MBA-DE(Second Year)
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CTP (418)

CORPORATE TAX PLANNING
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Lesson No. 1

BASIC FRAMEWORK OF TAXATION IN INDIA

STRUCTURE

1.0 OBJECTIVES

After the completion of this Lesson, you should be able to understand the following:

- the taxation structure in India
- the importance of taxes for the government and society
- legal frame work of tax laws and there operations
- types of taxes collected by the Government
- the scope of Income Tax and its Applicability

1.1 INTRODUCTION

Justice Holmes of US Supreme Court rightly said that 'tax' is the price which we pay for a Civilized Society. Taxes are conventionally broadly classified as Direct Taxes and Indirect Taxes. As the name suggests, 'direct taxes' are paid directly and "indirect taxes' are paid indirectly. The direct taxes are paid directly by the person concerned. In case of indirect taxes, one person pays them, but he recovers the same from another person. Thus, the person who actually bears the tax burden (the ultimate 'consumer[1]) pays it indirectly through some other person, who practically, merely acts as collecting agent. Of course, he is liable if he fails to pay the taxes.

Direct taxes are those which the tax payer pays directly from his income/ wealth/ estate etc., while indirect taxes are those which the tax payer pays indirectly i.e. while purchasing goods and commodities, paying for services etc. Broadly speaking, direct taxes are those which are paid after the income reaches hands of taxpayer; while indirect taxes are paid before the goods/services reach the tax payer. Important direct taxes are Income Tax, Gift Tax and Wealth Tax. Important indirect taxes are Central Excise (Duty on Manufacture), Customs (Duty on Imports and Exports); Sales Tax; Octroi, Entry Tax, Service Tax, Expenditure Tax etc.

Since Constitution of India is the foundation and source of powers to all laws in India, it is necessary to understand general background of Constitution to enable us to understand and appreciate each individual Law. In India, Constitution that came into effect on 26th January 1950 is supreme and all laws and Government actions are subordinate to our Constitution.

Constitution is supreme law - Clear understanding of concepts is vital for any discussion on taxation matters as power to levy and collect tax is derived from Constitution. If it is found that any Act, Rule, Notification or Government order is not according to the Constitution, it is illegal and void and it is called ultra vires the Constitution. In Vinay Chandra Mishra (1995) 2 SCC 584, it was held that statutory provisions cannot override constitutional provisions.

Various Laws can be passed (and amended) by Parliament within the framework prescribed by the Constitution.

1.2 MODE OP PASSING AN ACT

First, a bill is presented to Parliament. The bill is a draft of the proposed act to be passed. Often the bill is presented on the basis of recommendations of some Committee. Sometimes, the bill is studied by a Parliamentary Committee after presented to Parliament. The bill is discussed and it is then passed with or without amendments. After both Houses of Parliament pass it, it is sent to President for his assent. The bill becomes a Statute (Act) on the date on which President gives his assent.

The Act generally provides the date on which the Act comes into effect. Sometimes, it comes into effect immediately, while sometimes powers are delegated to government to decide the date on which the Act will come into force. Often, powers are given to bring the Act into force in parts,

i. e. various provisions of the Act can be brought into force in stages on different dates. Similar procedure is adopted to amend (modify) an existing Act.

1.3 EFFECTIVE DATE OF A NOTIFICATION

A notification has to be published in Official Gazette, which is then made available to public. In UOI v. Ganesh Das Bhojraj 116 ELT 431 - AIR 2000 SC 1102 * 2000(2) SCA1 E 17 - 2000 AIR SCW 764 (SC 3 member bench), it has been held that notification comes into operation from date of publication in Official Gazette. The gazette is official record evidencing public affairs. The Court is required to presume its contents as genuine u/s 35 & 38 of Evidence Act, unless contrary is proved. Thus, notification comes into effect on the day it is published in Official Gazette and no further publication is required.

There is gap between issue of a notification and its publication in Official Gazette. Supreme Court in some earlier judgments had held that a notification becomes effective only when it is published in Official Gazette and made available for sale. To overcome the difficulty that was created by this judgment, it has been provided that a notification will be effective on the date it is 'issued'. In order to ensure that public is aware of the change, it has been provided that the notification will be published and made available for sale by Director of Publicity & Public Relations, Central Excise 8s Customs, on the day the notification is 'issued' (section 5A(5) of CEA and section 102(4) of Customs Act]. (Now, mere publishing of notification in Official Gazette will be enough. It is not necessary for Government to prove that it was made available for sale].

Self Check Exercise

1. Which authority is responsible for administering corporate taxes in India?
2. Which tax is imposed on the distributed profits of a company in addition to the regular income tax?

1.4 TRADE CIRCULARS AND TRADE NOTICES

It is normal for Government to issue trade circulars, trade notices and clarifications from time to time. These are issued to clarify the views of the Government in respect of any Act, rules or notifications or to give some information, etc. Such trade circulars/trade notices do not have any legal force and they are not binding on taxpayers or quasi-judicial authorities. If such trade circular or trade notice is beyond the provisions of Act or Rules, such trade notice cannot be binding on government also, as there is no estoppels against a Statute. However, the department, which issued the trade notice, itself cannot take' a stand contrary to the trade notice, but they can withdraw the trade notice with prospective effect, if felt to be against law. The circulars/trade notices are not binding on asses see, quasi judicial authorities to courts.

1.5 BASIC SCHEME OF TAXATION UNDER INDIAN CONSTITUTION

In the basic scheme of taxation in India, it is envisaged that (a) Central Government will get tax revenue from Income Tax (except on Agricultural Income), Excise (except on alcoholic drinks) and Customs (b) State Government will get tax revenue from sales tax, excise on liquor and tax on Agricultural Income (c) Municipalities will get tax revenue from Octroi and house property tax.

Income Tax, Central Excise and Customs are administered by Central Government. As regards sales tax, Central Sales Tax is levied by Central Government while State Sales Tax is levied by individual State Governments. Though Central Sales Tax is levied by Central Government, it is administered by State Governments and tax collected in each State is retained by that State Government itself.

Article 246(1) of Constitution of India states that Parliament has exclusive powers to make laws with respect to any of matters enumerated in List I in the Seventh Schedule to Constitution. (Called "Union List) As per Article 246(3), State Government has exclusive powers to make laws for State with respect to any matter enumerated in List II of Seventh Schedule to Constitution. Seventh Schedule to Constitution (referred to in Article 246) indicates bifurcation of powers to make laws, between Union Government and State Governments. Parliament has exclusive powers to make laws in respect of matters given in list I of the Seventh Schedule of the Constitution (called 'Union List"). List II (State List) contains entries under jurisdiction of States. List III (concurrent list) contains entries where both Union and State Governments can exercise power. [In case of Union Territories, Union Government can make laws in respect of all the entries in all three lists.

Union List relevant to taxation - List I, called *Union List*, contains entries like Defence of India, Foreign affairs, War and Peace, Banking etc. Entries in this list relevant to taxation provisions are as follows:

Entry No. 82	Tax On Income Other Than Agricultural Income
Entry No. 83	Duties Of Customs Including Export Duties
Entry No. 84	Duties of Excise On Tobacco And Other Goods Manufactured Or • Produced In India Except Alcoholic Liquors For Human Consumption, Opium, Narcotic Drugs, Bur Including Medicinal And Toiler Preparations Containing Alcoholic Liquor, Opium Or Narcotics
Entry No. 85	Corporation Tax
Entry No. 92a	Taxes On The Sale Or Purchase Of Goods Other Than Newspapers

	Where Such Sale Or Purchase Takes Place In The Course Of Interstate Trade OR Commerce
Entry No. 92b	Taxes On Consignment Of Goods Where Such Consignment Takes Place During Interstate Trade Or Commerce
Entry No. 97	Any Other Matter Not Included In List II, List III, And Any Tax Note Mentioned In List II OR List III (These Are Called Residual Powers)

State list pertaining to taxation - State Government has exclusive powers to make laws in respect of matters in list II of Seventh Schedule to our Constitution. These entries include Police, Public Health, Agriculture, Land etc. Entries in this list relevant to taxation provisions are as follows:

Entry No. 46	Taxes On Agricultural Income
Entry No. 51	Excise Duty On Alcoholic Liquors, Opium And Narcotics
Entry No. 52	Tax On Entry Of Goods Into A Local Area For Consumption, Use Or Sale Therein (Usually Called Octroi)
Entry No. 54	Tax On Sale Or Purchase Of Goods Other Than Newspapers Except Tax On Interstate Sale Or Purchase

List III of Seventh Schedule, called “concurrent list*, includes matters where both Central Government and State Government can make laws. This list includes entries like Criminal Law and Procedure, Trust and Trustees, Civil procedures, economic and social planning, trade unions, charitable institutions, price control, factories, etc. In case of entries included in concurrent list, in case of conflict, law made by Union Government prevails. The only exception is that if law made by State contains any provision repugnant to earlier law made by Parliament, law made by State Government prevails, if it has received assent of President. Even in such cases, Parliament can make fresh law and amend, repeal or vary law made by State. [Article 254 of Constitution].

1.6 LIMITATIONS OF TAXATION POWERS

- Article 265 of the Constitution states that “no tax shall be levied or collected except by authority of law", and
- Article 300A of the Constitution states that “no person shall be deprived of its property save by authority of law".

The effect of these provisions is that any taxation which is found to be beyond the powers of Law is illegal and Government has no authority to levy that tax. If any amount is collected under a law which is found to be illegal, Government cannot retain such amount and must repay such illegally collected tax, Thus, whenever it has been found that Government, has collected tax without proper authority of law, Courts have held that the illegally collected taxes must be refunded, subject to provisions of “Unjust Enrichment’ in respect of Indirect Taxes.

Self-Check Exercise

3. Identify the tax imposed on companies for the development of specified industries and economic zones.
4. What is the name of the tax levied on the income earned by companies registered in India?
5. What is the tax levied on the production and sale of goods and services within a country?

India has a well-developed tax structure with a three-tier federal structure, comprising the Union Government, the State Governments and the Urban/Rural Local Bodies. The power to levy taxes and duties is distributed among the three tiers of Governments, in accordance with the provisions of the Indian Constitution, The main taxes/duties that the Union Government is empowered to levy are Income Tax (except tax on agricultural income, which the State Governments can levy), Customs duties, Central Excise and Sales Tax and Service Tax.

The principal taxes levied by the State Governments are Sales Tax (tax on intra-State sale of goods), Stamp Duty (duty on transfer of property), State Excise (duty on manufacture of alcohol), Land Revenue (levy on land used for agricultural/nonagricultural purposes), Duty on Entertainment and Tax on Professions & Callings. The Local Bodies are empowered to levy tax on properties (buildings, etc.), Octroi (tax on entry of goods for use/consumption within areas of the Local Bodies), Tax on Markets and Tax/User Charges for utilities like water supply, drainage, etc.

1.7 TAXATION STRUCTURE IN INDIA

Let's discuss about Taxation structure in India.

Taxation Structure in India

Direct Taxes	**Indirect Taxes**
Examples	Examples
1. Income Tax	1. Excise Duty
2. Wealth Tax	2. Customs Duty
	3. Sales Tax.

As the above taxation structure states there are two types of taxes Direct taxes and indirect taxes. Direct taxes are those taxes which is directly paid to the government and indirect taxes are those which are indirectly paid to the government, through some intermediaries like manufactures, wholesaler's, retailer's etc. Thus, broadly, there are two types of Taxes viz. Direct and Indirect taxes.

Direct Taxes: when a person is aware of the tax liability and pays the tax directly, it comes Under the purview of Direct taxes. The Income Tax, Wealth Tax and Corporate Tax are the classical example* of direct taxes in India.

Indirect taxes: When the taxes are paid indirectly, it comes under the purview of indirect taxes. The excise duty; customs duty and sales tax and service tax are the classic examples of indirect taxes. The Tax is levied on Total Income as per the tax rates of the Assessment Year.

The Tax is levied on the basis of the residential status and not on citizenship. Based on the residential status the assessee are classified into 1) Resident 2) Resident but not ordinary resident and 3) Non-resident. Hence, the incidence of tax and residential status are correlated.

The Central Board of Direct Taxes (CBDT) is the apex body. The objective of CBDT is collection and remittance of the Direct Taxes to the Government of India. Since 1991 tax system in India has under gone a radical change, in line with liberal economic policy and WTO commitments of the country.

Some of the changes are :

- Reduction in customs and excise duties
- Lowering corporate Tax
- Widening of the tax base and toning up the tax administration.

An understanding of the Income-tax law requires a study of the following:

a. The Income-tax Act, 1961 (amended up-to-date)
b. The Income-tax Rules, 1962 (amended up-to-date)
c. Circulars, clarifications issued from time to time by the CBDT
d. Judicial decisions

Let us discuss:

a. The Income-tax Act, 1961 (Amended up to date):

The provisions of income tax are contained in the Income-tax Act, 1961 which extends to the whole of India and (extended to state of Sikkim from 1.4.1990) became effective *from* 1- 4 - 1962 (Section 1).

The Income-tax Act contains provisions for determination of taxable income, determination of tax liability, procedure for assessment, appeals, penalties and prosecutions. It also lays down the powers and duties of various Income-tax authorities. Since the Income-tax Act, 1961 is a revenue law, there are bound to be amendments from time to time in this law. Therefore, the Income-tax Act has undergone innumerable changes from the time it was originally enacted. These amendments are generally brought in annually along with the Union Budget. Besides these amendments, whenever it is found necessary, the Government introduces amendments in the form of various Amendment Acts and Ordinances.

Annual amendments: Every year a Budget is presented before the Parliament by the Finance- Minister. One of the most important components of the Budget is the Finance Bill, which declares the financial proposals of the Central Government for the next financial year. The Bill contains various amendments, which are sought to be made in the areas of direct, and indirect taxes levied by the Central Government. The Finance Bill also mentions the rates of income tax and other taxes that are given in the First Schedule attached to such Finance Bill. The First Schedule gives the rates of income-tax in 4 parts:

Part-I : It gives the rates of income-tax for various assessees for the current assessment year e.g. the Finance Act, 2004 has given the rates of Income tax for the assessment year 2005-06.

Part-11: It gives the rates for deduction of tax at source from the income earned in the current financial year e.g. the Finance Act, 2004 has given the rates at which tax is to be deducted at source in the financial year 2004-05. Similarly, Finance Act, 2005 shall give the rates of TDS on the income earned during the financial year 2005-06.

Part-Ill: It gives the rates for calculating income-tax for deducting tax from income chargeable under the head 'Salaries'.

The same rates are applicable for computation of advance tax to be paid in the current financial year, e.g., Finance Act, 2004 has given the rates for the computation of advance tax for the assessment year 2005-06 and the Finance Act, 2005 shall give the rates of advance tax for assessment year 2006-07.

Part-IV: It gives the rules for computation of Net Agricultural Income.

Self Check Exercise

6. Which tax is levied by the central government on the income of individuals and companies in India?
7. What is the term for the tax imposed on the transfer of immovable property in India?

You should also note that

1. When the Finance Bill is approved by both the Houses of Parliament and receives the assent of the President, it becomes the Finance Act. The provisions of such Finance Act are thereafter incorporated in the Income-tax Act.
2. Besides the rates which are given in the Finance Act every year, there are certain incomes which are taxable at the special rates given in the Income- tax Act itself e.g. long term capital gain is taxable @ 10%/20% and income from lotteries, crossword puzzles, etc. are taxable @ 30%.

a. **Central Act for the charging of income-tax:** If on the first day of April in any assessment year, the Finance Act has not been enacted, the provisions of the previous Finance Act would continue to be effective. In case the Finance Bill is before the Parliament but has not yet been passed, then the rates at which the income is to be taxed shall be the rates prescribed in such Bill or the rates prescribed in the preceding Finance Act, whichever are more favorable to the assessee.

b. **Income-tax Rules 1962 (amended up to date):** Every Act normally gives power to an authority, responsible for implementation of the Act, to make rules for carrying out purposes of the Act. Section 295 of the Income-tax Act has given power to the Central Board of Direct Taxes to make such rules, subject to the control of Central Government, for the whole or any part of India. These rules are made applicable by notification in the Gazette of India. These rules were first made in 1962 and are known as Income-tax Rules, 1962. Since then, many new rules have been framed or existing rules have been amended from time to time and the same have been incorporated in the aforesaid rules.

c. **Circulars and Clarifications by CBDT:** The CBDT in exercise of the powers conferred on it under section 119 has been issuing certain circulars and clarifications from time to time, which have to be followed and applied by the Income-tax Authorities. However, these circulars are not binding on the assessee or the ITA T or on the Courts. But whenever there is any instruction that is in favour of the assessee, the Income-tax Authorities would not be permitted to go back on these instructions or circulars. Therefore, such circulars or clarifications are binding upon the Income- tax Authorities, but the same are not binding on the assessee, although the assessee can claim benefit under such circulars. (UCO Bank v CIT (1999) 237 ITR 889 (SC).

d. **Judicial Decisions:** Any decision given by the Supreme Court becomes a law which will be binding on all the Courts, Appellate Tribunals, the Income-tax Authorities as well as on all the assessees. Where there are apparently contradictory rulings by the Supreme Court, the decision of larger bench (whether earlier or later in point of time) should always prevail. However, where the apparently irreconcilable decisions are given by benches having equal number of judges, the principle of the later decision being applicable would be attracted.

Decisions given by a High Court, Income-tax Appellate Tribunal, etc. are binding on all the assessees as well as the Income-tax Authorities that fall under their jurisdiction, unless it is over-ruled by a higher authority. The decision of a High Court is binding on the Tribunal and the Income-tax Authorities situated in the area over which the High Court has jurisdiction.

1.8 SCHEME OF TAXATION

Assessee:

Income Tax Act 1961 (Act no. 43) defines 'assessee' as a person by whom any tax or any other sum of money is payable under this Act, and includes -

- Every person in respect of whom any proceeding under this Act has been taken for the assessment of his income or of the income of any other person in respect of which he is assessable, or of the loss sustained by him or by such other person, or the amount of refund due to him or to such other person;
- Every person who is deemed to be an assessee under any provision of this Act;
- Every person who is deemed to be an assessee in default under any provision of this Act;

Assessment Year:

Assessment year means the period of twelve months commencing on 1st April every year and ending on 31st March of the next year. Income of previous year of an assessee is taxed during the following assessment year at the rates prescribed by the relevant Finance Act.

Every person, whose total income of the previous year exceeds the maximum amount which is not chargeable to income tax, is an assessee and chargeable to income tax at the rate or rates prescribed in the Finance Act for the relevant assessment year. However, his total income shall be determined on the basis of his residential status in India.

1.9 SUMMARY

In India there arc two types of taxes Direct taxes and indirect taxes. Direct taxes are those taxes which are directly paid to the government and indirect taxes are those which are indirectly paid to the government, through some intermediaries like manufactures, wholesalers, retailer's etc. Thus, broadly, there are two types of Taxes viz. Direct and Indirect taxes. The lesson discuses the taxation structure in India, the importance of taxes for the government and society, legal frame work of tax laws and there operations, types of taxes collected by the Government and the scope of Income Tax and its Applicability.

1.10 Keywords

Direct Taxes: when a person is aware of the tax liability and pays the tax directly, it comes under the purview of Direct taxes* The Income Tax, Wealth Tax and Corporate Tax are the classical examples of direct taxes in India.

Indirect taxes: When the taxes are paid indirectly, it comes under the purview of indirect taxes. The excise duty; customs duty and sales tax and service tax are the classic examples of indirect taxes. The Tax is levied on Total Income as per the tax rates of the Assessment Year.

Assessee: Income Tax Act 1961 (Act no. 43) defines 'assessee' as a person by whom any tax or any other sum of money is payable under this Act

Assessment Year: Assessment year means the period of twelve months commencing on 1st April every year and ending on 31st March of the next year. Income of previous year of an assessee is taxed during the following assessment year at the rates prescribed by the relevant Finance Act.

Judicial Decisions: Any decision given by the Supreme Court becomes a law which will be binding on all the Courts, Appellate Tribunals, the Income-tax Authorities as well as on all the assessees.

1.11 PRACTICE QUESTIONS

Short Answer Type Questions

1. State the contents of List I, II and III of Seventh Schedule to Constitution.
2. Distinguish between Indirect Taxes and Direct Taxes.
3. Explain Status of Income Tax in Indian Constitution.

Long Answer Type Questions

4. State the contents of List I, II and III of Seventh Schedule to Constitution.
5. Explain Taxation Structure in India.
6. Tax Rates are not given under the Income Tax Act, 1961 but by the annual Finance Act - Discuss.
7. Give your comments on Taxation structure regarding-
   1. Is it in right manner or needs some improvement.
   2. If you think any improvement should be there, clearly state why and also state the loop holes in present structure.

1.12 SUGGESTED READINGS

- Mahrotra H.C. (2009): Tax planning & Tax management, Sahitya, Agra
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- Ahuja, Gupta (2009): Professional Approach to Direct Taxes, Bharat law house Pvt. Ltd. New Delhi.
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- Surry M. M. : Taxation in India (1925-2009), New Century, New Delhi.
- Sarkar C.R.: Tax incentives and Economic Growth, New Century Publication, New Delhi.
- Sorry M.M.: Tax Evasion in Theory & Practice, New Century, New Delhi.
- Lakhotia R.N.: How to save Income Tax on capital gain, Vison Books, New Delhi.

1.13 Self Check Exercise (Answer Key)

1. CBDT (Central Board of Direct Taxes),2. Dividend Distribution Tax (DDT), 3. Minimum Alternate Tax (MAT), 4. Corporate Tax, 5. Excise Duty, 6. Income Tax, 7. Stamp Duty

TAXATION OF COMPANIES

STRUCTURE

2.0 OBJECTIVES

After the completion of this Lesson, you should be able to understand the following:

- Definitions of major items
- Company in which the public are substantially interested
- Computation of Taxable income and tax liability of a company
- Report from a Chartered Accountant
- Loss which can be carried forward

2.1 INTRODUCTION

The Constitution of India vests the Parliament with legislative powers to impose taxes on matters specifically enumerated in the Union List and all the power of making any law imposing a tax not mentioned in Concurrent or State Lists, as provided by Article 248(2). "Tax on income* is defined in an inclusive manner by Article 366(29) under which the expression includes a tax in the nature of an excess profits tax. “Corporation tax* is defined by Article 366(6) to mean any tax on income, so far as it is payable by Companies and is a tax in case of which the three conditions mentioned therein are fulfilled, namely-

(a) that it is not chargeable in respect of agricultural income;

(b) that no deduction in respect of tax paid by Companies is, by any enactments which may apply to the tax, authorized to be made from dividends payable by the Companies to individuals; and

(c) that no provision exists for taking the tax so paid into account in computing for the purposes of Indian income-tax, the total income of individuals receiving such dividends, or in computing the Indian income-tax payable by, or refundable to such individuals.

Under entry 82 of the Union List, the Parliament has exclusive power to make laws with respect to “Taxes on income other than agricultural income*. The expression “agricultural income’ as defined under clause (1) of Article 366 means agricultural income as defined for the purposes of the enactments relating to Indian income-tax.

The companies residents in India are taxed on their worldwide income arising from all sources in accordance with the provisions of the Income Tax Act, 1961. Non-resident corporations are essentially taxed on the income earned from a business connection in India or from other Indian sources. A corporation is deemed to be resident in India if it is incorporated in India or if its control and management is situated entirely in India.

Let us discuss computation and liability of tax for a company in India.

2.2 DEFINITIONS

For the purpose of assessment of companies, the following definitions are important:

Company;

Sec. 2(17) - Under section 2(17), the expression 'company'* is defined to mean the following:

(a) any Indian company; or

(b) anybody corporate incorporated under the laws of a foreign country; or

(c) any institution, association or a body which is assessed or was assessable/ assessed as a company for any assessment year commencing on or before April 1, 1970; or

(d) any institution, association or a body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the Central Board of Direct Taxes to be a company.

Indian company [Sec. 2(26)]:

An Indian company means a company formed and registered under the Companies Act, 1956. Besides, it includes the following:

(a) a company formed and registered under any law relating to companies formerly in force in any part of India other than the State of Jammu and Kashmir and the Union territories specified in (e) infra; .

(b) a corporation established by or under a Central, State or Provincial Act;

(c) any institution, association or body which is declared by the Board to be a company under section 2(17) ;

(d) a company formed and registered under any law in force in the State of Jammu and Kashmir;

(e) a company formed and registered tinder any law for the time being in force in the Union territories of Dadra and Nagar Haveli, Goa, Daman and Diu and Pondicherry.

In the aforesaid cases, a company, corporation, institution, association or body will be treated as an Indian company only if its registered office is in India.

Domestic company:

"Domestic company* means an Indian company or any other company which in respect of its income liable to tax under the act has made arrangements for the declaration and payment of dividends within India as per section 194.

Arrangement for Declaration and Payment of Dividend:

Three requirements are to be satisfied cumulatively by a company before it can be said to be a company which has made the necessary "arrangements for declaration and payment of dividends in India', within the meaning of Section 194:

1. The share register of the company for all shareholders should be regularly maintained at its principal place of business in India, in respect of any assessment year, at least from April 1 of the relevant assessment year.
2. The general meeting for passing of accounts of the relevant previous year and for declaring dividends in respect thereof should be held only at a place within India.
3. The dividends declared, if any, should be payable only within India to all shareholders.

Foreign company:

Foreign company means a company which is not a domestic company.

Industrial company:

Sec. 2(8)(c) of the Finance Act, 1985 - Industrial company means company which is mainly engaged in the business of generation or distribution of electricity or another form of power or in the construction of ships or in the manufacture or processing of goods or in mining.

By virtue of the Explanation to section 2(8) (c) of the Finance Act, 1985, a company is deemed to be mainly engaged in the business of generation or distribution of electricity or any of the form of power or in construction of ships or in the manufacture or processing of goods or in mining if the income attributable to anyone or more of the aforesaid activities, included in its total income of the previous year (before allowing deduction under sections 80C to SOU) is not less than 51 per cent of such total income. However, the Board, in its Circular No. 103, dated February 17, 1973 while clarifying the exact meaning of a similar Explanation to section 2(7)(d) of the Finance Act, 1966, defines industrial company as :

(a) a company which is mainly engaged in the business of generation or distribution of electricity or any other form of power or in the construction of ships or in the manufacture or processing of goods or in mining, even if its total income from such activities is less than 51 per cent of its total income; and

(b) a company which, even though not mainly so engaged, derives in any year 51 per cent or more of its income from such activities.

The verdict of the Kerala High Court in Cochin Company v. CIT [1978) 114 ITR 822 also endorsed the aforesaid clarification of the Board.

Other Points:

The following activities are held as "manufacture* or "processing" of goods.

Book publishing- Circular No. 347, July 7, 1982.

Mixing different types of tea to arrive at a desired blend-G.A. Randerian Ltd. v. C/T[1983) 12 Taxman 160 (Cal.).

Manufacture and selling of carpets but having major source of income from sale of import entitlement (generated by export of carpets)-Obiter (P.) Ltd. v. CIT[1983) 12 Taxman 351 (All.)

Production of cinematographic films-Circular No. 24, dated July 23,1969.

Tailoring clothes-Nu-Look (P.) Ltd. v. C1T[19851 23 Taxman 39 (Delhi).

Self Check Exercise (True/ False)

1. Corporate tax is only levied on the profits of companies and does not consider other financial activities.
2. The definitions of taxable income for corporations may vary across countries, making international tax planning complex.

Sorting out, washing, drying and blending wool-Shree Mulchand Co. Ltd. v. CIT (1986)24 Taxman 188 (Bom.)

Undergoing a change in a commodity as a result of some operation (may be manual or mechanical and as a result a new and distinct commodity emerges-Koshy's (P.) Ltd. v. CIT[1984] 18 Taxman 481 (Kar.).

2.3 COMPANY IN WHICH THE PUBLIC ARE SUBSTANTIALLY INTERESTED [SEC. 2(18)

A company is regarded as a company in which the public are substantially interested in the following cases

1. Owned by Government/RBI:

A company owned by the Government or the Reserve Bank or in which not less than 40 per cent shares (in terms of value) are held by the Government or the Reserve Bank or a corporation owned by the Reserve Bank.

2. Section 25 companies:

A company registered under section 25 of the Companies Act, 1956, namely, companies for promotion of commerce, art, science, religion, charity and prohibiting the payment of any dividends to its members.

3. A company without share capital:

A company having no share capital and declared by the Central Board of Direct Taxes to be a company in which the public Eire substantially interested.

4. Nidhi or Mutual Benefit Society

A company which carries on, as its principal business, the business of acceptance of deposits from its members and which is declared by the Central Government under section 620A of the Companies Act to be a Nidhi or Mutual Benefit Society.

5. Company owned by a co-operative society

A company in which shares carrying not less than 50 per cent of the voting power having been allotted unconditionally to or acquired unconditionally by, and are throughout the relevant previous year held by one or more co-operative societies.

6. Listed companies

A company which is not a private company and its equity shares are, as on the last day of the previous year, listed in a recognized stock exchange in India.

7. Public limited company owned by Government and/or a widely-held company

A company which is not a private company Jas defined in section 3(1){ iii) of the Companies Act, 1956] and its shares carrying 50 per cent of voting power (40 per cent in the case of industrial companies, for meaning of industrial company) have been allotted unconditionally to, or acquired unconditionally by, and were throughout the relevant previous year beneficially held by

i. the Government; or
ii. a statutory corporation; or
iii. a company in which the public are substantially interested or any wholly-owned subsidiary company.

The second subsidiary company of first subsidiary company (parent company listed in the recognised stock exchange of India) falls within the term “wholly owned subsidiary company’, notwithstanding the fact that neither the parent company is holding any shares (or requisite shares) in the second subsidiary company nor is the first subsidiary company holding 100 per cent shares in the second subsidiary company-CIT v. Ajax Investment Ltd. [2003] 85 ITD 154 (Ahd.) (SB).

Onus to Prove

If company is composed mostly of family members owning lion's share in share capital, the onus to prove that it is a company in which public are substantially interested will be on the assessee-CIT v. Sahu Jain Ltd 11976] 103 ITR 135 (SC).

Investment company

Investment Company means a company whose gross total income consists mainly of income which is chargeable under the heads “Income from house property”, “Capital gains” and “Income from other sources.

Widely-held company

A company in which the public are substantially interested is known as widely-held company.

Closely-held company

A company in which the public are not substantially interested is known as a closely-held company.

2.4 COMPUTATION OF TAXABLE INCOME AND TAX LIABILITY

It is determined as follows

1. First ascertain income under the different heads of income.
2. Income of other persons may be included in the income of the company under sections 60 and 61.
3. Current and brought forward losses should be adjusted according to the provisions of sections 70 to 80.
4. The total of income so computed under different heads is gross total income.
5. From the gross total income so computed, the following deductions are permissible under sections 80C to 80U as shown below:
   - Donations to charitable institutions and funds -Under Section 80G
   - Donations for scientific research or rural development -Under Section 80GGA
   - Contribution to political parties -Under Section 80GGB
   - Profits and gains from industrial undertakings engaged in infrastructure, etc. - Under Section 80-LA

   e Profits and gains by am undertaking or enterprise engaged in development of Special Economic Zone - Under Section 80-IAB
   - Profits and gains from certain industrial undertakings other than infrastructure development undertakings -Under Section 80-IB
   - Profits and gains of certain undertakings in certain States -Under Section 80-IC
   - Profits from the business of collecting and processing of bio-degradable waste -Under Section 80JJA

Self Check Exercise

3. What is the tax levied on a company's income before any deductions?
4. Identify the tax applied to the profits of a company after deducting allowable expenses.
5. What is the term for the tax imposed on the capital gains realized by a company from the sale of assets?

- Profits of hotels and convention centre -Under Section 80-ID
- Profits of undertakings in North Eastern States -Under Section 80-IE
- Employment of new workmen -Under Section 80JJAA
- Income of Offshore Banking Units -Under Section 80LA

2.5 TAX LIABILITY

Tax liability of a company is calculated as follows

Computation under normal provisions

Step 1 - Find out taxable income under normal provisions

Step 2 - Find out income tax at the rate of 30% (40 per cent in the case of a foreign company) [In the case of long term capital gain it is 20 per cent. In the case of winnings from lotteries it is 30 per cent. There are a few more cases where a special rate of tax is applicable]. There is no exemption limit.

Step 3 - Deduct tax rebate under section 88E. Rebate under section 88E is not available from the assessment year 2009-10.

Step 4 - Find out (2) - (3) [it cannot be less than zero]

Step 5 - Add surcharge at the rate of 10 per cent of (4) [2.5 per cent in the case of a foreign company], if net income exceeds Rs. 1 crore.

Step 6 - Find out (4) + (5)

Step 7 - Add education cess at the rate of 2 per cent of (6) and secondary and higher education cess at the rate of 1 per cent of (6).

Step 8 - Deduct tax rebate or tax credit under sections 86, 90, 90A and 91 [There is no merit in contention that before adding surcharge, tax payable is to be reduced by credit for double taxation-Infosys Technologies Ltd. v. CIT [2007] 108 TTJ (Bang.) 282.) Step 9 - Find out (7) - (8) [it cannot be less than zero]

Computation under MAT

Step 10 - Find out book profit

Step 11 - Find out 10 per cent of book profit

Step 12 - Add surcharge at the rate of 10 per cent [2,5 per cent in the case of foreign company] of (11), if book profits exceed Rs. 1 crore.

Step 13 - Find out (11) + (12)

Step 14 - Add education cess at the rate of 2 per cent of (13) and secondary and higher education cess at the rate of 1 per cent of (13).

Step 15 - Find out (13) + (14)

Hence, Computation of Tax liability of a company is (9) or (15) whichever is more.

2.6 REPORT FROM A CHARTERED ACCOUNTANT

Every company to which section 115JB applies, shall furnish a report (in Form No. 29B) from a chartered accountant certifying that the book profit has been computed in accordance with the provisions of section 115JB along with the return of income filed under section 139(1) or along with the return of income furnished in response to a notice under section 142(1).

2.7 LOSS WHICH CAN BE CARRIED FORWARD

In respect of the relevant previous year, the amount determined under the provisions of

Sub-section (2) of section 32 o.‘ subsection (3) of section 32A or clause (ii) of sub-sectional) of section 73 or section 73 or section 74 or sub-section (3) of section 74A, shall be allowed to be carried forward to the subsequent year or years.

Tax credit - Section 115JAA is applicable for the assessment years 1997-98 to 2000-01 which provides a tax credit scheme by which minimum alternate tax (MAT) paid can be carried forward for set off against regular tax payable during the subsequent five-year period subject to certain Conditions, as under : -

1. When a company pays tax under MAT, the tax credit earned by it shall be an amount which is the difference between the amount payable under MAT and the regular tax.

2. MAT credit will be allowed carry forward facility for a period of five assessment-years immediately succeeding the assessment year in which MAT is paid. Unabsorbed MAT; credit will be allowed to be accumulated subject to the five year carry forward limit.
3. In the assessment year when regular tax becomes payable, the difference between the regular tax and the tax computed under MAT for that year will be set off against the MAT credit available.
4. The credit allowed will not bear any interest. The ration ale for allowing credit in respect of taxes paid under MAT in the aforesaid manner is that a company should always pay a minimum tax. The above method will ensure that the company will always pay a minimum tax even while offsetting the MAT credit against regular tax. It may be noted that tax credit in respect of MAT under section 115JB is not available.

2.8 SUMMARY

Tax on income is defined in an inclusive manner by Article 366(29) under which the expression includes a tax in the nature of an excess profits tax. “Corporation tax” is defined by Article 366(6) to mean any tax on income, so far as it is payable by Companies. The companies residents in India are taxed on their worldwide income arising from all sources in accordance with the provisions of the Income Tax Act, 1961. Non-resident corporations are essentially taxed on the income earned from a business connection in India or from other Indian sources. A corporation is deemed to be resident in India if it is incorporated in India or if its control and management is situated entirely in India.

2.9 QUESTIONS FOR PRACTICE

Short Answer Type Questions

1. Write short notes on a). Taxable Income b). Section 194.
2. Define the following terms as per Income Tax Act: Company, Domestic Company and Foreign Company.
3. What components constitute Total Taxable Income?

Long Answer Type Questions

4. What are the salient features of assessment of companies under the Income-tax Act, 1961? Discuss in this connection the ‘companies in which the public are substantially interested” and their tax liability.
5. Write in detail the steps in the computation of taxable income of a company.
6. Distinguish between Total Income and Tax Liability.

2.10 Keywords

Taxable Income: The portion of a company's earnings subject to taxation after allowable deductions.
Deferred Tax Liability: Future tax obligations resulting from temporary differences in financial and tax reporting.
Tax Credits: Reductions in tax liability granted by the government to incentivize specific behaviors or activities.
Transfer Pricing: Setting prices for transactions between affiliated companies to ensure fair taxation and prevent profit shifting.
Advance Pricing Agreement (APA): A pre-agreed method for determining transfer prices to avoid disputes and provide certainty for multinational companies.

2.11 SUGGESTED READINGS

- Mahrotra H.C. (2009): Tax planning & Tax management, Sahitya, Agra
- Singhania V.K. (2009): Direct 'fax Law & practice, Taxman Publication, New Delhi.
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2.11 Self Check Exercise (Answer Key)

1. False, 2. True, 3. Gross Tax, 4. Net Tax, 5. Capital Gain Tax

MBA-DE(Second Year) **CTP (418) CORPORATE TAX PLANNING**
Semester-IV
Lesson No. 3 **AUTHOR : SANJEEV KUMAR**

MINIMUM ALTERNATE TAX (MAT)

STRUCTURE

3.0 OBJECTIVES

After the completion of this Lesson, you should be able to understand the following:

- MAT or "Minimum Alternate Tax"
- Basic concepts
- History of MAT in India
- Limitations

3.1 INTRODUCTION

MAT or "Minimum Alternate Tax* has been a topic of intense discussion amongst tax payers as well as tax authorities all over the world. While a majority of the countries world over have refrained from levying such a tax, there are instances of countries like the United States, India, Mexico and Colombia among others who have introduced varying forms of MAT at one point or the other.

3.2 MAT OR "MINIMUM ALTERNATE TAX"

When looked at from a layman's point of view, and on preliminary thoughts, the principle of application of such a tax seems to be a very reasonable, social and fair principle. This is because the basic theme or logic of having such a tax seems very appealing to people who often wonder why they have to pay a large proportion of their hard earned money towards taxes while many large companies who earn millions do not pay any income tax at all!

It is this apparent inconsistency which has been bothering the minds of people across the world. In the six years up to 2000, Genera] Motors paid nothing in federal income taxes despite earning $22.4 billion in pretax US profits. Ford Motor Co. in the United States which earned $ 9.4 billion in pretax profits in 2000, paid only 6.3 % of that in federal income tax, at a time when the corporate tax rate was about 35%.

There were many more similar instances, e.g. in the cases of companies like General Electric, United Airlines etc. The idea that companies generating billions of dollars in profits and paying huge dividends actually pay negligible amounts of taxes appeared to be illogical and thus the concept of charging a "Minimum tax" (Alternate Minimum Tax or AMT) was born.

The phenomenon of flourishing companies paying little or no tax was not unique to

United States alone. Even in India, some of the biggest names in Indian industry were replicating the same model. In some instances, the earnings of these companies would be even more than the gross revenues of some of the states, but the total direct tax paid by them amounted to zero. This prompted the Indian Government to take note of the matter and in 1983, the concept of a minimum tax was introduced under section 80WA of the Income Tax Act 1961. Modified versions of this section were introduced later on as section 115J, 115JA and 115JB. These amendments were meant to streamline and fine tune the MAT provisions based on prevailing circumstances.

3.3 BASIC CONCEPTS

Normally, a company is liable to pay tax on the income computed in accordance with the provisions of the income tax Act, but the profit and loss account of the company is prepared as per provisions of the Companies Act. There were large number of companies who had book profits as per their profit and loss account but were not paying any tax because income computed as per provisions of the income tax act was either nil or negative or insignificant. In such case, although the companies were showing book profits and declaring dividends to the shareholders, they were not paying any income tax. These companies are popularly known as Zero Tax companies. In order to bring such companies under the income tax act net, section 115JA was introduced w.e.f assessment year 1997-98.

According to this section, if the taxable income of a company computed under this Act, in respect of previous year 1996-97 and onwards is Jess than 30 % of its book profits, the total income of such company is chargeable to tax for the relevant previous year shall be deemed to an amount equal to 30 % of such book profits.

A new tax credit scheme is introduced by which MAT paid can be carried forward for set-off against regular tax payable during the subsequent five year period subject to certain conditions, as under:-

When a company pays tax under MAT, the tax credit earned by it shall be an amount which is the difference between the amount payable under MAT and the regular tax. Regular tax in this case means the tax payable on the basis of normal computation of total income of the company.

MAT credit will be allowed carry forward facility' for a period of five assessment years immediately succeeding the assessment year in which MAT is paid. Unabsorbed MAT credit will be allowed to be accumulated subject to the five year carry forward limit.

In the assessment year when regular tax becomes payable, the difference between the regular tax and the tax computed under MAT for that year will be set off against the MAT credit available. The credit allowed will not bear any interest.

