DEPARTMENT OF COMMERCE

SECOND SEMESTER

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UNIT II

Tax Planning and Managerial Decisions

Introduction

In the present era of socio-economic growth, most of the world economies including India are very much eager to maximize tax revenue collection from the society to keep pace with the increasing demand of public fund for various public expenditure programmes. Tax mobilization is one of the most effective tools in the hands of the government of a nation. But the taxpayers are overburdened with the tax liability and they have to pay compulsorily a substantial part of their income in the form of tax payments to government. This compulsion in payment of tax without any direct benefit therefrom instigates the taxpayers to avoid tax payment. They try to undertake and identify the ways and means as to how they can save their income without payment of tax. But from the social view point, taxation is very much essential since it is a huge source of revenue for any government that helps to support to different public expenditure programmes.

The taxpayers take measures like tax evasion which is illegal and is a punishable offence. However, they can significantly reduce and cut their tax bills by adopting tax planning proposals which are legally permissible and which fall within the ambit of tax legislations. By taking various tax planning proposals in various management decision areas, they can effectively reduce their tax obligation in a successful and legal manner. The Indian Income Tax Act has several tax planning provisions which taxpayers can undertake to reduce their tax burden legally.

Tax Planning, Tax Avoidance and Tax Evasion - Basic concepts

The three terms tax planning, tax avoidance and tax evasion are very common in the parlance of taxation. It is necessary to have a proper conceptual understanding about them so that one can categorize different transactions into any of the three heads. The common point for these three is that they all aim at reducing the tax liability. But, the difference is the mechanism that is adopted to minimize the liability.

The principal methods adopted by the taxpayers to reduce the burden of tax liability may be grouped under any of the following three heads:

a) Tax evasion

b) Tax avoidance

c) Tax planning

The above exercises are discussed below:

a) Tax evasion- Tax evasion is an illegal activity to evade tax payment. It is an unlawful process by which a taxpayer attempts to reduce the burden of tax by resorting to false and dishonest means. When the taxpayer reduces his tax liability by deliberately suppressing income, inflating expenses, claiming for set-off of some bogus losses and so on and so forth, such an act of the taxpayer falls under the purview of tax evasion. It is unlawful and manipulative in nature where tax bill is reduced intentionally disregarding the tax laws. It is, therefore, an illegal attempt by taxpayers to reduce tax liability and is therefore a punishable offence. The punishment may be in terms of fines/penalties and can also lead to imprisonment depending on the case. Tax evasion denies the State and Centre its legitimate share of tax revenue.

Example:

- Disclosing the sales figure as Rs. 25 lacs when it is actually Rs. 40 lacs.
- Claiming depreciation on a car that is used for personal purpose.

b) Tax avoidance- Tax avoidance is considered to be an exercise undertaken by the taxpayer to reduce the burden of tax by taking advantages of the loopholes or lacuna in the laws of taxation. The taxpayer can adopt such exercises without breaking the laws of taxation though it vitiates the objectives of tax laws. Tax avoidance defeats the spirit of law and is manipulative in nature. The concept of tax avoidance can well be understood from the decision of Gujrat High Court in CIT vs. Sakarlal Bulabhai (1968) 69 ITR 186 as follows: 'Tax avoidance postulates that the assessee is in receipt of an amount which is really and in truth his income liable to tax but on which he avoids payment of tax by some artifice or device apparently showing the income as accruing to another person at the same time making it available for use and enjoyment by the assessee himself'. Such an act, though not illegal, goes against the basic intention of the legislation and is a crime against society. This act, though is legal, brings suspicion in the eyes of the law-makers and society as a whole as the intention of the transaction is questionable.

