

# Corporate Tax Planning

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DCOM508



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**P** ROFESSIONAL  
**U** NIVERSITY

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# CORPORATE TAX PLANNING

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## SYLLABUS

### Corporate Tax Planning

#### Objectives:

- The course aims to familiarize the students with major latest provisions of Indian tax laws and related judicial pronouncements pertaining to corporate world.
- The course will sensitize the students to recognize tax planning opportunities for developing appropriate tax strategies required in corporate decision making.
- This course will enable the learners to do effective tax planning to reduce tax liability of companies.

Sr. No.	Description
1.	Basic framework of tax laws in India, Residential status of a Company and incidence of tax, Corporate Tax Planning: meaning, Tax Evasion and Tax Avoidance. Tax Planning & Tax Management
2.	Planning regarding Set off & Carry Forward of Losses and Computation of taxable income of companies, Minimum Alternate Tax, Tax on distributed profits of domestic companies, Tax on dividends and income received from venture capital companies.
3.	Special provisions in respect of newly established undertakings in Free Trade Zones: General and specific conditions, consequence of amalgamation, demerger and sec 10A. Special provisions in respect of newly established undertakings in SEZ's.: conditions, consequence of amalgamation, demerger and sec 10AA. Special provisions in respect of newly established undertakings in 100% EOU's: specific conditions, consequence of amalgamation, demerger, sec 10 B
4.	Deductions available to undertakings developing infrastructure facility, SEZ, Industrial Park, power generation, Telecommunication, reconstruction of power unit. Deductions in respect of profits and gains of undertakings engaged in development of SEZ. Deductions in respect of certain undertakings in certain special category of states, North-Eastern States. Application of these special conditions
5.	Decision regarding form of organization. Tax Planning regarding form of organization with reference to sole proprietorship, Partnership & Company
6.	Financial Management Decisions: Capital Structure Decisions, regarding Dividend Policy: meaning of dividend and its distribution, DDT and regarding issue of Bonus Shares.
7.	Managerial Decision: Buy or Lease, Make or Buy and Export or Local Sales, Tax Planning regarding employees remuneration, FBT Planning and Remuneration Planning
8.	Tax Planning in case of liquidation, Advance payment of Tax and Double Taxation Relief
9.	Restructuring business, Amalgamation: conditions, transfer of capital asset, Setoff and carry forward of losses and consequences, Demerger: Conditions, transfer of capital asset, capital gains, Set off and carry forward of losses, expenditure on demerger and consequences
10.	Conversion of sole proprietorship into company and firm into company, Slump Sale and Transfer of assets between holding and subsidiary company

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## Unit 1: Income Tax: Basic Framework

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- 1.6 Income Tax Systems in India
- 1.7 Summary
- 1.8 Keywords
- 1.9 Review Questions
- 1.10 Further Readings

### Objectives

After studying this unit, you will be able to:

- Explain the concept of income
- Discuss the historical background of tax
- Elaborate the Income Tax Law in India
- Describe the basic concepts of income tax
- Discuss agricultural income
- Explain an overview of income tax systems in India

### Introduction

An income tax is a tax levied on the financial income of persons, corporations, or other legal entities. Various income tax systems exist, with varying degrees of tax incidence. Income taxation can be progressive, proportional, or regressive. When the tax is levied on the income of companies, it is often called a corporate tax, corporate income tax, or profit tax. Individual income taxes often tax the total income of the individual (with some deductions permitted), while corporate income taxes often tax net income (the difference between gross receipts, expenses, and

**Notes**

additional write-offs). Every country generates income from 'Income Tax' in the form of direct tax levied by government. Income tax plays a vital role in the economy of every country in the world. Income tax Act was enacted in the year 1961. So, before one can embark on a study of the law of income tax, it is absolutely vital to understand some of the expressions found under the Income tax Act, 1961. The purpose of this Unit is to enable the students to comprehend basic expressions. Therefore, all such basic terms are explained and suitable illustrations are provided to define their meaning and scope.

### **1.1 Concept of Income**

A basic income is an income unconditionally granted to all on an individual basis, without means test or work requirement. It is a form of minimum income guarantee that differs from those that now exist in various countries in three important ways:

1. it is being paid to individuals rather than households;
2. it is paid irrespective of any income from other sources;
3. it is paid without requiring the performance of any work or the willingness to accept a job if offered.

There is no specific definition of income but for statutory purposes there are certain items which are listed under the head income. These items include those heads also which normally will not be termed as income but for taxation we consider them as income. The definition of income as per the Income tax Act, 1961, begins with the words "Income includes". Income is a periodical monetary return with some sort of regularity. It may be recurring in nature. It may be broadly defined as the true increase in the amount of wealth which comes to a person during fixed period of time.

The definition of the term "income" in sec. 2 (24) is inclusive and not exhaustive. The term "income" not only indicates those things which are included in sec. 2(24), but also includes such thing which the term signifies according to its general and natural meaning.

Therefore, it is an inclusive definition and not an exhaustive one. Such a definition does not confine the scope of income but leaves room for more inclusions within the ambit of the term. Certain important principles relating to income are enumerated below:

1. Income, in general, means a periodic monetary return which accrues or is expected to accrue regularly from definite sources. However, under the Income tax Act, 1961, even certain incomes which do not arise regularly are treated as income for tax purposes e.g. Winnings from lotteries, crossword puzzles.
2. Income normally refers to revenue receipts. Capital receipts are generally not included within the scope of income. However, the Income tax Act, 1961 has specifically included certain capital receipts within the definition of income e.g. capital gains i.e. gains on sale of a capital asset like land.
3. Income means net receipts and not gross receipts. Net receipts are arrived at after deducting the expenditure incurred in connection with earning such receipts. The expenditure which can be deducted while computing income under each head is prescribed under the Income tax Act, 1961.
4. Income is taxable either on due basis or receipt basis. For computing income under the heads "Profits and gains of business or profession" and "Income from other sources", the method of accounting regularly employed by the assessee should be considered, which can be either cash system or mercantile system.
5. Income earned in a previous year is chargeable to tax in the assessment year. Previous year is the financial year, ending on 31st March, in which income has accrued/received.



Assessment year is the financial year (ending on 31st March) following the previous year. The income of the previous year is assessed during the assessment year following the previous year. For instance, income of previous year 2012-13 is assessed during the year 2013-14. Therefore, 2013-14 is the assessment year for assessment of income of the previous year 2012-13.

### 1.1.1 Features of "Income"

The following features of income can help a person to understand the concept of income:

1. **Definite Source:** Income has been compared with a fruit or a crop from the field. Fruit comes from a tree and crop from fields. Thus, the source of income is definite in both the cases. The existence of a source for income is somewhat essential to bring a receipt under the charge of tax.
2. **Income must come from outside:** No one can earn income from himself. There can be no income from transaction between head office and branch office. Contributions made by members for the mutual benefit and found surplus cannot be termed as income of such group.
3. **Tainted Income:** Income earned legally or illegally remains income and it will be taxed according to the provisions of the Act. Assessment of illegal income of a person does not grant him immunity from the applicability of the provisions of other act.
4. **Temporary or Permanent:** Whether the income is permanent or temporary, it is immaterial from the tax point of view.
5. **Voluntary Receipt:** The receipts which do not arise from the exercise of a profession or business or do not amount to remuneration and are made for reasons purely of personal nature are not included in the scope of total income.

### 1.1.2 Tax Treatment of "Income"

For the purposes of treatment of income for tax purposes it can be divided into three categories:

1. **Taxable Income:** These incomes from part of total income and are fully taxable. These are salaries, rent, business profits, professional gains, capital gain, interest dividend and so on.
2. **Exempted Income:** These incomes do not from part of total income either fully or partially. Hence, no tax is payable on such incomes.
3. **Rebateable (Tax Free Incomes):** These incomes form part of total income and are fully taxable. Tax is calculated on total income out of which a Rebate of Tax at average rate is allowed.

### Self Assessment

State whether the following statements are true or false:

1. Income means a periodic monetary return which accrues or is expected to accrue regularly from definite sources.
2. Income is taxable only on due basis.
3. Income earned in a previous year is chargeable to tax in the assessment year.

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Caselet

### Vodafone Wins Tax Case in SC; Deal With Hutchison 'bona fide'

Vodafone on Friday got relief in its income tax case after the Supreme Court ruled its deal with Hutchison as 'bona fide'. The Supreme Court on Friday in a majority verdict has upheld Vodafone International Holdings BV's contention that the Income Tax department did not have jurisdiction over a US \$11.2 billion deal in May 2007 in which the British group acquired Hutchison Telecommunications International as part of a complex transaction to buy the latter's majority stake in its Indian telecom business. The Indian unit, called Hutchison Essar then, is today named Vodafone Essar.

The verdict has asked the tax department to return the ₹ 2,500 crore that Vodafone had submitted as interim tax liability.

The verdict sets aside the uncertainty over the tax claim on Vodafone, as also companies involved in such transactions, but in future similar deals may come under the ambit of the proposed Direct Tax Code (DTC), which is being currently debated in Parliament. It taxes similar deals subject to certain conditions.

The telecom giant had moved the Apex Court challenging the Bombay High Court judgement of September 8, 2010 which had held that Indian IT department had jurisdiction over the deal.

Through the US \$11.2 billion deal in May 2007, Vodafone acquired 67 per cent stake in the Hutchison-Essar Ltd (HEL) from Hong Kong-based Hutchison Group through companies based in Netherlands and Cayman Island.

The IT Department maintained that since capital gains were made in India through the deal, Vodafone was liable to pay the tax and issued a showcause notice to it, asking as to why it should not be treated as a representative assessee of the Vodafone International Holding.

Vodafone, however, challenged the show cause notice before the Bombay High Court saying it was share transfer carried outside India.

The appeal was rejected by the high court in December 2008 which was again challenged by Vodafone before the Apex Court.

Source: <http://businesstoday.intoday.in/story/vodafone-wins-tax-case-in-supreme-court/1/21814.html>

## 1.2 Historical Background of Income Tax

The concept of taxing income is a modern innovation and presupposes several things: a money economy, reasonably accurate accounts, a common understanding of receipts, expenses and profits, and an orderly society with reliable records. For most of the history of civilization, these preconditions did not exist, and taxes were based on other factors. Taxes on wealth, social position, and ownership of the means of production (typically land and slaves) were all common. Practices such as tithing, or an offering of first fruits, existed from ancient times, and can be regarded as a precursor of the income tax, but they lacked precision and certainly were not based on a concept of net increase.

In the year, Emperor Wang Mang of China instituted an unprecedented tax – the income tax – at the rate of 10 percent of profits, for professionals and skilled labour. (Previously, all Chinese taxes were either head tax or property tax.) A true income tax was first implemented in Britain by William Pitt the Younger in his budget of December 1798 to pay for weapons and equipment in

preparation for the Napoleonic wars. Pitt's new graduated income tax began at a levy of 2d in the pound (0.8333%) on incomes over £60 and increased up to a maximum of 2s (10%) on incomes of over £200. Pitt hoped that the new income tax would raise £10 million but actual receipts for 1799 totalled just over £6 million (see UK income tax history for more information). The first United States income tax was imposed in July 1861, 3% of all incomes over 600 dollars (later rescinded in 1872).

Income tax in India was imposed by Sir James Wilson of British Government in the year 1860, to recover from losses of 1857's revolution. Another act was made in the year 1886, which can be treated as permanent base for Income tax system in India. This was amended several times in 1863, 1867, 1871, 1873 and 1878.

In the year 1922, 'Central Revenue Board' was established and Income Tax Act, 1922 was implemented with the help of this board. Direct Taxes Administration Enquiry Committee was appointed in the year 1958. In the year 1961, parliament announced new Income Tax Act, which came into enforcement from April, 1962. This act was based on report submitted by Mahavir Tyagi in 1959.

Types of Taxes:

1. **Direct Taxes:** Income Tax, Wealth Tax, Gift Tax etc.
2. **Indirect Taxes:** Excise, Customs duty, Sales tax etc.

However, Gift-Tax was removed from 30th September, 1998 and Estate Duty was removed from the assessment year 1986-87.

### 1.2.1 Importance of Income Tax

The importance of income tax is enumerated as below:

1. Income tax is the prime source of fund to the government.
2. It helps in removing inequalities of income levels among people.
3. It helps in eradication of poverty, as the government spends the amount collected through Income tax, for welfare of poor people.

### 1.2.2 Principles of Income Tax

The "tax net" refers to the types of payment that are taxed, which included personal earnings (wages), capital gains, and business income. The rates for different types of income may vary and some may not be taxed at all. Capital gains may be taxed when realised (e.g. when shares are sold) or when incurred (e.g. when shares appreciate in value). Business income may only be taxed if it is significant or based on the manner in which it is paid. Some types of income, such as interest on bank savings, may be considered as personal earnings (similar to wages) or as a realised property gain (similar to selling shares). In some tax systems, personal earnings may be strictly defined where labour, skill, or investment is required (e.g. wages); in others, they may be defined broadly to include windfalls (e.g. gambling wins).

Tax rates may be progressive, regressive, or flat. A progressive tax taxes differentially based on how much has been earned. A tax system may use different taxation methods for different types of income. However, the idea of a progressive income tax has garnered support from economists and political scientists of many different ideologies, from Adam Smith in the Wealth of Nations to Karl Marx in the Communist Manifesto.

Personal income tax is often collected on a pay-as-you-earn basis, with small corrections made soon after the end of the tax year. These corrections take one of two forms: payments to the government, for taxpayers who have not paid enough during the tax year; and tax refunds from

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the government for those who have overpaid. Income tax systems will often have deductions available that lessen the total tax liability by reducing total taxable income. They may allow losses from one type of income to be counted against another. For example, a loss on the stock market may be deducted against taxes paid on wages. Other tax systems may isolate the loss, such that business losses can only be deducted against business tax by carrying forward the loss to later tax years.

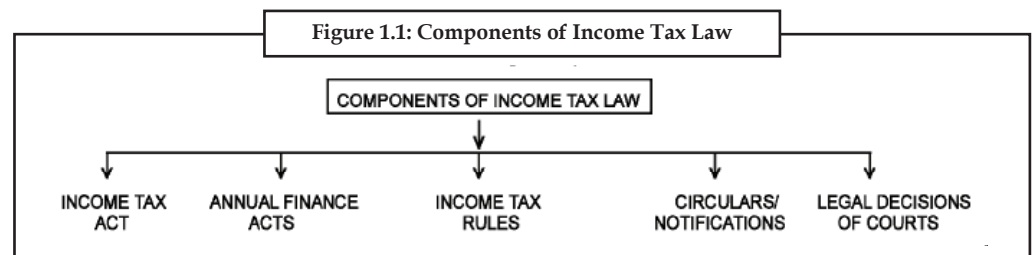
**Self Assessment**

State whether the following statements are true or false:

4. A true income tax was first implemented in Britain by William Pitt the Younger in his budget of December 1798.
5. Indirect Taxes Administration Enquiry Committee was appointed in the year 1958.
6. A flat tax taxes differentially based on how much has been earned.

**1.3 Overview of Income Tax Law in India**

Income tax is a tax levied on the total income of the previous year of every person. A person includes an individual, Hindu Undivided Family (HUF), Association of Persons (AOP), Body of Individuals (BOI), a firm, a company etc. Income tax is the most significant direct tax. The income tax law in India consists of the following components is shown in Figure 1.1:



Source: [http://220.227.161.86/18878sm\\_dtl\\_finalnew\\_cp1.pdf](http://220.227.161.86/18878sm_dtl_finalnew_cp1.pdf)

The various instruments of law containing the law relating to income tax are explained below:

1. **Income tax Act:** The levy of income tax in India is governed by the Income tax Act, 1961. This Act came into force on 1st April, 1962. The Act contains 298 sections and XIV schedules. These undergo change every year with additions and deletions brought about by the Finance Act passed by Parliament. In pursuance of the power given by the Income tax Act, 1961 rules have been framed to facilitate proper administration of the Income tax Act.
2. **Finance Act:** Every year, the Finance Minister of the Government of India presents the Budget to the Parliament. Part A of the budget speech contains the proposed policies of the Government in fiscal areas. Part B of the budget speech contains the detailed tax proposals. In order to implement the above proposals, the Finance Bill is introduced in the Parliament. Once the Finance Bill is approved by the Parliament and gets the assent of the President, it becomes the Finance Act.
3. **Income tax Rules:** The administration of direct taxes is looked after by the Central Board of Direct Taxes (CBDT). The CBDT is empowered to make rules for carrying out the purposes of the Act. For the proper administration of the Income tax Act, the CBDT frames rules from time to time. These rules are collectively called Income tax Rules, 1962. It is important to keep in mind that along with the Income tax Act, 1961, these rules should also be studied.

4. **Circulars and Notifications:** Circulars are issued by the CBDT from time to time to deal with certain specific problems and to clarify doubts regarding the scope and meaning of the provisions. These circulars are issued for the guidance of the officers and/or assessees. The department is bound by the circulars. While such circulars are not binding the assessees they can take advantage of beneficial circulars.
5. **Case Laws:** The study of case laws is an important and unavoidable part of the study of income tax law. It is not possible for Parliament to conceive and provide for all possible issues that may arise in the implementation of any Act. Hence the judiciary will hear the disputes between the assessees and the department and give decisions on various issues. The Supreme Court is the Apex Court of the country and the law laid down by the Supreme Court is the law of the land. The decisions given by various High Courts will apply in the respective states in which such High Courts have jurisdiction.

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### Self Assessment

Fill in the blanks:

7. The administration of direct taxes is looked after by the .....
8. The circulars are issued for the guidance of the .....
9. The levy of income tax in India is governed by the .....

### 1.4 Basic Concepts of Income Tax

Section 2 of the Act gives definitions of the various terms and expressions used therein. In order to understand the provisions of the Act, one must have a thorough knowledge of the meanings of certain key terms like 'person', 'assessee', 'income', etc. To understand the meanings of these terms we have to first check whether they are defined in the Act itself. If a particular definition is given in the Act itself, we have to be guided by that definition. If a particular definition is not given in the Act, reference can be made to the General Clauses Act or dictionaries. Students should note this point carefully because certain terms like "dividend", "transfer", etc. have been given a wider meaning in the Income tax Act, 1961 than they are commonly understood.

Some of the important terms defined under section 2 are given below:

- (1) **Assessee [Section 2(7)]:** 'Assessee' means a person by whom any tax or any other sources of money is payable under this act, and includes:
  - (a) every person in respect of whom any proceedings under this act have been taken for the assessment.
    - (i) of his income or of the income of any other person in respect of which he is assessable; or
    - (ii) of the loss sustained by him or by such other person; or
    - (iii) of the amount of refund due to him or to such other person;
  - (b) every person who is deemed to be an assessee under any provision of this Act.
  - (c) every person who is deemed to be an assessee in default under any provisions of this act.
- (2) **Person [Section 2(31)]:** The definition of 'assessee' leads us to the definition of 'person' as the former is closely connected with the latter. The term 'person' is important from another point of view also viz.; the charge of income tax is on every 'person'.

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The definition is inclusive i.e. a person includes,

- ❖ an individual,
- ❖ a Hindu Undivided Family (HUF),
- ❖ a company,
- ❖ a firm,
- ❖ an AOP or a BOI, whether incorporated or not,
- ❖ a local authority, and
- ❖ every artificial juridical person e.g., an idol or deity.

We may briefly consider some of the above seven categories of assessee each of which constitute a separate unit of assessment.

- (i) *Individual*: The term 'individual' means only a natural person, i.e., a human being. It includes both males and females. It also includes a minor or a person of unsound mind. But the assessment in such a case may be made under section 161(1) on the guardian or manager of the minor or lunatic. In the case of deceased person, assessment would be made on the legal representative.
- (ii) *HUF*: Under the Income tax Act, a Hindu Undivided Family (HUF) is treated as a separate entity for the purpose of assessment. It is included in the definition of the term "person" under section 2(31). The levy of income tax is on "every person". Therefore, income tax is payable by a HUF. "Hindu undivided family" has not been defined under the Income tax Act. The expression is however defined under the Hindu Law as a family, which consists of all males lineally descended from a common ancestor and includes their wives and unmarried daughters. The relation of a HUF does not arise from a contract but arises from status.

A Hindu is born into a HUF. A male member continues to remain a member of the family until there is a partition of the family. After the partition, he ceases to be a member of one family. However, he becomes a member of another smaller family. A female member ceases to be a member of the HUF in which she was born, when she gets married. Thereafter, she becomes a member of the HUF of her husband. Some members of the HUF are called coparceners. They are related to each other and to the head of the family. HUF may contain many members, but members within four degrees including the head of the family (kartha) are called coparceners. A Hindu coparcenary includes those persons who acquire by birth an interest in the joint coparcenary property. Only the coparceners have a right to partition. A Jain undivided family would also be assessed as a HUF, as Jains are also governed by the laws as Hindus.

- (iii) *Company [Section 2(17)]*: For all purposes of the Act the term 'Company', has a much wider connotation than that under the Companies Act. Under the Act, the expression 'Company' means:
  - (a) any Indian company as defined in section 2(26); or
  - (b) any body corporate incorporated by or under the laws of a country outside India, i.e., any foreign company; or
  - (c) any institution, association or body which is assessable or was assessed as a company for any assessment year under the Indian Income tax Act, 1922 or for any assessment year commencing on or before 1.4.1970 under the present Act; or

- (d) any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by a general or special order of the CBDT to be a company for such assessment years as may be specified in the CBDT's order.

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*Did u know?* There are two types of companies:

- (1) *Domestic Company [Section 2(22A)]*: means an Indian company or any other company which, in respect of its income liable to income tax, has made the prescribed arrangements for the declaration and payment of dividends (including dividends on preference shares) within India, payable out of such income.
- (2) *Foreign Company [Section 2(23A)]*: Foreign company means a company which is not a domestic company.
- (iv) *Firm*: The terms 'firm', 'partner' and 'partnership' have the same meanings as assigned to them in the Indian Partnership Act. In addition, the definitions also include the terms as they have been defined in the Limited Liability Partnership (LLP) Act, 2008. However, for income tax purposes a minor admitted to the benefits of an existing partnership would also be treated as partner. This is specified under section 2(23) of the Act. A partnership is the relation between persons who have agreed to share the profits of business carried on by all or any of them acting for all. The persons who have entered into partnership with one another are called individually 'partners' and collectively a 'firm'.



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1. Consequent to the Limited Liability Partnership Act, 2008 coming into effect in 2009 and notification of the Limited Liability Partnership Rules w.e.f. 1st April, 2009, the Finance (No.2) Act, 2009 has incorporated the taxation scheme of LLPs in the Income tax Act on the same lines as applicable for general partnerships, i.e. tax liability would be attracted in the hands of the LLP and tax exemption would be available to the partners. Therefore, the same tax treatment would be applicable for both general partnerships and LLPs.
2. Consequently, the following definitions in section 2(23) have been amended -
  - (a) The definition of 'partner' to include within its meaning, a partner of a limited liability partnership;
  - (b) The definition of 'firm' to include within its meaning, a limited liability partnership; and
  - (c) The definition of 'partnership' to include within its meaning, a limited liability partnership.
- (v) *Association of Persons (AOP)*: When persons combine together for promotion of joint enterprise they are assessable as an AOP when they do not in law constitute a partnership. In order to constitute an association, persons must join in a common purpose, common action and their object must be to produce income; it is not enough that the persons receive the income jointly. Co-heirs, co-legatees or co-donees joining together for a common purpose or action would be chargeable as an AOP.

*Body of Individuals (BOI)*: It denotes the status of persons like executors or trustees who merely receive the income jointly and who may be assessable in like manner and to the same extent as the beneficiaries individually. Thus co-executors or co-trustees are assessable as a BOI as their title and interest are indivisible.

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Income tax shall not be payable by an assessee in respect of the receipt of share of income by him from BOI and on which the tax has already been paid by such BOI.

- (vi) *Local Authority:* The term means a municipal committee, district board, body of port commissioners or other authority legally entitled to or entrusted by the Government with the control or management of a municipal or local fund.



*Notes* A local authority is taxable in respect of that part of its income which arises from any business carried on by it in so far as that income does not arise from the supply of a commodity or service within its own jurisdictional area. However, income arising from the supply of water and electricity even outside the local authority's own jurisdictional areas is exempt from tax.

- (vii) *Artificial Persons:* This category could cover every artificial juridical person not falling under other heads. An idol or deity would be assessable in the status of an artificial juridical person.
- (3) **Income [Section 2(24)]:** Section 2(24) of the Act gives a statutory definition of income. This definition is inclusive and not exhaustive. Thus, it gives scope to include more items in the definition of income as circumstances may warrant. At present, the following items of receipts are included in income:
- ❖ Profits and gains.
  - ❖ Dividends.
  - ❖ Voluntary contributions received by a trust/institution created wholly or partly for charitable or religious purposes or by an association or institution referred to in section 10(21) or section (23C)(iii ad)/(iii ae)/(iv)/(v)/(vi)/(via) or an electoral trust -

<b>Research association approved under section 35(1)(ii)</b>	<b>10(21)</b>
<b>Universities and other educational institutions</b>	<b>10(23C)(iiiad) and (vi)</b>
<b>Hospitals and other medical institutions</b>	<b>10(23C) (iii ae) and (via)</b>
<b>Notified funds or institutions established for charitable purposes</b>	<b>10(23C)(iv)</b>
<b>Notified trusts or institutions established wholly for public religious purposes or wholly for public religious and charitable purposes</b>	<b>10(23C)(v)</b>
<b>Electoral trust</b>	<b>13B</b>

Source: [http://220.227.161.86/18878sm\\_dtl\\_finalnew\\_cp1.pdf](http://220.227.161.86/18878sm_dtl_finalnew_cp1.pdf)

- ❖ The value of any perquisite or profit in lieu of salary taxable under section 17.
- ❖ Any special allowance or benefit other than the perquisite included above, specifically granted to the assessee to meet expenses wholly, necessarily and exclusively for the performance of the duties of an office or employment of profit.
- ❖ Any allowance granted to the assessee to meet his personal expenses at the place where the duties of his office or employment of profit are ordinarily performed by him or at a place where he ordinarily resides or to compensate him for the increased cost of living.



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- ❖ The value of any benefit or perquisite whether convertible into money or not, obtained from a company either by a director or by a person who has a substantial interest in the company or by a relative of the director or such person and any sum paid by any such company in respect of any obligation which, but for such payment would have been payable by the director or other person aforesaid.
- ❖ The value of any benefit or perquisite, whether convertible into money or not, which is obtained by any representative assessee mentioned under section 160(1)(iii) and (iv), or by any beneficiary or any amount paid by the representative assessee for the benefit of the beneficiary which the beneficiary would have ordinarily been required to pay.
- ❖ Deemed profits chargeable to tax under section 41 or section 59.
- ❖ Profits and gains of business or profession chargeable to tax under section 28.
- ❖ Any capital gains chargeable under section 45.
- ❖ The profits and gains of any insurance business carried on by Mutual Insurance Company or by a co-operative society, computed in accordance with Section 44 or any surplus taken to be such profits and gains by virtue of the provisions contained in the First Schedule to the Act.
- ❖ The profits and gains of any business of banking (including providing credit facilities) carried on by a co-operative society with its members.
- ❖ Any winnings from lotteries, cross-word puzzles, races including horse races, card games and other games of any sort or from gambling, or betting of any form or nature whatsoever. For this purpose,
  - ◆ “Lottery” includes winnings, from prizes awarded to any person by draw of lots or by chance or in any other manner whatsoever, under any scheme or arrangement by whatever name called;
  - ◆ “Card game and other game of any sort” includes any game show, an entertainment programme on television or electronic mode; in which people compete to win prizes or any other similar game.
- ❖ Any sum received by the assessee from his employees as contributions to any Provident Fund (PF) or superannuation fund or Employees State Insurance Fund (ESI) or any other fund for the welfare of such employees.
- ❖ Any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy will constitute income.



*Did u know?* “Keyman insurance policy” refers to a life insurance policy taken by a person on the life of another person where the latter is or was an employee or is or was connected in any manner whatsoever with the former’s business.

- ❖ Any sum referred to clause (va) of Section 28. Thus, any sum, whether received or receivable in cash or kind, under an agreement for not carrying out any activity in relation to any business; or not sharing any know-how, patent, copy right, trademark, licence, franchise, or any other business or commercial right of a similar nature, or information or technique likely to assist in the manufacture or processing of goods or provision of services, shall be chargeable to income tax under the head “profits and gains of business or profession”.
- ❖ Any sum of money or value of property referred to in section 56(2)(vii) or section 56(2)(viii).

Notes

- ❖ Any consideration received for issue of shares as exceeds the fair market value of shares referred to in section 56(2)(viib).
- (4) **Dividend [Section 2(22)]:** The term 'dividend' as used in the Act has a wider scope and meaning than under the general law. According to section 2(22) of the Act, the following receipts are deemed to be dividend:
  - (a) *Distribution of accumulated profits, entailing the release of company's assets:* Any distribution of accumulated profits, whether capitalised or not, by a company to its shareholders is dividend if it entails the release of all or any part of its assets. For example, if accumulated profits are distributed in cash it is dividend in the hands of the shareholders. Where accumulated profits are distributed in kind, for example by delivery of shares etc. entailing the release of company's assets, the market value of such shares on the date of such distribution is deemed dividend in the hands of the shareholder [section 2(22)(a)].
  - (b) *Distribution of debentures, deposit certificates and bonus shares to preference shareholders:* Any distribution to its shareholders by a company of debenture stock or deposit certificate in any form, whether with or without interest, and any distribution of bonus shares to preference shareholders to the extent to which the company possesses accumulated profits, whether capitalised or not, will be deemed as dividend. The market value of such bonus shares is taxable in the hands of the preference shareholder. In the case of debentures, debenture stock etc., their value is to be taken at the market rate and if there is no market rate they should be valued according to accepted principles of valuation [section 2(22)(b)].



**Caution** Bonus shares given to equity shareholders are not treated as dividend.

- (c) *Distribution on liquidation:* Any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not, is deemed to be dividend income [section 2(22)(c)].



**Notes** Any distribution made out of the profits of the company after the date of the liquidation cannot amount to dividend. It is a repayment towards capital

Accumulated profits include all profits of the company up to the date of liquidation whether capitalised or not. But where liquidation is consequent to the compulsory acquisition of an undertaking by the Government or by any corporation owned or controlled by the Government, the accumulated profits do not include any profits of the company prior to the 3 successive previous years immediately preceding the previous year in which such acquisition took place subject to certain exceptions.



**Caution** The dividend does not include a distribution made in accordance with sub-clause (c) in respect of any share issued for full cash consideration, where the holder of the share is not entitled in the event of liquidation to participate in the surplus assets.

- (d) *Distribution on reduction of capital:* Any distribution to its shareholders by a company on the reduction of its capital to the extent to which the company possessed accumulated profits, whether capitalised or not, shall be deemed to be dividend [section 2(22)(d)].

- (e) *Advance or loan by a closely held company to its shareholder:* Any payment by a company in which the public are not substantially interested of any sum by way of advance or loan to any shareholder who is the beneficial owner of 10% or more of the equity capital of the company will be deemed to be dividend to the extent of the accumulated profits. If the loan is not covered by the accumulated profits, it is not deemed to be dividend [section 2(22)(e)].

Notes



*Notes* There are two exceptions to this rule:

1. If the loan is granted in the ordinary course of its business and lending of money is a substantial part of the company's business, the loan or advance to a shareholder is not deemed to be dividend.
2. Where a loan had been treated as dividend and subsequently the company declares and distributes dividend to all its shareholders including the borrowing shareholder, and the dividend so paid is set off by the company against the previous borrowing, the adjusted amount will not again be treated as a dividend.

- (5) **India [Section 2(25A)]:** The term 'India' means:

- (i) the territory of India as per article 1 of the Constitution,
- (ii) its territorial waters, seabed and subsoil underlying such waters,
- (iii) continental shelf,
- (iv) exclusive economic zone, or
- (v) any other specified maritime zone and the air space above its territory and territorial waters.

Specified maritime zone means the maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and the Maritime Zones Act, 1976.

- (6) **Assessment Year:** The term has been defined under section 2(9). This means a period of 12 months commencing on 1st April every year. The year in which tax is paid is called the assessment year while the year in respect of the income of which the tax is levied is called the previous year. Income of previous year of an assessee is taxed during the next following assessment year at the rates prescribed by the relevant Finance Act



*Example:* For the assessment year 2013-14, the relevant previous year is 2012-13 (1.4.2012 to 31.3.2013).

- (7) **Previous Year [Section 3]:** It means the financial year immediately preceding the assessment year. The income earned during the previous year is taxed in the assessment year.

**Business or profession newly set up during the financial year:** In such a case, the previous year shall be the period beginning on the date of setting up of the business or profession and ending with 31st March of the said financial year.

If a source of income comes into existence in the said financial year, then the previous year will commence from the date on which the source of income newly comes into existence and will end with 31st March of the financial year.



*Example:* For the assessment year 2011-12, the immediately preceding financial year (i.e., 2010-11) is the previous year.

**Notes**

Income earned by an individual during the previous year 2010-11 is taxable in the immediately following assessment year 2011-12 at the rates applicable for the assessment year 2011-12.

Similarly, income earned during the previous year 2011-12 by a company will be taxable in the assessment year 2012-13 at the rates applicable for the assessment year 2012-13.



*Task* A Chartered Accountant sets up his practice on 1st July, 2012. Determine the previous year for the assessment year 2013-14.

- (8) **Gross Total Income:** 'Gross Total Income' may be defined as the aggregate of income computed in accordance with the provisions of this act before making any deduction under Chapter-VI A of Income Tax Act, 1961.
- (9) **Total Income:** Any assessee has to pay income tax on different types of income derived on the basis of residential status. As per section 45 of Income Tax Act, 1961 'Total Income' means, income shown in Section 5 of Income Tax Act, 1961:
  - (a) Salary Income,
  - (b) Income from House property,
  - (c) Income from Business and Profession,
  - (d) Capital gains, and
  - (e) Income from other sources.

These five are also called as 'Heads of Income'. The income is determined under different sections. But some of the incomes which are exempted are not included in Total Income.

### Self Assessment

State whether the following statements are true or false:

- 10. AOP denotes the status of persons like executors or trustees who merely receive the income jointly.
- 11. Accumulated profits include all profits of the company up to the date of liquidation whether capitalised or not.
- 12. Previous Year is the financial year immediately proceeding the assessment year.

### 1.5 Agricultural Income

Agricultural income is defined in section 2(1A) to mean, *inter alia*, income derived from land which is situated in India and is used for agricultural purposes. Also the income from a farm house, except the income from non-agricultural activity, is agricultural income. Such agricultural income is exempt from tax under section 10(1). From the assessment year 2009-10, any income derived from saplings or seedlings grown in a nursery is agricultural income.

Agriculture income does not include fisheries and mines. Also on an agricultural land, the income from poultry farming, dairy farming and aquaculture are not agricultural income. According to Section 10 (1) of Income Tax Act, 1961, 'Agricultural Income' is exempted from tax. However, income from agricultural sources will be included in 'total income', to determine tax-liability. It is to remember that 'Agricultural-Income' comes under purview of respective state governments.

Section 2 (1) states that the following conditions are to be satisfied to that 'income' as 'agricultural income':

- 1. Income should be received from land.

2. That 'Land' should be used for agricultural purpose.
3. The said 'land' should be existing in India.
1. **Income should be received from land:** Income received in the form of cash or agricultural produce from the lease holder to the land lord is treated as 'agricultural income'. If the leaseholder gives the land to sub-lease, such income is also treated as 'agricultural income'. Income received in the form of rent or income received by the sale of agricultural products is also treated as 'agricultural income'.



*Example:* 10 bags of paddy sold @ ₹ 500/- per bag.

Hence, 'Income' received is treated as agricultural income. Income, which has indirect source of land, is not treated as 'agricultural income'.



*Example:* Dividend received by the shareholder of the agro-based company.

2. **Land should be used for agricultural purpose:** Agricultural works can be categorised in to two types:
  - (a) Primary works or elementary works
  - (b) Ancillary works
3. **Land must be situated in India:** Income received from agricultural land situated in countries other than India, can not be treated as agricultural income.



#### Notes

The following incomes **CANNOT** be treated as 'Agricultural Income':

1. Income received from sale of 'Bricks'.
2. Income from sale of pots.
3. Income received from sea-food like fish etc.
4. Income earned from boat or ship transportation.
5. Income earned from supply of water into agricultural land.
6. Income received from excavation or depletion of rocks.
7. Income received from godown or warehouse to store agricultural output.
8. Income earned by way of selling agricultural land or compensation received from government for acquiring such land.
9. Royalty received from mines.
10. Income earned from poultry and dairy forms.
11. Interest or principal amount received on loan given for agriculture.
12. Commission on sales made by lease-holder which is collected by landlord.
13. Rent received on land for marketing the agricultural products.
14. Annual income earned on transfer of agricultural property to another person.

Notes

### 1.5.1 Certain income which is treated as Agricultural Income

Following are the certain incomes which are treated as agricultural income:

- (a) Income from sale of replanted trees.
- (b) Rent received for agricultural land.
- (c) Income from growing flowers and creepers.
- (d) Share of profit of a partner from a firm engaged in agricultural operations.
- (e) Interest on capital received by a partner from a firm engaged in agricultural operations.
- (f) Income derived from sale of seeds.

### 1.5.2 Certain income which is not treated as Agricultural Income

Following are the certain incomes which are not treated as agricultural income:

- (a) Income from poultry farming.
- (b) Income from bee hiving.
- (c) Income from sale of spontaneously grown trees.
- (d) Income from dairy farming.
- (e) Purchase of standing crop.
- (f) Dividend paid by a company out of its agriculture income.
- (g) Income of salt produced by flooding the land with sea water.
- (h) Royalty income from mines.
- (i) Income from butter and cheese making.
- (j) Receipts from TV serial shooting in farm house are not agriculture income.



*Did u know?* If a person just sells processed produce without actually carrying out any agricultural or processing operations, the income would not be regarded as agricultural income. Likewise, in cases where the produce is subjected to substantial processing that changes the very character of the product (for instance, canning of fruits), the entire operations cannot be regarded as agricultural operations. The profit from the sale of such processed products would have to be apportioned between agricultural income and business considered agricultural income since there is no active involvement in operations like cultivation and soil treatment.

## 1.6 Income Tax Systems in India

The Indian Income Tax department is governed by the Central Board for Direct Taxes (CBDT) and is part of the Department of Revenue under the Ministry of Finance.

The government of India imposes an income tax on taxable income of individuals, Hindu Undivided Families (HUFs), companies, firms, cooperatives societies and trusts (Identified as body of Individuals and Association of Persons) and any other artificial person. Levy of tax is separate on each of the persons. The levy is governed by the Indian Income Tax Act, 1961.

1. **Charge to Income tax:** Income tax is a tax payable, at the rate enacted by the Union Budget (Finance Act) for every Assessment Year, on the Total Income earned in the Previous Year by every Person. The chargeability is based on the nature of income, i.e., whether it is revenue or capital.

Section 4 of the Income tax Act, 1961 is the charging section which provides that:

- (i) tax shall be charged at the rates prescribed for the year by the annual Finance Act;
- (ii) the charge is on every person specified under section 2(31);
- (iii) tax is chargeable on the total income earned during the previous year and not the assessment year. (There are certain exceptions provided by sections 172, 174, 174A, 175 and 176);
- (iv) tax shall be levied in accordance with and subject to the various provisions contained in the Act.

This section is the back bone of the law of income tax in so far as it serves as the most operative provision of the Act. The tax liability of a person springs from this section.

2. **Rates of Tax:** Income tax is to be charged at the rates fixed for the year by the annual Finance Act. Section 2 of the Finance Act, 2012 read with Part I of the First Schedule to the Finance Act, 2012 specifies the rates at which income tax is to be levied on income chargeable to tax for the A.Y. 2012-13. Part II lays down the rate at which tax is to be deducted at source during the financial year 2012-13 i.e. A.Y. 2013-14 from income subject to such deduction under the Act; Part III lays down the rates for charging income tax in certain cases, rates for deducting income tax from income chargeable under the head "salaries" and the rates for computing advance tax for the financial year 2012-13 i.e. A.Y.2013-14. Part III of the First Schedule to the Finance Act, 2012 will become Part I of the First Schedule to the Finance Act, 2013 and so on.

The slab rates applicable for A.Y.2013-14 are as follows:

- (i) Individual/Hindu Undivided Family (HUF)/ Association of Persons (AOP)/Body of Individuals (BOI)/ Artificial Juridical Person.

Where the total income does not exceed ₹ 2,00,000	NIL
Where the total income exceeds ₹ 2,00,000 but does not exceed ₹ 5,00,000	10% of the amount by which the total income exceeds ₹ 2,00,000
Where the total income exceeds ₹ 5,00,000 but does not exceed ₹ 10,00,000	₹ 30,000 plus 20% of the amount by which the total income exceeds ₹ 5,00,000
Where the total income exceeds ₹ 10,00,000	₹ 1,30,000 plus 30% of the amount by which the total income exceeds ₹ 10,00,000

Source: [http://220.227.161.86/18878sm\\_dtl\\_finalnew\\_cp1.pdf](http://220.227.161.86/18878sm_dtl_finalnew_cp1.pdf)



*Example:* Mr. X has a total income of ₹ 12,00,000. Compute his gross tax liability.

<b>Tax liability</b>	= ₹ 1,30,000 + 30% of ₹ 2,00,000 = ₹ 1,90,000
<b>Alternatively:</b>	
<b>Tax liability:</b>	
First ₹ 2,00,000	- Nil
Next ₹ 2,00,000 – ₹ 5,00,000	- @ 10% of ₹ 3,00,000 = ₹ 30,000
Next ₹ 5,00,000 – ₹ 10,00,000	- @ 20% of ₹ 5,00,000 = ₹ 1,00,000
Balance i.e. ₹ 12,00,000 – ₹ 10,00,000	- @ 30% of ₹ 2,00,000 = ₹ 60,000
	<b>Total tax = ₹ 1,90,000</b>

**Notes**

It is to be noted that for a senior citizen (being a resident individual who is of the age of 60 years but not more than 80 years at any time during the previous year), the basic exemption limit is ₹ 2,50,000. Further, resident individuals of the age of 80 years or more at any time during the previous year, being very senior citizens, would be eligible for a higher basic exemption limit of ₹ 5,00,000.

Therefore, the tax slabs for these assesseees would be as follows –

(a) For senior citizens (being resident individuals of the age of 60 years up to 80 years)

Where the total income does not exceed ₹ 2,50,000	NIL
Where the total income exceeds ₹ 2,50,000 but does not exceed ₹ 5,00,000	10% of the amount by which the total income exceeds ₹ 2,50,000
Where the total income exceeds ₹ 5,00,000 but does not exceed ₹ 10,00,000	₹ 25,000 plus 20% of the amount by which the total income exceeds ₹ 10,00,000
Where the total income exceeds ₹ 10,00,000	₹ 1,25,000 plus 30% of the amount by which the total income exceeds ₹ 10,00,000

Source: [http://220.227.161.86/18878sm\\_dtl\\_finalnew\\_cp1.pdf](http://220.227.161.86/18878sm_dtl_finalnew_cp1.pdf)

(b) For resident individuals of the age of 80 years or more at any time during the previous year

Where the total income does not exceeds ₹ 5,00,000	NIL
Where the total income exceeds ₹ 5,00,000 but does not exceed ₹ 10,00,000	20% of the amount by which the total income exceeds ₹ 5,00,000
Where the total income exceeds ₹ 10,00,000	₹ 1,00,000 plus 30% of the amount by which the total income exceeds ₹ 10,00,000

Source: [http://220.227.161.86/18878sm\\_dtl\\_finalnew\\_cp1.pdf](http://220.227.161.86/18878sm_dtl_finalnew_cp1.pdf)

(ii) Firm/LLP

On the whole of the total income	30%
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Source: [http://220.227.161.86/18878sm\\_dtl\\_finalnew\\_cp1.pdf](http://220.227.161.86/18878sm_dtl_finalnew_cp1.pdf)

(iii) Local authority

On the whole of the total income	30%
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Source: [http://220.227.161.86/18878sm\\_dtl\\_finalnew\\_cp1.pdf](http://220.227.161.86/18878sm_dtl_finalnew_cp1.pdf)

(iv) Co-operative Society

Where the total income does not exceeds ₹ 10,000	10% of the total income
Where the total income exceeds ₹ 10,000 but does not exceed ₹ 20,000	₹ 1,000 plus 20% of the amount by which the total income exceeds ₹ 10,000
Where the total income exceeds ₹ 20,000	₹ 3,000 plus 30% of the amount by which the total income exceeds ₹ 20,000

Source: [http://220.227.161.86/18878sm\\_dtl\\_finalnew\\_cp1.pdf](http://220.227.161.86/18878sm_dtl_finalnew_cp1.pdf)

(v) Company

In case of a Domestic Company	30% of the total income
In case of a company other than a domestic company	However, specified royalties and fees for rendering technical services (FTS) received from Government or an Indian concern in pursuance of an approved agreement made by the company with the Government or Indian concern between 1.4.1961 and 31.3.1976 (in case of royalties) and between 1.3.1964 and 31.3.1976 (in case of FTS) would be chargeable to tax @ 50%.

Source: [http://220.227.161.86/18878sm\\_dtl\\_finalnew\\_cp1.pdf](http://220.227.161.86/18878sm_dtl_finalnew_cp1.pdf)



The above rates are prescribed by the annual Finance Acts. However, in respect of certain types of income, as mentioned below, the Income tax Act has prescribed specific rates –

- (1) Section 112 has prescribed the rate of tax @20% in respect of long term capital gains. In case of non-corporate non-residents and foreign companies, long-term capital gains arising from transfer of unlisted securities would be subject to tax@10% without giving effect to indexation provision and currency.
- (2) Section 111A provides for a concessional rate of tax (i.e. 15%) on the short-term capital gains on transfer of -
  - (i) an equity share in a company or
  - (ii) a unit of an equity oriented fund.
 The conditions for availing the benefit of this concessional rate are –
  - (i) the transaction of sale of such equity share or unit should be entered into on or after 1. 10.2004; and
  - (ii) such transaction should be chargeable to securities transaction tax.
- (3) Section 115BB prescribes the rate of tax @30% for winnings from-
  - (i) any lottery; or
  - (ii) crossword puzzle; or
  - (iii) race including horse race; or
  - (iv) card game and other game of any sort; or
  - (v) gambling or betting of any form.

### 3. Surcharge:

- (i) In the case of domestic companies, the rate of surcharge is 5%, where the total income exceeds ₹ 1 crore.
- (ii) In the case of foreign companies, the rate of surcharge is 2%, where the total income exceeds ₹ 1 crore.
- (iii) No surcharge is leviable for assesseees, other than companies.

4. **Marginal Relief:** The concept of marginal relief is applicable only in the case of companies' w.e.f. A.Y.2010-11. Marginal relief is available in case of companies having a total income exceeding ₹ 1 crore i.e. the additional amount of income tax payable (together with surcharge) on the excess of income over ₹ 1 crore should not be more than the amount of income exceeding ₹ 1 crore.

5. **"Education cess" and "Secondary and Higher education cess" on income tax:** The amount of income tax as increased by the union surcharge, if applicable, should be further increased by an additional surcharge called the "Education cess on income tax", calculated at the rate of 2% of such income tax and surcharge, if applicable. Education cess is leviable in the case of all assesseees i.e. individuals, HUF, AOP / BOI, firms, local authorities, cooperative societies and companies. Further, "Secondary and higher education cess on income tax" @1% of income tax plus surcharge, if applicable, is leviable to fulfil the commitment of the Government to provide and finance secondary and higher education.



**Task** Compute the tax liability of X Ltd., a domestic company, assuming that the total income of X Ltd. is ₹ 1,01,00,000 and the total income does not include any income in the nature of capital gain.

## Notes

## Self Assessment

Fill in the blanks:

13. The chargeability is based on the nature of .....that is whether it is revenue or capital.
14. For a senior citizen being a resident individual who is of the age of 60 years but not more than 80 years at any time during the previous year, the basic exemption limit is.....
15. In the case of ..... companies, the rate of surcharge is 2%, where the total income exceeds ₹ 1 crore.



Case Study

### Vodafone Tax case - A Case Study for Investments in India

India Inc has been surging ahead audaciously with the support of its Information Technology developments with its repertoire of resources. Global players have been eyeing the Indian market, owing to immense opportunities that the continent provides; both in terms of expansion and profit. Investment patterns in India have shown positive growth over the years with significant process on the de-regulation front. India has been greatly involved with the G-8 and G-20, including signing of the Double Taxations Avoidance Agreements/Treaties (DTAA) with various tax-haven countries. This has boosted the image of India as a 'lookout destination' for investment and an emerging hub for economical activities. World Report 2010 ranked India as the 9th most attractive investment destination, while Bloomberg Global Poll conducted in September 2010 put India in the third position, above the United States of America (US).

However, the very same image is said to have taken a beating with the recent Vodafone Tax case, which has been revolving in courts since 2009. With clear signs of the court ruling in favour of the tax authorities, many global companies are said to be rethinking their investment plans in India, keeping in mind the impact of the judgment on the taxation front. The Doing Business Report 2011 of World Bank has ranked India at 134, below neighbouring countries like Pakistan and Bhutan. This is a result of procedural difficulties for start-up companies and investment companies, in India and abroad.

Tax regulations play a major role in cross border transactions and investments in a country. Tax havens, open borders and DTAA countries are major destinations for investment through Foreign Direct Investment (FDI) or other routes. The Vodafone tax case throws an interesting question on the taxability of a non resident company acquiring shares of a resident company through an indirect route. This is a landmark case, as it is for the first time that the tax departments have sought to tax a company through a mechanism of tracing the source of acquisition. While we have heard about lifting the 'corporate veil', this instance has set a rare example wherein the Indian tax authorities have gone to length to interpret the existing tax laws, to bring a global company like Vodafone to its tax ambit.

Vodafone International Holdings BV, based in Netherlands and controlled by Vodafone UK, obtained the controlling interest and share of CGP Investments Holdings Ltd (CGP) located in Cayman Island for a value of US \$ 11.01 billion from Hutchinson Telecommunications International Ltd. (HTIL), which had stake in Hutchinson Essar Ltd (HEL) that handled the company's mobile operations in India. HEL had its stake in CGP Holdings, from which Vodafone bought 52 per cent of HEL's stake in 2007, thereby vesting controlling interest over them. The Bombay High Court, on September 8, ruled that where the underlying

Contd...

assets of the transaction between two or more offshore entities lies in India, it is subject to capital gains tax under relevant income tax laws in India. The Court invoked the nexus rule wherein a state can tax by connecting a person sought to be taxed with the jurisdiction, which seeks to tax. The treatment of the company as an Assessee in Default (AID) under Section 201(1) of the Income Tax Act and reading Sections 5(2), 9(1) and 195, the court came to the conclusion that Vodafone was liable to deduct tax at source (TDS). Vodafone has now appealed before the Supreme Court to revisit the judgment, which makes them liable for a record amount of ₹ 12,000 crores going to the tax authorities' kitty.

Vodafone raises pertinent questions on the issue of taxation of non-resident entities. The judgment will have direct impact on transactions of major acquisitions like SABMiller-Foster and Sanofi Aventis-Shanta Biotech. Similar transactions that existed earlier are Sesa Goa, AT&T and General Electric. British firm Cairn Energy has already agreed to pay tax in India as well as the UK on selling its stake in Cairn India to Vedanta Resources from \$6.65 billion to \$8.48 billion. Depending upon the size of the stake sale, the tax liability could range between \$868 million and \$1.1 billion. The judgment would definitely throw a cautious note to major investors and M&As in India; however, it does not have that great an impact to curtail the investment flow to an emerging destination like India. The judicial propriety of the case is still to be settled when the matter comes for final stages in the Supreme Court. Going by the events in the lower courts, the Supreme Court is unlikely to disturb the Bombay High Court ruling.

The global community is keenly watching the current trends happening in the Indian subcontinent, especially since it has become an emerging player at the socio-economic and political levels. United Nations Conference on Trade and Development (UNCTAD) has reported that India is set to dislodge the US by December 2012 to become the second best destination for FDIs, the major component of which is M&As. India is also set to revamp its taxations norms with significant changes at the regulatory level. The proposed Direct Tax Code contains key provisions, which will have a major impact on investments in India. India has improved its rankings in the WB 'Doing Business' Report on the number of regulatory changes taken in the existing year. This shows that the country is set to make a global footprint by branding itself as a 'Must Invest' destination.

The Vodafone tax case has given India the opportunity to create a model for other countries, which follow source-based taxation principles. It is an opportune time to bask in the glory of India, which is said to have had one third share of the world market in ancient times, as pointed out by economist Amartya Sen in his book *The Argumentative Indian*. Let's hope that we can revive the 'Real India' soon.

#### Questions:

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: [http://www.mindtext.org/view/89/Vodafone\\_Tax\\_case\\_\\_A\\_Case\\_Study\\_for\\_Investments\\_in\\_India/](http://www.mindtext.org/view/89/Vodafone_Tax_case__A_Case_Study_for_Investments_in_India/)

## 1.7 Summary

- Every country generates income from 'Income Tax' in the form of direct tax levied by government. Income tax plays a vital role in the economy of every country in the world. Income tax act was enacted in the year 1961.
- Income, in general, means a periodic monetary return which accrues or is expected to accrue regularly from definite sources.

Notes

- The “tax net” refers to the types of payment that are taxed, which included personal earnings (wages), capital gains, and business income. The rates for different types of income may vary and some may not be taxed at all.
- Tax rates may be progressive, regressive, or flat. A progressive tax taxes differentially based on how much has been earned.
- A tax system may use different taxation methods for different types of income.
- The Indian Income Tax department is governed by the Central Board for Direct Taxes (CBDT) and is part of the Department of Revenue under the Ministry of Finance.
- The Government of India imposes an income tax on taxable income of individuals, Hindu Undivided Families (HUFs), companies, firms, co-operative societies and trusts (Identified as body of Individuals and Association of Persons) and any other artificial person. Levy of tax is separate on each of the persons.
- Income tax is to be charged at the rates fixed for the year by the annual Finance Act.
- Income from agricultural sources will be included in ‘total income’, to determine tax-liability.
- The levy is governed by the Indian Income Tax Act, 1961.

### 1.8 Keywords

**Assessee:** He/She is a person by whom any tax or any other sources of money is payable.

**Body of Individuals (BOI):** It denotes the status of persons like executors or trustees who merely receive the income jointly and who may be assessable in like manner and to the same extent as the beneficiaries individually.

**Company:** A voluntary association formed and organised to carry on a business.

**Direct Tax:** A tax that is paid directly by an individual or organisation to the imposing entity

**Dividend:** Dividends are payments made by a corporation to its shareholder members. It is the portion of corporate profits paid out to stockholders.

**Flat Tax:** A flat tax (short for flat tax rate) is a tax system with a constant marginal rate, usually applied to individual or corporate income.

**Gross Total Income:** It is an individual’s total personal income before taking taxes or deductions into account.

**Income Tax:** An income tax is a tax levied on the income of individuals or businesses (corporations or other legal entities).

**Income:** Income is the consumption and savings opportunity gained by an entity within a specified timeframe that is generally expressed in monetary terms.

**Indirect Tax:** Indirect taxes are those paid by consumers when they buy goods and services.

**Progressive Tax:** A progressive tax is a tax in which the tax rate increases as the taxable base amount increases.

**Regressive Tax:** A regressive tax is a tax imposed in such a manner that the tax rate decreases as the amount subject to taxation increases.

**Surcharge:** A surcharge is an extra charge added to the price of something, or a standalone charge that exists for using something.

**Tax Net:** It refers to the types of payment that are taxed and include personal earnings (wages), capital gains, and business income.

## 1.9 Review Questions

Notes

1. Discuss the historical background of Income tax. What is its importance?
2. What is net tax?
3. What are the components of Income Tax Law?
4. Write brief notes on the following:
  - (a) Assessment Year
  - (b) Income
  - (c) Gross Total Income
  - (d) Previous Year
  - (e) Assessee
5. "Every financial year is an assessment year." Comment.
6. "Income of a previous year is chargeable tax in the immediately following assessment year." Discuss.
7. X starts his business on April 26, 2010. Determine the previous year to the assessment year 2011-12.
8. Mr. Sharma has a total income of ₹ 20,10,000. Compute his gross tax liability.
9. Discuss the Income Tax System in India.
10. What is agricultural income? Which incomes CANNOT be treated as Agricultural Income?

### Answers: Self Assessment

- |   |                         |
|---|-------------------------|
| 1. True                                 | 2. False                |
| 3. True                                 | 4. True                 |
| 5. False                                | 6. False                |
| 7. Central Board of Direct Taxes (CBDT) | 8. Officers/ Assesseees |
| 9. Income tax Act, 1961                 | 10. False               |
| 11. True                                | 12. True                |
| 13. Income                              | 14. ₹ 2,50,000          |
| 15. Foreign                             |                         |

## 1.10 Further Readings



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<http://www.tax4india.com/>

## Unit 2: Residential Status and Taxation

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### Objectives

After studying this unit, you will be able to:

- State the meaning and scope of residential status of an individual
- Discuss the provisions of analysing the residential status of an individual
- Describe the residential status of a company and other legal entities existing in India
- Explain incidence of tax and its importance
- Elucidate the concept of deemed receipt and accrual of income in India
- Trace the categories of income which are deemed to accrue or arise in India in detail

### Introduction

Tax incidence on an assessee depends on his residential status. For instance, whether an income, accrued to an individual outside India, is taxable in India depends upon the residential status of the individual in India. Likewise, whether an income earned by a foreign national in India or outside India taxable in India depends on the residential status of the individual, rather than on his citizenship. Therefore, the determination of the residential status of a person is very significant in order to find out his tax liability.

The inclusion of a particular income in the Total Income of a person for income-tax in India is based on his residential status. There are three residential statuses that we will study in detail this unit namely the Residents also referred to as Resident & Ordinarily Residents, the Resident but Not Ordinarily Residents and the Non-residents. There are several steps involved in determining

Notes

the residential status of person. All residents are taxable for all their income, including income outside India. Non residents are taxable only for the income received in India or Income accrued in India. Not Ordinarily Residents are taxable in relation to income received in India or income accrued in India and income from business or profession controlled from India.

## **2.1 Residential Status (Section 6)**

The incidence of tax on any assessee depends upon his residential status under the Act. Therefore, after determining whether a particular amount is capital or revenue in nature, if the receipt is of a revenue nature and chargeable to tax, it has to be seen whether the assessee is liable to tax in respect of that income. The taxability of a particular receipt would thus depend upon not only the nature of the income and the place of its accrual or receipt but also upon the assessee's residential status.

The following norms one has to keep in mind while deciding the residential status of an assessee:

1. ***Different taxable entities:*** All taxable entities are divided in the following categories for the purpose of determining residential status:
  - (a) An individual;
  - (b) A Hindu undivided family;
  - (c) A firm or an association of persons;
  - (d) A joint stock company; and
  - (e) Every other person.
2. ***Different residential status:*** An assessee is either: (a) resident in India, or (b) non-resident in India.

However, a resident individual or a Hindu undivided family has to be (a) resident and ordinarily resident, or (b) resident but not ordinarily resident.

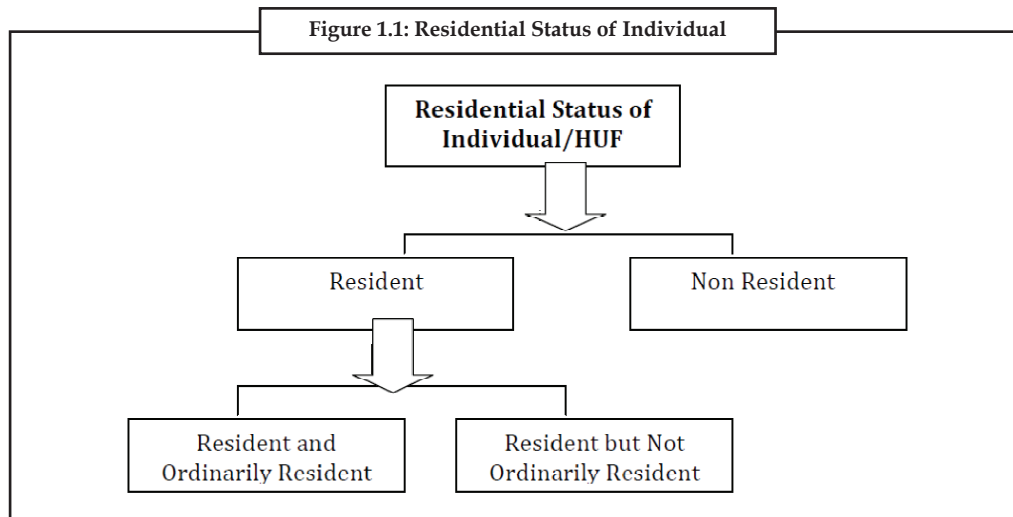
All other assessee who includes a firm, an association of persons, a joint stock company and every other person) can either be:

  - (a) Resident in India; or
  - (b) Non-resident in India.
3. ***Residential status for each previous year:*** Residential status of an assessee is to be determined in respect of each previous year as it may vary from previous year to previous year.
4. ***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).
5. ***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 two (or more) countries at the same time. It is, therefore, not necessary that a person who is resident in India will be non-resident in all other countries for the same assessment year.



Therefore you can say that for all purposes of income-tax, taxpayers are classified into three broad categories on the basis of their residential status as stated below and as reflected in Figure 2.1 below:

1. Resident and ordinarily resident,
2. Resident but not ordinarily resident, and
3. Non-resident.



**Source:** [http://www.mu.ac.in/myweb\\_test/TYBCOM%20study%20material/T.Y.B.Com.Paper%20-%20V%20-%20Sec.I%20-%20Direct%20Taxes.pdf](http://www.mu.ac.in/myweb_test/TYBCOM%20study%20material/T.Y.B.Com.Paper%20-%20V%20-%20Sec.I%20-%20Direct%20Taxes.pdf)

The residential status of an assessee must be ascertained with reference to each previous year. A person who is resident and ordinarily resident in one year may become non-resident or resident but not ordinarily resident in another year or *vice versa*. The provisions for determining the residential status of assessee are:

### Residential status of Individuals

Under section 6(1), an individual is said to be resident in India in any previous year, if he satisfies any one of the following conditions:

- (a) He has been in India during the previous year for a total period of 182 days or more, or
- (b) He has been in India during the 4 years immediately preceding the previous year for a total period of 365 days or more and has been in India for at least 60 days in the previous year.

If the individual satisfies any one of the conditions mentioned above, he is a resident. If both the above conditions are not satisfied, the individual is a non-resident also referred to as NRI.



*Example:* X left India for the first time on May 20, 2003. During the financial year 2005-06, he came to India once on May 27 for a period of 53 days. Determine his residential status for the assessment year 2006-07. Since X comes to India only for 53 days in the previous year 2005-06, he does not satisfy any of the basic conditions laid down in section 6(1). He is, therefore, non-resident in India for the assessment year 2006-07.

Notes



Notes

- (a) The term “stay in India” includes stay in the territorial waters of India (i.e. 12 nautical miles into the sea from the Indian coastline). Even the stay in a ship or boat moored in the territorial waters of India would be sufficient to make the individual resident in India.
- (b) It is not necessary that the period of stay must be continuous or active nor is it essential that the stay should be at the usual place of residence, business or employment of the individual.
- (c) For the purpose of counting the number of days stayed in India, both the date of departure as well as the date of arrival are considered to be in India.
- (d) The residence of an individual for income-tax purpose has nothing to do with citizenship, place of birth or domicile. An individual can, therefore, be resident in more countries than one even though he can have only one domicile.

**Exceptions**

The following categories of individuals will be treated as residents only if the period of their stay during the relevant previous year amounts to 182 days. In other words even if such persons were in India for 365 days during the 4 preceding years and 60 days in the relevant previous year, they will not be treated as resident.

- 1. Indian citizens, who leave India in any previous year as a member of the crew of an Indian ship or for purposes of employment outside India, or
- 2. Indian citizen or person of Indian origin\* engaged outside India in an employment or a business or profession or in any other vocation, who comes on a visit to India in any previous year



**Caution** A person is said to be of Indian origin if he or either of his parents or either of his grandparents were born in undivided India.

**Not-ordinarily Resident**

Only individuals and HUF can be resident but not ordinarily resident in India. All other classes of assesses can be either a resident or non-resident. A not-ordinarily resident person is one who satisfies any one of the conditions specified under section 6(6).

- (i) If such individual has been non-resident in India in any 9 out of the 10 previous years preceding the relevant previous year, or
- (ii) If such individual has during the 7 previous years preceding the relevant previous year been in India for a period of 729 days or less.

Therefore in simpler terms, an individual is said to be a resident and ordinarily resident if he satisfies both the following conditions:

- (i) He is a resident in any 2 out of the last 10 years preceding the relevant previous year, and
- (ii) His total stay in India in the last 7 years preceding the relevant previous year is 730 days or more.

If the individual satisfies both the conditions mentioned above, he is a resident and ordinarily resident but if only one or none of the conditions are satisfied, the individual is a resident but not ordinarily resident.



*Example 1:* Steve Waugh, the Australian cricketer comes to India for 100 days every year. Find out his residential status for the A.Y. 2013-14.

**Solution:** For the purpose of his residential status in India for A.Y. 2013-14, the relevant previous year is 2012-13.

Step 1: The total stay of Steve Waugh in the last 4 years preceding the previous year is 400 days (i.e.  $100 \times 4$ ) and his stay in the previous year is 100 days. Therefore, since he has satisfied the second condition in section 6(1), he is a resident.

Step 2: Since his total stay in India in the last 7 years preceding the previous year is 700 days (i.e.  $100 \times 7$ ), he does not satisfy the minimum requirement of 730 days in 7 years. Any one of the conditions not being satisfied, the individual is resident but not ordinarily resident.

Therefore, the residential status of Steve Waugh for the assessment year 2013-14 is resident but not ordinarily resident.



*Example 2:* Mr. B, a Canadian citizen, comes to India for the first time during the P. Y. 2008-09. During the financial years 2008-09, 2009-10, 2010-11, 2011-12 and 2012-13 he was in India for 55 days, 60 days, 90 days, 150 days and 70 days respectively. Determine his residential status for the A.Y. 2013-14.

**Solution:** During the previous year 2012-13, Mr. B was in India for 70 days and during the 4 years preceding the previous year 2012-13, he was in India for 355 days (i.e.  $55 + 60 + 90 + 150$  days). Thus, he does not satisfy section 6(1). Therefore, he is a non-resident for the previous year 2012-13.



*Example 3:* Mr. C, a Japanese citizen left India after a stay of 10 years on 1.06.2010. During the financial year 2011-12, he comes to India for 46 days. Later, he returns to India for 1 year on 10.10.2012. Determine his residential status for the A. Y. 2013-14.

**Solution:** During the previous year 2012-13, Mr. C was in India for 173 days (i.e.  $22 + 30 + 31 + 31 + 28 + 31$  days). His stay in the last 4 years is:

2011-12	-	46
2010-11	-	62 (i.e. $30 + 31 + 1$ )
2009-10	-	365 (since he left India on 1.6.2010 after 10 years)
2008-09	-	365 (since he left India on 1.6.2010 after 10 years)

The total number of days comes as 838. Thus Mr. C is a resident since his stay in the previous year 2012-13 is 173 days and in the last 4 years is more than 365 days. For the purpose of being ordinarily resident, it is evident from the above calculations, that his stay in the last 7 years is more than 730 days and since he was in India for 10 years prior to 1.6.2010, he was a resident in at least 2 out of the last 10 years preceding the relevant previous year.

Therefore, Mr. C is a resident and ordinarily resident for the A.Y. 2013-14.



*Example 4:* Mr. D, an Indian citizen, leaves India on 22.9.2012 for the first time, to work as an officer of a company in France. Determine his residential status for the A. Y. 2013-14.

**Solution:** During the previous year 2012-13, Mr. D, an Indian citizen, was in India for 175 days (i.e.  $30 + 31 + 30 + 31 + 31 + 22$  days). He does not satisfy the minimum criteria of 182 days. Also, since

**Notes**

he is an Indian citizen leaving India for the purposes of employment, the second condition under section 6(1) is not applicable to him.

Therefore, Mr. D is a non-resident for the A.Y.2013-14.

**Non-resident**

1. **Residential status of HUF:** A HUF would be resident in India if the control and management of its affairs is situated wholly or partly in India.

If the control and management of the affairs is situated wholly outside India it would become a non-resident. The expression 'control and management' referred to under section 6 refers to the central control and management and not to the carrying on of day-to-day business by servants, employees or agents. The business may be done from outside India and yet its control and management may be wholly within India. Therefore, control and management of a business is said to be situated at a place where the head and brain of the adventure is situated. The place of control may be different from the usual place of running the business and sometimes even the registered office of the assessee. This is because the control and management of a business need not necessarily be done from the place of business or from the registered office of the assessee. But control and management do imply the functioning of the controlling and directing power at a particular place with some degree of permanence.

If the HUF is resident, then the status of the Karta determines whether it is resident and ordinarily resident or resident but not ordinarily resident. If the karta is resident and ordinarily resident, then the HUF is resident and ordinarily resident and if the karta is resident but not ordinarily resident, then HUF is resident but not ordinarily resident.



*Caselet* **Residential Status of Mr. E (Karta of the HUF)**

**T**he business of an HUF is transacted from Australia and all the policy decisions are taken there. Mr. E, the karta of the HUF, who was born in Kolkata, visits India during the P.Y.2012-13 after 15 years. He comes to India on 1.4.2012 and leaves for Australia on 1.12.2012. Determine the residential status of Mr. E and the HUF for A.Y. 2013-14.

**Solution:** During the P.Y.2012-13, Mr. E has stayed in India for 245 days (i.e. 30+31+30+31+31+30+31+30+1 days). Therefore, he is a resident. However, since he has come to India after 15 years, he cannot satisfy any of the conditions for being ordinarily resident.

Therefore, the residential status of Mr. E for the P.Y.2012-13 is resident but not ordinarily resident. Since the business of the HUF is transacted from Australia and nothing is mentioned regarding its control and management, it is assumed that the control and management is also wholly outside India. Therefore, the HUF is a non-resident for the P.Y. 2012-13.

Source: <http://www.safeecollege.com/ankit/final2/dt%201.pdf>

2. **Residential status of firms and association of persons:** A firm and an AOP would be resident in India if the control and management of its affairs is situated wholly or partly in India. Where the control and management of the affairs is situated wholly outside India, the firm would become a non-resident.
3. **Residential status of companies:** A company is said to be resident in India if:
  - (a) It is an Indian company as defined under section 2(26), or
  - (b) Its control and management is situated wholly in India during the accounting year.

Thus, every Indian company is resident in India irrespective of the fact whether the control and management of its affairs is exercised from India or outside. But a company, other than an Indian company, would become resident in India only if the entire control and management of its affairs is in India.

The control and management of the affairs of company are said to be exercised from the place where the director's meetings (not shareholders' meetings) are held, decisions taken and directions issued.

4. **Residential status of local authorities and artificial juridical persons:** Local authorities and artificial juridical persons would be resident in India if the control and management of its affairs is situated wholly or partly in India. Where the control and management of the affairs is situated wholly outside India, they would become non-residents.



#### Task

1. X, a foreign citizen comes to India, for the first time in the last 30 years on March 20, 2005. On September 1, 2005, he leaves India for Nepal on a business trip. He comes back on February 26, 2006. Determine the residential status of X for the assessment year 2006-07.
2. X, an Italian citizen, comes to India for the first time (after 20 years) on May 28, 2005. Determine his residential status for the assessment year 2006-07.

### Self Assessment

Choose from the following the most appropriate answer:

1. 'R', a person of Indian origin visited India on 3.10.2010 and plans to stay here for 185 days. During 4 years prior to previous year 2011-12, he was in India for 750 days. Earlier to that he was never in India. For the AY 2012-13, 'R' shall be:
  - (a) resident and ordinarily resident in India
  - (b) resident but not ordinarily resident in India
  - (c) non-resident
2. 'X', a citizen of India left India for U.S. on 16.8.2010 for booking orders on behalf of an Indian Company for exporting goods to U.S. He came back to India on 5.5.2012. He had been resident in India for the past 10 years. For assessment year 2012-13, X shall be:
  - (a) resident and ordinarily resident in India
  - (b) resident but not ordinarily resident in India
  - (c) non-resident in India
3. 'Z', a citizen of India is employed on an Indian Ship. During the previous year 2011-12 he leaves India for Germany on 15.09.2011 for holidays and returned on 1.4.2012. He had been non-resident for the past 3 years. Earlier to that he was permanently in India. For assessment year 2012-13, Z shall be:
  - (a) resident and ordinarily resident in India
  - (b) resident but not ordinarily resident in India
  - (c) non-resident in India

**Notes**

4. 'S', a foreign national but a person of Indian origin visited India during the previous year 2011-12 for 181 days. During 4 preceding previous years he was in India for 400 days, 'S' shall be:
  - (a) resident in India
  - (b) Non-resident in India
  - (c) not ordinarily resident in India

## **2.2 Residential Status of a Company**

An Indian company is always resident in India. A foreign company is resident in India only if during the previous year, control and management of its affairs is situated wholly in India. Conversely, a foreign company is treated as non-resident if during the previous year, control and management of its affairs is either wholly or partly situated out of India.



*Example:* 'XYZ' Ltd., is an Indian Company, the entire control and management of its affairs is situated outside India. 'XYZ' Ltd., shall be considered as a resident in India.



*Notes* If control and management of a firm or association of firm is situated wholly or partially in India, it will be considered as Resident. Otherwise it will be considered as Non-Resident.

A company can never be ordinarily or not ordinarily resident in India. In case of a foreign company even the slightest control and management is exercised from outside India, it would be treated as a non-resident.

The term "control and management" refers to the "head and the brain" which directs the affairs of policy, finance, disposal of profits and vital things concerning the management of the company. Usually the control and management of a company's affairs is situated at the place where meetings of its board of directors are held. In case of a subsidiary company managed by its local board of directors, it is difficult to establish that control and management of its affairs vests at the place where the parent company resides.



*Did u know?* A foreign company means a company incorporated outside India but having a place of business in India

### **Self Assessment**

State whether the following statements are true or false:

5. An Indian Company is always resident in India.
6. A foreign company is always non-resident in India.
7. A foreign company means a company incorporated outside India but having a place of business in India.
8. Control and management refers to the head and the brain which directs the affairs of policy, finance, disposal of profits and vital things concerning the management of the company.
9. In case of a subsidiary company managed by its local board of directors, it is easy to establish that control and management of its affairs vests at the place where the parent company resides.

## 2.3 Incidence of Tax

Notes

The study of incidence is very important. The tax system is not merely aimed at raising a certain amount of revenue, but the aim is to raise it from those sections of the people who can best bear the tax. The aim, in short, is to secure a just distribution of the tax burden. This obviously cannot be done unless an effort is made to trace the incidence of each tax levied by the State. We must know who pays it ultimately in order to find out whether it is just to ask him to pay it, or whether the burden imposed on him is according to the ability of the tax-payer or not. If the tax system is to conform to Adam Smith's first canon of taxation, viz., the canon of equality, it becomes imperative to make a careful study of the reactions and repercussions of each tax and find out its final resting place.

There are certain taxes, called direct taxes, which are borne by the people who pay them first. The incidence in such cases is apparent. But the tax system of a country is not merely composed of direct taxes. There are indirect taxes also whose reactions are a complicated affair. These taxes are intended to be shifted. But in actual practice, on account of economic friction, the shifting may not take place at all or it may be partial, or the tax may be shifted on to a class of people quite different from those intended to bear it.

If Public Finance is to serve as an instrument of social justice, the question of incidence at once assumes great importance. The rich have to be taxed and the proceeds have to be spent for the benefit of the poor. If you have to tax the rich, the incidence must be on the rich, otherwise the object is not served. We must, therefore, follow each tax and make sure that it finds a rich home to rest in.



*Did u know?* The incidence of income tax paid by a person will be on him. Import duty is an indirect tax and can, therefore, be shifted. Income-tax, on the other hand, is a direct tax and it cannot be shifted.

As per section 5, incidence of tax on a taxpayer depends on his residential status and also on the place and time of accrual or receipt of income. In order to understand the relationship between residential status and tax liability, one must understand the meaning of "Indian income" and "foreign income".

1. **Indian income:** Any of the following three is an Indian income:
  - (a) If income is received (or deemed to be received) in India during the previous year and at the same time it accrues (or arises or is deemed to accrue or arise) in India during the previous year.
  - (b) If income is received (or deemed to be received) in India during the previous year but it accrues (or arises) outside India during the previous year.
  - (c) If income is received outside India during the previous year but it accrues (or arises or is deemed to accrue or arise) in India during the previous year.
2. **Foreign income:** If the following two conditions are satisfied, then such income is "foreign income":
  - (a) Income is not received (or not deemed to be received) in India; and
  - (b) Income does not accrue or arise (or does not deemed to accrue or arise) in India.

Notes

The above provisions may be explained in brief as follows:

**Table 2.1: Conditions for Deciding Status of Income**

Whether income is received (or deemed to be received) in India during the relevant year	Whether income accrues (or arises or is deemed to accrue or arise) in India during the relevant year	Status of the income
Yes	Yes	Indian income
Yes	No	Indian income
No	Yes	Indian income
No	No	Foreign income



**Notes Indian income:** Indian income is always taxable in India irrespective of the residential status of the taxpayer.

**Foreign income:** Foreign income is taxable in the hands of resident or resident and ordinarily resident in India. It is not taxable in the hands of non-resident in India.

Following table shows the overall scope of income and its income tax chargeability in case of Resident and Non-resident:

**Table 2.2: Income Tax Chargeability in Case of Resident and Non-resident**

Income	Resident and Ordinary Resident	Resident and Not ordinary Resident	Non-resident
1. Income received or deemed to be received in India whether earned in India or elsewhere	Taxable	Taxable	Taxable
2. Income which accrues or arise or deemed to accrue or arise in India during the previous year, whether received in India or elsewhere.	Taxable	Taxable	Taxable
3. Income which accrues or arises outside India and received outside India from a business controlled from India	Taxable	Taxable	Not Taxable
4. Income which accrues or arises outside India and received outside India in the previous year from any other source	Taxable	Not Taxable	Not Taxable
5. Income which accrues or arises outside India and received outside India during the years preceding the previous year and remitted to India during the previous year.	Not Taxable	Not Taxable	Not Taxable

For any other taxpayer like company, firm, co-operative society, association of persons, body of individual, etc the incidence of tax would include:

**Table 2.3: Incidence of Tax for Resident/non-resident Indians**

Types of Income	Resident in India	Non-resident in India
Indian income	Taxable in India	Taxable in India
Foreign income	Taxable in India	Not taxable in India





*Example 5:* The following details are known about the total income of Ms. Mamta:

Dividend received from Indian Company ₹ 1, 00,000

Dividend from foreign company ₹ 1, 50,000

Income from business in Kenya but controlled from India ₹ 2, 00,000

Income from business in Switzerland controlled from Bangladesh 5, 00,000

Income accrued in Indonesia ₹ 2, 00,000, 2/5<sup>th</sup> received in India.

**Solution:**

S. No	Particulars	ROR	NOR	NRI
1	Dividend received from Indian Company	-	-	-
2	Dividend from foreign company	1,50,000	1,50,000	1,50,000
3	Income from business in Kenya but controlled from India	2,00,000	2,00,000	NIL
4	Income from business in Switzerland controlled from Bangladesh	5,00,000	-	-
5	Income accrued in Indonesia, 2/5 <sup>th</sup> received in India	2,50,000	1,00,000	1,00,000
	<b>Total Taxable Income</b>	<b>11,00,000</b>	<b>4,50,000</b>	<b>2,50,000</b>

## Self Assessment

State which of the following is taxable in hands of a non-resident of India:

10. Income received or deemed to be received in India whether earned in India or elsewhere.
11. Income which accrues or arise or deemed to accrue or arise in India during the previous year, whether received in India or elsewhere.
12. Income which accrues or arises outside India and received outside India in the previous year from any other source.
13. Income which accrues or arises outside India and received outside India during the years preceding the previous year and remitted to India during the previous year.

## 2.4 Scope of Income

Section 5 provides the scope of total income in terms of the residential status of the assessee because the incidence of tax on any person depends upon his residential status. The scope of total income of an assessee depends upon the following three important considerations:

- (i) the residential status of the assessee;
- (ii) the place of accrual or receipt of income, whether actual or deemed; and
- (iii) the point of time at which the income had accrued to or was received by or on behalf of the assessee.

The ambit of total income of the three classes of assesses would be as follows:

1. **Resident and ordinarily resident:** The total income of a resident assessee would, under section 5(1), consist of:
  - (i) income received or deemed to be received in India during the previous year;
  - (ii) income which accrues or arises or is deemed to accrue or arise in India during the previous year; and

**Notes**

- (iii) income which accrues or arises outside India even if it is not received or brought into India during the previous year.

In simpler terms, a resident and ordinarily resident has to pay tax on the total income accrued or deemed to accrue, received or deemed to be received in or outside India.

2. **Resident but not ordinarily resident:** Under section 5(1), the computation of total income of resident but not ordinarily resident is the same as in the case of resident and ordinarily resident stated above except for the fact that the income accruing or arising to him outside India is not to be included in his total income. However, where such income is derived from a business controlled from or profession set up in India, then it must be included in his total income even though it accrues or arises outside India.
3. **Non-resident:** A non-resident's total income under section 5(2) includes:
  - (i) income received or deemed to be received in India in the previous year; and
  - (ii) income which accrues or arises or is deemed to accrue or arise in India during the previous year.



*Notes* All assesseees, whether resident or not, are chargeable to tax in respect of their income accrued, arisen, received or deemed to accrue, arise or to be received in India whereas residents alone are chargeable to tax in respect of income which accrues or arises outside India.

1. **Resident and Ordinarily Resident:** Income received/deemed to be received/accrued or arisen/deemed to accrue or arises in or outside India.
2. **Resident but Not Ordinarily Resident:** Income which is received or deemed to be received/accrued or arisen/deemed to accrue or arise in India. And income which accrues or arises outside India being derived from a business controlled from or profession set up in India.
3. **Non-Resident:** Income received/deemed to be received/accrued or arisen/deemed to accrue or arise in India.

**Self Assessment**

Fill in the blanks:

14. ....provides the scope of total income in terms of the residential status of the assessee.
15. The scope of total income of an assessee depends upon the ..... of the assessee
16. Total income of a resident assessee would, under section 5(1) consist of Income received or deemed to be received in .....during the previous year.
17. .... has to pay tax on the total income accrued or deemed to accrue, received or deemed to be received in or outside India.

**2.5 Deemed Receipt and Accrual of Income in India**

In addition to the above mentioned criteria it must also be understood that the taxability of a certain item as income would also depend upon the method of accounting followed by the assessee. This is because under the cash system of accounting an income would be taxable only when it is received by the assessee himself or on his behalf. But under the mercantile system

it would be taxable once the assessee gets the legal right to claim the amount. However, it has been specifically provided that in the case of income from salaries, the liability to tax arises immediately when the income is due to the assessee irrespective of the method of accounting followed. Likewise, in the case of dividends, the income would be included in total income of the shareholder under section 8 in the year in which the final dividend is declared and, in the case of interim dividend, in the year in which they are made unconditionally available to the shareholders.

Thus at this point of time to understand the incidence of tax efficiently it is essential to understand, which are the income that are deemed to be received in India, the meaning of income accruing or arising in India and the income deemed to accrue or arise in India. The same is explained in this section of the unit.

Income accrued in India is chargeable to tax in all cases irrespective of residential status of an assessee. The words "accrue" and "arise" are used in contradistinction to the word "receive". Income is said to be received when it reaches the assessee; when the right to receive the income becomes vested in the assessee, it is said to accrue or arise.

### 2.5.1 Meaning of "Income Received or Deemed to be Received"

All assesses are liable to tax in respect of the income received or deemed to be received by them in India during the previous year irrespective of:

- (i) their residential status, and
- (ii) the place of its accrual.

Income is to be included in the total income of the assessee immediately on its actual or deemed receipt. The receipt of income refers to only the first occasion when the recipient gets the money under his control. Therefore, when once an amount is received as income, remittance or transmission of that amount from one place or person to another does not constitute receipt of income in the hands of the subsequent recipient or at the place of subsequent receipt.

#### Income Deemed to be Received

Under section 7, the following shall be deemed to be received by the assessee during the previous year irrespective of whether he had actually received the same or not -

- (i) The annual accretion in the previous year to the balance to the credit of an employee participating in a Recognised Provident Fund (RPF). Thus, the contribution of the employer in excess of 12% of salary or interest credited in excess of 9.5% p.a. is deemed to be received by the assessee.
- (ii) The taxable transferred balance from unrecognised to recognised provident fund (being the employer's contribution and interest thereon).
- (iii) The contribution made by the Central Government or any other employer in the previous year to the account of an employee under a pension scheme referred to under section 80CCD.

### 2.5.2 Meaning of Income 'Accruing' and 'Arising'

Accrue refers to the right to receive income, whereas due refers to the right to enforce payment of the same. For example, salary for work done in December will accrue throughout the month, day to day, but will become due on the salary bill being passed on 31st December or 1st January. Similarly, on Government securities, interest payable on specified dates arise during the period of holding, day to day, but will become due for payment on the specified dates.

Notes



*Example:* Interest on Government securities is usually payable on specified dates, say on 1st January and 1st July. In all such cases, the interest would be said to accrue from 1st July to 31st December and on 1st January, it will fall due for payment.

It must be noted that income which has been taxed on accrual basis cannot be assessed again on receipt basis, as it will amount to double taxation. For example, when a loan to a director has already been treated as dividend under section 2(22) (e) and later dividend is declared, distributed and adjusted against the loan, the same cannot be treated as dividend income again.

With a view to removing difficulties and clarifying doubts in the taxation of income, Explanation 1 to Section 5 specifically provides that an item of income accruing or arising outside India shall not be deemed to be received in India merely because it is taken into account in a balance sheet prepared in India.

Further, Explanation 2 to Section 5 makes it clear that once an item of income is included in the assessee total income and subjected to tax on the ground of its accrual/ deemed accrual or receipt, it cannot again be included in the person's total income and subjected to tax either in the same or in a subsequent year on the ground of its receipt - whether actual or deemed.

### 2.5.3 Income Deemed to Accrue or Arise in India (Section 9)

Certain types of income are deemed to accrue or arise in India even though they may actually accrue or arise outside India. The categories of income which are deemed to accrue or arise in India are:

- (i) Any income accruing or arising to an assessee in any place outside India whether directly or indirectly
  - (a) Through or from any business connection in India,
  - (b) Through or from any property in India,
  - (c) Through or from any asset or source of income in India, or
  - (d) Through the transfer of a capital asset situated in India.



*Did u know?* The legislative intent of this clause relating to the transfer of a capital asset situated in India is to cover incomes, which are accruing or arising, directly or indirectly from a source in India. The section codifies the source rule of taxation, which signifies that where a corporate structure is created to route funds, the actual gain or income arises only in consequence of the investment made in the activity to which such gains are attributable and not the mode through which such gains are realised.

This principle which supports the source country's right to tax the gains derived from offshore transactions where the value is attributable to the underlying assets, is recognised internationally by several countries.

Consequently, Explanation 4 of the section has been inserted to clarify that the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of".

Further, Explanation 5 has been inserted to clarify that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

- (ii) Income, which falls under the head "Salaries", if it is earned in India. Any income under the head "Salaries" payable for rest period or leave period which is preceded and succeeded by services rendered in India, and forms part of the service contract of employment, shall be regarded as income earned in India.
- (iii) Income from 'Salaries' which is payable by the Government to a citizen of India for services rendered outside India. However, allowances and perquisites paid outside India by the Government are exempt.
- (iv) Dividend paid by an Indian company outside India.
- (v) Interest.
- (vi) Royalty.
- (vii) Fees for technical services.

The above mentioned categories of different of income which are deemed to accrue or arise in India are further explained in the subsequent section. Thus the categorisation of income which is deemed to accrue or arise in India can be summarised as below:

**Table 2.4: Categorisation of Income Deemed to Accrue in India**

Nature of income	Whether income is deemed to accrue or arise in India
Income from business connection in India	Yes
Income from any property, asset or source of income in India	Yes
Capital gain on transfer of a capital asset situated in India	Yes
Income from salary if service is rendered in India	Yes
Income from salary (not being perquisite/allowance) if service is rendered outside India (provided the employer is Government of India and the employee is a citizen of India)	Yes
Income from salary if service is rendered outside India (not being a case stated above)	No
Dividend paid by the Indian company	Yes



*Example:* For the assessment year 2006-07 (previous year 2005-06), X is employed in India and receives ₹ 24,000 as salary. His income from other sources includes:

Dividend received in London on June 3, 2005: ₹ 31,000 from a foreign company; share of profit received in London on December 15, 2005 from a business situated in Sri Lanka but controlled from India:

₹ 60,000; remittance from London on January 15, 2006 out of past untaxed profit of 2003-04 earned and received there: ₹ 30,000 and interest earned and received in India on May 11, 2006: ₹ 76,000. Find out his gross total income, if he is (a) resident and ordinarily resident, (b) resident but not ordinarily resident, and (c) non-resident for the assessment year 2006-07.

If X is resident and ordinarily resident, his gross total income will be ₹ 1,15,000 (i.e., ₹ 24,000 + ₹ 31,000 + ₹ 60,000). If X is resident but not ordinarily resident, his gross total income will work out to be ₹ 84,000 (i.e., ₹ 24,000 + ₹ 60,000). If X is non-resident, his gross total income will come to ₹ 24,000.

Notes



Notes

1. The remittance from London of ₹ 30,000 is not taxable in the previous year 2005-06 because it does not amount to “receipt” of income.
2. Although the interest of ₹ 76,000 earned and received in India is taxable, it is not included in the total income of the assessment year 2006-07, as it is not earned or received in the previous year 2005-06. It will, therefore, be included in the total income of X for the assessment year 2007-08.

### Self Assessment

Fill in the blanks:

18. The ..... of accounting an income would be taxable only when it is received by the assessee himself or on his behalf.
19. .... refers to the right to receive income.
20. .... to Section 5 specifically provides that an item of income accruing or arising outside India shall not be deemed to be received in India merely because it is taken into account in a balance sheet prepared in India.
21. Income from salary (not being perquisite/allowance) if service is rendered outside India (provided the employer is Government of India and the employee is a citizen of India) is deemed to accrue or arise in .....

### 2.6 Categories of Income which are Deemed to Accrue or Arise in India

As mentioned above there are seven main categories of income which are deemed to accrue or arise in India even though they may actually accrue or arise outside India. These are explained below as:

1. **Income from business connection:** The expression “business connection” has been explained in Explanation 2 to section 9(1)(i) to encompass the following:
  - (i) ‘Business connection’ shall include any business activity carried out through a person acting on behalf of the non-resident.
  - (ii) He must have an authority which is habitually exercised to conclude contracts on behalf of the non-resident. However, if his activities are limited to the purchase of goods or merchandise for the non-resident, this provision will not apply.
  - (iii) Where he 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, a business connection is established.
  - (iv) Business connection is also established where he habitually secures orders in India, mainly or wholly for the non-resident. Further, there may be situations when other non-residents control the above-mentioned non-resident. Secondly, this non-resident may also control other non-residents. Thirdly, all other non-residents may be subject to the same common control, as that of the non-resident. In all the three situations, business connection is established, where a person habitually secures orders in India, mainly or wholly for such non-residents.



**Caution** The following exceptions must be kept in mind while dealing with income from business connection

“Business connection”, however, shall not be held to be established in cases where the non-resident carries on business through a broker, general commission agent or any other agent of an independent status, if such a person is acting in the ordinary course of his business.

A broker, general commission agent or any other agent shall be deemed to have an independent status where he does not work mainly or wholly for the non-resident. He will however, not be considered to have an independent status in the three situations explained in (iv) above, where he is employed by such a non-resident.

Where a business is carried on in India through a person referred to in (ii), (iii) or (iv) mentioned above, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India.

2. **Income from property, asset or source of income:** Any income which arises from any property which may be either movable, immovable, tangible or an intangible property would be deemed to accrue or arise in India.



*Example:* Hire charges or rent paid outside India for the use of the machinery or buildings situated in India, deposits with an Indian company for which interest is received outside India etc.

3. **Income through the transfer of a capital asset situated in India:** Capital gains arising from the transfer of a capital asset situated in India would be deemed to accrue or arise in India in all cases irrespective of the fact whether (i) the capital asset is movable or immovable, tangible or intangible; (ii) the place of registration of the document of transfer etc., is in India or outside; and (iii) the place of payment of the consideration for the transfer is within India or outside.

