Corporate Tax Structure And Planning

DEBSL501

Edited by:
Dr. Lalit K. Bhalla

LOVELY PROFESSIONAL UNIVERSITY

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Unit 01: Introduction to Tax Planning

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Objectives

After studying this unit, you will be able to:

- Understand the meaning and objectives of Tax Planning, Tax Avoidance, Tax Evasion and Tax Management
- Justify the need for corporate tax planning and management,
- Understand the nature and scope of tax planning and management in the corporate sector and justification.

Introduction

Because of multiple deductions, exemptions, relief, and rebates, India's tax regulations are undoubtedly complex. As a result, it's only natural for taxpayers to structure their affairs in such a way as to incur the least amount of tax. However, tax evasion is a worldwide phenomena, and there is always a war between the taxpayer and the tax collector in this regard. Both have different perspectives. The taxpayer goes to great lengths to maximise his gains while attracting the least amount of attention. The tax collector, on the other hand, strives to thwart schemes whose main purpose is to save money.There are three main ways to save money on taxes:

(a) tax evasion,

(b) tax avoidance, and

(c) tax planning. In the next discussion, they will be discussed in further depth.

1.1 Concept of Tax Planning

Tax planning is the process of reducing income and/or capital gains by making the best use of all available allowances, deductions, exclusions, exemptions, and so on. Tax planning is the process of arranging one's financial and business affairs to take maximum advantage of all available deductions, exemptions, allowances, and refunds in order to lower one's tax liability to the bare minimum. To put it another way, all arrangements in which the tax is saved through ways and means that comply with legal responsibilities and requirements and are not colorable devices or techniques to meet the letters of the law but not the spirit of the law, would be considered tax planning.

Various judicial decisions have established the idea that the substance and form of transactions must be considered together in order to evaluate the net effect of a transaction. In CIT v. B M Kharwar (1969) 72 ITR 603, the Honble Supreme Court declared that "the taxing authority is authorised and indeed bound to identify the genuine legal relation emanating from a transaction." If the parties choose to disguise their legal relationship using a device, it is up to the taxation authorities to decipher the device and identify the true nature of the relationship. The legal consequence of a transaction, on the other hand, cannot be changed by a probe into the transaction's substance."

Any tax-planning mechanism is put to the test when it comes to the form and substance of a transaction. The form of transaction refers to a transaction as it looks on the surface, with the true objective of the transaction hidden. The term "substance of a transaction" refers to piercing the veil of legal documents and determining the genuine intentions of the parties involved.

Example: "Tax planning may be acceptable provided it is done within the scope of the law," the Hon'ble Supreme Court stated in McDowell & Co. v. CTO (1985) 154 ITR 148. Colorable devices cannot be used in tax planning, and it is wrong to advocate or entertain the notion that avoiding tax payment by using dubious means is honourable." Tax planning should not be done with the goal of defrauding the government; even if all of an assessee's transactions are legally correct, they could all be contrived to cheat the government. Colorable devices are those that are used when a statute is strictly fulfilled in language but the spirit underlying the statute is tainted.

Tax Management

Tax management entails ensuring that the law is followed and that the business's operations are organised in such a way that the tax burden is minimised. Maintenance of accounts, filing of returns, prompt deduction and deposit of TDS, timely payment of tax, and presence before the Appellate Authority are all functions that fall under tax management. Interest, penalties, and prosecution may be imposed as a result of poor tax management. If a return of loss is not made by the required date, losses may not be carried forward and set off. Tax management focuses on following legal requirements in order to reduce taxes, whereas tax planning focuses on lowering tax burdens.

1.2 Tax Planning, Tax Avoidance and Tax Evasion

a. **Tax evasion:** It is defined as a circumstance in which a person tries to reduce his tax responsibility by concealing income or inflating expenditures to make the income appear smaller than it actually is, as well as using various sorts of willful manipulations. Tax evasion by an assessee is penalised under the appropriate laws. Tax evasion can include willfully making a false statement, providing deceptive papers, suppressing information, failing to keep adequate accounting of earned income (if required by law), and omitting material facts in assessments. Tax evasion would be committed by an assessee who fraudulently claims the benefit under the statute by making false declarations.

b. **Tax Avoidance**: The boundary between tax planning and tax avoidance is extremely thin and hazy. Tax evasion may contain components of a malicious intentions as well. Tax avoidance can be defined as any strategy that, while precisely following legal criteria, defies the primary goal of the Legislature behind the statute. It's usually done by adjusting one's affairs in such a way that no tax laws are broken and loopholes are exploited to get the lowest tax rate possible. Previously, tax avoidance was regarded totally legal, but it may now be illegal in some circumstances. Tax avoidance has been deemed as terrible as tax evasion and a crime against society by the Supreme Court in McDowell v. United States, 1985 (154 ITR 148) SC. The majority of the adjustments are now geared at reducing avoidance behaviour.

c. **Tax planning**: It entails organising financial activities in such a way that the assessee receives the most tax benefits possible by utilising all beneficial provisions in the tax laws that enable the assessee to particular rebates and reliefs.This is legal, and it is not frowned upon. Thus, tax planning is adhering to the taxation requirements in such a way that all tax exemptions, deductions, concessions, rebates, and reliefs available under the Income Tax Act are fully utilised, resulting in the lowest possible tax incidence. With regard to a company, tax planning is the scientific planning of the company's operations in such a way as to attract minimum tax liability or postponement or, for that matter, deferment of the tax liability for the subsequent period by taking advantage of various incentives, concessions, allowances, rebates, and reliefs provided for in the tax laws. They are intended to be used, and they have certain goals to achieve. As a result, tax planning may be defined as the intelligent application of professional knowledge in the planning of company operations with the goal of achieving purposefully supplied tax benefits in accordance with the State's and the public's interests.

You've learned that tax planning entails lowering tax burden through full compliance with tax laws and compliance with tax obligations, which, while technically satisfying legal requirements, do not reflect legislative intent based on national priorities.

The types of cases that fall under the heading of "tax avoidance" are those in which a tax payer appears to have circumvented the law without committing an offence by employing a complex scheme, arrangement, or device whose main or sole purpose is to defer, reduce, or completely avoid the tax due under the law. Occasionally, tax avoidance is performed by transferring the tax liability to a non-at-arms-length party, in whose hands the tax payable is lowered or abolished. "Tax avoidance is the act of avoiding tax without really breaching the law," according to G.S.A. Wheat Craft. It is a way of decreasing tax incidence by exploiting tax law loopholes.As a result, the distinction between tax avoidance and tax planning is narrow and hazy. In order to avoid paying taxes, there must be a malafide motive.

Tax evasion is a dishonest way of avoiding tax duty by concealing income, showing lower incomes, violating rules knowingly, inflating expenses, and so on. This contraption must be criticised. It's a dubious method of obtaining tax benefits. A tax evader faces not only a penalty but also the possibility of prosecution. Tax evasion is never the same as tax planning since it involves breaking the law, whereas tax planning is done inside the legal framework by taking advantage of what the legislation has to offer. Tax planning assures not only the accrual of tax benefits within the confines of the law, but also the proper discharge of tax responsibilities in order to avoid penalties.

Example: The Royal Commission on Taxation for Canada defined tax avoidance as follows: "Tax Avoidance" will be used to denote any attempt by lawful methods to avoid or decrease tax responsibility that would otherwise be incurred, by taking advantage of any provisions or lack of provisions of law. It excludes deception, concealment, and other criminal practises."

1.3 Objectives of Tax Planning

Tax planning is, in fact, an ethical and legal method to maximising the benefits of taxes rules within their framework. As a result, the goals of tax planning cannot be construed as violating any idea of the taxation laws or as constituting an attempt to reduce revenue to the government coffers, as long as the tax planning procedures are in accordance with the statutory laws and court expositions thereof. The following are the primary goals of tax planning:

(a) Lessening of tax burden
(b) Litigation minimization
(c) productive investment
(d) Economic Growth that is Healthy
(e) overall economic stability

(a) Lessening of tax burden:In this case, a tax payer can save the most money by managing his affairs in accordance with the law's requirements, as laid out in the fiscal statutes. In many circumstances, a taxpayer may face a high tax burden not because of the amount of tax imposed by the Act, but because he is unaware of the legal requirements. Because every taxpayer prefers to keep as much of his earnings as possible rather than parting with it and suffering a financial crisis, it is in his best interests to correctly arrange his tax affairs and take advantage of the deductions and exemptions available under the Act (s).

(b) Litigation minimization: A common depiction of the tax administration scenario depicts a tug-of-war between tax payers aiming to pay the least amount of tax and the tax administrator attempting to recover the highest amount of money. This can potentially lead to long-running legal battles. In this situation, effective tax preparation pays off handsomely. The incidence of litigation is reduced when a tax payer uses adequate tax planning in accordance with the rules of the taxation legislation. This protects him from the hassles and inconvenient consequences of unneeded lawsuits, which can sometimes reach the level of the High/Supreme Court.

(c) Productive Investment: One of the primary goals of tax planning is to channel a tax payer's otherwise taxable income into various investment schemes in order to achieve two goals: I to harness resources for socially productive projects, and (ii) to relieve the tax payer not only from the initial burden of taxation, but also to convert the earnings into means of further earnings. Legal understanding of the avenues that the government provides from time to time reduces the need for avoidance/evasion and lends validity to the investments made.

(d) Economic Growth that is Healthy: The growth and prosperity of a nation's economy are inextricably linked. In this scenario, saving wages through legally sanctioned ways promotes the growth of both, because saves through dubious means result in the generation of black money, which has apparent negative consequences. Tax-planning initiatives, on the other hand, are geared towards creating white money in a free-flowing and unrestricted manner for the nation's overall progress. In this setting, tax planning is quite important.

(e) Overall Economic Stability: According to M.V.Valliapan v. ITO, (1988) 170 ITR 238 (Mad.), efficient tax planning ensures a smooth tax flow from the tax payer to the tax administrator, free of recriminations. This leads to economic stability by:

i. providing avenues for productive investments by tax payers; and

ii. mobilising resources for national programmes targeted at the general success of the national economy, with advantages accruing even to individuals who are not subject to income tax.

As a result, despite legal judgments in cases like McDowell, real and genuine transactions aimed at proper tax planning cannot be rejected solely on the basis of tax burden reduction. The potential for ploughing back profits for expansion and modernisation of existing plant and machinery, etc. is significantly reduced in the context of corporate taxation, because the incidence of tax on Indian enterprises is deemed rather high. As a result, the corporation must organise its taxation in such a way that it can take advantage of all of the government's tax advantages and other benefits.In this regard, the case of M.V. Valliapan v. ITO (1988) 170 ITR 238 (Mad.) established that adequate tax planning ensures a smooth tax flow from the tax payer to the tax administrator, free of recriminations.

1.4 The Benefits of Tax Planning

Tax preparation is critical for lowering tax liabilities. However, there are a number of other reasons why tax planning is so important:

(a) Claim deductions in a timely manner: If an assessee has not claimed all deductions and relief before the assessment is concluded, he will not be able to claim them at the time of appeal. In CIT v. Gurjargravures Ltd. (1972) 84 ITR 723, it was held that if there is no tax planning and the assessee makes mistakes, the advantage will be minimal.

(b) Tax planning is more dependable: Tax planning is more reliable since the Companies Act, 2013 and other related rules limit the possibility for tax evasion and tax avoidance strategies, putting a taxpayer in a position where he will face significant penalties.

(c) Government incentives to encourage public-interest activities: Companies are currently expected to promote activities and programmes that are of public interest and beneficial to a civilised society. The government has granted them with tax advantages in order to encourage them. As a result, a planner must be well-versed in the laws governing incentives.

(d) Enough time for tax preparation: As profits rise, the amount of corporate tax rises as well, necessitating the allocation of sufficient time to tax planning.

(e) Allows a company to carry the burden of both direct and indirect taxes during inflation: Tax planning allows a company to bear the cost of both direct and indirect taxes during inflation. It assists businesses to plan properly for expenses, capital budgets, and sales promotions, among other things.

