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Company eligible to claim depreciation on revalued intangible assets acquired from erstwhile partnership firm

The Karnataka High Court has rendered its decision that the taxpayer (converted from partnership firm to a company) is eligible to claim depreciation on revalued intangible assets (revalued by the erstwhile partnership firm)

Background:

- The taxpayer¹ is a company, engaged in the business of manufacturing, dealing and exporting of incense sticks and allied products. The taxpayer succeeded a partnership firm (firm) w.e.f. 1 February 2005. Before the firm was converted into private limited company, the firm had revalued all its intangible assets using standard valuation methods. All assets and liabilities (including the intangible assets) of the firm were transferred to the taxpayer and in consideration, the taxpayer allotted its shares (at a premium) to the partners of the firm.
- The taxpayer claimed depreciation on the intangible assets.
- The Assessing Officer (AO) disallowed the taxpayer's claim of depreciation in the reopened audit proceedings for four Financial Years (FY) 2004-05 to 2007-08, corresponding to Assessment Years (AY) 2005-06 to 2008-09 on the following basis:
 - Intangible assets valued in the hands of the taxpayer at the time of succession, were valued as per taxpayer's own valuation and not for any actual consideration;
 - The taxpayer neither purchased / acquired intangible assets from any third party nor incurred any actual cost. Therefore, the value of the assets partook the nature of notional value and not the real value;
 - Depreciation was allowable as per the fifth proviso (now sixth proviso) to section 32(1) of the ITA, which was actually existing in the earlier concern viz. the firm. Therefore, the original assets, which were added to the company, at the time of succession, could not be considered for the purposes of depreciation.

As per section 32(1)(ii), amongst others, trademarks, being intangible assets acquired on or after the 1 April 1998, owned, wholly or partly, by the taxpayer and used for the purposes of the business or profession, are eligible for depreciation.

As per the sixth proviso to section 32(1) of the ITA, the aggregate deduction, in respect of depreciation in respect of tangible or intangible assets allowable to the predecessor and the successor cannot exceed in any previous year the deduction calculated at the prescribed rates as if the succession had not taken place. Further, the deduction is required to be apportioned between the predecessor and the successor in the ratio of the number of days for which the assets were used by them.

¹ Padmini Products (P) Ltd v. DCIT ITA no. 154 of 2014 (Karnataka HC)

- On appeal, the Commissioner of Income-tax Appeals [CIT(A)] and the Bangalore Bench of Income-tax Appellate Tribunal (ITAT) upheld the AO's order.
- Aggrieved by the ITAT's order, the taxpayer filed an appeal before the Karnataka High Court (HC).

Relevant provisions in brief:

As per section 43(1) "actual cost" means the actual cost of the assets to the taxpayer, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority

Explanation 3 to section 43(1) of the ITA states that where, before the date of acquisition by the taxpayer, the assets were at any time used by any other person for the purposes of his business or profession and the AO is satisfied that the main purpose of the transfer of such assets, directly or indirectly was to claim depreciation with reference to an enhanced cost, the AO shall with the previous approval Deputy Commissioner shall determine the actual cost.

As per section 47(xiii) transfer of a capital asset or intangible asset by a firm to a company because of succession of the firm by a company in the business carried on by the firm, shall not be regarded as transfer on satisfaction of certain conditions.

Decision of the HC:

The HC held the following:

- The intangible asset of the taxpayer had a real money value and the trademark viz. the intangible assets, were transferred to the taxpayer for a valuable consideration, since:
 - The firm was the registered owner of various trademarks.
 - The taxpayer had followed Accounting standard (AS)-10 'Accounting for fixed Assets' and AS-26 'Intangible Assets' for valuation of the shares.
 - The lower authorities had neither questioned the valuation of the intangible assets nor did they doubt the genuineness of the transactions.

Section 32(1) of the ITA provided for depreciation in respect of trademarks owned wholly or partly by the taxpayer. In the case under consideration, the taxpayer had succeeded the business of the firm, which had trademarks registered in its name and therefore, the taxpayer under section 32(1) of the ITA was entitled for depreciation.

- The transaction was squarely covered under section 47(xiii) of the ITA and therefore, the taxpayer under section 32(1) of the ITA was entitled for depreciation with reference to actual cost incurred by it with reference to intangible assets.
- The fifth proviso (now sixth proviso) to section 32(1) of the ITA restricted aggregate deduction both by the predecessor and the successor and if in particular year there was no aggregate deduction, the fifth proviso (now sixth proviso) did not apply. Thus, the proviso had no role to play until and unless it was a case of aggregate deduction.

The said proviso would apply only in the year of succession and not in subsequent years and also in respect of overall quantum of depreciation in the year of succession.

- The prerequisite for invoking explanation 3 to Section 43(1) of the ITA was that the AO had to establish that the main purpose of the transfer of such asset was to reduce the income-tax liability by claiming extra depreciation on enhanced cost. The AO in the current case had not recorded any finding in this regard.

Accordingly, the HC held that the taxpayer was eligible to claim depreciation on the intangible assets.

Comment:

- This ruling lays down the following principles that:
 - Where a partnership firm revalues its intangibles (being eligible for depreciation) prior to succession into a company (succession of partnership firm by company in exchange of issue of shares to the partners), the company is entitled to depreciation on such intangibles.
 - Sixth proviso (earlier fifth proviso) to section 32(1) of the ITA has no role to play until and unless it is a case of aggregate deduction. Further, it is applicable only in the year of succession and not in subsequent years.



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