Explanation 1 to section 9(1)(i) lists out income which shall not be deemed to accrue or arise in India. They are given below:

- (a) *In the case of a business, in respect of which all the operations are not carried out in India: Explanation 1(a) to section 9(1)(i):* In the case of a business of which all the operations are not carried out in India, the income of the business deemed to accrue or arise in India shall be only such part of income as is reasonably attributable to the operations carried out in India. Therefore, it follows that such part of income which cannot be reasonably attributed to the operations in India, is not deemed to accrue or arise in India.
- (b) *Purchase of goods in India for export: Explanation 1(b) to section 9(1)(i):* 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) *Collection of news and views in India for transmission out of India: Explanation 1(c) to section 9(1)(i):* 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) *Shooting of cinematograph films in India: Explanation 1(d) to section 9(1)(i):* In the case of a non-resident, no income shall be deemed to accrue or arise in India through or from

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operations which are confined to the shooting of any cinematograph film in India, if such non-resident is:

- ◆ an individual, who is not a citizen of India; or
- ◆ a firm which does not have any partner who is a citizen of India or who is resident in India; or
- ◆ a company which does not have any shareholder who is a citizen of India or who is resident in India.

4. **Income from salaries:** Under section 9(1)(ii) income which falls under the head 'salaries', would be deemed to accrue or arise in India, if it is in respect of services rendered in India. Thus Section 9 (1)(ii) of the Act requires that salaries are to be considered as deemed to be accrued or arise in India only if it is "earned in India".

Further, the salaries payable for services rendered in India shall be regarded as income earned in India, though it may be paid in India or outside. i.e. the payment or receipt of salary is immaterial. What is important is the place of rendering of services? Section 9(2) makes an exception to the aforesaid rule in the case of certain retired civil servants and judges permanently residing outside India.

Section 9(1)(iii) provides that the salaries are chargeable to tax if the same is payable by the Government to an Indian Citizen for services rendered outside India. The residential status and the place of receipt of salary are not relevant for the purpose of this sub-section. For income to be treated as deemed to accrue or arise in India following four conditions needs to be satisfied:

- ❖ Income should be chargeable under the head "Salaries"
- ❖ Salary should be payable by Government of India
- ❖ The recipient should be an Indian Citizen, irrespective of their residential status
- ❖ The services should be rendered outside India



**Notes** It is important to note that all allowances or perquisites paid outside India by the Government to the Indian Citizens for their rendering services outside India are exempt under section 10(7).

5. **Income from dividends:** All dividends paid by an Indian company must be deemed to accrue or arise in India. Under section 10(34), income from dividends referred to in section 115-O are exempt from tax in the hands of the shareholder. It may be noted that dividend distribution tax under section 115-O does not apply to deemed dividend under section 2(22) (e), which is chargeable in the previous year in which such dividend is distributed or paid.
6. **Interest:** Under section 9(1)(v), an interest is deemed to accrue or arise in India if it is payable by -
- (i) the Central Government or any State Government;
  - (ii) a person resident in India except where it is payable in respect of any money borrowed and used for the purposes of a business or profession carried on by him outside India or for the purposes of making or earning any income from any source outside India;
  - (iii) a non-resident when it is payable in respect of any debt incurred or moneys borrowed and used for the purpose of a business or profession carried on in India by him. Interest on money borrowed by the non-resident for any purpose other than a



business or profession, will not be deemed to accrue or arise in India. Thus, if a non-resident 'A' borrows money from a non-resident '13' and invests the same in shares of an Indian company, interest payable by 'A' to '13' will not be deemed to accrue or arise in India.

7. **Royalty:** Royalty will be deemed to accrue or arise in India when it is payable by:
- (i) the Government; or
  - (ii) a person who is a resident in India except in cases where it is payable for the transfer of any right or the use of any property or information or for the utilisation of services for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or
  - (iii) a non-resident only when the royalty is payable in respect of any right, property or information used or services utilised for purposes of a business or profession carried on in India or for the purposes of making or earning any income from any source in India.

Lump sum royalty payments made by a resident for the transfer of all or any rights including the granting of a license in respect of computer software supplied by a non-resident manufacturer along with computer hardware under any scheme approved by the Government under the Policy on Computer Software Export, Software Development and Training, 1986 shall not be deemed to accrue or arise in India.



*Did u know?* Computer software means any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customised electronic data.

The term 'royalty' means consideration also including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head 'Capital gains' for:

- (i) the transfer of all or any rights including the granting of license, in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;
- (ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;
- (iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;
- (iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;
- (v) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 441313;
- (vi) the transfer of all or any rights including the granting of license, in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films;
- (vii) the rendering of any service in connection with the activities listed above.

Notes

The definition of 'royalty' for this purpose is wide enough to cover both industrial royalties as well as copyright royalties. The deduction specially excludes income which should be chargeable to tax under the head 'capital gains'.

*Consideration for Use or Right to Use of Computer Software is Royalty within the Meaning of Section 9(1)(vi)*

As per section 9(1)(vi), any income payable by way of royalty in respect of any right, property or information is deemed to accrue or arise in India. The term "royalty" means consideration for transfer of all or any right in respect of certain rights, property or information. There have been conflicting court rulings on the interpretation of the definition of royalty, on account of which there was a need to resolve the following issues -

Does consideration for use of computer software constitute royalty?

- (i) Is it necessary that the right, property or information has to be used directly by the payer?
- (ii) Is it necessary that the right, property or information has to be located in India or control or possession of it has to be with the payer?
- (iii) What is the meaning of the term "process"?

In order to resolve the above issues arising on account of conflicting judicial decisions and to clarify the true legislative intent, Explanations 4, 5 & 6 have been inserted with retrospective effect from 1<sup>st</sup> June, 1976.

Explanation 4 clarifies that the consideration for use or right to use of computer software is royalty by clarifying that, transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred.

Consequently, the provisions of tax deduction at source under section 194J and section 195 would be attracted in respect of consideration for use or right to use computer software since the same falls within the definition of royalty.



*Notes* The Central Government has, vide Notification No.21/2012 dated 13.6.2012 to be effective from 1st July, 2012, exempted certain software payments from the applicability of tax deduction under section 194J. Accordingly, where payment is made by the transferee for acquisition of software from a resident-transferor, the provisions of section 194J would not be attracted if:

- 1. the software is acquired in a subsequent transfer without any modification by the transferor;
- 2. tax has been deducted either under section 194J or under section 195 on payment for any previous transfer of such software; and
- 3. the transferee obtains a declaration from the transferor that tax has been so deducted along with the PAN of the transferor.

Explanation 5 clarifies that royalty includes and has always included consideration in respect of any right, property or information, whether or not,

- (a) the possession or control of such right, property or information is with the payer;
- (b) such right, property or information is used directly by the payer;
- (c) the location of such right, property or information is in India.

Explanation 6 clarifies that the term “process” includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, and optic fibre or by any other similar technology, whether or not such process is secret.

8. **Fees for technical services:** Any fees for technical services will be deemed to accrue or arise in India if they are payable by -
- (i) the Government;
  - (ii) a person who is resident in India, except in cases where the fees are payable in respect of technical services utilised in a business or profession carried on by such person outside India or for the purpose of making or earning any income from any source outside India;
  - (iii) a person who is a non-resident, only where the fees are payable in respect of services utilised in a business or profession carried on by the non-resident in India or where such services are utilised for the purpose of making or earning any income from any source in India.

A fee for technical services means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including providing the services of technical or other personnel). However, it does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head ‘Salaries’.

***Income deemed to accrue or arise in India to a non-resident by way of interest, royalty and fee for technical services to be taxed irrespective of territorial nexus (Explanation to section 9)***

Income by way of interest, royalty or fee for technical services which is deemed to accrue or arise in India by virtue of clauses (v), (vi) and (vii) of section 9(1), shall be included in the total income of the non-resident, whether or not:

- (i) the non-resident has a residence or place of business or business connection in India; or
- (ii) the non-resident has rendered services in India.

In effect, the income by way of fee for technical services, interest or royalty, from services utilised in India would be deemed to accrue or arise in India in case of a non-resident and be included in his total income, whether or not such services were rendered in India.

## Self Assessment

State whether the following statements are true or false:

22. The expression “business connection” has been explained in Explanation 2 to section 9(1)(i).
23. Any income which arises from any property which may be either movable, immovable, tangible or a intangible property would not considered to be deemed to accrue or arise in India.
24. All dividends paid by an Indian company must be deemed to accrue or arise in India.
25. The term ‘royalty’ means consideration also including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head ‘Capital gains’.

## Notes



Case Study

**Make it Count: Residential Status Key to Taxation**

**A**n individual is taxed in India based on his tax residential status – which, in turn, depends on the number of days he is in India during a tax year (April 1 to March 31). Based on this calculation, an individual may be Resident and Ordinarily Resident (ROR), Resident but Not Ordinarily Resident (RNOR), or Non-resident (NR).

While an ROR is liable to tax in India on worldwide income, an RNOR or NR is taxed in India primarily on income sourced in India. It is vital to correctly determine an individual's tax residential status for a particular tax year – if not, he/she could end up paying tax on their worldwide income in India; or, their foreign income, which is liable to tax in India, could escape the tax net.

One is, therefore, faced with the task of keeping track of the days a person is in India during a tax year. The challenge is: how do you count the number of days in India?

Does one consider calendar days, or is every 24 hours spent on Indian soil counted as one day? Is only a full day spent in India counted as a day, or is a fraction of the day also counted? If a fraction of the day is to be counted as a whole day, are the days of arrival and departure both counted as days in India? What happens if one spends less than 24 hours in India during a trip?

The Income Tax Act and Rules do not offer any answers. However, this issue has previously been a subject of litigation, and one can draw guidance from the judicial authorities' interpretation of the term 'days in India'.

In the case of Manoj Kumar Reddy, the Bangalore Tribunal noted that while computing the period for which an assessee is in India, the count should begin *from* the date of arrival of the assessee in India *to* the date he leaves the country. The Tribunal drew guidance from the provisions of the General Clauses, Act and concluded that in counting days in this manner, the first day should be excluded. Hence, when counting the 'days', the day of arrival should be ignored.

The Bangalore Tribunal's view was followed by the Mumbai Tribunal in the case of Fausta C. Cordeiro, wherein it held that the arrival date is to be excluded from the count, particularly when the assessee arrived late in the day.

Based on the Tribunals' views, one may consider counting on the basis of calendar days, excluding the day of arrival but including the day of departure, even if it is a fraction of a day. Thus, if an individual arrives in the evening and leaves the next morning, he would have been in India (for tax purposes) for one day.

**A word of caution:** tax officials tend to count both the day of arrival and day of departure as 'days in India', irrespective of whether it is a full day or a few hours. Hence, the 'days in India' in the example above would be two days, not one.

So, when you zoom in and out of India on business or for pleasure, don't forget to keep a tab on your 'days in India', lest you are entangled in the tax net.

**Questions:**

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: <http://www.thehindubusinessline.com/industry-and-economy/taxation-and-accounts/make-it-count-residential-status-key-to-taxation/article4085396.ece>

## 2.7 Summary

## Notes

- Tax incidence on an assessee depends on his residential status. Whether an income earned by a foreign national in India or outside India taxable in India depends on the residential status of the individual, rather than on his citizenship. Therefore, the determination of the residential status of a person is very significant in order to find out his tax liability.
- There are three residential statuses that we will study in detail this unit namely the Residents also referred to as Resident & Ordinarily Residents, the Resident but not Ordinarily Residents and the non-residents.
- Residential status of an assessee is to be determined in respect of each previous year as it may vary from previous year to previous year.
- 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).
- Under section 6(1), an individual is said to be resident in India in any previous year, if he satisfies any one of the conditions like he has been in India during the previous year for a total period of 182 days or more, or he has been in India during the 4 years immediately preceding the previous year for a total period of 365 days or more and has been in India for at least 60 days in the previous year. If the individual satisfies any one of the conditions mentioned above, he is a resident. If both the above conditions are not satisfied, the individual is a non-resident also referred to as NRI.
- Only individuals and HUF can be resident but not ordinarily resident in India. All other classes of assesses can be either a resident or non-resident.
- An individual is said to be a resident and ordinarily resident if he satisfies both the following conditions:
  - (i) He is a resident in any 2 out of the last 10 years preceding the relevant previous year, and
  - (ii) His total stay in India in the last 7 years preceding the relevant previous year is 730 days or more.

If the individual satisfies both the conditions mentioned above, he is a resident and ordinarily resident but if only one or none of the conditions are satisfied, the individual is a resident but not ordinarily resident.

- Every Indian company is resident in India irrespective of the fact whether the control and management of its affairs is exercised from India or outside. But a company, other than an Indian company, would become resident in India only if the entire control and management of its affairs is in India. The control and management of the affairs of company are said to be exercised from the place where the director's meetings (not shareholders' meetings) are held, decisions taken and directions issued.
- As per section 5, incidence of tax on a taxpayer depends on his residential status and also on the place and time of accrual or receipt of income. In order to understand the relationship between residential status and tax liability, one must understand the meaning of "Indian income" and "foreign income".
- The scope of total income of an assessee depends upon the following three important considerations like the residential status of the assessee, the place of accrual or receipt of income, whether actual or deemed and the point of time at which the income had accrued to or was received by or on behalf of the assessee.

## 2.8 Keywords

**AOP:** It is an entity or a unit of assessment which includes two or more persons who join for a common purpose with a view to earn an income.

**Company:** It is an association or collection of individual real persons and/or other business entities, each of which provide some form of capital.

**Hindu Undivided Family (HUF):** It is a legal term related to the Hindu Marriage Act.

**Incidence of tax:** Tax incidence means the final burden of tax. In other words, incidence of tax is on person who actually bears or pays the final tax liability.

**Income:** It is the consumption and savings opportunity gained by an entity within a specified timeframe that is generally expressed in monetary terms.

**Partnership firm:** It is a relation between two or more persons who have agreed to share the profits of a business carried on by all of them or any of them acting for all.

**Receipt:** The receipt of income refers to the first occasion when the recipient gets the money under his control.

**Remittance:** Remittance is transmission of income after its first receipt.

**Royalty:** It is a consideration which also includes any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head 'Capital gains'.

## 2.9 Review Questions

1. What do you understand by residential status of an individual? How is it related to incidence of an assessee?
2. Describe the division of taxable entities for the purpose of determining residential status.
3. Discuss, in detail, the provisions for determining the residential status of an assessee.
4. Describe how you would determine the residential status of an assessee.
5. Write a note on residential status of a company.
6. Define incidence of tax as per section 5 of the Income Tax Act, 1961.
7. Differentiate between Indian and Foreign Income.
8. Explain the meaning of income received or deemed to be received in India.
9. Mention the different categories of income which are deemed to accrue or arise in India.
10. X, an Indian citizen, leaves India on May 22, 2005 for vacation to Uganda and returns on April 9, 2006. Determine the residential status of X for the assessment year 2006-07.
11. Y, a foreign citizen, visits India since 1985 every year for a period of 100 days. Determine the residential status of Y for the assessment year 2006-07.
12. Rakesh was working as a crew member on an Indian ship plying in foreign waters. During the year ended 31.03.2008, the ship did not touch the Indian coast, except for 180 days. State the residential status for the assessment and taxability of his salary.
13. X got an employment in Singapore during the previous year 2008-09. He left for Singapore on August 9, 2008. He is an Indian Citizen. Determine the residential status for the Assessment Year 2009-10.

14. Following are the details of income of Mr. Subramani for the financial year 2009-2010 :

Notes

**Income from property in Sri Lanka remitted by the tenant to the assessee**

In India through SBI	₹ 2, 10,000
Profit from business in India	₹ 1, 00,000
Loss from business in Sri Lanka (whose control and management of business wholly remained in India)	₹ 80,000
Dividend from shares in foreign companies received outside India	₹ 60,000
Interest on deposits in India companies	₹ 1, 20,000

Determine the total income in terms of the Income-tax Act, 1961 in the following situations:

- (i) Resident and ordinarily resident of India;
- (ii) Resident but not ordinarily resident of India;
- (iii) Non-resident.

**Answers: Self Assessment**

- |                                    |                   |
|------------------------------------|-------------------|
| 1. (c)                             | 2. (a)            |
| 3. (a)                             | 4. (b)            |
| 5. True                            | 6. False          |
| 7. True                            | 8. True           |
| 9. False                           | 10. Taxable       |
| 11. Taxable                        | 12. Non Taxable   |
| 13. Non Taxable                    | 14. Section 5     |
| 15. Residential status             | 16. India         |
| 17. Resident and ordinary resident | 18. Cash system   |
| 19. Accrue                         | 20. Explanation 1 |
| 21. India                          | 22. True          |
| 23. False                          | 24. True          |
| 25. True                           |                   |

**2.10 Further Readings**



Books

Ahuja, G. K. & Gupta, Ravi, *Systematic Approach to Income Tax*, Bharat Law House.

Aggarwal, K., *Direct Tax Planning and Management*, Atlantic Publications.

Lakhotia, R.N., *Income Tax Planning Handbook*, Vision Books.

Singhania, V. K. & Singhania, Kapil, *Direct Taxes law & Practice*. Taxmann Publications.

Srinivas E. A., *Handbook of Corporate Tax Planning*, Tata McGraw Hill.

Notes



*Online links*

[http://220.227.161.86/19765ipcc\\_it\\_vol1\\_cp2.pdf](http://220.227.161.86/19765ipcc_it_vol1_cp2.pdf)

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[http://www.du.ac.in/fileadmin/DU/Academics/course\\_material/TM\\_02.pdf](http://www.du.ac.in/fileadmin/DU/Academics/course_material/TM_02.pdf)

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[http://www.indialiaison.com/residential\\_status.htm](http://www.indialiaison.com/residential_status.htm)

<http://www.welcome-nri.com/info/project/defnri.htm>

<http://www.ninemilliondollars.com/2012/06/knowning-your-residential-status-and-income-tax-implications/>



## Unit 3: Corporate Tax Planning

Notes

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### Objectives

After studying this unit, you will be able to:

- Explain the concept of tax planning
- Discuss corporate tax planning
- Describe tax evasion

Notes

- Discuss tax avoidance
- Explain the concept of tax management

## Introduction

Tax planning involves conceiving of and implementing various strategies in order to minimise the amount of taxes paid for a given period. For a small business, minimising the tax liability can provide more money for expenses, investment, or growth. In this way, tax planning can be a source of working capital. There are several general areas of tax planning that apply to all sorts of small businesses. These areas include the choice of accounting and inventory-valuation methods, the timing of equipment purchases, the spreading of business income among family members, and the selection of tax-favoured benefit plans and investments. So, before one can embark on a study of the tax planning, it is absolutely vital to understand the meaning of tax planning and the concept of tax evasion, tax avoidance, tax planning and tax management. The purpose of this unit is to enable the students to comprehend basic expressions. Therefore, all such basic terms are explained and suitable illustrations are provided to define their meaning and scope.

### 3.1 Concept of Tax Planning

Tax planning is a broad term that is used to describe the processes utilised by individuals and businesses to pay the taxes due to local, state, and federal tax agencies. The process includes such elements as managing tax implications, understanding what type of expenses are tax deductible under current regulations, and in general planning for taxes in a manner that ensures the amount of tax due will be paid in a timely manner.

One of the main focuses of tax planning is to apply current tax laws to the revenue that is received during a given tax period. The revenue may come from any revenue producing mechanism that is currently in operation for the entity concerned. For individuals, this can mean income sources such as interest accrued on bank accounts, salaries, wages and tips, bonuses, investment profits, and other sources of income as currently defined by law. Businesses will consider revenue generated from sales to customers, stock and bond issues, interest bearing bank accounts, and any other income source that is currently considered taxable by the appropriate tax agencies.

Tax planning involves conceiving of and implementing various strategies in order to minimise the amount of taxes paid for a given period. For a small business, minimising the tax liability can provide more money for expenses, investment, or growth. In this way, tax planning can be a source of working capital. Tax planning is not a device to reduce tax burden. In fact, it helps savings by investments in government securities. Savings reduce extravagance, and correspondingly inflation. Tax savings are permitted only for investment made in government securities and bonds of priority sectors which ultimately help the nation. Therefore, the savings in tax help the Central and State Governments to mobilise funds by way of investments and as such the government earns much by way of other benefits, by sacrificing small amount of tax. The Supreme Court in one case observed that "Tax planning may be legitimate provided it is within the framework of Law". By tax planning, the government is equally benefited.



*Did u know?* **Basic rules applicable to tax planning:**

1. Firstly, a small business should never incur additional expenses only to gain a tax deduction. While purchasing necessary equipment prior to the end of the tax year can be a valuable tax planning strategy, making unnecessary purchases is not recommended.

2. Secondly, a small business should always attempt to defer taxes when possible. Deferring taxes enables the business to use that money interest-free, and sometimes even earn interest on it, until the next time taxes are due.

Notes

Tax planning is an essential part of your financial planning. Efficient tax planning enables you to reduce your tax liability to the minimum. This is done by legitimately taking advantage of all tax exemptions, deductions rebates and allowances while ensuring that your investments are in line with your long term goals.

In many cases, a primary goal of tax planning is to apply current laws in a manner that allows the individual or business to reduce the amount of taxable income for the period. Thus, planning for taxes involves knowing which types of income currently qualify for as exempt from taxation. The process also involves understanding what types of expenses may be legitimately considered as deductions, and what circumstances have to exist in order for the deduction to be claimed on the tax return.



*Notes* There are three common approaches to tax planning for the purpose of minimising the tax burden.

The first is to reduce the adjusted gross income for the tax period. This is where understanding current tax laws as they relate to allowances and exemptions come into play.

A second approach to tax planning is to increase the amount of tax deductions. Again, this means knowing current laws and applying them when appropriate to all usual and normal expenses associated with the household or the business. Since these can change from one annual period to the next, it is always a good idea to check current regulations.

One final approach that may be applicable to effective tax planning has to do with the use of tax credits. This can include credits that relate to retirement savings plans, college expenses, adopting children, and several other credits.

### 3.1.1 General Areas of Tax Planning

There are several general areas of tax planning that apply to all sorts of small businesses. These areas include the choice of accounting and inventory-valuation methods, the timing of equipment purchases, the spreading of business income among family members, and the selection of tax-favoured benefit plans and investments. Some of the general taxes planning strategies are described below:

1. **Accounting Methods:** Accounting methods refer to the basic rules and guidelines under which businesses keep their financial records and prepare their financial reports. There are two main accounting methods used for record-keeping: the cash basis and the accrual basis. Small business owners must decide which method to use depending on the legal form of the business, its sales volume, whether it extends credit to customers, and the tax requirements set forth by the Internal Revenue Service (IRS). The choice of accounting method is an issue in tax planning, as it can affect the amount of taxes owed by a small business in a given year.

Accounting records prepared using the cash basis recognises income and expenses according to real-time cash flow. Income is recorded upon receipt of funds, rather than based upon when it is actually earned, and expenses are recorded as they are paid, rather than as they are actually incurred. Under this accounting method, therefore, it is possible to defer taxable income by delaying billing so that payment is not received in the current

**Notes**

year. Likewise, it is possible to accelerate expenses by paying them as soon as the bills are received, in advance of the due date. The cash method is simpler than the accrual method, it provides a more accurate picture of cash flow, and income is not subject to taxation until the money is actually received.

In contrast, the accrual basis makes a greater effort to recognise income and expenses in the period to which they apply, regardless of whether or not money has changed hands. Under this system, revenue is recorded when it is earned, rather than when payment is received, and expenses recorded when they are incurred, rather than when payment is made. The main advantage of the accrual method is that it provides a more accurate picture of how a business is performing over the long-term than the cash method. The main disadvantages are that it is more complex than the cash basis, and that income taxes may be owed on revenue before payment is actually received. However, the accrual basis may yield favourable tax results for companies that have few receivables and large current liabilities.



*Notes* Under Generally Accepted Accounting Principles (GAAP), the accrual basis of accounting is required for all businesses that handle inventory, from small retailers to large manufacturers. It is also required for corporations and partnerships that have gross sales over \$5 million per year, though there are exceptions for farming businesses and qualified personal service corporations—such as doctors, lawyers, accountants, and consultants. Other businesses generally can decide which accounting method to use based on the relative tax savings it provides.

Hence, we can conclude. Some form of record-keeping is required by law and for tax purposes, but the resulting information can also be useful to managers in assessing the company's financial situation and making decisions. It is possible to change accounting methods later, but the process can be complicated. Therefore it is important for small business owners to decide which method to use up front, based on what will be most suitable for their particular business.

2. **Cash vs. Accrual Basis:** A taxpayer chooses his accounting method when he files his first income tax return. The Tax Code requires that taxpayers use a consistent method of accounting from year to year. Thus, if a taxpayer wishes to change its accounting method it must get permission to do so from the IRS. To request a change in accounting method you must file IRS Form 3115. This is a highly complex form and should not be completed without the assistance of a qualified CPA or tax attorney. The two most commonly used methods of accounting are the Accrual and the Cash methods. The Cash Method of accounting allows taxpayers to report their revenues when received and expenses when paid. More than 95% of individual taxpayers use the Cash Method of accounting to report their taxable income and deductible expenses on their Forms 1040. Under the Accrual Method of accounting a taxpayer records his income when a sale occurs, not when payment is received. Likewise, he records a deductible expense when it's incurred, not when it's paid.

Since the recognition of revenues and expenses under the cash method depends upon the timing of various cash receipts and disbursements, however, it can sometimes provide a misleading picture of a company's financial situation. In contrast, the accrual basis makes a greater effort to recognise income and expenses in the period to which they apply, regardless of whether or not money has changed hands. Under this system, revenue is recorded when it is earned, rather than when payment is received, and expenses recorded when they are incurred, rather than when payment is made.



*Example:* Say that a contractor performs all of the work required by a contract during the month of May, and presents his client with an invoice on June 1. The contractor would still recognise the income from the contract in May, because that is when it was earned, even though the payment will not be received for some time.

The main advantage of the accrual method is that it provides a more accurate picture of how a business is performing over the long-term than the cash method. The main disadvantages are that it is more complex than the cash basis, and that income taxes may be owed on revenue before payment is actually received.

3. **Inventory Valuation Methods:** The method a small business chooses for inventory valuation can also lead to substantial tax savings. Inventory valuation is important because businesses are required to reduce the amount they deduct for inventory purchases over the course of a year by the amount remaining in inventory at the end of the year.



*Example:* Mr. X that purchased ₹ 10,000 in furniture during the year but had ₹ 6,000 remaining in furniture at the end of the year could only count ₹ 4,000 as an expense for furniture purchases, even though the actual cash outlay was much larger. Valuing the remaining furniture differently could increase the amount deducted from income and thus reduce the amount of tax owed by the business.

The tax law provides two possible methods for inventory valuation: the First-in, First-out (FIFO) method; and the Last-in, First-out (LIFO) method. As the names suggest, these inventory methods differ in the assumption they make about the way items are sold from inventory. FIFO assumes that the items purchased the earliest are the first to be removed from inventory, while LIFO assumes that the items purchased most recently are the first to be removed from inventory. In this way, FIFO values the remaining inventory at the most current cost, while LIFO values the remaining inventory at the earliest cost paid that year.



*Did u know?* LIFO is generally the preferred inventory valuation method during times of rising costs. It places a lower value on the remaining inventory and a higher value on the cost of goods sold, thus reducing income and taxes. On the other hand, FIFO is generally preferred during periods of deflation or in industries where inventory can tend to lose its value rapidly, such as high technology. Companies are allowed to file Form 970 and switch from FIFO to LIFO at any time to take advantage of tax savings. However, they must then either wait ten years or get permission from the IRS to switch back to FIFO.

4. **Equipment Purchases:** It is often advantageous for small businesses to use this tax incentive to increase their deductions for business expenses, thus reducing their taxable income and their tax liability. Necessary equipment purchases up to the limit can be timed at year end and still be fully deductible for the year.



*Caution* This tax incentive is also applicable to the personal property put into service for business use, but with the exception of automobiles and real estate.

5. **Benefits Plans and Investments:** Tax planning also applies to various types of employee benefits that can provide a business with tax deductions, such as contributions to life insurance, health insurance, or retirement plans. As an added bonus, many such benefit programs are not considered taxable income for employees. Finally, tax planning applies to various types of investments that can shift tax liability to future periods, such as treasury bills, bank certificates, savings bonds, and deferred annuities. Companies can avoid paying taxes during the current period for income that is reinvested in such tax-deferred instruments.

### 3.1.2 Tax Planning for Different Business Forms

“The first step in tax planning-for small business owners and professionals, at least-is to select the right form of organisation for your enterprise,” is according to Albert B. Ellentuck in the Laventhol and Horwath Small Business Tax Planning Guide. “You’ll end up paying radically different amounts of income tax depending on the form you select. And your odds of being audited by the IRS will change, too.” There are also some areas of tax planning that are specific to certain business forms – i.e., sole proprietorships, partnerships, C corporations, and S corporations.

Many aspects of tax planning are specific to certain business forms. Some of these are discussed below:

- (i) **Sole Proprietorships and Partnerships:** Tax planning for sole proprietorships and partnerships is in many ways similar to tax planning for individuals. This is because the owners of businesses organised as sole proprietors and partnerships pay personal income tax rather than business income tax. These small business owners file an informational return for their business with the IRS (Internal Revenue Service), and then report any income taken from the business for personal use on their own personal tax return.

Since they do not receive an ordinary salary, the owners of sole proprietorships and partnerships are not required to withhold income taxes for themselves. It is important that the amount of tax paid in quarterly instalments equal either the total amount owed during the previous year or 90 percent of their total current tax liability. Otherwise, the IRS may charge interest and impose a stiff penalty for underpayment of estimated taxes.

Since the IRS calculates the amount owed quarterly, a large lump-sum payment in the fourth quarter will not enable a taxpayer to escape penalties. On the other hand, a significant increase in withholding in the fourth quarter may help, because tax that is withheld by an employer is considered to be paid evenly throughout the year no matter when it was withheld. This leads to a possible tax planning strategy for a self-employed person who falls behind in his or her estimated tax payments. By having an employed spouse increase his or her withholding, the self-employed person can make up for the deficiency and avoid a penalty. The IRS has also been known to waive underpayment penalties for people in special circumstances.



*Example:* They might waive the penalty for newly self-employed taxpayers who underpay their income taxes because they are making estimated tax payments for the first time.

Another possible tax planning strategy applies to partnerships that anticipate a loss. At the end of each tax year, partnerships file the informational Form 1065 (Partnership Statement of Income) with the IRS, and then report the amount of income. This income can be divided in any number of ways, depending on the nature of the partnership agreement. In this way, it is possible to pass all of a partnership’s early losses to one partner in order to maximise his or her tax advantages.

- (ii) **C Corporations:** Tax planning for C corporations is very different than that for sole proprietorships and partnerships. This is because profits earned by C corporations accrue to the corporation rather than to the individual owners, or shareholders. A corporation is a separate, taxable entity under the law, and different corporate tax rates apply based on the amount of net income received. Personal service corporations like medical and law practices, pay a flat rate of 35 percent. In addition to the basic corporate tax, corporations may be subject to several special taxes.

Corporations must prepare an annual corporate tax return on either a calendar-year basis (the tax year ends December 31, and taxes must be filed by March 15) or a fiscal-year basis (the tax year ends whenever the officers determine). Most Sub-chapter S corporations,

as well as C corporations that derive most of their income from the personal services of shareholders, are required to use the calendar-year basis for tax purposes. Most other corporations can choose whichever basis provides them with the most tax benefits. Using a fiscal-year basis to stagger the corporate tax year and the personal one can provide several advantages.

Notes



*Example:* Many corporations choose to end their fiscal year on January 31 and give their shareholder/employees bonuses at that time. The bonuses are still tax deductible for the corporation, while the individual shareholders enjoy use of that money without owing taxes on it until April 15 of the following year.

Both the owners and employees of C corporations receive salaries for their work, and the corporation must withhold taxes on the wages paid. All such salaries are tax deductible for the corporations, as are fringe benefits supplied to employees. Many smaller corporations can arrange to pay out all corporate income in salaries and benefits, leaving no income subject to the corporate income tax. Of course, the individual shareholder/employees are required to pay personal income taxes. Still, corporations can use tax planning strategies to defer or accrue income between the corporation and individuals in order to pay taxes in the lowest possible tax bracket. The one major disadvantage to corporate taxation is that corporate income is subject to corporate taxes, and then income distributions to shareholders in the form of dividends are also taxable for the shareholders. This situation is known as “double taxation.”

- (iii) **S Corporations:** Sub-chapter S corporations avoid the problem of double taxation by passing their earnings (or losses) through directly to shareholders, without having to pay dividends. Experts note that it is often preferable for tax planning purposes to begin a new business as an S corporation rather than a C corporation. Many businesses show a loss for a year or more when they first begin operations. At the same time, individual owners often cash out investments and sell assets in order to accumulate the funds needed to start the business. The owners would have to pay tax on this income unless the corporate losses were passed through to offset it.

Another tax planning strategy available to shareholder/employees of S corporations involves keeping FICA (Federal Insurance Contributions Act) taxes low by setting modest salaries for themselves, below the Social Security base. S corporation shareholder/employees are only required to pay FICA taxes on the income that they receive as salaries, not on income that they receive as dividends or on earnings that are retained in the corporation. It is important to note, however, that unreasonably low salaries may be challenged by the IRS.

The key objective in effective corporate tax planning is to identify the main factors in the organisation’s structure that dictate the opportunities for tax efficiencies.



**Caution What tax planning is not?**

1. Tax Planning is NOT tax evasion. It involves sensible planning of your income sources and investments. It is not tax evasion which is illegal under Indian laws.
2. Tax Planning is NOT just putting your money blindly into any 80C investments.
3. Tax Planning is NOT difficult. Tax Planning is easy. It can be practiced by everyone and with a very little time commitment as long as one is organised with their finances.

### 3.1.3 Tax Planning Tips that can assist Salaried People to Reduce their Tax Accountability

Tax Planning India is an application to reduce tax liability through the finest use of all accessible allowances, exclusions, deductions, exemptions, etc, to trim down income and/or capital profits. Salaried individuals in India are not fully aware of the tax planning exercise which is why they rush at the end of the tax planning season and make investments to reduce their tax liability. This has negative effect on tax payable by them and they eventually end up paying more taxes than they are required to.

1. **Make full use of the entire Section 80C deduction:** The maximum reduction available in Section 80C is ₹ 100,000 and salaried citizens whose gross salary is ₹ 250,000 or more are entitled to use the full ₹ 100,000 limit. Individuals who make monetary infusions of over ₹ 100,000 in Section 80C in selected areas fail to understand that the advantages are limited. In spite of investing ₹ 70,000 and ₹ 40,000 in Public Provident Fund and ELSS (Equity Linked Savings Scheme) respectively, the amount entitled by the investor is only ₹ 100,000.



*Notes* Following investments/contributions meet the criteria for Section 80C reduction:

1. Public Provident Fund
  2. Accrued interest on National Saving Certificate
  3. Life Insurance Premium
  4. National Saving Certificate
  5. Tuition fees paid for children's education (maximum 2 children)
  6. Principal component of home loan repayment
  7. 5-Year fixed deposits with banks and Post Office
  8. Equity Linked Savings Schemes (ELSS)
2. **Reduction of tax liability beyond Section 80C deductions:** If your salary surpasses ₹ 250,000 pa and the reductions under Section 80C are not enough to minimise the general tax liability consider the following:
    - (a) *Home loan:* Interest payments of up to ₹ 150,000 pa are entitled for reduction under Section 24.
    - (b) *Medical insurance:* A deduction of up to ₹ 15,000 pa under section 80D is applicable under this.
    - (c) *Donations:* Tax advantages under Section 80G entitle the donations to particular funds/institutions.
  3. **Assert tax advantages on house rent paid:** If HRA (House Rent Allowance) is not included in the salary structure then the salaried individuals can asset rent paid by them for residential lodging. This reduction is accessible under Section 80GG and is smallest amount of the following:
    - (a) 25% of the total earnings, or
    - (b) ₹ 2,000 every month, or
    - (c) Surplus of housing charge paid over 10% of total salary.



4. **Reorganise the salary:** Reorganising the salary and incorporating certain apparatus can help in the long run in minimising the tax liability. In order to assert tax benefits salary reform is a more competent measure. The following can be included in an individual's salary structure:
- Food coupons can release up to ₹ 60,000 per year from tax.
  - Medical expenses which are compensated by the employer spare up to ₹ 15,000 per year.
  - House Rent Allowance (HRA) should be incorporated in the salaries of individuals who stay in rented houses
  - Transport allowance discharge up to ₹ 800 per month.
5. **Go for a combined home loan:** The primary reimbursement on a home loan is entitled for a reduction of up to ₹ 100,000 pa and the interest rewarded are entitled for a reduction of up to ₹ 150,000 pa. When a home loan is for a considerable amount then the interest and chief reimbursement surpass the allotted limit. A salaried individual can go for a combined joint home loan with his parent, spouse or sibling, to guarantee the best utilisation of tax advantages.

In this way both the owners can assert tax reductions in the percentage of their stake holding in the loan.

### 3.1.4 Different Types of Tax Planning Strategies

The goal of all tax planning strategies is to minimise an individual's or business' total tax liability for the year while also meeting personal or business financial goals. In order to achieve these goals, comprehensive research and exacting record keeping are essential elements of all types of successful planning strategies. An individual may not need to use every type of tax strategy, but having a broad knowledge of tax issues will assure that he minimises his tax liability and prepares an accurate return. Whether it is taking advantage of current education-related tax credits or understanding the intricacies of depreciation, each strategy relies on thorough research and meticulous record keeping.

Investigating all aspects of income taxes – concentrating on the areas that pertain to the individual's financial situation – is the most important tax planning strategy. Many credits, deductions and limits on retirement or health savings accounts contributions change from year to year. Taxpayers often remain unaware of these changes and miss opportunities that they would qualify for. The most accurate and updated information can be accessed through the federal, state or local tax entity.

Whether using a tax professional, accountant, or self-preparing the return, implementing tax planning strategies and maintaining records throughout the year provides the individual or business with the necessary tools to minimise tax liability. This second important tax planning strategy allows the individual or business to accurately track their progress on their goals through precise record keeping. It also assures nothing is missed when it is time to prepare the tax return. Spreadsheets and financial software are tax planning tools that help organise information. The software expense may be tax deductible.

Although the first two tax planning strategies apply to everyone, others are applicable depending on the individual's financial situation. Making sure that pre-tax contributions to retirement and health savings accounts are maximised and done within the allowed time span may help lower any tax liability. Homeowners should use strategies that take advantage of any credits available for expenses related to their residences.

Notes



*Example:* Property taxes and interest on mortgages are usually deductible expenses. Special tax credits may be temporarily available for improvements that increase the energy efficiency of the home, so taking advantage of these can also reduce tax liability.

College students, their families and anyone taking coursework should be aware of changes to the credits and deductions available for education-related expenses. The treatment of investment income and losses may change, too, so individuals might make advantageous adjustments based on current rules. Other tax planning strategies involve medical expenses, charitable contributions and adjustments to tax withholding amounts. Many people are unaware that deductions can be taken up to the amount of any earnings related to a hobby. In the same manner, gambling losses can be deducted up to the amount of gambling winnings.



Case Study

### Company Director Failed to Pay Employees' Income Tax

**T**he defendant was the director of two companies.

The Court was satisfied that at all material times the returns lodged by the defendant's companies were true and correct. There was no evidence of any false or misleading statements or evidence of their failure to pay being concealed.

The defendant's companies, in the usual fashion, deducted amounts from their employees' income for the purpose of satisfying income tax obligations. It appears, however, that due to severe cash flow issues, these amounts were never paid to the Commissioner.

The defendant was indicted on two charges of "Defrauding the Commonwealth" through not remitting in full the amounts owed to the Commissioner. In other words, the Commonwealth alleges that they were defrauded by the debtor's failure to pay their debt.

The debtor was sentenced to six months' periodic detention for the offences at first instance.

On appeal, the Court held that simply not paying a debt was not fraud in the absence of evidence that the defendant had somehow concealed either information or the non-payment of the debts. The Court said "in the present case... there was no evidence companies made any false or misleading statements to the Commissioner or concealed their failures to pay or that the Commissioner was deceived..." Thus the company's returns contained no fraudulent misrepresentations or non-disclosure, and in any event the Crown did not establish that they deprived the Commonwealth of the group tax or put that tax at risk.

On this basis the Court held that there was no defrauding of the Commonwealth and allowed the appeal, dismissing all the charges.

Source: <http://www.armstronglegal.com.au/corporate-crime/tax-fraud/cases>

### Self Assessment

State whether the following statements are true or false:

1. Savings increase extravagance, and correspondingly inflation.
2. In Inventory Valuation Methods, a small business chooses for inventory valuation can also lead to substantial tax savings.

3. LIFO assumes that the items purchased the earliest are the first to be removed from inventory.

Notes

## **3.2 Overview of Corporate Tax Planning**

Corporate tax refers to a tax levied by various jurisdictions on the profits made by companies or associations. As a general principle, the tax varies substantially between jurisdictions. In particular allowances for capital expenditure and the amount of interest payments that can be deducted from gross profits when working out the tax liability vary substantially. Also, tax rates may vary depending on whether profits have been distributed to shareholders or not. Profits which have been reinvested may not be taxed. The term “corporate tax planning” encompasses the strategic structuring of business operations in order to minimise tax liabilities. Corporate tax planning activities generally seek to avoid legally triggering tax costs rather than illegally evading an existing obligation to pay taxes. Tax planning represents a forward-looking activity, as opposed to tax compliance or reporting, which reflects back on events that have already taken place. Corporations typically engage certified public accountants or tax attorneys for technical advice in this complicated area. Basically Corporate Tax Planning is the strategies to reduce the taxes. Tax planning and management is a risky and complex issue. It is very much at high priority to deal with the taxes efficiently and effectively. There is indeed a need of perfect corporate tax planning that will really facilitate the smooth flow.

A fundamental aspect of corporate tax planning involves determining which particular countries, states and cities have the authority to impose tax on corporate activities. Each sovereign government maintains different rules for imposing tax, which means that jurisdictional arbitrage can create tax cost differentials. Corporate tax planning opportunities oftentimes arise from identifying the appropriate time to recognise an item of income or expense. Deferral of income recognition to a future period or acceleration of expense deductions to current period result in positive cash flows and savings due to the time value of money. Strategically exploiting the discrepancies in rules for book accounting versus tax accounting may help create timing differences that produce tax benefits.

Corporate tax rate in India is at par with the tax rates of other nations of the world. The corporate tax rate in India is based on the origin of the company. If the company is domicile to India, then the tax rate is flat at 30%. But for a foreign company, then the tax rate depends on several other factors and considerations. For companies that are domicile to India, tax is charged on the global income whereas for the foreign companies present in India, tax is charged on their income within Indian Territory. Incomes that are taxable for foreign companies include income from the capital assets in India, interest gained, income from sale of equity shares of the company, royalties, dividends earned, etc.

### **3.2.1 Domestic Corporate Income Taxes Rates**

In case of Domestic Corporations the effective tax rate as well the tax rate with surcharge is 30%. It should be noted that if the taxable income is greater than ₹ 1 million then a surcharge of 10% of the tax on income is also levied.



*Notes* It is important to note the fact that all the companies formed in India are considered as Indian domestic companies, even for ancillary units with mother companies in foreign countries.

### 3.2.2 Foreign Companies Income Tax Rates

Following are the foreign companies income tax rates:

1. **For dividends:** 20% for non-treaty foreign companies and 15% in case of companies under the treaty based in the United States
2. **For interest gains:** 20% for non-treaty foreign companies and 15% for companies under the treaty based in the United States
3. **For royalties:** 30% for non-treaty foreign companies and 20% for companies under the treaty based in the United States
4. For the technology based services in case of non-treaty foreign companies & 20% for companies under the treaty based in the United States
5. **For all other kinds of income and gains:** 55% in case of non-treaty foreign companies and 55% for the companies under the treaty based in the United States
6. Attention should be given on levying inter corporate rates in case holding is minimum
7. Attention should be given on the fact that sanctions of the tax authorities on tax withholding
8. Attention should be given on several of the tax treaties that India signed with other countries and also on the various encouraging tax rates

### 3.2.3 Tax Rebates under Corporate Tax Rate

Some of the tax rebates under corporate tax rate in India:

1. Gains pertaining to long term capital are subject to low tax incidence
2. Venture capital funds and venture capital companies have special tax provisions
3. Specula tax provisions are applicable for non resident Indians involved in activities in India
4. Under the Finance Bill 1996, the Minimum Alternative Tax (MAT) is levied on the corporate sector

Taxes can eat away at business profits. To address it, small business owners and corporate leaders look for ways to reduce their tax liability, and the tax planning process is an integral part of this activity.

- (i) **Identification:** Tax planning is the act of developing a plan to minimise or defer taxes paid against current business revenue or income. The planning process includes understanding all local, state and federal tax obligations, determining which deductions are available and how and when to pay each tax.
- (ii) **Function:** The essence of tax planning is determining how to maximise tax deductions against current revenue. Options include, but are not limited to, deductions associated with incorporation status (sole proprietorship, S-corporation, LLC or C-corporation), capital expenditures and setting up 401(k) plans for employees. Business owners use the tax planning process to find and take advantage of all deductions available.
- (iii) **Significance:** Companies decide whether to expand and hire new employees based on their tax burden. For this reason, tax planning is crucial and business owners do it religiously every year.

Wise corporate officials take time to perform due diligence in researching the availability of tax reducers, such as deduction and credits. They will use this research to design business activities to qualify for these reducers as often as possible. Corporate officials also can minimise tax liability by strategically locating business activities where they can take advantage of low-tax environments, deductions and credits.

### 3.2.4 Case for Levy of Corporate Tax

Under a system of general income taxation, whether companies should be taxed independently as separate entities has been the subject matter of prolonged debate among tax economists. One view is that since corporations are not persons, strictly speaking, there is no case in equity for taxing the profits of companies as such. The tax should be levied only on the owners, that is, the equity holders, by attributing the profits of the companies to the shareholders. Such a system, however, can operate smoothly only if all profits are distributed every year among the shareholders. Where part of the profits is retained, the gain to the shareholders accruing from appreciation in the value of equities escapes taxation unless there is an effective tax on realised capital gains or unless the undistributed profits are attributed notionally to the shareholders. This is not simple in the case of large corporations in which the shares undergo sale or transfer all the time.

Since capital gains are usually treated preferentially, even where the income tax is levied on capital gains, exclusion of retained profits of companies from taxation provides an easy way of avoiding taxation by accumulating profits under the corporate cover. Taxation on the basis of attribution also encounters problems in the determination of capital gains when the shares are transferred, as the cost basis has to be adjusted annually to take account of the notional distribution of accumulated profits underlying the capital gain. Besides, taxation on notional basis gives rise to liquidity problems and hence does not seem equitable or feasible. It is therefore generally accepted that some tax has to be levied on the profits of companies so long as individuals and unincorporated enterprises are subjected to tax on their profits.

Taxation of companies as separate entities is also justified as a withholding tax, which may be a useful means of ensuring that income flowing through the conduit is taxed in a comprehensive and timely manner and that the base of the individual income tax is protected. Many economists, including some who have not advocated full integration, have argued that this withholding function is indeed the main argument for the imposition of a tax on corporate income.

A separate tax on the profits of companies is considered reasonable also on the ground that incorporation confers substantial benefits such as limited liability of shareholders, right to sue and be sued and so on. What is more, corporate taxation is an administratively simple device for taxing an important type of income from capital.

### Self Assessment

Fill in the blanks:

4. .... Planning is the strategy to reduce the taxes.
5. Corporate officials also can ..... tax liability by strategically locating business activities.
6. Taxation on notional basis gives rise to ..... problems.

### 3.3 Tax Evasion

Tax evasion as the term implies refers to the phenomenon of evading tax. Tax evasion is the general term for efforts by individuals, firms, trusts and other entities to evade taxes by illegal means. Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting (such as declaring less income, profits or gains than actually earned; or overstating deductions).



*Example:* Some entities collect revenue in cash and do not record the same. The logic behind not disclosing the true income is to avoid paying taxes on the non-recorded income. This example is a clear example of tax evasion and is an illegal act. Tax avoidance on the other hand is a legal activity.

Tax evasion is usually understood to be an act in which an individual intentionally chooses to not pay income taxes due. This act of not paying taxes may be conducted by simply chooses to not file an income tax return, or choosing to not include information about taxable income on the filed return. In all instances, tax evasion can be considered to be fraud, and usually carries stiff penalties.



*Caution* Tax evasion is illegal, so those engaging in it have every reason to seek to conceal what they are doing. This introduces a fundamental difficulty into the measurement of tax evasion. Even so, the fact that the estimates that are available show evasion constitute a significant part of total economic activity underlines the importance of measurement. The lost revenue due to tax evasion also emphasises the value of developing a theory of evasion that can be used to design a tax structure that minimises evasion and ensures that policy is optimal given evasion occurs.

While there are some that consider any type of omission from the tax return to constitute tax evasion, it is important to remember that it is possible to omit an item simply because the data was overlooked when filing the return. Thus, the intent of the individual plays a key role in determining if tax evasion has taken place. When the return fails to include information simply because the filer overlooked the data, there is a good chance that the tax agency will still impose a fine of some sort, but no further action would be taken.

However, when it can be demonstrated that the individual wilfully attempted to hide information about income that was subject to withholding, the tax agency may choose to impose more than a simple interest fine on the amount omitted. The filer may be subject to stiff fines associated with the deliberate failure to file an accurate tax return, or even possibly face prosecution and some time spent in jail for the intentional negligence.

Tax evasion is considered a crime, and is often classified as fraud. All citizens suffer from tax evasion, as the act prevents the government from collecting funds to use for the operation of essential services to the population. When these funds are not collected, services have to be curtailed and thus result in a lower quality of life for all citizens.

Persons who become aware of an error on calculating taxes on reported income or notice that income was inadvertently left off the tax return for a given period should contact the tax agency and make arrangements to file an amended return as soon as possible. This will help to minimise the chances of being suspected of tax evasion, and allow the matter to be settled before interest charges become significant.



*Notes* Some of the instances of tax evasion relate to failing and claiming:

**Failing to:**

1. report all income
2. report cash wages
3. forward tax withheld from employee's wages to the ATO
4. withhold tax from a worker's wages - for example, paying cash in hand
5. pay employee super entitlements
6. lodge tax returns, in an attempt to avoid payment
7. lodge a tax return in order to avoid child support or other obligations

**Claiming:**

1. deductions for expenses not incurred or legally deductible
2. input credits for goods or services that GST has not been paid on.

### 3.3.1 Importance of Tax Evasion

Tax evasion is important for many reasons.

- (i) It reduces tax collections, thereby affecting taxes that compliant taxpayers face and public services that citizens receive.
- (ii) Evasion creates misallocations in resource use when individuals and firms alter their behaviour to cheat on their taxes.
- (iii) Its presence requires that government expend resources to deter non-compliance, to detect its magnitude, and to penalise its practitioners.
- (iv) Tax evasion alters the distribution of income unpredictably; unless tax evaders are caught, they pay fewer taxes than honest taxpayers. Evasion may contribute to feelings of unfair treatment and disrespect for the law, creating a self-generating cycle that feeds upon itself and leads to even more evasion. It affects the accuracy of macroeconomic statistics.
- (v) More broadly, it is not possible to understand the true impact of taxation without recognising the existence of evasion.

### 3.3.2 Causes of tax evasion

Following are the causes of Tax Evasion:

- (i) **Controls and Licensing System:** The system of controls, permits, quotas and licenses which are associated with misdistributions of the commodities in short supply results in the generation of black money which leads to tax evasion. Since considerable discretionary powers lay in the hands of those who administered controls this provided them with a scope for corruption - 'speed money' for turning a blind eye to the violation of controls. All this gave rise to trading in permits, quotas and licenses, malpractices in distribution and in the process; it generated sizeable sums of black money." Price and distribution controls have in the past led to the generation of black money on a significant scale.

Notes



*Did u know?* Any price control without any adequate machinery of distribution and speedy arrangement for increasing supplies is potentially a source of black money generation.

- (ii) **Tax Structure:** High tax rates and defective tax structure is a major cause of tax evasion. An individual has to pay a substantial amount of taxes on his salary and when he invests the remaining salary, the profit earned is also taxable. This is not the least, on every purchase of any product and commodities he pays the various taxes attached with it. This is annoying to an individual which encourages him to default taxes. Honest assesses are not aware how to file tax returns. This may lead to tax evasion.
- (iii) **Donation to Political Parties:** Ever since the Government decided to ban donations to political parties in 1968, it prompted businessmen to fund political parties, especially the ruling party, with the help of black money. Ostensibly, this decision was taken to reduce the influence of big business on the electoral process, but in practice what happened was precisely the opposite. Businessmen everywhere have by now learnt that they should pay a certain charge out of the black money to the coffers of political parties and then be sure that the political leaders will only bark but not bite.



*Did u know?* The political instability witnessed in the country in -various states has resulted in widespread horse-trading of the MLAs at the state levels and MPs at the Central level. In this process of buying political support, black money plays a crucial role. Consequently the determination of the ruling political party to curb black money has become very weak. As a consequence, businessmen feel they have an unfettered license to spin black money, pay a small part to the political parties as donations and then enjoy the rest the way they like. Unless the link between black money and political power is broken, there is no hope of controlling the generation of black money or its link with crime.

- (iv) **Ineffective Enforcement of Tax Laws:** Whereas the Government has an armoury of tax laws pertaining to income tax, sales tax, stamp duties, excise duty etc., their enforcement is very weak due to widespread corruption in these departments. . The high rates of these taxes induce businessmen to avoid recording of these transactions. This evasion largely goes unchecked and thus sets in a chain reaction for the generation of black money at the wholesale, retail as well as production levels.
- (v) **Generation of Black Money in the Public Sector:** Every successive five-year plan is planned for a larger size of investment in the public sector. The projects undertaken by the public sector have to be monitored by the bureaucrats in Government departments and public sector undertakings. Tenders are invited for the various works and these tenders are awarded by the bureaucracy in consultation with the political bosses. Thus, a symbiotic relationship develops between the contractors, bureaucracy and the politicians and by a large number of devices costs 'are artificially escalated and black money is generated by underhand deals. Instability of the political system has given a further momentum to this process. Since the ministers are not sure of their tenure and in a majority of cases, the tenure is very short, the principle 'Make hey while the sun shines' is adopted by most of them. The larger numbers of scandals that are unearthed by the Opposition only support the contention that huge investment in the public sector is a big potential source for black money generation. In this process, bureaucrats act as brokers for political leaders and thus the nexus between business, bureaucracy and politicians promotes the generation of black money.
- (vi) **Ceiling on Depreciation and Other Business Expenses:** Government has imposed restriction. It has also circumscribed expenses on advertisement, entertainment, guest houses, and payment of perquisites to directors. The purpose of these restrictions is to protect the shareholders and consumers from the unscrupulous action of businessmen.



But businessmen feel that these restrictions are unjustified. They take the maximum advantage of these provisions but do not like to part with the remaining part of by various clandestine devices; they convert it into black money and use it either for conspicuous production to satisfy the wants of the rich and elite sections of society.

- (vii) **Unscrupulous Charitable Trusts and Societies Create Tax Evasion:** Unscrupulous charitable trusts and societies including religious institutions manipulate the funds of the institutions run and managed by them and create black money.



*Example:* A stark example of this has come to light when crores of rupees in hard cash and several more crores of rupees worth jewellery, diamonds and other valuables have been taken over when the personal chambers of the late Satya Sai Baba were opened recently at Puttaparthi in Andhra Pradesh. There are a lot of discussions going on in the matter whether the money found at Satya Sai Baba's Ashram at Puttaparthi is accounted or unaccounted money. Only sincere investigations undertaken by the government in this matter can find out the exact truth. This is one example which has come to light and many more are still likely to exist running this fraudulent business simply because such institutions had been exempted to submit the reports of their income and expenditure. It is feared that a lot of tax evasion is taking place at the religious, social and educational trusts throughout the length and breadth of the country.

- (viii) **Foreign Banks are Havens for Tax Evaders:** Foreign banks especially the Swiss Banks which do not disclose the particulars of the account holders have become a safe haven for the people who want to hide their income without paying the taxes. There are different versions by different sources as to amount of the black money stashed in Swiss Banks.



*Example:* As alleged by Baba Ramdev during his agitations against black money, the amount of black money stashed in the Swiss banks ranges between ₹ 50-75 lakh crores of rupees.

- (ix) **Prohibited Trades:** Important source of unaccounted money generates from illegal activities like large-scale smuggling of gold, diamond and numerous luxury products and drug trafficking leads to tax evasion.

### 3.3.3 Impact of Tax Evasion

The impacts of tax evasion are as follows:

- (i) **Country's Economic Growth:** The biggest impact of tax evasion is that it halts the country GDP growth due to lack of funds from government. Government earning is depends upon the tax revenue. If the public will not pay the tax to government, Government cannot fund to particular sector which needs the funds for their better operation. Due to lack of funds government force to have take loan from World Bank or other's countries, which will increases the burden of foreign debit on the government.
- (ii) **Increase the Inflation:** The inflation rises while the black money circulates in the market. The price of eatable/others goods are increased to supply of that black money and less production of things in the market. So people which have that money they offer more price in the market. As compared from other person in the market. Higher inflation has affected middle and poor class families very badly. Since high amount of cash in limited hands has increased the purchasing power to that limited people and hence resulted in growth of market and prices.

The government taxes the people to earn revenue for its expenses in order to balance the budget. It is but natural that if the black money circulating in the economy is brought back to the government's treasury, the government will have more money in its hand for its expenses and thereby the tax burden on the people can be reduced.

Notes

- (iii) **Difficulty in the Formation of Monetary and Fiscal Policy:** Since the government cannot take into account the black money in circulation in the economy while forming its monetary and fiscal policies, the policies so formed by the government cannot be realistic. It is difficult to form these policies in the absence of the exact calculation of the black money and without bringing it in the accounting procedures of the government.
- (iv) **Decreasing Rate of Investment in India:** Since the black money of Indian is mostly deposited outside India, resulting decreasing rate of investment in India. The expected amount of black money is supposed to end the unemployment problem of India in a few years if it is bring back to India.
- (v) **Tax Evasion Causes Decrease in Quality of Public Goods and Services:** When bribes which are to paid as black money to the producers of goods and provider of services, it is but natural that they will provide the quality of goods and services only to the people who pay bribes whereas the general public has to suffer as the same quality and service is not provided to everyone.



*Example:* If you have to get a job done in office, your work will be done without any delay if you pay bribes to the officials who have to do your job. But for the same kind of job, another person who does not bribe the officials has to wait for several days, weeks or even months.

- (vi) **Rupee Depreciation:** Tax evasion leads to flow of money out of country in terms of dollars by selling rupee, which leads to its depreciation. If tax is paid to the government it leads to the development of country which boosts overall growth of economy which in terms increases the rupee value.
- (vii) **Formation of Parallel Economy:** The money generated through ill legal activities that are kept hidden from the concern government authorities. Taxes are not paid on that money. In opposite to this white money shown in accounts and tax paid on it. There is not transaction record of tax evaded money in the market. This is two different economy one is accountable and other is not accountable. Now a day's plenty of case of black money rises. The black money involved in illegal transaction accounts that it's between the ranges of 20% to 50% of country's growth. The effect of parallel economy is too much on Indian economy.
- (viii) **Impact on India's Reputation:** This tax evasion and corruptions put a very bad impression of India's reputation. Many big businessmen in world are pulling their hand back from India. They are not interested in to do business with India due to this corruption. In Corruption Perceptions Index (CPI) India is ranked 87 numbers out of 178 countries. Due to big scams like 2G scam, common wealth game scam.

### 3.3.4 Remedies to Overcome (Reduce) Tax Evasion

The remedies to overcome (reduce) tax evasion are as follows:

- (i) **Reducing Tax Rate:** Government by reducing the tax rate on an individual income and income earned after investment will encourage them to avoid tax evasion and invest in various investment instruments available in India itself, like DTC, tax deduction available in Provident fund, Post office schemes, etc.
- (ii) **Strong Surveillance System:** Government should bring strong surveillance system in place which will check suspicious trade and transaction taking place and will have also have the complete authority to check tax defaulter, etc.
- (iii) **Simplified Tax Laws and Filling Mechanism:** Present tax laws and tax filling mechanism is very complex and very difficult for a layman to understand it and claim for various deductions available in various sections. Simplified tax law will make things easy for everyone to pay taxes.

- (iv) **Disclosure of All Government Employees Assets:** Disclosure of assets of government employee every year will somehow restrict them to indulge them in illegal activities & pay taxes on all income earned rightfully. This will also leads to overcome the loss of country resources and force other to do work completely and legally.
- (v) **Transparency in Government Expenditure:** There should be transparency on government expenditure at every level to make sure the every rupee sent by government is reached at grass root level. This will avoid the vaporisation of a large chunk of money done by higher-class official, politician, bureaucrats, contractors, etc. All offices of government should be brought under the audit of Comptroller and Auditor General of India (CAG). Bringing expenditures of ministry of defiance was one of the major such developments.
- (vi) **Issue of Special Bonds by the Government:** Special bonds may be issued by the government asking the black money hoarders to invest in them by providing them immunity from criminal proceeding existing under the existing law.
- (vii) **Bringing Strong Corruption Laws:** Corruption is the root cause of tax evasion; if corruption is reducing it will considerable reduce the tax evasion. And for reducing corruption and effective strong law like LOKPAL is needed, which can have the power to investigate every government employee & framing the maximum time for every case to make the final judgments unlike present which take years and still cannot punish them.
- (viii) **Ban & Surveillance on Illegal Trade and Practices:** Trades like smuggling of commodities, drugs, baiting on cricket & various other activities like election polls, flesh trade are one of the major causes of tax evasion as this activities are illegal they are not viable to pay taxes on this and thus they evade taxes. Surveillance on these activities will reduce tax evasion & crime as well.

### Self Assessment

State whether the following statements are true or false:

7. Tax evasion is not considered a crime.
8. It is not possible to understand the true impact of taxation without recognising the existence of evasion.
9. Government earning is depends upon the tax revenue.

### 3.4 Tax Avoidance

Tax avoidance is the legal utilisation of the tax regime to one's own advantage, in order to reduce the amount of tax that is payable by means that are within the law. Tax avoidance is a strategy which involves exploiting legal means of reducing taxes with the goal of minimising tax liability. Avoidance is a perfectly legal approach to handling taxes, although sometimes avoidance practices can stray into the realm of being abusive, at which point people may cross the line into tax evasion. In tax evasion, people utilise illegal means to avoid paying all or part of their taxes; evasion can result in prosecution and fines or prison time.

Most taxpayers engage in a certain amount of tax avoidance, because people want to avoid paying more taxes than they need to. In a simple example, most people claim all of the exemptions available to them. Likewise, people may take advantage of retirement accounts which offer tax savings if they plan on saving money for retirement; as long as one is putting money aside, one might as well reduce taxes at the same time. These tax avoidance strategies are usually encouraged by financial planners and accountants.

## Notes



*Example:* A skilled accountant can show a taxpayer where he or she can save on taxes, and provide advice about conducting financial affairs in a way which will limit tax liability. Accountants will usually not guarantee to reduce tax liability by a set amount or percentage, but they do pride themselves on finding as many ways as possible to generate tax savings for their clients.

Other tax avoidance strategies may be more aggressive. While still legal, they are sometimes deemed ethically questionable, and taxpayers may skirt the line between legality and illegality. Most accountants have personal limits when it comes to assisting people with tax avoidance, and while they will provide advice and help with fully legal activities, they may be reluctant to be involved in more gray areas. Aggressive tactics can include taking advantage of loopholes in the law which may be subject to interpretation, and not all accountants interpret these loopholes in the same way.

When people engage in tax avoidance, they are knowingly trying to reduce their taxes, but they are not knowingly breaking the law. Tax evaders, on the other hand, are aware of the fact that the means they are using are not legal, and they are choosing to engage in evasion activities despite this. Evasion tactics vary by nation, but include hiding or moving income so that it cannot be taxed even though it is legally taxable, or simply refusing to send in tax payments.

### 3.4.1 Double Taxation

Double taxation is the levying of tax by two or more jurisdictions on the same declared income (in the case of income taxes), asset (in the case of capital taxes), or financial transaction (in the case of sales taxes). This double liability is often mitigated by tax treaties between countries. Most countries impose taxes on income earned or gains realised within that country regardless of the country of residence of the person or firm. Most countries have entered into bilateral double taxation treaties with many other countries to avoid taxing non-residents twice – once where the income is earned and again in the country of residence. However, there are relatively few double-taxation treaties with countries regarded as tax havens. To avoid tax, it is usually not enough to simply move one's assets to a tax haven. One must also personally move to a tax haven to avoid tax.

India has comprehensive Double Taxation Avoidance Agreements (DTAA) with 84 countries. This means that there are agreed rates of tax and jurisdiction on specified types of income arising in a country to a tax resident of another country. Under the Income Tax Act 1961 of India, there are two provisions, Section 90 and Section 91, which provide specific relief to taxpayers to save them from double taxation. Section 90 is for taxpayers who have paid the tax to a country with which India has signed DTAA, while Section 91 provides relief to tax payers who have paid tax to a country with which India has not signed a DTAA. Thus, India gives relief to both kinds of taxpayers.



*Did u know?* DTAA means that there are agreed rates of tax and jurisdiction on specified types of income arising in a country to a tax resident of another country.



*Example:* If a person earns ₹ 1000000 India, the income tax that will go to the Indian government will be ₹ 300000, whereas the foreign government also will demand tax as per the prevailing laws. This, however, has caused a lot of problems to the income tax payers in the form of added taxation. Then, there's also the Double Tax Avoidance Agreement.

A large number of foreign institutional investors who trade on the Indian stock markets operate from Mauritius and the second being Singapore. According to the tax treaty between India and Mauritius, capital gains arising from the sale of shares are taxable in the country of residence of the shareholder and not in the country of residence of the company whose shares have been sold.

Therefore, a company resident in Mauritius selling shares of an Indian company will not pay tax in India. Since there is no capital gains tax in Mauritius, the gain will escape tax altogether.



*Did u know?* The Indian and Cypriot tax treaty is the only other such Indian treaty to provide for the same beneficial treatment of capital gains.

Under the Income Tax Act, 1961 of India, there are two provisions, Section 90 and Section 91, which provide specific relief to taxpayers to save them from double taxation. Section 90 is for taxpayers who have paid the tax to a country with which India has signed DTAA, while Section 91 provides relief to taxpayers who have paid tax to a country with which India has not signed a DTAA. Thus, India gives relief to both kinds of taxpayers.

With DTAA, there are fixed TDS rates applicable for income in India. These rates vary from country to country. Countries such as UK (15%), USA (15%), UAE (12.5%), Germany (10%), China (10%), etc. have maintained good trade as well as income tax agreements with India. However, it is advisable for all NRIs to consult with a financial advisor before entering into any financial or investment-related agreement.

### 3.4.2 Difference between Tax Avoidance and Tax Evasion

Tax evasion and tax avoidance are both practices designed to reduce the amount people pay in taxes. The difference is that one involves legal means, while the other is illegal and is a form of tax fraud. Professionals such as attorneys and accountants who assist people with illegal means of reducing tax liability can be penalised along with the taxpayer.

In tax avoidance, people take advantage of the tax law to find ways to reduce their total tax liability. This is entirely legal and many people practice it every year at tax time. Using the services of a sharp tax attorney or tax accountant can save people significant amounts of money on their taxes. With tax avoidance, taxpayers seek out tax credits, write-offs, and other means of cutting down on their tax liability.


The tax code is constantly being updated. Tax professionals keep up with changes to the law so that they can advise their clients on the best ways to reduce the amount of money they owe. With tax avoidance, people declare all of their income as required by law and submit other financial documents as needed, and the means used to reduce their tax liability are clearly documented on their tax returns.

With tax evasion, people avoid taxes not by scrupulously following the tax code, but by hiding or moving income, making false claims on a tax return, and utilising other illegal means to pay less on their taxes. Some tax evaders avoid paying taxes altogether; people who work as independent contractors or receive monies under the table for their work, for example, may simply not declare this income and thereby avoid paying taxes on it.

The line between tax avoidance and tax evasion can sometimes be very fine. There are some things people can do with their money that are perfectly legal under the law, but could be read as attempts to evade taxes. Moving funds suspiciously and with no clear reason or documentation can attract the attention of tax authorities. Once tax authorities suspect someone of tax evasion, they will scrutinise that taxpayer closely.

Notable members of the criminal community, including no less a figure than infamous gangster Al Capone, have gotten in trouble for tax evasion. Sometimes, it is difficult to pinpoint illegal activity and prosecute people for activities such as Mob involvement, but those individuals can be thrown in jail for failing to pay taxes. In the eyes of the Internal Revenue Service, even income acquired from illegal activities needs to be declared and taxed.

Notes



*Task* Make a list of some people who are involved in tax evasion.

**Self Assessment**

Fill in the blanks:

- 10. .... is a perfectly legal approach to handling taxes.
- 11. .... is the levying of tax by two or more jurisdictions on the same declared income, asset, or financial transaction.
- 12. With tax....., people avoid taxes not by scrupulously following the tax code, but by hiding or moving income, making false claims on a tax return, and utilising other illegal means to pay less on their taxes.

**3.5 Tax Management**

Tax management refers to the compliance with the statutory provisions. While tax planning is optional, tax management is of law. It includes maintenance of accounts, filling of return, payment of taxes, deduction of tax at source, timely payment of advance tax, etc. Poor tax management may lead to levy of interest, penalty, prosecution, etc. In some cases it may lead to heavy financial loss if proper compliance is not made.



*Example:* If a loss return is not filed in time it will result in a financial loss because such loss will not be allowed to be carried forward.

Tax Management includes maintenance of records in prescribed format. It also includes getting audited the records, filing returns and pay taxes. It is a regular feature of business enterprises and a form of tax planning. Here employees use CBDT (Central Board of Direct Taxes) and employers can use TDCAN (Tax Deduction and Collection Account Number).

**3.5.1 Main Aim of Tax Management**

The main aim of tax management is as follows:

- (i) Compliance with legal formalities.
- (ii) Saving from penalties and prosecution.
- (iii) Taking advantage of various tax incentives and deductions.
- (iv) Review of department orders.

**3.5.2 Areas of Tax Management**

The main areas of tax management are as follows:

- 1. Deduction of tax at source: It can be done with respect of income from salaries, winning from lottery, horse race etc.
  - (a) Employer seeks for TDCAN and employee for Pan Card.
  - (b) TDS should be deposited in government treasury.

- (c) Employer should furnish to the employee a certificate regarding TDS.
  - (d) Employer should furnish quarterly and annual returns regarding TDS.
2. Payment of Tax on the basis of following:
    - (a) Advance payment of tax.
    - (b) Tax on Self Assessment
    - (c) Payment on Demand
  3. Audit of Accounts on the basis of the following:
    - (a) If business income exceeds 40 lakhs.
    - (b) If business income exceeds 10 lakhs.
  4. Fulfilment of conditions to claim deductions.
  5. Furnishing return of income.
  6. Documentation and maintenance of records.
  7. Review of Orders.

### 3.5.3 Difference between Tax Planning and Tax Management

While tax planning and tax management correlate with each other, the two aspects of taxes have several differences. The primary difference between tax planning and tax management is the time frame in which each part is conducted. The tax planning takes place ahead of time, while the tax management is the implementation of the plan.

The first primary difference between tax planning and tax management is the requirements. While tax planning is not a requirement for either a business or individual, tax management is a requirement. Every individual and business in the United States is required to manage taxes, which includes filing the appropriate state and federal tax returns.

The second primary difference between tax planning and tax management is about tax liability. When a business or individual goes through the tax planning process, they are trying to minimise the tax liability of the entity by planning deductions, purchases and expenses ahead of time. Tax management, however, involves making sure that when the tax plan is implemented, that it is according to the tax laws and regulations.

The third difference between tax planning and tax management pertains to liabilities. Tax planning involves taking the actions necessary to minimise the tax liabilities of the business or the individuals. Tax management on the other hand is about avoiding the payment of interest or fees for not abiding by the tax laws and regulations.

The fourth difference between tax planning and tax management is the time frame. Tax planning is an action that is taken in the present but relates to the future. Tax management, on the other hand, encompasses the past, present and future. This includes tracking past sales, deductions, assets and more, making current tax payments and preparing tax documents for any future payments that must be made.

While there are plenty of differences between tax planning and tax management, there is also one primary similarity. The primary similarity between tax planning and tax management is that tax planning is a subset, or a part, of tax management. When an individual or business is in the process of tax planning, they are also taking into account all of the aspects of tax management, including tax deductions, proper auditing of the accounting files and records, putting together and filing the tax return documents on time and planning for tax scenarios that may come up during that particular tax year.

## Notes

## Self Assessment

State whether the following statements are true or false:

13. Poor tax management may lead to levy of interest, penalty, prosecution, etc. In some cases it may lead to heavy financial loss if proper compliance is not made.
14. Tax planning is a requirement for either a business or individual.
15. Tax management on the other hand is about avoiding the payment of interest or fees for not abiding by the tax laws and regulations.



*Case Study* **Tax Avoidance or Tax Evasion**

**E**n. Khir, the company accountant, was deep in thought in his office. His friend, Ravi, who was passing by Khir's office, saw him through the glass window. On seeing his worried look, Ravi knocked and entered.

"What is haunting you? Immersed so deeply in something? What is in your mind," Ravi asked.

Khir replied, "Our human resources manager is recruiting some software employees from India and has assigned me the job of recommending the most tax efficient remuneration package equivalent to ₹ 200,000 per annum. To attract expatriates, the manager feels that they should pay lower income tax as compared to others earning the same level of income."

"How is it possible for us to pay lesser income tax for the same level of income? Is it not tax evasion?" Ravi asked. He cautioned Khir that tax evasion was illegal and both employees and the organisation would be penalised for this by the Government for violating the income tax laws. Moreover, tax evasion was unethical and also a crime against society.

Khir explained, "Ravi, yes, tax evasion is illegal and punishable. But tax avoidance is not punishable. In fact, tax law encourages assessors to plan their taxes and pay lesser tax by properly applying the relevant sections of the Income Tax Act."

"Is it so? It is interesting. Could you please elaborate? I am also an expatriate employee and I want to know more about this," Ravi replied.

Khir continued, "I think our employees especially those who draw more than ₹ 100,000 per annum should be advised on this tax avoidance and tax planning techniques because their income will be taxed at the maximum marginal tax rate which is 26% in 2010. If they apply tax avoidance techniques, they can save ₹ 260 in taxes for every ₹ 1,000 income avoided which is a substantial sum."

"Please give some simple examples so that I can understand all these tax jargons," Ravi requested.

"Sure, employees who draw higher salaries should not go for allowances. Take for instance, the House Rent Allowance (HRA) and Travelling Allowance (TA), these allowances are fully subjected to tax. Instead, if an employee opts for a Rent-Free Accommodation (RFA) provided by the employer the tax bill will be reduced. Similarly, the Travelling Allowance may be replaced by providing car, fuel and driver to these employees. The car can be used by the employees for private purposes also," Khir added.

"In what way will this save tax? Both are taxable at the same rates," Ravi insisted.

Khir gave an explanation on how different allowances were treated in the Income Tax Act.

*Contd...*



“The HRA is fully taxable whereas for RFA there is a formula to convert this non-cash item into cash equivalent. That formula produces a lesser value for the accommodation provided and this in turn will reduce taxable income. Similarly, instead of travelling allowance, one can opt for a car, fuel and driver from the employer. For the car, fuel and driver, there is also a formula that will produce lesser taxable value and the taxable income will be considerably reduced, especially for expatriates who are hesitant to buy cars as the disposal value of the used cars is generally very low. Most times, there is no market for used car in Malaysia. Another allowance that plays a significant role in tax planning is entertainment allowance. Entertainment allowance will be fully added in Section 13.1(a) and the expenditure incurred for official purposes will be given as a deduction. But the problem is the RFA value is calculated with the gross entertainment allowance and not with the net allowance.”

### Tax Planning

“Then what is this tax planning about?” Ravi asked.

“One of the approaches is to invest our savings in Income Tax Act - approved schemes so as to get approved reliefs and thus our chargeable income will be less and then subjected to lesser tax payable,” Khir replied.

“It is interesting. Could you please give more examples for this?” Ravi requested.

Khir then gave to Ravi the following list of individual tax reliefs.

No.	Individual Relief Types	Amount (₹)
1	Education Fees (self)	5,000 (Limited)
2	Complete medical examination (self)	500 (Limited)
3	Purchase of books, journals and magazines (not newspapers)	1,000 (Limited)
4	Purchase of personal computer (once in every 3 years)	3,000 (Limited)
5	Saving in SSPN's scheme	3,000 (Limited)
6	Purchase of sport equipment for sport activities (approved)	300 (Limited)
7	Life insurance and EPF contributions by employee	6,000 (Limited)
8	Insurance premium for education or medical benefit	3,000 (Limited)

Ravi had a look at the list and immediately responded, “I cannot understand any of the examples given. Rather than telling me and giving me this list, can you please come up with some hypothetical income levels with HRA or RFA, CAR or TA etc to illustrate how much tax reduction one can get by applying different levels of salaries and remuneration schemes. The illustrations you have prepared will not only be useful for expatriates but also for all employees.

We can advise our employees on these useful matters. They will be happy. We also can convince and educate them that tax evasion is unethical but tax avoidance and tax planning are acceptable. Please illustrate with figures for all the above tax jargons.”

“Sure, but give me at least one week to come up with all details because I have to update myself with the latest tax enactments,” Khir replied.

The following week Ravi received a call from Khir. He confirmed that he had prepared ten different salary schemes with the same gross total income of ₹ 200,000, but with different allowances, perquisites (PER) and benefits-in-kind (BIK).

He explained to Ravi that employees could get paid by employers in different forms and how these payments were taxed under the Income Tax Act. He provided the following table which provided all relevant details in matrix form.

Contd...

## Notes

	E1	E2	E3	E4	E5	E6	E7	E8	E9	E10
	Only salary	Sal + EPF	RFA	HRA	TA RFA	TA HRA	RFA CAR BIK	HRA CAR BIK	RFA CAR PER	HRA CAR PER
Salary	190000	154000	108000	108000	82000	82000	78000	78000	78000	78000
Entertainment allowance	10000	10000	10000	10000	10000	10000	10000	10000	10000	10000
Employer EPF		38000	38000	38000	38000	38000	38000	38000	38000	38000
Fair rent / HRA 3000			48000	48000	48000	48000	48000	48000	48000	48000
Travelling Allowance / Value of car (₹) 130,000					24000	24000	10000	10000	10000	10000
Fuel							8000	8000	8000	8000
Driver							12000	12000	12000	12000
Notebook given by employer							2000	2000	2000	2000
<b>Gross Package</b>	<b>200000</b>	<b>200000</b>	<b>200000</b>	<b>200000</b>	<b>200000</b>	<b>200000</b>	<b>200000</b>	<b>200000</b>	<b>200000</b>	<b>200000</b>
Official Entertainment expenses	10000	10000	10000	10000	10000	10000	10000	10000	10000	10000
Donations to Govt	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000
Notebook Purchased	2000	2000	2000	2000	2000	2000	0	0	0	0
Employee PF contribution	4000	4000	4000	4000	4000	4000	4000	4000	4000	4000

## Assumptions given:

- All employees receive the same gross income of ₹ 200,000. The payment method is different. The savings remain the same. For instance, all employees save:
  - ₹ 4,000 in EPF payment,
  - ₹ 2,000 for purchase of one notebook (computer),
  - ₹ 1,000 for donations to the Government, and
  - All employees claim that the entertainment allowance (EA) was fully spent on entertaining company's clients.
- Employee 1 (E1) gets his gross salary in two forms: ₹ 190,000 as salary and ₹ 10,000 as EA.
- Employee 2 (E2) gets ₹ 154,000 as salary, ₹ 10,000 EA and requests that his employer contribute to his approved provident fund account the sum of ₹ 3,000 monthly.
- Employee 3 (E3) receives ₹ 118,000, ₹ 10,000 and ₹ 36,000 as salary, EA and Rent Free Accommodation (RFA) and also requests his employer to contribute to his approved provident fund account the sum of ₹ 3,000 monthly.
- Employee 4 (E4) receives House Rent Allowance (HRA) instead of RFA for the same value as employee 3.
- Employee five (E5) gets the same allowances as E4 but RFA and his salary is further reduced as he gets Travelling Allowance (TA) of ₹ 24,000 for private purposes.
- Employee six (E6) gets the same allowances as E5 but gets HRA instead RFA.
- Employee 7 (E7) receives RFA and a car valued ₹ 130,000 (company charges ₹ 10,000 pa for the car), fuel and driver for ₹ 28,000 instead of travelling allowance.
- Employee 8 (E8) receives HRA instead of RFA and the same emoluments as E7.
- Employee 9 (E9) receives RFA and reimbursement of his personal car expenses, fuel and driver valued at ₹ 28,000.
- Employee 10 (E10) receives HRA instead of RFA and the same emoluments as E9.

**The Assignment**

Ravi was really confused with the above data and was not sure whether there could be any tax savings. He requested that Khir to give a more detailed calculations and explanations on the relevant income tax sections that allowed those deductions and reliefs. Ravi wanted

Contd...

to know the ultimate tax payable by each employee for the year of assessment 2010. (Appendix A: Tax Rates for YA 2010)

Notes

Appendix A: Tax Rates for YA 2010

Slabs	Chargeable Income (₹)	Slabs (₹)	Rate %	Tax (₹)	Cumulative Tax (₹)
1	0-2500	On the First 2,500	0	0	0
2	2,501-5,000	Next 2,500	1	25	25
3	5,001-20,000	Next 15,000	3	450	475
4	20,001-35,000	Next 15,000	7	1050	1525
5	35,001-50,000	Next 15,000	12	1800	3325
6	50,001-70,000	Next 20,000	19	3800	7125
7	70,001-100,000	Next 30,000	24	7200	14325
8	Above 100,000		26	?	?

### Questions

1. Comment on the differences in benefits to the employees.
2. What are the learning points from the case study?

Source: [http://ejournal.unirazak.edu.my/articles/TAX\\_AVOIDANCE-Ravindran.pdf](http://ejournal.unirazak.edu.my/articles/TAX_AVOIDANCE-Ravindran.pdf)

## 3.6 Summary

- Tax planning is not a device to reduce tax burden but is in fact helps savings by investments in government securities.
- Tax planning is an essential part of your financial planning.
- There are also some areas of tax planning that are specific to certain business forms – i.e., sole proprietorships, partnerships, C corporations, and S corporations.
- Tax planning also applies to various types of employee benefits that can provide a business with tax deductions, such as contributions to life insurance, health insurance, or retirement plans.
- Tax Planning India is an application to reduce tax liability through the finest use of all accessible allowances, exclusions, deductions, exemptions, etc, to trim down income and/or capital profits.
- Corporate Tax Planning is the strategies to reduce the taxes.
- Tax evasion is the general term for efforts by individuals, firms, trusts and other entities to evade taxes by illegal means.
- Tax avoidance is a strategy which involves exploiting legal means of reducing taxes with the goal of minimising tax liability.
- Double taxation is the levying of tax by two or more jurisdictions on the same declared income (in the case of income taxes), asset (in the case of capital taxes), or financial transaction (in the case of sales taxes).
- Tax management refers to the compliance with the statutory provisions and includes maintenance of records in prescribed format.

## 3.7 Keywords

**Accounting Methods:** Accounting methods refer to the basic rules and guidelines under which businesses keep their financial records and prepare their financial reports.

**Corporate tax:** It refers to a tax levied by various jurisdictions on the profits made by companies or associations.

**Notes**

**Double taxation:** It is the levying of tax by two or more jurisdictions on the same declared income (in the case of income taxes), asset (in the case of capital taxes), or financial transaction (in the case of sales taxes).

**Partnerships:** A business organisation in which two or more individuals manage and operate the business.

**Sole Proprietorships:** A business structure in which an individual and his/her company are considered a single entity for tax and liability purposes.

**Tax Rebates:** A tax rebate may be a partial sum of money refunded to people from paid taxes, or it may be an amount by which you reduce your taxes before you pay them.

**Tax avoidance:** It is the legal utilisation of the tax regime to one's own advantage, in order to reduce the amount of tax that is payable by means that are within the law.

**Tax evasion:** It is the general term for efforts by individuals, firms, trusts and other entities to evade taxes by illegal means.

**Tax management:** It refers to the compliance with the statutory provisions.

**Tax planning:** Tax planning is a broad term that is used to describe the processes utilised by individuals and businesses to pay the taxes due to local, state, and federal tax agencies.

**Tax savings:** The deduction a taxpayer can take on their tax form for interest paid on a home mortgage.

### **3.8 Review Questions**

1. Define tax planning. List out the general areas of tax planning.
2. "Tax planning is an essential part of your financial planning." Elucidate.
3. Write short note on the following:
  - (a) C corporations
  - (b) Sole proprietorships and partnerships
  - (c) Case for levy of corporate Tax
  - (d) Double taxation
4. Describe some of the planning tips that can assist salaried people to reduce their tax accountability.
5. What is Corporate Tax Planning?
6. Discuss the causes of tax evasion.
7. Highlight the impacts of tax evasion.
8. Differentiate the following:
  - (a) Tax avoidance and tax evasion
  - (b) Tax planning and tax management
9. What are the objectives of tax management?
10. Explain the remedies to overcome (reduce) tax evasion.

**Answers: Self Assessment**

Notes

- |                     |                  |
|---------------------|------------------|
| 1. False            | 2. True          |
| 3. False            | 4. Corporate Tax |
| 5. Minimise         | 6. Liquidity     |
| 7. False            | 8. True          |
| 9. True             | 10. Avoidance    |
| 11. Double taxation | 12. Evasion      |
| 13. True            | 14. False        |
| 15. True            |                  |

**3.9 Further Readings**

Books

Ahuja, G. K. & Gupta, Ravi, *Systematic Approach to Income Tax*, Bharat Law House.

Aggarwal, K., *Direct Tax Planning and Management*, Atlantic Publications.

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Srinivas E. A., *Handbook of Corporate Tax Planning*, Tata McGraw Hill.



Online links

<http://pegasus.cc.ucf.edu/~bandy/planha~1.htm>

<http://www.slideshare.net/anujbhatia09/corporate-tax-planning>

<http://www.itrust.in/content/tax-planning/What-Is-Tax-Planning-India>

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## **Unit 4: Set-off and Carry Forward of Losses**

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- 4.1 Set-off and Carry Forward of Losses: Meaning and Scope
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### **Objectives**

After studying this unit, you will be able to:

- State the meaning and scope of set-off and carry forward of losses
- Discuss the provisions for set-off and carry forward of loss from house property and of business losses
- Describe the carry forward and set-off of accumulated business losses and unabsorbed depreciation in certain cases of amalgamation or demerger
- Explain set-off of losses of a banking company against the profit of a banking institution under a scheme of amalgamation
- Recognise the concept of losses in speculation business and carry forward & set-off of losses by specified businesses
- Identify the provisions to the set-off and carry forward of losses under the head capital gains
- State the set-off and carry forward of losses from the activity of owning and maintaining race horses

## Introduction

Notes

Income-tax is a composite tax on the total income of a person earned during a period of one previous year. There might be cases where an assessee has different sources of income under the same head of income. Similarly, he may have income under different heads of income. It might also happen that the net result from a particular source or head may be a loss. This loss can be set off against other sources or head in a particular manner. For example, where a person carries on two businesses and one business gives him a loss and the other a profit, then the income under the head 'Profits and gains of business or profession' will be the net income i.e. after the adjustment of the loss. Similarly, if there is a loss under one head of income, it should normally be adjusted against the income from another head of income while computing the Gross Total Income, of course subject to certain restrictions. These provisions for set off or carry forward and set off of loss are contained in sections 70 to 80 of Income-tax Act.

### 4.1 Set-off and Carry Forward of Losses: Meaning and Scope

As discussed in the earlier units an assessee may have income from various sources like employment, business, interest, rent, etc. For the purpose of income tax we divide these incomes into five heads namely:

1. Income from salaries,
2. Income from house property,
3. Income from business & profession,
4. Capital gains, and
5. Income from other sources.

Similarly an assessee may have three to four sources of income under one particular head. For example a person might have two businesses A and B which are two sources of income under the same head business and profession. Similarly a person might be having two part time employments. He will receive salary from both the employers; each salary received is a source of income. But both are taxable under the head 'Income from Salary.'

While one endeavours to derive income, the possibility of incurring losses cannot be ruled out. Based on the principles of natural justice, a set-off should be available for loss incurred. The income tax laws in India recognise this and provide for adjustment and utilisation of the losses. However, there are conditions which have been introduced to prevent misuse of such provisions. To the common taxpayer, income tax is a crunch into the income earned. Accordingly, awareness of the relevant provisions pertaining to set off and carry forward of losses is essential in order to maximise tax benefits.


When income from a particular head and a loss from another head or same head are adjusted, it is called 'set off of loss against income'. A loss when not set off due to legal bar or due to insufficiency of income from other eligible source or head, it may be carried forward to a subsequent year for set off against income of that year.



*Example:* If a company experienced a negative Net Operating Income (NOI) in year one but positive NOI in one of the next two to seven years, the company could reduce its tax expense for one of those years by applying the loss experienced in the first year.

In the past, some equities have had large options redemptions that have caused share prices to plummet dramatically. Due to the increased amount of shares outstanding, investors who sell off their shares during that time will incur capital losses. Investors can carry forward these losses in order to reduce tax liabilities on future capital gains.

Notes



Notes

**Set-off of losses:** The adjustment of losses from one head against the income, profits or gains of any other head of income during the same tax year is called set-off of losses.

**Carry-Forward of Losses:** Where the losses are not fully adjusted against the income of the same tax year and such losses are transferred to the next tax year, this process of transferring un-adjustable losses to the next year is known as carry forward of losses.

Income Tax Ordinance, 2001 has provided the specific procedure for adjustment and carry forward of losses sustained by a taxpayer during the tax year.

Specific provisions have been made in the Income-tax Act, 1961 for the set-off and carry forward of losses. In simple words, "Set-off" means adjustment of losses against the profits from another source or head of income in the same assessment year. If losses cannot be set-off in the same year due to inadequacy of eligible profits, then such losses are carried forward to the next assessment year for adjustment against the eligible profits of that year. The maximum period for which different losses can be carried forward for set-off has been provided in the Act.



*Did u know?* Salary may not be in negative. So, there is no possibility of loss under the head 'salary'

#### 4.1.1 Inter Source Adjustment (Section 70)

Under Section 70, the losses incurred by the assessee in respect of one source shall be set-off against income from any other source under the same head of income, since the income under each head is to be computed by grouping together the net result of the activities of all the sources covered by that head. In simpler terms, loss from one source of income can be adjusted against income from another source, both the sources being under the same head.



*Example:*

1. Loss from one house property can be set off against the income from another house property.
2. Loss from one business, say textiles, can be set off against income from any other business, say printing, in the same year as both these sources of income fall under one head of income. Therefore, the loss in one business may be set-off against the profits from another business in the same year.

Inter-source set-off, however, is not permissible in the following cases -

1. **Long-term capital loss:** The set-off and carry forward in case of long-term capital loss is not permitted:
  - (a) Where the net result in respect of any short-term capital asset is a loss, such loss shall be allowed to be set-off against income, if any, for that assessment year under the head "capital gains" in respect of any other capital asset, and
  - (b) Where the net result in respect of any long-term capital asset is a loss, such loss shall be allowed to be set-off against income, if any, for that assessment year under the head "capital gains" in respect of any other asset not being a short-term capital asset.



Thus, short-term capital loss is allowed to be set off against both short-term capital gain and long-term capital gain. However, long-term capital loss can be set-off only against long-term capital gain and not short-term capital gain.

2. **Speculation loss:** A loss in speculation business can be set-off only against the profits of any other speculation business and not against any other business or professional income. However, losses from other business can be adjusted against profits from speculation business.
3. **Loss from the activity of owning and maintaining race horses:** See section 74A (3) deals with treatment of set-off of losses from the activity of owning and maintaining race horses.



**Caution** It must be noted that loss from an exempt source cannot be set-off against profits from a taxable source of income. For instance, long-term capital loss on sale of shares sold through a recognised stock exchange cannot be set-off against long-term capital gains on sale of land.

### 4.1.2 Inter Head Adjustment (Section 71)

Loss under one head of income can be adjusted or set off against income under another head. However, the following points should be considered:

- (i) Where the net result of the computation under any head of income (other than 'Capital Gains') is a loss, the assessee can set-off such loss against his income assessable for that assessment year under any other head, including 'Capital Gains'.
- (ii) Where the net result of the computation under the head "Profits and gains of business or profession" is a loss, such loss cannot be set off against income under the head "Salaries".
- (iii) Where the net result of computation under the head 'Capital Gains' is a loss, such capital loss cannot be set-off against income under any other head.
- (iv) Speculation loss and loss from the activity of owning and maintaining race horses cannot be set off against income under any other head.



**Example:** Mr. X submits the following particulars pertaining to the A.Y. 2013-14:

Income from salary	4, 00, 000
Loss from self-occupied property	(-) 70,000
Business loss	(-) 1, 00, 000
Bank interest (FD) received	80,000

In the above case of Mr. X his total taxable income for the A.Y. 2013-14 will be:

Income from salary	4, 00,000	
Income from house property	<u>(-) 70,000</u>	3, 30,000
Business income	(-) 1, 00,000	
Income from other sources (interest on fixed deposit with bank)	<u>80,000</u>	
	20,000	
<b>Gross total income</b>		<b>3, 30,000</b>
<b>Less: Deduction under chapter VIA</b>		<u>Nil</u>
<b>Taxable income</b>		<b>3, 30,000</b>

Notes



*Notes* Gross Total Income includes salary income of 3,30,000 after adjusting house property loss. Business loss of 1,00,000 is set off against bank interest of 80,000 and remaining business loss of 20,000 will be carried forward as it cannot be set off against salary income.