(f) Capital formation draws a large deduction:Since it aids in the replacement of technologically outmoded and outdated equipment and technology, allowing manufacturing operations to continue with a new and more complex system. Any move of this magnitude would necessitate a significant capital outlay, which is typically funded by reinvesting revenues, utilising reserves, and excess. Additional deductions as revenue expenditures for modernisation, replacement, repairs, and renewal of plant and machinery, for example, are also available.

(g) Money saved is money earned: In these days of credit crunch and tight money, even a decently saved rupee of tax can be used as an interest-free loan from the government, which an assessee may not have to repay.

(h) As a result, any reasonable efforts taken by an assessee to maximise tax benefits while keeping the meaning of the law in mind will benefit not just him but also society and promote the spirit of the legal provisions. In a welfare state like ours, all assessors who exercise tax planning can feel good about providing their best to the nation's broad purposes and aspirations.

1.5 Essentials of Tax Planning

The following characteristics/requirements should be present in successful tax planning techniques:

(a) Current knowledge of tax laws: Tax planning should be based on current tax law information. In addition, the assessee must be cognizant of court judgments. In addition, one must maintain track of the CBDT's periodic circulars, notifications, clarifications, and administrative directives.

(b) Disclosure and furnishing of information to the Income-tax Department: It is an absolute requirement of tax planning to disclose all material information and furnish it to the Income-tax Department, as concealment in any form would trigger penalty clauses, with penalties ranging from 100 percent to 300 percent of the tax sought to be evaded.

(c) Preparing to operate within the legal framework: Whatever is intended should not only meet the legal criteria as stated, but also remain within the legal framework. It indicates that sham transactions and colorable devices, which are engaged into only for the purpose of skirting legal requirements, must be avoided.It is totally permissible to use a legitimate tax planning device to carry out the rules of law and court rulings and to avoid a large tax burden.

(d) Capability of achieving desired goals and adaptability to change: A planning model must be capable of achieving a business's targeted objectives while also being adaptable to future developments. As a result, in relevant conditions, all significant aspects of company planning, whether linked to strategy planning, project planning, or operational planning incorporating tax concerns for long-term or short-term management objectives and policies, should be thoroughly scrutinised. A business's essence is foresight. Tax planning is one of its important attributes

1.6 Types of Tax Planning

The tax planning process includes anything from creating a model for a specific transaction to systematic company planning. There are two types of tax planning:

(a) short-term and long-term tax planning

Short-term planning is year-to-year planning aimed at achieving a specified or limited goal. For example, an individual taxpayer whose income is expected to grow at an extraordinary rate in a given year compared to the previous year may plan to invest in PPF/NSCs within the prescribed limitations in order to benefit from substantial tax savings. He is not making a long-term commitment by investing in this manner, but he is saving a significant amount of money in taxes. It's a good example of short-term planning.

Long-term planning entails laying out a strategy at the start of the fiscal year that will be followed throughout the year. This form of preparation may not provide immediate benefits, as short-term tax planning does, but it is likely to be beneficial in the long run. When an assessee passes his stock interests to his young son, for example, he understands that the income from the shares would be clubbed with his own. Clubbing, on the other hand, would come to an end whenever the minor reaches majority. In addition, if the company issues bonus shares, the income from those bonus shares is not taxable in the hands of the assessee (i.e., transferor).

(b) Tax planning that is permissive:

Permissive tax planning entails devising strategies that are legal under various tax legislation.Our country's tax rules include numerous exemptions and benefits. The goal of planning is to take advantage of various tax concessions, incentives, and deductions.

(c) Tax planning with a purpose

Purposive tax planning entails drafting plans with a specific goal in mind, such as ensuring the availability of maximum benefits through legal loopholes. This could occur as a result of:

- Proper investment selection.
- Making a suitable plan for asset replacement.
- Changing one's residential status; diversifying one's business activities and incomes, and so on.

The Statute expressly authorises permissive tax planning, whereas the Statute does not authorise purposive tax planning. The income of other persons is, for example, included in the assessee's income under Sections 60 to 65 of the Act.

1.7 Corporate Tax Planning Areas

(a) Form of Organisation

The choice of business structure is influenced not only by the size of the financial requirements and the owner's responsibilities, but also by tax concerns. A suitable form can usually be chosen depending on the amount of operations, estimated profitability, need for external financing, and expected technical expertise required.

Corporate enterprises may be viewed as a useful instrument of tax planning due to the continuity of business, the benefits emerging from limited liability, organised accounting, and the overall long-term tax benefits flowing to the company form of organisation. Because the corporation is a separate legal entity, it provides important tax planning benefits to its shareholders and those associated with the company's management.We will solely explore the benefits connected with the corporation form of organisation in this chapter because we are studying Corporate Tax Planning.

Company Form of Organisation

The following are the major tax benefits and advantages that a company has over other entities:

(a) Remuneration Deduction for Managing Persons: Remuneration is allowed for those who manage the company's affairs while also owning its shares.

(b) No Clubbing Provisions Applicable: Even if the business is carried on by family members through a company, the requirements relating to income clubbing under section 64 of the Act do not apply, resulting in a reduction in individual members' tax burden.

(c) Concessional Tax Rates Available to Domestic Companies: Effective from Assessment Year (AY) 2020-21 (Financial Year 2019-20), the Taxation Laws (Amendment) Ordinance, 2019 has made certain amendments to the Income-Tax Act, 1961 and the Finance (No. 2) Act, 2019, which allows a domestic company to pay income tax at a rate of 22 percent without claiming any specified exemptions or deductions. The new clause also states that any domestic manufacturing business that is formed on or after October 1, 2019, but commences production before March 31, 2023, has the option of paying income tax at a rate of 15% without claiming any specified exemptions or deductions. As a result, commencing in AY 2020-21, domestic companies will be able to use the reduced rate of income tax under sections 115BAA and 115BAB in any assessment year.

(d) Certain advantages are solely available to the company: Section 32AC, Section 33AC, Section 36(a)(ix), and Section 35D of the Act provide unique tax incentives, allowances, and deductions applicable only to company-formed business entities.

(e) Investing in shares is a good idea: Shares in companies are classified as long-term capital assets that qualify for tax deductions even if they are held for as little as a year by the assessee, as long as the shares are of a publicly traded company.

Tax liability is an important factor to consider while deciding on a legal business structure. However, in some situations, this issue is irrelevant. Significant businesses, for example, are driven to organise themselves in the form of a company since this structure allows them to raise large sums of capital. Similarly, a small retail business can only be run profitably as a sole proprietorship or partnership. When people have the ability to make their own decisions, taxation becomes a major factor.

From a long-term perspective, the corporate form of organisation is usually chosen.

(b) Aspect of Business Location:

Tax planning is important from a geographic standpoint. There are some areas that receive preferential tax treatment.

Here are a few of them:

I. Newly established units in SEZ: In the event of newly established units in SEZ on or after 1.4.2005, full exemption under Section 10AA for the first five years, 50% for the next five years, and a further deduction of 50% for another five years.
II. Developer of SEZ: Profits and gains of an entity or firm engaged in the development of SEZ are deductible under Section 80-IAB.
III. Industrial undertaking in an industrially backward state or district: A newly established industrial undertaking in an industrially backward state or district is eligible for a deduction under Section 80-IB.
IV. Industrial undertaking in certain special category states: In some special category states, a deduction under Section 80-IC is permitted for a newly established industrial undertaking or a substantial expansion of an existing undertaking.
V. Profits and gains from business of hotels and convention centres in designated area or a hotel at world heritage sites: Profits and gains from business of hotels and convention centres in specified area or a hotel at world heritage sites are authorised to be deducted under Section 80-ID.
VI. North-eastern States: Certain undertakings in the North-eastern States are eligible for a deduction under Section 80-IE.
VII. Additional Depreciation in Backward Areas Notified: Any assessee establishing a new manufacturing undertaking in the states of Andhra Pradesh, Telangana, Bihar, or West Bengal will be entitled for an additional depreciation of 15% of the cost of the new asset beginning in AY 2016-17.
VIII. Tax planning is also important when deciding on the type of business to start. Certain types of enterprises are given preferential tax status. The following are a few of them:
IX. Newly established units in SEZ [Section 10AA];
X. Tea, Coffee, and Rubber Development Accounts [Section 33AB];
XI. Site Restoration Fund [Section 33ABA];
XII. Specified business eligible for Capital Expenditure Deduction [Section 35AD];
XIII. Amortization of certain preliminary expenses [Section 35D];
XIV. Investment in mineral prospecting [Section 35E];
XV. Special reserve established by a financial corporation under Section 36(1)(viii);

XVI. Special provisions for deduction in the case of business for prospecting for mineral oil [Section 42 and 44BB];

XVII. Special provisions for computing profits and gains of business on presumptive basis [Section 44AD];

XVIII. Special provisions in the case of business of plying, hiring or leasing goods carriages [Section 44AE];

XIX. Special provisions in the case of shipping business in the case of non-residents [Section 44B];

XX. Special provisions in the case of business of operation of aircraft [Section 44BBA];

XXI. Special provisions in the case of certain turnkey power projects [Section 44BBB];

XXII. Special provisions in the case of royalty income of foreign companies [Section 44D];

XXIII. Special provisions in case of royalty income of non-residents [Section 44DA];

XXIV. Certain income of offshore banking units and International financial service centre [Section 80-LA];

XXV. Profits and gains of industrial undertakings or enterprises engaged in Infrastructure development etc. [Section 80-IA].

XXVI. Profits and gains of an undertaking or an enterprise engaged in development of SEZ [Section 80-IAB];

XXVII. Profits and gains from certain industrial undertaking other than infrastructure development [Section 80-IB];

XXVIII. Special provisions in respect of certain undertakings or enterprises in certain category states [Section 80-IC];

XXIX. Deduction in respect of profits and gains from business of hotels and convention centers in specified area or a hotel at world heritage site [Section 80-ID].

XXX. Special provisions in respect of certain undertakings in North-Eastern States [Section 80-IE];

XXXI. Profits and gains from the business of collecting and processing of bio-degradable waste [Section 80JJA]; x. Employment of new workmen [Section 80JJAA];

XXXII. Special tax rates under Section 115A, 115AB, 115AC, 115AD, 115B, 115BB, 115BBD, 115BA and 115D.

(c) Tax Planning for the set-up and commencement of a Business

Setting up a business within the scope of the act is an important factor to consider when developing a tax strategy. It is distinct from the start of a business. During the time between the company's formation and the start of business, it's possible that it will incur certain revenue-expenses (production). General costs incurred before to the date of setting up are inadmissible, but those incurred after the date of setting up and before the start of the business may be permitted as a tax deduction if they are of a revenue character and are expended completely and solely for the business.

From the Bombay High Court's decision in Western India Vegetable Products Ltd. v. CIT (1954) 26 ITR 151 (BOM) and the Supreme Court's decisions in CIT v. Ramaraju Surgical Cotton Mills Ltd. (1967) 63 ITR 478 (SC) and Travancore Lesson 17 • Tax Practices and Corporate Tax Planning 737 Cochin Chemical Pvt. Ltd. v. CIT (65 ITR 651), it is well established It's also worth noting that the business starts with the start of the first activity in time, which must always come before other activities.

The Gujarat High Court held in CIT v. Saurashtra Cement and Chemical Industries Ltd. (91 ITR 170) that the term "business" meant a continuous course of activity. The operations that make up the business do not have to begin at the same time in order for the business to start. When the activity that is first in time and must necessarily precede all other activities is started, the business will begin.

The Allahabad High Court relied on the above case in the case of Mod Industries Ltd. v. CIT (1977) 110 ITR 855, when deciding the question of business expenditure allowance. It was held in this case that the chairman's foreign tour expenses for setting up two new factories were not allowable as business expenditure under Section 37 and were of a capital nature. In the cases of Hotel Alankar v. CIT (1982) 133 ITR 866 and CIT v. O.P. Khanna and Sons (1983) 140 ITR 558, the judgement of Sarabhai Management Corporation Ltd. (above) was also cited. The Andhra Pradesh High Court established the following factors to evaluate whether a business has begun or not inCIT v. Sponge Iron India Ltd. (1993, 201 ITR 770):

It is an issue of fact whether a business has commenced or not.

There is a distinction to be made between setting up a business and commencing a business..Where a business consists of a continuous series of activities, all of the activities that make up the business do not have to be started at the same time. The business must be said to have started as soon as an activity that has the necessary activity in the course of carrying on the business has commenced. In this case, it was determined based on the facts that the interest income could not be classified as business income because the business had not yet commenced.

