

## 1. INTRODUCTION

### **General**

Incentives to promote socially desirable activities are not uncommon in tax systems all over the world. The Indian income tax also contains numerous provisions intended to influence allocation of resources according to Plan programmes and promote activities ranking high in the priorities of social and economic development. Among the various socio-economic objectives sought to be supported through concession in tax is the development of rural areas.

Since nearly three-fourths of the country's population live and work in rural areas, the bulk of them at low levels of income and consumption, development of these areas has naturally been a cornerstone of our planning strategy right from the inception of planning in the country. Massive outlays in the public sector on irrigation, rural electrification, communication and creation of financial infrastructure for the growth of agriculture and rural industries have been the principal instruments of this strategy. The tax system has also been used in various ways to lend support to this strategy. For instance, protection and development of handlooms has been a major element of our textile policy and products of cottage and village industries have in general been exempted from excise duties. On the direct taxes side, income of Khadi and Village Industries Commission and other government or non-profit agencies engaged in the development of khadi and village industries is exempt from income tax. In 1974 a scheme of tax holiday or partial exemption of the profits of new industrial undertakings was introduced specially for backward areas, most of which are of a rural character (section 80HH of Income-tax Act, 1961, hereinafter referred to as "the Act"). An alternative concession for newly established small-scale undertakings in rural areas was given under section 80HHA which was introduced in the Act in 1977. The provision of Tax Credit Certificates for shifting of indus-

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trial undertakings from urban areas introduced in 1965 was also in a way a measure towards industrialisation of rural areas. Apart from these, a few provisions of a distinctive character were introduced in the Act in 1960s and 1970s which were designed to promote the development of rural areas through application of modern technology in agriculture and spread of social services. These were the agricultural development allowance (section 35C), the rural development allowance (section 35CC) and the deduction for funding of rural development programmes through approved associations and institutions (section 35CCA) inserted in the Act in 1968, 1977 and 1978 respectively.

The distinguishing feature of the latter provisions was that unlike the tax holiday or exemption related to the source of income, these were linked to the use or application of income in the desired directions, irrespective of whether these happened to be within the fields of business activity of the taxpayer concerned. Agricultural development allowance permitted manufacturers (companies and cooperatives) using products of agriculture, animal husbandry, dairy or poultry farming as raw material to claim a deduction (weighted deduction of 120 per cent for and upto the assessment year 1983-84) from their taxable income for expenditure incurred by them in providing goods, services and other facilities to cultivators, growers and producers to raise their productivity. While the rural development allowance provided for deduction of expenditure incurred by companies and cooperative societies in undertaking approved rural development programmes, under section 35CCA any taxpayer carrying on a business or profession could claim deduction in respect of funding of approved programmes of rural development or training of personnel for their implementation through approved associations and institutions. In addition, by section 80GGA inserted in the Act in 1979, donations for the above purposes by assesseees not carrying on a business or profession also became entitled to tax relief.

While all these provisions subserved the objective of rural development, a feeling grew that there was considerable overlap among them. Also, doubts were felt about their efficacy *vis-a-vis* their cost in terms of revenue forgone, and the attendant complication in tax law. Hence, in line with the policy of

simplifying the tax laws and removing ineffectual or wasteful incentive provisions, the agricultural development allowance, rural development allowance and the deduction for funding of programmes through approved associations and institutions have since been withdrawn. Only contributions or donations made by taxpayers to the National Fund for Rural Development set up in 1984 are deductible in computing taxable income.

In order to evaluate the costs and benefits of incentives of this nature, the present study was commissioned by the Central Board of Direct Taxes (CBDT) in respect of one of the incentives for rural development, *viz.*, rural development allowance provided under section 35CC of the Act. The study was to ascertain:

- (a) How far the underlying purpose of the incentive was achieved, qualitatively and quantitatively,
- (b) Cost in terms of revenue,
- (c) Whether there has been abuse of the provision, and
- (d) Problems of implementation: Whether there have been difficulties in operation and if there have been problems arising from disputes over interpretation, court rulings and/or audit objections.

