Subsidy in the previous year	Actual cost
Plant and machinery	80	6.40[1]	73.60
Building	30	2.40[2]	27.60

1. Rs. 12 lakh × Rs. 80 lakh ÷ Rs. 150 lakh.

2. Rs. 12 lakh × 30 lakh ÷ Rs. 150 lakh.

■ *Subsidy given earlier - Explanation 10* was inserted with effect from April 1, 1999. A question arises whether any subsidy received in earlier years (not deducted from cost earlier) is now required to be deducted from the cost. In this regard, the position is now settled by the Supreme Court in the case of *Calcutta Electric Supply Corpn. Ltd.* v. *CIT* [1992] 194 ITR 296. Actual cost determined in earlier years (or written down value determined in earlier year) is not binding upon the Assessing Officer. The Assessing Officer is duty-bound to ascertain himself the actual cost of the assets and the written down value for each year. In case of changes in factual position or change of law, the actual cost/written down value determined in earlier years can be changed. Therefore, subsidy received in earlier years is also required to be deducted from the actual cost of assets if the asset is still in the block. In case any asset has been sold or discarded and the same is not continuing in the block of assets, then proportionate subsidy may be deducted from the cost of the block.

109.10-2m ASSET BROUGHT INTO INDIA BY A NON-RESIDENT [EXPLN. 11 TO SEC. 43(1)] - From assessment year 2000-01, where an asset is acquired outside India by an assessee, being a non-resident, such asset is brought by him to India and used for the purposes of his business or profession, the actual cost of asset to the assessee shall be the actual cost of the asset to the assessee as reduced by an amount equal to the amount of depreciation calculated at the rate in force that would have been allowable had the asset been used in India for the said purposes since the date of its acquisition by the assessee.

109.10.2m-P1 *X Ltd. is a foreign company. It is non-resident in India. It purchases a computer on November 10, 2003 for $ 12,000 (Rs. 43 = 1$). Further it purchases a biogas plant for $ 20,000 on June 30, 2005 (Rs. 45 = 1$). These plants are used outside India for business purposes. On March 1, 2009, X Ltd. starts a manufacturing business in India and the computer and biogas plant are transferred to its factory in Andhra Pradesh.*

Find out the "actual cost" of these assets on March 1, 2009 and the quantum of depreciation for the assessment year 2009-10. Depreciation rate is as follow—Computers : 60 per cent and biogas plant : 80 per cent.

SOLUTION :

Computation of "actual cost" on March 1, 2009

	Computer Rs.	Biogas plant Rs.
Cost of acquisition on November 10, 2003 ($12,000 × 43)	5,16,000	-
Less : Depreciation for the previous year 2003-04 (½ of 60% of Rs. 5,16,000)	1,54,800	-
Balance on April 1, 2004	3,61,200	-
Less : Depreciation for the previous year 2004-05 (60% of Rs. 3,61,200)	2,16,720	-
Balance on April 1, 2005	1,44,480	-
Cost of acquisition of biogas plant	-	9,00,000
Less : Depreciation for the previous year 2005-06 (60% of Rs. 1,44,480)	86,688	7,20,000
Balance on April 1, 2006	57,792	1,80,000
Less : Depreciation for the previous year 2006-07 (60% of Rs. 57,792)	34,675	1,44,000
Balance on April 1, 2007	23,117	36,000
Less : Depreciation for the previous year 2007-08 (60% of Rs. 23,117)	13,870	28,800
Balance on April 1, 2008	9,247	7,200
"Actual cost" on March 1, 2009	9,247	7,200
Less : Depreciation for the previous year 2008-09 (60% of Rs. 9,247)	5,548	5,760

The following points should be noted—

1. These plants are first put to use in India during the previous year 2008-09 (period of use being less than 180 days). Depreciation will not be restricted to 50% of normal depreciation, as these plants are not acquired by X Ltd. during the previous year 2008-09.

2. If X Ltd. transfers these plants to A Ltd. (an Indian company in which X Ltd. is one of the shareholders) for a specific consideration, then *Explanation 11* to section 43(*1*) is not applicable. The Assessing Officer can, however, apply *Explanation 3*.

109.10-2n TRANSFER IN THE CASE OF CORPORATISATION OF A RECOGNISED STOCK EXCHANGE [EXPLN. 12 TO SEC. 43(1)] - Where any capital asset is acquired by the assessee under a scheme for corporatisation of a recognised stock exchange in India (approved by SEBI), the actual cost of the asset shall be deemed to be the amount which would have been regarded as actual cost had there been no such corporatisation [applicable from the assessment year 2002-03].

109.10-3 ***POINTS NOT COVERED BY SECTION 43(1)*** - There is no specific provision under section 43(*1*) in respect of the following—

1. Section 43(*1*) does not provide as to what will be the "actual cost" of assets acquired by a person in a slump sale.

2. Likewise, there is no specific provision for finding out "actual cost" in case an asset is acquired by a company on conversion of a firm into company or conversion of a sole proprietary concern into company according to the provisions of section 47(*xiii*) or 47(*xiv*). In such a case, the Assessing Officer can invoke *Explanation 3* to sec. 43(*1*).

109.11 ***Depreciation on straight-line basis in the case of power units*** - An undertaking engaged in generation or generation and distribution of power can claim depreciation (in respect of assets acquired after March 31, 1997) in the case of tangible assets according to any one of the following methods —

Straight-line basis	Depreciation can be claimed according to straight-line basis in the case of tangible assets at the percentage specified in Appendix IA to the Income-tax Rules [*see* Appendix 4 given at the end of the book] on the actual cost of individual asset. The aggregate depreciation cannot exceed the "actual cost".
Written down value basis	Alternately, such undertaking can claim depreciation, at its option, according to written down value method like any other assessee [*see* para 109.6]. The option for this purpose shall be exercised before the due date of furnishing return of income. Once the option is exercised, it shall be final and shall apply to all the subsequent years.

■ The following points should be noted—

1. In the case of power generating unit, depreciation is available on straight-line basis method in respect of tangible assets acquired after March 31, 1997. To claim depreciation on written down basis under the block system, an option has to be exercised* before the due date of furnishing the return of income under section 139(1)—

a. for the assessment year 1998-99, in the case of an undertaking which began to generate power prior to April 1, 1997; and

b. for the assessment year relevant to the previous year in which it begins to generate power, in case of any other undertaking.

The above option once exercised shall be final and shall apply to all subsequent year.

It may be noted that if the above option is not exercised, then on tangible assets acquired on or after April 1, 1997 depreciation will be available on straight-line basis only.

2. Irrespective of the fact whether or not depreciation is claimed on written down basis, additional depreciation is not available [*see* para 109.8].

*The provisions of the Income-tax Rules, 1962 have not laid down any particular procedure for the exercise of the option by an assessee — ***Jindal Steel & Power Ltd.*** v. ***CIT*** [2006] 10 SOT 106 (Delhi).

3. The aggregate amount of depreciation in the case of straight-line basis cannot exceed the "actual cost."

4. In the case of intangible assets, depreciation cannot be claimed by a power generating unit on the basis of straight-line method. In other words, intangible assets are qualified for depreciation only on the basis of written down value method (*i.e.*, block of assets basis). A power generating unit can have straight-line method only for tangible assets.

5. If a power generating unit claims depreciation on the basis of straight-line method and in the first year in which an asset is acquired, the asset is put to use for less than 180 days, then depreciation allowance in respect of that asset will be restricted to 50 per cent of the normal depreciation.

6. A power generating unit can have straight-line basis method only in respect of tangible assets acquired after March 31,1997. For assets acquired before April 1, 1997, a power generating unit does not have any option but to claim depreciation on the basis of written down basis under block of assets system.

7. If an asset (in respect of which depreciation is claimed on the basis of straight-line method) is sold, discarded, etc., then terminal depreciation is available [*see* para 109.11-1] or balancing charge [*see* para 109.11-2] is taxable.