### Basic Rules Regarding Set-off and Carry Forward of Losses

1. A very important rule to remember is that losses that are carried forward have to be set off against income from the same head in the subsequent years – they cannot be set off against income from any other head of income.



*Example:* If you have a loss from house property, you can set it off against income from house property or income from salary in the year of the loss. But if you carry it forward, in the next year, you can set it off only against income from house property.

2. A carried forward loss can be set off against income in subsequent years only if the loss has been declared in the income tax return filed by you.

Additionally, if you have:

- ❖ A loss under the head capital gains, or
- ❖ Speculation business loss, or
- ❖ A loss under the head income from business or profession, or
- ❖ Loss from the activity of owning and maintaining race horses.

You have to file a loss return (or a return of loss) as per section 139 (3) if you want to carry forward the loss to subsequent years.

3. A loss for a particular year can be carried forward only if the income tax return for that year is filed by the due date. The only exception to this rule is loss from house property – this loss can be carried forward even if the IT return is not filed in time.
4. Loss from a source of income which is exempt from income tax (for example, an agricultural loss) cannot be set off against income from a taxable source of income.
5. Loss from none of the heads of income can be set off against winnings from lotteries, horse races, gambling, etc. The losses from these cannot be set off even against income from lotteries, horse races, gambling, etc.



*Caselet*

### Unabsorbed Depreciation Set-off at Sri Rajarathinam Transports Pvt. Ltd.

The assessee, a private limited company in this case, before the Madras High Court reported in 199 ITR 203, in the course of the assessment proceedings, for A.Y. 1965-66 claimed that unabsorbed depreciation totalling to ₹ 78,984 in respect of the A.Ys. 1960-61 to 1964-65 be allowed to him. The Assessing Officer held that the unabsorbed depreciation of ₹ 78,984 could not be allowed to be set-off in view of the fact that the depreciation had not been determined for the purpose of being carried forward. In that

*Contd...*

view, the Income-tax Officer accepted the income returned by the assessee and completed the assessment.

The Tribunal, also relying on S. 80, concluded that no loss inclusive of depreciation could be carried forward and set-off, unless it had been determined in pursuance of a return. The Tribunal dismissed the appeal of the assessee. The following questions of law were referred to the Court, at the instance of the assessee. "Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in holding that the assessee is not entitled to set-off of the depreciation claimed to the extent of ₹ 13,016, ₹ 18,012, ₹ 2,304 and ₹ 19,487 in the A.Ys. 1960-61, 1961-62, 1962-63 and 1964-65, respectively, inasmuch as the amount was not determined for the respective assessment years?" and that "Whether, on the facts and in the circumstances of the case, the Tribunal's decision that the assessee is not entitled to, in view of S. 80 of the Income-tax Act, 1961, the depreciation and allowance in 1965-66 of depreciation relating to the earlier years even though they were not quantified and notified for carry forward in those assessment years, is correct?"

The Court noted that u/s.32(2) read with S. 34 of the Act, the depreciation or part of the depreciation in a previous year to which effect has not been given, shall be added to the amount of depreciation for the following previous year and deemed to be part of that allowance, or if there was no such allowance for that previous year, it should be deemed to be the allowance for that previous year and so on for the succeeding previous years. The Court further observed that such finding that the depreciation was not absorbed was possible only in the assessment where full effect could not be given to the depreciation as claimed in any previous year owing to there being no profits or gains chargeable for that previous year or, owing to the profits or gains chargeable being less than the allowance. That in the absence of any specific and clear findings in the assessment order regarding the claim for depreciation, its allowance either in full or in part, as the case may be, and the carry forward of the unabsorbed depreciation in accordance with S. 32(2) of the Act, it was not possible for the assessee to claim set-off of unabsorbed depreciation.

The Court further observed that Section D of the return of income applicable to companies required adjustments to be made in the income on account of items shown in Section A and Section B of Part I of the return including on account of depreciation or capital expenditure on scientific research carried forward from earlier assessment years as per S. 32(2), S. 35(4) read with S. 72(2) and S. 73(3) of the Act. These adjustments were required to be indicated in the relevant part of the return and that in spite of the details having been so indicated, the depreciation or the carry forward of unabsorbed depreciation was disallowed, then it was for the assessee to further agitate its entitlement to the same and, if it was not so done, then the assessee could not turn around in a later assessment year and claim the benefit of set-off of unabsorbed depreciation, which, according to the Court was not in accordance with S. 32(2) read with S. 34 of the Act.

Source: <http://www.bcasonline.org/articles/artin.asp?581>

## Self Assessment

Fill in the blanks:

1. When income from a particular head and a loss from another head or same head is adjusted, it is called .....
2. Where the losses are not fully adjusted against the income of the same tax year and are transferred to the next tax year, it is known as .....
3. A loss in .....business can be set-off only against the profits of any other speculation business and not against any other business or professional income.

## 4.2 Section 71B

Section 71B deals with set-off and carry forward of loss from house property. Before understanding the provisions relating to set off and carry forward of losses pertaining to house property it is first essential to know the meaning of income from house property first.

By income from house property we mean the annual value of a property, consisting of any buildings or lands appurtenant thereto, of which the assessee is the owner, is chargeable to tax under the head 'Income from house property'. However, if a house property, or any portion thereof, is occupied by the assessee, for the purpose of any business or profession, carried on by him, the profits of which are chargeable to income-tax, the value of such property is not chargeable to tax under this head.

Thus, three conditions are to be satisfied for property income to be taxable under this head:

1. The property should consist of buildings or lands appurtenant thereto.
2. The assessee should be the owner of the property.
3. The property should not be used by the owner for the purpose of any business or profession carried on by him, the profits of which are chargeable to income-tax.



*Task* What do you think are the reasons for incurring losses from house property? You can also use a hypothetical example of your own.

In any assessment year, if there is a loss under the head 'Income from house property', such loss will first be set-off against income from any other head during the same year. If such loss cannot be so set-off, wholly or partly, the unabsorbed loss will be carried forward to the following assessment year to be set-off against income under the head 'Income from house property'. The loss under this head is allowed to be carried forward up to 8 assessment years immediately succeeding the assessment year in which the loss was first computed.

For example, loss from one house property can be adjusted against the profits from another house property in the same assessment year. Any loss under the head 'Income from house property' can be set off against any income under any other head in the same assessment year. However, if after such set off, there is still any loss under the head "Income from house property", then the same shall be carried forward to the next year.

It is to be remembered that once a particular loss is carried forward, it can be set off only against the income from the same head in the forthcoming assessment years.



*Notes* A loss from house property can be set off against income from any other head in the same year.

Any remaining loss can be carried forward for up to 8 years. In these subsequent years, this loss can be set off only against income from house property.

A loss for a particular year can be carried forward even if the income tax return for that year is not filed by the due date.

**Self Assessment****Notes**

State whether the following statements are true or false:

4. Income from house property we mean the annual value of a property, consisting of any buildings or lands appurtenant thereto, of which the assessee is the owner.
5. In any assessment year, if there is a loss under the head 'Income from house property', such loss will first be set-off against income from any other head during the same year.
6. Once a particular loss is carried forward, it cannot be set off only against the income from the same head in the forthcoming assessment years.

**4.3 Sections 72 and 80**

Sections 72 and 80 deals with carry forward and set-off of business losses. Under the Act, the assessee has the right to carry forward the loss in cases where such loss cannot be set-off due to the absence or inadequacy of income under any other head in the same year. The loss so carried forward can be set-off against the profits of subsequent previous years.

Section 72 covers the carry forward and set-off of losses arising from a business or profession.

**Conditions**

The assessee's right to carry forward business losses under this section is, however, subject to the following conditions:-

- (i) The loss should have been incurred in business, profession or vocation.
- (ii) The loss should not be in the nature of a loss in the business of speculation.
- (iii) The loss may be carried forward and set-off against the income from business or profession though not necessarily against the profits and gains of the same business or profession in which the loss was incurred. However, a loss carried forward cannot, under any circumstances, be set-off against the income from any head other than "Profits and gains of business or profession".
- (iv) The loss can be carried forward and set off only against the profits of the assessee who incurred the loss. That is, only the person who has incurred the loss is entitled to carry forward or set off the same. Consequently, the successor of a business cannot carry forward or set off the losses of his predecessor except in the case of succession by inheritance.
- (v) A business loss can be carried forward for a maximum period of 8 assessment years immediately succeeding the assessment year in which the loss was incurred.
- (vi) As per section 80, the assessee must have filed a return of loss under section 139(3) in order to carry forward and set off a loss. In other words, the non-filing of a return of loss disentitles the assessee from carrying forward the loss sustained by him. Such a return should be filed within the time allowed under section 139(1). However, this condition does not apply to a loss from house property carried forward under section 71B and unabsorbed depreciation carried forward under section 32(2).



*Did u know?* The income from business and profession is known as profit and gains. While calculating the profit and gains, we deduct various expenses from it. The expenses to be deducted for calculating the gain are defined in the Income Tax Act. Sections 30 to 37 cover expenses, which are expressly allowed as deduction while computing business income, sections 40, 40A and 43B cover expenses which are not deductible.

**Notes**

Expenses deductions under section 30 to 37 are of two types. The first is specific deductions which are covered under section 30 to 35 and second is general deductions which are covered under section 36 and 37. Specific deductions are allowed only to some of the businesses while general deductions are allowed to all the businesses.



*Example:* Mr. B, a resident individual, furnishes the following particulars for the P. Y. 2012-13:

Income from salary (Net)	45,000
Income from house property	(24,000)
Income from business - non-speculative	(22,000)
Income from speculative business	(4,000)
Short-term capital gains	(25,000)
Long-term capital gains	19,000

The total taxable income of Mr. B for assessment year 2013-14 in this case can be computed as:

Income from salaries	45,000	
Income from house property	<u>(24,000)</u>	21,000

**Profits and gains of business and profession**

Business loss to be carried forward (Note 1)	(22,000)
Speculative loss to be carried forward (Note 2)	(4,000)

**Capital Gains**

Long-term capital gain	19,000
Short-term capital loss	<u>(25,000)</u>
Short-term capital loss to be carried forward (Note 3)	(6,000)

**Taxable Income** **21,000**

*Note 1:* Business loss cannot be set-off against salary income. Therefore, loss of ₹ 22,000 from the non-speculative business cannot be set off against the income from salaries. Hence, such loss has to be carried forward to the next year for set-off against business profits, if any.

*Note 2:* Loss of ₹ 4,000 from the speculative business can be set off only against the income from the speculative business. Hence, such loss has to be carried forward.

*Note 3:* Short-term capital loss can be set off against both short-term capital gain and long-term capital gain. Therefore, short-term capital loss of ₹ 25,000 can be set-off against long-term capital gains to the extent of ₹ 19,000. The balance short-term capital loss of ₹ 6,000 cannot be set-off against any other income and has to be carried forward to the next year for set-off against capital gains, if any.



*Caution* Where more than one tax year's losses are being carried forward, the loss of the earliest tax year shall be set off first.

Any amount of unabsorbed depreciation shall be allowed as deduction against the incomes of following tax years. There is no limit of six tax years for carry forward of unabsorbed depreciation. Where losses and unabsorbed depreciation occur together, the losses shall be adjusted first and depreciation shall be adjusted last.

**Self Assessment**

Notes

Fill in the blanks:

7. ....covers the carry forward and set-off of losses arising from a business or profession.
8. A business loss can be carried forward for a maximum period of ..... assessment years immediately succeeding the assessment year in which the loss was incurred.
9. As per section 80, the assessee must have filed a return of loss under ..... in order to carry forward and set off a loss.

**4.4 Section 72A**

Section 72A deals with carry forward and set-off of accumulated business losses and unabsorbed depreciation in certain cases of amalgamation or demerger, etc which are explained as under:

**Amalgamation**

This section applies where there has been an amalgamation of:

- (i) A company owning an industrial undertaking or a ship or a hotel with another company or an amalgamation of a banking company with a specified bank; or
- (ii) Public sector companies engaged in the business of operation of aircrafts.

It provides that the accumulated loss and unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or depreciation, as the case may be, of the amalgamated company for the previous year in which the amalgamation took place. Other provisions of the Act relating to set off and carry forward shall also apply accordingly.

***Conditions for Availing Benefit under this Section:***

- (1) ***Conditions to be fulfilled by the amalgamating company includes:***
  - (i) The amalgamating company should have been engaged in the business, in which the accumulated loss occurred or depreciation remains unabsorbed, for 3 or more years.
  - (ii) The amalgamating company has held continuously as on the date of amalgamation, at least 3/4th of the book value of the fixed assets held by it, 2 years prior to the date of amalgamation.
- (2) ***Conditions to be fulfilled by the amalgamated company:***
  - (i) The amalgamated company should hold at least 3/4th in the book value of fixed assets of the amalgamating company acquired as a result of amalgamation for a minimum period of 5 years from the effective date of amalgamation.
  - (ii) The amalgamated company continues the business of the amalgamating company for at least 5 years.
  - (iii) The amalgamated company must also fulfil such other conditions prescribed under Rule 9C for the revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purpose :
    - (a) The amalgamated company shall achieve the level of production of at least 50% of the installed capacity (capacity as on the date of amalgamation) of the said undertaking before the end of 4 years from the date of amalgamation and continue to maintain the said minimum level of production till the end

**Notes**

of 5 years from the date of amalgamation. Central Government has the power to modify this requirement on an application made by the amalgamated company.

- (b) The amalgamated company shall furnish to the Assessing Officer a certificate in Form No.62 verified by a Chartered Accountant in this regard.

In case the above specified conditions are not fulfilled, that part of carry forward of loss and unabsorbed depreciation remaining to be utilised by the amalgamated company shall lapse and such loss or depreciation as has been set-off shall be treated as the income in the year in which there is a failure to fulfil the conditions.

**Demerger**

Demerger is a form of corporate restructuring. One of the prime reasons why large corporate houses go in for demerger is to increase the role of specialisation in the particular segment. In case of large conglomerates, demerging entities often are the departments which are growing at an impressive rate and have substantial potential.

According to the Sub-section 19AA of Section 2 of Income Tax Act, 1961 (19AA) “demerger”, in relation to companies, means the transfer, pursuant to a scheme of arrangement under sections 391 to 394 of the Companies Act, 1956 (1 of 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 by virtue of the demerger;
- (ii) all the liabilities relating to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;
- (iii) the property 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 on a proportionate basis;
- (v) the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become share-holders 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.

***Treatment of Set-off and Carry Forward of Losses***

Where there has been a demerger of an undertaking, the accumulated loss and the unabsorbed depreciation directly relating to the undertaking transferred by the demerged company to the resulting company shall be allowed to be carried forward and set off in the hands of the resulting company.

If the accumulated loss or unabsorbed depreciation is not directly relating to the undertaking, the same will be apportioned between the demerged company and the resulting company in the



same proportion in which the value of the assets have been transferred. The Central Government is empowered to notify such conditions as it considers necessary to ensure that the demerger or amalgamation is for genuine business purpose.

### Re-organisation of Business [Section 72A(6)]

In case of re-organisation of business, whereby a firm is succeeded by a company as per the provisions of section 47(xiii), or a sole proprietary concern is succeeded by a company as per the provisions of section 47(xiv), then the accumulated business loss and the unabsorbed depreciation of the firm/proprietary concern, as the case may be, shall be deemed to be the loss or depreciation allowance of the successor company for the previous year in which the business re-organisation took place. Other provisions of the Act relating to set-off and carry forward will apply accordingly.



Notes

#### Meanings of Certain Terms

**“Accumulated loss”** means so much of the loss of the predecessor firm or the proprietary concern or the amalgamating company or the demerged company, as the case may be, under the head “Profit and gains of business or profession” (not being a loss sustained in a speculation business) which such predecessor firm or the proprietary concern or amalgamating company or demerged company, would have been entitled to carry forward and set off under the provisions of section 72 if the re-organisation of business or amalgamation or demerger had not taken place.

**“Unabsorbed depreciation”** means so much of the allowance for depreciation of the predecessor firm or the proprietary concern or the amalgamating company or the demerged company, as the case may be, which remains to be allowed and which would have been allowed to the predecessor firm or the proprietary concern or amalgamating company or demerged company, as the case may be, under the provisions of this Act, if the re-organisation of business or amalgamation or demerger had not taken place.

**“Industrial undertaking”** means any undertaking which is engaged in -

- (i) the manufacture or processing of goods;
- (ii) the manufacture of computer software;
- (iii) the business of generation or distribution of electricity or any other form of power;
- (iv) providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service, network of trunking, broad band network and internet services;
- (v) mining;
- (vi) the construction of ships, aircraft or rail systems.

**“Specified bank”** means the State Bank of India (SBI) constituted under the SBI Act, 1955 or a subsidiary bank as defined in the SBI (Subsidiary Banks) Act, 1959 or a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

However, this facility will not be available if it is found that any of the conditions laid down in the corresponding sub-sections (xiii) and (xiv) of section 47 have not been complied with. In such case, the set-off of loss or allowance of depreciation made in any previous year in the hands of

**Notes**

the successor company shall be deemed to be the income of the company chargeable to tax in the year in which the conditions have been violated.

**Conversion of a Company into LLP [Section 72A (6A)]**

The successor LLP would be allowed to carry forward and set-off the business loss and unabsorbed depreciation of the predecessor company. However, if the entity fails to fulfil the conditions specified in section 47(xiiiib), the benefit of set-off of business loss/unabsorbed depreciation availed by the LLP would be deemed to be the profits and gains of the LLP chargeable to tax in the previous year in which the LLP fails to fulfil any of the conditions.

**Self Assessment**

Fill in the blanks:

10. .... deals with carry forward and set-off of accumulated business losses and unabsorbed depreciation in certain cases of amalgamation or demerger.
11. The amalgamating company should have been engaged in the business, in which the accumulated loss occurred or depreciation remains unabsorbed, for ..... years.
12. .... is a form of corporate restructuring.

**4.5 Section 72AA**

This section provides for carry forward and set off of accumulated loss and unabsorbed depreciation allowance of a banking company against the profits of a banking institution under a scheme of amalgamation sanctioned by the Central Government.



*Did u know?* Reserve Bank of India had constituted, on the recommendations of the Joint Parliamentary Committee (2002), a Working Group to evolve guidelines for voluntary mergers involving banking companies. Based on the recommendations of the Group, the guidelines laying down the process of merger proposal, determination of swap ratios, disclosures, the stages at which Boards will get involved in the merger process and norms of buying or selling of shares by the promoters before and during the process of merger have since been finalised.

Where a banking company has been amalgamated with a banking institution under a scheme sanctioned and brought into force by the Central Government under section 45(7) of the Banking Regulation Act, 1949, the accumulated loss and unabsorbed depreciation of the amalgamating banking company shall be deemed to be the loss or the allowance for depreciation of the banking institution for the previous year in which the scheme of amalgamation is brought into force, and all the provisions contained in the Income-tax Act, 1961, relating to set off and carry forward of loss and unabsorbed depreciation shall apply accordingly.

The *Explanation* to this section defines the expressions “accumulated loss”, “banking company”, “banking institution” and “unabsorbed depreciation” as follows –

- (i) **“accumulated loss”** means so much of the loss of the amalgamating banking company under the head “Profits and gains of business or profession” (not being a loss sustained in a speculation business) which such amalgamating banking company, would have been entitled to carry forward and set-off under the provisions of section 72 if the amalgamation had not taken place;
- (ii) **“banking company”** shall have the same meaning assigned to it in clause (c) of section 5 of the Banking Regulation Act, 1949;

- (iii) *"banking institution"* shall have the same meaning assigned to it in sub-section (15) of section 45 of the Banking Regulation Act, 1949;
- (iv) *"unabsorbed depreciation"* means so much of the allowance for depreciation of the amalgamating banking company which remains to be allowed and which would have been allowed to such banking company if the amalgamation had not taken place.

## Self Assessment

Fill in the blanks:

13. .... means so much of the loss of the amalgamating banking company under the head Profits and gains of business or profession.
14. .... shall have the same meaning assigned to it in clause (c) of section 5 of the Banking Regulation Act, 1949.

## 4.6 Section 72AB

Under this section, in a case where the amalgamation has taken place during the previous year, set-off of accumulated loss and the unabsorbed depreciation of the predecessor co-operative bank will be allowed in the hands of the successor co-operative bank as if the amalgamation had not taken place. All the other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation would apply accordingly.



*Did u know?* Section 32(2) provides for the carry forward of unabsorbed depreciation. It reads as:

*"where in the assessment of the assessee, full effect cannot be given to any allowance under Sub-section.(1) in any previous year, owing to there being no profits or gains chargeable for that previous year or owing to the profits or gains chargeable being less than the allowance, then subject to the provisions of Sub-section (2) of Section 72 and Sub-section (3) of Section 73, the allowance or the part of the allowance to which effect has not been given, as the case may be, shall be added to the amount of the allowance for depreciation for the following previous year and deemed to be part of that allowance or if there is no such allowance for that previous year, be deemed to be the allowance for the previous year and so on for the succeeding previous years."*

## Conditions

The benefit of carry-forward and set-off of accumulated losses under this section would be allowed only on fulfilment of the following conditions:

- (a) **Conditions to be fulfilled by the predecessor co-operative bank:**
- (i) It should have been engaged in the business of banking for three or more years; and
  - (ii) It has held at least three-fourths of the book value of fixed assets as on the date of the business reorganisation, continuously for two years prior to the date of business reorganisation;
- (b) **Conditions to be fulfilled by the successor co-operative bank:**
- (i) It should hold at least three-fourths of the book value of fixed assets of the predecessor co-operative bank acquired through business reorganisation, continuously for a minimum period of five years immediately succeeding the date of business reorganisation;

Notes

- (ii) It continues the business of the predecessor co-operative bank for a minimum period of five years from the date of business reorganisation; and
- (iii) It fulfils such other conditions as may be prescribed to ensure the revival of the business of the predecessor co-operative bank or to ensure that the business reorganisation is for genuine business purpose.

**Amount of Set-off of the Accumulated Loss and Unabsorbed Depreciation**

The amount of set-off of the accumulated loss and unabsorbed depreciation allowable to the resulting co-operative bank has to be calculated in the following manner -

1. *In a case where the whole of the amount of such loss or unabsorbed depreciation is directly relatable to the undertakings transferred to the resulting co-operative bank:* The entire accumulated loss or unabsorbed depreciation of the demerged co-operative bank is allowed to be set-off.
2. *In a case where the accumulated loss or unabsorbed depreciation is not directly relatable to the undertakings transferred to the resulting co-operative bank:* The amount which bears the same proportion to the accumulated loss or unabsorbed depreciation of the demerged co-operative bank as the assets of the undertaking transferred to the resulting co-operative bank bears to the assets of the demerged co-operative bank.



*Example:* If A Co-op. Bank is the demerged co-operative bank and B Co-op. Bank is the resulting co-operative bank, the amount of set-off of the accumulated loss and unabsorbed depreciation allowable to B Co-op. bank would be -

Assets of the undertaking transferred unabsorbed business loss/depreciation

to B Co-op. bank of A Co-op. bank Assets of A Co-op. bank

The Central Government may specify other conditions by notification in the Official Gazette as it considers necessary, to ensure that the business reorganisation is for genuine business purposes.

The period commencing from the beginning of the previous year and ending on the date immediately preceding the date of business reorganisation, and the period commencing from the date of such business reorganisation and ending with the previous year shall be deemed to be two different previous years for the purposes of set off and carry forward of loss and allowance for depreciation.



*Example:* If the date on which business re-organisation took place is 1.11.2012, then the period between 1.4.2012 and 31.10.2012 and the period between 1.11.2012 and 31.3.2013 would be deemed to be two different previous years for the purposes of set-off and carry forward of unabsorbed business losses and depreciation.

In a case where the conditions specified in benefit of carry-forward and set-off of accumulated losses on fulfilment of certain conditions mentioned above or notified under Official Gazette by Central Government are not complied with, the set-off of accumulated loss or unabsorbed depreciation allowed in any previous year to the successor co-operative bank shall be deemed to be the income of the successor co-operative bank chargeable to tax for the year in which the conditions are not complied with.

Accumulated loss means so much of loss of the amalgamating co-operative bank or the demerged co-operative bank, as the case may be, under the head "Profits and gains of business or profession" (not being a loss sustained in a speculation business) which such amalgamating co-operative bank or the demerged co-operative bank, would have been entitled to carry forward and set-off under the provisions of section 72 as if the business reorganisation had not taken place.

Unabsorbed depreciation means so much of the allowance for depreciation of the amalgamating co-operative bank or the demerged co-operative bank, as the case may be, which remains to be allowed and which would have been allowed to such bank as if the business reorganisation had not taken place.

### Self Assessment

State which of the following are the true conditions to be fulfilled by the predecessor co-operative bank:

15. It should have been engaged in the business of banking for three or more years.
16. It has held at least three-fourths of the book value of fixed assets as on the date of the business reorganisation, continuously for two years prior to the date of business reorganisation.
17. It should hold at least three-fourths of the book value of fixed assets of the predecessor co-operative bank acquired through business reorganisation, continuously for a minimum period of five years immediately succeeding the date of business reorganisation.

## 4.7 Section 73 and Section 73A

The Section 73 and Section 73A of the Income Tax Act, 1961, deals with the treatment of setoff and carry forward of losses in Speculation Business and Carry forward & set off of losses by specified businesses respectively. These are elaborate as under:



*Did u know?* A business is speculative to the extent that it takes risks and tries things that outcome is uncertain. A speculation in essence says "Maybe this will happen..." as compared to known quantities and established commercial patterns.

### 4.7.1 Losses in Speculation Business (Section 73)

The meaning of the expression 'speculative transaction' as defined in section 43(5) and the treatment of income from speculation business has already been discussed under the head "Profits and gains of business or profession".

Since speculation is deemed to be a business distinct and separate from any other business carried on by the assessee, the losses incurred in speculation can be neither set off in the same year against any other non-speculation income nor be carried forward and set off against other income in the subsequent years.

Therefore, if the losses sustained by an assessee in a speculation business cannot be set-off in the same year against any other speculation profit, they can be carried forward to subsequent years and set-off only against income from any speculation business carried on by the assessee.

The loss in speculation business can be carried forward only for a maximum period of 4 years from the end of the relevant assessment year in respect of which the loss was computed. Loss from the activity of trading in derivatives, however, is not to be treated as speculative loss.

The *Explanation* to this section discourages companies (other than banking and investment companies) from indulging in speculation business or dealing in shares otherwise than in the ordinary course of their business. It provides that where any part of the business of a company (other than investment company or banking or financing company) consists of the purchase and sale of the shares of other companies, such a company shall be deemed to be carrying on speculation business to the extent to which the business consists of the purchase and sale of such shares. Thus, companies engaged in the business of banking or the granting of loans and advances as their principal business would be exempted from the operation of this Explanation.

**Notes**

Accordingly, both investment companies and banking companies would not be treated as carrying on speculation business in cases where they purchase and sell shares of other companies.

For this purpose, an 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 the other sources".

**4.7.2 Carry Forward & Set-off of Losses by Specified Businesses (Section 73A)**

While dealing with Carry forward & set off of losses by specified businesses following things should be kept in mind:

1. Any loss computed in respect of the specified business referred to in section 35AD shall be set off only against profits and gains, if any, of any other specified business.
2. The unabsorbed loss, if any, will be carried forward for set off against profits and gains of any specified business in the following assessment year and so on.
3. There is no time limit specified for carry forward and set-off and therefore, such loss can be carried forward indefinitely for set-off against income from specified business.



*Notes* The loss of an assessee claiming deduction under section 35AD in respect of a specified business can be set-off against the profit of another specified business under section 73A, irrespective of whether the latter is eligible for deduction under section 35AD. An assessee can, therefore, set-off the losses of a hospital or hotel which begins to operate after 1st April, 2010 and which is eligible for deduction under section 35AD, against the profits of the existing business of operating a hospital (with at least 100 beds for patients) or a hotel (of two-star or above category), even if the latter is not eligible for deduction under section 35AD.

**Self Assessment**

Fill in the blanks:

18. The meaning of the expression 'speculative transaction' as defined in .....
19. The loss in speculation business can be carried forward only for a maximum period of .....
20. Any loss computed in respect of the specified business referred to in .....shall be set off only against profits and gains, if any, of any other specified business.

**4.8 Section 74**

Section 74 provides that where for any assessment year, the net result under the head 'Capital gains' is short-term capital loss or long-term capital loss, the loss shall be carried forward to the following assessment year to be set off in the following manner:

Where the loss so carried forward is a short-term capital loss, it shall be set off against any capital gains, short-term or long-term, arising in that year.

- (i) Where the loss so carried forward is a long-term capital loss, it shall be set off only against long-term capital gain arising in that year.
- (ii) Net loss under the head capital gains cannot be set off against income under any other head.

Notes

- (iii) Any unabsorbed loss shall be carried forward to the following assessment year up to a maximum of 8 assessment years immediately succeeding the assessment year for which the loss was first computed.



*Did u know?* Capital losses are classified as long-term or short-term. If you hold the asset for more than one year before you dispose of it, your capital loss is long-term. If you hold it one year or less, your capital loss is short-term.

To determine how long you held the asset, count from the date after the day you acquired the asset up to and including the day you disposed of the asset.



*Example:* During the P. Y. 2012-13, Mr. R has the following income and the brought forward losses:

Short-term capital gains on sale of shares	1, 50,000
Long-term capital loss of A. Y. 2011-12	(96,000)
Short-term capital loss of A.Y. 2012-13	(37,000)
Long-term capital gain	75,000

In this case the capital gain taxable in the hands of Mr. R for the A.Y. 2013-14 will be:

Short-term capital gains on sale of shares	1, 50,000	
<b>Less:</b> Brought forward short-term capital loss of the A.Y. 2012-13	(37,000)	1, 13,000
Long-term capital gain	75,000	
<b>Less:</b> Brought forward long-term capital loss of A.Y. 2011-12 (See Note below)	(75,000)	Nil
<b>Taxable short-term capital gains</b>		<b>1, 13,000</b>



*Notes* Long-term capital loss cannot be set off against short-term capital gain. Hence, the unadjusted long-term capital loss of A.Y. 2011-12 of ₹ 21,000 (i.e. ₹ 96,000 – ₹ 75,000) has to be carried forward to the next year to be set-off against long-term capital gains of that year.



*Task* Give examples of short-term and long-term capital losses.

**Self Assessment**

Fill in the blanks:

- If you hold the asset for more than one year before you dispose of it, your capital loss is .....
- If you hold it one year or less, your capital loss is .....
- .....under the head capital gains cannot be set off against income under any other head.

### 4.9 Section 74A(3)

According to provisions of section 74A(3), the losses incurred by an assessee from the activity of owning and maintaining race horses cannot be set-off against the income from any other source other than the activity of owning and maintaining race horses.



*Example:* A loss of 85,000 was sustained by Simran in the activity of owning and maintaining camels for races. Therefore in this case according to Sec 74A(3), the losses incurred by Simran from the activity of owning and maintaining race horses cannot be set-off against the income from any other source other than the activity of owning and maintaining race horses. Since the scope of this section is confined to the activity of owning and maintaining race horses only, therefore, set-off and carry forward of loss from the activity of owning and maintaining camels is not covered under section 74A(3).

It is possible to take a view that the loss from the activity of owning and maintaining camels for races may be governed by section 72 provided such activity amounts to business. Accordingly, the loss from the activity of owning and maintaining of camels for races can be set-off against any income (other than income from salary) of current year and unadjusted amount shall be carried forward for set off against any business income for a maximum period of 8 assessment years immediately succeeding the assessment year in which the loss was incurred.

Such loss can be carried forward for a maximum period of 4 assessment years for being set-off against the income from the activity of owning and maintaining race horses in the subsequent years. For this purpose, the "amount of loss incurred by the assessee in the activity of owning and maintaining race horses" means the amount by which such income by way of stake money falls short of the amount of revenue expenditure incurred by the assessee for the purpose of maintaining race horses. Therefore

$$\text{Loss} = \text{Stake money} - \text{Revenue expenditure for the purpose of maintaining race horses.}$$

Further, the expression 'horse race' means a horse race upon which wagering or betting may be lawfully made.

"Income by way of stake money" means the gross amount of prize money received on a race horse or race horses by the owner thereof on account of the horse or horses or any one or more of the horses winning or being placed second or in any lower position in horse races.



*Example:* Mr. D has the following income for the P.Y. 2012-13

Income from the activity of owning and maintaining the race horses	75,000
Income from textile business	85,000
Brought forward textile business loss	50,000
Brought forward loss from the activity of owning and maintaining the race horses (Relating to A.Y.2010-11)	96,000

The taxable income in the hands of Mr. D for the A.Y. 2013-14 will be:

Income from the activity of owning and maintaining race horses	75,000
<b>Less:</b> Brought forward loss from the activity of owning and maintaining race horses	<u>96,000</u>
Loss from the activity of owning and maintaining race horses to be carried forward to A.Y.2014-15	(21,000)
Income from textile business	85,000
<b>Less:</b> Brought forward business loss from textile business.	<u>50,000</u>
<b>Taxable business income</b>	<b>35,000</b>





**Caution** Loss from the activity of owning and maintaining race horses cannot be set-off against any other source/head of income.

## Self Assessment

State whether the following statements are true or false:

24. Provisions of section 74 A (3) deals with the losses incurred by an assessee from the activity of owning and maintaining race horses.
25. Losses incurred by an assessee from the activity of owning and maintaining race horses can be carried forward for a maximum period of 8 assessment years.

### 4.10 Section 78 and Section 79

The Section 78 and Section 79 of the Income Tax Act, 1961, deals with the treatment of setoff and carry forward of losses in case of change in constitution of firm or succession and of closely held companies respectively.

#### Carry Forward and Set-off of Losses in Case of Change in Constitution of Firm or Succession (Section 78)

Where there is a change in the constitution of a firm, so much of the loss proportionate to the share of a retired or deceased partner remaining unabsorbed, shall not be allowed to be carried forward by the firm. However, unabsorbed depreciation can be carried forward.

Where any person carrying on any business or profession has been succeeded in such capacity by another person otherwise than by inheritance, such other person shall not be allowed to carry forward and set off against his income, any loss incurred by the predecessor.



**Example:** X carrying on a business as sole proprietor, died on 31st March, 2012. On his death, the same business was continued by his legal heirs, by forming a firm. As on 31st March 2012, a determined business loss of 5 lakhs is to be carried forward under the Income-tax Act, 1961. Does the firm consisting of all legal heirs of Mr. X, get a right to have this loss adjusted against its current income?

**Solution:** Section 78(2) provides that where a person carrying on any business or profession has been succeeded in such capacity by another person, otherwise than by inheritance, then, the successor is not entitled to carry forward and set-off the loss of the predecessor against his income. This implies that generally, set-off of business losses should be claimed by the same person who suffered the loss and the only exception to this provision is when the business passes on to another person by inheritance.

The facts of case given in the question are similar to the case *CIT v. Madhukant M. Mehta* (2001) 247 ITR 805, where the Supreme Court has held that if the business is succeeded by inheritance, the legal heirs are entitled to the benefit of carry forward of the loss of the predecessor. Even if the legal heirs constitute themselves as a partnership firm, the benefit of carry forward and set off of the loss of the predecessor would be available to the firm.

In this case, the business of X was continued by his legal heirs after his death by constituting a firm. Hence, the exception contained in section 78(2) along with the decision of the Apex Court discussed above, would apply in this case. Therefore, the firm is entitled to carry forward the business loss of ₹ 5 lakhs of X.

Notes

**Carry Forward and Set-off of Losses in Case of Closely Held Companies (Section 79)**

Where in any previous year, there has been a change in the shareholding of a company in which the public are not substantially interested, any unabsorbed loss of the company shall be allowed to be carried forward and set off against the income of the previous year only if the beneficial shareholders of at least 51 % of the voting power on the last day of the previous year remained the same as on the last day of the year or years in which the loss was incurred.

However, this restriction shall not apply in the following two cases:

- (i) where a change in the voting power is consequent upon the death of a shareholder or on account of transfer of shares by way of gift by a shareholder to his relative; and
- (ii) where the change in shareholding takes place in an Indian company, being a subsidiary of a foreign company, as a result of amalgamation or demerger of the foreign company. However, this is subject to the condition that 51% of the shareholders of the amalgamating or demerged company continue to be shareholders of the amalgamated or resulting company.

The provisions of this section are applicable only in respect of carry forward of losses and not in respect of carry forward of unabsorbed depreciation, which is covered by section 32(2).

Where there is a succession by inheritance, the legal heirs (assessable as BOI) are entitled to set-off the business loss of the predecessor. Such carry forward and set-off is possible even if the legal heirs constitute themselves as a partnership firm. In such a case, the firm can carry forward and set-off the business loss of the predecessor.



*Did u know?* Any company that has only a limited number of shareholders, its closely held company stock is publicly traded on occasion, but not on a regular basis. These entities differ from privately owned firms that issue stock that is not publicly traded. Those who own shares of closely held corporations should consult a financial planner with expertise in the tax and estate ramifications that come with owning this type of stock.

**Self Assessment**

Fill in the blanks:

- 26. The .....of the Income Tax Act, 1961 deals with the treatment of setoff and carry forward of losses in case of change in constitution of firm or succession.
- 27. Where there is a succession by inheritance, the legal heirs assessable as..... are entitled to set-off the business loss of the predecessor.

**4.11 Order of Set-off of Losses**

As per the provisions of section 72(2), brought forward business loss is to be set-off before setting off unabsorbed depreciation. Therefore, the order in which set-off will be effected is as follows:

- (i) Current year depreciation or current year capital expenditure on scientific research and current year expenditure on family planning, to the extent allowed.
- (ii) Brought forward loss from business or profession [Section 72(1)]
- (iii) Unabsorbed depreciation [Section 32(2)]
- (iv) Unabsorbed capital expenditure on scientific research [Section 35(4)]
- (v) Unabsorbed expenditure on family planning [Section 36(1)(ix)]



*Example 1:* Mr. E has furnished his details for the A.Y. 2013-14 as under

Notes

Income from salaries	1, 50,000
Income from speculation business	60,000
Loss from non-speculation business	(40,000)
Short-term capital gain	80,000
Long-term capital loss of A.Y. 2011-12	(30,000)
Winning from lotteries	20,000

In this case the taxable income of Mr. E for the A.Y. 2013-14 will be:

Income from salaries	1, 50,000	
Income from speculation business	60,000	
<i>Less:</i> Loss from non-speculation business	(40,000)	20,000
Short-term capital gain		80,000
Winnings from lotteries		20,000
<b>Taxable income</b>		<b>2, 70,000</b>



*Notes* Long-term capital loss can be set off only against long-term capital gain. Therefore, long-term capital loss of ₹ 30,000 has to be carried forward to the next assessment year.



*Example 2:* The details of Mr. F for the A.Y.2013-14 from the information given below for which we need to compute the gross total income:

Net income from house property	1, 25,000
Income from business (before providing for depreciation)	1, 35,000
Short-term capital gains on sale of shares	56,000
Long-term capital loss from sale of property (brought forward from A.Y.2012-13)	(90,000)
Income from tea business	1, 20,000
Dividends from Indian companies carrying on agricultural operations	80,000
Current year depreciation	26,000
Brought forward business loss (loss incurred six years ago)	(45, 000)

From the above details the gross total income of Mr. F for the A.Y. 2013-14 is calculated as under:

Income from house property	1, 25,000
<b>Income from business</b>	
Profits before depreciation	1, 35,000
<i>Less:</i> Current year depreciation	26,000
<i>Less:</i> Brought forward business loss	<u>45,000</u>
	64,000

<b>Notes</b>	Income from tea business (40% is business income)	<u>48,000</u>	1, 12,000
	<b>Income from the capital gains</b>		
	Short-term capital gains	56,000	
	Long-term capital loss from property (cannot be set off	<u>Nil</u>	<u>56,000</u>
	<b>Gross Total Income</b>		<b><u>2,93,000</u></b>



*Notes*

Dividend from Indian companies is exempt from tax. 60% of the income from tea business is treated as agricultural income and therefore, exempt from tax.

### Self Assessment

28. A private limited company has share capital in the form of equity share capital. The shares were held until 31st March, 2011 by four members A, B, C and D equally. The company made losses/profits for the past three assessment years as follows:

Assessment Year	Business Loss	Unabsorbed Depreciation	Total
2009-2010	Nil	15, 00, 000	15, 00, 000
2010-2011	Nil	12, 00, 000	12, 00, 000
2011-2012	9, 00, 000	9, 00, 000	18, 00, 000
Total	9, 00, 000	36, 00, 000	45, 00, 000

The above figures have been accepted by the tax department. During the previous year ended 31.3.2012, A sold his shares to Y and during the previous year ended 31.3.2013, B sold his shares to Z. The profits for the past two previous years are as follows:

31.3.2012 18, 00, 000 (before charging depreciation of 9, 00, 000)

31.3.2013 45, 00,000 (before charging depreciation of 7, 50,000)

Compute taxable income for A.Y. 2013-14.



*Case Study*

### **Haryana Hotels Ltd.**

The Punjab & Haryana High Court was recently asked to deal with the same issue in the case of *CIT v. Haryana Hotels Ltd.*, 197 CTR 449. In this case, in passing the order of assessment u/s.143(3) of the Act for A.Y. 1987-88, the AO disallowed the brought forward losses and unabsorbed depreciation of earlier assessment years and their set-off on the ground that no valid assessment had been made for A.Y. 1986-87.

The assessee preferred an appeal before the Commissioner (Appeals) wherein it challenged the action of the AO in not allowing set-off of unabsorbed depreciation on the ground that the assessment for the year 1986-87 had not been completed. The Commissioner (Appeals), however, partly allowed the appeal and directed the AO to recalculate the depreciation by taking written-down value determined as on 31st March 1985, and thereafter to calculate and allow the same for the assessment year in question and ordered that the written-down value should accordingly be re-determined for being carried forward to the succeeding year.

*Contd...*

The assessee preferred further appeal to the Tribunal, challenging the order of the Commissioner (Appeals) regarding the carry forward of unabsorbed losses and disallowance of unabsorbed depreciation. The Tribunal allowed the appeal of the assessee and directed the AO to allow the claim of carry forward of unabsorbed depreciation as well as unabsorbed losses.

At the instance of the Revenue, the Court was requested to address the following question of law. "Without prejudice of the above, whether on the facts and in the circumstances of the case, the Tribunal was right in law in allowing the carry forward of business losses and depreciation when neither any valid return for the A.Y. 1986-87 was filed, nor any business loss and depreciation was determined for the A.Y. 1986-87 to be carried forward in the succeeding year *i.e.*, the A.Y. 1987-88?"

Attention of the Court was drawn to the provisions of S. 72, S. 80, S. 139(3) and S. 157 of the Act and it was contended by the Revenue that in the event of failure on the part of the assessee to file a valid return, no business loss could be carried forward and the Tribunal had, thus, erred in granting relief to the assessee. It was submitted that on the same analogy, as applicable to the carry forward of unabsorbed losses, even unabsorbed depreciation u/s.32(2) of the Act could not be allowed to be carried forward and that the Commissioner (Appeals) and the Tribunal had wrongly allowed the same. The Revenue placed reliance on *Sri Rajarathinam Transports (P) Ltd. v. CIT*, 199 ITR 203 (Mad.) to augment its submissions.

In reply, the assessee, controverting the submissions of the Revenue, supported the orders of the Commissioner (Appeals) and the Tribunal, and submitted that in view of the decision of the Apex Court in *CIT v. Virmani Industries (P) Ltd. etc.* 261 ITR 607 (SC), the Tribunal had rightly allowed set-off and carry forward of unabsorbed depreciation and business losses.

The Court observed that the reading of S. 32(2) of the Act made it clear that a carried forward unabsorbed depreciation allowance was deemed to be part of and stood on the same footing as current depreciation. It further observed that if in the assessment of the assessee, full effect could not be given to any allowance in any previous year, owing to there being no profits or gains chargeable for that previous year, the allowance or part of the allowance to which effect had not been given, should be added to the amount of the allowance for depreciation for the following previous year and deemed to be part of the said allowance. That there was no time limit provided u/s.32(2) of the Act for carry forward of unabsorbed depreciation to any subsequent year. The Court took note of the decision of the Apex Court in *CIT v. Jaipuria China Clay Mines (P) Ltd.*, 59 ITR 555 (SC), which had held that unabsorbed depreciation of past years had to be added to the depreciation of the current year and the aggregate unabsorbed and current year's depreciation had to be deducted from the total income of the assessment year.

The Court, on giving thoughtful consideration, was unable to accept the view as laid down by the Madras High Court in *Sri Rajarathinam Transports' case (supra)*, as according to the Court, u/s.32(2) of the Act, unabsorbed depreciation of earlier previous years formed part of the current year's depreciation and thereafter allowance for depreciation was given from the current year's income. That there was no such provision in S. 72 of the Act by virtue of which business losses of earlier years formed part of the current year's business losses and allowed to be set-off from current year's income and in view of that, only such business losses of earlier years which were notified by the AO were allowed to be carried forward and set-off from the current year's income. That there was no similar provision under the Act which made it mandatory for the assessee to file return for carry forward and set-off of unabsorbed depreciation which was to be notified by the AO as in the case of unabsorbed business loss. On a reading of the provisions of the Act, the distinction between unabsorbed depreciation and unabsorbed business loss for the purposes of set-off and carry forward was clear to the Court.

Contd...

Notes

**Questions**

1. Study and analyse the case.
2. Write down the case facts.
3. What inferences do you draw from the case about treatment of unabsorbed depreciation while setting-off losses

Source: <http://www.bcasonline.org/articles/artin.asp?581>

### **4.12 Summary**

- When income from a particular head and a loss from another head or same head is adjusted, it is called 'set off of loss against income'. A loss when not set off due to legal bar or due to insufficiency of income from other eligible source or head, it may be carried forward to a subsequent year for set off against income of that year.
- Under Section 70, the losses incurred by the assessee in respect of one source shall be set-off against income from any other source under the same head of income, since the income under each head is to be computed by grouping together the net result of the activities of all the sources covered by that head.
- In Inter head adjustment (Section 71) the loss under one head of income can be adjusted or set off against income under another head.
- A very important rule to remember is that losses that are carried forward have to be set off against income from the same head in the subsequent years – they cannot be set off against income from any other head of income. A carried forward loss can be set off against income in subsequent years only if the loss has been declared in the income tax return filed by you.
- A loss for a particular year can be carried forward only if the income tax return for that year is filed by the due date. The only exception to this rule is loss from house property – this loss can be carried forward even if the IT return is not filed in time.
- Loss from a source of income which is exempt from income tax (for example, an agricultural loss) cannot be set off against income from a taxable source of income. Loss from none of the heads of income can be set off against winnings from lotteries, horse races, gambling, etc. The losses from these cannot be set off even against income from lotteries, horse races, gambling, etc.
- In any assessment year, if there is a loss under the head 'Income from house property', such loss will first be set-off against income from any other head during the same year. If such loss cannot be so set-off, wholly or partly, the unabsorbed loss will be carried forward to the following assessment year to be set-off against income under the head 'Income from house property'. The loss under this head is allowed to be carried forward up to 8 assessment years immediately succeeding the assessment year in which the loss was first computed.
- A business loss can be carried forward for a maximum period of 8 assessment years immediately succeeding the assessment year in which the loss was incurred.
- As per section 80, the assessee must have filed a return of loss under section 139(3) in order to carry forward and set off a loss. In other words, the non-filing of a return of loss disentitles the assessee from carrying forward the loss sustained by him. Such a return should be filed within the time allowed under section 139(1). However, this condition does not apply to a loss from house property carried forward under section 71B and unabsorbed depreciation carried forward under section 32(2).

- Section 72A deals with carry forward and set-off of accumulated business losses and unabsorbed depreciation in certain cases of amalgamation or demerger. It provides that the accumulated loss and unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or depreciation, as the case may be, of the amalgamated company for the previous year in which the amalgamation took place. Other provisions of the Act relating to set off and carry forward shall also apply accordingly.
- Where there has been a demerger of an undertaking, the accumulated loss and the unabsorbed depreciation directly relatable to the undertaking transferred by the demerged company to the resulting company shall be allowed to be carried forward and set off in the hands of the resulting company.
- Section 72 provides for carry forward and set off of accumulated loss and unabsorbed depreciation allowance of a banking company against the profits of a banking institution under a scheme of amalgamation sanctioned by the Central Government.
- The Section 73 and Section 73A of the Income Tax Act, 1961, deals with the treatment of setoff and carry forward of losses in Speculation Business and Carry forward & set off of losses by specified businesses respectively.
- Capital losses are classified as long-term or short-term. If you hold the asset for more than one year before you dispose of it, your capital loss is long-term. If you hold it one year or less, your capital loss is short-term. To determine how long you held the asset, count from the date after the day you acquired the asset up to and including the day you disposed of the asset.
- According to provisions of section 74A(3), the losses incurred by an assessee from the activity of owning and maintaining race horses cannot be set-off against the income from any other source other than the activity of owning and maintaining race horses.
- Where there is a change in the constitution of a firm, so much of the loss proportionate to the share of a retired or deceased partner remaining unabsorbed, shall not be allowed to be carried forward by the firm. However, unabsorbed depreciation can be carried forward. Where any person carrying on any business or profession has been succeeded in such capacity by another person otherwise than by inheritance, such other person shall not be allowed to carry forward and set off against his income, any loss incurred by the predecessor.

### 4.13 Keywords

**Amalgamation:** It is an agreement (deal) between two or more companies to consolidate their business activities by establishing a new company having a separate legal existence.

**Carry forward of losses:** The losses which cannot be set-off in the same year are carried to the next year to set-off against income of next year.

**Demerger:** It is a form of corporate restructuring in which the entity's business operations are segregated into one or more components.

**Inter head adjustment:** Where in respect of any assessment year the net result of the computation under any head of income is a loss. He shall be entitled to have the amount of such loss set-off against his income, if any, under any other head of income.

**Inter source Adjustment:** When there is more than one source of income under the same head, the loss from one or more sources is allowed to be set-off against income from the other source under the same head.

**Notes**

**Restructuring:** It is the corporate management term for the act of reorganising the legal, ownership, operational, or other structures of a company for the purpose of making it more profitable, or better organised for its present needs.

**Set-off losses:** Setting off losses against the income of the same year.

**Unabsorbed depreciation:** A company depreciates long-term assets to recover expenses it incurs in operating activities and maintenance processes. Fiscal laws allow a firm to recover unabsorbed depreciation over a number of years.

#### **4.14 Review Questions**

1. Define set-off and carry forward of losses.
2. Explain, in detail, the inter source adjustment as provided under Section 70.
3. What all points should be kept in mind while setting-off of losses against income under another head?
4. Mention the basic rules governing set-off and carry forward of losses.
5. Discuss set-off and carry forward of losses from house property.
6. How can one set-off and carry forward of losses occurring from business?
7. Define group taxation.
8. Explain the set-off and carry forward of losses of accumulated business losses and unabsorbed depreciation in case of amalgamation and demerger.
9. Write a note on losses in speculation business.
10. Describe set-off and carry forward of losses by specified businesses.
11. What are capital losses? How are they set-off and carry forwarded?
12. M/s. JKLM, a firm, consists of four partners namely, J, K, L and M. They shared profits and losses equally during the year ended 31.3.2012. The assessed business loss of the firm for the assessment year 2012-13 which it is entitled to carry forward amounts to ₹ 3,60,000. A new deed of partnership was executed among J, K, L and M on 1.4.2012 in terms of which they agreed to share profits and losses in the ratio of 15:15:20:50 respectively. Compute the amount of business loss relating to the assessment year 2012-13, which the firm is entitled to set off against its business income for the assessment year 2013-14. The business income of the firm for the assessment year 2013-14 is 3, 30,000. Your answer should be supported by reasons.
13. An assessee sustained a loss under the head "Income from house property" in the previous year relevant to the assessment year 2012-13, which could not be set off against income from any other head in that assessment year. The assessee did not furnish the return of loss within the time allowed under section 139(1) in respect of the relevant assessment year. However, the assessee filed the return within the time allowed under section 139(4). Can the assessee carry forward such loss for set off against income from house property of the assessment year 2013-14?
14. M, an individual, was carrying on a business as sole proprietor. On his death, his legal heirs decide to continue the same business by forming a firm. At the time of death, M had a determined business loss of ₹ 2 Lakhs, under the provisions of the Income-tax Act, 1961 to be carried forward. Does the firm, consisting of all the legal heirs of M, get a right to have this loss adjusted against its current income? Discuss.
15. Rajesh & Co., the sole proprietary concern of Mr. Rajesh got converted into partnership after his death on 02.04.2012 by his two sons and the business of Rajesh & Co., was continued to



## Notes

be carried in the same manner. There were business losses of ₹ 4.25 Lakhs till 31.03.2012. The net results of the business for the year ended 31.03.2013 were profits of ₹ 5 Lakhs. The partners want to set off the losses of ₹ 4.25 Lakhs from the profits of the firm. Can they do so?

16. X Ltd., a pharmaceutical company having accumulated losses and unabsorbed depreciation to be set off in future for ₹ 130 lakhs and ₹ 250 lakhs as on 31.3.2012 was demerged on 16.5.2012 and 30% of its total assets were transferred to the resulting company, XY Ltd. How shall the accumulated losses and unabsorbed depreciation of the demerged company be dealt with in the return for Assessment Year 2013-14 of the resulting company:
- (a) When the same are not directly relatable to the undertakings transferred and
- (b) When the same are directly relatable to the undertakings transferred.
17. Aditya, an Indian citizen who is about 70 years old, submits the following information for the previous year 2012-13:

Profit from leather goods business in Lucknow	5,00,000
Profit from textile export business in Chennai	6,00,000
Loss from wholesale business in Sri Lanka	8,50,000
Unabsorbed depreciation of wholesale business	70,000
Income from house property in Lucknow (computed)	1,10,000
Income from house property in Sri Lanka (computed)	80,000

The profits from wholesale business in Sri Lanka are received in the bank account in Sri Lanka. Rental income from the Sri Lanka property is also received there. Assuming that Aditya is a resident and ordinarily resident for P.Y.2012-13, compute the taxable income and tax payable by Aditya for the A.Y. 2013-14.

**Answers: Self Assessment**

- |                                   |                            |
|-----------------------------------|----------------------------|
| 1. Set off of loss against income | 2. Carry-forward of losses |
| 3. Speculation                    | 4. True                    |
| 5. True                           | 6. False                   |
| 7. Section 72                     | 8. Eight                   |
| 9. Section 139(3)                 | 10. Section 72A            |
| 11. 3 or more                     | 12. Demerger               |
| 13. Accumulated loss              | 14. Banking company        |
| 15. True condition                | 16. True condition         |
| 17. False condition               | 18. Section 43(5)          |
| 19. 4 years                       | 20. Section 35AD           |
| 21. Long-term.                    | 22. Short-term             |
| 23. Net loss                      | 24. True                   |
| 25. False                         | 26. Section 78             |
| 27. BOI                           | 28. 1,50,000               |

Notes

### 4.15 Further Readings



*Books*

Ahuja, G. K. & Gupta, Ravi, *Systematic Approach to Income Tax*, Bharat Law House.

Aggarwal, K., *Direct Tax Planning and Management*, Atlantic Publications.

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Srinivas E. A., *Handbook of Corporate Tax Planning*, Tata McGraw Hill.



*Online links*

<http://www.investopedia.com/terms/l/losscarryforward.asp#axzz2H59iwfo9>

[http://wircicai.org/wirc\\_referencer/income%20tax%20&%20wealth%20tax/Set%20Off%20And%20Carry%20Forw rd%20of%20Losses.htm](http://wircicai.org/wirc_referencer/income%20tax%20&%20wealth%20tax/Set%20Off%20And%20Carry%20Forw rd%20of%20Losses.htm)

<http://www.raagvamdatt.com/set-off-and-carry-forward-of-losses-capital-gains-and-house-property>

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[http://www.du.ac.in/fileadmin/DU/Academics/course\\_material/TM\\_11.pdf](http://www.du.ac.in/fileadmin/DU/Academics/course_material/TM_11.pdf)

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<http://carocks.wordpress.com/2011/11/08/unabsorbed-depreciation-faqs/>

## Unit 5: Computation of Taxable Income of Companies

Notes

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### Objectives

After studying this unit, you will be able to:

- Discuss the computation of taxable income of companies
- Explain the concept of Minimum Alternative Tax (MAT)
- Elucidate the procedure for computation of MAT under Section 115JB
- Describe the treatment of tax on distributed profits of domestic company
- Calculate the tax on dividend and income received from venture capital companies

### Introduction

Taxable income refers to the amount of income that is used to calculate an individual's or a company's income tax due. Taxable income is generally described as gross income or adjusted gross income minus any deductions, exemptions or other adjustments that are allowable in that tax year. Taxable income is also generated from appreciated assets that have been sold or capitalised during the year and from dividends and interest income. Income from these sources is generally taxed at a different rate and calculated separately by the tax entity.

**Notes**

Company whether Indian or foreign is liable to taxation, under the Income Tax Act, 1961. Corporation tax is a tax which is levied on the incomes of registered companies and corporation. However, for the purpose of taxation, companies are broadly classified as domestic company which is a company formed and registered under the Companies Act, 1956 or any other company which, in respect of its income liable to tax, under the Income Tax Act, has made the prescribed arrangement for declaration and payments within India, of the dividends payable out of such income. A domestic company may be a public company or a private company and a foreign company which is a company whose control and management are situated wholly outside India, and which has not made the prescribed arrangements for declaration and payment of dividends within India.

In this unit, we will study the computation of taxable incomes for companies by taking into consideration the concepts of MAT, tax on distributed profits of Indian companies and tax on dividends and income by VCC etc.

## **5.1 Computation of Taxable Income of Companies**

Indian companies are taxable in India on their worldwide income, irrespective of its source and origin. Foreign companies are taxed only on income which arises from operations carried out in India or, in certain cases, on income which is deemed to have arisen in India. The later includes royalty, fees for technical services, interest, gains from sale of capital assets situated in India (including gains from sale of shares in an Indian company) and dividends from Indian companies. Thus, the tax-liability on income of a company depends upon the residential status of the company.

### **5.1.1 Residential Status of a Company**

A Company is said to be resident in India during any relevant previous year if:-

- (i) it is an Indian Company; or
- (ii) the control and management of its affairs is situated wholly in India. In case of Resident Companies, the total income liable to tax includes (section 5(1)):-
  - (a) any income which is received or is deemed to be received in India in the relevant previous year by or on behalf of such company;
  - (b) any income which accrues or arises or is deemed to accrue or arise in India during the relevant previous year;
  - (c) any income which accrues or arises outside India during the relevant previous year.

Similarly, a Company is said to be non-resident during any relevant previous year if:-

- (i) it is not an Indian company, and
- (ii) the control and management of its affairs is situated wholly or partially outside India. In case of Non-Resident Companies, the total income liable to tax includes (section 5(2)):-
  - (a) any income which is received or is deemed to be received in India during the relevant previous year by or on behalf of such company;
  - (b) any income which accrues or arises or is deemed to accrue or arise to it in India during the relevant previous year.

As a result a situation may arise where the same income becomes taxable in the hands of the same company in one or more countries, leading to 'Double Taxation'. The problem of double taxation may arise on account of any of the following reasons:-

1. A company (or a person) may be resident of one country but may derive income from other country as well, thus he becomes taxable in both the countries.

2. A company or person may be subjected to tax on his world income in two or more countries, which is known as concurrent full liability to tax. One country may tax on the basis of nationality of tax-payer and another on the basis of his residence within its border. Thus, a person domiciled in one country and residing in another may become liable to tax in both the countries in respect of his world income.
3. A company or person who is non-resident in both the countries may be subjected to tax in each one of them on income derived from one of them, for example, a non-resident person has a Permanent establishment in one country and through it he derives income from the other country.



*Did u know?* For companies, income is taxed at a flat rate of 30% for Indian companies, with a 5% surcharge applied on the tax paid by companies with gross turnover over 1 crore (10 million).

Foreign companies pay at the income tax at the rate of 40% plus 2% surcharge on the income tax payable. An education cess of 3% on both the tax and the surcharge are payable, yielding effective tax rates of 32.5% for domestic companies and 41.2% for foreign companies. From 2005-06, electronic filing of company returns is mandatory.

### 5.1.2 Taxable Income of Companies

The main source of income of a company is generally from “business”. A company would also earn income from under the following heads:

- (a) Income from house property
- (b) Income from capital gains
- (c) Income from other sources

Taxable income is calculated according to the rules for each class of income and then aggregated to determine total taxable income.

**Deductibility of expense:** While calculating income from business or profession, expense incurred wholly and exclusively for business purposes are generally deductible. These include depreciation on fixed assets, interest paid on borrowings in the financial year etc.

Certain expenses are specifically disallowed or the amount of deduction is restricted. These expenses include:

1. Entertainment expenses
2. Interest or other amounts paid to a non-resident without deducting without tax
3. Corporate taxes paid
4. Indirect general and administrative costs of a foreign head office.

**Set-off and carry forward of Losses:** Business losses incurred in a tax year can be set off against any other income earned during that year, except capital gains. Unabsorbed business losses can be carried forward and set off against business profits of subsequent years for a period of eight years; the unabsorbed depreciation element in the loss can however, be carried forward indefinitely. However, this carry forward benefit is not available to closely-held (private) companies in which there has been no continuity of business or shareholding pattern. Also, any change in beneficial interest in the shares of the company exceeding 51 per cent disqualifies the private company from the carry forward benefit.

## Notes

**Tax Rates for Companies:** The corporate tax rate in India is at par with the tax rates of the other nations worldwide. As mentioned above the corporate tax rate in India depends entirely on the origin of a company. In India the corporate tax rates differ with regards to the nature of the ownership of the company and their income.

## 1. Tax rates for Domestic Corporate &amp; LLP Income Taxes Rates

Table 5.1: Domestic Corporate and LLP Tax Rates

Company Type	Tax Rate	Effective Tax Rate with surcharge & Education cess
Domestic Corporations or Private Limited Companies	30%	33.99% <sup>1</sup>
Domestic Corporations or Public Limited Companies	30%	33.99% <sup>1</sup>
Limited Liability Partnership (LLP's)	30%	30.9% <sup>2</sup>

## Notes:

- \*1. For the above tax rates a surcharge of 10% of the income tax is levied, if the taxable income exceeds ₹ 1 million. Educational cess is also added.
  - \*2. An Educational Cess is added to the basic tax rates. Surcharge is not applicable to LLP. Unlike LLP's in the USA where they are pass-through entities for tax purposes, in case of LLP's in India, they are partially pass-through entities for tax purposes. In India tax an LLP is required to pay income tax on 40% of its income; since an LLP is allowed to pay the balance of 60% as remunerations to its partners. Partners of an LLP are required to pay tax on the amount paid to them. Besides, LLP's are not required to pay dividend distribution tax or Minimum Alternate Tax (MAT).
2. All companies incorporated in India are deemed as domestic Indian companies for tax purposes, even if owned by foreign companies.

Table 5.2: Foreign Corporate Income Tax Rates

Type of Income	Withholding Tax Rate for non-treaty foreign companies	Withholding Tax Rates for the USA Companies Doing Business in India under the India USA Tax Treaty
Dividends	20%	15% <sup>1</sup>
Interest Income	20%	15% <sup>2</sup>
Royalties	30%	20% <sup>2</sup>
Technical Services	30%	20% <sup>2</sup>
<i>Other income</i>	55%	55%

## Notes:

- \*1. Inter-corporate rates where there is minimum holding. These tax rates are applicable under the India USA Tax Treaty. For other countries the tax rates are different under the tax treaties between India and other countries, including Australia, Austria, Bangladesh, Belgium, Brazil, Belarus, Bulgaria, Canada, China, Cyprus, Czechoslovakia, Denmark, Finland, France, Germany, Greece, Hungary, Indonesia, Israel, Italy, Japan, Jordan, Kazakhstan, Kenya, Libya, Malta, Malaysia, Mauritius, Mongolia, Namibia, Nepal, Netherlands, New Zealand, Norway, Oman, Philippines, Poland, Qatar, Romania, Singapore, South Africa, South Korea, Spain, Sri Lanka, Sweden, Switzerland, Syria, Tanzania, Thailand, Trinidad & Tobago, Turkmenistan, Turkey, U.A.E., U.A.R., U.K., U.S.A., Russian Federation, Uzbekistan, Vietnam and Zambia
- \*2. 10% or 15% in some cases.
3. Withholding tax is charged on estimated income, as approved by the tax authorities.
4. There are other favourable tax rates under various tax treaties between India and other countries.

Therefore in crux for companies, income is taxed at a flat rate of 30% for Indian companies. Foreign companies pay 40%. An education cess of 3% (on the tax) is payable, yielding effective tax rates of 33.99% for domestic companies and 41.2% for foreign companies. From the tax year 2005-06, electronic filing of company returns is mandatory.

**Fringe Benefit Tax by Companies:** Fringe Benefit Tax is a tax payable by companies against benefits that are seen by employees but cannot be attributed to them individually. This tax is paid as 33.99% of the benefit, which is only a percentage of the actual amount paid. Some fringe benefits and their taxable rates are mentioned:

Table 5.3: Fringe Benefit Tax Rates

Fringe Benefit	Taxable percentage	Effective Tax Rate
Medical reimbursements	20%	6.8%
Telephone bills	20%	6.8%
Employee Stock Options (Difference between market value and purchase price on vesting date)	100%	33.99%

Source: <http://www.madaan.com/taxrates.htm>



**Caution** From April 1, 2007, Employees Stock Option Plan (ESOP) or Sweat Equity has also been brought within ambit of fringe benefit tax. Section 115WB(1)(d) specifies that any ESOP will attract Fringe Benefit Tax, and the benefit is equal to the difference between the price paid and the fair market value of the share, as determined by the Board. Tax is levied on the date of vesting of such options. "Fair Market Value" is not yet defined by the Income Tax Department.

### Important Corporate Tax Rates in India

Following are some other important taxes which are applicable for the business entities in addition to the corporate taxes:

1. **Fringe Benefit Tax (FBT):** The Finance Act, 2005 had introduced a new levy, namely Fringe Benefit Tax (FBT). The provisions relating to levy of this tax are contained in Chapter XIIIH (Sections 115W to 115WL) of the income-Tax Act, 1961. Fringe Benefit Tax (FBT) is an additional income tax payable by the employers on value of fringe benefits provided or deemed to have been provided to the employees.



**Notes** The FBT is payable by an employer who is a company; a firm; an association of persons excluding trusts or a body of individuals; a local authority; a sole trader, or an artificial juridical person. This tax is payable even where employer does not otherwise have taxable income. Fringe Benefits are defined as any privilege, service; facility or amenity directly or indirectly provided by an employer to his employees (including former employees) by reason of their employment and includes expenses or payments on certain specified heads.

The benefit does not have to be provided directly in order to attract FBT. It may still be applied if the benefit is provided by a third party or an associate of employer or by under an agreement with the employer. The value of fringe benefits is computed as per provisions under Section 115WC. FBT is payable at prescribed percentage on the taxable value of fringe benefits. Besides, surcharge in case of both domestic and foreign companies shall be livable on the amount of FBT. On these amounts, education cess shall also be payable. The tax rates are already mentioned above for your reference.

Notes

2. **Minimum Alternative Tax (MAT):** A company is liable to pay tax on the income computed according to 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. Under MAT, wherever the income tax payable on the total income of a company, in respect of any previous year, is less than the 'prescribed percentage of its book profits', such book profit shall be deemed to be the total income of the company and the tax payable on such total income shall be at the 'prescribed percentage of book profits', plus surcharge and education cess. The MAT is discussed in detail in the later section of this unit.

3. **Dividend Distribution Tax (DDT) or Tax on Distributed Profits of Domestic Companies:** Under Section 115-O of the Income Tax Act, any amount declared, distributed or paid by a domestic company by way of dividend shall be chargeable to dividend tax. Only a domestic company (not a foreign company) is liable for the tax. Tax on distributed profit is in addition to income tax chargeable in respect of total income. It is applicable whether the dividend is interim or otherwise. Also, it is applicable whether such dividend is paid out of current profits or accumulated profits.

The tax shall be deposited within 14 days from the date of declaration, distribution or payment of dividend, whichever is earliest. Failing to this deposition will require payment of stipulated interest for every month of delay under Section 115-P of the Act.

4. **Wealth Tax on Companies:** Wealth tax is a direct tax, which is charged on the 'net wealth' of the 'assessee' under the Wealth Tax Act. All companies (public or private) are liable to wealth-tax if their taxable 'net wealth' exceeds the prescribed limits. All the companies have thus been brought at par with other wealth-tax assesses.

Net wealth of a company is the excess of the 'aggregate value of specified assets' belonging to the company on the valuation date over the 'aggregate value of debts owned by the company' that are incurred in relation to the said assets.

### 5.1.3 Steps in Computation of Taxable Income of Companies

In order to compute the taxable income of a company the following steps are to be used:

1. **Step 1:** Ascertain the 'total income' of the company by aggregating incomes falling under following four heads:-

- (a) Income from House Property, whether residential or commercial, let-out or self-occupied. However, house property used for purpose of company's business does not fall under this head.
- (b) Profits and Gains of Business or Profession.
- (c) Capital Gains.
- (d) Income from other sources including interest on securities, winnings from lotteries, races, puzzles, etc.

Also, income of other persons may be included in the income of the company. But, income under the head 'Salary' is not included under company. To the total income so obtained, 'current and brought forward losses' should be adjusted for set off in subsequent assessment years to arrive at the gross total Income. Thus the total income so computed is the 'gross total income'. The 'set off' means, adjustment of certain losses against the incomes under other sources or heads as prescribed in Section 79. This section applies to all losses including losses under the head 'Capital Gains'.

Unabsorbed depreciation may be carried-forward for set-off indefinitely. But carry back of losses or depreciation is not permitted. However, business losses can be carried forward for eight consecutive financial years and can be set off against the profits of subsequent years.



2. **Step 2:** From the gross total income, prescribed 'deductions' under Chapter VI A are made to get the 'net income'. Generally, all expenses incurred for business purposes are deductible from taxable income; given that the expenses must be wholly and exclusively incurred for business purposes and also that the expenses must be incurred or paid during the previous year and supported by relevant papers and records. But expenses of personal or of capital nature are not deductible.

Capital expenditure is deductible only through depreciation or as the basis of property in determining capital gains or losses. Deductions shall also be allowed in respect of depreciation, as per Section 32 of Income Tax Act, of tangible assets such as machinery, buildings, etc and non-tangible assets such as know-how, patents, etc, which are owned by assessee and used for the purpose of business profession. Depreciation is deducted from the written-down value of the block of assets mentioned under Section 43 of the Act. However, where an asset is acquired by assessee during the previous year and is put to use for business or profession purpose for a period of less than 180 days, the deduction in respect of such assets shall be restricted to 50% of the normal value prescribed for all block of assets.

But no deduction shall be allowed in respect of any expenditure incurred in relation to income which does not form part of total income.

3. **Step 3:** Tax liability is computed on the 'net income' that is chargeable to tax. It is done either on accrual basis or on receipt basis (whichever is earlier). However if an income is taxed on accrual basis, it shall not be taxed on receipt basis. From the tax so computed, tax rebates or tax credit are deducted.

**Calculating Companies Taxable Income:** The key role played by any tax accountant is to calculate a company's taxable income. The taxable income of a company can be calculated using the following formula:

$$\text{Taxable income} = \text{Assessable income} - \text{Allowable deductions.}$$

This formula applies to all entities, whether they are people known as real entities, or companies, partnerships and trusts all referred to as artificial entities. We use a company here for simplicity as companies are by far the most common of the artificial entities for which taxable income calculations are carried out in practice. We also use the company because they typically have accounting records from which the operating profit can readily be determined.

The taxable income calculation is quite simple. It is as follows:

$$\text{Taxable income} = \text{Operating profit (+ or -) permanent differences} + \text{Timing additions} - \text{Timing subtractions (+ or -) future timing differences}$$

Where;

1. Operating profit = Revenue - Expenses.
2. Permanent differences = accounting revenue items which are not income for tax law purposes OR accounting expenses which are not deductions for tax law purposes. Some common examples include entertainment or non-assessable dividends. Many of these items are listed in Division 26 of the 1997 Income Tax Act.
3. Timing additions = accounting expenses which are not yet tax deductible. Some common examples include provisions for doubtful debts and annual leave.
4. Timing subtractions = accounting revenue items which are not yet assessable income like revenue in advance, or accounting assets which are immediately deductible for tax law purposes
5. Future timing differences = accounting expenses which must be deducted over a prescribed time period in accordance with the tax law like borrowing costs.

Notes



*Did u know?* The classical system of corporate taxation is followed in India which encompasses the following:

1. Domestic companies are permitted to deduct dividends received from other domestic companies in certain cases.
2. Inter company transactions are honoured if negotiated at arm's length.
3. Special provisions apply to venture funds and venture capital companies.
4. Long-term capital gains have lower tax incidence.
5. There is no concept of thin capitalisation.
6. Liberal deductions are allowed for exports and the setting up on new industrial undertakings under certain circumstances.
7. There are liberal deductions for setting up enterprises engaged in developing, maintaining and operating new infrastructure facilities and power-generating units.
8. Business losses can be carried forward for eight years, and unabsorbed depreciation can be carried indefinitely. No carry back is allowed.
9. Specula tax provisions apply to activities carried on by non-residents.
10. A minimum alternative tax (MAT) on corporations has been proposed by the Finance Bill 1996.
11. Dividends, interest and long-term capital gain income earned by an infrastructure fund or company from investments in shares or long-term finance in enterprises carrying on the business of developing, monitoring and operating specified infrastructure facilities or in units of mutual funds involved with the infrastructure of power sector are proposed to be tax exempt.

**Self Assessment**

Fill in the blank:

1. Indian companies are taxable in India on their worldwide income, irrespective of it's.....
2. While calculating income from business or profession, expense incurred wholly and exclusively for business purposes are generally .....
3. ....incurred in a tax year can be set off against any other income earned during that year, except capital gains.
4. For companies, income is taxed at a flat rate of .....for Indian companies.
5. ....is a tax payable by companies against benefits that is seen by employees but cannot be attributed to them individually.
6. ....is deductible only through depreciation or as the basis of property in determining capital gains or losses.

**5.2 Minimum Alternative Tax (MAT)**

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.



#### Caselet **Minimum Alternative Tax and Zero Tax Companies**

A company's book-profit is 10 lakhs Rupees. Then they use some creative accounting methods like depreciation, donations etc. to claim deductions and finally their 'taxable' income is reduced to almost zero. In 2009 during the recession time, Government of India launched a scheme to give 50% depreciation to commercial vehicles. (With assumption that it'll boost the vehicle demand and help the automobile industry to come out of the recession.)

So the company buys a truck, for 20 lakhs rupees on loan. Their deduction on first year = 50% of 20 lakhs rupees = 10 lakhs rupees. Their taxable income = book profit minus deductions = 10 minus 10 = 0. So they don't have to pay any tax on their profit at all. Other tricks involve donating 5,000 rupees to some religious institution run by con-man and getting donation-receipt of 5 lakhs rupees. These companies, making profit but having zero taxable income, are known as Zero tax companies.

Source: <http://mrunal.org/2011/04/economy-q-minimum-alternative-tax-mat.html>

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 less 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.



**Notes** Minimum Alternate Tax (MAT) is levied on companies as per section 115JB of the Indian Income Tax Act, 1961. And it is levied on Limited Liability Partnerships (LLPs) as per section 115JC.

### 5.2.1 When a Company has to Pay MAT

In India, in the case of companies, if the tax payable on their taxable income for any assessment year is less than 18.54% of their 'book profit' (if book profit does not exceed ₹ 10 m), or 19.9305% of book profit (if book profit exceeds ₹ 10 m), an amount equal to 18.54% of the book profit (if book profit does not exceed ₹ 10 m) or 19.9305% of book profit (if book profit exceeds ₹ 10 m) is regarded as their tax liability.

The tax so paid could be carried forward and set off against normal tax (in excess of MAT for that year) of future years up to ten years but from the financial year 2010-11 said carry forward shall not apply to a limited liability partnership which has been converted from a private company or unlisted public company.



**Did u know?** MAT is applicable in respect of Export Oriented Unit Schemes (EOU) but not Special Economic Zones (SEZ).

Notes

## 5.2.2 Preparing the Annual Accounts

Every assessee, being a company, shall, for the purposes of this section, prepare its profit and loss account for the relevant previous year in accordance with the provisions of Parts II and III of Schedule VI of the Companies Act, 1956.

While preparing the annual accounts including profit and loss account,

1. the accounting policies,
2. the accounting standards adopted for preparing such accounts including profit and loss account,
3. the method and rates adopted for calculating the depreciation,

shall be the same as have been adopted for the purpose of preparing such accounts and laid before the company at its annual general meeting in accordance with the provisions of section 210 of the Companies Act, 1956.

## 5.2.3 Calculating Book Profit

For the purposes of this section, "book profit" means the net profit as shown in the profit and loss account for the relevant previous year, as increased by the following amounts debited to Profit and Loss Account:

1. Income-tax paid or payable, and the provision thereof, including
  - (a) any tax on distributed profits under section 115-O or on distributed income under section 115R,
  - (b) any interest charged under this Act,
  - (c) surcharge, if any, as levied by the Central Acts from time to time,
  - (d) Education Cess on income-tax, if any, as levied by the Central Acts from time to time; and
  - (e) Secondary and Higher Education Cess on income-tax, if any, as levied by the Central Acts from time to time.
2. Transfer to Reserves (Other than Section 33AC - w.e.f. AY 2003-2004)
3. Amount set aside to meet unascertained liabilities,
4. Provision for losses of Subsidiaries,
5. Dividends Proposed or Paid,
6. Expenditure relatable to Income (eligible for deduction from Book Profit) exempt under section 10 or 11 or 12,
7. Amount of depreciation, including amount of depreciation on Revalued amount of Fixed Asset,
8. Amount of deferred tax and the provision thereof,
9. Amount or amounts set aside as provision for diminution in the value of any asset.

Such Net Profit, as increased, shall be *reduced* by the following amounts only, if credited to the Profit and Loss Account:

1. Amount withdrawn from Reserves or Provisions from those created before 01.04.1997 without debiting Profit and Loss Account,

- |   |                     |
|---|---------------------|
| <ol style="list-style-type: none"> <li>2. Amount withdrawn from reserves created on or after 01.04.1997 if such amount was allowed to be charged to Net Profit for the purpose of Section 115JB or Section 115JA,</li> <li>3. Income exempt under section 10 [other than 10(38), 10(23G)] or 11 or 12,</li> <li>4. Amount of Deferred Tax</li> <li>5. Amount withdrawn from Revaluation Reserve to the extent it does not exceed the depreciation on revalued amount of Fixed Asset charged to Profit and Loss Account</li> <li>6. Amount of depreciation, excluding amount of depreciation on Revalued amount of Fixed Asset,</li> <li>7. Lower of the following: -             <ol style="list-style-type: none"> <li>(i) Brought Forward Loss (as per Books) – Loss does not include Depreciation,</li> <li>(ii) Unabsorbed Depreciation (as per Books),</li> </ol> </li> <li>8. Profits eligible for deduction under section 80HHC or 80HHE or 80HHF, up to Assessment Year 2005-06</li> <li>9. Amount of Profits of Sick Industrial Company, during the period of sickness.</li> </ol> | <p><b>Notes</b></p> |
|---|---------------------|



*Notes* The aforesaid computation of Book Profit and Minimum Alternate Tax shall not affect the determination of the amounts in relation to the relevant previous year to be carried forward to the subsequent year(s) under the provisions of section 32(2) or of section 32A(3) or section 72(1)(ii) or section 73 or section 74 or of section 74A (3).

### 5.2.4 MAT Credit

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:

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. Regular tax in this case means the tax payable on the basis of normal computation of total income of the company.
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.

### 5.2.5 Procedure for Computation of MAT under Section 115JB

The provisions of section 115JB provide for working out the income-tax payable as MAT on a deeming basis. The MAT tax liability under section 115JB can be worked out by undergoing the following steps:-

1. Compute the total income of the company ignoring the provisions of under Section 115JB.
2. Compute the income-tax payable on total income.

**Notes**

3. Work out the Book Profit under the provisions of section 115JB.
4. Calculate 10 per cent of book profit as per provisions of section 115JB.
5. MAT tax liability which would be the tax payable if it is more than the amount of tax worked.



*Example:*

AB Pvt. Ltd has a tax liability on its normal taxable income of ₹ 3 lakhs.

AB Pvt. Ltd. has book profit of ₹ 20 Lakhs as computed under section 115JB.

Therefore as per section 115JB, tax on the book profit would be ₹ 3.70 Lakhs.

Hence, AB Pvt. Ltd., has to pay tax MAT (i.e., ₹ 3.70 Lakhs), since the normal tax liability (₹ 3.00 Lakhs) is less than 18.5% of the Book Profit.

**Self Assessment**

Fill in the blanks:

7. Companies who had book profits as per their profit and loss account but are not paying any tax because income computed as per provisions of the income tax act is either nil or negative or insignificant are referred to as .....
8. .... is levied on companies as per section 115JB of the Indian Income Tax Act, 1961.
9. MAT is applicable in respect of Export Oriented Unit Schemes (EOU) but not .....
10. .... means the net profit as shown in the profit and loss account for the relevant previous year.
11. A ..... 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.

**5.3 Tax on Distributed Profits of Domestic Company**

It must be noted that in India the treatment of tax on distributed profits of domestic companies is dealt in by Chapter XIID which contains a special provision relating to tax on distributed profits of domestic companies. This has only three sections, namely section 115 O, which is a charging section and also prescribes the period, the rate of additional tax, which is payable, and time and manner of payment etc. by company on dividend distributed. Section 115-P provides for interest payable for non-payment or delayed payment of additional tax by domestic companies. Section 115-Q is about when company is deemed to be in default. The concept of tax on distributed profits of domestic companies is further explained in detail in Unit number 9.

**5.3.1 Basis of Charge**

The Dividend Distribution Tax or DDT is in addition to income tax paid by company is:

1. applicable only on domestic companies;
2. charged on amount declared, distributed or paid by a domestic company;
3. applicable on interim and final dividend;

4. applicable whether the dividend is paid out of current profits or accumulated profits;
5. exemption to dividends out of SEZ.

Notes



**Caution** The dividend received by Assessee Company from its subsidiary shall be deducted provided subsidiary has paid dividend tax same amount is not taken as deduction more than once assessee is not a subsidiary of any other company.

On perusal of section 2(22) we can find that in case of other modes of distribution of profit, the company may distribute such profit in any manner but it will be to all the shareholders in proportion to the number of shares held by them, if all shares are equal in entitlement. In case there are different types of shares, then dividend will be in proportion to paid-up capital thereon and as per the terms of issue.

Whereas in case of payments which are deemed as dividend under clause (e), the payments are not in proportion to the share holding or paid up capital held by different members. Therefore, the deemed dividend u/s 2(22)(e) is materially different from other types of dividend-covered u/s 2(22).

In fact, the company does not declare a dividend of the nature contemplated in section 2(22)(e), rather the company advances certain money with a condition that the same will be in nature of loan or advance, it may bear interest also and it is refundable.

However, still it is deemed to be dividend in hands of shareholder who receives such payment because the purpose of treating such payment as dividend is to check the practice of giving away money of company to shareholders without paying corporate tax. This being the factual and legal position, it appears that such deemed dividends are excluded from the ambit of section 115 O and the company is therefore, not liable to pay additional tax on such payments.



**Example:** There is a company named Dividend Rich Manufacturing Company P. Ltd. The company is a manufacturing company and money lending is not its business. Its Paid up capital is ₹ 500000/- (500000 shares of ₹ 1/- each fully paid-up) Its Share holders are: A, B, C, and D each holding 125000 shares that is each has a stake of 25% and everyone is substantially interested. Dividend declared by the company is ₹ 10/- per share ₹ 50,00,000/-. This dividend will have to be paid in proportion of shares held by the shareholders on the record date. In this case as all shareholders hold equal number everyone will get equal amount of dividend that is ₹ 12,50,000/- as dividend will be paid to each of A, B, C and D. The company is required to pay additional tax on the sum of ₹ 50,00,000 distributed by way of dividend under section 115 O.

Suppose the company has accumulated a surplus of ₹ 10 crores. It advances a sum of ₹ one crore to Mr. A as loan bearing interest @ 14% p.a. and refundable after one year. Mr. A holds 25% (that is not less than 10% voting power) stake in the company and therefore clause (e) of subsection 22 of section 2 is applicable in his case. Any other shareholder has not taken any loan from the company. Here lies the difference; the loan or advance is not in proportion of capital held.

The sum of ₹ one crore, is not dividend for the purpose of Chapter XII D as it is expressly excluded from the scope of dividend for the purpose of the entire chapter. Therefore, the amount of loan granted to Mr. A, may be deemed dividend under clause (e) of sub section (22) of section 2 but it is not dividend for the purpose of Chapter XII D. Therefore, the company will not be liable to additional tax on this sum. The shareholder Mr. A, may be liable to tax by deeming such sum as dividend u/s 2 (22) (e), unless, he is able to bring it in some exempted category specified in section 2 (22) or if it can be established that the shares are eligible only for a fixed rate of dividend.

Notes



*Did u know?* Rate of dividend tax from April 1, 2010:

Dividend Tax – 15%

Surcharge – 1.125%

Education cess – 0.3225%

SHEC – 0.16125%

Total dividend Tax – 16.60875%

Time limit for payment of DDT is that it is to be paid within 14 days of Declaration Distribution or Payment of dividend whichever is earlier. Dividend income is exempt under section 10(34) in the hands of recipient. But dividend tax is not a deductible expense in the hands of company.

### Self Assessment

State whether the following statement is true or false:

12. The treatment of tax on distributed profits of domestic companies is dealt in by Chapter XIID which contains a special provision relating to tax on distributed profits of domestic companies.
13. Section 115-Q provides for interest payable for non-payment or delayed payment of additional tax by domestic companies.
14. The dividend received by Assessee Company from its subsidiary shall be deducted provided Subsidiary has paid dividend tax.
15. Time limit for payment of DDT is that it is to be paid within 16 days of Declaration Distribution or Payment of dividend whichever is earlier.
16. Dividend income is exempt under section 10(34) in the hands of recipient.

### 5.4 Tax on Dividend and Income Received from Venture Capital Companies

Venture Capital is a term coined for the capital required by an entrepreneur to 'venture' into something new, promising and unconventional. Investing in a budding company has always been a risky proportion for any financier. The risk of the business failure and the apprehensions of an all together new project clicking weighed down the small entrepreneurs to get the start-up fund. The Venture Capitalists or the angel investors then came to the forefront with an appetite for risk and willingness to fund the ventures.

At present, the Venture Capital activity in India comes under the purview of different sets of regulations namely:

1. The SEBI (Venture Capital Funds) Regulation, 1996 [Regulations] lays down the overall regulatory framework for registration and operations of venture capital funds in India.
2. Overseas venture capital investments are subject to the Government of India Guidelines for Overseas Venture Capital Investment in India dated September 20, 1995.
3. For tax exemptions purposes venture capital funds also needs to comply with the Income Tax Rules made under Section 10(23FA) of the Income Tax Act.

In addition to the above, offshore funds also require FIPB/RBI approval for investment in domestic funds as well as in Venture Capital Undertakings (VCU). Domestic funds with offshore



contributions also require RBI approval for the pricing of securities to be purchased in VCU likewise, at the time of disinvestment, RBI approval is required for the pricing of the securities. The provisions of Chapter XII-D or Chapter XII-E or Chapter XVII-B shall not apply to the income paid by a venture capital company or venture capital fund under this Chapter.

Thus taking from the perspective of taxation of income in India you can say that the Venture Capital Undertaking is defined under Section 10(23FB) of the Income Tax Act to cover unlisted companies. As per SEBI regulations, a VCU means a domestic unlisted company which is engaged in the business for providing services, production or manufacture of article or things. The company must not belong to such sectors which are specified in the negative list by the Board with the approval of the Central Government by notification in the Official Gazette in this behalf i.e. NBFCs, Gold Financing, etc.

Any amount of income distributed by a venture capital company or venture capital fund to the investors shall be chargeable to tax and such company or fund shall be liable to pay income-tax on such distributed income at the rate of twenty per cent. A venture capital company or venture capital fund shall be liable to pay income-tax at the rate of twenty per cent on any income which is not distributed to the investors within such time as may be specified, with the approval of the Central Government, by the Securities and Exchange Board of India, by notification in the Official Gazette, in this behalf.

The person responsible for making payment of the income distributed by the venture capital company or venture capital fund and the Venture Capital Company or venture capital fund shall be liable to pay tax to the credit of the Central Government within fourteen days from the date of distribution or payment of such income, whichever is earlier.

Clause 108 related to tax on income received from Venture Capital Company and venture capital fund states that any income received by a person out of investments made in a venture capital company or venture capital fund shall be chargeable to income-tax in the same manner as if it were the income received by such person had he made investments directly in the venture capital undertaking.

The venture capital company, the venture capital fund or the person responsible for making payment of the income on behalf of such company or fund shall furnish, within such time as may be prescribed, to the person receiving such income and to the prescribed income-tax authority, a statement in the prescribed form and manner, giving details of the nature of the income paid during the financial year and such other relevant details as may be prescribed.

The income paid by the venture capital company and the venture capital fund shall be deemed to be of the same nature and in the same proportion in the hands of the person receiving such income as it had been received by, or had accrued to, the venture capital company or the venture capital fund, as the case may be, during the financial year.

Moreover the Venture Capital Company or Venture Capital Fund is not liable to make payment of dividend tax under Section 115-O or a tax on distributed income to the unit holders under section 115-R.

### Self Assessment

Fill in the blanks:

17. .... is a term coined for the capital required by an entrepreneur to 'venture' into something new, promising and unconventional.
18. .... means a domestic unlisted company which is engaged in the business for providing services, production or manufacture of article or things.

Notes

- 19. The person responsible for making payment of the income distributed by the venture capital company shall be liable to pay tax to the credit of the Central Government within .....from the date of distribution or payment of such income, whichever is earlier.
- 20. The Venture Capital Company or Venture Capital Fund is not liable to make payment of dividend tax under .....



Case Study

**International Corporate Tax Case Study**

**A** U.S. corporation has worldwide operations and manufacturing facilities. Nearly all of these foreign entities were historically held directly by one of the consolidated U.S. entities, creating a 'flat' corporate structure. The European headquarters is located in Western Europe, with the largest manufacturing facilities outside the U.S. in four European, Middle Eastern and African countries. What are the issues, and what approach has KPMG taken?

Over the past ten years the company has made several business acquisitions in Europe. The funds for these acquisitions were sourced from the U.S. using cash reserves and/or debt.

Prior to 2004, approximately 70 percent of the company's sales and income came from products manufactured in the U.S. Because of the location of the majority of third-party debt, there was tremendous pressure to keep the flow of cash to the U.S. high enough to service the interest on this debt. This practice resulted in additional U.S. taxes (to the extent the U.S. tax rate was higher than the foreign jurisdiction tax rate plus any withholding taxes) and the need to find a way to utilize foreign tax credits.

In 2004 the company acquired a major European business, increasing market share in a particular business line. The acquisition was designed to create corporate synergies; consolidate functions, leverage customer relationship across business lines, strengthen corporate controls and reduce costs.

The acquisition meant a significant increase in worldwide sales. It also saw 60 percent of global revenue and income coming from non-U.S. manufactured products. Most of the funds used to acquire the European business were financed with third party debt by the U.S. entities. As a result of this transaction, the misalignment of third party debt and income was further exacerbated.

In addition, the company faced a mounting problem of integrating their existing European management structure with the acquired, and larger, business. In order to achieve the synergies contemplated as part of the acquisition, integrate the acquired company's back-office software and functions into the acquirers and significantly reduce the two companies total overhead, the U.S. Corporation contemplated a strategic realignment of functions and activities between the two companies.

**Issues**

- Can the company create synergies between the older European, Middle Eastern and African (EMEA) companies and the new business?
- Can the company source its debt in the jurisdiction(s) with the largest cash flows, eliminating the need to repatriate European earnings to the U.S.?
- Can the company reduce its overall third party debt?
- Can the company restructure its EMEA operations to take advantage of low-tax income to service newly-aligned third party debt?
- Can the company manage the increased tax burden arising from its non-U.S. operations?

Contd...

**Approach**

KPMG helped the company develop an appropriate structure to achieve its long term goals and address the issues described above.

The new structure created a principal European entity that assumed management responsibilities for nearly all of the EMEA manufacturing, development and distribution businesses thus eliminating the redundant functions performed by both the legacy entities and the acquired company. This principal entity owned all contracts, as well as accepting the risks associated with funding R&D activities in European and Asia.

The manufacturing entities received a fee based on costs incurred ('contract manufacturing' arrangement). Similar arrangements were concluded with entities providing R&D and other support services. The principal European entity also bought the existing intellectual property for an arm's length amount. All these arrangements were supported by transfer pricing studies between the various foreign entities and according to local law.