The essential features of section 35CC incentive provision were:<sup>1</sup>

- (i) Only companies and cooperative societies could avail of the incentive. The interested company or cooperative society had to draw up specific programme(s) of rural development for one or more rural areas.<sup>2</sup>
- (ii) To secure a deduction of the expenditure incurred on a rural development programme in computation of total income, the programme had to be approved by the prescribed authority before incurring any expenditure thereon. From 1.9.1977 till 31.5.1979 the prescribed authority was a Central inter-ministerial committee with the Secretary, Union Department of Agriculture as its chairman. To expedite clearance of schemes of rural development, the work relating to

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approval of programmes was decentralised from 1.6.79 and entrusted to State-level committees consisting of the Commissioner of Income Tax exercising jurisdiction over the State/Union Territory in which the programme was to be carried out, as the chairman, and the concerned Secretary of the State government/ Union Territory as a member.<sup>3</sup>

- (iii) "Programme of rural development" was defined as including any programme for promoting the social and economic welfare of, or the uplift of, the public in any rural area. The Central inter-ministerial committee drew up an illustrative list of 15 categories of programmes that would be considered by it for approval.<sup>4</sup> This illustrative list was also followed by the State-level committees. Following the amendment of section 35CC by the Finance Act, 1983, w.e.f. 1.4.1983 the prescribed authority could approve only those programmes which fell within the classes or categories of programmes specified by the Central government.<sup>5</sup>
- (iv) While according approval to a programme, the prescribed authority laid down the period during which it had to be implemented. Ordinarily, the implementation period was from the date of approval by the prescribed authority till the close of the accounting year of the assessee commencing next after that date. Before approving an extension, the prescribed authority could monitor the programme to satisfy itself that it was being implemented properly.
- (v) If the programme involved construction or acquisition of any building, machinery or plant or furniture, the assessee had to divest itself of the ownership of the asset in favour of the village panchayat or other local authority. On its failure to do so, it was not entitled to a deduction in respect of the expenditure incurred thereon and could only get depreciation on the cost of the asset, as if it was a business asset.
- (vi) A claim for deduction under section 35CC was admissible only if the assessee furnished a statement of expenditure in a prescribed form (Form No. 3AA) duly

signed and verified by a qualified accountant. This statement was to be filed along with the return of income for the assessment year in respect of which the deduction was claimed.

### **Data Base and Methology**

In evaluating the efficacy of the provision in question in terms of cost and benefit, information was required on various aspects of its operation, e.g., the number of cases in which the concession was availed of, nature of the programmes actually undertaken and the financial outlay thereon. None of these data was readily available. Section 35CC figures neither in the annual statistics brought out by the Income-tax Department nor in the Annual Reports on Direct Taxes issued by the Comptroller and Auditor General. The CBDT also could not furnish any information readily in this regard.

The Commissioners of Income Tax were accordingly requested to furnish particulars of rural development programmes approved under section 35CC in their respective jurisdictions during the period 1.9.1977 to 31.3.1984. The information furnished by them was supplemented with that contained in the answer to the Lok Sabha Unstarred Question no. 655 dated 23.2.1979 and further gathered by the team entrusted with the present study from the registers of the prescribed authorities for Maharashtra, West Bengal and Andhra Pradesh. This showed that during the period 1.9.1977 to 31.3.1984, 263 approval orders were issued by the Central and State-level prescribed authorities to 140 companies.

The Income Tax Officers/Assistant Commissioners assessing the above companies were requested through their respective Commissioners of Income Tax to furnish information in a pro-forma as to the amounts of deduction claimed and allowed under section 35CC over the assessment years 1978-79 to 1982-83, reasons for variation between the two, and the subsequent appeal, revision petition and audit history, if any. As assessing authorities, they were requested to indicate, along with their suggestions, the difficulties experienced in the administration of this provision including the lacunae in the law and administration procedures that might have come to notice. Filled-in proformae were received in respect of 43 companies.