109.11-1 ***TERMINAL DEPRECIATION (i.e., LOSS ON TRANSFER) OR BALANCING CHARGE (IN THE CASE OF GAIN) IN THE CASE OF POWER UNITS*** - When a depreciable asset (on which depreciation is claimed on straight-line basis) of a power generating unit is sold, discarded, demolished or destroyed* in a previous year, then terminal depreciation (in case of loss) is deductible or balancing charge (in case of gain) is taxable.

Terminal depreciation is calculated as follows—

[redacted]	Find out the written down value of the depreciable asset on the first day of the previous year in which such asset is sold, discarded, demolished or destroyed.
[redacted]	Find out the sale consideration (*i.e.*, money payable to the taxpayer in respect of such depreciable asset *plus* scrap value if any). It is the actual money (received or receivable in cash or by cheque or draft) and it does not include any other thing or benefit which can be converted in terms of money—*CIT* v. *Kasturi & Sons Ltd.* [1999] 103 Taxman 342 (SC).

109.11-1a TERMINAL DEPRECIATION - If the amount calculated under *Step two* is less than the amount of *Step one*, then the deficiency is deductible as terminal depreciation. The following points should be noted—

1. When the asset is sold, discarded, etc., in the previous year in which it is first put to use, any loss arising therefrom is not be allowed as terminal depreciation but is treated as capital loss.

2. Terminal depreciation allowance cannot be claimed if the asset is not used for the purpose of business or profession of the assessee at least for sometime during the previous year in which the sale takes place.

3. Terminal depreciation is allowed only if it is actually written off in the books of the assessee.

109.11-2 ***BALANCING CHARGE UNDER SECTION 41(2) AND CAPITAL GAIN UNDER SECTION 50A*** - If the amount calculated under *Step two* is more than the amount of *Step one*, then tax treatment of such surplus is as follows—

1. So much of the surplus which is equal to the amount of depreciation already claimed, is taxable as balancing charge under section 41(2) as business income.

2. The remaining surplus (if any) is taxable according to the provisions of section 45 under the head "Capital gains".

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*The expression 'demolished or destroyed' refers to physical demolition or destruction, and will not cover a case where the asset is reported as 'missing'—***Kerala Shipping Corporation Ltd.** v. ***CIT*** [2004] 265 ITR 43 (Ker.).

■ *Other points* - One should also keep in view the points —

1. Where an asset is sold, discarded, etc., in the previous year in which it is first put to use, any profit arising therefrom will not be chargeable to tax as balancing charge but will be treated as capital gains and chargeable to tax under section 45 under the head "Capital gains".

2. Balancing charge is taxable under section 41(2) in the previous year in which sale price, insurance, salvage or compensation money becoming due. If the assessee's business is acquired by the Government, the amount of compensation received is taxable in the year of receipt of such compensation. If any additional compensation is received, it will be taxable in the year of receipt— *CIT* v. *United Provinces Electric Supply Co.* [2000] 110 Taxman 134 (SC).

Provisions illustrated - X Ltd. is a power generating unit. On December 20, 2007, it purchases a plant for Rs. 20 lakh which is eligible for depreciation @ 12.77 per cent on straight-line basis. The plant is sold for (*a*) Rs. 30,000 or (*b*) Rs. 18,72,300, (*c*) Rs. 19,00,000 or (*d*) Rs. 21,50,000 on May 20, 2008.

	Rs.
Actual cost	20,00,000
Less : Depreciation for the previous year 2007-08 [½ of 12.77 per cent of Rs. 20 lakh, as it to use for less than 180 days]	1,27,700
Written down value on April 1, 2008 (*i.e.*, the first day of the previous year in which the plant is sold)	18,72,300

Terminal depreciation/balancing charge or capital gain

	[illegible]	[illegible]	[illegible]	[illegible]
Sale proceeds	30,000	18,72,300	19,00,000	21,50,000
Less : Written down value	18,72,300	18,72,300	18,72,300	18,72,300
Surplus	(-)18,42,300	*Nil*	27,700	2,77,700
Terminal depreciation deductible for the previous year 2008-09	18,42,300	*Nil*	—	—
Balancing charge under section 41(2) taxable for the previous year 2008-09 [not to exceed the depreciation claimed]	*Nil*	*Nil*	27,700	1,27,700
Capital gain under section 50A for the previous year 2008-09				
Sale proceeds	30,000	18,72,300	19,00,000	21,50,000
Less : Cost of acquisition† as per section 50A [*i.e.*, written down value - terminal depreciation + balancing charge]	30,000	18,72,300	19,00,000	20,00,000
Short-term capital gain	*Nil*	*Nil*	*Nil*	1,50,000

109.12 ***Depreciation claim not optional*** - As per *Explanation 5* to section 32(1)(*ii*), from the assessment year 2002-03, depreciation under section 32 is available whether or not the assessee has claimed the deduction for depreciation in computing his total income.

Investment deposit account scheme [Sec. 32AB]

110. Deduction under section 32AB can be claimed for the assessment years 1987-88 to 1990-91 by any person whose total income includes income chargeable under the head "Profits and gains of business or profession".

Tea/coffee/rubber development account [Sec. 33AB]

111. An assessee can claim deduction under section 33AB as follows—

†According to section 50A, "cost of acquisition" is written down value as "adjusted". Nowhere under the Act the word "adjusted" has been defined. It is assumed that the expression "adjusted" means written down value *minus* terminal depreciation and *plus* balancing charge.

111.1 *Conditions* - The assessee must satisfy the following conditions :

Condition one	The assessee must be engaged in tea, coffee or rubber plantation.
Condition two	It must make a deposit in "special account".
Condition three	The deposit should be made within specified time-limit.
Condition four	The accounts of the assessee should be audited.

■ *Engaged in tea/coffee/rubber plantation* - It must be engaged in the business of growing and manufacturing tea or coffee or rubber in India.

■ *Deposit* - It must make the following deposit (hereinafter referred to as "special account")—

a. deposit with National Bank for Agriculture and Rural Development (hereinafter referred to as "NABARD") any amount in accordance with a scheme approved by the Tea Board or Coffee Board or Rubber Board; or

b. deposit any amount in the Deposit Account opened by the assessee in accordance with, an approved scheme framed by the Tea Board or Coffee Board or Rubber Board with the previous approval of the Central Government.

■ *Time limit* - The aforesaid amount shall be deposited within 6 months from the end of the previous year or before the due date of furnishing the return of income, whichever is earlier.

■ *Audit* - The accounts of the taxpayer should be audited [audit report in Form No. 3AC]. In cases where the accounts of the taxpayer are required to be audited under any other law, *e.g.*, under the Companies Act, it would be sufficient if the accounts are audited under that law and the audit report as per that law is taken along with a further report in Form No. 3AC for the purposes of this provision.†

111.2 *Amount of deduction* - Amount of deduction is :

a. a sum equal to amounts deposited in special account as mentioned in para 111.1 ; or

b. 40 per cent of the profit of such business computed under the head "Profits and gains of business or profession" before making any deduction under section 33AB and before adjusting brought forward business loss under section 72,

whichever is less.

■ The following points should also be kept in mind :

1. Where any deduction is claimed under this section, no deduction shall be allowed in respect of such amount in any other previous year.

2. Where a deduction is claimed and allowed under this section to an association of persons or body of individual, no deduction shall be allowed to any member of the association or body in respect of the same deposit.

3. Any excess deposit in special account made during a previous year is not treated as deposit made in the next year or any other year.

111.3 *Amount can be withdrawn for the purpose of the scheme* - The amount standing to the credit of the "special account" may be withdrawn only for the purpose specified in approved scheme. Except in the circumstances mentioned in para 111.4, if the amount released from the "special account" in a year is not utilised in the same previous year for the purpose for which it is released, the amount not so utilised will be treated as taxable profits of that year and taxed accordingly.

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†It is not possible to attach any certificate, statement or audit report with new income-tax return forms. The assessee should himself retain the audit report in Form No. 3AC. It may be furnished in original whenever the Assessing Officer wants to examine it in assessment proceedings or otherwise.