Prior to converting to the new arrangement the company needed to address its third party debt issues. By taking advantage of IRC section 965 (which allowed for a one-year window for an 85 percent dividend received deduction on earnings repatriated from CFCs), the company was able to make significant distributions into the U.S., which were in turn used for corporate capital expenditures pursuant to a dividend reinvestment plan. In addition, as a result of the repatriated dividends, the U.S. company was in turn able to use its other available cash to repay third party debt. The remaining U.S. debt could then be serviced by the U.S. businesses income flow. Future funds needed in EMEA would be financed through the foreign entities directly.

The European operations were reorganized so they could raise debt without parental guarantees from the U.S. The reorganization was achieved by creating a partnership under European law. In turn, this partnership sold the relevant entities to the principal European entity in exchange for a note. The interest payable on this note created an interest deduction that significantly reduced the taxable income of the principal European entity.

The European partnership was set up so that any interest earned was not subject to tax in the jurisdiction of its formation, or in the U.S. unless repatriated. The earlier repayment of U.S. debt also meant it was no longer necessary to repatriate debt from Europe.

**Outcome**

The reorganization consolidates all of the European functions and risks. The new operating structure significantly decreases the amount of tax the company pays. By adopting a permanent reinvestment position under APB 23 the company also reduces its overall effective tax rate for financial statement purposes.

**Question:**

Critically analyse the above case study.

*Source:* <http://www.kpmg.com/global/en/services/tax/international-corporate-tax/pages/case-study.aspx>

**5.5 Summary**

- Company whether Indian or foreign is liable to taxation, under the Income Tax Act, 1961. Corporation tax is a tax which is levied on the incomes of registered companies and corporation. However, for the purpose of taxation, companies are broadly classified as domestic company or a foreign company.

Notes

- Indian companies are taxable in India on their worldwide income, irrespective of its source and origin. Foreign companies are taxed only on income which arises from operations carried out in India or, in certain cases, on income which is deemed to have arisen in India.
- A Company is said to be resident in India during any relevant previous year if it is an Indian Company; or if the control and management of its affairs is situated wholly in India. In case of Resident Companies, the total income liable to tax includes any income which is received or is deemed to be received in India in the relevant previous year by or on behalf of such company, any income which accrues or arises or is deemed to accrue or arise in India during the relevant previous year and any income which accrues or arises outside India during the relevant previous year.
- The main source of income of a company is generally from “business”. A company would also earn income from under the following heads: income from house property, income from capital gains and income from other sources Taxable income is calculated according to the rules for each class of income and then aggregated to determine total taxable income.
- Business losses incurred in a tax year can be set off against any other income earned during that year, except capital gains. Unabsorbed business losses can be carried forward and set off against business profits of subsequent years for a period of eight years; the unabsorbed depreciation element in the loss can however, be carried forward indefinitely. However, this carry forward benefit is not available to closely-held (private) companies in which there has been no continuity of business or shareholding pattern.
- For companies, income is taxed at a flat rate of 30% for Indian companies. Foreign companies pay 40%. An education cess of 3% (on the tax) is payable, yielding effective tax rates of 33.99% for domestic companies and 41.2% for foreign companies. From the tax year 2005-06, electronic filing of company returns is mandatory.
- In India, in the case of companies, if the tax payable on their taxable income for any assessment year is less than 18.54% of their ‘book profit’ (if book profit does not exceed ₹ 10 m), or 19.9305% of book profit (if book profit exceeds ₹ 10 m), an amount equal to 18.54% of the book profit (if book profit does not exceed ₹ 10 m) or 19.9305% of book profit (if book profit exceeds ₹ 10 m) is regarded as their tax liability.
- The tax so paid could be carried forward and set off against normal tax (in excess of MAT for that year) of future years up to ten years but from the financial year 2010-11 said carry forward shall not apply to a limited liability partnership which has been converted from a private company or unlisted public company.
- It must be noted that in India the treatment of tax on distributed profits of domestic companies is dealt in by Chapter XIID which contains a special provision relating to tax on distributed profits of domestic companies. This has only three sections, namely section 115 O, which is a charging section and also prescribes the period, the rate of additional tax, which is payable, and time and manner of payment etc. by company on dividend distributed. Section 115-P provides for interest payable for non-payment or delayed payment of additional tax by domestic companies. Section 115-Q is about when company is deemed to be in default.
- Any amount of income distributed by a venture capital company or venture capital fund to the investors shall be chargeable to tax and such company or fund shall be liable to pay income-tax on such distributed income at the rate of twenty per cent. A venture capital company or venture capital fund shall be liable to pay income-tax at the rate of twenty per cent on any income which is not distributed to the investors within such time as may be specified, with the approval of the Central Government, by the Securities and Exchange Board of India, by notification in the Official Gazette, in this behalf.

- The venture capital company, the venture capital fund or the person responsible for making payment of the income on behalf of such company or fund shall furnish, within such time as may be prescribed, to the person receiving such income and to the prescribed income-tax authority, a statement in the prescribed form and manner, giving details of the nature of the income paid during the financial year and such other relevant details as may be prescribed.

## 5.6 Keywords

**Dividend Distribution Tax (DDT):** It is the tax levied by the Indian Government on companies according to the dividend paid to a company's investors.

**Domestic company:** It is a company formed and registered under the Companies Act, 1956 or any other company which, in respect of its income liable to tax, under the Income Tax Act, has made the prescribed arrangement for declaration and payments within India, of the dividends payable out of such income.

**Employees Stock Option Plan (ESOP):** It is a plan through which a company awards Stock Options to the employees based on their performance.

**Foreign company:** It is a company whose control and management are situated wholly outside India, and which has not made the prescribed arrangements for declaration and payment of dividends within India.

**Fringe Benefit Tax (FBT):** It is a tax payable by companies against benefits that are seen by employees but cannot be attributed to them individually.

**Limited Liability Partnership (LLP):** It is a partnership in which some or all partners depending on the jurisdiction have limited liability.

**Venture Capital Undertaking (VCU):** It means a domestic unlisted company which is engaged in the business for providing services, production or manufacture of article or things.

**Venture Capital:** It is a term coined for the capital required by an entrepreneur to venture into something new, promising and unconventional.

**Wealth tax:** It is a tax based on the market value of assets that are owned. These assets include, but are not limited to, cash, bank deposits, shares, fixed assets, private cars, assessed value of real property, pension plans, money funds, owner occupied housing and trusts.

**Zero tax company:** It is a business that shows a book profit and pays dividends to investors but does not pay taxes.

## 5.7 Review Questions

1. How will you find the residential status of a company?
2. Explain the main sources of income of a company.
3. Mention, in detail, the expenses which are allowable as deductions while computing the taxable income of a company.
4. Write a short note on important corporate taxes paid by companies in India.
5. Discuss the steps in computation of taxable income of companies.
6. What are zero tax companies? Explain with the help of an example.

**Notes**

7. When does a company need to pay MAT?
8. Write a note on calculation of book profits.
9. Explain tax on distributed profits of domestic companies in India.
10. Elucidate the provisions for treatment of tax on income or dividends received from a VCC.

**Answers: Self Assessment**

- |                                 |                                |
|---------------------------------|--------------------------------|
| 1. Source and origin.           | 2. Deductible                  |
| 3. Business losses              | 4. 30%                         |
| 5. Fringe Benefit Tax           | 6. Capital expenditure         |
| 7. Zero tax companies           | 8. Minimum Alternate Tax (MAT) |
| 9. Special Economic Zones (SEZ) | 10. Book profit                |
| 11. New tax credit scheme       | 12. True                       |
| 13. False                       | 14. True                       |
| 15. False                       | 16. True                       |
| 17. Venture capital             | 18. VCU                        |
| 19. fourteen days               | 20. Section 115-O              |

**5.8 Further Readings**



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Srinivas E. A., *Handbook of Corporate Tax Planning*, Tata McGraw Hill.



*Online links*

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[http://business.gov.in/taxation/computation\\_income.php](http://business.gov.in/taxation/computation_income.php)

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<http://www.accounting-n-taxation.com/Minimum-Alternate-Tax.html>

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<http://www.taxlawsonline.com/news/DTC/chap6/dtc108.asp>

## Unit 6: Tax Planning: FTZ, SEZ and 100 % EOUs

Notes

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- 6.5 Keywords
- 6.6 Review Questions
- 6.7 Further Readings

### Objectives

After studying this unit, you will be able to:

- Explain the special provision in respect of newly established undertaking in FTZs
- Discuss the special provision in respect of newly established undertaking in SEZs
- Describe the special provision in respect of newly established undertaking in 100% EOUs

### Introduction

Free Trade Zone, also called Foreign-trade Zone, formerly Free Port, an area within which goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities.

Section 10AA was inserted in the Income-tax Act, 1961 by the Special Economic Zones Act, 2005 (the SEZ Act) with effect from 10-2-2006. The section was enacted specially with respect to provide tax exemption to the newly established units in the Special Economic Zone (SEZ).

The Export Oriented Unit (EOU) Scheme, which had been introduced in the early 1980s remains in the forefront of country's export production schemes. The Government amended in November 1983 a concession scheme to facilitate the setting up of Export-oriented Units (EOUs) in order to enable them to meet requirements of foreign demand in terms of pricing, quality, precision etc.

Notes

In this unit, you will be able to gain in-depth knowledge about the tax provisions in respect of newly established undertakings in FTZ, SEZ and 100% EOU in context with Income Tax Act, 1961.

## **6.1 Special Provision in Respect of Newly Established Undertaking in FTZ's**

Free Trade Zone, also called Foreign-trade Zone, formerly Free Port, an area within which goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities. Only when the goods are moved to consumers within the country in which the zone is located do they become subject to the prevailing customs duties.



*Did u know?* There are six free trade zones in India namely Kandla Free Trade Zone, Santa Cruz Electronics Export Processing Zone, Falta Export Processing Zone, Madras Export Processing Zone, Cochin Export Processing Zone and Noida Export Processing Zone.

Subject to the provisions of this section, a deduction of such profits and gains as are 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, shall be allowed from the total income of the assessee.

Provided that where in computing the total income of the undertaking for any assessment year, its profits and gains had not been included by application of the provisions of this section as it stood immediately before its substitution by the Finance Act, 2000, the undertaking shall be entitled to deduction referred to in this sub-section only for the unexpired period of the aforesaid ten consecutive assessment years.

An 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 referred to in this sub-section shall be reckoned from the assessment year relevant to the previous year in which the undertaking began to manufacture or produce such articles or things or computer software in such free trade zone or export processing zone.

For the assessment year beginning on the 1st day of April, 2003, the deduction under this sub-section shall be ninety per cent of the profits and gains derived by an undertaking from the export of such articles or things or computer software; provided also that no deduction under this section shall be allowed to any undertaking for the assessment year beginning on the 1st day of April, 2012 and subsequent years.

### **6.1.1 Conditions to be Fulfilled**

The tax benefit under section 10A is available to an undertaking which fulfils all the following conditions:

1. It has begun or begins to manufacture or produce articles or things or computer software during the previous year relevant to the assessment year
  - (a) commencing on or after 1-4-1981, in any Free Trade Zone; or
  - (b) commencing on or after 1-4-1994, in any Electronic Hardware Technology Park or Software Technology Park; or
  - (c) commencing on or after 1-4-2001, in any Special Economic Zone;



2. It is not formed by the splitting up or the reconstruction of a business already in existence except in the circumstances and within the period specified in section 33B of the Income-tax Act.
3. It is not formed by the transfer to a new business of machinery or plant previously used for any purpose.

This section applies to the undertaking, if the 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 further period as the competent authority may allow in this behalf.

### 6.1.2 Deductions

Notwithstanding anything contained in sub-section (1), the deduction, in computing the total income of an undertaking, which begins to manufacture or produce articles or things or computer software during the previous year relevant to any assessment year commencing on or after the 1st day of April, 2003, in any special economic zone, shall be:

- (i) hundred per cent 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 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, and thereafter, fifty per cent of such profits and gains for further two consecutive assessment years, and thereafter;
- (ii) for the next three consecutive assessment years, so much of the amount not exceeding fifty per cent of the profit as is debited to the profit and loss account of the previous year in respect of which the deduction is to be allowed and credited to a reserve account (to be called the "Special Economic Zone Re-investment Allowance Reserve Account") to be created and utilised for the purposes of the business of the assessee in the manner laid down in sub-section (1B).

No deduction under this section shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified under sub-section (1) of section 139.

The deduction under clause (ii) of sub-section (1A) shall be allowed only if the following conditions are fulfilled, namely:

- (a) the amount credited to the Special Economic Zone Re-investment Allowance Reserve Account is to be utilised:
  - (i) for the purposes of acquiring new machinery or plant which is first put to use before the expiry of a period of three years next following the previous year in which the reserve was created;
  - (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 or for remittance outside India as profits or for the creation of any asset outside India; and

**Notes**

- (b) the particulars, as may be prescribed in this behalf, have been furnished by the assessee in respect of new machinery or plant along with the return of income for the assessment year relevant to the previous year in which such plant or machinery was first put to use.

Where any amount credited to the Special Economic Zone Re-investment Allowance Reserve Account under clause (ii) of sub-section (1A):

- (a) has been utilised for any purpose other than those referred to in sub-section (1B), the amount so utilised; or
- (b) has not been utilised before the expiry of the period specified in sub-clause (i) of clause (a) of sub-section (1B), the amount not so utilised, shall be deemed to be the profits,—
  - (i) in a case referred to in clause (a), in the year in which the amount was so utilised; or
  - (ii) in a case referred to in clause (b), in the year immediately following the period of three years specified in sub-clause (i) of clause (a) of sub-section (1B), and shall be charged to tax accordingly.

In computing the total income of the assessee of the previous year relevant to the assessment year immediately succeeding the last of the relevant assessment years, or of any previous year, relevant to any subsequent assessment year:

- (i) Section 32, section 32A, section 33, section 35 and clause (ix) of sub-section (1) of section 36 shall apply as if every allowance or deduction referred to therein and relating to or allowable for any of the relevant assessment years in relation to any building, machinery, plant or furniture used for the purposes of the business of the undertaking in the previous year relevant to such assessment year or any expenditure incurred for the purposes of such business in such previous year had been given full effect to for that assessment year itself and accordingly sub-section (2) of section 32, clause (ii) of sub-section (3) of section 32A, clause (ii) of sub-section (2) of section 33, sub-section (4) of section 35 or the second proviso to clause (ix) of sub-section (1) of section 36, as the case may be, shall not apply in relation to any such allowance or deduction;
- (ii) No loss referred to in sub-section (1) of section 72 or sub-section (1) or sub-section (3) of section 74, in so far as such loss relates to the business of the undertaking, shall be carried forward or set off where such loss relates to any of the relevant assessment years 13;
- (iii) No deduction shall be allowed under section 80HH or section 80HHA or section 80-I or section 80-IA or section 80-IB in relation to the profits and gains of the undertaking; and
- (iv) In computing the depreciation allowance under section 32, the written down value of any asset used for the purposes of the business of the undertaking shall be computed as if the assessee had claimed and been actually allowed the deduction in respect of depreciation for each of the relevant assessment year.



*Notes* For the purposes of this section:

1. "Computer software" means:
  - (a) any computer programme recorded on any disc, tape, perforated media or other information storage device; or
  - (b) any customized electronic data or any product or service of similar nature, as may be notified 20 by the Board, which is transmitted or exported from India to any place outside India by any means.
2. "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 there under or any other corresponding law for the time being in force.
3. "Electronic hardware technology park" means any park set up in accordance with the Electronic Hardware Technology Park (EHTP) Scheme notified by the Government of India in the Ministry of Commerce and Industry.
4. "Export turnover" means the consideration in respect of export of articles or things or computer software received in, or brought into, India by the assessee in convertible foreign exchange in accordance with sub-section (3), but does not include freight, telecommunication charges or insurance attributable to the delivery of the articles or things or computer software outside India or expenses, if any, incurred in foreign exchange in providing the technical services outside India.
5. "Free trade zone" means the Kandla Free Trade Zone and the Santacruz Electronics Export Processing Zone and includes any other free trade zone which the Central Government may, by notification in the Official Gazette, specify for the purposes of this section.
6. "Relevant assessment year" means any assessment year falling within a period of ten consecutive assessment years referred to in this section.
7. "Software technology park" means any park set up in accordance with the Software Technology Park Scheme notified by the Government of India in the Ministry of Commerce and Industry.
8. "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 purposes of this section.

### 6.1.3 Consequences of Amalgamation, Demerger and Section 10 A

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, to another Indian company in a scheme of amalgamation or 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.

## Notes



Caselet

### **Nasscom for Tax Exemption under Section 10A or 10B**

**N**ew Delhi: As part of its budget recommendations to the government, National Association of Software and Services Companies (Nasscom) has reiterated its demand to retain the complete tax exemption under section 10A or 10B to the industry.

“Government should honour the commitment of full exemption from taxes on export profits till 2010, since investments and business plans have been made on the basis of this commitment. We urge the government not to be short sighted but look at long-term gains from this sector, which has contributed consistently to the growth of our economy,” Nasscom president Kiran Karnik said. Nasscom has also suggested that the government should pursue the totalisation agreement with the US and tax withholding issue with Japan and other countries to help the Indian IT companies further expand in these markets. It has recommended tax holiday benefits as well as demergers and amalgamations to be excluded from the provisions of sections 10A/10B. Under custom-related issues, it has recommended that all taxable services provided in relation to software and services of online information, database access and data processing within banking and financial services, should be exempted from the levy of service tax. Within e-commerce, it has demanded that a tax moratorium on e-commerce at least for the next five years.

Source: <http://www.financialexpress.com/news/nasscom-for-tax-exemption-under-section-10a10b/71143>

### **Self Assessment**

Fill in the blanks:

1. .... is an area within which goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities.
2. For the assessment year beginning on the 1st day of April, 2003, the deduction under this sub-section shall be ..... of the profits and gains derived by an undertaking.
3. .... deduction under this section shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified under sub-section (1) of section 139.
4. .... means any park set up in accordance with the Electronic Hardware Technology Park (EHTP) Scheme notified by the Government of India in the Ministry of Commerce and Industry
5. .... means any park set up in accordance with the Software Technology Park Scheme notified by the Government of India in the Ministry of Commerce and Industry

### **6.2 Special Provision in Respect of Newly Established Undertaking in SEZs**

Section 10AA was inserted in the Income-tax Act, 1961 by the Special Economic Zones Act, 2005 (the SEZ Act) with effect from 10-2-2006. The section was enacted specially with respect to provide tax exemption to the newly established units in the Special Economic Zone (SEZ).

### 6.2.1 Conditions to be Fulfilled

Notes

For claiming deduction under section 10AA of the Act following conditions are to be satisfied:

1. The assessee being an entrepreneur as defined under section 2(j) of the SEZ Act has to set up a unit in the SEZ;
2. The unit so set up by the assessee should commence to manufacture or produce articles or things or provide any service during the previous year commencing after 1-4-2006;
3. The undertaking should not be formed:
  - (a) by splitting up, or by the reconstruction, of a business already in existence; or
  - (b) by a transfer to new business of machinery and plant previously used for any purpose by the assessee;
4. The assessee has exported goods or provided services out of India from the SEZ, whether physically or otherwise;
5. The books of account are audited and audit report is filed along with the return of income and the assessee claims the deduction in its return of income.

Subject to the provisions of the Section 10AA(1), in computing the total income of an assessee, being an entrepreneur as referred to in clause (j) of section 228 of the Special Economic Zones Act, 2005, from his Unit, who begins to manufacture or produce articles or things or provide any services during the previous year relevant to any assessment year commencing on or after the 1st day of April, 2006, a deduction of:

- (i) Hundred per cent of profits and gains derived from the export, of such articles or things or from services for a period of five consecutive assessment years beginning with the assessment year relevant to the previous year in which the Unit begins to manufacture or produce such articles or things or provide services, as the case may be, and fifty per cent of such profits and gains for further five assessment years and thereafter;
- (ii) For the next five consecutive assessment years, so much of the amount not exceeding fifty per cent of the profit as is debited to the profit and loss account of the previous year in respect of which the deduction is to be allowed and credited to a reserve account (to be called the "Special Economic Zone Re-investment Reserve Account") to be created and utilised for the purposes of the business of the assessee in the manner laid down in sub-section (2).

The deduction under clause (ii) of sub-section (1) shall be allowed only if the following conditions are fulfilled, namely:

- (a) the amount credited to the Special Economic Zone Re-investment Reserve Account is to be utilised –
  - (i) for the purposes of acquiring machinery or plant which is first put to use before the expiry of a period of three years following the previous year in which the reserve was created; and
  - (ii) until the acquisition of the machinery or plant as aforesaid, for the purposes of the business of the undertaking other than for distribution by way of dividends or profits or for remittance outside India as profits or for the creation of any asset outside India;
- (b) the particulars, as may be specified by the Central Board of Direct Taxes in this behalf, under clause (b) of sub-section (1B) of section 10A have been furnished by the assessee in respect of machinery or plant along with the return of income for the assessment year relevant to the previous year in which such plant or machinery was first put to use.

**Notes**

Where any amount credited to the Special Economic Zone Re-investment Reserve Account under clause (ii) of sub-section (1):

- (a) has been utilised for any purpose other than those referred to in sub-section (2), the amount so utilised; or
- (b) has not been utilised before the expiry of the period specified in sub-clause (i) of clause (a) of sub-section (2), the amount not so utilised, shall be deemed to be the profits:
  - (i) in a case referred to in clause (a), in the year in which the amount was so utilised; or
  - (ii) in a case referred to in clause (b), in the year immediately following the period of three years specified in sub-clause (i) of clause (a) of sub-section (2), and shall be charged to tax accordingly:

Provided that where in computing the total income of the Unit for any assessment year, its profits and gains had not been included by application of the provisions of sub-section (7B) of section 10A, the undertaking, being the Unit shall be entitled to deduction referred to in this sub-section only for the unexpired period of ten consecutive assessment years and thereafter it shall be eligible for deduction from income as provided in clause (ii) of sub-section (1).

**Explanation:** For the removal of doubts, it is hereby declared that an undertaking, being the Unit, which had already availed, before the commencement of the Special Economic Zones Act, 2005, the deductions referred to in section 10A for ten consecutive assessment years, such Unit shall not be eligible for deduction from income under this section :

Provided further that where a Unit 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 referred to above shall be reckoned from the assessment year relevant to the previous year in which the Unit began to manufacture, or produce or process such articles or things or services in such free trade zone or export processing zone :

Provided also that where a Unit 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 and has completed the period of ten consecutive assessment years referred to above, it shall not be eligible for deduction from income as provided in clause (ii) of sub-section (1) with effect from the 1st day of April, 2006.

This sub-section applies to any undertaking, being the Unit, which fulfils all the following conditions, namely:

- (i) it has begun or begins to manufacture or produce articles or things or provide services during the previous year relevant to the assessment year commencing on or after the 1st day of April, 2006 in any Special Economic Zone;
- (ii) it is not formed by the splitting up, or the reconstruction, of a business already in existence:

Provided that this condition shall not apply in respect of any undertaking, being the Unit, which is formed as a result of the re-establishment, reconstruction or revival by the assessee of the business of any such undertaking as is referred to in section 33B, in the circumstances and within the period specified in that section;

- (iii) it is not formed by the transfer to a new business, of machinery or plant previously used for any purpose.

**Explanation:** The provisions of *Explanations 1* and *2* to sub-section (3) of section 80-IA shall apply for the purposes of clause (iii) of this sub-section as they apply for the purposes of clause (ii) of that sub-section.

Where any undertaking being the Unit which is entitled to the deduction under this section is transferred, before the expiry of the period specified in this section, to another undertaking, being the Unit in a scheme of amalgamation or demerger,—

- (a) no deduction shall be admissible under this section to the amalgamating or the demerged Unit, being the company for the previous year in which the amalgamation or the demerger takes place; and
- (b) the provisions of this section shall, as they would have applied to the amalgamating or the demerged Unit being the company as if the amalgamation or demerger had not taken place.

Loss referred to in sub-section (1) of section 72 or sub-section (1) or sub-section (3) of section 74, in so far as such loss relates to the business of the undertaking, being the Unit shall be allowed to be carried forward or set off.

For the purposes of sub-section (1), the profits derived from the export of articles or things or services including computer software shall be the amount which bears to the profits of the business of the undertaking, being the Unit, the same proportion as the export turnover in respect of such articles or things or services bears to the total turnover of the business carried on:

It is provided that the provisions of this sub-section shall have effect for the assessment year beginning on the 1st day of April, 2006 and subsequent assessment years. The provisions of sub-sections (5) and (6) of section 10A shall apply to the articles or things or services referred to in sub-section (1) as if:

- (a) for the figures, letters and word “1st April, 2001”, the figures, letters and word “1st April, 2006” had been substituted;
- (b) for the word “undertaking”, the words “undertaking, being the Unit” had been substituted.

The provisions of sub-section (8) and sub-section (10) of section 80-IA shall, so far as may be, apply in relation to the undertaking referred to in this section as they apply for the purposes of the undertaking referred to in section 80-IA.

**Explanation 1:** For the purposes of this section:

- (i) “*export turnover*” means the consideration in respect of export by the undertaking, being the Unit of articles or things or services received in, or brought into, India by the assessee but does not include freight, telecommunication charges or insurance attributable to the delivery of the articles or things outside India or expenses, if any, incurred in foreign exchange in rendering of services (including computer software) outside India;
- (ii) “*export in relation to the Special Economic Zones*” means taking goods or providing services out of India from a Special Economic Zone by land, sea, air, or by any other mode, whether physical or otherwise;
- (iii) “*manufacture*” shall have the same meaning as assigned to it in clause (r) of section 2 of the Special Economic Zones Act, 2005;
- (iv) “*relevant assessment year*” means any assessment year falling within a period of fifteen consecutive assessment years referred to in this section;
- (v) “*Special Economic Zone*” and “*Unit*” shall have the same meanings as assigned to them under clauses (za) and (zc) of section 2 of the Special Economic Zones Act, 2005.

**Explanation 2:** For the removal of doubts, it is hereby declared that the profits and gains derived from on site development of computer software (including services for development of software) outside India shall be deemed to be the profits and gains derived from the export of computer software outside India.

## Notes



*Did u know?* In order to remove this anomaly, the aforesaid provision of the sub-section (7) of section 10AA was amended by section 6 of the Finance (No. 2) Act, 2009, so as to substitute the reference to “assessee” by the word “undertaking”. Accordingly, the exemption under section 10AA was to be computed with reference to the total turnover of the undertaking in the SEZ and not with reference to the total turnover of the business of the assessee. The said amendment made by Finance (No. 2) Act, 2009 become effective from 1-4-2010 and accordingly, applied in relation to the A.Y. 2010-11 and subsequent years. At the time when this amendment by the Finance (No. 2) Act, 2009 was made doubts were expressed as to whether the amendment should be retrospective or prospective from 2010-11 so as to streamline the provisions of the section.

### 6.2.2 Amount of Deduction: A Simplified Explanation

If the above conditions are satisfied, one can claim deduction under section 10AA. Deduction depends upon quantum of profit derived from export of articles or things or services (including computer software). It is calculated as under:

$$\text{Profits of the business of the Unit} \times \frac{\text{Export Turnover of the Unit}}{\text{Total Turnover of the business carried out by the assessee}}$$



*Notes* In the above formula ‘export turnover’ means the consideration in respect of export by the undertaking of articles or things or services received in, or brought into India by the assessee, but does not include the following:

- (a) freight
- (b) telecommunication charges;
- (c) insurance attributable to the delivery of the articles or things or computer software outside India;
- (d) expenses, if any, incurred in foreign exchange in providing the technical services (including computer software) outside India.

Profits and gains derived from on site development of computer software (including services for development of software) outside India shall be deemed to be the profits and gains derived from the export of computer software outside India.

This formula was seemingly created discrimination between assessee who were having multiple units in the SEZ as well as in the Domestic Tariff Area (DTA) and the assessee who were having units only in the SEZ. Here it may be pertinent to note that section 10AA itself clarified that the word, ‘assessee’ for the purpose of this section would mean an entrepreneur referred to in section 2(j) of the SEZ Act, as such the word, ‘assessee’ referred to in the formula should be an undertaking in the SEZ.

**Deduction for First Five Assessment Years:** 100 per cent of the profit and gains derived from export of articles or things or from services is deductible for a period of 5 consecutive assessment years. Deduction for the first year is available in the assessment year relevant to the previous year in which the unit begins to manufacture or produce articles or things or provide services.

**Deduction for Sixth Assessment Year to Tenth Assessment Year:** 50 per cent of the profit and gains derived from export of articles or things or from services is deductible for the next 5 years.

**Deduction for Eleventh Assessment Year to Fifteenth Assessment Year:** For the next 5 years, a further deduction would be available to the extent of 50 per cent of the profit provided an



equivalent amount is debited to the profit and loss account of the previous year and credited to Special Economic Zone Re-investment Allowance Reserve Account (hereinafter referred to as Special Reserve Account). The following conditions should be satisfied:

1. The Special Reserve Account should be utilised for the purpose of acquiring new plant and machinery.
2. The new plant and machinery should be first put to use before the expiry of 3 years from the end of the year in which the Special Reserve Account was created. For instance, if the reserve account was created during the previous year ending March 31, 2007, it should be utilized for acquiring machinery or plant on or before March 31, 2010.
3. Until the acquisition of new plant and machinery the Special Reserve Account can be utilised for the business purposes of the undertaking but it cannot be utilised for distribution of dividends/profits or for remittance outside India as profits or for creating an asset outside India.
4. Prescribed particulars [Form No. 56FF] should be submitted in respect of new plant and machinery along with the return of income for the previous year in which such plant and machinery was first put to use.
5. If the Special Reserve Account is misutilised, then the deduction would be taken back in the year in which the Special Reserve Account is misutilised. If the Special Reserve Account is not utilised for acquiring new plant and machinery within three years as stated above then the deduction would be taken back in the year immediately following the period of three years. For instance, if ₹ 1,50,000 is transferred to the reserve account for the year ending March 31, 2007 and out of which only ₹ 96,000 is utilized for acquiring plant and machinery up to March 31, 2010, then ₹ 54,000 would be taxable for the previous year 2010-11.

**Special provisions for existing units:** The following points should be noted:

1. In respect of an undertaking setup in Special Economic Zone on or after April 1, 2003 a deduction is available under section 10A(1A). This deduction is available for 10 assessment years. If an undertaking is setup in a Special Economic Zone during April 1, 2003 and March 31, 2005, then such undertaking can claim deduction for the first ten assessment years under the provisions of section 10A(1A). Such undertaking can further claim deduction from eleventh year to fifteenth year.
2. If deduction has already been claimed by an undertaking (other than the undertaking mentioned above) under section 10A for ten consecutive assessment years before the commencement of SEZ Act, such Unit shall not be eligible for deduction under section 10AA.
3. Where a unit 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 and has completed the period of 10 consecutive assessment years referred to above, it shall not be eligible for deduction.



*Example:* X Ltd. owns an industrial undertaking in a notified special economic zone. It starts manufacturing on April 10, 2004. It can claim deduction under sections 10A and 10AA as follows:

**First 5 years:** For the assessment years 2005-06 to 2009-10, it can claim 100 per cent deduction under section 10A.

**Next 2 years:** For the next two assessment years, i.e., 2010-11 and 2011-12, it can claim 50 per cent deduction under section 10A.

**Notes**

*Next 3 years:* For the next three assessment years, i.e., 2012-13 to 2014-15, it can claim 50 per cent deduction (subject to an additional requirement of transferring an equivalent amount to Special Economic Zone Re-investment Allowance Reserve Account) under section 10A.

*Next 5 years:* For the next five assessment years, i.e., 2015-16 to 2019-20, it can claim 50 per cent deduction (subject to an additional requirement of transferring an equivalent amount to Special Economic Zone Re-investment Reserve Account) under section 10AA(1)(ii).

Y Ltd. owns an industrial undertaking. It was set up in a notified free trade zone on June 10, 1991. It claims deduction under section 10A for 10 consecutive assessment years (i.e., 1992-93 to 2001-02). Since the undertaking has already claimed deduction for 10 years before the assessment year 2006-07, no further deduction is available for the same industrial undertaking under section 10AA. Suppose in the aforesaid case, the free trade zone is converted into a special economic zone with effect from January 1, 2001. The undertaking will get deduction under section 10A for 10 consecutive assessment years (i.e., 1992-93 to 2001-02). After claiming deduction for 10 years under section 10A (before the commencement of Special Economic Zone Act, 2005), no further deduction will be available for the same industrial undertaking under section 10AA.

**6.2.3 Consequences for Amalgamation and Demerger**

Where an undertaking is transferred to another company under a scheme of amalgamation or demerger, the deduction under section 10AA shall be allowable in the hands of the amalgamated or the resulting company. However, no deduction shall be admissible under this section to the amalgamating company or the demerged company for the previous year in which amalgamation or demerger takes place.

*Consequences of claiming deduction under section 10AA:* One should note the following consequences:

1. For the assessment year(s) succeeding the last assessment year for which the deduction is claimed under this section, deduction under section 32 and the expenditures under sections 35 and 36(1)(ix) pertaining to the assessment year 2005-06 (or earlier year) would be considered as had been given full effect to for the period covered under the period of deduction. Thus, unabsorbed depreciation allowances or unabsorbed capital expenditure on scientific research or family planning (pertaining to the assessment year 2005-06 or earlier years) are not allowed to be carried forward and set off against the income of assessment years following the period of deduction.
2. The losses under section 72(1) or 74(1) or 74(3) (pertaining to the assessment year 2005-06 or earlier years) are not allowed to be carried forward in assessment years succeeding the period of deduction. The deductions under section 80-IA or 80-IB shall also not be available to such undertakings after the expiry of tax holiday period.
3. In the assessment year following period of deduction, the depreciation will be computed on the written down value of the asset as if the depreciation has actually been allowed in respect of each assessment year falling in the period of exemption.

*Exemption of capital gains on transfer of assets in cases of shifting of industrial undertaking from urban area to any Special Economic Zone:* Section 54GA has been inserted to give exemption in case of shifting of an industrial undertaking from urban area to a special economic zone. Exemption can be availed if the following conditions are satisfied –

1. A capital asset (being plant, machinery, land or building or any right in land or building) used for the purpose of an industrial undertaking situated in an urban area is transferred.
2. The transfer is affected in the course of, or in consequence of, the shifting of such industrial undertaking (hereinafter referred to as the “original asset”) to any Special Economic Zone. Such Special Economic Zone may be situated in urban area of any other area.

3. The assessee has within a period of one year before or 3 years after the date on which the transfer took place:
- purchased machinery or plant for the purposes of business of the industrial undertaking in the Special Economic Zone to which the said undertaking is shifted;
  - acquired building or land or constructed building for the purposes of his business in the Special Economic Zone;
  - shifted the original asset and transferred the establishment to Special Economic Zone; and
  - incurred expenses on such other purpose as may be specified in a scheme framed by the Central Government for the purposes of this section.

Notes

If the above conditions are satisfied, then the amount of exemption is equal to:

- the amount of capital gain generated on transfer of capital assets in the case of shifting of an industrial undertaking as stated above; or
- the cost and expenses incurred in relation to all or any of the purposes mentioned in (a) to (d) supra (such cost and expenses being hereinafter referred to as the new asset), whichever is lower.

**Consequences if the new asset is transferred within 3 years:** If the new asset is transferred within a period of 3 years from the date of its purchase or construction or acquisition, the amount of exemption given earlier under section 54G would be taken back. In such a case, the capital gain on transfer of the new asset will be calculated as follows:

Particulars	₹
Sale consideration of the new asset	xxxxxx
<i>Less: Cost of acquisition (original cost of acquisition of the new asset minus exemption given earlier under section 54GA which is going to be taken back because the new asset is transferred within 3 years)</i>	xxxxxx
Short-term capital gain	xxxxxx

**Deductions in respect of profits and gains by an undertaking or enterprise engaged in development of Special Economic Zone:** Section 80-IAB has been inserted to give deduction to the developers of special economic zone. The following conditions should be satisfied –

- The taxpayer is a developer of a special economic zone.
- The gross total income of the taxpayer includes profits and gains derived by an undertaking from any business of developing a special economic zone.
- Such special economic zone is notified on or after April 1, 2005.
- The books of the account of the taxpayer are audited.

If the above conditions are satisfied, the taxpayer can claim 100 per cent deduction in respect of the aforesaid profit.

The aforesaid deduction is available for 10 consecutive assessment years. The deduction may be claimed, at the option of the taxpayer, for any 10 consecutive assessment years out of 15 years beginning from the year in which the special economic zone has been notified by the Central Government. If a taxpayer who develops a special economic zone on or after April 1, 2005 (“transferor”) transfers the operation/maintenance of such zone to another developer (“transferee”), then deduction shall be allowed to the transferee for the remaining period of 10 years as if the operation and maintenance were not so transferred. Similar rule will be applicable

**Notes**

in the case of amalgamation of an Indian company which has developed a special economic zone with another Indian company.



*Caution* One should also keep in view the following points:

1. The profits and gains from the eligible business shall be computed as if such eligible business were the only source of income of the assessee during the relevant assessment year.
2. The Assessing Officer has power to recompute profit in some cases. These cases are given by section 80-IA (8)/ (10).
3. Where any amount of profits and gains is claimed and allowed as deduction under section 80-IAB for any assessment year, deduction to the extent of such profits and gains shall not be allowed under sections 80HH to 80RRB and shall in no case exceeds profits and gains of such eligible business.

**Self Assessment**

Fill in the blanks:

6. .... was inserted in the Income tax Act, 1961 by the Special Economic Zones Act, 2005 (the SEZ Act) with effect from 10-2-2006.
7. .... in relation to the Special Economic Zones means taking goods or providing services out of India from a Special Economic Zone by land, sea, air, or by any other mode, whether physical or otherwise
8. In case of an SEZ deduction for first five assessment years is .....of the profit and gains derived from export of articles or things or from services is deductible for a period of 5 consecutive assessment years.
9. In respect of an undertaking setup in Special Economic Zone on or after April 1, 2003 a deduction is available under .....
10. Where an undertaking is transferred to another company under a scheme of amalgamation or demerger, the deduction under section 10AA shall be allowable in the hands of the amalgamated or the .....

**6.3 Special Provision in respect of Newly Established Undertakings in 100% Export oriented Units (EOUs)**

The Export Oriented Unit (EOU) Scheme, which had been introduced in the early 1980s remains in the forefront of country's export production schemes. The Government amended in November 1983 a concession scheme to facilitate the setting up of export oriented units (EOUs) in order to enable them to meet requirements of foreign demand in terms of pricing, quality, precision etc.

The main objectives of the EOU scheme is to increase exports, earn foreign exchange to the country, transfer of latest technologies stimulate direct foreign investment and to generate additional employment. The scheme has witnessed many changes over the last twenty-four years in the context of ever changing economic realities. However, the basic premise remains the same. This premise is that the exporters are treated as a special class and given the required tariff, non-tariff and policy support to facilitate their export efforts. Thus, today the EOU Scheme has emerged as a dynamic policy initiative facilitating the exporting community in the task of increased exports. The EXIM Policy, 2002-07 reinforces the importance of Scheme in chapter 6 of the policy.



### *Did u know?* **Need for Special License**

To set up an EOU for the following sectors, an EOU owner needs a special license.

1. Arms and ammunition,
2. Explosives and allied items of defence equipment,
3. Defence aircraft and warships,
4. Atomic substances,
5. Narcotics and psychotropic substances and hazardous chemicals,
6. Distillation and brewing of alcoholic drinks,
7. Cigarettes/cigars and manufactured tobacco substitutes.

In the above mention cases, EOU owner are required to submit the application form to the Development Commissioner who will then put them up to the Board of Approvals (BOA).

### **Major Sectors in EOUs:**

1. Granite
2. Textiles/garments
3. Food processing
4. Chemicals
5. Computer software
6. Coffee
7. Pharmaceuticals
8. Gem & jewellery
9. Engineering goods
10. Electrical & electronics
11. Aqua & pearl culture

**Categories of 100% EOUs:** The 100% EOUs fall into three categories:

- (a) EOUs established anywhere in India and exporting 100% products except certain fixed percentage of sales in the Domestic Tariff Area (DTA) as may be permissible under the Policy.
- (b) Units in Free Trade Zones in Special Economic Zones (SEZs) and exporting 100% of their products.
- (c) EOUs set up in Software Technology Parks (STPs) and Electronic Hardware Technology Parks (EHTPs) of India for development of Software & Electronic Hardware.

### **6.3.1 Conditions to be Fulfilled**

A 100 per cent export-oriented unit is an industrial unit offering for export its entire production, excluding the permitted levels of domestic tariff area sales. EOUs may be set up with a foreign

Notes

equity participation of up to 100 per cent. For setting up a 100 per cent EOU the following conditions are applicable:

- (i) the entire production and operation of 100 per cent EOUs must be in a customs bonded factory, unless specifically exempt from physical bonding; Goods will be imported into the customs bonded factory;
- (ii) the unit shall undertake to manufacture in the bonded area and to export its entire production for a period of 10 years ordinarily and 5 years in case of products liable to rapid technological change;



*Did u know?* Regarding the export obligations of 100 per cent EOUs, the following conditions apply:

- 1. EOUs need not export their manufactured goods themselves but may use an export house/trading house/star trading house or other EOUs subject to certain conditions;
  - 2. EOUs may execute export orders also through third parties given that the goods will be directly transferred from the customs bonded factory to the port of shipment and all export benefits will be to EOUs only.
- (iii) an approved EOU will execute a bond/legal undertaking with the Development Commissioner concerned; Failure to fulfil the obligations stipulated in the letter of approval or intent will render the unit liable to penalty;
  - (iv) EOUs have to adhere to the minimum value addition conditions incorporated in the letter of permission/letter of intent/industrial license issued to them. In general, such minimum value addition will be 35 per cent for automatic approvals and 20 per cent for other cases;
  - (v) EOUs have to maintain a proper account of the imports, consumption and utilization of all imported materials and exports made by the unit. These accounts will be submitted periodically to the Development Commissioner. Wherever an existing industrial unit is operating both as a domestic unit as well as an approved 100 per cent EOU, it should have two distinct identities with separate accounts;
  - (vi) EOUs are permitted to sell part of the production in the domestic tariff area subject to certain limits;
  - (vii) the f.o.b. value of exports of an EOU can be clubbed with the f.o.b. value of exports of its parent company in the domestic tariff area to attain export house, trading house or star trading house status for the parent company;
  - (viii) supplies produced in the domestic tariff area under global tender conditions, against payment in foreign exchange, against advance licenses and other import licenses, and to other EOUs with the permission of the Development Commissioner, will be counted towards the fulfilment of export obligations.



*Notes* On completion of the bonding period, it shall be open to the unit to continue under the scheme or to opt out of the scheme. Debonding will, however, be subject to the industrial policy in force at the time the option is exercised. Where debonding is sought before the stipulated export obligation period of 5 to 10 years, or where EOUs are unable to fulfil their export commitments out of various reasons, it is considered premature debonding. This is subject to payment of all leviable duties without the benefit of depreciation, and also subject to penalties and other conditions as decided by the Board of Approvals for 100 per cent EOUs.



*Caution* Customs duties on capital goods as well as customs duties on unused raw materials, components, consumables and spares are leviable on debonding after the export period

### 6.3.2 Deductions

Section 10-B of the Income-tax Act provides for 100% deduction of profits derived by a hundred by a hundred per cent Export Oriented undertaking, from export of articles or things or computer software manufactured or produced by it. The deduction is available 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 articles or things or computer software. However, no deduction under section 10-B is available after assessment year 2009-10. The deduction u/s 10-B is available to an undertaking which fulfils and the following conditions:

- (i) it manufactures or produces any article or thing or computer software;
- (ii) it is not formed by the splitting up, or the reconstruction, of a business already in existence except in the circumstances specified under section 33B or the IT Act;
- (iii) it is not formed, by the transfer to a new business of machinery or plant previously used for any purpose.

Representations have been received from various quarters as to whether an undertaking set up in Domestic Tariff Area, which is subsequently approved as 100% EOU by the Board appointed by the Central Government in exercise of powers conferred under section 14 of the Industries (Development and Regulation) Act, 1951, is eligible for deduction u/s. 10B of the Income-tax Act.

The matter has been examined and it is hereby clarified that an undertaking set up in Domestic Tariff Area (DTA) and deriving profit from export of articles or things or computer software manufactured or produced by it, which is subsequently converted into EOU, shall be eligible for deduction u/s. 10B of the IT Act, on getting approval as 100% export oriented undertaking. In such a case, the deduction shall be available only from the year in which it has got the approval as 100% EOU and shall be available only for the remaining 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 articles or things or computer software, as a DTA unit. Further, in the year of approval, the deduction shall be restricted to the profits derived from exports, from and after the date of approval of the DTA Unit as 100% EOU. Moreover, the deduction to such units in any case will not be available after assessment year 2009-10.



*Example:* To clarify the above position, certain illustrations are given as under:

- (i) Undertaking 'A' is set up in domestic Tariff Area and starts manufacture or production of computer software in Financial Year 1999-2000 relevant to assessment year 2000-01. It gets approval as 100% EOU on 10th September, 2004 in the Financial Year 2004-05 relevant to assessment year 2005-06. Accordingly, it shall be eligible for deduction under section 10B from assessment year 2005-06 i.e. the year in which it fulfils the basic condition of being a 100% EOU. Further, the deduction shall be available only for the remaining period of ten years i.e. from AY. 2005-06 to A.Y. 2009-10. This deduction under section 10B for A.Y. 2005-06 shall be restricted to the profits derived from exports, from and after the date of approval of the DTA unit as 100% EOU.
- (ii) Undertaking 'B' set up in Domestic Tariff Area, begins to manufacture or produce computer software in financial year 96-97 relevant to assessment year 1997-98. It gets approval as

**Notes**

100% EOU in Financial year 2007-08 relevant to assessment year 2008-09. No deduction under section 10B shall be admissible to undertaking B as the period of 10 years expires in F.Y. 2005-06 relevant to A.Y. 2006-07 prior to its approval as 100% EOU.

- (iii) Undertaking 'C' is set up in Domestic Tariff Area in the financial year 2000-01 relevant to assessment year 2001-02 and engaged in the business of providing computer related services, other than those notified by the Board for the purpose of section 10B. In financial year 2002-2003, it acquires more than 20% of old plant & machinery and starts manufacturing computer software. It also gets approval as 100% EOU in financial year 2002-03. Undertaking 'C' shall not be eligible for deduction under section 10B, as there has been transfer of old plant and machinery.
- (iv) Undertaking 'D' is set up and starts producing computer software in Financial year 2003-04 relevant to AY 2004-05. It gets approval as 100% EOU in FY 2006-07 relevant to AY 2007-08. It shall be eligible for deduction u/s. 10B from AY 2007-08. However, the deduction shall not be available after AY 2009-10.
- (v) Undertaking 'E' is set up and starts producing computer software prior to 31.3.1994. It gets approval as 100% EOU in FY 2004-05 relevant to AY 2005-06. Undertaking 'E' shall not be eligible for deduction u/s. 10B as the period of deduction of 10 years expires prior to A.Y. 2005-06.

**6.3.3 Consequence of Amalgamation and Demerger**

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, to another Indian company in a scheme of amalgamation or demerger:

- (i) *Amalgamating or the Demerged Company:* 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.
- (ii) *Amalgamated or the Resulting Company:* Deduction shall be admissible under this section to the amalgamated or the resulting company for the unexpired period of deduction.

**Self Assessment**

Fill in the blanks:

- 11. The Government amended in November 1983 a concession scheme to facilitate the setting up of ..... in order to enable them to meet requirements of foreign demand in terms of pricing, quality, precision etc.
- 12. The EXIM Policy, 2002-07 reinforces the importance of Scheme in ..... of the policy
- 13. EOUs established anywhere in India and exporting 100% products except certain fixed percentage of sales in the ..... as may be permissible under the Policy.
- 14. .... of the Income-tax Act provides for 100% deduction of profits derived by a hundred by a hundred per cent Export Oriented undertaking, form export of articles or things or computer software manufactured or produced by it.
- 15. .... 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.





Case Study

### **Tata Infotech Limited, Mumbai vs. Assistant Commissioner of Income Tax**

**T**his is an appeal filed by the assessee against the order passed by the Commissioner of Income Tax under section 263 of the Income Tax Act, 1961, on 31.03.2008.

The appeal relates to the assessment year 2003-04. The assessment of the assessee was completed by the Assessing Officer on a total income of ₹ 8, 36,338/-. In the return the assessee had claimed deduction under section 10A in respect of income arising from the industrial undertakings located at the Electronic Hardware Technology Park (EHTP) at Goa and the Software Technology Parks (STP) situated at Pune, Bangalore and Chennai. Under the section, as it stood at the relevant time, the assessee was entitled to the deduction of 90% of the profits of the above undertakings. The assessee claimed deduction of 90% of the profits in the following manner: -

EHTP - Goa ₹ 10,78,39,621/- STP - Pune ₹ 16,69,51,092/- STP - Bangalore ₹ 7,76,04,345/- STP - Chennai ₹ (-)1,06,428/ and the total coming as ₹ 35,22,88,630/-

In support of the above claim for deduction, detailed computations in respect of each undertaking were submitted along with the return. In the statement of income from profits and gains of the business, the assessee started the computation of the income from the profit figure shown in the Profit and Loss Account and reduced there from the figure of ₹ 35,22,88,630/-. The ultimate income shown in the computation was a loss of ₹ 2,96, 39,052/-. In the assessment order passed under section 143(3), the Assessing Officer also started the computation from the figure of net profit as per the Profit and Loss Account, as was done by the assessee and deducted ₹ 32,15,58,051/- under section 10A. However, there was one change. Due to slight changes in the computation of the profits of each of the undertakings, there was a change also in the figure of 90% of the profits of the undertakings. As per the computation in the assessment order, the figure of 90% of the profits of the Goa unit came to ₹ 9,97,95,226/- as against the figure of ₹ 10,78,39,621/- as per the assessee's computation. There were similar changes in respect of the Pune and Bangalore units also. The result was as against the deduction of ₹ 35,22,88,630/- claimed by the assessee under section 10A, the Assessing Officer allowed deduction of ₹ 32, 15, 58,051/-. The Assessing Officer determined the taxable income of the assessee at ₹ 8, 36,338/-.

On 18.03.2008 the CIT issued notice to the assessee proposing to revise the assessment under section 263 of the Act. According to him, the Assessing Officer ought to have assessed the difference of ₹ 3,07,30,529/- between the claim of ₹ 35,22,88,630/- made by the assessee under section 10A and ₹ 32,15,58,051/- allowed by the Assessing Officer in the assessment order. Since this was not done, there has been an escapement of income to the extent of ₹ 2,98,94,191/-, which is the difference between ₹ 3,07,30,529/- and ₹ 8,36,338/-. According to the CIT the losses of the local units not eligible for deduction under section 10A, amounting to ₹ 2,96,94,241/- was adjusted against the 10% of the profits of the units enjoying deduction under section 10A, which were to be brought to tax. The CIT also observed in the notice that the assessee has been allowed deduction of ₹ 9,37,546/- under Chapter VI-A which was not allowable in view of the loss from the non 10A units and this has also resulted in short levy of tax.

The assessee objected to the notice and submitted that there was nothing in section 10A which prohibits the setting off of the 10% of the taxable profits of the units eligible for

*Contd...*

## Notes

the benefit under section 10A against the loss of the local units which do not enjoy any benefit under section 10A of the Act. It was pointed out that once the 10% of the profits of the units enjoying the benefit of section 10A are taxed as profits and gains of the business, provisions relating to set off of losses from other sources under the same head and under other heads of income, as provided in sections 70 and 71 of the Act, automatically come into play. In support of these submissions the assessee relied on the order of the Mumbai Bench of the Tribunal in *Navin Bharat Industries Ltd. vs. DCIT* (2004) 90 ITD 1 (Mum) (TM) and the Bangalore Bench of the Tribunal in *Mindtree Consulting Pvt. Ltd. vs. ACIT* (2006) 102 TTJ (Bang) 691. It was thus pleaded that the assessment order was neither erroneous nor prejudicial to the interests of the revenue.

The CIT did not accept the assessee's submissions. According to him the 10% of the profits of the section 10A undertakings have to be set apart and separately considered and brought to tax and cannot be utilised to be adjusted against the losses under the same head or under other heads of income. He held that the profits computed under section 10A have to be given separate treatment and cannot be merged with the profits computed under the remaining provisions of the Act. Section 10A, he opined, was a self contained code and none of the other provisions of the Act will apply.

He also held that the income computed under section 10A will not constitute part of the gross total income as defined under section 80B against which alone deductions under Chapter VI-A are allowed. In addition to this line of reasoning, the CIT also held that the orders of the Mumbai and Bangalore Benches of the Tribunal were not applicable and that he was in respectful disagreement with those orders. In this view of the matter, he directed the Assessing Officer to compute the total income of section 10A undertakings separately without allowing any set off of loss or unabsorbed depreciation in respect of the non 10A units. He also held that since there was a loss in the non 10A units, the deductions under sections 80G and 80-O were incorrectly allowed against the income from section 10A units. He thus directed the Assessing Officer to pass a fresh assessment order after giving the assessee proper opportunity.

The assessee is in further appeal before the Tribunal to contend that the assessment order was neither erroneous nor prejudicial to the interests of the revenue inasmuch as it was in conformity with the views expressed in several orders of the Tribunal. It was submitted that where the assessment order is in accordance with the views expressed by a higher judicial forum, it cannot be termed to be erroneous. It was argued that in any case the matter raised several legal questions and was highly debatable and just because the Assessing Officer adopted one of the possible legal interpretations of the provisions of the statute it does not follow that his order is erroneous. Our attention was drawn to several orders of different Benches of the Tribunal in which the view was taken that the 10% profits of the section 10A unit which are brought to tax for the assessment year 2003-04 can be utilised for being adjusted against the brought forward losses and the losses for the same year either under the same head of income but from a different source or under another head of income for the same year. It was thus submitted that the order under section 263 was bad in law.

The learned CIT Departmental Representative strongly relied on the order passed by the CIT and the reasoning given therein. She further submitted that the assessment order was contrary to the provisions of the statute and, therefore, was rightly held to be erroneous by the CIT. It was her contention that the 10% profits which are taxed under section 10A for the assessment year 2003-04 cannot be utilised for being adjusted against losses for the same year under different sources or heads of income or against brought forward losses. She submitted that such profits stand on a separate footing and cannot be considered to be part of the profits and gains of the business as computed under sections 29 to 43 of the Act.

Contd...

On a careful consideration of the rival contentions, we are of the view that the assessment order cannot be said to be erroneous since it is in accordance with the views expressed in several orders of different Benches of the Tribunal. In the case of *Mindtree Consulting Pvt. Ltd.* (supra), it was held that the profits which became taxable after availing of the exemption under section 10B of the Act were available to be adjusted against the loss assessed for the same year under the head "Income from other sources" as permitted under section 71.

It may be clarified that section 10B is substantially similar to section 10A of the Act. In the case of *Navin Bharat Industries Ltd.* (supra), the Mumbai Bench of the Tribunal held that the units under section 10A are entitled to set off their losses against the profits from non 10A units or against other business income for the same year. This order deals with the reverse situation. However, the question is whether the provisions of sections 70 and 71 are applicable even with regard to the losses or profits assessed in respect of units enjoying the benefits of section 10A.

That question was decided by the Tribunal by holding in the affirmative. In *Wipro BPO Solutions Ltd. vs. DCIT* [2010- TIOL-95-ITAT-BANG], the Bangalore Bench of the Tribunal was dealing with section 10B. After noting that 90% of the profits were deductible under the section and 10% of the profits were assessable for the assessment year 2003-04, it was held that the business loss brought forward from the assessment year 2001-02 can be set off against the 10% profits assessed under section 10B for the assessment year 2003-04. In *DCIT vs. A V Thomas Leather & Allied Products Ltd.* [2009-TIOL-434-ITAT-MAD], the Chennai Bench of the Tribunal held that the loss in respect of a unit under section 10A can be set off against the profit earned for the same year by the non 10A units. In the case of *Honeywell International India (Pvt.) Ltd. vs. DCIT* (2007) 108 TTJ (Del) 924, the Delhi Bench of the Tribunal was dealing with the loss of an unit eligible under section 10A for the assessment year 2003-04. It was held that the loss can be set off against the profits of any other unit or business under sections 70 and 71 of the Act. Again the Mumbai Bench of the Tribunal in the case of *Sovika Infotek Ltd. vs. ITO* [2008-TIOL- 343-ITAT-MUM], dealing with section 10B, held that the provisions of sections 70 and 71 were applicable and the loss from the 10A unit can be adjusted against the income from other sources for the same year.

Thus there is ample authority in the form of orders of different Benches of the Tribunal for the proposition that the 10% profits of an unit under section 10A which is assessed for the assessment year 2003-04 are not different in any way from the profits of any other business carried on by the assessee and, therefore, any losses for the same year or brought forward from an earlier year can be adjusted against those profits. The loss arising in the section 10A unit is also eligible for being adjusted against the profits of any other business for the same year or against income under other heads of income.

As against this view adumbrated in the orders of the Tribunal, in accordance with which the assessment order in the present case has been framed, the CIT has taken a different view. We are not here concerned with the correctness of either of the views. It is only to be noted that where the assessment order has been passed on the basis of one of the several plausible views or interpretations to be placed on the statutory provisions, it does not become erroneous and prejudicial to the interests of the revenue merely because the CIT prefers to adopt another view which is favourable from the Revenue's point of view.

This is a well settled position for which no authority needs to be cited. In this view of the matter, we hold that the Assessing Officer did not err and the assessment order passed by him cannot be said to be erroneous because the 10% profits of the units eligible for the benefit under section 10A have been used to adjust the losses from the local non 10A units. The appeal of the assessee is accordingly accepted and the order of the CIT passed under section 263 is set aside.

Contd...

Notes

**Questions:**

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: <http://www.indiankanoon.org/doc/41007109/>

## 6.4 Summary

- Free Trade Zone, also called Foreign-trade Zone, formerly Free Port, an area within which goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities.
- No deduction under this section shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified under sub-section (1) of section 139.
- 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, to another Indian company in a scheme of amalgamation or demerger.
- Section 10AA was inserted in the Income-tax Act, 1961 by the Special Economic Zones Act, 2005 (the SEZ Act) with effect from 10-2-2006.
- Where an undertaking is transferred to another company under a scheme of amalgamation or demerger, the deduction under section 10AA shall be allowable in the hands of the amalgamated or the resulting company.
- Section 54GA has been inserted to give exemption in case of shifting of an industrial undertaking from urban area to a special economic zone.
- The Export Oriented Unit (EOU) Scheme, which had been introduced in the early 1980s remains in the forefront of country's export production schemes.
- The main objectives of the EOU scheme is to increase exports, earn foreign exchange to the country, transfer of latest technologies stimulate direct foreign investment and to generate additional employment.
- A 100 per cent export-oriented unit is an industrial unit offering for export its entire production, excluding the permitted levels of domestic tariff area sales.
- EOUs may be set up with a foreign equity participation of up to 100 per cent.

## 6.5 Keywords

**Amalgamation:** An amalgamation is distinct from a merger because neither of the combining companies survives as a legal entity.

**Assessment Years:** An assessment year means the current year.

**Convertible foreign exchange:** It 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 there under or any other corresponding law for the time being in force.

**Deductions:** An expense subtracted from adjusted gross income when calculating taxable income, such as for state and local taxes paid, charitable gifts, and certain types of interest payments.

**Demerger:** Demerger is a form of corporate restructuring in which the entity's business operations are segregated into one or more components.

**Electronic Hardware Technology Park (EHTP):** It means any park set up in accordance with the Electronic Hardware Technology Park Scheme notified 21 by the Government of India in the Ministry of Commerce and Industry

**Export turnover:** Export turnover means the consideration in respect of export of articles or things or computer software received in, or brought into, India by the assessee in convertible foreign exchange in accordance with sub-section (3), but does not include freight, telecommunication charges or insurance attributable to the delivery of the articles or things or computer software outside India or expenses, if any, incurred in foreign exchange in providing the technical services outside India

**Free Trade Zone (FTZ):** A free trade zone or export processing zone (EPZ), also called foreign-trade zone, formerly free port is an area within which goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities.

**Relevant assessment year:** It means any assessment year falling within a period of ten consecutive assessment years referred to in this section.

**Software Technology Park (STP):** It means any park set up in accordance with the Software Technology Park Scheme notified by the Government of India in the Ministry of Commerce and Industry.

**Special Economic Zone (SEZ):** It means a zone which the Central Government may, by notification in the Official Gazette, specify as a special economic zone for the purposes of this section.

**Tax benefit:** A tax benefit is an allowable deduction on a tax return intended to reduce a taxpayer's burden while typically supporting certain types of commercial activity.

## 6.6 Review Questions

1. Write short note on Free Trade Zone.
2. What are the conditions to be fulfilled in Free Trade Zone?
3. Throw some light on the deductions of Free Trade Zone.
4. Describe the consequences of amalgamation and demerger Free Trade Zone.
5. Elucidate the conditions to be fulfilled under Special Economic Zone.
6. Describe the amount of deduction in Special Economic Zone.
7. Highlight the consequences for amalgamation and demerger in Special Economic Zone.
8. What are 100% Export Oriented Unit (EOU)?
9. Describe the categories of 100% EOUs.
10. Discuss the deduction part of 100% EOUs.

### Answers: Self Assessment

- |                             |  |
|-----------------------------|--|
| 1. Free Trade Zone          | 2. Ninety per cent                     |
| 3. No                       | 4. Electronic hardware technology park |
| 5. Software technology park | 6. Section 10AA                        |
| 7. Export                   | 8. 100 per cent                        |

- |              |                                  |                       |
|--------------|----------------------------------|-----------------------|
| <b>Notes</b> | 9. Section 10A(1A)               | 10. Resulting company |
|              | 11. Export-oriented units (EOUs) | 12. Chapter 6         |
|              | 13. Domestic Tariff Area (DTA)   | 14. Section 10-B      |
|              | 15. No                           |                       |
|              |                                  |                       |

## 6.7 Further Readings



### Books

Ahuja, G. K. & Gupta, Ravi, *Systematic Approach to Income Tax*, Bharat Law House.

Aggarwal, K., *Direct Tax Planning and Management*, Atlantic Publications.

Lakhotia, R.N., *Income Tax Planning Handbook*, Vision Books.

Singhania, V. K. & Singhania, Kapil, *Direct Taxes law & Practice*. Taxmann Publications.

Srinivas E. A., *Handbook of Corporate Tax Planning*, Tata McGraw Hill.



### Online links

[http://finance.indiamart.com/taxation/corporate\\_tax/ftz.html](http://finance.indiamart.com/taxation/corporate_tax/ftz.html)

<http://law.incometaxindia.gov.in/DIT/Income-tax-acts.aspx>

<http://law.incometaxindia.gov.in/dittaxmann/incometaxacts/2008itact/section10AA.htm>

<http://www.caclubindia.com/articles/amt-v-s-sez-units-13637.asp#.UO5sfoE43CM>

[http://icai.org/post.html?post\\_id=2453](http://icai.org/post.html?post_id=2453)

<http://www.vkaindia.com/notifications/43-income-tax/97-instruction-no-12006-dated-31-3-2006.html>

[http://finance.indiamart.com/exports\\_imports/export\\_financing/export\\_units/index.html](http://finance.indiamart.com/exports_imports/export_financing/export_units/index.html)

[http://www.eximguru.com/exim/eou/ch\\_1\\_export\\_oriented\\_units\\_eous\\_introduction.aspx](http://www.eximguru.com/exim/eou/ch_1_export_oriented_units_eous_introduction.aspx)

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## Unit 7: Deductions: For Special Conditions

Notes

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### Objectives

After studying this unit, you will be able to:

- State the meaning of SEZ
- Discuss the key tax benefits to be provided to SEZs and SEZ Units
- Recognise the deduction in respect of profits and gains by an undertaking or enterprise engaged in development of SEZ
- Interpret the special provisions in respect of certain undertakings or enterprises in certain special category states
- Elucidate tax holiday in respect of profits and gains from eligible business of certain undertakings in north-eastern states
- Demonstrate the application of the above special conditions

### Introduction

A Special Economic Zone (SEZ) is a specified, delineated and duty-free geographical region that has different economic laws from those of the country in which it is situated. In some countries, such a region is even treated as a deemed foreign territory. Therefore you can say that SEZs are free trade zones, having completely different set of administrative and taxation laws outside the purview of customs authorities. Traditionally SEZs are created as open markets within an economy that is dominated by distortional trade, macro and exchange regulations and other regulatory governmental controls. SEZs are believed to create conducive environment to promote investment and exports. Hence, many developing countries are developing SEZs with the expectation that they will provide the engines of growth for their economies to achieve industrialisation.

The Special Economic Zones and Tax Incentives offered as per the SEZ policy of India are indeed alluring. The Special Economic Zones and Tax Incentives offered covers areas like state and local taxes, levies, stamp duty and other duties. As per the Income-tax Act, 1961 there are a number of key tax benefits to be provided to SEZs and SEZ Units.

**Notes**

All the Special Economic Zones function under the guardianship and the jurisdiction of the Commerce Ministry, Government of India. The relevant or applicable exemptions and incentives as offered for the operation of the Special Economic Zones are provided in the Special Economic Zone Act of India. These exemptions on income taxes are detailed in the Second Schedule to the SEZ Act. Section 27 of the SEZ Act provides -

1. Provisions of Income tax Act;
2. As in force for time being;
3. Shall apply to developer or entrepreneur;
4. For carrying on authorised operations in an SEZ or Unit;
5. Subject to modifications specified in Second Schedule.

### **7.1 Key Tax Benefits for SEZs and SEZ Units**

As per the Income-tax Act, 1961 (ITA), there are various key tax benefits to be provided to SEZs and SEZ Units. Section 80-IA(1) provides a ten year tax holiday to an assessee, whose gross total income includes any profits and gains derived by an undertaking or enterprise from an eligible business i.e., business referred to in sub-section (4), namely:

#### **Infrastructure facility**

Any enterprise carrying on the business of:

- (a) developing;
- (b) operating and maintaining; or
- (c) developing, operating and maintaining any infrastructure facility.

#### **Conditions**

However, such enterprise must fulfil the following conditions:

- (i) It must be owned by a company registered in India or by a consortium of such companies or by an authority or a board or a corporation or any other body established or constituted under any Central or State Act.
- (ii) It has entered into an agreement with the Central or a State Government or a local authority or statutory body for:
  - (a) developing, or
  - (b) operating and maintaining, or
  - (c) developing, operating and maintaining a new infrastructure facility.
- (iii) It starts operating and maintaining such infrastructure facility on or after 1-4-1995.
- (iv) However, where an enterprise which developed such infrastructure facility transfers it to another enterprise on or after 1-4-1999, and such transferee enterprise operates and maintains it according to the agreement drawn up with the Government, etc.; this section will apply to the transferee enterprise for the unexpired period of deduction (which was available to the first enterprise).

#### **Meaning of "infrastructure facility"**

For this purpose, 'infrastructure facility' means:

- (i) a road, including toll road, a bridge or a rail system;



- (ii) a highway project including housing or other activities being an integral part of the highway project;
- (iii) a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system; and
- (iv) a port, airport, inland waterway or inland port or navigational channel in the sea.

Notes



Notes

1. Structures at the ports for storage, loading and unloading etc. will be included in the definition of port for the purpose of section 80-IA, if the concerned port authority has issued a certificate that the said structures form part of the port.
2. Effluent treatment and conveyance system is a part of water treatment system and would accordingly, qualify as an infrastructure facility for the purpose of section 80-IA.
3. The CBDT has, vide Circular No. 4/2010 dated 18.5.2010, clarified that widening of an existing road by constructing additional lanes as a part of a highway project by an undertaking would be regarded as a new infrastructure facility for the purpose of section 80-IA(4)(i). However, simply relaying of an existing road would not be classifiable as a new infrastructure facility for this purpose.

### Telecommunication Undertakings

Any undertaking providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service or network of trunking (NOT), broadband network and internet services on or after 1st April, 1995 but on or before 31st March, 2005.

#### *Meaning of "domestic satellite"*

'Domestic satellite' has been defined by sub-section (12) (a) as "a satellite owned and operated by an Indian company for providing telecommunication services."

### Industrial parks or Special Economic Zones

Any undertaking which develops, develops and operates, or maintains and operates an industrial park or develops, or develops and operates, or maintains and operates, a special economic zone.

#### *Conditions*

- (i) The undertaking begins to operate an industrial park or special economic zone in accordance with the scheme framed and notified by the Central Government.
- (ii) The scheme is notified by the Government for the period beginning on 1-4-1997 and ending on 31-3-2011 for industrial parks and 31.3.2006 for SEZs.

Rule 18C lays down the following eligibility criteria for Industrial Parks to claim benefit under section 80-IA (4) (iii) -

1. The undertaking should begin to develop, develop and operate or maintain and operate an industrial park any time during the period from 1.4.2006 to 31.3.2009.

**Notes**

2. The undertaking and the Industrial Park should be notified by the Central Government under the Industrial Park Scheme, 2008.
  3. The undertaking should continue to fulfil the conditions envisaged in the Industrial Park Scheme, 2008.
- (iii) However, where an undertaking develops an industrial park on or after 1.4.1999 or a special economic zone on or after 1.4.2001 and transfers the operation and maintenance to another undertaking (transferee undertaking), the deduction to the transferee undertaking shall be available for the remaining period in the ten consecutive assessment years, in such a manner as would have been available to the transferor undertaking, as if the operation and maintenance were not so transferred to the transferee undertaking.

**Power Undertakings**

Any undertaking which

- (i) is set up in any part of India for the generation or generation and distribution of power. However, such undertaking must begin to generate power at any time during the period between 1.4.1993 and 31.3.2013.;
- (ii) starts transmission or distribution by laying a network of new transmission or distribution lines at any time during the period from 1.4.1999 and 31.3.2013. However, the deduction shall be allowed only in respect of profits derived from the laying of such network of new lines for transmission or distribution.;
- (iii) undertakes substantial renovation and modernisation of the existing network of transmission or distribution lines at any time during the period beginning on 1.4.2004 and ending on 31.3.2013.;

Substantial renovation and modernisation means an increase in the plant and machinery in the network of transmission or distribution lines by at least fifty per cent of the book value of such plant and machinery as on 1st April, 2004.

Telecom and Power undertakings should fulfil the following conditions:

- (a) It is not formed by splitting up or reconstruction of a business already in existence. However, this condition shall not apply in the case of an undertaking which is formed as a result of reconstruction, re-establishment or revival of the business of any undertaking which has been discontinued in any previous year due to extensive damage or destruction of any building, machinery, plant or furniture owned by the assessee and used for the purposes of such business. Further, the reason for damage or destruction is due to any natural calamity or other unforeseen circumstances such as the following:
  - (i) Flood, typhoon, hurricane, cyclone, earthquake or other natural calamity, or
  - (ii) riot or civil disturbance, or
  - (iii) accidental fire or explosion, or
  - (iv) enemy action or action taken in combat, and such business is re-established or revived within 3 years from the end of such previous year.
- (b) The undertaking should not be formed by the transfer of machinery or plant previously used for any purpose.

However, these conditions do not apply in case of transfer, either in whole or in part, of machinery or plant previously used by a State Electricity Board. This is irrespective of whether or not such transfer is in pursuance of the splitting up or reconstruction of such State Electricity Board or reorganisation of the State Electricity Board under Part XIII of the Electricity Act, 2003.

Also, this condition shall not apply to second-hand machinery or plant imported by the assessee if the following conditions are fulfilled:

- (i) Such machinery or plant was not used in India prior to the date of installation by the assessee.
- (ii) No deduction on account of depreciation was allowed to any person prior to the date of installation by the assessee.

Further, where the total value of any plant or machinery previously used and now transferred to the new business does not exceed 20% of the total value of the machinery or plant used in the new business, such plant or machinery will be considered as new for this purpose.

### **Undertakings Owned by an Indian Company and set up for Reconstruction or Revival of a Power Generating Plant**

Clause (v) provides that the benefit under this section is available to an undertaking owned by an Indian company and set up for reconstruction or revival of a power generating plant.

Such Indian company should be formed before 30.11.2005 with majority equity participation by public sector companies for the purposes of enforcing the security interest of the lenders to the company owning the power generating plant.

Such Indian company should have been notified before 31.12.2005 by the Central Government for the purposes of this clause. Such undertaking should begin to generate or transmit or distribute power before 31.3.2011.

#### ***Rate of Deduction***

1. The amount of deduction available will be 100% of the profits and gains derived from such business for ten consecutive assessment years.
2. However, in case of telecom undertakings covered under (2) above, the deduction will be 100% for the first 5 assessment years and thereafter 30% for the further 5 assessment years.

#### ***Period of Tax Holiday or Concession***

1. The assessee has the option to claim deduction for any 10 consecutive assessment years out of 15 years beginning from the year in which the undertaking or the enterprise develops or begins to operate the eligible business.
2. The assessee may also claim deduction for 10 out of 15 years beginning from the year in which an undertaking undertakes substantial renovation and modernisation of the existing transmission or distribution lines.
3. In case of an infrastructure facility being a public facility like:
  - (i) a road, including a toll road, bridge or rail system; or
  - (ii) a highway project including housing or other activities which are an integral part of the highway project; or a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system, the assessee can claim deduction for any 10 consecutive assessment years out of 20 years beginning from the year of operation.

Notes

Other Provisions

1. For the purpose of computing deduction under this section, the profits and gains of the eligible business shall be computed as if such eligible business were the only source of income of the assessee during the relevant previous years [Sub-section (5)].
2. Where housing or other activities are an integral part of a highway project and the profits and gains have been calculated in accordance with the section, the profits shall not be liable to tax if the following conditions have been fulfilled:
  - (a) the profit has been transferred to a special reserve account;
  - (b) the same is actually utilised for the highway project excluding housing and other activities before the expiry of 3 years following the year of transfer to the reserve account; and
  - (c) the amount remaining unutilised shall be chargeable to tax as income of the year in which the transfer to the reserve account took place [Sub-section (6)].
3. The deduction shall be allowed to the industrial undertaking only if the accounts of the industrial undertaking for the relevant previous year have been audited by a Chartered Accountant and the assessee furnishes the audit report in the prescribed form, duly signed and verified by such accountant along with his return of income [Sub-section (7)].
4. Where any goods or services held for the purposes of the eligible business are transferred to any other business carried on by the assessee, or vice versa, and if the consideration for such transfer does not correspond with the market value of the goods or services then the profits and gains of the eligible business shall be computed as if the transfer was made at market value. However, if, in the opinion of the Assessing Officer, such computation presents exceptional difficulties, the Assessing Officer may compute the profits on such reasonable basis as he may deem fit [Sub-section (8)].



*Notes* For the purpose of section 80-IA(8), the market value, in relation to any goods or services transferred between the eligible business and any other business carried on by the assessee, shall mean:

1. The price that such goods or services would ordinarily fetch in the open market; or
2. The arm's length price as defined under section 92F, where the transfer of such goods or services is a specified domestic transaction referred to in section 92BA.

5. The deductions claimed and allowed under this section shall not exceed the profits and gains of the eligible business. Further, where deduction is claimed and allowed under this section for any assessment year no deduction in respect of such profits will be allowed under any other section under this chapter [Sub-section (9)].
6. The Assessing Officer is empowered to make an adjustment while computing the profit and gains of the eligible business on the basis of the reasonable profit that can be derived from the transaction, in case the transaction between the assessee carrying on the eligible business under section 80-IA and any other person is so arranged that the transaction produces excessive profits to the eligible business [Sub-section (10)].



*Caution* It has now been provided that if the aforesaid arrangement between the assessee carrying on the eligible business and any other person is a specified domestic transaction referred to in section 92BA, then, the amount of profit of such transaction shall be determined having regard to arm's length price as defined under section 92F and not as per the reasonable profit from such transaction.

7. The section empowers the Central Government to declare any class of industrial undertaking or enterprise as not being entitled to deduction under this section. The denial of exemption shall be with effect from such date as may be specified in the notification issued in the Official Gazette [Sub-section (11)].
8. In the case of any amalgamation or demerger, by virtue of which the Indian company carrying on the eligible business is transferred to another Indian company, deduction under this section will be available as follows:
  - (a) No deduction will be available to the amalgamating company or the demerged company, as the case may be, in the year of amalgamation or demerger.
  - (b) The provisions of this section will apply to the amalgamated or resulting company as they would have applied to the amalgamating or demerged company if the amalgamation or demerger had not taken place [Sub-section (12)].

However, such transfer of benefit of deduction to the amalgamated/resulting company would not be available in respect of any enterprise or undertaking which is transferred in a scheme of amalgamation or demerger affected on or after 1.4.2007 [Sub-section (12A)].
9. The deduction under section 80-IA would not be available in respect of any SEZ notified on or after 1.4.2005 in accordance with the Industrial Park Scheme, 2002 and notified schemes for SEZs, referred to in section 80-IA(4)(c)(iii) [Sub-section (13)].
10. The tax holiday under section 80-IA would not be available in relation to a business referred to in sub-section (4) which is in the nature of a works contract awarded by any person (including the Central or State Government) and executed by the undertaking or enterprise referred to in section 80-IA(1).



Caselet

### **Corporate Income Tax: Small Benefits, but SEZs Deal a MAT Blow**

**T**he corporate surcharge has been lowered from 7.5% to 5%. That reduces the effective corporate tax rate from 33.2% to 32.4%, which is a nice, even if small, relief for Indian companies. The new rate will be 30% plus a 5% surcharge, which works out to 31.5%, and after adding the education cess of 3%, it works out to 32.4%.

But the Minimum Alternate Tax (MAT) which is levied on firms has been increased to 18.5% of book profits from 18% earlier. This was to compensate for the lower surcharge, according to the FM. MAT is levied on those firms whose profits as per the Income Tax Act, is lower than that in their books prepared under the Companies Act.

So, companies will have to pay 18.5% of their book profits or tax as per the Income Tax Act, whichever is higher. But this tax is adjustable against future taxes payable. That is, when the company exits the tax holiday, or any other situation, which is lowering its tax incidence, it will be able to set off its MAT credit against the tax liability. This is in the nature of an advance tax, which lowers the cash flow of the company and in turn, hikes the cash flows of the government.

The Special Economic Zone Act has come under fire on several fronts. Earlier, profits earned by SEZ developers and units operating in these SEZs were exempt from tax.

In addition, the dividend paid by these SEZ units was exempt from tax, compared to other companies who paid a dividend distribution tax of 15%. This will go. The exemption of tax on dividends ends from June 2011 itself. This again does not affect their profits but will reduce the profits available for distributing to shareholders.

Contd...

**Notes**

SEZ profits will continue to be exempt from income tax, but they were also exempt from MAT. Now, they have to pay MAT of 18.5% on their profits earned in 2011-12. Their profits will fall to that extent. As said earlier, this is a cash flow and timing-related effect, and they will be able to set it off against future profits, as and when they become taxable.

But the SEZs may have to wait for a very long time for that. At present, units set up in SEZs get a 100% exemption on profits for the first five years, 50% for the next five years, and then 50% of the export profit reinvested in the business. And, developers of SEZs could get a tax holiday for 10 out of 15 years from the time it was notified. That is, their tax incidence will go up substantially only after 10 years.

In one shot, the government has ensured it loses no revenue (cash flow) due to companies using SEZs for their business nor from developers who were racing to set up residential and commercial complexes near the eligible areas surrounding the SEZ, and were eligible for tax exemptions.

Source: <http://www.indiabusinessview.com/news/921/corporate-income-tax-small-benefits-sezs-dealt-mat-blow>

**Self Assessment**

State whether the following is true or false in the context of the coverage of industrial undertaking:

1. A road, including toll road, a bridge or a rail system.
2. A highway project including housing or other activities being an integral part of the highway project.
3. Any undertaking providing telecommunication services, whether basic or cellular.
4. Any undertaking which develops, develops and operates, or maintains and operates, a special economic zone.
5. A port, airport, inland waterway or inland port or navigational channel in the sea.

**7.2 Deductions by an Undertaking Engaged in Development of SEZ**

Deductions in respect of profits and gains by an undertaking or enterprise engaged in development of SEZ (Section 80-IAB) will be discussed in this section. Sub-section (1) of Section 80-IAB provides for a deduction of 100% of profits and gains derived by an undertaking or an enterprise from any business of developing a SEZ for 10 consecutive assessment years. The deduction is available to an assessee, being a Developer, whose gross total income includes any profits and gains derived by an undertaking or an enterprise from any business of developing a SEZ, notified on or after 1st April, 2005 under the SEZ Act, 2005.

Here developer means -

- (i) a person who, or
- (ii) a State Government

which has been granted a letter of approval by the Central Government under section 3(10) of the SEZ Act, 2005.

A developer includes:

- (i) an authority, and
- (ii) a co-developer.

Here co-developer means:

- (i) a person who, or
- (ii) a State Government.

which has been granted a letter of approval by the Central Government under section 3(12) of the SEZ Act, 2005.

The deduction shall be allowed only if the accounts are audited by a Chartered Accountant and the audit report is furnished along with the return of income. The assessee has the option of claiming the said deduction for any ten consecutive assessment years out of fifteen years beginning from the year in which a SEZ has been notified by the Central Government.

In a case where an undertaking, being a Developer, who develops a SEZ on or after 1.4.2005 and transfers the operation and maintenance of such SEZ to another Developer, the deduction under sub-section (1) shall be allowed to such transferee Developer for the remaining period in the ten consecutive assessment years as if the operation and maintenance were not so transferred to the transferee Developer.

The profits and gains from the eligible business should be computed as if such eligible business were the only source of income of the assessee during the relevant assessment year.



*Task* Take any Indian firm of your choice who is engaged in development of SEZ and critically analyse on the deduction availed by it in respect of profits and gains incurred by it.

Where any goods or services held for the purposes of eligible business are transferred to any other business carried on by the assessee or, where any goods held for any other business are transferred to the eligible business and, in either case, if the consideration for such transfer as recorded in the accounts of the eligible business does not correspond to the market value thereof, then the profits eligible for deduction shall be computed by adopting market value for such goods or services. In case of exceptional difficulty in this regard, the profits shall be computed by the Assessing Officer on a reasonable basis.



*Notes* The market value, in relation to any goods or services transferred between the eligible business and any other business carried on by the assessee, shall mean:

- (1) The price that such goods or services would ordinarily fetch in the open market; or
- (2) The arm's length price as defined under section 92F, where the transfer of such goods or services is a specified domestic transaction referred to in section 92BA.

Where due to the close connection between the assessee and the other person or for any other reason, it appears to the Assessing Officer that the profits of eligible business is increased to more than the ordinary profits, the Assessing Officer shall compute the amount of profits on a reasonable basis for allowing the deduction.

The Assessing Officer is empowered to make an adjustment while computing the profit and gains of the eligible business on the basis of the reasonable profit that can be derived from the transaction, in case the transaction between the assessee carrying on the eligible business under section 80-IAB and any other person is so arranged that the transaction produces excessive profits to the eligible business.

Notes



*Caution* It has now been provided that if the aforesaid arrangement between the assessee carrying on the eligible business and any other person is a specified domestic transaction referred to in section 92BA, then, the amount of profit of such transaction shall be determined having regard to arm's length price as defined under section 92F and not as per the reasonable profit from such transaction.

The deduction under this section should not exceed the profits of such eligible business of the undertaking or the enterprise. Further, where any amount of profits of an undertaking or enterprise is allowed as deduction under this section, no deduction under any other provision of Chapter VI-A is allowable in respect of such profits. The Central Government may notify that the benefit conferred by this section shall not apply to any class of industrial undertaking or enterprise with effect from any specified date.

Where any undertaking of an Indian company which is entitled to the deduction under this section is transferred before the expiry of the period of deduction to another Indian company in a scheme of amalgamation or demerger, no deduction shall be admissible to the amalgamating or demerged company for the previous year in which the amalgamation or demerger takes place and the amalgamated or the resulting company shall be entitled to the deduction as if the amalgamation or demerger had not taken place.

### Self Assessment

Fill in the blanks:

6. Sub-section (1) of Section 80-IAB provides for a deduction of 100% of profits and gains derived by an undertaking or an enterprise from any business of developing a SEZ for ..... consecutive assessment years.
7. Developer means a ..... which has been granted a letter of approval by the Central Government under section 3(10) of the SEZ Act, 2005.
8. Co-developer means a person who, or a State Government which has been granted a letter of approval by the Central Government under ..... of the SEZ Act, 2005.
9. The deduction under section 80-IAB shall be allowed only if the accounts are audited by a Chartered Accountant and the audit report is furnished along with the .....
10. The deduction under section 80-IAB should not exceed the ..... of such eligible business of the undertaking or the enterprise.

### 7.3 Special Provisions in Respect of Certain Undertakings in Special Category States

Special provisions in respect of certain undertakings or enterprises in certain special category States (Section 80-IC) will be discussed in this section. Section 80-IC allows tax holiday to the new undertakings or existing undertakings on their substantial expansion in the States of Himachal Pradesh, Uttaranchal, Sikkim and North-Eastern States.

For this purpose, substantial expansion means increase in the investment in 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 tax holiday in the States of Himachal Pradesh and Uttaranchal will be 100% for the first five assessment years and 25% (30% in the case of a company) for the next five assessment years. However, tax holiday in the States of Sikkim and North-Eastern States will be 100% for ten assessment years commencing from the initial assessment year.



For the purpose of exemption, two classifications have been made and the Thirteenth Schedule and Fourteenth Schedule have been inserted in the Income-tax Act. The said Schedules specify the list of articles and the States for the purposes of availing deduction under this section.

The first classification is applicable to undertakings or enterprises which manufacture or produce any article or thing, not being any article or thing specified in the 13th Schedule (namely, tobacco, aerated beverages, pollution causing paper and paper products etc.) 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 areas or theme park in these States as notified by the Board. The second classification is applicable to those undertakings or enterprises which manufacture or produce article or thing specified in the 14th Schedule only in these States without any specification of the specified zone, area etc.



*Did u know?* The period during which the undertakings in different States should begin or should have begun to manufacture or produce are given hereunder:

Himachal Pradesh and Uttaranchal	From 7.1.03 and ending before 1.4.2012
Sikkim	From 23.12.02 and ending before 1.4.2007
North-Eastern States	From 24.12.97 and ending before 1.4.2007

No benefit to these undertakings will be available under any of the sections in Chapter VIA in relation to the profits and gains of such undertakings. While computing the total period of 10 years the period for which the benefit under section 80IB has already been availed, if any, shall also be included.



*Task* Take any company of your choice in India which has availed the benefit of Special provisions in respect of certain undertakings or enterprises in certain special category States as provided by Section 80-IC.

The other conditions such as that it should not be formed by splitting or reconstruction of a business already in existence, or by transfer to a new business of plant and machinery previously used for any purpose are the same as are applicable for claiming benefit under section 80IA.

Where any goods or services held for the purposes of the eligible business are transferred to any other business carried on by the assessee, or vice versa, and if the consideration for such transfer does not correspond with the market value of the goods or services then the profits and gains of the eligible business shall be computed as if the transfer was made at market value. However, if, in the opinion of the Assessing Officer, such computation presents exceptional difficulties, the Assessing Officer may compute the profits on such reasonable basis as he may deem fit.

The deductions claimed and allowed under this section shall not exceed the profits and gains of the eligible business. Further, where deduction is claimed and allowed under this section for any assessment year no deduction in respect of such profits will be allowed under any other section under this chapter.



*Caution* It has now been provided that if the aforesaid arrangement between the assessee carrying on the eligible business and any other person is a specified domestic transaction referred to in section 92BA, then, the amount of profit of such transaction shall be determined having regard to arm's length price as defined under section 92F and not as per the reasonable profit from such transaction.

Notes

**Self Assessment**

Fill in the blanks:

11. .... allows tax holiday to the new undertakings or existing undertakings on their substantial expansion in the States of Himachal Pradesh, Uttarakhand, Sikkim and North-Eastern States.
12. The tax holiday in the States of Himachal Pradesh and Uttarakhand will be 100% for the first five assessment years and ..... for the next five assessment years.
13. Tax holiday in the States of Sikkim and North-Eastern States will be ..... for ten assessment years commencing from the initial assessment year.

**7.4 Provisions for Tax Holiday**

Tax holiday in respect of profits and gains from eligible business of certain undertakings in North-Eastern States (Section 80-IE) will be discussed in this section. This section provides for an incentive to an undertaking which has during the period between 1st April, 2007 and 1st April, 2017, begun or begins, in any of the North-Eastern States (i.e., the States of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura) -

1. to manufacture or produce any eligible article or thing;
2. to undertake substantial expansion to manufacture or produce any eligible article or thing;
3. to carry on any eligible business.

Eligible article or thing means the article or thing other than the following:

- (a) goods falling under Chapter 24 of the First Schedule to the Central Excise Tariff Act, 1985 which pertains to tobacco and manufactured tobacco substitutes;
- (b) pan masala as covered under Chapter 21 of the First Schedule to the Central Excise Tariff Act, 1985;
- (c) plastic carry bags of less than 20 microns; and
- (d) goods falling under Chapter 27 of the First Schedule to the Central Excise Tariff Act, 1985 produced by petroleum oil or gas refineries.

Substantial expansion means increase in the investment in the plant and machinery by at least 25% of the book value of 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.

Eligible business means the business of -

- (a) hotel (not below two star category);
- (b) adventure and leisure sports including ropeways;
- (c) providing medical and health services in the nature of nursing home with a minimum capacity of 25 beds;
- (d) running an old-age home;
- (e) operating vocational training institute for hotel management, catering and food craft, entrepreneurship development, nursing and Para-medical, civil aviation related training, fashion designing and industrial training;
- (f) running information technology related training centre;

- (g) manufacturing of information technology hardware; and
- (h) Bio-technology.

Where the gross total income of an assessee includes any profits and gains derived by such an undertaking, a deduction of 100% of the profits and gains derived from such business for 10 consecutive assessment years commencing with the initial assessment year shall be allowed in computing the total income of the assessee. Initial assessment year means the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things, or completes substantial expansion.

However, the following conditions have to be fulfilled by the undertaking for claiming benefit of deduction under this section:

1. It should not be formed by splitting up, or the reconstruction, of a business already in existence (except in circumstances provided in section 33B)
2. It should not be formed by the transfer to a new business of machinery or plant previously used for any purpose exceeding 20% of the total value of machinery and plant used in the business.

For this purpose, any machinery or plant which was used outside India by any person other than the assessee shall not be regarded as machinery or plant previously used for any purpose if the following conditions are fulfilled:

- (a) such machinery or plant was not at any time used in India;
- (b) such machinery or plant is imported into India from any country outside India; and
- (c) no deduction on account of depreciation has been allowed in respect of such machinery or plant to any person earlier.

Where deduction has been allowed under this section in computing the total income of the assessee, no deduction shall be allowed under any other section contained in Chapter VIA or section 10AA in relation to the profits and gains of the undertaking. Further, no deduction shall be allowed to any undertaking under this section, where the total period of deduction inclusive of the period of deduction under this section, or under section 80-IC or under the second proviso to sub-section (4) of section 80-IB, as the case may be, exceeds 10 assessment years.

The profits and gains from the eligible business should be computed as if such eligible business were the only source of income of the assessee during the relevant assessment year.

The deduction under this section should not exceed the profits of such eligible business of the undertaking. The deduction shall be allowed only if the accounts are audited by a Chartered Accountant, who is also required to certify that the deduction has been correctly claimed. Further, the audit report should be furnished along with the return of income.

Where any goods or services held for the purposes of eligible business are transferred to any other business carried on by the assessee or, where any goods held for any other business are transferred to the eligible business and, in either case, if the consideration for such transfer as recorded in the accounts of the eligible business does not correspond to the market value thereof, then the profits eligible for deduction shall be computed by adopting market value for such goods or services. In case of exceptional difficulty in this regard, the profits shall be computed by the Assessing Officer on a reasonable basis.

Similarly, where due to the close connection between the assessee and the other person or for any other reason, it appears to the Assessing Officer that the profits of eligible business is increased to more than the ordinary profits, the Assessing Officer shall compute the amount of profits on a reasonable basis for allowing the deduction. The Central Government may notify that the benefit

**Notes**

conferred by this section shall not apply to any class of undertaking with effect from any specified date. Where any undertaking of an Indian company which is entitled to the deduction under this section is transferred before the expiry of the period of deduction to another Indian company in a scheme of amalgamation or demerger, no deduction shall be admissible to the amalgamating or demerged company for the previous year in which the amalgamation or demerger takes place and the amalgamated or the resulting company shall be entitled to the deduction as if the amalgamation or demerger had not taken place.

**Self Assessment**

State whether the following statements are true or false:

14. Substantial expansion means increase in the investment in the plant and machinery by at least 25% of the book value of plant and machinery, as on the first day of the previous year in which the substantial expansion is undertaken.
15. Where the gross total income of an assessee includes any profits and gains derived by such an undertaking, a deduction of 100% of the profits and gains derived from such business for 5 consecutive assessment years.
16. Where deduction has been allowed under this section in computing the total income of the assessee, only 25% deduction shall be allowed under any other section contained in Chapter VIA or section 10AA in relation to the profits and gains of the undertaking.
17. The profits and gains from the eligible business should be computed as if such eligible business were the only source of income of the assessee during the relevant assessment year.

