



**Estimating Non-agricultural Income:
Case of Seed Industry**

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**Directorate of Income Tax (Risk Assessment)
Central Board of Direct Taxes
Government of India**

1. Introduction

1.1 The Central Board of Direct Taxes, vide OM in F No: 149/260/2013-TPL dated 12.11.2014, directed the Directorate of Income Tax (Risk Assessment) to undertake a study for determination of the share of non-agricultural income in the total income in the seed industry . Pursuant to this direction, extensive discussions were held with representatives of the seed industry to understand the nature of the business and cost structure to enable determination of the share of non-agricultural income.

2. Background

2.1 Following the introduction of a new Seed Policy by the Government of India in 1988, lifting the barrier for private sector companies to engage in seed production, a number of multi-national seed companies and private seed companies started operations in India. An area, which was earlier a domain of only farmers, small scale nurseries, agricultural universities and their extension centers, was thrown open to several new players. Traditionally, the farmers produced seed for self-consumption and a small proportion was used for sale in the open market. Therefore, the income derived from sale of seeds was a very small amount generally below the threshold limit. Hence, it was not considered necessary to apportion the income into agricultural income and non-agricultural income. Consequently, the whole of the income received by the farmer on account of growing and sale of seeds was treated as agricultural income and therefore, exempt under section 10 of the Income Tax Act. However, with the entry of new and big players and also the introduction of technology and research in the growing and production of seed, companies started producing seed for the exclusive purpose of sale to farmers. The various activities in the process of production and distribution are agricultural and non-agricultural in nature. With increase in the volume of business of such companies, the amount of non-agricultural income has also increased. It is, therefore, imperative to estimate this amount so as to enable taxation under the Income tax Act.

2.2 The present size of the seed industry is about Rs 14,400 Crores in terms of turnover and there are around 550 seed companies carrying out operations all over India. Out of them 21 are

major players namely Nuzivedu, Rasi, Kaveri, Bayer, Monsanto, MAHYCO, DuPont Pioneer, Ankur etc. The major operations of seed companies are in the states of Andhra Pradesh, Karnataka, Maharashtra and Gujarat. They comprise about 60 percent of the seed trade followed by Haryana, Punjab, Uttar Pradesh and Madhya Pradesh. Small quantity of Vegetable seed and flower seed is grown in Himachal Pradesh and Uttarakhand.

2.3 The dispute regarding the taxability of income on account of growing and sale of seeds started in 1997 when in the case of M/s Pro Agro Seed Company Ltd for A.Y.1994-95, the Assessing Officer (AO) taxed the income on production and sale of germplasm seeds as non-agricultural income on the ground that the same involved transfer of technical knowhow also. The said addition was subsequently confirmed by the Delhi ITAT. In another case of M/s Namdhari Seeds Pvt Ltd, the addition of the AO was confirmed by the Karnataka High Court in view of the provisions of Karnataka Land Reforms Act under which leasing of land by the farmers was not allowed and hence the receipt was non agricultural in nature. Post these decisions, there was a visible change in the approach of the Income Tax Department and more and more Assessing Officers started treating the income on account of production and sale of seeds as non-agricultural, though for reasons not necessarily similar to the ones in the cases listed above and this in turn has lead to a multitude of litigation.

2.3 In the aforesaid background, the National Seed Association of India has approached the Ministry with a request to frame a rule on the lines of Rule 7A (for Rubber industry), Rule 7B (for Coffee industry) & Rule 8 (for Tea industry) of the Income tax Rules, 1962, so as to bring about uniformity in the tax treatment of the seed industry across AOs. In this regard, the National Seed Association of India (NSAI), a 300-member industry association of seed producers, has proposed that 10 percent of the total income may be treated as non-agricultural income and taxed as such.

3. Scheme of taxation for commercial crops

3.1 In the course of production and distribution of commercial crops, a taxpayer is engaged in both agricultural and non-agricultural activities. Since the scope of the Income tax Act, 1961 is limited to taxation of non-agricultural income, special provisions have been inserted in the Income Tax Rules for estimating the non agricultural component from the total income derived from the

composite activities of production and distribution of some commercial crops like tea, coffee and rubber. The Income Tax Rules regarding bifurcation of agricultural income and non-agricultural income of these industries is reflected in the table below:-

TABLE - PARTLY AGRICULTURAL AND PARTLY BUSINESS INCOME

| <i>Crop</i> | <i>Rule</i> | <i>Agricultural Income</i> | <i>Business Income</i> |
|--|-------------|----------------------------|------------------------|
| Growing and Manufacture of Tea | 8 | 60% | 40% |
| Rubber manufacturing business | 7A | 65% | 35% |
| Coffee grown and cured by seller | 7B(1) | 75% | 25% |
| Coffee grown, cured, roasted and grounded by the seller in India with or without mixing chicory or other flavoring ingredients | 7B(1A) | 60% | 40% |

3.2 The seed industry has also requested for framing of a similar Rule, that would allocate profits into agricultural and non-agricultural, so that inconsistency and discretion based approach to the income of these Companies is avoided.