111.3-P1 *X Ltd. is engaged in the business of growing and manufacturing tea in India. During the previous year 2007-08, it deposits Rs. 100 lakh in the "special account" and claims the same as deduction under section 33AB (i.e., 40 per cent of the business profit : Rs. 250 lakh). During 2008-09, the company withdraws Rs. 35 lakh from the "special account" which is utilised as follows —*

a. *Rs. 25 lakh on December 31, 2008 for the purpose of the scheme framed by the Tea Board ; and*

b. *Rs. 4 lakh for other purpose on January 27, 2009.*

Rs. 6 lakh is not utilised up to March 31, 2009.

Find out the amount chargeable to tax for the assessment year 2009-10.

SOLUTION : For the assessment year 2009-10, Rs. 10 lakh is treated as business income (*i.e.*, Rs. 4 lakh, being the amount misutilised by the company *plus* Rs. 6 lakh, being the amount which is not utilised by the company during 2008-09). Out of Rs. 10 lakh, 40% (*i.e.*, Rs. 4 lakh) is taken as non-agricultural income and 60% (*i.e.*, Rs. 6 lakh) is deemed as agricultural income.

111.4 ***Consequences in the case of closure of business*** - Apart from the purposes specified in the approved scheme, the amount standing to the credit of the "special account" may be allowed to be withdrawn in the following circumstances :

When the amount can be withdrawn and is taxable as profit	When the amount can be withdrawn and is not taxable as income
1. Closure of business *2.* Dissolution of firm	*1.* Death of the taxpayer *2.* Partition of Hindu undivided family *3.* Liquidation of company

Where an amount is withdrawn because of closure of business or because of dissolution of firm, the amount withdrawn will be treated as taxable profit and taxed accordingly on the basis as if the business was continuing or the firm had not been dissolved. In all other cases, *viz.*, death of the taxpayer, partition of the Hindu undivided family and liquidation of the company, the amounts withdrawn on closure of account because of the occurrence of any of these events will not be included in the taxable income even though the amounts have not been utilized for any of the purposes specified in scheme.

111.5 ***Amount withdrawn from the special account cannot be utilised for certain purposes*** - The amount withdrawn from the "special account" cannot be utilised for the purpose of purchase of any machinery or plant to be installed in any office premises or residential accommodation including guest houses ; any office appliance (other than computers) ; any other plant or machinery which either is installed in an undertaking producing low priority items specified in the Eleventh Schedule in the Income-tax Act or is an item of plant or machinery entitled to 100 per cent write off by way of depreciation or for any other reason in any one year.

111.6 ***Consequences if the new asset is transferred within 8 years*** - The deduction allowed under this section shall be withdrawn if the asset acquired out of the money withdrawn from the special account is sold or otherwise transferred. These provisions are given below -

To whom it is transferred	Transfer within 8 year after the end of the previous year in which the asset is acquired	Transfer after 8 years
■ Transfer to the Central Government, a State Government, a local authority, a statutory corporation or a Government company	Deduction will not be withdrawn	Deduction will not be withdrawn
■ Transfer in a scheme of succession of a firm by company [*see* Note]	Deduction will not be withdrawn	Deduction will not be withdrawn
■ Transfer in any other case	Deduction will be withdrawn	Deduction will not be withdrawn

Note: Transfer in a scheme of succession of a firm by company should satisfy the following points—

a. the scheme continues to apply to the company in the manner applicable to the firm;

b. the successor company takes over all the properties and liabilities of the firm; and

c. all the shareholders of the company were partners of the firm before the succession.

111.6-P1 *Find out the tax consequences in the following cases —*

1. Business profit of X Ltd., a tea growing and manufacturing company, is Rs. 70 lakh for the assessment year 2008-09. It deposits Rs. 25 lakh in the "special account" for claiming deduction under section 33AB. It wants to claim set off of brought forward business loss of Rs. 12,00,000.

2. By withdrawing Rs. 20 lakh on January 20, 2009 from the "special account", X Ltd. purchases a non-depreciable asset for Rs. 18 lakh according to the scheme framed by the Tea Board. The remaining amount of Rs. 2 lakh is not utilised up to March 31, 2009.

3. The asset which is purchased for Rs. 18 lakh is sold to Y for Rs. 31 lakh on December 3, 2011.

SOLUTION :

1. Amount deductible for the assessment year 2008-09 is —

a. Rs. 28 lakh (*i.e.*, 40% of Rs. 70 lakh); or

b. Rs. 25 lakh (being the deposit in the "special account"),

whichever is lower.

Rs. 25 lakh is, therefore, deductible under section 33AB. Taxable income of X Ltd. shall be determined as under —

	(Rs. in lakh)
Business income	70
Less : Deduction under section 33AB	25
Net income	45
As per rule 8 [see para 279.1] 40% of Rs. 45 lakh is taken as non-agricultural income which is chargeable to tax and the balance 60% is treated as agricultural income which is not taxable	
Non-agricultural income [*i.e.*, 40% of Rs. 45 lakh]	18
Less : Brought forward loss	12
Net income	6

2. Rs. 2 lakh, being the amount not utilised up to March 31, 2009 will be business income (40% of which will be taxable as non-agricultural income) for the assessment year 2009-10.

3. The new asset is transferred within eight years from March 31, 2009. Consequently, the taxable income for the assessment year 2012-13 (*i.e.*, previous year 2011-12 in which the asset is transferred) will be determined as follows —

	Rs.
Business income [40% of which is taxable as non-agricultural income]	18,00,000
Short-term capital gain (*i.e.*, Rs. 31 lakh – Rs. 18 lakh)	13,00,000

111.7 ***Double deduction not permissible*** - Where any amount standing to the credit of the assessee in the "special account" is utilised by the assessee for the purpose of any expenditure in accordance with the scheme, such expenditure shall not be allowed in computing the income chargeable under the head "Profits and gains of business or profession".

Site restoration fund [Sec. 33ABA]

112. An assessee can claim deduction under section 33ABA as follows :

112.1 ***Conditions*** - The assessee must satisfy the following conditions :

Condition one	The assessee must be engaged in production of petroleum/natural gas in India.
Condition two	The assessee has an agreement with the Central Government.
Condition three	It must make a deposit in "special account".

[illegible]	The deposit should be made within specified time-limit.
[illegible]	The accounts of the assessee should be audited.

■ *Production of petroleum/natural gas* - The taxpayer is engaged in the business of the prospecting for, or extraction or production of, petroleum or natural gas or both in India.

■ *Agreement* - The Central Government has entered into an agreement with the taxpayer for such business.

■ *Deposit* - It must —

a. deposit with SBI any amount in an account (hereinafter referred to as "special account") maintained by the assessee with that bank (the amount should be deposited in accordance with a scheme approved by the Government of India in the Ministry of Petroleum and Natural Gas); or

b. deposit any amount in an account (hereinafter referred to as "site restoration account") opened by the assessee in accordance with, in a scheme framed by the Ministry of Petroleum and Natural Gas (hereinafter referred to as "deposit scheme").

■ *Time-limit for deposit* - The aforesaid amount shall be deposited before the end of the previous year.

■ *Audit* - Books of account of the taxpayer should be audited (audit report* in Form No. 3AD).

112.2 *Amount of deduction* - Amount of deduction is :

a. a sum equal to amounts deposited as mentioned in para 112.1; or

b. 20 per cent of the profit of such business computed under the head "Profits and gains of business or profession" before making any deduction under section 33ABA and before adjusting brought forward business loss under section 72,

whichever is less.

■ The following points should also be kept in mind:

1. Where any deduction is claimed under this section, no deduction shall be allowed in respect of such amount in any other previous year.

2. Where a deduction is claimed and allowed under this section, to a firm, association of persons or body of individuals, no deduction shall be allowed to any partner of the firm or the member of the association or body in respect of the same deposit.

112.3 *Amount can be withdrawn for the purpose of the scheme* - The amount standing to the credit of such special account or site restoration account may be withdrawn only for the purpose specified in the scheme or the deposit scheme.