**7.5 Application of the Above Special Conditions**

The application of the deduction available under special circumstance can be availed by an undertaking or an enterprise only on fulfilment of certain important conditions which though mentioned above are explained in detail below:

***Application of Section relating to Tax deductions by SEZ***

As per section 10A(7B) of the IT Act, deduction under section 10A can be claimed by the unit in SEZ, which has begun to manufacture or produce articles or things or computer software between 1st April 2000 to 31st March 2005. No deduction under section 10A will be allowed to the SEZ unit, which has begun (to manufacture or produce articles or things) on or after 1st April 2005 i.e. year ended 31st March 2006 (AY 2006-07).

As per the proviso to section 10AA(3) of the IT Act, if due to the application of 10A(7B), deduction under section 10A is not available to the eligible unit in SEZ, then the said unit shall be able to claim deduction under section 10AA for the unexpired period of 10 consecutive AYs.

From the above, it can be observed that proviso to section 10AA (3) entitles deduction for unexpired period of 10 consecutive AYs to an unit, which became ineligible to claim deduction under section 10A due to application of sub-section 7B of section 10A.

Section 10A (7B) makes those unit ineligible to claim deduction under section 10A, which have begun after 1st April 2005. Section 10AA (1) provides for deduction only to those units which began after 1st April 2005.

In view of the above, it is not clear that proviso to section 10AA (3) refers to which units to be eligible to claim deduction for the unexpired period. This is because by virtue of section 10A(7B), those units which have begun after 1 April 2005 are not eligible for deduction under section 10A as such units are automatically eligible to claim deduction under section 10AA as per proviso of

section 10AA(1). In case of such units, there cannot be question of unexpired period because they began only after 1st April 2005.

Section 80-IAB applies to any industrial undertaking which fulfils all the following conditions, namely:

1. It is not formed by splitting up, or the reconstruction, of a business already in existence:

Provided that this condition shall not apply in respect of an industrial undertaking which is formed as a result of the re-establishment, reconstruction or revival by the assessee of the business of any such industrial undertaking as is referred to in section 33B, in the circumstances and within the period specified in that section.

2. It is not formed by the transfer to a new business of machinery or plant previously used for any purpose.

3. It manufactures or produces any article or thing, not being any article or thing specified in the list in the Eleventh Schedule, or operates one or more cold storage plant or plants, in any part of India:

Provided that the condition in this clause shall, in relation to a small scale industrial undertaking or an industrial undertaking referred to in sub-section (4) shall apply as if the words "not being any article or thing specified in the list in the Eleventh Schedule" had been omitted.

*Explanation 1.* – For the purposes of clause (ii), any machinery or plant which was used outside India by any person other than the assessee shall not be regarded as machinery or plant previously used for any purpose, if the following conditions are fulfilled, namely: –

- (a) Such machinery or plant was not, at any time previous to the date of the installation by the assessee, used in India;
- (b) Such machinery or plant is imported into India 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 provisions of this Act in computing the total income of any person for any period prior to the date of the installation of the machinery or plant by the assessee.

*Explanation 2.* – Where in the case of an industrial undertaking, any machinery or plant or any part thereof previously used for any purpose is transferred to a new business and the total value of the machinery or plant or part so transferred does not exceed twenty per cent of the total value of the machinery or plant used in the business, then, for the purposes of clause (ii) of this sub-section, the condition specified therein shall be deemed to have been complied with.

4. In a case where the industrial undertaking manufactures or produces articles or things, the undertaking employs ten or more workers in a manufacturing process carried on with the aid of power, or employs twenty or more workers in a manufacturing process carried on without the aid of power.

Section 80-IC applies to any industrial undertaking which fulfils all the following conditions, namely:

This section applies to any undertaking or enterprise:

- (a) Which has begun or begins to manufacture or produce any article or thing, not being any article or thing specified in the Thirteenth Schedule, or which manufactures or produces any article or thing, not being any article or thing specified in the Thirteenth Schedule and undertakes substantial expansion during the period beginning:

**Notes**

- (i) On the 23rd day of December, 2002 and ending before the 1st day of April, 2012, 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 the scheme framed and notified by the Central Government in this regard, in the State of Sikkim; or
  - (ii) On the 7th day of January, 2003 and ending before the 1st day of April, 2012, 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 the scheme framed and notified by the Central Government in this regard, in the State of Himachal Pradesh or the State of Uttaranchal; or
  - (iii) On the 24th day of December, 1997 and ending before the 1st day of April, 2007, 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 the scheme framed and notified by the Central Government in this regard, in any of the North-Eastern States;
- (b) Which has begun or begins to manufacture or produce any article or thing, specified in the Fourteenth Schedule or commences any operation specified in that Schedule, or which manufactures or produces any article or thing, specified in the Fourteenth Schedule or commences any operation specified in that Schedule and undertakes substantial expansion during the period beginning –
- (i) On the 23rd day of December, 2002 and ending before the 1st day of April, 2012, in the State of Sikkim; or
  - (ii) On the 7th day of January, 2003 and ending before the 1st day of April, 2012, in the State of Himachal Pradesh or the State of Uttaranchal; or
  - (iii) On the 24th day of December, 1997 and ending before the 1st day of April, 2007, in any of the North-Eastern States.

***Section 80-IE applies to any industrial undertaking which fulfils all the following conditions, namely:***

This section applies to any undertaking which has, during the period beginning on the 1st day of April, 2007 and ending before the 1st day of April, 2017, begun or begins, in any of the North-Eastern States, –

- (i) to manufacture or produce any eligible article or thing;
- (ii) to undertake substantial expansion to manufacture or produce any eligible article or thing;
- (iii) to carry on any eligible business.

This section also applies to any undertaking which fulfils all the following conditions, namely:

- (i) it is not formed by splitting up, or the reconstruction, of a business already in existence:  
Provided that this condition shall not apply in respect of an undertaking which is formed as a result of the re-establishment, reconstruction or revival by the assessee of the business of any such undertaking as referred to in section 33B, in the circumstances and within the period specified in the said section;
- (ii) it is not formed by the transfer to a new business of machinery or plant previously used for any purpose.

**Explanation.** The provisions of Explanations 1 and 2 to sub-section (3) of section 80-IA shall apply for the purposes of clause (ii) of this sub-section as they apply for the purposes of clause (ii) of that sub-section.

Notwithstanding anything contained in any other provision of this Act, in computing the total income of the assessee, no deduction shall be allowed under any other section contained in Chapter VIA or in section 10A or section 10AA or section 10B or section 10BA, in relation to the profits and gains of the undertaking.

Notwithstanding anything contained in this Act, no deduction shall be allowed to any undertaking under this section, where the total period of deduction inclusive of the period of deduction under this section, or under section 80-IC or under the second proviso to sub-section (4) of section 80-IB or under section 10C, as the case may be, exceeds ten assessment years.

The provisions contained in sub-section (5) and sub-sections (7) to (12) of section 80-IA shall, so far as may be, apply to the eligible undertaking under this section. For the purposes of this section, –

- (i) **“initial assessment year”** means the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things, or completes substantial expansion;
- (ii) **“North-Eastern States”** means the States of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura;
- (iii) **“substantial expansion”** means increase in the investment in the plant and machinery by at least twenty-five per cent of the book value of 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;
- (iv) **“eligible article or thing”** means the article or thing other than the following : –
  - ❖ Goods falling under Chapter 24 of the First Schedule to the Central Excise Tariff Act, 1985 (5 of 1986) which pertains to tobacco and manufactured tobacco substitutes;
  - ❖ Pan masala as covered under Chapter 21 of the First Schedule to the Central Excise Tariff Act, 1985 (5 of 1986);
  - ❖ Plastic carry bags of less than 20 microns as specified by the Ministry of Environment and Forests vide Notification No. S.O. 705(E), dated the 2nd September, 1999 and S.O. 698(E), dated the 17th June, 2003; or
  - ❖ Goods falling under Chapter 27 of the First Schedule to the Central Excise Tariff Act, 1985 (5 of 1986), produced by petroleum oil or gas refineries;
- (v) **“eligible business”** means the business of hotel (not below two star category); adventure and leisure sports including ropeways; providing medical and health services in the nature of nursing home with a minimum capacity of 25 beds; running an old-age home, pertaining vocational training institute for hotel management, catering and food craft, entrepreneurship development, nursing and para-medical, civil aviation related training, fashion designing and industrial training; running information technology related training centre; manufacturing of information technology hardware; and bio-technology.

## Self Assessment

Fill in the blanks:

18. As per section 10A (7B) of the IT Act, deduction under section 10A can be claimed by the unit in .....

- Notes**
19. Section 10A (7B) makes those unit ineligible to claim deduction under section 10A, which have begun after .....
  20. Section 80-IC applies to any undertaking or enterprise which has begun or begins to manufacture or produce any article or thing, not being any article or thing specified in the .....
  21. ....means the States of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura.



Case Study

**Coimbatore Hi-tech Infrastructure (P) Ltd. vs Additional Commissioner of Income Tax, Range-I, Coimbatore**

The assessee is a company engaged in the business of developing Special Economic Zone (SEZ) at Keeranatham Village, Coimbatore. The assessee company has set up a sector specific SEZ for Information Technology and Information Technology Enabled Services. A SEZ is set up, approved and governed under the provisions of the Special Economic Zones Act (SEZ Act), 2005 and the Special Economic Zones Rules (SEZ Rules), 2006 made there under. The administration of the scheme is vested with the SEZ authority functioning under the Rules promulgated in 2009.

The assessee company has satisfied the conditions to be complied with for obtaining approval from the competent authority notified under the SEZ Act. The Department of Commerce in the Ministry of Commerce and Industry, Government of India has granted the approval to the assessee company for setting up the sector specific SEZ through their proceedings dated 20.8.2006. The SEZ set up by the assessee company has been notified by the concerned authority in Official Gazette as required under the SEZ Act, 2005. In short, the assessee company is fully approved to develop SEZ under the SEZ Act, 2005.

In view of the approval granted by the competent authority, the assessee company carried out its activities to set up the SEZ. As per the SEZ Act, 2005, the assessee is in the status of a Developer, who shall develop, operate and maintain the SEZ in terms of the SEZ Act, 2005 and the Rules made there under. A Developer for the purpose of the SEZ Act, 2005 also includes a Co-developer. After having developed SEZ as per the conditions laid down in the approval granted by the competent authority, the assessee has let out the developed lands to three parties in the previous year relevant to the assessment year under appeal. The three parties are M/s. Robert Bosch India Ltd., M/s. Cognizant Technology Solutions India (P) Ltd. and M/s. KGISL IT Parks (P) Ltd. The assessee has leased out 21.88 acres, 23.68 acres and 11.74 acres respectively.

As the assessee company is an approved and notified SEZ, it claimed deduction in respect of its income, being profits and gains arising from development of SEZ as provided under sec.80-IAB. The deduction provided under sec.80-IAB is 100% of the profits and gains by an undertaking or entrepreneur engaged in the development of SEZ. Accordingly, the assessee filed a 'NIL' return of income.

The Assessing Officer, in the course of assessment proceedings examined the case in detail. He found that the assessee has developed a SEZ as provided under the SEZ Act, 2005 in the specific sector of Information Technology and Information Technology Enabled Services. He examined the conditions laid down in the approval given by the competent authority. One of the conditions is that the assessee shall develop a minimum area of one lakhs square meters. The Assessing Officer found that the assessee has not completed that minimum

Contd...



built up area by the end of the previous year relevant to the assessment year under appeal. The Assessing Officer accordingly, pointed out a case of breach of one condition stipulated in the approval granted to the assessee as a SEZ. The assessing authority has observed in page 10 of his order that "It is apparent from the details filed that this condition has not been fulfilled by the assessee in order to qualify for the deduction".

The Assessing Officer further observed that the assessee company has derived income only in the form of lease premium on leasing out the lands to three different companies and the assessee company has not derived any profits and gains as a developer of the SEZ. According to the Assessing Officer, the income declared by the assessee company has not been derived from the business of developing SEZ. The reason to come to the above conclusion is that the assessee company has given the land on a perennial lease of 99 years with further scope of renewal, which in effect is nothing but a sale. Relying on the decision of the Hon'ble Supreme Court in the case of *R. Palshikar (HUF) v. CIT* (172 ITR 311), the Assessing Officer held that the long term lease of 99 years granted by the assessee company is nothing but sale of land. He, therefore, held that the income of the assessee company was in the nature of capital gains arising on sale of land. He accordingly, declined assessee's claim of deduction under sec.80-IAB.

Once the Assessing Officer denied the exemption to the assessee company under sec. 80-IAB, he also made certain other additions to the taxable income of the assessee company. The assessee company has created a provision for project development cost on the basis of estimates for different works to the extent of ₹ 24,60,28,194/-. The assessee has treated an amount of ₹ 7, 88, 47,215/- as proportionate project development cost for the unleased area, from the above total provision. It was accordingly, taken as stock inventory. The balance provision of ₹ 16,71,80,979/- has been claimed by the assessee as pertaining to leased out lands. According to the Assessing Officer, only an amount of ₹ 3,89,84,177/- was actually spent on the project in the previous year and even that amount was not taken as part of the closing stock. On the other hand, it was written off as expenses. The Assessing Officer therefore, held that the provision should be treated as relating to the development expenditure of land and, therefore, to be disallowed. Accordingly, the amount of ₹ 16, 71, 80,979/- was added to the income. The assessee has made a donation of ₹ 2 crores in the previous year and debited the profit and loss account. This amount was also disallowed by the Assessing Officer and added back to the income. Thus, finally, the Assessing Officer has determined a total income of ₹ 89, 89, 01,282/- in the hands of the assessee company.

The assessment went through different courts and the final verdict reflected that the assessee is an approved Developer of SEZ. The only activity carried on by the assessee is developing a sector specific SEZ. It has leased out the developed plots to the entrepreneurs who had obtained the letter of approval from the competent authority. Sec.80-IAB provides that setting up of a SEZ is the business of developing SEZ. Therefore, the assessee is not expected to perform any other activity than developing of a SEZ to qualify for deduction.

In the facts and circumstances of the case, we find that the lower authorities are not justified in refusing deduction under sec. 80-IAB. The claim of deduction made by the assessee under sec. 80-IAB is in accordance with law. The assessing authority is directed to give the deduction. Other issues raised in this appeal relating to different additions are only academic for the reason that those items, even if added to the total income of the assessee, are still part of 100% deduction available under sec. 80-IAB; so also is the ground raised by the assessee on taxing of dividend income. This principle has been upheld by the Hon'ble Bombay High Court in *CIT v. Punit Commercial Ltd.* (245 ITR 550). The assessing authority is therefore, directed to re-do the assessment after giving the assessee deduction under sec. 80-IAB. In result, this appeal filed by the assessee is allowed.

Contd...

Notes

**Questions**

1. Study and analyze the case.
2. Write down the case facts.
3. What do you infer from it?

Source: <http://taxguru.in/income-tax-case-laws/deduction-80iab-sez-developer-allowable-income-lease-rentals-developed-area.html>

**7.6 Summary**

- A Special Economic Zone (SEZ) is a specified, delineated and duty-free geographical region that has different economic laws from those of the country in which it is situated. In some countries, such a region is even treated as a deemed foreign territory.
- The Special Economic Zones and Tax Incentives offered as per the SEZ policy of India are indeed alluring. The Special Economic Zones and Tax Incentives offered covers areas like state and local taxes, levies, stamp duty and other duties. As per the Income-tax Act, 1961 there are a number of key tax benefits to be provided to SEZs and SEZ Units.
- As per section 10A(7B) of the IT Act, deduction under section 10A can be claimed by the unit in SEZ, which has begun to manufacture or produce articles or things or computer software between 1st April 2000 to 31st March 2005. No deduction under section 10A will be allowed to the SEZ unit, which has begun (to manufacture or produce articles or things) on or after 1st April 2005 i.e. year ended 31st March 2006 (AY 2006-07).
- As per the proviso to section 10AA(3) of the IT Act, if due to the application of 10A(7B), deduction under section 10A is not available to the eligible unit in SEZ, then the said unit shall be able to claim deduction under section 10AA for the unexpired period of 10 consecutive AYs.
- Section 80-IA(1) provides a ten year tax holiday to an assessee, whose gross total income includes any profits and gains derived by an undertaking or enterprise from an eligible business i.e., business referred to in sub-section (4) including industrial undertaking, SEZ, industrial parks, power generation, telecom and firms engaged in reconstruction of power unit.
- Infrastructure facility means a road, including toll road, a bridge or a rail system, a highway project including housing or other activities being an integral part of the highway project; a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system; and a port, airport, inland waterway or inland port or navigational channel in the sea.
- Any undertaking providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service or network of trunking (NOT), broadband network and internet services on or after 1st April, 1995 but on or before 31st March, 2005 can avail tax deductions.
- Sub-section (1) of Section 80-IAB provides for a deduction of 100% of profits and gains derived by an undertaking or an enterprise from any business of developing a SEZ for 10 consecutive assessment years. The deduction is available to an assessee, being a Developer, whose gross total income includes any profits and gains derived by an undertaking or an enterprise from any business of developing a SEZ, notified on or after 1st April, 2005 under the SEZ Act, 2005.
- Section 80-IC allows tax holiday to the new undertakings or existing undertakings on their substantial expansion in the States of Himachal Pradesh, Uttaranchal, Sikkim and

North-Eastern States. For this purpose, substantial expansion means increase in the investment in 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 tax holiday in the States of Himachal Pradesh and Uttarakhand will be 100% for the first five assessment years and 25% (30% in the case of a company) for the next five assessment years. However, tax holiday in the States of Sikkim and North-Eastern States will be 100% for ten assessment years commencing from the initial assessment year.
- Section 80-IE provides for an incentive to an undertaking which has during the period between 1st April, 2007 and 1st April, 2017, begun or begins, in any of the North-Eastern States (i.e., the States of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura) – to manufacture or produce any eligible article or thing; to undertake substantial expansion to manufacture or produce any eligible article or thing; and to carry on any eligible business.
- Eligible article or thing means the article or thing other than the goods falling under Chapter 24 of the First Schedule to the Central Excise Tariff Act, 1985 which pertains to tobacco and manufactured tobacco substitutes; pan masala as covered under Chapter 21 of the First Schedule to the Central Excise Tariff Act, 1985; plastic carry bags of less than 20 microns; and goods falling under Chapter 27 of the First Schedule to the Central Excise Tariff Act, 1985 produced by petroleum oil or gas refineries.
- Where the gross total income of an assessee includes any profits and gains derived by such an undertaking, a deduction of 100% of the profits and gains derived from such business for 10 consecutive assessment years commencing with the initial assessment year shall be allowed in computing the total income of the assessee. Initial assessment year means the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things, or completes substantial expansion.

## 7.7 Keywords

**Arms length price:** The price at which two unrelated and non-desperate parties would agree to a transaction.

**Assessing officer:** He or she is an officer of the Income tax department who has been given jurisdiction over a particular geographical territory or class of persons.

**Co-developer:** It implies a person who, or a State Government which has been granted a letter of approval by the Central Government under section 3(12) of the SEZ Act, 2005.

**Deduction:** Any item or expenditure subtracted from gross income to reduce the amount of income subject to tax.

**Developer:** It is a person who, or a State Government which has been granted a letter of approval by the Central Government under section 3(10) of the SEZ Act, 2005.

**Domestic satellite:** It is a satellite owned and operated by an Indian company for providing telecommunication services.

**Market Value:** It is the price at which an asset would trade in a competitive auction setting.

**Special Economic Zones (SEZs):** These are free trade zones, having completely different set of administrative and taxation laws outside the purview of customs authorities.

**Substantial expansion:** It means increase in the investment in the plant and machinery by at least 25% of the book value of plant and machinery as on the first day of the previous year in which the substantial expansion is undertaken.

**Notes**

**Telecom undertakings:** Any undertaking providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service or network of trunking (NOT), broadband network and internet services on or after 1st April, 1995 but on or before 31st March, 2005.

**7.8 Review Questions**

1. What do you understand by an infrastructure facility?
2. In order to be referred to as infrastructure facility what all conditions are to be fulfilled by an organisation?
3. Explain the deductions available to power undertakings.
4. Write a note on deductions available to undertakings for reconstruction or revival of power generating plants.
5. Differentiate between a developer and a codeveloper in context with calming deductions relating SEZ.
6. Explain the deduction available in respect of profits and gains by an undertaking or enterprise engaged in development of SEZ.
7. Comment of the statement, "Section 80-IC allows tax holiday to the new undertakings or existing undertakings on their substantial expansion in the states of Himachal Pradesh, Uttaranchal, Sikkim and North-Eastern States".
8. Describe the following in context with Section 80-IE of Income Tax Act:
  - (a) Eligible article or thing
  - (b) Substantial expansion
  - (c) Eligible business
9. Mention the conditions that are needed to be fulfilled by the undertaking for claiming benefit of deduction under Section 80-IE of Income Tax Act.
10. Mention the application criteria for taking the benefits of deductions available under special conditions of IT Act.

**Answers: Self Assessment**

- |                                    |                         |
|------------------------------------|-------------------------|
| 1. True                            | 2. True                 |
| 3. False                           | 4. False                |
| 5. True                            | 6. Ten                  |
| 7. Person who, or State Government | 8. Section 3(12)        |
| 9. Return of income                | 10. Profits             |
| 11. Section 80-IC                  | 12. 25%                 |
| 13. 100%                           | 14. True                |
| 15. False                          | 16. False               |
| 17. True                           | 18. SEZ                 |
| 19. 1st April 2005                 | 20. Thirteenth Schedule |
| 21. North-Eastern States           |                         |

## 7.9 Further Readings

Notes



Books

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## Unit 8: Tax Planning for Different Organisations

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### Objectives

After studying this unit, you will be able to:

- Discuss the decision regarding forms of organisations
- Describe tax planning for sole proprietorship
- Explain tax planning for partnership
- Elucidate tax planning for company

### Introduction

Talking about organisation forms, the enterprise types include individual proprietorship enterprise, partnership enterprise and limited corporation which can be divided into limited liability company and joint stock limited partnership. The tax system regulates different tax burden levels for the enterprises with different organisation forms, so the establishment costs and advantages of different organisation forms are different. The tax is one of factors we should consider when we select the organisation form of the enterprise. Especially when the organisation form of the enterprise has large influence to the production and management, the tax will be the

important factor which we should consider, and investors can select the organisation form of the enterprise to reduce the tax burden for the enterprise. So, before one can embark on a study of tax planning for different organisations, it is absolutely vital to understand the meaning of tax planning and the concept of various kinds of business organisations and the importance of tax planning in sole proprietorship, partnership and company. The purpose of this unit is to enable the students to comprehend basic expressions. Therefore, all such basic terms are explained and suitable illustrations are provided to define their meaning and scope.

## 8.1 Decision Regarding Forms of Organisations

A business organisation can be owned and organised in several forms. Each form of organisation has its own merits and demerits. The ultimate choice of the form of business depends upon the balancing of the advantages and disadvantages of the various forms of business. The right choice of the form of the business is very crucial because it determines the power, control, risk and responsibility of the entrepreneur as well as the division of profits and losses. Being a long term commitment, the choice of the form of business should be made after considerable thought and deliberation.

The various forms of organisation are established by state law. There are a wide variety of business organisations recognised by the states. In order for an organisation to run smoothly, decisions must constantly be made. How those decisions are made is an important factor in the success of a decision?



*Example:* A popular form of organisation is the Limited Liability Company. The LLC is a state designation. At the federal level, an LLC is taxed as a partnership. If the LLC so chooses, it can be taxed as a corporation at the federal level.



*Notes* The Limited Liability Company is a relatively new type of hybrid business structure that is now permissible in most states. It is designed to provide limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. Formation is more complex and formal than that of a general partnership. The owners are members, and the duration of the LLC is usually determined when the organisation papers are filed. The time limit can be continued if desired by a vote of the members at the time of expiration. LLC's must not have more than two of the four characteristics that define corporations: limited liability to the extent of assets; continuity of life; centralisation of management; and free transferability of ownership interests.

### 8.1.1 Forms of Business Organisations

Tax is not levied at the corporate level; instead all profits are fully distributed to the shareholders, and reported & taxed on each shareholder's 1040. On a profitable business, this will increase each shareholder's taxable income, and possibly move them to a higher tax bracket. The various forms of business organisations are as follows:

1. **Sole Proprietors:** A sole proprietorship is a one-man business. The owner is liable for all of the company's debts. Furthermore, the company's income is considered to be the owner's personal income and must be reported on the owner's individual income tax return. The advantage of this form of business organisation is simplicity; no partnership agreements need to be signed, there are no corporate registration formalities to perform, and there is no need for corporate formalities, such as shareholder's meetings.

Notes

2. **Partnerships:** In a general partnership, the business is owned by two or more general partners. Each of the partners is liable for the debts of the business. Although the partnership must file a separate tax return, each general partner is required to report his *pro rata* share of the partnership's income on his individual income tax return. A partnership agreement is a practical necessity for this form of business organisation.



*Did u know?* There are two types of partnership forms:

- (a) **Limited Liability Partnership** – at least one partner must have unlimited liability.
- (b) **Unlimited liability Partnership** – all partners have unlimited liability.

A deed of partnership must be drafted which set out the terms and conditions of the partnership. Various types of partners are as follows:

- (a) **Ordinary/General Partners:** take an active part in the running of the business.
  - (b) **Sleeping Partners:** invest in the business but do not take an active part in the business.
  - (c) **Limited Liability Partners:** assets will not be lost if the business goes bankrupt.
3. **Company:** A company is meant an association of many persons who contribute money or money's worth to a common stock and employs it in some trade or business, and who share the profit and loss (as the case may be) arising there from. The common stock contributed is denoted in money and is the capital of the company. The persons who contribute it, or to whom it belongs, are members. The proportion of capital to which each member is entitled is his share. Shares are always transferable although the right to transfer them is often more or less restricted. The main essential features of a company are as below:
- (a) **Registration:** According to the Company Act 1994, registration is compulsory for a company. And a company comes into effect as a company after its registration.
  - (b) **Voluntary association:** The members of the company must be associated with their free consent and according to the choices of their purposes.
  - (c) **Contractual capacity:** A shareholder of a company can come into a contract with company and can be an employee of the company.
  - (d) **Management:** The Company and its whole functions must be managed by the Board of Director as formatted as prescribed in The Company Act 1994 and the Memorandum of Association of a company.
  - (e) **Capital:** Without capital a company can not run its functions.
  - (f) **Perpetual succession:** The Company has a perpetual succession. Death or insolvency of the shareholders of a company can not affect the existence of a company.
  - (g) **Registered office:** A company must have a registered office.
  - (h) **Seal:** A company must have a common seal to run its functions.
  - (i) **Limitation of liability:** The liabilities of a shareholder of a company are always limited.
  - (j) **Transferable share:** He shares of a company are always transferable.
  - (k) **Capacity to sue:** A company is capable to sue to any matter in any competent court.



## 8.1.2 Factors Involved in Selection of Organisation

Notes

One of the decision factors includes how profitable your business is, and how much of those profits you want distributed to you versus re-investing the profits back into the business. The choice of the form of business is governed by several interrelated and interdependent factors:-

1. **The nature of business is the most important factor:** Businesses providing direct services like tailors, restaurants and professional services like doctors, lawyers are generally organised as proprietary concerns. While, businesses requiring pooling of skills and funds like accounting firms are better organised as partnerships. Manufacturing organisations of large size are more commonly set up as private and public companies.
2. **Scale of operations:** That is volume of business (large, medium, and small) and size of the market area (local, national, international) served is the key factors. Large scale enterprises catering to national and international markets can be organised more successfully as private or public companies. Small and medium scale firms are generally set up as partnerships and proprietorship. Similarly, where the area of operations is wide spread (national or international), company ownership is appropriate. But if the area of operations is confined to a particular locality, partnership or proprietorship will be a more suitable choice.
3. **The degree of control desired by the owner(s):** A person, who desires direct control of business, prefers proprietorship, because a company involves separation of ownership and management.
4. **Amount of capital required for the establishment and operation of a business:** A partnership may be converted into a company when it grows beyond the capacity and resources of a few persons.
5. The volume of risks and liabilities as well as the willingness of the owners to bear it is also an important consideration.
6. Comparative tax liability.

### Self Assessment

Fill in the blanks:

1. Being a ..... term commitment, the choice of the form of business should be made after considerable thought and deliberation.
2. A ..... is a one-man business.
3. A ..... may be converted into a company when it grows beyond the capacity and resources of a few persons.
4. A ..... is meant an association of many persons who contribute money or money's worth to a common stock and employs it in some trade or business, and who share the profit and loss (as the case may be) arising there from.



Caselet

### Involving Limited Liability Companies and Registered Limited Liability Partnerships

The plaintiff sued her employer for hostile work environment and related claims. The complaint inaccurately identified the employer as a partnership rather than an LLC. The LLC's lawyer contacted the plaintiff's lawyer informing her of the mistake

Contd...

Notes

and offering to accept service of an amended complaint. The complaint was not amended, and the court dismissed it. A year and half later, an amended complaint was filed. In the new complaint, the plaintiff misidentified the LLC as a corporation. Two months later, after limitations had run, the defendant moved to dismiss the complaint, and the plaintiff moved to amend. The trial court denied the motion to amend and granted the motion to dismiss. The plaintiff appealed, arguing the trial court abused its discretion in finding inexcusable neglect on the part of the plaintiff. The plaintiff's lawyer explained that her files had been moved to off-site storage during the time the plaintiff was deciding whether to pursue a second lawsuit, and she did not have access to the documents showing the defendant was an LLC. The court took issue with this argument, stating that the plaintiff's lawyer chose not to access her files and to use the Washington Secretary of State's web site instead. The court acknowledged that the information in the web site is confusing in that LLC information is contained in the corporations' database and refers to the "state of incorporation" and "date of incorporation." Under "category," the site indicated the defendant was a "limited liability regular." The plaintiff's lawyer assumed that LLC meant Limited Liability Corporation. The court stated that the plaintiff's lawyer had no justification for assuming that the defendant was a corporation given the notice she received in the first lawsuit, the information obtained in the database search, and the availability of the LLC statute. The court concluded the failure to name the defendant as an LLC was inexcusable neglect and that the trial court's dismissal of the suit and award of attorney's fees to the defendant was proper.

Source: <http://apps.americanbar.org/buslaw/newsletter/0006/materials/llc1p.pdf>

## 8.2 Tax Planning for Sole Proprietorship

The term 'sole' means single and 'proprietorship' means 'ownership'. So, only one person is the owner of the business organisation. This means, that a form of business organisation in which a single individual owns and manages the business, takes the profits and bears the losses, is known as sole proprietorship form of business organisation. A sole proprietorship is the simplest form of business ownership. A sole proprietorship has but one owner. That sole owner may engage in any form of legal business activity any time and anywhere. Other than the various local and state business licenses that every business must purchase regardless of type of ownership, no legal formalities are required to start or operate the business. The owner is responsible for securing and investing the funds for the business. These funds may come from the owner's existing or borrowed financial resources.

The sole proprietorship is the oldest, simplest, and most common form of business entity. It is a business owned by a single individual. For tax and legal liability purpose, the owner and the business are one and the same. The proprietorship is not taxed as separate entity.



**Caution** The earnings of the business are taxed at the individual level, whether or not they are actually in cash. There is no vehicle for sheltering income.

For liability purposes, the individual and the business are also one and the same. Thus, legal claimants can pursue the personal property of the proprietor and not simply the assets used in the business.



*Notes* As a self-employed individual, one can have a number of income tax planning opportunities. Here are some which one may wish to consider:

1. **Shifting and Timing Income:** Shifting income to family members can be an important tax planning technique. If you run your own business, your ability to shift income to a family member who is in a lower marginal tax bracket can be a significant advantage. Your relative may benefit from the increased income and you may benefit by the decreased tax liability. It's also possible that the overall amount of federal income taxes paid by the two of you would be lower. But be aware that the IRS could question an unreasonable amount of compensation paid to a family member, considering the services actually provided by the family member.

As a self-employed taxpayer, you also have greater control and flexibility on timing the receipt of your income. This means that you have more control when you pay tax on the income.

2. **Planning Retirement:** Establishing a retirement plan is another tax planning advantage for the self-employed. If you're self-employed and have no employees, a qualified retirement plan may allow you to place pre-tax dollars into a retirement account to grow tax deferred until withdrawal. If you have employees, your business may have to provide coverage for them as well. The type of retirement plan that your business should establish depends on your specific circumstances.
3. **Reviewing Employee Benefit Plans:** Aside from retirement plans, there are other employee benefit plans – such as cafeteria plans and medical benefit plans. Employee benefit plans play an important role in attracting and retaining employees. Sole proprietors may also derive certain limited benefits under these plans.
4. **Considering Business Expenses and Other Deductions:** Make sure your business is taking advantage of all of the deductions it's entitled to, including deductions for certain start-up costs. For instance, you may be able to deduct a portion of the expenses for a business trip even when the trip is combined with vacation. Other key deductions that you should consider include the use of a home office, automobiles and business assets.

A sole proprietorship is an individual (or married couple) who owns a business which is not otherwise incorporated or organised as a separate legal entity (i.e., there is no partnership, limited liability company, corporation, etc.). Putting it differently, sole proprietorships are businesses where an individual conducts business and holds title to property in his or her name and is directly and personally liable for the obligations of the business. There is no corporate entity or other legal device employed to hold the business assets or ameliorate the liability of the owner for any debts or obligations of the business.

Despite the personal liability that comes with the sole proprietorship, this form can be preferable where the owner contemplates no complex financing and no co-owner relationships with other parties. In fact, there are 15 to 20 million sole proprietorships in the United States. This comprises over 80% of the businesses in the United States!

Maintenance costs are very low for the sole proprietorship. Apart from any "doing business as" filings necessary if the sole proprietorship is using a name different from that of its owner, no documentation is needed to organise a sole proprietorship and no special record-keeping or corporate formality is necessary. You would not even need an attorney to form this type of business entity. By hanging out a sign, you have opened up a sole proprietorship.

**Notes**

Unlike other forms of business entities, there are no specific statutes governing the creation and existence of sole proprietorships. Instead, basic rules of contract law, tort law, and property law will apply. In addition to these basic concepts, all regulatory restrictions applied to businesses generally will apply to the sole proprietorship (e.g., environmental laws, civil rights laws, etc.).

The existence of the sole proprietorship ends upon the death of the owner and the property of the business will be disposed of according to the terms of the owner's will. All assets of the sole proprietorship are owned by the owner as personal property. On the whole, if you are planning to have a business of any sophistication, you probably want to avoid this entity.

According to the IRS, you're self-employed if you carry on a trade or business as a sole proprietor, an independent contractor, a member of a partnership or if you're otherwise in business for yourself. You can be a full-time employee and still have self-employment income from a side job. To determine whether a particular income is self-employment income (rather than employee wages, for example), look at the source of your income and the extent of your involvement in the activity. If you're self-employed, understand the self-employment tax and be aware of the tax planning opportunities.



*Caution* The Internal Revenue Service (IRS) permits one exception to the "one sole owner" rule. If the spouse of a married sole proprietor works for the firm but is not classified as either a partner or an independent contractor, the business may still be considered to be a sole proprietorship and forgo having to submit a partnership income tax return. Also, the sole proprietorship can avoid self-employment taxes.

One major area of concern for many self-employed individuals is the high cost of health insurance. Fortunately, some of your health-care related expenses may be tax deductible.



*Example:* You may be eligible for the self-employed health insurance deduction, which would enable you to deduct the cost of health insurance that you provide for yourself, your spouse and your dependents. This deduction is taken on the front of your federal Form 1040 (i.e., "above-the-line") when computing your adjusted gross income, so it's available whether you itemise or not.

Contributions you make to a Health Savings Account (HSA) are also deductible "above-the-line." An HSA is a tax-exempt trust or custodial account you can establish in conjunction with a high-deductible health plan to set aside tax-free funds for health-care expenses.

Its main features are as follows:-

1. Ease of formation is its most important feature because it is not required to go through elaborate legal formalities. No agreement is to be made and registration of the firm is also not essential. However, the owner may be required to obtain a license specific to the line of business from the local administration.
2. The capital required by the organisation is supplied wholly by the owner himself and he depends largely on his own savings and profits of his business.
3. Owner has a complete control over all the aspects of his business and it is he who takes all the decisions though he may engage the services of a few others to carry out the day-to-day activities.
4. Owner alone enjoys the benefits or profits of the business and he alone bears the losses.
5. The firm has no legal existence separate from its owner.
6. The liability of the proprietor is unlimited i.e. it extends beyond the capital invested in the firm.

7. Lack of continuity i.e. the existence of a sole proprietorship business is dependent on the life of the proprietor and illness; death etc. of the owner brings an end to the business. The continuity of business operation is therefore uncertain.

Notes

### 8.2.1 Tax Aspects of a Proprietorship

When filing an income tax return, no legal distinction exists between a person as a sole proprietor and an individual person. The sole proprietor's personal income tax return (Form 1040) must include calculation of the proprietorship's income tax as well as any income or loss that the owner incurs from any additional entity, such as an employee, investor, or the like. The tax code treats the sole proprietorship and the owner as one and the same: income earned by the business is seen as income of the owner and must be reported on the owner's IRS Form 1040. Expenses of the business are also claimed by the owner as deductions against income on the owner's year-end tax return.

Another important point to remember about sole proprietorships is that sole proprietorships are taxed on all net income; there is no way for your small business to retain earnings without you being taxed on that money. So if you expect or want to use income from the business to grow (i.e., you are going to reinvest the profits back into the business), you may want to consider creating a C-corporation.

#### Computation of Tax Liability of the Individual

The tax liability of the Individual on its taxable income is computed in the following manner:

- (i) Ascertain the 'total income' of the individual by aggregating incomes falling under following four heads:-
  - (a) Income from House Property, whether residential or commercial, let-out or self-occupied. However, house property used for purpose of individual's business does not fall under this head.
  - (b) Profits and Gains of Business or Profession.
  - (c) Capital Gains.
  - (d) Income from other sources including interest on securities, winnings from lotteries, races, puzzles, etc.
- (ii) To the total income so obtained, 'current and brought forward losses' should be adjusted for set off in subsequent assessment years to arrive at the gross total Income. The total income so computed is the 'gross total income'.
- (iii) From the gross total income, prescribed 'deductions' of the Income Tax Act, 1961 shall be made to get the 'net income'. Generally, all expenses incurred for business purposes are deductible from taxable income, given that the expenses must be wholly and exclusively incurred for business purposes and also that the expenses must be incurred/paid during the previous year and supported by relevant papers and records. But expenses of personal or of capital nature are not deductible. Capital expenditure is deductible only through depreciation or as the basis of property in determining capital gains/losses. But no deduction shall be allowed in respect of any expenditure incurred in relation to income which does not form part of total income.
- (iv) Tax liability is computed on the 'net income' that is chargeable to tax. It is done either on accrual basis or on receipt basis (whichever is earlier). However if an income is taxed on accrual basis, it shall not be taxed on receipt basis.
- (v) From the tax so computed, tax rebates or tax credit are deducted.

## Notes

Tax Rates for Individuals, HUF's, AOPs, BOIs for the A.Y.2012-13 is shown in Table 8.1:

<b>Table 8.1: Tax Rates for Individuals, HUF's, AOPs, BOIs for the A.Y.2012-13</b>	
<b>For Resident Women (Age limit = below 60 years)</b>	
Up to ₹ 1,90,000	NIL
₹ 1,90,001 to ₹ 5,00,000	10 per cent
₹ 5,00,001 to ₹ 8,00,000	20 per cent
₹ 8,00,000 and above	30 per cent
<b>For Resident Senior Citizens (Age limit = 60 years or more at any time during the year but not more than 80 years on the last day of the year)</b>	
Up to ₹ 2,50,000	NIL
₹ 2,50,001 to ₹ 5,00,000	10 per cent
₹ 5,00,001 to ₹ 8,00,000	20 per cent
₹ 8,00,000 and above	30 per cent
<b>For Resident Super Senior Citizens (Age Limit = 80 years or more at any time during the year)</b>	
Up to ₹ 5,00,000	NIL
₹ 5,00,001 to ₹ 8,00,000	20 per cent
₹ 8,00,000 and above	30 per cent
<b>For any other individual, every HUF /AOP / BOI artificial juridical person</b>	
Up to ₹ 1,80,000	NIL
₹ 1,80,001 to ₹ 5,00,000	10 per cent
₹ 5,00,001 to ₹ 8,00,000	20 per cent
₹ 8,00,001 and above	30 per cent

Source: <http://tax-india.blogspot.in/2011/06/income-tax-rates-for-ay2012-13.html>

## 8.2.2 Advantages of Sole Proprietorship

Perhaps the greatest advantage of this form of business is its simplicity and low cost. You are not required to file with the government, nor are any legal charter required. The sole proprietorship form of business has other advantages:

1. The owner or proprietor is in complete control of business decisions.
2. The income generated through operations can be directed into the proprietor's pocket or reinvested as he or she sees fit.
3. Profits flow directly to the proprietor's personal tax return; they are not subject to a second level of taxation. In others words, profits from the business will not be taxed at the business level.
4. The business can be dissolved as easily and informally as it was begun.

These advantages account for the widespread adoption of the sole proprietorship in the India. Any person who wants to set up shop and begin dealing with customers can get right to it, in most cases without the intervention of government bureaucrats or lawyers.

### 8.2.3 Disadvantages of Sole Proprietorship

This legal form of organisation, however, has disadvantages:

1. The amount of capital available to the business is limited to the owner's personal funds and whatever funds can be borrowed. This disadvantages limits the potential size of the business, no matter how attractive or popular its product or service
2. Sole proprietors have unlimited liability for all debts and legal judgments incurred in the course of business. Thus, a product liability lawsuit by a customer will not be made against the business but rather against the owner.
3. The business may not be able to attract high-calibre employees whose goals include a share of business ownership. Sharing the benefits of ownership, other than simple profit-sharing, would require a change in the legal form of the business.
4. Some employee benefits, such as owner's life, disability, and medical insurance premiums, may not be deductible, or may be only partially deductible from taxable income.
5. The entity has a limited life; it exists only as long as the owner is alive. Upon the owner's death, the assets of the business go to his or her estate.

### Self Assessment

State whether the following statements are true or false:

5. Sole proprietorship is not owned by a single individual.
6. Maintenance costs are very high for the sole proprietorship.
7. Expenses of the business are also claimed by the owner as deductions against income on the owner's year-end tax return.
8. Sole proprietors have unlimited liability for all debts and legal judgments incurred in the course of business.

### 8.3 Tax Planning for Partnership

Partnership is the most common form of business organisation in India. Partnership firms are governed by the provisions of the Indian Partnership Act, 1932. The Act lays down the rules relating to formation of partnership, the rights and duties of partners and dissolution of partnership. It defines partnership as a "relationship between persons who have agreed to share the profits of business carried on by all or any of them acting for all". This definition gives three minimum requirements to constitute a partnership:-

1. There must be an agreement entered into orally or in writing by the persons who desire to form a partnership.
2. The object of the agreement must be to share the profits of business intended to be carried on by the partnership.
3. The business must be carried on by all the partners or by any of them acting for all of them.

Under the Act, persons who have entered into partnership with one another are individually called as 'partners' and collectively as 'firm' and the name under which they run their business is called the 'firm name'.

A partnership is a common vehicle in India for carrying on business activities (particularly trading) on a small or medium scale. A profession is generally carried on through a partnership.

**Notes**

There is no restriction on a company's participation in a partnership, but this is rare in practice. Under the general law a partnership is not a separate entity distinct from the partners, but for tax purposes a partnership is an entity. Partnership firm arises from a contract between two or more persons who contribute some tangible and some intangible assets together with an objective of earning profit there from which will be shared between them in predefined portion. Therefore,

1. The firm should be evidenced by an instrument [Section 184(1i)].
2. The individual shares of the partners in the asset of the firm and the profits (or losses) should be specified in the instrument [Section 184(1ii)].
3. A certified copy of the instrument of partnership shall accompany the return of income of the previous year in respect of which assessment of the firm is first sought [Section 184(2)].
4. Whenever changes take place in the constitution of the firm due to death or resignation of the partner or in the profit sharing ratio of the existing partners, a certified copy of the revised instrument of partnership shall be submitted along with return of income of the related year. Where a minor is admitted to the benefit of the firm and the shares of the partners are unequal, it is necessary to specify how the shares of loss of the minor will be borne by the major partner.

The provisions related to the taxation of partnership firms are included in Chapter XVI of the Income Tax Act, 1961. U/s 184(1) of the Act, with effect from April 1, 1993 a firm shall be assessed as a partnership firm (PFAS), if the given conditions are satisfied as follows:

1. Partnership is evidenced by a partnership deed and a certified copy thereof, which is duly signed by all partners, and is filed along with the Return of Income (ROI).
2. Individual shares (profit/loss) of all the partners are also specified in the instrument i.e. in the partnership deed
3. Whenever there is some change in the constitution of the firm, then the firm requires furnishing along with the ROI, the certified copy of the partnership deed that is duly signed by all the partners.
4. A change in constitution of the firm has been defined under section 187 of the Act which includes admission of new partner(s), retirement of existing partner(s) as well as any change in the profit/loss-sharing-ratio and excludes dissolution of the firm in case of death of any of its partners.

### **8.3.1 Position of Firm under the Income Tax Act**

Legally, a partnership firm does not have a separate entity from that of the partners constituting the firm as the partners are the owners of the firm. However, a firm is treated as a separate tax-entity under the Income-tax Act. Salient features of the assessment of a firm are as under:

1. A firm is treated as a separate tax entity.
2. While computing the income of the firm under the head 'Profits and gains of business or profession', besides the deductions which are allowed u/s 30 to 37, special deduction is allowed to the firm on account of remuneration to working partners and interest paid to the partners. However, it is subject to certain limits laid down u/s 40(b).
3. Share of profit which a partner receives from the firm (after deduction of remuneration and interest allowable) shall be fully exempt in the hands of the partner. However, only that part of the interest and remuneration which was allowed as a deduction to the firm shall be taxable in the hands of the partners in their individual assessment under the head 'profits and gains of business or profession'.



4. The firm will be assessed as a firm provided conditions mentioned under section 184 are satisfied. In case these conditions are not satisfied in a particular assessment year, although the firm will be assessed as firm, but no deduction by way of payment of interest, salary, bonus, commission or remuneration, by whatever name called, made to the partner, shall be allowed in computing the income chargeable under the head “profits and gains of business or profession” and such interest, salary, bonus, commission or remuneration shall not be chargeable to income-tax in the hands of the partner.

### 8.3.2 Provisions Relating to Taxation of Partnership Firms

The partnership firm is taxed as a separate entity, with no distinction as registered and unregistered firms. A partnership firm is or required to submit a copy of the partnership deed in the first year of assessment and later on only if there is a change in the terms/constitution of partnership. In computing the total income of the firm, any salary bonus, commission or remuneration, to a partner, shall be deductible subject to certain restrictions Partnership firm is subjected to taxation under the Income Tax Act, 1961. It is the umbrella Act for all the matters relating to income tax and empowers the Central Board of Direct Taxes (CBDT) to formulate rules (the Income Tax Rules, 1962) for implementing the provisions of the Act. The CBDT is a part of Department of Revenue in the Ministry of Finance. It has been charged with all the matters relating to various direct taxes in India and is responsible for administration of direct tax laws through the Income Tax Department. The Income Tax Act is subjected to annual amendments by the Finance Act, which mentions the ‘rates’ of income tax and other taxes for the corresponding year.

Under the Income Tax Act, the Partnership firm is taxed as a separate entity, distinct from the partners. In the Act, there is no distinction between assessment of a registered and unregistered firms. However, the partnership must be evidenced by a partnership deed. The partnership deed is a blue print of the rights and liabilities of partners as to their capital, profit sharing ratio, drawings, interest on capital, commission, salary, etc, terms and conditions as to working, functioning and dissolution of the partnership business.

Under the Act, a partnership firm may be assessed either as a partnership firm or as an association of persons (AOP). If the firm satisfies the following conditions, it will be assessed as a partnership firm, otherwise it will be assessed as an AOP:-

1. The firm is evidenced by an instrument i.e. there is a written partnership deed.
2. The individual shares of the partners are very clearly specified in the deed.
3. A certified copy of partnership deed must accompany the return of income of the firm of the previous year in which the partnership was formed.
4. If during a previous year, a change takes place in the constitution of the firm or in the profit sharing ratio of the partners, a certified copy of the revised partnership deed shall be submitted along with the return of income of the previous years in question.
5. There should not be any failure on the part of the firm while attending to notices given by the Income Tax Officer for completion of the assessment of the firm.

It is more beneficial to be assessed as a partnership firm than as an AOP, since a partnership firm can claim the following additional deductions which the AOP cannot claim:-

1. Interest paid to partners, provided such interest is authorised by the partnership deed.
2. Any salary, bonus, commission, or remuneration (by whatever name called) to a partner will be allowed as a deduction if it is paid to a working partner who is an individual. The remuneration paid to such a partner must be authorised by the partnership deed and the amount of remuneration must not exceed the given limits.

Notes

### 8.3.3 Income Tax Rates for Partnership Firm A.Y. 2012-13, 2011-12, 2010-11 and 2009-10

Income Tax rates applicable on partnership firm are listed below. Basic rates were unchanged in last four years however effective rates were reduced after removal of surcharge from firm tax.

**Table 8.2: Income Tax Rates for Partnership Firm**

FIRM	2009-10	2010-11	2011-12	2012-13
Tax Rate	30%	30%	30%	30%
Surcharge (if net income exceeds 1 Crore)	10%	-	-	-
Edu. Cess & SHE Cess	3%	3%	3%	3%

Source: <http://www.itaxindia.org/2011/10/income-tax-rates-for-partnership-firm.html>

### 8.3.4 Advantages of a Partnership

Following are the advantages of a partnership:

- Partnerships are relatively easy to establish; however time should be invested in developing the partnership agreement.
- With more than one owner, the ability to raise funds may be increased.
- The profits from the business flow directly through to the partners' personal tax return.
- Prospective employees may be attracted to the business if given the incentive to become a partner.
- The business usually will benefit from partners who have complementary skills.

### 8.3.5 Disadvantages of a Partnership

Following are the disadvantages of a partnership:

- Partners are jointly and individually liable for the actions of the other partners.
- Profits must be shared with others.
- Since decisions are shared, disagreements can occur.
- Some employee benefits are not deductible from business income on tax returns.
- The partnership may have a limited life; it may end upon the withdrawal or death of a partner.

### Self Assessment

Fill in the blanks:

- Partnership firms are governed by the provisions of the .....
- A ..... is generally carried on through a partnership.
- The partnership firm is taxed as a ..... entity.
- Under the Act, a partnership firm may be assessed either as a partnership firm or as an .....

## 8.4 Tax Planning for Company

Notes

Section 3(1)(i) of the Companies Act, 1956 defines a company as “a company formed and registered under this Act or an existing company”. Section 3(1)(ii) Of the act states that “an existing company means a company formed and registered under any of the previous companies laws”. A company is a separate legal entity. As such, it is able to hold property in its own name, sue and be sued and function separately from its owners. Individuals contribute capital to a company and are known as shareholders. It is the shareholders in the company directors who in turn will appoint managers for the day to day running of the business.

Tax planning is relevant in cases of surviving an audit, capitalising on company deductions and engaging a friendly tax regime to run a business. Planning of taxes should be done in an efficient manner so as not to jeopardise the business goals of expansion, profits and growth. Minimising the tax liability can provide more funds for the company and it can especially be useful in case of small businesses in need of more money than established firms or organisations for expansion of their activities. This source of increased funds can be utilised for larger expenses as a form of investment or even as a source for working capital. Deferring taxes is often a most popular way of tax planning as it allows the company to use the money interest free and sometimes even earn interest on the money until the next time when taxes will be due. Some of the general issues covering tax planning are choice of accounting and inventory valuation methods, the timing of purchase of necessary equipments and selection of tax-favoured benefit plans and investments.

As we know that in corporate tax planning, companies formulate strategies that are significant in minimising taxes. Some valuable ways to save include sponsoring a retirement plan, writing off company assets, claiming depreciation expense, taking deductions on business automobiles, office expenses, self employment health insurance, and employer sponsored child care resources, and using a home office for the company. Business tax planning involves understanding what it means to be self-employed. A company owner needs to be aware of anything that might impact taxes paid. Self-employment tax, company expenses and deductions, business assets, charitable contributions, shifting income, and retirement planning are important considerations.

Self-employment tax is due from those who are receiving income as an independent contractor, sole proprietor, or anyone who is conducting business through selling services or products. Corporate tax planning provides some ways that a business owner can save on income taxes both short-term and long-term. Income received must be reported but deductions can reduce the amount that is actually owed. The deductions can vary depending upon the type of industry and what are considered legitimate deductions.

Some company owners shift income to a family member as a tax advantage. In order to do this a family member must be providing some benefit to the business and the amount should be in line with the type of compensation. Shifting income legitimately can lower a company into a lower tax bracket. Of course the shifting of income to a family member could raise their income bracket and this should be considered. This is a business tax planning venture that should benefit both parties and should be done ethically and reasonably. To shift a large amount of income to a family member just to avoid paying taxes would be unethical unless there were a legitimate reason such as payment for services.

A retirement plan is a tax advantage to a person who is self-employed. This can be done with or without employees. However, it would affect the type of plan that is embraced. A self-employed person can place pre-tax dollars into a retirement account. Having employees mean providing for them the capability of doing the same. A company owner can also choose other employee benefit plans to attract employees. Corporate tax planning involves looking out for employees by offering retirement, cafeteria and medical benefit plans. Cafeteria plans allow employees to use a portion of pre-tax income for medical or child care expenses.

There are many deductions that a company can take advantage of including start-up costs, business trip expenses, home office use, the use of automobiles, and other assets. The costs of

**Notes**

health care expenses are often deductible especially for the owner and dependents. In addition, any contributions made to a health savings account are also deductible expenses. Business tax planning includes knowing what plans provide the greatest benefits and implementing those plans to not only provides benefits to the company but benefits to employees as well.

When starting up a company many of the initial expenses can be written off up to a certain dollar amount. Some of these may include personal property like furniture or office equipment. Other things that can be written off the first year of purchase include machinery, fixtures, storage facilities, and other personal property. Other considerations when starting up a business include travel, vehicle usage, home office, and uniforms. Corporate tax planning sources suggests making sure that write-offs are legitimate business expenses. When using a home office for company use only a percentage of expenses can be written off. Travel expense can only apply when the travel is for the company. Combining company business with personal business must be taken into consideration for any type of write-off to be legitimate.

There is a degree of burden that is felt from tax legislation by any and every owner. However, there are positive ways that a corporation can comply with obligations and find ways to develop a strong company otherwise. Business tax planning includes taking advantage of opportunities to provide relief when possible. A corporate planning attorney can provide some good advice on how to structure a company to be optimally successful while remaining compliant with considerations such as paying taxes. Information can be found on the Internet that can help prepare a new business owner with how to be compliant in every area when it comes to reporting income and deducting expenses.



*Task* You are an individual who wishes to know the most suitable form of organisation among Sole Proprietorship, Partnership and Company. How would you deal with the following questions which are given below?

1. What is the most appropriate structure for me, should I become a company?
2. Should I employ my spouse or children or bring them in as partners?
3. I am a partnership, what about introducing a company as a partner. What are the benefits and downsides?

Charitable contributions are a great way for a company to save on taxes and help those in the community. Many non profit organisations are set up to help those who are less fortunate within the community that they reside and some offer services to anyone who they can help no matter where they are located. There are limits on how much of a contribution that can be counted and the organisation has to fit the guidelines used by the IRS to be considered a legitimate charitable organisation. Some of the ones who usually do qualify are churches, educational companies, scientific or medical research institutions, those that provide true charitable services and organisations who help animals. There is more information on the Internet about organisations that truly qualify as charitable.

**Self Assessment**

State whether the following statements are true or false:

13. It is the shareholders in the company directors who in turn will appoint managers for the day to day running of the business.
14. Maximising the tax liability can provide more funds for the company and it can especially be useful in case of small businesses in need of more money than established firms or organisations for expansion of their activities.

15. A retirement plan is a tax advantage to a person who is self-employed.
16. A company owner needs to be aware of anything that might impact taxes paid.

Notes



### Case Study **A Self-employed IT Consultant**

Opes Wealth Trust met with Brian, a 41 year old self-employed IT Consultant earning €140,000 per annum. Brian is married to Emma and they have two children aged 7 and 4. They have a mortgage-free home. They have no Will in place. Opes Wealth Trust began the 'Financial Solutions Service' by firstly carrying out a detailed fact-finding exercise with Brian and Emma, followed by a comprehensive financial planning exercise.

We have detailed below some of the specific findings.

1. We have helped Brian and Emma identify their financial objectives and the level of lifestyle income they desire at their desired target date (when Brian is aged 60).
2. We outlined the capital fund required to meet this target.
3. We assessed their progress against this target based on their current asset base and the existing regular level of pension funding and savings/investing.
4. We outlined the additional regular funding that would be required to reach their financial target.
5. We outlined tax-efficient planning tools and how such structures can greatly enhance real returns.

We provided a detailed analysis of their investments and detailed the annual investment returns that would need to be achieved to reach their financial goals. We also provided an analysis of their stated tolerance to investment risk versus where their current assets actually are at present relative to this. We outlined the relevance of this to them, and the relationship between investment risk and reward.

#### **Choosing the Right Business Structure**

We outlined the drawbacks to operating as a sole trader and provided a comprehensive outline of the benefits (of which there are many as outlined in more detail below) to Brian of incorporating his business and operating as a company going forward.

Once we had quantified their monthly lifestyle income, which was €3,500 net per month, we showed Brian the advantages of the corporate structure in reducing his effective tax rate.

#### **Protection**

A comprehensive analysis of their protection requirements was undertaken.

Brian is the primary income earner, and particularly with two young children, it is essential that his income is protected in the event of illness, disability or death. We put the appropriate level of protection in place for the appropriate term at the most competitive cost.

#### **Estate Management**

As Brian and Emma have no Will in place, we highlighted the serious implications that this can have on their estate and their children's welfare in the event of their untimely death.

We held a number of meetings with them discussing the sensitive issue of their final wishes and who they would like to perform certain roles e.g. the Executor, Trustee and Guardian.

*Contd...*

Notes

We worked with Brian and Emma in devising a financial model that provided the Guardian to the children with access to funds on a regular basis and on a specific needs basis.

**Personal Tax Planning**

We provided Brian with a detailed breakdown of the level of tax he is currently paying and how we can reduce this significantly through tax planning and restructuring.

**Outcome**

As a result of the Opes Wealth Trust planning exercise, Brian and Emma now have a very focused and tax-efficient financial plan in place that is appropriate to their specific circumstances. We have helped Brian establish a new company from which he now provides his services. This new corporate structure will enable Brian to accumulate wealth much more efficiently going forward. They also have the peace of mind that comes with knowing that, in the unfortunate event of something happening either of them, they have a tax-efficient and up-to-date estate plan that deals with how their children are looked after and ensures that their final wishes for their estate are adhered to.

**Benefits to Operating in a Company Structure:**

1. **Limited Liability:** This provides a safeguard for individuals against their personal assets.
2. **Tax Efficiency:** A company can be a very tax efficient structure, both for transacting business and also through creating wealth in a personal capacity for the directors and employees through retirement planning. One of the major benefits of incorporation is access to the lower tax rates that apply to a company's profits, as well as it being more economical to build up working capital in a company rather than as a sole trader.
3. **Corporate Identity:** A company is a separate entity with its own sense of image, stability, sophistication and credibility.
4. **Raising Equity/Capital:** A company provides individuals with the ability to raise equity by selling its own shares to potential investors. This is on top of traditional sources of finance such as loans which require interest to be paid.
5. **Continuous Life:** A company can survive its founders. It also provides some additional comfort in the area of permanence of the business activity.
6. **Flexibility:** A company's shares can be transferred, pledged, sold, given away, used as security, or given as bonuses.
7. **Alignment of key individuals with success of the business:** A company can align key individuals to the longer term success of the business. Increasing salaries or paying bonuses can provide incentives for short term performance, whereas stock options align the individual in the longer term.
8. **Cash Extraction:** The process of incorporation itself, for an existing business, can be used as a tool to allow the sole trader to extract capital value from the business in a tax-efficient manner as a part of the transfer of the business to the new company.
9. **Succession Planning:** Generally speaking, a company will be a more attractive business prospect to either a potential purchaser in the future or to transferring ownership of the business to the children. Not only will the stamp duty cost be reduced with the company structure but the business owner may also be in a position to extract profits in a tax-efficient manner before the disposal, thus reducing the overall tax cost to both the seller and the purchaser.

Contd...

Questions	Notes
<ol style="list-style-type: none"> <li>1. Study and analyse the case.</li> <li>2. Write down the case facts</li> <li>3. What do you infer from it?</li> </ol>	

Source: Adapted from <http://www.opeswealthtrust.ie/self-employedprofessionals/case-study-2-a-self-employed-it-consultant-for-whom-we-recommended-that-he-incorporate-his-business/>

## 8.5 Summary

- A business organisation can be owned and organised in several forms – Sole Proprietorship, Partnership and Company.
- The various forms of organisation are established by state law.
- A sole proprietorship is a one-man business.
- In a general partnership, the business is owned by two or more general partners.
- A company is meant an association of many persons who contribute money or money's worth to a common stock and employs it in some trade or business, and who share the profit and loss (as the case may be) arising there from.
- The sole proprietor's personal income tax return (Form 1040) must include calculation of the proprietorship's income tax as well as any income or loss that the owner incurs from any additional entity, such as an employee, investor, or the like.
- A firm is treated as a separate tax-entity under the Income-tax Act.
- The partnership firm is taxed as a separate entity, with no distinction as registered and unregistered firms.
- Planning of taxes should be done in an efficient manner so as not to jeopardise the business goals of expansion, profits and growth.
- A company owner needs to be aware of anything that might impact taxes paid and for this self-employment tax, company expenses and deductions, business assets; charitable contributions, shifting income, and retirement planning are important considerations.

## 8.6 Keywords

**Company:** A voluntary association formed and organised to carry on a business.

**Limited Liability Partner:** He is a kind of partner whose assets will not be lost if the business goes bankrupt.

**Limited Liability Partnership (LLP):** A limited liability partnership (LLP) is a partnership in which some or all partners (depending on the jurisdiction) have limited liability.

**Ordinary/General Partner:** He is a kind of partner who takes an active part in the running of the business.

**Organisation:** An organisation is a social entity that has a collective goal and is linked to an external environment.

**Partnership:** A partnership is a strategic alliance or relationship between two or more people.

**Sleeping Partner:** He is a kind of partner who invests in the business but do not take an active part in the business.

**Notes**

**Sole Proprietors:** A business structure in which an individual and his/her company are considered a single entity for tax and liability purposes.

**Tax Liability:** The total amount of tax that an entity is legally obligated to pay to an authority as the result of the occurrence of a taxable event is called tax liability.

**Tax Planning:** Tax planning is the processes used by people and businesses to pay taxes.

### 8.7 Review Questions

1. Write short note on business organisation.
2. Discuss the various forms of business organisations.
3. Highlight the factors involved in selection of organisation.
4. What is sole proprietorship? Elucidate its features.
5. Describe the tax aspects of a proprietorship.
6. Throw some light on the advantages and disadvantages of sole proprietorship.
7. What is the position of firm under the Income Tax Act?
8. Elucidate the provisions relating to taxation of partnership firms.
9. Discuss the advantages and disadvantages of partnership.
10. "Planning of taxes should be done in an efficient manner so as not to jeopardise the business goals of expansion, profits and growth." Explain.

### **Answers: Self Assessment**

- |                                 |                                  |
|---------------------------------|----------------------------------|
| 1. Long                         | 2. Sole Proprietorship           |
| 3. Partnership                  | 4. Company                       |
| 5. False                        | 6. False                         |
| 7. True                         | 8. True                          |
| 9. Indian Partnership Act, 1932 | 10. Profession                   |
| 11. Separate                    | 12. Association of Persons (AOP) |
| 13. True                        | 14. False                        |
| 15. True                        | 16. True                         |

### 8.8 Further Readings



*Books*

Ahuja, G. K. & Gupta, Ravi, *Systematic Approach to Income Tax*, Bharat Law House.

Aggarwal, K., *Direct Tax Planning and Management*, Atlantic Publications.

Lakhotia, R.N., *Income Tax Planning Handbook*, Vision Books.

Singhania, V. K. & Singhania, Kapil, *Direct Taxes law & Practice*. Taxmann Publications.

Srinivas E. A., *Handbook of Corporate Tax Planning*, Tata McGraw Hill.





Online links

[http://business.gov.in/starting\\_business/location\\_industry.php](http://business.gov.in/starting_business/location_industry.php)

<http://www.entrepreneur.com/article/192164>

<http://www.enotes.com/sole-proprietorship-reference/sole-proprietorship>

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[http://www.startbizindia.in/propritor\\_taxation\\_individual.php](http://www.startbizindia.in/propritor_taxation_individual.php)

[http://business.gov.in/taxation/partnership\\_provisions.php](http://business.gov.in/taxation/partnership_provisions.php)

<http://www.tax4india.com/partnership-firms/partnership-firm-indian-tax.html>

## Unit 9: Financial Management Decisions

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### Objectives

After studying this unit, you will be able to:

- State the meaning and need of capital structure decision
- Explain the relationship between taxation and capital structure decision
- Discuss the meaning of dividend policy and distribution of dividend
- Elucidate the provisions of Dividend Distribution Tax (DDT) in India
- Describe the concept of issue of bonus shares and its tax implications

### Introduction

Financial management decisions include the decisions relating to planning, organising, directing and controlling the financial activities such as procurement and utilisation of funds of the

enterprise. It implies application of general management principles to financial resources of the enterprise. The key aspects of financial decision-making relate to investment, financing and dividends.

Investment decisions also called as capital budgeting includes investment in fixed assets. Financial decisions are related to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby. In dividend decision the finance manager has to take decision with regards to the net profit distribution. While undertaking all these above decision in order to attain the ultimate goal of shareholders wealth maximisation a firm always considers these decisions from the point of view of taxation.

Financing decisions are concerned with quality of finance basically focusing on achieving an optimum mix between debts and equity. Capital structure decision is a matrix of three considerations namely the risk, cost of capital and tax planning. Thus the tax planner should properly make a balance between risk, cost of capital and tax saving consideration in such a manner, which ensure maximum shareholder's return with optimum risk.

In this unit, we will study the relationship between the two main important financing decisions namely the finance and dividend decision and importance of taxation in taking such decisions.

## 9.1 Capital Structure Decisions

An organisation employs different types of funding to run a business smoothly. Capital structure is a composition of different types of financing employed by a firm to acquire resources necessary for its operations and growth. Capital structure primarily comprises of long-term debt, preferred stock, and net worth. It can be quantified by taking how much of each type of financing a company holds as a percentage of all its financing. Capital structure is different from financial structure as this includes short-term debt, accounts payable, and other liabilities.

Most of the companies raises fund by equity or debt. Debt comes in the form of bond or long-term notes payable, whereas equity is classified as common stock, preferred stock, or retained earnings. Both the financing has advantages and disadvantages over each other. The founders hold the ownership rights and control of the company if they raise capital by debt. The company has to pay the principal and interest to the concerned debt holders. This privilege will be lost in equity, as the shareholders become an integral part of the company. Debt financing is easier and less expensive for small firms. Payment of interest on regular becomes burden for a company and reduces their earnings. There is no obligation in equity financing to repay the money. Shareholders take a chance on good ideas for better growth opportunities of the firm.



*Did u know?* Capital structure is a mix of a company's long-term debt, specific short-term debt, common equity and preferred equity. Debt comes in the form of bond issues or long-term notes payable, while equity is classified as common stock, preferred stock or retained earnings. Short-term debt such as working capital requirements is also considered to be part of the capital structure.

Therefore you can say that capital structure is referred to as the ratio of different kinds of securities raised by a firm as long-term finance. The capital structure involves two decisions:

- (a) Types of securities to be issued are equity shares, preference shares and long term borrowings (Debentures).
- (b) Relative ratio of securities can be determined by process of capital gearing. On this basis, the companies are divided into two:
  - (i) *High geared companies:* Those companies whose proportion of equity capitalisation is small.

Notes

- (ii) *Low geared companies:* Those companies whose equity capital dominates total capitalisation.



*Example:* There are two companies A and B. Total capitalisation amounts to be ₹ 200,000 in each case. The ratio of equity capital to total capitalisation in company A is ₹ 50,000, while in company B, ratio of equity capital is ₹ 150,000 to total capitalisation, i.e., in Company A, proportion is 25% and in company B, proportion is 75%. In such cases, company A is considered to be a highly geared company and company B is low geared company.

### 9.1.1 Factors Determining Capital Structure

Various factors which are kept in mind by a firm while deciding on its capital structure are:

1. **Trading on Equity:** The word “equity” denotes the ownership of the company. Trading on equity means taking advantage of equity share capital to borrowed funds on reasonable basis. It refers to additional profits that equity shareholders earn because of issuance of debentures and preference shares. It is based on the thought that if the rate of dividend on preference capital and the rate of interest on borrowed capital is lower than the general rate of company’s earnings, equity shareholders are at advantage which means a company should go for a judicious blend of preference shares, equity shares as well as debentures. Trading on equity becomes more important when expectations of shareholders are high.
2. **Degree of control:** In a company, it is the directors who are so called elected representatives of equity shareholders. These members have got maximum voting rights in a concern as compared to the preference shareholders and debenture holders. Preference shareholders have reasonably less voting rights while debenture holders have no voting rights. If the company’s management policies are such that they want to retain their voting rights in their hands, the capital structure consists of debenture holders and loans rather than equity shares.
3. **Flexibility of financial plan:** In an enterprise, the capital structure should be such that there are both contractions as well as relaxation in plans. Debentures and loans can be refunded back as the time requires. While equity capital cannot be refunded at any point which provides rigidity to plans. Therefore, in order to make the capital structure possible, the company should go for issue of debentures and other loans.
4. **Choice of investors:** The company’s policy generally is to have different categories of investors for securities. Therefore, a capital structure should give enough choice to all kind of investors to invest. Bold and adventurous investors generally go for equity shares and loans and debentures are generally raised keeping into mind conscious investors.
5. **Capital market condition:** In the lifetime of the company, the market price of the shares has got an important influence. During the depression period, the company’s capital structure generally consists of debentures and loans. While in period of boons and inflation, the company’s capital should consist of share capital generally equity shares.
6. **Period of financing:** When company wants to raise finance for short period, it goes for loans from banks and other institutions; while for long period it goes for issue of shares and debentures.
7. **Cost of financing:** In a capital structure, the company has to look to the factor of cost when securities are raised. It is seen that debentures at the time of profit earning of company prove to be a cheaper source of finance as compared to equity shares where equity shareholders demand an extra share in profits.
8. **Stability of sales:** An established business which has a growing market and high sales turnover, the company is in position to meet fixed commitments. Interest on debentures

has to be paid regardless of profit. Therefore, when sales are high, thereby the profits are high and company is in better position to meet such fixed commitments like interest on debentures and dividends on preference shares. If company is having unstable sales, then the company is not in position to meet fixed obligations. So, equity capital proves to be safe in such cases.

9. **Sizes of a company:** Small size business firm's capital structure generally consists of loans from banks and retained profits. While on the other hand, big companies having goodwill, stability and an established profit can easily go for issuance of shares and debentures as well as loans and borrowings from financial institutions. The bigger the size, the wider is total capitalization.
10. **Tax Exposure:** Applicable tax laws and regulations may also play an important role in capital structure decisions. Since debt payments are tax deductible, if a company's tax rate is high, it may make sense to use debt as a means of financing. The tax deductibility of debt payments will protect some income from taxation.



Caselet

### The DCM Case

**Client Background:** The DCM division of a global banking group wanted to add additional capacity to its capital structure/modelling team. Within three weeks of the client signing off on the deal, we had established a dedicated team of eight financial professionals, mainly Chartered Accountants with significant debt modelling expertise.

**Service Offerings:** Copal had fully adopted the client's research methods, and was delivering a range of standard materials to the DCM team including:

1. Capital Markets overview
2. Capital structure analysis, leverage headroom analysis
3. Comparative studies on capital markets and instruments
4. Debt comparable company analysis
5. Debt precedent transaction analysis
6. Financial modelling
7. Indenture analysis
8. Liquidity analysis

**Results:** As a result of the solutions provided by the Copal team the client is now able to quickly and consistently conduct detailed analysis on optimal capital structure and financing solutions. The team supports the origination team and provides research analysis used both in preparing tender proposals and internally by the credit function. The Copal team delivers significant client advantages compared to the cost of employing staff internally, the time it takes to deploy the team and the ability of the client to operate flexibly, scaling efficiently in response to fluctuations in market activity.

Source: <http://www.copalpartners.com/case-study/dcm-case-study>

### 9.1.2 Need for Capital Structure Planning

For the real growth of the company the Financial Manager of the company should plan an optimum capital for the company. The optimum capital structure is one that maximises the market value of the firm. In practice the determination of the optimum capital structure is a formidable task and the manager has to perform this task properly, so that the ultimate objective of the firm can be achieved.

There are significant variations among industries and companies within an industry in terms of capital structure. Since a number of factors influence the capital structure decision of a company, the judgment of the person making the capital structure decisions play a crucial part. A totally theoretical model can't adequately handle all those factors, which affects the capital structure decision in practice. These factors are highly psychological, complex and qualitative and do not always follow accepted theory, since capital markets are not perfect and decision has to be taken under imperfect knowledge and risk.

An appropriate capital structure or target capital structure can be developed only when all those factors, which are relevant to the company's capital structure decision, are properly analysed and balanced. The capital structure should be planned generally keeping in view the interest of the equity shareholders and financial requirements of the company. The equity shareholders being the owner of the company and the providers of risk capital (equity), would be concerned about the ways of financing a company's operations. However, the interest of other groups, such as employee, customers, creditors, society and government, should be given reasonable consideration when the company lays down its objective in terms of the shareholders wealth maximisation, it is generally compatible with the interest of other groups. Thus, while developing an appropriate capital structure for a company the finance manager should inter alia aim at maximising the long-term market price per share. Theoretically, there may be precise point or range within which the market value per shares is maximum. In practice, for most companies within an industry there may be a range within which there would not be great differences in the market value per share. One way to get an idea of this range is to observe the capital structure patterns of company's vis-à-vis their market prices of share. The management of companies may fix its capital structure near the top of this range in order to make maximum use of favourable leverage, subject to other requirements such as flexibility, solvency, control and norms set by the financial institutions - The Security Exchange Board of India (SEBI) and Stock Exchanges.

### 9.1.3 Guidelines for Capital Structure Planning

The following are the guidelines of capital structure planning:

1. **Avail or Tax advantage of Debt:** Interest on debt finance is a tax-deductible expense. Hence, finance scholars and practitioners agree that debt financing gives rise to tax shelter which enhances the value of the firm. What is the impact of this tax shelter on the value of the firm? In this 1963 paper Modigliani and Miller argued that the present value of the interest tax shield is:

$$t_c D$$

where,  $t_c$  = corporate tax rate on a unit of marginal earnings and  $D$  = Debt financing.

2. **Preserve Flexibility:** The tax advantage of debt should not persuade one to believe that a company should exploit its debt capacity fully. By doing so, it loses flexibility. And loss of flexibility can erode shareholder value. Flexibility implies that the firm maintains reserve borrowing power to enable it to raise debt capital to respond to unforeseen changes in government policies, recessionary conditions in the market place, disruption in supplies, decline in production caused by power shortage or labour market, intensification in competition, and, perhaps most importantly, emergence of profitable

investment opportunities. Flexibility is a powerful defence against financial distress and its consequences which may include bankruptcy.

3. **Ensure that the Total Risk Exposure is Reasonable:** While examining risk from the point of view of the investor, a distinction is made between systematic risk (also referred to as the market risk or non-diversifiable risk) and unsystematic risk (also referred to as the non-market risk or diversifiable risk).

Business Risk refers to the variability of earnings before interest and taxes. It is influenced by the following factors:

- (a) **Demand Variability:** Other things being equal, the higher the variability of demand for the products manufactured by the firm, the higher is its business risk.
  - (b) **Price Variability:** A firm which is exposed to a higher degree of volatility in the prices of its products is, in general, characterised by a higher degree of business risk in comparison with similar firms which are exposed to a lesser degree of volatility in the prices of their products.
  - (c) **Variability in Input Prices:** When input prices are highly variable, business risk tends to be high.
4. **Subordinate Financial Policy to Corporate Strategy:** Financial policy and corporate strategy are often not integrated well. This may be because financial policy originates in the capital market and corporate strategy in the product market.
  5. **Mitigate Potential Agency Costs:** Due to separation of ownership and control in modern corporations, agency problems arise. Shareholders scattered and dispersed as they are not able to organise themselves effectively. Since agency costs are borne by shareholders and the management, the financial strategy of a firm should seek to minimise these costs. One way to minimise agency costs is to employ an external agent who specialises in low cost monitoring. Such an agent may be a lending organisation like a commercial bank or a term-lending institution.



**Notes** Agency cost refers to the cost incurred by a firm because of the problems associated with the different interests of management and shareholder and the information asymmetry that exists between the principal (shareholders) and the agent (management).

The agency cost of equity arises because of the difference in interests between the shareholders and the management. Similarly the agency cost of debt arises because of different interests of shareholders and debt-holders.

### 9.1.4 Capital Structure Decision and Tax Planning

Capital structure decisions are likely to affect companies' tax payments, since corporate taxation typically distinguishes between different sources of finance. Interest payments can generally be deducted from taxable profits while such a deduction is not available in the case of equity financing. Taxation of capital income at the shareholder level often differentiates between the types of capital as well. Therefore, it can be expected that the relative tax benefits of different sources of finance have an impact on financing decisions.

In addition to above theory suggests that both corporate profit tax and personal capital income taxes should be considered in order to analyse the tax consequences of capital structure choices more accurately. Tax incentives for using a particular source of finance differ significantly among different countries. Given that interest payments and dividends are taxed differently at the company level, this could lead to effective unequal treatment of debt and equity.

**Notes**

Therefore, we are interested in how flexible capital structure decisions are with respect to taxation, given a bunch of non-tax determinants of capital structures. If companies' capital structure decisions are significantly restricted by non-tax factors, distortions of financial decisions due to taxation may lead to inefficiencies in investment decisions and risk allocation. A higher tax benefit of debt has the expected significant positive impact on companies' financial leverage. Debt shares are positively affected by the level of dividend taxes and corporate profit taxes, whereas the taxation of personal interest income has only minor impact.

While suggesting a fundamental irrelevance of financial decisions for firm value, Modigliani and Miller already refer to company taxation as a reason for preferring debt to equity. Within their framework of perfect capital markets, the value of a permanently leveraged firm arises from adding the corporate tax shield of debt to the value of an identical but unleveraged company. Empirically, this proposition would imply a corner solution due to the tax shield which adds up to the corporate tax rate times the market value of debt.

In 1977 Miller develops a broader perspective on tax incentives by explicitly integrating personal income taxation into his model. He concludes that, under existing personal tax concessions made to equity income, there is no optimum capital structure for any single firm. In contrast, De Angelo and Masulis develop a theoretical explanation for the existence of a firm-specific optimal debt to equity ratio by taking alternative ways to reduce the corporate tax burden (e.g. depreciation allowances) into account. While a company's effective marginal tax rate on interest deduction depends on its non-debt tax shield substitutes and declines as leverage increases, the marginal personal tax disadvantage of interest income stays constant. This leads to a unique interior optimum, even in the absence of any non-fiscal incentives. There are several other studies also on the impact of corporate taxation on financing decisions specifying the same preference of debt to equity.

**Self Assessment**

Fill in the blanks:

1. .... is a composition of different types of financing employed by a firm to acquire resources necessary for its operations and growth.
2. .... is classified as common stock, preferred stock, or retained earnings.
3. A company whose proportion of equity capitalisation is small is referred to as .....
4. .... means taking advantage of equity share capital to borrowed funds on reasonable basis.
5. .... on debt finance is a tax-deductible expense.
6. The agency cost of ..... arises because of the difference in interests between the shareholders and the management.

**9.2 Dividend Policy: Meaning and its Distribution**

Dividend refers to the corporate net profits distributed among shareholders. Dividends can be both preference dividends and equity dividends. Preference dividends are fixed dividends paid as a percentage every year to the preference shareholders if net earnings are positive. After the payment of preference dividends, the remaining net profits are paid or retained or both depending upon the decision taken by the management.

Dividends are usually distributed in the form of cash known as cash dividends or share called share dividends. When a company distributes a cash dividend, it must have sufficient cash to do so. This creates a cash flow issue. Profit generated may not be in the form of cash. You may



verify this by looking at the cash flow statement of a company. A company may have profit of ₹ 400 million but the cash only increase by ₹ 190 million in a financial year. This is a concern to the management as insufficient cash may mean the company is unable to distribute a dividend.

Other factors in addition to profit and cash flow may influence the dividend level. In some countries, dividends are taxable. The higher the dividend, the higher the tax an investor needs to pay. In such cases, high dividends are not desirable. If a company is expanding, it needs to keep sufficient cash for its plans rather than having to go to the equity or debt market to raise additional finance.

### 9.2.1 Types of Dividends

These dividend types are:

1. **Cash dividend:** The cash dividend is by far the most common of the dividend types used. On the date of declaration, the board of directors resolves to pay a certain dividend amount in cash to those investors holding the company's stock on a specific date. The date of record is the date on which dividends are assigned to the holders of the company's stock. On the date of payment, the company issues dividend payments.



*Example:* ABC International's board of directors declares a cash dividend of ₹ 0.50 per share on the company's 2,000,000 outstanding shares, to be paid on June 1 to all shareholders of record on April 1.

2. **Stock dividend:** A stock dividend is the issuance by a company of its common stock to its common shareholders without any consideration. If the company issues less than 25 percent of the total number of previously outstanding shares, you treat the transaction as a stock dividend. If the transaction is for a greater proportion of the previously outstanding shares, then treat the transaction as a stock split. To record a stock dividend, transfer from retained earnings to the capital stock and additional paid-in capital accounts an amount equal to the fair value of the additional shares issued. The fair value of the additional shares issued is based on their fair market value when the dividend is declared.



*Example:* R Ltd declares a stock dividend to its shareholders of 10,000 shares. The fair value of the stock is ₹ 5.00, and its par value is ₹ 1. The amount of stock dividend will be ₹ 50,000.

3. **Property dividend:** A company may issue a non-monetary dividend to investors, rather than making a cash or stock payment. You record this distribution at the fair market value of the assets distributed. Since the fair market value is likely to vary somewhat from the book value of the assets, the company will likely record the variance as a gain or loss.
4. **Scrip dividend:** A company may not have sufficient funds to issue dividends in the near future, so instead it issues a scrip dividend, which is essentially a promissory note (which may or may not include interest) to pay shareholders at a later date. This dividend creates a note payable.



*Example:* XYZ Traders declares a ₹ 250,000 scrip dividend to its shareholders that has a 10 percent interest rate.

5. **Liquidating dividend:** When the board of directors wishes to return the capital originally contributed by shareholders as a dividend, it is called a liquidating dividend, and may be a precursor to shutting down the business. The accounting for a liquidating dividend is similar to the entries for a cash dividend, except that the funds are considered to come from the additional paid-in capital account.

## 9.2.2 Dividend Policy

Dividend policies are the regulations and guidelines that companies develop and implement as the means of arranging to make dividend payments to shareholders. Establishing a specific dividend policy is to the advantage of both the company and the shareholder. In order to make sure the policy is workable, a company should develop a viable policy and then run this policy through a number of test scenarios in order to determine what impact the dividend policy would have on the operation of the business.

A dividend policy shows how a company determines the amount of earnings to be paid out as dividends to its shareholders on a regular basis. It is characterised by its dividend payout ratio, which is the percentage of net earnings paid out to shareholders.



*Did u know?* The dividend payout ratio is the amount of dividends paid to stockholders relative to the amount of total net income of a company. The amount that is not paid out in dividends to stockholders is held by the company for growth. The amount that is kept by the company is called retained earnings.

## 9.2.3 Determinants of Dividend Policy

Establishing a dividend policy is important for business that intends to provide stock issues for investors. There are several determinants of dividend policy that are taken into account, including the desire to remain within the parameters of current trade regulations, and to protect the financial stability of the company. Considering all relevant factors and their impact on the operation makes it easier to create a policy that is fair to the business and still attractive enough to motivate investors to buy and hold the shares over the long term.

The main determinants of dividend policy of a firm can be classified into:

1. **Dividend payout ratio:** Dividend payout ratio refers to the percentage share of the net earnings distributed to the shareholders as dividends. Dividend policy involves the decision to pay out earnings or to retain them for reinvestment in the firm. The retained earnings constitute a source of finance. The optimum dividend policy should strike a balance between current dividends and future growth which maximises the price of the firm's shares. The dividend payout ratio of a firm should be determined with reference to two basic objectives – maximising the wealth of the firm's owners and providing sufficient funds to finance growth. These objectives are interrelated.
2. **Stability of dividends:** Dividend stability refers to the payment of a certain minimum amount of dividend regularly. The stability of dividends can take any of the following three forms:
  - (a) Constant dividend per share
  - (b) Constant dividend payout ratio or
  - (c) Constant dividend per share plus extra dividend
3. **Legal, contractual and internal constraints and restrictions:** Legal stipulations do not require a dividend declaration but they specify the conditions under which dividends must be paid. Such conditions pertain to capital impairment, net profits and insolvency. Important contractual restrictions may be accepted by the company regarding payment of dividends when the company obtains external funds. These restrictions may cause the firm to restrict the payment of cash dividends until a certain level of earnings has been achieved or limit the amount of dividends paid to a certain amount or percentage of earnings.

Internal constraints are unique to a firm and include liquid assets, growth prospects, and financial requirements, availability of funds, earnings stability and control.

4. **Owner's considerations:** The dividend policy is also likely to be affected by the owner's considerations of the tax status of the shareholders, their opportunities of investment and the dilution of ownership.
5. **Capital market considerations:** The extent to which the firm has access to the capital markets, also affects the dividend policy. In case the firm has easy access to the capital market, it can follow a liberal dividend policy. If the firm has only limited access to capital markets, it is likely to adopt a low dividend payout ratio. Such companies rely on retained earnings as a major source of financing for future growth.
6. **Inflation:** With due to inflation, the funds generated from depreciation may not be sufficient to replace obsolete equipments and machinery. So, they may have to rely upon retained earnings as a source of fund to replace those assets. Thus, inflation affects dividend payout ratio in the negative side.
7. **Company's reinvestment rate lower than that of shareholders:** Sometimes, there are companies that do not have significant reinvestment opportunities. More precisely, we say the reinvestment rate of the company is lesser than the reinvestment rate of shareholders. In such cases, obviously, it is better to pay earnings out than to retain them. As the classic theories of impact of dividends on market value of a share suggest, or what is anyway intuitively understandable, retention of earnings makes sense only where the reinvestment rate of the company is higher than that of shareholders.
8. **Tax disparities between current dividends and growth:** In case of indifference between current dividends and share price appreciation, taxes do play a spoilsport.



*Example:* If a company distributes dividends, the same may be taxed (either as income in the hands of shareholders, or by way of tax on distribution – like dividend distribution tax in India). Alternatively, if the shareholders have a capital appreciation, which they encash by partial liquidation of holdings, shareholders have a capital gain. Taxability of a capital gain may not be the same as that of dividends. Hence, taxes may differentiate between current dividends and share price appreciation.

9. **Shares with fixed returns:** Needless to say, there is no relevance of dividend policy where dividends are payable as per terms of issue – for example, in case of preference shares.
10. **Entities requiring minimum distribution:** There might also be situations where entities are required to do a minimum distribution under regulations.



*Example:* In case of real estate investment trusts, a certain minimum distribution is required to attain tax transparent status.

There might be other regulations or regulatory motivations for companies to distribute their profits. These regulations may impact our discussion on relevance of dividend policy on price of equity shares.

11. **Unlisted companies:** Technically speaking, in case of unlisted firms too, retained earnings belong to the shareholders, as shareholders after all are the owners of the residual wealth of the company. However, that residual ownership may be a myth as companies do not distribute assets except in event of winding, and winding up is a rarity.

## Notes

**Notes Dividend Policy Ratios**

It measure how much a company pays out in dividends relative to its earnings and market value of its shares. These ratios provide insights into the dividend policy of a company. They compare the dividends to the earnings to measure how much of its earnings a company is paying out in dividends. They also compare the dividends to share prices to see how much cash flow the investors get for their investments in the company's shares.

Dividend payout ratio and dividend yield are two most common examples of dividend policy ratios.

Dividend cover is another example of such ratios. Dividend payout ratio gives an idea how well the earnings support the dividends paid out. Dividend yield measures how much a company pays out in dividends relative to the market value of its shares.

Dividend policy ratios are affected by the age of a company. Companies which are mature, stable and large in size usually pay higher dividends. Therefore dividend policy ratios of such companies are usually high. On the other hand, companies which are young, small and seeking growth usually do not pay any dividends or pay very modest dividends. Therefore dividend policy ratios of such companies are not so handsome.

### 9.2.4 Tax Implications on Dividend Policy

The decision to pay dividends to investors does not have an impact on a company's corporate tax. Large investors can sometimes pressure the corporate board of directors, influencing their decision to pay dividends or not. During years when dividend taxes are lower than capital gains taxes, more companies use their excess cash to pay investor dividends. During times when dividend taxes are high relative to capital gains tax, fewer companies pay investor dividends.

When a company pays you a cash dividend, it reduces stockholder's equity for each share of stock. Stockholder's equity is calculated by subtracting company liabilities from assets. Paying dividends reduces cash, which is an asset. Reducing equity represented by each share of stock can have a negative impact on the stock's share price. In other words, paying dividends transfers some of the company's value directly to shareholders in the form of cash instead of capital gains. Because dividend taxes are lower than short-term capital gains taxes, companies can reduce the tax liability for some of their investors by issuing dividends.

It must also be noted that the dividend policy of a firm is also critically important as it affects both the corporate and personal taxes.



*Example:* The Regional Electric Company has ₹ 1000 of extra cash after tax. The company has different options to deal with this cash. It can either retain the cash or invest it in T-bills yielding 10% or it can pay the cash to shareholders as a dividend. Shareholders can also put the money in T-bills with the same yield. Suppose if the corporate tax rate is 34% and the individual rate is 28% than what is the amount of cash that investors will have after 5 years under each of the following scenarios:

**Options:**

- (a) Pay dividends
- (b) Retain the cash for investment in the firm earnings paid out to shareholders.

(a) *Pay dividends*

Shareholders receive in 5 years:

$$₹ 1000 (1 - .28) (1 + .072)^5 = ₹ 1019.30 \quad (.072 \text{ is individual's after tax return})$$

(b) *Retain the cash for investment in the firm*

The company retains the cash and invests in T-bills and pays out the proceeds 5 years from now. (Individuals pay the taxes at the end)

*Shareholders receive in 5 years:*

$$₹ 1000 (1 + .066)^5 (1 - .28) = ₹ 991.188 \quad (.066 \text{ is corporations after tax return})$$

- (a) Pay low (no) dividends if corporate rate is less than the individual rate.
- (b) Pay high dividends (higher tax benefit) when the individual rate is less than the corporate rate.
- (c) In addition, corporations (as holders of stock) are able to exclude 80% of the dividend income they receive from holding stock.



*Notes* In this case the holder and payee are both corporations. Treat the holder like an "individual".

### Self Assessment

State whether the following statements are true or false:

7. Dividend refers to the corporate net profits distributed among shareholders.
8. Cash dividend is the issuance by a company of its common stock to its common shareholders without any consideration.
9. A dividend policy shows how a company determines the amount of earnings to be paid out as dividends to its shareholders on a regular basis.
10. The retention ratio is the amount of dividends paid to stockholders relative to the amount of total net income of a company.
11. Legal stipulations require not only a dividend declaration but they specify the conditions under which dividends must be paid.
12. The decision to pay dividends to investors does not have an impact on a company's corporate tax.

### 9.3 Dividend Distribution Tax (DDT)

Dividend distribution tax is the tax levied by the Government on companies according to the dividend paid to a company's investors. Every domestic company is liable to pay Dividend Distribution Tax @ 15% on the amount declared, distributed or paid by such company by way of dividends. The effective rate of tax works out to 16.995%.

### 9.3.1 Special Provisions Relating to Tax on Distributed Profits of Domestic Companies

According to Section 115-O the Domestic Company shall, in addition to the income tax chargeable in respect of its total income, be liable to pay additional income tax on any amount declared, distributed or paid by such company by way of dividend (whether interim or otherwise), whether out of current or accumulated profits. Such dividend distribution tax shall be payable @ 15% plus surcharge @ 5% plus education cess @ 2% plus SHES @ 1% of amount so declared, distributed or paid.

The amount referred to in Sec. 115-O (1) (as above) i.e. dividend to be distributed shall be reduced by

1. The amount of dividend, if any, received by the domestic company during the financial year, if –
  - (a) such dividend is received from its subsidiary;
  - (b) the subsidiary has paid tax under this section on such dividend; and
  - (c) the domestic company is not a subsidiary of any other company.



**Caution** However, it must be noted that the same amount of dividend shall not be taken into account for reduction more than once.

A company shall be a subsidiary of another company, if such other company, holds more than 50% of nominal value of equity share capital of the company.