Example: A classic example of tax avoidance happened in 2007 when Vodafone acquired Hutchinson Essar by purchasing Hutchinson Essar Ltd.'s stake from Hutchinson's holding company. The smart move was that the indirect transaction took place far away in the Cayman Islands which is considered to be a tax haven. A tax haven is any location that has very lenient or even non-existent tax laws. Instantly, the Income Tax Department questioned the transaction and raised an issue over a claim of around Rs. 12,000 crores. However, the department lost the case and the government saw a loss of Rs. 20,000 cr. in lost taxes and fines. (Source: https://blog.tax2win.in/tax-saving-tax-avoidance-tax-evasion/)

c) Tax planning- It is a dignified and intelligent device adopted by the taxpayer to reduce his tax liability by availing various deductions, allowances, concessions, rebates, reliefs, etc. as provided by the Act. Tax planning is a systematic method of arranging one's economic and financial affairs with the basic objective to reduce the tax burden legally by complying with the tax laws in full. It is carried out within the framework of law by availing the deductions and exemptions permitted by law so as to minimize the tax obligation. Thus, arrangement of economic affairs by the taxpayer through the intelligent application of the tax laws without resorting to any colourable devices with a view to reduce the burden of tax comes under the purview of tax planning. This is legally permissible and it helps to motivate assesses to save tax by making payments or by contributing sums in designated areas by means of which the taxpayers enjoy induced savings for future. Adoption of such device obviously requires the expertise knowledge on tax laws by the tax planners.

Distinction between tax evasion and tax avoidance

Reduction of tax liability can be made mainly by adopting three exercises- tax planning, tax avoidance and tax evasion. Out of these three exercises, tax planning is considered to be the most dignified exercise and device since it goes on within the legal framework by availing several benefits and exemptions promulgated under the legislation. Tax avoidance, though not illegal, is a crime against society and tax evasion is purely illegal. Though tax avoidance is not considered illegal, it is considered as a highly immoral and unethical practice to deceit the basic intentions of the legislation. There are certain differences between tax evasion and tax avoidance although the line of demarcation is very thin and blurred. The distinction between 'tax evasion' and 'tax avoidance' has been discussed by Wanchoo Committee in their report as follows:

“The distinction between ‘evasion’ and ‘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 manoeuvers involving an element of deceit, misrepresentation of facts, falsification of accounts, including downright fraud. The first represents what is tax planning and the latter concept is tax evasion. However, between these two extremes, there lies a vast domain for selecting a variety of methods which, though technically satisfying the requirements of law, in fact circumvent it with a view to eliminate or reduce tax burden. It is these methods which constitute tax avoidance.”
Based on the decision of the Supreme Court in McDowell’s case, tax avoidance is considered as heinous as tax evasion and is a crime against society.

Objectives of Tax Planning

Tax planning is a significant tool to reduce burden of tax in a lawful manner since tax planning does not forgo the basic intentions of tax legislations. The objectives of tax planning may be highlighted as below:

(a) Reduction of tax liability: The basic objective of tax planning is to reduce tax liability by availing various deductions, exemptions, reliefs, rebates, etc. as per the Income Tax Act, 1961. Thus, the taxpayers can substantially reduce their tax bill by undertaking proper tax planning programmes so as to retain their hard-earned income by paying less tax to the government.

(b) Minimization of litigation: Most of the taxpayers want to pay less tax as far as possible while the tax authorities are keenly interested to increase tax mobilization from the public. This tug-of-war between the taxpayers and taxation authorities very often leads to litigation. However, by adopting a proper tax planning within the legal pursuit, a taxpayer can avoid tax litigation and can enjoy a hassle-free economic life.

(c) Productive investment: Tax planning offers unique opportunities to the taxpayers to make effective investments in one hand and enjoy tax benefits on the other hand. Thus, by making payments/contributions on various aspects of tax planning like deposit in provident fund, purchase of NSC etc., the taxpayers can afford to have reduction of tax bill and also make productive investments for future growth and prosperity.

(d) Healthy growth of economy: Tax planning acts as a multiplier of economic growth. It ensures effective earnings by means of making investments in several tax planning programmes. Thus, tax planning contributes towards economic growth of self and the economy.

(e) Economic stability: Productive as well as regular investments in various tax planning proposals provide economic stability to the taxpayers. In fact, tax planning acts as a guide to help secure economic stability of the nation and its people by even distribution of economic resources in the society.

Relevance of Tax Planning and Managerial Decisions

Tax planning is a vital factor to the taxpayers. The taxpayers are seen to become highly interested to adopt tax planning to save payment of tax or in other words to reduce the tax burden. Different taxpayers namely corporate bodies, firms, sole-proprietors, individuals etc. are allowed under the Income Tax Act to take several tax planning proposals to reduce burden of tax for which they can make planning for managerial decisions to enjoy deductions, exemptions, allowances and rebates etc. Corporate assesses can undertake tax planning programmes with reference to setting up a new business, taking financial management decision, specific managerial decisions etc. within the legal framework of tax laws so as to significantly reduce their tax bills.