■ *Purpose specified in the scheme* - A depositor shall be entitled to withdraw from the amount standing to the credit of the account only such amount as is necessary to meet any expenditure to be incurred by him on the expiry or termination of the agreement or relinquishment of part of the contract area, towards removal of all equipments and installations, in a manner agreed with the Central Government pursuant to an abandonment plan or towards all necessary site restoration in accordance with the good international petroleum industry practice and towards meeting all other expenses necessary to prevent hazards to life or property or environment consequent on such expiry, termination or relinquishment.

■ *Consequences of non-utilisation* - If amount released or withdrawn in a year is not utilized in the same previous year for the purpose for which it is released, the amount not so utilised will be treated as taxable profits of that year and taxed accordingly.

*It is not possible to attach any certificate, statement or audit report with new income-tax return forms. The assessee should himself retain the audit report in Form No. 3AD. It may be furnished in original whenever the Assessing Officer wants to examine it in assessment proceedings or otherwise.

112.4 ***Consequences in case of closure of business*** - Where any amount standing to the credit of the assessee in the special account or in the Site Restoration Account is withdrawn on closure of the account during any previous year by the assessee, the amount so withdrawn from the account shall be chargeable to income-tax as the income of that previous year. However, the amount, if any, payable to the Central Government by way of profit or production share as provided in the agreement referred to in section 42 shall be reduced from the amount chargeable to tax as stated above.

Where any amount is withdrawn on closure of the account in a previous year in which the business carried on by the assessee is no longer in existence, the above provisions shall apply as if the business is in existence in that previous year.

112.5 ***Amount cannot be utilised for certain purposes*** - The amount withdrawn cannot be utilized for certain purposes [*see* para 111.5].

112.6 ***Consequences if the new asset is transferred within 8 years*** - The deduction allowed under this provision will be withdrawn if the asset (acquired in accordance with the scheme) is sold or otherwise transferred within 8 years from the end of the previous year in which it is acquired. These provisions are given in para 111.6.

Reserves for shipping business [Sec. 33AC]

113. Deduction under section 33AC is not available from the assessment year 2005-06 onwards.

Expenditure on scientific research [Sec. 35]

114. The term "scientific research" means "any activities for the extension of knowledge in the fields of natural or applied sciences including agriculture, animal husbandry or fisheries".

If any dispute arises as to whether any activity constitutes scientific research or any asset is being used for scientific research, the Central Board of Direct Taxes will refer the question to the prescribed authority.[1]

With a view to accelerating scientific research, section 35 provides tax incentives. Under this section amount deductible in respect of scientific research may be classified as under—

1. In-house research - It includes the following—

a. revenue expenditure [*see* para 114.1];

b. capital expenditure [*see* para 114.3]; and

c. expenditure on an approved in-house research under section 35(2AB) [*see* para 114.6].

2. Payment to outsiders - It includes the following—

a. contribution to an approved scientific research association [*see* para 114.2];

b. contribution to an approved national laboratory, etc. [*see* para 114.4]; and

c. contribution to an Indian scientific research company [*see* para 114.5].

114.1 ***Revenue expenditure incurred by an assessee who himself carries on scientific research [Sec. 35(1)]*** - Where the assessee himself carries on scientific research and incurs revenue expenditure during the previous year, deduction is allowed for such expenditure only if the research relates to the business.

114.1-1 ***PRE-COMMENCEMENT PERIOD EXPENSES*** - Revenue expenses (other than expenditure on providing perquisites to employees) incurred before the commencement of business (but within three years immediately before commencement of business) on scientific research related to the business is deductible in the previous year in which business is commenced.

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1. For the purpose of section 35, the prescribed authority shall be the Director General (Income-tax Exemptions) in concurrence with the Secretary, Department of Scientific & Industrial Research, Government of India. When the question relates to any activity under clauses (*ii*) and (*iii*) of section 35(1), it shall be referred by the Board to the Central Government, and the decision of the Central Government shall be final.

In this context the following points one should keep in mind —

- The deduction is available only in respect of expenditure on scientific research *related* to the assessee's business.
- Deduction is limited to an amount certified by the prescribed authority (*i.e.*, the Director General (Income-tax Exemptions) in concurrence with the Secretary, Department of Scientific and Industrial Research, Government of India).
- It may be mentioned that expenditure incurred on the provision of "perquisites" before commencement of business is not allowed as deduction. In other words, expenditure incurred by the assessee on providing different perquisites (such as free or concessional residential accommodation, or any benefit or amenity free of cost or at a concessional rate, etc.) to research personnel before commencement of business is not allowable as deduction.

114.2 ***Contribution made to outsiders [Sec. 35(1)(ii)/(iii)]*** - Where the assessee does not himself carry on scientific research but makes contributions to the following institutions for this purpose, a weighted deduction is allowed. The amount of deduction is equal to one and one-fourth times of any sum paid to a scientific research association or to a university, college or other institution —

a. the payment is made to an approved* scientific research association which has, as its object, undertaking of scientific research related or unrelated to the business of assessee [sec. 35(1)(*ii*)];

b. the payment is made to an approved* university, college or other institution for the use of scientific research related or unrelated to the business of assessee [sec. 35(1)(*ii*)]; and

c. the payment is made to an approved* university, college or other institution for the use of research in social sciences or statistical research related or unrelated to the business of the assessee [sec. 35(1)(*iii*)].

- *"Other institution"* - University and college are undoubtedly educational institutions. Following the principle of *ejusdem generis*, the expression "other institutions" will take colour from the expressions preceding it. Thus, the expression 'other institution' is meant to be an institution imparting education in any discipline which may, in addition, carry out scientific research.

The expression "other institution" would necessarily mean an educational institution imparting education in any discipline, be it science, commerce, law, medicine, arts, fine arts, etc.—***Shri Ram Scientific & Industrial Research Foundation*** v. ***Director of Income-tax*** [2005] 93 ITD 223 (Delhi).

114.2-1 *OTHER RELEVANT POINTS* - In this context, one should note the following points —

- If the Assessing Officer is satisfied that the activities of the aforesaid university/college/institution [referred to in section 35(1)(*ii*)/(*iii*)] are not being carried out in accordance with all or any of the conditions subject to which approval was given to such institution, he may recommend the Central Government to withdraw the approval given under section 35 [second proviso to sec. 143(3)].
- Weighted deduction in respect of contribution made by an assessee to the aforesaid institutions shall not be denied (from the assessment year 2006-07) merely on the ground that after the contribution made by the assessee to these institutions, the approval granted to these institutions have been withdrawn. In other words, contribution to these institutions will be qualified for weighted deduction even if after the date of making contribution, the approval granted to these institutions have been withdrawn.

114.3 ***Capital expenditure incurred by an assessee who himself carries on scientific research [Sec. 35(2)]*** - Where the assessee incurs any expenditure of a capital nature on scientific research related to his business, the whole of such expenditure incurred in any previous year is allowable as deduction for that previous year.

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*For approved association/institutions, *see Taxmann's Direct Taxes Circulars*, 2006 edn., Vol. 1. If notification under section 10(*23C*)(*iv*) or 35(1)(*ii*) is issued after the completion of assessment of the taxpayer for the relevant assessment year, exemption/deduction can be given by rectification of mistake under section 154—Circular No. 725, dated October 16, 1995.

The three ingredients necessary to be satisfied for allowance under section 35 are: (*i*) that the expenditure has been incurred during the year; (*ii*) that it is of capital nature; and (*iii*) that it is on scientific research.

The following are some of the examples of capital expenses deductible under section 35—

1. Expenditure on purchase of plants and equipments for laboratory and on purchase or construction of a building for conducting research.

2. Expenditure on purchase of air-conditioners for laboratory.

3. Expenses on purchase of cars and buses which are used to transport employees engaged in scientific research—*CIT* v. *Smith Kline & French (India) Ltd.* [1994] 77 Taxman 153 (Kar.) [a special leave petition of the Department has been dismissed by the Supreme Court on July 12, 1994 in SLP (Civil) No. 14916 of 1994].

4. Expenditure incurred by the assessee on construction of approach road to its research and development laboratories — *CIT* v. *Sandoz (India) Ltd.* [1994] 74 Taxman 225 (Bom.).

