BUDGET PROPOSALS
(1991 - 92)
REGARDING
DEPRECIATION

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Depreciation is a periodic non-cash book charge to the profit and loss account of a particular accounting period to recognise the fall in value of assets on account of:

* passage of time/use of assets (wear and tear)/change in tastes, technology and fashion;
* the demands of statutory requirements of the Income Tax Act and the Companies Act;
* the needs of management—planning and control, decision making and product costing; and
* the need for identifying resources for replacement.

It is the purpose of this paper to limit itself to appraise the provisions concerning depreciation in the budget for 1991-92, but not before knowing the meaning of the expression "block of assets" as defined in 52{11} of the Income Tax Act which reads as follows: "a group of assets falling within a class of assets being buildings, machinery, plant or furniture in respect of which the same percentage of depreciation is prescribed". The accelerated rates of depreciation, visualised in the Long Term Fiscal Policy found a place in the statute books since the assessment year 1988-89, that is to say with effect from 1-4-1988. The provisions relating to the grant of depreciation allowance experienced a complete change as per the Taxation Laws (Amendment and Miscellaneous Provisions) Act 1986 with effect from 1-4-1988. From the assessment year 1988-89 depreciation is to be allowed with reference to "a block of assets" and not individual assets as earlier.
Depreciation rates diluted

The fiscal proposals of Dr. Manmohan Singh for the year 1991-92 have not only enhanced the tax rates but also attempted a quicker reach to the bottom line of companies through diluted depreciation rates with a view to mop up additional revenues. In so-far-as depreciation rates are concerned, the chequered history requires to be noted before commenting upon the current year's fiscal proposal in this regard. The Long Term Fiscal Policy of 1985-90 made it clear in unequivocal terms that depreciation rates had to be accelerated to "ensure that 80% of the cost of the plant and machinery is written off in a period of 4 years or less." And there was in the budget of 1986-87 a translation of the said philosophy into action by drastic amendments to Section 32 of the Income Tax Act, 1961. However, unlike the then Congress Government which felt that accelerated depreciation facilitates capital formation, technological development and overcoming obsolescence, the present philosophy of the Congress Government again, stated in the Finance Minister's words reads as follows:

"The rates of depreciation prescribed in 1987, in relation to plant and machinery, are far too generous and provide much more than is needed to compensate for wear and tear .... I think an eight year period would be more reasonable taking into account the place of technological change in India, the true economic life of the business assets, and the need to discourage tax induced replacement of assets."
"The changes in the rates include decrease from 50% to 40%
in the case of aeroplanes, motor buses, motor taxies and
some other equipment and from 33.33% to 25% with respect to
plant and machinery. This means that the recoupment will take
place in six instead of five years. In fact the reduction in
rates of depreciation are comparable to the restriction of
depreciation charges to 75 per cent of the entire quantum
otherwise permitted, when the Taxation Law (Amendment) Act,
1991 was passed.

Diluted depreciation rates which have an adverse impact
on the corporate sector will reduce the tax shelter by the
product of the tax rate and the amount of depreciation that
stands disallowed, owing to the reduction in the depreciation
rates. It will also affect the cash flows of the company in
two ways:
(a) a larger profit subject to tax, gets reported
automatically because of the reduced depreciation and the
said larger amount of profits will be subject to tax at the
revised, enhanced, corporate tax rates. The increased tax
liability represents a cash outflow in the course of the year
itself as required by the provisions of the Income Tax Act,
1961, by way of Advance tax under the 'Pay-as-you-earn'
scheme; and
(b) the taxes saved on account of the shelter afforded by
erstwhile enhanced depreciation rates will have to be
foregone.
Thus, a resource crunch may develop on account of the two-pronged attack of enhanced tax rates coupled with depreciation rates which facilitates an earlier reach to the augmented bottom line by the fisc.

Fine Tuning of 832 of I.T.Act 1961

There is some fine tuning of the I.T. provisions regarding the claim of depreciation allowance under Section 32 of the Income Tax Act. Presently, Section 32 (1) of the Income Tax Act says that:

"In respect of depreciation of buildings, machinery, plant or furniture owned by the assessee and used for the purpose of business or profession the ..... deductions shall be ..... allowed."

