UNION BUDGET 1980-81 GIVES A STUNNING BLOW TO INDUSTRY

by

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"Free Enterprise was born with man and shall survive as long as man survives."

—**A. D. Shroff**
1899-1965
Founder-President
Forum of Free Enterprise

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H. P. RANINA *

The first Budget of Mr. R. Venkataraman, Finance Minister of India, has been widely hailed as a Budget of the common man and one which has given wide ranging reliefs particularly to industry. This has been the reaction of most financial experts, leaders of commerce and industry and the general public, partly because of the fact that the Finance Minister himself in his Budget Speech has taken pains to point out that he had lightened the burden on consumers and introduced a relief-studded budget.

On a close perusal of the Budget papers one is stunned at the far-reaching changes proposed to be made which will virtually deal a crippling and stunning blow to industry. In fact, a detailed study reveals that most of the reliefs are purely illusory and they are more in the nature of a gimmick to placate the expectations of the people.

There is no doubt that Mr. Charan Singh's budget last year shattered the economy but there is equally no doubt that Mr. Venkataraman's proposals this year will do nothing to revive the economy and put it on an even keel. In fact, far from reviving the economy, some of the budget proposals, specially in regard to industry, will bring further stagnation and in its wake a higher rate of inflation which even now has assumed menacing proportions.

It is true that the Finance Minister has reduced excise duties on consumer items like toothpaste, soaps, pressure cookers, bulbs, life-saving drugs, cloth, cycles and sewing machines. Licence fees on single and 2-band radio sets have been abolished. There is no doubt that these measures will to some extent mitigate the tax burden on the common

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man but the crying need of the hour is not to give these marginal reliefs but to bring down the price level substantially.

To this objective of controlling inflation, the Finance Minister has not addressed himself at all and if the prices rise still further, the common man will be in a worse position than he is today notwithstanding the aforesaid marginal reliefs. In fact, there is no doubt that the price level will spurt at an accelerated rate than during the last year in view of the tremendous increase in oil prices and railway freight rates which will intensify the cost-push inflationary pressures.

In the Economic Survey presented by the Finance Minister last week, he himself took pains to point out that the great need of the hour was to increase productivity as the only means of combating inflation and also to strengthen the efforts at export promotion. Apart from the fact that not a single incentive is given to industry for increasing production, what the Finance Minister has proposed in the Finance Bill as clarificatory amendments with retrospective effect, will completely throw the industrial sector out of gear.

Two reliefs are sought to be given for promoting investment in capital assets and for setting up new undertakings. The first relief is, in fact, no relief at all.

This is a provision to give 50 per cent more deprectation that what would be allowable at the normal rates in the year in which the plant and machinery are installed. It is important to emphasize that the relief is available only in the year of installation and not in subsequent years.

The effect of this amendment would be that if an assessee is entitled to depreciation at the normal rate of 10 per cent, he would get depreciation at the rate of 15 per cent in respect of assets acquired after 31st March, 1980, and before 1st April, 1985. The benefit would be available in the year in which the machinery or plant is installed.

The important question is, what is the exact effect of this so-called benefit. The only effect is that in the year of

installation the tax liability is reduced to the extent of the extra depreciation.

However, in the subsequent years the liability would go on increasing. Therefore, the provision merely results in postponement of tax liability and not its actual reduction.

This is because under section 34 of the Income-tax Act, 1961, the total of all the depreciation allowances, namely, the normal, extra-shift and initial allowance cannot exceed the original cost of the asset. Therefore, all that the new sub-section (ii)(a) does is to accelerate the depreciation and thereby postpone the tax liability.

Even while giving this paltry relief certain conditions are laid down :

(i) that the machinery or plant must be new;

(ii) that the machinery or plant should not be installed in office premises or in residential accommodation including a guest house;

(iii) that the machinery or plant should not be office appliances or road transport vehicles; and

(iv) that the machinery or plant should not be such, the whole of the actual cost of which is allowed as a deduction in computing the income of one previous year.

It is clear beyond doubt that if the intention of the Finance Minister is to encourage industry to continue investing in capital assets, then the relief sought to be given is utterly inadequate to meet this objective. In fact, what is necessary for inducing industry to modernize its assets and to plough back profits for growth is to allow depreciation on the replacement cost of an asset.

It cannot be gainsaid that the replacement cost of an asset goes on increasing year by year. In fact, 20 per cent could be described as a normal rate of increase in the cost of an asset on account of inflation and increases in excise duties.