4. Judicial View

4.1 Litigation in the seed industry has not yet reached finality. There are several decisions by the ITAT and the High Courts but unfortunately there is no uniformity; some are in favour of the Department while some others in favour of the assessee. In the case of Pro Agro Seed Company and Namdhari Seed Pvt. Ltd, the Courts have upheld the additions made by AO. However, in cases like Advanta India Ltd V/s Deputy Commissioner of Income Tax, ITAT Bangalore Bench 'B' and DCIT V/s Monsanto India Pvt. Ltd, ITAT Bench 'G', Mumbai the decision is in favor of the assessee.

4.3 The industry has informed that a number of litigations are pending at different levels and are on rise. The introduction of a rule along the lines framed for tea, coffee and rubber will resolve the dispute.

5. Change in law from 1st April, 2009

5.1 The Finance Act, 2008 amended section 2 of the Income Tax Act, 1961, with effect from 1st April, 2009, to provide that *“any income derived from saplings or seedlings grown in a nursery shall be deemed to be agricultural income”*.

5.2 This amendment has set to rest a large number of litigation; the mode of production used for producing seeds is irrelevant in determining whether the income is agricultural or non-agricultural. Thus, all activities post-production constitutes non-agricultural activity and any income derived from such activities constitutes non-agricultural income.

6. Study conducted by India Development Foundation

6.1 The National Seed Association of India has got a study conducted by India Development Foundation¹ (IDF) on the issue relating to taxation of private seed companies. The Study has concluded that a rule based approach is required for taxation in the Seed industry. The Study also makes recommendation on the ratio of agricultural income to non-agricultural income (business income) of the private seed companies.

6.2. In general, the income attributable to production activities would constitute agricultural income and the income attributable to distribution could be characterized as non-agricultural income. However, seed companies engaged in both production and distribution of seed do not maintain activity-wise accounts and therefore, the net profit reported in their profit and loss accounts is the combined income from production (agricultural operations) and distribution (non-agricultural operations). In this background, IDF has applied the principle of transfer pricing to decompose income from production (agricultural income) and distribution (non-agricultural income).

¹ IDF is a privately funded, non-profit, non-partisan research foundation set up as a Trust on April 2, 2003. Its major objective is to develop awareness about how markets work, why they are desirable and how they can be developed. IDF aims to help policy makers transform emerging economies into market based societies. IDF conducts research on various issues of the economy, seeking to address the issue of selling reforms to a larger constituency.

IDF used the profit-split method on the basis of the ratio of expenditure attributable to production (agricultural activities) and distribution (non-agricultural activities). It identified a wholly seed marketing company (National Seeds Corporation Limited, a PSU) to determine the ratio of expenditure attributable to agricultural operations (cost of seeds procured at arm's length) to total cost.

6.3 National Seeds Corporation Limited (NSC) is a Public Sector Enterprise that is solely engaged in the business of branding and sale of seeds that it purchases from farmers. To put it simply, NSC buys seeds from the farmers and sells the same after processing. Undisputedly the entire income of NSC is offered to tax on account of the activity of branding, packaging and marketing of seeds being non-agricultural in nature. The price paid by NSC for purchase of Seeds is entirely on account of manufacture of seeds and thus agricultural in nature.

6.4 Private and MNC Seed companies carry out almost similar operation as compared to the combined activity of Farmers who produce the seed and NSC which processes and sells the Seed. Thus it is possible to use the NSC's purchase value of seeds as a benchmark for ascertaining the value of agricultural activity undertaken by the private/MNC seed company that is involved in the integrated activity of growing, processing and marketing of the seed.