114.3-1 ***PRE-COMMENCEMENT PERIOD EXPENSES*** - Where any capital expenditure has been incurred on scientific research related to business before the commencement of the business, the aggregate of such expenditure, incurred within the three years immediately preceding the commencement of the business, is deductible in the previous year in which the business is commenced [*Explanation* to section 35(2)(*ia*)] and is, accordingly, deductible during the year in which business is commenced.

114.3-2 ***EXPENDITURE ON LAND NOT DEDUCTIBLE*** - The aforesaid deduction (*i.e.*, paras 114.3 and 114.3-1) is not available in respect of capital expenditure incurred on the acquisition of any land after February 29, 1984.

114.3-3 ***TAX TREATMENT WHEN ASSET IS SOLD*** - If the asset is sold without having been used for other purposes, the following amount shall be chargeable to tax—

a. surplus (*i.e.*, sale price); or

b. deduction already allowed under section 35,

whichever is less.

It is chargeable to tax as business income of the previous year in which the sale takes place [sec. 41(3)]. The excess of sale price over cost of acquisition (or indexed cost of acquisition) is chargeable to tax under section 45 under the head "Capital gains" [*see* problem 114-P2 for detailed discussion].

114.3-4 ***DEPRECIATION NOT ADMISSIBLE*** - Deduction by way of depreciation is not admissible in respect of an asset used in scientific research either in the year in which capital expenditure is incurred or in a subsequent year.

114.3-5 ***OTHER POINTS*** - One should also keep in the following—

1. Asset may not be complete in all respect - Section 35 refers only to 'capital expenditure' and does not further require that the asset brought into existence by incurring such expenditure should have been complete in all respects. The deduction is for the expenditure to the extent incurred. Expenditure incurred on ongoing construction of a building designed for housing the research wing is clearly capital expenditure and is deductible under this provision—***CIT*** v. ***Rane Brake Linings Ltd.*** [2003] 126 Taxman 231 (Mad.), ***CIT*** v. ***Gujarat Alluminium Extrusions (P.) Ltd.*** [2003] 133 Taxman 542 (Guj.).

2. Expenditure should be incurred for scientific research - There is no provision in the Act, which provides that if the assessee has acquired some assets for the business and after using these assets for business for sometime, transfers them by mere entry from the business side to the research side, he can get the benefit of deduction under section 35. For the purpose of depreciation if the assessee owns the asset it is enough, but for the benefit of allowance under section 35, the assessee should incur expenditure for scientific research—*Multi Metals Ltd.* v. *CIT* [2002] 254 ITR 652/123 Taxman 466 (Raj.).

3. Assessee not necessarily engaged in manufacturing - Allowability of the expenditure under section 35 is not restricted to manufacturing activity alone but the same is allowable if it is related to the business of the assessee—***Anjaleem Enterprises (P.) Ltd.*** v. ***CIT*** [2005] 149 Taxman 9 (Ahd.) (Mag.).

4. Actual payment not necessary - Under provisions of section 35, it is not necessary that the assessee must have actually paid the amount expended as expenditure on the scientific research before claiming deduction—***Hero Honda Motors Ltd.*** v. ***CIT*** [2005] 3 SOT 572 (Delhi).

5. Asset not necessarily put to use - As per provisions of section 35(1)(*iv*), it is not mandatory that plant and machinery purchased must be put to use—***CIT*** v. ***Metallizing Equipment Co. (P.) Ltd.*** [2005] 149 Taxman 43 (Jodh.) (Mag.).

114.4 *Contribution to National Laboratory [Sec. 35(2AA)]* - The provisions of section 35(2AA) are given below—

114.4-1 *CONDITIONS* - The following conditions should be satisfied—

[illegible]	The payment is made to— *a.* National Laboratory; or *b.* University; or *c.* Indian Institute of Technology; or *d.* Specified person as approved by the prescribed authority.
[illegible]	The above payment is made under a specific direction that it should be used by the aforesaid person for undertaking a scientific research programme approved by the prescribed authority.

114.4-2 *AMOUNT OF DEDUCTION* - If the aforesaid conditions are satisfied the taxpayer is eligible for weighted deduction which is equal to one and one-fourth times of actual payment.

Such contribution which is eligible for weighted deduction is not eligible for any other deduction under the Act.

The aforesaid weighted deduction will not be denied merely on the ground that after the payment made by the assessee to these institutions, the approval granted to National Laboratory/specified person has been withdrawn or approval granted to scientific research programme of National Laboratory/University/IIT/specified person have been withdrawn.

114.4-3 *MEANING OF DIFFERENT TERMS* - The meaning of different terms is as follows—

- "National Laboratory" for this purpose means a scientific laboratory functioning at national level under the aegis of the Indian Council of Agricultural Research, the Indian Council of Medical Research or the Council of Scientific and Industrial Research, the Defence Research and Development Organisation, the Department of Electronics, the Department of Bio-Technology or the Department of Atomic Energy.
- The prescribed authority is the head of a National Laboratory or a University or an Indian Institute of Technology, as the case may be. In the case of "specified person" the prescribed authority is the Principal, Scientific Adviser to the Government of India. Such authority shall before granting approval satisfy itself about the feasibility of carrying out the scientific research. The aforesaid authority shall submit its report to the Director-General in such form as may be prescribed.

Weighted deduction is available under section 35(2AA) in respect of payment to a specified National Laboratory or a University or an IIT or a specified person if a few conditions are satisfied. One of the conditions is that the payment should be given with a specific direction that it shall be used by the recipient institution for conducting scientific research under a programme approved by the prescribed authority.

114.4-4 *APPLICATION FORM AND TIME-LIMIT* - The application for obtaining approval under sub-section (2AA) of section 35 shall be made by a sponsor in Form No. 3CG.

- The prescribed authority before granting approval in Form No. 3CH satisfy itself about the feasibility of carrying out the scientific research.

- A reasonable opportunity of being heard shall be granted to the sponsor before rejecting an application.
- The above order shall be passed within two months of the receipt of the application.

114.4-5 CONDITIONS FOR APPROVAL - Approval of a programme under section 35(2AA) is subject to conditions given in rule 6(7).

114.5 ***Contribution to a company to be used by such company for scientific research [Sec. 35(1)(iia)]*** - With a view to encouraging outsourcing of scientific research, particularly by small companies which are handicapped in making lumpy investment for building in-house scientific facilities, clause (*iia*) has been inserted in section 35(1) with effect from the assessment year 2009-10.

- *Conditions* - Section 35(1)(*iia*) is applicable if the following conditions are satisfied—

1. The taxpayer is any person (maybe an individual, HUF, firm, company or any other person).

2. The taxpayer has paid any sum to a company (hereinafter referred as "payee-company") to be used by the payee for scientific research.

3. The scientific research may or may not be related to the business of the taxpayer.

4. The payee-company is registered in India.

5. The payee-company has as its main object the scientific research and development.

6. The payee-company is for the time being approved by the prescribed authority.

7. The payee-company fulfils such other conditions as may be prescribed.

- *Amount of deduction* - If the above conditions are satisfied, then the taxpayer can claim a weighted deduction of 125 per cent of the amount paid by him to the payee-company.
- *Payee-company cannot claim weighted deduction under section 35(2AB)* - With a view to avoid multiple claims for deduction, it has been provided that the payee-company approved under the provisions of section 35(2)(*iia*) will not be entitled to claim weighted deduction of 150 per cent under section 35(2AB). However, deduction to the extent of 100 per cent of the sum spent as revenue expenditure or capital expenditure on scientific research, which is available under section 35(1), will continue to be allowed.

114.6 ***Expenditure on in-house research and development facility [Sec. 35(2AB)]*** - Section 35(2AB) provides for a weighted deduction in respect of expenditure on in-house research and development facility subject to the following —

- *Conditions* - One has to satisfy the following conditions —

1. The taxpayer is a company.

2. It is engaged in the business of bio-technology or in the business of manufacture or production of any drugs, pharmaceuticals, electronic equipments, computers, telecommunication equipments, chemicals or any other article or thing notified by the Board [*i.e.*, manufacture or production of helicopter or aircraft or computer software or automobiles (including automobiles components)].

