# PREFACE

In the curricular structure introduced by this University for students of Post Graduate Degree Programme, the opportunity to pursue Post Graduate course in any Subject introduced by this University is equally available to all learners. Instead of being guided by any presumption about ability level, it would perhaps stand to reason if receptivity of a learner is judged in the course of the learning process. That would be entirely in keeping with the objectives of open education which does not believe in artificial differentiation.

Keeping this in view, study materials on the Graduate level in different subjects are being prepared on the basis of well laid-out syllabus. The course structure combines the best elements in the approved syllabi of Central and State Universities in respective subjects. It has been so designed as to be upgradable with the addition of new information as well as results of fresh thinking and analysis.

The accepted methodology of distance education has been followed in the preparation of these study materials. Co-operation in every form of experienced scholars is indispensable for a work of this kind. We, therefore, owe an enormous debt of gratitude to everyone whose tireless efforts went into the writing, editing and devising of a proper lay-out of the materials. Practically speaking, their role amount to an involvement in invisible teaching. For, whoever makes use of these study materials would virtually derive the benefit of learning under their collective care without each being seen by the other.

The more a learner would seriously pursue these study materials the easier it will be for him or her to reach out to larger horizons of a subject. Care has also been taken to make the language lucid and presentation attractive so that it may be rated as quality self-learning materials. If anything remains still obscure or difficult to follow, arrangements are there to come to terms with them through the counselling sessions regularly available at the network of study centres set up the University.

Needless to add, a great part of these efforts is still experimental-in fact, pioneering in certain areas. Naturally, there is every possibility of some lapse or deficiency here and there. However, these do admit of rectification and further improvement in due course. On the whole, therefore, these study materials are expected to evoke wider appreciation the more they receive serious attention of all concerned.

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Fourth Reprint : January, 2016

Printed in accordance with the regulations and financial assistance of the Distance Education Bureau of the University Grants Commission.

# Post Graduate : Commerce
**[M. Com.]**

**Paper : 16**

**Corporate Tax Planning and Management**

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**Notification**

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**Post Graduate : Commerce**
**M. Com-16**

## Module 1


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# Unit 1 ❑ Concept of Tax Planning

**Structure**

**1.1 Tax Planning**

**1.2 Tax Planning Differentiated from 'Tax Evasion' and 'Tax Avoidance'**

**1.3 Objectives of Tax Planning**

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## 1.1 Tax Planning

Tax planning is well thought out scheme of the tax payers to reduce their tax burden by methods which are sound and legal. It has assumed far-reaching importance in the confounded complexities of the taxation laws. The planning has proved a saviour of the economic life of the tax payer who can reduce the incidence of tax to the minimum if he can diligently and intelligently plan his tax affairs. On the other hand tax-authority is to realize the maximum revenue from tax. Laws on taxation have been suffering from legislative experiments at amendments in order to remain content after what is left by the taxing authorities or is there any scope for him to counteract the onerous effects of the taxation laws on his pockets. So a tax payer attempts to take all possible advantages over the taxation laws. For this purpose the requirements of tax planning includes—

(i) a sound knowledge of tax laws;

(ii) a thorough knowledge on judicial rulings and views of the Government on such rulings;

(iii) readiness to stand adjusted to the correct legal position as a result of Supreme Court judgement or as a result of Parliament's effort to amend the law remedying theerrors in drafting which surface in such rulings.

A tax planner has to follow the court rulings meticulously and at the same time he has to give proper attention to the mood of the Revenue Departments.

It may be pointed out that in the case of corporate assessees tax planning is an important segment of corporate planning. It should be conscious efforts made by companies to avoid 'tax-shocks'or 'tax-attacks' on their business, by systematically planning the financial or managerial decision-making after fully knowing the possible tax consequences of them. Tax planning, if properly linked with corporate planning, can result in great flexibility in business operations.

## 1.2 Tax Planning differentiated from 'Tax Evasion' and 'Tax Avoidance'

**Tax evasion :** It is a method of evading tax liablity by dishonest means like suppression of sales, inflation of expenses, concealment of income, etc. For example, an employee may claim that the free domestic servant provided by his employer was a gardener (whose salary paid by the employer is a tax-free perquisite), although the possibility of providing a gardener by any sensible employer is remote, since the flat occupied by the employee is on the tenth floor of a multi storied building with no terrace or verandah.

This form of tax planning is deplorable. It is a dubious way of solving tax problems and should be condemned.

**Tax avoidance :** G.S.A. Wheat Craft says it is 'the art of dodging tax without actually breaking the law'. It is a method of reducing tax liability by taking advantage of certain loopholes in the law. This is attempted by splitting legal heirs. wheat Craft analyses tax avoidance as a tranasction which couldnot be adopted it the tax planning elements were absent. Thus tax avoidance involves: (i) a transaction entered into to avoid tax and with full legal backing; and (ii) a transaction which the legislature would not intend to encourage.

Tax planning : This is a method of planning the affairs by availing of incentives and benefits provided by the legislature and thus promoting the spirit behind the provisions made in the law. Tax planning is neither 'tax evasion' nor 'tax avoidance'. The Wanchoo Committee report brought out above distinctions as under :—

"The distinction between tax evasion and tax avoidance, therefore, is largely dependent on the difference in methods of escape resorted to.

Some are instances of merely availing, strictly in accordance with law, the tax exemptions or tax privileges offered by the Government. Others are manoeuvres involving an element of deceit, misrepresentation of facts, falsification of accounts, including downright fraud. The first represents what is truly tax planning, the latter, tax evasion. However, between these two extremes, there lies a vast domain for selecting variety of methods, which, though technically satisfying it with a view to eliminating or reducing tax burden. It is these methods which constitute tax avoidance".

There is no dispute in accepting tax evasion as different from tax planning, but the subtle difference between tax avoidance and tax planning is often overlooked.

In McDowell Co. vs. CTO (1989) 22 Taxman II (SC), it was held that "tax avoidance was the same as tax evasion. The thin line of distinction between tax avoidance and tax evasion was obliterated."...... "We now live in a welfare state whose financial needs, if backed by the law, have to be respected and met. We must recognize that there is as much moral sanction behind taxation laws as any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical ......"

## 1.3 Objectives of Tax Planning

Tax planning is an honest and valid approach to the taxation laws within their framework to achieve the objective of tax reduction and therefore, the objectives of tax planning cannot be regarded as offending any concept of taxation laws.

The prime objectives of tax planning may be summarized as follows :

(i) Reduction of tax liability,

(ii) Mimimisation of litigation.

(iii) Productive investment

(iv) Healthy growth of economy

(v) Economic stability.

**(i) Reduction of tax liability :** One of the supreme objectives of tax planning is the reduction of tax liability of the tax payer and the resultant saving of earning for a better enjoyment of the fruits of the hard labour. By proper tax planning, a tax payer can oblige the administrators of the taxation laws to keep their hands off from his earnings.

**(ii) Minimisation of litigation :** Where a proper tax planning is resorted to by the tax payer in conformity with the provisions of the tax laws, the chances of

unscrupulous litigation are certainly to be minimized and the taxpayer may be saved from the hardships and inconveniences caused by the unnecessary litigations which move often than not even knock the doors of the supreme judiciary.

**(iii) Productive investment :** The planning is a measure of awareness of the tax payers to the intrecacies of the taxation laws and it is the economic consciousness of the income earner to find out the ways and means of the productive investment of the earnings which would go a long way to minimize his tax burden.

The taxation laws offer large avenues for the productive investment granting absolute or substantial relief from taxation. A tax payer has to be constantly aware of such legal avenues as are designed to open floodgates of his well-being, prosperity and happiness. When earnings are invested in the avenues recognized by law, they are not only relieved of the burnt of taxation but they are also converted into means of further earnings.

**(iv) Healthy growth of economy :** The saving of earnings is the only basement upon which the economic structure of human life is founded. A saving of earnings by legally sanctioned devices is the prime factor for the healthy growth of the economy of a nation and its people. An income saved and wealth accumulated in violation of law are the scours on the economy of the people. Generation of black money darkness the horizon of the national economy and leads the nation to avoidable economic destruction. In the suffocating atmosphere of black money, a nation sinks with its people. But tax planning is the generator of a superbly white economy where the nation awakens in the atmosphere of peace and prosperity, a phenomenon undreamed of otherwise.

**(v) Economic stability :** Under tax planning, taxes legally due are paid without any headache either to the tax payer or to the tax collector. Avenues of productive investments are largely availed of by the taxpayers. Productive investments increase contours of the national economy embracing in itself the economic prosperity of not only the tax payers but also of those who earn the income not chargeable to tax. The planning thereby creates economic stability of the nation and its people by even distribution of economic resources.

## 1.4 Factors for Tax Planning

A tax planning may be for a short—term, that is to say, yearly like the annual plans of the government and it may also be for a long-term depending upon the exigencies of the sources of income, like five-year plans of the Government. But both types may

be employed in a given situation because both are supplementary to each other and they may not be found overlapping. When a tax planner is prepared to do his job meticulously, efficiently and intelligently, he has to take into consideration the following factors :

(i) Residential status;

(ii) Complete information of financial position of tax payer;

(iii) Heads of income;

(iv) Latest legal position;

(v) Form vs. substance: the subject is not to be charged to tax unless the charging provision clearly imposes to the obligation. There is no scope for presumption or intendment.

## 1.5 Methods of Tax Planning

Tax planning may be effective in every area of business management. Some of the important areas where planning may be attempted are

(i) Short-term tax planning

(ii) Medium-term tax planning

(iii) Long-term tax planning

## 1.6 Some of the areas of Tax Planning

Tax planning may be effective in every area of business management. Some of the important areas where planning may be attempted are

(i) Location of business,

(ii) Natrue and size of business,

(iii) Form of busines organization and the pattern of its ownership,

(iv) Specific management decisions like make-or buy, own or lease, capital structure, renew or replace, etc.

(v) Employees' remuneration,

(vi) Merger/amalgamation of companies,

(vii) Double taxation relief,

(viii) Personal taxation-Indian and non-residents,

(ix) Tax implications in (a) receiving foreign collaboration & (b) giving foreign collaboration,

(x) Tax incentives and export promotion,

(xi) Advance ruling.

## 1.7 Tax Planning and Corporate Planning

In the corporate planning process, of various phases like strategy formulation and functional plans, are very important. It is at this stage of strategy formulation corporate tax planning helps corporate planners. Depending upon the results of gap analysis, company develops strtegy to fill the gap. It may be in any form like expansion, diversification or the closure of units. To make right choice it is necessary to induct taxation into the corporate planning process. The chart given in the following page represents the areas where corporate planners should seek the guidance and advice of the corporate tax planner. This diagram seeks to establish linkages between corporate planning and tax planning. This linkage process is briefly explained below:

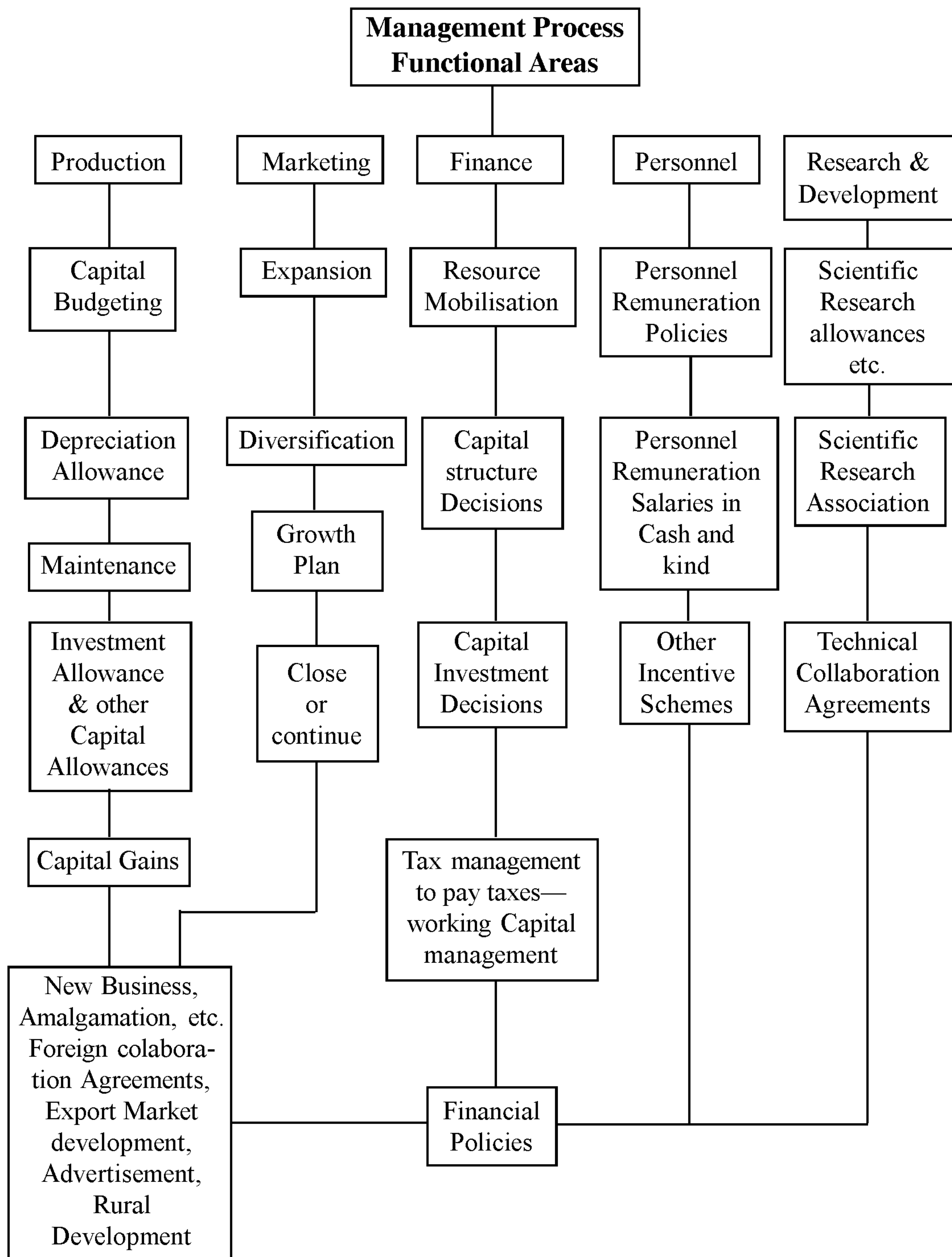
**Production planning :**

The possible problems in production after setting out production plans are— maintenance, capacity utilization, etc. Tax laws provide depreciation allowance and maintenance allowance like allowance for repairs, etc. Similarly, investment allowance, taxation of capital gains and deemed profits should be considered for acquiring more machines or selling obsolete machines and also for deciding the timing of either purchase or sale of assets.

**Market planning :**

The assessee can claim export market deductions in addition to allowances for entertainment and advertisement expenditure u/s 37. However market plans depend upon strategy formulation which includes expansion, diversification and closure of certain units. Expansion involves promoting a new business undertaking adding one more department or amalgamation of two or three companies. For these the tax implications involved in a particular decision should be studied in depth.

Promoting a new business or opening a new department or amalgamation of two


Management Process
Functional Areas
Production
Marketing
Finance
Personnel
Research & Development
Capital Budgeting
Expansion
Resource Mobilisation
Personnel Remuneration Policies
Scientific Research allowances etc.
Depreciation Allowance
Diversification
Capital structure Decisions
Personnel Remuneration Salaries in Cash and kind
Scientific Research Association
Maintenance
Growth Plan
Investment Allowance & other Capital Allowances
Close or continue
Capital Investment Decisions
Other Incentive Schemes
Technical Collaboration Agreements
Capital Gains
Tax management to pay taxes—working Capital management
New Business, Amalgamation, etc. Foreign colabora-tion Agreements, Export Market development, Advertisement, Rural Development
Financial Policies

or more companies or closure of certain sick units, or splitting up of the business would involve either solving or creating some more production, marketing, personnel or financial problems. It is thus necessary that tax planning should be attempted not only by isolating each of the departmental problems but also integrating them.

**Financial planning :** In financial management, capital structure decision have been considered as very important. Tax planning helps in deciding the capital gearing required and in computing the optimum capital mix and the cost of capital as well.

Similarly, since almost 39.5% of the taxable profits have to be paid to the government in the form of income-tax, it would be difficult to marshal the necessary working capital required to pay taxes regularly. This problem would become more complicated in the absence of tax management.

**Personnel planning :** Personnel mnagement in companies in not only a social responsibility but has become a statutory obligation too. To arrive at proper remuneration plans and to evolve sound wage policies companies should pay the utmost attention to the tax implications involved in the fixation of salary. perquisites, allowances and other employee welfare benefits.

**Research and development :** Without research and development efforts companies may be able to serve only the needs of yesterday and run the risk of being outdated in the market. The tax benefits have provided stimulus for expansion of research activity in industry. But without proper tax planning, companies might loose these tangible tax benefits.

**Conclusion :** So far many companies have pursued corporate planning as an isolated and independent legal exercise confined to the chambers of tax advisers and solicitors. However, it may be argued that tax planning should be integrated into overall corporate long-range planning process. The scheme of corporate taxation is comprehensive affecting all important areas of corporate management.

Any planning exercise done exclusively for a single area creates imbalances in the master plan and leads to sub-optimal utilization of corporate resources. Such an integrated approach to the planning process requiress that tax planning be an important and equal partner along with other segments like production planning, marketing planning, etc. Just as corporate planning is an incomplete endeavour without being fitted into the corporate planning framework, corporate planning should also go hand in glove with each other.

## 1.8 Questions

1. Explain the concept of 'Tax planning'. What are the requirements of tax planning?
2. (a) Distinguish between 'Tax evasion' and 'Tax avoidance'

   (b) 'It is said that distiction between Tax planning and Tax avoidance is very thin and delicate'—Discuss.
3. (a) What are the objectives of Tax planning?

   (b) What are the areas where tax planning may be attempted?
4. What is the relevance of corporate planning with Tax planning? Show with a diagram the areas where the corporate planner may take the help of a tax planner.

## 1.9 References


1. Corporate Tax Planning—E. A. Srinivas.
2. Corporate Tax Planning and Management—Ahuja & Gupta.

# Unit 2 ❑ Tax Planning in Functional Management

**Structure**

**2.1 Tax Planning in Respect of Employees' Remuneration**

2.1.1 The residential accommedation to the employee

2.1.2 Bonus or commission to employee

2.1.3 Payment of salaries made to research personnel

2.1.4 Premium paid for insuring the health of the employees and their family members

2.1.5 Company's contribution towards RPF or approved superannuation fund

2.1.6 Expenditure on Family Planning

**2.2 Tax Planning from Employee's Point of View**

2.2.1 Medical allowance vs. medical facility/reimbursement

2.2.2 Lunch allowance vs. food and beverages

2.2.3 Transport allowance vs. conveyance for travelling from residence to the office and back to residence

2.2.4 Conveyance allowance vs. conveyance facility

2.2.5 Children's education allowance/hostel expenditure allowance vs. reimbursement of the expenses of the children's education/education facility

2.2.6 Servant allowance vs. facility of watchman, sweeper or gardener

2.2.7 House rent allowance vs. rent free accommodation

2.2.8 Planning through employee stock option plan/scheme

2.2.9 Other exemptions

**2.3 Tax Planning in Respect of Research and Development**

2.3.1 Expenditure on scientific research

2.3.2 Expenditure on in-house research and development expenses [S.2 AB]

2.3.3 Pre-commencement Period Expenses

2.3.4 Depreciation not admissible

**2.4 Deduction in respect of expenditure on know-how**

**2.5 Deduction in respect of donations for scientific research or rural development [S. 80GGA]**

**2.6 Payment to the association and institutions carrying out rural development programmes [S.35CCA]**

**2.7 Planning for R&D with respect to S.115JB**

**2.8 Expenditure on acquisition of copyrights and patent rights [S.35A]**

**2.9 Questions**

**2.10 References**

## 2.1 Tax Planning in respect of employees' remuneration

Corporate assesses should pay special attention to the tax implications of personnel remuneration, In a country like India which is aiming at rapid industrialization, personnel remuneration policies assume utmost importance from the point of view of employees of all levels, the indsutry and society as well, Employees' interest, to-day, is highly protected by various statutory measures taken by the government while the industry is not encouraged to pay more remuneration than what is necessary from the point of view of social needs. Managers of companies must now attempt to strike a balance between these/interests, viz. that of employees, the industry and society. Their performance would then be directly evident from the number of Mandays utilized, the production levels achieved and industrial peace secured. The tax planning in case of employees' remuneration requires the full knowledge of income-tax laws and other allied economic and corporate laws like Companies Act in regard to allowability and taxation of salary income of executives and directors, etc.

The tax planning in this respect requires the study both from the employer and employees point of view because tax provisions affect both employer and the employees. Companies have the responsibility to pay that form of remuneration which least attracts tax in the employees' hands and is at the same time eligible for deduction in their own assessment. Remuneration can be paid either in cash or in kind, which include perquisites.

Again remuneration can be paid either immediately or can be deferred or a combination of both. All these should be decided in consideration of tax liability both for the employees and the employer company.

**Tax planning from employer point of view :** While calculating business income of the employer, remuneration paid to employees are fully deductible. If such expenditure is not allowed as deduction, then tax bill of the employer increases. On the other hand, one has to see that remuneration received by the employees is taxable in their hands at concessional rates, to minimize their tax bill and to maximize their take home pay.

The company is allowed full deduction on account of any salary, allowance, perquisites, bonus or any other remuneration paid or payable to the employee as per the method of accounting followed by it but the following points must be kept in mind in this regard:

### 2.1.1 The residential accommodation to the employee

A company may provide a residential accommodation to the employee which may be owned by it or taken on rent. Further such accommodation may be provided as unfurnished or furnished.

A. Deduction is allowable if the accommodation is owned by the company employer

   (i) Current repairs, insurance premium and rates and taxes of such premises. However, rates and taxes shall be allowed as deduction on due basis only when the payment of the same is made on or before the last date of furnishing the return of income u/s 139(10) as per provisions of sec. 43B.

   (ii) Depreciation on such premises on the basis of written down value method on Block of Assets.

B. Deduction allowable if the accommodation is taken on rent by the employer

In this case, the employer will be eligible for deduction on account of rent, repairs, insurance premium and rates and taxes of such premises. Rates and taxes shall however be subject to sec 43B. Further, the repairs other than of capital nature shall be allowed as deduction in this case. If the above to cases, the furniture owned by the employer is also provided with the accommodation, the assessee shall be eligible for repairs, insurance premium and depreciation on such furniture provided to the employee. If the furniture is taken on hire and given to employee actual hire charges shall be allowed as deduction.

### 2.1.2 Bonus or commission to employee

Any sum paid to an employee as bonus or commission for services rendered shall be allowed as deduction to the employer provided such sum would have been payable

otherwise payable to him as profit or dividend. However, if such sum is claimed as deduction on due basis the same shall be allowed only when the payment of the same is made on or before the due date of furnishing return of income u/s 139(1) as per provisions of sec 43B.

### 2.1.3 Payment of salaries made to research personnal

If the assessee carries on research which is related to his business, any salary paid to such research personnel shall be allowed as deduction. Further salary paid to such research personnel within 3 years immediately preceeding the date of commencement of the business, shall also be allowed as deduction in the previous year in which the business has commenced, to the extent such expenditure was certified by the prescribed authority.

### 2.1.4 Premium paid for insuring the health of the employees and their family members

Any sum paid by cheque by the employer to General Insurance Corporation or any other insurer for insuring the health of the employees shall be allowed as deduction. Further, any sum reimbursed by the employer in respect of any premium paid by the employee to effect or to keep in force an insureance on his health or the health of any family member shall be allowed as deduction.

### 2.1.5 Company's contribution towards RPF or approved superannuation fund

Payment made by a company towards the above funds call for the following tax implications:

Where the company sets apart amounts in the books of accounts towards the above funds, and do not part with the rights on the said amount, no deduction is possible unless they pay their share of the contribution standing to the credit of the employee in the fund account.

In such a case it would be advisable to set apart the above amounts and settle them upon trust, which is valid and effective. But a liability for terminal benefits of employees collectively, if actuarially valued, is allowed u/s sec. 37.