This is proposed to be replaced by the following:

"Provided also that where any asset falling within a block of assets as acquired by the assessee during the previous year and is put to use for the purpose of business or profession for a period of less than 180 days in that previous year, the deduction under this clause in respect of such asset shall be restricted to 50 %, of the amount calculated at the percentage prescribed under this clause in the case of block of assets comprising such assets."

In the past the word 'use of asset' has been interpreted by the courts to mean active as well as passive use. The intention to use and keeping facilities ready for use rather than actual physical consumption or expiration of utilities of the asset, are the key requirements behind the word 'use' under S 32. In the circumstances, the amended version may lead to increased litigation. In the current budget the Finance Minister says "I also propose to restrict the rates of depreciation in cases where the asset is used for less than 6 months in a year". The companies be set with problems like seasonal demand, dearth of demand and want of use of assets due to labour problems are likely to incur the wrath of this new proposal.

Corporate Capital Investment Decisions

As a result of the said fine tuning of S32 of I.T.Act 1961 the corporate capital investment decisions have to gear themselves to be phased between April and September that is within 6 months from April 1, 1991 this year. The fixed asset expansion hereafter will be crowded between April and September of each year to ensure the availability of the full dose of the depreciation rates. Inspite of the cash crunch, companies will have to wily-nily find funds/alternative financing schemes and arrangements to enjoy the full benefits of S 32. In future cash budgets of companies have to align their outflows on capital account to this new dimension of S
32 and procurement of funds has to be timed between April and September of a fiscal year if the benefits of S 32 are to fully accrue and the tax planning exercises motivated to transmit operating excellence to shareholders are to be fruitful. The corporate financial objective of maximising return on shareholders equity can be sustained only if the Operating excellence of the company are salvaged through appropriate tax planning exercises. And that means the new dimension of S 32 being a key input in the formulation of corporate financial policy. It is believed that because **Capital Investment Decisions** are all being bunched to be made before 30-9-1991; lease rents will go up sharply after that, because the general depreciation rate will fall to 12.5 percent after 30-9-1991. As mentioned earlier profits will increase, depreciation will be lower and cash outgo on account of tax will depress cash flows and post tax profit.

There is yet another point as regards the new provision concerning use for minimum period of 180 days. In the event of the sale of the asset from a given block, the salvage value when compared with the opening balance of the block of assets at the start will show a higher profit than when compared with the block value on a 'Cum acquisition' basis. The former position will be favourable to the Treasury while the latter position will be preferred by the assessee. However in the opinion of the author S50 of the I.T.Act is explicitly and unequivocally **clear** on this count. The value of
the block of asset to be reckoned with, for comparison with salvage value, should include inter alia conclusion vide S50 (i) (iii) "the actual cost of any asset falling within the block of assets acquired during the previous year".

CONCLUSION

If the corporate sector has to positively respond to the winds of change blowing on account of the measures of deregulation and liberalisation (following the amendments to MRTP Act, FERA and other licensing regulations), large amounts of disposable surpluses are required to fund new projects. The theme that emerges is that the corporate sector may have to either slow down the asset formation rate to the decreased amount of resources available (post-tax and post-dividend) or in the alternative if the asset formation rate has to be stepped up, increasing resort to external capital — new issues of equity and debt will be required. Though the corporate sector may have been mentally prepared for a harsher treatment from the Exchequer's proposals and therefore is exhibiting joyous response in the stock-market as a bear-covering reaction, yet the resource crunch to emerge as a result of enhanced tax obligation and increased resources required to sustain future capital formation and investors' expectations has perhaps escaped the immediate canvass of the players in the stock-markets. Surely, paying more to the Exchequer and managing new programmes inspite of reduced deployable surpluses should call for initiating corporate financial policies which embrace financial
rectitude through austerity, discipline and parsimony. Corporate sector ostentation and prodigal dispensation of exiguous resources has to be brought under control through enlightened self-restraint, if harsher measures are not to be attracted in the interim phase of the current fiscal year.