It is the normal human propensity to avoid tax payment since it is a compulsory payment to the government out of their hard earned income without getting any direct benefit. So, they always try to evade tax which is an unlawful activity and is a punishable offence. However, the taxpayers can undertake tax planning in a safe and lawful manner to reduce their tax burden. The areas where tax planning can be resorted to include:

a) Tax planning for different categories of assesses / taxpayers and

b) Tax planning as to different sources of income.

Tax laws provide different tax incentives for different categories of assesses and for different sources of income. All exemptions, deductions, allowances, etc are not available to all categories of taxpayers. One may operate his or her business or organization under any one of several organizational structures. Each type of structure has certain advantages and disadvantages that should be considered. Tax considerations are available on the nature of activity as well as the type of ownership pattern. The following sub-points discuss about the aspect of tax planning with reference to different decisions.

Tax planning with reference to capital structure decisions

At the time of taking decision for the commencement of business relating to capital financing, management of business enterprises should undertake and duly consider various issues concerning the selection of capital structure. This decision is a very crucial one for management since there are various sources from which capital can be raised but each source has its specific cost, control and risk factors. The selection of an optimum capital structure is of great significance so far as the maximization of shareholders' return, cost and risk involvement are concerned. A judicious mix of different sources of finance is thus highly important to maximize shareholders' wealth and to minimize cost of finance. Between equity capital and debt capital, there are several merits and demerits. Dividend on share capital is not tax deductible while interest on debt capital is allowable as deduction u/s 36(1) in computing taxable income. Debt finance has tax advantages as the interest is deductible and as such raising finance through debt finance is beneficial to the equity shareholders but there are inherent risks (interest obligation and repayment) associated with this financing option. Over and above, dividend income is exempt in the hands of the shareholders and the company (domestic company) paying dividend is required to pay dividend distribution tax. A choice of a particular source of finance is, therefore, very much significant.

Problem-1: Vision India Ltd., a domestic company in India, wants to raise capital of Rs. 20,00,000 for financing a project. The project's earning before tax is estimated at 30% of capital employed. The company has three alternative financing proposals as stated below:

Proposal-I: To raise entire finance by issue of equity;

Proposal-II: To raise finance by means of equity capital of Rs. 16,00,000 and balance Rs. 4,00,000 by way of debt finance on which 12% interest is payable; and

Proposal-III: To raise finance by means of equity capital of Rs. 4,00,000 and debt finance of Rs. 16,00,000 at 12% interest.

Corporate tax rate is 30%. Surcharge and education cess are as applicable. Dividend distribution tax rate is 20.358% of dividend paid [inclusive of surcharge and education cess]. Advise the company as to the best financing proposal.

Solution: **(Fig. in Rs.)**

	PROPOSAL-I	PROPOSAL-II	PROPOSAL-III
EBIT [a]	6,00,000	6,00,000	6,00,000
Less: Interest on debt fund @12% [b]	Nil	48,000	1,92,000
PBT [c=a – b]	6,00,000	5,52,000	4,08,000
Less: Tax @ 30% + Edu. Cess [d= cx0.309] [Surcharge not applicable]	1,85,400	1,70,568	1,26,072
PAT [e = c - d]	4,14,600	3,81,432	2,81,928
Less: Dividend Distribution Tax [f= e x (20.358/120.358)	70,128	64,517	47,687
Amount paid as dividend [g = e – f]	3,44,472	3,16,915	2,34,241
Return on equity capital [h = (g/eq.cap) x 100]	17.22%	19.81%	58.56%

(Note: Dividend distribution tax is 20.358%)

From the above calculations, it is highlighted that the highest return on equity capital is 58.56% if financing Proposal-III is chosen. Hence, it is advised that Vision India Ltd. should accept Proposal-III for financing its project. However, if the return on capital employed varies significantly, the choice of financing proposal may vary significantly.

