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KARNATAKA HIGH COURT ALLOWS DEPRECIATION ON INTANGIBLE ASSETS ACQUIRED UPON CONVERSION OF A FIRM INTO COMPANY

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The Karnataka High Court (HC) in the case of *Padmini Products Private Limited vs DCI* (ITA No 154 of 2014) allowed depreciation on intangible assets acquired by Padmini Products Private Limited (Taxpayer or Company) upon conversion from a firm into a company.

The HC further held that in case of succession, provisions restricting the quantum of depreciation between successor and predecessor would apply only in the year of succession and not in the subsequent years.

Background

- Taxpayer is a company engaged in the business of manufacturing, dealing, and exporting of incense sticks and allied products.
- The Taxpayer succeeded the business of Padmini Products, a partnership firm (PF). The PF got converted into the Company in the financial year (FY) 2004-05.
- Before conversion into a company, the PF had revalued all its intangible assets using acceptable valuation methods.
- Upon conversion of the PF, all its assets (including the revalued intangible assets) and liabilities were transferred from the PF to the Taxpayer and in lieu thereof, the Taxpayer allotted shares to each of the erstwhile partners of the PF.
- The Tax Officer disallowed the depreciation claim on intangible assets acquired by the Taxpayer during the re-opening proceedings.
- Upon appeal, the first and second appellate authority (ITAT) confirmed the order of the Tax Officer.
- Primarily, the depreciation claim on intangible assets was disallowed on account of the following: -
 - The intangible assets in the hands of the Taxpayer were valued as per its own valuation;

- Intangible valuation was merely a notional device to claim depreciation on a non-existent asset as:-
 - Taxpayer had not purchased such assets from a third party nor incurred any cost towards intangible assets;
 - Taxpayer merely succeeded the business of PF, which is not a transfer;
 - Depreciation claim of the Taxpayer will be restricted to the extent that was allowable to the PF, owing to
 - specific provision of Section 32 of the Income-tax Act, 1961 (IT Act) which restricts the quantum of depreciation to be split between the successor and predecessor in case of succession as if the succession had not taken place;
 - specific anti abuse provision which permits Tax Officer to disregard the actual cost of asset and determine the revised cost base for the purpose of claiming depreciation, subject to previous approval of the Joint Commissioner, provided such asset was previously used by another person and the main intention of transfer of such asset is to claim depreciation on enhanced cost by the transferee (Explanation 3 to Section 43(1))
- Being aggrieved by the order of the ITAT, the Taxpayer filed an appeal before the HC.

HC Ruling

The HC ruled in favour of the Taxpayer and held the following: -

➤ Depreciation on actual cost of intangible assets:

The Taxpayer is entitled to depreciation on the intangible assets on the actual cost incurred by it.

The HC noted the following: -

- The business of manufacture and sale of incense sticks is built on an intangible experience of aroma and PF was the registered owner of various trademarks.
 - Tax authorities never challenged the valuation of the intangible assets nor did they doubt the genuineness of the transactions. Thus, the intangible assets have a real money value.
 - The HC held that the Taxpayer and the PF are different entities and that there was a transfer of intangible assets by the PF to the Taxpayer upon conversion, for a valuable consideration by way of allotment of shares.
- Restrictions on quantum of depreciation in case of succession
- The HC held that the provisions which restrict aggregate depreciation claim both by the predecessor and the successor, will apply only in the year of succession and if in a particular year there is no aggregate deduction then such restrictions will not apply.
- Specific anti abuse provision: Explanation 3 to Section 43(1)

The HC held that the Tax Officer had neither recorded a finding to the effect that main purpose of transfer of asset was reduction of tax liability by claiming depreciation on enhanced cost nor had he obtained previous approval of the joint commissioner to disregard the enhanced price, both of which are prerequisites to invoke Explanation 3 to section 43(1) and hence the same cannot be invoked.

Comments

- There has been a debate regarding claim of depreciation on self generated assets which are acquired on merger, demerger and succession and whose cost in the hands of the transferor/ predecessor is NIL.
 - In relation thereto, the HC has clarified that even in case of acquisition of self generated assets upon conversion of firm into company, depreciation would be available on the actual cost incurred to acquire such intangible assets.
 - Section 43 of the IT Act, which lays down the actual cost and written down value for the purpose of claim of depreciation including for transaction of the nature of merger/ demerger. However, it does not contain a specific provision for assets acquired upon conversion of a partnership firm into a company. Thus, applicability of the ratio laid down in this ruling to self generated assets acquired under tax neutral transactions such as merger/ demerger would require closer evaluation and would also have to pass the muster of the anti abuse provisions to ensure that the intangible assets have commercial value and the transaction is not being undertaken only for the purpose of claiming enhanced depreciation.
 - The HC has further clarified that restriction in Section 32 on the claim of depreciation in case of merger/ demerger/ succession is applicable only in the year in which the transaction takes place and not in subsequent years.
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