CHAPTER - II

NATURE OF VARIOUS DEDUCTIONS

The income referred to under this head shall be computed in accordance with the previsions contained in section 30 to 44 D. Various deductions shown as section-wise, these are follows :-

Section	Particular's with brief comments
30	Rent, Rates, Taxes, Repairs and Insurance for building - under this section 30, deductions are allowed in respect of rent, rates, taxes, repairs and insurance for premises used for the purpose of business or profession.
31	Repairs and Insurance of machinery, Plant and m furniture - a) Amount paid on account of current repairs. b) Amount of insurance premium paid in respect of insurance against risk of damage or destruction.
32	Depreciation - Depreciation usually means loss or decline in the value which occurs gradually over useful life of a material thing.
32 A	Investment Allowance - The Government has however, announced to reintroduce investment Allowance in respect of assets installed after March 31, 1988.

33 A	Development Allowance - An assessee, who carries on business of growing and manufactruing tea in India is entitled to Development Allowance.
33 A B	Tea Development Allowance - No deduction is available under section 33 AB w.e.f. the A.Y. 1988-89.
33 B	Rehabiliation Allowance
34	Conditions for Depreciation allowance and development rebate.
35	Expenditure on scientific research The term "Scientific research means " any activities for the extension of knowledge in the fields of natural or applied sciences <u>Note</u>:Deduction under section 35 is not available from the A.Y. 1989-90 onwards.
35 A	Expenditure on acquisation of patent rights or copyrights - Any capital expenditure, incurred after February 28, 1966 in acquiring patent rights or copyrights used for the purpose of business is allowable as business expenditure in equal instalments over a period of 14 years.

35 A B	Expenditure on know-how - Any lump sum consideration paid by the taxpayer for - acquiring any know-how to use for the purpose of his business is allowed as deduction by spreading it equally over 6 years.
35 B	Export markets Development Allowance
35 C	Agricultural Development Allowance Noting is deductible u/s 35 C in respect of expenditure incurred after February 29, 1984.
35 C C	Rural Development Allowance - No deduction is available under section 35 C C from the assessment year 1989-90 onwards. One can, however avail deduction under section 80 G.
35 C C A	Expenditure by way of payment to associations and in situations for carrying out rural development programmes - Deduction under section 35 C C A will not be available from the A.Y. 1989-90 onwards one may, however, avail deduction under section 80 G.
35 CC B	Expemditure by way of payment to associations and institutions for carrying out any approved programmes of conservation of natural resources.

35 D	Amortisation of certain preliminary expenses - certain preliminary expenses incurred by an Indian company or resident non corporate assessee before commencement of business or extension of undertaking or setting up new industrial unit, quality for deduction.
35 E	Expenditure on prospecting for the development of specified minerals.
36	Other deductions - Includes, Insurance premium Bonus or commission to employees. Interest on borrowed capital Bad debts; write off allowance for animals; contribution towards approved gratuty fund etc.
37	General deductions - Includes - entertainment expenditure, Expenditure on advertisement Travelling expenses.
38	Building etc. partlyu used for business etc. not exclusively so used.
39	Managing Agency commission.
40 a	Amounts not deductible - A) any interest payable out of India which tax has not been paid. b) any sum paid on account of any rate or tax levied on the profits or gains of any business or profession.

c) any sum paid on account of wealth tax under the wealth tax Act 1957.

d) Salary payable out of India, If tax has not been paid or deducted at source and

e) any payment to a provident or other fund established for the benifit of employee's of the assessee.

41 Profit chargeable to tax.

42 Special provision for deduction in the case of business for prospecting etc -- for mineral oil.

43 Definition of certain terms.

43 A Changes in rate of exchange of currency.

43 B Certain deductions to be only on actual payment.

44 Insurance business.

44 AA Maintenance of accounts by certain persons. The requirement of section 44 AA and rule 6 F for compulsory maintanance of books of account may be summarised by grouping different tax payers in the A, B, C, and D category.

44 AB Audit of accounts of certain persons carrying on business and profession : The finance Act, 1984 has made a provision in the Income-tax Act making it obligatory for a person carrying on business to

get his accounts audited w.ef. the assessment year 1985-86 before the "specified date" by an accountant.

44 B Special provisions for computing profits and gains of shipping business in the case of non resident.

44 C Deductions of Head-Office expenditure in the case of non resident.

44 D Special provision for computing income by way of royalties etc. in the case of foreign companies.

2. SIGNIFICANCE OF DEPRECIATION IN GENERAL :

The interest on borrowed capital is normaly considered in the cost of production. The depreciation allowance, which is in the nature of notional expenditure and which is chargeable to the profit and not to the cost needs to be ignored. It is only for making decision as to produce or not to produce an item in the total production cost depreciation allowance may be taken into account by the management for the purpose of decision making for profit or for price-fixation.