Income is contingent on the setting up of a business.

It is likely that, while a company's money are being raised, they will be temporarily invested so that they do not sit idle. Income from such investments is taxable as other sources of income. Expenses incurred prior to the setup of a business, such as employee salaries and office expenses, cannot be deducted from investment income [Traco Cable Co. Ltd. v. CIT (1969) 72 ITR 503 (Ker.)].

In such a situation, companies are in an unpleasant position. On the one hand, they have expenses that go unpaid, while on the other side, they have taxed income from investments.

Measures of tax planning in relation to setting up and commencement

- Setting the business up and running as soon as possible: A company that has planned the installation programme should make sure that the business is set up and running as soon as possible, even if the actual commencement of the business may be delayed depending on other relevant considerations weighing on the company, such as deferring production for a period of time if the company's comparative income and loss position permits, allowing the company to 738 Lesson 17 • PP-ATL to take advantage of tax incentives, investment allowances, and the ability to carry forward unabsorbed losses and depreciation for a longer period of time.

- Expenses must be of a revenue nature and incurred solely for the purpose of the business in order to be deducted. The phrase "for the purpose of the business" differs from "for the purpose of making a profit" in that it specifies that the expenditure must be for the purpose of carrying on the business and that the assessee must spend it in his role as a person carrying on the business. [CIT v. Muir Sugar Mills Co. Ltd., 123 ITR 534 (Allahabad High Court, 1980)]. Such expenses may be deductible as part of the preliminary expenses and may be eligible for amortisation u/s 35D of the Act for a term of five years

- Certain tax holidays are in effect from the start of a business: In the case of a freshly founded industrial endeavour, the phrase "start-up" is also relevant. The tax holiday provided by Sections 80-IA and 80-IB of the Act also kicks in when production begins. This continues until the time limit is reached

- Preliminary expenditures allowable from the year of commencement: Under Section 35 of the Act, any expenditure on scientific research, whether capital or revenue, incurred during the three accounting years immediately preceding the year commencement is allowable as a deduction in the year of start-up. The company can then examine the previous three years' worth of expenditures and compare them to the amount of expenditures incurred or predicted to be made in the next period, allowing it to get the most advantage by modifying the timing of business commencementaccordingly.

(d)Financial Management Decisions and Tax Planning

When making financial management decisions, keep the following considerations in mind:

- Debenture/deposit issue expenses should be incurred once the business has been established set-up: When a company raises long-term loans from financial institutions, or raises deposits from the public through a public issue of debentures, it should plan for the costs of such debentures, as well as stamp duty, registration fees, and lawyer's fees, to be incurred only after the business is set-up.

- Interest paid for the acquisition of fixed assets should be capitalised: Interest paid on loans taken by the company for the acquisition of its plant and machinery and other assets before the commencement of production but after the set-up of the business forms part of the actual cost of the asset and should be capitalised in the actual cost of the asset. As a result, the business would be able to capitalise the costs and claim a higher depreciation and investment allowance.

- Borrowing to finance the purchase of fixed assets: The company should also plan how to utilise its share capital and borrowed funds most effectively. It's worth noting that borrowings should be used as much as possible for the acquisition and installation of assets such as buildings, plant, and machinery, so that interest can be capitalised for the time after the acquired assets are set up but before production commences. Interest and a higher amount of depreciation (due to expense capitalization) might be claimed as revenue expenditures related to the company's activity.

- Purchase of depreciable assets on credit or on hire: The company should plan to purchase depreciable assets on credit terms, with an agreed amount of interest paid on such credit purchases, or on the basis of a hire purchase agreement, allowing the company to claim the amount of interest paid as revenue business expenditure. The corporation would also be able to claim depreciation for asset use or regard the hire costs as rent for the asset in the ordinary course of business and claim a revenue account deduction.

- The following is a comparison of the pre-commencement period and the post-commencement period based on the source of funds, i.e., capital or borrowings:

- a) I Dividends are not deductible in either the pre-commencement or post-commencement periods in India;

- Interest is capitalised during the pre-commencement period, that is, it is added to the project cost (cost of fixed assets). Its depreciation is based on the capitalised value of the assets.

- After the commencement phase, Interest is entirely deductible .

- In the case of capital, the cost of raising funds is not deductible as a revenue expense, but it is amortised under Section 35D of the Act. Section 35D applies if the expenditure is made after the business has commenced, as long as it is for the purpose of expanding the businessin the instance of a industrial undertaking,

- The cost of borrowing funds is capitalised in the pre-commencement period and in the post-commencement period it is completely deductible in the year.
- By offering an optimal capital mix for the company, the following consideration will go a long way in advising corporate executives to adopt a proper capital structure and select acceptable funding sources.

(e)Non-Resident Companies Tax Planning

Non-residents (NRs) might consider the following tax planning strategies:

(a) Non-Resident Company Exemptions: Foreign companies are eligible for a number of exemptions under Section 10 of the Income Tax Act of 1961. These exemptions might be factored into a foreign company's tax planning. Here are a few examples of such exemptions:

1. Foreign companies that provide technical assistance in projects related to India's security [Section 10(6C)]
2. Sections 10(48), 10(48A), and 10(48B) of the Income Tax Act of 1961 exempt the following foreign company income:
   i. Income obtained in India from the sale of crude oil pursuant to a Central Government-approved arrangement [Section 10(48)].

   ii. Income earned or arising in India as a result of the storage and sale of crude oil in India pursuant to a Central Government-approved arrangement [Section 10 (48A)].

   iii. Income accruing or arising in India as a result of the sale of remaining shares following the expiration of a Central Government-approved agreement [Section 10(48B)]. The Finance Act of 2018 has been amended to provide that a foreign firm will be eligible for the exemption advantage under Section 10 (48B) even if the agreement is terminated.

- Agents must keep enough money from nonresidents to cover their tax obligations in India: Anyone working with nonresidents must be aware of the provisions of Sections 162 and 163. They should keep sufficient funds on hand to pay the NR's tax burden on his behalf, so that they are not obligated to pay such taxes on their own account.

- NR should be informed of the tax deductions made by the agent so that they can plan accordingly: A NR must be absolutely explicit about his tax liability while dealing with an agent. He must be aware that the agent will take a portion of the sum due to the NR from the total payment due.

- Person who could be considered an NR agent: A NR's authorised agents include people who work for or on behalf of the NR, those who have a business relationship with the NR, and statutory agents. A NR may even be considered the agent of another NR.

- Tax paid by Agent is a dead loss if not recovered from NR: In light of the Supreme Court decision in CIT v. AbdullabhaiAbdhulkadar, it is important to remember that if the agent is unable to recover the amount of tax paid on his behalf from the NR, he cannot claim it as a bad debt or a business loss (41 ITR 545).

- Business link resulting from a tight financial relationship between an NR and a resident: Another significant consideration is the financial relationship that exists between a resident and an NR. This can also be construed as a business relationship.

(f)Indian collaborators' tax planning

When engaging into a foreign collaboration agreement, the Indian collaborator should consider factors that will allow him to organise his tax affairs in a way that maximises after-tax earnings and return on investment. In this case, the Indian collaborator might be encouraged to take the following tax-planning steps:

Capitalization of Installation Expenses: It goes without saying that the procurement of capital goods from a foreign collaborator is a capital expenditure for which depreciation is allowed. It's also important to make sure that the installation costs, including the collaborator's supervision fees, are capitalised and depreciation is claimed on them.

Other expenses related to the partnership agreement must be spent after the date of the business's establishment, because only then can they be capitalised as other expenses.

(a) Treating spares purchases as revenue expenditures: For the acquisition of spares for the plant, the Indian collaborator should intend to receive the spares after the facility's commissioning year, preferably through a separate contract. It will allow the Indian firm to treat the entire cost of spare parts as revenue expenditure.

In this regard, the Madras High Court's decision in CIT v. Rama Sugar Mills Ltd. (21 ITR 191) is noteworthy. At one of its factories, a sugar company had three boilers. Two of these were always in operation, while the third was stored as a "spare" in case one of the other two boilers needed to be cleaned at some point. One of the boilers' productive capabilities deteriorated, and the company was forced to purchase the other for Rs. 85,000.The Madras High Court held that the expenditure was deductible on the basis that "the boiler that was substituted was exActly similar to the old one and by this expenditure, the assessee company did not bring any additional advantage to the trade or business that they were carrying on and there is no improvement." It cannot be said that by substituting a new boiler for an old one, the sugar producing unit's production capacity was increased in any way."

(b) Treating blueprints, drawings, and other documents as plants for the purpose of depreciation:

Plant now includes ships, cars, books, scientific apparatus, and medical equipments used for the purpose of business or profession, according to the Supreme Court's decision in CIT v. Alps Theatre (65 ITR 177)

However, know-how acquired on or after 1.4.1998, owned totally or partially by the assessee and used for the purpose of his business or profession, shall form a separate block of asset from other intangible assets and will be eligible for depreciation under Section 32(1) @ 25% on written down value.

(g)Tax Planning for Employee Remuneration

Because the focus of this chapter is on corporate tax planning, we will only examine tax planning for employee remuneration from the perspective of the employer. According to the accounting technique used, a corporation is authorised to deduct the full amount of salary, allowances, bonus, or any other remuneration paid to an employee.

When it comes to employee remuneration, a corporate employer should consider the following factors:

Employees are provided with housing that is owned by the employer; the following expenses are allowed:

1. Current repairs, insurance premiums, and property rates and taxes (section 30). Section 43B, on the other hand, governs the deduction of rates and taxes.

2. Depreciation of such premises pursuant to section 32.

Treating spares purchases as revenue expenditures: For the acquisition of spares for the plant, the Indian collaborator should intend to receive the spares after the facility's commissioning year, preferably through a separate contract. It will allow the Indian firm to treat the entire cost of spare parts as revenue expenditure.

If a bonus or commission is paid to employees and it is not otherwise receivable as a distribution of profits to employees, it is allowed as a deduction under section 36(1)(ii). Section 43B also applies to this deduction.

c) To the extent allowed by prescribed authority, salary to research workers (excluding perquisites) for three years prior to the date of commencement of business is allowed as a deduction in the year of commencement of business.

In this situation, the research should be connected to the assessee's business.

Employer contributions to an employee's RPF or approved superannuation fund account, or to a National pension plan or approved gratuity fund account, are deductible if made before the due date.

(Subject to the provisions of Section 43B).

If an employer deducts money from an employee's wage to contribute to an employee benefit plan like EPF, such money is added to the employer's income under Section 2(24). (x). However, if the employer transfers the money into the employee's benefit fund on time, the amount can be deducted under section 36(1). (va)

Any payment made under the head salaries to an employee outside India or to a non-resident shall not be recognised as a deduction u/s 40(a)(iv) if no tax is paid on it or no TDS is deducted. g) If the employer pays tax on non-monetary perquisites granted to the employee (which is taxable in hands) u/s 10(10CCC), then the tax paid by the employer is exempt in the hands of the employee. Employer's deduction u/s 40(a)(v) in respect of such tax paid by employer on behalf of the employee is disallowed.

Summary

Tax planning may be legal if it is done within the confines of the law. Colorable devices cannot be used in tax planning, and it is wrong to advocate or entertain the notion that avoiding tax payment by using dubious means is honourable.Tax planning is, in fact, an honest and proper strategy to maximising the benefits of tax rules within their framework.When preparing his or her own or their clients' tax affairs, the tax planner must consider not only the applicable law provisions, but also the judicial pronouncements of Appellate Tribunals, High Courts, and the Supreme Court. He should also consider any relevant rules, notifications, circulars, and other documents.

Keywords

- Tax evasion: it is the illegal practise of reducing a taxpayer's tax due by intentionally suppressing income or sales, or raising expenses, etc., resulting in a reduction in the assessee's total income.
- Tax evasion: It is a practise in which an assessee takes advantage of loopholes in the law for a nefarious purpose.
- Tax planning: It is the process of systematically evaluating one's finances and investments in order to legally lower one's tax burden.
- Tax Management: It is a technique for adhering to the law's provisions.
- Commencement:As soon as an activity which has the essential activity in the course of carrying on the business is started, the business must be said to have commenced.