MAT, as the name implies, is the minimum amount of tax which a company has to pay, even if it is not liable to pay any tax on its regular assessment. Assessee have to calculate their taxes as per the regular method as well as per the procedure laid down for MAT computation, and pay the tax which is higher of the two. Under the regular computation, the person is entitled to all the deductions, exemptions and incentives available under the provisions of the tax code, such as accelerated depreciation, investment allowance, rebate for setting up industries in a backward area etc. The resultant computed income, therefore, normally would be much lower than the book profits.

Self Check Exercise

1. Minimum Alternate Tax (MAT) is applicable only to foreign companies operating in India.
2. MAT ensures that companies with significant book profits but low taxable income pay a minimum amount of tax.
3. MAT is calculated based on the actual taxable income of a company, irrespective of its book profits.

However, for the computation of income for the purposes of MAT, there are very few adjustments, if any, to be made to the book profits. Most importantly, the method of depreciation followed for the purpose of accounts is different from that considered for taxation purposes. As a result, MAT ensures that every profitable company would have to pay some tax every year. For the Assessment Year 2009-10, Minimum Alternate Tax (MAT) has been increased to 15 per cent of book profits from 10 per cent. The period allowed to carry forward the tax credit under MAT to be extended from seven years to ten years.

The Indian Income Tax Act contains large number of exemptions from total income. Besides exemptions, there are several deductions permitted from gross total income. Further, depreciation allowable under the Income Tax Act is not the same as required under the Companies Act. The result of such exemptions, deductions, and other incentives under the Income tax Act in the form of liberal rates of depreciation is the emergence of Zero tax companies which in spite of having high book profit are able to reduce their taxable income to nil.

The system of minimum alternate tax has accordingly been introduced under which a company is required to pay a minimum tax of 7 % of the book profit in case the tax on the total income computed under the normal provisions of law works out to less than this amount [Sec 115JB).

3.4 HISTORY OP MAT IN INDIA

With a view to compel highly profitable companies, paying little or no tax due to availment of tax incentives, the concept of MAT was introduced in 1983 by way of insertion of section 80 WA of the Income Tax Act 1961 (the Act). This section laid down certain restrictions on the aggregate amount of deductions allowable under the provisions of the Act. However, the unabsorbed deductions were allowed to be carried forward and set off against taxable income in future *years.* Section 80 WA remained in operation for the assessment years 1984-85 to 1987- 88.

From 1st April 1988, Section 115 J was introduced to replace Section 80 WA. By virtue of this section, in case of a company whose total income was less than 30 % of the book profits, the total income to be charged to income tax was deemed to be 30 % of the book profits. Section 115 J was in operation for the assessment years 1988-89 to 1990-91,

In the year 1991-92, in view of rationalization of tax structure including discontinuance of certain investment incentives, it was felt that there should be no necessity of retention of the concept of a Minimum Alternate Tax, and therefore this section was withdrawn from assessment year 1991-92

After a gap of about six years, the Minimum Alternate Tax was re-introduced under section 115 JA with effect from assessment year 1997-98. In the next year, Section 115 JAA was introduced to give effect to a tax credit scheme by which the tax paid under MAT was allowed to be carried forward for set off against regular tax payable during the subsequent five year period.

In 2000, the Government had yet another rethink on the concept of MAT, and section 115 JB was introduced. The introduction of Section 115JB was a conceptual departure from" deemed total income” to “deemed tax* on book profits. In other words, while the earlier section concentrated on computation of a minimum deemed income, the new section laid emphasis on computation of a minimum deemed tax. Moreover, the provision for allowing credit for MAT under section 115JAA was discontinued. In the current year, credit for MAT paid has again been allowed.

3.5 LIMITATIONS

Prima-facie, it would appear that the introduction of MAT is a very logical step to ensure that companies that otherwise would avoid paying their “fair share*’ of taxes, also end up paying some amount of tax on income.

However, if studied in great detail, Minimum Alternate Tax has some very far reaching implications. Economists all over the world have been debating on the efficacy of levying such type of a minimum tax. This is because MAT has the effect of reducing investment spending in several ways. Application of MAT on profitable companies results in a higher tax outflow than what would have been payable under regular assessment, and as a result the retained earnings available for investment activities goes down- The cash flow constraint becomes more relevant for companies at times when the capital markets are not doing well and the access to capital becomes tougher.

Apart from putting a strain on regular cash flows, MAT also discourages capital spending by raising the cost of capital or the base financial parameter which a project must meet before deciding to go ahead on the same.

The tax rate under MAT is much lower than the rate applicable under regular assessment. This may sound very logical but it needs to be remembered that MAT is applied to a much broader base. Consequently, MAT frequently results in a higher overall tax collection.

A key lope behind introduction of Minimum Alternate Tax was that hugely profitable companies paying substantial dividends must also contribute something by way of taxes. However, this logic does not necessarily hold true in many cases, in as much as there are a lot of medium sized companies which do not pay dividend and instead, retain the earnings in the company for re-investment. Thrusting MAT on companies is nothing short of penalization for good performance.

The companies to suffer the most because of MAT are the huge capital intensive industrial companies which have been putting up projects from time to time. More often than not, such projects are mega projects which any country desperately needs to stimulate growth. They are sources of employment for a big populace in and around the areas where they are put up. Levying MAT on these companies results in a disincentive to their efforts in putting up big projects.

The fact that many of the big corporate who earn substantial profits do not pay any tax may sound incongruous but the larger picture needs to be seen to correctly understand this phenomenon. While it may be true that these companies may not be paying any direct tax but what about the huge amounts of indirect taxes that they contribute to the national and state exchequer. They pay hefty amounts of customs duty on the imported equipment as well as excise and sales taxes on indigenous purchases and turnover. What MAT does is to narrow the picture, confining it only to the direct tax contribution, and consequently distorting the overall picture. It is a fact that the so-called zero tax companies are among the largest contributors to the national exchequer and this fact needs to be clearly understood by the people who have a wrong notion about the contribution of these companies to the overall economic development of the country.

Self Check Exercise

4. How is MAT calculated?
   a) Based on book profits
   b) Based on turnover
   c) Based on employee salaries
   d) Based on export revenue

5. Which type of companies is primarily subject to MAT?
   a) Micro-enterprises
   b) Non-profit organizations
   c) Companies enjoying tax holidays
   d) Sole proprietorships
6. MAT is primarily applicable to:
   a) Individuals
   b) Foreign companies
   c) Companies enjoying tax incentives
   d) Non-resident entities

There are umpteen instances of companies which have been spending millions of rupees putting up large projects, very often in backward areas, providing local employment opportunities to thousands of people, paying huge amount of indirect taxes, but still maligned by the authorities and the public just because their direct tax contribution is zero or marginal.

Very often MAT hits hard at marginally profitable, capital intensive, cyclical industries. This was clearly demonstrated in the case of several of the American steel companies, at a time when they were striving hard to keep themselves in the black amidst a severe downtrend, the likes of which were not witnessed in past few decades.

In the international context, it has been seen that the circumstances at the time of introduction of the MAT concept are entirely different from the current prevailing circumstances. In the United States, many of the tax incentives that arguably allowed some highly profitable companies to minimize their tax outgo in the mid 1980's (safe harbor leasing etc.) no longer exist. In the earlier times, there were jungles of complex deductions and myriad of other exemptions which facilitated the zero tax syndromes.

However, with increasing stress and emphasis that is nowadays being given by countries across the world to simplify and rationalize their tax laws, the rationale of having a so called “Minimum Alternate Tax" definitely needs to be revisited and reviewed.

Under Indian tax laws, the deductions allowable to companies for export profits or for investments in backward area's are gradually being phased out and therefore the relevance of having a parallel MAT system gets diluted to that extent. The accelerated depreciation under tax laws in comparison to the book depreciation still remains, but taxing this differential seems to contradict the basic aim of the Government to promote industrial growth by inducing the corporate sector to invest more.

It is quite ironical that at a time when the whole world is talking about and pointing out the need to have simpler and more rational tax system, some governments are still continuing with provisions such as MAT, which create a sort of parallel tax system requiring intricate computations and adjustments and resulting in differing interpretations and legal disputes. The Indian government, in particular, has never had a stable policy regarding MAT and very often we have seen contradictory amendments being made with respect to MAT and its applicability. Frequent changes in tax policies do not provide a conducive investing environment and this fact needs to be realized at the earliest.

The adverse effects of having a Minimum Alternate Tax have been realized by many countries. Recognizing that AMT (Alternate Minimum Tax, as it is known in the United States) is having a severe adverse impact on corporate capital expenditure spending, President George Bush, in his economic stimulus proposal to the Congress, made a strong case for elimination of AMT. It was recognized that such a Minimum Tax was inhibiting investment and was diminishing the value of various investment incentives, such as accelerated depreciation.

It would not be out of place to mention here that this move on the part of US, was not only on recognition of the adverse impact of MAT on its domestic companies, but it was also prompted by the realization that foreign investment was getting diverted to other countries with more conducive tax regimes. This fact is all the more relevant for developing countries like India, which are in desperate need of foreign investment.

Assuming other factors to remain same, it is very obvious that any overseas investor would prefer to invest in a country with no MAT, e.g. China, rather than investing in India. The overall tax rate and the taxation structure in China is much more investor friendly and therefore the persistence with Minimum Alternative Tax reduces India's competitiveness to a great extent. Arguable it may be, but there is a view gaining strength that the concept of MAT is no longer relevant in the current economic scenario of stiff competition amongst countries trying to attract and promote investments. Some would even go to the extent of saying that MAT exists only to help governments evade adverse media comments on the idea of large companies paying zero taxes.

In fact, if, viewed from a broader perspective, the very existence of MAT indicates that the taxing authorities do not appear to be very dear in their thought process about what exactly they want to achieve. In the first instance, they propose various forms of tax incentives to the corporate sector as an inducement to invest more. When companies go ahead, take the risks, invest money into big projects, and use these tax incentives to reach the so called zero tax or marginal tax paying status, the authorities then wake up with a knee jerk reaction and come up with such concepts as a "Minimum Alternate Tax'.

It should be realized that the so called zero tax companies are not following any fraudulent tax practices but are only planning their tax liability in a legal and healthy manner, using the incentives which are existing in the rulebook. It should not be forgotten that their overall contribution to the national exchequer is quite meaningful and substantial.

What is actually needed is to have a clear, long term roadmap of a suitable and desired tax regime instead of having short term, conflicting measures such as incentives for capital spending on one hand and Minimum Alternate Tax on the other.

In India as well as internationally, the implications of MAT have been discussed and researched in great detail and the overall view seems to be that there is a very strong case for repeal of Minimum Alternate Tax (in whatever form it exists in various countries). The repeal of MAT would promote greater capital spending; facilitate better cash flows; reduce the cost of capital; create additional employment opportunities; and above all, accelerate overall economic growth.

3.6 SUMMARY

The lesson discusses the basic concepts of MAT. MAT is the minimum amount of tax which a company has to pay, even if it is not liable to pay any tax on its regular assessment. Assessee have to calculate their taxes as per the regular method as well as per the procedure laid down for MAT computation, and pay the tax which is higher of the two. Under the regular computation, the person is entitled to all the deductions, exemptions and incentives available under the provisions of the tax code, such as accelerated depreciation, investment allowance, rebate for setting up industries in a backward area etc. The resultant computed income, therefore, normally would be much lower than the book profits.

3.7 Keywords

Minimum Alternate Tax (MAT): A statutory requirement ensuring companies with substantial book profits pay a minimum level of tax, preventing the avoidance of tax liability.

Book Profits: Profits calculated as per the company's books of accounts, adjusted for certain tax-related adjustments, and used as the basis for MAT computation.

Credit for MAT: The excess tax paid under MAT in a particular year that can be carried forward and set off against regular income tax in subsequent years.

Tax Holiday: A period during which a company is exempt from payingincome tax but may still be subject to MAT, ensuring a minimum level of tax payment.

3.8 QUESTIONS FOR PRACTICE

Short Answer Type Questions

1. Explain the basic concepts of Minimum Alternate Tax for Indian companies.
2. What are the Limitations of Minimum Alternate Tax?
3. Discuss the concept of Minimum Alternate Tax in the international perspective.

Long Answer Type Questions

4. Write a detailed note on the history of MAT in India.

5. Evaluate the implications of Minimum Alternate Tax (MAT) on different categories of companies. Discuss the criteria for applicability, exemptions, and the impact on companies enjoying tax incentives or operating in specific industries.

3.9 SUGGESTED READINGS

- Mahrotra H.C. (2009): Tax planning 6s Tax management, Sahitya, Agra
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3.10 Self Check Exercise (Answer Key)

1. False, 2. True, 3. False, 4. Based on book profits, 5. Companies enjoying tax holidays, 6. Companies enjoying tax incentives

MBA-DE{Second Year) **CTP (418) CORPORATE TAX PLANNING**

Semester-IV

Lesson No. 4 **AUTHOR : SANJEEV KUMAR**

FRINGE BENEFIT TAX

STRUCTURE

4.0 OBJECTIVES

After the completion of this Lesson, you should be able to understand the following:

- Reason For Introducing Fringe Benefit Tax
- What is Fringe Benefit Tax?
- Applicability
- Who pays Fringe Benefit Tax?
- Rationale For Levy
- Explanation Of How FBT Will Operate
- Constitutional Validity
- Implications and Difficulties

4.1 INTRODUCTION

Fringe Benefit Tax may seem new to India, but it's not a, novel concept. This tax is already levied in the United States, the United Kingdom, Canada, Australia, New Zealand, Japan and some other nations.

The Finance bill, 2005 has introduced Chapter XII-H providing for the levy of Income-tax on fringe benefits offered by employers to their employees.

The fringe benefit tax rules proposed in the Budget by the finance minister are modeled on the Australian system. With the only difference that fringe benefit tax is proposed to be taxed at between 10 per cent and 50 per cent in India, whereas in Australia it is taxed at a flat rate of 60%.

The Finance Minister Mr. P. Chidambaram while presenting the budget in the year 2005 had made the statement that T have looked in to the present system of taxing the perquisites and I have found that many perquisites are disguised as fringe benefits and escape tax. Neither the employer nor the employee pays any tax on these benefits, which are certainly of considerable material value.

At present where the benefits are fully attributable to the employee they are taxed in the hands of the employee: the position will continue. He also justifies that this tax has to continue to provide equity in taxation in this year while moving the Finance Bill 2006. The Fringe Benefit Tax is a tax on expenditure incurred by employers on their employees and thus strictly speaking does not constitute a tax on income. It is for consideration whether the cost of the fringe benefits which constitutes the tax base should be deemed to be income under the Income-tax Act. A similar provision is contained in section 115JB.

The concept of presumptive taxation has become the order of the day. The fringe benefit tax was tackled to a certain amounts in the hands of the employees by way of valuation of perquisites using certain elements of presumption. The Finance Act 2005 covers the concept of taxation of fringe benefits in the nature of personal elements in the hands of the employer. The Amendments carried out by the Finance Act 2006 gave certain relief to a group of employers.

4.2 REASON FOR INTRODUCING FRINGE BENEFIT TAX

Attribution of the personal benefit poses problems, or for some reasons, it is not feasible to tax the benefits in the hands of the employee, thereby, it was proposed to levy a separate tax known as the fringe benefit tax on the employer on the value of such benefits provided or deemed to have been provided to the employees.

For this purpose, a new Chapter XII-H is proposed to be inserted in the Income-tax Act containing sections 115W to 115WL, which provides for the levy of additional income tax on fringe benefits.

Perquisites which can be directly attributed to the employees will continue to be taxed in their hands in accordance with the existing provisions of section 17(2} of the Income-tax Act and subject to the method of valuation outlined in rule 3 of the Income-tax Rules.

4.3 WHAT IS FRINGE BENEFIT TAX?

The taxation of perquisites or fringe benefits provided by an employer to his employees, in addition to the cash salary or wages paid, is fringe benefit tax.

Any benefits or perks that employees (current or past) get as a result of their employment are to be taxed, but in this case in the hands of the employer.

This includes employee compensation other than the wages, tips, health insurance, life insurance and pension plans.

Fringe benefits as outlined in section 115WB of the Finance Bill, mean any privilege, service, facility or amenity directly or indirectly provided by an employer to his employees (including former employees) by reason of their employment.

They also include reimbursements, made by the employer either directly or indirectly to the employees for any purpose, contributions by the employer to an approved superannuation fund as well as any free or concessional tickets provided by the employer for private journeys undertaken by the employees or their family members.

Self Check Exercise

1. What is the term for the tax imposed on certain non-monetary benefits provided by employers to employees?
2. What is the purpose of Fringe Benefit Tax in the corporate tax framework?

4.4 FRINGE BENEFIT TAX [SECTION 115W (B)]

"Fringe Benefit Tax" or "Tax' means the tax chargeable under section 115WA. Fringe Benefit Tax helps in eliminating discretion. Under FBT, scope for evasion is very limited. FBT will increase effective rate of corporate tax by 1 to 1.5%. FBT is one method of requiring corporate to pay a little more tax.

4.5 APPLICABILITY

The Fringe Benefit tax is a tax to be paid by an employer in addition to the income tax payable for every assessment year starting from the assessment year 2006-07. the tax is to be paid in respect of the fringe benefits provided or deemed to have been provided by an employer to his employees. The liability to pay Fringe Benefit Tax shall be there even when there is no liability to pay income tax by an employer. Accordingly, all those who fall within the definition of employer shall be required to pay tax on the fringe benefits provided to the employees irrespective of the fact that income, which an employer is earning, is exempt under the Income Tax Act or there is a loss. Accordingly, those entities which are claiming exemption under Section 10 such as mutual funds, undertakings in free trade zone claiming exemption under Section 10A, export-oriented units claiming exemption under Section 10B or Section 10BA, shall be iiable to pay Fringe Benefit Tax. The Fringe Benefit Tax is a liability of the tax of the employees to be bom by the employer. That is why even loss making entities and entities whose income is exempt shall also be required to pay Fringe Benefit

4.6 FRINGE BENEFITS [SECTION 115WB (1) AND (2)]

As per section 115 WB [1} - Means Benefits, any consideration provided for employment

1. Any privilege, service, facility or amenity directly or indirectly provided by an employer whether by way of reimbursement or to his employees (including former employee or employees] and
2. Any free or concessional ticket provided by the employer for Private journey of his employees or their family members and
3. Any Contribution by the employer to an approved Super annuation fund for employees. The above definition of fringe benefits consists of three clauses. Clauses
   (b) and (c) are specific cases of fringe benefits.

Further, as per Section 115WB (2), the fringe benefits shall be deemed to have been provided if the employer has incurred any expense or made any payment for the purposes of :

(a) entertainment;
(b) festival celebrations;
(c) gifts;
(d) use of club facilities;
(e) provision of hospitality of every kind to any person whether by way of food and beverage or in any other manner, excluding food or beverages provided to the employees in the office or factory;
(f) maintenance of guest house;
(g) conference;
(h) employee welfare;
(i) use of health club, sports and similar facilities,
(j) sales promotion including publicity;
(k) conveyance tour and travel including foreign travel expenses;
(1) hotel boarding and lodging;
(m) repair, running and maintenance of motor cars;
(n) repair, running and maintenance of aircrafts;
(o) consumption of fuel other than industrial fuel;
(p) scholarship to the children of the employees.

In cases where the employer is engaged in the business of carriage of passengers or goods by motor car or by aircraft, a lower percentage of expenses on repair, running and maintenance of motor cars or aircrafts or fuel expenses has been specified.

Similarly, for hotels, a lower percentage of the expenses incurred on hospitality has been specified for purposes of calculating the liability under the fringe benefit tax.

An employer liable to pay fringe benefit tax is required to furnish a return of fringe benefits before the due date as given in Section 115WD.

Section 115WE outlines the procedure for the assessment of the return of fringe benefits filed by the employer and the determination of tax or interest payable or refund due and in either case the issue of intimation to that effect.

4.7 WHO PATS FRINGE BENEFIT TAX?

Under the proposed provisions, fringe benefit tax is payable by an employer who is either an individual or a Hindu undivided family engaged in a business or profession; a company; a firm; an association of persons or a body of individuals; a local authority; a sole trader, or an artificial juridical person.

The tax is payable in respect of the value of fringe benefits provided or deemed to have been provided by an employer to his employees during the previous year.

The value of fringe benefits so calculated, is subject to additional income tax in respect of fringe benefits at the rate of thirty per cent, as provided in section 115WA.

The fringe benefit tax is payable by the employer even where he is not liable to pay income- tax on his total income computed in accordance with the other provisions of this Act.

The benefit does not have to be provided by the employer directly for him to attract fringe benefit tax. fringe benefit tax may still be applied if the benefit is provided by a third party or an associate of the employer or by under an arrangement with the employer.

The taxation of perquisites of fringe benefits provided by an employer to his employees in addition to his cash salary or wages paid is subject to varying treatment in different countries. These benefits are either taxed at the hands of the employees themselves or the value of such benefits is subject to a 'fringe benefit tax' at the hands of the employer. The rationale for levying a fringe benefits tax on the employer lies in the inherent difficulty in isolating the 'personal element' where there is collective enjoyment of such benefits and attributing the same directly to the employee. So, this is especially where the expenditure incurred by the employer is ostensibly for purposes of the business but includes, in partial measure, a benefit of a personal nature. Moreover, in cases where the employer directly reimburses the employee for expenses incurred, it becomes difficult to effectively capture the true extent of the perquisite provided because of the problem of cash flow in the hands of the employer.

Therefore, it is proposed to adopt a two-pronged approach for the taxation of the fringe benefits under the Income-tax Act. Perquisites, which can be directly attributed to the employees, will continue to be taxed at their hands in accordance with the existing provisions of Section 17(2) of the Income-tax Act and subject to the method of valuation outlined in rule 3 of the Income- tax Rules. In cases, where attribution of the personal benefits poses problems, or for some reasons, it is not feasible to tax the benefits in the hands of the employee, it is proposed to levy a separate tax known as the fringe benefit tax on the employer on the value of such benefits provided or deemed to have been provided to the employees.

Self Check Exercise

3. Name the regulatory body responsible for administering and regulating Fringe Benefit Tax.

4. What is the term for the percentage used to calculate Fringe Benefit Tax on the taxable value of specified benefits?
5. Identify the financial year during which Fringe Benefit Tax was abolished in India.

4.8 RATIONALE FOR LEVY

The need for introducing fringe benefits tax on the employer arose on account of the inherent difficulty in identifying the personal element' where there is collective enjoyment of certain perquisites, amenities & benefits and attributing the same directly to the employee. This is so specially where the expenditure incurred by the employer is ostensibly for purposes of the business but inherently includes, at least partially, the benefit of a personal nature. Moreover, in cases where the employer directly reimburses the employee for expenses incurred, it becomes difficult to effectively capture the true extent of the perquisite provided because of the problem of cash flow in the hands of the employer.

- Under the proposed provisions, fringe benefit tax is payable by an employer who is either an individual or a Hindu undivided family engaged in a business or profession; a company; a firm; an association of persons or a body of individuals; a local authority; or an artificial juridical person. The fringe benefit tax is payable by the employer even where he is not liable to pay Income-tax on his total income computed in accordance with the provisions of this Act.

4.9 EXPLANATION OF HOW FBT WILL OPERATE

Fringe benefit tax on use of cars, etc-The tax on perquisites like maintenance of a car, club membership, free meals, credit cards and tours and travel, which were earlier taxed in the hands of the employees, has been withdrawn and the employer will now be liable to pay tax on this. Whereby, it will not give any relief to the employees.

Illustration: In the case of the perquisite value of a car, employees are taxed at a rate ranging between Rs 1,100 (for small cars) and Rs 1,700 a month (for bigger vehicles) in addition to Rs 300 or 500 for a driver provided by the company.

It will badly hit the Corporate in India-Reports suggest that the fringe benefits tax will result the Indian incorporations to an additional expenditure of about Rs 25,000 crore.

Advertising agencies will be hit by fringe benefit tax-The 30 per cent fringe benefit tax will hurt advertising agencies badly as in this sector about 10% o 12% of an employee's salary comes in the form of perks.

In the glamorous world of advertising attending conferences all over the world, wining and dining to network with clients and bag more business, etc is . Now all these expenses will come under the ambit of fringe benefit tax.

Also, advertising agencies are people-oriented one and staff welfare and salaries account for almost 50 per cent of their expenses. The fringe benefit tax will thus hurt ad agencies badly.

Reaction of the Indian Incorporations as to the enactment of FBT-India Inc is quite nervous about the proposed fringe benefit tax and feels that the gains from the reduction in corporate tax announced in the last Budget would be nullified by the cut in depreciation rates.

Reaction of Software firms(6]-Some software firms feel that a wide variety of payments would come under the ambit of fringe benefit tax. A recent survey also said that because of the impact of the fringe benefit tax, companies across sectors are likely to cut down on the increments that employees would get. The proposal has invited criticism even from the Institute of Chartered Accountants of India, which has otherwise praised the finance minister for rationalizing the tax administration.

Small firms might be spared: A Business Standard report said that the finance ministry is considering threshold staff strength for levying the fringe benefit tax on employers.

Finance ministry officials indicated that organizations with very few employees could be exempted from the tax. This is based on the assumption that small employers do not spend large amounts on fringe benefits. The ministry will also examine combining the tax return for fringe benefits with the income tax return to avoid the need for filing separate forms, the report said.

4.10 CONSTITUTIONAL VALIDITY

Entry 82 of List I of the 7th schedule to the Constitution empowers the Parliament to frame laws to levy taxes on income and not on expenditure. After the decision of A. Sanyasi Rao's case in and Union of India v. Sanyasi Rao, by the Supreme Court the argument about the validity of this provision may not hold good. The entire system of FBT based on the valuation of specified expenditures incurred by the taxpayers irrespective of the allow ability to be considered under the regular assessment. This fringe benefit tax is a tax on the expenditure incurred instead of income earned.

The sections 44AD, 44AF and 44AE are in the statute book with the intention to tax the income on presumptive basis where the tax payers are not maintaining the books of account. The taxpayers can declare lower income provided that they maintain the books of accounts and get their account audited u/s 44AB. The taxpayers are given options to choose their presumptive taxation or maintain the books of accounts, as per the law for regular computation. Thus this concept of presumptive taxation is different from the present mode of taxation of fringe benefits.

The Chapter XII H provides presumptive taxation on the fringe benefits enjoyed by the employees and deemed fringe benefits enjoyed by everybody. This chapter is a separate enactment within the income tax Act, which provides for total compartmental system of tax computation, assessments, recoveries, appeals, interest payments etc. the chapter XI1-H with section 115W to section 115WL would cover the total tax system of FBT. Now the question can be raised as to whether the basic concept of FBT is applicable for the expenses incurred for and on behalf of employees alone of for others also.

The finance minister assured that the genuine business expenditure will not be hit by the FBT. But unfortunately no such remedy is available in the Act.

FBT is constitutionally valid as it has come into force by the powers conferred by Indian Constitution through the below Articles:

1. **Article 39:**

   Principles of policy to be followed by the state for securing economic justice- © to ensure , the economic system should not result in concentration of wealth and means of production to the common detriment. Whereby, it's the duty of Centre to take steps for securing economic justice. This new measure is nothing but a step taken by the government as a functional form highlighted under the Article 39 of the constitution.

2. **Article 265:**

   No tax can be levied or collected except by authority of law. The Authority of law means the legislative competence of the legislature imposing the tax. In this case, the Finance Ministry as passed this legislation which has the absolute legislative competence to pass the law.

3. Article 14:

The principle of classification is applied somewhat liberally in case of taxing statutes.

" where the power to tax exist, the extend of the burden is a matter for discretion of the law makers". The evident indent and general operations the tax legislation is to adjust the burden with the fair and reasonable degree of equality.

4. Article 270:

All taxes and duties referred to in the Union List except the duties and taxes referred to in Article 271 and any tax levied for the specific purposes under any law made by Parliament shall be distributed between the Union and the states.

5. Article 271:

Centre could levy a surcharge on Income tax on non-agricultural income for its exclusive use without sharing with States.

Hence, Central Government -can levy Tax + Surcharge which is similar to levying Fringe Benefit tax , thereby, it is validated by the constitutional provision (i.e.) through Article 270 and 271

6. **FBT** is also constitutionally validated by applying the Schedule VII of Indian Constitution.

Entry 82- Taxes on income other than agricultural income can be levied by Central Government . Therefore, FBT is nothing but a tax on income.

Entry 97- Any other matter not enumerated in List II or III including any tax not mentioned in either of those lists.

"If however, no entry in any of these lists covers it, then it must be regarded as a matter not enumerated in any of the three lists. Then, it belongs exclusively to parliament under Entry 97 of the Union List as a topic of legislation". Wherefore, the Expenditure tax also falls in the Residuary Entry as there is no entry in any list under which it can fall. Hence, it is very clear from above constitutional provisions that FBT is a valid one.

Self Check Exercise (True/False)

6. Fringe Benefit Tax (FBT) is currently applicable in the Indian corporate tax system.

7. Fringe Benefit Tax was primarily imposed on the employer rather than the employee for certain non-monetary benefits provided.

4.11 Implications and Difficulties

The apparent contradiction in legislative intent and proposed provision would lead to litigation. The issues which need focus and deliberation are the following:-

It is an independent or additional tax with independent provision of filing the return, assessment, payment of tax. The chapter XII H is complete code for this.

The tax is impossible even where assessee does not have taxable income, but expenditure are incurred in course of business.

Even charitable institution carrying incidental business without profit motive will also be required to pay tax.

The tax rate is 30% irrespective of the level of remuneration of employees or income of assessee.

Purpose of expenditure i.e. entertainment, gift, conveyance etc. will cause a lot of litigation to explain their meanings.

The levy of tax may be even where the number of employees is one or more.

Where the expenditure is disallowed on the allegation of personal nature, this can again be taxed under this section.

Even where part of expenditure mentioned in section 115WB (2) is recovered, the deemed fringe benefit would be a proportion of gross amount debited in the books without allowing credit.

In certain cases, the provisions may lead to encourage the incurring the expenditure out of books.

FBT applies to non-resident employees of the Indian company:

Indian company is liable to pay for non-resident. As the non-resident employees are none other than the employees who arc deputed by the Indian company to go to foreign country. The deputed employees becomes non-resident but still they continue to be the employees of Indian *company,* therefore, non-resident employees comes within the ambit of employees for whom Indian company is liable to pay tax.

This provision is introduced as a presumption tax so as not to avoid incentive accounting practices. There is a possibility of shift of classification of expenditure from one heads of account to another . Therefore, in order to avoid the leakage of tax and evasion of tax this FBT provision has come into play.

Grounds Cited As An Argument Against The Constitutionality Of FBT - An Analysis It is to be noted that the following grounds are being cited as an argument Fringe Benefit Tax is unconstitutional. Now, let us just analyse the provisions cited below:

1. FBT is termed as both arbitrary and discriminatory and is against Article 14 of our constitution. It should be noted that Article 14(8] strikes, at arbitrariness and it should involve negation of equality. But FBT has exempted only the charitable institutions, individuals and Hindu undivided family as it satisfies the test of reasonableness and acts as a "right and just and a fair" provision.
2. FBT affects the employees trade and profession as elucidated under Article 19(l)(g){ 10] read with Article 301 [11] of the Indian Constitution. But this provision of constitution cannot be claimed as a ground as FBT is just a new tax that is enhanced upon the employees and will not have any sort of effect on their profession or employment or trade. This argument is of very weak parlance in nature.
3. The next that is claimed is that FBT is not a tax on income but on expenditure. But under Entry 97 [12]- "Any other matter not enumerated in List 11 or III including any tax not mentioned in either of those lists can be taxed*. Therefore, the Expenditure tax comes under the purview of taxation and is constitutionally valid.

Hence, FBT is a legislation made within the ambit of vested to the parliament under List 1 and List II of the Schedule VII.

Therefore, from the above we can clearly understand the reason why the center (Finance Ministry) has enacted this Fringe Benefit Tax. This will surely act as a boon as this tax is nothing but an economic security measure that is enhanced by the Government in order to achieve the equality and also increase the government fund through a rightful mean. Hence, FBT is constitutionally valid. Whereby, its time for the Government to make clarifications as to the doubts tl.iat has raised in the application of FBT.

4.12 SUMMARY

The Fringe Benefit tax is a tax to be paid by an employer in addition to the income tax payable for every assessment year starting from the assessment year 2006-07. the tax is to be paid in respect of the fringe benefits provided or deemed to have been provided by an employer to his employees. The liability to pay Fringe Benefit Tax shall be there even when there is no liability to pay income tax by an employer. Accordingly, all those who fall within the definition of employer shall be required to pay tax on the fringe benefits provided to the employees irrespective of the fact that income, which an employer is earning, is exempt under the Income Tax Act or there is a loss. Accordingly, these entities which Eire claiming exemption under Section 10 such as mutual funds, undertakings in free trade zone claiming exemption under Section 10A, export-oriented units claiming exemption under Section 10B or Section 10BA, shall be liable to pay Fringe Benefit Tax. The Fringe benefit Tax is a liability of the tax of the employees to be borne by the employer. That is why even 1'oss making entities and entities whose income is exempt shall also be required to pay Fringe Benefit

4.13 QUESTIONS FOR REVIEW

Short Answer Type Questions

1. What is Fringe Benefit Tax? Explain.
2. What are the reasons for Introducing Fringe Benefit Tax?
3. Discuss the Applicability of Fringe Benefit Tax in India.
4. Elaborate the implications and difficulties of Fringe Benefit Tax.

Long Answer Type Questions

5. Explain the types of benefits considered as perquisites, the valuation methodology used for taxable benefits, and the historical context leading to the introduction of FBT.

6. Provide a comprehensive overview of Fringe Benefit Tax (FBT) in the context of corporate taxation.

4.14 Keywords

Perquisites: Non-monetary benefits provided by an employer to employees, subject to taxation under Fringe Benefit Tax.

Taxable Value: The determined value of fringe benefits provided by an employer, used as the basis for calculating Fringe Benefit Tax.

CBDT: Central Board of Direct Taxes, the regulatory body responsible for administering and regulating Fringe Benefit Tax in India.

4.15 SUGGESTED READINGS

- Mahrotra H.C. (2009) : Tax planning & Tax management, Sahitya, Agra
- Singhania V.K. (2009) : Direct Tax Law & practice, Taxman Publication, New Delhi.
- Ahuja, Gupta (2009) : Professional Approach to Direct Taxes, Bharat law house Pvt. Ltd. New Delhi.
- Ahuja, Gupta (2009) : Tax planning & Management, Bharat law house Pvt. Ltd. New Delhi.
- Surry M. M. : Taxation in India (1925-2009), New Century, New Delhi.

4.16 Self Check Exercise (Answer Key)

1. Fringe Benefit Tax, 2. Taxation, 3. CBDT, 4. Rate, 5. 2009-2010, 6. False, 7. True

AN OVERVIEW OP TAX PLANNING

STRUCTURE

5.0 Objectives
5.1 Introduction
5.2 Objectives and importance of tax planning
5.2.1 Maximum taxpayer units
5.2.2 Maximum exemptions and deductions
5.2.3 Avoiding unwarranted addition to trading account
5.2.4 Avoiding worry and tension
5.3 Methods of Corporate tax management
5.4 Tax planning and tax avoidance and tax evasion
5.5 What is tax planning?
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5.7 What is tax evasion?
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5.9 Summary
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5.12 Suggested Readings
5.13 Self Check Exercise (Answer Key)

5.0 OBJECTIVES

This lesson discusses all the significant aspects of tax planning resulting in saving of income tax for companies. After the completion of this Lesson, you should be able to understand the following:

- Concept of Tax Planning
- Exemptions and deductions
- Tax Avoidance
- Tax Evasion
- Objective and Importance of Tax Planning
- Methods of Tax Planning
- Tax avoidance v. Tax evasion

5.1. INTRODUCTION

A major portion of the income tax revenue of the Government of India is contributed by the corporate sector, i.e. the companies. It cannot be denied that the Income Tax Law, in particular, and the tax laws in general, have become quite complicated in recent years. Even a slight error in understanding and implementing the provision of the Income Tax Law results in higher tax incidence for companies. Hence, legal saving of income tax through proper tax planning has become all the more essential. This is because the income tax legally saved by a company goes to mop up its internal resources which would otherwise help in its expansion and diversification. It also helps in the distribution of higher dividends to shareholders and enhances the status and reputation of the company concerned in the corporate world.

5,2. OBJECTIVES AND IMPORTANCE OP TAX PLANNING

Tax Planning is the legitimate right of every taxpayer. However, the scope of tax planning and the methodology to be applied in achieving optimum tax planning with a view to saving maximum income tax and avoiding undue harassment is not appreciated by many companies. Hence we should begin by understanding the very objective of tax planning. The various objectives could be grouped under four different heads:

1. Having maximum taxpayer units;
2. Having maximum advantage of the exemptions, deductions, rebates, reliefs, and other tax concessions;
3. Legally avoiding unwarranted additions to the income; and
4. A voidance of tax worries and tensions through voluntary tax compliance and tax management.

These objectives are described in brief to throw light on the importance of the subject of

corporate tax planning.

5.2.1. Maximum taxpayer units

Corporate tax planning lies not merely in planning for one or a few companies in the corporate sector of a particular group but it consists in planning for the different types of companies and also for those individuals and other entities that control the corporate enterprise. Thus the tax planning of allied partnership firms, 'trusts, promoters and other individuals controlling the corporate enterprise are also covered within the scope of corporate tax planning. Hence, a company should not only adopt tax planning for its own income and expenditure but also plan for various other units or income tax files, i.e. independent income tax entities in the controlling group of the promoters or directors of the company. The rate of income tax payable by a company varies from 35% with 2.5% surcharge on I.T. for the Indian companies to 40% to 50% for the nonresident or foreign companies. This is quite high. Hence a company should adopt tax planning not only for its total income but should also see that the various disbursements by it suffer the least possible income tax.

The various important disbursements of a company for which tax planning is to be adopted, relate to: (a) profit; (b) rent; {c} interest; (d) salary to senior personnel; (e) commission; and (f) dividends.

These disbursements should legally be so distributed that they go to the various units in the promoters' families in a legal manner. Thus, for example, the shares of a company on which dividend is declared should not merely be held by the husband, wife or the adult members of the family but should also be so held by the HUF, if any, the minor children, parents and distant relatives of the family as well. Further, trusts for unborn persons like a would-be son or a would- be daughter or would-be wife of a son or the would-be husband of the daughter, etc., can also be created so as to achieve proper tax planning within the scope of the 1st proviso to Section 164(1). Further, dividend income should be so distributed as to enable every unit of the family to enjoy total exemption under Section 10(34) and also take the benefit of the initial exemption of Rs.
which is generally available to a non-corporate taxable entity like an individual, HUF, AOP, etc. However, as per the Finance Act, 2003 w.e.f A.Y.2004-2005 the dividend income is fully exempted from income tax. Further, the significance of “artificial juridical person" should also be realized and wherever possible and feasible the scope of holding shares by genuine personal deity *or* endowment should be explored.

Even amongst companies the scope of having a public limited company vs. a private limited company should be fully explored. As regards various activities of a company or a group of companies like trading, industrial, manufacturing, investment, etc. they should be distributed well in different taxable entities. The scope of a holding company and subsidiary companies should also be fully explored to achieve maximum tax saving. The benefit of having a separate export company to achieve the phased-over tax exemption should be achieved in actual practice.

5.2.2. Maximum exemptions and deductions

Another very important objective of tax planning to be adopted by a company is to secure maximum exemptions and deductions allowed under the Income Tax Act. There are various types of income which are completely exempt from income tax, for example, agricultural income, etc. Similarly, there are certain types of income which if earned from a particular source and in a particular locality or area or zone are also completely exempt from income tax for a specified period, like the profits of new industrial undertakings in Free Trade Zones, Special Economic Zones, etc. under Section 10-A and 100% E.O.Us under Section 10B. Some of the companies engaged in a new industrial undertaking, whether by way of starting a new unit or by way of expansion or diversification, become eligible to the 30% deduction allowed under Section 80-IE for a period of 10 years and, in some industrially backward States, Union Territories and industrially backward districts @ 100% tax exemption for 5 years. Similarly tax-holiday is allowed for industries in North Eastern states, power plants and infrastructure enterprises. Certain undertakings and enterprises in certain category States are also entitled to a special tax deduction u/s 80IC. Liberal depreciation is allowed to a company in respect of the plant and machinery and other assets used by it for the purpose of business.

A proper planning adopted in the selection of a particular asset entitles the company to a higher rate of depreciation. Judicious planning, if adopted in regard to the use of one method of deduction, enables the company to enjoy a higher deduction and thus enables the company to save on income tax. Sometimes a company may incur losses or an associate concern may have losses and the company through proper planning can take the benefit of the losses either by amalgamating the sick company with it or through other measures. All these methods and many more relating to the claim of maximum deductions, reliefs and exemptions are discussed in different chapters of this section and should be properly taken advantage of by a company interested in ideal tax planning.

Self Check Exercise (True/False)

1. One of the objectives of tax planning is to minimize the tax liability by taking advantage of available deductions and exemptions.
2. Maximum taxpayer units refer to the concept of spreading income among family members to utilize lower tax brackets effectively.

5.2.3. Avoiding unwarranted addition to trading account

The third objective of tax planning is to avoid unwarranted additions to the trading account on account of low gross profit or excess shortage or any other reason. The ideal should be to offer a detailed and proper explanation at the right time whenever there is a variation in the trading result in comparison to the immediately preceding year so that the Assessing Officer is fully satisfied about the bona tides of the explanation. This planning, if properly done, prevents an addition to the total income. If, however, an addition is made by the AO to the Trading Account for lower margin of gross profit or for excessive shortage, etc. then the company can win in appeal if proper preparation is made.

