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# Summary of Conclusions and Recommendations

## Introduction

Capital allowances in the form of accelerated depreciation or development rebate have been in operation in India with a brief interruption for almost forty years now. Along with tax holiday for new industrial undertakings, capital allowances were considered necessary to further industrialisation and capital formation especially in crucial areas.

For producers' goods and capital goods industries, Taxation Enquiry Commission (1953-54) recommended a new incentive termed 'development rebate' by way of reduction in computation of taxable income of a stipulated sum over and above the cost of new plant and machinery whether intended for replacement or for expansion by new or existing concerns.

Development rebate as an allowance in the computation of business income was introduced in 1955 in respect of new machinery or plant installed after March 31, 1954. It remained on the statute book for two decades. The principle of selectivity recommended by the Taxation Enquiry Commission for grant of development rebate was not followed except to the extent it may be said to have been applied by grant of the rebate at a higher rate to certain industries.

Following an unforeseen steep escalation of capital costs, investment allowance was introduced in April 1976 to facilitate investment in new plant and machinery in priority industries listed in the Ninth Schedule to the Income-tax Act, 1961. Like the erstwhile development rebate, the allowance admissible under

section 32A of the Act was given over and above full recoupment of the cost of the asset through depreciation allowance and was available for new ships or aircraft installed or new machinery or plant installed upto March 31, 1987. Investment allowance is no making way for a new "funding scheme" enacted as section 32AB (investment deposit account) of the Act. During its operative period section 32A has seen a number of amendments.

The change of eligibility criterion from the manufacture of the Ninth Schedule Priority Goods to manufacture mainly of other than the Eleventh Śchedule low priority articles considerably enlarged the area of eligibility. Extensive pruning of the Eleventh Schedule list widened it still further. Raising of the aggregate value of machinery and plant installed for an industrial undertaking to be deemed small-scale and thus entitled to investment allowance irrespective of the line of manufacture or production also extended its scope.

A wide range of investment incentives is available to serve different purposes. In the nature of things, the choice of a tax incentive by a country and its exact shape depends upon the state of its economy, its tax system and its perception as to how the object in view may best be realised. Lately, there is a noticeable shift from high nominal rates of tax with generous allowances and reliefs to fewer tax incentives with comparatively low tax levels.

**Investment Allowance and Growth of Investment**

In order to isolate the impact of investment allowance on growth of corporate investment in India, a model of the investment decision-making process at the company level has been constructed on the basis of certain plausible assumptions. This has been done in an integrated framework of corporate behavior covering its three major aspects, namely, investment, financial structure and dividend distribution.

Investment is determined by cost factors and the expected demand for output. Taxes are assumed to affect investment by altering the rental cost of capital or the net minimum required rate of return. Using the cost effectiveness criterion, a quantitative relationship showing the dependence of cost of capital on a few variables (factors) was derived which incorporates the

major tax elements including the investment allowance. The cost of capital thus quantified was employed as a variable in the investment function. This relationship was used to estimate the impact of investment allowance. The parameters of the model were estimated using time series sample data relating to Indian companies published by the Reserve Bank of India. The empirical results show that both the cost as well the output demand factors play significant roles in corporate investment decisions.

The estimated model was used for simulating the effect of development/investment allowance by substituting a hypothetical rental cost variable computed without the development rebate/investment allowance. The impact of the incentive was interpreted as the difference between the actual and the hypothetical investment in each year. The government sector was left out while simulating the model as the rental cost variable may not be the decisive factor for investment in the case of government companies.

The results of the simulation exercise show that investment induced by the incentive, on the average, was less than 2 per cent. In absolute terms the effect is not negligible, particularly, since the introduction of investment allowance, the inducement effect was more pronounced. The inducement effect of the investment allowance was markedly higher than that of its predecessor, viz., the development rebate.

In percentage terms, during the years 1960-61 through 1982-83, the inducement effect of development rebate/investment allowance was marginal both for public limited and private companies. While for public limited companies, it ranged between 0.9 per cent and 2.7 per cent of the investment which would otherwise have taken place, for private companies it generally hovered around 1 per cent. For public limited companies, the investment allowance inducement was from 1.5 to 2.4 per cent (1977-83) as against 0.9 to 2.7 per cent for development rebate (1960-61 to 1974-75). In absolute terms, the year 1982-83 saw the peak of the inducement effect of the investment allowance, viz., Rs. 58.64 crore and Rs. 12.44 crore for public limited and private limited companies respectively. These are rough approximations estimated with the help of the model and should be taken to indicate only the broad order

of the dimensions involved rather than the exact quantum.