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Of the 140 companies carrying 263 approvals upto 31.3.1984, 93 companies with 182 approvals happened to be assessed at the three metropolitan cities, namely, Bombay (58 companies with 119 approvals), Calcutta (21 companies with 32 approvals) and Delhi (14 companies with 31 approvals). In May-June, 1985 the Institute's study team scrutinised the income-tax assessment records of the companies concerned available at these places, to extract the relevant assessment details wherever these were not furnished by the assessing officers. The team found that out of 93 companies assessed at these places 69 had claimed deductions under section 35CC for and upto the assessment year 1984-85 in 188 assessment proceedings. In all, information about deductions claimed under this section *vis-a-vis* the total income returned, became available in respect of 92 companies in 223 assessment proceedings. The team found that of the 69 companies assessed at Bombay, Calcutta and Delhi which had claimed deductions under section 35CC, only 56 companies had filed the prescribed Form No. 3AA in support of their claims. The team scrutinised these forms to extract information as to the programmes content actually implemented, nature of capital assets created, if any, and their divestment.

The provisions of section 35CC evoked considerable interest in official and business circles and a number of seminars and workshops were held over the years to evaluate their merits and shortcomings. Their proceedings brought out in sharp relief the views on the subject, of the CBDT, Commissioners of Income Tax, trade associations, the corporate sector including the large industrial houses, voluntary agencies and others interested in rural development. The views expressed in these seminars provided valuable material for this study.

### **Plan of the Report**

Chapter 2 indicates the corporate sector's response to the incentive provided through section 35CC of the Act, and the cost thereof in terms of revenue forgone. It also attempts to indicate how far the underlying purpose behind the objective was achieved. Chapter 3 deals with the problems of implementation. Chapter 4 contains the conclusions and recommendations.

### Cooperative Sector

In the nature of things, a cooperative's capacity to spare funds and human resources for a project which is not an essential part of its day-to-day operations, is very limited. Cooperatives making substantial profits enjoy many tax concessions and their contribution to income tax is relatively small. Their response to the incentive of the type offered by section 35CC, therefore, cannot but be muted. The study team's scrutiny of the registers of the State-level prescribed authorities for Maharashtra, West Bengal, Bihar and Orissa did not show any response of the cooperative sector to this incentive. The only information available is that a few cooperative societies got their programmes approved in other States and one of them implemented a modest programme. It was, therefore, no surprise that proceedings of the various seminars which discussed the problems arising out of the working of section 35CC at considerable length are silent on the role of cooperatives and the difficulties, if any, faced by them in this regard. The study is, therefore, confined to the corporate sector.

### NOTES

1. Government of India, Ministry of Finance (Department of Revenue) Circular No. 231 (F. No. 203-201/77-ITAI) dated November 14, 1977 contains the guidelines for approval of programmes of rural development for purposes of Section 35CC: *Direct Taxes Circulars*, Taxmann, 1985, Vol. 1, pp. 318-322.
2. "Rural area" as defined in clause (b) of the Explanation to sub-section (1) of Section 35CC: Notification issued under sub-clause (ii) thereof: No. S O. 691 (E) dated September 29, 1977, *ibid.* p. 323.
3. Central Board of Direct Taxes: Notification No. S.O. 327 (E) dated May 31, 1979 (1979), for States and Union Territories having more than one commissioner of income tax, Central Board of Direct Taxes: Notification No. S.O. 327 (E) dated May 31, 1979: (1979) 118 *I.T.R.* 28-29 (St).
4. Government of India, Ministry of Finance (Department of Revenue) Notification No. GSR 47 (E), dated 28.1.1984, as amended by GSR 720 (E), dated 12.10.1984, *Direct Taxes Circulars*, Taxmann, 1985, Vol. 1, p. 322.