Sometimes even if the books of account are properly kept, there may be a variation in the value of stock, depending on the method of valuation adopted by the company. Hence, if proper tax planning is adopted for valuation of closing stock, it would stop unwarranted additions being made b*y the AO to the Trading Account. Sometimes the AO adds some amount on account of the difference between the estimated cost of construction of a building, etc. and that shown in the books of account. If proper planning is adopted in this regard no addition can be made by the AO Likewise, an area of addition which could be made by the AO is about cash expenditure in excess of Rs. 20,000 at a particular time. Proper tax planning to be adopted in regard to cash expenditure in excess of Rs. 20,000, incurred due to certain exceptional circumstances can result in a saving to the company-even from an awkward situation whereby the AO has no option but to make the addition of 20% of cash expenditure to the total income-if proper tax planning is adopted in this regard.

5.2.4. Avoiding worry and tension

The last but not the least important objective of tax planning is to avoid worry and tension. Even if a company maintains proper books of account, claims maximum exemptions and deductions, takes proper steps for avoiding unwarranted additions to the Trading Account, and yet does not follow proper tax management through tax planning, it may suffer penal interest for low payment of advance tax or tax or for defeating the installment of advance tax. It may also become liable to penalty. Likewise, due to ignorance and lack of proper tax planning a company may also suffer during the course of an income tax survey of the business premises or godowns, etc. Income tax searches and seizures are very common these days. If proper tax planning is not adopted by a company, then a company may suffer the seizure of its stocks or books of account or other valuable articles or things, even though it may not have concealed any income at all. The rules regarding tax deduction at source should be carefully observed by a company. Any failure to do so may result in a penal action against the company and many even result in prosecution if tax deducted is not deposited with the Government in time. Sometimes, a cash loan may be taken by a company and, if proper precaution is not taken about restricting the amount of cash loan to below Rs. 20,000 per creditor, then the company stands to suffer a heavy penalty equal to the amount of cash loan. Hence, proper tax planning in this regard and several other aspects can help the company to avoid not only the penal interest, penalty and consequential worry and tension but also the risk of prosecution. Observance of the rules and tips regarding tax planning to be adopted by a company in such matters can help the company to avoid worry and tension.

5.3 METHODS OP CORPORATE TAX MANAGEMENT

A number of obligations have been cast upon a company, not only in the matter of compliance with the rules regarding the deduction of tax at source but also in various other spheres regarding the filing of periodical returns, statements, etc. All the necessitate voluntary compliance by a company at the right time. This is possible only when proper tax planning is adopted for having a good system of tax management in the corporate office. The extent of tax management to be adopted by a company would depend upon the volume of its transactions and the work involved. The ideal tax management should be such that it does not become costly and at the same time is able to tackle the need for maintenance of proper records, statements and the furnishing of proper statements and returns to the Income Tax Department.

Benjamin Franklin is credited with this classic statement: There are two certainties in this world - death and taxes. This naturally makes all the taxpayers in general, and the companies in particular, realize the bitterness or hardship of taxes. As a result companies start finding ways to save taxes.

Three methods of saving taxes have been developed in most countries of the world in the past few decades: tax evasion,': tax avoidance and tax planning. A great deal of confusion prevails in the corporate sector about the correct connotation of these terms. Hence we shall attempt to explain these terms to show that tax planning is absolutely legal. The expression. 'I'ax evasion' means illegally hiding income or concealing the particulars of income or concealing the particular source or sources ofincome or in manipulating the- accounts so as to inflate the expenditure and other outgoings with a view to illegally reduce the burden of taxation. Hence, tax evasion is illegal and unethical. It is uneconomical as well.- It deserves to be deprecated not only by the Government but the companies as well. The next expression Is Tax avoidance'which is the art of dodging taxes, without breaking the law, In my opinion, tax avoidance means travelling within the framework of the law or acting as per the language of the law only in form, but murdering the very spirit of the law and thus acting against the intention of the law and defeating the purpose of the particular legal enactment. If, by adopting an artifice or device against the intention of the legislature but apparently on the face of it acting within the framework of the law, a company is able to dodge income tax, it ~would be a clear case; of tax avoidance. In contrast, "Tax Planning' takes maximum advantage of the exemptions, deductions, rebates, reliefs and other tax concessions allowed by taxation statutes,.leading to the reduction of, the tax liability of the tax payer. Tax planning' has been contrasted with the expression tax avoidance and has the legal sanction of the Supreme Court as well! In recent years the sentiments in favour of tax avoidance have changed and the courts view tax avoidance with displeasure. For example, Lord Sumner in IRC v. Fisher's Executors (1926] 10 T.C. 302 (H.L.) had earlier as per the ratio of Westminster's case said:

"My Lords, the highest authorities have always recognized that the subject is entitled so to arrange his affairs as not to subtract taxes imposed by the Crown, so far as he can do so with the law, and that he may legitimately claim the advantage of any expressed terms or any omissions that he could find in his favour in taxing Acts. In so doing, he neither comes under liability nor incurs blame."

The significance of Ramsay as a turning point in the interpretation of tax laws in England and the departure from the principle of Westminster's case were explained in IRC v. Burmah Oil Co.Ltd., [1982] STC 30 where Lord Tip lock said:

"It would be disingenuous to suggest and dangerous on the part of those who advise on elaborate tax-avoidance schemes to assume, that Ramsay's case did not mark a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which they were inserted steps that have no commercial purpose apart from the avoidance of a liability to tax, which in the absence of those particular steps would have been payable. The difference is in approach."

Commenting on this judgment the Supreme Court of India in the case of Me Dowell 8K Co Ltd. v CTO [1985J 154. ITR 148 (Sc) said:

"It is neither fair nor desirable to expect the legislature to intervene and take care of every device and scheme to avoid taxation. It is up to the court to stock to determine the nature of new and sophisticated legal devices to avoid tax and consider whether the situation created by the devices could be related to the existing legislation with the aid of emerging techniques of interpretation as was one in Ramsay, Burmah Oil and Dawson cases to expose the devices' for what they really are and to refuse to give judicial benediction."

In the same judgment, Supreme Court Judges made a clear distinction between tax avoidance and tax planning. This is what the judges of the Supreme Court have said in the same case:

"Tax Planning may be legitimate provided it is within the framework of law. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges."

Referring to the Supreme Court's ruling in McDowell's case (1985) 154 ITR 148 (SC) the Madras High Court in M. V. VallippanITO (1986) 170 ITR 238 held that genuine transactions were not hit by, McDowell's case. Likewise the Supreme Court in c-W.T. v Arvind Narotlam (1988) 173 ITR 479(SC) held that where the true effect on the construction of deeds is clear the appeal to discourage tax avoidance is not a relevant consideration. Further the Gujarat High Court in Banyanand Berry v. CIT (1996) 222 ITR 831 examined the effect of McDowell's case and by distinguishing it held that the ratio of any decision has to be. Understood in the context it has been made.

From the above it is very clear that tax planning by a company cannot be called a crime or an illegal activity or an immoral action as is wrongly considered by confused thinkers on the subject. What constitutes a crime is tax evasion and what is undesirable is tax avoidance but it is certainly desirable to engage in the exercise of tax planning. In this book, we have discussed only tax planning aspects which enable a company to save a good deal of tax and also avoid unwarranted harassment, worry and tension.

Over the last eight decades, since the introduction of income-tax, it has been observed that there is a constant struggle between taxpayers and tax collectors, the former trying to reduce (if not negate) their tax liability, and the latter seriously struggling to plug in the loopholes in the statute.

Self Check Exercise

3. What is the term for the legal process of rearranging financial affairs to minimize tax liability?
4. Identify the method of managing taxes that involves adjusting the timing of income or deductions to optimize tax outcomes.

5.4 TAX PLANNING AND TAX AVOIDANCE AND TAX EVASION

To understand the meaning of tax planning, tax avoidance and tax evasion, one can go through the following cases:

Case *X*

X is an individual. For the assessment year 2007 -08, his gross total income is Rs. 2,40,000. Tax on Rs. 2,40,000 is Rs. 23,460. To reduce his tax liability, he deposits Rs. 50,000 in public provident fund account. Consequently, his taxable income and tax liability thereof will be reduced to Rs. 1,90,000 and Rs. 13,260 respectively. As the tax liability has been reduced within the legal framework, it is tax planning.

Case 2

X Ltd. is a chemical manufacturing company. It has a factory in Haryana near Delhi border. Within the factory campus a piece of land of 2000 square meter is lying unutilized. The company wants to start a new unit to manufacture computer components. If this manufacturing unit is started in the existing factory campus, deduction under section 80- IB is not available. However, if the new unit is started in Jammu & Kashmir, the company can claim deduction under section 80-IB. To get the benefit of deduction under section 80-IB, the company starts the new unit in a village near Jammu. The company has two options. Under one of the options, deduction under section 80-IB is not available. However, this deduction is available under the other option. To get the benefit of deduction under section 80-IB, the new unit has been started in Jammu & Kashmir. As the tax liability has been reduced to get the benefit of deduction available under the income- tax, it is tax planning.

Case 3

Suppose in Case 2, the process of manufacturing actually takes place in Haryana. To get the benefit of deduction under section SO-IB, the company takes a factory building on rent in a village in Jammu and only on paper it is shown that the new manufacturing unit is situated in a village near Jammu. As the company wants to reduce the tax liability by making incorrect statement about the location of manufacturing process, it is tax evasion.

Case 4

If a sum of money is gifted by a husband to his wife,' income generated there from is taxable in the hands of husband under the clubbing provisions of section 64(1). Section 64(1) is not applicable if gift is made by the same person out of the funds of his Hindu undivided family in capacity as Karta of the family.

If gift is made by Karta of the family to his wife, clubbing provisions can be avoided and ultimate tax liability will be reduced. However, the tax liability will be reduced by taking the help of a loophole in the law but within the legal framework. It is tax avoidance.

5.5 WHAT IS TAX PLANNING?

Tax planning can be defined as an arrangement of one's financial and economic affairs by taking complete legitimate benefit of all deductions/ exemptions, allowances and rebates so that tax liability reduces to minimum. Tax planning also involves-the procedures of compliance with the statutory provisions of law. Essential features of tax planning are as under:

- It comprises arrangements by which tax laws are fully complied.
- All legal, obligations and transactions (both individually and as a whole) are met.
- Transactions do not take the form of colorable devices (i.e., those devices where statute is followed in strict words but actually spirit behind the statute is marred would be termed as colorable devices).
- There is no intention to deceit the legal spirit behind the tax law.

Self Check Exercise

5. Tax planning involves:
   a)Legally minimizing tax liability
   b) Illegally evading taxes
   c) Both a and b
   d) None of the above

6. Tax evasion involves:
   a)Compliance with tax laws
   b) Intentionally violating tax laws to escape paying taxes
   c) Strategic tax planning
   d) None of the above

7. Tax management includes:
   a)Efficiently organizing financial affairs to minimize tax liability
   b) Illegally manipulating financial records to evade taxes
   c) Both a and b
   d) None of the above

8. Which of the following is considered a proactive approach to dealing with taxes?
   a) Tax evasion
   b) Tax avoidance
   c) Tax compliance
   d) none of the above

5.6 WHAT IS TAX AVOIDANCE?

The line of demarcation between tax planning and tax avoidance is very thin and blurred. The English courts about eight decades ago recognized the right of a taxpayer to resort to the legal method of tax avoidance. It is well settled that it is unconstitutional for the Government to attempt tax collection without the authority of law or legal basis. Similarly, a taxpayer cannot escape tax payment outside the legal framework, as he renders himself liable for prosecution as a tax evader.

Tax avoidance is reducing or negating tax liability in legally permissible ways and has legal sanction. Essential features of tax avoidance are as under:

- Legitimate arrangement of affairs in such a way so as to minimize tax liability.
- Avoidance of tax is not tax evasion and carries no public disgrace with it.
- An act valid in law cannot be treated as fictitious merely on the basis of some underlying motive supposedly resulting in lower payment of tax to authorities.
- There is no element of malafide motive involved in tax avoidance.

Over and over again, the courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Tax avoidance is sound law and certainly not bad morality for any body to so arrange his affairs in such a way that the brunt of taxation is the minimum. This can be done within the legal framework even by taking help of loopholes in the law. If on account of a lacuna in the law or otherwise, the assessee is able to avoid payment of tax within the letter of law, it cannot be said that the action is void because it is intended to save payment of tax. So long as the law exists in its present form, the taxpayer is entitled to take its advantage.

The above meaning of tax avoidance has also now acquired the judicial blessings of the Supreme Court of India in Union of India v. AzadiBachaoAndolan (2003) 263 ITR 706/132 Taxman 373, which reversed the findings in its earlier judgment in McDowell & Co. Ltd. v. CTO [1985] 154 ITR 148/122 Taxman 11 as legally incorrect.

If the Court finds that notwithstanding a series of legal steps taken by an assessee, in case the intended legal result has not been achieved, the court might be justified in overlooking the intermediate steps. But it would not be permissible for the court to treat the intervening legal steps as fictitious based upon some hypothetical assessment of the “real motive’ of the assessee. The Court must deal with what is tangible in an objective manner. In other words, an act which is otherwise valid in law cannot be treated as fictitious merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests. A transaction or arrangement which is perfectly permissible under law and has the effect of reducing the tax burden of the assessee, should not be looked upon with disfavor.

5.7 WHAT IS TAX EVASION?

All methods by which tax liability is illegally avoided are termed as tax evasion. An assessee guilty of tax evasion may be punished under the relevant laws. Tax evasion may involve stating an untrue statement knowingly, submitting misleading documents, suppression of facts, not maintaining proper accounts of income earned (if required under law), omission of material facts on assessment. All such procedures and methods are required by the statute to be abided with but the assessee who dishonestly claims the benefit under the statute before complying with the said abidance by making false statements, would be within the ambit of tax evasion.

A person may plan his finances in such a manner, strictly within the four comers of the taxing statute that his tax liability is minimized or made nil. If this is done and as observed strictly in accordance with and taking advantage of the provisions contained in the Act, by no stretch of imagination can it be said that payment of tax has been evaded for. In the context of payment of tax, 'evasion* necessarily means, *to try illegally to avoid paying tax’ - CIT v. Sri AbhayanandaRath Family Benefit Trust [2002] 123 Taxman 81 (Ori.).

5.8 TAX AVOIDANCE V. TAX EVASION

The following are the broad areas of distinction between the two:

Tax avoidance	*Tax evasion*
1. Any planning of tax which aims at reducing or negating tax liability in legally recognized permissible ways, can be termed as an instance of tax avoidance.	l. An AU method by which tax liability is illegally avoided is termed as tax evasion.
2. Tax avoidance takes into account the loopholes of law.	**2.** Tax evasion is an attempt to evade tax liability with the help of unfair means/ methods.
3. Tax avoidance is tax hedging within the framework of law.	**3.** Tax evasion is tax omission.
4. Tax avoidance has legal sanction	**4.** Tax evasion is unlawful and an assessee guilty of tax evasion may be punished under the relevant laws.
5. Tax avoidance is intentional tax planning before the actual tax liability arises.	**5.** Tax evasion is intentional attempt to avoid payment of tax after the liability to tax has arisen.

5.9 SUMMARY

This lesson has shown the importance and the necessity for corporate tax planning. The extent of tax saving that can be affected by a company or a corporate enterprise or a group is not theoretical but all depends upon the practical implications of the tax planning ideas. One thing of which a company can be certain is that corporate tax planning, if adopted in the true spirit will definitely enable the company to save a good deal of its hard earned income in taxes which would be available for the company for not only its internal resources but also for carrying out its schemes for future development, whether by way of diversification or expansion, 1-sading ultimately to overall prosperity of the corporate enterprise. A very useful point that should be remembered by every company is the preparation of charts to work out the different possibilities and the result of alternative approaches in tax saving over a period of say, 4 to 5 years before finally embarking upon a particular scheme of tax planning. Thus, the preparation of statistical charts and a good deed of homework in this regard is absolutely essential for the adoption of an ideal 'scheme of tax planning in regard to the measures'. In the case of Bharat Construction Co (P) Ltd. v. CIT (2001) 250 ITR 291 it was held that a conclusion about the nature of a transaction i.e., whether it is a colorable or otherwise, if supported by material or evidence is essentially one of fact.

5.10 Keywords

Tax Liability: The amount of taxes an individual or business is obligated to pay based on their taxable income.

Deductions: Expenses or allowances that reduce taxable income, often utilized in tax planning to minimize tax liability.

Exemptions: Certain incomes or amounts excluded from taxable income, influencing tax planning strategies.

Tax Credits: Direct reductions in tax liability provided by the government to incentivize specific behaviors or activities.

5.11 QUESTIONS FOR REVIEW

Short Answer Type Questions

1. Discuss the objectives and importance of tax planning in detail.
2. What are Maximum taxpayer units? Explain.
3. Discuss the methods of corporate tax management.
4. What is tax planning? What is tax avoidance? Elaborate.

Long Answer Type Questions

5. Differentiate between Tax avoidance and Tax evasion.
6. Explain the significance of tax planning in personal finance and business management.
7. Explore the ethical considerations and potential challenges in tax planning.

5.12 SUGGESTED READINGS

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5.13 Self Check Exercise (Answer Key)

1. True, 2. True, 3. Legally minimizing tax liability, 4. Intentionally violating tax laws to escape paying taxes, 5. Efficiently organizing financial affairs to minimize tax liability, 6. Tax Avoidance, 7. Tax planning, 8. Timing

MBA-DE(Second Tear) **CTP (418) CORPORATE TAX PLANNING**
Semester-IV
Lesson No. 6 **AUTHOR: SANJEEV KUMAR**

TAX PLANNING AREAS

STRUCTURE

6.0 OBJECTIVES

This lesson discussesall the significant aspects of tax planning areas. After the completion of this Lesson, you should be able to understand the following: ,

- Tax planning regarding organizational set-up
- Forms of Organization
- Tax planning through location of business
- Tax planning regarding financial structure of a company
- Tax planning through commencement of production
- Tax planning of executive salary and perquisites
- Method of accounting

6.1 INTRODUCTION

A company should adopt proper tax planning before setting up a new business enterprise. Thus tax planning, to be really effective, must precede the management decisions in relation to a new business. For example, if a company wants to set up a new business - say, a new industrial undertaking - it must decide on the type of organizational set-up in respect of the new undertaking, the financial structure of the undertaking, its location and the timing of its commencement, etc. Likewise, it must also take decision on whether it should invest its funds in acquiring the immovable property, plant and machinery, etc., of the business or it should go in for leasing of these assets.

Another important consideration, that should be considered as part of important management decisions at the time of starting, a new business, is the total salary and perks package (especially after the new rules for valuation of perquisites) which it should offer to its senior executives. The system of accounting to be followed and, in particular, the method of valuation of stock, should also be decided upon at the start itself. All these aspects of tax planning for a new business help in saving a good deal of money on income tax by a company. These aspects are discussed in detail in this lesson.

6.2 TAX PLANNING REGARDING ORGANISATIONAL SET-UP

The organizational set-up of a new business may differ a great deal from the case of an existing company in comparison to a new company formed for carrying on a business. The rate of income tax applicable to an Indian company is 35% with 2.5% surcharge thereon for the AY 2005-2006. As per the Finance (No.2) Bill, 2004, there is 2% Education cess on the amount of IT fit S.C. from the assessment year 2005-2006. Hence, the corporation tax payable by a company on the type of business activity to be adopted by it plays an important role in deciding the nature of business of the company and also its organizational set-up.

Thus, wherever possible, the corporate enterprise should set up a public limited company to secure the lower rate of income tax, if any. However, in case of family controlled concerns which are closely held companies, initially, the small and medium scale enterprises may be set Up as a private limited concern. Where public funds are required in substantial quantities the only alternative for a company is to organize itself as a public limited company. Another feature which has some bearing on the choice of the organizational set-up is the 1 % wealth tax payable by companies on certain assets like farms houses, open land, motor cars, jewellery, etc.

Further, if a company wants to carryon an export business only, then it would be advisable to form a separate company for the purposes of export so that part of the export profits could be partly exempted from income tax under Section 80-HHC. Where, however, the margin of profit in the export business is lower than the margin of profit in the domestic business and the export turnover is comparatively large, it may be advisable to have a composite business activity under the same company so that greater part of the total profits couid be exempted from income tax. If a company is an existing one and sets up a new business either in an expansion or by way of diversification then it could set up another unit to be known as a new industrial undertaking of the existing company.

In that case the profits and gains of the new industrial undertaking also become eligible to the deduction of 30% thereof under Section 80-IB, And, in some States, Union Territories and industrially backward districts it may even be exempt up to 100% for the initials years. Likewise, certain undertakings and enterprises in certain category States are entitled to 100% deduction on their income as per Section 80IC. The main point that should be taken into account, while deciding the organizational set-up is the rate of income tax applicable to the income of the company and the tax concessions which could be easily obtained by having one particular type of set-up in preference to another.

Further, the company should prepare a statistical chart of the tax incidence over a period of 4 or 5 years and see the effect of income tax over different alternatives and then choose the one which results in the least possible income tax. The decision whether to set up a particular type of company as a closely-held company or as a public limited company, etc., should normally be a tailor-made decision depending on the peculiar facts and circumstances of each case.

6.3 FORMS OF ORGANISATION

Following are common forms of organizations for doing business in India:

1. **Sole Proprietor:** At the time of startup the entrepreneur usually has to handle all functional responsibilities of the venture and handles production, marketing, personnel, finance himself. As a result the vast majority of new businesses start as sole proprietors. This form has the added merit of being free from formalities regarding incorporation or maintenance of accounts or auditing etc.

2. **Partnership;** As the business grows the requirements for funds and management will also increase which might lead him to enter into partnership with one or more persons. It is always preferable to have a written -agreement in the form of a partnership deed which clearly indicates the names and addresses of the partners, their ages, contribution to capital, profit sharing, ratio etc.' This form also makes for pooling of skills and responsibilities and spread of risk.

3. **Company:** A company can be a private limited company, in. which case it can have a minimum of 2 and a maximum of 50 members. It can be a public limited company, which /has to have a minimum of 7 members, and there is no maximum limit. This form of organization provides vast amounts of capital as they, unlike the private limited company, invite the general public to subscribe to its shares and also provide limited liability. The Companies Act of 1956 governs the companies.

4. **Co-operative:** A co-operative is an enterprise owned and controlled by people working in it. Generally they are formed for some specific purpose like a housing cooperative society.

Clearances and Approvals: Setting up of an industrial unit requires the entrepreneur to ^obtain a number of clearances and approvals regarding land use, pollution control and safety. In this regard, you would be required to interact .with the local government authorities such as the municipalities/ village panchayat and state pollution control boards. In case, you wish to avail the incentives accruing to the firms registered under Export Processing Zone/Special Economic Zone (SEZ), Software Technology Park (STP),or 100% Export Oriented Unit you would be required to register as such. Besides, certain products may require specific clearances from the relevant departments/authorities.

Self Check Exercise

1. What is the term for the legal structure or arrangement of a business entity that has significant implications for tax planning?
2. Identify the tax planning strategy that involves choosing a specific legal structure for a business based on its tax implications.
3. In tax planning, what refers to the specific legal status a business entity adopts for its operations?

6.4 TAX PLANNING THROUGH LOCATION OF BUSINESS

The location of business, say, of a new industrial undertaking, has great significance in saving income tax for a company. Where a company is dealing in exports, it will have to decide whether to set up a new industrial undertaking in a Free Trade Zone or Software Technology Parks (STPs) or Electronic Hardware Technology* Parks (EHTPS) or to set it up as a 100% export oriented unit (EOU) or in Special Economic Zone (SEZ) or to set it up as an export company at any place. The main factor which is to be considered by a company in this regard is the availability of the income tax concession for a period of 10 years so as to make the entire profits of the company 100% exempt from tax relief under section 10-A and 10 B.' However, as per the Finance Act, 2002 only for one Assessment Year namely, A.Y, 2003-2004 income tax would be payable on 10% income of those units which are covered within ambit of Section 10A & 10B of the IT Act. There is no guarantee of the continuance of the 100% tax exemption under Section 80-HHC in respect of . export profits because of the phasing out policy as per the Finance Act, 2000.

Hence, a company interested in securing a guaranteed tax exemption, if it can afford to do so, should have set it up as a new industrial undertaking in a Free Trade Zone or EHTP, SEZ, or STP or as a 100% EOU only or an industry in North-Eastern States or certain undertakings in special category States like Uttaranchal, Himachal, Sikkim & N.E. States. Thus, tax planning regarding the location of the industry has to be adopted to secure maximum tax advantage.

6.5 TAX PLANKING REGARDING FINANCIAL STRUCTURE OF A COMPANY

Before commencing a new company or business a vital managerial decision regarding selecting right type of capital structure has to be taken. An optimum capital structure is one which maximizes shareholders' return. The advantages of having an optimum capital structure are two-fold. It maximizes the value of the assets of the company and wealth of its cover and minimizes the cost of capital which, in turn, raises its ability to find inbuilt additional it vestment opportunities. Problem of planning capital structure is of crucial importance and has] on^'-terra implications. The tax planner should properly balance risk, cost, control and tax consideration. In capital structure decisions, the cost of capital is an important consideration along with, risk factor. One of the main reasons for raising finance through borrowing (as against issue of equity shares) is to increase earning on equity share capital. But excessive use of debt capital Increases the financial risk of the company.

6.6 TAX PLANNING THROUGH COMMENCEMENT OF PRODUCTION

Often, due to ignorance about proper tax planning, some companies lose the benefit of proper deduction in computing the total income under Section 80-IA or 80IB. In some cases the loss of income tax is a heavy one where no thought is given to the actual date of commencement of production. As a general rule, wherever possible, a company, having a new industrial undertaking should commence its production in a commercial sense as soon after the dosing date of the financial year as possible.

In other words, the commencement of production should not be towards the end of the financial year. This is because if the commencement of commercial production is towards the end of the year, then the profits and gains for the particular year due to late start of the commercial production are likely to be much less in comparison with the normal profit and the benefit of tax deduction or exemption for one year is not availed of by the company in a practical sense. For example, if a small scale company starts its production in J. & K. in the month of March, 2004 and its commercial production is valued at say, Rs. 10 lakh as against the normal expected production of Rs. 4 crore per year, then the profits and gains for the financial year 2003-2004 relevant to the AY 2004-2005 will of course become entitled or eligible to tax deduction under Section 80IB (5) @ 100% but there will in actual effect be no tax advantage-due to the smallness the profit resulting from the late start of the commercial production. If, however, the said production in a commercial sense is commenced from 1 April, 2004, then the company would be able to enjoy the full benefit of deduction @ 100% for the full financial year 2004-2005 relevant to the A Y 2005-2006 and it can continue to enjoy the benefit for the next 10 assessment years as per the Finance (No.2) Bill, 2004. If one year of tax deduction is lost due to non-availability in a practical sense of the tax deduction then the company stands to lose a good deal of tax benefit. There is only one exception in this connection and that is where a company has several profit earning units in relation to the new industrial undertaking and if the commercial production is shown even at the end of the year then a good deal of depreciation can be claimed in the year itself resulting into reduction of tax liability in the year.

Hence', these aspects should be kept in view while adopting proper tax planning in relation to the commercial production. If this is not feasible, or desirable, a company could can on trial production for some time till the beginning of the next financial year. This tax planning will help in enabling the company to enjoy the tax benefit in a full measure for one full additional year. Reference may be made to the facts and decision in an important case on trial production and commercial production. It is the decision of the Bombay High Court in the case of CIT v. Hindustan Antibiotics Ltd [1974) 93 ITR 528.

In this case the company undertook a project for the manufacture of penicillin. It started actual operations for the manufacture of crude penicillin in December 1954. The first samples of crude penicillin were required to be sent to the USA and the UK for obtaining certificates as to their qualities.

The certificates were obtained in June 1955 and the assessee company started regular production of penicillin the only product that could be sold in the market in August 1955. The question arose as to when the company started the manufacture of proper penicillin. Thus the benefit of exemption under Section 15- C of the bid IT Act (akin to the present Section 80-IE) arose to the assessee company for the first time in the AY 1956-57 and it was eligible to exemption for the assessment year 1960-61 also. It was also held in the case that the word “articles" used in the expression "has begun or begun to manufacture or produce articles* of the section must be interpreted by having regard to the object for which the section was enacted.

The provision was enacted with a view to encouraging the establishment of new industrial undertakings and the object was sought to be achieved by granting exemption from tax on profits derived profit such undertakings during the first 5 years as per Section 15-C of the old IT Act. The object of the section presupposes that profits are capable of being earned.

Hence until an assessee reaches a stage where it is in a position to decide that the final product which can be sold in the market can be manufactured, it cannot be said to have started manufacture of the articles. If it becomes necessary for an assessee to produce a trial product at an earlier stage to verify whether it can be used ultimately in the manufacture of the final article, the commencement of operation for the manufacture of the trial product would not constitute commencement of manufacture of articles for the purposes of this exemption. This is an important decision which can be appropriately utilized by an assessee company, if the facts and circumstances of the case so warrant, so that it does not lose that benefit of tax exemption for one year due to the late commencement of production during which time the manufacturing or production of articles can be termed as trial production.

Self Check Exercise (True/False)

4. Tax planning regarding the financial structure of a company involves optimizing the mix of equity and debt to achieve favorable tax outcomes.
5. Tax planning through the location of business focuses solely on minimizing local taxes and does not consider broader economic factors.
6. Tax planning through the commencement of production involves strategizing the timing of production activities to maximize tax benefits.

6.7 STATISTICAL CHARTS

The statistical charts, tables, diagrams and details play a very important role in saving more tax while adopting corporate tax planning. Whatever important management decision is to be considered by a company should be followed or preceded by a statistical chart in relation to the tax effect pertaining to the decision concerned. Hence every decision reflects the incidence of income tax for a period of 4 or 5 years in comparison with its alternative decision. This exercise of preparation of statistical data of charts and diagrams or tables alone would help in the proper adoption of tax planning while setting up a new business and taking several management decisions in relation thereto.

6.8 OWNERSHIP VERSUS LEASING OF ASSETS

At the time of starting of a new business an important decision which has to be taken by the management of a company is whether it should own the various assets or if it should take these lease or hire. Ownership of a building, say, an office building, could be acquired by a company either through registered conveyance deed or through an agreement to sell with a power of attorney or on hire-purchase basis. The main advantage in having the ownership of an office building or a factory building is that the company gets depreciation on the cost of the building.

Further, it has the advantage of appreciation of the value. Hence, whenever the funds of a company so permit, surplus funds of the company can be used in acquiring assets particularly immovable property. If, however, land is required by a company for its own work then it should not buy the land out of its own funds but should take the land, wherever it is possible to do so, on lease basis. This is because no depreciation is allowed on the value of the land whereas a reasonable amount of rent in respect of the land could be claimed as deduction. This would help in reducing the incidence of income tax on the company concerned.

The question of repairs assumes importance after a period of time in relation to ownership or leasing of assets. This is because, in the case of leased out assets, even heavy repairs can easily be claimed as current revenue expenditure, whereas, in the case of ownership, they are likely to be considered as an investment in the setting up a structure, etc. to become eligible for depreciation only, and not eligible for the 100% deduction for repairs in one year itself.

If a work is to be taken by a company as a temporary measure, then it is always advisable to take the office building as well as the other assets on lease basis only. Similarly, motor cars may not be purchased by a company but could be acquired on lease basis where the work is temporary in nature or is for a short duration only. In many cases companies are found to be resorting to taking the entire plant and machinery on lease basis. Plant and machinery should be taken on lease basis only where the company does not have sufficient funds for acquiring the entire plant and machinery on ownership basis. The income tax liability in this case generally is not adversely affected because the quantum of hire charges are so fixed as to take into consideration the depreciation which otherwise could have been enjoyed by the company had it owned the assets.

Generally speaking, the rate of 25% is a rate of depreciation available to the generality of items of plant and machinery. A company should not acquire motor car from its own funds but should acquire these only from borrowed funds so that it does not become liable to I % wealth tax on the value of motor cars beyond the initial exemption limit of Rs. 15 lakh. Likewise, the company should not acquire or own residential buildings for directors or top persons in the management from its own funds but should so acquire from borrowed funds so that in effect there is no tax liability of 1 % wealth tax.

6.9 TAX PLANKING OF EXECUTIVE SALARY AND PERQUISITES

At the time of the start of a new business an important aspect of tax planning which is generally lost sight of by many companies is about the salary and perks package to the senior executives. Of course, the entire salary and perks would be allowable to the company in any case whether it adopts one type of package in preference to the other package. But if a particular package of salary and perks helps in reduction of tax liability for the executive concerned then it could secure better management personnel and secure for them a lower tax incidence through proper tax planning.

. Hence, as part of its management decision while starting a new business, a company should devise the salary and perks package in such a manner as to secure maximum tax-free perquisites to the senior executives concerned. This principle is also applicable to middle-level executives and other executives as well who become liable to pay income tax. Thus, from the point of view of a management decision the tax planning of their perks, etc. may be very relevant for the company. Even in the case of an existing company, setting up a new unit or in the case of a continuing business also the tax planning aspects regarding salary and perks packages play an important role in saving income tax particularly for the executives concerned.

This is illustrated in the following Example.

In this example, the various allowances and perks like HRA of Rs, 3,750 and conveyance of Rs. 3,000 per month, medical reimbursement of Rs. 15,000, leave travel concession of Rs. 26,000 and the cost of office uniform of Rs. 13,000 would be completely exempt from income tax. Similarly, the attendant allowance received by him would also be exempt as he has fully spent the money.

Annual taxable salary of the Vice-President would be gross salary of Rs. 7,500 p.m., i.e. Rs. 90,000. Standard deduction of Rs. 30,000 would be allowed leaving a taxable total income of Rs. 60,000 on which he would be liable to pay income tax of Rs. 1,000, nil surcharge thereon i.e., total tax of Rs. 1,000 only. For the F.Y. 2004-2005 i.e., AY 2005-2006 as per new Section 88D, he would get rebate of tax of Rs 1,000 and the tax payable would be NIL. This example clearly shows a heavy saving of income tax of Rs. 37,000 by the Senior Executive because of judicious tax planning.

Example

There are two companies, let us say, A and B. One company takes a Vice President in its employment and offers him a total salary package of Rs. 2,40,000 including a sum of Rs. 15,000 to be spent approximately by him an attendant for which he receives this amount as attendant allowance: In this case the Vice President Would be required to pay income tax on the gross salary of Rs. 2,40,000 reduced by the standard deduction of Rs. 30,000, i.e. on Rs. 2,10,000. Income tax payable on the total income of Rs. 2,10,000 for the financial year 2004-2005 relevant to the AY 2005-2006 would be Rs. 37,000. Let us take the case of Company B which also spends Rs. 2.40 lakh is providing salary and various perks and allowances to its Vice-President. However, the salary, allowances and perks are analyzed and divided into the following groups:

Salary at Rs. 7,500 p.m.	Rs.90000
House rentRs. 3,750 p.m.	Rs.45000
(The Vice-President has to incur Rs, 5,000 per month on the residential accommodation at New Delhi, a part of which is used for office purposes as well)	
Conveyance allowance at Rs. 3,000 p.m.(fully spent by the Vice-President on office duties}.	Rs.36000
Attendant Allowance (fully spent by him)	Rs. 15000
Medical reimbursement for the executive and family Rs. 15000 Leave Travel concession for travelling to Trivandrum under Section 10(5) for self and family	Rs.26000
Amount spent on two safari suits and one suit as a part of compulsory uniform to be worn by all executives in office.	Rs. 13000

Self Check Exercise

7. In tax planning, what does "Expenditure" primarily refer to?
8. What term describes the legal entity or arrangement through which a business conducts its operations for tax planning purposes?

6.10 METHOD OP ACCOUNTING

The system of accounting plays a crucial role in the case of a new business set up by a company. After a recent amendment to the Companies Act, it has become compulsory for all companies to maintain books of account as per the mercantile system of accounting. Hence the only system of accounting that can be followed by the company is the mercantile system.

However, a company can adopt for its associate concerns which are in the non-corporate sector, like a partnership concern or a trust concern, etc., a system of accounting which is a cash system of accounting. The decision regarding the method bf accounting to be followed should be made after proper deliberations about the utility of the system to the special facts and circumstances of the case. This is because once a system is adopted, either cash system of accounting or the mercantile system, it cannot normally be changed later.

Only in exceptional cases a change from one system of accounting to another is permitted. The same is true in the case of the system of valuation of stock. The closing stock of goods of a company can be valued either at the cost price or at the market price or at cost t r market price, whichever is lower.

Generally speaking, the company should adopt the last method of valuation of closing stock, namely, the lower of two values, normally the cost price or the market value, whichever is lower. This would enable the company to minimize its profits for the relevant year concern .led and not pay for the expected hidden profits. This system of accounting reflects the correct profits of the company and also enables the company to pay the least possible income tax for the relevant year in question. From the A Y 1997-98 the Central Government may notify different accounting standards for different businesses. One such Notification is S.O. 69(E) dated 25.1.96 per CBDT Circular No. 9949 dated 25.1.96.

6.11 SUMMARY

In this lesson we have highlighted the importance of tax planning for a company setting up a new business enterprise. In particular, we have seen the significance of various decisions particularly when a new industrial undertaking is being set up, so that the benefit of maximum deductions and exemptions is obtained by the company in saving income tax. The other aspects of management decisions—connected with the setting up of a new business like ownership versus leasing as also the salary and perks packages and the system of valuation of stock, along with the decision on when to have the commencement of commercial production-have a great bearing on the computation of the taxable liability of a company and should therefore be kept in view as a part of prudent corporate tax planning.

6.12 Keywords

Tax Credits: Incentives provided by the government to corporations that reduce their tax liability directly.
Transfer Pricing: Determining the prices for transactions between affiliated entities to optimize tax outcomes.
Carry forward: The ability of corporations to offset current losses against future profits for tax planning purposes.

6.13 QUESTIONS FOR REVIEW

Short Answer Type Questions

1. Discuss tax planning regarding organizational set-up for a new business.
2. Discuss the different forms of Organization.
3. Discuss tax planning through location of business.

Long Answer Type Questions

4. Analyze the factors businesses consider when deciding on the geographical location of their operations, including tax rates, incentives, and economic conditions.
5. Discuss how businesses strategically choose locations to minimize tax burdens and maximize profitability

6.14 SUGGESTED READINGS

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6.15 Self Check Exercise (Answer Key)

1. Organization, 2. Structure,3. Entity, 4. True, 5. False, 6. True, 7. Deductions, 8. Structure

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TAX PLANNING AND FINANCIAL MANAGEMENT

STRUCTURE

7.0 OBJECTIVES

This lesson discusses all the significant aspects of tax planning and financial management. After the completion of this Lesson, you should be able to understand the following:

- Financing and capital structure decision
- Selecting an appropriate source of finance
- - Debt versus equity decision
- Cost of finance
- Business risk
- Capital Rationing
- Major sources of finance
- Tax planning and Capital structure decisions

7.1 INTRODUCTION

Financing decision is an important function to be performed by the finance manager. Broadly, he or she must decide when, where and how to acquire funds to meet the firm's project needs. The central issue is to determine the proportion of equity and debt. The mix of debt and equity is known as the firm's capital structure. The financial manager must strive to obtain the best financing mix or the optimum capital structure for his or her firm. The firm’s capital structure is considered to be optimum when the market value of shares is maximized.

7.2 FINANCING AND CAPITAL STRUCTURE DECISION

According to Gerstenberg, the capital structure of a company is defined as the makeup of its capitalization. Capitalization comprises a corporation's owned capital and borrowed capital, as represented by its long-term indebtedness. "Capital structure" refers to the kind of securities that make up the capitalization. Decisions about the amount of securities are reflected in the capitalization; decisions as to the kind of securities are reflected in the capital structure. The use of debt affects the return and risk of shareholders; it may increase the return on equity funds but it always increases risk. A proper balance will have to be struck between return and risk. When the shareholders' return is maximized with minimum risk, the market value per share will be maximized and the firm's capital structure would be considered optimum. Once the manager is able to determine the best combination of debt and equity, he or she must raise the appropriate amount through the best available sources. In practice, a firm considers many other factors such as control, ^^flexibility loan convenience, legal aspects etc. in deciding its capital structure.

7.3 SELECTING AN APPROPRIATE SOURCE OF FINANCE

A business faces three major issues when selecting an appropriate source of finance for a new project:

- Can the finance be raised from internal resources or will new finance have to be raised outside the business?
- If finance needs to be raised externally, should it be debt or equity?
- If external debt or equity is to be used, where should it be raised from and in which form?
- Can the necessary finance be provided from internal sources?

In answering this question the company needs to consider several issues:

How much cash is currently held? The company needs to consider the amount held in current cash balances and short-term investments, and how much of this will be needed to support existing operations. *If* spare cash exists, this is the most obvious source of finance for the new project. If the required cash cannot be provided in this way then the company should consider its future cash flow. If the company's projected cash flow is not sufficient to fund the new project then it could consider tightening its control of working capital to improve its cash position.

Pressurizing debtors for early settlement, running down stock levels and lengthening the payment period to creditors could increase cash resources. Note however, there are dangers in such tactics. For example, lost customer/supplier goodwill and production stoppages due to running out of stock etc.