Self Assessment

1. Making plans which are permissible under different provisions of tax laws is called

A. Permissive Tax Planning
B. Purposive Tax Planning
C. Long Range Tax Planning
D. Short Range Tax Planning

2. Which of the following is wrong about important tax privileges and advantages to a company over the other forms?

A. Remuneration is allowed for the persons who are managing the affairs of the company and also owning its shares.
B. The provisions relating to clubbing of income under section 64 of the Act apply.
C. any domestic manufacturing company which is incorporated on or after 01.10.2019 but begins the production on or before 31.03.2023, has an option to pay income tax @ 15% without claiming any specified exemption and deductions.
D. The shares in companies are treated as long term capital assets qualifying for considerable leniency in taxation even if they are held by the assessee for a small time as 12 months provided shares are of a listed company.

3. Which of the following is wrong about Tax evasion?

A. It refers to the reduction of tax liability by illegal or fraudulent meansYes, as Amru is willing to pay a sum of Rs.200 to get vase.
B. There generally exists an intention, or a presumed intention, on part of the taxpayer not to pay the requisite taxes.
C. It is a situation, where a taxpayer tries to reduce one’s tax liability by deliberately suppressing the income or by inflating the expenditures as to show lower/reduced income than the actual income

D. An assessee guilty of tax evasion is punishable under the relevant laws with fines and penalties ranging from 10% to 30% of tax evaded.

4. Which of the following is wrong about Tax avoidance?
A. Any planning which, though done strictly according to legal requirements defeats the basic intention of the legislature behind the statute could be termed as an instance of tax avoidanceThe seller may get out of stock with that product
B. It is usually done by taking full advantage of various loopholes in the law and adjusting the affairs in such a manner that there is no infringement of taxation laws and least taxes are attracted.No, as mental acceptance to buy product is no acceptance of offer
C. There is an element of malafide motive involved in tax avoidance.
D. The arrangement could be strictly illegal.

5. Which of the following is wrong about Tax Planning?
A. Tax planning means compliance with the taxation provisions in such a manner that full advantage is taken of all tax exemptions, deductions, concessions, rebates and reliefs permissible under the Income Tax act so that the incidence of tax is the least.
B. Tax planning can either be equated to tax evasion or to tax avoidance.
C. it is the scientific planning of the assessee's operations in such a way so as to attract minimum tax liability by availing various incentives, concessions, allowances, rebates and reliefs provided for in the tax laws.
D. it is the scientific planning of the assessee's operations in such a way so as to postpone or for that matter defer liability for the subsequent period by availing various incentives, concessions, allowances, rebates and reliefs provided for in the tax laws by availing various incentives, concessions, allowances, rebates and reliefs provided for in the tax laws.

6. Which of the following is not an evil Consequences of Tax Avoidance
A. Substantial loss of much-needed public revenue, particularly in a welfare State like ours
B. Serious disturbance caused to the economy of the country by piling up mountains of black money directly causing inflation.
C. Largely hidden loss to the community by some of the best brains in the country being involved in perpetual war waged between tax avoider and his expert team of advisors, lawyers and accountants on one side, and the tax Officer and his not so skillful advisors on the other side.
D. Tansferring the burden of tax liability to the shoulders of the artful dodgers from those of guideless, good citizen.

7. Which of the following is wrong about Tax Management?
A. Tax Management involves regular and timely compliance of law as well as the arrangement of the affairs of the business in such manner that it reduces the tax liability.
B. Poor tax management can lead to imposition of interest, penalty, prosecution.
C. Tax management emphasizes on compliance of legal formalities for minimization of taxes
D. It emphasizes on minimization of tax burden.

8. Which of the following is wrong about measures of tax planning in relation to setting up and commencement?
A. Achievement of setting up at the latest
B. Expenses after setting up of the business must be of revenue nature and they should be incurred wholly and exclusively for business purpose for being admissible for deduction.
C. The tax holiday under the provisions of Section 80-IA and 80-IB of the Act also becomes operative from the point of time production is commenced and continues upto the prescribed period.
D. Preliminary expenditure allowable from year of commencement

9. Which of the following is wrong about tax Planning in Relation to Financial Management Decisions?
A. Expenses on issue of debentures/deposits should be after setting up of business
B. Interest paid for acquisition of fixed assets to be capitalized
C. depreciation is calculated on non-capitalized value of assets

D. borrowings should be utilised as far as possible for the acquisition and installation of assets like buildings, plant and machinery so that interest can be capitalized for the period after setting up of the acquired assets like buildings, plant and machinery but before the commencement of production

10. Which of the following is wrong about tax Planning with respect of Non-Resident Companies?
A. Agents to retain sufficient money of NR to meet its tax liability in India
B. NR to be aware about tax deduction by Agent to plan accordingly
C. Persons employed by or on behalf of a NR, those who have a business connection with NR and statutory agents are all considered as authorised agents of a NR
D. close financial association between a resident and a NR does not amount to a business connection.

11. Which of the following is wrong about tax Planningfor Indian collaborators
A. Indian company should be vigilant that expenses relating to the collaboration agreement must be incurred after the date of setting up of the business, because only then it would be entitled to be capitalized as other expenses.
B. For the purchase of spares for the plant, the Indian collaborator should plan to receive the spares prior to the year of commissioning of the plant and preferably execute a separate contract in this behalf. It will enable the Indian company to treat the whole of the amount of spares as revenue expenditure.
C. Treating plans and drawings etc. as Plant for availing full value as depreciation:
D. As far as purchase of capital goods from the foreign collaborator is concerned, cost of installation, including the supervision expenses charged by the collaborator, are also capitalized and depreciation claimed thereon.

12. Which of the following is wrong about tax Planning with respect of Employee's Remuneration?
A. Bonus or commission paid to employees is allowed as deduction under section 36(1)(ii), if it is not otherwise payable as distribution of profits to employees. Consensus ad idem
B. Salary to research personnel (excluding perquisites) for 3 years prior to date of commencement of business is allowed as deduction in the year of commencement of business to the extent allowed by the prescribed authority. In this case it ies not necessary that the research should be related to business of assessee.
C. Amount contributed by employer to RPF or Approved superannuation fund account or to National pension scheme or Approved Gratuity fund account of an employee is allowed as deduction if contributed till due date. (subject to Section 43B).
D. Amount deducted by employer from salary of employee for contributing it to employee benefit scheme such as EPF etc. then such amount shall be added into the income of employer u/s 2(24)(x). However if employer deposits this amount to employee's benefit fund in due time then such amount is allowed as deduction u/s 36(1)(va).

13. Starting a business in an industrially underdeveloped backword state qualifies an assessee for a deduction under section 80IB.
A. Tax planning
B. Tax management
C. Tax evasion
D. Tax avoidance

14. Assets are transferred to another person without adequate consideration.
A. Tax planning
B. Tax management
C. Tax evasion
D. Tax avoidance

15. To ensure timely compliance with legislative provisions, X & Y Ltd. keeps proper documents and registers of tax deducted at source.

A. Tax planning
B. Tax management
C. Tax evasion
D. Tax avoidance

Answers for Self Assessment

1.	A	2.	B	3.	D	4.	D	5.	B
6.	D	7.	D	8.	A	9.	C	10.	D
11.	B	12.	B	13.	A	14.	D	15.	B

Review Questions

1. Recognize the difference between tax evasion and tax avoidance.
2. What are the goals of taxation planning? List the requirements for its success.
3. Discuss the areas where an assessee can use tax planning to his or her advantage.
4. Examine the various organisational structures in terms of tax liabilities.
5. How is MAT calculated?
6. Describe the types of tax planning.
7. Explain what tax planning is and why it's important for a business.
8. Describe the three methods an assessee can use to lower his tax liability.

Further Readings

1. https://www.icsi.edu/media/webmodules/16112021_Advance_Tax_Laws.pdf
2. A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications
3. Study Material on Direct Tax Laws and International Taxation by ICAI
4. Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta
5. https://www.incometaxindia.gov.in/Charts%20%20Tables/Deductions.htm

Unit 02: Residential Status of Companies

CONTENTS

Objectives

After studying this unit, you will be able to:

- Understand different kinds of companies.
- Understand Residential Status of the companies.
- Understand Incidence of Tax in case of company assesses after ascertaining their residential status.

Introduction

Corporation Tax, often known as Corporate Tax, is a direct tax placed on a corporate entity's net income or profit from its operations, whether foreign or domestic. The Corporate Tax Rate is the rate at which the tax is levied in accordance with the requirements of the Income Tax Act of 1961.In India, the rate of corporate tax varies depending on the type of organization; for example, domestic companies and foreign corporations pay various rates of tax. Furthermore, the corporate tax rate differs based on a slab rate system, depending on the kind of corporate entity and the various income received by each of them.

2.1 Meaning of Company

The term "Company" has a significantly broader connotation under the Income-tax Act of 1961 than it does under the Companies Act. For the purposes of assessment proceedings, the company is treated as a "person" [Section 2(31)(iii)].

For income-tax purposes, a company is defined in Section 2(17) of the Income-tax Act of 1961. As a result, 'company' means –

(i) any Indian company as defined in section 2(26); or

(ii) any body corporate incorporated by or under the laws of a country outside India, i.e., any foreign company; or

(iii) 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

(iv) 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.

Such institution, association, or other entity shall be deemed as a company for the assessment year(s) mentioned in the CBDT's ruling.

2.2 Types of Companies

A. Domestic and Foreign Company:
Companies are divided into two categories:

1. Domestic Companies
2. Foreign Companies.

Domestic company

Domestic company means an Indian company or any other company that has made the appropriate arrangements for the declaration and payment of dividends (including dividends on preferential shares) payable out of its taxable income within India [Section 2(22A)].

[Section 2(26)] Indian Company –

In order to be considered an Indian company, a company must meet the following two conditions:

(a) the company must have been formed and registered in accordance with the Companies Act of 1956.

(b) the company's registered office or principal office must be in India.

The term 'Indian Company' also refers to the following entities if their registered or principal office is in India:

I a company formed and registered under any law relating to companies that was previously in force in any part of India [except in Jammu and Kashmir, Goa2, Dadra and Nagar Haveli, Daman and Diu, and Pondicherry, where companies formed and registered under any law that is currently in force in the respective union territories are included in the definition];

(ii) a corporation constituted by or under a Central, State, or Provincial Act (for example, a Financial Corporation or a State Road Transport Corporation); (iii) an institution, association, or body designated to be a company by the Board (CBDT) under section 2(17)(iv);

Prescribed procedures for declaring and paying dividends within India [Rule 27]:

Sections 194 and 236 require a company to make the following arrangements for the declaration and payment of dividends (including dividends on preference shares) within India:

(i) In respect of any assessment year beginning on or after April 1st, the company concerned's share register for all its shareholders shall be maintained on a regular basis at its principal place of business within India.

(ii) The general meeting for passing the previous year's accounts relevant to the assessment year and declaring any dividends in respect thereof shall be held exclusively in India.

(iii) The dividends declared, if any, shall be payable only within India to all the shareholders.

It is necessary for Indian companies to make the above-mentioned arrangements; non-Indian companies will be recognised as domestic corporations only if they make the above-mentioned arrangements for dividend declaration and payment in India.

Foreign Company:

A foreign company is one that is not a domestic company [Section 2(23A)].

B. Closely held and widely held Company

Domestic companies are further classified into three major categories:

(1) companies in which the general public has a substantial interest - referred to as "widely-held companies" - and

(2) companies in which the general public has no substantial interest - referred to as "closely-held enterprises."

To assess whether a company is of substantial interest to the public, the tests outlined in section 2 must be used (18). In a nutshell, the following companies fit into this category:

(i) A company owned by the government (either central or state, but not foreign) or the Reserve Bank of India (RBI), or in which the government or the RBI owns at least 40% of the shares, or a corporation owned by that bank.

(ii) A company registered under Section 25 of the Companies Act of 19563 (formed for promoting commerce, arts, science, religion, charity, or any other useful object and which prohibits payment of dividends to its members).

(iii) A company with no share capital that the CBDT declares to be a company in which the public is substantially interested during the specified assessment years.

