

Direct Tax Alert

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Karnataka HC allows depreciation on intangible assets acquired on conversion of a firm into a company

The fifth (now sixth) proviso to section 32(1) of the Income-tax Act, 1961 ('the Act') will apply only in the year of succession and not in subsequent years. Further, it would not be applicable on the assets acquired from predecessor on which the predecessor has not claimed depreciation.

In the case of *Padmini Products (P) Ltd v. DCIT*¹, the Karnataka High Court ('High Court') held that the taxpayer is eligible to claim depreciation on the intangible assets acquired, for consideration paid by way of allotment of shares, on conversion of the partnership firm into a company. The Court held that such a transaction was covered under section 47(xiii) of the Act and therefore it was a transfer of assets and the taxpayer was entitled to claim depreciation under section 32(1) of the Act on the intangible assets. Furthermore, the Court laid down an important principle that the fifth proviso (now sixth) to section 32(1) applies only in the year of succession and not in the subsequent years. Further, the fifth proviso to section 32(1) of the Act would not apply to the assets acquired by the taxpayer from predecessor on which the predecessor was not claiming depreciation.

Facts of the case

- Padmini Products, a partnership firm, was engaged in the business of manufacturing and dealing in incense sticks and allied products. The partnership firm had various intangible assets and was registered owner of various trademarks, however the same were not recorded in the books of accounts of the firm.
- The business of the firm was succeeded by a private limited company in the process of converting it into a company, Padmini Products (P) Ltd ('Assessee Company') with effect from February 1, 2005. All the assets and liabilities, including all the intangible assets, were transferred to the Assessee Company on succession.

¹ I.T.A No. 154/2014 (Karnataka High Court)



- Before succession, the partnership firm had revalued all its intangible assets using standard valuation methods.
- The Assessee Company, in consideration of succession of business, allotted shares to the partners of the erstwhile firm.
- It was the claim of the assessing officer that the assets (i.e., intangible assets) not existing in the firm and added in the Assessee Company at time of succession are not eligible for depreciation allowance under section 32(1) of the Act.
- The assessing officer therefore disallowed the claim of the Assessee Company for depreciation on intangible assets acquired from the firm on following grounds:
 - On conversion, there was no transfer of assets involved. Consequently, the Assessee Company neither actually acquired nor purchased the intangible assets, nor was the actual consideration paid for the purchase of assets.
 - In view of the fifth (now sixth) proviso to section 32(1) of the Act, depreciation is only allowable on the assets that actually existed in the earlier concern. In the present case the intangibles did not exist in the hands of the firm and were for the first time added in the hands of the company at time of succession. Therefore, pursuant to fifth (now sixth) proviso to section 32(1) of the Act no depreciation allowance was permissible to the Assessee Company on the assets added at time of succession.
- On appeal, the CIT(A) upheld the order of the assessing officer. On further appeal, Tribunal while upholding the order of assessing officer, held as follows:
 - The transaction itself is not transfer but is akin to succession and therefore in view of the fifth (now sixth) proviso to section 32(1) of the Act, depreciation is not permissible on the intangible assets acquired by the Assessee Company.
- CIT(A) has rightly justified the action of assessing officer by citing the provisions of Explanation 3 to section 43(1) of the Act.
- Aggrieved by the decision of the Tribunal, the Assessee Company preferred an appeal to the High Court.