If the necessary finance cannot be provided internally then the *company* has to consider raising finance externally.

7.4 DEBT VERSUS EQUITY DECISION

Here a company needs to consider how much it should borrow. This is a very important decision and several companies have experienced major problems with this decision in recent years. Issues to be considered include:

7.5 COST OF FINANCE

Debt finance is usually cheaper than equity finance. This is because debt finance is safer from a lender's point of view. Interest has to be paid before dividend. In the event of liquidation, debt finance is paid off before equity. This makes debt a safer investment than equity and hence debt investors demand a lower rate of return than equity investors. Debt interest is also corporation tax deductible (unlike equity dividends) making it even cheaper to a taxpaying company. Arrangement costs are usually lower on debt finance than equity finance and once again, unlike equity arrangement costs, they are also tax deductible.

7.6 CAPITAL GEARING

Although debt is attractive due to its cheap cost, its disadvantage is that interest has to be paid. If too much is borrowed then the company may not be able to meet interest and principal payments and liquidation may follow. The level of a company's borrowings is usually measured by the capital gearing ratio (the ratio of debt finance to equity finance) and companies must ensure this does not become too high. Comparisons with other companies in the industry or with the company's recent history are useful here.

7.7 SECURITY

Many lenders will require assets to be pledged as security against loans. Good quality assets such as land and buildings provide security for borrowing - intangible assets such as capitalized research and development expenditure usually do not. In the absence of good asset security, further borrowing may not be an option.

7.8 BUSINESS RISK

Business risk refers to the volatility of operating profit. Companies with highly volatile operating profit should avoid high levels of borrowing as they may find themselves in a position where operating profit falls and they cannot meet the interest bill. High-risk ventures are normally financed by equity finance, as there is no legal obligation to pay equity dividend.

7.9 Operating gearing

Operating gearing refers to the proportion of a company's operating costs that are fixed as opposed to variable. The higher the proportion of fixed costs, the higher the operating gearing. Companies with high operating gearing tend to have volatile operating profits. This is because fixed costs remain the same, no matter the volume of sales. Thus, if sales increase, operating profit increases by a larger percentage. But if sales volume falls, operating profit falls by a larger percentage. Generally, it is a high-risk policy to combine high financial gearing with high operating gearing. High operating gearing is common in many service industries where many operating costs are fixed.

Self Check Exercise

1. In capital structure decisions, what is the term for the mix of debt and equity used to finance a company's operations?
2. When selecting an appropriate source of finance, what is the common term for funds raised by issuing shares to the public?
3. In the debt versus equity decision, what is the term for the ownership interest in a company represented by shares?
4. In business risk, what is the term for the specific risks arising from changes in economic conditions, technological advancements, or market dynamics?

7.10 DILUTION OP EARNINGS PER SHARE (EPS)

Large issues of equity could lead to the dilution of EPS if profits from new investments are not immediate. This may upset shareholders and lead to falling share prices.

7.11 VOTING CONTROL

A large issue of shares to new investors could alter the voting control of a business. If the founding owners hold over 50% of the equity they may be reluctant to sell new shares to outside investors as their voting control at the AGM may be lost.

7.12 STATE OF MARKET

In a period of falling share prices many companies will be reluctant to sell new shares. They feel the price received Will be too low. This will dilute the wealth of the existing owners. Note this does not apply to rights issues where shares are sold to the existing owners of the company.

After consideration of the above points the company will be in a. position to decide between the use of debt or equity finance. The last major decision is what type of finance should be used and where should it be raised?

7.13 CAPITAL RATIONING

One additional complication is capital rationing, which occurs when the firm has a limited total amount of dollars available for investment and the outlay for profitable investments exceeds this limit. On the other hand, when the firm has sufficient funds available to invest in all profitable projects, we say the firm is operating without a funding constraint.

Another dimension is Capital Rationing, which occurs when the firm has a limited amount of funds available for investment and the outlay for profitable investments exceeds this limit. On the other hand, when the firm has sufficient funds available to invest in all profitable projects, we say the firm is operating without a funding constraint. There are many reasons why there is capital rationing:

(1) A' firm may be unwilling to use external funding (i.e. debt and common stock) and rely solely on retained earnings. This is because the managers feel that using debt makes the firm riskier and using common stocks dilute their controlling power.

(2) A firm may have shortage of resources such that additional projects cannot be properly managed.

(3) A firm limits the investment budget to control the expansion rate so that it will not be over-extended.

Further, capital rationing can be: soft capital rationing or hard capital rationing. Soft capital rationing is when the firm puts a limit on the capital budget for reasons mentioned above. On the other hand, hard capital rationing is a situation where the finance manager is unable to raise any capital for any capital project. This is a very unique situation, and the manager usually faces hard capital rationing when the firm faces severe financial difficulties or due to some preexisting contractual agreements.

7.14 MAJOR SOURCES OF FINANCE

Sources of project finance can be divided into two broad categories: Long-term Sources and Short-Term Sources. When financial Institution looks at a project, they consider only long term sources of finance. Following are the prime sources of finance:

1. Equity Finance

Large and well-known industries generally raise a major portion of their funds to meet their capital demands by selling shares of different types, namely, equity or ordinary shares, cumulative and non cumulative preference shares. The trend in recent times has been to issue shares of Rs. 10, Rs. SO and Rs. 100 to enable persons in the middle income group to subscribe to the share capital. Because of substantial money with the public, well-known industrial concerns find it quite easy to raise funds by selling equity shares, which are often oversubscribed.

For companies who already have shares in issue rights, issues are mandatory under company law. This means that any new shares have to be offered to existing shareholders in proportion to their existing holdings. This is to protect existing shareholders from the company selling shares to new investors at a low price and diluting the wealth of existing shareholders. This requirement may be overcome if existing shareholders are prepared to vote to “waive their pre-emption rights'.

The current status of the company is important. Companies listed on the Stock Exchanges can raise new equity finance by selling new shares on these markets by way of rights issues, offers for sale or placing. Other companies which lack access to the stock exchange find it more difficult to raise equity finance and may need to turn to venture capitalists if they require equity finance.

Equity capital represents ownership capital as equity shareholders collectively own the company. They enjoy the rewards and bear the risks of ownership. However, their liability, unlike the liability of the owner in a proprietary firm and the partners in a partnership concern, is limited to their capital contributions.

Authorized, Issued, Subscribed, and Paid up Capital:

The amount of capital that a company can potentially issue, as per its memorandum, represents the authorized capital. The amount offered by the company to the investors is called the issued capital. That part of issued capital which has been subscribed to by the investors represents the subscribed capital. The actual amount paid up by the investors is called the paid up capital typically the issued, subscribed, and paid up capital are the same.

Par Value, Issue Price, Book Value, and Market Value:

The par value of an equity share is the value stated in the memorandum and written on the share scrip. The par value of equity shares is generally Rs.10 (the most popular denomination) or Rs.100. Infrequently; one comes across par values like Rs.l, Rs.2, Rs.5, Rs.50, and Rs. 1,000.

The issue price is the price at which the equity share is issued. Generally the issue price and par value are one and the same for new companies. An existing company may sometimes set As issue price higher than the par value. Sonata Software (India) Limited, for example, set its issue price at Rs.80 per share as against the par value of Rs.10 per share. When the issue price exceeds the par 'value, the difference is referred to as the share premium. It may be noted that the issue price cannot be, as per law, lower than the par value.

The book value of an equity share is equal to:

Paid-up equity capital + Reserves and surplus divided by Number of outstanding equity shares

Quite naturally, the book value of an equity share tends to increase as the ratio of reserves and surplus to paid-up equity capital increases.

The market value of an equity share is the price at which it is traded in the market. This price can be easily established for a company which is listed on the stock market and actively traded. For a company which is listed on the stock market but traded very infrequently, it is difficult to obtain a reliable market quotation. For such a company, the market quotation may reflect the sale of a few shares in a past period and hence may not reflect the current market value of the firm. For a company which is not listed on the stock market, one can merely conjecture as to what its market price would be if it were traded. The market price is determined by a variety of factors like current earnings, growth prospects, risk, and company size.

2. Debt Finance

Debt finance comes in many different forms. The major considerations in raising debt finance are detailed below.

Generally, short-term borrowing (loans for leas than one year) is cheaper than longer-term borrowing (loans for more than one year). This is because many lenders equate time with risk. The longer they lend for, the more risk is involved as more things can go wrong. Hence they charge a higher interest rate on longer-term lending than on short-term lending.

However, short-term borrowing has a major disadvantage - renewal risk. Short-term loans have to be regularly renewed and the company carries the risk that lenders may refuse to extend further credit. This risk is at its highest on overdraft borrowing where the bank can call in the overdraft 'on demand'. With long-term borrowing, as long as the borrower does not breach the debt covenants involved, the finance is assured for the duration of the loan.

In choosing between short-term and long-term borrowing, the firm should consider the rule of thumb for prudent financing: 'finance short-term investments with short-term funds and long-term investments with long-term funds'. Simply, this means use cheap short-term borrowing where it is safe to do so (investments that are short-term in nature and hence renewal risk is not a problem) but use long-term finance for long-lived investments,

Fixed versus floating-rate borrowing

Many lenders offer the borrower the choice between a fixed rate of interest and one that floats (i.e. varies) with the general level of interest rates. Fixed-rate borrowing has the attraction of certainty but on average is more expensive. This is because lenders see themselves as taking more risk on fixed-rate lending as they may lose out if interest rates increase. Generally, floating rate borrowing is cheaper, but it carries more risk to the borrower as interest payable may increase if interest rates rise. If a firm is already highly geared it may consider the risks of floating-rate borrowing too high.

Statue of the company

Some types of debt finance are only available to large listed companies. Small companies are usually restricted to short-term borrowing. If long-term debt finance is available it is usually in the form of leasing, sale and leaseback, hire purchase or mortgage loans on property.

Currency of borrowing

It is important to remember that if a company borrows in a foreign currency it has to repay the loan and the interest in that currency. Currency fluctuations may add to the cost of the loan and increase the risk involved.

Debt Covenants

Borrowing money often entails certain obligations for the borrower over and above repaying the interest and principal. These are referred to as covenants. These include restrictions on the use of assets financed by the loan, restrictions on dividend payments and restrictions on further borrowing. Such covenants restrict the flexibility of the borrower and should be carefully considered before borrowing money.It is not possible to recommend an ideal source of finance for any project. What is important is that one should know the advantages and disadvantages of different financing methods and then can decide the source (s) accordingly.

Self Check Exercise (True/False)

5. Capital rationing involves allocating limited capital among various investment projects based on their priority and profitability.
6. In capital rationing, the primary criterion for project selection is the size of the investment required.
7. Equity is a major source of finance that represents ownership in a company and is often obtained through the issuance of shares.
8. Debt is a major source of finance that does not require repayment and does not contribute to capital rationing decisions.

3. Preference Capital

Preference capital represents a hybrid form of financing , some characteristics of equity and some attributes of debentures. It resembles equity in the following ways:

(i) preference dividend is payable only out of distributable profits;

(ii) preference dividend is not an obligatory payment (the payment of preference dividend is entirely within the discretion of directors); and (iii) preference dividend is not a tax-deductible payment.

Preference capital is similar to debentures in several ways:

(i) the dividend rate of preference capital is usually fixed;

(ii) the claim of preference shareholders is prior to the claim of equity shareholders; and

(iii) Preference shareholders do not normally enjoy the right, to vote.

Preference capital offers the following advantages:

- There is no legal obligation to pay preference dividend. A company does not face bankruptcy or legal action if it skips preference dividend.
- There is no redemption liability in the case of perpetual preference shares. Even in the case of redeemable preference shares, financial distress may not be much because
- periodic sinking fund payments are not required and (ii) redemption can be delayed without significant penalties.
- Preference capital is regarded as part of net worth, if its redemption is subordinated to repayment of debt.
- Preference shares do not, under normal circumstances, carry voting right. Hence, there is no dilution of control.
- NO security of assets is provided to preference shareholders. Hence, the mortgage able assets of the firm are conserved.

4: **Internal Accrual***

The internal accruals of a firm consist of depreciation charges and retained earnings. Depreciation represents the allocation of capital expenditure to various periods over which the capital expenditure is expected to benefit the firm. Suppose a machine costs Rs. 100, 000 and has an economic life of five years at the end of which its expected salvage value is 0. If the machine is depreciated using the straight line method the annual depreciation charge will be Rs 20,000. Each year a depreciation cost of Rs 20,000 is. shown in the profit and loss account. This cost merely represents a periodic write off of a capital cost incurred in the beginning, Put differently, it is a non cash charge. Hence, it is considered an internal source of finance.

Retained earnings are that portion of equity earnings (profit after tax less preference dividends) which are ploughed back in the firm. Because retained earnings are the sacrifice made by equity shareholders, they are referred to as internal equity. Companies normally retain 30 percent to 80 percent of profit after tax for financing growth. If you look at a sample of corporate balance sheets you will find that reserves and surplus (other than share' premium reserve and revaluation reserve), which essentially represent accumulated retained earnings, are an important source of long-term financing. Even this is an understatement of the contribution of retained earnings to long-term financing because a portion of reserves and surplus would have been capitalized by the firm if it had issued bonus shares.

S. **Term Loans**

Firms obtain long - term debt mainly by raising term loans or issuing debentures. We have discussed at length the features and types of debentures. Historically, term loans given by financial institutions and banks have been the primary source of long term debt for private firms and for most of the public firms. Term loans, also referred to as term finance represents a source of debt finance which is generally repayable in less than 10 years. They are employed to finance acquisition of fixed assets and working capital margin. Term loans differ from short term bank loans which are employed to finance short term working capital need and tend to be self liquidating over a period of time, usually less than one year.

7.15 TAX PLANNING AND CAPITAL STRUCTURE DECISIONS

Under the income tax laws, dividend on shares is not deductible, while interest paid on borrowed capital is allowed as deduction under section 36(l)(iii). Cost of raising finance through borrowing is deductible in the year in which it is incurred (if, however, it is incurred during recommencement period, it has to be capitalized. Cost of issue of share is allowed as deduction in five years under section 35D. Because of the aforesaid provisions, corporate taxation plays an Important role in determining the choice between different sources of financing.

The financial structure of a company plays an important role in influencing the incidence of income tax payable by a company. For example, if a company utilizes maximum capacity for loans from banks, from directors, from friends and others it can get 100% deduction in respect of the interest payable on the loans. In contrast, if a company raises its funds mostly by issue of capital then the return on the capital in the form of dividend is only out of tax-paid profits. The dividend payable by a company is not eligible for any deduction in the computation of taxable income of a company and thus the burden of tax on a company increases in the second case where it banks more on the funds through the issue of capital than through borrowings. In the case of a public limited company there are certain limitations regarding borrowings as per the Companies Act.

However, maximum utilization should be made by the company for making available financial resources through borrowings from shareholders in preference to the capital. Where the company does not have good profit earning capacity in the beginning or for a few years, and requires loans which can be given by the associate concern in the same corporate group, then the associate Concern could adopt proper tax planning and give part of its own funds without charging any interest.

. Thus, the interest-free loans or deposits by the associate concerns would help in the tax planning for both the companies. In the case of the company giving interest-free loans, there would not be any addition in respect of the interest which has not been charged because it is treated as interest-free accommodation loan. Likewise, in the case of the losing concern or the sick concern because of the lack of profits, the advantage of claiming deduction for interest cannot be availed of by it and hence there would not be any loss in income tax in the case of the borrowing company as well. This is as per the principles laid down by the Supreme Court of India in the case of CIT v. A. Raman & Co. 67 ITR 11 (sc). This decision was followed by the Punjab and Haryana High Court in the case of CIT v Ferozepore Finance P. Ltd. 121 ITR 619.In the latter case, the Supreme Court did not grant the Special Leave Petition as reported in 145 ITR 50 (statutes). Thus, proper tax planning can be adopted regarding the financial structure of a company through the medium of interest-free loans within the same organization, particularly where the borrowing company is a sick company or is a company with a long gestation period. The manner of incurring the cost before actual commencement of production is also to be decided on by a company through proper tax planning, as all the expenditure incurred by a company forms part of the 'actual cost' of the plant and machinery on which the benefit of depreciation can be obtained by a company.

7.16 SUMMARY

Financing decision is an important function to be performed by the finance manager. Broadly, he or she must decide when, where and how to acquire funds to meet the firm's project needs. The capital structure of a company is defined as the make up of its capitalization. Capitalization comprises a corporation's owned capital and borrowed capital, as represented by its long-term indebtedness. "Capital structure* refers to the kind of securities that make up the capitalization. Decisions about the amount of securities are reflected in the capitalization; decisions as to the kind of securities are reflected in the capital structure. The use of debt affects the return and risk of shareholders; it may increase the return on equity funds but it always increases risk. A proper balance will have to be struck between return and risk when the shareholders' return is maximized with minimum risk, the market value per share will be maximized and the firm's capital structure would be considered optimum. Once the manager is able to determine the best combination of debt and equity, he or she must raise the appropriate amount through the best available sources. In practice, a firm considers many other factors such as control, flexibility loan convenience, legal aspects etc. in deciding its capital structure.

7.17 Keywords

Tax Efficiency: Structuring financial activities to minimize tax liability while staying compliant with relevant tax laws.

Deductions: Expenses or allowances subtracted from income to reduce taxable income.

Tax Credits: Direct reductions in tax liability provided by the government to incentivize specific behaviors or activities.

7.18 QUESTIONS FOR REVIEW

Short Answer Type Questions

1. What are financing and capital structure decisions for a company?
2. Discuss Debt versus equity decision for a company.
3. What is Capital gearing? Discuss.
4. What are the major sources of finance? Discuss.
5. Discuss Tax planning and Capital structure decisions.

Long Answer Type Questions

4. Outline the objectives and strategies involved in tax planning, emphasizing its impact on cash flow, profitability, and overall financial health.

5. Explore the various methods individuals can employ to optimize their tax position, including investment choices, retirement planning, and estate planning.

7.19 SUGGESTED READINGS

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7.20 Self Check Exercise (Answer Key)

1. Structure, 2. Equity, 3. Equity, 4. External. 5. True, 6. False, 7. True, 8. False

MBA-DE(Second Year) CTP (418)
Semester-IV **CORPORATE TAX PLANNING**
Lesson No. 8 **AUTHOR: DHIRAJ SHARMA**

TAX CONSIDERATIONS IN DIVIDEND POLICY AND BONUS SHARES

STRUCTURE

8.1 Introduction
8.2 Accumulated profits
8.3 Distribution of accumulated profits entailing release of company's assets (Sec. 2(22).(a)j
8.4 Distribution of accumulated profits in the form of debentures, debenture stock {Sec. 2(22){b)J
8.5 Distribution of accumulated profits at the time of liquidation (Sec. 2(22)(c)]
8.6 Distribution of accumulated profits on the reduction of its capital (Sec. 2(22}(d)]
8.7 Distribution of accumulated profits byway of advance or loan (Sec. 2 (22)(e)]
8.8 Payments to a shareholder or concern not treated as dividend
8.9 Points to be borne in mind while applying section 2(22)(e)
8.10 Tax treatment in the h arid s of shareholders
8.11 Dividend Received From A Domestic^ Company
8.12 Dividend Received From A Non-Domestic Company
8.13 Bonus shares to equity shareholders '
8.14 Bonus shares to preference shareholders
8.15 Capital Gain On Bonus Shares
8.16 Summary
8.17 Keywords
8.18 Questions for review
8.19 Suggested Readings
8.20 Self Check Exercise (Answer Key)

8.0 OBJECTIVES

This lesson discusses all the significant aspects of tax planning concerning Dividend policy for companies.After the completion of this Lesson, you should be able to understand the following:

Dividend policy
Accumulated profits ,>
Distribution of accumulated profits entailing release of company's assets
Distribution of accumulated profits in the form of debentures, debenture stock
Distribution of accumulated profits at the time of liquidation
Distribution of accumulated profits on the reduction of its capital
Distribution of accumulated profits by way of advance or loan
Payments to a shareholder or concern not treated as dividend
Tax treatment in the hands of shareholders
Dividend Received From A Domestic Company
Dividend Received From A Non-Domestic Company

8.1 INTRODUCTION

Section 2(22) gives the definition of "deemed dividend" However, the definition laid down, by section 2(22) is inclusive and not exhaustive. If, therefore, a particular distribution is not regarded as dividend within the extended meaning of the expression in section 2(22), it may still be dividend for the purpose of the Income-tax Act.

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:

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) (supra), then the payer-company will pay dividend tax under section 115-0 and in the hands of recipient shareholders, it is not chargeable to tax.

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

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 77 A 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.

8.2 ACCUMULATED PROFITS

Any payment or distribution under the aforesaid clauses is treated as dividend. However, the payment or distribution under the aforesaid clauses can be treated as dividend only to the extent of accumulated profits of the company, Therefore, it is essential to discuss the meaning and scope of the expression "accumulated profits".

Explanations to section 2(22) throw light on the meaning of accumulated profits.

1. It is expressly provided that it does not include capital gains arising before April 1, 1946 and after March 31, 1948 but before April 1, 1956.
2. In the case of a company, which is not in liquidation, it includes all profits of a company up to the date of distribution or payment.
3. in the case of a company in liquidation, it includes all profits of the company up to the date of liquidation. Where, however, the liquidation is consequent on the compulsory acquisition of a company's undertaking by the Government or a Government company, accumulated profits do not include any profits of the company prior to the three successive years immediately preceding the previous year in which such acquisition took place. For instance, if accounting year of a company is financial year and compulsory acquisition takes place on, March 13,2007, its accumulated profits will exclude profits accumulated up to March 31, 2003.

Whether Accumulated Profits Include Current Profits

Accumulated profits include all profits (accumulated or current) up to the date of distribution or payment (or up to the date of liquidation in the case of liquidation.).

Computation of Accumulated Profits

Whether on the basis of commercial profits or assessed profits - In a number of cases it has been held that accumulated profits are computed on the basis of commercial profits.

Controversial Aspects of the Term Accumulated Profits

Judicial clarifications - On the basis of different judicial decisions, the following conclusions can be drawn in respect of accumulated profits:

Accumulated profits are computed on the basis of commercial profits and not on the basis of assessed incomes.

Depreciation - While calculating “accumulated profits", an allowance for depreciation at the rates provided by the Income-tax Act itself has to be made by way of deduction.

General reserve - Accumulated profits include general reserve.

Development rebate reserve, etc. - Accumulated profits also include development rebate reserve, development allowance reserve and investment allowance reserve, as these reserves are not in the nature of any expenditure or outgoing.

provision for taxation and dividend - Provisions for taxation and dividends do not form part of accumulated reserve.

: Additions by Assessing Officer - Addition made by the Assessing Officer on account of concealed income forms part of accumulated profits. Accumulated profits do not include additions made by the Assessing Officer on account of disallowance of inadmissible expenditure.

Tax free income - Accumulated profits include tax-free incomes/revenue receipts, e.g., agricultural income. However, capital profits (i.e., capital gains) are taxable only when such gains are taxable under section 45.

Whether profit of amalgamating company is part of accumulated profit > Strictly construed, ‘accumulated profits’, whether capitalized or not, held by the amalgamating companies, which are separate independent entities, cannot by any stretch of imagination be treated as accumulated profits or capitalized profits of amalgamated company.

Self Check Exercise (True/False)

1. Tax considerations play a role in dividend policy and bonus share decisions, influencing the distribution of profits by companies.
2. Section 2(22)(a) of the Income Tax Act deals with the distribution of accumulated profits that entail the release of a company's assets.
3. The tax implications outlined in Section 2(22)(a) are relevant to the distribution of accumulated profits but not to bonus share issuances.

8.3 DISTRIBUTION OF ACCUMULATED PROFITS ENTAILING RELEASE OF COMPANY'S ASSETS (SEC. 2(22)(A)J

Under sub-clause (a) of section 2(22), any distribution by a company of its accumulated, profits (whether capitalized or not) is dividend if it entails the release of company's assets. In other words, there are two conditions prescribed by this clause-first, distribution should be from accumulated profits (not from capital) and secondly, such distribution must result in the release of the assets by the company.As no specific mode of distribution is prescribed by the clause, distribution may be in the form of payment in cash or kind.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 distributes ordinary or equity bonus by capitalizing its profits, then there is no release of assets and, consequently, bonus shares are not taxable as dividend. If, however, bonus shares are issued to preference shareholders, it amounts to distribution of dividend by virtue of sub-clause (b) of section 2(22).

8.4 DISTRIBUTION OF ACCUMULATED PROFITS IN THE FORM OF DEBENTURES, DEBENTURE STOCK (SEC. 2{22)(B)]

Under this clause the following two distributions are treated as dividend to the extent of accumulated profits (whether capitalized or not) of the company:

a. distribution by a company to its shareholders (whether equity shareholders or preference shareholders) of debentures, debenture-stock or deposit certificates in any form, whether with or without interest; and
b. distribution *by* a company to its preference shareholders of bonus shares.
c. It is worthwhile to note that under the aforesaid circumstances distribution amounts to dividend in the hands of recipient even if there is no release of assets at the time of distribution.

8.5 DISTRIBUTION OF ACCUMULATED PROFITS AT THE TIME OF LIQUIDATION (SEC. 2(22MC)J

Under sub-clause (c), any distribution made by a company to its shareholders on its liquidation is treated as dividend to the extent to which such distribution is attributable to the accumulated profits (whether capitalized or not) of the company immediately before its liquidation.

Under sub-clause (c), the following are, however, not treated as dividend:

a. any distribution in respect of preference shares issued for full cash consideration; and
b. any distribution insofar as such distribution is attributable to the capitalized profits of the company representing bonus shares allotted to its equity shareholders after March 31,1964, but before April 1,1965.

8.6 DISTRIBUTION OF ACCUMULATED PROFITS ON THE REDUCTION OF ITS CAPITAL (SEC. 2(22)(D)]

Any distribution by a company to its shareholders on the reduction of capital is treated as dividend to the extent the company possesses accumulated profits (whether capitalized or not).

However, the following are not treated as dividend under this clause:

a. any distribution out of accumulated profits which arose up to the previous year 1932-33 or up to the previous year ending during 1932-33;
b. any distribution in respect of preference shares issued for full cash consideration; and
c. any distribution insofar as such distribution is attributable to the capitalized profits of the company representing bonus shares allotted to its equity shareholders after March 31,1964 but before April 1,1965.

If there is only re organization of capital and it, in fact, results in splitting up of capital of the company into two companies, and there is no reduction of capital in the aggregate, section 2(22)(d) would not apply.

8.7 DISTRIBUTION OF ACCUMULATED PROFITS BY WAY OF ADVANCE OR LOAN (SBC. 2 (22XE)]

Under sub-clause (e); any loan or advance to a shareholder or concern is treated as dividend in certain cases.

Loan or advance to a shareholder is treated as dividend if the following conditions are satisfied:

a. payment by way of loan or advance is given by a company in Which the public are not substantially interested;

b. payment is made after May 31,1987 by way of loan or advance to a shareholder (being a person who is the beneficial owner of at least 10 per cent equity shares) ;

c the company should possess accumulated profits (excluding capitalized profits) at the time it makes payment of loan or advance.

If all the aforesaid conditions are satisfied, the amount of loan or advance is treated as dividend to the extent the company possesses accumulated profits. For the purpose of this subclause, capitalized profits do not form part of accumulated profits. This sub-clause covers the following types of payments:

a. any payment by way of advance or loan to a shareholder;

b. any payment on behalf of a shareholder; or

c. any payment for the benefit of a shareholder.

Loan or advance to a concern

Loan or advance given to a concern is treated as a deemed dividend under section 2(22)(e) in the hands of the concern if the following conditions are satisfied:

a. loan or advance is given by a company in which the public are not substantially interested;

b. loan or advance is given after May 31,1987 ;

c. the company should possess accumulated profit (excluding capitalized profit) at the time it makes payment of loan or advance; and

d. loan or advance is given to a concern (i.e., a Hindu undivided family, or a firm or an association of persons or a body of individuals or a company) in which a shareholder (who is beneficially holding at least 10 per cent equity share capital) of the company (giving loan or advance) has substantial interest.

A person, shall be deemed to have a substantial interest in a concern, if he is at any time during the previous year, beneficially entitled to at least 20 per cent of income of such concern (if such concern is a company then he should beneficially hold at least 20 per cent equity share capital of the company).

If all the aforesaid conditions are satisfied, then such payment shall be treated as dividend income of the payee-concern.

Self Check Exercise

4. What is the term for the distribution of accumulated profits by way of an advance or loan to a shareholder, as per Section 2(22)(e) of the Income Tax Act?
5. In tax regulations, what does Section 2(22)(d) address regarding the distribution of accumulated profits?
6. What is the term for the distribution of accumulated profits at the time of liquidation, as specified under Section 2(22)(mc) of the Income Tax Act?
7. Identify the section of the Income Tax Act that deals with the distribution of accumulated profits in the form of an advance or loan.

8.8 PAYMENTS TO A SHAREHOLDER OR CONCERN NOT TREATED AS DIVIDEND

The following payments are, however, not treated as dividend:

a. Any advance or loan made to a shareholder or a concern by a company in the ordinary course of its business, where money-lending is a substantial part of the business of the company.

b. Any dividend paid by a company and set off against any loan or other monetary benefit which has already been treated as dividend. {If, however, the dividend is not so set off but it is paid to a shareholder even when the loan is outstanding against him, it would not be covered by this exception].

8.9 POINTS TO BE BORNE Ilf BUND WHILE APPLYING SECTION 2{22)(E)

Only registered shareholder

Under sub-clause (e), the word 'shareholder' refers to the registered shareholder and not beneficial owner of a share and hence a loan granted to a beneficial owner of shares, who is not a registered shareholder, cannot be regarded as loan or advance to a "shareholder*.

No restriction on account of deemed dividend

There is nothing in sub-clause (e) of section 2(22) to restrict the deemed dividend to that portion of accumulated profits which corresponds to the assessee's shareholding in the capital of the company. If a loan is given by a company to a shareholder who owns 25 per cent of share capital, the amount of loan to the extent of entire accumulated profits (and not to the extent of 25 per cent of accumulated profits) will be treated as dividend.

Accumulated profits dividend under section 2(22)(e)

For the purpose of section 2(22), accumulated profits get reduced by the amount deemed as dividend under section 2(22) even if no adjustment is made in the books of account. For instance, the total accumulated profit of A Ltd. is Rs. 120 lakh. It gives a loan to X of Rs. 50 lakh which is deemed as dividend under section 2(22)(e). Later on, the company advances Rs. 761akh to Y and such advance falls under section 2(22)(ej. Now Rs. 70 lakh (i.e., Rs. 120 lakh minus Rs. 50 lakh) only shall be treated as dividend. Suppose, A Ltd. further gives a loan to Z (HUF) amounting to Rs. 10 lakh which satisfies conditions of section 2(22)(e), then nothing shall be taxable as dividend since there is no accumulated profit left [Rs. 120 lakh-Rs. 50 lakh-Rs. 70 lakh].

Relationship of debtor and creditor

In order to attract the provision of section 2(22)(e), the important consideration is that there should be loan/advance by a company to its shareholder. Every payment by a company to its shareholder may not be loan/advance. To be treated as loan every amount paid must make the company a creditor of the shareholder for that amount. If, however, at the time when payment is made, the company is already a debtor of the shareholder, the payment would be merely a repayment by the company towards its already existing debt.

Repayment of loan

Section 2(22)(e) is applicable even if loan is repaid before the end of the previous year. In other words, the liability is attracted at the moment the loan is given.

Bona fide loans

A bona fide loan for a short duration is treated as dividend if all the conditions of section 2(22) (e) are satisfied. If, however, any amount is deposited by the shareholder with the company, its repayment does not attract the provisions of section 2(22)(e) because it does not result in advancing or giving loan to the shareholder.

Overdraft

An overdraft taken by a shareholder from the company is treated as loan and taxable as dividend if conditions of section 2(22)(e) are satisfied.

Loan in kind

Section 2(22)(e) is applicable even if loan is given in kind.

Loan on behalf of assesses

Where whenever the assessee, a managing director of a company, needed money he used to ask an employee to take a loan from the company and pass it on to him even without executing any promote, it was held that the loans made by the company to the employee fell in the category of "benefit* to the assessee and were, therefore, assessable as deemed dividends in his hands - L. AlagusundaramChettiar v. CIT(2002] 121 Taxman 587 (SC).

Payment on behalf of shareholder

Section 2(22)(e) covers not only advances and loans to shareholders but any other payments by the company on behalf of or for the individual shareholders, such as payments of shareholder's personal expenses, insurance premia, etc., to the extent of the accumulated profits of the company - CfT v. K. Srinivasan [1963] 50 ITR788 (Mad.).

Call money

The amounts due by the assessee to the company towards the first and second call moneys on the shares held by it in the company and which were treated as having been paid up by making book entries in running account cannot be treated as a payment by way of loan by the company to the assessee for the purpose of section 2(22){e)-G.R. GovindarajuluVaidu v. CITJ1973) 90 1TR 13 (Mad.).

Share application money

Share application money received by a closely held company cannot be related as dividend under section 2(22)(e) pending allotment of shares-ArdeeFinvest (P.) Ltd. v. CIT|2001j 79 ITD 547 (Delhi).

Advance rent

X holds more than 10 per cent equity share capital in A (Pvt.) Ltd. He lets out a property to A (Pvt.) Ltd. under an agreement. On May 20, 2004, he receives Rs. 1,00,000 as advance rent under that agreement. Advance rent will be deemed as dividends even if the amount is received under the lease agreement (not as a shareholder but as landlord) or even if it has to be' adjusted against future rent-CfT v. P.S. Abu bucker (2004) 135 Taxman 77 (Mad.).

Self Check Exercise

8. What is the key factor to consider when applying Section 2(22)(e) regarding the distribution of accumulated profits in the form of an advance or loan?
9. When applying Section 2(22)(e), what is crucial to bear in mind to ensure compliance with tax regulations?
10. What term is emphasized in Section 2(22)(e) to denote the nature of the distribution involving accumulated profits?

8.10 TAX TREATMENT IN THE HANDS OF SHAREHOLDERS

Tax treatment of dividend is as follows

8.11 DIVIDEND RECEIVED FROM A DOMESTIC COMPANY

If dividend is covered by section 2(22) (not by clause (e) of section 2(22)] and declared, distributed or paid during April 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(33) or 10(34). On such dividend the company declaring dividend will pay dividend tax under section l-15-O.

If a loan or advance is given after May 31, 1997 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.

8.12 DIVIDEND RECEIVED FROM A NON-DOMESTIC COMPANY

The exemption under section 10(33) or 10(34) is not available if dividend is received from a company other than a domestic company and, consequently, such dividend is chargeable to tax in the hands of recipient (in such case there is no dividend tax by the payer).

8.13 BONUS SHARES TO EQUITY SHAREHOLDERS

The table given below highlights the tax consequences

Situations	Tax *treatment in the hands oj company issuing bonus shares*	*Tax treatment in the hands of shareholders*
At the time of issue of Bonus shares At the time of sale of bonus share by shareholder At the time of redemption of bonus share or at the time of liquidation	No tax liability No tax liability Under section *2(22}(a)* or *2(22)(c),* it will be treated as dividend distribution to the	No tax liability Capita/ *Gain* Out of the amount received at the time of redemption or liquidation,
of the company	extent of accumulated profit and, consequently, the payer company will pay dividend tax	amount treated as "dividend" under section *2(22)(a)/(c)* will be exempt in the hands of shareholders, balance will be sale consideration to compute capital gain

8.14 BONUS SHARES TO PREFERENCE SHAREHOLDERS

Situation	*Issued before June,*1, 1997		*Issued after April* 31, 1997	
	Company	*Shareholders*	*Company*	*Shareholders*
At time of issue of bonus shares •	No tax liability	It will be deemed as dividend under section *2(22}(b)*	Under section *2(22)(b)* it will be deemed as dividend and chargeable to dividend tax	No tax liability

Rarely bonus shares are issued to preference shareholders. Tax treatment is given below:

8.15 CAPITAL GAIN ON BONUS SHARES

Section 55 specifies that the cost of acquisition of any additional financial asset as bonus shares or security or otherwise which is received without any payment by the assessee on the basis of his holding any financial asset shall be taken to be nil.

Moreover, in the case of a capital asset being a share, security or unit which is allotted without any payment on the .basis of holding of any other financial asset, the period for treating such share, security or unit as a short-term capital asset shall be calculated from the date of allotment of such share, security or unit, as the case may be.

Effect of the above provision may be summarized as follows:

	Cost *of acquisition of original and bonus shares*
If original shares and bonus shares are acquired before April 1, 1981	Original shares - Actual cost or fair market value on April I.. 1981, whichever is more Bonus shares - Fair market value on April I, 1981
If original shares are acquired before April 1, 1981 but bonus share are allotted after April 1, 1981	Original shares - Actual cost or fair market value on April I, 1981, whichever is more Bonus shares - *Nil*
If original and bonus shares are acquired after April 1, 1981	Original shares - Actual cost Bonus shares - *Nit*

8.16 SUMMARY

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: 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. Any payment or distribution under the aforesaid clauses is treated as dividend. However, the payment or distribution under the aforesaid clauses can be treated as dividend only to the extent of accumulated profits of the company. 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 distributes ordinary or equity bonus by capitalizing its profits, then there is no release of-assets and, consequently, bonus shares are not taxable as dividend.

8.17 Keywords

Dividend Policy: The strategy and guidelines a company follows in distributing dividends to its shareholders, considering tax implications.
Bonus Shares: Additional shares issued by a company to existing shareholders as a form of dividend, with tax implications.
Tax Efficiency: The ability of a company to optimize its dividend policy and bonus share issuance to minimize tax liability for both the company and its shareholders.

8.18 QUESTIONS FOR REVIEW

Short Answer Type Questions

1. Discuss the concept of Dividend for a company
2. Discuss the concept of Accumulated profits for a company
3. Discuss the distribution of accumulated profits entailing release of company's assets. Also, discuss the distribution of accumulated profits in the form of debentures, debenture stock.
4. Discuss the payments to a shareholder not treated as dividend.

Long Answer Type Questions

5. What are the points to be borne in mind while applying section 2(22)(e)? Discuss.
6. Discuss the Tax treatment in the hands of shareholders for dividends.
7. Discuss the tax treatment for bonus shares to equity shareholders.

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8.20 Self Check Exercise (Answer Key)

1. True, 2. False, 3. True, 4. Loan, 5. Capital Reduction, 6. Liquidation, 7. 2(22)(e), 8. Loan, 9. Conditions, 10. Deemed

MBA-DE(Second Year)
Semester-IV

CTP (418) CORPORATE TAX PLANNING

Lesson No. 9 **AUTHOR : SANJEEV KUMAR**

SETTING UP OF NEW BUSINESS AND TAX PLANNING

STRUCTURE

6. Objectives
9.1. Introduction
9.2. Deduction of the profits of a new industrial and infrastructure undertaking
9.3 Five year tax holiday
9 *A* Extension of exemption in case of renovation and modernization of power transmission & distribution lines-Section 80IA
9.5. Deduction allowed regarding new ships
9.6. Deduction allowed in the case of new hotels
9.7. Reconstruction of a business already in existence
9.8. Precaution to be taken in the case of transfer of second-hand assets in new business
9.9. Special factors while computing profits and gains of a new industrial undertaking
9.10 Summary
9.11 Keywords
9.12 Questions for review
9.13 Suggested Readings
9.14 Self Check Exercise (Answer Key)

9.0 OBJECTIVES

These lesson discuses all the significant aspects of tax planning regarding new business. After the completion of this Lesson, you should be able to understand the following:

Deduction of the profits of a new industrial and infrastructure undertaking
Five year tax holiday
Extension of exemption in case of renovation and modernization of power
Transmission& distribution lines-Section 80IA
Deduction allowed regarding new ships
Deduction allowed in the case of new hotels
Reconstruction of a business already in existence
Precaution to be taken in the case of transfer of second-hand assets in new business
Special factors while computing profits andgains of a new industrial undertaking

9.1. INTRODUCTION

The Income Tax Act confers several privileges on the new industrial undertaking and new hotels. These benefits or tax concessions can be availed of even by all existing concerns which set up new industrial undertakings, etc. In this lesson let us describe the various conditions governing the tax concessions in the matter, of new industrial undertakings or hotels and the precautions that are to be taken by a company so that it is able to take full advantage of the concessions so available, As regards new industrial undertakings or hotels in the rural areas or backward areas after 31-3-1990, the same have been discontinued as per the Finance Act 1990. The tax planning aspects of new industrial undertakings in Free Trade Zone under Section 10-A are described also.

9.2. DEDUCTION OF THE PROFITS OF A NEW INDUSTRIAL AND INFRASTRUCTURE UNDERTAXING

A deduction from the gross total income of a company is allowed in respect-of the profits and gains of a new industrial undertaking owned by it under the provisions of Section SCMA [to be known as SO-IE from the AY 2000-2001] of the Income Tax Act. This section was inserted by the Finance (No.2) Act, 1991 wef the AY 1992-93. Under Section SO-IE (3) a company, like any other assessee, would be entitled to a deduction in relation to any profits and gains derived by it from an industrial undertaking which begins to manufacture or produce articles or things 01 to operate its cold storage plant or plants in or after 1-4-1991 while computing it, total income. The rate of such deduction for a company is 30% of the profits and gains of the new industrial undertaking so set up on or after 1-4-1991. It should be set up by 31-3-1995. The rate of deduction for any other assessee is only 25%.