The CBDT has specified a condition that the total amount of contribution that shall be taken into account shall not exceed twenty-seven per cent of the employees salary for each year of his past services with the employer's contribution, if any, to any provident fund (whether recognized or not) in respect of that employee for each such year. This is applicable where there is no annual contribution on some definite basis by reference to his income chargeable under the head 'salaries'. Payment of gratuity: The

employer shall be allowed deduction on account of gratuity in the previous year in which such gratuity is due to an employee. The employer can, on the other hand, claim deduction of contribution towards an approved gratuity fund created by him for the exclusive benefit of his employees under an irrevocable trust. This deduction can be claimed in the year in which the contribution is made.

### 2.1.6 Expenditure on Family Planning

Any expenditure bonafide incurred by a company only for the purpose of promoting family planning amongst its employees will be admissible. If such expenditure is of capital nature, it will be allowed as deduction in five equal instalments starting from the previous year in which such expenditure was incurred.

Tax payable by employer on non-monetary perquisites of the employee: As per sec. 40(a), any tax actualy paid by an employer on the perquisites not provided by way of monetary payment shall not be eligible for deduction while calculating the business income of the employer.

Sum deducted by employer as provident fund, E.S.I., etc from salary of employee: Such amount deducted is treated as income of the employer and if such sum deducted is deposited in the fund on or before the due date ofdeposit applicable for each such fund, the amount so deposited shall be allowed as deduction.

## 2.2 Tax Planning from employee's point of view

The salary received by the employee, whether in cash or in kind, should attract minimum tax liability. However, certain allowances / perquisites received by the employees from the employer either exempt or tax free. The only area of tax planning in case of employee remuneration is that he should take those allowances which are fully exempt or exempt upto a certain limit. Similarly, he should take those perquisites from his employer which are either taxfree or taxable at concessional rate. A comparative study of allowances vis-a-vis perquisites on the basis of its taxability, discussed below, will enable the employee to decide as to which, out of the two, shall be beneficial in his case—

### 2.2.1 Medical allowance vs. medical facility/reimbursement

Any medical allowance received by an employee shall be fully taxable, irrespective of any amount spent by him on medical treatment or treatment of his family members. On the other hand any medical facility granted by the employer to the employee and his

family members in a hospital etc. maintained by the employer shall be a tax free perquisite. Similarly, any reimbursement of medical expenses by the employer on account of the medical treatment of the employee or his family members shall be tax free perquisites subject to the maximum of Rs. 15000. Further, if the treatment of the employee or his family members is done in a Govt. hospital/hospital approved by the Govt. for its employees or treatment is done for any specified disease or ailment in a hospital approved by the CIT, the entire amount incurred shall be tax free perquisite, in addition to the above Rs. 15000.

Similarly, expenses incurred/reimbursed by the employer on medical treatment of the employes and his family members out side India shall also be tax free as regard to expenses on medial treatment, stay, outside India of the patient and one attendent, are concerned. However, the travel expenses of the patient and one attendent, for going outside India for such purpose, shall be tax free only, if the gross total income of the employee before including such perquisite of travel does not exceed Rs. 2 lacs.

### 2.2.2 Lunch allowance vs. food and beverages

Any lunch allowance received by an employee shall be fully taxable. On the other hand in the following cases there shall be no perquisite value—

(i) Where free meals are provided by the employer during office hours at office or business premises or through paid vouchers which are not transferable and usable only at eating points if the value thereof in either case is up to Rs. 50 per meal, or

(ii) to tea or snacks provided during office hours, or

(iii) to free meals during working hours provided in a remote area or an offshore installation.

### 2.2.3 Transport allowance vs. conveyance for traveling from residence to the office and back to residence

Any transport allowance received by an employee from the employer for travelling from residence to the office and back to residence shall be exempt to the extent of Rs. 800 p.m. irrespective of any amount spent on such travelling. On the other hand, if the conveyance is provided by the employer to the employee for travelling from residence to the office and back to the residence it will be tax free perquisite.

### 2.3.4 Conveyance allowance vs. conveyance facility

Any conveyance allowance received by an employee shall be exempt to the extent such amount is spent on the conveyance for official purposes. Any amount spent on conveyance for personal purposes shall be fully taxable. On the other hand, if car is

provided by the employer to the employee partly for his office purpose and partly for personal purpose, the value of this perquisite taxable in the hands of the employee shall be Rs. 1200 pm. if the car is up to 16 H.P. and Rs. 1600 pm. if it exceeds 16 H.P. if driver is provided by the employer, the value of this perquisite taxable shall be Rs. 600 p.m.

### 2.2.5 Children's education allowance / hostel expenditure allowance vs. reimbursement of the expenses of the children's education/education facility

If an employee takes C.E.A. from his employer for his children, education allowance shall be exempt subject to the maximum of Rs. 100 p.m. per child for a maximum of 2 children. Similarly, H.E.A shall be exempt up to Rs. 300 p.m. per child up to 2 children. On the other hand, any expenses on the education of children reimbursed by the employer shall be fully taxable.

However, where the educational institution itself is maintained and owned by the employer and free educational facilities are provided to the children of the employee or where such free educational facilities are provided in any institution by reason of his being in employment of that employer, nothing contained in this sub-rule shall apply if the cost of such education or the value of such benefit per child does not exceed Rs. 1000 pm.

### 2.2.6 Servant allowance vs. facility of watchman, sweeper or gardener

Any servant allowance received by an employee shall be fully taxable unless the servant helps the employee to do official work. On the other hand, if watchman, sweeper or gardener is employed by the employer and the facility of such person is given to the employee free of cost, the valuation of this perquisite for taxability of the same shall be the actual cost to the employer.

Telephone allowances; Telephone facility received by the employee at his residence or telephone (including mobile phone) expenses actually incurred by the employer on behalf of the employee shall be a tax free perquisite.

### 2.2.7 House rent allowance vs. rent free accommodation

Any HRA received by an employee is exempt as per provisions of sec. 10(13A) of the Income-tax Act; on the other hand the perquisite of rent free accommodation shall be according to Rule (1) to the Income-tax Act.

### 2.2.8 Planning through employee stock option plan/scheme

W. e.f. A.Y. 2001-02, the value of any benefit provided by a company free of cost or at a concessional rate to its employees by way of allotment of shares, debentures or

warrants directly or indirectly under employees' stock option plan/scheme of the said company shall no longer be treated as perquisite in the hand of the employees.

Tax planning can be effected in respect of retirement benefits such as gratuity, commuted pension, leave encashment, etc. by complying with the provisions of the relevant sections and Rules of the Income tax Act.

### 2.2.9 Other exemptions

Apart form the abave deductions/allawances, before finalisation of salary structure of an employee, following exempltions may also be taken into consideration as per provisions of the Income Tax Act, 1961.

(i) Exemption for death-clam retirement gratuilty [u/s 10(10)]

(ii) Exemption for commuted pension [u/s 10(10A)]

If an employee commutes his pension, he can get an exemption against his commuted pension. In case of employees of goverment / local authoritts / corporation, the whole amount will be exempted. In any other case, it shall be exempt to the extent of commuted value of $^1/_2$ of normal person if, the employee does not get gratuity, if he gets gratuity the exemption will be $^1/_3$ rd of normal pension.

(iii) Exemption for retirement compensation [u/s 10(10B)]

Any retrenets compensation received by an employee under the Industual Dispute Act or under an order of court shall be exempt.

(iv) Exemption for compensation received on voluntary retirement [u/s 10(10C)]

Any compensation received or receivable by an cmployee under an approved Voluntary Retirement Scheme shall be exempt to the extent of Rs. 500000.

(v) Exemption for specified allowance [u/s 10(14)] e.g. underground allowance (upto Rs. 800 pm), Compensatory field area allowance (upto Rs. 2600 pm). High altitude allowance (upto Rs. 300 to Rs. 7000 pm) etc.

**Conclusion :** While framing salary structure of employees, one has to keep in view, tax planning under the head 'salaries'; for example, payment of dearness allowance or dearness pays, perquisites, free use of car, etc. Tax bill for employees can be reduced substantially if salary is divided into different allowances (which are not taxable or which are partially exempt from tax) and perquisites which are taxable at concessional rates. The optimum combination of allowances and perquisites depends upon individual requirement of each employee taking into consideration present take-home pay and

future benefits of different items in salary structure.

The problem that generally confronts us while computing an item of income under the head 'salaries', may boil down to the existence of the employer-employee relationship between the granter and the recipient of the money. The company and the granter of remuneration must come together in such a relationship. Now, the company should know the tax implications with respect to salary both in its own hands as well as in the hands of the employees.

The tax planner must consider as to admissiblity of any payment of remuneration to the employees under the provisions of the Act.

## 2.3 Tax Planning in Respect of Research and Development

Research and development (R & D) activity is vital for the growth of a country like India. Greater initiative and dedication of purpose is necessary to promote productive research.

The success story of companies in private sector reveals that taxation has a powerful and positive influence on the research planning. So, investment in efficient production through the better technology, and also the proper utilization of resources towards refining the technology should be encouraged by the State through taxation.

Research design and development expenditure incurred by companies is of varied nature and normally very substantial. Research and development expense is either incurred by a company even before its incorporation or afterwards, for introducing a product line or new design for already existing line of activity. It may be in-house R&D or contribution made to certain R&D association. Of late, companies have realized that there are a number of tax benefits availabe under the Income-tax Act for the various forms of R&D expenditure. It is with a view to securing optimum tax benefits with reference to R&D expenditure incurred or to be incurred by companies, that one should make an attempt to find out the tax concessions and comply with the conditions set by them. However, a tax planning exercise should never be attempted in isolation. The non-tax factors involved should also be unearthed and due attention paid to them.

### 2.3.1 Expenditure on scientific research

Expenditure on scientific research incurred by an assessee is deductible u/s 35 of the Income-tax Act It is pertinent here to quote sec 37(1), where it is stated as under: "Any expenditure (not being expenditure stated in sections 30 to 36 and .....) laid out or

expended wholly and exclusively for the purpose of the business ...... shall be allowed in computing the income chargeable under the head profits and gains of business or profession".

So, at the very outset for tax planning, it may be noted that expenditure on scientific research disallowed u/s 35 may be claimed u/s 37, provided all the conditions contemplated in sec. 37 are complied with.

Revenue expenditure incurred by an assessee who himself carries on scientific research related to his business during the previous year is allowed as deduction u/s 35(1)

Contribution made to outsiders: Where the assessee does not himself carry on scientific research but makes contributions to the following institutions for the purpose, a weighted deduction equal to one and one-fourth times of any sum paid to—

a. The payment is made to an approved scientific research association which has, as its object, undertakes scientific research related to or unrelated to the business of the assessee. [sec. 35(1) (ii)]

b. payment is made to an approved university, college or institution for the use of scientific research related or unrelated to the business of the assessee Sec. 35(10)(ii)].

c. the payment is made to an approved university, college or institution for the use of research in social sciences or statistical research related or unrelated to business of the assessee. [See. 35(1)(iii)]

Contribution to National Laboratory; Any sum paid by an assessee to a National Laboratory or a University or an Indian Institute of Technology for carrying out programmes of scientific research, approved by the prescribed authority, is eligible for weighted deduction of one and one-fourth times of actual payment. Such contribution qualified for weighted deduction shall not be entitled to any other deduction under the Act.

It should be noted that such payment is made under a specific direction that it should be used by the above person for undertaking on scientific research programme approved by the prescribed authority.

### 2.3.2 Expenditure on in-house research and development expenses [S.2 AB]

Under this section an assessee being a company assessee only is entitled to get the weighted deduction @ 125% for the A.Y. 2000-2001 and @ 150% from the A.Y. 2001-02 of the actual expenditure incurred by the assessee for in-house research and development provided the following conditions are fulfilled :

1. It is engaged in the business of manufacture or production of any drugs, pharmaceuticals, electronic equipments, computers, telecommunication equipments, chemicals or any other article or thing notified by the Board.
2. It incurs an expenditure on scientific research and such expenditure is of capital nature or revenue nature (not being expenditure in the nature of cost of land and buildings).
3. The said expenditure is incurred on in-house research and development upto 31st march, 2005.
4. An application in Form No. CK, has to be made by the assessee for approval of such facility and to be approved by the appropriate authority.
5. The assessee has entered into an agreement with the prescribed authority for cooperation in such research and development facility and for audit of the accounts maintained for that facility.

### 2.3.3 Pre-commencement Period Expenses

Where any capital expenditure has been incurred before the commencement of the business, the aggregate of such expenditure, incurred within three years immediately preceding the commencement of the business, is deemed to have been incurred in the previous year in which business is commenced.

Revenue expenditure incurred by the assessee on payment of salary to the research personnel and on material in put during the period of three years immediately preceding the commencement of the business is regarded as having laid out or expended in the previous year in which the business is commenced. Such expenditure is allowed as deduction in computing assessee's income of the year in which the business is commenced.

For expenditure incurred before the commencement of business as a matter of tax management, it would be better to maintain separate payroll and inventory records with respect to this expenditure and it should not be mixed with usual business books of accounts. Also the admissible expenditure covered above does not include the finance cost on the capital borrowed for promoting scientific activity and for acquiring scientific assets. However, the company can claim deduction on such expenditure u/s 37(1).

The tax provisions regarding capital expenditure on research prompt us to argue that commencement of scientific activity should be attempted after setting up of a business and also commencement of business to the extent possible may be made within three years after setting up of business. Also, generally, it would be difficult for a company

to secure profits in the year of commencement of business. In such cases, the expenditure on scientific research can be carried forward and set off against future profits.

The deduction u/s 35 will not be denied even if the main object of the company is not to promote research activity and sell the know-how, provided it falls within the frame work of the section discussed earlier.

It may be pertinent to ask how, as to what are the implications if the company either transfers to the business property or sells the capital asset on which it has already claimed 100% deduction? In this connection, answer may be found in S.41(3) which lays down that whenever there is a sale of such an asset without it having been used for other purpose (i.e., directly sold while it was used for scientific research), the assessee may be liable to pay tax on the difference between the amount of expenditure and the sum of sale proceeds plus the deduction allowed.

In the case of a new business the accounting year commences on the date when the business is set up. Expenditure occurred before setting up of a business cannot be allowed as deduction under the Income-tax Act. This is because, before setting up, such expenditure would fall outside an accounting year and hence outside the scope of S. 28 which applies to business carried on. Secondly, an expenditure incurred after setting up but before commencement of business may be allowed u/ss 35-37, since it would fall within the accounting year. Also, there may be a case where a business has been commenced by the promoters of a company before its incorporation and in such a case the expenditure so incurred before incorporation should be allowed as a deduction against revenue receipts of the same period.

### 2.3.4 Depreciation not admissible

Deduction by way of depreciation is not admissible in respect of an asset used in scientific research either in the year in which capital expenditure is incurred or in subsequent year, with reference to which the whole amount has been claimed as a deduction u/s 35.

Carry forward and sat off ofdeficiency in subsequent years: If on account of inadequacy or absence of profits of the business, deduction on account of capital expenditure referred to in sec. 35(1) cannot be allowed, fully or partly, the deficiency so arising at is to be carried forward or unlimited years and set off in any subsequent year. However, carry forward of deficiency is subject to the condition that business loss already brought forward, if any, will have precedence over such deficiency in the matter of set off. To put it little differently, the aforesaid deficiency will be given the same treatment as given to unabsorbed depreciation vis-a-vis brought forward business losses.

## 2.4 Deduction in respect of expenditure on know-how

From A.Y. 1999-2000 the capital expenditure incurred by an assessee for the acquisition of technical know-how will be allowed as deduction in the form of depreciation u/s 32. Deduction for the revenue expenditure will be allowed u/s 37(1).

Expenditure on eligible projects or scheme [Sec. 35AC]: Deduction is available under this section for promoting social and economic welfare or upliftment of the public. The deduction is allowed in cases where the expenditure is either incurred by way of payment to the public sector company, a local authority or to an approved association or institution for carrying out any eligible project or scheme. Companies may, however, be allowed the deduction also in cases where expenditure is incurred by them directly on any eligible project or scheme.

## 2.5 Deduction in respect of donations for scientific research or rural development [S. 80GGA]

An assessee (other than an assessee whose gross total income includes income chargeable under the head Profits and gains of business or profession) is entitled to deduction in the computation of his total income in respect of donations for scientific research or rural development. (Students should go through the detailed provisions in this respect).

## 2.6 Payment to the association and institutions carrying out rural development programmes [S. 35CCA]

This section provides deduction of sums paid by an assessee to :—

a. an association or institution to be used for carrying out any programme for rural programme;

b. an association or institution which has its object to the training of persons for implementation of rural development programme;

c. the National Fund for Rural Development set up by the Government;

d. W.e.f. A.Y. 1969-97, The National Urban Eradication Fund set up and notified by the government. [Students should know the detailed provisions in this respect]

## 2.7 Planning for R&D with respect to S.115JB

(W.e.f. A.Y. 2001-2002) At present every company has to pay at minimum rate tax on its book profit.

According to the provision of the Act, if one incurs R&D expenditure u/s 35(1)(i) or (ii) he can claim it first followed by current depreciation. Expenditure on acquisition of patent rights or copyrights, preliminary expenses and expenditure on prospecting etc. for certain minerals should be amortised for accounting purpose according to the provisions of sections 35A and 35E respectively. In this regard legal provisions must be carefully followed. If possible, avoid donations u/s 35(1)(i), (iii) and prefer donation u/s 35(1)(ii), But an assessee cannot avoid R&D capital expenditure budgets or in-house R&D efforts. Wherever he incurs such expenditure he will be getting deduction u/s 35(2). Sections 35AB provides deduction in regard to expenditure on know-how and the quantum of deduction can be availed of in a span of 6 years (3 years in certain cases) or depreciation allowance equally. This benefit is not rationed u/s 115JB. Hence the assessee can plan as under:

A group of assesses can start a scientific research association u/s 35(1)(ii) or a company whose object is to further research activity or given the R&D responsibility to an individual scientist. This company sells, know-how u/s 35AB to the group of companies who can claim deduction. If the know-how is developed in an institution recognized u/s 32A(2B), then the group companies using the know-how can claim deduction of expenditure on know-how in 3 years or depreciation. It is to be noted that 115JB is applicable to only corporate assessees.

## 2.8 Expediture on acquisition of copyrights and patent rights [S. 35A]

Such deduction was available for expenditure of capital nature incurred prior to April 1, 1998. But such expenditure after 31st March, 1998 is only entitled to depreciation u/s 32.

Any profit or loss on sale of patent rights / copy rights is taken into consideration while computing income.

In conclusion, it is suggested that a new company may be formed by a group of asseessees with the object of promoting research and development. Such company can produce and sell technical know-how and enjoy deduction u/s 35. even if such company plough back all its profits only for its R&D purpose, it can claim deduction under this section. This model helps finding the research since resources are marshalled by a sort of pooling arrangement. No extra tax liability would also be generated from this model.

Another important area of tax planning is that companies may enroll as members to various recognized research associations and claim the membership fees as a deduction. If such fees are disallowed u/s 35 as it is not related to business, the assessee can claim deduction u/s 37.

## 2.9 Questions

1. "Tax consideration in respect of employees, remuneration is an essential aspect of corporate management"—Discuss.
2. What are the points shuld an employer bear in mind from the tax point of view while devising wage system and allowing perquisites to employees?
3. What are the tax aspects should an employee consider while receiving salary, either in cash or in kind, so that tax liability might be kept to the minimum?
4. "It is said that taxation has a powerful and positive influence in corporate research planning'—Discuss.
5. Write short notes on:
   (a) Set off and carry forward of research and development expenditure.
   (b) Weighted deduction for research and development expenditure.

## 2.10 References

1. Direct Taxes—Law and Practice—V. K. Singhania & K. Singhania.
2. Corporate Tax Planning & Manaagement—Ahuja & Gupta.

# Unit 3 ❑ Tax Planning in Financial Management Decisions

**Structure**

**3.1 Capital Structure Decision**

3.1.1 Means of financing

**3.2 Dividend Policy**

**3.3 Tax on distribted profits of Domestic Companies**

3.3.1 Basis of charge [Sec. 115-O(1)]

3.3.2 What is "dividend"

3.3.3 Nature of tax

**3.4 Bonus shares (Capitalisation of Reserve and Surplus)**

**3.5 Questions**

**3.6 References**

## 3.1 Capital Structure Decision

**Importance in selection of capital structure :** Before setting up a new project, an important decision about the type of capital structure has to be taken. While selecting a particular capital structure, the entrepreneur has to keep in view the following considerations:

(i) serving the capital base with consistent dividend policy

(ii) cost of capital to be raised form the market

(iii) chargeability or otherwise of taxes. i.e., direct and indirect taxes

(iv) keeping a margin for ploughing back of profits for future plan towards diversification, expansion, modenisation and other development aspects.

### 3.1.1 Means of financing

Generally, the following means of finance are available for a new project:

(i) Equity share capital

(ii) Debentures/Loans and borrowing/Lease Finance.

**Effect of financial leverage:** In making capital structure decision, financial leverage plays an important role. The financial leverage states the percentage increase in earning before taxes corresponding to percentage increase in earning before interest and taxes. This can be explained with the help of following example:

| | |
|---|---|
| Earning before interest and taxes (EBIT) | 2,000 |
| Less: Interest on securities | 1,000 |
| Earning before taxes (EBT) | 1,000 |

$$\text{Financial leverage} = \frac{2000}{1000} = 2$$

Here, this financial leverage states that any increase in earning before interest and taxes will have two fold increase in earning before taxes. So if EBIT is Rs. 3,000 then EBT will be—

| | |
|---|---|
| EBIT | 3,000 |
| Less: Interest | 1,000 |
| EBT | 2,000 |

Hence, it is clear that 50% increase in EBIT has resulted 100% increase in EBT.

Therefore, a high financial leverage would result in a very high return when there is high profitability. But in case of depression, this may prove to be dangerous because the residual net income available to shareholders may reduce to a great extent and sometimes may convert in losses. How much financial leverage is safe is considered with reference to the likely fluctuation in the operating profits and the debt equity mix.

**Capital mix :** A capital structure is said to be optimum when it has a mix of debt and equity that will yield the lowest weighted average cost of capital. At the same time, a capital mix should not have high debt equity ratio. A high debt/equity ratio has its own advantages and disadvantages.

**Case I**

A company wants to raise capital of Rs. 20,00,000 for a project where earning before tax shall be 30% of the capital employed. The company can raise debt fund @ 12% p.a. Suggest, which of the following 3 alternatives should it opt for:

(a) Rs. 20,00,000 to be raised by equity capital (b) Rs. 16,00,000 by equity and Rs. 4,00,000 by loans (c) Rs. 4,00,000 by equity capital and Rs. 16,00,000 by loans.

Assume the company shall distribute the entire amount of profits as dividend and tax rate is 30% plus 10% surcharge plus 2% education cess.

**Case II**

What will be the option, if the earning before tax is 10% of capital employed.

**Solution for Case I**

| | Alternative | | |
|---|---|---|---|
| | A | B | C |
| Equity share capital (A) | 20,00,000 | 16,00,000 | 4,00,000 |
| Debt capital | — | 4,00,000 | 16,00,000 |
| Total investment | 20,00,000 | 20,00,000 | 20,00,000 |
| Earning before interest and taxes (EBIT) | 6,00,000 | 6,00,000 | 6,00,000 |
| Less : Interest on debt @ 12% p.a. | — | 48,000 | 1,92,000 |
| Earning before taxes (EBT) | 6,00,000 | 5,52,000 | 4,08,000 |
| Less: Tax @ 30% + surcharge @ 10% + Ec 2% | 2,01,960 | 1,85,803 | 1,37,333 |
| Earning after tax (EAT) | 3,98,040 | 3,66,197 | 2,70,667 |
| As per section 115-O | | | |
| Tax on dividend to be distributed | | | |
| $398040 \times \frac{16.998}{116.998}$ | 57,829 | | |
| $366197 \times \frac{16.988}{116.988}$ | | 53,203 | |
| $270667 \times \frac{16.998}{116.998}$ | | | 39,324 |
| Amount of dividend distributed (b) | 3,40,211 | 3,12,994 | 2,31,343 |
| Rate of return on equity share capital (B/A) | 17.01% | 19.56% | 57.84% |

**Solution to Case II**

Position when EBIT is 10% of capital, i.e., only Rs. 2,00,000

| | | | |
|---|---|---|---|
| EBIT | 2,00,000 | 2,00,000 | 2,00,000 |
| Less : interest on debt | — | 48,000 | 1,92,000 |
| EBT | 2,00,000 | 1,52,000 | 8,000 |
| Less: Tax @ 30% + surcharge 10% + EC 2% | 67,320 | 51,163 | 2,693 |
| EAT | 1,32,680 | 1,00,837 | 5,307 |
| As per section 115-O | | | |
| Tax on dividend to be distributed | | | |
| $1{,}32{,}680 \times \frac{16.998}{116.998}$ | 19,276 | | |
| $1{,}00{,}837 \times \frac{16.998}{116.998}$ | | 14,650 | |
| $5{,}307 \times \frac{16.998}{116.998}$ | | | 771 |
| Amount of dividend distributed | 1,13,404 | 86,187 | 4,536 |
| Return on equity share capital | 5.67% | 5.39% | 1.134% |

The above two situations make it clear that the existence of securities bearing a fixed rate of return in capital structure has a magnifying effect on earning after tax. But it is also clear form the second situation that the shareholders suffer to a great extent.