Tax planning with reference to specific managerial decisions

Tax planning is of great significance with regard to specific managerial decisions taken on various issues like “make or buy” decision, “own or lease”, “repair or replace” etc. and all these managerial decisions have tax implications which require due attention from tax savings point of view.

Tax planning with reference to purchase or acquisition of asset

Tax planning with reference to the purchase or acquisition of assets for business purposes is of great significance. Purchase of assets may be made out of own fund or borrowed fund from bank or financial institution or asset may be taken on lease basis. Each such proposal has some merits from the tax savings view point viz. tax savings due to interest payment, depreciation, lease rent etc. since these are charge against profits and as such these help to reduce tax burden.

Purchase/acquisition of assets out of Debt Fund vs. Own Fund

While taking managerial decision relating to the acquisition of business asset either out of own fund or debt fund, special considerations should be given on the aspects like interest payable on debt fund, depreciation chargeable etc. In case of buying an asset out of own fund, tax shield is available on depreciation chargeable on the asset purchased while in case of buying an asset out of debt fund, tax shield is available both on depreciation on asset and interest on debt fund. Thus, debt fund is considered to be the better option for buying an asset from the view point of tax shield or tax advantage. But there are problems on debt fund like its availability, specific interest obligation etc. which are not associated with buying an asset with own fund.

Problem-2: Emcee India Ltd. wants to acquire a new machine costing Rs. 2,00,000. The company has two alternative proposals-

I) to buy the machine out of debt fund, and

II) to acquire the machine out of own fund

For borrowing the machine, interest is payable @14% p.a. on yearly balances left. The borrowed fund is to be repaid by five equal annual instalments at the end of each year plus interest obligation as payable thereon. The machine is depreciable @15% p.a. under diminishing balance method. The scrap value of the machine at the end of its effective life of 5 years is Rs. 18,000. Assume that the market rate of return is 12 % and corporate tax rate is 33.99% including surcharge and education cess as applicable. The present value factors at 12% over the 5 year period are given below:

Yr. 1:: 0.893; Yr. 2 0.797; Yr. 3: 0.712; Yr. 4: 0.635 and Yr. 5: 0.567

Advise Emcee India Ltd. as to which proposal it should accept. (Assume rate of corporate tax to be 33.99%)

Note: However, note that for the assessment year 2019-2020, the rate of tax will be as follows: Basic rate on domestic companies – 25%. Surcharge depends on the turnover and the rate of cess is 4%. The solution below will help to understand the concept. Students are advised to solve it again using the rate applicable for the assessment year 2019-2020.

Solution: Computation of net cash flows after tax when the machine is bought out of borrowed fund (Proposal-I) **[Figures in Rs.]**

Year	Depreciation [other than addl. depreciation] (a)	Interest (b)	Total (c=a+b)	Tax savings (d=c*.3399)	Installment payment (e)	Net cash outflow after tax (f=b+e-d)	P.V. factor (g)	P.V. of net cash outflow after tax (h=f*g)
1	30000	28000	58000	19714	40000	48286	0.893	43119
2	25500	22400	47900	16281	40000	46119	0.797	36757
3	21675	16800	38475	13078	40000	43722	0.712	31130
4	18424	11200	29624	10069	40000	41131	0.635	26118
5	15660	5600	21260	7226	40000	38374	0.567	21758
							Total	158882

Present value of tax adjusted cash outflow	Rs. 1,58,882
Less: Present value of cash inflow by way of scrap value, i.e. Rs.(18,000x0.567)	Rs. 10,206
Present value of tax adjusted net cash outflow	Rs. 1,48,676

Computation of net cash flows after tax when the machine is bought out of own fund (Proposal-II) **[Figures in Rs.]**

Year	Depreciation[other than addl. depreciation] (a)	Tax savings (b=a*.3399)	P.V. factor (c)	P.V. of tax savings (d=b*c)
1	30000	10197	0.893	9106
2	25500	8667	0.797	6908
3	21675	7367	0.712	5245
4	18424	6262	0.635	3976
5	15660	5323	0.567	3018
				Total 28253

Amount of initial investment for buying the machine	Rs. 2,00,000
Less: Present value of tax savings	Rs. 28,253
	Rs. 1,71,747
Less: Present value of cash inflow by way of scrap value, i.e. Rs. (18,000x0.567)	Rs. 10,206

Present value of tax adjusted net cash outflow	**Rs. 1,61,541**

It is now observed that the present value of tax adjusted net cash outflow is less in case of buying the machine out of borrowed fund (Rs. 1,48,676) than buying the same out of own fund (Rs. 1,61,541). Hence, it is advised that Emcee India Ltd. should acquire the machine out of borrowed fund.