In respect of any industrial undertaking, located in a backward State or Union Territory specified in the 8th Schedule like Arunachal, Assam, Goa, Himachal, J8&K, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura and the Union Territories of Andaman and Nicobar Islands, Dadra and Nagar Haveli, Daman and Diu, Lakshadweep and Pondicherry, which start manufacture or production on or after 1-4-93 and before 1-4-2002 a deduction of 100% of the profits in respect of the first five assessment years from the year of manufacture, etc. would be allowed. The Finance Act, 2002 further extended the period from 31.3.2002 to 31.3.2004 by which if any new industrial undertaking is set up in a backward state, then it will be eligible to the tax holiday as is allowed to other industries set up earlier, namely 100% tax holiday for five years and 25% or 30% for the balance five years.

Further, there is no restriction on the type of manufacturing, etc., on such an undertaking. For the subsequent assessment years, deduction would be allowed at the normal rate of 30% or 25%, as the case may be. The Finance (No.2) Bill, 2004 has extended the date of setting up a new industrial undertaking on the State of Jammu &Kashmir to 31.3.2005. Similar tax holiday will be allowed for the power sector also which may be set up before 1-4-2006 in any part of India.

The five-year tax holiday will also be available to new industrial undertakings located in industrially backward category districts notified by the Central Government on the basis of prescribed guidelines and which begin production on or after 1-10-1994 but before 31-3-2002 as per the Finance Act, 1994 as amended by the Income Tax (Amendment) Act, 1998, with effect from 1-4-1995 i.e., AY 1995-96 to provide only 3-year full tax holiday for category B districts and modified by the Finance Act, 2000. The Finance Act, 2002 further extended the period from 31.3.2002 to 31.3.2004 by which if any new industrial undertaking is set up in a backward district, then it will be eligible to the tax holiday as is allowed to other industries set up earlier, namely 100% tax holiday for five years and 25% or 30% for the balance five years.

The new industrial undertaking in general should fulfill all the following conditions as per Section 80-IB(2), namely:

(i) It is not formed by the splitting up, or the reconstruction of a business already in existence;

(ii) It is not formed by the transfer to a new business of machinery or plant previously used for any purpose;

(iii) It manufactures or produces any article or thing (not being an article or thing specified in the list in the 11th Schedule to the IT Act-applicable only for a nonsmall scale industrial undertaking) or operates one or more cold storage plant or plants, in any part of India, at any time by 31-3-1995;

(iv) in a case where the industrial undertaking manufactures or produces articles or things, the undertaking employs 10 or more workers in a manufacturing process carried on with the aid of power, or employs 20 or more workers in a manufacturing process carried on without the aid of power.

It is important to note that condition (i) does not apply in respect of any industrial undertaking which is formed as a result of the re-establishment, reconstruction or revival by the company of the business of any such industrial undertaking as is referred to in Section 33 B in circumstances like flood, typhoon, hurricane, cyclone, earthquake or riot or civil disturbances or accidental fire or explosion or enemy action.

As regard the above clause-(ii), any machinery or plant which was used outside India other than the assessee company would not be regarded as machinery or plant previously used for any purpose, if the following conditions are fulfilled, viz:

(a) Such machinery or plant was not, at any time previous to the date of the installation by the assessee company, used in India;

(b) Such machinery or plant is imported from any country outside India; and

(c) No deduction on account of depreciation in respect of such machinery or plant has been allowed or is allowable under the IT Act to any person prior to the date of such installation by the assessee company.

The total value of the old plant or machinery transferred to the new industrial undertaking should not exceed 20% of the total value of the machinery or plant used in the business.

As per the Finance Act, 2003 the benefit of Section 80 IB shall not be allowed for the AY. 2004- 05 or subsequent years to any undertaking or enterprise referred to in sub-section (2) of Section 80IC.

SelfCheck Exercise (True/False)

1. The deduction of profits for new industrial and infrastructure undertakings is a tax incentive aimed at promoting investments in these sectors.
2. This deduction is available only for established companies and not for newly formed enterprises.
3. The purpose of this deduction is to encourage the growth of industries and infrastructure by allowing a portion of the profits to be exempt from taxation for a specified period.

9.3 FIVE YEAR TAX HOLIDAY

Five year tax holiday for infrastructure development and tax holiday for SSIs from 1.4.95 Section 80 IA and 80-IB. The Finance Act, 1995 inserted a new provision which provides for a 5- year tax holiday for any enterprise which builds, maintains or operates any infrastructure facility such as roads, highways, expressways, new bridges, air ports and rapid rail transport systems on BOT or BOOT or similar other basis (where there is ultimate transfer of the facility to a Government or Public authority), would be allowed. Thereafter, for the next 5 years 30% deduction would be allowed. Likewise, S51 industrial units, commencing production on or after 1.4.95 and any time before 31.3.2002 would also be allowed partial tax holiday of 25% or 30% for 10. years.

The Finance Act, 1999 has, with effect from the AY 2000-2001 substituted two Sections 80-IA and 80-IB for the earlier Section 80-1 A.

The deduction under Section 80-1 in respect of a new industrial undertaking set up by a company prior to 31-3-1990 is available only @25% and for a total of eight assessment years only.

The Central Board of Direct “Taxes vide its Circular No. 733, dated 3-1-1996 has clarified that the benefit of S. 80 IA would be available to Build-cum-Lease Transfer (BOLT) scheme of Indian Railways for development of Railway System. However, this concession shall be applicable only to an infrastructure facility meant for development of a rail system and not to any other infrastructure facility including rolling stocks.

The Finance (No.2) Act, 1996 provided for a five-year tax holiday under Section 80-IA {now Section 80IB (8)) of the Income Tax Act, 1961, to approved companies engaged in scientific and industrial research and development activities on commercial lines. This incentive shall be available to any company that has as its main objective, activities in the areas of scientific and industrial research and development and which has been accorded approval by the prescribed authority, namely, Secretary, Department of Scientific and Industrial Research. This tax holiday shall be available to any company, whether new or existing, which is accorded approval by the aforesaid prescribed authority at any time before 1-4-1999. The 100% deduction for a five-year period, shall commence from the assessment year relevant to the pervious year in which the approval by the prescribed authority is accorded to such a company. This will, accordingly, apply to the Assessment Year 1997-98 and subsequent years.

The Finance (No.2) Act, 1996 extended the benefit of tax holiday under Sect' in 80-IA(4), to Other infrastructure facilities like water supply projects, irrigation systems, sanitation and sewerage systems. This amendment will apply in relation to the assessment year 1997-98 and subsequent years. The profits of such enterprises would be excluded for MAT under Section 115JA but not under Section 115JB.

The Finance Act, 1997 provided many new incentives for certain industries, hotels and other enterprises. Thus, a new provision in Section 80IA(4C) has been made to provide for 100% deduction from the profits and gains of an assessee engaged in the business of providing telecommunication services for the initial five assessment years. A deduction of 25% {30% in the case of companies) from such profits and gains will be allowed for a further period of five years.

Thus, the total period of tax holiday will be 10 years. This deduction will be allowed to an undertaking which begins to provide the telecommunication services at any time during the period beginning on 1-4-1995 and ending on 31st March, 2000. This amendment will take effect retrospectively from the AY 1996-97 and apply subsequent years.

Another amendment in Section 801A(4D) relates to the extension of the tax holiday to industrial parks notified for this purpose, in accordance with any scheme to be framed by the Central Government. This tax holiday will encourage investments in industrial infrastructure. Those industrial parks which start operating during the period beginning on 1st April, 1997 and ending on 31.3.2002 will be eligible for 100% deduction for the initial five assessment years followed by 25% (30% in case of companies) deduction from profits for the next five years. This amendment is effective from the A Y 1998-99.

The Finance Act, 1997 inserted a new sub-Section (4E) in Section 80-IA wef e AY 1998-99 to provide that the tax holiday would also be applicable to any undertaking which begins the commercial production of mineral oil in the North Eastern Region, i.e. in the State of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland and Tripura and other parts of India on or after 14-1997 (as per the Income Tax (Amendment) Act, 1998 from the AY 1998-99). The tax holiday is 100% and applies for 7 initial Assessment Years, beginning from the assessment year relevant to the previous year in which the undertaking commences commercial production of mineral oil.

The Income Tax (Amendment) Act, 1998 made several amendments in Section 80-LA, some of which have been mentioned above. The infrastructure facility is extended from the AY 1998-99 to a highway project including housing on other activities being an integral part of the highway project.

It is provided in Section 80-LA (7A) from the A Y 1998-99 that where housing ':on other activities arc an integral part of the highway project and the profits of, which are to be computed as per prescribed rules such profit would not be liable to tax where the profit has been transferred to a special reserve account and the same is actually utilized for the highway project excluding housing and other activities before the expiry of 3 years following the year in which such amount was transferred to the reserve account. The amount remaining unutilized would be taxable as income of the year in which transfer to reserve account took place.

The Finance (No.2) Act, 1998 as further amended by the Finance Act, 2000 made a number of amendments in the scheme of tax-holiday under Section 80-IA, the most important of which are given below:

(a) The benefit of tax-holiday would be extended to undertaking which commenced generation, or generation and distribution of power on or before 31-32003. This would be applicable from the A Y 1999-2000.

(b) The tax-holiday to undertakings set up in industrially backward States as specified in the VIIISchedule which start manufacture even after 31-3-1998 is extended up to 31-3-2002. Likewise, the tax-holiday is also extended to the undertakings set up in industrially backward districts up to 31-3-2002. These amendments would be operative from the AY 1999-2000.

(c) The benefit of tax-holiday would be available to telecommunication service like radio-paging, domestic satellite services or network oftrucking and electronic data interchange services before 31-3-2000. In the case of domestic satellite service the deduction would be available only to those Indian companies which own and operate satellites. This amendment would be operative from the AY 1999-2000.

(d) The benefit of tax-holiday for a period of 7-years available to the undertaking engaged in commercial production or refining of mineral oil has been extended to such undertakings which commence production of oil refinery on or after 1-10-98.

(e) Inland ports and waterways are included in the definition of "infrastructure facility" so that the benefit of tax-holiday would be available to them with effect from the A Y 1999-2000.

(f) Certain approved housing projects would come under "infrastructure" facility. A very important amendment has been made effective from A Y 1999-2000 by way of insertion of sub-section (4F) in Section 80-IA to provide that the deduction under Section 80-IA would apply to an undertaking engaged in developing and building housing projects approved by a local authority subject to the condition that the size of the plot of land has a minimum of one acre, and the residential unit has a built- up area not exceeding 1,000 sq. ft. Another condition for obtaining the benefit of deduction in respect of housing projects is that the undertaking commences development and construction of the housing project on or after 1.10.1998, gets it approved by 31.3.2001 and completes the same before 31-3-2003 (later amended).

(g) Old Section 80-IA(5)(vi) is amended with effect from the AY 1999-2000 that in the case of a housing project referred in old Section 80I-A(4F) [New Section 80-IB(10)] hundred percent of profits and gains derived from such business would be eligible for deduction.

(h) The newly inserted sub-section (9A) in Section 80-IA to provide prohibition of double deduction under Section 80-IA and in every section would be operative only from the AY 1999-2000.

(i) The Finance Act, 2000 has, from the A.Y. 2001-2002 added a water treatment system and solid waste management system as infrastructure for Section 80-IAJ4),

(j) As per the Finance, Act, 2003 Section 80IB (10) was amended to provide for tax exemption for housing project to the extent of 100% where the approvals, etc., are received by 31-3-2005. Similarly, the deduction @ 100% as per Section 80 IB (11) in respect of business of setting up and operating a cold chain facility for agriculture produce has been extended to units set up before 1-4-2004.

Vide Notification No. S.O. 744(E) dated 1.9.1998, the CBDT has notified Inland Container Depot (ICD) and Central Freight Station (CFS) as infrastructure for the purpose of Section 80- A(12)(ca). It is, of course, provided that such places should be notified as Inland Container Deport and Centered Freight Station under the Customs Act, 1961.

The earlier Section 80-IA was split by the Finance Act, 1999 from the AY 2000-2001 into two sections, namely 80-IA dealing with the deduction in respect of profits and gains from industrial undertakings or enterprises engaged in the infrastructure development, etc. and 80- IB dealing with other industrial undertakings, hotels, ships and certain housing projects.

Though broadly speaking the provisions for deduction of 100% tax profits for the initial five years and 30% of profits for the next five years, etc. remained the same, yet for making the existing fiscal concessions for more meaningful, it has been provided that such infrastructure undertakings may avail of the benefit in any ten consecutive years out of the initial 15 years from the year in which these commence operations. This benefit has been extended to undertakings generating or generating and distributing power, undertaking, developing and operating industrial park and undertakings engaged in providing telecom services also.

The benefit of tax holiday has also been extended to undertakings setting up new transmission lines for transmission and distribution of power on or after 1.4.1999, to profits derived there from in the same manner as are available for generation or generation and distribution of power. These profits would also be eligible for deduction if the ‘undertaking sets up new transmission or distribution lines on or after 1.4.1999 but before 31.3.2006.

The benefit and concession under Section 80-IA regarding infrastructure facility developed by an enterprise would also be available now from the AY 2000-2001, if the infrastructure facility has been transferred to any person other than a developer who may undertake operations and maintenance if the terms of agreement so provide. The benefits and concession under Section 80-IA in such cases for the remaining period out of the period of 10 consecutive years, would be availed of by the undertaking operating and maintaining such infrastructure facility. It is also further provided that in the case of industrial parks, the developer and the operator or the developer or the operator would also be entitled to avail of the benefit in a similar manner.

Various industrial parks notified for the purpose of sub-clause (iii) of Section 80-IA(4), as per Notification No.S.O,236(E) dated 14.3.2000 are about the International Tech Park Ltd., the details of which can be seen at (2000) 242 ITR 207 (ST).

Various infrastructure facilities as per Section 80-IA(4) and Section 10(23G) as per Notification No.S.0.254(E) dated 10.3.2000 are Mass Rapid Transit System, Light Rail Transit System Expressways; Intra-urban/semi-urban, Roads like ring roads/urban bypasses/flyovers; Bus and truck terminals; Subways; and Road dividers. The Finance (No.2) Bill, 2004 has extended the time limit for telecommunication lines to 31-3-2005.

Self Check Exercise

4. What is the term for the incentive that grants a new business complete exemption from income tax for a specified period?
5. In the context of setting up a new business, what does the term "SETTING UP" typically refer to?
6. What is the duration of the tax holiday period typically granted to new businesses in many jurisdictions?
7. What does the term "New Business" often imply in the context of tax planning and incentives?

Under the provisions of old Section 80-IA up to the assessment year 1999-2000 deduction has been allowed in respect of new industrial undertakings subject to certain conditions broadly speaking the same conditions continue to exist for new industrial undertakings in certain backward States and Districts and also small scale industrial undertakings commencing the production on or before 31.3.2002.

The Finance Act, 1999 with effect from the AY 2000-2001 provides that the benefit of 5- year tax holiday in respect of profits and gains of an assessee operating the cold storage in an industrially backward State and in industrially backward-District, would be extended at 100% tax holiday for a period Of 5 years and 25% (30% in case of companies) deduction from profits derived from operating a cold chain facility which starts operating on or after 1.4.1999 to be allowed for a further period of 5 years.

Earlier provisions of Section 80-IA (4F) regarding tax holiday to approved housing projects are now contained in Section 80-lB(10) from the AY 2000-2001. These existing benefits have been modified to provide that in areas other than falling in and within 25 kms from the Municipal limits of Delhi and Mumbai, the built-Up area of dwelling units must be up to a maximum limit of
1, 500 sq.ft. instead of 1,000 sq.ft. at present to make them entitled for the tax holiday benefit. Thus, the built-up area for areas falling in Delhi and , Mumbai and within 25 kms of the Municipal limits of both, however, would remain the same. , r

As per the Finance Act, 2003 substantial amendments have been made to the provisions, relating to tax exemption in respect of certain housing projects. As per the new amendments the exemption would view be available u/s 80 IB (10) for housing projects for residential units on land exceeding One Acre if such Undertaking completes approvals by 31-3-2007 as amended by the Finance (No. 2) Sill, 2004. The rates of deduction remain unchanged. The conditions with regard to time period for completion have been deleted.

The time limit for obtaining approval from the local authority for housing projects has been extended to 31.3.2007. However, the housing project will have to be completed within 4 years from the end of the financial year in which it is so approved. The built-up area of the shops and other Commercial establishments included in the housing projects should not exceed 5% of the built-up area or 2,000 sq.ft.Whichever is less. The condition of minimum plot size of 1 acre would be relaxed in some cases of redevelopment of slum dwellings as per the scheme to be notified. This amendment is operative for the A.Y. 2005-2006, as per the Finance (No.2) Bill, 2004.

It is also provided by the second proviso to Section 80- IB (4) that in the case of such industries in the North-Eastern Region as may be notified by the Central Government, the amount of deduction would be 100% of the profits and gains for a period of ten assessment years and total period of tax in such cases would not exceed 10 assessment years. This would be broadly on the lines of the exemption granted Under the new Section 10C.

The Finance Act, 2000 inserted sub-section (8A) in Section 80 IB effective from the A.Y.
2001- 2002. Section 80 IB (8A) is as under:

'The amount of deduction in the case of any company carrying on scientific research and development shall be hundred per cent of the profits and gains of such business for a period of ten consecutive assessment years, beginning from the initial assessment year, if such company -

(i) is registered in India:
(ii) has its main object the scientific and industrial research and development;

(iii) is for the time being approved by the prescribed authority at any time after the 31 at day of March, 2000 but before the 1st day of April, 2005 (amended by the Finance (No.2) , 2004);

(iv) Fulfils such other conditions as may be prescribed.

The prescribed authority for approval of companies carrying on scientific research and development for the purposes of Section 80-IB(8A) as per new Rule 18D would be the Secretary, Department of Scientific and Industrial Research, Ministry of Science and Technology, Government of India. As per Rule 18DA, various conditions have been prescribed for the deduction under Section 80IB(8A).

Various modifications have been made to Section 80-IA by the Finance Act, 2001 from the A.Y. 2002-2003 to provide incentives for infrastructure, etc. These modifications in brief are:

(a) The existing two-tier benefit to provide a 10-year tax holiday is replaced by a new provision that for an infrastructure facility in the nature of a road, including a toil road, bridge, rail system, highway project, water supply project, sanitation; sewerage and solid waste management system, a 10-year tax holiday may be availed consecutively out of 20 years beginning from the year in which the undertaking begins operating the infrastructure facility.

(b) An identical 10-year tax holiday may be availed in a block of 15 years in the case of other infrastructure, namely, for airport, port, inland port and inland waterways.

(c) The mandatory requirement that such infrastructure facility shall be transferred to the Central Government, State Government, local authority or any other statutory authority, has been removed.

(d) The two-tier benefit available to undertakings in tele-communication services is reintroduced and it is extended to internet service providers and broadband networks, for those undertakings which provide the services on or before 31.3.2004.

(e) The tax holiday period to undertakings commencing generation of power or laying a network of new transmission and distribution lines on or before 31.3.2006 would be allowed for a 10-year period in place of the two-tier benefit out of the initial 15 years.

(f) The tax benefit available to the developers of industrial parks has been extended to the developers of Special Economic Zones. Thus, this benefit would be available to the developers of new special economic zones and also to developers of industrial parks if such economic zones and industrial parks are developed on or before 31.3.2006. Further, the tax holiday period would be ten-year period which could be availed in ten consecutive assessment years in a block of fifteen years.

The Finance Act, 2002, with effect from the AY. 2003-2004, provided the grant of deduction under Section 80-IA(2) to an undertaking which develops and operates or maintains and operates a special economic zone.

As per the Finance Act, 2003 this benefit has also been extended to an undertaking which develops a Special Economic Zone. Besides, separate audit for undertakings claiming deduction under Sections 80-IA and 80-IB has also been made mandatory for companies and co-operative societies.

Self Check Exercise

8. What is the primary purpose of providing a tax holiday to new businesses?
9. In tax planning, what is the primary benefit that a new business derives from a five-year tax holiday?

The Finance Act, 2003 made a retrospective amendment to Section 80IA w.e.f. the A Y.

2002-03 to provide that in a case where an undertaking develops an industrial park on or after the 1st day of April, 1999 or a special economic zone on or after the 1st day of April, 2001 and transfers the operation and maintenance of such industrial park or such special economic zone, as the case may be, to another undertaking (hereafter in the section referred to as the transferee undertaking), the deduction under sub-section (1) shall be allowed to such transferee undertaking for the remaining period in the ten consecutive assessment years as if the operation and maintenance were not so transferred to the transferee undertaking. The Finance (No. 2) Bill, 2004 has extended the deeds tax on to agro-based industries under Section 801B(11A).

9.4 EXTENSION OF EXEMPTION IN CASE OF RENOVATION AND MODERNISATION OF POWER TRANSMISSION & DISTRIBUTION UNES-SECTION 801A

100% deduction f6r 10 years would be allowed to an undertaking which undertakes substantial renovation and modernization of the existing power transmission or distribution lines,

i. e. by 50% of the book value of plant and machinery, This amendment is operative for the AY. 2005-2006, as per. the Finance (No. 2) Bill, 2004,

9.5 DEDUCTION ALLOWED REGARDING NEW SHIPS

Under the provisions of new Section 80-IB(6) wef the A Y 1992-93 in relation to the profits and gains derived by any assessee company from a ship which is first brought into use on or after

1. 4.1991 and before 1.4.1995 a deduction equal to 30% from such profits and gains will be allowed in computing the total income of the assessee company. Such a deduction will be allowed for the relevant assessment year and the subsequent nine years, i.e. in all ten assessment years. In respect of new ships already brought into use before 1.4.1990 the rate of deduction for the remaining years would be allowed at the rate of 25% only and the total number of assessment years would be eight. All the following conditions have to be fulfilled in the case of a ship under Section 80-TB (6):

(i) it is owned by an Indian company and is wholly used for the purposes of the business carried on by it;

(ii) it was not previous to the date of its acquisition by the Indian company, owned or used in Indian territorial waters by a resident person; and.

(iii) it is brought into use by the Indian company during the period 1-4-1991 and 31-3- i995.

9.6 DEDUCTION ALLOWED IN THE CASE OF NEW HOTELS

Under new Section 80- IB (7) wef the A Y 1992-93 in relation to any profits and gains of a company from the business of a hotel which starts functioning on or after 1-4-1991 and before 1- 4-1995 a deduction equal to 30% of the profits and gains of the hotel business would be allowed in computing its total income.

9.7 RECONSTRUCTION OF A BUSINESS ALREADY IN EXISTENCE

One of the conditions to be fulfilled by an industrial undertaking under Section 80IA in order to avail itself of this exemption is that it should not have been formed by the reconstruction of a business already in existence. The reconstruction of a business of an industrial undertaking must necessarily involve the concept that the original business or undertaking is not to cease functioning and its identity is not to be lost or abandoned. The concept essentially rests on changes but the changes must be constructive and not destructive. The underlying idea of a reconstruction is of a “business already in existence"; there must be a continuation of the activities and business of the same industrialundertaking. The undertaking must continue to canyon the same business though in some altered or varied form. If the alterations and changes are substantial, there would be little scope for describing what emerges as a reconstruction of the business.

Similarly, if the particular nature of the business or undertaking is changed that again would not be reconstruction. On the other hand, reorganization of the business on sounder lines or alterations in the mode or method or scope of the activities of the business or in its personnel of infusion of new blood in the management or control of the business which may even be by some changes in the constitution of persons interested in the undertaking would be no more than reconstruction of the business if it is substantially the same business carried on by substantially the same persons. In these matters we have to look at the substance of the transaction. If it is a sale, then the concept of reconstruction must be ruled out for in such a case there is no scope for speaking about any reconstruction of an existing business. In CIT v. Indian Aluminum Co. Ltd. [1977] 108 ITR 367 (sc) it has been held that the separate business need not be a different kind of business.

The commodity which the original business produces or manufactures or sells may be a relevant factor in finding out whether the subsequent business is an expanded business or anIndependent business. But such a factor by itself cannot be the determining factor. If the assessee's original business remains intact and retains its original character and the assessee establishes separate independent undertaking, whether of the same or different commodity, the subsequent undertaking cannot be called a "reconstruction" of an existing business. The newness of the subsequent industrial undertaking does not necessarily exclude all cases of expansion of the original business as held in Texmaco v. C/T [1977] 107 ITR 195 (sc) approving C/T v. Gaekwar Foam and Rubber Co. Ltd .(1959] 35 ITR 662 and other cases. Where the assessee invests large sums of money and establishes new production units of similar or of a different nature, as a result of which the original business of the assessee does not intrinsically alter its original character and continues to produce, to manufacture or carry on the original activity in the same way even after the establishment of subsequent undertaking, the latter may be called extension of such a nature which may be called a kind of new industrial undertaking which is entitled to get tax relief.

As a matter of fact the question whether the expression "reconstruction" would include the case of substantial extension or expansion of the assessee's original business so as to invoke the benefit of Section 80-IA would depend upon the facts of each case. Broadly speaking, exemption under Section 80-IA would only be available to those industrial undertakings which are not established by division or reorientation of the assessee's original business or which have not been formed by the substantial transfer to it of a plant or machinery, etc. used in the assessee's original business. Substantial expansion of an assessee's original business cannot be called "reconstruction* unless there is a finding of fact that a subsequent industrial undertaking is really a fresh formation, resuscitation, reorganization, revival or resumption of the assessee's earlier business.

9.8 PRECAUTION TO BE TAKEN IN THE CASE OP TRANSFER OF SECOND-HAND ASSETS IN NEW BU8INE88

One of the important conditions to be fulfilled by a new industrial undertaking to get tax exemption it that is should not be formed by the transfer to a new business, of machinery or plant previously used for any purpose. Explanation 2 to Section 80-lA(2) provides that if the value of the second-hand machinery or plant by the transfer of which a new industrial undertaking is formed, etc. does not exceed 20% of the total value of the machinery and plant used in the business, the condition may be considered as fulfilled. Thus when a new industrial undertaking is formed by the transfer of second-hand machinery or plant the value of the new machinery or plant should be at least 80% of the total plaint and machinery.

9.9 SPECIAL FACTORS WHILE COMPUTING PROFITS AND GAINS OF A NEW INDUSTRIAL UNDERTAKING

It is a settled law that the profits and gains of the industrial undertaking to which Section 80-IA applies are to be computed in accordance with the provisions contained in Sections 28 to 43A of the Income Tax Act. In computing the profits for the purpose of deduction or exemption, the raw material, if any, supplied by the old industrial undertaking should be valued at the market price and not at its cost of production as per Section 80-IA(9). The unabsorbed depreciation and carried forward losses of the past years have to be set off in accordance with Section 72.

9.10 SUMMARY

The lesson describes various conditions governing the tax concessions in the matter, of new industrial undertakings or hotels and the precautions that are to be taken by a company so that it is able to take full advantage of the concessions so available, As regards new industrial undertakings or hotels in the rural areas or backward areas after 31-3-1990, the same have been discontinued as per the Finance Act 1990. The tax planning aspects of new industrial undertakings in Free Trade Zone under Section 10-A are described also.

9.11 Keywords

Incorporation: The legal process of forming a new business entity, often a key step in tax planning.
Start-up Costs: Expenses associated with establishing a new business, considered in tax planning for potential deductions.
Tax Incentives: Special provisions in tax laws designed to encourage specific behaviors, such as setting up new businesses, through favorable tax treatment.

9.12 QUESTIONS FOR REVIEW

Short Answer Type Questions

1. Discuss the deduction of the profits of a new industrial and infrastructure undertaking. Also discuss Five year tax holiday.
2. Discuss the extension of exemption in case of renovation and modernization of power transmission & distribution lines u/s Section 80IA
3. Discuss the Special factors while computing profits and gains of a new industrial undertaking.

Long Answer Type Questions

4. Discuss the deduction allowed regarding new ships and new hotels.
5. Explain the reconstruction of a business already in existence.
6. What are the precautions to be taken in the case of transfer of second-hand assets in new business?

9.13 SUGGESTED READINGS

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9.14 Self Check Exercise (Answer Key)

1. True, 2. False, 3. True, 4. Tax Holiday, 5. Establishment, 6. Five-Years, 7. Start-up, 8. Encouragement, 9. Exemption

Lesson no.: 10 **Author: Sanjeev Kumar**

SPECIAL PROVISIONS IN RESPECT OF NEWLY ESTABLISHED INDUCTRIAL UNDERTAKING IN EOUs AND SEZs

STRUCTURE

10.0 OBJECTIVES

This lesson discuses all the significant aspects of tax planning regarding new business in EOUs and SEZs. After the completion of this Lesson, you should be able to understand the following:

- Tax planning in respect of newly established industrial undertaking in a Free Trade Zone
- Ten-year tax holiday, Free Trade Zone and 100% E.O.Us
- Ten-Year Tax Holiday for industries in North-East - Section 10C
- New Provisions for exemption of new industrial undertakings in free trade zones or hundred percent EOUs
- Exemption for old industrial undertakings and new industrial undertakings
- Special provisions in respect of newly established hundred per cent export-oriented undertakings
- rationalization of provisions relating to undertakings in Free Trade Zones, Export Processing Zones, Special Economic Zones and Export Oriented Units
- Tax holiday for convention centre and multiplex centre
- Special provisions in respect of certain undertakings in special category States

10.1 DEFINITIONS

Let us first of all understand the basic terms to understand special provisions in respect of newly established industrial undertaking in EOUs and SEZs.

Industrial Company:

The expression "industrial company' is defined under Section 2(7) (e) of the Finance Act, 1979. The provision contemplates that an industrial company should either manufacture or process goods. Section 2(7) (c) makes a distinction between the manufacture and the processing of goods.

- C1T v. e.g. Textiles (P) Ltd. (2000) 245 ITR 820.

Industrial Undertaking:

The demonstrative objective "industrial" qualifying the word "undertaking* unmistakably and with precision shows that the undertaking must be one which partakes of the character of a business. - P. Ali Kunju, M.A. Nazeer Cashew Industries v CIT [1987] 166 ITR 804,

The expression "industrial undertaking" has not been defined in the Income Tax Act. "Industry" is a term of wide import. Where there is (i) systematic activity; (ii) organized by co-operation between employer and employee; (iii) for the promotion and/or distribution of goods and services calculated to satisfy human wants and wishes, prima facie there is an industry. "Undertaking" is in actual effect an activity of man which, in commercial or business parlance, means an activity engaged in with a view to earn profit. - Shanker Construction Co. v CIT (1991) 189 ITR 463.

The Income Tax Act does not define the expression "industrial undertaking." The expression "industrial undertaking" occurring in Section 32A (2) (b) (iii) of the Income Tax Act, 1961, should be construed in a liberal, wide and practical sense. The statutory language is clear and no limitation should be imported into it. It cannot be stated that in all cases, manufacture or production is a condition precedent to call an activity, business, or trade an "industrial undertaking." Thus, the industrial undertaking may be one of the category of the business.

10.2 Tax planning in respect of newly established industrial undertaking in a Free Trade Zone • Section 10A

At present there are six Free Trade Zones viz., Kandla, Seepz Bombay, Fatta (Calcutta), NOIDA, Madras and Cochin. With a view to encouraging establishment of export-oriented industries in the free trade zones, a new Section 10A wef 1-4-1981 was inserted to provide for complete tax exemption in respect of the profits and gains derived from industrial undertakings set up before

1. 4.2000 in these zones for a period of five (extended later to ten) assessment years. This concession will also apply in relation to other free trade zones that may be set up in future. This tax concession is available to all tax-payers, including foreign companies and nonresident non-corporate taxpayers. This "tax holiday" is in lieu of all other tax concessions, e.g. investment allowance, the partied tax holiday, etc. It is also provided that after the expiry of the tax holiday period, there will be no carry forward of any unabsorbed losses, depreciation, development rebate, investment allowance, tax holiday deficiency or any other deduction or allowance admissible under the income Tax Act.

For the purposes of depreciation, the written down value of the assets used in the industrial undertaking for the assessment year subsequent to the tax holiday period will be determined as if the depreciation allowable under the existing provisions had actually been claimed and allowed. The details of this tax concession are given in the next chapter which deals with tax planning of export profits.

As per Finance Act, 1995 in the case of industrial units in Free Trade Zones also, the five-year tax holiday would be restricted to units exporting at least 75% of their turnover. Units which export less than 75% of their turnover can, however, avail of the normal 100% deduction U/S 80HHC to the extent of the export profits. This restriction will apply only to new units which began to manufacture or produce an article or thing on or after 1-4-95.

As per the Finance Act, 2003 w.e.f. the A.Y. 2004-05 it is provided that where any undertaking of an Indian company which is entitled to deduction u/s 10A is transferred, before the expiry of the period specified in this section to another Indian company in a scheme of amalgamation or demerger.

(a) no deduction shall be admissible under this section to the amalgamating or other demerged company for the previous year in which the amalgamation or the demerger takes place, and

(b) the provisions of this section shall, as far as may be, apply to the amalgamated or the . . resulting company as they would have applied to the amalgamating or the demerged company if the amalgamation or demerger had not taken place. It is also provided that manufacture or produce shall include the cutting and polishing of precious and semi-precious stones. Besides, the facility for carry forward of unabsorbed depreciation to business loss would be available for projects in Special Economic Zone. Besides, the facility for carry forward of unabsorbed depreciation and business loss would be available for project in SEZ.

Rule 16DD of the Income Tax Rules, 1962 contains a Form of particulars to be furnished 'along with return of income for claiming deduction under Section 10 A. These particulars are to be submitted in Form No. 56FF.

10.3 TEN-YEAR TAX HOLIDAY, FREE TRADE ZONE AND 100% E.O.US

The Income Tax (Second Amendment) Act, 1998 with effect from the AY 1999-2000, amended Section 10A to provide for the period of tax holiday to 10 years in place of 5 years. The option earlier allowed to choose any 5 years out of a period of 8 years, has consequently been omitted. The period of tax holiday has been extended from 5 years to 10 years to all newly established industrial undertakings set up in Free Trade Zones and to units set up before 1.4.2000 in Software Technology Parks, Likewise, under Section 10B also the 5-year tax holiday period has been extended to 10 years to all 100% export-oriented units.

10.4 TEN-YEAR TAX HOLIDAY FOR INDUSTRIES IN NORTH-EAST - SECTION IOC

The Finance Act, 1999 has, with effect from the AY 1999-2000, inserted a new Section IOC to provide a 10-year tax holiday to the new industrial undertakings set up in Integrated Infrastructure Development Centres and Industrial Growth Centres to be notified by the Central Gmzemment. The North-Eastern Region means the region comprising the States to Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura. The various conditions for the applicability of the tax holiday's the new industrial undertaking which begins to manufacture or produce any article or thing on or after 1.4.1998 are broadly similar to the conditions applicable to new industrial undertaking as per Section 80-IA.

It is also specifically provided in the section that deduction in respect of depreciation, scientific research expenditure, etc. will be deemed to have been allowed and no business loss would be allowed to be carried forward if it relates to any of the relevant 10 years. It is also made clear that if any assessee does not wish to avail itself of the tax holiday under Section 10C, then he may furnish a declaration in writing that the provisions of this section would not be applied to him, and in that event, the provisions of section would not apply to him in any of the relevant 10 assessment years, beginning from the year in which the industrial undertaking begins to manufacture or produce articles or things. A similar benefit would also be given to such other industries in the North-Eastern Region as may be notified by the Central Government again as per Section 80-lB{4).

SELF CHECK EXERCISE

1. **How does the expression "industrial undertaking" qualify the term "undertaking" in the context of tax provisions?**

   a. It emphasizes financial investments
   b. It highlights charitable activities
   c. It indicates an activity with a business character
   d. It refers exclusively to manufacturing activities

2. **What does Section 10A of the Income Tax Act, 1961, provide for in relation to Free Trade Zones?**

   a. Investment allowance
   b. Tax exemption for export-oriented industries
   c. Capital gains tax reduction
   d. Deduction for research and development expenses

3. The written down value of assets for depreciation after the tax holiday period is determined as if depreciation had not been claimed during the tax holiday. T/F

4. Section 10C provides a 10-year tax holiday for new industrial undertakings in the North-Eastern Region, and business losses cannot be carried forward during this period. T/F

10.5 NEW PROVISIONS FOR EXEMPTION OF NEW INDUSTRIAL UNDERTAKINGS IN FREE TRADE ZONES OR HUNDRED PERCENT EOUS

The Finance Act, 2000, has substituted two important sections namely 10A and 10B of the Income Tax Act with effect from the A.Y. 2001-2002 to provide for some new provisions for exemption in a phased-out manner in respect of newly established industrial undertakings in free trade zones or electronic hardware technology park or software technology park or new economic zone from the A.Y. 2001-2002.

As these new provisions put a time limit to the grant of exemption under Section 10A and 10B and provide for exemption to new industrial undertakings or hundred percent export-oriented units in a phased-out manner with certain new conditions, the same are analyzed in this chapter for the benefit of business enterprises interested in the establishment of new industrial undertakings or information technology centres or hundred per cent export-oriented units, etc. on or after 1.4.2000.

10.6 EXEMPTION FOR OLD INDUSTRIAL UNDERTAKINGS AND NEW INDUSTRIAL UNDERTAKINGS

The newly substituted Section 10A provides that a deduction of the profits and gains derived by an undertaking from the export of articles or things or computer software for a period of ten consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce such articles or things or computer software, as the case may be, would be allowed from the total income of the assessee. As regards the old undertakings, it is specifically provided that the profits and gains of the newly established industrial undertakings in the free trade zone would continue to be governed by the provisions of the old Section 10A as it stood immediately before its substitution by the Finance Act, 2000, for the remaining, i.e. unexpired period of the aforesaid ten consecutive assessment years.

It is further provided that if the undertaking initially located in any free trade zone or export processing zone, is subsequently located in a special economic zone by reason of conversion of such free trade zone or export processing zone into a special economic zone, the period of ten consecutive assessment years would be reckoned from the assessment year relevant to the previous year in which undertaking was first set up in such free trade zone or export processing zone. The formal conditions regarding manufacturing of articles, etc. as were contained in the old Section 10A are also contained in the newly substituted Section 10A with a few modifications which are described hereunder.

It is also clearly provided that the benefit of the deduction would be available to an undertaking set up not only in a free grade-zone or export processing zone or in a special economic zone but also in any electronic hardware technology park or software technology park. Likewise, in respect of any assessment year, commencing from the AY 2001-2002 any undertaking set up in special economic zone would be allowed deduction till the AY. 2009-2010. This is because it has been categorically declared under the newly substituted Section 10A that no deduction under this section would be allowed to any undertaking for any assessment year beginning from the AY 2010-2011, and subsequent assessment years. It is clearly provided that the profits and gains derived from such domestic sales of articles or things or computer software as do not exceed twenty-five per cent of total sales would be deemed to be the profits and gains derived from the export of articles or things or computer software.

As the specific provision has been incorporated in the new Section 10A regarding the deduction available to the profits; and gains of any undertaking from the export of articles or things or computer software, a provision has been specifically incorporated on the lines of Section 80HHC or 90HHE to provide that if sale proceeds of articles or things or computer software exported out of India are received in, or brought into, India by the assessee in convertible foreign exchange, within a period of six months from the end of the previous year, or within such period as the competent authority would allow in this behalf, then only the deduction would be available.

The expression “competent authority” means the Reserve Bank of India or such other authority as is authorized under any law for the time being in force for regulating payments and dealings its foreign exchange. The sale proceeds would be deemed to have been received in India where such sale proceeds are credited to a separate account maintained for the purpose by the assessee with any bank outside India with the approval of the Reserve Bank of India. Further, it is provided that the profits derived from the export of articles or things or computer software would be the amount which bears to the profits of the business, the same proportion as the export turnover in respect of such articles or things or computer software bears to the total turnover of the business carried on by the assessee. The assessee is also required now to furnish a prescribed form along with the return of income, containing the report of a chartered accountant, certifying that the deduction has been correctly claimed as per Section 10A from the AY. 2001-2002. “Special economic zone* means a zone which the Central Government may, by notification in the Official Gazette, specify as a special economic zone, for the purpose of Section 10A.

Phased out deduction to new industrial undertakings in free trade zone, etc. from the AY. 2001-2002 to the AY. 2009-2010

As a categorical declaration has been made in substituting Section 10A that no deduction under Section 10A would be allowed to any undertaking for the assessment year beginning from the AY. 2010-2011 and subsequent years, a provision has been made for the grant of this deduction or exemption or tax holiday to the newly established undertaking on or after 1.4.2000 for nine years and eight years and so on from the AY. 2001-2002 to 2009-2010. Thus, it is provided that if any new industrial undertaking, etc. is set up in a free trade zone or any electronic hardware technology park or software technology park or a special economic zone during’ the financial year 2000-2001 relevant to the AY. 2001-2002, then it would be entitled to a deduction for nine assessment years, i.e. from the. AY. 2001-2002 to the AY. 2009-2010. Likewise, if a new undertaking is set up during the financial year 2001-2002 relevant to the AY. 2002-2003, then it would be entitled to the deduction under Section 10A for the eight assessment years only beginning from the AY. 2002-2003 to the AY 2009-2010, and so on.