**Case III**

X. Ltd. is a widely-held company. It is currently considering a major expansion of its production facilities and the following alternatives are available:

| | Alternative one Rs. | Alternative two Rs. | Alternative three Rs. |
|---|---|---|---|
| Share capital 50,00,000 | 50,00,000 | 20,00,000 | 10,00,000 |
| Debentures (14 per cent) | — | 20,00,000 | 15,00,000 |
| Loan from financial institution /bank @18 per cent | — | 10,00,000 | 25,00,000 |

Expected rate of return (before tax) is 25 per cent. The rate of dividend of the company since 1980 is not less than 20 per cent and the date of dividend declaration is June 30 every year.

Capital structure decision

| | Alternative one Rs. | Alternative two Rs. | Alternative three Rs. |
|---|---|---|---|
| Return on Rs. 50,00,000 | 12,50,000 | 12,50,000 | 12,50,000 |
| Less: | | | |
| Interest on debenture | — | 2,80,000 | 2,10,000 |
| Interest on loan | — | 1,80,000 | 4,50,000 |
| Taxable profit | 12,50,000 | 7,90,000 | 5,90,000 |
| Tax @ 30% (plus 10% of tax as surcharge plus 2% of tax and surcharge as education cess) | 4,20,750 | 2,65,914 | 1,98,594 |
| Return on equity share capital | 8,29,250 | 5,24,086 | 3,91,406 |
| Rate of return on equity share capital (before dividend tax) | 16.585% | 26.20% | 39.14% |

The company should, therefore, opt for the third alternative.

## 3.2 Dividend Policy

◆ Under section 2 (22), the following payments or distributions by a company to its shareholders are deemed as dividends to the extent of accumulated profits of the company (it may be noted that these payments may not be "dividrnd" under the Companies Act):

a. any distribution entailing the release of company's assets;

b. any distribution of debenture, debenture-stock, deposit certificates and bonus to preference shareholders;

c. distribution on liquidation of company;

d. distribution on reduction of capital;

e. any payment by way of loan or advance by a closely-held company to a shareholder holding substantial interest provided the loan should not have been made in the ordinary course of business and money-lending should not be a substantial part of the company's business.

◆ If dividend comes under (a) to (d), then the payer-company will pay dividend tax under section 115-O and in the hands of recipient shareholders, it is not chargeable to tax.

Conversely, if dividend comes under (e), then it is taxable in the hands of shareholder. In such case, the payer-company will not pay dividend tax.

◆ With effect from the assessment year 2000-01, the following shall not be treated as "dividend"—

a. any payment made by a company on purchase of its own shares in accordance with the provisions contained in section 77A of the companies Act; or

b. any distribution of shares made in accordance with the scheme of demerger by the resulting company to the shareholders of the demerged company whether or not there is a reduction of capital in the demerged company.

**Accumulated profit :**

The accumulated profit should include the credit balance of the profit and loss account, general reserve, investment allowance, Capitalised profits and profits of the year upto the date of the distribution or liquidation. Provision for incame tax, provision for dividend, reserve for depreciation, share premium will not form a part of the accumulated profits. The accumulated profit refer to the commercial profits accumulated by a company [Badiani (P.K) Vs. CIT (1976) 105 ITR 642 (SC)].

## 3.3 Tax on distributed profits of Domestic Companies

The provisions of sections 115-O, 115-P and 115-Q are given below.

**Tax treatment in the hands of shareholders if dividends are distributed during June 1, 1997 and March 31, 2002 or after march 31, 2003**—Tax treatment of dividend is as follows—

**Dividend received from a domestic company**—If dividend is covered by section 2(22) [not by clause (e) of section 2(22)] and declared, distrbuted or paid during June 1, 1997 and March 31, 2002 or after March 31, 2003, then it is not taxable in the hands of

shareholders by virtue of section 10(34)/(33). On such dividend, the company declaring dividend will pay dividend tax under section 115-O. If a loan or advance is given which is deemed as dividend under section 2(22)(e), then such loan or advance is taxable under section 56 as "dividend" in the hands of recipient without claiming any deduction under section 80L or 80M.

**Dividend received from a non-domestic company**—If dividend is received form a company other than a domestic company, it is chargeable to tax in the hands of recipient.

### 3.3.1 Basis of charge [Sec. 115-O(1)]

A separate and additional charge has been created by section 115-O(1). It is subject to the following propositions—

1. Tax on distributed profit is in addition to income-tax chargeable in respect of total income.
2. Only a domestic company (not a foreigan company) is liable for above tax.
3. Any amount declared, distributed or paid by a domestic company by way of dividend shall be charged to dividend tax.
4. It is applicable whether the dividend is interim or otherwise.
5. It is applicable only if such dividend is declared, distributed or paid on or after June 1, 1997 but before April 1, 2002 or after March 31, 2003.
6. It is applicable whether such dividend is paid out of current profit or accumulated profit.

### 3.3.2 What is "dividend"

Dividend declared, distributed or paid on or after June 1, 1997 but before April 1, 2002 or after March 31, 2003 is subject to dividend tax [for meaning of "dividend" for the purpose of section 115-O the expression "dividend" shall have the same meaning as is given to "dividend" under section 2(22), but it shall not include sub-clause (e) of section 2(22)].

### 3.3.3 Nature of tax

The levy of additional tax is in addition to normal tax payable by a company. This additional tax incidence cannot be avoided even if no income-tax is payable by a domestic company on its total income computed under the provisions of the Act. Moreover, brought forward MAT credit under section 115JAA cannot be adjusted against the additional tax on dividend.

Rate of dividend tax-The amount of dividend tax is as follows—

| | Dividend tax (as a % of dividend) | Surcharge (as a % of dividend) | Education cess (as a % of dividend) | Total (as a % of dividend) |
|---|---|---|---|---|
| April 1, 2001 to May 31, 2001 | 20 | 0.40 | — | 20.40 |
| June 1, 2001 to March 31 2002 | 10 | 0.20 | — | 10.20 |
| April 1, 2002 to March 31, 2003 | NA | NA | — | NA |
| April 1, 2003 to March 31, 2004 | 12.5 | 0.3125 | — | 12.8125 |
| April 1, 2004 to March 31, 2007 | 12.5 | 0.3125 | 0.25625 | 13.06875 |
| April 1, 2007 to March 31, 2008 | 15 | 10 | 2 EC 1% SHEC | 16.998 |

When the additional tax should be paid-The tax on distributed profit shall be paid within 14 days from the date of—

a. declaration of any dividend; or

b. distribution of any dividend; or

c. payment of any dividend,

whichever is the earliest.

Who is liable to pay tax—The principal officer of the domestic company and the company shall be liable to pay the aforesaid tax.

**Dividend tax is the final levy—**Tax on dividend paid by a domestic company shall be taken as the final tax payment in respect of the amount declared, distributed or paid as dividend. In respect of tax so paid, no credit is available to the company paying tax, or the recipient of dividend or to any other person. By virtue of section 10(33) or 10(34), dividend income (in respect of which tax is charged under section 115-O) will be exempt in the hands of recipient.

**Dividend tax is not deductible—**The company (or the shareholders) cannot claim any deduction from taxable income in respect of dividend tax levied under section 115-O. Moreover, no deduction is available from the tax on dividend under any provision.

**Inter corporate dividend—**Section 80M has been re-introduced with effect from the assessment year 2003-04. A deduction under this section would be available to a domestic company, which receives dividend from another domestic company and distributes dividend out of its profits. The amount of deduction on the dividends, so received by a domestic company from another domestic company, shall be limited to the extent of dividends distributed by the recipient company on or before the due date of filing of return. Where any deduction, in respect of the amount of dividend distributed

by the domestic company, has been allowed under section 80M in any previous year, no deduction shall be allowed in respect of such amount in any other provision.

## 3.4 Bonus shares (Capitalisation of Reserve and Surplus)

A stock dividend represents a distribution of shares in lieu of or in addition to the cash dividend (known as bonus in India) to the existing shareholders. This has the effect of increasing the number of outstanding shares of the company. The shares are distributed proportionately.

One of the conditions laid down in sub-clause (a) of section 2(22) is that distribution must entail the release of assets by the company to its shareholders. When, therefore, a company issues bonus shares by capitlisation of its profits, then there is no release of assets and, consequently, bonus shares are not taken as dividend. It, however, bonus shares are issued to preference sharholders, it amounts to distribution of dividend by virtue of sub-clause (b) ofsection 2(22).

If bonus shares are issued to equity shareholders, it does not amount to distribution of dividend at the time of issue of bonus shares, as there is no release of assets. But if bonus shares are redeemed (redemption is possible only in case if bonus shares are in the form of redeemable preference shares), there will be release of assets and in that event these would constitute dividend—Shashibala Navnitlal v. CIT [1964] 54 ITR 478 (Guj.).

Distribution of dividend in cash requires sufficient cash in the companies bank account. If the company does not have enough bank balance at the time of paying cash dividend, arrangement should be made to borrow funds. Moreover distribution of cash dividend will reduce both the cash balance and reserve account. As a result both the total assets and the net worth of the company are reduced.

One of the advantages to shareholders in the receipt of stock dividends is the beneficial treatment of such dividends with regard to income taxes. When a shareholder receives cash dividend from the company, this is included in his ordinary income and taxed at ordinary income tax rate. But the receipt of the stock dividends by the shareholder is not taxable as income. Further, the shareholder can sell the new shares received by way of the stock dividend to satisfy his desire for income and pay capital gain taxes, which are usually less than the income taxes on the cash dividends. The shareholder could sell a few shares of his original holding to derive capital gains. But selling the original shares are considered as a sale of principal by some shareholders. They do not mind selling the shares received by way of the stock dividend as they consider it a windfall gain and not a part of the principal.

**Example :**

XYZ Ltd. is a company registered in India. The balance sheet of the company on March 31, 2004 is as under.

| Liabilities | Rs. | Assets | Rs. |
|---|---|---|---|
| Preference share capital | | Fixed assets (before depreciation) | 15,00,000 |
| (issued for cash) | 4,00,000 | Investment in share (market value | 4,00,000 |
| Equity share capital | | Rs. 13,00,000) | |
| issued for cash | 6,00,000 | Other assets | 9,20,000 |
| issued as bonus shares in 1960 | | | |
| and 1976 by capitalising profits | 6,00,000 | | |
| General reserve | 3,00,000 | | |
| Investment allowance reserve | 90,000 | | |
| Depreciation reserve | 1,00,000 | | |
| Profit and Loss A/c balance | | | |
| as on April 1, 2003: Rs. 2,40,000 | | | |
| Add : Profit of the year | | | |
| ending March 31, 2004 Rs. 60,000 | 3,00,000 | | |
| Provision for taxation and dividend | 2,30,000 | | |
| Current liabilities | 2,00,000 | | |
| | 28,20,000 | | 28,20,000 |

**Note :** Profit and loss account balance on April 1, 2003 includes agricultural income of Rs. 30,000. As under the provisions of section 2(22), a payment/distribution is treated as dividend only to the extent of accumulated profits, one has to first ascertain "accumulated profits" to apply the deeming fiction of section 2(22). Accumulated profit, as on March 31, 2004, is calculated as under :

| | For the Sub-clauses (a), (b), (c), and (d) of section 2(22) | For the Sub-clauses (c) of section 2(22) |
|---|---|---|

| | Rs. | Rs. |
|---|---|---|
| Capitalise profit (i.e., bonus shares issue) [*not considered under section 2(22) (e)] | 6,00,000 | —* |
| General reserve | 3,00,000 | 3,00,000 |
| Investment reserve, etc. | 90,000 | 90,000 |
| Depreciation reserve (*Not taken into account) | —* | —* |
| Balance of P&L A/c on April 1, 2003 (agricultural income, even if tax-free, forms part of accumulated profits) | 2,40,000 | 2,40,000 |
| Current profit of the year ending March 31, 2004 | 60,000 | 60,000 |
| Provisions for taxation/dividend (*not considered, if it is a provision; may be considered if it is reserve) | —* | —* |
| Total | 12,90,000 | 6,90,000 |

It the company declares and pays dividend of Rs. 10,00,000 on April 1, 2004 in cash, the entire amount would be treated as dividend as it does not exceed Rs. 12,90,000 and the company would have to pay dividend tax at the rate of 13.06875 per cent, i.e., Rs. 1,30,687.50.

If the company distributes investment in shares on April 1, 2004 to its shareholders, the distribution would constitute dividend. Amount of dividend would be ascertained on the basis of market value of shares on the date of distribution. If, on the date of distribution, the market value of shares so distributed is Rs. 13,00,000, the distribution would amount to dividend to the extent of Rs. 11,40,899 (i.e., 100/113.06875 Rs. 12,90,0000) and the company would have to pay dividend tax at the rate of 13.06875 per cent, i.e., Rs. 1,49,101. If X holds 10 per cent share capital and receives shares worth Rs. 1,30,000 (being 10 per cent of Rs. 13,00,000), Rs. 1,14,090 (being 10 per cent of Rs. 11,40,899) would amount to dividend which would be exempt from tax and Rs. 15,910 would be return of capital which would be taken into consideration at the time of computation of capital gains when transfer of shares takes place.

If the company gets right shares of the company in which it is shareholder and renounces its right in favour of its own shareholders on April 10, 2004, the market value of rights is "dividend" and is chargeable in the hands of the company to dividend tax, as renouncement of tight to subscribe share amounts to release of asset by the company. However, market value of right on the date of renouncement, in excess of accumulated profits (i.e., Rs. 12,90,000), is not chargeable to dividend tax in the hands of the company.

If the company issues bonus shares of Rs. 3,00,000 by capitalising general reserve to its equity shareholders, it is not treated as dividend and hence not chargeable to dividend tax in the hands of company, as it does not amount to release of asset by the company.

If the company issues redeemable preference shares on April 1, 2004 of Rs. 3,00,000 to its equity shareholders as bonus shares by capitalising general reserve, it will not amount to dividend. e.g., X, one of the shareholders receives preference share of Rs. 30,000 as bonus shares; no tax on Rs. 30,000 would be attracted at the time of issue of bonus shares. If the company redems these preference shares and X receives Rs. 30,000 on May 10, 2004, Rs. 30,000 would be dividend (on which the company will have to pay dividend tax) as it amounts to release of assets (if the company is in possession of accumulated profits at the time of redemption).

If the company issues bonus shares to its preference shareholders on April 5, 2004, it amounts to dividend (to the extent of accumulated profit) and is chargeable in hands of the company to dividend tax, even if it does not amount to release of assets, as it is specially covered by section 2(22) (b).

If the company issues debentures or debenture-stock to its shareholders (equity or preference) the distribution will amount to dividend and is chargeable in the hands of the company to dividend tax, so long as it does not exceed Rs. 12,90,000.

If the company reduces its share capital and pays Rs. 8,00,000 on May 1, 2004 to its shareholders, it will amount to dividend under section 2(22) (d), as it does not exceed Rs. 12,90,000. Consequently, on Rs. 8,00,000, the company will have to pay dividend tax.

## 3.5 Questions

1. "Corporate planner should take the help of tax planner in arriving at capital structure decisions".—Discuss.
2. What do you understand by capital mix? What consideration should management of a company take into account while deciding optimum capital mix?
3. Explain with a suitable example showing the tax effects on the financial leverage in making capital structure decisions?

4. What is dividend according to section 2(22) of the income tax act?

   "Stock dividend (bonus shares) has certain advantages to the company and also to the shareholders".—Discuss.

5. What are the provisions under the Income-Tax Act relating to deduction for inter-corporate dividend?

## 3.6 References

1. Corporate Tax Planning and Management—G. Ahuja & R. Gupta.
2. Direct Taxes-Law & Practice—V. K. Sinhgania & K. Sinhgania.

# Unit 4 ❑ Corporate Strategies

**Structure**


**4.1 Tax Planning for setting up new business**

4.1.1 Nature of business

4.1.2 Size of industry

4.1.3 Location of business

4.1.4 Form of business

**4.2 Capital Structure Decisions**

**4.3 Tax aspects of Amalgamation and Merger**

4.3.1 Tax planning in case of amalgamation

4.3.2 Tax benefits to the amalgamated company

**4.4 Demerger**

4.4.1 Provisions relating to demerger introduced by the Finance Act, 1999

4.4.2 Points for consideration for demerger

4.4.3 Meaning of demerged company [Section 2(19AA)]

4.4.4 Tax concession/incentives in case of demerger

**4.5 Tax implication of Foreign Collaboration Agreements**

4.5.1 Signifiance of foreign collaborations

4.5.2 Need for Tax planning

4.5.3 Tax liability of foreign collaborator in India

4.5.4 Deduction from profits and gains from projects outside India

4.5.5 Deductions for royalties, commission, etc.

**4.6 Corporate Failure and Corporate Contraction**

4.6.1 Reasons for industrial sickness

4.6.2 Discontinance of business and tax implications

4.6.3 Tax Implications

**4.7 Questions**

**4.8 References**

## 4.1 Tax Planning for setting up new business

New business entry is the most strategy among the corporate strategies. For some companies, planning for expansion or diversification becomes inevitable to keep their optimum capital mix stable. For some other companies, to invest in new business becomes a way out either due to stagnant market conditions in the existing line of activity or due to mounting competition in the same resulting in the lesser unattractive margins for the level of risk undertaken, if not loss or market share itself. Change in line of activity may or may not involve new business proposition so that it can offer a sound business combination with the existing line of activity.

New business also may be the honourable challenge by dynamic entrepreneurs. New business could be in the areas of capital-intensive or labour-intensive, seasonal or regular, large or small scale.

Of the various considerations to be taken for setting up a new business income tax is by far the most important one. Within the ambit of existing tax structure, many advantages are available to a new business in respect of location, form of business, finance, etc.

In order to avail fully of those benefits one should make proper tax planning regarding different aspects, namely selection of method of keeping books and records and documents. Capital structure decisions, timing for starting of least time of the new venture and also the process of manufacturing and also dimension of business.

A new business should be understood with reference to Income-tax Act.-New entrepreneurs may start a new business. It is not brought into existence by way of amalgamation or merger. Business acquired by way of purchase, transfer, gift, settlement, covenant etc., to any or any set of proprietors other than those or including some of the existing proprietors should be considered a business new set up in which case the advantage of the Act may be made available. New industrial undertaking, and new business are understood in the same sense.

**Setting up a new business** involves many complexities. In this regard, the enterpreneur has to take many decisions. Some of the major decisions that he will be required to take are :

(i) Nature of business;

(ii) Size of business;

(iii) Location of business;

(iv) Form of business organization;

(v) Capital requirement and sources of funds.

Besides the above he has to comply with requirements of various laws including direct and indirect tax laws, partnership law, corporate laws, labour laws, environmental laws, etc.

### 4.1.1 Nature of business

In setting up a new busines, the first and the foremost decision to be made is regarding the nature of business activity which it should carry out. The assessee may decide to go for manufacturing activity, trading activity or may start a service industry. Under the Income-tax Act various incentives are available for carrying on different activities. Some of the major tax incentives are discussed below.

**(A) In case of all industrial under-taking**

(i) Depreciation under section 32;

(ii) Deduction on account of revenue/capital expenditure on scientific research under section 35;

(iii) Amortisation of preliminary expenses under section 35D;

(iv) Deduction in case of exports the goods manufactured by it;

(v) Deduction under section 80-IB;

Tax incentives in case of certain specific industries;

Besides the above tax incentives which are available to all industrial undertakings, some of the other tax incentives which are meant for specific industries are given below:

(i) Tea Development Account under section 33AB for industries engaged in the business of growing and manufacturing tea;

(ii) Site Restoration Fund under section 33ABA for assessees engaged in the business of prospecting for or production of petroleum or natural gases or both in India;

(iii) Deduction for expenditure on prospecting, etc. for certain minerals available to mining industry under section 35E;

(iv) Deduction in respect of profits and gains from Foreign Projects;

(v) Deduction in respect of profits and gains from Foreign Projects aided by World Bank;

(vi) Deduction in respect of profits from export of computer software;

(vii) Deduction to an industrial undertaking which is engaged in the business of commercial production or refining of mineral oil in North East Region or any part of India under section 80-IB;

(viii) Deduction to an undertaking engaged in developing and building housing project under section 80-IB;

(ix) Deduction to assessees engaged in business of collecting and processing of bio degradable waste under section 80JJA;

(x) In case of assessees engaged in business of civil constructing, an option to be taxed under presumptive income scheme as per section 44AD.

**(B) Tax incentives for trading activities**

(i) Deduction in respect of export of trading goods;

(ii) In the case of an assessee carrying on retail trade, an option to be taxed under presumptive income scheme as per section 44AF;

**(C) Tax incentives for service industry**

(i) Reserves for Shipping Business under section 33AC;

(ii) Deduction for expenditure for obtaining Licence to operate telecommunication services under section 35ABB;

(iii) Deduction on account of provision for bad and doubtful debts in respect of banking institutions under section 36(1)(viia);

(iv) Deduction on account of special reserve created by Financial Corporations under section 36(1)(viii);

(v) Deduction from profits derived from services provided to Foreign Tourists under section 80HHD;

(vi) Deduction on account of profits from the export of film software, television software, music software, television news software, including telecast rights under section 80HFF;

(vii) Deduction under section 80-IA available to an enterprise/undertaking engaged in infrastructure development, telecommunication services, etc.;

(viii) Deduction to assessees engaged in the integrated business of handling, storage and transportation of foodgrains;

(ix) In the case of an assessee engaged in the business of plying goods carriages an option to be faxed under presumptive income scheme as per section 44AE.

### 4.1.2 Size of industry

The decision regarding the size of the business would depend mainly upon the choice of the nature of business.

Tax inccntives available on the basis of the size of business are now negligible. However, a small scale industry is entitled to claim deduction under section 80-IB even if it is engaged in the business of manufacturing non-priority goods listed under Eleventh Schedule of the Income-tax Act. Further, new industries, other than small scale industries, will be eligible for deduction under section 80-IB only if it is stablished in a backward area or notified backward districts while small scale industries are eligible for deduction under this section wherever established in India.

### 4.1.3 Location of business

The location of a business would be dependent inter alia upon the incentives available under the Income-tax Act. The tax incentives which are relevant in connection with the location of the business are as under:

(1) Exemption available to newly established industrial undertaking in Free Trade Zone under section 10A.

(2) Exemption available to a newly established units in special economic zones on or after 1-4-2005.

(3) Exemption available to newly established 100% Export Oriented Undertakings under section 10B.

(4) Deduction available under section 80-IB for industries/hotels set up in specified areas.