(iv) A mutual benefit financing company that accepts deposits from its members as its primary activity and is designated as Nidhi or a Mutual Benefit Society by the Central Government under Section 620A of the Companies Act, 19564.

(v) A company whose equity shares (not fixed rate dividend-paying shares) carrying at least 50% of the voting power were unconditionally allotted to or acquired unconditionally by, and were beneficially owned by, one or more co-operative societies during the relevant previous year.

(vi) A company that is not a private company as defined by the Companies Act of 1956.

And which meets any of the following criteria: - its equity shares should have been listed in a recognised stock exchange in India as of the last day of the relevant previous year; or - its equity shares carrying at least 50% (40 percent in the case of an Indian company in the ship construction business, manufacture or processing of goods, mining, generation or distribution of electricity, or any other form of power) voting power should have been unconditionally allotted to or acquired by and should have been beneficially held throughout the relevant previous year by

a) Government or
b) a Statutory Corporation or
c) a company in which public are substantially interested or
d) any wholly owned subsidiary of company mentioned in (c).

As a result, all public limited companies must be treated automatically as companies in which the public is substantially interested, but all private limited companies will be viewed as companies in which the public is not substantially interested.

Relevance of the preceding classification: (1) The contrast between domestic and foreign enterprises is significant due to, among other things, tax rates.

Domestic enterprises are taxed at –

25% if total turnover or gross receipt in the previous year 2019-20 does not exceed 400 crore –

30% in all other cases

Foreign companies will be taxed at a rate of 40%. However, the rate of tax is 50% in respect of specified royalties and fees for technical services received from the Government or an Indian concern in pursuance of an agreement made by the foreign company with the Government or an 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).

Surcharge

A surcharge of 7% of the tax payable in the case of domestic companies and 2% of the tax payable in the case of foreign companies is levied if the total income exceeds 1 crore but does not exceed 10 crore.

Domestic companies have the option of opting for tax concessions indicated in sections 115BAA or 115BAD.

Section 115BAA provides for a concessional tax rate of 22% (plus surcharge of 10% and HEC of 4%) for domestic companies, subject to certain conditions, such as the absence of profit-linked deductions and investment-linked tax deductions under the Act, the absence of deduction for contribution to research and development, additional depreciation, and so on.

Section 115BAB grants a concessional rate of tax of 15% (plus surcharge of 10% and HEC of 4%) to new manufacturing or electricity generating companies established and registered on or after 1.10.2019 and commencing manufacturing or generating electricity on or before 31.3.2023, subject to certain conditions, such as the Act's prohibition on profit-linked deductions and investment-linked tax deductions, and the Act's prohibition on deduction for contributionto research and development, additional depreciation etc.

It should be noted that companies who exercise their option under Sections 115BAA or 115BAB are not subject to the minimum alternate tax under Section 115JB.

The question of whether a company is substantially interested in the public or not is relevant for the implementation of certain regulations that apply only to closely held companies, companies in which public are not substantially interested.

Certain special requirements apply only to companies in which the public is not substantially interested. Here are some examples of such unique provisions:

- 2(22)(e): Advance or loan by a closely held company - deemed dividend
- 56(2)(viib): Consideration received in excess of FMV of shares issued by a closely held company to be treated as income of such company, where shares are issued at a premium
- 68: Taxation of the sum received by the closely held company as share application money, share capital, share premium and the explanation offered by the company is not satisfactory
- 79: Carry forward and set-off of losses in case of closely held companies
- 179: Liability of directors of the private company in liquidation

3. Section 8 Company

- Company registered under companies act 2013 or previous applicable act and has in objects to,
- – Sports Promote commerce, art, science, education, research, social welfare, religion, charity, protection of environment or any such other object;
- And intends to apply its profits, if any, or other income in promoting its objective, intends to prohibit the payment of any dividend to its members is called section 8 companies under companies act 2013.
- numerous advantages as compared to Trust or Society and also has better credibility among donors, departments of government, and other stakeholders

- not to earn profits.
- No dividend distribution
- Less stamp duty
- Tax Benefits

2.3 Residential Status of a Company

Is the company an Indian Company?

Answer………………Yes?

The company is a resident in India for the relevant P.Y.

Is the company an Indian Company?

Answer………………No?

Whether POEM of the company is in India in the relevant P.Y?

Answer………………Yes?

The company is a resident in India for the relevant P.Y.

Is the company an Indian Company?

Answer………………No?

Whether POEM of the company is in India in the relevant P.Y?

Answer………………No?

The company is a non-resident in India for the relevant P.Y.

2.4 Principles to be followed for determination of POEM

Concept of Substance over form

Whether the company is engaged in active business outside India?

A company is considered to be engaged in "active business outside India"

- if the passive income is not more than 50% of its total income; and
- less than 50% of its total assets are situated in India; and
- less than 50% of total number of employees are situated in India or are resident in India; and
- the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

Example 1:

- Company Andy Ltd incorporated in Uk is 100% subsidiary of Indian company.
- Assets located in UK.
- Employees located in Company UK.
- Breakup of the company's total income:
- Income from purchases made from parties
- which are non- associated enterprises
- and sold to associated enterprises 30%
- income from transaction where purchases
- are made from associated enterprises and
- sold to associated enterprises; 30%

income from purchases made from

- associated enterprises and sold to
- non-associated enterprises; 30%
- Interest 10%

Solution
In this example, passive income accounts for 40% of the company's overall income. The passive income consists of:
30% income from transactions in which both the purchase and sale are from/to associated enterprises; and
10% income from interest
The A Co. meets the first condition of the test, which is to do active business outside of India. Because A Co. has no assets or employees in India, the other elements of the test are likewise met. As a result, the company does active business outside of India.

Example 2:

- Company Andy Ltd incorporated in Uk is 100% subsidiary of Indian company.
- Assets located in UK.
- Out of 50, 47 Employees located in UK.
- MD, CEO and sales head are Indian resident.
- Annual payroll expenditure of company is 5 crore of which 3 crore belong to MD, CEO and sales head .
- Same income break up as in Example 1.

Solution
Although A Co. meets the first leg of the active business test, only 40% of its overall income is passive in nature. Furthermore, more than half of the personnel are based outside of India. All of the assets are located outside of India. However, the payroll spend for the MD, CEO, and sales head, all of whom are based in India, exceeds 50% of the total payroll expenditure. As a result, A Co. does not conduct active business outside of India.

2.5 Place of Effective Management

In the case of companies engaged in active business outside India, the POEM is deemed to be outside India if the majority of board meetings are held outside India.

The average of the data from the previous year and the two years before to that will be used to determine whether the company is engaged in active business outside India.

Example 3: The basic facts are same as in Example 1.

- All the directors of the Andy Co. ltd. are Indian residents.
- During the relevant previous year 5 meetings of the Board of Directors is held of which only two were held in India.

Solution:

As the facts in Example 1 show, the A Co. is active in business outside of India. The vast majority of board meetings have taken place outside of India. As a result, the POEM of A Co. is assumed to be located outside of India.

In case of companies not engaged in active business outside India

- Identifying the person(s) who actually make the key management and commercial decisions for the conduct of the company as a whole.
- Determining the place where these decisions are, in fact, being the place where these management decisions are taken would be more important than the place where such decisions are implemented. For the purpose of determination of POEM, it is the substance which would be made

Example 4: Basic facts are same as in Example 3

- Documents signed by A Co.'s senior management but further submitted forrecommendation to B Co.

- During the previous yearmore than 99% ofthe contracts are above 10 lakh and over past years also the same trend in respect of value contribution of contracts above 10 lakh is seen.

Solution

These findings show that the parent company B Co. may have usurped the effective administration of A Co. As a result, even though A Co. is engaged in active business outside India and the majority of board meetings is held outside India, POEM of A Co. may not be considered to be outside India in such instances.

2.6 Principles to consider when Determining POEM

1. The location where a company's Board of Directors meets on a regular basis and takes decisions.

The location where a company's Board of Directors meets and makes decisions on a regular basis may be the company's effective management location, provided that the Board retains and exercises its authority to govern the company and, in essence, make the key management and commercial decisions required for the conduct of the company's business as a whole. The mere formal holding of board meetings at a location would not be decisive in determining POEM's location.

If a board has de facto delegated the authority to make key management and commercial decisions for the company to senior management or any other person, such as a shareholder, promoter, strategic or legal or financial advisor, etc., and does nothing more than routinely ratify the decisions that have been made, the company's place of effective management will ordinarily be the location where these senior managers or the other person make those decisions.

2.Location of Head Office:

Because it frequently reflects the area where critical company decisions are made, the location of a company's head office will be a very essential component in determining the company's place of effective management. The following factors must be considered while deciding the location of the company's headquarters:

- If the company’s senior management and their support staff are based in a single location and that location is held out to the public as the company’s principal place of business or headquarters, then, that location is the place where head office is located.
- If the company is more decentralized then, the company’s head office would be the location where these senior managers,-
    - are primarily or predominantly based; or
    - normally return to following travel to other locations; or
    - meet when formulating or deciding key strategies and policies for the company as a whole.

3. Use of modern Technology

physical location of board meeting or executive committee meeting or meeting of senior management may not be where the key decisions are in the substance being made.

In such cases the place where the directors or the persons taking the decisions or majority of them usually reside may also bea relevant factor.

5. Decisions made by Shareholders are not relevant factor in determination of POEM

decisions like sale of all or substantially all of the company’s assets, the dissolution, liquidation or deregistration of the company, the modification of the rights attaching to various classes of shares or the issue of a new class of shares etc. typically affect the existence of the company itself or the rights of the shareholders as such, rather than the conduct of the company’s business from a management or commercial perspective and are therefore, generally not relevant for the determination of a company’s place of effective management.

However, the shareholder's involvement can, in certain situations, turn into that of effective management.

6. Day to day routine operational decisions are not relevant for the determination of POEM

Day to day routine operational decisions are undertaken by junior andmiddle management shall not be relevant for the purpose of determination of POEM.

7. Secondary factors

- Place where main and substantial activity of the company is carried out; or
- Place where the accounting records of the company are kept.

Examples of facts are not conclusive evidence of establishing POEM

- a foreign company is completely owned by an Indian company
- a Permanent Establishment of a foreign entity in India
- one or some of the Directors of a foreign company reside in India
- local management being situated in India in respect of activities carried out by a foreign company in India
- existence in India of support functions that are preparatory and auxiliary

Example5:

An Indian multinational group's holdings

local holding company:	**Andy Co. in country X.**
100% Subsidiaries of Andy Co.:	**B Co. and C Co. in country X and D Co. in country Y.**
The Andy Co. source of income:	**Dividend and interest from investments made in its subsidiaries.**
POEM of Andy Co.	**India and is exercised by ultimate parent company of the group.**

What is the POEM of its subsidiaries B, C and D which are engaged in active business outside India. The meetings of Board of Director of B Co., C Co. and D Co. are held in country X and Y respectively.

Solution

Simply because the POEM of an intermediate holding company is in India does not mean that the POEM of its subsidiaries is in India. Each subsidiary must be assessed independently. As shown in the facts, companies B Co., C Co., and D Co. are separately engaged in active business outside India, and the bulk of their Board meetings are also held outside India. The POEM of B Co., C Co., and D Co. will be assumed to be located outside of India.

Furthermore, the CBDT stated in Circular No. 8/2017 dated 23.02.2017 that POEM norms do not apply to companies with a turnover or gross receipts of Rs. 50 crores or less in a fiscal year.

3.

2.7 Scope of Total Income

The scope of an assessee's total income is determined by three significant factors:

the assessee's residential status;

the place of accrual or receipt of income, whether actual or presumed; and

the period at which the income accrued to or was received by or on behalf of the assessee.

Resident

The total income of a resident assessee would, under section 5(1), consist of:

- income received or deemed to be received in India during the previous year;
- income which accrues or arises or is deemed to accrue or arise in India during the previous year; and
- income which accrues or arises outside India even if it is not received or brought into India during the previous year.

Non-Resident

A non-resident's total income under section 5(2) includes:

1. income received or deemed to be received in India in the previous year; and
2. income which accrues or arises or is deemed to accrue or arise in India during the previous year.

Meaning of Received

The term "receipt of income" solely refers to the first time the recipient receives money into his possession. As a result, once an amount has been received as income, transfer 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 later receipt.