2. The amount of dividend paid to any person for, or on behalf of, the New Pension System Trust established on the 27th day of February, 2008 under the provisions of the Indian Trusts Act, 1882.

The holding company should not be a subsidiary of any other company i.e. benefit u/s 115-O (1A) is available only to the ultimate holding company. But ultimate holding company can claim the benefit on dividend received from multiple subsidiary companies. Dividend received from other type of subsidiaries i.e. subsidiaries having Controlling composition of board, sub-subsidiaries, joint venture, etc. shall not qualify benefit u/s 115-O(1A). The expression 'dividend' shall have the same meaning as is given in clause (22) of Section 2, but shall not include sub-clause (e) of clause (22) of Section 2. Dividend u/s 2(22)(e) is not covered by this Chapter and the same shall be taxable in the hands of the shareholder and the company shall not pay tax on such dividend.



#### *Did u know?* **Due Date of Tax Payment**

The principal officer of the domestic company and the company shall be liable to pay the tax on the dividend distribution profit within 14 days from the date of declaration or distribution or payment of any dividend, whichever is earlier.

The tax on the dividend distribution profit shall be payable whether or not the domestic company is liable to pay income tax on its total income computed in accordance with the provision of this Act. The tax on dividend distribution profit shall be treated as the final payment of the tax in respect of the amount declared, distributed or paid as dividends and no further credit shall be claimed by the company or by any other person in respect of the amount so paid. The company or the shareholder shall not be allowed any deduction in respect of the amount which has been charges to tax or the tax thereon under Sec. 115-O(1).

The interpretation of this clause is that no deduction shall be allowed to the shareholder under any provision of the Income tax Act, 1961 in respect of any expenditure which he has incurred on collection or earning of the dividend (Sec. 14A). No deduction shall be allowed to the company under any provision of the Income tax Act, 1961 in respect of the dividend so paid or tax thereon.

The distributed profit on which tax is paid u/s 115-O (1) shall be exempted in the hands of shareholder u/s 10(34). The tax on distributed profits shall be payable by domestic company whether or not such profit is distributed out of current year profit or accumulated profit. Dividend received from a foreign company is not covered by Sec.115-O and shall not be exempted in the hands of shareholders u/s 10(34). Such dividend is taxable in the hands of shareholder at the normal tax rates. Dividend on both preference shares and equity shares shall be considered.

### **Exemptions for Companies Developing, Operating or Maintaining SEZ [Sec. 115-O (6)]**

No tax on distributed profits shall be chargeable in respect of the total income of an undertaking or enterprise engaged in developing or developing and operating or developing, operating and maintaining a Special Economic Zone for any assessment year on any amount declared, distributed or paid by such Developer or enterprise, by way of dividends (whether interim or otherwise) on or after the 1st day of April, 2005 out of the current income either in the hands of the Developer or enterprise or the person receiving such dividend. The provision of this sub-section is done away with effect from 1-6-2011. Accordingly dividend distribution tax is chargeable on amount declared, distributed by way of dividend by the said undertaking or enterprise after 1-6-2011.

### **Section 115-P: Interest Payable for Non-payment of Tax by Domestic Companies**

Where the principal officer of domestic company and the company fail to pay the whole or any part of tax on distributed profits within the time i.e. 14 days, he or it shall be liable to pay simple interest @ 1% for every month or part thereof on amount of such tax for the period beginning on the date immediately after the last date on which such tax was payable and ending with the date on which the tax is actually paid.

### **Section 115-Q: Consequences for Non-payment of Dividend Distribution Tax**

If principal officer of a domestic company and the company does not pay tax on distributed profits in accordance with the provisions of Section 115-O, then, he or it shall be deemed to be an assessee in default in respect of the amount of tax payable by him or it and all the provisions of the Income Tax Act, 1961 for the collection and recovery of income tax shall apply. The assessee who is deemed to be in default in making the payment of tax on distributed profits is liable for penalty under section 221 of the Act.



*Notes* DDT is payable by a company and not by the shareholder. Any deduction from the base which is subject to the DDT will only be advantageous to the Company and not to the shareholder. If the intention is to provide more dividend to small shareholders (on the presumption that the same is not subject to the DDT), then the rate of dividend payable to this class of shareholders will be different from the rate of dividend paid to others, which is not permissible under the Companies Act.

1. Dividend distribution tax is the tax levied by the Indian Government on companies according to the dividend paid to a company's investors.

*Contd...*

Notes

2. As per existing tax provisions, income from dividends is tax free in the hands of the investor. There is a levy of 15% of the dividend declared as distribution tax. This tax is paid out of the profits/reserves of the company declaring the dividend.
3. The provisions of this Section applies to a domestic company for any assessment year, on an amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise).
4. The Company is required to pay the Dividend Distribution Tax within 14 days from the date of declaration or distribution or payment of any dividend whichever is earlier.
5. The said dividend distribution tax is in addition to the income tax chargeable on the total income of the Company and the same shall be payable @15% and the same shall be increased by Surcharge @10%, and such aggregate of tax and surcharge shall be further increased by an Education cess @2% and higher education cess 1% .
6. The Section applies to dividend payments made either out of current or accumulated profits.
7. The dividend so paid will be eligible for exemption for the shareholders under Section 10(34).
8. The Dividend Distribution Tax is payable by a Domestic Company even if no income-tax is payable on its total income.

**9.3.2 Special Provisions Relating to Tax on Distributed Income**

Section 115R states that any amount of income distributed by (i) a specified company, or (ii) a mutual fund to unit holders shall be chargeable to tax and such specified company or mutual fund shall be liable to pay additional income tax on such distributed income at the following rate:

**Table 9.1: Tax on Distributed Income to Unit Holders**

Sr. No.	Particulars	Rate of tax
1	Income is distributed by a money market mutual fund or a liquid fund to-	
	Individual or HUF	25% + 5% SC + 2% EC + 1% SHEC (w.e.f. 1-6-2011)
	Any person other than Individual or HUF	30% + 5% SC + 2% EC + 1% SHEC (w.e.f. 1-6-2011)
2	Income is distributed by a fund other than money market mutual fund or a liquid fund to-	
	Individual or HUF	12.5% + 5% SC + 2% EC + 1% SHEC
	Any person other than Individual or HUF	30% + 5% SC + 2% EC + 1% SHEC (w.e.f. 1-6-2011)

Source: [http://wircicai.org/wirc\\_referencer/income%20tax%20&%20wealth%20tax/Dividend%20Distribution%20Tax.htm](http://wircicai.org/wirc_referencer/income%20tax%20&%20wealth%20tax/Dividend%20Distribution%20Tax.htm)

Provision of Sec.115R shall not apply in respect of any income distributed:

1. by the Administrator of specified undertaking, to the unit holders; or
2. to a unit holder of an equity oriented fund in respect of any distribution made from such fund.



For the purpose of this clause “Administrator” means the Administrator as referred to in clause (a) of section 2 of the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002 and “specified company” means a company as referred to in clause (h) of section 2 of the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002.

The administrator of specified undertaking shall not be required to pay the tax on income distributed to the unit holders. Even the unit holders are also exempt from tax in respect of such incomes under section 10(35).

### **Due Date for Payment of Tax**

The person responsible for making payment of income distributed by the specified company or a Mutual Fund and the specified company or the Mutual Fund, as the case may be, shall be liable to pay the tax on the distribution income within 14 days from the date of distribution or payment of such income whichever is earlier.

The person responsible for making payment of income distributed by the Unit Trust of India or a Mutual Fund and the Unit Trust of India or the Mutual Fund, as the case may be, shall be filed on or before 15th day of September in each year, in case of the Unit Trust of India statement of distributed income in Form No. 63 and in case of Mutual Fund statement of distributed income in Form No. 63A and verified by specified persons (an accountant) in the manner indicated therein to the Assessing Officer so designated by the Chief Commissioner or Commissioner of Income-tax within whose area of jurisdiction, the principal office of the Unit Trust of India or the concerned Mutual Fund is situated or in any other case, to the Assessing Officer within whose area of jurisdiction, the principal office of the Unit Trust of India or the concerned Mutual Fund is situated.

1. The Unit Trust of India or the Mutual Fund shall not be allowed any deduction in respect of the amount which has been charged to tax or the tax thereon under section 115R(1) or under section 115R(2).
2. Unit holder shall not be liable to pay tax on income distributed on units by the specified company or a mutual fund or administrator by virtue of section 10(35).
3. The specified company or a mutual fund will not be liable to pay the tax in respect of income distributed to a unit holder of equity oriented funds. Even the unit holder shall not be liable to pay tax on such income since it is exempted under section 10(35) in hands of the unit holder.
4. Tax is on distributed income i.e. amount of income distributed by mutual fund or the specified company. Therefore, redemption of units or repurchase of units is not covered by this chapter.

### **Section 115-S: Interest Payable for Non-payment of Tax**

Where the person responsible for making payments of the income distributed by the specified company or a Mutual Fund and the specified company or a Mutual Fund, as the case may be, fails to pay the whole or any part of the tax as is referred to in sub-section (1) or sub-section (2) of section 115R, within the 14 days mention above, he or it shall be liable to pay simple interest at the rate of 1% for every month or part thereof on the amount of such tax for the period beginning on the date immediately after the last date on which such tax was payable and ending with the date on which the tax is actually paid.

Notes

**Section 115-T: Consequences for Non-payment of Additional Income Tax on Income Distributed to Unit Holders**

Where any person responsible for making payment of income distributed defaults to pay tax on distributed profits in accordance with the provisions sub-section (1) and sub-section (2) of Section 115-R, then, he or it shall be deemed to be an assessee in default in respect of the amount of tax payable by him or it and all the provisions of the Income Tax Act, 1961 as applicable for the collection and recovery of taxes thereon shall apply accordingly.



*Did u know?* In India, domestic companies that declare, distribute or pay dividends are subject to dividend distribution tax at 16.61% on the amount of such dividends. However, income distributed by a specified company or mutual fund is taxable at differential rates as follows:

Income distributed from the Money market/liquid funds is taxable at 27.68% Income distributed from other mutual funds to individuals or HUFs is taxable at 13.84% and to others at 22.15%. However, no additional tax is payable on income distributed to unit holders of equity oriented funds.

**Self Assessment**

Fill in the blanks:

- 13. Dividend distribution tax is the tax levied by the ..... on companies according to the dividend paid to a company's investors.
- 14. Every domestic company is liable to pay Dividend Distribution Tax at the rate ..... on the amount declared.
- 15. The amount of dividend paid to any person for, or on behalf of, the New Pension System Trust established on the 27th day of February, 2008 under the provisions of the .....
- 16. No tax on distributed profits shall be chargeable in respect of the total income of an undertaking or enterprise engaged in developing or developing and operating or developing, operating and maintaining a .....
- 17. The ..... shall not be allowed any deduction in respect of the amount which has been charged to tax or the tax thereon under section 115R(1) or under section 115R(2).

**9.4 Issue of Bonus Shares**

The perception of a stock is dependent upon the expected price movement of the stock and the company's dividend payout policies, which can be in the form of cash dividends or stock dividends, commonly known as bonus issues. A company's ability and willingness to pay steady dividends over time and its power to increase them reinstate investors' faith in the stock.

Many a time, a company is not in a position to pay cash dividends, in spite of sufficient profits. In such a case, a bonus issue of shares is a powerful alternative. A bonus issue is also perceived by investors to be a strong signal by the company's management of its readiness to service an enhanced shareholder base.

Thus when the additional shares are allotted to the existing shareholders without receiving any additional payment from them, it is known as issue of bonus shares. Bonus shares are allotted by capitalising the reserves and surplus. Issue of bonus shares results in the conversion of the company's profits into share capital. Therefore it is termed as capitalisation of company's profits.



*Example:* If a company announces a bonus issue of 1:1 and if you were originally holding 100 shares, you would get another 100 shares after the bonus issue.

Since such shares are issued to the equity shareholders in proportion to their holdings of equity share capital of the company, a shareholder continues to retain his or her proportionate ownership of the company. Issue of bonus shares does not affect the total capital structure of the company. It is simply a capitalisation of that portion of shareholders' equity which is represented by reserves and surpluses. It also does not affect the total earnings of the shareholders. Issue of Bonus Shares is more or less a financial gimmick without any real impact on the wealth of the shareholders. Still firms issue bonus shares and shareholders look forward to issue of bonus shares.

A bonus issue or scrip issue is a stock split in which a company issues new shares without charge in order to bring its issued capital in line with its employed capital (the increased capital available to the company after profits). This usually happens after a company has made profits, thus increasing its employed capital. Therefore, a bonus issue can be seen as an alternative to dividends. No new funds are raised with a bonus issue.



*Did u know?* A stock split is a decision by the company's board of directors to increase the number of shares that are outstanding by issuing more shares to current shareholders.

For example, in a 2-for-1 stock split, every shareholder with one stock is given an additional share. So, if a company had 10 million shares outstanding before the split, it will have 20 million shares outstanding after a 2-for-1 split.

In a stock split the face value per share is reduced and the number of shares is increased proportionately. A stock split is similar to a bonus issue from economic point of view. But there are some differences from the accounting point of view.

Unlike a rights issue, a bonus issue does not risk diluting your investment. Although the earnings per share of the stock will drop in proportion to the new issue, this is compensated by the fact that you will own more shares. Therefore the value of your investment should remain the same although the price will adjust accordingly. The whole idea behind the issue of Bonus shares is to bring the Nominal Share Capital into line with the true excess of assets over liabilities.

#### 9.4.1 Conditions for Issue of Bonus Shares

Bonus shares are issued by converting the reserves of the company into share capital. It is nothing but capitalisation of the reserves of the company. There are some conditions which need to be satisfied before issuing bonus shares:

1. Bonus shares can be issued by a company only if the Articles of Association of the company authorises a bonus issue. Where there is no provision in this regard in the articles, they must be amended by passing special resolution act at the general meeting of the company.
2. It must be sanctioned by shareholders in general meeting on recommendations of BOD of company.
3. Guidelines issue by SEBI must be complied with. Care must be taken that issue of bonus shares does not lead to total share capital in excess of the authorised share capital. Otherwise, the authorised capital must be increased by amending the capital clause of the Memorandum of association.
4. If the company has availed of any loan from the financial institutions, prior permission is to be obtained from the institutions for issue of bonus shares. If the company is listed on the stock exchange, the stock exchange must be informed of the decision of the board to issue bonus shares immediately after the board meeting. Where the bonus shares are to be issued to the non-resident members, prior consent of the Reserve Bank should be obtained.

## Notes

5. Only fully paid up bonus share can be issued. Partly paid up bonus shares cannot be issued since the shareholders become liable to pay the uncalled amount on those shares.



*Notes* It is important to note here that Issue of bonus shares does not entail release of company's assets. When bonus shares are issued or credited as fully paid up out of capitalised accumulated profits, there is distribution of capitalised accumulated profits but such distribution does not entail release of assets of the company.

### 9.4.2 Advantages of Bonus Shares

One of the major reasons why companies declare bonus issues is that a higher number of shares improves float and liquidity and thereby traded volumes of the stock. A lower price also makes the stock seem more affordable to small retail investors, who might otherwise give it a miss at high price levels. Another aspect of a bonus issue is that it reflects the confidence of the company in its ability to service a larger equity base. Thus, bonus issues are said to be a good signalling mechanism on the company's capacity to deliver future benefits to shareholders in terms of increased dividend.

The issue of bonus shares has once again come into limelight as several companies like Infosys, Wipro and Sun Pharma etc, have recently declared bonus shares for their shareholders. The announcement of a bonus certainly excites shareholders, because they would be receiving shares from the company without having to pay any consideration to the company.



*Example:* A company has an authorised share capital of ₹ 1, 00,000. It has issued 10,000 shares with a face value of ₹ 10 each. Thus, its issued share capital is also ₹ 1, 00,000. It has an accumulated reserve of ₹ 10, 00,000. It decides to issue bonus shares in the ratio of 1:1 or "1 for 1" – that is, 1 bonus shares for each share held. In this case, it transfers ₹ 1, 00,000 from its reserves to its authorised share capital. Thus, its reserves come down to ₹ 9,00,000, and its authorised share capital increases to ₹ 2,00,000. Using this new share capital of ₹ 1,00,000, the company issues 10,000 new shares, each having a face value of ₹ 10, and gives a new share – the bonus share – for each share held. Its issued share capital also goes up to ₹ 2, 00,000.

Advantages of issue of bonus shares to the company:

1. **Conservation of Cash:** Issue of bonus shares does not involve cash outflow. The company can retain earnings as well as satisfy the desire of the shareholders to receive dividend.
2. **Keeps the EPS at a reasonable level:** A company having high EPS may face problems both from employees and consumers.
  - (a) Employees may feel that they are underpaid.
  - (b) Consumers may feel that they are being charged too high for the company's products.
  - (c) Issue of bonus shares increases the number of shares and reduces the earning per share.
3. **Increases the marketability of company's shares:** Issue of bonus shares reduces the market price per share. The price of the share may come within the reach of ordinary investors. This increases the marketability of shares.
4. **Enhances prestige of the company:** By issuing bonus shares, the company increases its credit standing and its borrowing capacity. It reflects financial strength of the company.

5. **It helps in financing its projects:** By issuing bonus shares, the expansion and modernisation programmes of a company can be easily financed. The company need not depend on outside agencies for finances.
6. **Retention of managerial control:** Any new issue of shares has a danger of dilution of managerial control over the company. Since bonus shares are issued to the existing shareholders in proportion to their current holdings, there is no threat of dilution of managerial control over the company.

### Advantages to the Shareholders

1. **Tax benefits:** When a shareholder receives dividend in cash, it adds to his total income and is taxed at usual income tax rates. From this point of view the bonus shares increase the wealth of shareholders. In case the shareholder requires cash he can sell his additional shares.
2. **Indication of higher future profits:** Issue of bonus shares is generally an indication of higher future profits. This is because a company declares a bonus issue only when its earnings are expected to increase.
3. **Increase in future dividend:** The shareholder will get more dividends in the future even if the company continues to offer existing cash dividend per share.
4. **High psychological value:** Issue of bonus shares is usually perceived positively by the market. This tends to create greater demand for the company's shares. In fact, always the share prices rise at the declaration of bonus shares.



*Example:* Ashok Leyland, Titan Industries and Bhuwalka Steel Industries offered bonus shares to investors, resulting in a rise in prices. The share prices of Ashok Leyland, Titan Industries and Bhuwalka Steel jumped around 2 per cent, 9 per cent and 10 per cent, respectively, from the date of announcement till the record date.

### Issue of Bonus Shares and Taxation

The tax benefit provided by issue of bonus shares holds the concern for every company whose in the process of dividend declaration Firms opt for issue of bonus shares due to a number of reasons as stated above however among them the one related to tax benefit also hold a significant importance. An issue of bonus shares on capitalisation of profits does not entail payment of any tax either for the company or its shareholders. When bonus shares are sold, the cost of such shares will be considered to be nil. If such bonus shares are held for more than 12 months and sold on a stock exchange, the capital gains are exempt from tax (subject to payment of securities transaction tax). If sold within the 12-month period, the capital gains are taxable at 15% (plus surcharge). The cost price of the original shares is not adjusted pursuant to the bonus issue.

### Self Assessment

Fill in the blanks:

18. A ..... issue is a stock split in which a company issues new shares without charge in order to bring its issued capital in line with its employed capital
19. Bonus shares can be issued by a company only if the ..... of the company authorises a bonus issue.
20. One of the major reasons why companies declare bonus issues is that a higher number of shares improves ..... and thereby traded volumes of the stock.

Notes

21. In a ..... the face value per share is reduced and the number of shares is increased proportionately.
22. If bonus shares are held for more than ..... and sold on a stock exchange, the capital gains are exempt from tax.



Case Study

**Issue of Bonus Shares: A Capital v/s Revenue Expenditure: Fusion & Confusion**

It is said that India has the most complex Income-tax legislation. The tax system bristles with complexities and uncertainties. Consequent upon this there are problems of evasions and avoidance. As such, let us probe two fiercely debated concepts of taxation laws i.e. Capital & Revenue Expenditure which is very much relevant mentioning here. These two propositions are rays with different wave-lengths but from the same source. While the former is susceptible to tax being more extensive, the latter is advantageous to assessee.

This is being done with regard to the issuance of bonus shares but simultaneously dealing with other tests mechanism. The controversy was whether the expenditure incurred by the assessee Company on account of issue of bonus shares was Revenue Expenditure or a Capital Expenditure. This was remotely connected with Section 37 of the Income Tax Act, 1961 and Section 75 (1)(c)(I) of the Companies Act, 1956. On this issue, there was a conflict of opinion between the High Courts of Bombay & Calcutta on the one hand and Gujarat & Andhra Pradesh on the other. The Bombay and Calcutta High Courts were of the view that the expenses incurred in connection with bonus shares is a revenue expenditure whereas Gujarat and Andhra Pradesh High Courts have taken a contrary view and have ruled that the expenses incurred in connection with the bonus shares is in the nature of capital expenditure because it expanded the capital base of the company.

This matter went to the Apex Court in the case of *CIT, Mumbai v. General Insurance Corporation*. In the instant case before their Lordships the assessee Company had during the concerned accounting year - incurred expenditure separately for the increase of its authorised share capital and the issue of bonus shares. The assessee being unsuccessful at various forums finally went to the Supreme Court on the second category i.e. the nature of expenditure incurred in the issuance of bonus shares. In *Empire Jute Company Ltd v. CIT* Supreme Court laid down the test for determining whether a particular expenditure is revenue or capital expenditure. It was observed that there was no all-embracing formula, which could provide ready solution to the problem, and that no touchstone had been devised. It laid down that every case had to be decided on its own canvass keeping in mind the broad picture of the whole operation in respect of which the expenditure has been incurred.

The Apex Court endorsed the text laid down by Lord Cave, LC, in *Altherton v. British Insulated and Helsby Cables Ltd*. In this case it was observed that when an expenditure was made, not only once and for all but with a view to bringing into existence an asset of advantage for the enduring benefit of a trade then there was a very good reason for treating such an expenditure as properly attributable not to Revenue but to Capital. This brings us to the crux of the problem. One of the arguments that could be advanced is that the expenses incurred towards issue of bonus shares conferred an enduring benefit to the Company, which resulted in an impact on the capital structure of the company, and in that perception it should be regarded as capital expenditure. Conversely, the issuance of bonus shares by capitalisation of reserves was merely reallocation of a company's fund and there was no inflow of fresh funds or increase in the capital employed which remained

Contd...

the same therefore did not result in conferring an enduring benefit to the company and therefore the same should be regarded as revenue expenditure. The “enduring benefit” is of paramount importance while examining the rival contentions with which these two concepts are interwoven.

There is also no unanimity in verdicts of various High Courts. In the back ground, the Supreme Court laid down the test whether a particular expenditure was Revenue or Capital in *Empire Jute Company Ltd. v. CIT* whereas the cases of Karnataka and Gujarat High Court dealt with the issuance of fresh shares and therefore the ratio decided of these courts did not apply to the issuance of bonus shares. However, the view as taken appears to be as laying down correct law. The Supreme Court did not agree with the observation of learned author A. Ramaiya which was of the view that while issuing bonus shares a company converts the accumulated large surplus into Capital and divides the Capital among the members in proportion to their rights. The learned author felt that the bonus shares went by the modern name “Capitalisation of Shares”. The Apex Court has, therefore, marshalled the entire arithmetic and chemistry of the two very important propositions of the taxation law i.e. capital expenditure and revenue expenditure and made over a conceptual clarity by reiterating the evolved principle of “enduring benefit” vis-à-vis reallocation of a company’s fund. The court has also laid down acid test for determining these two contingencies although the occasion was the event of issuance of bonus shares. The capital expenditure is expenditure for long-term betterments or additions.

This expenditure is in the nature of an investment for future chargeable to capital asset account whereas revenue expenditure is incurred in the purchase of goods for resale, in selling those goods and administering and carrying of the business of the Company. The freewheeling dissections by the Apex Court in *Commissioner of Income Tax v. General Insurance Corporation* of the various limbs of these twin concepts have cleared much of the haze. The Court held that the expenditure incurred in connection with the issuance of bonus shares is in the nature of revenue expenditure. The Bench said “the issue of bonus shares by capitalisation of reserves is merely a reallocation of company’s funds. There is no inflow of fresh funds or increase in the capital employed, which remains the same. If that be so, then it cannot be held that the company has acquired a benefit or advantage of enduring nature. The total funds available with the company will remain the same and the issue of bonus shares will not result in any change in the capital structure of the company. Issue of bonus shares does not result in the expansion of capital base of the company.”

### Conclusion

The economy is booming, the markets are buoyant, and Indian companies are increasing their profitability. Consequential of all this, many companies have announced issues of bonus shares to their shareholders by capitalising their free reserves this year. In this bullish market, shareholders have benefited tremendously, even after accounting the inevitable reduction in share prices post-bonus, since the floating stock of shares increases. The whole purpose is to capitalise profits. We can say that Bonus shares go by the modern name of “Capitalisation Share”.

Fully paid bonus shares are not a gift distributed of capital under profit. No new funds are raised. Earlier there was also a lot of confusion & chaos between the two fiercely debated concepts of taxation laws i.e. Capital & Revenue Expenditure which was finally settled after the case which come up in SC in 2006, named *Commissioner of Income Tax v. General Insurance Corporation*. Now it is also settled law that a bonus issue in the form of fully paid share of the company is not income for the Income Tax purpose. The undistributed profit of the company is applied and appropriated for the issue of bonus shares.

Contd...

Notes

**Questions**

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it about issue of bonus shares in Indian Tax Regime?

Source: <http://www.legalserviceindia.com/article/I204-Issue-of-Bonus-Shares.html>

**9.5 Summary**

- Financial management decisions include the decisions relating to planning, organising, directing and controlling the financial activities such as procurement and utilisation of funds of the enterprise. It implies application of general management principles to financial resources of the enterprise. The key aspects of financial decision-making relate to investment, financing and dividends.
- Financing decisions are concerned with quality of finance basically focusing on achieving an optimum mix between debts and equity. Capital structure decision is a matrix of three considerations namely the risk, cost of capital and tax planning. Thus the tax planner should properly make a balance between risk, cost of capital and tax saving consideration in such a manner, which ensure maximum shareholder's return with optimum risk.
- Capital structure is a composition of different types of financing employed by a firm to acquire resources necessary for its operations and growth. Capital structure primarily comprises of long-term debt, preferred stock, and net worth. It can be quantified by taking how much of each type of financing a company holds as a percentage of all its financing. Capital structure is different from financial structure as this includes short-term debt, accounts payable, and other liabilities.
- For the real growth of the company the financial manager of the company should plan an optimum capital for the company. The optimum capital structure is one that smaximises the market value of the firm.
- Interest on debt finance is a tax-deductible expense. Hence, finance scholars and practitioners agree that debt financing gives rise to tax shelter which enhances the value of the firm. The tax advantage of debt should not persuade one to believe that a company should exploit its debt capacity fully.
- Capital structure decisions are likely to affect companies' tax payments, since corporate taxation typically distinguishes between different sources of finance. Interest payments can generally be deducted from taxable profits while such a deduction is not available in the case of equity financing. Taxation of capital income at the shareholder level often differentiates between the types of capital as well. Therefore, it can be expected that the relative tax benefits of different sources of finance have an impact on financing decisions.
- A dividend policy shows how a company determines the amount of earnings to be paid out as dividends to its shareholders on a regular basis. It is characterised by its dividend payout ratio, which is the percentage of net earnings paid out to shareholders.
- The decision to pay dividends to investors does not have an impact on a company's corporate tax. Large investors can sometimes pressure the corporate board of directors, influencing their decision to pay dividends or not. During years when dividend taxes are lower than capital gains taxes, more companies use their excess cash to pay investor dividends. During times when dividend taxes are high relative to capital gains tax, fewer companies pay investor dividends.



- When a company pays you a cash dividend, it reduces stockholder's equity for each share of stock. Stockholder's equity is calculated by subtracting company liabilities from assets. Paying dividends reduces cash, which is an asset. Reducing equity represented by each share of stock can have a negative impact on the stock's share price. In other words, paying dividends transfers some of the company's value directly to shareholders in the form of cash instead of capital gains. Because dividend taxes are lower than short-term capital gains taxes, companies can reduce the tax liability for some of their investors by issuing dividends.
- Dividend distribution tax is the tax levied by the Government on companies according to the dividend paid to a company's investors. Every domestic company is liable to pay Dividend Distribution Tax @ 15% on the amount declared, distributed or paid by such company by way of dividends. The effective rate of tax works out to 16.995%.
- A bonus issue or scrip issue is a stock split in which a company issues new shares without charge in order to bring its issued capital in line with its employed capital. This usually happens after a company has made profits, thus increasing its employed capital. Therefore, a bonus issue can be seen as an alternative to dividends. No new funds are raised with a bonus issue.
- The tax benefit provided by issue of bonus shares holds the concern for every company whose in the process of dividend declaration. Firms opt for issue of bonus shares due to a number of reasons as stated above however among them the one related to tax benefit also hold a significant importance. An issue of bonus shares on capitalisation of profits does not entail payment of any tax either for the company or its shareholders.

## 9.6 Keywords

**Capital budgeting decision:** It is a decision relating planning process an organisation's long term investments such as new machinery, replacement machinery, new plants, new products, and research development projects are worth pursuing.

**Capital structure:** It refers to the way a corporation finances its assets through some combination of equity, debt, or hybrid securities.

**Dividend decision:** It is a decision made by the directors of a company about the amount and timing of any cash payments made to the company's stockholders.

**Dividend:** A share of the after-tax profit of a company, distributed to its shareholders according to the number and class of shares held by them.

**Equity shares:** Equity shares means that part of the share capital which is not a preference share capital. It means all such shares which are not preference shares. Equity shares are also called as ordinary shares.

**Finance decision:** The decisions are related to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns etc.

**Finance:** It is the study of how money is managed and the actual process of acquiring needed funds.

**Financial management:** It implies planning, organising, directing and controlling the financial activities such as procurement and utilisation of funds of the enterprise.

**Interim dividend:** A dividend payment made before a company's AGM and final financial statements. This declared dividend usually accompanies the company's interim financial statements.

**Notes**

**Payout ratio:** It is the amount of earnings paid out in dividends to shareholders.

**Preference shares:** Preference shares are those shares which fulfil both the following two conditions: (i) They carry preferential share right in respect of dividend at a fixed rate, (ii) They also carry preferential right in regard to payment of capital on winding up of the company.

**9.7 Review Questions**

1. Write short note on financial management.
2. What do you understand by capital structure decisions?
3. List down the factors which are to be kept in mind while deciding the capital structure of an organisation.
4. Comment on the statement, "For the real growth of the company the financial manager of the company should plan an optimum capital for the company".
5. Mention the guidelines for planning capital structure of an organisation.
6. How is capital structure decision of a firm influenced by tax planning?
7. Describe the dividend policy and mention its determinants.
8. Write a short note on tax implications on dividend policy.
9. Explain, in detail, the special provisions relating to tax on distribution of profits by domestic companies.
10. What are bonus shares?
11. Describe the advantages of issuing bonus shares to firms and shareholders.
12. Is issue of bonus shares taxable in hands of company and shareholder? Comment critically.

**Answers: Self Assessment**

- |  |                           |
|--|---------------------------|
| 1. Capital Structure                       | 2. Equity                 |
| 3. Highly geared companies                 | 4. Trading on equity      |
| 5. Interest                                | 6. Equity                 |
| 7. True                                    | 8. False                  |
| 9. True                                    | 10. False                 |
| 11. False                                  | 12. True                  |
| 13. Government                             | 14. 15%                   |
| 15. Indian Trusts Act, 1882.               | 16. Special Economic Zone |
| 17. Unit Trust of India or the Mutual Fund | 18. Bonus or scrip        |
| 19. Articles of Association                | 20. Float and liquidity   |
| 21. Stock split                            | 22. 12 months             |

## 9.8 Further Readings

Notes



Books

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Aggarwal, K., *Direct Tax Planning and Management*, Atlantic Publications.

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Singhania, V. K. & Singhania, Kapil, *Direct Taxes law & Practice*. Taxmann Publications.

Srinivas E. A., *Handbook of Corporate Tax Planning*, Tata McGraw Hill.



Online links

<http://www.managementstudyguide.com/capital-structure.htm>

<ftp://ftp.zew.de/pub/zew-docs/dp/dp08020.pdf>

<http://www.incometaxmanagement.com/Pages/Tax-Management-Managerial-Financial-Decisions/7-Tax-Management-Capital-Structure.html>

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[http://www.taxmann.com/taxmannflashes/ChXI\\_DividendDistributionTax.htm](http://www.taxmann.com/taxmannflashes/ChXI_DividendDistributionTax.htm)

[http://wiki.answers.com/Q/What\\_is\\_dividend\\_distribution\\_tax](http://wiki.answers.com/Q/What_is_dividend_distribution_tax)

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## **Unit 10: Tax Consideration in Specific Managerial Decisions**

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### **Objectives**

After studying this unit, you will be able to:

- Explain the concept of managerial decision
- Discuss tax planning regarding employees remuneration
- Describe tax planning regarding fringe benefit planning
- Identify tax planning with relation to remuneration planning

## Introduction

Notes

Managerial decision is influenced by a number of factors depending on the facts of a case. They are not always guided by tax considerations. However it would be better if tax factor is also analysed before making such decision. Managerial decisions are considerably influenced by taxes, e.g., the choice of location, buying or leasing decisions, or the proper mix of debt and equity in the company's capital structure increasingly demand qualified employees in an economic environment that is becoming more and more complex. Due to the worldwide economic integration and constant changes in tax legislation, companies are faced with new challenges – and the need for information and advice is growing accordingly. So, before one can embark on a study of the tax consideration in specific managerial decisions, it is absolutely vital to understand the concept of managerial decisions along with tax planning regarding employee remuneration, Fringe Benefit Tax (FBT) and remuneration planning. The purpose of this unit is to enable the students to comprehend basic expressions. Therefore, all such basic terms are explained and suitable illustrations are provided to define their meaning in this unit.

### 10.1 Managerial Decision

Managerial Decision-making depends on 'tax planning'. It may be defined as a systematic approach to formulate strategies for positioning the business in relation to its environment to ensure continued success and offer security from surprises. While no approach can guarantee continuous success and total security, an integrated approach to strategy formulation, involving all levels of management, can go some way in this direction. In simple words, we can state that managerial decisions are useful for tax planning.

#### 10.1.1 Functional Management and Decision-making

Management means doing things and getting things done by others. It is concerned with objectives, policies, procedures, strategies, etc. Management consists of the following important stages:

1. **Planning:** It is a stage of 'Strategic Formulation'. Strategic formulation includes forecasting, formulating objectives, policies and goals.
2. **Organising:** It is strategy implementation process. It includes all those managerial activities that result in a structure of task, authority and responsibility relationship.
3. **Directing:** It also comes under strategy implementation process. Directing involves efforts directed towards shaping human behaviour. It includes; leadership, communication, motivation, morale, organisational change etc.
4. **Staffing:** Recruitment is an important function of staff. Man power is required to implement strategies.
5. **Controlling:** It can be called as strategy evaluation. Controlling refers to all those activities directed towards assuring that actual results are consistent with planned targets.

#### 10.1.2 Other Dimension of Managerial Decision-making

The various dimensions of managerial decision-making are as follows:

1. **Role of C.E.O:** Chief Executive Officer plays key role in decision-making. These decisions are related with various functional levels of organisations. Hence it is necessary that these decisions must be made with in consultation with the CEO.
2. **Preparation of budget:** Decision-making involves budget allocation i.e., resource allocation to various aspects of decision. Budget may be allocated to various factors of production.

Notes

3. **Future development:** Strategic plans are usually expected to have a significant on future prosperity of the organisation. This is because there is a long-term commitment. In case of absence of long-term commitment, the firm cannot achieve future development.
4. **Orientation:** Strategic planning should keep in view of the competition existing in the market. Some times firms have to face non-price competition.
5. **Factors of Environment:** Plans are always influenced by business environment always influencing factor for decision-making. There may external or internal factors that influence business. Buyers, Suppliers, government and competitors are likely to react in accordance with changes in environment. Thus business also should act in the same passion.
6. **Risk:** Strategic plans mostly face the problem of risk. The plans should able to tackle the risk bearing capacity. Risk and uncertainty are two important aspects, which cannot be expected by business man.

### 10.1.3 Considerations Involved in Choosing Between Taxable and Tax-free Sales or Acquisitions

Taxable sales and tax-free reorganisations can involve dispositions of stock or assets.

Careful consideration must be given to the type of payment used and the amount and kind of stock or assets to be given or received in deciding between a taxable and a tax-free reorganisation.

Both taxable sales and tax-free reorganisations can involve dispositions of either assets or stock. The parties are free to plan the transaction in whichever way is most beneficial to them. The tax-free reorganisation provisions are drafted to allow the transaction to be structured to fall within or outside of these provisions. Literal compliance with the statutory rules is required before tax-free treatment will be granted but, as stated above, literal.

Unlike the target corporation and its shareholders, the acquiring corporation is generally not concerned with immediate or deferred recognition of gain or loss because neither gain nor loss will be realised unless the consideration provided by the acquirer is appreciated property.

### 10.1.4 Make-or-Buy Decision

The decision of whether to make or to buy is a problem that is frequently encountered by supply managers who want to reveal and exploit every competency within the links of the supply chain. Make or buy is a decision not to be made only on the basis of economic considerations, since acquisition or loss of core competencies may also be involved.

Decisions regarding outsourcing significant functions are among the most strategic that can be made by an organisation. They address the basic organisational choice of the functions for which internal expertise is developed and nurtured and those for which such expertise is purchased. Even an individual make-or buy decision can affect a company's production methods, working capital, and cost of borrowing or competitive position.

The make-or-buy decision is the act of making a strategic choice between producing an item internally (in-house) or buying it externally (from an outside supplier). The buy side of the decision also is referred to as outsourcing. Make-or-buy decisions usually arise when a firm that has developed a product or part significantly modified a product or parts having trouble with current suppliers, or has diminishing capacity or changing demand. Make-or-Buy decision (also called the outsourcing decision) is a judgment made by management whether to make a component internally or buy it from the market. While making the decision, both qualitative and quantitative factors must be considered.



*Example:* Qualitative factors in make-or-buy decision are control over quality of the component, reliability of suppliers, and impact of the decision on suppliers and customers, etc.



*Caution* The quantitative factors are actually the incremental costs resulting from making or buying the component.

Make-or-buy analysis is conducted at the strategic and operational level. Obviously, the strategic level is the more long-range of the two. Variables considered at the strategic level include analysis of the future, as well as the current environment. Issues like government regulation, competing firms, and market trends all have a strategic impact on the make-or-buy decision. Of course, firms should make items that reinforce or are in-line with their core competencies. These are areas in which the firm is strongest and which give the firm a competitive advantage.

Outsourcing provides companies with the freedom to concentrate their energies on key activities that are critical to maintaining their competitive edge. This results in improvement of industrial relations and rising labour productivity. For activities eligible for outsourcing, the key strategic question is whether the firm can perform those service activities on a level that is comparable with the best organisations in the world. If a service activity meets several criteria, the next step is deciding whether the service is central to the firm's core strategic activities. Moreover, to make the best make-or-buy decision, companies must determine how that decision will affect final product quality and the company's technology.

### Factors Affecting Firms to Buy

Factors that may influence firms to buy a part externally include:

1. Lack of expertise
2. Suppliers' research and specialised know-how exceeds that of the buyer
3. Cost considerations (less expensive to buy the item)
4. Small-volume requirements
5. Limited production facilities or insufficient capacity
6. Desire to maintain a multiple-source policy
7. Indirect managerial control considerations
8. Procurement and inventory considerations
9. Brand preference
10. Item not essential to the firm's strategy

### Elements of the "Make" Analysis

Elements of the "make" analysis include:

1. Incremental inventory-carrying costs
2. Direct labour costs
3. Incremental factory overhead costs
4. Delivered purchased material costs

- Notes
5. Incremental managerial costs
  6. Any follow-on costs stemming from quality and related problems
  7. Incremental purchasing costs
  8. Incremental capital costs

### Consideration of Cost for “Buy” Analysis

Cost considerations for the “buy” analysis include:

1. Purchase price of the part
2. Transportation costs
3. Receiving and inspection costs
4. Incremental purchasing costs
5. Any follow-on costs related to quality or service



*Notes* One will note that six of the costs to consider are incremental. By definition, incremental costs would not be incurred if the part were purchased from an outside source. If a firm does not currently have the capacity to make the part, incremental costs will include variable costs plus the full portion of fixed overhead allocable to the part’s manufacture. If the firm has excess capacity that can be used to produce the part in question, only the variable overhead caused by production of the parts are considered incremental. That is, fixed costs, under conditions of sufficient idle capacity, are not incremental and should not be considered as part of the cost to make the part.

### Classification in Make-or-buy

Make-or-buy investigations are triggered by a firm’s desire to improve the efficiency of the supply chain and to offer better products and services to its customers. Make-or-buy decision can be strategic or tactical and may involve parts, capital items, services of every type and a wide range of items supporting industrial operations (e.g., castings, tools, spare parts, etc.)

Products and services in make-or-buy investigations have widely differing attributes and, depending on how they are used by enterprises, involve a multitude of complexities that make it difficult to derive workable and simple typologies of make-or-buy decisions. In contrast, by considering the circumstances that trigger a make-or-buy investigation, a simple and easily conceivable typology can be derived. All make-or-buy decisions fall into one of three categories defined as follows:

- (i) **M-items:** The items/services made by the enterprise prior to the resolution of the make-or-buy issue.
- (ii) **B-items:** The items/services purchased from external suppliers prior to the resolution of the make-or-buy issue.
- (iii) **N-items:** The items/services used for the first time by the enterprise.





*Notes* This framework has some obvious advantages, listed below:

- (i) It is conceptually simple for managers to grasp, since it specifies situations easily understood in any business environment.
- (ii) All make-or-buy decisions, irrespective of item/service attributes, fall clearly into one of the three categories.
- (iii) The limited number of categories included in the framework enables analysis by statistical methods and facilitates interpretation of the findings.

### 10.1.5 Buy or Lease Decision

An entity's non-financial assets can be acquired either through outright purchase or leasing arrangements. When making a 'lease or buy' decision an entity must not only consider the financial implications of the options including the government's procurement criterion relating to 'value for money', but consideration must also be given to long-term strategic priorities and to qualitative factors. It is important to understand the implication of both options for the service delivery needs of the entity when determining the most appropriate option.

When leasing an asset the entity only pays for the use of the asset over the term of the lease and ownership of the asset does not pass to the entity at any stage unless the lease contract specifically states it. Leases where substantially all the risks and rewards incidental to ownership are transferred are usually classified as finance leases. When buying an asset, the entity pays the full cost of the asset at acquisition date and has full ownership over the asset.

A finance lease is recorded as an asset when the transaction (contract) is entered into and, similar to the outright purchase option, will give rise to depreciation expense as would be the case of other assets controlled by the entity. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset is required to be fully depreciated over the lease term or its useful life, whichever is shorter.

An operating lease on the other hand, will usually specify a period over which an entity will have the right to use the goods, and have them replaced if they stop working during the lease period, but will then return the goods to the lesser at the end of the lease.

Better practice entities will usually undertake a risk assessment and cost benefit analysis to assess the implication of the operating lease vs. finance lease vs. outright purchase decision when considering key asset acquisitions.

#### Assessment of Advantage and Disadvantages

The table 10.1 below outlines the advantages and disadvantage of buying and leasing options to assist entities in considering the most appropriate option for their circumstances.

The decision to either lease an asset or purchase it outright not only requires consideration of the broad advantages and disadvantages outlined above, but also requires an analysis of the financial implications of the decision. Financial parameters, such as the interest rate which may be charged on the financed amount as well as the implied opportunity cost of using the entity's own cash resources, may have a significant impact on the lease versus purchase decision.

## Notes

Table 10.1: Advantages and disadvantages of buying and leasing options

Buying		Leasing	
Advantages	Disadvantages	Advantages	Disadvantages
Outright asset ownership	Major capital outlay up-front.	Cash-flow effective method for gaining access to assets as no major capital outlay up-front.	No asset ownership.
Assets can be modified at any stage to suit changing business requirements.	Entity incurs maintenance and repairs costs which typically increase as assets age.	Entity may not incur repair and maintenance costs as assets may fall under the warranty of the lessor over the term of the lease.	Assets may not be able to be modified to suit changing business requirements without lessor approval and attracting fees.
Asset can be replaced or disposed of at any time.	Entity incurs costs for the replacement or disposal of assets at the end of their useful lives.	The entity may not incur costs associated with disposal and replacement of assets at the end of their useful lives.	Lease terms are generally fixed so asset replacements and early terminations at the request of the entity may attract penalties and fees.
		Assets may be replaced more frequently, allowing the entity access to latest technology for no additional cost.	
		Possible access to knowledge, purchasing power and discounts offered by the lessor.	Potential capital outlay at the end of the lease term if purchasing the asset at the end of the lease.

Source: [http://www.anao.gov.au/bpg\\_assets2010/HTML/4\\_3\\_Lease\\_versus\\_purchase\\_considerations.html](http://www.anao.gov.au/bpg_assets2010/HTML/4_3_Lease_versus_purchase_considerations.html)

### 10.1.6 Export or Local Sales Decision

Exporting is crucial to any country's economic health. Increased exports means business growth, and business growth means bigger profits for the companies – all of which ultimately result in more jobs for workers. Making the decision to export requires careful assessment of the advantages and disadvantages of expanding into new markets. Once the decision is made to export, developing an international marketing plan is essential.

Export financing is often a key factor in a successful sale. Contract negotiation and closure are important, but at the end of the day, the company must get paid. Exporters naturally want to get paid as quickly as possible, while importers usually prefer to delay payment until they have received or resold the goods. Because of the intense competition for export markets, being able to offer attractive payment terms customary in the trade is often necessary to make a sale. Exporters should be aware of the many financing options open to them so that they choose the most acceptable one to both the buyer and the seller. In many cases, government assistance in export financing for small and medium-sized businesses can increase a firm's options. The following factors are important to consider in making decisions about financing:

1. **The need for financing to make the sale:** In some cases, favourable payment terms make a product more competitive. If the competition offers better terms and has a similar product, a sale can be lost. In other cases, the buyer may have preference for buying from a particular exporter, but might buy your product because of shorter or more secure credit terms.
2. **The length of time the product is being financed:** This determines how long the exporter will have to wait before payment is received and influences the choice of how the transaction is financed.
3. **The cost of different methods of financing:** Interest rates and fees vary. Where an exporter can expect to assume some or all of the financing costs, their effect on price and profit should be well understood before a pro forma invoice is submitted to the buyer.

4. *The risks associated with financing the transaction:* The riskier the transaction, the harder and more costly it will be to finance. The political and economic stability of the buyer's country can also be an issue. To provide financing for either accounts receivable or the production or purchase of the product for sale, the lender may require the most secure methods of payment, a letter of credit (possibly confirmed), or export credit insurance or guarantee.
5. *The need for pre-shipment finance and for post-shipment working capital:* Production for an unusually large order, or for a surge of orders, may present unexpected and severe strains on the exporter's working capital. Even during normal periods, inadequate working capital may curb an exporter's growth.

Therefore, exporters should be aware of the many financing options open to them so that they choose the most acceptable one to both the buyer and the seller.

### *Advantages of Exporting*

Consider some of the specific advantages of exporting. Exporting can help the business in:

1. Enhance domestic competitiveness
2. Increase sales and profits
3. Gain global market share
4. Reduce dependence on existing markets
5. Exploit corporate technology and know-how
6. Extend the sales potential of existing products
7. Stabilise seasonal market fluctuations
8. Enhance potential for corporate expansion
9. Sell excess production capacity
10. Gain information about foreign competition

### *Disadvantages of Exporting*

In comparison, there are certain disadvantages to exporting. The business may be required to:

1. Subordinate short-term profits to long-term gains
2. Hire staff to launch the export expansion
3. Modify your product or packaging
4. Develop new promotional material
5. Incur added administrative costs
6. Dedicate personnel for travelling
7. Wait longer for payments
8. Apply for additional financing
9. Obtain special export licenses

**Notes**

These disadvantages may justify a decision to forego direct exporting at the present time, although your company may be able to pursue exporting through an intermediary. If your company's financial situation is weak, attempting to sell into foreign markets may be ill-timed. The decision to export needs to be based on careful analysis and sound planning.

**Self Assessment**

State whether the following statements are true or false:

1. Managerial Decision-making depends on tax planning.
2. An individual make-or-buy decision cannot affect a company's production methods, working capital, and cost of borrowing or competitive position.
3. An entity's non-financial assets can be acquired either through outright purchase or leasing arrangements.
4. Export financing is often a key factor in an unsuccessful sale.

**10.2 Tax Planning Regarding Employees Remuneration**

Employee Remuneration refers to the reward or compensation given to the employees for their work performances. Remuneration provides basic attraction to an employee to perform job efficiently and effectively. Remuneration leads to employee motivation. A salary constitutes an important source of income for employees and determines their standard of living. Salaries affect the employees' productivity and work performance. Thus the amount and method of remuneration are very important for both management and employees.

For employees of large Indian and multinational companies, benefits go beyond salaries to include lifestyle perks such as company accommodation or club membership. Growth in business operations and competition for talent are now prompting even mid-sized companies to adopt the HR practices of such large companies. However, with tax regulations constantly evolving, it is not clear whether these perks are tax efficient or not. Certain perks such as company mediclaim, which doesn't qualify as a lifestyle perk, is a useful benefit offered to employees. Here is a look at some company perks and how they benefit you:

All income received as salary under Employer-Employee relationship is taxed under this head. If the Income exceeds the minimum exemption limit the Employers must withhold tax compulsorily as Tax Deducted at Source (TDS), to their employees, which shows the Details of tax deductions and net paid income.

Tax planning for your Salary Cost to Company (CTC) the Components of Salary is divided into DA, HRA, Conveyance Allowance, Variable Incentives etc. In order to get Maximum Tax Benefits, the following provisions of income tax which are beneficial to employee should be included in the Salary CTC. Therefore tax planning is a process which is enables employers and employees to evaluate their financial profile with the objective of tax minimisation on their personal income or business profits. It entails the structuring of salary, timing of income and purchase plans, selection of best investment plan, the process and outlays in tax filing etc.



*Example:* Rajiv earns salary of ₹ 10, 00,000 per annum. He has purchased for his family and himself a health Insurance policy costing ₹ 10,000. He also invested ₹ 30,000 in ELSS funds and paid LIC premium for Insurance Policy for ₹ 70,000 and did charity of ₹ 10,000 to Prime Minister Relief Fund. You can see his tax planning effects as reflected below in the table.

## Calculating Your Income Tax Liability in India-2010-11

Heads	Amounts (₹)	
Gross Total Income		1,000,000
Less: Section 80C Deductions		1,00,000
LIC Premium	70,000	
ELSS Funds	30,000	
Total	100,000	
Less: Other Deductions		20,000
Section 80D Health Insurance Premium	10,000	
Section 80G Donation to a Charity	10,000	
Total Taxable Income		880,000
Income Tax Calculations		Tax (₹)
Tax on Income upto ₹ 1,60,000	0%	zero
Tax on the next ₹ 3,40,000 (Slab ₹ 1,60,001 to ₹ 5,00,000)	10%	34,000
Tax on the next ₹ 3,00,000 (Slab ₹ 5,00,001 to ₹ 8,00,000)	20%	60,000
Tax on the next ₹ 80,000 (above ₹ 8,00,001)	30%	24,000
Income Tax Due		1,18,000
Surcharge on total tax (No Surcharge is payable from previous year 2009-10 onwards)	0%	Nil
Income Tax Due		1,18,000
Educational Cess @ 3%		3,540
Total Tax Payable		1,21,540

Source: <http://www.itrust.in/content/tax-planning/calculating-your-income-tax-liability-in-india-2010-11>

In this case, the tax payer took advantage of Section 80C availing full deduction of ₹ 1,00,000. In addition he is also availing an extra deduction of ₹ 20,000 for a combined contribution in insurance policy and charity. You can simply address Rajiv as taken advantage of effective tax planning.

From the above illustration it is clear that the tax planning in compensation management aims at planning three basic elements:

1. **Salary:** The word salary is used to define the remuneration paid by employer to the employee on periodic basis as mentioned in the employment contract.
2. **Allowances:** The other major component of remuneration/compensation package is allowances which are chargeable to income tax. If, however, such payments are made to meet expenses that are wholly, in the performance of duties of an office will be permissible as deductions.
3. **Perquisites:** The third component of an employer's remuneration is perquisites. Perquisites are normally in the nature of voluntary payments attached to an office or employment.



**Task** Critically analyse your own compensation structure in terms of Tax Planning and calculate the savings that you have accumulated out of your investment plans for a period of say 2 to 5 years.

### 10.2.1 Tax Implications of Employee Compensation Package to Employer

While deciding the salary packages, its various elements as well as tax provisions which have implications to the employer must be taken into account. It must be kept in mind that values and principles of any profession or business should not be sacrificed for the reason of attaining the goals of reduction in liability of tax of an employee.

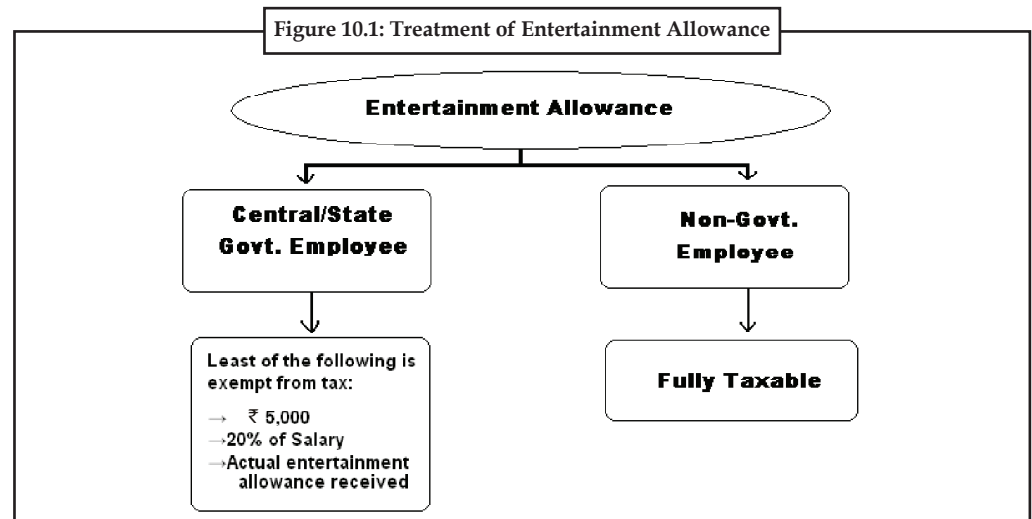
In respect of perquisites and compensation, the scope of tax planning is limited as the law gives the treatment of each and every elements of the salary package. Hence, the provisions made by the Income Tax for the following deductions from the compensation of employees are as follows:

1. Commission and bonus
2. Payment of perquisites and allowances/salary
3. Expenditure on remuneration planning
4. Contribution of employer on staff welfare fund
5. Expenditures on entertainment

Therefore, employer has to make ensure that tax must be deducted apart from complying with the necessity of the above listed provisions. And for this he/she must consider certain aspects:

According to Secs. 15 and 17 of Income Tax Act, 1961, Remuneration is chargeable to tax either on due basis or on receipt which ever falls before. Here the term remuneration comprises of commission, basic pay, leave encashment, fee, perquisites etc.

1. **Deductions:** You can found various types of deductions which are available to the income earning of individuals in the form of compensation such as tax on employment on paid basis, standard deduction and entertainment allowance. Entertainment allowance as shown in figure 10.1 is maximum deductible to the least of following three for only government employees.



Source: <http://www.incometaxmanagement.com/Pages/Graphical-ITax/Entertainment-Allowance-Salary.html>

2. **Allowances:** An employer offered the allowances to his/her employees for the personal benefit as well as for the purpose of assessment of income tax will form the part of the compensation. Some of the allowances which you found in Section 10(4) of the Income Tax Act are as follows:

- (a) *Travelling Allowance and Expenses:* The allowance which is either offered for the period of journey or on trip journey in association with transfer or to meet the ordinary every day cost or to meet the travelling expenses which are incurred by the employee on account of absence from his normal place of job is thus exempted from the income tax.
- (b) *Conveyance Allowance:* This allowance is exempted from income tax to the degree of which is essentially utilised for the performance of duties in an organisation.
- (c) *House Rent Allowance:* Tax exemption from HRA will be offered to the employees only if the same is received as repayment for payment of rent made by employee as a tenant for the house occupied.

In addition to the above allowances, the employer may grant to the employee any other special allowance provided it is in the nature of expenditure incurred in performance of duties attached to the employees' official duties. Any allowance which does not satisfy this requirement will ordinarily be taxable unless some specific provision exists or is made in the Income Tax Act.

3. *Perquisites:* A substantial part of the salary is in the form of perquisites. While planning the compensation package, it is important that care is taken to distinguish whether a particular perquisite is taxable or not.
  - (a) *Rent-free accommodation:* The valuation of rent-free accommodation as a perk at Delhi, Mumbai, Kolkata and Chennai is taken at 10% of salary so long as the rent of the accommodation does not exceed 60% of salary. In respect of any other place, the ceiling of fair rent for the purpose of assessment of perquisite value rent free accommodation is 50% of salary.
  - (b) *Provision of company owned car:* The perquisite value of this benefit is nil when the car is used wholly for the purpose of official work. On the other hand, if the car is entirely used for employee's private purpose than the amount actually spent by the employer for the maintenance and running of the car including normal depreciation or hire charges of the car if taken on hire is taken as the perquisite value in addition, the remuneration paid to the driver is also included for calculating the expenditure incurred on running and maintenance of the car.
  - (c) *Furniture:* The perquisite value of furniture like radio sets, television sets, refrigerators, air-conditioners provided by the employer is 10% per annum of the original furniture cost or actual hire charges payable if the furniture was hired by the employer.
  - (d) *Leave Travel Concession:* The exemption in respect of leave travel concession is available for vesting any place in India up to the amount equivalent to air-conditioned second class rail fare by the shortest route or the amount spent whichever is lower. In case the place visited is not connected by rail, first class or deluxe fare in any recognised public transport by the shortest route or the actual expenditure incurred whichever is lower.
  - (e) *Medical facilities:* The benefits derived by employees from medical facilities do not constitute a part of the salary which are in form of reimbursement of expenditure actually incurred on the treatment or the provision of facilities for diagnosis, treatment etc
  - (f) *Other non-taxable perquisites:*
    - (i) Refreshment provided during working hour of office premises
    - (ii) Subsidised lunch or dinner provided in the company's canteen
    - (iii) Recreational facilities
    - (iv) Good manufactured by the company sold to the employees at concessional rates

**Notes**

- (v) Subsidised transport to cover journeys between office and residence
- (vi) Employee's contribution to group insurance scheme
- (vii) Payment of premium for personal accident policy
- (viii) Education allowance to the extent of ₹ 50 and hostel allowance of ₹ 150 per month per child for utmost two children.
- (g) *Gas, Electricity, Water, etc.:* This facility is non-taxable if gas, electricity, or water is supplied to the employee out of employees own sources, the amount spent on purchases is liable to tax in the hands of the employee.



*Caution*

1. LTC under section 10(5) IT Act is exempted from tax
2. Transport allowance @ ₹ 800/- per month is exempted from tax
3. Foreign allowance/perquisites under clause 10(7) paid outside to Indian citizen by government for providing services outside India is exempted from tax.
4. Gratuity up to 3.5 lakh is exempted from tax
5. Leave salary or unavailed leave on retirement
6. Government employees fully exempted
7. Non-government employees up to 3 lakh
8. Pension is fully exempted
9. Retirement compensation are exempted
10. Retrenchment compensation under IT Act is exempted
11. Payment from statutory PF is exempted
12. HRA under Section 10(13A) is exempted
13. Awards are exempted



*Did u know?* There are some exceptions about tax rebate as follows:

1. Tax rebate of ₹ 12,000 on education per child to the maximum of two children
2. Rebate under Sections 88, 88A and 88B
3. Under section 88 the rebate will be available under the following items:
4. Payment of insurance premium for life of the individual, the wife/husband/any child
5. Any contribution made to provident fund either EPF or approved superannuation fund
6. Any deposit with the post office saving bank
7. National Saving Certificates
8. Unit Link Insurance Plan 1971 of UTI
9. Unit Link Insurance Plan of LIC mutual fund notified by Central Govt. under Section 10(23d)



10. Any subscription made to deposits or any contribution made the National Housing Bank's Pension Funds.

Notes

### 10.2.2 Fixation of Tax Liability

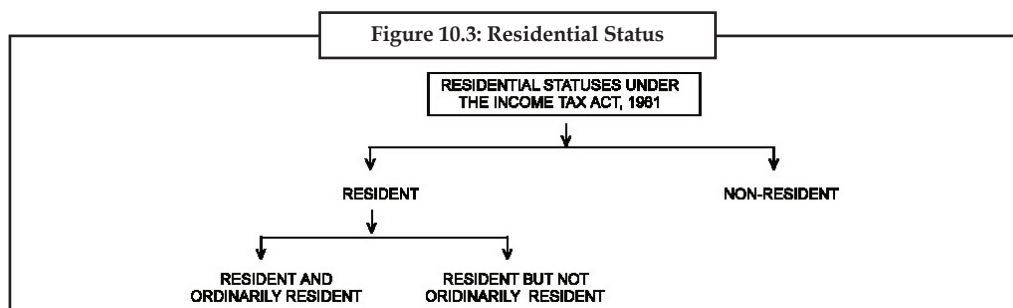
In India the income tax payable under the head salaries is imposed by Government of India for individuals, firms, trusts, co-operative societies and any other artificial person. The tax is levied differently on every person depending on the components of his compensation package. The Tax is levied by the department of Central Board of Direct Taxes (CBDT), acting as a part of Ministry of Finance as governed by the Income Tax Act, 1961.

The taxes on salaries or any other income of individual is fixed after a combined working of different income tax Acts, rules, notifications and legal decisions taken in court concerning that head of income.

To fix up the tax liability on both employer and employee in respect to salary income the information about their residential status as given in figure 10.3 is of critically important to judge the amount of the taxes to be paid by them in a assessment year. The residential status is divided into three broad categories:

1. Resident and Ordinary Resident (ROR)
  2. Resident and Not Ordinary Resident (RNR)
  3. Non-resident of India (NRI)
1. **Resident of India:** A person is accounted as a resident in India if he fulfils any one of the below mentioned basic conditions:
    - (a) He is in India for a period of 182 days or more in the previous year.
    - (b) He is in India for a period of 60 days or more in the previous year and 365 days or more during 4 years immediately preceding the previous year.
  2. **Resident and Ordinary Resident (ROR):** An individual fulfilling the below mentioned two conditions in addition to the one of the basic condition mentioned above will be referred to as ROR for taxation purpose in an assessment year.
    - (a) He is a resident in India for 9 out of 10 years immediately preceding the relevant previous years
    - (b) He has been in India for a period of 730 days or more during last 7 years immediately preceding the relevant previous year.

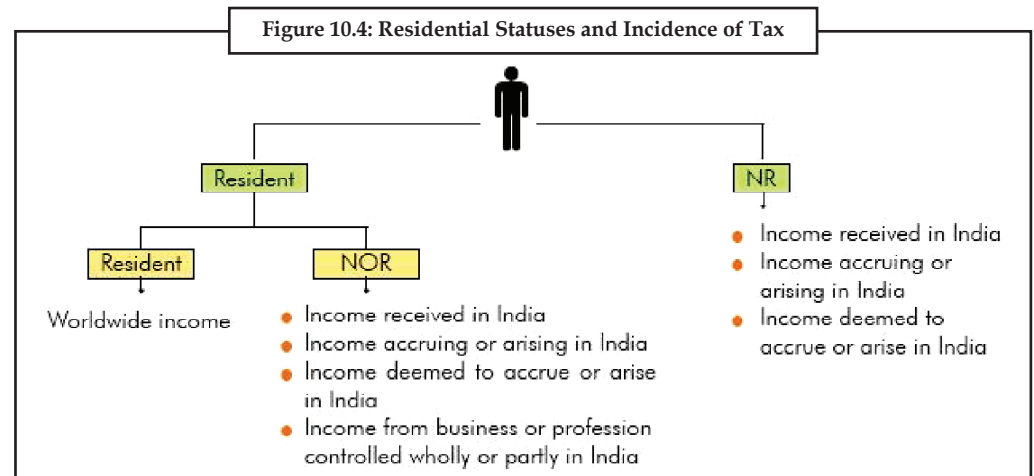
Any person who satisfies the basic conditions of residency not satisfying the above two additional conditions is termed as Resident but Not Ordinary Resident (RNR). Any person not even fulfilling any one of the two basic conditions is termed as Non-resident of India (NRI) for tax assessment purpose.



Source: <http://www.itact.co.cc/>

Notes

The income for which tax is paid by an assessee is shown in figure 10.4.



Source: <http://www.itact.co.cc/>

The Tax slabs for Assessment year 2012-13 is given in table 10.2. On the basis of these tax slabs an individual employee will pay taxes for their income earned under the head salaries.

**Table 10.2: Tax slabs for assessment year 2012-13**

<b>1. Annual IIT Rates for All Individuals, Hindu Undivided Families, Associations of Persons, Bodies of Individuals, or Artificial Juridical Person</b>	
Amount (₹)	Tax Rate
Upto ₹ 200,000	Nil
₹ 200,001 to ₹ 500,000	10 percent
₹ 500,001 to ₹ 1,000,000	20 percent
Above ₹ 1,000,000	30 percent

<b>2. Annual IIT Rates for Individuals Aged Between 60 and 80 Years Anytime During the Previous Year</b>	
Amount (₹)	Tax Rate
Upto ₹ 250,000	Nil
₹ 250,001 to ₹ 500,000	10 percent
₹ 500,001 to ₹ 1,000,000	20 percent
Above ₹ 1,000,000	30 percent

<b>3. Annual IIT Rates for Individuals Aged Over 80 Years Anytime During the Previous Year</b>	
Amount (₹)	Tax Rate
Upto ₹ 500,000	Nil
₹ 500,001 to ₹ 1,000,000	20 percent
Above ₹ 1,000,000	30 percent

Source: <http://www.india-briefing.com/news/indias-tax-structure-year-201213-5297.html/>



Caselet

### **National Fertilizers Ltd. (NFL)**

**A** continuous chemical process industry, National Fertilizers Limited (NFL) is in the business of producing fertilizers. It basically produces urea under a trade name. Its production capacity is around 32 lakh million tonnes per year. With a market share of around 14 per cent, NFL is one of the largest producers of nitrogenous fertilizers in India. NFL also manufactures and markets industrial products, namely methanol, argon, liquid nitrogen, liquid oxygen, nitric acid and carbon dioxide; sulphur is also produced as a by-product.

The mission of NFL is to produce as well as market its products efficiently and economically and serve the farmer community and other customers with quality products and maintain its leading position in the fertilizer industry to the benefit of the national economy. Towards this end, the company has been striving to move its workforce to improve production capacity utilisation, securing optimum manpower utilisation, and reducing consumption of major process material through better operation, process control and maintenance of equipment. Therefore, various incentive schemes have been introduced from time to time with objective of tax planning. These schemes give an opportunity to employees to improve their earnings. After rethinking and a lot of deliberations with the help and guidance of an outside consultant, NFL has recently restructured its salary and incentive scheme enabling employees avail tax planning benefits.

Source: Compensation and Reward Management, 1st Edition, B. D Singh, Excel Books

### **Self Assessment**

Fill in the blanks:

5. The scope of ..... is limited as the law gives the treatment of each and every elements of the salary package.
6. The Tax is levied by the department of ....., acting as a part of Ministry of Finance as governed by the Income Tax Act, 1961.
7. To fix up the tax liability on both employer and employee in respect to salary income the information about their residential status is of critically important to judge the amount of the taxes to be paid by them in a ..... year.
8. The tax is levied differently on every person depending on the components of his ..... package.

### **10.3 Tax Planning Regarding Fringe Benefit Planning**

A fringe benefit is a form of pay (including property, services, cash or cash equivalent) in addition to stated pay for the performance of services. Some forms of additional compensation are specifically designated as “fringe benefits” in the Internal Revenue Code; others, such as moving expenses or awards, have statutory provisions providing for special tax treatment but are not designated as fringe benefits by the Code. Fringe Benefit Tax (FBT) is a tax on benefits that employees receive as a result of their employment, including those benefits provided through someone other than an employer. The definition of fringe benefits applies to services of employees and independent contractors; however, unless otherwise indicated, this guide applies to fringe benefits provided by an employer to an employee.

**Notes**

Fringe Benefit Tax (FBT) is a tax levied on perquisites-or fringe benefits -provided by an employer to his employees, in addition to the cash salary or wages paid. Fringe Benefit Tax was introduced in India in the year 2005-2006. Fringe Benefit Tax is subject to varying treatment in different countries. These benefits are either taxed in the hands of the employees themselves or the value of such benefits is subject to a 'fringe benefit tax' in the hands of the employer. The rationale for levying a fringe benefit 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. 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.



*Notes* A two-pronged approach has been adopted for the taxation of fringe benefits under the Income-tax Act.

Perquisites which can be directly attributed to the employees are 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.

In cases, where 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, 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.

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 fringe benefit tax rules proposed in the Budget by the finance minister are modelled 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 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.

From a tax savings perspective, fringe benefit planning can achieve considerable results. The business would be able to deduct the cost of these qualified benefits to save on taxes; yet the recipient would not have to pay current taxes on the value of the benefits received. A "two for one savings" results, especially for an owner who is also a qualified employee. So a business owner should have an overview of some of the options in regard to fringe benefits, and potential limitations or caveats. By definition, a fringe benefit is a form of compensation—other than cash—given to a qualified recipient. Generally speaking, the bulk of the tax-free fringe benefits can be granted to a qualified recipient who is an employee or to an owner who can also be set up as a qualified employee.

Fringe benefits shall be deemed to have been provided if the employer has incurred any expense or made any payment for the purposes of:

Notes

1. entertainment;
2. festival celebrations;
3. gifts;
4. use of club facilities;
5. 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;
6. maintenance of guest house;
7. conference;
8. employee welfare;
9. use of health club, sports and similar facilities;
10. sales promotion, including publicity;
11. conveyance, tour and travel, including foreign travel expenses;
12. hotel boarding and lodging;
13. repair, running and maintenance of motor cars;
14. repair, running and maintenance of aircraft;
15. consumption of fuel other than industrial fuel;
16. use of telephone;
17. scholarship to the children of the employees.

The IRC may provide that fringe benefits are non-taxable, partially taxable, or tax-deferred. These terms are defined below.

1. **Taxable:** Includible in gross income unless excluded under an IRC section. "Taxable" means the benefit is included in the employees' wages and reported on Form W-2, Wage and Tax Statement, and generally is subject to Federal income tax withholding, social security (unless the employee has already reached the current year social security wage base limit), and Medicare. If the recipient is an employee, this amount is includible as wages.



*Example:* Bonuses are always taxable because no IRC section excludes them from taxation.

2. **Non-taxable (excludable):** Excluded from wages by a specific IRC section.



*Example:* Qualified health plan benefits excludable under section 105.

3. **Partially taxable:** Part is excluded by IRC section and part is taxable. Benefits may be excludable up to dollar limits, such as the public transportation subsidy under IRC section 132.

4. **Tax-deferred:** Benefit is not taxable when received, but subject to tax later.



*Example:* Employer contributions to an employee's pension plan may not be taxable when made, but may be taxed when distributed to the employee.

**Notes**

A benefit provided on behalf of an employee is taxable to an employee even if the benefit is received by someone other than the employee, such as a spouse or a child. If an employee's wages are not normally subject to social security or Medicare taxes (for example, because the employee is covered by a qualifying public retirement system), otherwise taxable fringe benefits are not be subject to social security or Medicare taxes.

**10.3.1 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.

The chapter is divided into three parts. Part A contains the meaning of certain expressions used, Part B enumerates the basis of charge, and Part C delineates the procedures for filing of return in respect of fringe benefits, assessment and the payment of tax thereon.

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.

**10.3.2 Who pays 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.



*Caution* 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 are 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.

### 10.3.3 An Overview of the Possible Fringe Benefit Options

Notes

While there are limitations, compliance issues, and non-discrimination rules that can vary according to the particular fringe benefits being set up and the type of business structure you have, it's important to get an idea of the major fringe benefits that may be available.

The following list gives a brief synopsis of the main ones:

- (i) **Health & Accident Insurance:** The cost of this tax-free benefit for employees, their spouses and dependents may be deducted by the business.
- (ii) **Life Insurance:** Certain other types of life insurance arrangements may be set up with some limited tax-free or tax-deferred benefits.
- (iii) **Disability Insurance:** The premiums paid by the business for the policy are a tax-free benefit to employee.
- (iv) **Conditional Meals & Lodging:** If meals provided to employee on business premises, and lodging provided as a condition of employment—both for the employer's convenience—these are tax-free to the employee. Business deducts the full cost of lodging, and 50% of the cost of meals.
- (v) **Qualified Retirement Plan:** Contributions made by employer and/or employee may be deducted. Various limitations on amount of contributions depending on type of plans and participation percentages.
- (vi) **Working Condition Fringes:** If primarily for benefit of employment conditions, tax-free to employee.



*Example:* Parking costs, professional association dues, business publications, business equipment (including computers, telephones, etc.) for required use at home, entertainment and travel/transportation expenses, convention expenses, required qualified office in home expense reimbursement, etc.

- (vii) **Vehicle Expenses:** Cost of vehicle used for business purposes and/or as required by employer for business use may be tax-free to employee and deductible by business.
- (viii) **Transportation Benefits:** Qualified commuter transportation expense, transit passes, commuter parking costs may be tax-free to recipient.
- (ix) **On-premises facilities:** Eating facilities, day-care facilities, and athletic facilities available to all employees can be provided tax-free.
- (x) **Outplacement Assistance:** This can be a very valuable fringe to a terminated employee. Costs associated with finding another job may be fully tax-free: secretarial services, use of business facilities, counselling and resume services, etc.
- (xi) **Moving Expense Reimbursements:** Subject to various dollar cost limitations, certain costs associated with a qualified job-related move would be tax-free to employee and tax-deductible by the business.
- (xii) **Spousal Travel Costs:** If the business requires an employee's spouse to travel with the employee for business purposes, these costs can be paid by the business and not taxable to employee.
- (xiii) **Interest Rate Advantaged Loans:** If set up properly, employee can get lower rate loans (in some cases NO interest charges) than on the outside without paying taxes on the differential costs.

Notes

- (xiv) **Various Stock Options:** Depending on the types, and employee status, the value of these options may be tax-free, or tax-deferred. Overall goal of these options is to create opportunity to buy stock at a price lower than its actual worth.
  - (a) *Incentive Stock Options:* Employee buys at reduced value, benefit not normally taxable when exercised, but when stock is sold.
  - (b) *Restricted Stock Option:* Given subject to forfeiture rules if employee leaves prematurely. Not taxable until forfeiture period elapses, then taxed at fair market value and provides possible capital gains tax savings.
  - (c) *Non-qualified Option:* Taxable when exercised.
- (xv) **Stock Grants:** Business grants employee actual stock, not just options. The fair market value of the stock is taxable to employee. But if stock appreciates this hidden value is tax deferred, and may be taxable at reduced capital gains rates later on when sold. This can be a substantial tax benefit to people in high tax brackets.
- (xvi) **Deferred Compensation Plans:** Allows business to defer paying an employee for current work until a future date. Can be a good tax saving tool in situations where the expectation exists that the tax bracket for the recipient will be lower at the future date vs. the current date and/or vice versa for the business paying it. This is primarily a tax-deferring benefit, and the business takes the deduction for the paid compensation at the future date as well.
- (xvii) **Cafeteria Plans:** A benefit plan in which the employee has a choice of either receiving cash or two or more qualified benefits in lieu of cash. The allowable benefits that can be included in this plan are: disability, accident, health, dental insurance premiums, medical costs not covered by insurance, dependant care costs, and qualified 401(k) pension plans.

The bulk of the other fringe benefits that may not be allowed for the owners or controllers of the business entity types are summarised as follows:

- (a) **Sole Proprietors:** Cannot get tax-free status in on-premise facilities, outplacement assistance, deferred compensation, disability insurance, death benefits, achievement awards, transportation benefits, moving expense, cafeteria plans, interest rate advantaged loans, stock options, stock grants.
- (b) **Partner/owners:** Cannot get tax-free status in outplacement services, cafeteria plans, deferred compensation, disability insurance, stock options, stock grants, and interest rate advantaged loans.
- (c) **2% owner/shareholders of Sub Chapter S Corporation:** Cannot get full tax-free/ tax-deferred status in disability insurance, and cafeteria plans.

Be advised that these restrictions mostly apply to owners or controllers of these business entities. They usually do not restrict general employees from the tax-free/tax-deferred status of the above-mentioned fringe benefits. Fringe benefits can be a very valuable aspect of a business. Firstly, the potential tax-savings can be substantial. The business may be able to deduct the entire cost of these benefits, yet the recipients (business owner, employees) may be able to enjoy these fringes tax-free. Secondly, offering fringe benefits can help to attract better employees, and reduce employee turnover. This can save a business a considerable amount of money since employee turnover is so expensive to deal with, and higher quality employees usually translate into higher business profits.

But it may require some advance planning for some of the potential fringe benefits, especially if there is any possibility of a problem meeting the highly compensated/non-discrimination tests for certain fringe benefits.

Finally, the administration and reporting requirements make some of the fringes a chore to maintain, while for others it is relatively simple. So an analysis of the risk to rewards in this area



is always recommended before plunging in. Nevertheless, the business environment in regard to providing fringe benefits is getting more and more commonplace. So it is an area in which you, the business owner, should at least have a rough idea of the options and pitfalls.



*Did u know?*

1. **Prescribed interest rates:** These are the FBT prescribed interest rates, which are used to determine the fringe benefit value of low-interest loans provided to employees.
2. **Liable low-interest loans:** Learn about the FBT liability for current account debit balances, expense accounts, and loans to life insurance policyholders.
3. **Exempt low-interest loans:** A low-interest loan to employees may not be subject to fringe benefit tax if the loan credit is the same as normal commercial credit or if it is an employee share-purchase scheme. Learn about these circumstances.
4. **Record keeping for low-interest loans:** In most cases, your existing records will provide enough information to work out the value of low-interest loans for FBT purposes. See if you need to keep any extra records regarding accrued interest, the daily balance of the loans, and non-reviewable interest rates.
5. **FBT applied to low-interest loans:** FBT is calculated on loans by comparing the interest on the loan with the interest calculated using the prescribed rate.

### 10.3.4 Explanation of How FBT Will Operate

Finance Ministry officials indicated that organisations 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

- (a) **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.



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

- (b) **It will badly hit the corporates in India:** Reports suggest that the fringe benefits tax will result the Indian incorporations to an additional expenditure of about ₹ 25,000 crore.
- (c) **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.



*Did u know?* 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 the done thing. 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.

- (d) **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.

## Notes

**Notes Constitutionality of Fringe Benefit Tax**

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 exists, the extent 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 Assessment**

State whether the following statements are true or false:

9. Fringe Benefit Tax was introduced in India in the year 2000-2001.
10. Non-taxable (excludable) is not excluded from wages by a specific IRC section.
11. The fair market value of the stock is taxable to employee.
12. 2% owner/shareholders of Sub Chapter S Corporation cannot get full tax-free/tax-deferred status in disability insurance, and cafeteria plans.

## 10.4 Tax Planning Regarding Remuneration Planning

Remuneration planning refers to minimisation of the employees' tax liability. Restructuring is done for present remuneration plan by keeping in view present and future tax liability of employees. Remuneration is defined as the reward received from one's employment and the term covers all forms of salary and wages, including tips, allowances, benefits (such as company cars, medical plans and pension provisions), bonuses, cash and non-cash awards and incentives. It also includes the private use of company assets, although there are exemptions.

In terms of attracting and retaining the best people or rewarding them when they leave or retire, a tax efficient remuneration structure can be crucial in a competitive market. Whether considering termination payments ("Golden Handshakes") or inducement payments ("Golden Hellos") the tax issues are often central to the Decision-making process and our team has the knowledge and experience to guide you through all the issues.

### 10.4.1 Tax Planning for Salary Package

All income received as salary under employer-employee relationship is taxed under this head. If the income exceeds the minimum exemption limit the employers must withhold tax compulsorily as Tax Deducted at Source (TDS), and provide Form 16 to their employees, which show the details of tax deductions and net paid income. The components of salary are divided into DA, HRA, Conveyance Allowance, variable incentives etc. In order to get maximum tax benefits, the following provisions of income tax which are beneficial to employee should be included in the salary CTC.

#### HRA

Calculation of HRA as shown in table 10.3. Under sections 10(13A) of Income Tax Act, 1961 allowance is defined as an amount received by an employee paid by his/ her employer as a rent of his/her house. There is no exemption in tax if he is living in his own house or house for which he is not paying rent.

Table 10.3: Computation of Taxable HRA

Particulars	Amt (₹)	Amt (₹)
<b>Amount Received during the Year HRA</b>		XXX
Exemption under section 10 (13A) Less: Least of the following is exempt :	Xxx Xxx	XXX
1. Actual Amount of House Rent Allowance	Xxx	
2. 50% (for Chennai, Mumbai, Kolkata and Delhi) or 40% (for Other Place) of Salary.		
3. Rent paid for the accommodation over 10% of the salary*.		
<b>Taxable House Rent Allowance</b>		<b>XXX</b>

Source: [http://www.taxpeople.in/Tax\\_Planning\\_For\\_Salary-%20CTC.html](http://www.taxpeople.in/Tax_Planning_For_Salary-%20CTC.html)

Salary = Basic + DA (forming part of benefits) + Commission on sale on fixed rate.

#### Tax Point for HRA

The maximum benefit of HRA can be derived by having all the above 3 components be of more or less the same amount. Taxless Allowances are as follows:

1. Research Allowance: Any allowance granted for encouraging the academic researches and other professional pursuits.

- Notes**
2. Providing for use of Computer or Laptop.
  3. Gifts in kind up to ₹ 5000 is exempt.
  4. Telephone charges or Mobile charges are not chargeable to tax.
  5. Amount spent for providing free education facilities and training of employees is not taxable.
  6. Free Food & Beverage
  7. Medical Facility
  8. The amount of employer contribution towards
    - (a) Recognised PF (Up to 12% of Salary).
    - (b) Approved superannuation fund.
    - (c) Group insurance schemes.
    - (d) Employees state insurance schemes.
    - (e) Fidelity Guarantee Scheme
  9. Children Education Allowance : ₹ 100/child Max for 2 Children
  10. Hostel Expenditure Allowance ₹ 300/child Max for 2 Children
  11. Medical Expenses Reimbursement\*Max Up to ₹ 15000 pa
  12. Transport Allowance ₹ 800 pm (Irrespective of the amount spent)
  13. Leave Travel Allowance

Computation of Taxable Salary Income as shown in table 10.4.

**Table 10.4: Computation of Taxable Salary Income**

Particulars	Amt (₹)	Amt (₹)
Gross Salary Income		xxx
Add: Value of Perquisites Chargeable to Tax	xxx	
Add: Profits in Lieu Of Salary	xxx	xxx
<i>Less: Allowance to the extent Exempt From Tax</i>		
1. House Rent Allowance*		XXX
2. Leave Travel Allowance*		XXX
3. Children Education Allowance: ₹ 100/child Max for 2 Children	XXX XXX	XXX
4. Hostel Expenditure Allowance ₹ 300/child Max for 2 Children	XXX XXX	XXX
5. Medical Expenses Reimbursement* Max Up to ₹ 15000 pa	XXX XXX	XXX
6. Transport Allowance ₹ 800 pm (Irrespective of the amount spent)	XXX XXX	XXX
<i>Less: Deduction under Section 16 :</i>		
1. Professional tax	xxx	Xxx
2. Entertainment Tax	xxx	
<b>Income from Salary</b>		<b>Xxx</b>

Source: [http://www.taxpeople.in/Tax\\_Planning\\_For\\_Salary-%20CTC.html](http://www.taxpeople.in/Tax_Planning_For_Salary-%20CTC.html)

## 10.4.2 Tax Efficient Compensation Package

Notes

Provisions relating to tax laws associated with salaries, the exemptions limits on different types of allowances and reimbursement and rule relating to perk valuation should be known for an effective planning of tax package.

1. **Medical Reimbursement:** Tax exemption up to ₹ 15,000 per year is available for your medical expenses reimbursed by the employer against production of vouchers or bills for such payments. Even hospitalisation bills on self and family members are exempt if such expenses are incurred in a hospital which is under government empanelment or approved for notified diseases by the Chief Commissioner of Income Tax. Medical Insurance reimbursement can be taken as a without limit tax-free perquisite.
2. **Leave Travel Assistance:** The leave travel concession incurred by employee and his family members for travelling in India is available as exemption to the extent of actual amount spent excluding hotel lodging.
3. **Transport Allowance:** Transport allowance which helps an employee to meet the outlay related to work place commuting is exempt up to the extent of ₹ 800 per month.
4. **Motor Car:** This perk has the capacity to significantly reduce the senior executives' taxable salary. The taxable value of a motor car provided by your employer for both personal and official use is premeditated at ₹ 600 per month for cars having 16 hp rating and ₹ 800 per month for car with a higher rating. An additional cost of ₹ 300 for month is added for availing driver facilities.



*Example:* Mohan working as a senior executive with R Ltd is provided with a car on hire purchase with monthly instalment of ₹ 8,000. The driver and fuel charges are ₹ 3,000 and ₹ 5,000 respectively. An average of ₹ 1000 is paid on taxes, insurance and maintenance of car. Therefore his company is spending ₹ 17,000 for car but his taxable perk will only be ₹ 1100 per month.

5. **Rent-free Accommodation:** The taxable value of Rent free accommodation acting as a major tool for tax reduction for senior personnel is computed as 10 percent of basic salary, bonuses, commission, taxable allowances except DA, employer's contribution to PF and perks etc. In addition the fair rental value of house in excess of 60 percent if house is in metropolitan cities and 50 percent in other places is also included.



*Example:* Ram employee of a company lives in Delhi in a house provided by his employer for which he incurs expenses worth ₹ 30,000 per month. Ram's salary excluding perks is ₹ 50,000. The fair rental value of house is ₹ 30,000. In this case the value of rent free accommodation will be 10 percent of salary or ₹ 5,000 per month.

6. **House Rent Allowance:** The House Rent Allowance (HRA) provided to employees by their employers is exempt to the extent of the least of the three:
  - (a) Excess of rent paid over 10 per cent of salary
  - (b) If the house is provided in metropolitan cities than 50 per cent of salary or 40 per cent of salary for other place
  - (c) Actual amount received

### 10.4.3 Salary Restructuring

You can define salary restructuring as the process of redesigning your salary in such a way that it results in minimisation of total tax liability. While restructuring your salary include the following questions to enable you to reduce your tax liability to minimal:

1. See whether your employer provide House Rent Allowance or Rent Free Accommodation or not. If yes than include it in your salary as it gets deducted from your total taxable salary
2. If uniform is mandatory
3. in your organisation than make sure that you take the advantage of expenses that you incur on purchasing and maintaining uniform as it is not charged to tax.
4. Does your salary structure include children education and hostel allowance? You can claim it as exemption under Section 10 (14).
5. Are you availing any telephone facility? It is non-taxable. But it does not include telephone allowance which is fully taxable.
6. Take advantage of Car facility if provided by employer as the value of motor car as a perk is quite inferior to the actual expenses incurred on car.
7. At time of visiting doctor use medical reimbursement to save up to ₹ 15,000 per annum but not medical allowance as it is fully taxable.
8. Take the benefits arising out of Fringe Benefit as it tax-free in hands of employees.
9. You can also take the advantage of salaries paid in advance or salaries that are in arrear under Section 89 (1).
10. Inclusion of dearness allowances and commission will help you lower your tax liability on HRA, pension and gratuity payments.
11. Try to commute your pension as it is partially exempted from non-government and fully exempted for government employees.
12. If your previous employer was participating authorised provident fund, and going for job change within 5 years from joining the firm than make sure that your new employer is also affiliated to an authorised provident fund enabling transfer of corpus without any tax.
13. You can plan your resignation or retirement at beginning of the financial year to lower your retirement benefit tax.
14. Try to take the advantage to the highest possible level regarding leave travel concession.



*Example:* Mr. A has an annual salary of ₹ 3,00,000. He gets HRA for ₹ 20,000, Medical reimbursement for ₹ 6,000. He also received an allowance of ₹ 16,000 for his daughter's education. Mr A's total Taxable Salary is now = ₹ 2,58,000 (3,00,000 – 20,000 – 6,000 – 16,000) instead of ₹ 3,00,000.

Therefore after restructure your salary you can opt for any of the following tax saving instruments to take advantage of maximum exemption up to ₹ 1, 00,000:

1. **Insurance:** Payment made in respect of health and life insurance is eligible for tax benefit. Health insurance over and above the upper limit of ₹ 1, 00,000 can provide you a benefit of ₹ 15, 000.
2. **Public Provident Fund:** Both capital and interest are tax free.
3. **Post office Accounts/National Saving Certificates:** These are the saving schemes of the government with lock-in period of 5 years available at post office.
4. **ELSS:** Equity Linked Saving Schemes offered by mutual funds provide investment option in various qualities of stocks.

5. Housing/Education Loans.
6. Charity/Religious trusts.



*Example:* Table 10.5 mentioned below shows some of the examples and maximum deductions that you can include while restructuring your salary.

**Table 10.5: Examples of Investments and Deductions Available**

Example of Investments		Deductions available	
Amount	Your numbers (in ₹)	Sections	When, where and how much of deductions
Insurance Premium	20,000	80C	₹ 1 lakh in specified instruments like life insurance and ELSS
Public provident fund	70,000	80CCC	Pension plans of Life insurance companies; 80 C limit stands reduced by 80CCC investment
Investment in ELSS	10,000	80D	₹ 10,000 deduction on mediclaim, ₹ 15,000 for senior citizens
Medical Insurance Premiums	10,000	80DD	₹ 50,000 reduced from total income of a person with a handicapped dependent
Donations	5,000	80DDB	₹ 40,000 and ₹ 60,000 (sr. citizen) deduction for expenditure on treatments of special diseases
Other deductions	0	80E	Interest on education loan – entire amount tax deductible
		80G	Donations (all donations don't qualify for 100% deduction)
		80GG	Deduction according to formula for rent paid for housing
₹ 1,15,000 – Total Deductions		80U	₹ 50,000 deduction from total income for handicapped persons

*Source:* <http://www.slideshare.net/vikramsankhala/tax-planning-for-salaried-individuals>

Therefore to conclude you can say that first thing that you need to perform is to configure your salary to minimise the tax liability. It reduces the need for tax savings investments and then opt for the most effective tax saving plans to reduce your tax liability to zero or minimal.



*Task* List down any ten investments which are covered under section 80 C. Compare and identify the best amongst them.

### Self Assessment

Fill in the blanks:

13. Remuneration planning refers to ..... of the employees' tax liability.
14. Under sections 10(13A) of Income Tax Act, 1961 ..... is defined as an amount received by an employee paid by his/ her employer as a rent of his/her house.
15. Tax exemption up to ..... per year is available for the medical expenses reimbursed by the employer against production of vouchers or bills for such payments.
16. .... as the process of redesigning your salary in such a way that it results in minimisation of total tax liability.

Notes



Case Study **Indian IT Companies**

**T**he techies in three major cities - Chennai, Bangalore and Hyderabad are not taking care about financial and tax planning, according to 70 percent of the respondents of the annual tax survey conducted.

The survey conducted by Right Horizons, an investment advisory firm, among 1,169 salaried individuals also finds that 82 percent of the respondents do not have any medical insurance and only 13 percent has medical insurance cover provided by their employees, reported The Times of India. As per the survey, 36 percent of the respondents in Chennai do not have any life insurance policies. 20 percent of the employees use PF investments as it is mandatory in many companies.

“Investments under Section 80C earn tax breaks for investors up to a maximum limit of ₹ 1 lakh. Therefore, it comes as a surprise that more than 75 percent of those surveyed had not fully utilised the limit and many of them actually went on to pay income-tax which could have been saved through better financial or tax planning,” the survey said.

The study clearly indicates that traditional investments such as PPF, NSC and life Insurance are still dominating in the investment profile with 58 percent of the respondents have these kinds of investments only. The survey also shows that only 35 percent have equity-linked savings scheme (ELSS) in their tax saving portfolio, while 5 percent respondents had more than 50 percent exposure to mutual funds as part of the 80C investments.

**Questions**

1. What do you think is the problem with Indian Tax Planning companies regarding Tax Planning for its employees?
2. What do you think is the reason for dominance of traditional investment techniques?
3. What suggestion would you like to provide them in taking advantage of Tax Planning?