10.7 SPECIAL PROVISIONS IN RESPECT OF NEWLY ESTABLISHED HUNDRED PER CENT EXPORT-ORIENTED UNDERTAKINGS

The Finance Act, 2000 also substituted Section 10B by a new section, with effect from theAY. 2002*2002 to provide for not only the continuance of the exemption or deduction or tax holiday in respect of the earlier hundred per cent export-oriented units or undertakings for the unexpired period out of the ten years tax holiday period but also to provide for a phased-out manner of deduction for the new hundred per cent export-oriented undertakings setup on or after 1.4.2000. As per the Finance Act, 2003 w.e.f. the A.Y. 2004-05 manufacture or produce shall also include the cutting and polishing of precious and semi-precious stones.

It is also categorically provided that no deduction under the newly substituted Section 10B would be allowed to any undertaking from the A.Y. 2010-2011. The old hundred per cent export-oriented units set up prior to 1.4.2000 would, however, continue to enjoy the excerption or deduction under the provisions of the old Section 10A as it stood prior to its substitution by the Finance Act, 2000 for the “'unexpired period for the aforesaid ten consecutive assessment years.

The formal conditions regarding the receipt in India of the sale proceeds in convertible foreign exchange within a period of six months from the end of the previous year or further extended period allowed by the RBI as also furnishing of the certificate along with the return of income duly certified by a chartered accountant, etc. have also been incorporated. The phasing out of this exemption would mean that if any hundred per cent export-oriented unit is set up during the A.Y.
2000-2001 relevant to the assessment year 2001-2002, it would be allowed this deduction only for a period of nine assessment years, i.e. from the A.Y, 2001-2002 to the A.Y. 20092010, and so on. It is specifically provided that the profits and gains derived from such domestic sales of articles or things or computer software as do not exceed 25% of the total sales would be deemed to be the profits and gains derived from the export of articles or things of computer software, However, one new important provisions must be noted that if there is a transfer of beneficial interest in the undertaking or any person by any means, the deduction would be forfeited for the subsequent assessment years.

SELF CHECK EXERCISE

5. **The Finance Act, 2000, substituted which sections of the Income Tax Act to provide for new provisions for exemption?**

   a. Sections 10A and 10B
   b. Sections 20 and 30
   c. Sections 50 and 60
   d. Sections 5 and 15

6. **Under the newly substituted Section 10A, what does "competent authority" refer to?**

   a. Central Government
   b. Reserve Bank of India
   c. Chartered Accountant
   d. Ministry of Finance

7. **The phasing-out of the exemption for new industrial undertakings applies only to those set up after 1.4.2000. T/F**

8. **The deduction under Section 10B is available for a maximum period of 15 consecutive assessment years. T/F**

10.8 RATIONALISATION OF PROVISIONS RELATING TO UNDERTAKINGS IN FREE TRADEZONES, EXPORT PROCESSING ZONES, SPECIAL ECONOMIC ZONES AND EXPORT ORIENTED UNITS - SECTIONS 1QA AND 10B

The Finance Act, 2001, with effect from the A.Y. 2002-2003, made some amendments to Sections 10A and 10B to amend the definition "Export turnover" to clarify that the working of the proportionate deduction on export profits are meant to be of the undertaking, and not of the business, as a whole and to further clarify that in the event of a conversion of a Free Trade Zone into Special Economic Zones, the period of ten years would be reckoned from the date the unit first begins to manufacture or produce articles or things or computer software's. The provision which provides for deduction of profits on sale made in domestic tariff area would now be omitted to make such domestic profits taxable.

The Finance Act, 2002 amended Section 10 A to provide that profits and gains as are derived by an undertaking from manufacture or production of articles or things or computer software as the case may be, will be allowed deduction to the extent of 90% of such profits and gains only as against the usual 100% for the assessment year 2003-2004 only. Likewise, under Section 10B, 9 through an amendment only for the assessment year 2003-2004 deduction allowed on the profits and gains derived by an undertaking which is 100% EOU from the export of articles or things or computer software will be restricted to 90% of such profits and gains only.

The Finance Act, 2002 provided that new industrial undertaking set up in a special economic zone on or after 1.4.2002 which begins to manufacture or produce article or things or computer software will be eligible to deduction for five years in respect of profits and gains derived from the export of such articles or things or computer software for a period of five consecutive assessment years beginning with the assessment year in which the undertaking begins to manufacture or produce such articles or things or computer software and thereafter 50% of the profits for further-two assessment years.

As per the Finance Act, 2003 where any undertaking of an Indian company which is entitled to the deduction under this section is transferred, before the expiry of the period specified in this section, another Indian company in a scheme amalgamation demerger:

(a) no deduction shall be admissible under this section to the amalgamating or the demerged company for the previous year, in which the amalgamation or the demerger takes place, and

(b) the provisions of this section shall, as far as may be, apply to the amalgamated or the resulting company as they would have applied to the amalgamating or the demerged company if the amalgamation or demerger had not taken place.

The above-mentioned new provisions are applicable for newly established undertakings in free trade zone, special economic zones as also newly established hunched per cent export-oriented undertakings.

The Finance Act, 2 003, w.e.f. the A. Y. 2004-05 extended the exemption to units in a Special Economic Zone for the next 3 years on satisfying following conditions:

(a) the amount credited to the Special Economic Zone Reinvestment Allowance Reserve A/c is to be utilized:

(i) for the .purposes-of acquiring new machinery or plant which is first put to use before the expiry of a period of 3 years next following the previous year in which the reserve was created; and

(ii) until the acquisition of new machinery or plant, as aforesaid, for the purposes of the business of the undertaking other than for distribution by way of dividends or profits a remittance outside India as profits or for the creation of any attest outside India;

(b) the prescribed particulars have been furnished by the assessee in respect of new machinery or plant along with the? return of income for the previous year in which such plant or machinery was first put to use.

As per the Finance Act, 2003 w.e.f the A.V. 2001-02' the provisions contained in Section 1OA and 10B have been amended £0 provide for carry forward and set oi f of unabsorbed depreciation u/s 32(2) as also unabsorbed expenditure on scientific research u/s 35 and the unabsorbed capital expenditure on family planning u/s 36 (1) (ix) even after the expiry 01? the tax holiday period, likewise, the losses u/s 72(1) or 74(1) or 74(3) would be allowed to be carried forward even after the expiry of the tax holiday period.

10.9 TAX HOLIDAY FOR CONVENTION CENTRE AND HDLT1P1AX CENTRE - SECTION SO-B

The Finance Act, 2002, with effect from the A.Y. 2003-2004, allowed a detection of 50% for a period of five years from the profits of the business of building, owning, and operating a multiplex theatre of prescribed norms, in cities other than Delhi, Chennai, Kolkata, and Mumbai, if such multiplex theatre is constructed during 1.4.2002 to 31.3.2005. The deduction is available from the year the multiplex theatre starts commercial operation. Besides, 50% deduction would also be allowed for a period of five years from the profits of business of building, owning and operating the convention centre of prescribed norms, if such convention centre is constructed during 1.4.2002 to 31.3.2005. This deduction would be available from the year the convention centre starts commercial operation.

10.10 RURAL HOSPITAL TO BE EXEMPT FOR 5 YEARS - SECTION SO IB(11B)

The Finance (No.2) Bill, 2004 has from the A.Y. 2005-2006 inserted a new subsection (1 IE) in Section 80IB to provide for 5-year full tax holiday, beginning with the initial assessment year provided such hospital is constructed at any time during 1-10-2004 and 31-3-2008 and has 100 beds for patients. The construction should be as per local regulations.

10.11 SPECIAL PROVISIONS IN RESPECT OF CERTAIN UNDERTAKINGS IN SPECIAL CATEGORY STATES - SECTION SOIC

A new Section 80IC was inserted by the Finance Act, 2003 to provide for a special deduction in respect of profits and gains derived by an industrial undertaking or an enterprise which manufactures any article or thing (other than articles mentioned in the Thirteenth Schedule) from different dates mentioned in the section in the State of Sikkim, Himachal Pradesh, Uttaranchal as well as in the North-Eastern States in the notified Export Processing Zone, or Integrated Infrastructure Development Centre or Industrial Growth Centre or Industrial Estate or Industrial Park or Software Technology Park or Industrial Area or Theme Park. Similarly, a new Fourteenth Schedule of the l.T. Act has been listed which provides for setting up of selected industries in any part of the above States.

The Union Cabinet had announced a package of fiscal and non-fiscal concessions for the special category States of Himachal Pradesh, Uttaranchal, Sikkim and North-Eastern States, in order to give boost to the economy in these states.

With a view to give effect to these new packages announced by the Union Cabinet in respect of these states, a new Section SOIC has been inserted by the Finance Act, 2003 to allow a deduction for ten years from the profits of new undertakings of enterprises or existing undertakings or enterprises on their substantial expansion, in the States of Himachal Pradesh, Uttaranchal, Sikkim and North-Eastern States. For this purpose, substantial expansion is defined as increase in the investment in the plant and machinery by at least 50% of the book value of the plant and machinery (before taking depreciation in any year), as on the first day of the previous year in which the substantial expansion is undertaken.

The deduction would now be provided to such undertakings or enterprises which manufacture or produce any article or thing, not being any article or thing specified in the Thirteenth Schedule and which commences operation in any Export Processing Zone, or Integrated Infrastructure Development Centre or Industrial Growth Centre or Industrial Estate, or Industrial Park, or Software Technology Park or Industrial Area or Theme Park, as notified by the Board in accordance with schemes framed by the Central Government in this regard. Similar deduction shall be available to thrust sector industries, as specified in the Fourteenth Schedule. The amount of deduction in case of undertakings or enterprises in the States of Sikkim and the North-EasternStates shall be one hundred per cent of the profits of the undertaking for ten assessment years. The amount of deduction in case of undertakings or enterprises in the states of Uttaranchal, Himachal Pradesh shall be one hundred per cent of the profits of the undertaking for fiveassessment years, and thereafter twenty-five per cent (thirty per cent for companies) for five assessment years.

It is further provided that no deduction shall be allowed Vo any undertaking or enterprise tinder this section, where the total period of deduction inclusive of the period of deduction under this section or under Section 80IB or under Section 10C, as the pace may be exceeds ten assessment years. It is also proposedto provide that in computing the total income of the assessee, no deduction shall be allowed under any other section contained in Chapter VIA or VIB Section 10A or 10B, in relation to the profits and gains of the undertaking or enterprise.

The Thirteenth Schedule and Fourteenth Schedule in the Income 1'ax Act, have been inserted. The said Schedules specify the list of articles and things and the States for the purposes of availing deduction under this section. Consequent to these amendments, h" is proposed to make the provisions of Section IOC and subsection (4) of Section 80IB inoperative in respect of the Undertakings or enterprises eligible for deduction under Section 801C with effect from the 1st day of April, 2004.

Please refer to Notification No. 1269(E) dated 4-11-2003 regarding Industrial Estate or Industrial Area notified in the State of Himachal Pradesh as printed in (2003) 264 ITR 145 (statutes). Similarly, please refer to Notification No. 400 (E) dated 26-3-2004 regarding Industrial Estate or Industrial Area notified in the State of Assam, Tripura, Meghalaya, Mizoram, Nagaland, Manipur and Arunachal Pradesh as printed in (2004) 246 ITR 118 (Statutes).

SELF CHECK QUESTIONS

9. **What amendment did the Finance Act, 2001, make to Sections 10A and 10B regarding the definition of "Export turnover"?**

   a. Increased the tax holiday period

   b. Clarifiedss5 the deduction on export profits to be of the undertaking, not the business as a whole

   c. Extended the exemption to all businesses

   d. Removed the provision for deduction of profits in the domestic tariff area

10. **According to the Finance Act, 2002, what percentage of deduction on export profits was allowed for the assessment year 2003-2004?**

a. 100%

b. 90%

c. 80%

d. 50%

11. **The Finance Act, 2003, extended the exemption to units in Special Economic Zones for the next 3 years starting from the assessment year 2004-05. T/F**

12. **The Finance Act, 2003, introduced a new Section 80IC for special deductions in special category states, including Himachal Pradesh, Uttaranchal, Sikkim, and North-Eastern States. T/F**

10.12 SUMMARY

A company having a new industrial undertaking or an infrastructure facility or a ship or a hotel can derive maximum advantage of partial tax holiday under Section 80-IA or 80-IB by adopting tax planning as suggested in this lesson. The expression "industrial undertaking" has not been defined in the Income Tax Act. "Industry* is a term of wide import. Where there is (i) systematic activity; (ii) organized by co-operation between employer and employee; (iii) for the promotion and/or distribution of goods and services calculated to satisfy human wants and wishes, prima facie there is an industry. "Undertaking* is in actual effect an activity of man which, in commercial or business parlance, means an activity engaged in with a view to earn profit. At present there are six Free Trade Zones viz., Kandla, Seepz Bombay, Fatta (Calcutta), NOIDA, Madras .and Cochin. With a view to encouraging establishment of export-oriented industries in the free trade zones, a new Section 10A wef 1-4-1981 was inserted to provide for complete tax exemption in respect of the profits and gains derived from industrial undertakings set up before 1.4.2000 in these zones for a period of five (extended later to ten) assessment years. This concession will also apply in relation to other free trade zones that may be set up in future. This tax concession is available to all tax-payers, including foreign companies and nonresident non-corporate tax-payers.

10.13 KEYWORDS

- **TAX PLANNING:** The process of organizing financial activities in a way that minimizes tax liability and maximizes financial benefits within the legal framework.
- **FREE TRADE ZONES:** Areas with relaxed trade barriers, where goods can be imported, manufactured, and re-exported with fewer restrictions.
- **INDUSTRIAL UNDERTAKINGS:** An enterprise or business involved in industrial activities such as manufacturing, production, or processing of goods.
- **DEDUCTION:** An amount subtracted from income for tax purposes, reducing the total taxable income.
- **TAX HOLIDAY:** A temporary reduction or elimination of tax liability granted to a particular group or sector to encourage economic activity.

10.14 QUESTIONS FOR REVIEW

- **SHORT ANSWER QUESTIONS**
  1. What is Special Economic Zones?
  2. What are Section 10A and Section 10B?
  3. What are EOUs (Export Oriented Units)?

- **LONG ANSWER QUESTIONS**

1. Discuss Tax planning in respect of newly established industrial undertaking in a Free Trade Zone u/s Section 10A
2. Discuss Ten-year tax holiday, Free Trade Zone and 100% E.O.Us
3. Discuss Ten-Year Tax Holiday for industries in North-East u/s Section 10C
4. What are the new provisions for exemption of new industrial undertakings in free trade zones or hundred percent EOUs.
5. What are the Exemptions for old industrial undertakings and new industrial undertakings?
6. What are the special provisions in respect of newly established hundred per

cent export-oriented undertakings?

7. Discuss Tax holiday for convention centre and multiplex centre u/s Section 80-B

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ANSWER KEY

1. c, **2.** b, **3.** T, **4.** T, **5.** a, **6.** b, **7.** T, **8.** F, **9.** b, **10.** b, **11.** F, **12.** T.

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AMALGAMATION, DEMERGER AND TAX PLANNING

8TRUCTURE

11.0 OBJECTIVES

After the completion of this Lesson, you should be able to understand the following:

- Type of amalgamation which entitles a company to enjoy tax concessions.
- Status of unabsorbed depreciation or carry forward of business losses on amalgamation of companies
- Right to carry forward unabsorbed development rebate or investment allowance not lost on amalgamation
- Incidental provisions in company amalgamation
- Exemption available from capital gains tax on company amalgamation
- Special tax planning for the carry forward and set off of accumulated business loss and unabsorbed depreciation of sick units on amalgamation
- Modification of the provisions regarding amalgamation - Section 72A
- Tax incentives for facilitating demerger

11.1 INTRODUCTION

Sometimes it so happens that two or more companies merge themselves into one company with a view to achieve economic benefits or to curtail losses, or to take advantage of each other's special factors in mutual interest or due to any other reason. There are various advantages in the matter of carry forward of unabsorbed investment allowance, unabsorbed development allowance, etc. which are admissible to a company even after amalgamation. Some of these tax concessions are lost when a company loses its identity by merger thereof into another company. However, there are certain special circumstances when a company does not stand to lose some o£ the advantages in the matter of carry forward of unabsorbed business loss or depreciation, etc., when the amalgamation is carried out as per the special conditions laid down in the Income tax Act. It is, 'therefore, absolutely necessary for companies desiring to have a merger to adopt proper tax planning so that maximum tax advantage is obtained by the companies merging into one another. It is mainly the amalgamated company which has to take special precautions as it stands to lose several of the tax benefits which are otherwise available if the conditions prescribed in the Income Tax Act, in the matter of amalgamations are not followed by it.

In this lesson, we will describe the type of amalgamation which entitles the companies to enjoy these tax concessions. We have also described the various tax benefits which are not lost as a result of such amalgamation. Similarly, we have also described in this chapter certain advantages which are lost irrespective of the fact whether the amalgamation is one as per the definition laid down in the Income Tax Act or not. If the company has proper knowledge about these provisions it stands to benefit in the matter of tax planning in relation to company amalgamations or mergers.

11.2 TYPE OF AMALGAMATION WHICH ENTITLES A COMPANY TO ENJOY TAX CONCESSIONS

Section 2(1B) of the Income Tax Act, lays down the definition of "amalgamation". This definition has to be understood by companies intending to amalgamate or merge with one another so that the tax concessions available under amalgamation are properly availed of. Thus, "amalgamation", in relation to companies, means the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger as the amalgamated company) in such a manner that

(i) all the properly of the amalgamating company or companies immediately before the amalgamation become the property of the amalgamated company by virtue of the amalgamation;

(ii) all the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of the amalgamation;

(iii) shareholders holding not less than 3/4ths (from the AY 2000-2001) in value of the shares in the amalgamating company or companies (other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation, otherwise than as a result of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of the distribution of such property to the other company after the winding up of the first mentioned company.

The other type of amalgamation or merger of companies which does not fulfill the conditions laid down above is nevertheless a merger. However, the latter is not entitled to certain advantages -carry forward of unabsorbed investment allowance, etc. of the company which merges itself into another. It is, therefore, very important to know and remember the various conditions attached to the "amalgamation* as defined in the Income Tax Act.

11.3 STATUS OF UNABSORBED DEPRECIATION OR CARRY FORWARD OF BUSINE8S LOSSES ON AMALGAMATION OF COMPANIES

Where a company amalgamates itself with another company the unabsorbed depreciationor carry forward losses from earlier years would be lost to the company which loses its identity, as it would be no longer in existence. Similarly, the transferee company or the amalgamated company into which the amalgamating company merges itself would not be entitled to claim the carry forward of the unabsorbed depreciation and the past business losses of the merged company. This is because the merged company is a different assessee. This universal rule cannot be circumvented even where an amalgamation or merger of the companies takes place under conditions which fall under Section 2(1B) of the Income Tax Act. If the Indian transferee company takes over the assets of the merged company at a value higher than the written down value, to take into consideration the past unabsorbed depreciation and carry forward of losses, the advantages cannot be availed of by the transferee company because it is provided in Explanation 2A to Section 43(6) of the Income Tax Act, that the written down value of the assets of the Indian transferee company in such a case should be taken to be the same as it would have been in the case of merged or transferor company. However, the transferee company would be entitled to carry forward the unabsorbed development rebate or investment allowance in the types of amalgamation falling under Section 2(1B) as described below,

SELF CHECK EXERCISE

1. **According to Section 2(1B) of the Income Tax Act, what does "amalgamation" in relation to companies entail?**

   a. Merger of two companies only

   b. Merger of one or more companies to form one company

   c. Merger of two companies and formation of a new company

   d. Merger of companies without any change in ownership

2. **What is a condition for an amalgamation to be considered under Section 2(1B) of the Income Tax Act?**

   a. All shareholders become shareholders of the amalgamated company

   b. Shareholders holding at least 1/2 in value of the shares become shareholders of the amalgamated company

   c. Shareholders holding not less than 3/4ths in value of the shares become shareholders of the amalgamated company

   d. Shareholders holding not less than 1/4th in value of the shares become shareholders of the amalgamated company

3. In an amalgamation, the amalgamated company is entitled to claim the carry forward of unabsorbed depreciation and past business losses of the merged company. T/F

4. The conditions for amalgamation under Section 2(1B) ensure that the amalgamated company retains the status of the amalgamating company for tax purposes. T/F

11.4 RIGHT TO CARRY FORWARD UNABSORBED DEVELOPMENT REBATE OR INVESTMENT ALLOWANCE NOT LOST ON AMALGAMATION

Normally, the right to development rebate or investment allowance is lost where the transfer of the assets is affected within eight years where there is any business reorganization or expansion,

e.g., when an assessee converts his business into a limited company. However, an exception has been provided in the case of "amalgamation* of two or more companies fulfilling the conditions laid down in Section 2(IB) of the Act, as described in para 2 (supra). Where, in a scheme of amalgamation as described earlier, the amalgamating company sells or otherwise transfers to the amalgamated company (i.e., the company which continues to exist and in which the amalgamating or transferor company merges itself) any ship, machinery or plant in respect of which development rebate or investment allowance has been allowed to the amalgamating company, the benefits of the development rebate or investment allowance, as the case may be, would be available to the amalgamated company in the same manner as they would have been applicable in the case of the amalgamating company, under Section 33{3) or 32A(6) provided the amalgamated company continues to fulfill the conditions mentioned in Section 34(3) or 32A(4). Similarly, the total period for the cany forward of the development rebate or investment allowance would not exceed eight years.

11.5 INCIDENTAL PROVISIONS IN COMPANY AMALGAMATION

There are various other matters connected with amalgamations, which are either of an incidental nature or as a/matter of corollary to the main provisions giving tax benefit on “amalgamation* falling under the provisions of Section 2(1B) as already described above. One of the provisions is that contained in Section 33A(5) which allows the benefit of unabsorbed development allowance to tea industries to be carried forward in the hands of the amalgamated company in the same manner as the unabsorbed investment allowance is allowed to be carried forward. Unabsorbed investment allowance is available for set off in case of amalgamation under the provisions of Section 32A (6).

Incidental provisions have also been incorporated in Section 35(5) in relation to the expenditure on scientific research and Section 35A(6) of Act in relation to capital expenditure on acquisition of patent rights or copyrights. As regards the actual cost of an asset, it has been providedin Explanation 7 to Section 43(1) of the Income Tax Act that where, in a scheme of amalgamation any capital asset is transferred by the amalgamating company to the amalgamated company (i.e., the transferee company) and the amalgamated company is an Indian company, the actual cost of the transferred capital asset to the amalgamated company would be taken to be same as it would have been if the amalgamating company had continued to hold the capital assets for the purpose of its own business. Similarly, a provision has been inserted in Explanation 2A to Section 43(6) in the matter of determination of the written down value (W.D.V.) in the case of assets in the hands of the amalgamated company (i.e. the transferee company). The intention of these two provisions is that the amalgamated company or the transferee company would be entitled to the benefit of depreciation in respect of assets belonging to the amalgamating company (i.e. the company which merges itself into the other company) in the same manner as it would have enjoyed had it not been merged into other amalgamated company.

11.6 EXEMPTION AVAILABLE FROM CAPITAL GAINS TAX ON COMPANY AMALGAMATION

Where there is any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the Indian amalgamated company (or the transferee company) Section 47 (vi) expressly provides that such a transfer is not considered as a ‘transfer" for the purpose of Section 45 and thus any capital gains arising as a result of such transfer are not liable to capital gains tax.

Similarly, under the provisions of Section 47(vii) it is laid down that any transfer by a shareholder, in a scheme of amalgamation, of a capital asset being a share or shares held by him in amalgamating company would not be considered as a “transfer” and thus would be outside the purview of “capital gains" if

(a) the transfer is made in consideration of the allotment to him of any share or shares in the amalgamated company; and

(b) the amalgamated company is an Indian company.

Though the Income Tax Act provides for specific exemptions in the case of company amalgamations falling within the definition of the expression “amalgamation” as defined in above, yet, we are of the view that even normal amalgamations would not be covered under the definition of the expression' transfer* within the meaning of Section 2(47) of the Income Tax Act and thus no tax would be leviable under the head "capital gains” on the shareholders of the amalgamating company on such amalgamation.

An incidental provision has been inserted in Section 49(1) (iii) (e), under which it has been laid down that cost of acquisition of the asset in the case of an assessee would be deemed to be the cost for which the previous owner of the property acquired it, as increased by the cost of improvement of the asset, incurred or borne by the previous owner or the assessee, as the case may be. Section 49(2) provides that where the capital asset being a share or shares in an amalgamated Indian company becomes the property of the assessee in consideration of a transfer as referred to in Section 47{vii), the cost of acquisition of the asset would be deemed to be the cost of acquisition to him of the share or shares in the amalgamating company, i.e., the transferor company.

Under Section 47(via), from the AY 1993-94, any transfer, in a scheme of amalgamation, of a capital asset being a share or shares held in an Indian Company, by the amalgamating foreign company to the amalgamated foreign company, is not regarded as a transfer for the purpose of capital gains provided the following two conditions are fulfilled:

(a) at least 25%: of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company; and

(b) such transfer does not attract any capital gains in the country, in which the amalgamating company is incorporated.

11.7 SPECIAL TAX PLANNING FOR THE CARRY FORWARD AND SET OFF OF ACCUMULATEDBUSINESS LOSS AND UNAB80RBED DEPRECIATION OF SICK UNITS ONAMALGAMATION

Section 72A of the Income Tax Act facilitates the merger of sick industrial units with sound ones as the provisions relating to carry forward and set-off of an accumulated business loss and carry forward of unabsorbed depreciation are relaxed in certain cases where there has been an amalgamation of a company owning an industrial undertaking or a ship or, ships with another company. The amalgamation should/be such as defined in Section 2(1B) of the Income Tax Act. Industrial undertakings with heavy accumulated losses can be purchased at a nominal price and with proper tax planning and by taking the advantage of the provisions of Section 72A, the entire unabsorbed business loss, etc. can be carried forward and set off against the profits of- sound industrial concern owned by a company and millions of rupees worth of tax saving can be affected. It is provided in the said section that the-Central Government on the recommendation of the “specified authority," should be satisfied that the following conditions are fulfilled (till the A Y 1999-2000):

(a) The amalgamating company was not immediately before such amalgamation, financially viable;

(b) The amalgamation was in the public interest; and

(c) Such other conditions as the Central Government may, by notification in the Official Gazette, specify, to ensure that the benefit under this section is restricted to amalgamations which would facilitate the rehabilitation or revival of the business of the amalgamating company.

Example

A Co. Ltd has become a sick industrial unit. It has an accumulated business loss and unabsorbed depreciation amounting to Rs. 2 crore. It gets amalgamated with B Co. Ltd., a sound industrial company and the entire scheme of merger is so approved by the Central Government. The net profit, earned by B company during the accounting year 2007-2008 relevant to the AY 2009-2010 is, say Rs. 5 crore. B company would be allowed to set off the unabsorbed business loss and depreciation of the A company, amounting Rs. 2 crore, against its income of Rs. 5 crore and would thus be liable to pay tax on only Rs. 3 crore. Thus, there would be a tax saving of Rs. 70,00,000 (i.e.. 35% income tax only). I.T.S.C. saving is extra.

The Supreme Court in Indian Shaving Products Ltd. v. BIFR and Another [1996] 218 ITR 140 (SC) has held that the BIFR, which sanctions a scheme of amalgamation of a sick industrial company cannot deny the privilege of carry forward of the business loss and unabsorbed depreciation of the amalgamating company, (see above Example).

The Supreme Court of India in the case of Marshall Sons & Co. (India) Ltd. v. ITO (1997) 223 ITR 809 has held that amalgamation takes effect on the date of transfer specified in the scheme and not on the date of court's order. Hence, the income from subsidiary company from the date of transfer is the income of the holding company.

In case of Indian Metals and Ferro Alloys Ltd. v. Union of India and Others (1999] 235 ITR 575, it was held by the Orissa H.C. that the Central Government was justified in not according approval for the scheme of amalgamation under Section 72A, as inter alia, majority of the workers of the Sick Unit were retrenched, the amalgamation was not in the public interest and there was no revival and rehabilitation of the Sick Unit but a new project had come into being.

SELF CHECK EXERCISE

5. **What is the purpose of Section 33A(5) in the Income Tax Act?**

   a. Carry forward of business losses

   b. Carry forward of development allowance for tea industries

   c. Carry forward of unabsorbed depreciation

   d. Carry forward of investment allowance

6. **Which section of the Income Tax Act provides exemptions from capital gains tax on company amalgamation?**

   a. Section 43

   b. Section 47(vi) and 47(vii)

   c. Section 49(1) (iii) (e)

   d. Section 72A

7. **Under Section 47(vii), the transfer of shares in a scheme of amalgamation is not considered a "transfer" if the amalgamated company is a foreign company. T/F**

8. **The Supreme Court held in the case of Marshall Sons & Co. (India) Ltd. v. ITO that amalgamation takes effect on the date of the court's order. T/F**

11.8 MODIFICATION OF THE PROVISIONS REGARDING AMALGAMATION - SECTION 72A

The Finance Act, 1999, with effect from the AY 2000-2001, amended the definition of the expression "amalgamation in Section 2(1)(B) of the shareholders being required, it would suffice if only three-fourth of the shareholders of the amalgamating company approves the amalgamation. Further, the provisions of Section 72A regarding amalgamation have been relaxed by the Finance Act, 2000. The benefit of carry forward of accumulated losses and unabsorbed depreciation would be available to the amalgamated company if 75% in book value of the fixed assets are retained by the amalgamated company for a period of at least five years and further that the amalgamated/ company carries on the business of the amalgamating company for at least five years from the date of amalgamation.

The Central Government could prescribe such other conditions as it considers necessary to ensure the revival of business or to prevent the misuse of the concession. Thus, the procedure regarding taking the approval of the prescribed authority has been done away with under the newly substituted Section 72A with effect from the A Y 2000-2001. The amended provisions of Section 72A would also be applicable in the case of reorganization of business by conversion of a proprietary business into a firm or by conversion of a partnership firm into a company and also in the case of demerger so that the benefit of a carry forward business loss and unabsorbed depreciation is allowed to the successor.

Rule 9C has been inserted in the I.T. Rules, 1962. Form No.62 has been prescribed. The conditions for carry forward or set off of accumulated loss and absorbed depreciation allowance as per Section 72A(2)(iii) have now been prescribed. Thus, the amalgamated company, owning an industrial undertaking of the amalgamating company by way of amalgamation, should achieve the level of production of at least 50 per cent of the installed capacity of the said undertaking before the end of four years from the date of amalgamation and continue to maintain the said minimum level of production till the end of five years from the date of amalgamation. However, these conditions can be relaxed by the Central Government in genuine cases. The amalgamated company is required to furnish to the Assessing Officer a certificate in Form No.62, duly verified by a chartered accountant, with reference to the books of accounts and other documents showing the particulars of production along with return of income for the assessment year relevant to the previous year during which the prescribed level of production is achieved, for subsequent assessment years relevant to the previous year falling within five years from the date of amalgamation. In this rule the expression "installed capacity* means the capacity of production existing on the date of amalgamation.

The Finance Act, 2001 has, retrospectively defined "industrial company" to mean any undertaking which is engaged in - (i) the manufacture or processing of good; or (ii) the manufacture of computer software; (iii) the business of generation or distribution of electricity or any other form of power; or (iv) mining; or (v) the construction of ships, aircrafts or rail systems.

The Finance Act, 2003 amended sub-sections (I) and (2) of Section 72 of the Income TaxAct, 1961 w.e.f. the A.Y. 2004-05 to provide that where there has been an amalgamation of a company owning an industrial undertaking or a ship or a hotel with another company or an amalgamation of a banking company referred to in clause (c) of Section 5 of the Banking Regulation Act, 1949 with a specified bank, then, notwithstanding anything contained in any other provision of this Act, the accumulated loss and the unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or, as the case may be, allowance for depreciation of the amalgamated company for the previous year in which the amalgamation was effected, and other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly. It is also provided that the accumulated loss shall not be set off or carried forward and the unabsorbed depreciation shall not be allowed in the assessment of the amalgamated company unless:

(a) the amalgamating company
    (i) has been engaged in the business for at least three years during which the accumulated loss has occurred or the unabsorbed depreciation has accumulated;
    (ii) has held continuously as on the date of the amalgamation at least three- fourths of the book value of fixed assets held by it two years prior to the date of amalgamation.

(b) The amalgamated company:
    (i) holds continuously for a minimum period of two years from the date of amalgamation at least three-fourths of the book value of fixed assets of

the amalgamating company acquired in a scheme of amalgamation;

(ii) continues the business of the amalgamating company for a minimum period of five years from the date of amalgamation;

(iii) fulfils such other conditions as may be prescribed to ensure the revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purpose.

11.9 TAX INCENTIVES FOR FACILITATING DEMERGER

Sections 2(19AA), 2(19AAA), 2(31 A), 2(42A), 2(42C), 72(1)(ii), 4th proviso, 33AC, 35A(7), 35AB(3), 35ABB(7), 350, 35E, 41 (2),42(2)$_1$43(1),43(6),47,49, 50B, 72, 79, and 115AC

With a view to recognize the demerger, slump sale and to rationalize the provisions of amalgamation a number of amendments have been made by the Finance Acts, 1999 and 2000, with effect from the A Y 2000-2001. The effect of these provisions is that de merger would now be taxed neutral and would not attract any additional liability to tax. Further, in demerger, the tax benefit and concession available to any undertaking would be available to the said undertaking on its transfer to the resulting company. Section 2(19AA) gives the definition of “demerger" as under:

(19AA) “demerger”, in relation to companies means the transfer, pursuant to a scheme of arrangement under Section 391 to 394 of the Companies Act, 1956, 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 byvirtue of the demerger;

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

(iii) the properly and the liabilities 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;

(iv) the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company 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 sub-Section (5) of Section 72A by the Central Government in this behalf.

Explanation 1.

For the purposes of this clause, "undertaking" shall include any part of an undertaking, or a unit or division 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.

Explanation 2.

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 utilized solely for the activities or operations of the undertaking, 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 value of the assets of such demerged company immediately before the demerger.

Explanation 3.

For determining the value of the property referred to in sub-clause (iii), any change in the value of assets consequent to their revaluation shall be ignored.

Explanation 4.

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 demerger if such split up or reconstruction fulfils such conditions as may be notified in the Official Gazette, by the Central Government.

The expression “demerged company” as per Section 2(19AAA) means the company whose undertaking is transferred, pursuant to a demerger to a resulting company. The expression "resulting company" has been defined by Section 2(41 A) to mean that 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.

The demerger is closely connected with the economic activity known as “slump sale” in which case also tax incentives as applicable to demerger have been provided. The expression “slump sale” has been defined by Section 2(42C) to mean the transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales. For this purpose, the expression “undertaking” would include any part of an undertaking or a unit or division of an undertaking or a business activity taken as a whole as applicable in the case of demerger. It has also been provided in Explanation 2 for the removal of doubts that the determination of the value of an asset or liability for the sole purpose of payment of stamp duty, registration fees or other similar taxes or fees would not be regarded as assignment of values to individual assets or liabilities.

A new Section SOB as amended by the Finance Act, 2000 provides that any profits or gains arising from the slump sale would be chargeable to income tax as capital gains arising from the transfer of long-term capital assets and shall be deemed to be the income of the previous year in which the transfer took place. However, it is also provided that any profits gains arising from the transfer under the slump sale of any capital asset being one or more undertakings owned and held by an assessee for not more than thirty-six months immediately preceding the date of its transfer would be deemed to be the capital gains arising from the transfer of short-term capital assets. In relation to capital assets being an undertaking or division transferred by way of such sale, the “net worth* of the undertaking or the division, as the case may be, would be deemed to be the cost of acquisition and the cost of improvement for the purposes of Sections 48 and 49 and no regard would be given to the provisions of Cost Inflation Index, etc. contained in second provision to Section 48.

Every assessee in the case of slump sale, would be required to furnish in the prescribed form along with the return of income, and a report of the chartered accountant about the computation of "net worth" of the undertaking or division, as the case may be, and certifying that the same has been correctly arrived at in accordance with this section. The expression "net worth" shall be the aggregate of total assets of the undertaking or division as reduced by the value of its liabilities as per books of account {by ignoring the effect of revaluation of assets). The aggregate value of total assets is WDV of the block of depreciable assets and book value of other assets.

To facilitate the provisions regarding carry forward and set off of accumulated loss and unabsorbed depreciation in the case of demerger, etc., Section 72A has been substituted by a new section. In Section 72A (4), it is provided that in the case of a demerger, the accumulated loss and the allowance for unabsorbed depreciation of the demerged company would, where such loss or unabsorbed depreciation is directly relatable to the undertakings transferred to the resulting company, be allowed to be carried forward and set off in the hands of the resulting company.

Where such loss or unabsorbed depreciation is not directly relatable to the undertakings transferred to the resulting company, it would be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings have been retained by the demerged company and transferred to the resulting company, and be allowedto be carried forward and set off in the hands of the demerged company or the resulting company, as the case may be.

The provisions of Section 115AC would be applicable where the assessee acquired shares or bonds in an amalgamated or resulting company by virtue of his holding shares or bonds in the amalgamating or demerged company, as the case may be.

SELF CHECK EXERCISE

9. What does Section 2(1B) of the Income Tax Act define?

a. Amalgamation

b. Tax concessions

c. Merger conditions

d. Unabsorbed depreciation

10. In an amalgamation, what happens to the unabsorbed depreciation and past business losses of the amalgamating company?

a. Transferred to the amalgamated company

b. Lost

c. Shared between companies

d. Carried forward indefinitely

11. The right to development rebate or investment allowance is always lost in case of amalgamation. T/F

12. Section 72A was modified by the Finance Act, 1999, to relax conditions for amalgamation approval. T/F

11.10 SUMMARY

The foregoing provisions of law, particularly of Sections 32A(6), 33(3), 33A(S), 41(2), 47(vi), 47(vii) and 72A, clearly show the specific advantages which are allowed by the Income Tax Act in the case of amalgamation of two or more companies provided the amalgamation is such that it fulfils “the conditions as laid down in para 2. If a company adopts a proper scheme of tax planning and remembers the provisions of the Income Tax Act in this regard, it can derive maximum tax benefits available to it on such mergers or amalgamations. Likewise, full tax benefits can be derived in case of demerger. An “amalgamation” may be defined as an arrangement whereby the assets of two companies become vested in, or under the control of one company (which may or may not be one of the original two companies), which has as its shareholders all, or substantially all, the shareholders of the two companies. An amalgamation is affected by the shareholders of one or both or the amalgamating companies exchanging their shares (either voluntarily or as the result of a legal operation) for shares in the other or a third company.

11.11 KEYWORDS

- **AMALGAMATION:** The process of merging two or more companies into one entity to achieve economic benefits, cut losses, or leverage each other's strengths.
- **CONDITIONS FOR AMALGAMATION:** Requirements such as the transfer of assets and liabilities, shareholder approval, and maintaining specific proportions for shares.
- **Incidental Provisions in Company Amalgamation:** Covers additional provisions related to amalgamations, including treatment of assets, liabilities, and provisions for scientific research and patents.
- **Tax Incentives for Facilitating Demerger:** Highlights changes in tax laws related to demergers, slump sales, and provisions for amalgamation with a focus on recognizing and facilitating demergers.

11.12 QUESTIONS FOR REVIEW

- **SHORT ANSWER QUESTIONS**

1. How does the Income Tax Act define Amalgamation, and what conditions are specified for tax benefits?
2. How are Unabsorbed Depreciation and Business Losses treated in the context of Amalgamation?
3. Explain the exemptions provided under Section 47(vi) and 47(vii) related to Capital Gains Tax in Amalgamation.
4. How have amendments through the Finance Act, 1999, and subsequent years modified provisions regarding Amalgamation?

- **LONG ANSWER QUESTIONS**

1. Discuss the Type of amalgamation which entitles a company to enjoy tax concessions.
2. Discuss the Status of unabsorbed depreciation or carry forward of business losses on amalgamation of companies
3. Discuss the Right to carry forward unabsorbed development rebate or investment allowance not lost on amalgamation
4. Discuss the Incidental provisions in company amalgamation
5. Discuss the Exemptions available from capital gains tax on company amalgamation
6. Discuss the Special tax planning for the carry forward and set off of accumulated business loss and unabsorbed depreciation of sick units on amalgamation
7. Discuss the Tax incentives for facilitating demerger

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ANSWER KEY

1. b, **2.** c, **3.** F, **4.** F, **5.** c, **6.** b, **7.** T, **8.** F, **9.** a, **10.** b, **11.** F, **12.** T.

Lesson no.: 12 **Author: Sanjeev Kumar**

TAXATION OF NON-RESIDENTS

STRUCTURE

12.0 OBJECTIVES

After the completion of this Lesson, you should be able to understand the following:

- Residential status
- Resident in India and abroad
- Basic Conditions to test as to when an individual is resident in India
- Taxability of Non-residents in India
- Special provisions relating to certain incomes of non-residents
- Avoidance of income-tax by transactions resulting in transfer of income to non-residents
- Avoidance of tax by certain transactions in securities
- Recovery of tax in respect of non-residents

12.1 RESIDENTIAL STATUS - GENERAL NORMS

One has to keep in mind the following norms while deciding the residential status of an assessee:

Different taxable entities

Section 6 lays down the test of residence for the following taxable entities: a- an individual ;

b. a Hindu undivided family;

c. a firm or an association of persons or a body of individuals; d. a company; and e. every other person.