**Revenue Forgone**

Based on the relationships derived from the model, corporation tax forgone on account of development rebate/investment allowance appears to have ranged from Rs. 24.7 crore in 1960-61 to Rs 285.5 crore in 1982-83 (accounting year). For the years 1980-81, 1981-82 and 1982-83 the percentage of corporation tax forgone was 13.3, 11.1 and 13.0 respectively of the tax actually realised.

Government companies accounted for 46.1 per cent of the revenue forgone for the year 1982-83 because of investment allowance. After taking into account the estimated additional tax revenue of Rs 32 crore owing to the inducement effect of the incentive, net tax forgone in favour of non-government companies for the year 1982-83 works out to Rs 122 crore. For the companies falling in the selected sample, the amount of deduction claimed during the entire period 1977-78 to 1982-83 under section 32A was about 46 per cent of the total deductions claimed under section 32A and chapter VIA deductions taken together. The other major tax deduction was on account of tax holiday under section 80J/80I of the Act.

While for government companies, tax holiday is the major tax benefit, for other companies the investment allowance accounts for 67 per cent of the total tax deductions. For non-government companies, the importance of investment allowance had been growing over the years.

As was to be expected, the major portion of claims for investment allowance was made by large companies. Companies with paid-up capital of Rs 1 crore to Rs 5 crore and Rs 10 to Rs 15 crore accounted for 30 per cent and 26.5 per cent respectively of the total deductions claimed by the sample companies. While companies with total income of over Rs 150 crore during the study period claimed 54.1 per cent of the investment allowance deductions, loss-making companies accounted for 25.6 per cent.

Industry-wise: The share of engineering industries in the aggregate claims for investment allowance deduction was over 46 per cent. Other industries making substantial claims were paper, chemicals and pharmaceuticals, textiles and cement.

Area-wise: Over 51 per cent of the investment alllowance was claimed by industrial undertakings located in backward areas.

**Investment Allowance and Corporate Capital Structure**

An attempt was also made to measure the impact of investment allowance on the capital financial pattern with the help of a sub-model which formed part of the investment model.

Investment allowance may be expected to encourage profit retention *vis-a-vis* dividend distribution. This is because of the prescribed requirement to transfer 75 per cent of the investment allowance actually allowed to the statutory Investment Allowance Reserve Account.

The study did not find empirical evidence to show that the investment allowance led to additional retention of profits. The companies would seem to have switched funds which would otherwise have gone to other reserve accounts to the statutory Investment Allowance Reserve.

As compared with debt financing, the investment allowance makes equity financing more attractive. This effect is felt on account of the attendant tax rate reduction and not so much through the creation of the statutory Investment Allowance Reserve.

**Inflation and Investment Allowance**

One of the primary objectives of introducing the investment allowance after the abolition of development rebate was to compensate for the inadequacy of depreciation allowance due to inflation. An attempt has been made to quantify the required compensation in order to see how far the rate of investment allowance has compensated for inflation.

Given the depreciation allowances ranging from 15 to 35 per cent during the period under reference, capital allowance required to compensate for inflation is estimated at 13 to 16 per cent. Thus, the investment allowance at the rate of 25 per cent of the cost of machinery more than compensated for the erosion in the value of depreciation deduction through inflation. During the four-year period 1978-89 to 1981-82 the price rise was steeper than in earlier years. Even so the investment allowance more than compensated for inflation.

**Problems of Implementation**

A sample study of the assessments involving claims for investment allowance showed that in over 25 per cent of the assessments some disallowance was made. However, the amount disallowed was only about 2 per cent of the total claims. Over the years, sections 32, 33, 43 and 80J have been the subject matter of considerable litigation and judicial pronouncements thereon have assisted in interpreting the provisions of section 32A, thus reducing disputes on its account.

About 69 per cent of the disallowances were on two counts viz., (*i*) that, the assets were ineligible for the allowance (53 per cent) and (*ii*) that, the government subsidy against capital investment was not taken into account in determining the actual cost of the machinery or plant for working out the allowance (16 per cent).