Therefore, if the original price of an asset is allowed to be adjusted to the extent of 20 per cent each year and depreciation provided on that basis, it would not only give considerable benefit to industry and enable it to modernize its plant and machinery regularly but it would also give the necessary fillip to acquiring new capital assets and increasing the productive capacity of the industrial unit.

The Finance Minister has sought to replace the relief under section 80-J available in respect of new industrial undertakings by a new relief under the proposed section 80-I. The main change is in the mode of calculating the relief by shifting the base from the capital employed to the profits earned.

As a justification for this change, the Finance Minister has observed that there is no particular advantage in encouraging capital intensive units and that he would rather give an incentive on the basis of the profit earning capacity of a unit. Though there is some justification in this view, there is also much to be said for giving particular advantage to capital intensive units because such units have a greater productive potential and bring a more enduring benefit to the economy as a whole.

Moreover, capital intensive units are in the core sector which manufactures the basic raw materials like steel, cement, etc., which are in short supply in the country today. Hence, it would not be altogether prudent to ignore or belittle the importance of capital intensive units.

Turning to the provisions of the proposed section 80-I, the relief is sought to be given at the rate of 25 per cent of the profits of an industrial unit belonging to a company. In the case of non-corporate assessees the relief is 20 per cent of the profits of the industrial undertaking.

The benefit is given for eight assessment years commencing with the year in which commercial production begins. In the case of co-operative societies the benefit is for 10 assessment years.

However, the benefit for the aforesaid period is illusory. The reason is obvious that the benefit being linked to the

profits, very few industrial undertakings would make a profit from the year in which commercial production commences.

In fact, the profits on which the relief is to be given are not the commercial profits but are the taxable profits computed in accordance with the provisions of the Income-tax Act and after claiming the other benefits and deductions like the depreciation and investment allowances. Therefore, normally an industrial unit would become eligible for the relief under section 80-I only three or four years after the commencement of commercial production and in case of capital intensive units perhaps only the fifth or sixth year may show a taxable profit.

Hence, in effect the benefit to the industrial unit would rarely be for the full eight year period and in most cases it would be for just half that period. This is specially so in view of the fact that there is no provision for the carry forward of the unabsorbed relief and that if the relief of a particular year cannot be availed of due to lack of taxable profits, there would be no relief which can be availed of in a subsequent year, as it was so under section 80-J.

In fact, the provision proposed to be made by the Finance Minister for granting additional depreciation allowance would itself reduce the chances of the relief under section 80-I being available initially because the higher the depreciation the lower would be the taxable profits or the greater would be the chances of there being no taxable profits at all.

Therefore, if the Finance Minister desires to make the relief given under section 80-I meaningful, it is imperative to provide that the eight-year period would commence, at the option of the assessee, three years after the commencement of commercial production. Alternatively, the rate of relief could be linked with the turnover and a specific provision be made that the unabsorbed relief can be carried forward to three more years after the end of the eight-year period.

The second alternative will, apart from the tax incentive for new undertakings, also serve as an incentive for greater production because the higher the production or turnover, the greater would be the relief under section 80-I.

Since the Prime Minister herself had emphasized recently that the crying need of the hour is to increase production in order to check the prices, an amendment on the aforesaid lines of linking the relief to the productivity would carry the dual advantage of setting up of a new unit and inducing the entrepreneur to increase production year after year. It needs to be repeated that under the second alternative it would be necessary to have a provision for carry forward of the unabsorbed relief to a period of at least three years after the expiry of the eight-year period for which the relief is actually determined.

A very mischievous provision is sub-section (6) in section 80-I which will reduce the relief substantially. This sub-section provides that for the purpose of determining the quantum of deduction, the profits and gains of the industrial undertaking would be computed as if the undertaking was the only source of income of the assessee during the years in which the relief is to be determined.

The implications of this sub-section are that if in the initial years a loss is made in the industrial undertaking, then though such loss may have been set off against other businesses of the assessee or other source of income, in the subsequent years when profits are made the losses already set off against the other income would still be required to be set off against the profits of the undertaking in the subsequent year so that either no relief at all is available in the year of profits or such relief is substantially curtailed.

This is because by a fiction of Law the profits of the industrial undertaking for the purpose of determining the relief are treated as the only source of income of the assessee and if it is the only source of income it would mean that the loss of the earlier years has to be set off against the profits of the undertaking of subsequent years

even though the earlier years' losses have already been set off under the provisions of sections 70 and 71 against the profits of other businesses or against other heads of income.