The following deduction are available under section 80-IB on the basis of location of the business:

(A) **Deduction for industrial undertakings**

| | Assessee | Period of Deduction (commencing from initial assessment year) | % of profit eligible for deduction |
|---|---|---|---|
| 1. | (A) Industrial undertaking | | |
| | (i) in an industrially backward State | | |
| | (ii) in district of category 'A'* excluding notified industries in North Eastern Region | | |

| Assessee | Period of Deduction (commencing from initial assessment year) | % of profit eligible for deduction |
|---|---|---|
| (iii) operating a cold chain facility | | |
| (a) Owned by a company | First 5 years | 100 |
| | Next 5 years | 30 |
| (b) Owned by a co-operative society | First 5 years | 100 |
| | Next 7 years | 25 |
| (c) Owned by any other assessee | First 5 years | 100 |
| | Next 5 years | 25 |
| (B) Notified Industries in North Eastern Region | 10 years | 100 |
| 2. (A) Industrial undertaking in an industrially Backward district of category 'B'* | | |
| (i) Owned by a company | First 3 years | 100 |
| | Next 5 years | 30 |
| (ii) Owned by a co-operative society | First 3 years | 100 |
| | Next 9 years | 25 |
| (iii) Owned by any other assesee | First 3 years | 100 |
| | Next 5 years | 25 |
| 3. Industrial undertakings other than those specified above | | |
| (a) Owned by a company | 10 years | 30 |
| (b) Owned by a co-operative society | 12 years | 25 |
| (c) Owned by any other assessee | 10 years | 25 |
| 4. Undertaking engaged in the integrated business of handling, storage and transportation of food grains | | |

| | Assessee | Period of Deduction (commencing from initial assessment year) | % of profit eligible for deduction |
|---|---|---|---|
| (a) | Owned by a company | First 5 years | 100 |
| | | Next 5 years | 30 |
| (b) | Owned by a co-operative society | First 5 years | 100 |
| | | Next 5 years | 25 |

(B) **Deduction for hotel [Section 80-IB(7)]**

| | | | | |
|---|---|---|---|---|
| (a) | (i) | Hotel located in hilly/rural area or notified place of pilgrimage (specified hotel) | 10 years | 50 |
| | (ii) | Specified hotel which commenced business on or after 1-4-1997 | 10 years | 50 |
| (b) | (i) | Any other hotel | 10 years | 30 |
| | (ii) | Any other hotel which commenced business on or after 1-4-1997 | 10 years | 30 |

**(C) Deduction available to undertakings engaged in the business of opening an industrial park or special economic zone [Section 80-IA(4)(iii)].**

Essential conditions to be satisfied—

(i) The undertaking should develop, develop and operate or maintain and operate an industrial park or special economic zone notified by the Central Government in accordance with a scheme framed for such purpose.

(ii) The industrial park should begin to operate, develop etc., at any time on or after 1-4-1997 but before 1-4-2006. whereas, in case of special economic zone, it should begin to develop or develop and operate or maintain and operate a special economic zone any time on or after 1-4-2001 but before 1-4-2006.

**Quantum of deduction**

| Assessee | Period of Deduction (commencing from initial assessment year) | % of profit eligible for Deduction |
|---|---|---|
| In case of undertaking operating an industrial park | For 10 year | 100% |

The deduction will be available for any ten consecutive assessment years out of 15 years beginning with the year in which the undertaking develops an industrial park.

**(D) Deduction available to industrial undertaking in the North Eastern Region or in any part of India [Section 80-IB(9)]**

**Conditions to be satisfied—**

(i) Deduction is allowed to the industrial undertaking which begins commercial production of mineral oil in any part of India.

(ii) Where the undertaking is located in the North Eastern Region, it has begun or begins commercial production of mineral oil before 1-4-1997 or on or after 1-4-1997.

Where it is located in any other part of India it begin commercial production on or after 1-4-1997.

(iii) An industrial undertaking engaged in the business of refining of mineral oil on or after 1-10-1998 shall also be eligible for deduction under this section.

North Eastern Region means the region comprising of the States of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland and Tripura.

**Quantum of deduction :** Deduction shall be available @ 100% of eligible profits for 7 assessment years commencing form the initial assessment year.

**Initial assessment year :** It means the assessment year relevant to the previous year in which the undertaking commences the commercial production or refining of mineral oil.

**Selection of Previous Year :** There is little scope of such selection because of the introduction of uniform previous year with effect from 1989-90. The uniform previous year (i.e., 1st April to March 31) has to be followed for all sources of income.

In the case of newly set up business or profession or a source of income newly coming into existence, the first previous year will be the period commencing from the

date of setting up of business, profession or as the case may be, the date of which the source of income newly comes into existence and ending on immediately following March 31.

**Selection of form of Organisation :** Before starting a new business the assessee has to choose the form of organisation, keeping in view the magnitude of his proposed business, the different tax implications and incentives like rates of tax involved in each form of organisation, the strength, weakness, opportunity and threat (SWOT analysis) of each form of organisation.

The tax burden varies considerably between a corporate form and non-corporate form under the Income-tax Act.

Generally speaking, corporate forms are advantageous form for larger amount of income. If so, question arises whether it should be a widely owned or a closely held company. Widely owned company may be preferable over closely held company because of difference in respect of certain provisions of sections 2(22) and 79.

Section 10A makes special provision in respect of newly established industrial undertaking in free trade zones. An industrial undertaking set up in free trade zones is exempt from income tax if it fulfils certain conditions. [Students should know, in details, the provisions of sec. 10A].

Section 10B provides incentive to hundred percent export-oriented units if they satisfy the following conditions:

(a) It must be an approved hundred percent export-oriented undertaking.

(b) It must produce or manufacture articles or things.

(c) Export should not be less than 75 per cent in case an undertaking commenced production after March 31, 1994. S. 10-B imports a value based restriction and not a quantitative restriction. What is required is that export turnover should constitute 75 per cent of the total turnover, although in quantitative terms, the export quantity might be less that 75% of the total sale quantity.

If the above conditions are satisfied, complete exemption can be claimed in respect of any five consecutive assessment years following within a period of eight years beginning with the initial assessment year in which undertaking begins to manufacture or to produce articles or things.

S. 10-B will be applicable to all eligible undertaking unless the assessee opts out of the scheme by making a declaration under sub-section (7) before the due date of furnishing return of income. Sec 10C is applicable in the case of certain industrial undertakings in North-Eastern Region.

Secs. 10A and 10B have been amended from the A.Y. 2000-2001. 80-IA or 80-IB as the case may be. Under section 80-IA, a deduction is allowed to a new industrial undertaking or an operation of a ship or a business of hotel or developing, maintaining and operating any infrastructural facility. From the assessment year 1997-98 deduction will also be allowed to scientific and industrial research and development; of course the assessee has the option to take benefit of deduction for 10 consecutive assessment years falling within a period of 12 years in which the assessee begins operating and maintaining infrastructural facilities. [Students should know, in details, the provision of sec. 80-1A].

A new business may also be started in the form of Co-operative Society which are engaged in carrying out activities of such nature as would enable it to enjoy full exemption from payment of income tax under section 80-P. However, for being eligible to exemption u/s 80 P(2) (iii) [i.e., activity in marketing agricultural products], agricultural produce marketed by co-operative society must be produced by its members.

### 4.1.4 Form of business

The form of ownership is an important fool of tax planning. Different forms of business organisation have different tax incidence at a given level of operation. From ownership point of view, the business organisation may be classified as Sole Proprietorship, Partnership, HUF, Cooperative Society, Company etc. The tax treatments differ from one organisation to another organisation. Different organisation enjoy different sets of exemptions, concession etc. and also they pay tax at different rate of tax as per Finance Act.

## 4.2 Capital Structure Decisions

Another major problem is the acute shortage of funds at sometimes when the management have to make a choice of projects at their disposal (i.e., under capital rationing). Awareness of the cost of capital principle would help management to optimise utilization of funds and explore various opportunities at their disposal with minimum cost.

Financing a company either through sale of equities or from borrowings has a definite bearing on the incidence of tax payable by a company. It is a known fact that debt is cheaper than equity capital as dividend is an appropriation of profits whereas interest on borrowed capital is a charge against profit. So a company should try to finance its business to the maximum possible extent through market borrowings,

debentures or loans. Interest on such loan together with expenses incurred in raising such loans for capital investment proposals are allowable for deduction as revenue expenditure. Therefore, assessees must equate the benefits and disincentives attached to debt capital and take a decision. In such a process they may have to compare the tax holiday relief to be lost and tax deduction available to interest paid and the net cash inflows in both the alternatives after considering taxation. Here lies the decision either to go in for debt or not and if so the amount of debt to be included from time to time. They must also remember that servicing of debt means heavy cash outflows and would be committed cost. Generally companies find it irksome service debt during the initial years when profits are very meagre and cash flow is dry.

A debt-equity ratio may vary from 1 : 1 to 5 : 1 from industry to industry. Capitalisation of interest paid on loaned capital before the commencement of production is allowed according to the decision of the Supreme Court of India. This leads to enhanced depreciation to a newly started undertaking. Utilisation of equity capital in the purchase of land is encouraging while debt should be utilised towards acquisition of depreciable assets like plant and machinery.

## 4.3 Tax aspects of Amalgamation and Merger

Amalgamation is a blending of two or more existing undertakings into one undertaking. The shareholders of each blending company become substantially the shareholders in the company which is to carry on the business of blended undertakings. There may be amalgamation either by the transfer of two or more undertakings to a new company, or by the transfer of one or more undertakings to an existing company.

Meaning of amalgamation under the Income-tax Act—For the purpose of the Income-tax Act, amalgamation of companies means either merger of one or more companies with another company or the merger of two or more companies to form one company. The definition of amalgamation under section 2(1B) covers the following cases.

- ❑ Merger of A Ltd. with X Ltd. (A Ltd. goes out of existence).
- ❑ Merger of A Ltd. and B Ltd. with X Ltd. (A Ltd. and B Ltd. goes out of existence).
- ❑ Merger of A Ltd. and B Ltd. into a newly incorporated company X Ltd. (A Ltd. and B Ltd. goes out of existence).

- ❑ Merger of A Ltd., B Ltd and C Ltd., into a newly incorporated company X Ltd. (A Ltd., B Ltd. and C Ltd. goes out of existence).

In the aforesaid cases, A Ltd., B Ltd and C Ltd. are amalgamating companies, while X Ltd. is an amalgamated company.

CONDITIONS—For a merger to qualify as an "amalgamation" for the purpose of the Income-tax Act, it has to satisfy the following conditions—

| | |
|---|---|
| Condition 1 | All the properties of the amalgamating company immediately before the amalgamation should become the property of the amalgamated company by virtue of the amalgamation. |
| Condition 2 | All liabilities of the amalgamating company immediately before the amalgamation should become the liabilities of the amalgamated company by virtue of the amalgamation. |
| Condition 3 | Shareholders holding not less than three-fourths (in value) of the shares in the amalgamating company (other than shares already held by the amalgamated company or by its nominee) should become shareholders of the amalgamated company by virtue of the amalgamation. |

TRANSACTIONS NOT TREATED AS "AMALAMATION"—Section 2(1B) specifically provides that in the following two cases there is no "amalgamation" for the purpose of the Income-tax Act, though the element of merger exists:

a. where the property of the company which merges is sold to the other company and the merger is a result of a transaction of sale;

b. where the company which merges is wound up in liquidation and the liquidator distributes its property to the other company.

### 4.3.1 Tax planning in case of amalgamation

1. The benefit of tax concession is allowed to the amalgamating and amalgamated company only when the amalgamation satisfies the conditions provided under section 2(IB) of the income-tax act. One of the conditions laid down is that all the assets and liabilities of the amalgamating company, as on the date of amalgamation should be taken over by the amalgamated company. Therefore if some assets or liabilities of the amalgamating companies are not proposed to be taken over by the amalgamated company before the amalgamation takes effect, that will not be taken as amalgamation for the purpose of income-tax.

2. Similarly there is a condition that at least 75% of the shareholders of the amalgamating company should become shareholders of the amalgamated company. If more than 25% of the shareholders of the amalgamating company are not willing to become shareholders of the amalgamated company, then so much shares of such shareholders may be purchased by the other shareholders or by the amalgamated company, before the amalgamation, so that at the time of amalgamation the condition of 75% of the shareholders becoming shareholders of the amalgamated company is satisfied.

3. As per section 72A the amalgamated company can carry forward the business loss and unabsorbed depreciation of the amalgamating company only when certain conditions, are satisfied.

Where it is not possible to satisfy such conditions the companies may opt for a Reverse Merger i.e., instead of the loss making company merging with the profit making company the profit making company may merge with the loss making company. In this case, the amalgamated company, which was the loss making company will be able to carry forward its own business loss and unabsorbed depreciation and set it off against the profits or the business which has merged with it, in the scheme of amalgamation.

4. The benefit under section 47(viii) shall be allowed only when the shareholders of the amalgamating company are allowed only shares of the amalgamated company in lieu of shares held by them in the amalgamating company. If the shareholders are allotted something other than shares in the amalgamated company viz. bonds or debentures, etc. no benefit will be available under section 47(iii).

**Illustration :** A Ltd., which owns an industrial undertaking wishes to amalgamate with B Ltd., an Indian company during previous year 2007-08. The details of the losses/ allowances/expenditure incurred by A Ltd., are given below:

| | | Rs. |
|---|---|---|
| (i) | Unabsorbed depreciation of— | |
| | (a) Assessment year 2007-08 | 80,000 |
| | (b) Assessment year 2006-07 | 40,000 |
| (ii) | Brought forward business loss of— | |
| | (a) Assessment year 2007-08 | 20,000 |
| | (b) Assessment year 2006-07 | 40,000 |
| | (c) Assessment year 2005-06 | 20,000 |

| | | Rs. |
|---|---|---|
| (iii) | Brought forward capital loss of— | |
| | Assessment year 2007-08 | 40,000 |
| (iv) | Brought forward speculation loss of— | |
| | Assessment year 2005-06 | 50,000 |
| (v) | Preliminary expenses | |
| | (incurred in previous year 2003-2004) | 50,000 |

A. Ltd., had incurred the following capital expenditure during previous year 2006-2007:

| | | Rs. |
|---|---|---|
| (a) | Capital expenditure on Scientific Research | 3,00,000 |
| (b) | Capital expenditure on family planning | 2,50,000 |

Submit a report to the Board of Directors as to the requirements of tax incentives available both to A Ltd., & B Ltd.

**Solution :** The Board of Directors

B Ltd., New Delhi

As per the particulars furnished to us, the amalgamation of company R can take place in any of the following three ways.

**(I) Amalgamation where neither conditions of 2(IB) nor under section 72A are satisfied :**

In this case, no tax concessions are available, either to amalgamating company or to amalgamated company. Therefore the amalgamating company and its shareholders shall both be liable to capital gains arising no such amalgamation. Further, the amalgamated company will not be allowed any tax concession in respect of :

(i) carry forward of loss and unabsorbed depreciation of the amalgamating company :

(ii) Amortisation of preliminary expenses of the amalgamating company not yet written off.

(iii) Capital expenditure on family planning and scientific research of the amalgamating company will not be allowed as a deduction to the amalgamated company.

**(II) Amalgamation where conditions under section 2(IB) are satisfied but conditions of section 72A are not satisfied:**

The following benefits are available in this case.

Tax benefits to the amalgamating company

(i) there will be no capital gains chargeable on the company.

(ii) Similarly there will be no capital gains for the shareholders of A Ltd., on exchange of shares.

### 4.3.2 Tax benefits to the amalgamated company

(i) Preliminary expenses : A Ltd. incurred Rs. 50,000 during previous year 2003-2004 and as such it must have claimed 1/5th of Rs. 50,000 i.e., Rs. 10,000 per year in previous years 2003-2004, 2004-05, 2005-06 and 2006-07. Therefore the balance Rs. 10,000 shall be allowed as deduction to B Ltd. in the previous year 2007-08 being the fifth year of deduction.

**Expense on acquisition of capital asset**

(a) Capital expenditure on scientific research : Although A. Ltd., had incurred capital expenditure on scientific research during previous year 2006-07, but it could not claim the deduction in the said previous year as the company had incurred the business loss. The entire capital expenditure on scientific research of Rs. 3,00,000 will be allowed to be carried forwarded in the hands of B. Ltd.

(b) Capital expenditure on family planning: A Ltd., incurred the capital expense of Rs. 2,50,000 during previous year 2006-07. It had a right to claim deduction of Rs. 50,000 i.e., 15 of Rs. 2,50,000 in the previous year 2006-07 and the balance Rs. 2,00,000 was allowable to A Ltd., in 4 equal instalments. Therefore B Ltd. will be allowed deduction during previous year 2006-07 amounting to Rs. 1,00,000 calculated as under:

| | | Rs. |
|---|---|---|
| (a) | Unabsorbed capital expense on family planning of previous year 2006-07 of A Ltd., not allowed earlier as there was business loss | 50,000 |
| (b) | 1/5 capital expenditure on family planning of previous year 2007-08 | 50,000 |
| | | 1,00,000 |

Balance Rs. 1,50,000 will be allowed in 3 subsequent years in equal instalments of Rs. 50,000.

Business loss and unabsorbed depreciation will not be allowed to be carried forward and set off by B Ltd., as conditions laid down under section 72A are not satisfied.

(III) Amalgamation where conditions laid down udner sections 2(IB) and 72A are satisfied: In addition to the tax concession/benefits given in answer II above, B Ltd. will be entitled to carry forward the business loss of Rs. 1,80,000 and unabsorbed depreciation of Rs. 1,20,000 of A Ltd. for 8 assessment years commencing for the assessment year 2008-09 i.e., previous year 2007-08.

It may be memtioned that capital loss or loss from speculation business are not allowed to be carry forward in any scheme of amalgamation of companies.

Again, if it is not possible to satisfy the conditions of section 72A, it is advisable to merge B Ltd. with A Ltd. i.e., reverse merger so the A Ltd. is able to set off its business loss and unabsorbed depreciation from the profits of the business of B Ltd. which will be merged with A Ltd.

## 4.4 Demerger

Demerger is relatively a new phenomenon in the Indian corporate sector. While there are no specific provisions under the Companies Act, 1956 governing demergers some transactions of this nature do take place through scheme of compromise or arrangement under sections 391 to 394 of the Companies Act.

With a view to recognise demergers, a number of amendments have been made by the Finance Act. 1999 on the basis of following broad principles:—

(a) Demergers, should be tax neurtal and should not attract any additional liability to tax.

(b) In demergers tax benefits and concessions available to any undertaking should be available to the said undertaking on its transfer to the resulting company.

(c) Tax benefits to such business reorganisation should be limited to the transfer of business as a going concern and not to the transfer of specific asset which would amount to sale of assets and not a business reorganisation.

(d) The accumulated loss and unabsorbed depreciation, in a demerger, should be allowed to be carried forward by the resulting company if these are directly relatable

to the undertaking proposed to be transferred. Where it is not possible to relate these to the undertaking, such loss and depreciation shall be apportioned between the demerged company and the resulting company in proportion of the assets coming to the share of each as a result of demerger.

(e) The Central Government, it if considers necessary, may prescribe certain guidelines or conditions to ensure that demergers are made for genuine business purposes.

(f) The benefit available for demergers are also proposed to be extended to Authorities or Boards set up by Central or State Governments. This will help unbuilding of State Electricity Boards and such other authorities and help them in corporatisation.

### 4.4.1. Provisions relating to demerger introduced by the Finance Act, 1999

**Meaning of demerger [Section 2(19A)]:** "Demerger", in relation to companies, means the transfer, pursuant to a scheme of arrangement under sections 391 to 394 of the Companies Act. 1965 by a demerged company of its one or more undertakings to any resulting company in such a manner that—

(i) all the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;

(ii) all the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the liabilities of the resulting company by virtue of the demerger;

(iii) the property and the liabilites of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger (revaluation is to be ignored);

(iv) the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis;

(v) the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;

(vi) the transfer of the undertaking is on a going concern basis;

(vii) the demerger is in accordance with the conditions, if any, notified under subsection (5) of section 72A by the Central Government in this behalf.

### 4.4.2 Points for consideration for demerger

**(A) Meaning of undertaking being transferred [Explanation 1 to Section 2(19AA)] :** For the purposes of this cause, "undertaking" shall include any part of an undertaking, or a unit or division of an of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

**(B) Meaning of liabilities referred to in sub-cause (ii) of section 2(19AA) above [Explanation 2 to Section 2(19AA) :** For the purposes of this clause, the liabilities referred to in sub-clause (ii), shall include—

(a) the liabilities which arise out of the activities or operations of the undertaking;

(b) the specific loans or borrowings (including debentures) raised, incurred and utilised solely for the activities or operations of the undertakings; and

(c) in cases, other than those referred to in clause (a) or clause (b), so much of the amounts of general or multipurpose borrowings, if any, of the demerged company as stand in the same proportion which the value of the assets transferred in a demerger bears to the total value of the assets of such demerged company immediately before the demerger. In other works it will be computed as under:

$$\text{General or multipurpose borrowings if any, of the demerged company} \times \frac{\text{Value of the assets transferred in a demerger}}{\text{Total value of assets of such demerged company immediately before demerger}}$$

**(C) Value of the property of the undertaking being transferred [Explanation 3 to Section 2(19AA)] :** Section 2(19AA) (iii) specifies that the value of the property and the liabilities of the undertaking (s) being transferred by the demerged company should be at book value appearing in books immediately before demerger. This is also required to be read with Explanation 3 to section 2(19AA) which specifies that any change in the value of assets consequent to revaluation shall be ignored.

**(D) Benefit of demerger also available to certain authorities or Boards [Explanation 4 to Section 2(19AA)] :** For the purposes of this clause, the splitting up or the reconstruction of any authority or a body constituted or established under a Central, State or Provincial Act, or a local authority or a public sector company, into separate authorities or bodies or local authorities or companies, as the case may be shall be deemed to be a demerger, if such split up or reconstruction is as per the conditions, if any, specified by the Central by the Central Government.

**(E) Shares to be issued on a proportionate basis :** Under the provision of section 2(19AA) the resulting company should issue shares on a proportionate basis to the shareholders of demerged company.

### 4.4.3 Meaning of demerged company [Section 2(19AA)]

"Demerged company" means the company whose undertaking is transferred, pursuant to a demerger, to resulting company.

Meaning of resulting company [Section 2(41A)]: "Resulting company" means one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger and, the resulting company in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company and includes any authority or body or local authority or public sector company or a company established, constituted or formed as a result of demerger.

**Illustration :** From the following details submitted by X Ltd before demerger, determine the value of shares to be issued by the resulting company (say Y Ltd.) to the shareholders of X Ltd. assuming Division II is proposed to be hived off.

| Description | Division I | Division II | Head office i.e., Common to to both divisions | Total |
|---|---|---|---|---|
| Fixed Assets after depreciation | 15,00,000 | 10,00,000 | 4,00,000 | 29,00,000 |
| Current Assets | 10,00,000 | 5,00,000 | 1,00,000 | 16,00,000 |
| Total | 25,00,000 | 15,00,000 | 5,00,000 | 45,00,000 |
| Share capital | | | 20,00,000 | 20,00,000 |
| Reserves & surplus | | | 7,00,000 | 7,00,000 |
| Loans | 3,00,000 | 2,00,000 | 4,00,000 | 9,00,000 |
| Current Liabilities | 4,00,000 | 3,00,000 | 2,00,000 | 9,00,000 |
| Total | 7,00,000 | 5,00,000 | 33,00,000 | 45,00,000 |

Also determine the ratio of shares of the reulting company to be issued to the shareholders of demrged company assuming the share holders of R Ltd. held the shares as under:

(a) Promoters 40%

(b) Financial institutions 25%

(c) Public 35%

**Solution**

| | Rs. | Rs. |
|---|---|---|
| Value of Asset of Division II | | 15,00,000 |
| Less: Liabilities of Division II | 5,00,000 | |
| Proportionate liability of Division II out of common liability of X Ltd. | | |
| Common Liability $\times \dfrac{\text{Book value of assets transferred}}{\text{Total value of assets of X Ltd}}$ | | |
| $6{,}00{,}000 \times \dfrac{15{,}00{,}000}{45{,}00{,}000}$ | 2,00,000 | 7,00,000 |
| Balance | | 8,00,000 |

The resulting company i.e., Y Ltd shall issue shares of Rs. 8,00,000. They will be issued on the same basis which the existing shareholders of the demerged company have in the share capital of the company. Thus, these will be offered in the following ratio.

| | Rs. |
|---|---|
| Promoters $\left(8{,}00{,}000 \times \dfrac{40}{100}\right)$ | 3,20,000 |
| Financial Institutions $\left(8{,}00{,}000 \times \dfrac{25}{100}\right)$ | 2,00,000 |
| Public $\left(8{,}00{,}000 \times \dfrac{25}{100}\right)$ | 2,80,000 |
| Total | 8,00,000 |

### 4.4.4 Tax concession/incentives in case of demerger :

If any demerger takes places within the meaning of section 2(19AA) of the Income-tax Act, the following tax concession shall be available :

(1) Tax concessions to demerged company.

(2) Tax concessions to shareholders of demerged company.

(3) Tax concessions to resulting company.

These concessions are on similar lines as are available in case of amalgamation discussed earlier. However, some concessions available in case of amalgamation are not available in case of demerger.

**(1) Tax concession to demerged company :** (i) Capital gains tax not attracted [Section 47(vib)]: According to section 47(vid) where there is a transfer of any capital asset in a demerger by the demerged company to the resulting company, such transfer will not be regarded as a transfer for the purpose of capital gain provided the resulting company is an Indian company.