6.5 The Profit & Loss account of National Seeds Corporation Limited for financial year 2010-11 is presented in Table-2. On the basis of the Profit and Loss Account, the various items of expenditure on the acquisition of seeds (agricultural operations) were identified separately and

आय**INCOME**

| | | | |
|--|----|-------------------|-------------------|
| बिक्री Sales | 17 | 6270167977 | 4645287092 |
| सेवाएं Services | 18 | 2755742 | 2681697 |
| सहायता अनुदान में से खरीदी गई परिसम्पत्तियों पर मूल्यह्रास Depreciation on assets purchased out of Grant-in-aid | | 7698065 | 7293762 |
| अन्य आय Other Income | 19 | 44145497 | 36527755 |
| प्रावधान व देयताएं जिनकी अब आवश्यकता नहीं Provision and Liabilities no longer required | 20 | 8638510 | 32271348 |
| | | <u>6333405791</u> | <u>4724061654</u> |

व्यय**EXPENDITURE**

| | | | |
|--|----|-------------------|-------------------|
| खरीद Purchases | 21 | 4805808705 | 3302984150 |
| परिचालन व्यय Operational Expenses | 22 | 350713856 | 257195401 |
| कर्मचारी पारिश्रमिक व प्रसूविधाएं Employees Remuneration and Benefits | 23 | 496419191 | 379932740 |
| प्रशासनिक व्यय Administrative Expenses | 24 | 85398868 | 66052006 |
| बिक्री व्यय Selling Expenses | 25 | 73799757 | 66229774 |
| व्याज Interest | 26 | 103628039 | 36768336 |
| मूल्यह्रास Depreciation | 7 | 16036726 | 14242236 |
| प्रावधान व बट्टे-खाते Provisions and Write-offs | 27 | 1956300 | 9677306 |
| | | <u>5933761442</u> | <u>4133081949</u> |

estimated to be 87 percent of the total expenditure. The same method was applied to a sample of six private seed companies comparable to National seeds Corporation Limited. The expenditure attributable to agricultural activities varied from a low of 0.87 to a high of 0.95. Based on this, IDF has recommended the bifurcation of the total income of a seed company into 90 percent as

agricultural income and the balance 10 percent as non-agricultural income for the purposes of taxation under the Income tax Act. The underlying assumption is that the margin of profit on both agricultural and non agricultural operations is the same.

7. Undertaking by the National Seed Association of India

7.1 A meeting was held between members of the National Seed Association of India and the Directorate of Income Tax (Risk Assessment) on 09/01/2015. Following are the minutes of the meeting:-

- The representatives of the seed association gave the brief overview of the issue involved with the taxation of private seed industry. They submitted that before A.Y. 1994-95 profit earned by seed companies were considered agriculture in nature. However, in an individual case of M/s Pro Agro Seed Company Ltd for the A.Y. 1994-95, the A.O. taxed the income on production and sales of seeds as nonagricultural on the ground that the same involved transfer of technical knowhow also. The addition was confirmed by ITAT and thus litigations between the department and seed companies is going on for long time.
- The NSAI approached an independent body called India Development Foundation (IDF) to conduct a study to ascertain the quantum of non-agricultural income of the seed companies. The study was undertaken by IDF which has taken National Seed Corporation of India Ltd (NSCI) as benchmark. As per their analysis, they have applied the concept of transfer pricing concept on the expenditure side of NSCI. IDF has followed the cost apportionment methodology developed from NSCI and agricultural component of sample 6 private seed companies. IDF suggested that the ratio of agricultural component varied from 0.93 to 0.87 for these 6 companies. IDF suggests 90:10 (agricultural income: non-agricultural income) ratio for bifurcating the income of seed companies.
- Director General of Income Tax (Risk Assessment) enquired about the litigation details and asked the representatives to bring forward solution to mitigate the litigation. The representatives of NSAI said that they will have a discussion with their members about the withdrawal of litigation if a new Tax Rule comes into force. They also stated that payment of taxes and taking back all litigations will be done if 90:10 formula is applied.

7.2 Subsequently the NSAI on behalf of its members submitted a written undertaking that in case a Rule based approach on the lines as suggested by them is framed, the members would be encouraged to withdraw all the pending litigation and settle the same as per the new scheme of taxation. This would help in mitigating the existing litigation in the sector.

8. Study by Directorate General of Income Tax (Legal & Research)

8.1 A study regarding feasibility of taxing a part of income from development and production of hybrid seed was assigned by Central Board of Direct Taxes to Directorate General of Income Tax (Research). The Director General of Income Tax (Research) submitted a report on "Possibility of Taxation as non-agricultural income of production of hybrid seeds" in December 2002 to the Central Board of Direct Taxes. The members of the research team visited various offices of the government agencies viz. Indian Agricultural Research Institute, Department of Bio-Technology, Seed Division of Ministry of Agriculture etc. The members also had interactions with various field officers in the Income Tax Department dealing with assessments of seed companies. The members also had meeting with various companies dealing in production of hybrid seeds.