3. It incurs an expenditure on scientific research and such expenditure is of capital nature or revenue nature (not being expenditure in the nature of cost of any land and building*). The expenditure on scientific research in relation to drugs and pharmaceuticals shall include expenditure incurred on clinical drug trial, regulatory approval and filing an application for a patent.

4. The above expenditure is incurred on in-house research and development facility up to March 31, 2012.

5. On the application of the company in Form No. 3CK, the research and development facility is approved by the prescribed authority (*i.e.*, Secretary, Department of Scientific and Industrial Research). Once facility is approved, the entire expenditure incurred during the previous year

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*Cost of building (excluding cost of land) is eligible for 100 per cent deduction under section 35(2) [*see* para 114.3]— *Tube Investments of India Ltd.* v. *CIT* [2002] 125 Taxman 421 (Mad.).

(whether incurred before or after the date of approval) on development facility has to be allowed for weighted deduction—***Claris Lifesciences Ltd.*** v. ***CIT*** [2008] 112 ITD 307 (Ahd.)

6. The taxpayer has entered into an agreement with the prescribed authority for co-operation in such research and development facility and for audit of the accounts maintained for that facility.

▪ *Amount of deduction under section 35(2AB)* - If all the above conditions are satisfied, then a sum equal to one and one-half times of the expenditure so incurred shall be allowed as deduction.

However, deduction under section 35(2AB) is not available in respect of expenditure incurred by a company [which is approved under section 35(1)(*iia*)(*C*), *i.e.*, payee-company as referred to para 114.5 (*supra*)] after March 31, 2008.

▪ *Deduction is not available under section 35(2AB) - Can it be claimed under other provisions of section 35* - If the above conditions are not satisfied, weighted deduction at the rate of 150 per cent under section 35(2AB) is not available. However, 100 per cent deduction in respect of revenue expenditure and/or capital expenditure is available under section 35(1) [*see* paras 114.1 and 114.3]. Moreover, a company approved under section 35(1)(*iia*) [*i.e.*, payee-company as referred to para 114.5 (*supra*)] which is not eligible for weighted deduction at the rate of 150 per cent under section 35(2AB) in respect of expenditure incurred after March 31, 2008 can continue to claim a deduction to the extent of 100 per cent of the sum spent as revenue expenditure or capital expenditure on scientific research, under section 35(1).

114.7 ***Expenditure on scientific research*** - In view of section 43(4)(*ii*), references to expenditure incurred on scientific research include all expenditure incurred for the prosecution, or the provision of facilities for the prosecution, of scientific research, but do not include any expenditure incurred in the acquisition of rights in, or arising out of, scientific research.

114.8 ***Scientific research related to business*** - In view of section 43(4)(*iii*), references to scientific research related to a business or class of business include :

a. any scientific research which may lead to or facilitate an extension of that business or, as the case may be, all businesses of that class ; and

b. any scientific research of a medical nature which has a special relation to the welfare of workers employed in that business or, as the case may be, all businesses of that class.

114.9 ***Carry forward and set off of deficiency in subsequent years*** - If on account of inadequacy or absence of profits of the business, deduction on account of capital expenditure referred to in section 35(1)(*iv*) [*i.e.*, para 114.3 *supra*] cannot be allowed, fully or partly, the deficiency so arising is to be carried forward for unlimited years and set-off in any subsequent assessment year. However, carry forward of deficiency is subject to the condition that business loss already brought forward, if any, will have precedence over such deficiency in the matter of set-off. To put it little differently, the aforesaid deficiency will be given the same treatment as is given to unabsorbed depreciation *vis-a-vis* brought forward business losses [*see* para 109.9].

114.10 ***Consequences in the case of amalgamation*** - In pursuance of an agreement of amalgamation [*see* para 19], if the amalgamating company transfers to the amalgamated company, which is an Indian company, any asset representing capital expenditure on scientific research, provisions of section 35 would apply to the amalgamated company as they would have applied to the amalgamating company if the latter had not transferred the asset.

114-P1 *XY, a partnership firm, commenced production on December 1, 2008. The firm has made the following expenditure on scientific research up to the year ending on March 31, 2009 :*

1. On December 13, 2008, the firm pays Rs. 90,000 to the Indian Agricultural Research Institute, New Delhi, being an approved scientific research institution under section 35(1)(ii), for the purpose of carrying out scientific research in natural science.

2. On December 21, 2008, the firm pays Rs. 60,000 to the Indian Institute of Management, Ahmedabad, being an approved institute under section 35(1)(iii), for the purpose of carrying out scientific research in social or statistical science.

3. *On January 10, 2009, the firm pays Rs. 40,000 to an approved National Laboratory for carrying out programmes of scientific research.*

4. *On December 23, 2008, the firm purchases a plot of land for Rs. 2,00,000. Later on a laboratory building is constructed (cost of construction : Rs. 1,70,000, date of completion of construction : March 1, 2009) to start in-house research.*

5. *Before the commencement of the production, the firm had made the following revenue expenditure for its research laboratory :*

- *Expenditure on salary and perquisite to research personnel and research material during the 12 months ending on November 30, 2005 : Rs. 20,000.*
- *Expenditure on salary of research personnel from December 1, 2005 to November 30, 2008 : Rs. 61,000 (out of which amount certified by the prescribed authority is Rs. 42,000).*
- *Expenditure on providing rent-free flats and club facility to research personnel, from December 1, 2005 to November 30, 2008 : Rs. 8,000.*
- *Expenditure on research material from December 1, 2005 to November 30, 2008 : Rs. 46,800 (out of which amount certified by the prescribed authority is Rs. 34,800).*
- *Capital expenditure on scientific research (not certified by the prescribed authority) —*

	Expenditure incurred up to November 30, 2005 Rs.	Expenditure incurred between December 1, 2005 and November 30, 2008 Rs.
Purchase of land for growing herbals for research	50,000	60,000
Purchase of equipments for research	30,000	40,000
Expenditure of capital nature for cultivation of herbals	2,000	4,600

Determine the amount of deduction available to XY under section 35(1) for the assessment year 2009-10, if the scientific research is (a) related or (b) unrelated to the business of the assessee-firm.

SOLUTION : *The amount of deduction under section 35 for the assessment year 2009-10 will be determined as under —*

	Where the scientific research is related to the business Rs.	Where the scientific research is unrelated to the business Rs.
1. Payment of Rs. 90,000 to an approved scientific research institution for carrying on research in natural science is qualified for a weighted deduction under section 35(1)(*ii*) even if the research is not related to the business of assessee [*i.e.*, Rs. 90,000 × 1.25]	1,12,500	1,12,500
2. Payment of Rs. 60,000 to an approved institution for carrying on scientific research in social science is qualified for a weighted deduction under section 35(1)(*iii*) even if the scientific research is not related to the business of assessee [*i.e.*, Rs. 60,000 × 1.25]	75,000	75,000
3. Payment of Rs. 40,000 to an approved National Laboratory is qualified for weighted deduction (even if scientific research is not related to the business of assessee) [*i.e.*, Rs. 40,000 × 1.25]	50,000	50,000
4. Cost of laboratory building (excluding cost of land)	1,70,000	—
5. Expenditure on salary (excluding perquisite) to research personnel and expenditure on material for scientific research incurred within 3 years before commencement of business is deductible under section 35(1)(*i*) if the research is related to the business of the assessee —		
❑ Rs. 20,000 being expenditure on salary and perquisites is not deductible as it is not incurred within 3 years before commencement of business	*Nil*	*Nil*
❑ Rs. 42,000 being expenditure on salary to research personnel as certified by the prescribed authority within 3 years before commencement of business is deductible if research is related to the business of assessee	42,000	*Nil*

	Where the scientific research is	
	related to the business Rs.	unrelated to the business Rs.
❑ Rs. 8,000 being expenditure on providing perquisites to research personnel before commencement of business is not deductible even if research is related to the assessee's business	*Nil*	*Nil*
❑ Rs. 34,800 being expenditure as certified by the prescribed authority on purchasing research material within 3 years before commencement of business is deductible if research is related to the assessee's business	34,800	*Nil*
❑ Cost of land purchased for growing herbals (not deductible)	—	—
❑ Rs. 40,000 (being the cost of equipment) is deductible if research is related to the business	40,000	—
❑ Rs. 4,600 being cost of growing herbals is deductible if research is related to the business	4,600	—
Amount deductible under section 35 for the assessment year 2009-10	5,28,900	2,37,500

114-P2 *XYZ Ltd., a paper manufacturing concern, purchases a machine on March 1, 1997 for Rs. 6,10,000 for its laboratory with a view to improving the quality of art paper manufactured by the company.*

1. What will be the amount of deduction under section 35 on account of capital expenditure of Rs. 6,10,000 for the assessment year 1997-98.