Different kinds of residential status

Asses sees are either (a) resident in India, or (b) non-resident in India. As far as residentIndividuals and Hindu undivided families are concerned, they can be further divided into two categories, viz., (a) resident and ordinarily resident, or (b) resident but not ordinarily resident. All other assessees (viz., a firm, an association of persons, a company and every other person) can simply be either a resident or a non-resident.

Different residential status in respect of different previous years of the same assessment

year not possible [sec. 6(5) J

If a person is resident in a previous year relevant to an assessment year in respect of any source of income, he shall be deemed to be resident in India in the previous year (s) relevant to the same assessment year in respect of each of his other sources of income.

Different residential status for different assessment years

An assessee may enjoy different residential status for different assessment years. For instance, an individual who has been regularly assessed as resident' and ordinarily resident, has to be treated as non-resident in a particular assessment year if he satisfies none of the conditions of section 6(1).

12.2 RESIDENT IN INDIA AND ABROAD

it is not necessary that a person who is resident in India, cannot become resident in any other country for the same assessment year. A person may be resident in more than one country at the same time for tax purposes, though he cannot have two domiciles simultaneously. It is, therefore, not necessary that a person, who is resident in India, will be non-resident for all other countries for the same assessment year.

Onus of proof

Whether an assessee is a resident or a non-resident is a question of fact and it is the duty of the assessee to place all relevant facts before the income-tax authorities.

Residential status of an individual [Sec. 6]

An individual may be (a) resident and ordinarily resident, (b) resident but not ordinarily resident, or (c) non-resident.

Resident and ordinarily resident Sec. 6(1), 6(6)(a)- To find out whether an individual is "resident and ordinarily resident# in India, one has to proceed as follows

Step 1 - First find out whether such individual is “resident” in India.

Step 2 - If such individual is “resident# in India, then find out whether he is “ordinarily resident' in India.

12.3 BASIC CONDITIONS TO TEST AS TO WHEN AN INDIVIDUAL 18 RESIDENT IN INDIA

Under section 6(1) an individual is said to be resident in India in any previous year, if he satisfies at least one of the following basic conditions

a. he is in India in the previous year for a period of 182 days or more; or
b. he is in India for a period of 60 days or more during the previous year and 365 days or more during the 4 years, preceding the previous year.

EXCEPTIONS

The aforesaid rule of residence is subject to the following exceptions:
Exception one - By virtue of Explanation (a) to section 6(1), the period of “60 days' referred to in (b) above has been extended as follows:

Assessment years	Who can take the benefit of extended period	Extended period
1990-91 onwards	An Indian citizen who leaves India during the previous year for the purpose of employment outside India or an Indian citizen who leaves India during the previous year as a member of the crew of an Indian ship	182 days

Exception two - By virtue of Explanation (b) to section 6(1], the period of “60 days# referred to in (b) above has been extended as follows		
Assessment years	Who can take the benefit of extended period	Extended period
1995-96 onwards	An Indian citizen or a person of Indian origin who comes India during the previous year	182 days
1990-91 to 1994-95	An Indian citizen or a person of Indian origin who comes India during the previous year	150 days

A person is deemed to be of Indian origin if he, or either of his parents or any of his grandparents, was born in undivided India. It may be noted that grand-parents include both maternal and paternal grand-parents.

Employment outside India - Meaning of - One has to ascertain the facts of each case in order to decide as to whether the employee is employed in India or outside India. In each case, one will have to construe the terms and conditions of the contract. Merely because the contract is entered in India will not be the conclusive test to decide as to whether an employee was employed in India or outside India. The terms of the contract, the nature of the work, the nature of business and all other relevant facts are required to be considered to decide as to whether the employment was in India or outside India-CITY .Indo Oceanic Shipping Co. Ltd. [2001] 114 Taxman 722 (Born.)-

Person of Indian origin -A person is deemed to be of Indian origin if he, or either of his parents or any of his grand-parents was born in undivided India.

ADDITIONAL CONDITIONS TO TEST WHEN A RESIDENT INDIVIDUAL IS ORDINARILY RESIDENT IN INDIA

Under section 6(6) a resident individual is treated as “resident and ordinarily resident” in India if he satisfies the following two additional conditions

i. he has been resident in India in at least 2 out of 10 previous years [according to basic conditions noted above] preceding the relevant previous year; and

ii. he has been in India for a period of 730 days or more during 7 years preceding the relevant previous year.

In brief it can be said that an individual becomes resident and ordinarily resident in India if he satisfies at least one of the basic conditions and the two additional conditions [i.e., (i) and
(il)J-

12.4 RESIDENT BUT NOT ORDINARILY RESIDENT (SEC. 6(1), 6(6)(A)J

An individual who satisfies at least one of the basic conditions but does not satisfy the two additional conditions [i.e., conditions (i) and (ii) 2], is treated as a resident but not ordinarily resident in India. In other words, an individual becomes resident but not ordinarily resident in India in any of the following circumstances:

If he satisfies at least one of the basic conditions [i.e., condition (a) or (b) and none of the additional conditions [i.e., (i) and (ii)].

If he satisfies at least one of the basic conditions and one of the two additional conditions [i.e., (i) or (ii)].

Non-resident

An individual is non-resident in India if he satisfies none of the basic conditions. In the case of non-resident, the additional conditions [i.e., (i) and (ii)] are not relevant.

Rule of residence in brief - The Table given below summarizes the rule of residence for NRIs:

Resident and ordinarily resident	Resident but not ordinarily resident	Non-resident
Must satisfy at least one of the basic conditions and the two additional conditions [i.e.„ one of (a) or (b) and both of (I) and (ii)} one or none of (i) or (ii)}	Must satisfy at least one of Should not satisfy any of the basic conditions and basic conditions, one or none of the additional conditions e.g., one of (a) or (b) and	

SELF CHECK EXERCISE

1. **What determine a person of Indian origin?**
   a. Birth in India
   b. Birth of parents in India
   c. Birth of grandparents in undivided India
   d. All these
2. **To decide if an employee is employed in India or outside, what must be considered?**
   a. Place of contract
   b. Terms of the contract, nature of work, and other relevant factors
   c. Nationality of the employee
   d. Duration of employment
3. **To be "resident and ordinarily resident" in India, an individual must satisfy at least one basic condition and both additional conditions. T/F**
4. **An individual is considered "non-resident" if he satisfies none of the basic conditions, and the additional conditions are not relevant in this case. T/F**

12.5 TAXABILITY OP NON-RESIDENTS IN INDIA

Subject to the provisions of this Act, the total income of any previous year of a person who is a resident includes all income from whatever source derived which

(a) is received or is deemed to be received in India in such year by or on behalf of such person ; or

(b) accrues or arises or is deemed to accrue or arise to him in India during such year ; or

(c) accrues or arises to him outside India during such year :

Provided that, in the case of a person not ordinarily resident in India within the meaning of sub-section (6) of section 6, the income which accrues or arises to him outside India shall not be so included unless it is derived from a business controlled in or a profession set up in India.

(2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which

(a) is received or is deemed to be received in India in such year by or on behalf of such person ; or

(b) accrues or arises or is deemed to accrue or arise to him in India during such year.

Explanation 1.

Income accruing or arising outside India shall not be deemed to be received in India within the meaning of this section by reason only of the fact that it is taken into account in a balance sheet prepared in India.

Explanation 2.

For the removal of doubts, it is hereby declared that income which has been included in the total income of a person on the basis that it has accrued a or arisen a or is deemed to have accrued a or arisen a to him shall not again be so included on the basis that it is received or deemed to be received by him in India.

Income deemed to accrue or arise in India

The following incomes shall be deemed to accrue or arise in India :

(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India.

Explanation 1.

For the purposes of this clause

(a) in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India;

(b) in the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export;

(c) in the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India ;)

(d) in the case of a non-resident, being

(1) an individual who is not a citizen of India ; or

(2) a firm which does not have any partner who is a citizen of India or who is resident in India ; or

(3) a company which does not have any shareholder who is a citizen of India or who is resident in India, no income shall be deemed to accrue or arise in India to such individual, firm or company through or from operations which are confined to the shooting of any cinematograph film in India.]

Explanation 2*

For the removal of doubts, it is hereby declared that business connection shall include any business activity carried out through a person who, acting on behalf of the non-resident,

(a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or

(b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or

(c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident:

Provided that such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having an independent status, if such broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business :

Provided further that where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident (hereafter in this proviso referred to as the principal non-resident) or on behalf of such non-resident and other non-residents which are controlled by the principal non-resident or have a controlling interest in the principal non-resident or are subject to the same common control as the principal non-resident, he shall not be deemed to be a broker, general commission agent or an agent of an independent status.

Tax on investment income and long-term capital gains.

Where the total income of an assessee, being a non-resident Indian, includes

(a) any income from investment or income from long-term capital gains of an asset other than a specified asset;

(b) income by way of long-term capital gains, the tax payable by him shall be the aggregate of (i) the amount of income-tax calculated on the income in respect of investment income referred to in clause (a), if any, included in the total income, at the rate of twenty per cent;

(ii) the amount of income-tax calculated on the income by way of long-term capital gains referred to in clause (b), if any, included in the total income, at the rate of ten per cent; and

(iii) the amount of income-tax with which he would have been chargeable had his total income been reduced by the amount of income referred to in clauses (a) and(b).]

Capital gains on transfer of foreign exchange assets not to be charged in certain cases.

Where, in the case of an assessee being a non-resident Indian, any long-term capital gains arise from the transfer of a foreign exchange asset (the asset so transferred being hereafter in this section referred to as the original asset), and the assessee has, within a period of six months after the date of such transfer, invested the whole or any part of the net consideration in any specified asset, or in any savings certificates referred to in clause (4B) of section 10(such specified asset, or such savings certificates being hereafter in this section referred to as the new asset), the capital gain shall be dealt with in accordance with the following provisions of this section, that is to say,

(a) if the cost of the new asset is not less than the net consideration in respect of the original asset, the whole of such capital gain shall not be charged under section 45;

(b) if the cost of the new asset is less than the net consideration in respect of the original asset, so much of the capital gain as bears to the whole of the capital gain the same proportion as the cost of acquisition of the new asset bears to the net consideration shall not be charged under section 45.

Special provision for computation of total income of non-residents.

(1) No deduction in respect of any expenditure or allowance shall be allowed under any provision of this Act in computing the investment income of a non-resident Indian.

(2) Where in the case of an assessee, being a non-resident Indian,

(a) the gross total income consists only of investment income or income by way of long-term capital gains or both, no deduction shall be allowed to the assessee 91 [under Chapter VI-A and nothing contained in the provisions of the second proviso to section 48 shall apply to income chargeable under the head Capital gains];

(b) the gross total income includes any income referred to in clause (a), the gross total income shall be reduced by the amount of such income and the deductions under Chapter VI-A shall be allowed as if the gross total income as so reduced were the gross total income of the assessee.

12.6 SPECIAL PROVISIONS RELATING TO CERTAIN INCOMES OP NON-RESIDENTS (CHAPTER XII-A)

In this Chapter, unless the context otherwise requires,

(a) convertible foreign exchange means foreign exchange which is for the time being treated by the Reserve Bank of India as convertible foreign exchange for the purposes of the Foreign Exchange Regulation Act, 1973 {46 of 1973), and any rules made thereunder;

(b) foreign exchange asset means any specified asset which the assessee has acquired or purchased with, or subscribed to in, convertible foreign exchange;

(c) investment income means any income derived [other than dividends referred to in section 115-0] from a foreign exchange asset;

(d) long-term capital gains means income chargeable under the head Capital gains relating to a capital asset, being a foreign exchange asset, which is not a short-term capital asset;

(e) non-resident Indian means an individual, being a citizen of India or a person of Indian origin who is not a resident.

Explanation.

A person shall be deemed to be of Indian origin if he, or either of his parents or any of his grand-parents, was born in undivided India;

(f) specified asset means any of the following assets, namely :

(i) shares in an Indian company;

(ii) debentures issued by an Indian company which is not a private company as defined in the Companies Act, 1956 (1 of 1956);

(iii) deposits with an Indian company which is not a private company as defined in the Companies Act, 1956 (1 of 1956};

(iv) any security of the Central Government as defined in clause (2) of section 290 of the Public Debt Act, 1944 (18 of 1944);

(v) such other assets as the Central Government may specify in this behalf by notification in the Official Gazette.

12.7 RETURN OP INCOME NOT TO BE FILED IN CERTAIN CASES

It shall not be necessary for a non-resident Indian to furnish under sub-section (1) of section 139 a return of his income if

(a) his total income in respect of which he is assessable under this Act during the previous year consisted only of investment income or income by way of long-term capital gains or both; and

(b) the tax deductible at source under the provisions of Chapter XVH-B has been deducted from such income.

12.8 BENEFIT UNDER CHAPTER TO BE AVAILABLE IN CERTAIN CASES EVEN AFTER THE ASSESSEE BECOMES RESIDENT

Where a person, who is a non-resident Indian in any previous year, becomes assessable as resident in India in respect of the total income of any subsequent year, he may furnish to the [Assessing] Officer a declaration in writing along with his return of income under section 139 for the assessment year for which he is so assessable, to the effect that the provisions of this Chapter shall continue to apply to him in relation to the investment income derived from any foreign exchange asset being an asset of the nature referred to in sub-clause (ii) or sub-clause (iii) or subclause (iv) or sub-clause (v) of clause (f) of section 115C; and if he does so, the provisions of this Chapter shall continue to apply to him in relation to such income for that assessment year and for every subsequent assessment year until the transfer or conversion (otherwise than by transfer) into money of such assets.

Chapter not to apply if the assessee so chooses.

A non-resident Indian may elect not to be governed by the provisions of this Chapter for any assessment year by furnishing [his return of income for that assessment year under section 139 declaring therein] that the provisions of this Chapter shall not apply to him for that assessment year and if he does so, the provisions of this Chapter shall not apply to him for that assessment year and his total income for that assessment year shall be computed and tax on such total income shall be charged in accordance with the other provisions of this Act.]

Special provision for computing profits and gains of the business of operation of aircraft in the case of non-residents

(1) Notwithstanding anything to the contrary contained in sections 28 to 43A, in the case of an assessee, being a non-resident, engaged in the business of operation of aircraft, a sum equal to five per cent of the aggregate of the amounts specified in sub-section (2) shall be deemed to be the profits and gains of such business chargeable to tax under the head Profits and gains of business or profession.

(2) The amounts referred to in sub-section (1) shall be the following, namely :

(a) the amount paid or payable (whether in or out'. of India) to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods from any place in India; and

(b) the amount received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods from any place outside India-}

Special provision for computing profits and gains of shipping business in the case of non-residents.

(1) Notwithstanding anything to the contrary contained in sections 28 to 43A, in the case of an assessee, being a non-resident, engaged in the business of operation of ships, a sum equal to seven and a half per cent of the aggregate of the amounts specified in sub-section

(2) shall be deemed to be the profits and gains of such business chargeable to tax under the head Profits and gains of business or profession.

(1) The amounts referred to in sub-section (1) shall be the following, namely :

(i) the amount paid or payable (whether in or out of India) to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods shipped at any port in India; and

(ii) the amount received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India.]

Explanation.

For the purposes of this sub-section, the amount referred to in clause (i) or clause (ii) shall include the amount paid or payable or received or deemed to be received, as the case may be, by way of demurrage charges or handling charges or any other amount of similar nature.]

Deduction of head office expenditure in the case of non-residents.

Notwithstanding anything to the contrary contained in sections 28 to 43A, in the case of an assessee, being a non-resident, no allowance shall be made, in computing the income chargeable under the head Profits and gains of business or profession, in respect of so much of the expenditure in the nature of head office expenditure as is in excess of the amount computed as hereunder, namely:

(a) an amount equal to five per cent of the adjusted total income; or

(b) the amount of so much of the expenditure in the nature of head office expenditure incurred by the assessee as is attributable to the business or profession of the assessee in India,

whichever is the least:

Provided that in a case where the adjusted total income of the assessee is a loss, the amount under clause (a) shall be computed at the rate of five per cent of the average adjusted total income of the assessee.

Explanation.

For the purposes of this section,

(i) adjusted total income means the total income computed in accordance with the provisions of this Act, without giving effect to the allowance referred to in this section or in sub-section (2) of section 32 or the deduction referred to in section 32A or section 33 or section 33A or the first proviso to clause (ix) of sub-section (1) of section 36 or any loss carried forward under sub-section (1) of section 72 or sub*section (2) of section 73 or sub-section (1) 59[or sub-section (3)] of section 74 or sub-section (3) of section 74A or the deductions under Chapter VI A;

(ii) average adjusted total income means,

  (a) in a case where the total income of the assessee is assessable for each of the three assessment years immediately preceding the relevant assessment year, one-third of the aggregate amount of the adjusted total income in respect of the previous year's relevant to the aforesaid three assessment years;

  (b) in a case where the total income of the assessee is assessable only for two of the aforesaid three assessment years, one-half of the aggregate amount of the adjusted total income in respect of the previous year's relevant to the aforesaid two assessment years;

  (c) in a case where the total income of the assessee is assessable only for one of the aforesaid three assessment years, the amount of the adjusted total income in respect of the previous year relevant to that assessment year;

(iii) head office expenditure means executive and general administration expenditure incurred by the assessee outside India, including expenditure incurred in respect of

  (a) rent, rates, taxes, repairs or insurance of any premises outside India used for the purposes of the business or profession;

  (b) salary, wages, annuity, pension, fees, bonus, commission, gratuity, perquisites or profits in lieu of or in addition to salary, whether paid or allowed to any employee or other person employed in, or managing the affairs of, any office outside India;

(c) travelling by any employee or other person employed in, or managing the affairs of, any office outside India; and

(d) such other matters connected with executive and general administration as may be prescribed.]

SELF CHECK EXERCISE

5. **What determines the taxability of a non-resident's income in India?**
   - a. Only income received in India
   - b. Income received or deemed to be received in India
   - c. Income accrued or arisen in India
   - d. All of the above

6. **What is the rate of tax on investment income for a non-resident Indian under special provisions?**
   - a. 10%
   - b. 155
   - c. 20%
   - d. 25%

7. **The special provision for computing profits and gains of the business of operation of aircraft applies only to residents. T/F**

8. **A non-resident Indian is required to file a return of income if tax deductible at source has been deducted from the investment income. T/F**

12.9 AVOIDANCE OF INCOME-TAX BY TRANSACTIONS RESULTING IN TRANSFER OF INCOME TO NON-RESIDENTS

(1) Where there is a transfer of assets by virtue or in consequence whereof, either alone or in conjunction with associated operations, any income becomes payable to a non-resident, the following provisions shall apply

(a) where any person has, by means of any such transfer, either alone or in conjunction with associated operations, acquired any rights by virtue of which he has, within the meaning of this section, power to enjoy, whether forthwith or in the future, any income of a non-resident person which, if it were income of the first-mentioned person, would be chargeable to income-tax, that income shall, whether it would or would not have been chargeable to income-tax apart from the provisions of this section, be deemed to be income of the first-mentioned person for all the purposes of this Act;

(b) where, whether before or after any such transfer, any such first-mentioned person receives or is entitled to receive any capital sum the payment whereof is in any way connected with the transfer or any associated operations, then any income which, by virtue or in consequence of the transfer, either alone or in conjunction with associated operations, has become the income of a non-resident shall, whether it would or would not have been chargeable to income-tax apart from the provisions of this section, be deemed to be the income of the first-mentioned person for all the purposes of this Act.

Explanation.

The provisions of this sub-section shall apply also in relation to transfers of assets and associated operations carried out before the commencement of this Act. Where any person has been charged to income-tax on any income deemed to be his under the provisions of this section and that income is subsequently received by him, whether as income or in any other form, it shall not again be deemed to form part of his income for the purposes of this Act.

12.10 AVOIDANCE OF TAX BY CERTAIN TRANSACTIONS IN SECURITIES

(1) Where the owner of any securities (in this sub-section and in sub- section (2) referred to as the owner) sells or transfers those securities, and buys back or reacquires the securities, then, if the result of the transaction is that any interest becoming payable in respect of the securities is receivable otherwise than by the owner, the interest payable as aforesaid shall, whether it would or would not have been chargeable to income-tax apart from the provisions of this sub-section, be deemed, for all the purposes of this Act, to be the income of the owner and not to be the income of any other person.

Explanation.

The references in this sub* section to buying back or reacquiring the securities shall be deemed to include references to buying or acquiring similar securities, so, however, that where similar securities are bought or acquired, the owner shall be under no greater liability to income- tax than he would have been under if the original securities had been bought back or reacquired.

Where any person has had at any time during any previous year any beneficial interest in any securities, and the result of any transaction relating to such securities or the income thereof is that, in respect of such securities within such year, either no income is received by him or the income received by him is less than the sum to which the income would have amounted if the income from such securities had accrued from day to day and been apportioned accordingly, then the income from such securities for such year shall be deemed to be the income of such person.

The provisions of sub-section (1) or sub-section (2) shall not apply if the owner, or the person who has had a beneficial interest in the securities, as the case may be, proves to the satisfaction of the [Assessing] Officer

12.11 RECOVERY OF TAX IN RESPECT OF NON-RESIDENTS

Without prejudice to the provisions of sub-section (1) of section 161 or of section 167, where the person entitled to the income referred to in clause (i) of sub-section (1) of section 9 is a non-resident, the tax chargeable thereon, whether in his name or in the name of his agent who is liable as a representative assessee, may be recovered by deduction under any of the provisions ofChapter XVII-B and any arrears of tax may be recovered also in accordance with the provisions of this Act from any assets of the non-resident which are, or may at any time come, within India.

SELF CHECK EXERCISE

9. **What does Section 12.9 of the Income Tax Act address?**
   a. Avoidance of tax by non-residents
   b. Avoidance of tax through transactions resulting in the transfer of income to non-residents
   c. Taxation of securities transactions
   d. Recovery of tax in respect of non-residents
10. **The provisions of Section 12.11 may apply to a non-resident's tax recovery even if the assets are not in India. T/F**

12.12 SUMMARY

An individual may be (a) resident and ordinarily resident, (b) resident but not ordinarily resident, or (c) non-resident. It is not necessary that a person who is resident in India, cannot become resident in any other country for the same assessment year. A person may be resident in more than one country at the same time for tax purposes, though he cannot have two domiciles simultaneously. It is, therefore, not necessary that a person, who is resident in India, will be nonresident for all other countries for the same assessment year.

Under section 6(1) an individual is said to be resident in India in any previous year, if he satisfies at least one of the following basic conditions a. he is in India in the previous year for a period of 182 days or more; or b. he is in India for a period of 60 days or more during the previous year and 365 days or more during the 4 years, preceding the previous year.

13.13 KEYWORDS

- **Residential Status:** Determined by Section 6 for various taxable entities, including individuals, Hindu undivided families, firms, companies, and others.
- **Basic Conditions for Individual's Residency:** Involves presence in India for 182 days or more in the previous year or 60 days or more in the previous year and 365 days or more in the preceding four years.
- **Non-Resident:** Individual not meeting basic conditions for residency.
- **Avoidance of Tax by Certain Transactions in Securities:** Provisions related to the sale, transfer, and reacquisition of securities to prevent tax avoidance.
- **Recovery of Tax in Respect of Non-Residents:** Methods for recovering tax from non-residents, including deductions and recovery from assets within India.

13.14 QUESTIONS FOR REVIEW

- **SHORT ANSWER QUESTIONS**
  1. What are the different taxable entities for determining residential status?
  2. What are the special provisions for non-residents under Chapter XII-A?
  3. What is the impact of transactions in securities on the income tax liability of the owner?
- **LONG ANSWER QUESTIONS**
  1. Discuss the general norms concerning Residential status under Income Tax Act.
  2. Discuss the basic conditions to test as to when an individual is resident in India.
  3. Discuss the Taxability of Non-residents in India.
  4. Discuss the special provisions relating to certain incomes of non-residents u/s Chapter XII'A.

12.14 SUGGESTED READINGS

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ANSWER KEY

1. d, **2.** b, **3.** T, **4.** T, **5.** d, **6.** c, **7.** F, **8.** F, **9.** b, **10.** T.

Lesson no.: 13 **Author: Ratinder Kaur**

SPECIFIC MANAGEMENT DECISIONS

Structure:

13.0OBJECTIVE

After studying this chapter, you should be able to understand.

- The Concept of Make or Buy, Lease or Buy, Repair or Replacement and Closure or Continuance of Business Decisions.

13.1 INTRODUCTION

In business, the decisions are taken with a view of better return to the shareholders. Managerial decisions are influenced by a number of factors depending on the case. Such decisions are not always guided by the tax consideration. However, it would be better if tax (direct as well as indirect taxes) factor is also analyzed before taking such decisions. Taix provisions effecting various managerial decisions are given below.

1. Make or Buy
2. Lease or Buy
3. Repair/Renewal or Replacement of assets
4. Closure or Continuance of business

13.2 MAKE OR BUY

A Concern can utilize its idle capacity by making the component or product instead of buying them from the market. In this decision, the variable cost <bf making the component is compared with its purchase price prevailing in the market. If the variable cost is lower than the price demanded by the outside supplier, the component should be manufactured in the factory. Here it is assumed that no extra fixed costs are to be incurred on the manufacturing of these components.

However, the component manufacturing involve additional fixed costs or purchase of any plant and machinery, then total cost (Variable cost + Additional fixed cost) will have to be considered. In such cases the following tax consideration must be kept in mind while taking make or buy decision.

1. Where the manufacturing of the product requires additional fixed cost also : In this case the assessee will have to incur the additional fixed cost, it will form part of the cost of manufacturing of the component.

2. Where the manufacturing the product requires establishing a new unit : In this case there will be cash outflow for establishing a new unit but the tax incentives shall be made as under

3. Depreciation : Assessee shall be eligible for depreciation on such capital assets.

4. Deduction of interest on money borrowed for acquisition of such capital

assets. Example:

A Company manufactures motor components. The company has the option to either make or buy motor component from the market. The motor component will be manufactured on a new machine costing Rs.50,000 with a life 5 years. This machine manufactures 5000 motor components per year. The following are the total cost of manufacturing 5000 motor components:

	Rs.
Material cost	1,00,000
Labor	50,000
Variable overhead	25,000

Assume tax rate 30% Cos of capital 14% Depreciation 15% (WDV)

The motor component is available in the market Rs. 36 (Per motor component)

Advise whether the company should make or buy the motor component.

Solution:

Make the components

Year	Depreciation(Rs.)	Tax saving on Depreciation (30%)(Rs.)_
1	7500	2250
2	6375	1913
3	5419	1626
4	4606	1382
5	3915	1175

Present worth of tax saving (Discounted rate 14%) (Make the component)

Year	Tax saving of Depreciation (Rs.)(30%)	PVF (14%)	PV of tax saving (Rs.)
1	2250	0.877	1973
2	1913	0.769	1471
3	1626	0.675	1098
4	1382	0.592	818
5	1175	0.519	610
Rs.	Total	5970	

Cost of New machine 50,000 Less Tax saving 5,970 Net Cost of New Machine 44,030 Total Motor component (5000*5) "25000

Making the components

a) Variable cost per unit Rs. 35.00
(1,00,000 + 50,000 + 25,000)/5,000
b) Add fixed cost per unit Rs. 1.76
(44,030/25000)
Total cost of making the component (a+b) = Rs. 36.76.
The motor component is available in the market Rs. 36

Advice Since suppliers' cost is less than manufacturing cost, it is advice to buy the motor component.

Check your progress 1

A manufacturing company finds that while the cost of making a components part is Rs. 12, the same is available in the market at Rs. 11 with an assurance of continuous supply.

Advise whether the company should make or buy the component. The cost data as under.

Materials	5.50
Labour	3.00
Other variable expenses	1.50
Fixed expenses	2.00
Total Cost	12.00

13.3 LEASE OR BUY

Now a days, leasing has become a popular source of financing in India. From the lessee point of view cost of leasing, that is lease rent can be claimed as admissible expenditure against the business income. Lease rent charged by the lessor would be less as compared to market rate because the lessor will claim depreciation on assets so there is tax saving to the lessor. Besides, it reduces cash outflow. Leasing avoids risk of obsolescence, if assets become obsolete, it may be replaced by new asset. On the other hand, if assets are purchased by the assessee he can claim depreciation and interest on borrowed capital as deduction.

For this purpose, a case study on the following data has been made

A company is faced with two options as under in respect of acquisition of an asset valued Rs. 1,00,000

Either,

(a) to acquire the asset directly by taking a bank loan of Rs. 1,00,000 repayable in 5-year installments at an interest of 15%.

OR

(b) To lease in assets at yearly rental of Rs. 320 per Rs. 1,000 of the asset value for 5 year payable at year end.

The following additional information are available :

1. Rate of Depreciation 15% (WDV)
2. Tax Rate 50%
3. Cost of capital 16%
4. You have to indicate in your report which option is more preferable to the company. Restrict calculations over a period of five years.

Solution

Option A- Purchase assets

(Rs.)

1	2	3	4	5	6
Year	Principal	Interest®	Depreciation® 15%	Tax saving	Net Cash
	repayment	15%	(WDV)	50% of Col	outflow(2+3-5)
				3 & 4	
1	20,000	15,000	15,000	15,000	20,000
2	20,000	12,000	12,750	12,375	19,625
3	20,000	9,000	10,838	9,919	19,081
4	20,000	6,000	9,212	7,606	18,394

5	20,000	3,000	7,830	5,415	17,585
					(Rs.)
	Year Net Cash outflow		PVF{ 16%)	Discounted	
				cash outflow	
	1	20,000	0.862		17,240
	2	19,625	0.743		14,581
	3	19,081	0.641		12,231
	4	18,394	0.552		10,153
	5	17,585	0.476		8,370
		Total	62,575		
Option B- Leasing option					(Rs.)
	1 2	3	4	5	6
	Year Lease rental	Tax saving	Net Cash	PVF(16%)	Discounted cash
		50% of Col. 2	outflow(2-3)		outflow
1	32,000	16,000	16,000	0.862	13,792
2	32,000	16,000	16,000	0.743	11,888
3	32,000	16,000	16,000	0.641	10,256
4	32,000	16,000	16,000	0.552	8,832
5	32,000	16,000	16,000	0.476	7,616
			Total	52,384	

Advice

Option B is preferred to option A. Thus, leasing option is recommended.

Check your progress 2

Example: : Decide which one is better Lease or Buy in the following situation.
Cost of a Machine is Rs. 1,00,000 with a salvage value Rs.2000 at the end of fifth year. Tax rate 40 % Cost of Capital 14%
Depreciation rate (income tax) 15% WDV
Lease cost Rs. 30,000 per annum for 5 years (per Rs. 1, 00,000)
Present Value of Rs.l discounted @ 14% is as under

Year	Discounted® 14%
1	0.877
2	0.769
3	0.675
4	0.592

13.4 REPAIR/RENEWAL OR REPLACEMENT OF ASSETS

The old assets need to be either repaired/renewed or replaced at regular intervals. The main tax consideration which assessee has to keep in mind, while computing his business income, shall be allowed as deduction of such expenditure or not.

If the asset has to be repaired/renewed, the full amount of such repair/renewal shall be allowed as revenue expenditure against business income.

Example: If the tax rate is 50% and a repair expenditure of Rs. 50,000 allowed as deduction, then effective cost is Rs. 25,000.

Profit and loss Account

Repair 50,000

Less 50% tax

saving 25,000

Effective cost 25,000

While in case of replacing the asset, the expenditure incurred on replacement shall be treated as capital expenditure and the assessee cam claim only depreciation on such assets against business income.

13.5 CLOSURE OR CONTINUANCE OF BUSINESS

If the assessee has incurred business loss and discontinued his business and started a new business then loss of his business man be carried forward and set off against the business income under the head Business and Profession up to eight years.

But unabsorbed loss can be carried forward for even after 8 years. This exception is applicable if the following conditions are satisfied.

- The business or profession is discontinued.
- Loss of such business or profession pertaining to the year in which it is discontinued could not be set off against any other income of that year.
- Such business is not a speculation business.
- After discontinuation of such business or profession, there is a receipt which is deemed as business income under section 41(1) (3) (4).

The unabsorbed loss pertaining to the year in which business was discontinued is permitted to be set off against notional business income even after 8 years.

Example

A business is discontinued on January 12, 1986. At that time there is unadjusted business loss of Rs. 30,000. On, June 2008, the asssessee recover a debt of Rs. 50,000 which was earlier allowed as bad debts in 1980-81. The profit chargeable to tax for the year 2008-09 will be as under:

	Rs.
Recovery of debt under section 41(4)	50,000
Less Unadjusted business loss of previous year in which business was discontinued	30,000
Business income chargeable to tax	20,000

SELF CHECK EXERCISE

1. **In managerial decision-making, which of the following is NOT a factor influencing decisions?**

   a. Tax considerations
   b. Shareholder preferences
   c. Market demand
   d. Economic trends

2. **What is the primary criterion for deciding whether to make or buy a component in-house?**

   a. Variable cost
   b. Fixed cost
   c. Market demand
   d. Shareholder preferences

3. **In the context of "Lease or Buy" decisions, what is a potential advantage of leasing over buying?**

   a. Tax savings for the lessee
   b. Higher depreciation claims
   c. Increased cash outflow

d. Risk of obsolescence

4. **When considering the repair or renewal of assets, what expenditure is allowed as a deduction against business income?**

a. Capital expenditure
b. Repair and renewal costs
c. Market expenses
d. Variable costs

5. **Tax considerations are always the primary guiding factor in managerial decisions. T/F**

6. **If a company incurs a business loss and discontinues its operations, the loss can be carried forward for an unlimited period. T/F**

7. **In the "Make or Buy" decision, if the variable cost is higher than the purchase price from an outside supplier, it is advisable to manufacture the component in-house. T/F**

8. **Lease rent charged by a lessor is typically higher than the market rate due to the tax benefits the lessor receives. T/F**

9. **Unabsorbed losses can be carried forward for more than eight years if the business is discontinued and specific conditions are met. T/F**

13.6 SUMMARY

From the above discussion regarding tax planning of Make or Buy, Lease or Buy, Repair or Replacement and Closure or Continuance of Business Decisions it becomes clear that a Company can adopt proper tax planning in the circumstance best suitable to it so that it may get maximum deductions in respect of the depreciation, interest on borrowed capital, leasing charges, repair charges etc. of the assets.

13.7 KEYWRODS

- **Managerial Decisions:** Business decisions influenced by factors beyond tax considerations.
- **Additional Fixed Costs:** Consideration of tax implications when manufacturing involves additional fixed costs.
- **Depreciation and Interest Deduction:** Tax benefits related to depreciation and interest on borrowed capital in the context of leasing.
- **Net Cost Analysis:** Calculation of net cost considering tax savings, depreciation, and cost of a new machine.
- **Closure or Continuance of Business:** Conditions for carrying forward business losses after discontinuation, and tax treatment of recovered debts.

13.8 SELF-ASSESSMENT EXERCISES

- **SHORT ANSWER QUESTIONS**

1. What factors influence managerial decisions in business, and why is tax consideration important?
2. How does tax treatment differ for establishing a new manufacturing unit compared to routine manufacturing?
3. Describe the tax implications of repair/renewal versus replacement of assets in business.

- **LONG ANSWER QUESTIONS**

Q(l) If the tax rate is 50% and a repair expenditure of Rs. 25,000 allowed as deduction, then what is effective cost of repair.

Q{2) A Company manufactures motor components. The company has the option to either make or buy motor component from the market. The motor component will be manufactured on a new machine costing Rs.50,000 with a life 5 years. This machine manufactures 3000 motor components per year. The following are the total cost of manufacturing 3000 motor components:

Rs.

Material cost 50,000
Labor 30,000
Variable overhead 20,000
Assume tax rate 30% Cos of capital 14% Depreciation 15% (WDV)
The motor component is available in the market Rs. 35 (Per motor component)
Advise whether the company should make or buy the motor component.

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ANSWER KEY

1. b, **2.** a, **3.** a, **4.** b, **5.** F, **6.** F, **7.** F, **8.** F, **9.** T.

Lesson no.: 14 **Author: Ratinder Kaur**

CHOICE OF A SYSTEM OF ACCOUNTING

STRUCTURE:

14.0 OBJECTIVE

After studying this chapter, you should be able to understand.

- The Method of Accounting.
- The Concept of Mercantile and Cash basis accounting.

14.1 INTRODUCTION

Income under the head profits and gains of business or profession and income under the head income of other sources are to be computed with the method of accounting regularly employed by the assessee. The method of accounting is irrelevant for computing the income under the head salary, house property a capital gains. In these cases, the income tax act has specifically provided the basis for taxability of such income for e.g. salary is taxable on due or receipt basis whichever is earlier. Similarly, capital gains are taxable in the year in which the capital asset is transferred.

14.2 METHOD OF ACCOUNTING

The following are the two types of accounting methods, which are generally in use.

(1) Cash .System of accounting

(2) Mercantile System of accounting

14.2.1 CASH SYSTEM OF ACCOUNTING

Under the Cash system of accounting, actual cash receipt and actual cash payments are recorded. Outstanding expenses, prepaid expenses and income accrued or income received in advance are not recorded at all and are ignored till the cash is actually paid or received. Under this method an income is taxable only when it is realized. Trading concern such as a charitable institution, a club, a school, a college etc. and professional men like a doctor, a chartered accountant> a lawyer etc. can be cited as the best example of cash system. Thus, under this basis of accounting income or profit of a particular accounting period is calculate on the basis of cash receipt and cash expenses; incurred during that period.

Example:

During the financial year 2008-09 X Company had cash sales of Rs. 90,000 and credit sales of Rs. 60,000 and other cost data as under :

	Rs.
Expenses paid	50,000
Expenses paid in advance	5,000

Expenses not paid yet	25,000
Commission received	10,000
Commission received in advance	5,000
Commission not received yet	3,000

Find out Net profit of the X Company if he adopts Cash System of accounting.

Solution:

Revenue		Rs.
1.	Cash sales	90,000
2.	Commission received	10,000
	Total Revenue Received	1, 00,000

Low Expense:

Expenses paid	50,000
Net Profit	50,000

14.2.2 MERCANTILE SYSTEM OP ACCOUNTING

Under this method, the taxable income is calculated after taking into account all the income and all the expenditure relating to the period whether such income has been actually received or not and whether such expenditure has been actually paid or not. It is a reliable basis of accounting because it makes a complete record of all cash and credit transactions. Thus, net income for a period is the result of matching of revenue realized in the period and cost expired during the period. Under the Companies Act 1956, all companies are required to maintain the books of account according to mercantile system of accounting.

Case Study

R Ltd. Following mercantile system of accounting, debited Hs. 1, 50,000 being salary of the managing director, to profit and loss account. The approval from the Central Government is received after the end of the previous year, but before filling the return of income.

Solution

This case was decided by the Supreme Court in C1T v. Nonsuchan Estate Ltd (1975) Where it was held that even an assessee following the mercantile system of accounting is not entitled to claim of deduction until liability for the same for the sum which deduction is claimed has accrued. Approval of the Central Government is required before the appointment of the e managing director become effective. Thus, no liability will accrue till such approval has been obtained.

In the present problem, since the approval was received after the end of the previous year, having regard to the above provisions, the salary paid to the managing director cannot be claimed as a deduction even though the approval is received before the due date for filling C-he returnedincome.

The central Govt, notifies the following two Accounting Standard to be followed by all assesses who are following Mercantile System of accounting.

1. Accounting Standard 1 relating to disclosure of accounting policies.
2. Accounting Standard 2 relating to disclosure of prior period and extra ordinary items and change in accounting policies.

Example:

During the financial year 2008-09 X Company had cash sales of Rs. 90,000 and credit sales of Rs. 60,000 and other cost data as under:

	Rs.
Expenses paid	50,000
Expenses paid in advance	5,000
Expenses not paid yet	25,000
Commission received	10,000
Commission received in advance	5,000
Commission not received yet	3,000

Find out Net profit of the X Company if he adopts Mercantile System of accounting

(2) **Mercantile System of accounting**

Revenue	**Rs.**	
1. Total Sales	1,50,000	
(Cash sales-*- Credit sales)		
2. Commission receive	10,000	
Add Commission not received yet	3,000	
	13,000	
Less Commission received in advance	5,000	8,000
Total Revenue		1,58,000
Less Expense:		
Expenses paid	50,000	
Add Expenses not paid yet	25,000	
Total Expenses	75,000	
Less Expenses paid in advance	5,000	70,000
Net Profit	88,000	

Check your progress 1

Explain mercantile system of accounting. How is it better cash system of accounting?

14.3 CHOICE OF METHOD OF ACCOUNTING

As per section. 145 of income Tax Act, an assessee may select either Cash or Mercantile system of accounting. Once a particular method of accounting is followed by the assessee, he must follow it in a consistent basis.

The assessee can adopt cash system of accounting for one business and mercantile system of accounting for another business. Similarly, the assessee can adopt cash system of accountingfor one source of income under the head income from other source and mercantile system of accounting for another source under the same head.

14.4 CHARGE IK METHOD OF ACCOUNTING

It is open to the assessee to change the method of accounting employed by him provided that the change is for a BONAFIDE REASON and the change method is consistently followed by the assessee. The income tax department shall have to accept the change method even if it results into reduction of tax liability.