Purchase/acquisition of assets out of Own Fund vs. Lease Rent

In case of purchase/acquisition of an asset either out of own fund or on payment of lease rent, managerial decision should be taken giving emphasis on the amount of lease rent payable since it is a specific obligation to be satisfied. For buying out of own fund, depreciation on asset is available for tax shield purpose while in case of acquiring an asset on lease rental basis, lease rent is available for tax shield.

Problem-3: Intex India Ltd. wants to acquire a new machine costing Rs. 3,00,000. The company has two alternative proposals-

I) To acquire the machine out of own fund;

II) To acquire the machine lease rental basis.

The lease rental is Rs. 66,000 p.a. payable at the end of each year for 6 years. A lease processing fee of 2% on the cost of machine is payable at the time of signing the lease agreement. Depreciation is to be charged on the machine @14% p.a. under diminishing balance method. Assume that the market rate of return is 10 % and corporate tax rate is 33.99% including surcharge and education cess as applicable.

The present value factors at 10% over the 5 year period are given below:

Yr. 1: 0.909; Yr. 2: 0.826; Yr. 3: 0.751; Yr. 4: 0.683; Yr. 5: 0.621 and Yr. 6: 0.564

Which of the above two proposals should be accepted by Intex India Ltd. and why?

Solution: Computation of net cash flows after tax when the machine is bought out of own fund (Proposal-I) **[Figures in Rs.]**

Year	Depreciation[other	Tax savings	P.V. factor	P.V. of tax

	than addl. depreciation] (a)	(b=ax0.3399)	(c)	savings (d=bxc)
1	42000	14276	0.909	12,977
2	36120	12277	0.826	10,141
3	31063	10558	0.751	7,929
4	26714	9080	0.683	6,202
5	22974	7809	0.621	4,849
6	19758	6716	0.564	3,788
				Total 45,656

Amount of initial investment for buying the machine	Rs. 3,00,000
Less: Present value of tax savings	Rs. 45,656
Present value of tax adjusted net cash outflow	**Rs. 2,54,344**

Computation of net cash flows after tax when the machine is acquired on lease rental basis (Proposal-II) **[Figures in Rs.]**

Year	Lease processing fee/lease rent (a)	Tax savings (b=ax0.3399)	Lease rent net of tax (c=a-b)	P.V. factor (d)	P.V. of tax savings (e=cxd)
0	6,000	2,039	3,961	1.000	3,961
1	66,000	22,433	43,567	0.909	39,602
2	66,000	22,433	43,567	0.826	35,986
3	66,000	22,433	43,567	0.751	32,719
4	66,000	22,433	43,567	0.683	29,756
5	66,000	22,433	43,567	0.621	27,055
6	66,000	22,433	43,567	0.564	24,572
				Total	**Rs. 1,93,651**

From the above calculations, it appears that the present value of tax adjusted net cash outflow is less in case of taking the machine on lease basis (Rs. 1,93,651) than buying the same out of own fund (Rs. 2,54,344). Hence, it is advised that Intex India Ltd. should acquire the machine on lease rental basis.

Tax Planning with reference to setting up a new business

Setting up a new business has much significance under the Income Tax Act, 1961. For a new business, the spheres in which the question of tax planning is relevant may be discussed as below:

a) Location of business unit

b) Nature of the business

c) Forms of business organization etc.

Location of business

Location of business i.e. where a business unit is to be set up is of great significance from the tax planning concept. Under the Income Tax Act, 1961 there are various concessions available under the tax laws for specific location of businesses. Thus, tax concessions and tax holidays pay a prominent role in deciding the location of setting up new industrial undertakings. The object of giving such tax concessions and tax holidays is to eradicate and eliminate regional disparities by means of setting new industrial units in rural and backward areas. Sections 10AA, 80-IB, 80-IC, 80-ID, 80-IE etc. are provided under the Act to boost up balanced industrial growth in the country. The industrialists and business entities that will set up in new industrial units in rural and backward areas will enjoy tax concessions and tax holidays (tax holidays are meant for total exemption from tax payments for a specified period). Besides, the setting up of units in those areas will help magnify the scope of employment of local people, will help increase the use local resources otherwise left unutilized and as result of which local people will have the opportunity to earn their livelihood and ultimately the economy will be developed as well as the regional disparities will be curbed.