Ruling of the High Court

- The business of manufacturing and sale of incense sticks is built on an intangible experience of aroma which can rarely be secured in the form of tradename/ trademark. Further the assessing officer knew that firm was registered owner of various trademarks.
- The authorities have neither questioned the valuation of intangible assets nor doubted the genuineness of the transaction. Thus, the intangible assets of the Assessee Company have a real money value.
- Any transfer of capital assets or intangible assets by a firm to a company pursuant to succession of the firm by a company under section 47(xiii) of the Act, is a recognised mode of transfer.
- The Assessee Company and erstwhile firm are different entities, and there was transfer of intangible assets by the partnership firm to the Assessee Company for a valuable consideration that is by way of allotment of shares. Therefore, the Assessee Company was entitled for depreciation with reference to the actual cost incurred by it.
- High Court took note of Memorandum to Finance Bill, 1996 and observed that the fifth (now sixth) proviso to section 32(1) of the Act was introduced to restrict the aggregate depreciation allowable both to the predecessor and the successor. The High Court held that If in a particular year there is no aggregate depreciation, then the said proviso does not apply. The erstwhile firm was not claiming depreciation on intangible assets (since the intangible assets were self-generated assets and recorded only before succession), hence fifth (now sixth) proviso will not apply with respect to the intangible assets acquired by the Assessee Company.



- Furthermore, the fifth (now sixth) proviso in any case will apply only in the year of succession and not in the subsequent years, and also in respect of overall quantum of depreciation in the year of succession.
 - The prerequisite to invoke Explanation 3 to section 43(1) of the Act is that the assessing officer has to establish that the main purpose of the transfer of assets was the reduction of tax liability by claiming extra depreciation on enhanced cost and he has to obtain the previous approval of the joint commissioner. In the current case, the assessing officer has not complied with the aforesaid conditions.
 - With regard to the above, the High Court finally concluded that the Assessee Company is eligible to claim depreciation on the intangible assets acquired at time of succession, on the cost incurred by it.
- applicability of the fifth proviso to section 32(1) of the Act.
- In this ruling, the High Court has categorically held that the fifth (now sixth) proviso to section 32(1) of the Act will apply only in the year of succession and only where there is a case of aggregation. This is a very welcome ruling and will clear up the ambiguity relating to the applicability of this proviso and shall have application to various transactions including succession, amalgamation, demerger, etc.
 - The High Court's interpretation of the provisions of the fifth (now sixth) proviso to section 32(1) of the Act also means that said proviso will apply only in respect of the assets which that the successor has acquired from the predecessor, and on which the predecessor was claiming depreciation i.e. the fifth proviso will not apply to the assets acquired by the successor on which the predecessor was not claiming depreciation.

Dhruva Comments

- Applicability of fifth (now sixth) proviso to section 32(1) of the Act in the years succeeding the year of succession/ amalgamation/ etc. has been a matter of debate. The tax officers have often resorted to restrict depreciation even for subsequent years by relying on the fifth (now sixth) proviso. Further, the Tribunals² in the past have held that pursuant to fifth (now sixth) proviso to section 32(1) of the Act the depreciation on assets received on succession/ amalgamation/ etc. is to be computed as if no succession had taken place and that the consideration paid for acquisition of such asset was not relevant. However, the Hyderabad Tribunal³ dealing with the applicability of fifth proviso to the goodwill arising on merger had held that said proviso was not applicable to asset (goodwill) that arose consequent to the merger as there was no aggregate depreciation allowable to the predecessor and successor on such asset. Thus, before this ruling of the High Court we had diverse Tribunal rulings on the
- This ruling of the High Court shall serve as an important precedent for the taxpayers claiming depreciation on the asset/s that has arisen upon succession, amalgamation, demerger, etc and the predecessor/ transferor entity was not claiming depreciation on the same.
- This ruling also accepts the proposition that the shares issued on succession to the partners of the erstwhile firm is an actual consideration discharged for acquiring the assets, and the value of shares issued shall be the actual cost incurred for acquisition of assets from the erstwhile firm.
- While undertaking such a restructuring exercise, the taxpayers should take appropriate caution with regard to applicability of anti-abuse provisions. The taxpayer will not only have to comply with the specific anti-abuse provisions contained in Explanation 3 to section 43(1) of the Act, but also ensure that GAAR provisions are not attracted.

² United Breweries Ltd. (I.T. A. No.722, 801 & 1065/Bang/2014) and M/s. PIK Studios P. Ltd. (I.T.A. No. 6681/Mum/2018)

³ Mylan Laboratories Ltd (I.T.A. No. 2335/Hyd./2018)



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