Source: [http://www.siliconindia.com/shownews/Indian\\_IT\\_employees\\_careless\\_about\\_tax\\_planning\\_-nid-51778-cid-3.html](http://www.siliconindia.com/shownews/Indian_IT_employees_careless_about_tax_planning_-nid-51778-cid-3.html)

**10.5 Summary**

- Managerial decision may be defined as a systematic approach to formulate strategies for positioning the business in relation to its environment to ensure continued success and offer security from surprises.
- The make-or-buy decision is the act of making a strategic choice between producing an item internally (in-house) or buying it externally (from an outside supplier).
- Make-or-buy decision can be strategic or tactical and may involve parts, capital items, services of every type and a wide range of items supporting industrial operations (e.g., castings, tools, spare parts, etc.)
- An entity's non-financial assets can be acquired either through outright purchase or leasing arrangements.
- Export financing is often a key factor in a successful sale.
- For employees of large Indian and multinational companies, benefits go beyond salaries to include lifestyle perks such as company accommodation or club membership.



- The Tax is levied by the department of Central Board of Direct Taxes (CBDT), acting as a part of Ministry of Finance as governed by the Income Tax Act 1961.
- Fringe Benefit Tax (FBT) is a tax levied on perquisites-or fringe benefits -provided by an employer to his employees, in addition to the cash salary or wages paid and was introduced in India in the year 2005-2006.
- Remuneration planning refers to minimisation of the employees' tax liability.
- Salary restructuring as the process of redesigning your salary in such a way that it results in minimisation of total tax liability.

## 10.6 Keywords

**Allowances:** Money that a company or government agency provides to an employee for a specific purpose, such as transportation, healthcare costs or a flexible spending account.

**Buy or Lease Decision:** Business decision that compares the cost and benefits of a lease arrangement with the cost of a purchase.

**Employees Remuneration:** Employee remuneration refers to the reward or compensation given to the employees for their work performances.

**Fringe Benefit Tax (FBT):** It is a tax levied on perquisites-or fringe benefits -provided by an employer to his employees, in addition to the cash salary or wages paid.

**Fringe benefit:** It is a form of pay (including property, services, cash or cash equivalent) in addition to stated pay for the performance of services.

**Make-or-buy decision:** It is the act of making a strategic choice between producing an item internally (in-house) or buying it externally (from an outside supplier).

**Managerial decision:** It may be defined as a systematic approach to formulate strategies for positioning the business in relation to its environment to ensure continued success and offer security from surprises.

**Perquisites:** The term perquisite is defined to signify some benefit in addition to the amount that may be legally due by way of contract of services rendered.

**Remuneration planning:** It refers to minimisation of the employees' tax liability.

**Salary restructuring:** It is the process of redesigning your salary in such a way that it results in minimisation of total tax liability.

**Stock Options:** An option in which the underlier is the common stock of a corporation, giving the holder the right to buy or sell its stock, at a specified price, by a specific date which is also called equity option.

## 10.7 Review Questions

1. Define managerial decision. What are the dimensions of managerial decision-making?
2. Discuss the considerations involved in choosing between taxable and tax-free sales or acquisitions.
3. Write short note on the following:
  - (a) Make or buy decision
  - (b) Buy or lease decision
  - (c) Export or local sales decision

**Notes**

4. Discuss employee remuneration. Explain with the help of example.
5. Highlight the tax implications of employee compensation package to employer.
6. Explain Fringe Benefit Tax. Why is it important to introduce FBT?
7. Who pays Fringe Benefit Tax?
8. Elucidate an overview of the possible fringe benefit options.
9. Mr. Sharma employee of a company lives in Bangalore in a house provided by his employer for which he incurs expenses worth ₹ 40,000 per month. Ram's salary excluding perks is ₹ 60,000. The fair rental value of house is ₹ 40,000. Using these details what criteria you will use to find the value of rent free accommodation.
10. Ram has an annual salary of ₹ 5, 00,000. He gets HRA for ₹ 30,000, Medical reimbursement for ₹ 8,000. He also received an allowance of ₹ 18,000 for his daughter's education.

**Answers: Self Assessment**

- |                  |   |
|------------------|---|
| 1. True          | 2. False                                |
| 3. True          | 4. False                                |
| 5. Tax Planning  | 6. Central Board of Direct Taxes (CBDT) |
| 7. Assessment    | 8. Compensation                         |
| 9. False         | 10. False                               |
| 11. True         | 12. True                                |
| 13. Minimisation | 14. Allowance                           |
| 15. ₹ 15,000     | 16. Salary restructuring                |

**10.8 Further Readings**



*Books*

Ahuja, G. K. & Gupta, Ravi, *Systematic Approach to Income Tax*, Bharat Law House.

Aggarwal, K., *Direct Tax Planning and Management*, Atlantic Publications.

Lakhotia, R.N., *Income Tax Planning Handbook*, Vision Books.

Singhania, V. K. & Singhania, Kapil, *Direct Taxes law & Practice*. Taxmann Publications.

Srinivas E. A., *Handbook of Corporate Tax Planning*, Tata McGraw Hill.



*Online links*

<http://www.enotes.com/make-buy-decisions-reference/make-buy-decisions>

<http://accountingexplained.com/managerial/relevant-costing/make-or-buy-decision>

<http://taxguru.in/income-tax/income-tax-planning-in-respect-of-salary-perquisites.html>

[http://www.irs.gov/pub/irs-tege/fringe\\_benefit\\_fslg.pdf](http://www.irs.gov/pub/irs-tege/fringe_benefit_fslg.pdf)

<http://www.rmsaccounting.com/PDFs/Fringe-Benefits-Tax.pdf>

## Unit 11: Tax Planning for Liquidation

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### Objectives

After studying this unit, you will be able to:

- Discuss the concept of liquidation
- Describe tax considerations in liquidations
- Explain liquidating a corporation
- Elucidate tax implications of liquidating a company

### Introduction

When companies go into liquidation, they need to do with the corporate Income Tax problems related to liquidation income, liquidation income tax and dividend distribution. Liquidation typically involves an adoption of a plan of liquidation, necessary local law notifications to various interested parties, winding down of business operations, distributions of assets, and the eventual dissolution of the corporate law shell. Sections 332 and 337 generally govern liquidations of solvent, 80 percent (vote and value) controlled subsidiaries into their corporate shareholder. These rules are widely understood to allow a tax-free transaction in which neither the corporate

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shareholder nor the liquidating subsidiary recognises any gain or loss in the liquidation. So, before one can embark on a study of tax planning in case of liquidation, it is absolutely vital to understand the concept of liquidation along with its tax implications and considerations. The purpose of this unit is to enable the students to comprehend basic expressions. Therefore, all such basic terms are explained and suitable illustrations are provided to define their meaning and scope.

### 11.1 Concept of Liquidation

A liquidation or winding up is a process whereby a liquidator is appointed to realise the companies' property and distribute the proceeds to its creditors and thereafter distribute any surplus to the companies' shareholders. The liquidator has responsibilities to all of the creditors of the company and he becomes the proper officer of the company for tax purposes. Unlike the position for insolvent liquidation where there is very little scope for tax planning as the sole concern of the liquidator will be to minimise corporation tax liabilities and to maximise any claims or relief in solvent liquidations there may be considerable scope for the liquidator to undertake some tax planning. Liquidation of a business involves selling the assets of the firm paying liabilities and distributing any remaining assets. Liquidation may result from the sale of the business by mutual agreement of the partners from the death of a partner or from bankruptcy.

A formal corporate liquidation typically involves an adoption of a plan of liquidation necessary local law notifications to various interested parties winding down of business operations distributions of assets and the eventual dissolution of the corporate law shell. As a practical matter however many corporate attorneys prefer to simply merge a corporate subsidiary into its parent as a means of eliminating the subsidiary because corporate law merger procedures are often less onerous than the more formal liquidation procedures.

#### 11.1.1 Definition of Complete Liquidation

When companies cease their business operations, they go into a process of complete liquidation. This process essentially involves the dismantling of the company into its assets and the conversion of those assets into cash. Complete liquidation can be initiated by the owners of a company the creditors of a company or a court based on a petition by stakeholders of the company.

- (i) **Winding Up:** Once a company is ordered to liquidate, it will typically remain a going concern long enough to wind up its operations. This might include filling remaining orders paying suppliers satisfying contracts still in place or other unfinished business. The process of winding up can potentially take several years depending on the complexity of the business however courts ordering complete liquidation as well as business owners and creditors typically wish to have a short winding down period because it costs money to continue a business that is already facing financial difficulty.
- (ii) **Liquidation of Assets:** After businesses affairs have been wound up it will then liquidate its remaining assets, these assets could include inventory equipment land and buildings among other items. Depending of the nature of the companies business and the market for its assets the company may be forced to liquidate those assets at a significant discount relative to their true value or their original cost.



*Example:* A railroad company that goes out of business because its route is no longer profitable will have a hard time selling its track and may have to dismantle its tracks and sell the component parts at a significant loss.

- (iii) **Repaying Creditors:** After the companies' assets have been converted to cash the company must repay creditors for any outstanding debts. For a company that has gone bankrupt there may not be enough money to repay all creditors. In such a situation the creditors with

the highest priority debt will be repaid first and creditors with the most subordinated debt may not be repaid at all.

- (iv) **Distribution of Remaining Assets:** If there are any assets remaining after repaying creditors the final step in a complete liquidation is to distribute any remaining financial assets to the companies' owners or shareholders. In some cases a company goes out of business because a key member has died or retired and not because of poor financial health meaning that there may be significant assets remaining to be distributed. Typically shareholders are repaid in proportion to their level of ownership unless there is some agreement to the contrary.

### 11.1.2 When is it Appropriate to Seek Liquidation of a Company?

Liquidation of a company should be pursued where other case working actions including enforcement have not been successful or are unlikely to be successful given the circumstances of the case in securing the debt and where:

- (i) The tax debt is increasing and not under control; or
- (ii) The company has ceased trading and the tax debt is therefore no longer increasing but there is information available that there are assets remaining in the company which cannot otherwise be secured and which allowing for the liquidators costs will result in some payment by the liquidator towards the tax debts.

### 11.1.3 Procedure for Liquidation

The Companies Law provides for liquidation procedures for the various types of companies including General Partnerships Limited Liability, Companies Private Shareholding Companies and Public Limited Companies. The Law also states that the Liquidation Procedures for Public Limited Companies shall be detailed in a regulation issued pursuant to the provisions of the Companies Law no such regulation has been issued to date.

- (i) **General Partnership:** The Liquidator is appointed by the partners in the event of voluntary liquidation and by the court in the case of involuntary forced liquidation. Proceedings commence by publishing the liquidation decision in the local papers and preparing a list of the companies' assets and identifying its rights and obligations via third parties. The liquidator may not dispose of such rights or assets except with the permission of the partners or the Court as the case may be The Company shall maintain its legal entity until the liquidation procedures are complete.
- (ii) **Public and Private Limited Company:** The Company shall be liquidated upon final decisions of the Court by the appointed liquidator and the Company maintains its legal entity until liquidation procedures are complete but its operations shall be suspended. The party that declared the liquidation must notify the Jordan Securities Commission the Company Controller the Securities Depository Centre and the Stock Exchange the Controller shall publish the decision in the Official Gazette and local news papers. If the liquidation proceedings are not completed with within one year the Liquidator shall notify the Controller and in all cases proceedings shall not exceed three years.



*Did u know?* In the event of voluntary liquidation the General Assembly of the Company appoints the liquidator.

- (iii) **Branches of Foreign Companies:** The Companies Law stipulates that the branches of foreign companies operating in Jordan shall be subject to the same liquidation procedures under the Law.

Notes

- (iv) *Special proceedings for various types of companies:* The legislation provides for special liquidation procedures for certain types of companies under their special laws particularly banks and insurance companies. Banks are liquidated upon the decision of the Central bank and the liquidation procedures are carried out under the supervision of the Deposit Insurance Corporation while the insurance companies are liquidated by the Board of the Insurance Regulatory Commission.

**Self Assessment**

State whether the following statements are true or false:

1. Liquidation may not result from the sale of the business by mutual agreement of the partners from the death of a partner or from bankruptcy.
2. After the companies' assets have been converted to cash the company must repay creditors for any outstanding debts.
3. The Liquidator is appointed by the partners in the event of voluntary liquidation and by the court in the case of involuntary forced liquidation.
4. If the liquidation proceedings are completed with within one year the Liquidator shall notify the Controller and in all cases proceedings shall not exceed three years.

**11.2 Tax Considerations in Liquidations**

Generally when a person is experiencing extreme financial distress income tax liability is not a major concern. After all, the lack of income is at least partially responsible for the person's financial difficulties. If rather than selling assets the taxpayer turns the assets over to a creditor in partial or total satisfaction of the debt or the creditor exercises the right to foreclose on the assets the outcome is essentially the same. The transfer of property to a creditor and a foreclosure are both treated as a sale of the property for an amount equal to the property fair market value. There is of course the possibility of further income tax liability if the indebtedness that is discharged by the transfer or foreclosure is greater than the value of the assets. When property is transferred or foreclosed upon in satisfaction of a debt the general rule is that the taxpayer realises.

- (i) Gain on the property transferred possibly capital gain to the extent that the fair market value of the property exceeds the income tax basis in the property; and
- (ii) Debt discharge income to the extent the amount of debt discharged exceeds the fair market value of the property.



*Example:* In the case of farming operations however income tax liabilities present real difficulties. For farm debtors using the cash method of accounting the income tax basis of raised animals or stored grain is zero Machinery and equipment have often been depreciated rapidly with a resulting low basis and land that was purchased some time ago frequently has a low basis derived from the original purchase price and adjusted for improvements made in depreciation claimed. Thus there is a potential income tax liability created when assets are sold or turned over to creditors. In addition income taxes may be generated when debt is forgiven.

There are several options available to the farmer in dealing with these income tax problems. If farm assets are liquidated outside of bankruptcy any resulting tax liability is solely the responsibility of the debtor as the taxpayer In the event of liquidation tax liabilities may take several forms:

- (i) Ordinary income will result from the sale of assets such as grain or live stock held for resale.
- (ii) Ordinary income will result from the recapture of certain previously claimed tax benefits such as depreciation soil and water conservation expenses land clearing expenses and government cost sharing payments excluded from income.

- (iii) If capital assets such as real estate are sold to pay debts capital gains may result from the sale.
- (iv) An alternative minimum tax may be imposed on preference income that includes the portion of capital gains that individuals do not include as income.
- (v) If a taxpayer negotiates an arrangement with his creditors to transfer property to the creditor in forgiveness of the debt such debt forgiveness may generate ordinary income.

### 11.2.1 Affect of Appointment

The corporation tax accounting period ends immediately before the day of appointment of the liquidator and therefore the first day of liquidation becomes the first day in the new corporation tax accounting period. Once the liquidation has begun, the tax accounting period can only be brought to an end by the expiry of 12 months following the start of the tax accounting period or the conclusion of the liquidation.

The company in liquidation will lose beneficial ownership of its assets and therefore the company in liquidation will be degrouped from its subsidiaries for group relief purposes. However, by virtue of Section 170(11), a company in liquidation will remain part of a capital gains group. It is not clear in the cases of solvent liquidations (where shareholders may be said to have significant influence over the liquidator's actions) whether or not shareholders continue to exercise control over the company for the purposes of Section 840 of ICTA, 1988. Where shareholder control is lost the company will no longer be connected with other group companies for the purposes of transfer pricing and loan relationship legislation.

### 11.2.2 Cessation of Trade

The company is likely to cease trade on the appointment of a liquidator. Where trade and assets are sold the current period trading losses should be eligible to offset against any capital gains arising. When a company stops trading a tax account period comes to an end (Section 12(3) of ICTA, 1988) and any unrelieved trading losses are generally not available to shelter income in subsequent periods. However, where post-cessation trading income that is taxable under Section D Case VI arises, such as the release of trading debts, Section 105 of ICTA, 1988 allows trading losses otherwise extinguished from cessation to be set against such income.

1. Excess management expenses and Schedule A losses cannot be carried forward after the company ceases to carry out investment business and property business respectively.
2. Excess loan relationship deficits and capital losses are unaffected by cessation of trade and generally can be carried forward.
3. Where a loss arises in the final 12 months of trading it can be carried back to earlier periods or, if appropriate, sold to a fellow subsidiary.

### 11.2.3 Income Tax Treatment upon Enterprise Liquidation

Income tax treatment upon liquidation concerns the treatment of matters such as proceeds from liquidation income tax liability upon liquidation and payment of dividends in respect of any enterprise required to be liquidated under the Enterprise Liquidation Law or any enterprise to be treated as being liquidated under taxation laws and regulations such as conversion from a legal person into an organisation without legal personality upon the occurrence of economic acts of the enterprises such as termination of business disposal of assets settlement of debts and distribution of its remaining properties to the owners. On the basis of the Enterprise Income Tax

**Notes**

Law and its implementation regulations following provisions on the specific tax treatment for enterprise liquidation:

- (i) the gain or loss from the transfer of all assets should be recognised based on their realisation value or transaction value.
- (ii) the gain or loss from the cleaning up of debts and debt settlement should be recognised.
- (iii) the continuing operation accounting principle should be changed and costs of a withholding or apportionment nature should be handled.
- (iv) losses should be made up in accordance with the law and proceeds from the liquidation should be recognised.
- (v) income tax upon liquidation should be calculated and paid.
- (vi) the remaining properties distributable and dividends payable to shareholders should be determined etc.

**11.2.4 Tax Consequences of Liquidating a Subsidiary**

A subsidiary is an organisation that a larger business acquired and allowed to continue running its operations. Subsidiaries usually have clear differences between their business objectives and the parent company's, they may work in a different area of the supply chain, or sell entirely different products altogether so the parent company can benefit from revenues. Liquidation occurs when the parent company decides to end the subsidiary, closing it down and selling all its assets. While planning liquidation for a company, we also plan for the liquidation of its subsidiaries which entails the following consequences:

1. Parent companies have many reasons for liquidating a subsidiary.



*Example:* If a subsidiary is too far outside the scope of the parent company, the company may decide to sell it off as a way of moving back to core competencies. If a subsidiary becomes too expensive to run, it may be more economically feasible to sell it rather than keep. The parent company may simply want extra money in order to make another purchase.

2. At the corporate level, the corporation will receive a gain or loss upon full liquidation. The company recorded a specific fair market value for the subsidiary when it was first bought. Upon liquidating the subsidiary, the corporation will then receive two types of income. The first type is the money derived from the sale up to the amount that the subsidiary is worth on the books, which counts as taxable income. The second amount is above the book value, which counts as a net gain and is subjected to the capital gains tax. A loss allows for a lower taxable amount. There are also accumulated earnings credits that businesses can earn and use to reduce taxable income.
3. The gain and loss rules for the liquidation of a subsidiary depend on many different factors, including the varied laws by which different states operate. However, the company must sell the subsidiary as an actual division of the company, not just an investment business it was holding, in order to qualify for benefits like an accumulated earnings credit. The subsidiary must be fully sold, not simply broken apart and redistributed, to qualify for gains or losses.
4. At the shareholder level, all shareholders will receive remaining assets after liquidation, in proportion to their ownership (the shareholders not affiliated with the parent company). The shareholder also recorded a gain or a loss, usually a capital gain or loss, based on the current fair market value of the stock. Shareholders are allowed to defer gain recognition until the money is actually received in order to allow for market changes.



## Self Assessment

## Notes

Fill in the blanks:

5. Gain on the property transferred possibly capital gain to the extent that the ..... of the property exceeds the income tax basis in the property.
6. The corporation tax accounting period ends immediately before the day of appointment of the .....
7. A ..... is an organisation that a larger business acquired and allowed to continue running its operations.
8. At the ..... level, all shareholders will receive remaining assets after liquidation, in proportion to their ownership.



Caselet

### **In Real Life, Sometimes the Good Guys Win**

Consider the case of William Norwalk and Robert DeMarta when they liquidated their Fremont, California, CPA firm and traded the equipment, office furniture and their client list to a large regional firm in exchange for a partnership interest. The IRS determined their firm had realised a \$588,000 gain on liquidation of its goodwill and Norwalk and DeMarta, as shareholder partners, realised capital gains from the distribution of the goodwill.

**The IRS said the distribution of clients was a taxable event.** The IRS argued that when the corporation was liquidated, it distributed to its shareholders “customer-based intangibles” in addition to tangible assets. The intangible assets at issue included the corporation’s client base, client records and work papers and goodwill (including going-concern value). These intangibles, the IRS said, were corporate assets that had a specific value and when distributed to the shareholders in the liquidation, triggered taxable gains for both the corporation and the shareholders.

**The CPAs said the corporation didn’t own the clients.** The CPAs argued that the corporation did not own the intangibles in question. The accountants themselves owned the intangibles, they said, and therefore no tax was attributable.

**Agreements said that clients were assets of the corporation.** Prior to the liquidation, the firm had employment and non-compete agreements with the shareholders, which said, “Employee recognises and acknowledges that the list of the corporation’s clients, as it may exist from time to time, is a unique asset of the corporation’s business.” The agreements prohibited disclosure of the identity of the clients, barred the employee from performing services for clients outside the firm and set forth penalties for breach of these provisions.

**The Tax Court ruled the liquidation not taxable because agreements had lapsed.** At the time the firm liquidated, the agreements had expired and it did not have any effective employment or non-compete agreements with the two shareholders. Because of this, the Tax Court held that the distribution of the client base to the shareholders did not result in a taxable event to either the corporation or to the individuals.

The court found that client lists and goodwill have no “meaningful value” absent an effective non-compete agreement: “Because there was no enforceable contract which restricted the practice of any of the accountants at the time of the distribution, their personal goodwill did not attach to the corporation. Any goodwill transferred to the partnership was that of

Contd...

Notes

the individual accountants, not the corporation. Under these circumstances, we conclude that the value of any 'customer-based intangibles' that the corporation may have had was nominal".

Source: <http://www.journalofaccountancy.com/Issues/2001/May/AvoidTaxesInLiquidation.htm>

### 11.3 Liquidating a Corporation: How to Structure a Plan of Liquidation to Avoid Unanticipated Tax Liabilities?

Before the Tax Reform Act of 1986 (TRA) was enacted, a corporation generally did not recognise any gain or loss on the distribution of property in liquidation, or from corporate asset sales conducted pursuant to a plan of liquidation. Corporate assets sales are now fully taxable, and distributions in liquidation are treated as a deemed sale of property between the corporation and its shareholders for Fair Market Value (FMV) on the date of distribution. This deemed sale can present valuation problems if not an arm's-length transaction. This article will discuss the issues connected with the liquidation of a corporation, valuation of assets, limitations on losses for certain liquidating distributions and other problem areas and offer planning opportunities and techniques to minimise the overall tax consequences of liquidation.



*Notes* The Tax Reform Act of 1986 (100 Stat. 2085, 26 U.S.C.A. §§ 47, 1042) made major changes in how income was taxed. The act altered or eliminated many deductions, changed the tax rates, and eliminated several special calculations that had been permitted on the basis of marriage or fluctuating income. Though the act was the most massive overhaul of the tax system in decades, some of its key provisions were changed in the Revenue Reconciliation Act of 1993.

#### 11.3.1 Distribution of Assets

Sec. 336(a) provides, in general, that a liquidating corporation will recognise gain or loss on the distribution of its property in a complete liquidation as if the property were sold to its shareholders at FMV. If, however, any of the assets are subject to a liability, or if the shareholder assumes a liability, FMV cannot be less than the liability. This corporate "exit tax" will reduce the amount of assets available to distribute to the shareholders. While there is no limitation on the recognition of gain from a liquidating distribution, statutory anti-abuse provisions may restrict the recognition of losses. The distribution of assets in liquidation of the corporation will be treated as full payment in exchange for the shareholder's stock. The amount of gain or loss recognised by the shareholder will be the difference between the FMV (net of liabilities) of the assets received and the shareholder's basis in his cancelled stock.



*Did u know?* Probable price at which a willing buyer will buy from a willing seller when

- (1) both are unrelated,
- (2) know the relevant facts,
- (3) neither is under any compulsion to buy or sell, and
- (4) all rights and benefit inherent in (or attributable to) the item must have been included in the transfer.

FMV is generally the basis for tax assessment and court awards.

### 11.3.2 Concerns of the Liquidating Corporation

Notes

In theory, the tax consequences of liquidation should be the same whether the corporation sells assets to a third party and then distributes the proceeds to its shareholders or simply distributes all assets in liquidation.

- (i) **Valuation of assets:** The deemed sale created by a distribution may produce valuation problem not present in an actual sale to a third-party purchaser. Because the burden of proof of valuation is on the taxpayer, the corporation should retain a qualified appraiser to defend the value assigned to the assets. Obtaining an appropriate value for individual assets is not the only concern for the liquidating corporation. Since a liquidating distribution is a deemed sale of all corporate property, the IRS may seek to value the company as a going concern, if a shareholder continues the business as a sole proprietorship, proprietorship, with a result in valuation in excess of the aggregate value of the company's identifiable assets. In this regard, it is necessary to consider the applicability of Sec. 1060.



**Caution** If Sec. 1060 applies to the deemed sale, it is possible that an allocation to goodwill or going concern value would be required, increasing the corporate and shareholder tax burden.

- (ii) **Rules and applicability of Sec. 1060:** Under pre-TRA law, there existed a competing interest between buyers and sellers in the allocation of purchase price in asset purchases. Sellers generally benefited from a larger allocation to capital assets, including goodwill or going concern value, because of preferential capital gains taxation. Buyers generally benefited from a larger allocation to depreciable tangible assets or amortisable intangible assets, with goodwill or going concern allocations avoided to the extent possible. This adverse interest between the buyer and seller gave the allocation of a fixed purchase price to individual assets a measure of credibility. When the TRA eliminated preferential capital gains taxation, sellers could be expected to be indifferent to how a lump-sum sales price was allocated, since this allocation generally no longer had an effect on their tax liability. As a result, Congress was concerned about potential abuses in purchase price allocations, with particular emphasis on the assignment of value to goodwill or going concern value. Its response was to enact Sec. 1060, which mandates the use of the "residual method" of valuation to asset acquisitions.



**Notes** Sec. 1060 applies to any "applicable asset acquisition," which is defined as any direct or indirect transfer of assets that constitute a trade or business in the hands of either the seller or the purchaser, and with respect to which the transferee's basis is determined solely by reference to the consideration paid for the assets. The regulations issued under Sec. 1060 define a group of assets to constitute a trade or business if — the use of the assets would constitute an active trade or business for purposes of Sec. 355; or the character of the assets is such that goodwill or going concern value could attach to those assets.

Sec. 1060(a) provides that a lump-sum purchase price will be allocated among specific assets using the residual method approach prescribed in Sec. 338(b). Under the Sec. 338 temporary regulations, the residual method allocates the purchase price to identifiable tangible and intangible assets, up to their FMV, with any remainder allocated to goodwill or going concern value.

- (iii) **Disallowance of losses:** Losses are disallowed to the liquidating corporation on the distribution of any property to a related person if the distribution is not pro rata or consists of "disqualified property." For this purpose a related party generally refers to any

Notes

shareholder owning, directly or indirectly, more than 50% in value of the outstanding stock of the liquidating corporation. Disqualified property includes any property acquired by the liquidating corporation in a Sec. 351 transaction or as a contribution to capital during the five-year period ending on the date of distribution.

Losses may also be limited for certain distributions or sale or exchange transactions with a tax-avoidance motive. This limitation is to prevent shareholders from shifting losses to the corporation by contributing property with a built-in loss, with the objective of recognising the loss on a sale or distribution in liquidation. Any built-in loss cannot be recognised with respect to any property contributed in a Sec. 351 transaction or as a contribution to capital, if the contribution had a tax-avoidance motive. Any decline in value occurring after the contribution will result in a deductible loss. If the contribution occurs within two years of the adoption date of a plan of liquidation, the transaction is presumed to have a tax-avoidance motive.



*Did u know?* The loss disallowance rule may be difficult to apply for two reasons:

1. Determining the allowed loss requires knowing the asset's FMV at the date of contribution. It is unlikely the taxpayer had the foresight to appraise the asset at that time, creating significant potential for controversy.
  2. The adoption date of a plan of liquidation is subjective. The taxpayer's purposes may be served by delaying the adoption of a formal plan to a date more than two years from the contribution of the asset. The IRS would then be expected to argue that an informal plan had been previously adopted.
- (iv) **Using capital losses at the corporate level:** Since capital losses of a corporation are allowed to offset only capital gains, it is particularly important that the liquidating corporation generate sufficient capital or net Sec. 1231 gains to offset capital loss carry forwards and capital losses arising in the year of liquidation. Otherwise, all tax attributes disappear on liquidation, and no tax benefit will ever be realised from the capital losses.

On the sale or distribution of Sec. 1245 property, any recognised gain will be ordinary income up to the amount of depreciation claimed. Sec. 1250 requires the corporation to recognise ordinary income to the extent that depreciation claimed under the accelerated method exceeds the amount that would have been claimed using the straight line method. If real property is sold or distributed in liquidation, Sec. 291(a) requires the corporation to recognise ordinary income in an amount equal to 20% of the excess (if any) of the amount treated as Sec. 1245 recapture if that section had applied, over the amount treated as Sec. 1250 recapture. These recapture provisions may limit the ability of the liquidated corporation to offset capital losses.

### 11.3.3 Tax Treatment to the Shareholder

Various treatments of tax to shareholder are as follows:

- (i) **Character of gain or loss:** The character of gain or loss recognised by the shareholder from a liquidating distribution is generally capital in nature. If the liquidated corporation meets the definition of a collapsible corporation, any shareholder gain will be considered ordinary income. A collapsible corporation basically entails a distribution of property by a corporation to its shareholders before the corporation realises a substantial part of the taxable income to be derived from such property. Following the TRA, collapsibility is unlikely to be an issue because all corporate level income is recognised.
- (ii) **Gain deferral through the open-transaction doctrine:** A corporation may make a series of distributions in the course of a complete liquidation extending over several tax years.

Provided a legitimate business purpose exists for delaying the liquidating distributions, shareholder gain may be deferred by permitting the shareholder to first fully recover his basis. Losses cannot be recognised until all distributions are completed. Legitimate business purposes may include the retention of assets to satisfy liabilities, continued efforts to sell assets and the completion of all steps necessary to wind up the corporation's affairs. If there is no legitimate business purpose for delaying corporate distributions, the shareholder will be in constructive receipt of all funds, with all gain recognised immediately. A corporation discharged all of its liabilities and liquidated all of its assets. The company notified its shareholders that they would be able to receive a liquidating distribution on surrender of their shares of stock after a given date. Although a cash-basis shareholder postponed surrendering his shares until the following year, all income was recognised in the year in which the corporation notified the shareholder that a distribution was available. Postponement of gains recognition may be available when a distributed asset has no ascertainable value.



*Example:* A taxpayer sold shares of stock in exchange for cash and a contract to receive 60 cents per ton of iron ore to be mined in the future. The taxpayer received payments under the contract, but did not include them in income because she felt that the contingent nature of the payments should permit the use of basis recovery. The Supreme Court ruled that the mere promise of future monetary payments contingent on non ascertainable factors is not equivalent to the receipt of cash. Therefore, as annual payments based on the amount of extracted ore were received, they were apportioned first as return of capital and later as profit. The IRS has taken the view that only in "rare and extraordinary cases" will the valuation of an asset be non ascertainable.

(iii) *Income shifting through a pre-liquidation gift of shares:* If a shareholder has charitable desires or is interested in transferring wealth to a family member, a corporate liquidation presents a tax planning opportunity. A taxpayer may be reluctant to transfer shares in a closely held corporation because the transfer may result in a loss of control or a shift of ownership outside a family group. However, if a complete liquidation is contemplated, a transfer of shares can create tax savings without adverse ownership changes. As a general rule, income can be assigned provided the property that produces the income is transferred.

A gift of shares to a family member can shift the income from a liquidating distribution to the donee. Similarly, a donation of shares to a qualified charitable organisation can produce an immediate charitable contribution deduction while also shifting income to the exempt entity. The contribution deduction will be the FMV of the donated shares, unless the taxpayer is subject to the alternative minimum tax for the year of the transfer. Also, if a gift of non-publicly traded stock is made to a private foundation, the regular tax deduction is limited to adjusted basis.

## Self Assessment

State whether the following statements are true or false:

9. Corporate assets sales are not fully taxable.
10. Due to limitation on the recognition of gain from a liquidating distribution, statutory anti-abuse provisions may restrict the recognition of losses.
11. Losses may also be limited for certain distributions or sale or exchange transactions with a tax-avoidance motive.
12. If the liquidated corporation meets the definition of a collapsible corporation, any shareholder loss will be considered ordinary income.

## 11.4 Tax Implications of Liquidating a Company

It is not common for solvent companies to be liquidated; it's usually ones in distress where there is little to be paid to shareholders. Sometimes, if a company's active life has passed and there are untaxed capital profits in the company, liquidation might be worthwhile.

1. **Period of assessment:** Under Section 27(7) slightly different rules apply in relation to the length of a period of assessment when a company is being wound up. A new period of assessment starts at the commencement of the winding up (that is, the decision to wind up triggers the end of a period of assessment and the start of the next one). Thereafter, the periods will end every 12 months or, if earlier, the completion of the winding up. Section 27(7)(b) clarifies that the commencement of the winding up is on:
  - (a) the company passing a resolution to wind up; or
  - (b) the presentation of a winding up petition, or equivalent under company law.

A company in liquidation has ceased to be the owner of its own assets or liabilities. Section 26(2) provides that a company in liquidation remains chargeable to corporation tax on its profits.

2. **Filing and payment dates:** Where a company is in a winding up situation the definition of a specified return date for the chargeable period, as per Section 950(1), is amended. Where an accounting period under Section 14.8.1 above ends, the return is due within 3 months of the period end. Remember that Section 958(3)(d) still requires that the tax liability of a company be fully paid by the specified return date, so this earlier filing brings with it an earlier payment date. You will remember also that preliminary tax should be paid before the 21st of the sixth month of the accounting period and of the penultimate month of the accounting period Section 958(2A)(a).



**Caution** In a winding up situation, this payment rule remains unchanged even though the decision to wind up (and thereby trigger the end of the accounting period) has not yet been made at the new due date for the two instalments of preliminary tax.

3. **Loss relief:** The decision to wind up a company is often taken when the company is incurring losses. You will recall however that the amount of loss relief available depends on the length of the accounting period in which it was incurred.
4. **Group relationships:** When a liquidator is appointed, the liquidator becomes the beneficial owner of all assets of the company, thereby breaking any corporation tax or stamp duty group structures. Section 616(4) has special rules for CGT groups where it specifically states that a resolution or order for winding up shall not break the 75% relationship.



**Notes** Section 623(1) (d) also provides that where a company ceases to be a member of a group as a result of a bona fide dissolution or winding up, it shall not result in a crystallisation of any gains previously deferred under Section 617.

5. **Close company surcharge:** Distributions for the purposes of the close company provisions in Part 13 TCA 1997 are defined in Section 130 and Section 130 (1). Therefore, a company:
  - (a) which is a close company; and
  - (b) which has undistributed income which could give rise to a surcharge; and then
  - (c) decides to wind up,



**Caution** Cannot use a distribution in the course of winding up reducing or avoiding the surcharge on the pre-winding up income.

Therefore, a close company should ensure that it has no undistributed income which could give rise to a surcharge before deciding to wind-up.

Section 434(7) provides that a close company surcharge cannot arise where the company cannot legally make a distribution for a period. When a company is in liquidation it cannot legally make a distribution of any income earned during the liquidation and therefore no surcharge should apply. One exception to this is in the case of voluntary liquidations. In the case of a voluntary liquidation, the company can apply to the High Court to be removed from liquidation, thereby removing the legal impediment to making the distribution.

6. **Cessations:** The appointment of a liquidator does not necessarily mean the cessation of a trade. Whether or not the trade has ceased will be a matter of fact. If the trade has ceased then the normal cessation rules apply. When a liquidator is appointed to a company they will often negotiate with creditors to only pay. If the balance written off does not relate to a trading balance then Section 87 will not apply and you need to decide, based on first principles, if income tax under another Schedule or capital gains tax will apply.



**Example:** R Limited held a 35% interest in S Limited. During the year, S Limited went into liquidation owing 250k to R Limited. As part of the liquidation process the freehold interest in a site was transferred to R Limited in settlement of the outstanding liability. The market value of the site at the date of transfer was 500k.

A distribution in specie on a liquidation is treated as a mere conveyance for stamp duty purposes (and therefore exempt as it does not fall within any of the heads of charge in Schedule 1, SDCA 1999) unless the shareholder provides any form of consideration for the asset acquired. The assumption or waiver of a debt is treated as consideration under Section 41, SDCA 1999. R Limited is therefore liable to stamp duty of 250k (i.e. the amount of the debt outstanding from Limited at the date of liquidation) at a rate of 6% as a conveyance on sale (i.e. liability of 15k).

At general law, distributions made by a liquidator on the winding up of a company are a receipt of capital, not a dividend. However, subsection 47(1) of the Income Tax Assessment Act 1936 (ITAA 1936) deems a liquidator's distribution to be assessable as dividends to the extent that it represents income derived by the company. Subsection 47(1A) specifies that income is income according to ordinary concepts and statutory income including capital gains (but ignoring capital losses). Despite the fact that capital losses are ignored under subsection 47(1A), in most cases there will be no practical impact because only the amount actually available for distribution will be a dividend. A deemed dividend under subsection 47(1) is frankable.



**Task** Take a company of your choice and study its tax implications while liquidation.

## Self Assessment

Fill in the blanks:

13. A new period of assessment starts at the commencement of the .....
14. Section 26(2) provides that a company in liquidation remains chargeable to corporation tax on its.....

- Notes
15. The decision to wind up a company is often taken when the company is incurring.....
  16. The appointment of a liquidator does not necessarily mean the .....of a trade.



*Case Study* **Determining Tax Consequences of Corporate Liquidation to the Shareholders**

**U**nder Sec. 331, a liquidating distribution is considered to be full payment in exchange for the shareholder’s stock, rather than a dividend distribution, to the extent of the corporation’s Earnings and Profits (E&P). The shareholders generally recognise gain (or loss) in an amount equal to the difference between the Fair Market Value (FMV) of the assets received (whether they are cash, other property, or both) and the adjusted basis of the stock surrendered. If the stock is a capital asset in the shareholder’s hands, the transaction qualifies for capital gain or loss treatment.

If the corporation sells its assets and distributes the sales proceeds, shareholders recognise gain or loss under Sec. 331 when they receive the liquidation proceeds in exchange for their stock. If the corporation distributes its assets for later sale by the shareholders, the assets generally “come out” of the corporation with a basis equal to FMV (and with the related recognition of gain or loss under Sec. 331 for the difference between the FMV and the shareholder’s basis in the stock). As a result, the tax consequences of a subsequent sale of the assets by the shareholder should be minimal.

The result of these rules is double taxation. The corporation is treated as selling the distributed assets for FMV to its shareholders, with the resulting corporate-level tax consequences. Then, the shareholders are treated as exchanging their stock for the FMV of the assets distributed in complete liquidation, with the resulting gains or losses at the shareholder level.

***Recognising Capital Gains Rather Than Dividends***

When determining whether a closely held corporation should be liquidated, the tax consequences to the shareholders should be considered. If the stock is a capital asset in the hands of the shareholder, the shareholder has a capital gain or loss on the exchange. The maximum tax rate for both long-term capital gains (realised after May 5, 2003, and before 2013) and dividends (for tax years beginning after 2002 and before 2013) is 15%. For taxpayers in the 10% or 15% ordinary tax brackets, there is no tax on most long-term capital gains and dividends realised after 2009 and before 2013. Shareholders may want to evaluate the sale or disposal of stock by the end of 2012 to take advantage of the 15% dividend tax rate, lower individual income tax rates, and lower capital gain tax rates set to expire on Dec. 31, 2012. Guidance on the tax treatment of these items in 2013 and subsequent tax years is uncertain, so practitioners should watch for future legislation.

Shareholders that do not have a strong preference on whether distributions in 2012 are taxed as dividends or capital gain/loss may prefer sale or exchange (capital) treatment in 2012 if they:

1. Have capital losses or capital loss carry forwards, since Sec. 301 dividend income cannot be used to offset capital losses;
2. Have basis in stock that can be used to offset the distribution income (if the basis is higher than the amount of the distribution, the shareholder could potentially report a loss); or

*Contd...*



3. Desire instalment sale treatment – capital gain income can potentially be reported on an instalment basis, while Sec. 301 dividend income cannot.

#### ***Handling Corporate Liabilities***

Shareholders that assume corporate liabilities or receive property subject to corporate liabilities take the liabilities into account in computing their gain or loss. They do not increase their basis in the property received on liquidation because doing so would give them a double tax benefit. Instead, the liability reduces the amount realised by the shareholder.

If the property distributed is worth less than the amount of the liability itself, the FMV of the property is treated as no less than the amount of the liability [Sec. 336(b)]. The assumption of a contingent or unknown liability is disregarded in determining the property's FMV. However, the IRS has stated that a shareholder that assumes such a liability will receive capital loss treatment when the liability is ultimately paid by the shareholder (Rev. Rul. 72-137).

#### ***Handling Unrealised Receivables***

A corporation, whether it uses the cash or accrual basis, may have earned income that it has not collected before the liquidation takes place. The corporation recognises gain or loss for the receivable when it distributes the receivable to the shareholder. The shareholder does not recognise and report additional income as it collects the receivable because the shareholder has already included this amount in its gain or loss computation when it received the liquidating distribution. But if the amount of the receivable that the shareholder ultimately collects differs from the amount that the corporation distributed, the shareholder recognises gain or loss for the differences in the amounts reported and collected.

#### ***Receiving Liquidating Distributions in More Than One Year***

A distribution is treated as one made in complete liquidation of a corporation if it is one in a series of distributions in redemption of all the stock of the corporation pursuant to a plan of liquidation [Sec. 346(a)]. As a result, all the distributions necessary to effect a complete liquidation of a corporation do not have to take place on the same date or even in the same year.

**Observation:** Distributions in partial liquidation of a corporation must be made in the year the plan is adopted or in the subsequent year. No such requirement exists for distributions made in a complete liquidation of a corporation.

Unfortunately, no clear-cut guidance exists regarding the period over which liquidating distributions can be made. In fact, Sec. 346 does not address this issue. The IRS indicates it will normally not issue a ruling or determination letter on the tax effects of a corporate liquidation accomplished through a series of distributions made over a period in excess of three years from adoption of the plan of liquidation.

The liquidation should be completed as quickly as possible to ensure sale or exchange treatment (as opposed to possible dividend treatment if the corporation has E&P) for the liquidating distributions. Note also that Rev. Rul. 80-177 raises the issue of the constructive receipt of assets by shareholders when a corporation adopts a plan of liquidation and the shareholders are entitled to a liquidation distribution at any time after a certain date. Finally, it may be desirable to avoid a lengthy liquidation period to minimise exposure to double taxation and to avoid Sec. 541 Personal Holding Corporation (PHC) status for the corporation after the assets are sold.

Shareholders should maintain documentation that multiple distributions are liquidating distributions whenever multiple distributions are necessary (especially if they will span

*Contd...*

Notes

several tax years and, therefore, result in tax deferral). For example, a plan of liquidation documented in the corporate minutes could state that multiple liquidating distributions will occur and explain the business reasons for this.

**Recovering Stock Basis before Recognising Gain**

Generally, shareholders are allowed to recover their entire basis before recognising gain (Rev. Ruls. 68-348 and 85-48; and Quinn, 35 B.T.A. 412 (1937), acq. 1937-1 C.B. 21). The full amount (100%) of all distributions made after basis has been recovered is recognised as gain.

**Observation:** The current reduction of the maximum tax rate on capital gains and on qualifying dividends to 15% through 2012 somewhat mitigates the traditional preference for a sale or exchange transaction (e.g., a Sec. 331 liquidation payment) over a dividend. However, under current law, distributions made after 2012 will be taxed at higher capital gain and dividend rates. Therefore, taxpayers should consider making the final distribution before 2013.

When a shareholder holds several blocks of the same class of stock (acquired at different times and at different prices) and several distributions are made in complete liquidation, each distribution is allocated among the different blocks in proportion to the number of shares in each block.

**Claiming a Loss on a Liquidation**

A shareholder may claim a loss on a series of distributions only in the year the loss is definitely sustained. Generally, a loss cannot be recognised until the tax year in which the final distribution is received. However, there have been some exceptions to this rule (e.g., in the year the last substantial distribution was made because the amount of the final distribution was then determinable with reasonable certainty).

**Requesting a Prompt Assessment**

The normal period for assessment of tax is three years from the date the return is filed. A corporation can accelerate the period in which the IRS can assess tax by requesting a prompt assessment of tax [Sec. 6501(d)]. Form 4810, Request for Prompt Assessment under Internal Revenue Code Section 6501(d), is used to request a prompt assessment. The request limits the time for assessing tax or beginning a court action to collect the tax to 18 months from the date the request is filed. It does not extend the time in which an assessment can be made beyond three years from the date the return was filed.

One example of a situation when a request for prompt assessment might be appropriate is the liquidation of a corporation because of shareholder differences. If the IRS assesses an additional tax liability after the assets have been divided among the shareholders, disagreements could arise regarding who is responsible for the deficiency. On the other hand, filing a request for prompt assessment when there is only one shareholder might not be warranted.

**Questions**

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

Source: [http://www.aicpa.org/publications/taxadviser/2012/september/pages/casestudy\\_sep2012.aspx](http://www.aicpa.org/publications/taxadviser/2012/september/pages/casestudy_sep2012.aspx)

## 11.5 Summary

Notes

- A liquidation or winding up is a process whereby a liquidator is appointed to realise the companies' property and distribute the proceeds to its creditors and thereafter distribute any surplus to the companies' shareholders.
- Liquidation may result from the sale of the business by mutual agreement of the partners from the death of a partner or from bankruptcy.
- The process of winding up can potentially take several years depending on the complexity of the business however courts ordering complete liquidation as well as business owners and creditors typically wish to have a short winding down period because it costs money to continue a business that is already facing financial difficulty.
- The Companies Law provides for liquidation procedures for the various types of companies including General Partnerships Limited Liability, Companies Private Shareholding Companies and Public Limited Companies.
- Generally when a person is experiencing extreme financial distress income tax liability is not a major concern.
- The corporation tax accounting period ends immediately before the day of appointment of the liquidator and therefore the first day of liquidation becomes the first day in the new corporation tax accounting period.
- Subsidiaries usually have clear differences between their business objectives and the parent company's, they may work in a different area of the supply chain, or sell entirely different products altogether so the parent company can benefit from revenues.
- Liquidation occurs when the parent company decides to end the subsidiary, closing it down and selling all its assets.
- In theory, the tax consequences of liquidation should be the same whether the corporation sells assets to a third party and then distributes the proceeds to its shareholders or simply distributes all assets in liquidation.
- At general law, distributions made by a liquidator on the winding up of a company are a receipt of capital, not a dividend.

## 11.6 Keywords

**Cessation:** In Cessation, a company stops business operations.

**Corporate Assets:** Something valuable that an entity owns, benefits from, or has use of, in generating income.

**Creditors:** An entity (person or institution) that extends credit by giving another entity permission to borrow money if it is paid back at a later date.

**Liquidation:** A liquidation or winding up is a process whereby a liquidator is appointed to realise the companies' property and distribute the proceeds to its creditors and thereafter distribute any surplus to the companies' shareholders.

**Parent Company:** Firm that owns or controls other firms which are legal entities in their own right.

**Partnership:** A partnership is a strategic alliance or relationship between two or more people.

**Notes**

**Private Limited Company:** A private limited company is a voluntary association of not less than two and not more than fifty members, whose liability is limited, the transfer of whose shares is limited to its members and who is not allowed to invite the general public to subscribe to its shares or debentures.

**Public Limited Company:** A company whose securities are traded on a stock exchange and can be bought and sold by anyone.

**Shareholders:** A shareholder or stockholder is an individual or institution (including a corporation) that legally owns a share of stock in a public or private corporation.

**Subsidiary:** A subsidiary is an organisation that a larger business acquired and allowed to continue running its operations.

### **11.7 Review Questions**

1. Discuss the meaning of liquidation.
2. When is it appropriate to seek liquidation of a company?
3. Elucidate the procedure for liquidation.
4. Describe affect of appointment.
5. Throw some light on the treatment of Income tax upon enterprise liquidation.
6. What are the tax consequences of liquidating a subsidiary?
7. How to structure a plan of liquidation to avoid unanticipated tax liabilities?
8. Elucidate the tax implications of liquidating a company.
9. Write short note on cessation of trade.
10. "When property is transferred or foreclosed upon in satisfaction of a debt, the general rule is that the taxpayer realises." Explain.

### **Answers: Self Assessment**

- |                            |                |
|----------------------------|----------------|
| 1. False                   | 2. True        |
| 3. True                    | 4. False       |
| 5. Fair market value (FMV) | 6. Liquidator  |
| 7. Subsidiary              | 8. Shareholder |
| 9. False                   | 10. False      |
| 11. True                   | 12. False      |
| 13. Winding up             | 14. Profits    |
| 15. Losses                 | 16. Cessation  |

## 11.8 Further Readings

Notes



Books

Ahuja, G. K. & Gupta, Ravi, *Systematic Approach to Income Tax*, Bharat Law House.

Aggarwal, K., *Direct Tax Planning and Management*, Atlantic Publications.

Lakhotia, R.N., *Income Tax Planning Handbook*, Vision Books.

Singhania, V. K. & Singhania, Kapil, *Direct Taxes law & Practice*. Taxmann Publications.

Srinivas E. A., *Handbook of Corporate Tax Planning*, Tata McGraw Hill.



Online links

[http://taxinstitute.ie/TaxFind/ContentHTML/ParsedHTML/AITImanuals\\_htmlfiles%5CBT2\\_htmlfiles%5Cc14.t5.html](http://taxinstitute.ie/TaxFind/ContentHTML/ParsedHTML/AITImanuals_htmlfiles%5CBT2_htmlfiles%5Cc14.t5.html)

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## **Unit 12: Advance Tax Planning and Tax Relief**

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### **Objectives**

After studying this unit, you will be able to:

- Discuss the concept of advance tax payment
- Describe due dates and interest on late payment on advance tax payment
- Explain double taxation relief
- Elucidate double taxation relief provisions in India

## Introduction

Notes

Tax payers whose total income is likely to be chargeable to tax for the assessment year are required to pay tax in advance during the financial year (April 1 to March 31) on their estimated current income, which will be assessable to tax during the next following financial year called assessment year. The current income for this purpose means the total income which will be chargeable to tax in the relevant assessment year. The advance tax payable is the tax on the current income minus the tax deductible at source or collectible out of any income included in the current income. Although the income of previous year of the assessee is taxable in the immediately following assessment year, the assessee has to pay advance tax during the financial year proceeding the assessment year on the basis of his own computation of income. At present, all items of income including capital gains, winnings from lotteries, etc. are liable for payment of advance tax. So, before one can embark on a study of advance tax planning and tax relief, it is absolutely vital to understand the concept of advance tax payment along with its due dates and Interest on late payment on it as well as understand the meaning of double taxation relief and its provisions in India. The purpose of this unit is to enable the students to comprehend basic expressions. Therefore, all such basic terms are explained and suitable illustrations are provided to define their meaning and scope.

### 12.1 Concept of Advance Tax Payment

Advance payment of tax is another method of collection of tax by the Central Government in the form of 'Prepaid Taxes'. Such advance tax is in addition to deduction of tax at source or collection of tax at source. Scheme of advance payment of tax is also known as 'pay as you earn' scheme i.e., the assessee is required to pay tax during the course of earning of income in the previous year itself, though such income is chargeable to tax during the assessment year. Advance tax is payable on current income in instalments during the previous year.



*Example:* All persons including salaried employees and pensioners, in whose case tax payable during a financial year is ₹ 10,000 or more after adjusting all deductions, rebates & TDS are required to pay advance tax.

The provisions of advance tax are applicable on all types of persons irrespective of the residential status of the person. The advance tax is paid in the previous year itself. Thus, the tax is paid in the year of earning of income, in other words the earning of income and payment of tax goes simultaneously. Thus, the tax is paid as income is earned. This scheme of advance payment of tax is also called pay as you earn scheme, i.e., pay tax as you earn income. Payment of advance tax on estimated Income during the current year is required to pay for all assesses.



*Example:* In the Financial Year 2010-11 (Assessment Year 2011-12) advance tax is payable in instalments during the period 01.04.2010 to 31.03.2011 itself. The total amount of Advance Tax will be adjusted during the Assessment Year 2011-12 at the time of assessment.

Tax on current income at the rate in force during the financial year will be calculated by the assessing officer. From such tax calculated, the amount of income-tax which would be deductible or collectible at source during the said financial year shall be reduced and the amount of income-tax as so reduced shall be the advance tax payable. In revision of order for payment of advance tax [Section 210(4)], if, after making the above order, by the assessing officer, but before 1st March, return of income is furnished by the assessee or a regular assessment of the assessee is made in respect of any later year, for any higher figure the assessing officer may make an amended/ revised order to pay advance tax. On receipt of the revised order, the assessee will have to pay advance tax accordingly.

## Notes



**Notes Payment of Advance Tax in Case of Capital Gains/Casual Income [Proviso to Section 234C]**

- (1) Advance tax is payable by an assessee on his/its total income, which includes capital gains and casual income like income from lotteries, crossword puzzles etc.
- (2) Since it is not possible for the assessee to estimate his capital gains, income from lotteries, etc., it has been provided that if any such income arises after the due date for any instalment, then, the entire amount of tax payable (after considering tax deducted at source) on such capital gains or casual income should be paid in the remaining instalments of advance tax which are due.
- (3) Where no such instalment is due, the entire tax should be paid by 31st March of the relevant financial year.
- (4) No interest liability under section 234C would arise if the entire tax liability is so paid.

### 12.1.1 Who is Liable to Pay Advance Tax?

If the Income Tax Liability of any assessee is more than ₹ 10,000 in a financial year, then he is liable to pay such tax in instalments during the year itself rather than paying this tax at the end of the year. This tax which is payable during the year is called "Advance Tax" or "pay as you earn tax" as tax is liable to be paid at the time the income is earned i.e. during the year rather than paying this tax at the end of the year.

1. Advance Tax is required to pay under section 208 of Income Tax Act, 1961 for all those assesses including Salaried and Pensioners whose advance tax on estimated income comes (after deducted TDS/TCS if any) to ₹ 10,000/- or more in a Financial Year F.Y. 2010-11.

Thus, if Income Tax payable (after deducting all deductions, rebates and TDS) is less than 10000 in a financial year 2010-11, there is no need to deposit any Advance Tax and the same tax will be deposited at the time of self assessment before filing of income tax return.

2. In case an order u/s 210(3) is received by the person to pay an amount by way of Advance Tax in Form No. 28, should deposit such amount in the instalments as specified in the order. This type of orders can be issued up to the last day of February of the financial year.

If that person estimates his income at a higher amount than that specified in the orders u/s 210(3), then he should pay advance tax in accordance with such higher estimate.

However under sections 210(4) & (5) of Income Tax Act, 1961, if he estimates his income at a lower amount, then he should send an estimate of such lower income in Form 28-A, before the next instalment falls due and deposit the remaining instalments of advance tax accordingly.



**Notes** Advance Tax is different from Tax Deducted at Source (TDS). In case of salaried people, normally tax is deducted at source from their salaries, by the employer. Their income for the year is estimated, tax calculated thereon and 1/12th of such estimated tax is deducted from their monthly salary bill.

Salaried persons are normally not required to pay advance tax. However, in case the tax liability estimated for the year is more than the TDS, then such employees shall be liable to pay advance tax as indicated above.



### 12.1.2 Computation and Payment of Advance Tax where the Calculation is made by the Assessee Himself [Section 209]

Notes

As per the various provisions [Section 208 to 219] relating to Advance tax, tax shall be payable in advance during the financial year in respect of the total income of the assessee which would be chargeable to tax during the assessment year immediately following the financial year. Such income shall be referred to as 'Current income'. We know that income earned during the financial year 2010-11 shall be charged to tax in the assessment year 2011-12. but the assessee is required to pay tax, in advance, on the taxable income of financial year 2010-11 during the financial year 2010-11 itself, if certain conditions are fulfilled. Thus, Advance tax payable by an assessee in the financial year on his own accord shall be computed as follows:

**Step 1 - Estimation of Income:** Current income of the financial year for which the advance tax is payable should be estimated.

**Step 2 - Computation of tax:** The tax payable on estimated income at the rates applicable for the financial year should be computed.

**Step 3 - Adjustment of Rebate:** From the tax computed in Step 2, rebate if any likely to be allowed under Section 88E should be reduced.

**Step 4 - Surcharge on tax:** On the net tax computed in step 3, Surcharge as applicable should be added and relief, if any, under section 89 should be allowed.

**Step 5 - Education cess @ 2% of tax and Surcharge is to be added.**

**Step 6 - Deduction of tax at source:** Tax deductible at source as per relevant provisions should be deducted from the tax payable before payment of net amount of tax.

**Step 7 - Advance tax payable:** The balance amount is the advance tax payable and if it happens to be more than ₹ 5,000, it will be payable in certain instalments as provided in Section 211.

### 12.1.3 How to Deposit Advance Tax?

Advance Tax can be deposited through Challan No. 280 in the Government Treasury (RBI) or any of the authorised branches of nationalised banks. Printed challan forms are available with the Income Tax Office free of cost. While filing challan the following fields are required to be filed.

1. Assessee's Name
2. Complete Address of Assessee.
3. Permanent Account Number
4. Assessment Year
5. Assessing Officer's Ward or Circle
6. Amount of Advance Tax, Surcharge and Cess (if any).

Online deposit of Advance Tax is best payment method. When we deposit or pay online Advance Tax, there is no need to collect Physical Challan No. 280 or no need to stand in big rows to deposit advance tax in banks or treasury etc. Thus, the payment of Advance Income Tax is to be made

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through Challan No. 280 by selecting Advance Tax (100) as the type of payment as shown below in figure 12.1:

Figure 12.1: Challan No. 280

* Important : Please see notes overleaf before filling up the challan		Single Copy (to be sent to the ZAO)	
<b>CHALLAN NO./ ITNS 280</b>	<b>Tax Applicable (Tick One)*</b>		<b>Assessment Year</b>
	(0020) INCOME-TAX ON COMPANIES (CORPORATION TAX) <input type="checkbox"/>	(0021) INCOME TAX (OTHER THAN COMPANIES) <input type="checkbox"/>	- <input type="text"/>
Permanent Account Number <input type="text"/>			
Full Name <input type="text"/>			
Complete Address with City & State <input type="text"/>			
Tel. No. <input type="text"/>		Pin <input type="text"/>	
<b>Type of Payment (Tick One)</b>			
Advance Tax (100) <input type="checkbox"/>	Self Assessment Tax (300) <input type="checkbox"/>	Tax on Distributed Profits of Domestic Companies (106) <input type="checkbox"/>	Surtax (102) <input type="checkbox"/>
Tax on Regular Assessment (400) <input type="checkbox"/>		Tax on Distributed Income to Unit Holders (107) <input type="checkbox"/>	
<b>DETAILS OF PAYMENTS</b>		<b>FOR USE IN RECEIVING BANK</b>	
	Amount (in Rs. Only)	Debit to A/c / Cheque credited on	
Income Tax	<input type="text"/>	<input type="text"/> - <input type="text"/> - <input type="text"/>	
Surcharge	<input type="text"/>	D D      M M      Y Y	
Education Cess	<input type="text"/>		
Interest	<input type="text"/>		
Penalty	<input type="text"/>		
Others	<input type="text"/>	<b>SPACE FOR BANK SEAL</b>	
Total	<input type="text"/>		
Total (in words)			
CRORES	LACS	THOUSANDS	HUNDREDS    TENS    UNITS
<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>
Paid in Cash/Debit to A/c /Cheque No. <input type="text"/>		Dated <input type="text"/>	
Drawn on <input type="text"/>			
(Name of the Bank and Branch)			
Date: <input type="text"/>	Signature of person making payment		Rs.
<b>Taxpayers Counterfoil (To be filled up by tax payer)</b>		<b>SPACE FOR BANK SEAL</b>	
PAN <input type="text"/>			
Received from <input type="text"/>	(Name)		
Cash/ Debit to A/c /Cheque No. <input type="text"/>	For Rs. <input type="text"/>		
Rs. (in words) <input type="text"/>			
Drawn on <input type="text"/>	(Name of the Bank and Branch)		
on account of <input type="text"/> Companies/Other than Companies/Tax			
Income Tax on <input type="text"/> (Strike out whichever is not applicable)			
Type of Payment <input type="text"/> (To be filled up by person making the payment)			
for the Assessment Year <input type="text"/>	- <input type="text"/>		Rs.

Source: <http://law.incometaxindia.gov.in/dittaxmann/incometaxrules/pdf/challanitns-280.pdf>

**Caution**

1. Please use a separate challan for each type of payment.
2. Please note that quoting your Permanent Account Number (PAN) is mandatory.
3. Please note that quoting false PAN may attract a penalty of ₹ 10,000/- as per section 272B of I.T. Act, 1961.
4. Please note that to deposit Appeal Fees either Major Head 020 or 021 (depending upon the tax payer's status) has to be stocked under 'Tax Applicable'. Followed by this; Minor Head: Self Assessment Tax (300) has to be ticked under 'Type of Payment' and the amount is to be filled under Others in 'Details of Payments'.
5. To deposit taxes, appeal fees, etc. in respect of block period cases; enter the first Assessment Year of the block period followed by the last Assessment Year of the period. For example, if the block period is 1/04/85 to 5/3/96, it would be entered as 1986-97 in the space indicated for Assessment Year. If taxes are being deposited, tick the box Self Assessment (300) under Type of Payment and fill up amount under 'Tax' while in respect of appeal fees, enter amount under 'Others'.

Please use this challan for depositing taxes (types of payment) mentioned overleaf.

Kindly do not use this challan for depositing tax deduction at source (TDS)

Kindly ensure that the bank's acknowledgement contains the following:

1. 7 DIGIT BSR CODE OF THE BANK BRANCH
2. DATE OF DEPOSIT OF CHALLAN (DD MM YY)
3. CHALLAN SERIAL NUMBER

These will have to be quoted in your return of income.

### Self Assessment

State whether the following statements are true or false:

1. Advance Payment of tax is method of collection of tax by the central government in the form of prepaid taxes.
2. The advance tax is not paid in the previous year.
3. Tax on current income at the rate in force during the financial year will be calculated by the Assessing Officer.
4. Advance Tax can not be deposited through Challan.

### 12.2 Advance Tax Payment: Due Dates and Interest on Late Payment

Advance Tax receipts help the Govt. to receive a constant flow of tax receipts throughout the year so that expenses can be incurred rather than receiving all tax payments at the end of the year. Advance Tax is liable to be paid by all assesses like Salaried, Self Employed, Businessman etc. before the filing of Income Tax Return.

For Individuals with Salary as the sole source of income, Advance Tax would be taken care of by the TDS deducted by the employer at the time of payment of salaries as reflected in Form 16 and thus there would hardly be any Advance Tax payable. For all assesses earning income from

**Notes**

any source other than salary, Advance Tax is payable in instalments. Advance tax on the current income calculated in the manner laid down in section 209 shall be payable by:

- (i) all the companies, who are liable to pay the same, in four instalments during each financial year and the due date of each instalment and the amount of such instalment shall be as specified in table 12.1 below :

<b>Table 12.1: Due Date and Amount Payable</b>	
Due date of instalment	Amount payable
On or before the 15th June	Not less than fifteen per cent of such advance tax.
On or before the 15th September	Not less than forty-five per cent of such advance tax, as reduced by the amount, if any, paid in the earlier instalment.
On or before the 15th December	Not less than seventy-five per cent of such advance tax, as reduced by the amount or amounts, if any, paid in the earlier instalment or instalments.
On or before the 15th March	The whole amount of such advance tax as reduced by the amount or amounts, if any, paid in the earlier instalment or instalments.

Source: <http://law.incometaxindia.gov.in/DitTaxmann/IncomeTaxActs/2005ITAct/section211.htm>

- (ii) all the assesseees (other than companies), who are liable to pay the same, in three instalments during each financial year and the due date of each instalment and the amount of such instalment shall be as specified in Table 12.2 below :

<b>Table 12.2: Due Date and Amount Payable</b>	
Due date of instalment	Amount payable
On or before the 15th September	Not less than thirty per cent of such advance tax.
On or before the 15th December	Not less than sixty per cent of such advance tax, as reduced by the amount, if any, paid in the earlier instalment.
On or before the 15th March	The whole amount of such advance tax as reduced by the amount or amounts, if any, paid in the earlier instalment or instalments.

Source: <http://law.incometaxindia.gov.in/DitTaxmann/IncomeTaxActs/2005ITAct/section211.htm>

Provided that any amount paid by way of advance tax on or before the 31st day of March shall also be treated as advance tax paid during the financial year ending on that day for all the purposes of this Act.



*Did u know?* If the notice of demand issued under section 156 in pursuance of an order of the Assessing Officer under sub-section (3) or sub-section (4) of section 210 is served after any of the due dates specified in sub-section (1), the appropriate part or, as the case may be, the whole of the amount of the advance tax specified in such notice shall be payable on or before each of such of those dates as fall after the date of service of the notice of demand.



*Task* State whether Mr. X is liable to pay advance tax and if yes then what amount should be paid by what date. The income of Mr. X is ₹ 2, 00,000.

### 12.2.1 Interest under Section 234C for Deferment of Payment of Tax

If you don't pay an advance tax instalment in full, you have to pay interest at 1 per cent a month for three months on the amount that falls short of the required payment. However, in the case of default on the last instalment (March 15), the penal interest of 1 per cent is chargeable for only a month is shown in table 12.3:

**Table 12.3: Interest under Section 234C is Liable to be Paid @ 1% Per Month**

(a)	Advance Tax paid on or before 15th Sept	<	30% of the Tax Due on Returned Income
		OR	
(b)	Advance Tax paid on or before 15th Dec	<	60% of the Tax Due on Returned Income
		OR	
(c)	Advance Tax paid on or before 15th Mar	<	Tax Due on Returned Income
		OR	
(d)	No Tax has been paid by the Assessee		

Source: <http://www.rupeex.com/doc/advancetax.html>



*Example:* Let's say you are an individual taxpayer and are liable to pay ₹ 10,000 by way of advance tax. Suppose you pay ₹ 9,500 in three instalments (₹ 3,000 on September 14, ₹ 2,000 on December 15, and ₹ 4,500 on March 15), would you have kept to your payment schedule?

There will have been no default in respect of the first instalment (₹ 3,000, which is 30 per cent of ₹ 10,000). The second instalment amount should, however, have been ₹ 3,000 (60 per cent of ₹ 10,000, less ₹ 3,000 paid in the first instalment). Hence, the shortfall is ₹ 1,000, on which the interest payable is ₹ 30 (1 per cent of ₹ 1,000 for three months). Since the third instalment is ₹ 4,500, there will have been a shortfall of ₹ 500, on which the interest charged would be ₹ 5 (1 per cent of ₹ 500 for a month). Thus, you end up with a penal interest of ₹ 35 for the year. If in the last month, that is March, you delay payment of the last instalment by even a day, you will have to pay interest on the entire balance of ₹ 5,000.

This has reference to Section 234C of Income Tax Act.

### 12.2.2 Consequences of Non-payment of Advance Tax

If the amount of advance tax paid is less you will have to pay penalty interest as per the below:

*For Non-corporate assessee:*

1. If advance tax paid in the first two instalments is less than specified, simple interest @ 1% per month is charged on the deficit amount for a period of 3 months.
2. If the aggregate of advance tax paid is less than 90% of tax payable on 15th March penalty of simple interest @ 1% per month is charged on the amount shortfall until the tax is paid

*For Corporate assessee:*

Simple interest @ of 1% is charged on the deficit amount for a term of 3 months if you have failed to pay advance tax or if advance tax paid is less than tax due as per the above slab. For the 4th and final instalment if the advance tax paid is less than 90% of tax payable simple interest @ 1% per month is charged on the deficit from 1st April until the tax is fully paid.

## Notes

## Self Assessment

Fill in the blanks:

5. Advance Tax is liable to be paid by all assesses like Salaried, Self Employed, Businessman etc. before the filing of .....
6. If advance tax paid in the first two instalments is less than specified, simple interest @ 1% per month is charged on the deficit amount for a period of ..... months.
7. For ..... with Salary as the sole source of income, Advance Tax would be taken care of by the TDS deducted by the employer at the time of payment of salaries.
8. For all ..... earning income from any source other than salary, Advance Tax is payable in instalments.



*Caselet*

### **Citi's Deferred Tax - An Asset of Dubious Worth**

Citigroup is at the centre of a dispute among analysts and accounting experts over whether it should set aside funds to cover \$50bn of deferred taxes, a move that would reduce its capital buffer and weaken its balance sheet. As it says, the assets, a product of the accounting principles applied by US tax authorities to companies, are crucial to Citi's financial health. At the end of the second quarter, deferred tax assets made up more than a third of Citi's tangible equity - a measure of balance sheet strength.

The US bank has rebuffed calls to reserve for its DTAs - the biggest held by a US company - arguing that it will earn enough money in the future to justify keeping the assets on its books. Under accounting rules, Citi has to be confident it will earn \$99bn in taxable income during the next two decades to avoid making provisions for DTAs. In the 2002-2006 periods Citi had annual pre-tax profits of at least \$20bn.

However, some argue Citi is being too optimistic given its recent record - its pre-tax losses in 2008 and 2009 topped \$60bn - and continued global economic uncertainty. Deferred tax calculation is at best a black art. In this case Citi says that because it has either losses it can carry forward or the benefit of allowances it has not yet claimed their cash value for tax purposes.

The most significant source of these timing differences is the loan loss reserve build, which accounts for approximately \$15 billion of the net DTA. In general, Citi would need to generate approximately \$86 billion of taxable income during the respective carry forward periods to fully realize its U.S. federal, state and local DTAs. First of all, two generic things have to be noted there. Note that its clear future tax revenues from banks are going to be severely limited by the carry forward of tax losses. Second, note the injustice in this: those losses were already state funded.

Citigroup's ability to utilize its deferred tax assets (DTAs) to offset future taxable income may be significantly limited if it experiences an "ownership change" under the Internal Revenue Code.

As of December 31, 2009, Citigroup had recognized net DTAs of approximately \$46.1 billion, which are included in its tangible common equity. Citigroup's ability to utilize its DTAs to offset future taxable income may be significantly limited if Citigroup experiences an "ownership change" as defined in Section 382 of the Internal Revenue Code of 1986, as amended (the Code). In general, an ownership change will occur if there is a cumulative

*Contd...*

change in Citigroup's ownership by "5-percent shareholders" (as defined in the Code) that exceeds 50 percentage points over a rolling three-year period.

The common stock issued pursuant to the exchange offers in July 2009, and the common stock and tangible equity units issued in December 2009 as part of Citigroup's TARP repayment, did not result in an ownership change under the Code. However, these common stock issuances have materially increased the risk that Citigroup will experience an ownership change in the future. On June 9, 2009, the Board of Directors of Citigroup adopted a Tax Benefits Preservation Plan. This Plan is subject to shareholders' approval at the 2010 Annual Meeting. The purpose of the Plan is to minimize the likelihood of an ownership change occurring for Section 382 purposes. Despite adoption of the Plan, future transactions in Citigroup stock that may not be in its control may cause Citigroup to experience an ownership change and thus limit its ability to utilize its DTAs, as well as cause a reduction in Citigroup's tangible common equity and stockholders' equity.

Notes

Source: Adapted from <http://www.taxresearch.org.uk/Blog/2010/09/07/citis-deferred-tax-an-asset-of-dubious-worth/>

## 12.3 Double Taxation Relief

Double taxation refers to a situation where the same income becomes taxable in the hands of the same company or individual (tax-payer) in more than one country. Such a situation arises due to different rules for taxation of income in different countries. If a person is resident of a country, he/she may have to pay tax on any income earned outside that country as well. Thus, the same person may be taxed in respect of his/her income on the basis of source of income rule in one country and on the basis of residence in another country leading to double taxation.

In the present era of cross-border transactions across the globe, the effect of taxation is one of the important considerations for any trade and investment decision in other countries. One of the most significant results of globalisation is the visible impact of one country's domestic tax policies on the economy of another country. This has led to the need for continuously assessing the tax regimes of various countries and bringing about necessary reforms. Where a taxpayer is resident in one country but has a source of income situated in another country it gives rise to possible double taxation. DTAA's lay down the rules for taxation of the income by the source country and the residence country. Such rules are laid for various categories of income, for example, interest, dividend, royalties, capital gains, business income etc. Each such category is dealt with by separate article in the DTAA.

### 12.3.1 Main Reasons for Double Taxation

The concept of double taxation comes into existence generally due to the following reasons:

1. A Company or a person may be resident of one country but may derive income from other country as well, thus he/she becomes taxable in both the countries.
2. A Company or a person may be subjected to tax on his/her world income in two or more countries, which is known as concurrent full liability to tax. One country may tax on the basis of nationality of tax-payer and another on the basis of his/her residence within its border. Thus, a person domiciled in one country and residing in another may become liable to tax in both the countries in respect of his/her world income.
3. A company or a person who is non-resident in both the countries may be subjected to tax in each one of them on income derived from one of them. For example, a non-resident person has a permanent establishment in one country and through it he/she derive income from the other country.

### 12.3.2 Rules Due to which Double Taxation Arises

Double taxation means taxation of same income of a person in more than one country. This results due to countries following different rules for income taxation. There are two main rules of income taxation i.e.

- (a) **Source of income rule:** Under which the income of a person is subjected to taxation in the country where the source of such income exists i.e. where the business establishment is situated or where the assets/property is located irrespective of whether the income earner is a resident in that country or not; and
- (b) **Residence rule:** Under which the income earner is, taxed on the basis of his/her residential status in that country. Hence, if a person is resident of a country, he/she may have to pay tax on any income earned outside that country as well.

As per source of income rule, the income may be subject to tax in the country where the source of such income exists (i.e. where the business establishment is situated or where the asset/property is located) whether the income earner is a resident in that country or not. On the other hand, the income earner may be taxed on the basis of his/her residential status in that country.



*Example:* If a person is resident of a country, he may have to pay tax on any income earned outside that country as well. Further, some countries may follow a mixture of the above two rules.

Thus problem of double taxation arise if a person is taxed in respect of any income on the basis of source of income rule in one country and on the basis of residence in other country or the basis of mixture of above two rules.

In India, the liability under the Income tax Act arises on the basis of the residential status of the assessee during the previous year. Hence, if the assessee is resident in India, he/she has to pay tax not only on the income which is received in India but also on that income which accrues, arises outside India or received outside India. Thus he/ she become liable to pay double taxes. This puts unnecessary and prohibitive burden on the tax-payer. If the tax rates are sufficiently high, it may even leave him/her with a negative balance. It also has harmful effects on the trade and services as well as on movement of capital and people across countries. The relief against such double taxation in India has been provided under Section 90 and Section 91 of the Income Tax Act. They contain two ways of double taxation relief.

A condition in which two or more taxes may need to be paid for the same asset, financial transaction or income is known as double taxation. It generally takes place due to the overlapping of the tax laws and regulations of different countries. Thus, double taxation occurs when a taxpayer is charged income tax, both at his country of residence as well as in the country where the income is generated. Taking into account the laws of income tax in India, a non-resident becomes liable to tax payment in India, given that it is the place where the income is generated. Moreover, he has to additionally bear the burden of tax payment in his own country, by virtue of the inclusion of the same income in the 'total world income', which forms the tax base of the country where he resides.



**Notes** To effectively deal with the problems related to double taxation, Central Government, under Section 90 of the Income Tax Act of 1961, has been certified to enter into Double Tax Avoidance Agreements (DTAA) with other countries. These agreements are meant to alleviate various problems related with double taxation. So far, India has entered into Double Taxation Avoidance Agreements with 65 countries, including U.S.A, Canada, U.K, Japan, Germany, Australia, Singapore, U.A.E and Switzerland. The tax treaties offers relaxation from double taxation, by providing release or by providing credits for taxes paid in one of the countries.



### 12.3.3 Types of Relief

Double taxation relief in India is of two type's unilateral relief and bilateral relief which are as follows:

1. **Unilateral Relief:** Under Section 91, Indian government can relieve an individual from burden of double taxation, irrespective of whether there is a DTAA between India and the other country concerned or not, under certain conditions. Cases where a person enjoys double taxation relief as per the unilateral relief scheme are:
  - (a) If the person or company has been a resident of India in the previous year.
  - (b) If the person or company has paid income tax under the laws of the foreign country.
  - (c) The same income should be gained and received by the tax payer outside India in the previous year.
  - (d) The income should have been taxed in India and in a country with which India has no tax treaty
2. **Bilateral Relief:** Under Section 90, Indian government provides protection against double taxation by entering into a mutually agreed tax treaty (DTAA) with another country. Under bilateral relief, protection against double taxation is provided either by completely avoidance of overlapping tax or waiving a certain amount of the tax payable in India. Such relief may be offered under two methods:
  - (a) *Exemption method:* This ensures complete avoidance of tax overlapping.
  - (b) *Tax credit method:* This provides relief by giving the tax payer a deduction from the tax payable in India.

### 12.3.4 Method of Giving Relief from Double Taxation

Relief from double taxation is provided by abatement on the basis of mutual agreement between two states concerned whereby the assessee is given relief by credit/refund in a particular manner even though he is taxed in both countries. Relief may be in the form of credit for tax payable in another country or by charging tax at lower rate.

The procedure to be adopted by the authorities for granting relief is to determine in the first place, the total income of the person liable to tax in India in accordance with the provisions of the Income-tax Act, and then allow relief as per the terms of the tax treaty entered with the other contracting country where the income has suffered double taxation.

Almost every treaty provides that the tax paid in the contracting country should be deducted from the tax payable by the assessee in the assessing country on the income taxable in both the countries. The treaty generally stipulates which country will grant relief and the manner and extent of the relief on the various heads of income.



*Example:* Income from immovable property is taxed in the source country where it is situated, but the country of residence of the owner can also tax the same income unless the tax treaty between the countries expressly provides for exclusion of the property income from being taxed in the country of residence of the assessee. Relief can, however, be claimed and given in terms of tax treaty on providing proof of payment or at least proof of assessment.

Relief cannot be granted unless the income which has been taxed in one of the contracting countries has also suffered tax in the other contracting country. Proof has to be provided of the income having suffered double taxation. If there is no tax treaty with the country levying double tax, then relief can be granted.

**Notes**

In case, one earns income which suffers tax outside India, the Income Tax Act has clear provision of relief from such double taxation. The relevant provisions are contained in section 90 and section 91 of the I T Act. Section 90 is applicable for the cases when the tax has been paid in a country with which India has signed comprehensive double taxation avoidance agreements. There are Double Taxation Avoidance Agreements with as many as 81 countries. Section 90(2) of the I T Act provides that the provision of the Income Tax Act shall apply in those cases where DTAA s signed, to the extent is more beneficial to the person. CBDT's circular No 333 dt 2.4.1998 [137 ITR 1 &2] clarified that whenever there is any conflict noticed on an issue between the provisions contained in both statutes, DTAA shall prevail over the statutory provision of the I T Act. In this regard, Supreme Court held that DTAA constitute special provisions which would prevail over general provision of the I T Act and effect must be given to the special provision of the DTAA even if they are in conflict with general provision of the I T Act.

In that case, section 91 of the I T Act provides relief from double taxation. Provision of Section 91 of the I T Act says

“If any person who is resident in India in any previous year proves that, in respect of his income which accrued or arose during that previous year outside India (and which is not deemed to accrue or arise in India), he has paid in any country with which there is no agreement under section 90 for the relief or avoidance of double taxation, income-tax, by deduction or otherwise, under the law in force in that country, he shall be entitled to the deduction from the Indian income-tax payable by him of a sum calculated on such doubly taxed income at the Indian rate of tax or the rate of tax of the said country, whichever is the lower, or at the Indian rate of tax if both the rates are equal”.



*Did u know?* The general rule of computation of relief is as under:

1. Ascertain doubly taxed income.
2. Ascertain tax by applying Indian rate of tax as well as rate of foreign country separately.
3. Which ever is less, relief is given to that extent.

### **12.3.5 Taxation of Business Process Outsourcing Units in India**

The provisions containing taxation of IT-enabled business process outsourcing units are not contained in the Income-tax Act, 1961 but are given in Circular No.5/2004 dated 28.9.2004 issued by CBDT. The provisions are briefed hereunder -

- (a) A non-resident entity may outsource certain services to a resident Indian entity. If there is no business connection between the two, the resident entity may not be a Permanent Establishment of the non-resident entity, and the resident entity would have to be assessed to income-tax as a separate entity. In such a case, the non-resident entity will not be liable under the Income-tax Act, 1961.
- (b) However, it is possible that the non-resident entity may have a business connection with the resident Indian entity. In such a case, the resident Indian entity could be treated as the Permanent Establishment of the non-resident entity.
- (c) The non-resident entity or the foreign company will be liable to tax in India only if the IT enabled BPO unit in India constitutes its Permanent establishment.
- (d) A non-resident or a foreign company is treated as having a Permanent Establishment in India if the said non-resident or foreign company carries on business in India through a branch, sales office etc. or through an agent (other than an independent agent) who habitually exercises an authority to conclude contracts or regularly delivers goods or merchandise or

habitually secures orders on behalf of the non-resident principal. In such a case, the profits of the non-resident or foreign company attributable to the business activities carried out in India by the Permanent Establishment becomes taxable in India.

- (e) If a foreign enterprise carries on business in another country through a Permanent Establishment situated therein, the profits of the enterprise may be taxed in the other country but only so much of them as is attributable to the Permanent Establishment.
- (f) Profits are to be attributed to the Permanent Establishment as if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a Permanent Establishment.
- (g) In determining the profits of a Permanent Establishment there shall be allowed as deduction, expenses which are incurred for the purposes of the Permanent Establishment including executive and general administrative expenses so incurred, whether in the State in which the Permanent Establishment is situated or elsewhere.
- (h) The expenses that are deductible would have to be determined in accordance with the accepted principles of accountancy and the provisions of the Income-tax Act, 1961.
- (i) The profits to be attributed to a Permanent Establishment are those which that Permanent Establishment would have made if, instead of dealing with its Head Office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's length principle".
- (j) Hence, in determining the profits attributable to an IT-enabled BPO unit constituting a Permanent Establishment, it will be necessary to determine the price of the services rendered by the Permanent Establishment to the Head office or by the Head office to the Permanent Establishment on the basis of "arm's length principle".

### 12.3.6 Concept of Permanent Establishment

In order to determine the taxability of business income of foreign enterprises operating in India, it is important to determine the existence of a Permanent Establishment ('PE'). Article 5(1) of the DTAA provides that for the purpose of this convention the term 'Permanent Establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on. The term 'Enterprise' has been defined in section 92F (iii).

According to Article 5(2), which enumerates various instances of PE, the term PE includes (a) a place of management; (b) a branch; (c) an office; (d) a factory; (e) a workshop; (f) a sales outlet; (g) a warehouse; (h) a mine, an oil or gas well, a quarry or other place of extraction of natural resources (but not exploration).

1. Permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. Every DTAA has a specific clause, which will deal with an explanation of permanent establishment for the purpose of such DTAA.
3. Business Income of a non resident will not be taxed in India, unless such non-resident has a permanent establishment in India.

### Self Assessment

State whether the following statements are true or false:

9. Double taxation is a situation where the same income becomes taxable in the hands of the same company or individual (tax-payer) in more than one country.

- Notes**
10. Double taxation means taxation of same income of a person in less than one country.
  11. Under Section 90, Indian government can relieve an individual from burden of double taxation.
  12. Tax credit method provides relief by giving the tax payer a deduction from the tax payable in India.

## **12.4 Double Taxation Relief Provisions in India**

Sections 90 and 91 of the Income tax Act, 1961 provide for double taxation relief in India. In India, a relief for avoidance of double taxation is provided in both ways that is Unilateral and Bilateral Relief. Provisions relating thereto are enumerated here in below:

### **Agreement with Foreign Countries or Specified Territories - Bilateral Relief [Section 90]**

1. Section 90(1) provides that the Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India,—
  - (a) for the granting of relief in respect of—
    - (i) income on which income-tax has been paid both in India and in that country or specified territory; or
    - (ii) income-tax chargeable under this Act and under the corresponding law in force in that country or specified territory to promote mutual economic relations, trade and investment; or
  - (b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory; or  
Accordingly, the Central Government has notified that where such an agreement provides that any income of a resident of India may be taxed in the other country then, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act, 1961, and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement [Notification No. 91/2008, dated 28.8.2008].
  - (c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory or investigation of cases of such evasion or avoidance; or
  - (d) for recovery of income-tax under this Act and under the corresponding law in force in that country or specified territory. The Central Government may by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.
2. Where the Central Government has entered into such an agreement with the Government of any country outside India or specified territory outside India for granting relief of tax, or for avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.
3. Any term used but not defined in this Act or in the agreement referred to above shall have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf, unless the context otherwise requires, provided the same is not inconsistent with the provisions of this Act or the agreement. The meaning assigned would be deemed to have come to effect from the date on which the said agreement came into force and not from the date of the said notification.

4. The DTAA's under section 90 are intended to provide relief to the taxpayer, who is resident of one of the contracting country to the agreement. Such tax payer can claim relief by applying the beneficial provisions of either the treaty or the domestic law. However, in many cases, taxpayers who were not residents of a contracting country also resorted to claiming the benefits under the agreement entered into by the Indian Government with the Government of the other country. In effect, third party residents claimed the unintended treaty benefits.

Therefore, sub-section (4) has been inserted in section 90 to provide that the non-resident to whom the agreement referred to in section 90(1) applies, shall be allowed to claim the relief under such agreement if a Tax Residence Certificate (TRC) obtained by him from the Government of that country or specified territory is furnished, containing such particulars as may be prescribed, declaring his residence of the country outside India or the specified territory outside India, as the case may be. The submission of TRC containing prescribed particulars shall be a necessary but not sufficient condition for availing benefits of the agreements referred to in these sections. In effect, further conditions can be stipulated for claiming treaty benefits, in addition to the requirement of submission of TRC.

5. The charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company.

However, the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company.



**Caution** However, the above mentioned position is likely to be changed as and when the General Anti-avoidance Rules (GAAR) becomes effective.



**Notes** Tax treaties are generally based on certain models. The most common ones are:

1. OECD model (Organisation of Economic Cooperation and Development) - Most of India's treaties are based on this model.
2. U.N. models Double Taxation Convention, 1980 between developed and developing countries.

### **Double Taxation Relief to be Extended to Agreements (Between Specified Associations) Adopted by the Central Government [Section 90A]**

1. Section 90A provides that any specified association in India may enter into an agreement with any specified association in the specified territory outside India and the Central Government may, by notification in the Official Gazette, make the necessary provisions for adopting and implementing such agreement for -
  - (a) grant of double taxation relief,
  - (b) avoidance of double taxation of income,
  - (c) exchange of information for the prevention of evasion or avoidance of income tax, or
  - (d) recovery of income-tax.

**Notes**

Section 90A(1) provides that an agreement may be entered into by any specified association in India with any specified association in the specified territory outside India which may be adopted by the Central Government by way of notification in the Official Gazette, for granting relief of tax or, as the case may be, for avoidance of double taxation. The Central Government has, vide Notification No.90/2008 dated 28.8.2008, notified that where such an agreement provides that any income of a resident of India may be taxed in the other country then, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act, 1961, and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement.

2. In relation to any assessee to whom the said agreement applies, the provisions of the Income-tax Act, 1961 shall apply to the extent they are more beneficial to that assessee.
3. Any term used but not defined in the Income-tax Act, 1961 or in the said agreement shall have the same meaning as assigned to it in the said notification, unless the context requires otherwise, and it is not inconsistent with the provisions of the Act or the said agreement. The meaning assigned would be deemed to have come to effect from the date on which the said agreement came into force and not from the date of the said notification.
4. The DTAA's under section 90A are intended to provide relief to the taxpayer, who is resident of one of the contracting country to the agreement. Such tax payer can claim relief by applying the beneficial provisions of either the treaty or the domestic law. However, in many cases, taxpayers who were not residents of a contracting country also resorted to claiming the benefits under the agreement entered into by the Indian Government with the Government of the other country. In effect, third party residents claimed the unintended treaty benefits.

Therefore, sub-section (4) has been inserted in section 90A to provide that the non-resident to whom the agreement referred to in section 90A(1) applies, shall be allowed to claim the relief under such agreement if a Tax Residence Certificate (TRC) obtained by him from the Government of that country or specified territory is furnished, containing such particulars as may be prescribed, declaring his residence of the country outside India or the specified territory outside India, as the case may be. The submission of TRC containing prescribed particulars shall be a necessary but not sufficient condition for availing benefits of the agreements referred to in these sections. In effect, further conditions can be stipulated for claiming treaty benefits, in addition to the requirement of submission of TRC.

5. The charge of tax at a higher rate for a company incorporated in the specified territory outside India as compared to a domestic company would not be considered as less favourable charge or levy of tax in respect of such company
6. For the purpose of this section, the 'specified association' means any institution, association or body, whether incorporated or not, functioning under any law for the time being in force in India or the laws of the specified territory outside India and which may be notified as such by the Central Government and 'specified territory' means any area outside India which may be notified by the Central Government

**Countries with Which no Agreement Exists – Unilateral Agreements [Section 91]**

In the case of income arising to an assessee in countries with which India does not have any double taxation agreement, relief would be granted under Section 91 provided all the following conditions are fulfilled:

- (i) The assessee is a resident in India during the previous year in respect of which the income is taxable.
- (ii) The income accrues or arises to him outside India.

- (iii) The income is not deemed to accrue or arise in India during the previous year.
- (iv) The income in question has been subjected to income-tax in the foreign country in the hands of the assessee
- (v) The assessee has paid tax on the income in the foreign country.
- (vi) There is no agreement for relief from double taxation between India and the other country where the income has accrued or arisen.

In such a case, the assessee shall be entitled to a deduction from the Indian income-tax payable by him. The deduction would be a sum calculated on such double tax income at the Indian rate of tax or the rate of tax in the said country, whichever is lower, or at the Indian rate of tax if both the rates are equal.

Sub-section (2) provides that where a person who is resident in India in any previous year has any agricultural income in Pakistan in respect of which he has paid the income tax payable in that country, he shall be entitled to a deduction from the Indian income-tax payable by him to the following extent:

- (i) of the amount of tax paid in Pakistan on such income which is liable to tax under this Act, also; or
- (ii) of a sum calculated on that income at the Indian rate of tax, whichever is less.

Sub-section (3) provides for relief to a non-resident assessee in respect of his share in the income of a registered firm assessed as resident in India in any previous year, provided all the following conditions are fulfilled –

- (i) The share income from the firm should include income accruing or arising outside India during that previous year;
- (ii) Such income should not be deemed to accrue or arise in India;
- (iii) The income should accrue or arise in a country with which India has no agreement under section 90 for the relief or avoidance of double taxation; and
- (iv) The assessee should have paid income-tax in respect of such income according to the law in force in that country.

In such a case, the assessee will be entitled to a deduction from the Indian income-tax payable by him. The deduction will be a sum calculated on such doubly taxed income so included, at the Indian rate of tax or the rate of tax of the said country, whichever is lower, or at the Indian rate of tax, if both the rates are equal.

## Self Assessment

Fill in the blanks:

13. For exchange of information for the prevention of ..... of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory or investigation of cases of such evasion or avoidance.
14. The ..... under section 90 are intended to provide relief to the taxpayer, who is resident of one of the contracting country to the agreement.
15. The charge of tax of a foreign company at a rate ..... than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company.
16. Sub-section (3) provides for relief to a ..... assessee in respect of his share in the income of a registered firm assessed as resident in India in any previous year.

## Notes



Case Study

**Commissioner v. Indianapolis Power & Light Co.**

Indianapolis Power & Light Company (IPL) required customers with suspect credit to make deposits with it to assure payment of future bills for electric service. IPL paid interest on deposits held for a certain period of time. A customer could obtain a refund prior to termination of service by making on time payments or by demonstrating acceptable credit. The refunds were normally made in cash or by check but a customer could also choose to have the deposit amount applied against future bills. Any deposit unclaimed after seven years would escheat to the State. At the time of receipt, IPL did not treat the deposits as income for tax purposes. The Internal Revenue Service (IRS) audited the utility and assessed a tax deficiency. IPL appealed this assessment to the United States Tax Court, which sided with IPL. This decision was then appealed, eventually reaching the Supreme Court.

In front of the Supreme Court, the IRS argued that the deposits were advance payments for electricity and therefore taxable to IPL in the year of receipt. In response, the utility stressed its obligation to refund the deposits with interest. IPL argued the payments were not taxable income because they were similar to loans.

To determine whether the deposits were income, the Supreme Court noted that “undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion” constitute income in *Commissioner v. Glenshaw Glass Co.* The Court found that IPL did not enjoy “complete dominion” over the customer deposits; rather, the IPL had an express obligation to repay a deposit when a customer established good credit or terminated service. IPL’s right to keep the money thus depended upon the customer’s subsequent decision to have the deposit applied to future bills, not merely upon the utility’s adherence to its contractual duties. As such IPL’s dominion over the funds was far less than is ordinarily present in an advance payment situation.