(ii) Tax concession to a foreign demerged company [Section 47(vic)]: Where a foreign company holds any shares in an Indian company and transfer the same, in a demerger, to another resulting foreign company, such transaction will not be regarded as transfer for the purpose of capital gain under section 45 if the following conditions are satisfied:

(a) at least seventy-five per cent of the shareholders of the demerged foreign company continue to remain shareholders of the resulting foreign company; and

(b) such transfer does not attract tax on capital gains in the country, in which the demerged foreign company is incorporated.

(iii) Reserves for shipping business: Where a ship acquired out of the reserve is transferred in a scheme of demerger, even within the fperiod of eight years of acquisition there will be no deemed profits to the demerged company.

**(2) Tax concessions to the shareholders of the demerged company [section 47(vid)]:** Any transfer or issue of shares by the resulting company, in a scheme of demerger to the shareholders of the demerged company shall not be regarded as a transfer if the transfer or issue is made in consideration of demerger of the undertaking.

In the case of demerger the existing shareholders of the demerged company will now hold:

(a) shares in resulting company; and

(b) shares in demerged company,

and in case the shareholder transfers any of the above shares subsequent to the demerger, the cost of such shares shall be calculated as under :—

cost of aquisition of shares in the resulting company [Section 49(2c)]: It shall be the amount which bears to the cost of acquisition of share held by the assessee in the demerged company the same proprotion as the net book values of the assets transferred

in a demerger bears to the net worth of the demerged company immediately before such demerger.

In other words:

$$\text{Cost of acquisition of the shares in the resulting company} = \text{cost of acquisition of share held by the assessee in the demerged company} \times \frac{\text{Net book value of the assets transferred in a demerger}}{\text{Net worth of the demerged company immediately before demerger.}}$$

Cost of acquisition of shares in the demerged company [Section 49(2D)]: In the case of acquisitions of the original shares held by the shareholder in the demerged company shall be deemed to have been reduced by the amount so arrived at under section 49(2C) above.

*For the above purpose net worth shall mean the aggregate of the paid up share capital and general reserves as appearing in the books of account of the demerged company immediately before the demerger.*

Period of holding of shares of the resulting company [Section 2(42A) (g)]: In the case of a capital asset, being a share or shares in an Indian company, which becomes the property of the assessee in consideration of a demerger, there shall be included the period for which the share or shares held in the demerged company were held by the assessee.

**(3) Tax concession to the resulting company:** The resulting company shall be eligible for tax concessions only if the following two conditions are satisfied:

(i) The demerger satisfies all the conditions laid down in section 2(19AA); and

(ii) The resulting company is an Indian company.

The following concessions are available to the resulting company pursuant to a scheme of demerger:

(a) Expenditure on acquisition of patent rights or copyrights [Section 35A(7)].

(b) Expenditure on know-how [Section 35B(3)].

(c) Expenditure for obtaining licence to operate telecommunication services [Section 35ABB(7)].

(d) Treatment of preliminary expenses [Section 35D(5A)].

(e) Treatment of expenditure on prospecting, etc. of certain minerals [Section 35E(7A)].

(f) Treatment of bad debts [Section 36(1)(vii)].

(g) Amortisation of expenditure in case of demerger [Section 35DD].

(h) Carry forward and set off of business losses and unabsorbed depreciation of the demerged company [Section 72A(4) & (5)].

(i) Deduction available under section 80-1A or 80-1B.

## 4.5 Tax Implication of Foreign Collaboration Agreements

### 4.5.1 Significance of foreign collaborations

Every aspect of growth in the economy requires a constant study and implementation of the various schemes of modernisation and improvement of the industrial, commercial, foreign trade and allied activities of different categories of commercial and non-commercial enterprises in India with a view to achieving the targets of planned economic growth in private as well as public sector. In view of the ever-growth changes, innovations and rapid development in advanced countries particularly in the field of science and technology, foreign collaborations have assumed great importance in modern times for accelerated growth of the economy of developing country like ours. It is quite natural and essential for the public and the private sectors to explore ways and means of importing advanced technology and production methods into India from various developed and developing countries.

**Government's Attitude**

With the increasing internationalisation of trade, commerce and finance in recent years countries in the world cannot remain independent of each other. The interdependence of countries is so great that any economic imbalance in one country affects the economy of another and even influences its course. National politics have, therefore, international oriented, and normally it is reflected in the tax legislation and practice. It is well-known that any change in tax laws of a country has effect on its trade and economic relations with other countries. The country, therefore, exercises great care and caution in the formulation of its tax laws so as not to endanger its international economic interests.

July 1991 saw many radical changes in the Indian Government policy relating to trade, investment and economy. All these aim at rectifying distortions and imbalances in the economic structure of the country. The budgets for 1991-92, 1992-93 and 1993-94, the industrial policy, trade policy and amendments in various regulatory enactments have ushered in an era of market economy which is to be guided by market forces rather than to be administered, controlled and regulated by the Government. The budget for 1994-95 is to consolidate gains of earlier reforms and to boost our industrial growth to globalise our economy.

Very recently the centre is evolving schemes and programmes aimed at promoting efficient absorption and adoption of imported technology by Indian Industry. The first scheme called absorption and adoption is being evolved by the Science and Technology Ministry to build up industrial capabilities and improve the technology level being used in the country. The Department of Scientific and Industrial Research had also a National Register of foreign collaboration to review and analyse the imported technology and suggest various measures to acquire and utilise foreign know-how.

### 4.5.2 Need for Tax planning

Tax planning has assumed a far reaching importance in the confounded complexities of the taxation laws. It is the act of planning the business operations in a way that attracts the least liability to tax by availing of the various concessions, allowances and reliefs existing in the tax laws. It is not evasion but legal avoidance of tax liability. Quite often if becomes necessary for entrepreneurs to explore possibility of bringing about modifications in the collaboration agreement to reduce the rigours of taxation. The contractural, legal, financial and tax implications arising from collaborations have a significance not only to the collaborators who operate from abroad but also the Indian enterprise functioning from India.

The non-resident companies are clever enough and in many cases, they are insisting on tax-free payments, resulting in the incidence of liability on the Indian company. So the tax implications of foreign collaborations require a proper tax planning in this behalf so that incidence of tax may not prove detrimental to the objective sought to be achieved through such collaborations.

**Residential status and scope of income of foreign collaboration :**

The foreign collaborator, just like his Indian counterpart, would like to minimise his tax burden under the Indian Income-tax Act. The incidence of tax under the Income-tax Act depends on residential status of an assessee. It likely that the foreign collaborators would be a company but in some cases it may even be individual. It is also be a not-ordinary resident, or it may be a company owned by such persons.

U/s 5(1) a resident has to pay in India on income (a) received or deemed to be received in India by himself or anybody in his behalf, (b) accrues or arises or is deemed to accrue or arise to him in India, (c) accrues or arises to him outside India. While u/s 5(2) a non-resident pays tax liability only on income (a) received or it deemed to be received in India by himself or anybody on his behalf, or (b) accrues or arises or deemed to accrue or arise to him in India. It has also been laid down that the foreign income of a resident but nor ordinarily resident is not be taxed in India unless it is derived from business controlled in or profession set up in India. Thus, while a resident has to pay tax in India on his world income, a non-resident pays tax in India only on his Indian Income.

Again under the provisions of sec. 9(1) it is laid down that all incomes accruing or arising, whether directly or indirectly through or from any business connection in India is deemed to accrue or arise in India. So, while planning a foreign collaboration agreement, the foreign collaborator would try to ensure that no business connection is established with Indian counterpart.

**Meaning of business connection for the purpose :**

The concept of business connection is most important for the assessment of any foreign collaborator with a view to determining the amount and nature of the income which would be deemed to accrue or arise in India u/s 9(1). But the question as to what constitutes business connection has been a matter of judicial scrutiny in a large number of cases. So it admits of no precise definition and solution of the question depends upon the facts of each case. The expression business connection postulates a real and intimate relation between trading activities within taxable territories, the relation between the two contributing to the earning of income by the non-resident in his trading activity. Therefore, business connection is not equivalent to carrying on a business. To establish business connection, it is necessary that the thread of mutual interest must run through the fabric or trading activities carried on outside and inside the taxable territory, there must be a real and intimate connection. The commonness of interest may be by way of sharing of profits. It may materialise in some other manner also and sale between principal and pancipal. The business connection therefore, involves the concept of a control, supervision or a continuous activity in nature. A solitary transaction of purchase of capital goods cannot amount to business connection between the assessee and the foreign company. Where there is continuity of business relationship between the person in India who helps to make the profits and the person outside India who receives or realises the profits, such relationship does constitute a business connection.

So a tax planner must concentrate on the following points in order to lighten the tax burden of the foreign collaborator,

(a) If no operations are caried out in India, no income can be deemed to arise in India even though there may be business connection in India.

(b) Technical information should be furnished by the foreign collaborator by post. The technical personnel made available to an Indian company, the foreign collaborator would also not constitute business connection.

(c) Technical advice given by a foreign company outside India would not constitute any business connection.

(d) The supply of machinery, plant or other equipment can be made outside India without attracting any tax liability.

(e) Providing facility of supervision of the work, the installation of plant of the Indian enterprise by the foreign collaborator would not bring about any business connection.

**4.5.3 Tax liability of foreign collaborator in India**

In view of the disavantages faced by foreign companies in the matter of taxation of income by way of interest, royalties, and fees for technical services at flat rates on gross basis, it may be advisable for the foreign company to enter into a partnership with another foreign company outside India and thereafter the partnership firm located outside India and continuing to be a non-resident in India may enter into a collaboration agreement with Indian tax payer so that u/ss 9(1) (vi) and (vii), 44C, 44D, 44DA and 15A for the Indian Income-tax Act disadvantages arising from the statute of the foreign company are avoided. The status of an individual would be most appropriate in cases where technical services are sought to be provided under the agreement by the foreign collaborator so that he can be employed and in that capacity derive income by way of remuneration which could be claimed as exempt from tax u/ss 10(6) (vi), 10(6) (viia), 10(14) and even u/s 9(1) (ii).

In cases where different types of services are sought to be rendered or facilities or assets sought to be made available under the collaboration agreement by the foreign collaborator to the Indian enterprise, it would be advisable to have separate contracts for each type of facility, asset or service made available so that the difficulties in determining the income attributable to each category of transaction or service do not come up.

The supply of capital goods by foreign colaborators to Indian Tax payers should, in every case, be made only by having contracts of sale on FOB or FOR basis wherein the delivery of the assets are made by the foreign collaborator outside India and the carrier or transport operator acts as the agent of the Indian assesee in transporting the

asset to its destination in India. While supplying capital goods, care should also be taken to see that the documents for the sale are not sent to banker in India requiring the Indian enterprise to obtain the document by making the payment of the price for the asset because if this is done, the sale price of the asset could be regarded as having been received in India by the foreign collaborator thus attracting liability to tax in India.

Besides supplying the goods on FOB basis, letter of credit should be opened by foreign collaborator in order that the Indian party could make the payment outside India to the foreign collaborator.

Wherever the foreign collaborator becomes entitled to receive income by way of royalty, the liability to tax is attracted in India regardless of the mode of payment and the place at which the moneys are remitted. If the foreign collaborator does not desire to continue to have ownership of the patents, designs, etc., it would be advisable for him to deliver the same outside India and receive payment for the same in lumpsum in a foreign country so that it does not attract any liability to tax in India nor does the Indian enterprise have any disadvantage by virtue of the expenditure being of capital nature.

It will be advisable not to sell the assets on hire purchase basis because the interest receivable under the hire purchase agreement becomes assessable to tax in every case in the hands of the collaborator unless the case in one which could be brought us 10(15) (iv) for claiming exemption. The purchase of the asset on hire purchase basis is also disavantageous to the Indian assessee because of the claim for investment allowance being last wholly.

In every case of foreign collaboration agreement it would be advisable for the Indian tax payer not to undertake the tax liability of the foreign collaborator so that not only the Indian taxpayer is away from the problem of disallowance of the tax paid by him on behalf of the non-resident but also the non-resident is not made to pay a much larger amount of tax ultimately by virture of grossing up of the tax paid or payable by the Indian enterprise leading to tax being levied on the non-resident on the amount of tax paid by the Indian enterprise.

As a part of the foreign collaboration agreement, quite often preference is to be given to a foreign company or enterprise residing in a country with which India has entered into a double taxation avoidance agreement. The benefit arising from proper exercise of the tax planning consideration in this regard would provide the most valuable solution to the Indian enterprise as well as the foreign collaborators as they can by and large be certain of their tax liability and obligation in the respcetive countries as compared to a situation where the foreign collaborator is left in uncertainty by virtue of not being

governed by the double taxation avoidance agreements beside being exposed to the problems and difficulties arising form the uncertain statutory provisions of the Indian Income-tax laws.

A foreign collaborator can change his residential status by changing the place of control and management of his affairs or by increasing or decreasing the number of days of stay in India. [A foreign collaborator carrying substantial income in India and suffering huge losses outside may change his residential status from non-resident to resident and accordingly, get the benefits of setting off foreign losses against Indian income which facility would not be available if he continues to remain non-resident]. From the point of view of Indian collaborator the prospects and possibilities of tax planning evolve round the allocation of the amount between capital expenditure and revenue expenditure. It is only where the expenditure bears on the fixed capital or other capital structure of the assessee that it can be regarded as capital expenditure in nature. Where the expenditure, although enduring in character has its impact on the running of the business, there can be no doubt that it is out and out revenue expenditure. In the light of judicial pronouncements it may now be regarded as well settled law that: [For this purpose let us take up the case of payment to foreign collaborator for supply of technical know-how.]

(a) technical know-how and technical advice cannot be treated as capital assets merely because the assessee who had entered into a contract with regard to know-how is entitled to use it even after the agreement has expired would not mean that he has acquired a benefit of an enduring nature.

(b) any expenditure incurred to obtain know how under the collaboration agreement is only to improve and maintain quality of products already being manufactured without any right to trade mark or patent right is a revenue expenditure.

### 4.5.5 Deduction from profits and gains from projects outside India

From the assessment year 1983-84 u/s 80 HHB, deduction form profits and gains from projects outside India is admissible to an Indian company or a person (other than a company who is resident in india subject to fulfilment of certain conditions. This deduction is available in respect of any profits or gains derived from the business of (a) the execution of a foreign project undertaken by the assessee in pursuance of a contract entered into by him, or (b) the execution of any work undertaken by him and forming part of a foreign project undertaken by any other person, in pursuance of a contract entered into by such other person, with the government of a foreign stage or any statutory or other public authority or agency in foreign state or a foreign enterprise. Among other

conditions, creation of foreign project reserve account of the extent of 20% of profits from such project and 20% of profit to be brought into in foreign exchange are two pertinent conditions. Deduction is available to the extent of (i) 20% of profits, (ii) amount credited to the reserve account and (iii) amount brought into in convertible foreign exchange whichever is less. This provision gives an efficatious incentive to the Indian entrepreneurs to enter into joint ventures abroad.

### 4.5.5 Deductions for royalties, commission, etc.

S. 80-0 provides deduction from total income of the Indian companies in respect of any royalty, commission, fees or any similar payments received from a foreign state or foreign enterprises in consideration for the use outside India of any technical know-how made available or provided or agreed to be made available or provided or agreed to be provided to such government or enterprise by the Indian companies under an agreement approved by the Board in this behalf. The amount of deduction under this section is 20% of the income received in, or brought into India in convertible foreign exchange before the prescribed date, or before the extended date, if any, granted by the commissioner. This deduction has to be allowed on income brought into India in the shape of convertible foreign currency without taking into account expenses incurred in India. Of-course no deduction is available from A. Y-2005-06.

Section 91 provides for grant of unilateral relief in the case of resident taxpayers on income which has suffered tax in India as well as in the country with which there is no Avoidance of Double Taxation agreement, subject to fulfilment of certain conditions.

Deduction in respect of expenditure on know-how [S. 35AB] was available up to the assessment year 1998-99. From assessment year 1999-2000 one may claim depreciation u/s 32, in the case of lumpsum consideration paid or [payable for acquiring any know-how which shall be used by the tax-payer for his business. Any other consideration for acquiring technical know-how is not covered by this section. Lumpsum consideration is allowed as deduction by spreading it equally over 3 years, namely the year in which the lumpsum consideration is paid and the two immediately succeeding years. This provision is applicable if a know-how is developed in a laboratory owned or financed by the Govt., or a laboratory owned by a public sector company or a University or by an institution recognised by DSIR, Govt. of India. In any other case, the lumpsum consideration is spread over 6 years equally.

**(4) Exemption u/s 80-RRA :**

In cases the Indian collaborator is an individual covering on a profession or business, he may consider it advisable to render services outside India as a part-time

employee or even as a full time employee for a part of a year to get exemption u/s 80-RRA in respect of remuneration received for services rendered outside India. The amount deductible u/s 80 RRA is equal to 30% of such amount as is brought into India in convertible foreign exchange within a period of 6 months from the end of the previous year or within such period as the CIT or commissioner may allow.

No such deduction is available from A.Y. 2005-06.

## 4.6 Corporate Failure and Corporate Contraction

The incidence of industrial sickness is to some extent and inevitable concomitant of the process of industrial development which involves the surfacing on inadequacies, bottlenecks, imbalances in different sectors of the economy. Sickness is the most prominent among business risks, for it is the one phenomenon that absorbs all the causes of business risk. Whereas atleast a small phase of sickness is almost certain in any enterprise, industrial sickness in India is assuming epidemic dimensions and this is mainly attributed to the failure of the concerned management. Van Horne stated that "very seldom is one bad decision the cause of the difficulty, usually the cause is a series of errors and the difficulty evolves gradually". However, corporate strategies are meant for taking certain diagonostic measures to combat sickness either to postpone or reduce the level and period of sickness. Huxley stated "there is the greatest practical benefit in making a few failures early in life".

The Government of India realised the magnitude of the problem and awake to the malaise of industrial sickness and the urgency of the recovery of units, which fell sick, only after nationalisation of bank in 1969 and the revival of stick units began to be regarded as one of the many social objectives of the banking system.

**Symptoms :** According to the Reserve Bank of India, a unit is considered financially sick if the following symptoms are observed (i) Accumulated losses eating away the networth, (ii) Sharp increase in debt/equity ratio, (iii) Decline in share prices, (iv) default in paying taxes, (v) Disappearence of margins for loans, (vi) Failing to stick to schedule to repay the an and the interest, (vii) High potential costs, reducing profits, (viii) No further financial assistance from lending institutions under normal conditions, (ix) problems of working capital management and chronic shortage and complete lack of liquidity in operations.

Financial sickness can be diagonosed be the financial ratio analysis which can predict sickness with reasonable accuracy from certain angles. The erratic behaviour in

the following ratios may warrant that corrective measures are to be taken: (a) current ratio, (b) debt-equity ratio, (c) return on total capital employed.

Besides the above mentioned symptoms, the Income-tax Act considers that business, to be sick which is discontinued in any previous year by reasons of extensive damage to or destruction of any depreciable business assets owned by the assessee as a result of natural calamities, riots, accidents, fire action by the enemy and thereafter, at any time before the expiry of three years, from the end of such previous year the business is reestablished, reconstructed or revived by the assessee.

According to the Industrial Companies (Special provisions) Bill 1985, a sick industrial company (being a company registered) for not less than seven years is one, which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth has also suffered cash losses in such financial year immediately preceding such financial year. Cash loss means loss as computed without providing for depreciation. Net worth is the sum total of the paid up capital plus free reserves.

### 4.6.1 Reasons for industrial sickness

Sickness is a phase of corporate life which if diagonosed early and properly may be combated with corrective measures. The expression 'sickness' or 'failure' is vague since there are varying degrees of failure in an industrial situation with the two extremes ranging from a technical failure to total insolvency.

Of the various reasons, the most important are (a) slump in demand, (b) failure to keep pace with fast moving technology, (c) excessive statutory interference, (d) heavy tax burden, (e) trade unionism, (f) mismangement, (g) government control over price fixation, (h) financial problems.

So sickness coexists with business and depends on management policies, programmes, actions and inactions. Of the above heavy taxation is by far the weightiest. Heavy taxation has uncontrollable effects on prices and other management policies.

Whereas sickness is a threat to business, certain tax planning measures can turn it into an opportunity wherever it becomes unavoidable.

**Industrial Sickness vis-a-vis Tax Planning:** Depending upon the gravity of the situation, companies may opt of the following courses of action: (a) close and sell, (b) continue with reduced level of activity, (c) amalgamate with healthier unit, (d) reorganisation.

### 4.6.2 Discontinuance of business and tax implications

A unit will have to be closed, if the expected return is less than the required rate

of return. In such a case the company cannot even earn its economic up-keep. But if a decision is to be taken to discontinue an existing business, the following points may be considered:

(i) A business which is inactive for a very long time, need not be considered as closed. Maintaining the registered office, holding statutory meetings and incurring normal expenditure are considered to be conclusive tests of the continuance of a business. But mere letting out of plant and machinery or other assets after the normal activities, if business are discontinued, cannot be considered as carrying on of business.

(ii) Section 28(1) provides that the business should be carried on by the assessee at any point of time during the previous year. Thus, if business is discontinued before the commencement of an accounting year, the profits of the business cannot be taxed. But sec. 176 (3A) provides that where any business is discontinued in any year, any sum received after the discontinuance shall be deemed to be the income of the recepient and charged to tax accordingly in the year of receipt, as if such sum would have been included in the total income of the person who carried on the business, had such amount been received before such discontinuance.

(iii) Any expenditure relating to the discontinued business cannot be claimed as deduction after the discontinuation of the business. Though such expenses may be deducted if cash system of accounting is followed, yet these should have been incurred for profits made in the accounting year towards the trading activities carried on by the company at least for some part of the accounting year.

(iv) Allowances relating to a discontinued business cannot be adjusted against the profits of a separate existing independent business.

(v) Interest on borrowed money u/s 36(1) can neither be claimed if borrowing is for purposes of the discontinued business, before the commencement of the accounting year nor it can be claimed against profits of a separate business.

(vi) Bad debts of a discontinued business cannot be allowed as deduction u/s 36(1) (vii). Continued at a reduced level of activity.

In view of the disadvantages associated with discontinuance of a business a sick company may study the feasibility of an alternative course of actions i.e., operating at a reduced level of activity. This course of action involves certain tax implications in respect of carry forward of past losses. The following example will highlight the position:

XYZ Limited has two businesses-Firm I and Firm II. Soon their Firm I was in the red and it was expected that it would result in an annual loss of Rs. 50,00,000 in the future. But it was hopeful that the company could, by reducing the volume of activity in the losing firm, reduce the annual loss to Rs. 25,000 only, However the company expected Rs. 1,00,000 (nat) from firm II p.a. Currently the company has an unabsorbed loss of Rs. 2 lakhs. The Company is receiving an offer for the purchase of Firm I and the most favourable among them, if accepted would fetch the company Rs. 1,000 (net). Then the question arises whether the company should sell the Firm I or continue at reduced level of activity. If the sale is accepted the unabsorbed loss of Rs. 2,00,000 would lapse. Assuming the tax rate to be 38.5%, the net loss, if the offer is accepted, would be Rs. 77,000—Rs. 10,000 i.e., Rs. 67,000/- But if it is continued at a reduced level of activity, the following picture would emerge:

| Post losses corried forward | Year of operation to absorb past losses and current losses | Profit from Firm II | Tax Saving | Loss in Firm I |
|---|---|---|---|---|
| | | Rs. | Rs. | Rs. |
| Presently Rs. 2,00,000 | 2 | 2,00,000 | 77,000 | 50,000 |
| Currently Rs. 50,000 | 1 | 1,00,000 | 19,250 | 25,000 |
| Next year Rs. 25,000 | 1 | 1,00,000 | 9,625 | 25,000 |
| | | | 1,05,875 | 1,00,000 |

If the Firm I is run for 4 years at a reduced level of activity the company is likely to get Rs. 5875 as net gain. After 4 years, if the Firm I is sold for, say Rs. 6,000, the total gain would be Rs. 11, 875. Moreover, the aforesaid disadvantages of discontinuance may be avoided. This analysis suggests that the company should continue to operate both the businesses though Firm I should be run at a low level of activity. Again, new lines of business in the same company, where it has already developed know-how and experience of the old business can be utilised.