Deemed to be received [Secs. 7 & 8]

- Contribution in excess of 12% of salary to Recognised provident fund or interest credited in excess of 9.5% p.a (Annual accretion to the credit of RPF)
- Contribution by the CG or other employer under a pension scheme referred u/s 80CCD
- Amount transferred from unrecognised provident fund to recognised provident fund (being the employer's contribution and interest thereon)
- TDS

Income which are deemed to accrue or arise in India

1. The categories of income which are deemed to accrue or arisein India are:

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

would be deemed to accrue or arise in India.**[Section 9(1)(i)]**

a) What is Business Connection?

Any business activity carried out on behalf of a non-resident shall be considered a 'business connection' [Explanation 2 to section 9(1)(i)].

To establish a business connection, the person acting on behalf of the non-resident must have authority that is routinely exercised to conclude contracts on behalf of the non-resident or; however, if his activities are limited to the purchase of goods or merchandise for the non-resident, this provision will not apply.

In a scenario where he lacks such power but consistently keeps a stock of goods or merchandise in India from which he routinely delivers goods or merchandise on behalf of the non-resident, or habitually secures orders in India, primarily or entirely on behalf of the non-resident.

Furthermore, there may be instances where the person acting on behalf of the non-resident secures an order for the benefit of additional non-residents. In such a case, a business connection for other non-residents is established if the other non-resident controls the non-resident, the non-resident controls the other non-resident, or the other non-resident is controlled by the non-resident, or the other non-resident is subject to the same control as the non-resident.

In all three cases, a business link is created, if a person routinely secures orders in India, primarily or entirely for such non-residents.

Business Connection does not include agents that are independent.

However, a business connection shall not be established if the non-resident does business through a broker, general commission agency, or any other independent agent acting in the ordinary course of his business.

A broker, general commission agent, or any other agent is considered independent if he does not operate primarily or solely for the non-resident.

In the three instances described above, where he is hired by a non-resident, he will not be recognised to have an independent status.

Exceptions:

Income from a business link is only deemed to accrue or arise in India to the extent of profits due to operations in India. Assume a 10% weightage is assigned to work in ndia, only 10% of profits would be considered to accrue or arise in India.

- A NR's purchase of products for the purpose of export will not be considered a business connection in the country of India.

- News and views gathered by a news channel, news agency, etc. in India will not be considered to have a business connection in India;

- Filming in India is permitted:

If the filmmaker is an individual, he must not be an Indian citizen.

Neither must you be a resident of India.

If the maker is a firm/AOP, none of its members/partners must be Indian citizens or Indian residents; if the maker is a company, none of its shareholders must be Indian citizens or Indian residents.

b) In India, income from any property/assets or source of income

The following income is deemed to accrue or arise in India:

- Income from any assets or property in India, whether tangible or intangible, movable or immovable; or
- Income from a source situated in India

c) Income from the transfer of a capital asset in India

Any gain arising from the transfer of a capital asset located in India is deemed to accrue or arise in India.

d)Salary payable by the Government to Indian citizen for services rendered outside India [Sec. 9(1)(iii)]

Any salary - • payable by the Government of India; • to an Indian citizen; • for services provided outside India; - is deemed to accrue or arise in India.

Note: It should be noted that any allowances or perquisites provided by the government to an Indian citizen for services rendered outside India are exempt [Sec. 10(7)].

e) Dividend income [Sec. 9(1)(iv)]

Any dividend paid by an Indian company outside of India is deemed to have accrued or arisen in India.

f) Income from Interest [Sec. 9(1)(v)]

Under section 9(1)(v), an interest is deemed to accrue or arise in India if it is payable by -

1. the Government;
2. a person resident in India;

Exception:

However, In the case of a person resident in India, it will not be deemed to accrue or arise in India if it is payable in respect of any money borrowed and utilized 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.

Non-resident

when it is due in respect of any debt incurred or money borrowed and used for the purpose of carrying on a business or profession in India by him

Exception: in case of Non-resident ,Interest on money borrowed by a non-resident for purposes other than business or profession shall not be considered to accrue or arise in India.

g) Royalty Income

Royalty will be deemed to accrue or arise in India when it is payable by –

- the Government;
- a person who is a resident in India

Condition: The right, property, information or services are not utilized for the purpose of –

- business or profession carried on by such person outside India; or
- earning any income from any source outside India

A Non-Resident Person

The right, property, information or services must be utilised for the purpose of –

- business or profession carried on by such person in India; or
- earning any income from any source in India.

h)Income from technical services [Sec. 9(1)(vii)]

Following income from fees for technical services is considered to accrue or arise in India if they are payable by –

1. the Government
2. a person who is resident in India

Exception: Where the fees is payable in respect of technical services utilized 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.

a person who is a non-resident, only where the fees are payable in respect of services utilized in a business or profession carried on by the non-resident in India or where such services are utilized for the purpose of making or earning any income from any source in India.

Summary

The Indian Income-tax Act allows for the imposition of income tax on the income of foreign companies and non-residents, but only to the amount of their income derived in India. A foreign company or any other non-resident person is subject to tax under section 5 of the Act on income received or deemed to be received in India by or on behalf of such person, or income accruing or arising or assumed to accrue or arise to such person in India. A taxpayer must pay income tax on the total income computed by the Assessing Officer under the terms of the Income Tax Act 1961, regardless of whether he is a resident taxpayer, a non-resident taxpayer, or a non-resident Indian.

Keywords

Substantial interest: In relation to a company, it means a person who is the beneficial owner of shares, not being shares entitled to a fixed rate of dividend, whether with or without a right to participate in profits, carrying not less than twenty percent of the voting power.An individual is deemed to have a substantial interest if he, individually or along with his relatives, beneficially holds equity shares carrying not less than 20% of the voting rights at any time during the previous year.

Senior Management: "Senior Management" in respect of a company means the person or persons who are generally responsible for developing and formulating key strategies and policies for the company and for ensuring or overseeing the execution and implementation of those strategies on a regular and on-going basis. While designation may vary, these persons may include:

- Managing Director or Chief Executive Officer;
- Financial Director or Chief Financial Officer;
- Chief Operating Officer; and
- The heads of various divisions or departments (for example, Chief Information or Technology Officer, Director for Sales or Marketing).

"Head Office" of a company would be the place where the company's senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located. A company's head office is not necessarily the same as the place where the majority of its employees work.

Widely-heldcompanies: companiesinwhich the public are substantially interested

Closely heldcompanies:companies in which the public are not substantially interested

Indian Company: the company should have been formed and registered under Companies Act,1956[1]the registered office or the principal office of the company should be in India

Self Assessment

1. Which section of the Income-tax Act, 1961 defines a company for income-tax purposes?

A. Section 2(17)

B. Section 2(18)

C. Section 2(19)

D, Section 2(20)

2. Which of the following statements is true about Domestic company?

A. It is an Indian company
B. any other company, which, in respect of its income liable to tax, has made the prescribed arrangements for the declaration and payment of the dividends outside India
C. any other company, which, in respect of its income not liable to tax, has made the prescribed arrangements for the declaration and payment of the dividends (including dividends on preferential shares) within India, payable out of such income [Section2(22A)].

D. any other company, which, in respect of its income liable to tax, has not made the prescribed arrangements for the declaration and payment of the dividends (excluding dividends on preferential shares) within India, payable out of such income [Section2(22A)].

3. Which of the followingis wrong for prescribed arrangements for the declaration and payment of dividends within India as per Rule 27?

A. The share register of the company concerned for all its shareholders shall bemaintained regularly at its principal place of business within India in respect of anyassessmentyearfromadatenotlaterthan1stMarch ofsuchyear.

B. The general meeting for passing the accountsof the previous year relevant to the assessment year and for declaring any dividendsin respect thereof shall beheld only at a place withinIndia.

C. The dividends declared, if any, shall be payable only within Indiato all the shareholders.

D. non-Indian companies will be treated as domestic companies only if they make the prescribed arrangements for the declaration and payment of dividends in India.

4. Which one of these is not the is one in which the public are substantially interested?

A. A company owned by the Government (either Central or State but not Foreign) or the Reserve Bank of India (RBI) or in which not less than 40% of the shares are held by the Government or the RBI or corporation owned by that bank.

B. A company which is registered under section 25 of the Companies Act, 1956[3](formed for promoting commerce, arts, science, religion, charity, or any other useful object and which prohibits payment of dividend stoits members).

C. A company having no share capital which is declared by the CBDT for the specified assessmentyearstobeacompanyinwhichthepublicaresubstantiallyinterested.

D. Accompany whichisaprivatecompanyasdefinedintheCompaniesAct,1956[5]

5. A company is said to be a company in which the public are substantially interested if:

A. It is owned by Government or Reserve Bank of India or

B. Its atleast50% shares are held by the Government or the RBI or

C. Non profit company

D. company whose principal business is to accept deposits from its members or

6. Foreign companies are be taxed at:

A. 20%

B. 30%

C. 40%

D. 45%

7. in respect of specified royalties and fees for technical services received from Government or an Indian concern in pursuance of an agreement, approved by the Central Government, made by the foreign 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), the rate of tax for Foreign companies is:

A. 20%

B. 30%

C. 40%

D. 50%

8. Surcharge@7% of the tax payable is leviable in the case of domestic companies and @ 2% of tax payable in the case of foreign companies if the total income exceeds 1 crore but does not exceed ` ---------crore.

A. 10
B. 20
C. 30
D. 50

9. Surcharge@ 12% of the tax payable is leviable in the case of domestic companies and @ 5% of tax payable in the case of foreign companies if the total income exceeds …….crore.

A. 10
B. 20
C. 30
D. 50

10. The option to domestic companies to opt for concessional rates of tax specified is available:

A. under section 115BAA
B. under section 116BAA
C. under section 117BAA
D. under section 118BAA

11. Which of the following incomes shall be deemed to be received in India and taxable in hands of all assessee irrespective of their residential status?
A. The contribution made, by the employer in the previous year, to the account of an employee under a pension scheme notified u/s 80CCD [Sec. 7(iii)]
B. Tax Deducted at source [Sec. 198]
C. Deemed profit.
D. Income from disclosed sources

12. Which of the following is not an instance of a non-resident having a business connection in India?
A. Maintaining a branch office in India for the purchase or sale of goods or transacting other business.
B. Appointing an agent in India for the systematic and regular purchase of raw materials or other commodities, or for sale of the non-resident's goods, or for other business purposes.
C. Erecting a factory in India where the raw produce purchased locally is worked into a form suitable for export abroad.
D. Collection of news and views by a news channel or news agency etc. in India

13. Which of the following cases is true about Salariesdeemed to accrue or arise in India.?

A. Salary payable for Services rendered outside India; and the rest period or leave period which is preceded and succeeded by the period during which services were rendered outside India and forms part of the service contract of employment
B. Any salary payable by the Government of Indiato a citizen of India; for services rendered outside India

C. Any salary payable by the Government of Foreign country; to a citizen of India for services rendered outside India
D. any allowances or perquisites paid by the Government to a citizen of India for services rendered outside Indiaare deemed to accrue/arise in India and are taxable in India.

14. Which of the following statement is true about interest that shall be deemed to accrue or arise in India?
A. interest shall be deemed to accrue or arise in India if payable by Government of India with no condition precedent.
B. interest shall be deemed to accrue or arise in India if payable by a resident person with no condition precedent.
C. interest shall be deemed to accrue or arise in India if payable by a non-resident person with no condition precedent.
D. In case of non-resident, money borrowed and used for the purpose of earning an income from any other source in India, interest shall be treated as deemed to accrue or arise in India.

15. Which of the following statement is true aboutIncome from royalty that shall be deemed to accrue or arise in India?
A. interest shall be deemed to accrue or arise in India if payable by Government of India with condition precedent.
B. interest shall be deemed to accrue or arise in India if payable by a resident person with no the condition precedent.
C. interest shall be deemed to accrue or arise in India if payable by a non-resident person with no condition precedent.
D. In case of resident person, the right, property, information or services areutilized for the purpose of - business or profession carried on by such person outside India; or earning any income from any source outside India.