3. MEANING AND DEFINITION OF DEPRECIATION BY VIEW POINT OF ACCOUNTING :

Depreciation has been defined by various authors in the following ways -

1. B.G. Wickery :

"Depreciation may be defined as the permanent decrease in the value of an asset through wear and tear in use or the passage of time".

2. SPICER AND PEGLAR :

"Depreciation may be defined as the measure of the exhaustion of the effective life of an asset from any cause during a given period".

3. THE AMERICAN INSTITUTE OF ACCOUNTANT'S COMMITTEE ON TERMINOLOGY :

DEFINITION OF DEPRECIATION ACCOUNTING :

"Depreciation Accounting is a system of accounting which aims to distribute the cost or other basic values of tangible capital assets less salvage (if any) over the estimated useful life of the unit (which may be group of assets) in a systematic and rational manner. It is a process of allocation not of valuation depreciation for the years is the portion of the local charge under such a system that is allocated to the year. Although the allocation may properly take into account. Occurrences during the year. It is not intended to be a measurement of the effect of all such occurrences".

METHODS OF DEPRECIATION :

1. Fixed instalment method.
2. Diminishing balance method.
3. Annuity method.
4. Depreciation fund method.
5. Insurance policy method.
6. Annual valuation method.
7. Charging one sum to recover repairs, renewals and depreciation.
8. Kilometer method.
9. Machine hour rate method or efficiency hour method.

10. Global method.
11. Depreciation unit method or production unit method.
12. Compound interest method.
13. The sum of the year digit method.
14. Replacement cost method.
15. Group depreciation of Homogeneous method.
16. Double declining balance method.
17. Statutary method.

4. MEANING OF DEPRECIATION BY VIEW POINT OF ECONOMICS :

In every business equipment, machines, and buildings wear out with time and use in course of time these assets become useless from the point of view of the business apart from the scrap value that can be realised from their sale as junk. Therefore inorder to measure the true income of a business, ascharge is made against the annual income of the business this charge is known as depreciation represents the decrease in the value of the assets due to use during a particular period the provision of depreciation also enables the firm to provide for replacement of the assets by the time it becomes scrap.

The depreciation charge varies in importance from company to company for example very heavy depreciation charges are provided for in industries like iron and steel, railways, air-transport, aluminium etc. whereas, in the case of insurance companies banks and other financial institutions, advertising retail and wholesale business depreciation costs are relatively lower.

However, there are a number of methods of measuring depreciation for the purpose of reporting business profits to the shareholders and taxable profit to the income tax authorities. As depreciation is an important internal source of funds, the amount and hence the method of depreciation becomes significant as tool of capital formation.

There are three commonly accepted methods of depreciation.

1. Straight line method.
2. Declining balance method.
3. Sum of the years Digits method.

Discription of the above noted points are given in a nutshell -

1. STRAIGHT LINE METHOD :

Under this method an asset is supposed to wear out evenly during it's normal life. The amount of annual cost of depreciation, is obtained by dividing the annual cost of the assets, by the estimated life in years assuming that there is no scrap value if there is any estimated scrap value it's amount will have to be deducted from the initial cost before dividing it by the estimated life in years. The straight line method has the advantage of simplicity.

EXAMPLE :

Assume that an asset who's original cost is Rs.1,000/- with a scrap value of Rs.100/- and a life of 5 years, is to be depreciated. The annual depreciation charge on this asset

will be Rs. $\frac{1000 - 100}{5}$ = Rs. 180

There are two variants of this method which may also be noted here :-

i) Under the working hours method the life of an asset is expressed in terms of working hours rather than the years.

ii) Under the units of production method the useful life of the asset is expressed in terms of expected units of production.

2. <u>DECLINING BALANCE METHOD</u>

Under this method depreciation is provided at a uniform rate on the written down value of the asset at the begining of the year. The formula for determining the fixed rate of depreciation is as follows.

Exam : If the assets cost Rs. 1000 and the rate of depreciation is 20% The depreciation in first year would be Rs. 200.

$$\therefore \quad d = 100 \left(1 - \sqrt[n]{\frac{s}{c}} \right)$$

where d = percentage of depreciation.

s = scrap or residual value of the asset.

c = Initial cost of the asset

n = Estimated life of the asset in years.