Third alternative is the amalgamation / merger with healthy units thereby claiming the benefit of set off and carry forward of losses by satisfying all the conditions contained in secs. 72A, 2(19AA) of the Act.

If the two operating companies, one good and one bad, decide on an amalgamation strategy it is beneficial from tax point of view to merge the good company into the bad company and not the other way about. If the bad company has any unabsorbed

depreciation or trading loss brought from earlier years, the benefit of set-off such unabsorbed items lapses, as soon as it goes out of existence. On the other hand, if it continues, such benefit continues to be available. However, the finance Act, 1977 enacted sec. 72A of the Income-tax Act, 1961, for granting certain tax benefits where two companies amalgamate under scheme which is approved by the Central Government. The benefit relates to the setting off of the accumulated losses, unabsorbed depreciation and investment allowance of the amalgamating company against the profits of the amalgamated company. As the following example will highlight the position. Company A is proposed to be amalgamated with company B and the following are the particulars of Company A: (a) unabsorbed depreciation Rs. 2,50,000 (b) unabsorbed losses Rs. 5,00,000 (c) unabsorbed investment allowance Rs. 2,00,000 and with a view to retaining all tax advantages with company A, it will be advisable to take over the business of company B in that case, all unabsorbed losses and allowances will be retained and profits earned by company B will be available for such set-off and absorption. Where amalgamation is contemplated and sec. 72 is to be operative, the following three conditions have to be followed:

(1) The amalgamated company owns an industrial undertaking or a ship.

(2) The amalgamated company continues to hold at least three-fourths in book value of fixed assets of the amalgamating company which is acquired as a result of amalgamation for five years from the effective date of amalgamation.

(3) The amalgamated company continues the business of the amalgamating company for minimum period of 5 years.

(4) The amalgamated company fulfills such other conditions as may be prescribed to ensure that the amalgamation is for genuine purpose.

The whole basis of the provisions of sec. 72A for giving tax benefits to the amalgamated company by allowing the unabsorbed depreciation and losses to be set-off, is that these tax benefits would be utilised for meeting the cost of reviving the sick industrial undertaking. Apart from the tax benefits, the cash generation by the sick unit itself is required to be ploughed back for rehabilitiating it.

If either the sick company or the amalgamated company owns an industrial undertaking which is registered under the Monopolies and Restrictive Trade Practices Act, 1969, the specified authority would decide on the application only after the approval from the M.R.T.P. Commission has been obtained.

Sub-section (4) has been inserted in section 72A w.e.f. the assessment year 1999-2000. It provides that in cases of succession of business, whereby, a firm is succeeded

by a company fulfilling the conditions laid down in section 47(xiii) and a proprietary concern is succeeded by a company fulfilling the conditions laid down in section 47(xiv), the accumulated loss and unabsorbed depreciation of the predecessor firm or proprietary concern, as the case may be, allowance of depreciation of the successor company for the previous year in which business reorganisation takes places, set off and carry forward of loss and allowance for depreciation shall apply accordingly.

When conditoins of section 47(xi)/(xiv) are not complied with, the set off of loss or allowance of depreciation made in the previous year in the hands of the successor company shall be deemed to be the in come of the company chargeable to tax in the year in which the conditions are not complied with.

**Last alternative :**

**Reorganisation or restructuring of the existing business:** Managers of the companies which are sick should think twice before they plan to discontinue the companies. In certain cases reorganisation of the capital base and other functional activities may be found suitable. Much also depends upon intensity of the problem. An early diagonisis of tendencies would leave time and scope for reorganisation.

Reorganisation may involve actions taken to induct stability in the capital structure. It may at sometime even go to the extent of splitting up the business.

Factors to be considered for reorganisation :

(a) expected future profitability of the company,

(b) the cost of reorganisation,

(c) the revocability of the various tax benefits,

(d) the effect of reorganisation on the overall tax liability of the company,

(e) the effect of reoganisation on the morale of the employees of the reorganisation.

**Broad methodology**

**Reorganisation involves the following steps :** First, the total valuation of the reorganised company is to be determined. Second, a new capital structure for the company is to be formulated to reduce the amount of fixed charges so that there may be an adequate coverage margin. For this it may be felt a more conservative ratio of debt to equity in order to provide for future financial flexibility. Third step or the last step involves the valuation of the old securities and their exchange ratio for new securities. The exchange ratio determined to compute stable capital gearing depends upon the

negotiable status of the creditors. However, the equity shareholders may be asked to sacrifice more in such a move.

### 4.6.3 Tax Implications

Reorganisation involves a variety of strategies and splitting up of business may be one of the important where a lot of tax problems arise. Most of such tax problems consists of the revocability of various tax benefits involves in reviving the returns. Some of the tax problems are given below :

(a) In the case of splitting up a business thereby effecting a change in ownership, if the consideration for the sale is less than the written down value of the asset sold, the parent company can claim terminal depreciation with reference to the depreciable asset provided it is sold in other than the first accounting year when the asset is put to use by the parent company. Moreover, the terminal depreciation would enter for want of profits in the hands of the parent company and can be set off by the parent company in any year under any head of income as laid down in the Act. As a matter of tax plan, it may be necessary to see that the scheme of splitting up of a business fixes the sale price at less than the actual cost of the asset to the parent company. But the component company can claim depreciation on the amount paid for the asset received from the parent company constitutes actual cost [sec. 47(iv) and (v)]. Since the amount paid to the parent company constitutes the actual cost, the higher is the depreciation allowance for the component company. The ITO has nothing to do with computation of capital gains in the hands of the company [students are advised to go through the provisions of sec. 43(6) for changes due to introduction of new system of depreciation on block of assets.]

(b) As regards past and present business losses, it is best to let the parent company retain the loss of the running unit under its ownership and pass on to subsidiary company only the unit that does not possess unabsorbed past losses, that the right to carry forward and set off the unabsorbed past losses would not lapse, for the parent company due to splitting up of the business. But it may be noted here that in case there are no prospects for the business now running at a loss to generate profits to absorb its past losses, it would be wrong to separate such loss making business from the profit generating one, since if that be so, due to difference in ownership and assessable status, the right to carry forward the past losses of the parent company would be relegated to a proper benefit and the subsidiary company would have to pay

taxes on the profits generated by it. This is because, had there been no split up of business, the past losses of the loss-running business could be absorbed by the profits of the profitable business thereby resulting in lower tax incidence and hence reduced overall tax liability of the company as a whole.

(c) As per law, investment allowance would be revoked if there be transfer of plant and machinery due to splitting up before the expiry of prescribed time-limit. But if splitting up of the business is so arranged that all the concerned manufacturing activities continue to be run by the parent company and only the trading activities are transferred to the subsidiary company there is no danger of losing investment allowance and at the same time, the performance of manufacturing and trading activities are separately traced out. Tax planning may also consider capital expenditure on scientific research (u/ss 35, 35A, 35D and 35E).

In the case of splitting up of business of a parent company, it is profitable from tax angle to see that the parent company continues to exist. If by any accident the income of the parent company has escaped assessment or in case of reassessment proceedings against it, the tax liability would have to be shouldered by transferee company in the absence of the existence of the parent company [sec. 170]. For such contingencies the scheme may find it difficult to provide for while computing the consideration. The tax problems relating to deemed dividend u/s 2(22) (c) may also have to be considered. There are some other tax benefits due to split up which must be taken into account in arriving at a decision. A bove all any reorganisation plan must be fair and equitable to all security holders.

## 4.7 Question

1. (a) While starting a new business what factors should an assessee consider in order to avail fully of the benefits available under the provisions of the Income-tax Act?

   (b) "Capital structure decision has a definite bearing on the incidence of tax payable by a company". Discuss fully.

2. "On the various considerations to be taken for setting up a new business, Income tax is by far the most important one." Discuss giving reasons the implications of the statement.

3. (a) What do you understand by the terms ‘Business’ and “Business connections” in the context of foreign collaboration agreement?

(b) “The incidence of tax on foreign collaborator depends on the assessee’s residential status”. Discuss.

4. What are the various aspects of Tax Planning to be considered in connection with foreign collaboration agreement to minimise the tax liabilities of either side-foreign collaborator as well as Indian counterpart?

5. (a) Define ‘amalgamation’ according to section 2(1B). What are the conditions to be satisfied for a merger to qualify as an amalgamation for the purpose of the Income-Tax Act?

(b) What are the special provisions u/s 72A for carry forward and set off of accumulated losses and unabsorbed depreciation in certain cases of amalgamations. Illustrate your answer.

6. What are the important factors in respect of tax planning of amalgamation or demerger of companies?

7. What do you understand by “Demerger”? What are the provisions relating to demerger introduced by the Finance Act, 1999?

8. What do you understand by “Demerged” company and “Resulting” company? What are the tax concessions/incentives in case of demerger available to:

(a) demerged company,

(b) shareholders of demarged company,

(c) resulting company,

9. When is a company considered to be sick? What are the factors responsible for sickness of a company?

10. (a) What are the different courses of action may a sick company opt for?

(b) “When a company become sick, it can continue at a reduced level of activity”. Comment on the statement with a suitable illustration.

11. “A sick company can convert sickness into an opportunity by reducing its level of activity.” Discuss with a suitable illustration.

12. What do you understand by “Reorganisation” of an existing business to overcome sickness?

## 4.8 References


1. Corporate Tax Planning and Management—E.A. Srinivas.
2. Direct Taxes—Law and Practice—V. K. Singhania & M. K. Singhania.
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# Unit 5 ❑ Tax Planning in Specific Managerial Decisions

**Structure**

**5.1 Make or Buy**

**5.2 Own or Lease**

**5.3 Repair/Renewal or Replacement of an asset**

**5.4 Questions**

**5.5 References**

## 5.1 Make or Buy

Many costing or non-costing considerations guide the decision relating to "make or buy". Some of these considerations are—(a) utilization of capacity, (b) inadequacy of funds, (c) latest technology, (d) variable cost of manufacturing vis-a-vis purchase price, (e) dependence upon supplier, (f) labour problem in the factory, etc. The following tax considerations one has to keep in mind while taking "make or buy" decision—

1. Establishing a new unit—If the decision to manufacture a part or component involves setting up a separate industrial unit, then tax incentives available under sections 10A, 10B, 32, 80-1A and 80-1B one has to keep in mind.

2. Export—If "make or buy" decision is taken for exporting goods, then tax incentive is available under section 10B in case the assessee is a newly established hundred per cent export oriented undertaking.

3. Sale of plant and machinery—If buying is cheaper than manufacturing and the assessee decides to "buy" parts/components for a long period of time, he may like to sell the existing plant and machinery. Tax implications, as specified by section 50, one has to consider for taking the dceision.

**Illustration-1**

X Ltd. manufactures electric pumping sets. The company has the option to either make or buy from the market component Y used in manufacture of the sets.

The following details are available:

The component will be manufactured on new machine costing Rs. 1 lakh with a life of 5 years. Material required cost Rs. 2 per kg. and wages Re 0.30 per hour. The salary of the foreman employed is Rs. 1,500 per month and other variable overheads include Rs. 20,000 for manufacturing 25,000 components per year. Material requirement is 25,000 kgs. and requires 50,000 labour hours. Rate of depreciation is 25% p.a. Rate of Tax is 30%, Discounting rate 14%.

The component is available in the market at Rs. 4.30 per piece.

Will it be profitable to make or to buy the component? Does it make any difference if the component can be manufactured on an existing machine.

Ans. :

The estimated cost of manufacture will be :

| | Rs. |
|---|---|
| Material @ Rs. 2 kg. (25,000 × Rs. 2) | 50,000 |
| Labour @ 0.30 hour (50,000 × Re. 0.30) | 15,000 |
| Foreman's salary (Rs. 1,500 × 12) | 18,000 |
| Variable overhead | 20,000 |
| Total variable cost | 1,03,000 |
| Cost per unit (i.e., Rs. 1,03,000 / 25,000)(a) | 4.12 |
| Fixed cost | |
| Cost of new machine (net of taxes) Rs. 83,145 | |
| New fixed cost per unit (i.e., Rs. 83,145 / 2,50,00 × 5 units to be manufactured in 5 years)(b) | 0.67 |
| Total [(a) + (b)] | 4.79 |

| Conclusion | If new machine is required | If existing machine can be used |
|---|---|---|
| | Rs. | Rs. |
| Cost of manufacture | 4.79 | 4.12 |
| Cost of buying | 4.30 | 4.30 |
| Which one is better | Buy | Make |

**Workings :**

| Year | 25% Deprecation | PV at 14% | Discounted value | PV of Tax Savings |
|---|---|---|---|---|
| 1 | 25000 | .877 | 21925 | 6578 |
| 2 | 18750 | .765 | 14418 | 4325 |
| 3 | 14062.5 | .675 | 9492 | 2847 |
| 4 | 10547 | .552 | 6244 | 1873 |
| 5 | 7910 | .519 | 4105 | 1232 |
| | | | Rs. | 16,855 |

Cost of new machine → (1,00,000 – 16,145) = 83,145

**Illustration-2**

XYZ Ltd. needs a component in an assembly operation. It is contemplating the proposal to either make or buy the aforesaid component.

1. If the company decides to make the product itself then it would need to buy a machine for Rs. 8 lakh which would be used for 5 years. Manufacturing costs in each of the five years would be Rs. 12 lakh, Rs. 14 lakh, Rs. 16 lakh, Rs. 20 lakh and Rs. 25 lakh respectively. The relevant depreciation rate is 25 per cent. The machine will be sold for Rs. 1 lakh at the end of fifth year.

2. If the company decides to buy the component from a supplier the component would cost Rs. 18 lakh, Rs. 20 lakh, Rs. 22 lakh, Rs. 28 lakh and Rs. 34 lakh respectively in each of the five year.

The relevant discounting rate and tax rate are 14 per cent and 35 per cent respectively. Should XY Ltd. make the component or buy from outside?

Ans. :

**Alternative 1—Make the component**

| Year | Depreciation (25%) Rs. | WDV Rs. |
|---|---|---|
| 1. | $\left(800000 \times \frac{25}{100}\right)$ 2,00,000 | 6,00,000 |
| 2. | 1,50,000 | 4,50,000 |
| 3. | 1,12,500 | 3,37,500 |
| 4. | 84,375 | 2,53,125 |
| 5. | 63,282 | 1,89,843 |

Computation of short-term capital loss

| | Rs. |
|---|---|
| Sales consideration | 1,00,000 |
| Less : cost of acquisition | 1,89,843 |
| Short-term capital loss | (-) 89,843 |

| Year | Manufacturing cost (a) Rs. | Depreciation (b) Rs. | Tax saving (a +b) × 35% Rs. | Cash outflow from operations (COFO) Rs. |
|---|---|---|---|---|
| 1. | 12,00,000 | 2,00,000 | 4,90,000 | 7,10,000 |
| 2. | 14,00,000 | 1,50,000 | 5,42,500 | 8,57,500 |
| 3. | 16,00,000 | 1,12,500 | 5,99,375 | 10,00,625 |
| 4. | 20,00,000 | 84,375 | 7,29,532 | 12,70,468 |
| 5. | 25,00,000 | 63,282 | 8,97,149 | 16,02,851 |

Discounted cash flow analysis of make proposal

| | Year | PVF/A | Cash outflow | PV Rs. |
|---|---|---|---|---|
| Investment | 0 | 1 | 8,00,000 | 8,00,000 |
| Cash outflow | 1 | 0.877 | 7,10,000 | 6,22,670 |
| Cash outflow | 2 | 0.769 | 8,57,500 | 6,59,418 |
| Cash outflow | 3 | 0.675 | 10,00,625 | 6,75,422 |
| Cash outflow | 4 | 0.592 | 12,70,468 | 7,52,117 |
| Cash outflow | 5 | 0.519 | 16,02,851 | 8,31,880 |
| Sale of machine | 5 | 0.519 | (1,00,000) | (–) 51,900 |
| | | | | 42,89,607 |

**Alternative 2—Buy the component**

| Year | Purchase Cost | Tax saving (35%) | Cash outflow from operations (COFO) |
|---|---|---|---|
| | Rs. | Rs. | Rs. |
| 1. | 18,00,000 | 6,30,000 | 11,70,000 |
| 2. | 20,00,000 | 7,00,000 | 13,00,000 |
| 3. | 22,00,000 | 7,70,000 | 14,30,000 |
| 4. | 28,00,000 | 9,80,000 | 18,20,000 |
| 5. | 34,00,000 | 11,90,000 | 22,10,000 |

Discounted cash flow analysis of buy proposal

| | Year | PVF/A | Cash outflow Rs. | PV Rs. |
|---|---|---|---|---|
| Cash outflow | 1 | 0.877 | 11,70,000 | 10,26,009 |
| Cash outflow | 2 | 0.769 | 13,00,000 | 9,99,700 |
| Cash outflow | 3 | 0.675 | 14,30,000 | 9,65,250 |
| Cash outflow | 4 | 0.592 | 18,20,000 | 10,77,440 |
| Cash outflow | 5 | 0.519 | 22,10,000 | 11,46,990 |
| | | | | 52,15,470 |

Decision—The above analysis shows that there are considerable savings in making the component, amounting to Rs. 9,25,863 (i.e., Rs. 52,15,470—Rs. 42,89,607). Hence, it is beneficial to manufacture the component. Moreover, XYZ Ltd. will have a short term capital loss of Rs. 89,843 after the end of the fifth year. Assuming that, it has an equal amount of short-term capital gain also this will result in tax savings of Rs. 32,876 at the current corporate tax rate (i.e., 89,843 × 36. 5925).

## 5.2 Own or Lease

In recent years, leasing has become a popular source of financing in India. From the lessees point of view, leasing has the attraction of eliminating immediate cash outflow, and the lease rentals can be claimed as admissible expenditure against the business income. On the other hand, buying has the advantages of depreciation allowance and interest on borrowed capital being tax-deductible. Thus, an evaluation of the two alternatives is to be made in order to take a decision.

**Illustration—1**

An asset costing Rs. 1,00,000 is to be acquired. There are two alternatives available to the entrepreneur. First one is buying the asset by taking a loan of Rs. 1,00,000 repayable in five equal instalments of Rs. 20,000 each along with interest @ 14% p.a. assuming that lease rentals, processing fees, interest as well as the principal amounts are payable at the year end. The second one is leasing the asset for which annual lease rental is Rs. 300,000 up to five years. The lessor charges 1% as processing fees in the first year. Assume the internal rate of return to the 10% and the present value factor at 10% is:

| Years | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| PV Factor | .909 | .826 | .751 | .683 | .621 |

Suggest which alternative is better in the above case.

**Alternative 1**

Purchasing the asset with the amount of loan

| | | Years | | | | |
|---|---|---|---|---|---|---|
| Sl. No. | Particulars | 1 | 2 | 3 | 4 | 5 |
| | | Rs. | Rs. | Rs. | Rs. | Rs. |
| 1. | Loan repayment | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 |
| 2. | Interest @ 14% p.a. | 14,000 | 11,200 | 8,400 | 5,600 | 2,800 |
| 3. | Cash outflow (1+2) | 34,000 | 31,200 | 28,400 | 25,600 | 22,800 |
| 4. | Depreciation @ 25% on WDV | 25,000 | 18,750 | 14,062 | 10,547 | 7,910 |
| 5. | Total of (2) & (4) | 39,000 | 29,950 | 22,462 | 16,147 | 10,710 |
| 6. | Tax saving [@ 35.875% on the amount calculated under (5)] | 13,991 | 10,745 | 8,058 | 5,794 | 3,842 |
| 7. | Adjusted cash outflow (3-6) | 20,009 | 20,455 | 20,342 | 19,806 | 18,958 |
| 8. | Present value factor at 10% | 0.909 | 0.826 | 0.751 | 0.683 | 0.621 |
| 9. | Present value of adjusted cash outflow (7 × 8) | 18,188 | 16,896 | 15,277 | 13,527 | 11,773 |
| | Total net present value of cash outflows = Rs. 75,661 | | | | | |

**Alternative 2**

| Sl. No | Particulars | Years | | | | |
|---|---|---|---|---|---|---|
| | | 1 | 2 | 3 | 4 | 5 |
| | | Rs. | Rs. | Rs. | Rs. | Rs. |
| 1. | Lease rentals | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 |
| 2. | Processing fees | 1,000 | — | — | — | — |
| 3. | Cash outflow (1+2) | 31,000 | 30,000 | 30,000 | 30,000 | 30,000 |
| 4. | Tax savings [@ 35.875% of (3)] | 11,121 | 10,763 | 10,763 | 10,763 | 10,736 |
| 5. | Adjusted cash outflow (3-4) | 19,879 | 19,237 | 19,237 | 19,237 | 19237 |
| 6. | Present value factor at 10% | 0.909 | 0.826 | 0.751 | 0.638 | 0.621 |
| 7. | Present value of adjusted cash outflow (5 × 6) | 18,070 | 15,890 | 14,447 | 13.139 | 11,946 |

Total net present value of cash outflows = Rs. 73,492

Hence, in the present case, lease finance works out to be cheaper than term loan.

**A case study :**

A plant is to be purchased for Rs. 1,00,000. The depreciation rate is 25 per cent and the corporate tax rate 35 per cent. The weighted average cost of capital 10 per cent. The life of the machine is 10 years. A loan of Rs. 75,000 can be had by accepting public deposits at the interest rate of 18 per cent for financing the investment in plant. It is assumed that the public deeposits are repaid after 10 years. On the other hand, the asset can be obtained on lease. The lease rentals are at the rate of Rs. 34,000 per annum for the primary lease period of 5 years. Beyond this period rentals of Rs. 600 per annum are to be paid. A lease management fee of Rs. 1,000 is payable on inception of the lease. In all, three situations have been studied:

**Situation 1**—Purchase with own funds—The following results one can obtain on the basis of data presented in Table 1.

**Table 1**

Present value of outflow of cash when plant is purchased out of own funds

| | Rs. |
|---|---|
| Investment in plant and machinery | 1,00,000 |
| Tax savings on account of depreciation | 24,451 |
| Outflow of cash | 75,549 |

**Situation 2**—Purchase with borrowed funds—To finance purchase of plant and machinery, a loan (by way of public deposits) of Rs. 75,000 is obtained at the rate of 18 per cent. While interest is paid annually, principal is repaid in year ten. The following results one can obtain on the basis of information presented in Table 2.

**Table 2**

Present value of outflow of cash when plant is purchased out of borrowed funds

| | Rs. |
|---|---|
| Present worth of total outflow on principal and interest net of tax | 1,07,866 |
| Present worth of tax sacings on account of deduction under section 32 | 24,451 |
| Outflow of cash (net of taxes) | 83,415 |

**Situation 3**—Taking asset on lease—Table 3 presents data when plant is obtained on lease from own funds.

**Table 3**

Present value of differential cash outflow on leasing with own funds

| Year | Lease management fee Rs. | Lease rentals Rs. | Tax saving on fee and rentals (tax Rate: 35 per cent) Rs. | Differential cash outflow Rs. | Present value of differential cash outflow (discount rate: 10 per cent) Rs. |
|---|---|---|---|---|---|
| Year zero | 1,000 | 34,000 | 12,250 | 22,750 | 22,750 |
| Year one | — | 34,000 | 11,900 | 22,100 | 20,089 |
| Year two | — | 34,000 | 11,900 | 22,100 | 18,255 |
| Year three | — | 34,000 | 11,900 | 22,100 | 16,597 |
| Year four | — | 34,000 | 11,900 | 22,100 | 15,094 |
| Year five | — | 600 | 210 | 390 | 242 |
| Year six | — | 600 | 210 | 390 | 220 |
| Year seven | — | 600 | 210 | 390 | 200 |
| Year eight | — | 600 | 210 | 390 | 182 |
| Year nine | — | 600 | 210 | 390 | 165 |
| Year ten | — | — | — | — | — |
| Total | | | | | 93,794 |



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**Conclusion**—From the above it would be evident that purchase of plant out of won fund is the best alternative.

**Disadvantages of the finance :** before opting for a lease decision one has to keep in mind the following disadvantages:

(i) Leased assets are not owned assets and therefore, the asset cover to equity comes down due to increased dependence on lease finance.

(ii) Financial ratios are also distorted due to greater dependence on lease finance.

(iii) Lease rent payments are made out of working capital funds which means that fixed assets are financed out of short-term funds.

(iv) The asset taken on lease is taken back by the lessor at the expiry of lease period. Thus, he will be bothered about finding alternative asset at the expiry of lease period.