Forms of business organization

Form of business organization plays a crucial role from the tax planning point of view. The choice of an appropriate form of organization has to be made very carefully since any change in the form of business organization after the commencement of new business, would attract tax liabilities. A new business can be formed under any of the following forms:

a) Sole proprietorship

b) Hindu undivided family

c) Association of persons or Body of individuals

d) Partnership firm/ Limited Liability Partnership

e) Corporate body

f) Co-operative society

Depending upon the taxable status and level of tax liability of the new owners, a selection of a specific form of business should be made carefully.

Sole Proprietorship Concern

In the case of a sole proprietorship concern, the greatest disadvantage is that no allowance or relief is available to the sole proprietor taxpayer under the Act in computing his business income in respect of even a reasonable amount of remuneration attributable to the service rendered by him in connection with the carrying out of his business. As a result, the taxable income arrived at would be higher than what it would have been if it had been the case of, say, a private limited company in which the individual himself is the Managing Director. In such a case, the reasonable amount of remuneration to the Managing Director, is allowable as business expenditure under section 37(1) and accordingly, the taxable income from business would have been reduced to attract less of tax incidence. The taxable income from business would become also lower if the organization would become a partnership firm since under section 40(b) remuneration payable to partners is allowable as deduction in computing business income subject some restrictions specified in the said section.

Hindu Undivided Family (HUF)

HUF is a specific form of business organization found to operate in large numbers where the business is carried on by the members of the HUF. The law does not have any restrictions on the allowability of expenses of HUF in computing its income from business. Thus, it is advantageous to carry on a business through the HUF, wherever possible. The HUF is liable to pay tax on its income and any income thereafter distributed among the members is exempt from tax under section 10(2) of the Income Tax Act, 1961. To put it differently, the members of HUF would not be liable to tax in respect of receipt of any portion of HUF's income.

Partnership Firm/LLP

While computing taxable income of a firm, certain prescribed deductions in respect of interest and remuneration to partners are allowed under the Act in terms of section 40(b). The partnership firm is liable to pay tax on its total income at a flat rate of 30% plus education cess as applicable without any basic exemption. The share of income of a firm in the hands of its partners is fully exempt from tax under section 10(2A).

Association of Person (AOP)/Body of Individuals (BOI)

In computing the income from business of AOP/BOI, any salary, bonus, commission or remuneration paid to its members is not allowable as deduction. In the same way, any interest paid by AOP/BOI to its members on any loan, capital or borrowings is also not deductible. Total income of the AOP/BOI shall be taxable at the rates applicable to an individual, or at the maximum marginal rate or at a rate higher than the maximum marginal rate. The share of a member in the income of AOP/BOI is treated separately depending upon the mode of taxing the income of the AOP/BOI.

Company (Corporate Body)

The form of organization like a corporate body i.e. limited liability company is found to operate in a large number where substantial amount of capital from a large block of owners are usually required. The limited liability company may be of several types like a widely held company (i.e. a company in which public are substantially interested), a closely held company (being not a publicly held company), a domestic company (i.e. a company formed and incorporated in India and any other company which has made the prescribed arrangement for declaration and payment of dividends within India under section 194, a foreign company (not being a domestic company) etc. The domestic companies are liable to tax at a flat rate of 30% plus surcharge and education cess as applicable from time to time. Foreign companies are liable to tax at 40% (50% in case of fees, royalty etc. received from Government of India or from an Indian concern) plus surcharge and education cess as applicable. Domestic companies are to pay dividend distribution tax under section 115-O and as such any dividend received by a shareholder from a domestic company is fully exempt from tax under section 10(34).