The formula can be easily solved with the help of logarithmic tables -

$$\therefore \quad d = 100 \left(1 - \sqrt[5]{\frac{100}{1000}} \right)$$

$$\therefore \quad d = 36.9043 \text{ or } 37\%$$

Years (i)	Annual Depreciation (ii)	Written down value (iii)	Cumulative Depreciation (iv)
1	369.04	630.96	369.04
2	232.85	398.11	601.89
3	146.92	251.19	748.81
4	92.70	158.49	841.51
5	58.49	100.00	900.00

It will be seen that the written down value at the scrap value of the asset.

3. SUM OF THE YEAR'S DIGITS METHODS

The basic idea of this method is similar to that of the declining balance method. The amount of depreciation in the beginning of the life of the asset is higher and it progressively declines with the passage of time, as is the case with the declining balance method. The variable rate of depreciation is calculated in the following manner.

i) Each digit of the year's of the useful life of the asset is added up and the resulting figure is the demominator of the fraction to find out depreciation rate.

ii) The numerator of the fraction for each year is the expected life of the asset in that particular year and this declines by one each year. Thus the depreciation rate is composed of varying numerator and an unvarying denominator. And this rate is applied for each year to the assets original cost. Example - Assets original cost is Rs. 1000. It'sscrap value is Rs. 100 and expected life is 5 year's. Thus the expected life periods are 5, 4, 3, 2, and 1 years.

Age of assets in year's	Varying dep. rates	Annual Dep.	Accumulated Depreciation	Book Value
1	5/15	300	300	700
2	4/15	240	540	460
3	3/15	180	720	280
4	2/15	120	840	160
5	1/15	60	900	100

Either of these two methods declining balance method and the sum of the year's digits method will be found useful as well as equitable where experience has shown that the cost of repairs increases as depreciation charges d

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DEPRECIATION METHOD AND TAX LIABILITY

1. Taxable income and income tax liability would be substantially larger towards later year's under the declining balance method and the sum of the year's digits method assuming no change in tax rates or in income before depreciation.

2. Under the accelerated depreciation methods the tax liability being lower in the earlier year's of the life of an asset the company has the benefit of retaining a part of the funds which would have been payable as tax under the straight line method.

3. In the case of assets subject to rapid obsolencence it is desirable to write off the asset as soon as possible and in this respect accelerated methods of depreciation are more effective than the straight line method.

4. The capacity of a firm to earn profit from the use of an asset is necessarily lower in the earlier part of the life of asset. Thus the capacity to pay tax is also lower under the accelerated depreciation method. The tax liability is lower in the begining and high towards the end. Thus there is an adjustment in the capacity to pay taxes and the tax liability is adjusted with capacity to pay.

5. There is another aspect of the problem. In economics with inflationary bias as is usual these day's the tax rate is more likely to go up than go down. As the profits would increase in the later years even without a change in income before depreciation tax would have to be paid at a higher rate on higher profit if accelerated depreciation methods are followed. But if the tax rate goes down, there will be a double advantage in this methods, higher profits will be taxed at a lower rate.

In view of the fore-going discussion one can conclude that accelerated depreciation methods offer a clear advantage to young growing companies.

COUNTRIES AND APPLICATION OF DEPRECIATION METHOD :

There are certain restrictions placed on the managerial choice about depreciation methods by the tax rules of different countries. In the U.S.A. internal revenue act permits a company to choose any one of the three methods described above. Other countries such as France, Denmark, Holland and Sweden have introduced accelerated depreciation methods mainly to stimulate investment. In Australia, the straight line or the declining balance method may be used. In India except in the case of ships there are prescribed rates of depreciation to be applied to the written down value of the asset under the declining balance method. In the case of ships, the depreciation is calculated on the basis of actual cost.

5. SIGNIFICANCE OF DEPRECIATION FROM THE POINT OF VIEW OF INCOME-TAX ACT 1961

The Income-Tax Act 1961 provides for the grant of depreciation allowance in the computation of income.where the Provisions have been devised to eliminate hardship to assessee's who could not otherwise claim any depreciation in regard to wear and tear in or obsolescence of capital assets not withstanding that the dimination in value or wastage arose by reason of their employment in the production of taxable income on the ground that the assets concerned were not part of the circulating capital.

The depreciation allowance in it's present form is a matter of timing of the allocation to expenses of the cost of the capital assets. It is based upon the principle of wear and tear and is granted year after year so as to enable the creation of a fund sufficient to replace the asset at a time when it's life is going to expire and same shall become permanently useless. Although the scheme of the Act is to allow generally the deductions only for an expenditure which is of a revenue nature but as capital may, in the process of production, depreciate get used up or lost, the income tax Act while taxing income. Profit and gains takes note of it and makes allowance for such eventualities in the shape of depreciation allowance.