## 5.3 Repair / Renewal or Replacement of an Asset

The old and worn out assets need to be either repaired/renewed or replaced at regular intervals. Sometimes, even a good maehine requires upgradation or replaecment so as to compete in the market. The main tax consideration in these cases shall be whether the assessee, while computing his business income, shall be allowed deduction on account of such expenditure or not.

**Repairs/renewal :** Deduction for expenditure on repairs/renewal will be allowed as revenue expenditure in computation of business income as under :—

If the building is a rented building, any expenditure on repairs shall be allowed as deduction. On the other hand, if the building is owned, only current repairs shall be allowed as deduction.

> The Finance Act, 2003 has inserted an explanation to this section w.e.f. assessment year 2004-05 so as to clarify that the amount paid on account of the cost of repairs (i) and the amount paid on account of current repairs shall not include any expenditure in the nature of capital expenditure. [Explanation to section 30].

As regards plant and machinery, only current repairs shall be allowed as deduction.

However, the accumulated repairs in the above cases can be claimed under section 37(1).

It may be noted that if the repairs expenditure are of capital nature it shall not be allowed as deduction either under section 30,31 or 37.

**Replacement of assets:** If the asset has to be replaced, the expendituer incurred on replacement shall be capital expenditure and the assessee shall only be entitled to depreciation on such assets and as such, the entire expenditure cannot be claimed as deduction which was allowed in case of repairs. The capital expenditure incurred on construction of super structure on rented building is also eligible form depreciation under section 32.

The main tax consideration which one has to keep in mind is whether expenditure on repair, replacement or renewal is deductible as revenue expenditure under section 30,31 or 37(1). If the expenditure is deductible as revenue expenditure under these sections, then cost of financing such expenditure is reduced to the extent of tax saved. For instance, if tax rate is 35 percent and a "renewal" expenditure of Rs. 1,00,000 is allowed as deduction under section 30, 31 or 37(1), then effective out of pocket expenditure is Rs. 65,000 [i.e., Rs. 1,00,000 minus 35 percent of Rs. 1,00,000]. On the other hand, if such expenditure is not allowed as deduction under section 30, 31 or 37(1), then it may be capitalised and on the amount so capitalized, depreciation is available if certain conditions are satisfied.

XYZ Ltd. is considering the purchase of a new machine costing Rs. 60,000 with an expected life of 5 years with salvage value of Rs. 3,000, in replacement of an old machine purchased 3 years ago for Rs. 30,000 with expected life of 8 years. The present market value of this old machine is Rs. 35,000 because of the purchase of new machineary, the annual profits before depreciation are expected to increase by Rs. 12,000. the relevant depreciation rate of the machine is 25 percent on written down value basis and the tax rate is 35 percent. Assume the after tax cost of capital (discounting rate) to be 14 percent. Advise the company suitably.

**Assumptions :**

1. It is assumed that the old machine is sold and the new machine is purchased at the beginning of fourth year of the purchase of old machine.
2. There is no other asset in the block.

Working note

Computation of the written down value of the old machine (after providing three years depreciation)

| Year | Depreciation Rs. | WDV Rs. |
|---|---|---|
| 1. | 7,500 | 22,500 |
| 2. | 5,625 | 16,875 |
| 3. | 4,219 | 12,656 |

| | Rs. |
|---|---|
| WDV of the old machine (in the beginning of the fourth year) | 12,656 |
| Add: Purchases | 60,000 |
| Total | 72,656 |
| Less: Sales | 35,000 |
| WDV at the beginning of fourth year for old machine (or first year for new machine) | 37,656 |

| Future years | Change in profit Rs. | Change in depreciation Rs. | Change in tax Rs. | Change in cash flow Rs. |
|---|---|---|---|---|
| 1. | 12,000 | 6,250 | 2,013 | 9,987 |
| 2. | 12,000 | 4,688 | 2,560 | 9,440 |
| 3. | 12,000 | 3,516 | 2,970 | 9,030 |
| 4. | 12,000 | 2,636 | 3,278 | 8,722 |
| 5. | 12,000 | 4,910 | 2,481 | 9,519 |

**Discounted cash flow anlysis of the project**

| | Year | PVF/A | Cash flow Rs. | Present value Rs. |
|---|---|---|---|---|
| Net investment | 0 | 1 | – 25,000 | – 25,000 |
| Cash inflow from operations | 1 | 0.877 | + 9,987 | + 8,759 |
| Cash inflow from operations | 2 | 0.769 | + 9,440 | + 7,260 |
| Cash inflow from operations | 3 | 0.675 | + 9,030 | + 6,096 |
| Cash inflow from operations | 4 | 0.592 | + 8,722 | + 5,164 |
| Cash inflow from operations | 5 | 0.519 | + 9,519 | + 4,940 |
| Sale of scrap | 6 | 0.519 | + 3,000 | + 1,557 |
| Net present value | | | | + 8,776 |

**Decision**—Since the net present value on the basis of the above stated analysis is positive, the old machine should be replaced with the new machine.

## 5.4 Questions

1. What are the tax considerations to be taken while taking 'make' or 'buy' decisions?

2. XYZ Ltd. may purchase or lease a machine costing Rs. 2,00,000. If purchased, the cost of the machine would be recovered using straight line method of depreciation over its 5-year life. The corporate tax rate is 35 percent and the weighted average cost of capital is 10 percent. A loan of Rs. 1,50,00 can be had by accepting public deposits at the interest rate of 18 percent for financing the investment in plant. It is assumed that the public deposits are repaid after 5 years. On the other hand, the asset can be obtained on lease. The lease rentals are at the rate of Rs. 68,000 p.m. for the lease period of 5 years.

Advise the company whether is should purchase the machine or take on lease under the following situations:

(a) purchase with own funds;

(b) purchase with borrowed funds;

(c) taking asset on lease.

3. R. Ltd. requires 30,000 units of components every year for manufacturing T. V. sets for next four years. These components can either be manufactured by the company in its factory or be purchased from the market. In case, such components are manufactured, R Ltd. will have to buy a new machine costing Rs. 1,00,000 which will have a life of four years and thereafter it can be sold for Rs. 10,000. The rate of depreciation on such machine is 25%. The other expenses for manufacturing of components shall be as under:

(i) Material cost 30,000 kgs @ Rs. 3 per kg.

(ii) Labour cost @ Rs. 5 per unit

(iii) Foreman Salary Rs. 2,500 p.m.

(iv) Variable overheads Rs. 60,000

In case the machine is to be purchased, R. Ltd. shall have to borow Rs. 1,00,000 @ 14% p.a. which will be repayable in four equal instalments along with interest.

Which option will be better if the component is available in the market at (a) Rs. 12 per unit (b) Rs. 11 per unit?

4. What are the tax considerations to be taken into account while arriving at decision relating to repair/renewal or replacement of an asset?

## 5.5 References

1. Direct Taxes—Law & Practice—V. K. Singhania & K. Singhania.
2. Corporate Tax Planning and Management—E. A. Srinivas.
3. Corporate Tax Planning and Management—G. Ahuja &R. Gupta.

# Unit 6 ❑ Tax Management

**Structure**

**6.1 Procedural Aspects**

**6.2 Voluntary Return of Income [Sec. 139(1), (4A), (4B), (4C)]**

**6.3 Procedure of Assessment**

**6.3.1 Inquiry before assessment [Section 142]**

**6.4 Apeals & Revision**

**6.5 First Appeal**

**6.6 Appeal to the Supreme Court [Section 261]**

**6.7 Questions**

**6.8 References**

## 6.1 Procedural Aspects

[Students should note that most of the procedural aspects such as filing of return of income, types of assessments and advance payment of tax etc. have been incorporated in the study materials meant for M. Com. Part I examination. Only those relevant parts not included in the previous study materials have been discussed here. Students are required to go through previous study notes particularly in this regard for their Part II examination.

## 6.2 Voluntary Return of Income [Sec. 139(1), (4A), (4B), (4C)]

The following persons are under statutory obligation to file return by virtue of section 139(1), (4A), (4B), (4C)—

| Taxpayer | Minimum income to attract the provisions of filing return of income |
| --- | --- |
| Company [sec. 139(1)] | Any income or loss |
| A person other than a company [sec. 139(1)] | If the income is in excess of the amount not chargeable to tax (i.e., the amount of exempted slab) |
| A person in reecipt of income derived from property held under a trust for charitable or religious purposes [sec. 139(4A)] | If the income (without giving exemption under section 11 or 12) exceeds the maximum amount not chargeable to tax |
| Chief executive officer of every political party [sec. 139(4B)] | If the income (without giving exemption under section 13A) exceeds the maximum amount not chargeable to tax |
| Scientific research assotiation, news agency, association/institution for control or supervision of a profession, institution for development of khadi and village industries, fund/institution referred to in section 10(23C) (iv), (v), education/medical institution, trade union [sec. 139(4C)]. | If the income (without giving exemption under section 10) exceeds the maximum amount not chargeable to tax. |

**Where the permanent account number should be quoted**—The permanent account number should be quoted as follows—

Quote own permanent account number in returns, certificates, correspondence—Every person shall qote his Permanent Account Number or General Index Register Number in all documents pertaining to the transactions specified below, namely—

a. sale or purchase of amy immovable property valued at Rs. 5 lakh or more;

b. sale or purchase of motor vehicle or vehicle which requires registration by a registering authority;

c. a time deposit, exceeding Rs. 50,000, with a banking company to which the Banking Regulation Act, 1949 applies;

d. a deposit, exceeding Rs. 50,000 in any account with Post Office Saving Bank;

e. a contract of a value exceeding Rs. 1 lakh for sale or purchase of securities as defined in section 2(h) of the Securities contracts (Regulation) Act, 1956;

f. opening an account with a banking company to which the Banking Regulation Act, 1949 applies (but other than time deposit account);

g. making an application for installation of a telephone connection (including a cellular telephone connection);

h. payment to hotels and restaurants against their bills for an amount exceeding Rs. 25,000 at any one time;

i. payment in cash for purchase of bank drafts or pay orders or banker's cheques from a bank for an amount aggregating Rs. 50,000 or more during any one day;

j. deposit in cash aggregating Rs. 50,000 or more during any one day, with a bank;

k. payment in cash in connection with travel to any foreign country of an amount exceeding Rs. 25,000 at any one time.

**Class or classes of persons to whom provisions of section 139A shall not apply—**The provisions of section 139A shall not apply to following class or classes of persons, namely—

(a) persons who have agricultural income and are not in receipt of any other income chargeable to income-tax [such persons shall make declaration in Form No. 61 in respect of transactions mentioned above];

(b) non-residents;

(c) the Central Government, state Government and Consular Officers in transactions where they are the payers.

## 6.3 Procedure of Assessment

After submission of return of income by the assessee to the Income-tax Department, the process of assessment commences. In some cases, the assessment may be taken up by the assessing Officer, even though the return of income is not submitted, although the assessee was required to do so. The Assessing Officer can make the assessment in any of the following ways:

| | | |
|---|---|---|
| (i) | Summary Assessment | On the basis of the return of income [u/s 143(1)]. |
| (ii) | Scrutiny Assessment | On the basis of return of income and hearing further additional evidence [u/s 143(3)]. |
| (iii) | Best Judgement Assessment | Under section 144. |

### 6.3.1 Inquiry before assessment [Section 142]

I. **Serving of a Notice [Section 142(1)] :** For the purpose of making an assessment, the Assessing Officer may take any/all of the following steps:

(i) serve a notice under section 142(1) (i) to the person requiring him to furnish a return of his income, or the income of any other person in respect of which he is assessable under the Act, in the prescribed form and within the time specified in the notice, if the person has not filed a return of income and the time allowed under section 139(1) has expired.

(ii) serve a notice under section 142(1) (ii) to any person who has filed a return of income or not to produce or cause to produce, such accounts or documents as the Assessing Officer may require. However, the Assessing Officer shall not require the assessee to produce any accounts relating to a period more than three years prior to the previous year. Further, the notice under this clause can be sent only when the return has been submitted under section 139 [i.e., u/s 139(1) or 139(2) or 139(3) or 139(4A) or 139(5)] or when the time allowed under section 139(1) for furnishing the return has expired and the return is not submitted.

A reading of section 142(1) makes it clear that the Assessing Officer has wide powers to call for any books of account from the assessee but he will not require production of any accounts relating to a period more than 3 years prior to the previous year relevant to the assessment year for which enquiry for assessment is made. [Krisha Mohan Banik v ITO (1998) 232 ITR 339(Gau)].

(iii) serve a notice under section 142(1)(iii), to furnish, in writing and verified in the prescribed manner information in such form and on such points and matters as he may require. The Assessing Officer may also ask for a statement of all assets and liabilities of the assessee whether included in the accounts or not. However, prior approval of the Joint Commissioner of Income-tax will be required, if the Assessing Officer requires the assessee to furnish a statement of assets and liabilities not included in the accounts. Statement of assets and liabilities can be asked for any number of previous years.

1. Notice under section 142(1) (i) or (ii) or (iii) can be issued only for the purpose of making an assessment under the Income-tax Act but assessment cannot be made by issuing notice under this section alone. It is normally issued for collecting information for the purpose of making best judgement assessment.
2. Notice under section 142(1)(i) to file a return of income can be given only after the time allowed under section 139(1) has expired.
3. Further, the notice 142(1)(ii) or (iii) can be given whether the return of income has been submitted or not but if no return is furnished then the notice can be served only after the time allowed under section 139(1) has expired.
4. The law does not provide any time limit for issue of notice under section 142(1) (i) for filing the return but as per general provision, a return cannot be filed after the expiry of one year from the and of the relevant assesment year.
5. If the assessee has not furnished the return of income within the time allowed under section 139(1), it is not mandatory for the Assessing Officer to issue notice under section 142(1) (i) for filing the return of income in case he wishes to make best judgement assessment under section 144. In that case, he shall have to follow the procedure given under section 144.

II. **Make Inquiry [Section 142(2)] :** For the purpose of obtaining full information in respect of income or loss of any person, the Assessing Officer may make such inquiry, as he considers necessary. While section 142(1) empowers the Assessing Officer to collect information from the assessee himself, section 142(2) on the other hand, empowers him to collect information from sources other than the assessee.

III. **Audit of Accounts [Sections 142(2A) to (2D)] :** The Assessing Officer may, at any stage of the proceedings before him, direct the assessee to get the accounts audited by a Chartered Accountant nominated by the Assessing Officer, if:

(a) having regard to the nature and complexity of the accounts of the assessee, and

(b) for the interest of the revenue,

he is of the opinion that it is necessary to do so. The Assessing Officer can issue such directions only with prior approval of the Chief Commissioner / Commissioner of Income tax [Section 142(2A)].

Direction of audit can be given even if the accounts are already audited under the Income-tax Act or under any other law [Section 142(2B)].

**Audit / expenses [Section 142(2D)] :** The remuneration and expenses of, and incidental to such audit shall be determined by the Chief Commissioner/Commissioner of Income-tax and shall be paid by the assessee and in the event of assessee's default in making payment, the amount payable shall be recovered from the assessee in the manner provided for collection and recovery to tax.

1. The direction to get accounts audited can be issued only in the course of assessment procedings and not after the completion of assessment. Further the assessment also includes assessment.
2. No appeal is possible against the orders under section 142(2A) for audit of accounts.

IV. **Opportunity of being heard [Section 142(3)] :** The Assessing Officer shall give an opportunity to the assessee of being heard in respect of any information gathered by the Assessing Officer on the basis of the aforesaid inquiry under section 142(2) or on the basis of the audit conducted as per section 142(2A) above, where the Assessing Officer proposes to utilise such information for the purpose of any assessment. However, no such opportunity is necessary when the assessment is made under section 144.

**Time limit for completion of all assessments and reassessments [Section 153]**

Section 153 prescribes time limit for completion of various assessments and reassessments, which is as follows:

| | Time limit for completion |
|---|---|
| 1. Assessment u/s 143/144 | 2 years from the end of relevant assessment year in which the income was first assessable [Section 153(1)] |
| 2. Assessment/re-assessment u/s 147 | 1 year from the end of the Financial Year in which the notice u/s 148 was served on the assessee. [Section 153(2)] |
| 3. Fresh assessment where original assessment has been set aside or cancelled by Appellate Authority u/s 250, or by CIT u/s 263 or 264 | 1 year from the end of the Financial Year in which such order of set aside or cancelling the order passed by the appellate authority u/s 250 or 254, was 254 received by the CIT/or order u/s 263 or 264 was passed by the CIT, as the case may be. [Section 153(2A)].<br>W.e.f. 1-6-2001, the Commissioner (Appeals) cannot cancel/set aside the assessment and refer back to the Assessing Officer for fresh assessment. However, it can |

be set aside by ITAT or Commissioner under section 263 or 264.

The order of assessment or reassessment should be made (i.e., passed/signed) before the expiry of limitation period, although the order and demand notice under section 156 can be served even after the expiry of the period, but it should be prepared before the expiry.

1. If the assessment is canceled or set aside and a direction is given to make a fresh assessment, then the Assessing Officer shall make the fersh assessment under the asme section in which original assessment was made (i.e., under section 143(3)/144/147).
2. Further, for making fresh assessment in the above case, no notice under section 143(2)/144/148 is required to be issued. In the case notice on a plain paper shall suffice.
3. Where an assessment is not set aside for fresh assessment but annulled, no extended limitation is available. However, if the original time limit is available, the Assessing Officer may proceed from the stage at which illegality which resulted into the annulment of the assessment supervened and make the assessment afresh. [CIT v Mrs. Ratanbai N. K. Dubhash (1998) 130 ITR 495 (Bom)].

No time limit of assessment/reassessment in certain cases [Section 153(3)]: Notwithstanding any things contained in section 153(1), there is no time limit or making the assessment/reassessment, etc. in the following cases:

(a) where the assessment/reassessment, etc. is made on the assessee or any person in consequence of, or to give effect to, any findings or directions contained in order under sections 250, 254, 262, 263 and 264 or order of a court under any other law, and

(b) where incase of a firm an assessment is made on a partner of the firm in consequence of an assessment made on the firm under section 147.

However, if in the above case, the order is set aside or cancelled, the period will be 1 year as given in point 3 above.

**What are the provisions regarding rectification of mistakes [Sec. 154]**

The provisions of Section 154 are given below—

**Which order can be rectified [Sec. 154(1)]**—To rectify any mistake apparent from record, an income-tax authority may amend the following orders—

a. an order passed under any provision of the Act;

b. an intimation or deemed intimation under section 143(1).

**If the above order is subject to an appeal [Sec. 154(1A)]**—If the above mentioned order has been subject matter of an appeal / revision then it cannot be amended by the Assessing Officer under section 154. However, the Assessing Officer can amend the order in respect of any matter other than the matter considered and decided in appeal/ revision. In other words, even if appeal has been prefered against an order, a mistake in that part of the order which was not subject matter of appeal and which was left untouched by the appellate authority, can be rectified under section 154(1) [Sec. 154(1A)].

**Meanings of "mistake"**—A mistake which can be rectified under section 154 is one which is patent, which is obvious and whose discovery is not dependent on argument or elaboration.

**Mistake which can be rectified**—The following are some of the examples of mistakes which can be rectified under this section : an error of law or fact, a clerical or arithmetical mistake, error in determining written down value, overlooking the obligatory provisions of the Legislature, and mistake arising as a result of subsequent retrospective amendment of law—Southern Industrial Corpn. Ltd. v. CIT [2002] 258 ITR 481 (Mad.).

Where the sums referred to section 43B had in fact been paid after the end of the previous year but on or before the due date of submission of return of income, but the evidence therefore had been omitted to be furnished along with the return, the Assessing Officers can entertain applications under section 154 for rectification of the intimation.

**Mistake which cannot be rectified**—Where the controversy can be resolved only by way of a complicated process of invstigation, recourse cannot be taken to section 154. If on a question of construction on a point of law, two views are possible, no rectification can be done by in voking section 154. A question on which there is difference of opinion among the two judges of High Court, cannot be rectified by invoking provisions of section 154.

**Who can point out the mistake to be rectified [Sec. 154(2)]**—The provisions of section 154(2) are given below—

- An income-tax authority can rectify the mistake apparent from records on its on.
- An income-tax authority can rectify the mistake apparent from record if it has been brought to his notice by the assessee.
- If there is mistake apparent from record in an order passed by the

Commissioner (Appeals), the Commissioner (Appeals) can rectify the mistake if it has been brought to his notice by the assessee or the Assessing Officer.

Successor Commissioner cannot refuse to entertain rectification application in respect of the order passed by this predecessor on the ground that, he being a succeeding Commissioner, cannot sit over the judgement of his predecessor and review his order under the guise of making rectification under section 154.

An order to rectify mistake can be made within the time-limit given below—

No amendment under section 154 can be made after the expiry of 4 years from the end of the financial year in which the order sought to be amended was passed. The point at which the period of limetation commences is 4 years form the date or order sought to be amended (and no the date of original order).

Where while allowing the appeal, the entire order of assessment dated February 20, 1980 was set aside and certain directions were given to the assessing authority to re-do the assessment and, thereafter, a fresh assessment came to be made on February 2, 1983, the period of limitation for rectification of the order is to be counted from February 2, 1983 and not from the date of assessment order which was set aside.

When order can be passed after the time limit—The authorities making rectification are, however, authorised by the Board to dispose of an application even after the expiry of time-limit if a valid application had been filed by the assessee within the statutory time limit but was not disposed of by the concerned authority within the aforesaid time limit.

## 6.4 Appeals & Revision

There are two alternatives open to an aggrieved assessee who is not satisfied with the order of the Assessing Officer, namely

(i) Appeal : First appeal against the order of the A.O. shall in any case, lies with the Commissioner (Appeals) or

(ii) Revision : Alternatively, if the appeal is not preferred, or if it could not be filed within the time limit allowed, the assesse can apply under section 264 to the CIT for revision of the order of the A.O. This is known as revision in favour of the assessee. The CIT can also take up suo motu the case for revision u/s 264.

In some cases the CTI can also take up the case for revision u/s 263. This is known as revision of the order of the A.O. which is erroneous and prejudicial to the interest of the revenue.

Remedy available against the order of the Commissioner (Appeals)/Revision Orders:

The assessee can file an appeal against the orders of the Commissioner (Appeals) or the revision orders of the CIT in the following cases:

(a) Second appeal: If the assessee is not satisfied with the order passed by the Commissioner (Appeals), he can appeal against that order to the Appellate Tribunal. Similarly, the CIT may also direct the Assessing Officer to file an appeal against that order with the Appellate Tribunal if the Revenue is not satisfied with the order of the Commissioner (Appeals).