Co-operative Society

The co-operative form of business is highly suitable from tax angle since in addition to the general benefits flowing from the co-operative form of society, all reasonable remuneration payable to the members of the society for their services rendered, including the commission, interest on deposits or loan payable to them. The co-operative society (other than a co-operative bank w.e.f. A.Y. 2007-08) also enjoys tax benefit/deduction under section 80P depending upon the nature of income and /or the amount of income.

Nature of the Business

Apart from the form of business organization, the choice of the nature of the business also calls for special tax planning so as to avail several special benefits which are not normally available to others. These benefits are of such nature that they deserve special consideration in determining the nature of business. Business for this purpose may be of two types - trading business and manufacturing business. A taxpayer carrying on manufacturing activity or industrial activities is entitled to enjoy several tax concessions like normal depreciation allowance, additional depreciation allowance under section 32, benefits of amortization under section 35ABB, 35D and 35E etc., tax holiday under section 80-IA, 80-IB, 80-IC etc.

Summary

The taxpayers have a reluctance to pay taxes as it is a compulsory payment which substantially reduces their disposable income for consumption purpose and since they do not see any physical benefit flowing directly to them. Moreover, when they see people around not paying the correct amount of taxes, people having disproportionate amount of wealth, find tax evasion as a rampant practice all around, they also fall in the same line. They try to find out the ways and means of avoiding tax payment from their hard earned income. But evading tax is illegal and is a punishable offence. Though, the practice of tax evasion is true, there are assesses who legally using correct means minimize taxes which is known as tax planning. It is a legally permissible process whereby taxpayers can enjoy various tax exemptions and deductions provided under the Income Tax Act to reduce their tax burden.

Tax planning can be practiced by all types of assesses. Considerations like tax shield on interest on debt finance, interest on loan, depreciation on assets, lease rent etc. are very helpful in taking various managerial decisions like capital structure decision (capital raising by means of issuing share capital to form owner’s fund or by issue of debentures to form of debt finance), decision on making purchase of business assets out of own fund or borrowed fund or for acquiring assets out of lease rental basis. Besides these, tax planning is also very significant in case of setting up of new business where issues like location of business, form of business units (sole-proprietorship, HUF, Partnership/LLP, Company etc.), nature of business etc. offer various tax concessions and tax holidays under the Income Tax Act, 1961.

Solve

(i) ABC Ltd. wants to acquire an asset costing Rs. 2,00,000. The company has two alternative proposals – i) to acquire the asset partly out of own fund and partly out of borrowed fund [ratio of own fund and debt fund is 40:60]; and ii) to acquire the asset on lease rental basis. Interest is payable on debt fund @ 14% p.a. on yearly balances left. The debt fund is repayable by equal annual instalment at the end of each year for six years. Depreciation is chargeable on the asset is 15% p.a. on diminishing balance method. For taking the asset on lease basis, a lease processing fee of 2% on the cost of asset is payable initially. Lease rent of Rs. 48,000 is payable at the beginning of each year for six years. Advise the company as to which alternative proposal it should accept.

[Hints: Net cash outflow after tax is lower in case of asset acquired on lease basis i.e. Rs. 1,27,502 than buying it partly out of own fund and partly out of debt fund i.e. Rs. 1,53,683.]

(ii) X Ltd. wants to acquire an asset costing Rs.1,20,000. The company has two competing proposals –

(a) to acquire the machine on lease rental basis, and

(b) to acquire the machine out of borrowed fund.

The lease rental is Rs. 40,000 p.a. payable at the end of each year for 5 years. A lease processing fee of Rs. 2,250 is payable initially. The loan amount (principal) is repayable by Rs. 24,000 at the end of each year for 5 years. Interest on loan is payable @ 12% p.a. on the yearly balances left. Depreciation is to be charged on the machine @16% p.a. under diminishing balance method. Assume that the market rate of return is 10% and corporate tax rate is 30.9%. The present value factors at 10% over the 5 year period are given below:

Yr. 1: 0.909; Yr. 2: 0.826; Yr. 3: 0.751; Yr. 4: 0.683 and Yr. 5: 0.621. Which one of the competing proposals X Ltd. should prefer?

[Hints: Tax adjusted net cash outflow is less in case of buying the asset out of borrowed fund (Rs. 90,962) than taking the same on lease rental basis (Rs. 1,01,556)].