Answers for Self Assessment

1.	A	2.	D	3.	D	4.	A	5.	B
6.	A	7.	B	8.	A	9.	D	10.	A
11.	A	12.	C	13.	A	14.	D	15.	D

Review Questions

1. Explain the term 'POEM' Place of Effective Management in detail.

2. What is meant by Income deemed to accrue or arise in India.

3. What is meant by Income deemed to be received in India.

4.Differentiate domestic and foreign companies.

5.Differentiate between closely held and widely held companies.

Further Readings

1. https://www.icsi.edu/media/webmodules/TL_Final_pdf_25102021.pdf

2. A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications

3. Study Material on Direct Tax Laws and International Taxation by ICAI

4. Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta

5. www.incometaxindia.gov.in

6. https://icmai.in/upload/Students/Syllabus2016/Inter/Paper-7-Jan-2022.pdf

Unit 03: Carry forward &Set off of losses

CONTENTS

Objectives

After studying this unit, you will be able to:

- understand various provisions of Carry Forward and Set Off of Losses in case of Companies,
- understand various provisions relating to carry forward of losses of companies under section 79.

Introduction

Income from diverse sources is computed under the different heads of income for the purpose of calculating Gross Total Income (GTI). If all of the sources and headings have positive income (i.e. profit), the GTI can simply be added.However, if certain source(s) or certain head(s) have negative income (i.e. loss) then such loss needs to be adjusted with income of another source(s) or head(s). Set off refers to adjustment of loss from one source or one head against income from another source or another head. If a negative income is not fully offset in the current year, the unabsorbed loss is carried forward to the following years , subject to certain restrictions and requirements.

3.1 Meaning of Set off and Carry Forward of Losses

Set-Off and Carry Forward

“Set-off” means adjustment of losses against the profits from another source/head of income in the same assessment year.

Carry forward

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.

If an assessment year's income is inadequate to set off the year's losses, such losses (which could not be offset) can be carried forward to following assessment year(s) for set off against income in such later year (s). However, not all losses can be carried forward; for example, losses under the head 'Income from other sources' (other than losses from the 'Activity of owning and maintaining racehorses') cannot be carried forward.

The following losses are allowable to be carried forward:

- Under the head 'Income from house property,' there is a loss. [Section 71B]
- Loss other than speculative loss under the head "Profits and gains of business or profession" [Section 72]
- Losses from the speculative business [Section 73]
- Loss from specified business is covered under section 35AD. [Section 73A]
- A loss under the head 'Capital gains.' [Section 74]
- Loss incurred as a result of the 'activity of owning and maintaining race horses.' [Section 74A]

3.2 Inter Source Adjustments(section 70)

Loss from one source of income can be adjusted against income from another source, both the sources being under same head

3.3 Impermissible Inter-Source Set-Off

a. Long-term capital loss [Section 70(3)]

Only long-term capital loss can be set off against long-term capital gain [Section 70(3)]. However, short-term capital losses can be set off against both short-term and long-term capital gains [Sec. 70(2)].

b. Speculation loss [Section 73(1)]

Losses from a speculative business can only be set off against profits from a speculative business under the heading 'Profits and gains of business or profession.' However, loss from a non-speculative business can be set off against income from a speculative business [Sec. 73(1)].

c. Loss from the activity of owning and maintaining racehorses [Section 74A(3)]

Losses incurred in the business of owning and managing racehorses can only be set against income derived from such activity [Sec. 74A].

d. Losses from specified business [Section 73A(1)]

The loss of a specified business covered by section 35AD can only be set off against the profit of another specified firm.

Loss from a non-defined business, on the other hand, can be set off against income from a specified business.

3.4 Which are the Businesses Covered Under Section 35AD

1 Business of laying and operating a cross country natural gas or petroleum or crude pipeline network for distribution including being an integral part of such a network.
2 Setting up and Operating Cold Chain Facility for specified products.
3 Setting up and Operating Warehousing Facility for storing Agricultural Produce
4 Building and Operating anywhere in India, a hotel of two-star or above as specified by Central Government
5 Building and Operating a hospital with at least 100 beds for Patients
6 Developing and Building a Housing Project under Slum Redevelopment or Rehabilitation under a notified scheme by Central or State Government
7 Developing and Building Affordable Housing Project under a notified scheme by Central or State Government
8 Production of Fertilizer
9 Setting up and Operating an Inland Container Depot or a Container Freight Station notified or approved under the Customs Act 1962
10 Beekeeping and Production of Honey or Beeswax
11 Setting up and Operating Warehousing Facility for storage of Sugar
12 Laying and Operating a slurry pipeline for transportation of Iron Ore
13 Setting up and operating a semiconductor wafer fabrication manufacturing unit
14 Developing or Operating and Maintaining or Developing, Operating and Maintaining a new Infrastructure Facility

3.5 Inter Head Adjustments [Section 71]

If the net result of any head of income is a loss in any assessment year, the loss can be set off against the income under any other heads in the same assessment year, subject to the following exceptions:

Loss under any head other than capital gains

Losses from the activity of owning and maintaining racehorses cannot be set off against any other income except profit from the activity of owning and maintaining racehorses [Sec. 74A]. However, loss under any other head, such as business loss, maybe set off against income from the activity of owning and maintaining racehorses.

Losses in excess of $200,000 under the head 'Income from house property' cannot be set against income under other heads.

Loss under the head "Profits and gains from business or profession

Losses under the head 'Profits and gains of business or profession' incurred as a result of speculation business cannot be set off against any other income except profits from speculation business.

However, loss under any other head, such as loss from home property, may be set off against revenue from a speculating business.

Loss under the head "Capital Gains

Losses under the head 'Capital gains' cannot be set off against income under any other heading. However, loss under any other head, such as business loss, may be set off against income under the head 'Capital gains.'

3.6 Section 73A

Section 73A of the Income Tax Act: Carry forward and set off of losses by specified business

Any loss, computed in respect of any specified business referred to in section 35AD shall not be set off except against profits and gains, if any, of any other specified business.

Where for any assessment year any loss computed in respect of the specified business referred to in sub-section (1) has not been wholly set off under sub-section (1), so much of the loss as is not so set off or the whole loss where the assesses has no income from any other specified business, shall, subject to the other provisions of this Chapter, be carried forward to the following assessment year, and—

it shall be set off against the profits and gains, if any, of any specified business carried on by him assessable for that assessment year; and

if the loss cannot be wholly so set off, the amount of loss not so set off shall be carried forward to the following assessment year and so on.

Example

Loss from the Specified Business 1	50000
Profit from Specified Business 2	20000
Profit from Normal Business	40000
Total Profit Earned	10000

No Double Deduction

Once the taxpayer has claimed the deduction allowed under section 35AD of the Income Tax Act for a particular assessment year in respect of a specified business (business specified under section 35AD), the taxpayer cannot claim any benefit under Chapter VI-A under the heading "C. Assessed also cannot claim the deductions in respect of certain incomes" or section 10AA, for the same or any other year and vice versa.

3.7 Loss Under Specified Business (Business Under Section 35AD)

There is no time limit prescribed under the law to carry forward the losses from the specified business under 35AD

It is not mandatory requirement to continue the business at the time of set off in future assessment years

Carry forward and claim of the same shall not be allowed if the return of income is not filed within the original due date as specified under section 139(1)

The loss of the specified business can be adjusted only against Income from specified business under 35AD

The loss from a specified business under section 35AD in respect of any assessment year 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.

3.8 Carry Forward and Set off of Loss From House Property [Section 71b]

Set-Off

- Income from any other house property.
- Income from any other head to the extent of 2,00,000 during the same year.

Carry Forward and Set-Off

- Following 8 years, Income from house property'.

3.9 Carry Forward and Set off of Business Losses [Section 72]

Set Off

- Income from any other business or profession.
- Any other head of income.

Carry Forward and set off

- In the following 8 years, income from business or profession.

Note: In the assessment year 2022-23, losses prior to the assessment year 2014-2015 cannot be set off

Conditions:

- The loss should have been incurred in business, profession or vocation.
- The loss should not be in the nature of a loss in the business of speculation.
- Loss from one business can be carried forward & set-off against the income from any other business.
- The person who incurred the loss alone is entitled to carry forward & set-off the loss.

Business losses can be carried forward and set against the profits of the assesses who suffered the loss; however, the assessee and the assessee must be the same to carry forward the loss. This rule, however, has the following exceptions –

a. Amalgamation: If the amalgamation is within the terms of section 72A of the Income Tax Act, the business losses and unabsorbed depreciation of the amalgamating company can be set against against the income of the amalgamated company.
b. Succession: According to Sections 47(xiii), (xiiib), and (xiv), business losses and unabsorbed depreciation of a proprietary concern, a partnership firm, or a specified company that is succeeded by a company or limited liability partnership can be carried forward by the succeeded company or limited liability partnership.
c. Inheritance: Under Section 78(2), if an assessee obtains a business through inheritance, losses from such business may be carried forward for the remaining number of years.
d. Demerger: In the event of a demerger, the loss of the demerged company must be carried forward and set off by the resulting business.

Note: Please keep in mind that in the following situations, losses cannot be carried forward.

i. Business of a HUF in which the business of the HUF is taken over by the Karta of the HUF;
ii. Proprietorship business taken over by a firm in which the proprietor is one of the partners;
iii. A firm being succeeded by another firm;
iv. A firm in which the business of the firm is taken over by one of the firm's partners;

- Maximum period for carry forward & set-off of losses
- Rehabilitation of business [Proviso to section 72 (1)]

Exceptions to the above period

1. Closure of business due to specified reasons [Sec. 33B] Situation:

Where any loss remains unabsorbed of a business undertaking that is discontinued due to damages caused by –

(i) flood, typhoon, hurricane, cyclone, earthquake, or another natural convulsion; or

(ii) riot or civil disturbance; or

(iii) accidental fire or explosion; or (iv) action by an enemy or action taken in combating an enemy (whether with/without a declaration of war)

Treatment: Losses of such business [including past eligible losses (to be carried forward)] shall be adjusted with profit in the year in which the business is revived, and if the loss cannot be entirely set off, it shall be allowed to be carried forward for a period of seven years.

2. Set-off of losses from the year of business closure against deemed profit [Section 41(5)]

Situation: Any portion of a loss (other than a speculative loss) incurred during the previous year that remains unabsorbed in the prior year in which the business ceased to exist.

Treatment: Such loss may be carried forward for any number of years (up to a maximum of eight years) against taxable income under Sections 41(1), (3), and (4). (4A).

Tax point: Such a loss can be set off even if the loss return is not filed on time.

3.10 Losses in Speculation Business [Section 73]

Speculative transaction means a transaction in which contract for purchase and sale of any commodity including stock and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scripts. [Sec. 43(5)] 2. As per explanation to sec. 73, where any part of the business of a company consists of purchase and sale of shares of other companies, such company shall be deemed to be carrying on speculation business to the extent of purchase and sale of shares. However, this rule is not applicable in case of companies –

a. of which gross total income mainly consists of income which is chargeable under the head "Income from house property", "Capital gains", and "Income from other sources"; or
b. of which principal business is the business of trading in shares or banking or granting of loans and advances.

Notes: Above explanation covers only transactions of purchase and sale of shares. Debentures, units of UTI or of Mutual Funds are not covered by this explanation.

Set Off

- Income from speculation.

Carry forward and set off

- In following 4 years, income from speculation.

Note: In the assessment year 2022-23, losses prior to the assessment year 2018-19 cannot be set off.

3.11 Carry Forward & set off of Losses by Specified Businesses [Section 73a]

Set off

- Income form any other specified business.

Carry forward and set-off

- Income from any other specified business.

3.12 Losses Under the Head 'Capital Gains' [Section 74]

Short term capital loss

Set-off

- STCG
- LTCG

Carry forward and set-off

In the following 8 years from

- STCG
- LTCG

Long term capital Loss

Set-off

- Long term capital gain.

Carry forward and set off

- In the following 8 years from Long term capital gain.

3.13 Losses From the Activity of Owning and Maintaining Race Horses [Section 74a(3)]

Set-off

- Income from activity of owning and maintaining horse races.

Carry forward and set-off

- In the following 4 years from Income form activity of owning and maintaining horse races.

3.14 Set Off and Carry Forward of Unabsorbed Depreciation

Sec. 32(2) governs set off and carry forward of unabsorbed depreciation, not Sec. 72.