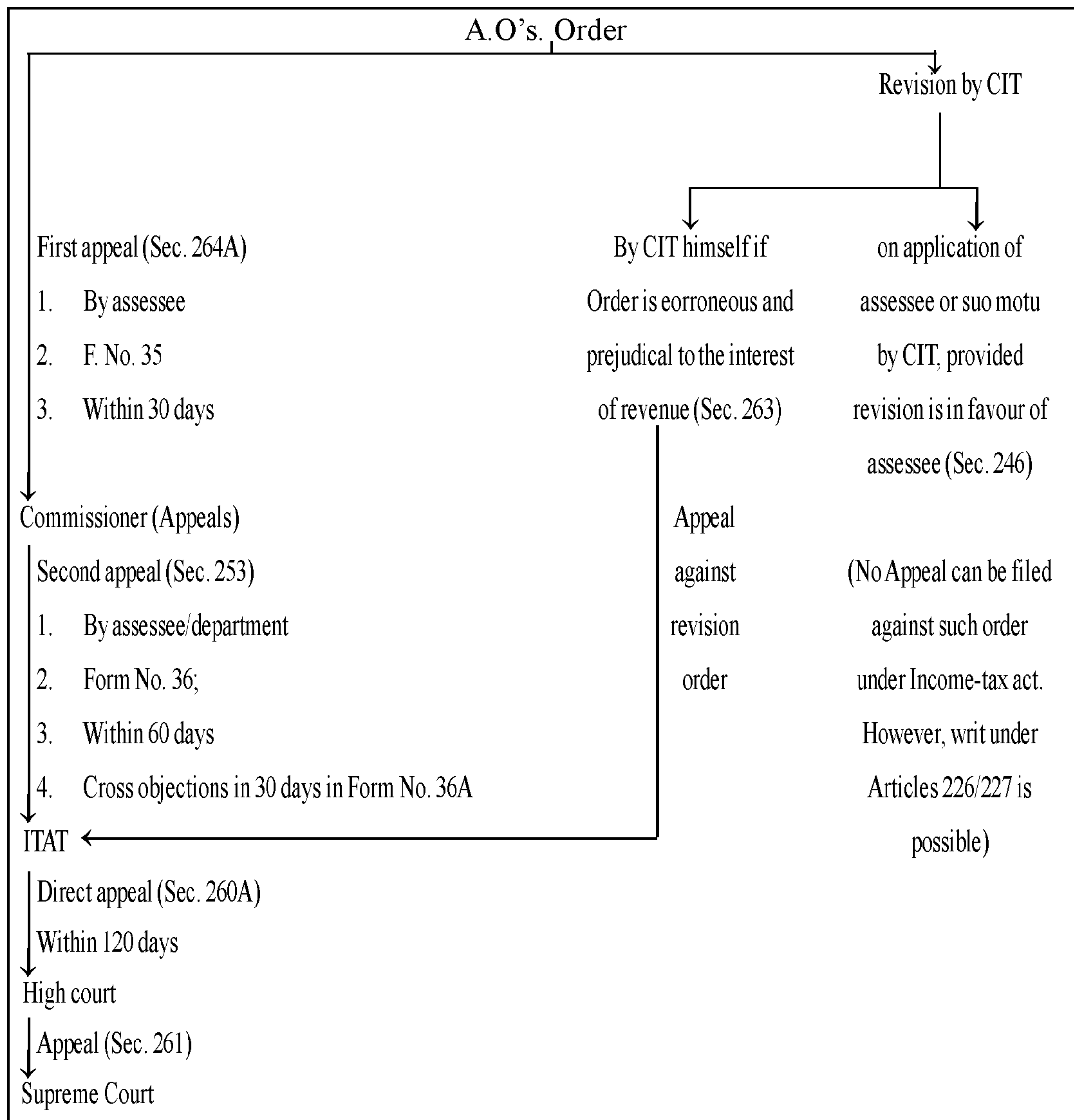
(b) Appeal against revision: If the revision of the order of the A.O. is done u/s 264, by the CIT which is revision in favour of the assessee, no appeal can be filed against this order under the Income-tax Act. However, writ under article 226/227 is possible. On the other hand, if the revision order is passed u/s 263, by the CIT which is known as revision of orders prejudicial to the interest of revenue, the assessee can file an appeal with the Appellate Tribunal.

Remedy against the orders of Appellate Tribunal.

If the assessee or the CIT is not satisfied with the order of the Appellate Tribunal, the appeal lies to the High Court, if the High Court is satisfied that the case involves a substantial question of law.

Appeal against order of the High Court to Supreme Court.

If the assessee or the CIT is not satisfied with order passed by the High Court, they may file an appeal against the order of the High Court to the Supreme Court, provided it is treated as a fit case by the High Court. The Supreme Court is the final appellate authority.




## 6.5 First Appeal

The first appeal against the order of Assessing Officer shall lie to the Commissioner (Appeals).

**Appealable orders before Commissioner (Appeals) [Section 246A] :** Any assessee agrieved by any of the following orders, may appeal to the Commissioner (Appeals) against—

(a) an order against the assessee, where the assessee denies his liability to be assessed under this Act; or

(b) any order of assessment under section 143(3) or 144, where the assessee objects:

   (i) to the income assessed,

   (ii) to the amount of tax determined, or

   (iii) to the amount of loss computed, or

   (iv) to the status under he is assessed;

(c) an order of assessment, reassessment or re-computation under section 143 or section 150;

(d) an order of assessment or reassessment under section 153A consequent upon any search conducted or books of account requisitioned (w.e.f. 1-6-2003);

(e) an order of rectification made under section 154 or order under section 155 having the effect of:

   (i) enhancing the assessment, or

   (ii) reducing a refund, or

   (iii) order refusing to allow the claim made by the assessee under either of these sections;

(f) an order u/s 163 treating the assessee as the agent of a non-resident;

(g) an order under section 170(2) or (3) relating to assessment on successor when the predecessor cannot be found of recovery of tax of the predecessor from the successor in case of succession to business otherwise than on death;

(h) an order u/s 171 refusing to recognize partition of a HUF;

(i) an order u/s 201 trating the assessee deemed to be assessee in default for failure to deduct the whole or any part of the tax or pay tax after deduction;

(j) an order u/s 237 relating rounds;

(k) an order imposing penalty under sections 221, 271, 271A, 271B, 271F, 272AA and 272BB;

(l) an order made by Joint Commissioner imposing a penalty under sections 271C, 271D, 271E and 272AA;

(m) an order of Joint Commissioner/Joint Director imposing a penalty under section 272A;

(n) an order imposing a penelty under chapter XXI i.e., under sections 270 to 275;

(o) an order of assessment made by an Assessing Officer under clause (c) of section 158BC i.e., Block Assessment, in respect of search initiated under section 132 or books of account, other documents or any asset requisitioned under section 132A, on or after 1-1-1997;

(p) an order imposing a penelty under section 158BFA(2) for concealment of income in case of Block assessment;

(q) an order made by an Assessing Officer other than a Joint Commissioner under the provisions of this Act in the case of such person or class of persons, as the Board may, having regard to the nature of the cases, the complexities involved and other relevant considerations direct.

**Appeal by person denying liability to deduct tax [Section 248] :** Any person having in accordance with the provisions of sections 195 and 200 deducted and paid tax in respect of any sum chargeable under this Act, other than interest, who denies his liability to make such deduction, may appeal to the Commissioner (Appeals) to be declared not liable to make such deduction.

**Procedure for filing appeal; Section 249 and Rules 45 and 46]**

**Form of appeal :** The appeal is to be filed in Form No. 35, verified in the prescribed manner.

**Signing of appeal :** Form No. 35, grounds of appeal and the form of verification appended thereto shall be signed and verified by the person who is authorised to sign the Return of Income under section 140.

**Time limit for filing appeal [Section 249(2)] :** The appeal should be filed within a period of 30 days of—

(a) the date of service of notice of demand relating to assessment or penalty if the appeal relates to assessment or penalty; or

(b) the date of payment of tax, if it relates to any tax deducted under section 195(1) in respect of payment to non-resident in certain cases; or

(c) the date on which intimation of the order sought to be appealed against is served if is related to any other cases.

**Exclusion of time for calculating time limit for filing appeal [Section 268] :** For this purpose, the date on which the order complained of is served is to be excluded. Further, if the assessee was not furnished with a copy of the order when the notice of the order (say notice of demand) was served upon him then the time required for obtaining a copy of the order should be excluded, i.e., period taken for obtaining the order shall be added to the time limit of 30 days.

**Condonation of delay in filing appeal [Section 249(3)] :** The Commissioner (Appeals) may admit an appeal after the expiration of the prescribed period, if he is satisfied that the appellant had sufficient cause for not presenting it within that period. If the Commissioner (Appeals) refuses to admit appeal after the prescribed period, the assessee has a right to file an appeal against such order.

**Procedure in hearing appeal [Section 250] :** (i) The Commissioner (Appeals) shall fix a day and place for the hearing of the appeal and shall give notice of the same to the appellant and to the Assessing Officer against whose order the appeal is preferred.

(i) The following persons shall have a right of being heard at the hearing of the appeal:—

 (a) the appellant, either in person or through authorised representative;

 (b) the assessing Officer, either in person or through a reprsentative.

(ii) The appellate authority shall have the power to adjourn the hearing of the appeal from time to time.

(iii) The appellate authority may, before disposing off any appeal, make such further inquiry as he thinks fit and may direct the Assessing Officer to do so and report the same.

(iv) The appellate authority may, at the hearing of the appeal, allow the appellant to go in to any ground of appeal not specified in the grounds of appeal, if he is satisfied that omission of such ground of appeal was not wilful or unreasonable.

(v) The order of the appellate authority disposing off the appeal shall be in writing and shall state the points for determination, the decision thereon and the reason for the decision.

(vi) The order passed by the Commissioner (Appeals) shall be communicated to the assessee and to the Chief Commissioner / Commissioner.

**Powers of the Commissioner (Appeals) [Section 251] :** In disposing off an appeal, the Commissioner (Appeals) shall have the following powers:

(a) in an appeal against an order of assessment, he may confirm, reduce, enhance or annul the assessment; or

(b) in an appeal against an order imposing a penalty—he may confirm or cancel such order or vary it so as either to enhance or to reduce the penalty;

(c) in any other cse—he may psass such orders in the appeal as he thinks fit.

The Commissioner (Appeals) shall not enhance an assessment or a penalty or reduce the amount of refund unless the appellant has had a reasonable opportunity of showing cause against such enhancement or reduction.

**Appellate Tribunal [Section 252]**

The Central Government shall constitute an Appellate Tribunal consisting of as many judicial and accountant members as it thinks fit to exercise the powers and discharge the functions conferred on the Appellate Tribunal by this Act.

A judicial members shall be a person who has for atleast ten years held a judicial office in the territory of India or who has been a member of the Indian Legal Service and has held a post in Grade II of that service or any equivalent or higher post for at least three years or who has been an advocate for atleast ten years. However, in certain cases, his past experience may also be considered for computing the period of 3 years\10 years.

An accountant member shall be a person who had for at least ten years been in the practice of accountancy as a chartered accountant under the Chartered Accountants Act, 1949, or as a registered accountant under any law formerly in force or partly as a registered accountant and partly as a chartered accountant, or who has been a member of the Indian Income-tax Service, Grup A, and has held the post of Additional Commissioner of Income-tax or any equivalent or higher post for atleast three years.

The Central Government shall ordinarily appoint a judicial member of the Appellate Tribunal to be the President there of.

The Central Government may appoint one or more members of the Appellate Tribunal to be the Vice-President or, as the case may be, Vice-Presidents thereof and may also appoint one of the Vice-Presidents of the Appellate Tribunals to be the Senior Vice-President thereof.

The senior Vice-President or a Vice-President shall exercise such of the powers and perform such of the functions of the President as may be delegated to him by the President by general or special order in writing.

The Central Government shall appoint Vice-President or one of the Vice-Presidents of the Tribunal to be the President of the Tribunal.

**Appeals to Appellate Tribunal [Section 253(1) & (2)]**

(A) As per section 253(1), any assessee may file an appeal before the Appellate Tribunal against the following orders:

(a) An order passed by Commissioner (Appeals):

(i) under section 250 i.e., order passed on the appeal filed before him.

(ii) Imposing penalty under sections 271, 271A, and 272A.

(iii) Under section 154 regarding regarding rectification of mistakes in an order passed under section 250 or in an order imposing penalty under the above sections, if the rectification has not been done/satisfactorily done by him.

(b) an order passed by a Commissioner:

(i) under section 12AA relating to registration of a trust or institution;

(ii) under section 263 relating to revision of erroneous order passed by Assessing Officer;

or

(iii) imposing penalty under section 271 or section 272A;

(iv) under section 154 amending his order u/s 263 or order of penalty.

(c) order passed by a Chief Commissioner, Director General or Director u/s 272A imposing penalty.

(B) The Commissioner may also, if he objects to any order passed by the Commissioner (Appeals) u/s 154/250, direct the Assessing Officer to appeal to the AppellateTribunal against the order [Section 253(2)].

**Procedure for appeal to Appellate Tribunal [Section 253(3), (4), (5) and (6)]**

- Time limit for filing appeal; the appeal to the Appellate Tribunal shall be filed within 60 days of the date on which the order sought to be appealed against, is communicated to the assessee or to the CIT, as the case may be. [Section 253(3)]

- Filling of cross objections and time limit: The Assessing Officer or the assessee, as the case may be, on receipt of notice that an appeal against the order of Commissioner (Appeals) has been filed by the other party, may notwithstanding that he has not appealed against such order or any part

thereof, file a memorandum of cross objections shall be in form No. 36A and shall be disposed of by the Appellate Tribunal as if it were any appeal before it. The memorandum of cross objections has to be filed within 30 days of the receipt of above said notice. No fee is payable in case of memorandum of cross objections. [Section 253(4)]

- Condonation of delay of time limit: The Appellate Tribunal may admit an appeal or permit the filing of a memorandum of cross objections after the expiry of 60/30 days, if it is satisfied that there was sufficient cause for not persenting it within the specified period. [Section 253(5)].
- Prescribed forms and documents to accompany: The appeal to the Appellate Tribunal shall be in Form No. 36 and memorandum of cross objections in Form No. 36A.
- Signing of appeal: Form No. 36, grounds of appeal at the verification should be signed by the person authorised to sign the return of income under section 140.
- Fee for filing appeal: An appeal to the Appellate Tribunal shall be accompanied by a fee.

**Remedy against the order of Appellate Tribunal**

**Direct Appeal to High Court [Section 260A] :** An appeal shall lie to the High Court of every order passed in appeal by the Appellate Tribunal on or after 1-10-1998, if the High Court is satisfied that the case involves a substantial question of law.

Procedure for filing appeal : (1) The Chief Commissioner/Commissioner or assessee aggrieved by any order passed by the Appellate Tribunal may file an appeal to the High Court.

(2) The appeal should be filed within 120 days from the date on which the order appealed against received by the assessee or the Chief Commissioner/ Commissioner.

(3) It should be accompanied by such fee as may be specified in the relevant law relating to Court fees for filing appeals to the High Court.

(4) It should be in the form of a memorandum of appeal precisely stating therein the substantial questions of law involved.

## 6.6 Appeal to the Supreme Court [Section 261]

The assessee or the commissioner may prefer an appeal to the Supreme Court for any judgement of the High Court in an appeal made to it under section 260A. However, the appeal can lie to Supreme court only if the High Court certifies the case to be a fit case for appeal to the Supreme court. Thus, this certificate of fitness is a must for preferring an appeal to the Supreme court. If, however, the High court decides not to give such a certificate, then an aggrieved party may make an application to the Supreme Court under Article 136 of the Constitution of Special Leave to Appeal against the decision of the judgement.

Time limit for passing the revision order under section 263: The Commissioner cannot revise the order of the Assessing Officer after the expiry of 2 years from the end of the financial year in which the order sought to be revised was passed. In computing the period of limitation of 2 years, the following period shall be excluded:

(1) the time taken in giving an opportunity to the assessee to be reheard under the provision to section 129 and

(2) any period during which any proceeding under this section is stayed by an order or injunction of any court.

No time limit in the following cases: As order of revision may be passed at any time in the case of an order which has been passed in consequence of, or to give effect to, any finding or direction contained in an order of the Appellate Tribunal, the High Court or the Supreme Court under the income-tax Act or order of Court under any other law.

Commissioner's power of revision extends to matters not covered in appeal [Clause (c) of Explanation to section 263]: Where an order passed by the Assessing Officer has been subject matter of any appeal, it cannot be revised by the Commissioner. However, in respect of such matters which have not been considered and decided in appeal, the Commissioner has powers under section 263 for revision.

**Revision of orders in favour of assessee [Section 264] :** Revision of orders not covered by Section 263, can be made by the Commissioner either on his own motion or on an application made by the assessee, provided orders have been passed by an authority subordinate to him. The application made by the assessee shall be accompanied by a fee of Rs. 500 (Rs. 25, upto 31-5-2001). The Commissioner call for the record of any proceeding under this Act on the basis of which such order has been passed and may make such inquiry or cause such inquiry to be made. He may pass such orders thereon

as he thinks fit as are not prejudicial to the assessee. The Commissioner, under this section can cancel the assessment and direct the Assessing Officer to make a fresh assessment but such direction shall not be prejudicial to the assessee.

The Commissioner shall not revise any order under the section in the following cases :

(a) where the order has been made more than one year previously, the Commissioner shall not, on his own motion, revise such an order; or

(b) where the application for revision by the assessee has been made after one year from the date on which the order in question was communicated to him or the date on which he otherwise came to know of it, whichever is earlier. However if the Commissioner is satisfied that the assessee was prevented by sufficient cause from making the application within the prescribed period he may admit an application made after the expiry of that period.

(c) Where an appeal against the order lies to the Commissioner (Appeals) but it has not been made and the time within which such appeal may be made has not expired; and the assessee has not waived his right of appeal; or

(d) Where the order has been made the subject of an appeal to the Commissioner (Appeals) i.e., where an appeal has been filed to CIT (Appeal) on any issue relating to such order.

Time limit for passing the revision order under section 264 : On application made by the assessee under this section on or after 1-10-1998, the Commissioner shall pass an order within one year from the end of the financial year in which the application is made by the assessee. In computing the period of limitation of one year, the following period shall be excluded:

(1) the time taken in giving an opportunity to the assessee to be re-heard under the provision to section 129 and

(2) any period during which any proceeding under this section is stayed by an order or injunction of any court.

No time limit in the following case: However, an order of revision may be passed at any time in consequence of or to give effect to any finding or direction contained in an order of the Appellate Tribunal, High court or the supreme Court.

## 6.7 Questions

1. Who are required under statutory obligations to file return of income under sections 139(1), (4A), (4B), (4C)?
2. What are the transactions where PAN or GIR Numbers are to be quoted in the documents related to such transactions?
3. What are the provisions of the Income-tax Act regarding Tax Audit u/s 142(2A to 2D)?
4. What are the time limits for completion of all assessments and reassessments u/s 153?
5. What do you understand by 'Mistake' which can be rectified u/s 154?
6. What is the remedy open to an aggrieved assessee against the order of the Commissioner (Appeals / Revision)?
7. Summarise the procedure of redressal of grievances with the help of a chart.
8. What are the appealable orders before the Commissioner (Appeals) u/s 246(a)?
9. What is the time-limit for filing appeal as laid down u/s 249(2)?
10. State the procedure for appeal to the Appellate Tribunal u/s 253 (3-6). When can the Commissioner revise the orders u/ss 263 & 264?
11. What are the timt limits for passing revision orders u/s 263 and 264?

## 6.8 References

1. Direct Taxes Law & Practice—V. K. Singhania & K. Singhania.
2. Corporate Tax Planning & Management-Ahuja & Gupta
3. Corporate Tax Planning & Management—E. A. Srinivas
4. How to Handle Income Tax problems—Jain & Loylka.

Term End Examination — 2006

# M. Com.

## Corporate Tax Planning and Management

### Paper - XVI

Time : Two Hours | Full Marks : 50

Answer *one* question from each group.

### Group A

1. (a) Distinguish between "Tax evasion" and "Tax avoidance." "It is said that distinction between Tax Planning and Tax Avoidance is very thin and delicate"— Discuss. 10

   (b) Write a note on 'Tax management'. 5

2. P Ltd. wants to expand its capital by Rs. 15,00,000. This additional fund can be raised in any of he following alternatives—

   (i) entirely by equity shares.

   (ii) Rs. 12,00,000 by equity shares and Rs. 3,00,000 by 12% debt.

   (iii) Rs. 3,00,000 by equity shares and Rs. 12,00,000 by 12% debt.

   If expects profit before interest and tax is 30% on capital employed,

   (a) Show the amount of cash outflow on account of tax in each of the above alternatives. 10

   (b) State, which of the above alternatives would you select and why? 5

### Group B

3. MNC Ltd. is going to launch a long term project for which purchase of plant and machinery is required to be done. The fund available will not allow to purchase all of them new. So some of them are bound to be secondhand.

   The plant and machinery to by purchased are—

   Packing machine, Road transport vehicle, Bottle filling machine and Office appliance. The management of the company wants to make the choice between new and secondhand purchase in such a manner as would enable it to take maximum advantage of tax provisions.

   As a tax expert what will be your suggestion in this regard so as to minimise tax liability? 10

4. What is dividend according to 2(22) of the Income Tax Act ? 10

## Group C

5. What are the tax considerations to be taken into account while arriving at the decision relating to repair/renewal or replacement of an asset. 15

6. Kanpur Plastipack Ltd. is in an urgent need for a machinery costing Rs. 3,00,000. Two alternatives are available to the company—

   Alternative 1 : Buying the asset with loan of Rs. 3,00,000 from a bank, repayable in five equal instalments of Rs. 60,000 plus interest @ 12% p.a.

   Alternative 2 : Acquire it under a lease agreement as below :

   (a) annual lease rental Rs. 80,000, for five years.

   (b) Processing fees 1% in the first year.

   Instalments, interest, lease rentals & processing fees are payable at the year end. Internal rate of return 10%. Suggest which alternative is better. 15

## Group D

7. K. Ltd. requires 30,000 units of component-P every year for manufacturing T.V. sets. These components can either be manufactured by the company in its factory or be purchased from the market. In case of manufacturing operation, the company will have to buy a new machine costing Rs. 2,00,000 with a life of ten years. Depreciation on such machine is 25%. Other manufacturing expenses are—

   (i) material : 30,000 kgs @ Rs. 3 per kg.

   (ii) labour : 45,000 hours @ Re. 0.20 per hour.

   (iii) technical supervisor's salary : Rs. 24,000 p.a.

   (iv) other variable overheads : Re. 0.80 per unit.

   Annual requirement of component-P is 25,000 units.
   Will it be profitable to make or to buy the component-P, if such components are available in the market at Rs. 3.90 per unit ? 10

8. (a) Who are required to file return of income under sections 139(1), (4A), (4B), (4C) ? 7

   (b) When mistakes can be rectified under section 154 of the Income Tax Act ? 3

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Term End Examination — December, 2007

# M. Com.

Corporate Tax Planning and Management

Paper - XVI

*Time : 2 Hours* *Full Marks : 50*

*(Weightage of marks—80%)*

Answer **one** question from **each group**.

## Group A

1. The objectives of tax planning cannot be regarded as offending any concept of taxation laws. 10

   (a) Give definition of the term 'Tax planning'.

   (b) Discuss the prime objectives of tax planning. 5 + 10

2. Q Ltd., a domestic company, went to liquidation on 1.1.2005. On that date Q Ltd. had the follwing balances—Share Capital Rs. 8,00,000 (including capitalized reserve Rs. 1,00,000), General Reserve Rs. 4,00,000. The company (Q. Ltd.) distributed investments amounting to Rs. 7,00,000 (market value Rs. 6,00,000) among its shareholders.

   R Ltd. holding 10% equity shares in X Ltd. (acquired on 1.4.2004 for Rs. 50,000) received investments of the market value of Rs. 60,000.

   State the tax implication of the distribution :

   (a) for Q Ltd.

   (b) for R Ltd. $7\frac{1}{2} + 7\frac{1}{2}$

## Group B

3. Tax consideration in respect of employees' remuneration is an essential aspect of corporate management—Discuss. 10

4. Your client Priya Ltd. acquired a plant for in-house research a few years back. The plant so no longer required for research purpose but can be used in its business proper.

   It has two options before it—

   Option I : To sell the asset immediately

   Option II : To use it in the business proper and then to sell off in the same year.

   You are requested to advise the company as to which option will usefull in more tax saving. 10

## Group C

5. Of the various considerations to be taken for setting up a new business, income tax is by for the most important one—Discuss, giving reasons, the implications of the statement. 15

6. (a) Bad Luck Ltd. an indian company, went to liquidation on 1.1.2005.

   On that date the company had

   (i) Equity Share Capital Rs. 10,00,000

   (ii) Accumulated profit Rs. 5,00,000

   (iii) Investments in shares of Dunlop India Ltd (held for 10 months) costing Rs. 3,00,000 (market value Rs. 9,00,000).

   The liquidator of the company wants to choose out of the following two alternatives:

   Alternative I : Distribute the investments among the equity share holders

   Alternative II : Sell the investments and distribute the proceeds among the equity sharesholders.

   Your advice is solicited. 10

   (b) What do you understand by "Reorganisation" of an existing business to overcome sickness ? 5

## Group D

7. (a) What are the transactions where PAN are to be quoted in the document related to such transactions ? 5

   (b) What are the appealable order before commission (Appeals). 5

8. X Ltd. needs to acquire an asset costing Rs. 2,00,000. There are two-alternatives available to the company :

   Alternative I : Buying the asset by taking a loan of Rs. 2,00,000 repayable in five equal instalments of Rs. 40,000 each along with interest @ 14% p.a.

   Alternative II : Acquiring the asset under a lease agreement with lease rental Rs. 60,000 p.a. for five years. The lessor charges 1% as processing fees in the first year.

   Assume :

   (i) lease rentals, processing fees, interest as well as principal amounts are payable at the year end.

   (ii) Internal rate of return 10%. Suggest which alternative is better.

   Given : Present value factor at 10%

| Year : | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| P.V. Factor | .909 | .826 | .751 | .683 | .621 |

10

## Notes