2. If the research activity for which the aforesaid machine is purchased ceases in 2007 and the machinery is brought into business proper on November 1, 2007 (market value of the machine : Rs. 2,30,000) ; depreciation is admissible at the rate of 15 per cent ; depreciated value of the relevant block of assets on April 1, 2007 is Rs. 14,07,860, the scientific research machine is sold for Rs. 1,90,000 on April 4, 2008, what will be the amount of depreciation and amount of chargeable profit under section 41(3).

3. If the research activity for which the machine was purchased ceases on November 1, 2007 (market value of the machine : Rs. 2,30,000) and the machine is sold on April 4, 2008 without using it for another purpose, sale price being Rs. 1,90,000, or Rs. 5,40,000, or Rs. 8,10,000 or Rs. 15,00,000.

SOLUTION :

1. As the scientific research is related to the business of assessee, the whole of capital expenditure of Rs. 6,10,000 is allowable as deduction under section 35(2)(*ia*) for the assessment year 1997-98.

2. The machine is brought into business proper on November 1, 2007. Profit arising on sale of machinery is, in this case, not chargeable under sub-section (3) of section 41. Provision of sub-section (3) of section 41 would not apply as the section covers only such assets which are represented by expenditure of capital nature on scientific research that is sold *without having been used for any other purpose.*

Tax treatment of depreciation will be as under :

	Rs.
Depreciated value of the block of assets on April 1, 2007	14,07,860
Add : Cost of machine transferred from laboratory on November 1, 2007 [*i.e.*, Rs. 6,10,000 — deduction of Rs. 6,10,000 claimed under section 35 — *see* para 109.10-2]	*Nil*
Written down value	14,07,860
Less : Depreciation for the previous year 2007-08 [15% of Rs. 14,07,860]	2,11,179
Depreciated value of the block on April 1, 2008	11,96,681
Less : Sale proceeds of machine sold on April 4, 2008	1,90,000
Written down value	10,06,681
Less : Depreciation for the previous year 2008-09 [15% of Rs. 10,06,681]	1,51,002
Depreciated value of the block on April 1, 2009	8,55,679

There will be no capital gain or loss in this case [*see* para 173.1-3].

3. Tax treatment should be as under :

	If sale price is			
	Rs. 1.90 lakh Rs.	Rs. 5.40 lakh Rs.	Rs. 8.10 lakh Rs.	Rs. 15 lakh Rs.
Amount chargeable under section 41(3) (*i.e.*, sale proceeds but subject to maximum of deduction claimed under section 35 for the assessment year 1997-98)	1,90,000	5,40,000	6,10,000	6,10,000
Capital gain under section 45				
Sale proceeds	1,90,000	5,40,000	8,10,000	15,00,000
Less : Indexed cost of acquisition [*i.e.*, Rs. 6,10,000 × 582/305 - see para 175.2-2]	11,64,000	11,64,000	11,64,000	11,64,000
Long-term capital gain or loss	(-)9,74,000	(-)6,24,000	(-)3,54,000	3,36,000

Note - It can be seen from the above computation that when the capital asset is transferred for Rs. 1.90 lakh without putting it to some other use, the taxpayer can claim long-term capital loss of Rs. 8,04,000 apart from claiming deduction under section 35—***Pharmson Pharmaceuticals Ltd.*** v. ***CIT*** [2003] 87 ITD 668 (Delhi)*. To avoid double deduction, it is suggested to the Government that a suitable amendment should be made in section 35 incorporating the following—

"Where deduction is allowed in respect of a capital expenditure under section 35(1)(*iv*), no deduction shall be allowed in respect of the said expenditure under any other provision of the Act in any year".

114-P3 *XYZ Ltd. is doing business in the manufacture of rayon yarn, tyre cord and chemicals and proposes to set up a plant for manufacturing pulp from bamboo. In its return for the assessment year 2009-10 it claims deduction of Rs. 2,55,000 as research expenses paid to a foreign company in connection with research, being carried on in foreign company's laboratory, on pulping of bamboo and conversion of such pulp into yarn. The Assessing Officer wants to disallow the claim holding (a) that, even though the pulp is admittedly the principal raw material for the manufacture of viscose rayon, the bamboo pulp project contemplated by it is new and altogether different from its business during the previous year ; and (b) that the expenditure is not related to its business within the meaning of section 35(1)(i), and research is not carried on by the assessee-company itself. Is the view taken by the Assessing Officer justified?*

SOLUTION : The activities of the assessee-company in the year in which the expenditure is incurred is, *inter alia*, the manufacture of rayon yarn. The research activity is related to the substitution of the raw material currently being used. Even if the assessee's present activities alone are considered as acceptable, even then the research undertaken should be properly regarded as being related to its business. To take any other view must be regarded as impractical and contrary to common sense—*CIT* v. *National Rayon Corpn. Ltd.* [1982] 8 Taxman 11 (Bom.). The other argument of the Assessing Officer that the research must have been carried on by the assessee-company itself is not borne out by the phraseology of the statutory provision. In *CIT* v. *Ciba of India Ltd.* [1968] 69 ITR 692, it has been made clear by the Supreme Court that an assessee can claim the amount as permissible deduction although the research was carried on by some other persons, provided the research was *carried on for or on behalf of the assessee* . The mere argument that the deduction under section 35(1)(*i*) is not available, unless the expenditure is incurred for research carried on by the assessee-company is not justified by the statutory provision and is against the observation of the Supreme Court in the *Ciba's* case (*supra*).

Expenditure on acquisition of patent rights and copyrights [Sec. 35A]

115. For claiming deduction under section 35A, the following conditions should be satisfied —

a. the know-how, secret formula, designs and specifications are either patent rights or copyrights ;

b. the expenditure is of capital nature ;

c. the expenditure is incurred on acquisition of the patent rights/copyrights ;

d. patent rights/copyrights are used for the purpose of business or profession of the taxpayer ; and

e. the capital expenditure is incurred prior to April 1, 1998.

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*Contrary ruling is given by the Mumbai Tribunal in the case of ***Maharashtra Hybrid Seeds Co. Ltd.*** v. ***CIT*** [2008] 24 SOT 475.

- If all the aforesaid conditions are satisfied, then deduction is available under section 35A [*see* para 115.1].
- If all the aforesaid conditions are not satisfied, then —

a. in respect of capital expenditure incurred on or after April 1, 1998, one can claim depreciation under section 32 ;

b. in respect of any other capital expenditure, no deduction is available ; and

c. in respect of revenue expenditure, one can claim deduction under section 37(1) [*see* para 141].

115.1 ***Amount of deduction*** - Any capital expenditure in acquiring patent rights or copyrights used for the purpose of the business, is allowable as business expenditure in equal instalments over a period of 14 years (as reckoned from the previous year in which such rights were acquired).

For instance, X purchases a patent right on November 1, 1997 for manufacturing art paper for a sum of Rs. 70,000. A sum of Rs. 5,000 is written off over a period of 14 years beginning with the assessment year 1998-99 up to the assessment year 2011-12. If this expenditure is incurred on or after April 1, 1998, then one can claim depreciation under section 32 @ 25 per cent.

115.2 ***Profit or loss on sale of patent rights/copyrights*** - Any profit or loss on sale of a copyright/ patent right is taken into consideration while computing income.