For an assessee engaged in the operation of ships or air-craft, eligibility to investment allowance was restricted to the initial investment in the ship or aircraft and did not extend to renewals, replacements and additions. The scheme of the new section 32AB avoids this anomaly.

Through statutory amendments and judicial pronouncements, the scope of what was originally intended to be a special incentive for industries considered important from the point of view of national development was widened considerably. However large-scale manufacturers of some articles of daily mass, commercial and industrial use remained outside its ambit on account of the said articles being listed in the Eleventh Schedule. Experience shows that selectivity in the operation of such an incentive is very difficult to operate in practice through provisions like investment allowance and the Eleventh Schedule.

To determine whether a particular activity amounts to 'manufacture or production' or merely constitutes 'processing' has sometimes presented difficulty. This question will continue to crop up under section 32AB and other provisions of the Act, which employ the expression 'manufacture or production.' To avoid litigation, it may be desirable to clarify whether for purposes of section 32AB(2) (*i*) (*a*), "processing" comes within the ambit of the expression "manufacture or production".

It would be appropriate to insert a definition of 'industrial

undertaking' in section 2 of the Income-tax Act, 1961 which defines various terms and expressions commonly used in the Act.

It may be appropriate to insert in section 43 of the Act provisions stating the circumstances in which a hirer/lessee may be deemed to be owner of an asset, as also when the asset may be deemed to be wholly used for purposes of the lessor's business.

To prevent abuse and artificial manipulation of profits which is possible if the parties to a hire-purchase/lease are subject to common control and the transaction is not done at arm's length, "transfer pricing" provisions may be incorporated.

It would be desirable to obtain an early authoritative court ruling as to whether government subsidies granted against capital investment are to be taken into account in determining 'actual cost' of assets under section 43(1) of the Act, and if the answer is in the affirmative, to provide for corrective action in the event of their belated receipt. In the alternative the controversy may be set at rest through a clarificatory amendment.

It may be desirable to obtain the Supreme Court's rulings early in respect of disputes whether conversion of a sole proprietory concern into a partnership or allotment of assets to co-owners on partition of a Hindu Undivided Family amounts to a "transfer". In the alternative, the relevant provision in section 32AB may be amended to clearly spell out the correct acceptable position.

If the assessee ceases to exist except by amalgamation or succession referred to in sub-sections (6) and (7) of section 32A, the investment allowance reserve cannot obviously be utilised in accordance with the scheme of section 32A, leaving no scope for application of section 155(4A) (b) for withdrawal of the allowance. Similar situations may arise under section 32AB and should be provided for in the Investment Deposit Account Scheme, 1986.

The court decision that for set-off of the brought forward development rebate the business for which it was originally allowed need not be in existence in the year of set-off, is likely to be followed in investment allowance cases as well.

With the repeal of the investment allowance, there is no need to go into the following propositions for its modification, viz., that (*i*) in the absence of adequate profits, it may be allowed to be carried forward indefinitely instead of only for eight years, (*ii*) in the matter of set-off it should be given precedence over the brought forward depreciation which can be carried forward indefinitely, and (*iii*) in the event of competition between set-off of brought forward loss (also subject to 8 years' time limit) and brought forward investment allowance an earlier year's loss or investment allowance should get precedence. These questions do not arise under the new funding provision of section 32AB which follows a different pattern.

The statutory audit organisation of the Comptroller and Auditor General and the internal audit set-up of the Department have pointed out to a number of mistakes on the part of the assessing authorities in acceptance of the claims for investment allowance. As to C & AG annual audit reports, upto 1984-85, objections have been raised in cases of 83 assessees (114 assessments) involving excessive investment allowance amounting to Rs 370.71 lakh resulting in short levy of tax of Rs 208.18 lakh. Objections pointing out excessive investment allowance of Rs 240.90 lakh in the case of 49 assessees were on three counts: (*a*) incentive allowed on ineligible assets (Rs 154.75 lakh), (*b*) government subsidies not taken into account in determining 'actual cost' of the assets (Rs 28.14 lakh) and (*c*) the industrial undertaking not engaged in manufacture or production (Rs 58.01 lakh). Similar mistakes have been observed by Internal Audit. Only a few of the audit objections involved questions of interpretation. Most of the objections point to administrative lapses in giving due effect to the statutory requirements of section 32A.