8.2 On the basis of their study, following recommendations were made by the Directorate of Income Tax (Research):-

- i. *Since the revenue implication of exemption u/s 10(1) in the case of seed companies is not very significant (only 35 crores to 40 crores), it may not be necessary for the Government to intervene in the matter at this stage. It may like to let the law to take its own course. However, the important aspects of this problem may be brought to the notice of field authorities by way of a circular.*
- ii. *In an alternative, if it is decided that the Government needs to intervene, perhaps because the Indian arms of foreign companies are deriving substantial benefit on account of exemption u/s 10(1) the following suggestions are made:-*
 - a) *The definition of agricultural income given in sub section (1A) of section 2 of the I.T.Act, 1961 may be so amended as to exclude income from the development and production of hybrid seeds, or*
 - b) *A new Rule may be inserted in the Income Tax Rules , 1962 on the lines of Rule 7A,7B and 8, prescribing certain percentage of total income from the development and production of hybrid seeds as non-agricultural income.*

8.3 This Directorate is not aware of the follow up action on this Report. However, wait and watch approach recommended by the Directorate of Income Tax (Legal and Research) may not be an appropriate strategy in the context of ever-growing litigation on the issue.

8.4 A perusal of the calculations by IDF shows that even though the cost of purchase of seeds represent the comprehensive cost of carrying out agricultural operations, various other elements of the operational costs have also been attributed to agricultural operations for determining the total cost of agricultural operations thereby, leading to double counting.

8.5 This fact of double counting was put forward to the National Seed Association of India and they were asked to explain. The association referred the matter back to IDF which accepted the contention raised by this Directorate and stated that operational expenses cannot be included. **NSAI revised its estimate of non-agricultural income from 10 percent of combined total income to 18 percent.**

8.6 A three year analysis of purchase to total expenditure was carried out for the P & L a/c of National Seed Corporation by the Directorate. Same is reflected as follows:-

| Financial Year | Expenditure on purchase of seeds | Total Expenditure | Ratio |
|----------------|----------------------------------|-------------------|-------|
| 2009-10 | 330.3 | 392.7 | 0.841 |
| 2010-11 | 458.4 | 580.8 | 0.789 |
| 2011-12 | 466.1 | 583.7 | 0.801 |

Average of the ratio = 0.819

8.7 Upon perusal of the financials of NSC it is seen that the value of seeds purchased by NSC and therefore, the agricultural component of the total expenditure, is 82 percent of its total expenditure. The remaining 18 percent of expenditure is on account of non-agricultural activities. If we consider the suppliers of NSC and NSC as one single entity, as in the case of private/MNC seed companies, then the profits made by NSC will be the total profit of the integrated entity. If

we assume the profit margin of both agricultural and non-agricultural activities to be the same, it follows that 82 percent of the profit reported by the integrated entity is agricultural profit and the remaining 18 percent is non-agricultural and hence taxable under the Income Tax Act.

9. Recommendations

9.1 The seed sector is, indisputably, critical to a vibrant farm economy. Considering the importance of the seed sector and the existing precedence in Tea, Coffee and Rubber, a rule based approach is necessary to support this growing sector and to settle all the ongoing litigations. It is unlikely that the matter will be settled soon through judicial decisions. **In the light of the discussions in the foregoing sections of this Report, it is recommended that the Income tax Rules, 1962 should be amended to provide that 20 percent of the combined profits of an assessee engaged in the production and distribution of seed should be deemed to be non-agricultural income for the purposes of taxation under the Income tax Act, 1961. Further, the Government should allow any such assessee, who is engaged in a pending litigation, to also take advantage of the new rule. Further, since the exercise was constrained by the limited availability of data, the allocation ratio may be reviewed after 5 years.**

9.2 The advantage of making such a Rule lies in the fact that there shall be clarity and consistency in the approach of the Department towards Seed companies which undisputedly have a mixed activity of agricultural and non-agricultural operations. This shall also lead to an increase in revenue collection, as seed companies which are presently not paying taxes will be covered within the gambit of the new rule and at least 20 percent of their profits would be liable to tax. Going for a rule based approach will be a big step towards dispute resolution.