Therefore, if the relief under section 80-I is to be made meaningful, the Finance Minister should make the following amendments to the new section :

(i) The relief should be made available for the full eight year period by allowing it to commence from the third year from the commencement of commercial production or alternatively if it is to start immediately from the year of production, it should be based on the production and the unabsorbed relief, if any, should be permitted to be carried forward for three years after the seven-year period;

(ii) Sub-section (6) of section 80-I should be dropped so that full benefit is derived by a new industrial undertaking.

This brings me to the most damaging amendment proposed to be made by the Finance Act, 1980, which is the insertion of sub-section (1-A) in section 80-J of the Act. This amendment is proposed to supercede the decisions of the Calcutta High Court in **Century Enka Limited** v. **I.T.O.** (107 I.T.R. 123) and (107 I.T.R. 909), the decision of the Madras High Court in **Madras Industrial Linings Ltd.** v. I.T.O. (110 I.T.R. 256) and the decision of the Allahabad High Court in **Kota Box Manufacturing Company** v. **I.T.O.** ((1978 Tax Law Report, Page 649).

In these three cases it has been held that Rule 19-A is ultra vires section 80-J on the following two points :

(i) that the relief is to be calculated under the Rule on the net assets after deducting liabilities, that is, only on the shareholders' capital and reserves; and

(ii) that the capital is to be determined on the first day of the accounting year and introduction of fresh capital during the course of the accounting year is to be ignored.

The reason why these Courts have rightly taken the view that Rule 19-A is ultra vires is that the concept of capital employed both in legal and accounting parlance can only be the gross value of assets used in an undertaking whether those assets are financed by the shareholders themselves or by creditors and financiers. Further, it is totally irrational that capital introduced during the course of the accounting year should be ignored and that capital only on the first day should be taken into account.

Therefore, if at all any amendment was to be made to section 80-J, it should have been made to clarify the Law on the basis of the decisions of the aforesaid three High Courts so as to bring the Law in conformity with the true concept of capital employed in the industrial undertaking.

It is also important to note that if relief is given only on the shareholders' funds and reserves, there would be no benefit at all or a very marginal one to most industrial undertakings. This is because with the high rates of taxation on the corporate sector during the last two decades, it has been virtually impossible to plough back funds and to have self-generated growth.

Almost every industrial undertaking has had to rely substantially and even completely on borrowings to expand and set up new undertakings. Hence, if relief under section 80-J is now sought to be given only on net assets, there would virtually be no relief at all.

Therefore, this proposed amendment is a crippling blow to industrial growth during the 1970s because the relief is sought to be whittled down with retrospective effect from 1st April, 1972. The effect of this retrospective amendment would be that Income-tax Officers and Appellate authorities would rectify all completed assessments under section 154 and raise tax demands for all the rectified assessments at one point of time. This would impose an unbearable burden on the corporate sector which, on a very conservative estimate, would be around Rs. 150 crores.

This staggering burden would cripple industry at this stage when it is going through a period of "stagflation" and is subjected to intense pressures of cost-push inflation on account of the hike in oil prices and increase of railway freight. In fact, most entrepreneurs and financial institutions had made calculations on the basis of the gross assets when they had made their future projections while determining the financial viability of an industrial undertaking.

It was this tax benefit on the basis of gross assets which made it possible for financial institutions to extend loans which could be repaid from the tax savings. With the retrospective amendment being proposed, all these calculations will go awry and it would be impossible for industrial undertakings to repay financial institutions as per the time schedule.

Hence, ultimately the Government through the financial institutions would suffer and industrial growth would receive a severe jolt and set-back.

It may be clarified that the burden would arise because so far the relief on the basis of gross assets has already been availed of by industry though the Income-tax Department had gone on the basis of Rule 19-A. However, the Appellate Authorities had been following the decisions of the three High Courts and the Income-tax Officers had been granting refunds while giving effect to the decisions of the Appellate Authorities.

Therefore, when a retrospective amendment is made, the Income-tax Officers would be entitled to rectify the assessment under section 154 within four years from the date of the Assessment Orders for the relevant assessment year. This would be possible because the Supreme Court has held in **I.T.O.** v. **Bombay Dyeing & Mfg. Co. Limited** (34 I.T.R. 143) that where a law is amended with retrospective effect it must be held to have been in force at the time when the Order sought to be rectified was passed.