In none of the cases of the sample selected for this study, for which information was furnished by the assessing officers, was any penal action reported for furnishing false or inaccurate particulars in respect of a claim for investment allowance. However, on the data furnished by the assessees, a number of claims for investment allowance were found by the assessing authorities to be inadmissible. As in the case of audit objections, a large number of the claims found inadmissible by assessing officers on their own were claims in which the prescribed

conditions were indisputably not fulfilled properly and the claims were patently untenable.

Most of the post-assessment work (appellate or corrective) thrown up by section 32A was the direct result of an inadequate scrutiny of the claims for investment allowance at the initial assessment stage.

A condition precedent for obtaining a deduction under section 32A was that the particulars prescribed in this behalf were furnished by the assessee. However, the particulars prescribed under Rule 5AA of the Income-tax Rules, 1962 were patently inadequate to help decide whether the preferred claim for investment allowance fulfilled all the statutory requirements. Much of the requisite information was left to be furnished *suo moto* by the assessee or to be gathered by the assessing officer. It is, therefore, no surprise that in the rush of assessment work, one or the other relevant information remained to be gathered or failed to attract due notice of the assessing authority and instances of incorrect deduction allowed under section 32A come to notice year after year.

It is desirable that simultaneously with the introduction of a new incentive or its subsequent modification, the statutory form of return of income and its prescribed accompaniments are reviewed closely in order that necessary amendments are made therein to clearly bring out how the prescribed conditions for availing of the incentive are fulfilled. Under the new concept of assessment by acceptance of all returns without any prior scrutiny, this becomes all the more necessary. It will be in order to also amend the audit report forms No. 3CD and 3CE prescribed under section 44/rule 6G for persons carrying on a business or profession with gross receipts etc. above the prescribed minimum so as to clearly indicate the amounts of deduction to which the assessee may be entitled on account of the various tax incentives and how the prescribed conditions for grant of each incentive are fulfilled. So far as section 32AB is concerned, the prescribed audit report (Rule 5AB/Form No. 3AA) which is to accompany the pattern of income, gives the requisite information.

Simultaneously with the enactment of a tax incentive, an information system to ensure its correct and speedy accounting and feedback of the essential data to enable a proper moni-

toring and evaluation thereof should be introduced.

The Comptroller and Auditor General may consider reviving the practice of indicating in the annual reports the number of assessees availing of the various tax incentives and the amount of revenue forgone on their respective accounts. Indeed, so far as the major tax incentives are concerned, the relevant data should find place in the Union Government Annual Budget Papers as in the budgets of countries like the USA where "tax expenditures" are shown separately.

**The New "Funding" Scheme**

To the extent the phraseology of section 32AB is drawn from section 32A, working of the incentive may present similar problems. The more important of them are dealt with in Chapter 6. The recommendations made therein which are of interest from the viewpoint of section 32AB are contained in the section on "Problems of Implementation" in that chapter.

It may be desirable to amend sub-section (1) of section 32AB or at least clause 9 of the Incentive Deposit Account Scheme, 1986 (IDAS '86) to bring out clearly that the deposits have to be out of the profits of an "eligible business or profession" and the utilisations, whether initially or after withdrawals from the deposit account, have also to be for the specified purposes.

Investment allowance was criticised for strengthening the bias for capital intensive technology. That bias remains under section 32AB.

It may be appropriate to amend sub-section (7) of section 32AB to provide that besides sale or transfer, utilisation of an asset acquired in accordance with the scheme for an ineligible business at any time before the expiry of eight years, will entail the adverse tax consequences spelt out therein.

The provision for determination of profits of the eligible business or profession in proportion to its turnover, etc., if separate accounts for it are not maintained or are not available, gives an undue advantage to a taxpayer with other established business/profession *vis-a-vis* another taxpayer having only one new eligible business/profession, as a new eligible business/profession may initially suffer losses and take time to catch up with the profit rate of an established business/profes-

sion. Accordingly, the actual working of this provision needs to be closely watched.

*Prima facie*, it may be appropriate to withhold the benefits of the new incentive from those classes of assessees who are engaged in highly profitable lines or are burdened with indisputably high idle capacity.

Section 32AB is a bold measure aimed at encouraging corporate savings. But, many legal and administrative aspects need to be attended to, in order to ensure its smooth working. Its actual operation should also be closely monitored and evaluated in order that the tax expenditure entailed by it serves the national scheme of priorities.