115.3 ***Consequences in the case of amalgamation or demerger*** - Where, under the scheme of amalgamation [*see* para 19], the amalgamating company chooses to sell the patent rights or copyrights or otherwise transfers them to the amalgamated company (being an Indian company), section 35A(3) and 35A(4) would not be applicable in the case of amalgamating company. However, the provisions of section 35A continue to apply to the amalgamated company as these would have applied to the amalgamating company if the latter had not sold or otherwise transferred the rights [sec. 35A(6)].

- A similar rule will be applicable in the case of transfer in a scheme of "demerger" with effect from the assessment year 2000-01. The provision of section 35A(3) or (4) shall not be applicable to the demerged company transferring such rights to a resulting company in a case of demerger but it will be applicable to the resulting company as if demerger had not taken place.

Deduction in respect of expenditure on know-how [Sec. 35AB]

116. Deduction under section 35AB is available only if expenditure is incurred before April 1, 1998. If expenditure on acquisition of technical know how is incurred after March 31, 1998, depreciation is available under section 32.

Amortization of telecom licence fees [Sec. 35ABB]

117. The provisions of section 35ABB are given below :

117.1 ***Conditions*** - Deduction under section 35ABB is available if the following conditions are satisfied —

[illegible]	The expenditure is capital in nature.
[illegible]	It is incurred for acquiring any right to operate telecommunication services.
[illegible]	The expenditure is incurred either before the commencement of business or thereafter at any time during any previous year.
[illegible]	The payment for which has actually been made.

If all the above conditions are satisfied, then one can claim deduction under section 35ABB [*see* para 117.2]. If, however, these conditions are not satisfied, then deduction under section 35ABB is not available [one may claim deduction under section 37(1)].

117.2 ***Amount of deduction*** - The payment will be allowed as deduction in equal instalments over the period starting from the year in which such payment has been made* and ending in the year in which the licence comes to an end. It may be noted that the deduction starts from the year in which actual payment of expenditure is made irrespective of the previous year in which the liability for the expenditure is incurred according to the method of accounting regularly employed by the assessee.

117.3 ***Profit or loss on sale of telecom licence*** - Any profit or loss on sale of telecom licence is taken into consideration while computing business income. The relevant rules are given below. In the table given below, WDV is the written down of value (*i.e.*, the expenditure incurred remaining unallowed) on the first of the previous year in which telecom licence is transferred—

Different situations	*Tax treatment*
1. Entire telecom licence is transferred *1.1* When sale consideration is less than WDV *1.2* When sale consideration is more than WDV	WDV *minus* sale consideration is allowed as deduction under section 35ABB in the year of sale. The excess of sale consideration over WDV is taxable as business income in the year of sale (subject to rules given in Notes below).
2. When a part of telecom licence is transferred *2.1* When sale consideration is less than WDV *2.2* When sale consideration is more than WDV	WDV *minus* sale consideration will be allowed as deduction over the un-expired period. Same tax treatment as is given in 1.2 (*supra*)

Notes -

1. In *Situations 1.2* and *2.2*, the amount taxable as business income cannot exceed deduction allowed under section 35ABB in the earlier years.

2. The aforesaid amount is taxable whether (or not) business is in existence.

3. In respect of the same expenditure, no further deduction will be allowed under section 35ABB.

117.4 ***Consequences in the case of amalgamation or demerger*** - Where, under the scheme of amalgamation, a telecom licence is transferred by the amalgamating company to the amalgamated company (being an Indian company) or by a demerged company to a resulting company (being an Indian company), then deduction will not be available under section 35ABB to the amalgamating or demerged company. However, the provisions of section 35ABB continue to apply to the amalgamated company or resulting company, as these would have applied to the amalgamating or demerged company if the latter had not transferred the licence.

117.5 ***Depreciation under section 32 not available*** - Where a deduction for any previous year is claimed and allowed under section 35ABB, then no deduction of the same expenditure shall be allowed under section 32 for the same previous year or any subsequent previous year.

117-P1 *X Ltd., a company providing telecommunication service, obtains a telecom licence on April 20, 2008 for a period of 10 years which ends on March 31, 2018 (licence fee being Rs. 18 lakh). Find out the amount of deduction under section 35ABB if —*

a. the entire amount is paid on May 6, 2008;

b. the entire amount is paid on April 1, 2009; or

c. the entire amount is paid in three equal instalments on April 30, 2008, April 30, 2009 and April 30, 2010.

*If the licence fees is actually paid before the commencement of the business to operate telecommunication services, such payment is deductible from the previous year in which the business is commenced.

SOLUTION : *Situation (a)* - The payment of Rs. 18 lakh is deductible in 10 instalments over a period of 10 years from the previous years 2008-09 to 2017-18 (the amount deductible each year being Rs. 1.8 lakh).

Situation (b) - The payment is deductible in 9 years starting from the year of payment, *i.e.*, the previous year 2009-10 and ending with the previous year 2017-18 (the amount deductible each year being Rs. 2 lakh).

Situation (c) - The entire payment is made in three instalments. Deduction under section 35ABB is available as under —

	First instalment	*Second instalment*	*Third instalment*	*Total*
Date of payment	April 30, 2008	April 30, 2009	April 30, 2010	
Period during which deduction is available	10 years (2008-09 to 2017-18)	9 years (2009-10 to 2017-18)	8 years (2010-11 to 2017-18)	
Amount of payment	Rs. 6 lakh	Rs. 6 lakh	Rs. 6 lakh	
	Rs.	*Rs.*	*Rs.*	*Rs.*
Amount deductible in previous year				
2008-09	60,000	-	-	60,000
2009-10	60,000	66,667	-	1,26,667
2010-11 to 2017-18	60,000	66,667	75,000	2,01,667

117-P2 *X Ltd., a company which provides telecom services, acquires a telecom licence on April 5, 2008 for a period of 15 years which ends on March 31, 2023 (licence fees being Rs. 15 lakh paid on May 6, 2008). The licence is transferred by X Ltd. on December 20, 2010 for (a) Rs. 6,92,000, (b) Rs. 13,70,000 or (c) Rs. 15,60,000. Compute the amount chargeable to tax.*

SOLUTION :

	Rs.
Cost of licence which is paid on May 6, 2008	15,00,000
Less : Amount written off during the previous years 2008-09 and 2009-10	2,00,000
Written down value of telecom licence on April 1, 2010	13,00,000

Tax treatment when telecom licence is transferred on December 20, 2010

	Sale consideration		
	Rs. 6.92 lakh	*Rs. 13.70 lakh*	*Rs. 15.60 lakh*
	Rs.	*Rs.*	*Rs.*
Sale proceeds	6,92,000	13,70,000	15,60,000
Less : Written down value on April 1, 2010	13,00,000	13,00,000	13,00,000
Surplus	(-)6,08,000	70,000	2,60,000
Amount deductible during the previous year 2010-11 under section 35ABB(2)	6,08,000	-	-
Amount chargeable to tax during the previous year 2010-11 as notional business income, it cannot exceed the amount of deduction claimed in earlier years under section 35ABB	-	70,000	2,00,000
Short-term capital gains			
Sale proceeds	6,92,000	13,70,000	15,60,000
Less : Cost of acquisition	15,00,000	15,00,000	15,00,000
Short-term capital gain/loss	(-)8,08,000	(-)1,30,000	(+)60,000

Note - It can be seen from the above data that where the telecom licence is transferred for Rs. 6.92 lakh, the taxpayer can claim short-term capital loss of Rs. 8.08 lakh, apart from claiming deduction under section 35ABB. To avoid double deduction, it is suggested to the Government that a suitable amendment should be made in section 35ABB incorporating the following —

"Where a deduction is allowed in respect of capital expenditure under section 35ABB, no deduction shall be allowed in respect of said expenditure under any other provision of the Act in any year".

117-P3 *Suppose in problem 117-P2 X Ltd. transfers a part (40 per cent) of telecom licence for (a) Rs. 6,80,000 or (b) Rs. 18,90,000 on May 6, 2010. Compute the amount chargeable to tax.*