It is further important to emphasize that apart from the severe burden on industry which would come about as a result of rectification of past Assessment Orders,

tremendous hardships would be caused even to lakhs and lakhs of shareholders whose assessment will be reopened. This is because shareholders were entitled to relief under section 80-K on dividends declared from profits eligible for relief under section 80-J.

The reduction under section 80-K was calculated on the basis that the relief under section 80-J would be on gross assets and not on the net amount. Therefore, if the relief under section 80-J is to be whittled down it would consequentially follow that the relief under section 80-K would also stand reduced and therefore assessments of lakhs and lakhs of tax payers would need to be reopened bringing tremendous hardships on small shareholders spread all over the country.

As regards exports which in the opinion of the Finance Minister need to be encouraged, the Finance Act seeks to curtail the relief and allow the weighted deduction for export promotion only on three categories of expenditure as against seven given at present. Another contradiction between the Finance Minister's policies and his proposals is in respect of scientific research. He has rightly emphasized the need for promoting indigenous research but while giving effect to his proposal he has sought to withdraw depreciation allowance in respect of scientific research assets.

The implication of this proposal is that while ordinary commercial assets are entitled to 125 per cent deduction (depreciation and investment allowances), after the amendment, scientific research assets would be entitled to only 100 per cent deduction. Again, this amendment withdrawing depreciation is sought to be made with retrospective effect from 1972 which will bring a staggering burden to industries as soon as this amendment becomes Law. The weighted deduction proposed by the Finance Minister for scientific research assets is only in respect of very selective fields of scientific research which are approved by the prescribed authority and will not apply to scientific research in general.

The Finance Minister has with great fanfare announced the relief to new undertakings by exempting 25 per cent

of their profits for seven years in case of companies. Since this seven-year period is to commence from the year of initial production, and most industries have a long gestation period, the benefit will in fact be available for no more than three to four years out of the seven-year period. Likewise, the benefit of the additional depreciation allowance would prove illusory because that benefit is only in the year of installation and at best the benefit will only postpone the tax liability and not reduce it.

The Finance Minister has proposed that if any partial partition of a Hindu Undivided Family has taken place after 31st December, 1978, such partial partition would be ignored and the members and the Hindu Undivided Family would be responsible and liable for all the tax, interest, penalty or fine which may be levied. Another amendment is in respect of discretionary trusts which are at present taxed at the rate of 65 per cent. It is proposed that this rate be increased to the maximum marginal rate applicable.

It is also provided that unless the specific share of the beneficiaries is mentioned in the trust deed itself, the trust would be treated as a discretionary trust. The further proposal is that the exemption available to trusts where each of the beneficiaries do not have any taxable income would apply only to a trust where such beneficiaries are not beneficiaries of any other trust, whether specific or discretionary.

Likewise, a trust declared under a will is exempt from the flat rate if and only if the trust is the only trust so declared by him. The Law is also amended to provide that the value of benefits or perquisites enjoyed by beneficiaries or trustees of a trust are not chargeable to income-tax. Since the grant of such benefits or perquisites in kind avoids tax, it is proposed to amend the definition of income so as to include therein the value of any benefit or perquisite whether convertible into money or not which is obtained by a beneficiary or a trustee from a trust.

Where a return of income is incomplete, it is proposed that the Income-tax Officer should by a notice in writing require the tax-payer to rectify or

complete the return within a period of 15 days or such further extended period as the Income-tax Officer may grant. This will come into force from the assessment year 1980-81.

As regards summary assessments, it is proposed to omit the requirement of making adjustment in respect of the deduction, allowance or relief which although admissible is not claimed or having been claimed is not admissible. Such a provision will go against the small tax-payer who very often omits to claim reliefs which are legally due to him merely because he is not aware of them.

Apart from reducing the surcharge on income-tax from 20 per cent to 10 per cent, a few marginal reliefs are given to individuals. For example, deduction under section 80-C is restored to the 1979 level and standard deduction is proposed to be extended to pensioners. The deduction under section 80-U for the blind is proposed to be doubled to Rs. 10,000. The deduction under section 80-RR in respect of income earned abroad is proposed to be extended to sportsmen.

To sum up, far from the budget proposals invigorating the economy, the fiscal proposals will put a greater burden on the industrial sector and the lack of any measure to curb prices in the light of the increasing oil and freight costs, will add fuel to the fire of inflation. If today the economy is stagnating and is in the doldrums, it will be more so if the damaging proposals of the Budget are implemented with retrospective effect.

The views expressed in this booklet do not necessarily represent the views of the Forum of Free Enterprise

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good."

—**Eugene Black**

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