The Court, in a unanimous decision, held that whether a payment constitutes income when received depends upon the rights and obligations of the parties at the time the payments are made. The ability to choose what happens to the deposit distinguishes a loan from an advance payment. An individual who makes an advance payment retains no right to insist upon the return of the funds. In contrast, the IPL utility customers retained the right to repayment. While a customer might apply the money to the purchase of electricity, he or she assumed no obligation to do so. Because the utility did not acquire unfettered “dominion” over the money, the deposits did not constitute income for tax purposes at the time of receipt.

**Questions**

1. Study and analyze the case.
2. Write down the case facts.
3. What do you infer from it?

Source: Adapted from [http://en.wikipedia.org/wiki/Commissioner\\_v.\\_Indianapolis\\_Power\\_%26\\_Light\\_Co](http://en.wikipedia.org/wiki/Commissioner_v._Indianapolis_Power_%26_Light_Co).

**12.5 Summary**

- Advance Payment of tax is another method of collection of tax by the Central Government in the Form of ‘Prepaid Taxes’.
- Advance Tax can be deposited through Challan No. 280 in the Government Treasury (RBI) or any of the authorised branches of nationalised banks.



- Advance Tax is liable to be paid by all assesses like salaried, self employed, businessman etc. before the filing of Income Tax Return.
- Double taxation refers to a situation where the same income becomes taxable in the hands of the same company or individual (tax-payer) in more than one country.
- Double taxation arises from the two basic rules that enable the country of residence as well as the country where the source of income exists to impose tax namely, the source rule and the residence rule.
- DTAA's lay down the rules for taxation of the income by the source country and the residence country.
- In India, the liability under the Income tax Act arises on the basis of the residential status of the assessee during the previous year.
- Relief from double taxation is provided by abatement on the basis of mutual agreement between two states concerned whereby the assessee is given relief by credit/refund in a particular manner even though he is taxed in both countries.
- In order to determine the taxability of business income of foreign enterprises operating in India, it is important to determine the existence of a Permanent Establishment ('PE').
- Sections 90 and 91 of the Income tax Act, 1961 provide for double taxation relief in India.

## 12.6 Keywords

**Advance Tax:** Advance tax is the income tax payable if the person's tax liability exceeds ₹ 10,000 in a financial year.

**Assessee:** As per Section 2(7) of Income Tax Act 1961 'assessee' is a person by whom any tax or any other sum of money is payable under the Act.

**Bilateral Relief:** In this the governments of two countries can enter into an agreement to provide relief against double taxation by mutually working out the basis on which the relief is to be granted.

**Business Process Outsourcing:** The contracting out of a particular business function to an outside company in order to reduce costs.

**Deferred Tax Liability:** It is an account on a company's balance sheet that is a result of temporary differences between the company's accounting and tax carrying values, the anticipated and enacted income tax rate, and estimated taxes payable for the current year.

**Double taxation:** It refers to a situation where the same income becomes taxable in the hands of the same company or individual (tax-payer) in more than one country. Such a situation arises due to different rules for taxation of income in different countries.

**Income Tax Return:** It is a completed tax form, with details of income and allowances.

**Income:** The flow of cash or cash-equivalents received from work (wage or salary), capital (interest or profit), or land (rent).

**Provisions:** A legal clause or condition contained within a contract that requires or prevents either one or both parties to perform a particular requirement by some specified time.

**Unilateral Relief:** This method provides for relief of some kind by the home country even where no mutual agreement has been entered into by the two countries.

### **12.7 Review Questions**

1. Discuss the concept of Advance Tax payment with the help of example.
2. Who is liable to pay Advance Tax?
3. Elucidate the procedure of computing Advance Tax Payment.
4. How to deposit Advance Tax?
5. What are the consequences of non-payment of advance tax?
6. Define double taxation. Highlight the rules due to which double taxation arises.
7. Describe the types of double taxation relief.
8. Throw some light on the method of giving relief from double taxation.
9. Write short note on permanent establishment.
10. Discuss Double Taxation Relief provisions in India.
11. An individual resident in India, having income earned outside India in a country with which no agreement under section 90 exists, asks you to explain whether the credit of the tax paid on the income in that country will be allowed to him in India.
12. The Income-tax Act, 1961 provides for taxation of a certain income earned by X. The Double Taxation Avoidance Agreement, which applies to X, excludes the income earned by X from the purview of tax. Is X liable to pay tax on the income earned by him? Discuss.

### **Answers: Self Assessment**

- |                          |                  |
|--------------------------|------------------|
| 1. True                  | 2. False         |
| 3. True                  | 4. False         |
| 5. Income Tax Return     | 6. Three         |
| 7. Individuals           | 8. Assesses      |
| 9. True                  | 10. False        |
| 11. False                | 12. True         |
| 13. Evasion or Avoidance | 14. DTAA's       |
| 15. Higher               | 16. Non-resident |

### **12.8 Further Readings**



*Books*

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Aggarwal, K., *Direct Tax Planning and Management*, Atlantic Publications.

Lakhotia, R.N., *Income Tax Planning Handbook*, Vision Books.

Singhania, V. K. & Singhania, Kapil, *Direct Taxes law & Practice*. Taxmann Publications.

Srinivas E. A., *Handbook of Corporate Tax Planning*, Tata McGraw Hill.



Online links

- [http://classof1.com/homework\\_answers/taxation/advance\\_payment\\_of\\_tax/](http://classof1.com/homework_answers/taxation/advance_payment_of_tax/)
- <http://www.stockmarkettipz.info/payment-of-advance-tax-how-to-calculate-advance-tax.html>
- <http://law.incometaxindia.gov.in/DitTaxmann/IncomeTaxActs/2005ITAct/section211.htm>
- [http://www.du.ac.in/fileadmin/DU/Academics/course\\_material/TM\\_16.pdf](http://www.du.ac.in/fileadmin/DU/Academics/course_material/TM_16.pdf)
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- <http://www.indianinvest.com/doubletax1.htm#ce>
- [http://www.companylegalgroup.com/Double\\_Taxation\\_Relief.html](http://www.companylegalgroup.com/Double_Taxation_Relief.html)
- <http://www.hmrc.gov.uk/international/dta-intro.htm>

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## **Unit 13: Tax Treatment for Business Restructuring**

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### **Objectives**

After studying this unit, you will be able to:

- State the meaning and scope of business restructuring
- Discuss the types of business restructuring
- Explain the concept of amalgamation and its various tax treatments under Income Tax Act, 1961
- Elucidate the concept of demerger and its tax implications

### **Introduction**

Business restructuring is the process of rearrangement of business activities and has become the buzzword to cope with the fierce competitive environment prevailing all throughout the globe in the era of globalisation and liberalisation.

To face the growing challenges, the corporate entities are under sheer pressure to go for redefining their strategies on a continuous move based on their core competencies and market excellences to enter into new venture resulting corporate restructuring. The Income tax laws have been eager to cater different tax exemptions to give fillips to such reorganisations for the noble mission to protect corporate entities from the fierce competitions as well as to help them survive and grow for the greater interests of the society at large.

In this unit, we will focus of few very important forms of business restructuring from the point of view of their tax implications. However, the main area of our concern will be merger and amalgamations and demergers.

## 13.1 Business Restructuring

One of the dictionary meanings of the word “restructuring” is “rearrangement”. Thus, business restructuring refers to a rearrangement of the corporate structure. In today’s world, along with increasing focus on globalisation and liberalisation, there is free competition amongst businesses. As a result, corporates are trying to identify opportunities so that they can command a presence in the market. They are redefining their strategies, looking at core competency and trying to create a value for the shareholder in a competitive business environment. This has given rise to business restructuring.

Corporate restructuring is the process of redesigning one or more aspects of a company. The process of reorganising a company may be implemented due to a number of different factors, such as positioning the company to be more competitive, survive a currently adverse economic climate, or poise the corporation to move in an entirely new direction. Here are some examples of why corporate restructuring may take place and what it can mean for the company.

Restructuring a corporate entity is often a necessity when the company has grown to the point that the original structure can no longer efficiently manage the output and general interests of the company.



*Example:* A corporate restructuring may call for spinning off some departments into subsidiaries as a means of creating a more effective management model as well as taking advantage of tax breaks that would allow the corporation to divert more revenue to the production process. In this scenario, the restructuring is seen as a positive sign of growth of the company and is often welcome by those who wish to see the corporation gain a larger market share.

### 13.1.1 Types of Business Restructuring

Corporate restructuring may take place as a result of the acquisition of the company by new owners. The acquisition may be in the form of a leveraged buyout, a hostile takeover, or a merger of some type that keeps the company intact as a subsidiary of the controlling corporation. When the restructuring is due to a hostile takeover, corporate raiders often implement a dismantling of the company, selling off properties and other assets in order to make a profit from the buyout. What remains after this restructuring may be a smaller entity that can continue to function, albeit not at the level possible before the takeover took place.

In today’s era Mergers, Amalgamations, takeovers has become day to day activity. Many mergers and amalgamations are taking place all over the world. We all are well acquainted to these words. When two or more companies are added together to form a new entity for better synergy, we terms it as merger or amalgamation. But there are many types of corporate restructuring which people combine under the umbrella of words mergers and amalgamation. Let us try to understand the difference between these terms and also take a look on different types of business restructuring given as under:

1. **Amalgamation and Merger:** The words merger and amalgamation are always interchangeably used. Many interpret mergers and amalgamations as synonyms. Indian Companies Act, 1956 does not differentiate between the words Merger and Amalgamation, however there is slight difference in merger and amalgamation. Merger is combination of two or more companies which can be done either by way of amalgamation or by way of absorption. Amalgamation is the process where two or more companies dissolve their identity to form a new entity.



*Example:* Merger of Brooke Bond and Lipton has formed a new entity called Brooke Bond Lipton India Limited.

Notes

2. **Absorption:** It is the other type of merger which is nothing but dissolution of a company's identity into other company's identity. As the name suggest, in absorption a company absorbs other company to form a new larger entity.
3. **Demerger:** Demerger is also a type of corporate restructuring which results in formation of two entities. The entity which undertakes demerger is termed as Demerged Company and the new entity formed is called as Resulting Company. Companies adopt demerging strategy to sell subsidiaries or to get rid of non-profit making division of company. Demerger takes place in the form of spin off, split off, split up, sale off, etc.
  - (a) In spin-off, company distributes its shareholding in subsidiary to its shareholders thereby not changing the ownership pattern.



*Example:* Air India formed Air India Engineering Services Limited by spinning off its engineering department.

- (b) Split-off is the form of demerger where shareholders of existing company form a new company to takeover specific division of existing company.
  - (c) When existing company is dissolved to form few new companies, it is called a Split-up.
  - (d) Sell-off takes place when company sells its non-profit making division.
4. **Reverse Merger:** When financially weak company absorbs financially strong company it is corporate restructuring made in the form of Reverse Merger. Merging of large sized company into small sized company is also form of Reverse Merger.



*Example:* Merger of Corus with Tata: Now-a-days, public companies opt route of reverse merger for merging with private companies to avoid lengthy procedure of merger.

5. **Takeovers:** Takeover is another type of restructuring. When a bidder company takeover the management of target company with permission of its Board, it is termed as Friendly takeover. When a company secretly acquires the control over Target Company against wish of their management, it is termed as Hostile takeover.
6. **Joint Venture:** Joint Venture is an entity formed by two or more companies for a specific period with a specific objective. Joint ventures are useful for a company to enter into new segment of market. Joint venture creates a new entity, however Strategic Alliance allows companies to remain independent while perusing agreed goal.
7. **Management Buyout:** When a group of people buy the controlling stake in a company through leveraged (borrowed) funds, it is Leveraged Buyout. When such buyout is carried out by management, strategy is termed as Management Buyout.



*Did u know?* Buy-back is also used as restructuring strategy so as to increase Earning Per Share (EPS) of the company.

Strategy used to increase market price of share is called as Subdivision of shares, which is also type of corporate restructuring. Thus the minute differences between various restructuring techniques must be considered while selecting the best suitable technique of restructuring for a company. However in doing so the tax implications of each type of business restructuring should be kept in mind.

### 13.1.2 Advantages and Disadvantages of Business Restructuring

Notes

Business restructuring can be called to have the following below mentioned advantages and disadvantages:

#### Advantages of Business Restructuring

1. **Increasing Value of Parts:** One of the main reasons that businesses use business restructuring is to divide the business up for sale. If a company is trying to sell as a conglomerate, it will likely get lower offers from investors. When the company is split up into separate parts, it can often get better offers for those individual parts. This can increase the value of the company as a whole and help get a higher sales price for the business.
2. **Reduce Costs:** Another benefit of restructuring a company is to reduce business costs.



*Example:* A company could merge with another company that is very similar and use economies of scale to run more efficiently. It could cut back on employees and equipment to streamline business operations. In this way, the company can expand its reach without adding too much to the overhead of the business. If handled correctly, the company can add significant value for its shareholders.

#### Disadvantages of Business Restructuring

1. **Costs of Restructure:** Even though you can reduce long-term costs by restructuring the business, the process of restructuring can be expensive in itself. When a company restructures itself, it must pay legal fees and other costs associated with the restructure. If a company merges with another company, it will also have to come up with the money to buy the other company. If the restructure does not work out, it could cost the company dearly and ultimately lead to its demise.
2. **Hurt Employee Relations:** When a company goes through a corporate restructure, it can significantly hurt its relations with employees. Employees fear change and when they are scared of being downsized, it can affect morale. In many of these moves, companies have to release some of the workforce. This can affect the loyalty of employees and it could hurt the company in the long run. When employees do not know if they will be one of the unlucky few who get released, it can create tension.

#### Self Assessment

Fill in the blanks:

1. .... refers to a rearrangement of the corporate structure.
2. .... is the process where two or more companies dissolve their identity to form a new entity.
3. Companies adopt ..... strategy to sell subsidiaries or to get rid of non-profit making division of company.
4. .... is the form of demerger where shareholders of existing company form a new company to takeover specific division of existing company.
5. .... is an entity formed by two or more companies for a specific period with a specific objective.

## **13.2 Amalgamations**

Amalgamation is a restructuring phenomenon in which two or more companies are liquidated and a new company is formed to acquire business. In simpler terms, it means that a new company is formed that buys the business of minimum two companies. The new company or the acquiring company is known as the amalgamated company. It acquires the assets and liabilities of the other companies known as amalgamating companies. Commonly, such companies are also referred as target companies or merging companies.



*Did u know?* Amalgamations are considered to be a safe route for sick units who want to save their existence.

Many other companies facing possible bankruptcy also opt for amalgamations.

Similarly, cash-rich firms that have lot of liquid assets but no profitable business opportunities aim for it as a long-term investment.

The most challenging task in any amalgamation is to create a sense of co-operation among the employees of different amalgamating companies.

Ultimately, the success of any venture depends upon people handling it.

In India, mergers and amalgamations are used interchangeably in legal parlance. However, they are an entirely different accounting treatment. It is a complicated procedure involving lot of legal, tax, and accounting considerations. Therefore, one needs to be very careful while evaluating an amalgamation proposal. Tax treatment is an important aspect of amalgamation. According to the Income Tax Act, the amalgamating companies are not liable to pay the capital gain tax levied on them following their liquidation. The incidence of tax falls on the amalgamated company. Moreover, all expenses related to amalgamation are not tax-deductible.

In the context of taxation, amalgamation includes not only the merger of one existing company with another existing company but also the merger of two or more existing companies to form a third company.

### **13.2.1 Definition as per Income Tax, 1961**

The Income-tax Act, 1961 defines amalgamation in section 2(1 B) as a merger of one or more companies with another company, or the merger of two or more companies to form one company, in such a manner that:

1. All the properties of the amalgamating company or companies immediately before the amalgamation, become the properties of the amalgamated company by virtue of the amalgamation;
2. 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; and
3. Shareholders holding not less than 75% 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.

Amalgamation is assumed to take effect on the date on which it is approved by the High Court. Once amalgamation is approved, it should be treated as relating back to the appointed date with reference to which the accounts of both the amalgamating and amalgamated companies are made up.



Keeping the above definition provided by the Income tax Act we can say that Thus, mergers or amalgamations may take two basic forms:-

1. **Merger through Absorption:** As stated above absorption is a combination of two or more companies into an 'existing company'. All companies except one lose their identity in such a merger.



*Example:* Absorption of Tata Fertilisers Ltd (TFL) by Tata Chemicals Ltd. (TCL): TCL, an acquiring company (a buyer), survived after merger while TFL, an acquired company (a seller), ceased to exist. TFL transferred its assets, liabilities and shares to TCL.

2. **Merger through Consolidation:** A consolidation is a combination of two or more companies into a new company. In this form of merger, all companies are legally dissolved and a new entity is created. Here, the acquired company transfers its assets, liabilities and shares to the acquiring company for cash or exchange of shares.



*Example:* Merger of Hindustan Computers Ltd, Hindustan Instruments Ltd, Indian Software Company Ltd and Indian Reprographics Ltd into an entirely new company called HCL Ltd.

A fundamental characteristic of merger (either through absorption or consolidation) is that the acquiring company (existing or new) takes over the ownership of other companies and combines their operations with its own operations.



*Notes* Besides, there are three major types of mergers:-

1. **Horizontal merger:** It is a combination of two or more firms in the same area of business. For example, combining of two book publishers or two luggage manufacturing companies to gain dominant market share.
2. **Vertical merger:** It is a combination of two or more firms involved in different stages of production or distribution of the same product. For example, joining of a TV manufacturing (assembling) company and a TV marketing company or joining of a spinning company and a weaving company. Vertical merger may take the form of forward or backward merger. When a company combines with the supplier of material, it is called backward merger and when it combines with the customer, it is known as forward merger.
3. **Conglomerate merger:** It is a combination of firms engaged in unrelated lines of business activity. For example, merging of different businesses like manufacturing of cement products, fertilizer products, electronic products, insurance investment and advertising agencies. L&T and Voltas Ltd are examples of such mergers.

### 13.2.2 Reasons behind Mergers and Amalgamation

Mergers sometimes happen because business firms want diversification. Diversification is the reduction of risk through investment decisions. If a large, conglomerate firm thinks that it has too much exposure to risk because it has too much of its business invested in one particular industry, it may buy a business in another industry. That would provide a measure of diversification for the acquiring firm. In other words, the acquiring firm no longer has all its eggs in one basket.

Business firms may merge for other reasons regarding diversification. In our diverse economic and political climate, they may be able to reduce risk by merging with firms in other countries.

**Notes**

This gives the benefit of reducing foreign exchange risk and localised recessions. We have to look carefully at diversification as a motive for merger and acquisition and make sure that it really does maximise the wealth of the shareholder as there is evidence to the contrary. Imagine the problems in production, for example, a company might face by entering a completely new line of business.

Improved financing is another motive for merger. If a company is in trouble financially, it may look for another company to acquire it. The alternative may be to go out of business or take bankruptcy.

Larger business firms may have better access to sources of financing in the capital markets than smaller firms. The expansion that results because of merger may enable the recently enlarged firm to access debt and equity financing that had formerly been beyond its reach.

There are tax advantages associated with mergers; specifically, a tax loss carry forward. If one of the firms involved in the merger has previously sustained net losses, those losses can be offset against the profits of the firm that it has merged with, a significant benefit to the newly merged entity. This is only valuable if the financial forecasting for the acquiring firm indicates that there will be operating gains in the future that will make this tax shield worthwhile.

If two companies merge that are in the same general line of business and industry, then operating economies may result due to the merger. Duplication of functions within each firm may be eliminated to the benefit of the combined firm. Functions such as accounting, purchasing, and marketing efforts immediately come to mind. This is particularly true if two relatively small firms merge. Business functions are expensive for small business firms. The combined firm will be better able to afford the necessary activities of a going concern.

An important financial reason often given for merger is economies of scale. Economies of scale simply mean that the cost of doing business, whether in manufacturing or the aforementioned operating economies, will be lower in the combined business firm. The thinking, in one camp, is that if the cost of doing business is lower, that cost will be passed on to the consumer, resulting in a win-win situation. Not every financier and economist believes this theory but many do. Some believe that merger results in the monopolisation of an industry and that will cause the exact opposite effect.

### **13.2.3 Tax Implication of Mergers and Amalgamations**

This section of the unit will help you to gain information about the exemptions, carry forward and set-off of accumulated loss and unabsorbed depreciation, and tax benefits resulting from merger of firms or companies.

#### **Exemptions Available under the Income-tax Act, 1961**

1. **Exemption from capital gains in the hands of the amalgamating companies:** Under section 47(vi), capital gains arising from the transfer of assets by the amalgamating companies to the Indian amalgamated company are exempt from tax.
2. **Exemption from capital gains for the shareholders of the amalgamating companies:** Under section 47(vii), capital gains arising from the transfer of shares by a shareholder of the amalgamating companies are exempt from tax, if:
  - (a) the transfer is made in consideration of the allotment to him of shares in the amalgamated company except where the shareholder itself is an amalgamated company; and
  - (b) the amalgamated company is an Indian company.

The issue of exemption from capital gains is not free from doubt where the transaction is not structured as a share for share exchange and the consideration is paid in other forms. There are two contrary High Court judgments in this regard.



*Notes* In the case of *CIT vs. Gautam Sarabhai Trust* [1988] 173 ITR 216, the Gujarat High Court held that to qualify for exemption under section 47(vii), the shareholder should receive the entire consideration in the form of shares of the amalgamated company alone. In other words, if besides the share or shares in the amalgamated company, the shareholders of the amalgamating company are allotted something more, namely, bonds or debentures in consideration of the transfer of his share or shares in the amalgamating company, he cannot get the benefit of section 47(vii).

The other view is based on the judgment in the case of *CIT vs. M.C.T.M Corporation Private Ltd.* [1996] 221 ITR 525. In this case, the Madras High Court held that in as much as shares and debentures are allotted to the assessee on account of the amalgamation of the two companies and in view of the fact that the identity of the transferor company got lost in the amalgamation, there was no transfer or extinguishments of any right in allotting the shares and debentures in favour of the assessee under the provisions of section 2(47). Even if there was a transfer, the gains arising there from, were entitled to exemption under section 47(vii).

3. **Exemption from capital gains in case of international restructuring:** Under section 47(via), in case of amalgamation of foreign companies, transfer of shares held in Indian company by amalgamating foreign company to amalgamated foreign company is exempt from tax, if the following two conditions are satisfied:
- (a) At least 25% of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company; and
  - (b) The amalgamation is tax-free in the foreign company

### Transfer of Capital Assets

#### ***Transfer of Capital a in a Scheme of Amalgamation where the Amalgamated Company is an Indian Company [Sec. 47 (vi)]***

Any transfer of a capital asset by the amalgamating company to the amalgamated company in the scheme of amalgamation is not treated a "transfer", provided amalgamated company is an Indian Company. [Sec. 47 (vi)]

#### ***Transfer of Shares of an Indian Company by an Amalgamating Foreign Company to a Foreign Amalgamated Company. [Sec. 47 (via)]***

Any transfer of shares of an Indian Company by a foreign company to another foreign company is not treated transfer, provided the following conditions are satisfied:

- (i) The transfer of shares is under a scheme of amalgamation between two foreign companies;
- (ii) At least 25% of the shareholders of the Amalgamating Foreign Company continue to remain shareholders of the Foreign Amalgamated Company.
- (iii) No tax is levied on such capital gain in the country where foreign amalgamating company is incorporated. [Sec. 47 (via)]

Notes

***Transfer of Capital Asset by a Banking Company to a Banking Institution in a Scheme of Amalgamation Sanctioned by the Central Government [Sec. 47 (viaa)]***

Where a capital asset is transferred by a Banking Institution in a scheme of amalgamation sanctioned and brought into force by the Central Government under section 45(7) of the Banking Regulation Act 1949, it is not treated as transfer. Banking company and Banking Institution have got the same meaning as assign to them under section 5(c) and section 45(15) respectively of the Banking Regulation Act 1949. This provision is operative from assessment year 2005-06 and onwards.

***Carry Forward and Set-off of Accumulated Loss and Unabsorbed Depreciation in Certain Cases of Amalgamation (Section 72A)***

Sub-section (1) of section 72A provides that where there is an amalgamation of a company, owning an industrial undertaking or a ship or a hotel with another company or the amalgamation of a banking company with a specified bank, then the accumulated loss and unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or allowance for depreciation of the amalgamated company for the previous year in which the amalgamation was effected and other provisions of the Act shall apply accordingly.



**Caution** The “specified bank” means the State Bank of India constituted under the State Bank of India Act, 1955 or a subsidiary bank as defined in the State Bank of India (Subsidiary Banks) Act, 1959 or a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

**Conditions**

However, sub-section (2) lays down the following conditions for admissibility of set-off and carry forward in hands of the amalgamated company:

***Conditions to be Fulfilled by the Amalgamating Company***

1. The amalgamating company should have been engaged in the business, in which the accumulated loss occurred or depreciation remains unabsorbed, for three or more years.
2. The amalgamating company has held continuously as on the date of amalgamation at least three-fourths of the book value of the fixed assets held by it, two years prior to the date of amalgamation.

***Conditions to be Fulfilled by the Amalgamated Company***

1. The amalgamated company holds continuously for a minimum period of 5 years from the date of amalgamation at least 75% in the book value of fixed assets of the amalgamating company acquired in a scheme of amalgamation;
2. The amalgamated company continues the business of the amalgamating company for a minimum period of 5 years from the date of amalgamation;
3. The amalgamated company fulfils such other conditions as may be prescribed to ensure the revival of the business of the amalgamated company or to ensure that the amalgamation is for genuine business interest.

## Withdrawal of Deduction or Allowance

Notes

Sub-section (3) provides that where any of the conditions laid down in sub-section (2) are not complied with, the set off or allowance for depreciation made in any previous year in the hands of the amalgamated company shall be deemed to be the income of the amalgamating company chargeable to tax for the year in which such conditions are not complied with.



### Caution Meaning of "Industrial undertaking"

Industrial undertaking means any undertaking which is engaged in:

1. The manufacture or processing of goods; or
2. The manufacture a computer software; or
3. The business of generation or distribution of electricity or any other form of power; or
4. The business of providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service, network of trunking, broadband network and internet services; or
4. Mining; or
5. The construction of ships, aircrafts or rail systems."

## Power of Central Government to Prescribe Other Conditions

Section 72A (2)(iii) empowers the Central Government to prescribe other conditions to ensure that the amalgamation is for "genuine business purpose" or for the purpose of revival of the business of amalgamating company.

Rule 9C prescribes that the amalgamated company should achieve the level of production of at least 50% of the installed capacity of the said undertaking before the end of 4 years from the date of amalgamation and maintain the said minimum level till the end of 5 years from the date of amalgamation. The assessee is required to obtain a report in the prescribed form as given in the Rules.

An issue arises that the above condition prescribed vide the above notification cannot be satisfied in case where the installed capacity is not there. Examples could be software companies, units engaged in assembly/processing activities etc.

Apart from carrying forward unabsorbed business loss and unabsorbed depreciation, the amalgamated company shall also be entitled to carry forward and set off the following unabsorbed expenditures of the amalgamating company:

1. Capital expenditure on Scientific Research u/s 35;
2. Expenditure in connection with amalgamation u/s 35DD;
3. Expenditure for obtaining licence to operate telecommunication services u/s 35ABB;
4. Preliminary expenses u/s 35D;
5. Deduction for expenditure on prospecting etc. for minerals u/s 35E.

**Other Benefits of Amalgamation**

After going through the above stated provisions we can say that if a company complies with all formalities as mentioned in the provisions of Income Tax Act in relation to Amalgamation and merger than its can enjoy the benefits of following Tax Concessions:

1. **Expenditure on Scientific Research Section 35(5):** Where an amalgamating company transfers any asset represented by capital expenditure on the scientific research to the amalgamated Indian company in a scheme of amalgamation, the provisions of section 35 which were applicable to the amalgamating company shall become applicable to the amalgamated company consequently
  - (a) Unabsorbed capital expenditure on scientific research of the amalgamating company will be allowed to be carried forward and set off in the hands of the amalgamated company
  - (b) If such asset ceases to be used in a previous year for scientific research related to the business of amalgamated company and is sold by the amalgamated company without having being used for other purposes, the sales price, to the extent of the cost of the asset shall be treated as business income other amalgamated company. The excess of the sale price over the cost of the asset shall be subject to the provisions of the capital gains
2. **Expenditure on acquisition of patent rights or copy rights Section 35A(6):** Where the patent or copyrights acquired by the amalgamating company is transferred to any amalgamated Indian company, the provisions of section 35A which were applicable to the amalgamating company shall become applicable in the same manner to the amalgamated company consequently
  - ❖ The expenditure on patents copyrights not yet written off shall be allowed to the amalgamated company in the same number or balance instalments
  - ❖ Where such rights are later on sold by the amalgamated company, the treatment of the deficiency or surplus will be same as would have been in the case of the amalgamating company However, if such expenditure is incurred by the amalgamating company after 31-3-1998, deduction under section 35A is not allowed, as such expenditure will be eligible for depreciation as intangible asset. In this case, provisions of depreciation shall apply
3. **Expenditure of know-how Section 35AB (3):** With effect from assessment year 2000-01, where there is a transfer of an undertaking under a scheme of amalgamation, the amalgamated company shall be entitled to claim deduction under section 35AB in respect of such undertaking to the same extent and in respect of the residual period as it would have been allowable to the amalgamating company, had amalgamation not taken place. However, if such expenditure is incurred by the amalgamating company after 31--31998, deduction under section 35AB is not allowed, as such expenditure will be eligible for depreciation as intangible asset. In this case provisions of depreciation shall apply
4. **Treatment of preliminary expenses Section 35D(5):** Where an amalgamating company merges in a scheme of amalgamation with the amalgamated company, the amount of preliminary expenses of the amalgamating company, which are not yet written off, shall be allowed as deduction to the amalgamated company in the same matter as would have been allowed to the amalgamating company.
5. **Amortisation of expenditure in case of amalgamation Section 35DD:** Where an assessee, being an Indian company, incurs any expenditure, on or after the 1st day of April, 1999, wholly and exclusively for the purposes of amalgamation or demerger of an undertaking, the assessee shall be allowed a deduction of an amount equal to one-fifth of such expenditure

for each of the five successive previous years beginning with the previous year in which the amalgamation or demerger takes place.

6. **Treatment of capital expenditure on family planning Section 36(1)(ix):** Where the asset representing the capital expenditure on family planning is transferred by the amalgamating company to the Indian amalgamated company, in a scheme of amalgamation, the provisions of section 36(a)(ix) to the amalgamating company shall become applicable in the same manner, the amalgamated company. Consequently
  - (a) Such transfer shall not be regarded as transfer by the amalgamating company
  - (b) The capital expenditure on family planning not yet written off shall be allowable to the amalgamated company in the same number of balance instalments
  - (c) Where such assets are sold by amalgamated company, the treatment of the deficiency or surplus will be same as would have been in the case of amalgamating company
7. **Treatment of bad debts Section 36(1)(vii):** Where due to amalgamation, the debts of amalgamating company have been taken over by the amalgamated company and subsequently such debt or part of the debt becomes bad, such bad debt will be allowed a deduction to the amalgamated company
8. **Deduction available under section 80-1A or 801B:** Where an undertaking which is entitled to deduction under section 801A/80-1B is transferred in the scheme of amalgamation before the expiry of the period of deduction under section 80-1A or 80-1B then:
  - (a) No deduction under section 80-1A or 80-1B shall be available to the amalgamating company for the previous year in which amalgamation takes place and
  - (b) The provisions of section 80-1A or 80-1B shall apply to the amalgamated company in such manner in which they would have applied to the amalgamating company

Similarly, the provisions of 41(1) shall be applied for the amalgamated company.

Moreover the Income-tax Act is strewn with innumerable provisions which are related to or consequent on amalgamation. These are briefly referred to below:

1. In determining the period for which a capital asset is held by an assessee, the period for which the shares were held in the amalgamating company shall be considered. This benefits the shareholders of the amalgamating company.
2. Where an undertaking entitled to deduction under these two sections is transferred to another company in a scheme of amalgamation, no further deduction will be allowable to the amalgamating companies and the provisions will apply to the amalgamated company, as they would have to the amalgamating companies.
3. The aggregate deduction in respect of depreciation shall not exceed the deduction at the prescribed rates, as if the amalgamation has not taken place, and such deduction will be apportioned between the amalgamating and amalgamated companies in the ratio of the number of days for which the assets were used by them.
4. The term 'sale' does not include a transfer in a scheme of amalgamation.
5. Where in a scheme of amalgamation, the amalgamating company sells or transfers any assets on which investment allowance has been allowed, the amalgamated company should continue to fulfil the conditions in respect of the reserve created. If any balance of investment allowance is outstanding to the amalgamated company, it shall be allowed to the amalgamated company.
6. Where the amalgamating company sells or transfers to the amalgamated company any assets representing expenditure of a capital nature on scientific research, the amalgamating

**Notes**

company shall not be allowed any further deduction and the amalgamated company will be subjected to the provisions of S. 35, as if sale or transfer of assets had taken place.

7. Expenditure on acquisition of patents, copyrights, know-how and expenditure on obtaining license to operate telecommunication services.

In all these cases, where the amalgamating company sells or transfers the assets of an intangible nature to the amalgamated company, the provisions will cease to apply to the amalgamating companies, but they will apply to the amalgamated company, as if the transfer has not taken place.



*Notes*

**Pros of Merger**

Synergy in operating economies

Taxation benefits

No capital gains tax

Carry forward and set-off of losses

Consolidation of reserves without any tax impact

Indirect tax benefits

Growth in terms of size, scope, brand equity etc.

**Consequences:**

Time consuming process – Court approval

Taxation benefits subject to explicit conditions

Carry forward and set-off of losses available only in case of industrial undertaking

**Self Assessment**

State whether the following statement as true or false:

6. As per the Income Tax Act, the amalgamating companies are not liable to pay the capital gain tax levied on them following their liquidation.
7. All expenses related to amalgamation are tax-deductible.
8. A consolidation is a combination of two or more companies into a new company.
9. Under Section 47(vi) capital gains arising from the transfer of assets by the amalgamating companies to the Indian amalgamated company are exempt from tax.
10. Unabsorbed capital expenditure on scientific research of the amalgamating company will not be allowed to be carried forward and set off in the hands of the amalgamated company.

**13.3 Demerger**

The concept of demerger was introduced in the context of taxation by Finance Act, 1999. The objective was to enable corporate undertakings to undertake business restructuring in a tax neutral form.



Section 2(19AA) defines demerger in relation to companies, as the transfer, pursuant to a scheme of arrangement under section 391 to 394 of the Companies Act, 1956, by the demerged company of one or more of its undertakings to any resulting company in such manner that:

1. All the property and liabilities of the undertaking which is being transferred by the demerged company become the property and liabilities of the resulting company by virtue of the demerger;
2. The property and liabilities of the undertakings being transferred by the demerged company are transferred at their book values immediately before the demerger;
3. In consideration of the demerger, the resulting company issues shares to the shareholders of the demerged company on a proportionate basis except where the resulting company itself is a shareholder of the demerged company;
4. Shareholders holding not less than 75% in value of the shares in the demerged company (other than shares already held therein immediately before the demerger by the resulting company or by a nominee of the resulting company or its subsidiary) becomes shareholders of the resulting company by virtue of the demerger;
5. The transfer of the undertaking is on a going concern basis;
6. The demerger is in accordance with the conditions, if any, notified by the Central Government under section 72A(5).

For this purpose, the following points need to be noted:

1. An '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.
2. 'Liabilities' shall mean the following:
  - (a) those which arise out of the activities or operations of the undertaking;
  - (b) the specific loans or borrowings (including debentures) raised, incurred and utilised solely for the activities or operations of the undertaking;
  - (c) so much of the general or multipurpose borrowings of the demerged company as stand in the same proportion which the value of the assets transferred in a demerger bears to the total value of the assets of the demerged company immediately before the demerger.
3. For determining the value of the property, any change in the value of assets consequent to their revaluation shall be ignored.
4. Demerged company means the company whose undertaking is transferred pursuant to demerger, to the resulting company.
5. The splitting up or the reconstruction of any authority or a body constituted or established under a Central, State or Provincial Act, or a local authority or a public sector company, into separate authorities or bodies or local authorities or companies, as the case may be, shall be deemed to be a demerger if such split up or reconstruction fulfils the conditions specified by the Central Government.



*Did u know?* 'Resulting company' means one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger and against which the resulting company 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.

## Notes

**Capital Gain Tax not attracted:** As per section 47 (vib) of the Income Tax Act, the transfer of any capital asset by the demerged company to the resulting company will not be regarded as transfer for the purpose of capital gain.

**Dividend:** Section 2(22) has been amended by inserting a new clause (v) to provide that no dividend income shall arise in the hands of shareholders of demerged company on demerger.



Caselet

### Indian Corporate Restructuring Initiatives

Corporate India is witnessing a restructuring revolution. The somewhat guarded, tentative response of the early years of economic reforms is slowly giving place to more decisive initiatives in corporate restructuring. Consolidation at the group and industry levels through mergers and acquisitions, strategic divestitures to permit sharper focus, strategic alliances and to a lesser extent demergers and spin-offs etc; are transforming the ownership profile and competitive structure of the Indian Industry.

Almost every company in India is struggling with this issue of how to face change and to face change effectively what to restructure. As India moves away from a seller's market into a buyer's one, corporate India is compelled to reassess the way they operate and how to respond. Coping with uncertainty, which accelerated with the opening up of the Indian economy to the winds of competition in the mid-1980s; is one of the key drivers for corporate restructuring in India. The pace and extent of firm level or enterprise level restructuring varied depending upon the competitive structure at the industry/economy levels, the structural flexibility, capital market expectations and the regulatory environment. For example, there is broad consensus that the significant improvement in the competitive position of the US and to an extent the UK industries in the 90's has come about on account of the wide spread restructuring carried out by the companies in these countries. The problems of Indian industries in pre-liberalisation flow, not inconsiderably, from the inability of the companies to carry out decisive and comprehensive restructuring on account of structural rigidities, high tolerance level of capital markets, and somewhat interwoven ownership structure of corporate shareholding.

Demergers are carried out for a variety of reasons, and the number is steadily growing. In India typically demerger is carried out as an arrangement under sections 391 to 394 of the Companies Act, much in the same manner as an amalgamation or merger. Consequently the process calls for the involvement of and approval by High Courts. As part of liberalisation process Government carried out number of changes in tax policies to facilitate demergers. The Income Tax Act has been amended to remove any ambiguity regarding the tax liability arising from demerger. The Income Tax Act provides for the explicit exemption of capital gains tax for companies and shareholders on demerger as also for the carry forward of the unabsorbed business loss and depreciation by the resulting companies.

Demergers are not a new phenomenon and corporate India resorted to demergers for variety of reasons. To illustrate the point few examples are mentioned here. DCM Ltd. Demerger into DCM Ltd., DCM Shriram Industries Ltd., DCM Engineering Industries Ltd., and Rath Foods Ltd.; Hoechst India Ltd split into Hoechst India Ltd. and Hoechst Schering AgrEvo Ltd.; Sandoz (India) Ltd. into Clariant (India) Ltd. and Sandoz India Ltd.; KCP Ltd demerged into KCP Ltd. and KCP Sugar and Industries Corporation Ltd; Hindustan Ciba-Geigy Ltd demerged into Hindustan Ciba-Geigy Ltd. and Ciba Speciality Chemicals (India) Ltd. etc. In the case of some (e.g., DCM, HCL, KCP), demerger involved reduction of capital in the "parent" company, while no capital reduction was involved in respect of

Contd...

others. One may recall that the demerger of DCM Ltd. arose from the division of business interests amongst the 4 promoter groups, whereas in the case of HCL, this was on account of the need to induct Hewlett Packard in HCL's computer-related business. In the case of Hoechst, Sandoz, Hindustan Ciba and Cyanamid, demerger in India followed restructuring at the parent company level. Demerger in Apple Industries Ltd., Ramco Industries Ltd. and Blue Star Ltd. was to capture the high stock market valuation of the information technology businesses to the resultant companies into which the IT divisions of these companies were transferred. In some of these cases splitting up of the company has certainly helped in ensuring greater transparency and managerial accountability in these companies. Some of these demergers were undertaken to induct strategic partner into the demerged entity.

The spur these demergers in India are varied from family reasons to genuine business considerations, though everybody vouch safe vociferously commitment to core competency and focus. Impressive growth potential in the auxiliary businesses have seen companies demerging their businesses in a bid to unlock the inherent value of the demerged company. The point to be remembered is, demerger is not just a convenient way of hammering out settlements; promoters have to be sure that such a move will result in value creation. If a company is confident of sustaining each of the businesses in the long run and creating value for each of them, then only it should attempt demergers. Take the case of Reliance Group demerger. The igniting reason is issue of succession. Demerger which results in a split in businesses; meets the family need. Take another example .Great Eastern Shipping, is taking the oilfield service operations out of the flagship, leaving it as a pure shipping company. The articulated reason as per Mr. K. M. Sheth, Executive Chairman of GE Shipping, the entire restructuring of the business through the demerger route is aimed at providing greater focus to each of the businesses of the company as well as to unlock shareholder value. Mr. Bharat Sheth will manage the shipping operations, whilst his cousin Vijay Sheth will head the offshore oilfield services business.

Source: <http://mergersindiainfo.com/indiascene/indiascene1.html>

### Exemption and Benefits

A demerger transaction fulfilling the conditions of section 2(19AA) is free from capital gains tax, both with respect to the transfer of assets as well with respect to issue of shares to the shareholders.

Section 2(22) provides that the issue of shares directly to the shareholder pursuant to the demerger of an undertaking will not constitute deemed dividend.

Further, in respect of international demergers, provisions similar to amalgamation of foreign companies have been made. Transfer of shares of an Indian company pursuant to the demerger of a foreign company is exempt provided the following two conditions are satisfied.

1. At least 75% of the shareholders in the demerged foreign company continue to be shareholders in the resulting company;
2. Such transfer should not attract capital gains tax in the foreign company.

### Set-off and Carry Forward of Accumulated Losses and Depreciation


Accumulated losses and depreciation relating to the undertaking being transferred in a scheme of demerger is allowed to be carried forward and set off in the hands of the resulting company.

In case such past losses cannot be directly attributed to the undertaking being transferred, the Act provides for the apportionment of the same between the demerged company and the resulting company in the same proportion in which the value of the assets have been transferred.

**Notes**

**Depreciation in the hands of the resulting company:** The depreciable assets base for tax purposes in the hands of the resulting company would be tax written down value in the hands of the demerged company.

**Reduction from book value of assets in the hands of the demerged company:** The tax depreciable assets base for the demerged company will be reduced by the tax written down value of the assets transferred in the demerger process.



*Task* Take any Indian company of your choice and comment on its process of carry forward and set-off of losses in detail.

**Cost of Acquisition of Shares in the Resulting Company**


In a demerger transaction, the shareholders of the demerged company are allotted shares in the resulting company by virtue of the demerger.

The cost of acquisition of the shares of the demerged company in the hands of the shareholders will be calculated by apportioning the cost of acquisition of the shares of the demerged company in the ratio of net assets transferred (to the resulting company) to the net worth of the demerged company.

In case, the shareholders transfer these shares subsequent to the demerger, the cost of such shares will be calculated as under:

Table 13.1: Calculation of Cost of Acquisition of Shares				
Cost of acquisition of Shares in resulting Company	=	Cost of acquisition of Shares held by assessee in the demerged company	X	Net book value of assets transferred in demerger.
Net Worth of the demerged company immediately before demerger				

Source: <http://www.lexvidhi.com/article-details/taxation-aspects-of-demerger-in-india-46.html>

 *Example:* We can illustrate and substantiate the concept by means of an example of Reliance Industries Limited which is the Demerged Company and the new companies of which shares were issued are the Resulting Companies.

In this case, Reliance Industries Ltd. (RIL) has transferred four of its businesses to four separate companies. The telecom leg has been transferred to Reliance Communication Ventures Ltd, the coal based energy system has been transferred to Reliance Energy Ventures Ltd, the financial services leg has been transferred to Reliance Capital Ventures Ltd. And lastly the gas based energy business has been transferred to Reliance Natural Resources Ltd.

**Consequence of the Demerger**

The existing shareholders of RIL got one share each in the Resulting Companies for every share that they held in RIL.

**Tax impact of the above**

As per the Income Tax Act, a transaction of demerger, per se, has no tax implications on the shareholders. In other words, when the shareholders of RIL are allotted the new shares in each of the four companies, there would be absolutely no tax implication whatsoever.

The tax implication will only arise when either the shares of RIL or the shares of the new Resulting Companies are sold.

Tax implications when shares are sold:

When the shares of any of the companies are sold, it would give rise to capital gains tax liability. The three issues that arise are:

1. Whether the new shares (in the Resulting Companies) are long-term assets or short-term.
  2. Indexation of the capital gains.
  3. Cost of acquisition of the various shares after the demerger transaction
- (a) To find out whether or not shares in the Resulting Companies are long-term or not, the holding period of the RIL shares will be included in the period of holding of the new shares.
- (b) The indexation will start from the date of allotment of the new shares and not from the date of acquisition of RIL. Relevance of indexation is only for working out the capital gain amount if the same has to be set-off against capital loss. However, as explained further on, for most shareholders, there will be no need of this.
- (c) To calculate capital gains when the shares are sold, a vital piece of information is the cost of acquisition. Your original cost of acquisition of RIL shares will change now on account of the demerger. Plus there will be a new cost accorded to the new shares of the Resulting Companies. The Income Tax Act specifies a complicated formula that takes into account the proportion of the net worth of RIL vis a vis the book value of the businesses transferred to arrive at the new costs of acquisition.

The net results of the above calculations are summarised in the following table:

**Table 13.2: Cost of Acquisition of RIL Shares**

Name of Company	% of Cost of Acquisition of RIL Shares
Reliance Industries Limited	52.0%
Reliance Communication Ventures Limited	38.7%
Reliance Energy Ventures Limited	7.3%
Reliance Capital Ventures Limited	1.3%
Reliance Natural Resources Limited	0.7%
	100.0%

Source: <http://www.lexvidhi.com/article-details/taxation-aspects-of-demerger-in-india-46.html>

What the above table indicates is the proportion in which your original cost of acquisition of RIL shares will be apportioned to the new shares.

It can be understood by an example:



*Example:* Say, Rakesh had purchased 100 shares of RIL for ₹ 534 on January 10th 2005. Consequently, his total cost of acquisition would be ₹ 53,400. Now, post the demerger, his new costs would be as in the table here.

**New Cost Post Demerger**

RIL (52% of ₹ 53,400)	₹ 27,768
RCVL (38.7% of ₹ 53,400)	₹ 20,666
REVL (7.3% of ₹ 53,400)	₹ 3,898
RCVL (1.3% of ₹ 53,400)	₹ 694
RNRL (0.7% of ₹ 53,400)	₹ 374
Total	₹ 53,400

Source: <http://www.lexvidhi.com/article-details/taxation-aspects-of-demerger-in-india-46.html>

**Notes**

For the per share cost, the above values be divided by the number of shares. For example, Rakesh's new cost of acquisition of RIL post demerger would be ₹ 27,768 divided by 100 which work out to ₹ 277.68.

Now let's say he sells the all the above shares on January 15th. As explained earlier, since he has bought the shares on Jan 10th last year, 12 months have elapsed and hence the RIL shares will be long-term capital assets. Similarly, for the new shares, the period of holding RIL will be taken into account, thereby making these too long-term assets.

Therefore, since long-term capital gains are tax-free, if any or all of the above shares are sold on a recognised stock exchange, there would be absolutely no tax payable by Rakesh in the entire process.

**Expenditure of Demerger**

The Act provides that where an assessee being an Indian company incurs any expenditure on or after the 1st day of April, 1999, wholly and exclusively for the purposes of demerger of an undertaking, the assessee shall be allowed a deduction under section of an amount equal to of one-fifth of such expenditure for each of the successive previous years beginning with the previous year in which the amalgamation or demerger takes place.

**Deductibility of certain Expenditure Incurred by Demerged Companies**

The Act provides for continuance of deduction of certain expenditure incurred by the demerged company as the case may be in the hands of the amalgamated company or resulting company, post amalgamation or demerger viz. expenditure on acquisition of patents or copyrights, expenditure on know-how, expenditure for obtaining license to operate telecommunication services.



Notes

**Advantages:**

1. Segregation of business verticals into independent entities
2. Focus on core competencies
3. Value separately captured for each business
4. Taxation benefits
5. No capital gains tax
6. Carry forward and set-off of losses
7. Indirect tax benefits
8. Automatic listing of transferee company in case the transferor company is a listed company

**Consequences:**

1. Time consuming process – Court approval
2. Demerged asset must constitute an undertaking for availing taxation benefits

**Self Assessment**

Fill in the blanks:

11. The concept of demerger was introduced in the context of taxation by .....

12. .... defines demerger in relation to companies, as the transfer, pursuant to a scheme of arrangement under section 391 to 394 of the Companies Act, 1956.
13. As per ..... of the Income Tax Act, the transfer of any capital asset by the demerged company to the resulting company will not be regarded as transfer for the purpose of capital gain.
14. Accumulated losses and depreciation relatable to the undertaking being transferred in a scheme of demerger is allowed to be carried forward and set off in the hands of the .....
15. The depreciable assets base for tax purposes in the hands of the resulting company would be tax ..... in the hands of the demerged company.

Notes



Case Study

### **Corporate Business Restructuring gets a Tax Fillip**

**M**umbai 2010: In a ruling that will provide great relief to corporate planning to restructure their businesses, the Authority for Advance Ruling (AAR) held that restructuring of businesses cannot be construed as an exercise for avoiding tax in India.

AAR, a quasi judicial body for settling tax disputes involving foreign entities, in an order last week on an application filed by the Star Group companies, held that any tax benefit resulting from the restructuring of businesses cannot be a ground for income-tax (IT) authorities to conclude that the entire exercise was for avoiding tax.

The parties that applied before AAR were Star Television Entertainment (STEL), the entity which owns Star Plus TV channel, and Star Asian Movies (SAML), which owns Star Gold, and Star Asia Region, the owners of Star Utsav and Star One. While STEL and SAML are based in British Virgin Islands, Star Asia Region is based in the United Arab Emirates (UAE). These three companies have been amalgamated with the Indian company Star India with effect from April 1, 2009.

These companies' rationale for the amalgamation was based on business and commercial grounds. The group had told AAR that with this amalgamation, all the three overseas entities' assets as well as liabilities would be transferred to the Indian company.

This ground was acceptable to AAR, which held that it is within the legitimate right of the parties to enter into transactions that would help them access the benefits given under the tax statute. The AAR also observed that the contracting parties are not expected to do transactions in a way that would entail any tax liability.

The three foreign entities had moved the AAR in relation to the tax benefits resulting from the amalgamation. The AAR's ruling is binding on the company paying taxes and the I-T department.

The I-T authorities did not dispute the fact that its laws provided exemption from capital gains tax on such cases. However, despite admitting that transfer of capital asset is entitled to exemption provided under Section 47 with Section 2 IB of the I-T Act, the tax authorities held that since the entire exercise was driven by a motivation to avoid tax, the amalgamation should not be accepted by the AAR. It is this argument the AAR had declined to accept. M Lakshminarayanan, national tax leader, Deloitte India, said "this order will benefit cross-border M&A transactions".

Contd...

Notes

The department held the view that the amalgamation was just an exercise to avoid capital gains tax and, therefore, any scheme that is opposed to the public interest cannot receive legal recognition. Further, the I-T department had told the AAR that the latter should not make any decision until the high court decides on the application for amalgamation filed by the group. The I-T department had proposed to intervene in this application and present its case of adverse revenue implications in the event of the approval of the scheme.

The AAR, however, observed that since the amalgamation includes taking over all assets and liabilities, which also included tax recoverable, tax avoidance cannot be seen as the objective of the Star Group. Besides, the department is proposing to intervene in the matter in the high court, it is free to request for appropriate direction for recovery of the IT arrears.

**Questions:**

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it about taxation amalgamation?

Source: [http://articles.economicstimes.indiatimes.com/2010-01-28/news/28434312\\_1\\_aar-capital-gains-tax-tax-authorities](http://articles.economicstimes.indiatimes.com/2010-01-28/news/28434312_1_aar-capital-gains-tax-tax-authorities)

### 13.4 Summary

- Corporate restructuring is the process of rearrangement of business activities and has become the buzzword to cope with the fierce competitive environment prevailing all throughout the globe in the era of globalisation and liberalisation.
- Corporate restructuring is the process of redesigning one or more aspects of a company. The process of reorganising a company may be implemented due to a number of different factors, such as positioning the company to be more competitive, survive a currently adverse economic climate, or poise the corporation to move in an entirely new direction. Here are some examples of why corporate restructuring may take place and what it can mean for the company.
- Corporate restructuring may take place as a result of the acquisition of the company by new owners. The acquisition may be in the form of a leveraged buyout, a hostile takeover, or a merger of some type that keeps the company intact as a subsidiary of the controlling corporation. When the restructuring is due to a hostile takeover, corporate raiders often implement a dismantling of the company, selling off properties and other assets in order to make a profit from the buyout. What remains after this restructuring may be a smaller entity that can continue to function, albeit not at the level possible before the takeover took place.
- Amalgamation is a restructuring phenomenon in which two or more companies are liquidated and a new company is formed to acquire business. In simpler terms, it means that a new company is formed that buys the business of minimum two companies. The new company or the acquiring company is known as the amalgamated company. It acquires the assets and liabilities of the other companies known as amalgamating companies. Commonly, such companies are also referred as target companies or merging companies.
- The conditions to be fulfilled in merger includes: all the properties of the amalgamating company or companies immediately before the amalgamation, become the properties of the amalgamated company by virtue of the amalgamation; 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; and Shareholders holding not less than 75% 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.

- Under section 47(vi), capital gains arising from the transfer of assets by the amalgamating companies to the Indian amalgamated company are exempt from tax.
- Sub-section (1) of section 72A provides that where there is an amalgamation of a company, owning an industrial undertaking or a ship or a hotel with another company or the amalgamation of a banking company with a specified bank, then the accumulated loss and unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or allowance for depreciation of the amalgamated company for the previous year in which the amalgamation was effected and other provisions of the Act shall apply accordingly.
- In determining the period for which a capital asset is held by an assessee, the period for which the shares were held in the amalgamating company shall be considered. This benefits the shareholders of the amalgamating company.
- Where an undertaking entitled to deduction under these two sections is transferred to another company in a scheme of amalgamation, no further deduction will be allowable to the amalgamating companies and the provisions will apply to the amalgamated company, as they would have to the amalgamating companies.
- The aggregate deduction in respect of depreciation shall not exceed the deduction at the prescribed rates, as if the amalgamation has not taken place, and such deduction will be apportioned between the amalgamating and amalgamated companies in the ratio of the number of days for which the assets were used by them.
- The term 'sale' does not include a transfer in a scheme of amalgamation.
- Where in a scheme of amalgamation, the amalgamating company sells or transfers any assets on which investment allowance has been allowed, the amalgamated company should continue to fulfil the conditions in respect of the reserve created. If any balance of investment allowance is outstanding to the amalgamated company, it shall be allowed to the amalgamated company.
- Where the amalgamating company sells or transfers to the amalgamated company any assets representing expenditure of a capital nature on scientific research, the amalgamating company shall not be allowed any further deduction and the amalgamated company will be subjected to the provisions of S. 35, as if sale or transfer of assets had taken place.
- The concept of demerger was introduced in the context of taxation by Finance Act, 1999. The objective was to enable corporate undertakings to undertake business restructuring in a tax neutral form. Section 2(19AA) defines demerger in relation to companies, as the transfer, pursuant to a scheme of arrangement under section 391 to 394 of the Companies Act, 1956.
- As per section 47 (vib) of the Income Tax Act, the transfer of any capital asset by the demerged company to the resulting company will not be regarded as transfer for the purpose of capital gain.
- Section 2(22) has been amended by inserting a new clause (v) to provide that no dividend income shall arise in the hands of shareholders of demerged company on demerger.

### **13.5 Keywords**

**Absorption:** It is the other type of merger which is nothing but dissolution of a company's identity into other company's identity.

**Notes**

**Amalgamation:** It is a restructuring phenomenon in which two or more companies are liquidated and a new company is formed to acquire business.

**Business restructuring:** It refers to a rearrangement of the corporate structure.

**Copy rights:** It is a legal concept, enacted by most governments, giving the creator of an original work exclusive right to it, usually for a limited time.

**Demerger:** It is a form of corporate restructuring in which the entity's business operations are segregated into one or more components.

**Joint Venture:** Joint Venture is an entity formed by two or more companies for a specific period with a specific objective.

**Patent rights:** These are the rights reserved exclusively to the inventor or the person to whom the patent has been issued as per the law.

**Reverse Merger:** When financially weak company absorbs financially strong company it is corporate restructuring made in the form of Reverse Merger.

**Spin-off:** It is a kind of restructuring in which a company distributes its shareholding in subsidiary to its shareholders thereby not changing the ownership pattern.

**Split-off:** It is the form of demerger where shareholders of existing company form a new company to takeover specific division of existing company.

**Subdivision of shares:** It is a strategy used to increase market price of share which is also type of corporate restructuring.

### **13.6 Review Questions**

1. Write short note on business restructuring.
2. Mention the different types of business restructuring.
3. Why do firms go for business restructuring?
4. What do you understand by amalgamation or merger as per Income Tax Act 1961?
5. Write a note on different form of mergers witnessed in Indian industries.
6. Mention the exemptions available under the Income-tax Act, 1961 in respect of mergers and amalgamations.
7. Explain carry forward and set-off of accumulated loss and unabsorbed depreciation for certain cases of amalgamation.
8. Mention the consequences of mergers.
9. Write short note on demerger.
10. Discuss the exemption and benefits that a firm gets while it demerges as per Income Tax Act 1961.
11. Explain the treatment of set-off and carry forward of accumulated losses and depreciation during demerger.

### **Answers: Self Assessment**

- |                           |                 |
|---------------------------|-----------------|
| 1. Business restructuring | 2. Amalgamation |
| 3. Demerging              | 4. Split-off    |

5. Joint Venture	6. True	Notes
7. False	8. True	
9. True	10. False	
11. Finance Act, 1999	12. Section 2(19AA)	
13. Section 47 (vib)	14. Resulting company	
15. Written down value		

### 13.7 Further Readings



*Books*

Ahuja, G. K. & Gupta, Ravi, *Systematic Approach to Income Tax*, Bharat Law House.

Aggarwal, K., *Direct Tax Planning and Management*, Atlantic Publications.

Lakhotia, R.N., *Income Tax Planning Handbook*, Vision Books.

Singhania, V. K. & Singhania, Kapil, *Direct Taxes law & Practice*. Taxmann Publications.

Srinivas E. A., *Handbook of Corporate Tax Planning*, Tata McGraw Hill.



*Online links*

<http://www.amalgamation.in/amalgamation-meaning.htm>

<http://www.caclubindia.com/articles/merger-and-amalgamation-an-overview-9561.asp#.UO1QLoE43CM>

<http://www.caclubindia.com/articles/taxation-aspect-of-mergers-and-amalgamation-9630.asp#.UO1QMoE43CM>

<http://www.bcasonline.org/articles/artin.asp?431>

<http://taxbymanish.blogspot.in/2012/02/types-of-corporate-restructuring.html>

[http://www.asa.in/pdf/mergers\\_amalgamations.pdf](http://www.asa.in/pdf/mergers_amalgamations.pdf)

[http://mgcoca.com/index\\_files/AMALGAM.pdf](http://mgcoca.com/index_files/AMALGAM.pdf)

## **Unit 14: Restructuring: Conversion and Slump Sale**

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### **Objectives**

After studying this unit, you will be able to:

- Discuss the conversion of sole proprietary business into company
- Describe the conversion of partnership firm into company
- Explain the concept of slump sale
- Elucidate the transfer of assets between holding and subsidiary company

### **Introduction**

The sole proprietorship is a completely separate legal form from a company and the law does not provide any process for conversion from one form to the other. Where a firm is converted into a company and as a result of such conversion, the firm transfers any capital asset (whether tangible or intangible) to the company. Slump Sale is one of the widely accepted ways of conducting business transfers. In relation to a capital asset being an undertaking or divisions transferred by way of such sale, the 'net worth' of the undertaking or the division shall be deemed to be the cost of acquisition and cost of improvement. A company controlled by a Holding Company is called a Subsidiary Company. So, before one can embark on a study it is absolutely vital to understand the conversion of Sole Proprietary Business into Company and Partnership Firm into Company, the concept of Slump Sale and transfer of Assets between Holding and Subsidiary Company. The purpose of this unit is to enable the students to comprehend basic expressions. Therefore, all such basic terms are explained and suitable illustrations are provided to define their meaning and scope.

## 14.1 Conversion of Sole Proprietary Business into Company

Notes

Where a sole proprietary concern is converted into a company and as a result of such conversion, the sole proprietary concern transfers any capital asset (whether tangible or intangible) to the company, such transfer will not be charged to capital gains tax if the following conditions are complied with:

- (i) all the assets and liabilities of the sole proprietary concern immediately before its succession should become the assets and liabilities of the company;
- (ii) the shareholding of the sole proprietor in the company is not less than 50% of the total voting power in the company and his shareholding continues to remain so for a period of 5 years from the date of succession;
- (iii) the sole proprietor does not receive any consideration or benefit (whether directly or indirectly) other than the shares allotted to him by the company section 47(xiv).

Many entrepreneurs start their businesses as a sole proprietorship due to the low compliance requirements. As the business and the revenues grow, there is a need to separate the bank accounts and the tax filings of the sole proprietor and that of the business.



Caution

1. To achieve this separation a possible solution is to convert the sole proprietorship into a private limited company.
2. To convert a sole proprietorship concern into a private limited company, an agreement has to be executed between the sole proprietor and the private limited company (once it is incorporated) for the sale of the business.

Further, such private limited company so incorporated must have “the takeover of a sole proprietorship concern” as one of the objects in its Memorandum of Association. Further, there are also certain other requirements and issues related to this process as set forth below:

- (i) **Requirements under the Companies Act:** Section 75 of the Companies Act, 1956, as amended (Companies Act) states that whenever a company makes any allotment of its shares as fully or partly paid up otherwise than in cash, to any person, then a written contract of sale, or a contract for services or other consideration in respect of which that allotment was made must be produced for inspection to the relevant Registrar of Companies (RoC).



*Notes* Such company is also required to within thirty (30) days, thereafter, file with the RoC within thirty (30) days, copies of all such contracts and a return stating the number and nominal amount of shares so allotted and the extent to which they are paid up along with the mode of consideration.

- (ii) **Exemption under the Income Tax Act:** Conversion of a sole proprietorship into a private limited company entails a “transfer” within the meaning of the Income Tax Act, 1961, as amended (Income Tax Act). That is, the assets of the sole proprietorship concern are considered transferred to the newly formed company, which makes the sole proprietor liable to pay tax for any capital gains calculated on such transfer. However, there is a provision under section 47(xiv) of the Income Tax Act, which lays down certain conditions for exemption from any capital gains.

Notes



*Did u know?* If any of the conditions laid down above are not complied with (say the sole proprietor sells his share in two years instead of holding on to the shareholding for five years), the amount of profits or gains arising from the transfer of such capital assets or intangible assets not charged earlier by virtue of these conditions, shall be deemed to be the profits and gains chargeable to tax of the successor company for the previous year in which the requirements are not complied with.

So therefore, if you are a sole proprietor who intends to convert his sole proprietorship into a private limited company, and also allot shares to yourself, then it is imperative that an agreement is entered into for such allotment and one of the conditions in the agreement should state that your shareholding/voting rights will not fall below fifty per cent (50%) in the next five years.

The sole proprietorship is a completely separate legal form from a company and the law does not provide any process for conversion from one form to the other. Instead, what needs to be done is:

1. Incorporate a new company. At the point of incorporating the company, you will indicate that the company is going to take over the business of the sole proprietorship. You must indicate the date of termination of the business (which can be post-dated up to 3 months).
2. You will need to transfer the business assets and any existing contracts over to the newly incorporated private company from the old entity.
3. The final step is to terminate the sole proprietorship and inform the Company Registrar that you have ceased to carry on business as a sole proprietorship.

### Self Assessment

Fill in the blanks:

1. All the assets and liabilities of the ..... concern immediately before its succession should become the assets and liabilities of the company.
2. Many entrepreneurs start their businesses as a sole proprietorship due to the ..... compliance requirements.
3. Conversion of a sole proprietorship into a private limited company entails a ..... within the meaning of the Income Tax Act, 1961.
4. There is a provision under section 47(xiv) of the Income Tax Act, which lays down certain conditions for exemption from any .....

## 14.2 Conversion of Partnership Firm into Company

Where a firm is converted into a company and as a result of such conversion, the firm transfers any capital asset (whether tangible or intangible) to the company, such transfer will not be charged to capital gains tax if the following conditions are complied with:

- (i) all the assets and liabilities of the firm immediately before its succession should become the assets and liabilities of the company;
- (ii) all the partners of the firm immediately before its succession become the shareholders of the company in the same proportion in which their capital accounts stood before such succession;
- (iii) the partners of the firm do not receive any consideration or benefit (whether direct or indirect) other than the shares allotted to them by the company;

- (iv) the partners' aggregate shareholding in the company is not less than 50% of the total voting power in the company and their shareholding should continue to remain so for a period of 5 years from the date of succession – Section 47(xiii).



*Example:* In case of carry forward of loss and unabsorbed depreciation with respect to reorganization of business: If a firm or a proprietary concern is succeeded by a company fulfilling the conditions laid down in sections 47(xiii) and 47(xiv), then the accumulated loss and the unabsorbed depreciation of the predecessor firm or the proprietary concern shall be allowed to be carried forward and set off by the successor company.

If any of the conditions laid down in clause (xiii) or clause (xiv) are not complied with in any subsequent year, the set-off of loss or allowance for depreciation made in any previous year in the hands of the successor company shall be deemed to be the income of the company chargeable to tax in the year in which such conditions are not complied with. If the transfer is on a going concern basis, even though no specific exemption is spelt out, the firm shall not be taxable since there can be no inference of a sale of any specific item comprised therein.



*Task* Will the firm be liable to pay tax on depreciable assets?

### 14.2.1 Advantages of Conversion

Following are the advantages of conversion of partnership firm into company:

1. All the assets and liabilities of the firm immediately before the conversion become the assets and liabilities of the company.
2. All movable and immovable properties of the firm automatically vest in the company. No instrument of transfer is required to be executed and hence no stamp duty is required to be paid.
3. No capital gains tax shall be charged on transfer of property from partnership firm to company.
4. The goodwill of the partnership firm and its brand value is kept intact and continues to enjoy the previous success story with a better legal recognition.
5. The accumulated loss and unabsorbed depreciation of partnership firm is deemed to be loss/ depreciation of the successor company for the previous year in which conversion was effected. Thus such loss can be carried for further eight years in the hands of the successor company.

### 14.2.2 Requirements for Conversion

Following are the requirements of conversion of partnership firm into company:

1. Registered Partnership firm.
2. Minimum Share Capital shall be ₹ 100,000 (INR One Lac) for conversion into a Private Limited Company.
3. Minimum Share Capital shall be ₹ 500,000 (INR five Lac) for conversion into a Public Limited Co.
4. If the above requirement is not fulfilled by the firm, then the Partnership deed should be altered.

- Notes**
5. Minimum 7 Shareholders (for Public Limited Co.) and 2 shareholders (for Private Limited Co.).
  6. Minimum 2 Directors (for Private Limited Co.) and 3 Directors (for Public Limited Co.)
  7. The directors and shareholders can be same person.
  8. DIN (Director Identification Number) for all the Directors.
  9. DSC (Digital Signature Certificate) for one of the Directors.

### Self Assessment

State whether the following statements are true or false:

5. All the assets and liabilities of the firm immediately after its succession should become the assets and liabilities of the company.
6. The partners' aggregate shareholding in the company is not more than 50% of the total voting power in the company and their shareholding should continue to remain so for a period of 5 years from the date of succession - Section 47(xiii).
7. No Capital Gains tax shall be charged on transfer of property from partnership firm to company.
8. All movable and immovable properties of the firm automatically vest in the company.

## 14.3 Slump Sale

'Slump sale' means 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. If value of an asset or liability is determined for the sole purpose of payment of stamp duty, registration fees or other similar taxes or fees, that should not be regarded as assignment of values to individual assets and liabilities.

The Income- tax Act, 1961 ('IT Act') defines Slump Sale as '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'. One question that arises in this context is whether in a situation where an undertaking is transferred against the allotment of shares in the acquiring company, the transaction would qualify as "slump sale" under the Income-tax Act, 1961. One view in this regard is that the transfer must necessarily be affected against a monetary consideration and a transfer against allotment of share is merely an "exchange" which will not qualify as a "sale". However, a more reasonable view seems to be that the allotment of shares is merely a manner of discharge of consideration and the transaction would still qualify as a slump sale if other conditions are satisfied.

### 14.3.1 Key Characteristic Features of Slump Sale

Slump Sale is one of the widely accepted ways of conducting business transfers. In general parlance, Slump Sale is transferring of whole or part (capable of carrying out operations independently) of a business undertaking as a going concern - lock, stock and barrel. It includes transfer of not only tangible and intangible assets, but also debts, obligations and liabilities.

1. **Sale of an undertaking:** For any sale to constitute as Slump Sale there should be a 'sale' of business. Transfer of an undertaking by any other mode (like exchange, relinquishment, extinguishment, compulsory acquisition, etc) other than sale would not qualify as Slump Sale transaction.



2. **Going concern basis:** A significant test to fall within the ambit of Slump Sale is the ability of the buyer to continue the business post acquisition.

### 14.3.2 Chargeability

Any profits arising from the slump sale effected in the previous year shall be chargeable to tax as capital gains and shall be deemed to be the income of the previous year which the transfer took place. In relation to a capital asset being an undertaking or division transferred by way of such sale, the 'net worth' of the undertaking or the division shall be deemed to be the cost of acquisition and cost of improvement for the purposes of sections 48 and 49. The benefit of indexation shall not be allowed. If the undertaking is owned and held by the assessee for not more than 36 months, it shall be taken as short-term capital asset.

1. The Supreme Court held that the undertaking is distinct from the various assets which comprise the undertaking. The aforesaid principle has now been statutorily recognised.
2. "Undertaking" is defined to include any part of an undertaking or a unit or division of an undertaking or a business activity as a whole, but does not include individual assets or liabilities or any combination thereof not constituting business activity. [Section 2(42C)].



*Did u know?* In case of a slump sale, every assessee shall furnish in the prescribed form along with the return of income.

'Net worth' shall be the aggregate value of total assets of the undertaking or division as reduced by the value of liabilities of such undertaking or division as appearing in its books of account. Change in value of assets on account of revaluation shall be ignored. The value of depreciable assets shall be the written down value of block of assets determined in accordance with section 43(6) (c). The value of capital assets in respect of which the whole of the expenditure has been allowed or is allowable as a deduction under section 35AD would be Nil. The value of all other assets would be the book value.

The auditor of the company is required to give a certificate in Form No.3CEA (Rule 6H) relating to the computation of capital gains in case of slump sale. This certificate should be filed along with the return of income duly accompanied by copies of the profit and loss account and Balance Sheet in accordance with the provisions of section 139 of the Income-tax Act, 1961.

### 14.3.3 Steps in Slump Sale

Under Indian Income tax Act, 1961, "slump sale" means 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. Therefore transferor is not required to assign value to each "assets and liabilities" of "business undertaking" to be transferred.

Slump sale is carried out through following steps:

#### Step 1: Finding Buyer

To finding potential buyers, register your details and requirements on our "buy sell centre". Before opting for slump sale there are various issues that needs to be analysed first, especially impact of capital gain tax to the seller and stamp duty to the buyer needs to be analysed in lights of business strategies.

1. **Short listing of buyer:** The buyer or transferee companies needs to be short listed by refining the business and tax objectives.

Notes

2. **Primary Valuation:** This valuation done by seller to get better idea about value of the business to be sold.
3. **Analyse and Finalise buyer:** Analysis of short listed buyer; should consider objective of the deal, cost and time required for execution and structure of the deal. This helps to get a better idea about the deal before finalisation.

**Step 2: Sign MoU/Term Sheet**

Once the buyer company is selected there is the need to sign MoU (Memorandum of understanding) which helps the buyer company to get access of seller entities information for making due diligence, valuation etc.

**Step 3: Make Valuation**

Valuation is a process of determining the value of assets and liabilities of business. It is one of the most important aspects of slump sell process, as seller wants maximum valuation for its business whereas buyer wants it at lowest end. Valuation of business is mandatory for listed company. Following are various methods to value business:

1. Discounted cash flow method
2. Profit based methods
3. Net Asset Value Method
4. Comparable company Analysis
5. Maintainable Profit Method

**Step 4: Deal Structuring**

A deal should be structured considering agreement between buyer and seller. It should be time, cost and compliance effective. While structuring a deal following factors must be taken into consideration:

1. **Objective of the deal:** This includes the core objective set for deal of slump sale while structuring the deal it must be taken into consideration that objective is getting achieved fully. As post deal factors such as ownership and control, financial impact depends on structuring of the deal.
2. **Transaction cost:** Transaction cost under slump sale mainly involve capital gain tax to the seller, stamp duty tax to the buyer and withdrawal of exemption deduction and allowances and apart from these professional fees to the consultants. Transaction costs involved in slump sale can go up to 5-10% of deal size.
3. **Discharge of consideration:** Lump sum Consideration may be discharged by payment in cash or by way of issue of debentures and or both. Consideration being imperative aspect of slump sale should be discharged by taking in to consideration future financial, legal and strategic impact on transacting companies.

**Step 5: Slump Sale Agreement**

Deal needs to be executed through agreement, capturing all slump sale clauses, effecting objectives predetermined and executed by both parties. And executed agreement needs to be registered as per applicable Stamp Act.

### 14.3.4 Taxability of Gains Arising on Slump Sale

Notes

Sec. 50B provides the mechanism for computation of capital gains arising on slump sale. On a plain reading of the Section, some basic points which arise are:

1. Sec. 50B reads as 'Special provision for computation of capital gains in case of slump sale'. Since slump sale is governed by a 'special provision', this Section overrides all other provisions of the Act.
2. Capital gains arising on transfer of an undertaking are deemed to be long-term capital gains. However, if the undertaking is 'owned and held' for not more than 36 months immediately before the date of transfer, gains shall be treated as short-term capital gains. It is important to note that Circular No. 779, dated 14-9-1999, issued at the time of introduction of Sec. 50B, has used the words 'held' instead of 'owned and held' used in the text of S. 50B. It is not clear whether this difference in terminology is of any significance.
3. Where an undertaking was acquired by an assessee under a will, and such an undertaking is transferred by him as a slump sale within a year, the undertaking will be classified as short-term or a long-term asset based on the period for which the previous owner 'owned and held' the undertaking [Sec. 49(1)(ii)].
4. Taxability arises in the year of transfer of the undertaking. The undertaking will be deemed to be transferred on execution of the agreement and registration thereof coupled with the handing over of possession of the undertaking to the transferee. However, if the year of the agreement of the undertaking and registration thereof and the year of its possession fall in two different previous years, then the previous year in which the possession of the undertaking is handed over to the transferee will be considered as the year of transfer.
5. Capital gains arising on slump sale are calculated as the difference between sale consideration and the net worth of the undertaking. Net worth is deemed to be the cost of acquisition and cost of improvement for Sec. 48 and Sec. 49 of the Act.
6. As per Sec. 50B, no indexation benefit is available on cost of acquisition, i.e., net worth.
7. In the year of transfer of the undertaking, the assessee has to furnish an accountant's report in Form 3CEA along with the return of income indicating the computation of net worth arrived at and certifying that the figure of net worth has been correctly arrived at. Although the certification of computation is based on the information and explanations obtained by the accountant, the essence of the form is on reporting that the computation is 'true and correct' rather than 'true and fair'.
8. In case of slump sale of more than one undertaking, the computation should be done separately for each undertaking. This is substantiated by Note 5 to Form 3CEA, which requires the computation of net worth of each undertaking to be indicated separately.
9. In case of slump sale in the nature of succession of a firm or a proprietary concern by a company, capital gains made on slump sale may be entitled to exemption u/s.47(xiii) and (xiv), respectively, provided the other conditions of these Sections are satisfied. In case of violation of conditions of S. 47(xiii) or (xiv) in any subsequent year, the benefit availed by the firm or the sole proprietor will be taxable in the hands of the successor company in the year in which the violation takes place as per S. 47A (3).
10. Besides, if the successor company violates the conditions of S. 47(xiii) or (xiv) by transferring that undertaking under a slump sale within three years of conversion, the undertaking will be classified as a short-term capital asset as per Sec. 50B. Then, the company would have to pay for the loss of tax benefit due to violation of conditions, as well as tax on the short-term capital gains arising on the slump sale.

**Notes**

11. Gains made by a foreign resident from the alienation of a permanent establishment or a fixed base in India by way of slump sale, shall be taxable in India as per Sec. 50B read with Article 13 (Capital Gains) of the UN/ OECD Model Convention on Double Taxation Avoidance Agreement.

**14.3.5 Trade-off between Itemised Sale and Slump Sale**

An assessee has to choose what is best suitable for him – an itemised sale or a slump sale. This is done by evaluating the advantages and disadvantages of slump sale.

**Advantages**

If the undertaking is owned and held for more than 36 months, the long-term capital gains are taxable @ 20% (plus surcharge and education cess), even though there may be some assets held only for a few months. Further, long-term capital gains are eligible for deduction u/s.54EC and u/s.54F. Since S. 50B overrides the Sections which provide the mode of computation of capital gains on sale of an asset, S. 50C, providing for substitution of sale consideration of land/building by its value as per valuation of stamp valuation authority, is not applicable where land/building is part of the undertaking. Thus, the effective rate of long-term gains may turn out to be much lower than 20%.

**Disadvantages**

No indexation benefit is available. Also, where the undertaking comprises plots of land acquired prior to 1-4-1981, whose value has appreciated, cost cannot be substituted by the FMV as on 1-4-1981. In case the undertaking is a short-term capital asset, capital gains made on slump sale are taxable at normal rates of tax, without availability of exemption.



*Caution* An assessee may select what is most appropriate for him – an itemised sale or a slump sale, so as to minimise the capital gains tax liability. Where itemised sale is more beneficial, one can simply break up the sale consideration by assigning values to individual assets and liabilities. Since sale consideration of an undertaking is expected to be sizable, determining sale consideration appropriately can save huge tax liability.

**Self Assessment**

Fill in the blanks:

9. .... is transferring of whole or part (capable of carrying out operations independently) of a business undertaking as a going concern.
10. .... shall be the aggregate value of total assets of the undertaking or division as reduced by the value of liabilities of such undertaking or division as appearing in its books of account.
11. .... is a process of determining the value of assets and liabilities of business.
12. Transaction costs involved in slump sale can go up to ..... of deal size.



Caselet

### **Sankheya Chemicals' Case**

In *Sankheya Chemicals Ltd. v. ACIT*, 8 SOT 50 (Mum.), the Chemical Division of the assessee-company was sold as a going concern on 1st April, 1990 for a lump sum price of ₹ 20 lakhs. The said business consisted of the leasehold rights of the land, factory building, plant and machinery and electrical installation which were transferred to the subsidiary company, along with other assets and liabilities including transfer of raw material and other licences, etc.

The same Mumbai Tribunal was inter alia asked to consider whether provisions of S. 50B were retroactive in its operation so as to bring within its net the gains of transfer of a business for a slump consideration prior to introduction of S. 50B.

Taking into consideration the facts of the case in totality, the Tribunal held that no tax was eligible to the gains arising on the transfer of the business undertaking as a going concern by the assessee-company and the gains on such transfer were not includible in the hands of the assessee as income from short-term capital gains by relying on *Coromandel Fertilisers Ltd. v. DCIT*, 90 ITD 344 (Hyd.). The Tribunal also noted that S. 50B of the IT Act was introduced w.e.f. 1st April 2000 and in the facts of the present case, the business undertaking was sold on 1st April 1990, i.e., prior to the introduction of the provisions of S. 50B of the IT Act.

The Mumbai Tribunal in this case noted with approval the decision of the Hyderabad Bench in the case of *Coromandel Fertilizers Ltd.* (supra) which held as under: ". . . . S. 50 and S. 50B are mutually exclusive. In other words, S. 50B is attracted when there is a slump sale and S. 50 is attracted when there is an itemised sale. S. 50B was not applicable for the assessment year in question, as it had no retrospective operation. So, the position that emerged was that what was transferred by the assessee was the cement unit as a going concern for a lump sum price, and so, the sale in question was a slump sale, and so, S. 50 was not attracted. . . ."

Source: <http://www.thetaxcorp.in/Contents/details.aspx?ID=3157>

## **14.4 Transfer of Assets between Holding and Subsidiary Company**

A Holding Company is one which controls another company either by means of holding shares in that company or by having power to appoint the whole or majority directors of that company. A Holding Company may have control on more than one company also. A company controlled by a Holding Company is called a Subsidiary Company. The companies becoming subsidiaries continue to remain and function as separate legal entities. The terms "subsidiary" and "holding company" are frequently defined by reference to section 1159 of the Companies Act, 2006 or section 736(1) of the Companies Act, 1985 (the former drafted to reflect the latter) which set out that a company is the "subsidiary" of its "holding company" if the holding company:

1. holds a majority of the voting rights in it; or
2. is a member of it and has the right to appoint or remove a majority of its board; or
3. is a member of it and (under an agreement with other members) controls a majority of the voting rights in it.

A "member" is any person that is entered into a company's register of members. In most cases a holding company will hold the majority of the voting rights in its subsidiary and therefore will rely on the first part of the above definition. However, in cases where the holding company only controls the voting rights or board appointments and the legal title of the shares has been transferred to a nominee, the relationship between holding company and subsidiary for the purposes of the definition has been broken.

**Notes**

A company is a subsidiary of another company that is the holding company if the holding company holds more than half the shares or controls the subsidiary company. A holding company and all its subsidiaries and the subsidiaries of its subsidiaries constitute a group. Each company in a group is a separate entity for tax purposes. However, Tax Law gives special treatment to groups of companies. Two companies are associated if the companies are under the control of another or both are under the control of the same person or persons. Where companies are associated/ in a group the upper and the lower limits determining the tax rates are divided between the associated companies.



*Example:* Where companies are in a 75% group that is where one company is a 75% subsidiary of another or both companies are 75% subsidiaries of a third company, special relief are available to them.

Where companies form a group, losses may be surrendered to other companies in the group which can relieve them against their own profits which are subject to the tax. The loss may be surrendered by any member company to another member of the same group. The loss must be specifically surrendered from one company to another. Therefore, the companies must have the corresponding accounting periods. Certain reliefs from capital gains tax also apply to the group. A 75% capital gains group applies where there is a parent company and a 75% subsidiary. Assets can be transferred between companies in the group at a nil gain nil loss. Assets can be transferred to take the advantage of capital losses and lower tax rates. Where assets are transferred within a group they are deemed to be at a price which does not give rise to a gain or loss. Effectively the transferee company inherits the capital gains tax basis of the original company. No claim is necessary. Where the acquiring company sells the asset outside the group capital gain or loss arises in the usual way. Nothing contained in section 45 shall apply to the following transfers:

- (a) Any transfer of a capital asset by a company to its subsidiary company, if –
  - (i) The parent company or its nominees hold the whole of the share capital of the subsidiary company; and
  - (ii) The subsidiary company is an Indian company;
- (b) Any transfer of a capital asset by a subsidiary company to the holding company, if –
  - (i) The whole of the share capital of the subsidiary company is held by the holding company, and
  - (ii) The holding company is an Indian company.

Provided that nothing contained in clause (iv) or clause (v) shall apply to the transfer of a capital asset made after the 29th day of February, 1988, as stock-in-trade;

- (c) Any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company;
- (d) 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, if –
  - (i) At least twenty-five per cent of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company, and
  - (ii) Such transfer does not attract tax on capital gains in the country, in which the amalgamating company is incorporated;
- (e) Any transfer, in a demerger, of a capital asset by the demerged company to the resulting company, if the resulting company is an Indian company;

- (f) Any transfer in a demerger, of a capital asset, being a share or shares held in an Indian company, by the demerged foreign company to the resulting foreign company, if –
- (i) At least seventy-five per cent of the shareholders of the demerged foreign company continue to remain shareholders of the resulting foreign company; and
  - (ii) Such transfer does not attract tax on capital gains in the country, in which the demerged foreign company is incorporated.

Provided that the provisions of sections 391 to 394 of the Companies Act, 1956 (1 of 1956) shall not apply in case of demergers referred to in this clause.

### Self Assessment

State whether the following statements are true or false:

13. A holding company may have no control on more than one company.
14. Each company in a group is a separate entity for tax purposes.
15. A member is any person that is entered into a company's register of members.
16. Any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is a foreign company.



Case Study

#### **Swastik Research Centre and Operation Research Group (Transfer of Assets to Subsidiary Company)**

Operation Research Group, in 1974, transferred the industrial undertakings and businesses of Swastik Household & Industrial Products Division, business of Operation Research Group and the Sarabhai Research Centre to its subsidiary company, M/s. Ofisade Pvt. Ltd. The Income-tax Officer in his order refers to this transfer "as a going concern to its subsidiary company. In the earlier transfer, goodwill of the business was transferred at ₹ 2 crores. Scanning the details regarding the present transfer, the ITO came to the conclusion that the transfer did not represent in its terms the correct position. The value ascribed to goodwill, the other assets, etc., was not realistic. In effect, he came to the conclusion that on account of the transfer the assessee had gained substantial amounts taxable under Section 41(2). Read with the order of the Inspecting Asst. Commissioner under Section 144B, the order of the ITO reveals that he found that the assets have been transferred at their written down value without having any regard to their present market value. The fact that an amount.

Attributable to goodwill, in fact, reflected the value of the fixed assets transferred to the subsidiary company. The assessee-company itself had not supplied any material regarding the market value of the assets. Under the direction of the IAC, therefore, the ITO ascertained the difference between the actual value of the assets transferred and the written down value and treated the difference as income taxable under Section 41(2). The ITO also held that any amount over and above the actual cost of the asset transferred would constitute capital gains; but in view of the provisions of Section 47(iv), the capital gains would not be taxable in respect of a transfer made to a subsidiary company. The ITO, therefore, assessed a sum of ₹ 4 crores as profit under Section 41(2). He, however, noted that this working would be subject to modifications on the ascertainment of the actual cost of the assets, if furnished by the assessee. On appeal, the CIT (Appeals) went in detail into the facts. According to him, the claim of the assessee that there was a slump sale could not be accepted on facts. Even in the case of a slump sale.

*Contd...*

**Notes**

Interim to its 100 per cent subsidiary, M/s Ofisade Pvt. Ltd.: The transfer was affected under the agreement referred to above. The preamble to the agreement recites the nature of the businesses carried on by the assessee which cover four items, i.e., Swastik Oil Mills, Operations Research Group, Sarabhai Technical Services and Sarabhai Research Centre. The assessee is also in possession of several agreements relating to services, leases such as the HRO Agreement, the PACKART Agreement, the STDS Agreement, etc., which give the assessee substantial rights, etc. These are also detailed in the transfer agreement.

The vendor shall transfer and assign and the purchaser shall purchase and accept the transfer and assignment of the industrial undertaking and business of Swastik Oil Mills Division and the businesses and activities of Operations Research Group, Sarabhai Technical Services Division and Sarabhai Research Centre of the Vendor as going concerns on and with effect from the 1st day of March, 1977 and as incidental thereto, the Vendor shall sell, transfer and assign to the Purchaser and the Purchaser shall purchase and accept the transfer and assignment of goodwill of the aforesaid businesses provisions, to execute this conveyance. The assessee, therefore, had to go through the device of getting this land conveyed to an amalgamated company. The business undertaking consists of several assets and liabilities. In a transfer of the undertaking, it is not always necessary that every item of assets and liabilities should be transferred. Some of the items may be incapable of being transferred; some on account of their onerous nature may not be acceptable to the purchaser. In ordinary business transactions, it is not uncommon that one or other such items are not transferred. For instance, in an extensive business carried on by a Hindu undivided family or an individual, transferred to another, if a house belonging to the family or individual to whom sentimental attachments are there, is not transferred, it cannot be said that the business undertaking remains not transferred. On facts, the business is continued by the subsidiary company on its own terms. The mere fact that land and buildings were not transferred is irrelevant for deciding the issue of a slump sale of the entire undertaking. In fact, where a purchaser has his own premises where he can more advantageously carry on a newly purchased business.

**Questions**

1. Study and analyse the case.
2. Write down the case facts.
3. What do you infer from it?

*Source:* <http://indiankanon.org/docfragment/843113/?formInput=%22transfer%20of%20assets%20to%20subsidiary%20company%22>:

**14.5 Summary**

- Many entrepreneurs start their businesses as a sole proprietorship due to the low compliance requirements.
- All the assets and liabilities of the sole proprietary concern relating to the business immediately before the succession become the assets and liabilities of the company
- The sole proprietorship is a completely separate legal form from a company and the law does not provide any process for conversion from one form to the other.
- Where a firm is converted into a company and as a result of such conversion, the firm transfers any capital asset (whether tangible or intangible) to the company, such transfer will not be charged to capital gains tax if the following conditions are complied with all the assets and liabilities of the firm immediately before its succession should become the assets and liabilities of the company.



- If the transfer is on a going concern basis, even though no specific exemption is spelt out, the firm shall not be taxable since there can be no inference of a sale of any specific item comprised therein.
- The Income tax Act, 1961 ('IT Act') defines Slump Sale as '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'.
- Slump Sale is one of the widely accepted ways of conducting business transfers.
- 'Net worth' shall be the aggregate value of total assets of the undertaking or division as reduced by the value of liabilities of such undertaking or division as appearing in its books of account.
- An assessee has to choose what is best suitable for him – an itemised sale or a slump sale.
- A Holding Company is one which controls another company either by means of holding shares in that company or by having power to appoint the whole or majority directors of that company.
- A "member" is any person that is entered into a company's register of members. In most cases a holding company will hold the majority of the voting rights in its subsidiary.

## 14.6 Keywords

**Capital Gains:** An increase in the value of a capital asset (investment or real estate) that gives it a higher worth than the purchase price.

**Company:** A voluntary association formed and organised to carry on a business.

**Memorandum of understanding (MOU):** A memorandum of understanding (MoU) is a document describing a bilateral or multilateral agreement between parties.

**Net worth:** Net worth shall be the aggregate value of total assets of the undertaking or division as reduced by the value of liabilities of such undertaking or division as appearing in its books of account.

**Partners:** A person who takes part in an undertaking with another or others, esp. in a business or company with shared risks and profits.

**Share Capital:** Share capital is the money invested in a company by the shareholders.

**Slump sale:** It means 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.

**Sole Proprietor:** The sole proprietor is an unincorporated business with one owner who pays personal income tax on profits from the business.

**Takeover:** Assumption of control of another (usually smaller) firm through purchase of 51 percent or more of its voting shares or stock.

**Transfer:** A changing of ownership, such as real estate, a security or a financial account, from one party to another.

**Valuation:** Valuation is a process of determining the value of assets and liabilities of business.

Notes

**14.7 Review Questions**

1. What are the conditions applied in the conversion of sole proprietary business into company?
2. Elucidate the requirements and issues related to the takeover of a sole proprietorship concern.
3. "The sole proprietorship is a completely separate legal form from a company and the law does not provide any process for conversion from one form to the other." Explain.
4. What are the conditions applied in the conversion of partnership firm into company?
5. Highlight the advantages of conversion of partnership firm into company.
6. Define slump sale. What are the key characteristic features of slump sale?
7. Write short note on net worth.
8. Discuss the steps involved in slump sale.
9. Explain the role of taxability in slump sale.
10. Describe trade-off between itemised sale and slump sale.
11. Define holding company. Explain transferring of assets between holding and subsidiary company.

**Answers: Self Assessment**

- |                     |                  |
|---------------------|------------------|
| 1. Sole Proprietary | 2. Low           |
| 3. Transfer         | 4. Capital gains |
| 5. False            | 6. False         |
| 7. True             | 8. True          |
| 9. Slump Sale       | 10. Net worth    |
| 11. Valuation       | 12. 5-10%        |
| 13. False           | 14. True         |
| 15. True            | 16. False        |

**14.8 Further Readings**



Books

Ahuja, G. K. & Gupta, Ravi, *Systematic Approach to Income Tax*, Bharat Law House.

Aggarwal, K., *Direct Tax Planning and Management*, Atlantic Publications.

Lakhotia, R.N., *Income Tax Planning Handbook*, Vision Books.

Singhania, V. K. & Singhania, Kapil, *Direct Taxes law & Practice*. Taxmann Publications.

Srinivas E. A., *Handbook of Corporate Tax Planning*, Tata McGraw Hill.

Notes



Online links

<http://yourstory.in/2012/07/conversion-of-a-sole-proprietorship-concern-to-a-company-legal-talk/>

<http://www.incometaxmanagement.com/Pages/Tax-Management-Managerial-Financial-Decisions/8-Conversion-of-Firm-Sole-Proprietorship-to-Company.html>

<http://www.3ecpa.com.sg/convertng-sole-proprietor-to-company/>

[http://www.sunshinecorp.biz/partnership\\_firm\\_to\\_pvt\\_or\\_pub\\_co.php?id=services](http://www.sunshinecorp.biz/partnership_firm_to_pvt_or_pub_co.php?id=services)

<http://www.bmcgroup.in/company-registration/partnership-firm-into-private-public-company.html>



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