SELF CHECK EXERCISE

1. **What is the basis for computing income under the head "Salary" according to the Income Tax Act?**

   a. Cash basis

   b. Mercantile basis

c. Due or receipt basis, whichever is earlier

d. Approval basis

2. **Which of the following is an example of an entity that typically follows the cash system of accounting?**

   a. Manufacturing company

   b. Charitable institution

   c. Technology firm

   d. Consulting agency

3. **Under the mercantile system of accounting, when is income considered taxable?**

   a. When it is realized

   b. When it is approved

   c. When it is received in advance

   d. When it is matched with expenses during the period

4. **In the provided case study, why was the deduction for the salary of the managing director not allowed?**

   a. Because it was not approved by the board

   b. Because it was not actually paid

   c. Because it was not disclosed in the financial statements

   d. Because it was not claimed before the due date

5. **Which Accounting Standard relates to the disclosure of accounting policies under the mercantile system?**

   a. Accounting Standard 1

   b. Accounting Standard 2

   c. Accounting Standard 3

   d. Accounting Standard 4

6. **Income under the head "Profits and Gains of Business or Profession" is computed based on the method of accounting regularly employed by the assessee. T/F**

7. **Under the cash system of accounting, outstanding expenses and prepaid expenses are recorded when they are actually paid or received. T/F**

8. **Once a particular method of accounting is selected by an assessee, it must be followed consistently. T/F**

9. **An assessee can adopt different accounting methods for different sources of income under the same head. T/F**

10. **If an assessee changes the method of accounting for a bonafide reason, the income tax department is required to reject the change even if it reduces the tax liability. T/F**

14.5 8UMMARY

In Mercantile accounting system revenue are recognized as they are earned, not necessarily when cash is received and expenses are recognized as they are incurred, not necessarily when cash is paid. So Mercantile accounting system provides a more accurate picture of a company's financial position and operating results than does cash system of accounting.

14.6 KEYWORDS

- **Method of Accounting:** Regularly employed by the assessee for computing income under various heads, including profits and gains of business or profession.
- **Mercantile System of Accounting:** Calculates taxable income by considering all income and expenditures, irrespective of actual receipt or payment; considered reliable and mandated for companies.
- **Accounting Standards:** Specifically, Accounting Standard 1 and Accounting Standard 2, related to disclosure of accounting policies and disclosure of prior period and extraordinary items, respectively.

14.7 SELF-ASSESSMENT EXERCISES

- **SHORT ANSWER QUESTIONS**

1. Explain the relevance of the method of accounting in computing income under different heads of taxation.
2. Provide an example illustrating the computation of net profit using the Cash System of Accounting.
3. What are the Accounting Standards related to disclosure and prior period items that apply to entities following the Mercantile System of Accounting?

- **LONG ANSWER QUESTIONS**

Q. (1) Distinguish between Mercantile and Cash system of accounting.

Q ,(2) During the financial year 2006-09 X Company had cash sales of Rs. 80,000 and credit sales of Rs. 30,000 and other cost data as under;

	Rs.
Expenses paid	40,000
Expenses paid in advance	3,000
Expenses not paid yet	20,000
Rent received	5,000
Rent received in advance	3,000
Rent not received yet	1,000

Find out Net profit of the X Company if he adopts: (1) Mercantile System of Accounting (2} Cash System of Accounting

14.8 BIBLIOGRAPHY & FURTHER READINGS

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ANSWER KEY

1. c, **2.** b, **3.** d, **4.** b, **5.** a, **6.** T, **7.** T, **8.** T, **9.** T, **10.** F.

Lesson no.:15 **Author: Ratinder Kaur**

TAX PLANNING OF EMPLOYEE REMUNERATION

STRUCTURE

15.0 OBJECTIVE

After studying this chapter, you should be able to understand.

- The tax planning of employee remuneration
- Understanding of computation of retirement benefits

15.1 INTRODUCTION,

While planning for employee's remuneration, the tax planner has to consider the interest of the employer as well as the interest of the employee. The target of the tax planner would be to get 100% deduction in respect of remuneration paid to employee. Efforts should be made to pay the salary in the form of allowance and perquisite which are wholly exempt or partially exempt, to minimize their tax bill and to maximize their take home pay. The following are the some of the exemptions/concessions available to employee under Income tax Act as under

15.2 ADVANCE SALARY

An employee should avoid taking advance salary because it is fully taxable on receipt basis. Instead, he get loan from employer, thereby reducing his tax liability. However, such loan should not exceed Rs.50,000.

15.3 HOUSE RENT ALLOWANCE

House Rent Allowance is an allowance given by an employer to an employee. The sole purpose of this is to meet the cost of renting a home.HRA is taxable under the head salary. HRA is exempt under section 10{13A) to the extent of the minimum of the following three amounts:

- The actual amount of HRA received
- 40% of salary. This increases to 50% if you are renting out the house in Delhi, Mumbai, Chennai or Kolkata.
- Rent paid minus 10% of salary (basic component + dearness allowance, if any)

Thus, the employee has to so plan his HRA that after meeting the cost of rent to the extentof

10% salary, the entire amount of HRA becomes exempt from income tax.

Example

Mr. X , is entitled to a basis salary Rs.4,000 per month and dearness allowance of Rs. 1,000 p.m. He is also entitled to HRA of Rs. 2,500 p.m. He actually pays Rs. 3,000 per month as rent for a house in Delhi. Compute the taxable HRA.

Solution:

	Particulars		Rs.	Rs.
	Amount received during the year for HRA (2,500x12)			30,000
	Less: Exemption u/s 10(13A) least of the following			
	M	Actual amount received (2500x12)	30,000	
	(b)	50% of salary of Rs. 60,000 (5,000x12)	30,000	
	(0	Rent paid less 10% of salary		
		(3000x12 - 10% 60,000)	30,000	30,000
		Taxable HRA		NIL

15.4 MEDICAL EXPENSES

Medical allowance is fully taxable. Instead of a fixed medical allowance, an employee should opt for reimbursement of medical expenses. Reimbursement of medical expenses up to Rs. 15000 per annum is not a taxable perquisite.

Example:

To take a medical allowance of Rs. 500 per month or reimbursement of medical expenses up to Rs. 15,000 per annum. Which is more tax effective to an employee?

Solution

Reimbursement of medical expenses is a better option as medical allowance of Rs. 6,000 per annum is taxable while reimbursement of medical expenses up to Rs. 15,000 is fully exempt from income tax.

Check your progress 1

Mr. B , is entitled to a basis salary Ra.3,000 per month and dearness allowance of Rs. 1,000 p.m. He is also entitled to HRA of Rs. 2,000 p.m. He actually pays Rs. 1,000 per month as rent for a house in Delhi. Compute the taxable HRA.

15.5 LEAVE TRAVEL ASSISTANCE

Leave travel allowance is fully taxable. Instead of a fixed leave travel allowance an employee should opt. for leave travel concession/reimbursement. Leave travel concession is fully exempt from income tax under section 10(5).

SELF CHECK EXERCISE

1. **What is the purpose of House Rent Allowance (HRA) given by an employer to an employee?**
   a. To cover travel expenses
   b. To meet the cost of renting a home
   c. To provide medical assistance
   d. To cover education expenses
2. **What is the tax treatment of medical allowance?**
   a. Fully exempt
   b. Partially exempt
   c. Fully taxable

d. Deductible from gross income

3. **An employee can receive a loan from the employer without any tax implications. T/F**
4. **Reimbursement of medical expenses up to Rs. 15,000 per annum is a taxable perquisite. T/F**

15.6 CONVEYANCE AND TRAVELLING ALLOWANCE

One 'of the most important allowances generally granted to an employee is the conveyance and traveling allowance. These allowances are fully exempt from tax, provided the same is really incurred for the purpose.

Mr. A is granted a CA Rs. 2000 per month in the city Patiala where he is employed to go to and meet his customers. Mr. A has kept scooter for thiS[1] purpose. He incurs about Rs. 2000 per month expenditure on travelling for office purpose. The entire CA of Rs. 2000 per month will be fully exempt from tax under section 10(14)(1).

15.7 COMMUTATION OF PENSION

Pension is fully taxable in income tax. But if an employee gets it commuted, he may seek exemption in respect of the commuted value. The commuted pension in case of Govt, employee is fully exempt from tax. In case of any other employee, it shall be exempt 50% of the normal pension, in case the employee is not in receipt of gratuity. The exemption shall be 1 / 3rd in case he ii in receipt of gratuity as well.

Example

C retired on 10.4.2008 from X Company ltd. He was entitled to a pension of Rs. 5,000 per month. At the time of retirement, he got 75% of the pension commuted and received Rs. 1, 20,000 as commuted pension. Compute the taxable portion of the commuted pension if :

1. He is also receive gratuity
2. He is not

received gratuity Solution:

(1) 75% of Computed Pension is equal to Rs. 1,20,000 Heride commuted value 1 /3 of the pension would amount to Rs. 1,20,000/50?100 XI/3 = Rs. 53,333, Rs.53,333 Would therefore, be exempt and balance Rs. 66,667 Would be taxable.

(2) 75% of Computed Pension is equal to Rs. 1,20,000 Hence commuted value 50% of the pension would amount to Rs. 1,20,000/50*100 XI/2 " Rs. 80,000, Rs.80,000 Would therefore, be exempt and balance Rs. 40,000 Would be taxable.

15.8 GRATUITY

If the gratuity is received by an employee under the payment of Gratuity Act 1972, it shall be exempt to the . extent of minimum of the following 3 limits:

- Actual Gratuity received.
- 15 days salary for each completed year of service or part there of exceeding 6 months.
- Rs. 3,50,000

In any other case, the gratuity shall be exempt to the extent of mini mum of the following 3 limits:

e Actual Gratuity received.

e Half months average salary of each completed year of service or part there of exceeding 6 months.

Salary for this purpose shall include DA. Average salary here means salary for the last ten months immediately proceeding the month in which the event occurs.

15.9 COMMBN8ATJON RECEIVED UNDER VOLUNTARY SCHEME

Any compensation received by an employee under voluntary scheme shall be exempt up to maximum amount of Rs. 5,00,000 from income tax. W.e.f assessment year if the compensation is received in installments, the exemption shall be allowed.

15.10 SAVING AND INVESTMENT

In very simple terms, the major several avenues for tax saving instruments are specified u/ s 80CC of the Income Tax Act that allows investments in certain notified instrument to reduce tax liability. Though, one can save as much as possible in these instruments, however the Income Tax Act has specified a ceiling limit of Rs. 1, 00,000 beyond which the tax benefits are not allowed. Investments can be made in different instruments viz. Life Insurance Premium, National Saving Certificates (NSC), Public Provident Fund (PPF), Banks Fixed Deposits with a maturity period of five years or more, Post office (CTD) accounts.

Check your progress 2

C retired on 15.4.2008 from X Company ltd. He was entitled to a pension of Rs. 4,000 per month. At the time of retirement, he got 75% of the pension commuted and received Rs. 1, 00,000 as commuted pension. Compute the taxable portion of the commuted pension if :

1. He is also receive gratuity
2. He is not received gratuity

SELF CHECK EXERCISE

5. **How is the taxable portion of commuted pension calculated for an employee who is not in receipt of gratuity?**
   a. 1/4th of the commuted value
   b. 1/3rd of the commuted value
   c. 1/2 of the commuted value
   d. 2/3rd of the commuted value
6. **Under Section 80CC of the Income Tax Act, what is the ceiling limit for tax benefits on specified investments?**
   a. Rs. 50,000
   b. Rs. 1,00,000
   c. Rs. 2,00,000
   d. Rs. 5,00,000
7. **The commuted pension is fully exempt for government employees regardless of whether they receive gratuity. T/F**
8. **Compensation received under a voluntary scheme is exempt up to a maximum amount of Rs. 1,00,000 from income tax. T/F**

15.11 SUMMARY

Tax bill of an employee can be reduced substantially if remuneration is divided into different allowance (which are not taxable or which are partially exempt from income tax) and perquisites (which are taxable at concession rates).

15.12 KEYWORDS

- **Employee's Remuneration Planning:** Balancing the interests of employers and employees to achieve maximum deductions in remuneration.
- **Leave Travel Allowance (LTA):** Fully taxable; employees are advised to opt for leave travel concession/reimbursement under section 10(5).
- **Gratuity:** Exempt to the extent of the minimum of actual gratuity received, 15 days' salary for each completed year of service, or Rs. 3,50,000 (under the Payment of Gratuity Act).
- **Compensation under Voluntary Scheme:** Exempt up to Rs. 5,00,000; exemptions allowed for installment receipts post the assessment year.

15.13 SELF-ASSESSMENT EXERCISES

- **SHORT ANSWER QUESTIONS**

1. Why should an employee avoid taking advance salary, and what alternative is suggested for reducing tax liability?
2. Briefly describe the taxation status of Leave Travel Allowance (LTA) and the recommended alternative for employees.
3. Under what conditions is the commuted pension fully exempt, and what are the exemptions for gratuity under the Payment of Gratuity Act?

- **LONG ANSWER QUESTIONS**

1. Mr. X, is entitled to a basis salary Rs. 5,000 per month and dearness

allowance of Rs. 1,000 p.m. He is also entitled to HRA of Rs. 2,000 p.m. He actually Rs. 2,000 per month as rent for a house in Delhi. Compute the taxable HRA.

2. To take a medical allowance of Rs. 750 per month or reimbursement of medical expenses up to Rs. 15,000 per annum. Which is more tax effective to an employee?

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ANSWER KEY

1. b, **2.** c,**3.** T, **4.** F, **5.** c, **6.** b, **7.** F, **8.** T.

Lesson no.: 16 **Author: Ratinder Kaur**

TAX DEDUCTION AT SOURCE

STRUCTURE:

16.0 OBJECTIVE

After studying this chapter, you, should be able to understand.

- The Concept of Tax Deduction at source.
- How tax is deducted from salary income, Interest income, winning from lottery or crossword puzzle, payment of rent, payment to Contractors and professionals or Technical fees.

16.1 INTRODUCTION

Assessee pay tax in the assessment year on the income earned in the previous year. To overcome these problems Central Government started deducting some amount of tax from certain payments this is receivable by the assessee. The amounts of tax deducted from each payment are called "Tax Deducted at Source". The scheme of deduction of tax at source applies to salary income, Interest income, winning from lottery or crossword puzzle, payment of rent, payment to Contractors and professionals or technical fees etc.

16.2 TDS ON SALARIES

Every employer has to deduct tax from salary of employees. The total tax is to be deducted, on the estimated income of the employee for the financial year in which the payment is made.

Example

Estimate taxable salary of the employee for the year 2008-09 is Rs. 3,50,000. Determine the amount of tax is to be deducted at source every month by the employer.

Solution:

Tax on Rs. 3, 50,000	Rs.25,000
Add Education cess 2%	500
Add SHEC 1%	250
Total Tax	Rs. 25750

Amount of tax to be deducted every month Rs.25750/ 12«=Rs. 2146
TDS is deducted after considering the following

1. Income from previous employer may be considered.
2. Relief u/s 89(1) shall also be considered.

3. The employer can consider the investment made by employee which qualify for exemption, payment for purchase or construction of house, med claim insurance policy etc.

Income tax is to be deducted every month and should be paid to Govt, with in a weak after deduction.

Example

X, an employee of the Punjab state electricity board receives arrears of salary Rs. 1, 00,000 for the earlier four years. He enquires whether he is liable for TDS on the entire amount during the current year.

Solution

The arrears of salary received by Mr. X is liable for deduction of tax during the current year but relief under section 89(a) shall be allowed.

16.3 TD8 ON INTEREST ON SECURITIES

Interest on securities means;

1. Interest on any security of the Central or State Govt.
2. Interest on debenture or other securities issued by a company or a corporation established by a Central or State Act.

Any person responsible for paying to a resident any income by way of interest on securities is required to deduct tax at the following rates:

Payment is made to Non company assessees.	10% (plus surcharge if applicable plus education cess @2% plus SHEC @ 1%)
Payment is made to company assessees.	20% (plus surcharge if applicable plus education cess @2% plus SHEC @1%)

No TDS on the following:

1. No TDS shall be deducted on any security issued by the company, where such security in demat form and is listed on stock exchange in India.
2. No TDS shall be deducted on interest payable on any security of the Central or State Govt.
3. No TDS shall be deducted on interest payable
   (a) to the Life Insurance Corporation of India.
   (b) to the General Insurance Corporation of India.
4. No TDS shall be deducted from any interest paid to individual, on listed debentures issued by a company of an amount not exceeding Rs. 2500 during a financial year.

16.4 TDS ON INTEREST OTHER THAN SECRITKE8

Interest other than interest on securities includes payments made in respect to :

1. Public deposits
2. Loans

Any person (other than an individual or HUF who are not liable to tax audit in preceding ■ financial year) is responsible for paying to a resident any income by way of Interest other than Interest on securities is required to deduct tax at the following rates.

Payment is made to Non company assessees.	10% (plus surcharge if applicable plus education cess @2% plus SHEC @1%)
Payment is made to company assessees.	20% {plus surcharge if applicable plus education cess @2% plus SHEC @1%)

TDB shall not be deducted

(1) If interest paid does not exceed:

1. Rs. 10,000-where payer is Banking Company.
2. Rs.10, 000 -Where payer is co-operative society.
3. Rs, 10,000-on deposit with post office.
4, Rs.5,000-in any other case.

(2) Interest is credited or paid by the firm to its partner.

(3) Interest on zero Coupon Bond.

Notes

TDS is no$ required to be deducted on interest on FDR with bank if the amount of such interest paid during the year by a branch of the bank does not exceed Rs. 10,000.Although the total interest payable by different branches in aggregate exceed Rs. 10,000.

SELF CHECK EXERCISE

1. **What does TDS stand for in the context of income tax?**
   a. Tax Deduction System
   b. Tax Deducted at Source
   c. Total Deduction Scheme
   d. Total Deducted Source
2. **In the case of interest other than securities, TDS shall not be deducted if the interest paid does not exceed:**
   a. Rs. 5,000
   b. Rs. 7,500
   c. Rs. 10,000
   d. Rs. 15,000
3. **TDS is not required on interest payments by a co-operative society if the amount does not exceed Rs. 10,000. T/F**
4. **TDS is required on interest payments to individuals on listed debentures issued by a company. T/F**

16.5 TDS ON WINNING FROM LOTTERY OR CROSSWORD PUZZLE OR ANY OTHER GAME OF ANY SORT

Any person is responsible for paying to a resident any income by way of winning from lottery or crossword puzzle shall deduct tax at source an amount equal to 30%(plus surcharge if applicable plus education cess @2% plus SHEC @ 1%) on such income.

No tax is deductible where amount does not exceed Rs, 5,000 during the financial year.

Example: A TV Channel pays Rs. 5, 00,000 to X as prize money of a quiz programmed “Kaun Banega Crorepati".

Solution: The payer shall deduct income tax at the rate 30% (plus education cess @ 2% SHEC @ 1%) at the time of making the payment to X. Rs. 1,54,500, (30.90% of Rs. 5,00,000) Shall be tax deduction at source.

Example: Mr. Bhatia won the first prize in lottery ticket and the prize was a Motor Cycle worth Rs. 50,000. What is the procedure to be adopted before handing over the Motor Cycle to Mr. Bhatia.

Solution: In this Case, Tax deduction at source is on the prize in kind. Rs. 15,450, (30.90% of Rs. 5,00,00) which may be received by the person responsible for tax deduction, from Mr. Bhatia and the same can be deposited with the Govt, on account of tax deduction.

Cheek your progress 1

What are the rates of Tax Deduction of Source in case of:

1. Interest on securities
2. Winning from lotteries or. crossword puzzles

3. **TDS ON PAYMENT TO CONTRACTORS AND SUB CONTRACTORS**

Any person (other them an individual or HUF who are not liable to tax audit in preceding. financial year) is responsible for paying any sum to any contractor or sub-contractor for carrying out any work shall deduct tax at source at the following rates.

The rate of TDS is as under:

In Case of Contractors	In case of advertising	1% (plus surcharge if applicable plus education cess @2% plus SHEC @ 1%)
	In any other case	2% (plus surcharge if applicable plus education cess @2% plus SHEC @ 1%)
In Case of Sub-Contractors	All cases	1% (plus surcharge if applicable plus education cess @2% plus SHEC @ 1%)

The following are the person shall be required to deduct tax at source

1. The Central Govt, or any State Govt.
2. Any Local Authority
3. Any Company
4. Any Co-operative Society
5. Any trust, University, Society etc.
6. Any firm
7. An Individual or HUF who are subject to tax audit u/s 44AB of the Act during preceding financial year.

No TDS where amount payable does not exceed:

1. Rs. 20,000 in case of single contract.
2. Rs. 50,000 in case of aggregate of contracts during a financial year.

	Situations	Whether TDS to be deducted
1	Single contract of Rs. 20,000 in the year	No TDS
2	Two contract of Rs. 20,000 in the year	No TDS
3	Three contracts of Rs. 20,000 in the year	TDS to be deducted on Rs. 60,000
4	Single contracts of Rs. 30,000 in the year	TDS to be deducted on Rs. 30,000
5	Five contracts of Rs. 30,000 in the year	No TDS
6	Six contracts of Rs. 30,000 in the year	TDS to be deducted on Rs. 60,000

16.7 TDS ON INSURANCE COMMISSION

Any person responsible for paying commission to a resident is required to deduct tax at source at the following rates.

Payment is made to Non company assesses	10% (plus surcharge if applicable plus education cess @2% plus SHEC @ 1%)
Payment is made to company assessees.	20% (plus surcharge if applicable plus education cess @2% plus SHEC @ 1%)

No tax is deductible where amount of commission does not exceed Rs. 5,000 during the financial year.

16.8 TDS ON RENT

Any person (other than an individual or HUF who are not liable to tax audit in preceding financial year) is responsible for paying rent to a resident is required to deduct tax at source at the following rates:

Assets	Payee	Rate of TDS
For use of any Machinery or plant	Any payee	10%'(plus surcharge if applicable
or equipment’s		plus, education cess @2% plus SHEC
		@ 1%)
For use of any Land or Building or	Individual	15% (plus surcharge if applicable
furniture or fittings	or HUF	plus, education cess @2% plus
		SHEC @ 1%)
For use of any Land or Building	A person other	20% (plus surcharge if applicable
or furniture or fittings	than an	plus, education cess @2% plus
	individual	SHEC @ 1%)
	or HUF	

No tax is deductible if aggregate amount of rent paid or credited does not exceed Rs. 1, 20,000 during the financial year.

Example:

Mr. Ram owns a building which he gives on rent to XYZ Ltd. The total rent per annum is Rs.
1, 30,000.

Solution:

The XYZ Ltd shall deduct income tax at the rate 15% (plus education cess @ 2% SHEC @ 1% j at the time of making the payment to Ram Rs. 20,085, (15.45% of Rs. 1,30,000) Shall be tax deducted at source.

16.9 TDS ON FEES FOR PROFESSIONAL OR TECHNICAL SERVICE

Any person (other than an individual or HUF who are not liable to tax audit in preceding financial year) is responsible for paying to a resident any sum by way of (a) fees for professional service OR (b) fees for technical service is required to deduct tax at source an amount equal to 10%(plus surcharge if applicable plus education cess @2% plus SHEC @ 1%) on such income.

No tax is deductible where amount does not exceed Rs. 20,000 during the financial year for each type of payment.

Professional services: means services rendered by a person in the course of carrying in any of the following professions:

- Legal
- Medical
- Engineering
- Accountancy

TechnicalServices: means fees rendering of any managerial, technical or consultancy services.

Example: A Ltd. paid Rs, 18,000 towards fees for professional services and Rs, 15,000 for technical service to H ltd. The total sum Rs. 33,000 was paid by cheque to H Ltd.

Solution: A Ltd .is not liable to deduct tax at source as payment to H Ltd in each of the two services does not exceed Rs. 20,000, even though the aggregate amount of both the services exceeds Rs. 20,000.

Check your progress 2

What is the maximum amount on which TDS is not deducted in case of :

a) Rent
b) Professional Fees
c) Payment to contractor
d) Insurance commission

SELF CHECK EXERCISE

5. **What is the rate of TDS on winning from lotteries or crossword puzzles?**

a. 20%
b. 25%
c. 30%
d. 35%

6. **Who is responsible for deducting TDS on payments to contractors and sub-contractors?**

a. Individuals only
b. Companies only
c. Government and certain entities
d. Trusts and universities only

7. **No TDS is required on insurance commission if the amount does not exceed Rs. 10,000 during the financial year. T/F**

8. **No TDS is required on fees for professional or technical services if the aggregate amount does not exceed Rs. 20,000 during the financial year for each type of payment. T/F**

16.10 SUMMARY

TDS stand for tax deducted at source. It means the tax is deducted at source by the payer at the prescribed rate at the time of payment of such income to the payee.

16.11 KEYWORDS

- **Tax Deducted at Source (TDS):** Amount deducted from certain payments receivable by the assessee to overcome problems in tax payment.
- **TDS on Salaries:** Every employer deducts tax from employees' salaries based on estimated annual income.
- **TDS on Insurance Commission:** Deduction of tax on insurance commission payments at specified rates.

16.12 SELF-ASSESSMENT EXERCISES

- **SHORT ANSWER QUESTION**

1. What are the rates of Tax Deduction at Source in the case of interest on securities?
2. Under what conditions is TDS not required on payments to contractors and sub-contractors?
3. When is TDS not required on payments for professional or technical services?

- **LONG ANSWER QUESTIONS**

Discuss the liability for tax deduction in the following cases:

1. Punjab National Bank pays Rs. 40,000 per month as rent to the State Government for a building in which one of its branch is situated.
2. Mr. Z won the first prize in lottery ticket and the prize was a Car worth Rs. 2, 50,000. What is the procedure to be adopted before handing over the Car to Mr. Z.?
3. X Ltd. paid Rs, 21,000 towards fees for professional services to H Ltd.

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ANSWER KEY

1. b, **2.** c, **3.** T, **4.** F, **5.** c, **6.** c, **7.** T, **8.** T.

Lesson no.: 17 **Author: Ratinder Kaur**

ADVANCE PAYMENT OF TAX

STRUCTURE

17.0 OBJECTIVE

After studying this chapter, you should be able to understand.

- The Concept of Advance Tax
- The due dates for payment of advance tax,
- Concept of "The pay as you Earn" scheme.

17.1 INTRODUCTION

Advance payment of tax is another method of collection of tax in the form of pre-paid taxes. Tax is deducted from salary payable to an employee. Since a businessman earns his income, there is no tax deducted at source. Hence he is liable to pay advance tax as he earns income. Such scheme of advance tax is also known as *Pay Tax as your Earn*. Advance tax is payable on current income estimated by the assesses. The assesses has to pay advance tax on or before each of the due dates and no notice will be issued to him.

17.2 CONDITION OF LIABILITY TO PAY ADVANCE TAX

An assessee (Whether a company assessee or non-companyassessee) is required to pay advance tax if his liability for advance tax is Rs. 5000 or more

Check your progress 1

What do you mean by "Pay as you Earn" scheme?

17.3 COMPUTATION OF ADVANCE TAX

Advance tax shall be calculated by estimating the current year income and then applying the tax rate in force. Therefore, advance tax is to be computed as under:

1. Income under the five heads-of income
2. Brought forward losses and allowances
3. Gross Total Income- 1-2
4. Chapter VI-A deduction
5. Total Income"3-4
6. Tax on Total Income
7. Surcharge on (6)
8. Total tax payable-6+7
9. Relief under section 89
10. Tax liability-8-9
11. Add 3% education Cess on 10
12. Total Tax liability: 10+11
13. Relief of tax u/s 90,90A,91
14. MAT Credit u/s 115 JAA

15. TAX Deducted at source/Tax collected at source

16. ADVANCE TAX LIABILITY=12-(13+14+15)

17.4 INSTALMENTS OP ADVANCE TAX AND DUE DATES

In the Case of assesses other than company, advance tax has to be paid in three installments. However, in case of a company assesses, advance tax is payable in four installments.

IN CASE 07 ASSESSEES OTHER THAN COMPANIES

Dae date of Installment	A mount Payable
On or before 15 September	Not less than 30% of the advance tax liability
On or before 15 December	Not less than 60% of the advance tax liability as reduced by the amount, if any, paid in earlier installment.
On or before 15 March	The whole amount of the advance tax liability as reduced by the amount, if any, paid in earlier installment. IN CASE OF COMPANIES
Due date of Installment	A mount Payable
On or before 15 June	Not less than 15% of the advance tax liability ' On or before 15 September Not less than 45% of the advance tax liability as reduced by the amount, if any, paid in earlier installment.
On or before 15 December	Not less than 75% of the advance tax liability as reduced by the amount, if any, paid in earlier installment.
On or before 15 March	The whole amount of the advance tax liability as reduced by the amount, if any, paid in earlier installment.

Note:

Any advance tax paid on or before 31st march is also treated as tax paid during the financial year.

- **Example:**

The estimated Gross Total income of Mr. X is Rs. 3,50,000 for the financial year 200S-09 and his estimated tax liability is Rs 20,800.Compute the advance tax payable by Mr. X in the financial year 2008-09.

Solution: Since, tax is more than Rs. 5,000, therefore, advance tax is payable. The advance tax is payable as under:

Due date of Installment	Amount Payable
On or before 15 September	First 30% of Rs. 20800 = Rs. 6240
On or before 15 December	Next 30% of Rs. 20800 - Rs. 6240.
On or before 15 March	Balance 40% of Rs. 20800 “ Rs. 8320

Check your progress 2

The estimated Gross Total income of B Company is Rs. 4,00,000 for the financial year

2008- 09 and his estimated tax liability is Rs 50,800.Compute the advance tax payable by Co. in the financial year 2008-09.

17.5 DEFAULT IN PAYMENT OF ADVANCE TAX

If advance tax is not paid or the amount of advance tax is less than 90% of the assessed tax, interest @1% per month from first April till the months of payment under section 234B.

If the installments of advance tax are not paid, interest J% of per month, for a period of 3 months, will be payable for every installments, except for the last installment of 15th march where it will be 1% for one month under section 234 C.

NOTE :

If the due date of payment of advance tax is a banking holiday, the assessee can make the payment on the next immediately following working day. In such cases, no interest shall be payable u/s 234B or 234C.

SELF CHECK EXERCISE

1. **What is the condition for an assessee to be liable to pay advance tax?**

   a. Rs. 2,000 or more

   b. Rs. 5,000 or more

   c. Rs. 10,000 or more

   d. Rs. 1,000 or more

2. **What is the rate of interest applicable for default in payment of advance tax under section 234B?**

   a. 2% per month

   b. 1% per month

   c. 3% per month

   d. 4% per month

3. **If the due date of payment of advance tax falls on a banking holiday, what is the provision regarding payment?**

   a. Payment must be made on the next banking holiday

   b. No payment is required

   c. Payment can be made on the next immediately following working day

   d. Payment can be made anytime during the month

4. **Advance tax is payable on the income earned in the previous year. T/F**

5. **A company assesses is required to pay advance tax in three installments. T/F**

6. **Interest is not levied for default in payment of advance tax if the amount paid is less than 80% of the assessed tax. T/F**

7. **If the due date of payment of advance tax is a banking holiday, interest under section 234B or 234C is not applicable. T/F**

17.6 SUMMARY

Every assessee whose estimated tax liability during that year is Rs. 5000 or more is liable to pay advance tax. The first installment is paid on or before 15 June by company assessee while non company assessee pays the first installment on or before 15 September .The entire advance tax is paid on or before by 15 March by both the company and non-companyassessee.

17.7 KEYWORDS

- **Advance Tax:** A method of collecting tax in the form of pre-paid taxes, applicable to individuals and businesses.
- **Computation of Advance Tax:** The calculation involves estimating current year income, applying tax rates, deductions, and calculating the total advance tax liability.
- **Default in Payment of Advance Tax:** If advance tax is not paid or is less than 90% of the assessed tax, interest is charged at 1% per month. Non-payment of installments incurs interest of 1% per month for each installment.

17.8 SELF-ASSESSMENT EXERCISES

- **SHORT ANSWER QUESTIONS**

1. What is the purpose of the "Pay Tax as You Earn" scheme in advance tax?
2. What are the steps involved in the computation of advance tax?
3. What is the consequence of not paying advance tax or paying less than 90% of the assessed tax?

- **LONG ANSWER QUESTIONS**

Q. Estimate advance tax liability for the financial year 2008-09 in case of different assessees is given below :

Name of the assessee	Amount of advance tax payable (Rs.)
1. Nalco LTD	1,50,000
2. Miss Sunita	4.999
3. Mr. Ram	5.000

Am.

1. (22500+45000+67,500+1,12,500)
2. No advance tax payable
3. (1,500+1,500+3,000)

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ANSWER KEY

1. b, **2.** b, **3.** c, **4.** F, **5.** F, **6.** F, **7.** T.

Lesson no.: 18 **Author: Sanjeev Kumar**

FILLING OF RETURN OF INCOME

STRUCTURE:

18.0 OBJECTIVE

After studying this chapter, you, should be able to understand.

- The New Return form.
- Due dates of filling of income tax returns.
- Concept of E- filling

18.1 INTRODUCTION

After the completion of the previous year, every assessee is required to furnish the return of income in the prescribed form on or before the due dates. The details of filling the income tax return and related issues are discussed here in this lesson.

18.2 COMPULSORY FILLING OF RETURN OF INCOME 139 (1)

An assessee should furnish the return of income voluntarily in accordance with the following provisions:

Return by any Company/Firms:

It is compulsory for every Companies and Firms to file its return voluntarily. Every Company/ Firm is required to furnish' its return even if it incurs a loss.

Return by any other person:

Any other person, other than company and firm should voluntarily furnish the return if his total income exceeds the maximum amount which is not chargeable to income tax. At present for the Assessment year 2009-10, return of income is required to be filled by the following persons:

Person	If Gross total income exceeds
1 Any person (i.e. Man below 65 years age)	Rs. 1,10,000
2 Woman	Rs. 1,45,000
3 Senior Citizen (person age 65 year or more)	Rs. 1,95,000

18.3DUE DATES FOR FILLING RETURN OF INCOME

The due dates for filling income tax returns are:

Different Situations	Due dates
1. Where the assessee is:	
(a) a company or	October 31
(b) a person(other than accompany) whose	October 31
accounts are required to be audited	
under any law.	
© a working partner of a firm whose	October 31
accounts are required to be audited	
under any law.	
2. In the case of any other assessee	July 31

NOTE:

Where the last day for filling return of income is a day on which the office is closed, the assessee can file the return on the next day afterwards on which the office is open.

Example

Find out the due date for submission of return of income in the following case for assessment year 2009-10

Name of tax payer:

C Ltd Taxable income (-) Rs

50,000 Turnover Rs. 2,

50,000 Solution:

In case of company assessee, it is compulsory to file return of income even if there is a loss and the due date for filling the return of income is 31st October of the assessment year.

The company will have to file the return on 31st October even if there is a loss.

18.4 RETURN FORM

The Central Board of Direct Taxes (CBDT) has prescribed new return forms for the assessment years 2008-09 onwards. Every assessee should file an annual return in prescribed form. The new return form numbering ITR-1 to ITR-8 is annexure less. Hence no documents needed to be attached

- The prescribed forms are as under:

ITR-1

It is the most basic IT return form, and is applicable only for people having a salary or pension income and having saving bank accounts, fixed deposits, and other interest-bearing securities.

ITR-2

It is for individuals and Hindu Undivided Families (HUFs) having income from:

- Salary / Pension / Family Pension
- interest -You have saving bank account, fixed deposit, and other interest-bearing securities.
- House Property -You have paid EMI for your house to repay your home loan
- Capital Gains -You have sold shares/mutual funds/house in the past years.

ITR-3

< t It is for individuals or HUFs that cure partners in firms, but who are not carrying out business

or profession under any proprietorship.

ITR-4

It is for individuals and HUFs that have income from a proprietary business or profession.

ITR-S

It is for firms, Association of Persons, and Body of Individuals.

ITR-6

It is for Companies other than companies calming exemption under section 11

ITR-7

It is for person including companies required to furnish return under section 139 (4A 4B, 4C, 4D).

1TR-8

In the case of a person who is not required to furnish the return of income but is required to furnish the return of fringe benefits.

Check your progress 1

(1) Which ITR form used in the following cases:
  1. A person having pension income
  2. A person sold old shares

(2) What documents are to be enclosed along with the return of income?

SELF CHECK EXERCISE

1. **Which ITR form is applicable for individuals and Hindu Undivided Families (HUFs) having income from salary, pension, family pension, interest, house property, and capital gains?**
   a. ITR-1
   b. ITR-2
   c. ITR-3
   d. ITR-4
2. **In the case of a firm whose accounts are required to be audited under any law, what is the due date for filing the return of income?**
   a. JULY 31
   b. OCTOBER 31
   c. SEPTEMBER 30
   d. NOVEMBER 30
3. **A working partner of a firm whose accounts are required to be audited under any law is required to file the return of income by July 31. T/F**
4. **A person, other than a company and a firm, is required to furnish the return of income only if his total income exceeds the maximum amount not chargeable to income tax.**
   T/F

18.5 WHO SHOULD SION THE RETURN

1) **In case of individual:**

   (a) By the individual himself.

   (b) Where the individual is absent from India, then by the individual himself or by any other person duly authorized by him.

2) **In case of partnership firm:**

   (a) By the managing partner.

   (b) If there is no managing partner or if managing partner is not able to sign because of unavoidable reasons, then by any partner of a firm, not being minor.

3) **In case of an HUF:**

   (a) By the Karta.

   (b) If the is Karta is absent from India or is mentally incapacitated, then by any adult member of the family.

4) In use of Company:

(a) By the managing director.

(b) If there is no managing partner or if managing partner is not able to sign because of unavoidable reasons, then by any director of the company.

(c) In case of company wound up, by the liquidator.

5) In case of any other person, by that person or by a person competent to act on his behalf.

Check your progress 2

Who is required to sign the return of income on behalf of the company?

18.6 MANNER OF FILLING OF RETURN

These returns can be submitted in the following manner:

(i) a paper form;

(ii) e-filing Paper Form:

If the assessee furnishes the return in paper format, acknowledgement slip attached with the return should be dully filled in. The new forms are not required to be filled in duplicate.

E-Filling:

Returns can be e-filed through the internet. From the assessment year 2008-09 Companies and firms are compulsorily required to file their return electronically, while for others it is Still optioned. For electronic filing of return you have to log on to the Departmental website http://www.incometaxindia.gov.in/ and upload the information of income and taxes in the prescribed form. If you have digital signature the same can be appended and there would be no need to file a paper return. In case you do not have a digital signature you will be required to file a paper return quoting the provisional acknowledgement number received on completion of uploading.

The documents, statements, receipts, certificates or audited reports which may not be furnished along with the return in electronic form but shall be produced before the Assessing Officer on demand

18.7 PENALTY FOR NOT FILLING OF RETURN OF INCOME

If a person who is required to furnish of his income, fails to furnish return before the end of the relevant Assessment Year, the Assessing Officer shall direct that such person shall pay, a sum of five thousand rupees.

SELF CHECK EXERCISE

5. **Who is required to sign the return in case of an HUF (Hindu Undivided Family)?**

   a. Any adult member of the family

   b. By the Karta

   c. Any minor member of the family

   d. By the eldest member of the family

6. **In the case of a partnership firm, who should sign the return?**

   a. Any partner of the firm, whether minor or major

   b. By the managing partner or any partner, not being a minor

   c. By any employee authorized by the partners

d. By the firm's auditor

7. **Companies and firms are compulsorily required to file their return electronically. T/F**

8. **If an assessee furnishes the return in paper format, it should be filled in duplicate. T/F**

18.8 SUMMARY

It is a legal obligation of every person, whose total income tax during the previous year exceeds the maximum amount, which is not chargeable to income tax should furnish income tax •return in the prescribed form on or before due dates.

18.9 KEYWORDS

- **Return of Income:** The document required to be filed by every assessee after the completion of the previous year, providing details of income.
- **Penalty for Not Filing Return of Income:** Failure to file returns by the end of the relevant assessment year may result in a penalty of Rs. 5,000.

18.10 SELF-ASSESSMENT EXERCISES

- **SHORT ANSWER QUESTIONS**

1. What is the purpose of filing a Return of Income?
2. What are the due dates for filing returns for companies, individuals with audited accounts, and other assesses?

- **LONG ANSWER QUESTIONS**

1. Find out the due date for submission of return of income in the following case for assessment year 2009-10
   Name of tax payer: B Ltd
   Taxable income (-) Rs2,
   50,000 Turnover Rs. 5,
   50,000
2. Which ITR form used in the following cases:
   (a) A person having salary income
   (b) A person sold old mutual funds

18.11 BIBLIOGRAPHY & FURTHER READINGS

1. Ahuja Girish & Gupta Ravi, Direct Taxes Law & Practice including Tax Planning, Bharat Law House Private limited, New Delhi 2008, Ch. 25.pp 1128-1195
2. Singhania.K Vinod 8s SinghaniaKapil, Direct Taxes Law & Practice including Tax Planning, Taxmann Publications Private limited, New Delhi 2007, Ch. 19.pp 834-843

ANSWER KEY

1. b, **2.** b, **3.** F, **4.** T, **5.** b, **6.** b, **7.** T, **8.** F.