Depreciation that could not be fully absorbed in any previous year because: • there were no profits or gains chargeable in that previous year; or • the profits or gains chargeable were less than the amount of depreciation.

Tax treatment: The allowance or the portion of the allowance of depreciation that remains unabsorbed shall be added to the amount of depreciation for the following previous year and deemed to be the depreciation-allowance for that previous year, and so on for the succeeding previous years (subject to sections 72 and 73).

3.15 Carry Forward and set off of Accumulated Business Losses and Unabsorbed Depreciation in Certain Cases of Amalgamation/ Demerger, Etc. [Section 72a]

1. Business continuation: Unabsorbed depreciation can be carried forward even if the business for which the loss was initially calculated is not carried on during the preceding year.

2. Return filing: Unabsorbed depreciation can be carried forward even if the income tax return is not filed on time.

1. Amalgamation.

amalgamation of –

- 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
- public sector companies engaged in the business of operation of aircrafts.

- Accumulated loss and unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or unabsorbed depreciation, as the case may be, of the amalgamated company for the previous year in which the amalgamation took place.
- Conditions to be fulfilled by the amalgamating company.
    - The amalgamating company should have been engaged in a business in which the accumulated loss occurred or depreciation remained unabsorbed for 3 or more years.
    - The amalgamating company held continuously, as on the date of amalgamation, at least 3/4th of the book value of the fixed assets held by it for 2 years prior to the date of amalgamation.
    - The amalgamated company should hold at least 3/4th of 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.
    - The amalgamated company continues the business of the amalgamating company for at least 5 years.
    - The amalgamated company must also fulfill 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 a genuine business purpose.
    - The amalgamated company shall achieve a level of production of at least 50% of the installed capacity (capacity of production 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 of 5 years from the date of amalgamation. The Central Government has the power to modify this requirement on an application made by the amalgamated company.
    - The amalgamated company shall furnish to the Assessing Officer a certificate in the prescribed form verified by a Chartered Accountant in this regard.

2. Demerger

- 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.
- If the accumulated loss or unabsorbed depreciation is not directly relatable to the undertaking, it will be apportioned between the demerged company and the resulting company in the same proportion as the value of the assets retained by the demerged company have been transferred to the resulting company.
- Conditions for availing benefits under this section: The Central Government is empowered to notify such conditions as it considers necessary to ensure that the demerger is for a genuine business purpose.

3. Re-organisation of Business

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.

4. Conversion of a Company Into LLP [Section 72A(6A)]

Whereby a private company or unlisted company is succeeded by a LLP as per the provisions of section 47(xiiib), then the successor LLP would be allowed to carry forward and set-off the business loss and unabsorbed depreciation of the predecessor company.

Example

KBC Limited was amalgamated with XYZ Limited on 01.04.2020.

All the conditions of section 2(1B) were satisfied.

KBC Limited has the following carried forward losses as assessed till the Assessment Year 2020-21:

Speculative Loss 4 lacs

Unabsorbed Depreciation 18 lacs

Unabsorbed expenditure of capital nature on scientific research 2 lacs

Business Loss 120 lacs

XYZ Limited :

profit = 140 lacs for the financial year 2020-21 before setting off the eligible losses of KBC Limited but after providing depreciation at 15% per annum on 150 lacs, being the consideration at which plant and machinery were transferred to XYZ Limited.

The written down value as per Income-tax record of KBC Limited as on 1st April, 2020 was 100 lacs.

profit of XYZ Limited includes speculative profit of 10 lacs.

Compute the total income of XYZ Limited for Assessment Year 2021-22 and indicate the losses/ other allowances to be carried forward by it.

Solution

Computation of total income of XYZ Limited for the A.Y. 2021-22

Particulars	(in lacs)
Business income before setting-off brought forward losses of ABC Ltd.	140
Add: Excess depreciation claimed in the scheme of amalgamation of KBC Limited with XYZ Limited.` 50 lacs × 15 %	7.5
Set-off of brought forward business loss of KBC Ltd.	-120
Set-off of unabsorbed depreciation under section 32(2) read with section 72A	-18
Set-off of unabsorbed capital expenditure under section 35(1)(iv) read with section 35(4) (See Note 5)	-2

Business income	7.5

3.16 Carry Forward & Set-Off of Accumulated Loss in Scheme of Amalgamation of Banking Company or General Insurance Companies [Sec. 72aa]

Situation: In the event of the amalgamation of:

a. one or more banking companies with any other banking institution under a scheme sanctioned and brought into force by the Central Government under Section 45(7) of the Banking Regulation Act, 1949; or
b. one or more corresponding new bank or banks with any other corresponding new bank under a scheme sanctioned and brought into force by the Central Government under Section 9 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or similar
c. one or more Government companies with any other Government company under a scheme sanctioned and implemented by the Central Government in accordance with Section 16 of the General Insurance Business (Nationalisation) Act, 1972.

Treatment: The cumulative loss and unabsorbed depreciation of the amalgamating business are regarded to constitute the loss of the amalgamated concern for the prior year in which the amalgamation scheme was implemented.

1. 'Accumulated loss' means the portion of a loss under the heading "Profits and gains of business or profession" (other than a loss sustained in a speculation business) that such amalgamating company would have been entitled to carry forward and set-off under section 72 if the amalgamation had not occurred.
2. Unabsorbed depreciation refers to the portion of the amalgamating company's allowance for depreciation that remains to be permitted and would have been allowed to such company if the amalgamation had not occurred.

3.17 Provisions of Carry Forward and set off of Losses in the Case of Change in Shareholding of Closely held Company [Section 79]

Section 79 of the Income Tax Act provides conditions for carry forward and set off of losses in case of a company not being a company in which the public are substantially interested.

Section 79 is amended by Finance (No. 2) Act, 2019 effective from AY 2020-21.

No loss shall be carried forward and set off against the income of the previous year in the case of a company in which the public are not substantially interested (even if the same is an eligible start-up company), unless at least 51 percent of the voting power of the company are beneficially held (on the last day of the previous year in which the loss is sought to be set off) by the same person(s) who held at least 51 percent of the shares on the last day of the financial year in question.

Tax point:

a. The assessee must be a company in which the general public has no considerable interest.
b. 51 percent of equity shares must be beneficially held by the same person(s) on the final day of the prior year in which the loss occurred; andon the last day of the previous year in which the brought forward loss is to be set off

Option for an eligible start-up company 1

In the case of an eligible start-up company that is not a company in which the public is substantially interested, the loss incurred in any year prior to the previous year shall be carried forward and set off against the income of the previous year if:

All shareholders of such company who held voting power on the last day of the year or

years in which the loss was incurred continue to hold those shares on the last day of such previous year; and

The loss occurred during a seven-year period commencing with the year in which the company was formed:

Exceptions: However, change in the share holding due to following reasons shall not be considered

1. Transfer due to death: Where a change in the said voting power takes place in a previous year consequent upon the death of a shareholder
2. Transfer by way of gift: Where a change in the said voting power takes place in a previous year on account of transfer of shares by way of gift to any relative of the shareholder making such gift
3. Amalgamation or demerger of foreign company: Any change in the shareholding of an Indian company which is a subsidiary of a foreign company as a result of amalgamation or demerger of a foreign company subject to the condition that 51% shareholders of the amalgamating or demerged foreign company continues to be the shareholder of the amalgamated or the resulting foreign company.
4. Insolvency and Bankruptcy Code, 2016: Where a change in the shareholding takes place in a previous year pursuant to a resolution plan approved under the Insolvency and Bankruptcy Code, 2016, after affording a reasonable opportunity of being heard to the jurisdictional Principal Commissioner or Commissioner
5. Relocation of Fund: The section is not applicable to a case to the extent that a change in the shareholding has taken place during the previous year on account of relocation referred to in the Explanation to sec. 47(viiac) and (viiad).
6. Distressed Company: The provision is not applicable to a company, and its subsidiary and the subsidiary of such subsidiary, where:

(i) the National Company Law Tribunal (NCLT), on an application moved by the Central Government u/s 241 of the Companies Act, 2013, has suspended the Board of Directors of such company and has appointed new directors nominated by the Central Government, u/s 242 of the said Act; and

(ii) a change in shareholding of such company, and its subsidiary and the subsidiary of such subsidiary, has taken place in a previous year pursuant to a resolution plan approved by the Tribunal u/s 242 of the Companies Act, 2013 after affording a reasonable opportunity of being heard to the jurisdictional Principal Commissioner or Commissioner.

Notes:

a. Losses under the head "Capital gains": Section 79 applies to all losses, including losses under the head "Capital gains."
b. Unabsorbed depreciation: Because the preceding paragraph does not apply to unabsorbed depreciation, such unabsorbed depreciation may be carried forward.

3.18 Company in Which the Public is Substantially Interested

Company owned by the Government or the Reserve Bank of India or in which not less than forty per cent of the shares are held (whether singly or taken together) by the Government or the Reserve Bank of India or a corporation owned by that bank ; or

Registered under section 25 of the Companies Act, 1956; or

Company having no share capital and declared by order of the Board to be such company ; or

Mutual benefit finance company: business of acceptance of deposits from its members and which is declared by the Central Government under section 620A of the Companies Act, 1956 ; or

A company whose more than 50% Equity shares held by one or more cooperative societies throughout the previous year ; or

A company which is not a private company and whose shares were, as on the last day of the relevant previous year, listed in a recognised stock exchange in India; or

Government company not being a private company

Italindia Cotton Co. P Ltd

- Hon'ble Court observed that the object sought to be served by the enacting section 79 appears to be to discourage persons claiming a reduction on their tax liability on the profits earned in companies which had sustained losses in the earlier years.

Select Holiday Resorts P Ltd

- Provision of section 79 did not apply as the beneficial shareholding pre and post-merger remained same.

AMCO Power Systems Ltd

- It should be restricted to cases of transfer of 'beneficial shareholding.

Yum Restaurants India (P) Ltd

- Transfer of 100% shares in the assessee company from one holding company to another holding company resulted in change in the beneficial ownership of the assessee company and therefore brought forward losses was not allowed to set off even though the ultimate beneficial owner remained same.

Wadhwa & Associates Realtors (P) Ltd

- Ownership of shares with the same person is not contemplated for denying set off of loss under section 79.
    - More important is exercise of 'voting power' and not holding of shares.
    - The word used in section 79 is 'held' and not 'owned'.
    - The phrase 'beneficially held' would contemplate wider meaning.

Order of set off

- Current depreciation
- Capital expenditure on scientific research and family planning
- Carried forward business losses
- Unabsorbed depreciation
- Unabsorbed capital expenses on scientific research and family planning

Example

- Company incorporated on 1/4/2016
- Capital only in form of equity shares held equally by X,Y,Z.

Assessment Year	Business Loss	Unabsorbed depreciation	Total

2017-18		1000000	1000000
2018-19		800000	800000
2019-20	450000	750000	1200000
Total	450000	2550000	3000000

Example

Transfer of shares:

Parties	P.Y. ended
From A to P	31/03/2020
From B to Q	31/03/2021

Profits

Profits(Before charging depreciation)	P.Y. ended
1000000(Before charging depreciation ,600000)	31/03/2020
3000000(Before charging depreciation ,500000)	31/03/2021

Shareholding on Relevant Dates

Shareholding on relevant dates					
	A	B	C	P	Q
As at 31/03/2019	33.33%	33.33%	33.33%		
As at 31/03/2020		33.33%	33.33%	33.33%	
As at 31/03/2021			33.33%	33.33%	33.33%

Computation of Taxable Income(in) for Assessment Year 2020-21

- For A.Y. 2020-21 Section 79 restriction not applicable.

Business profit	1000000
Less: Current Depreciation	600000
	400000
Less: B/F Business loss of A.Y. 2019-20	400000
Taxable Income	Nil
Position of Unabsorbed depreciation	
2017-18	1000000
2018-19	800000
2019-20	750000
Position of B/F business loss of A.Y.2019-20	50000

Computation of Taxable Income(in) for Assessment Year 2021-22

Business profit	30000000
Less: Current Depreciation	500000
	2500000
Less: Unabsorbed Depreciation	2500000
Taxable Income	Nil
Position of Unabsorbed depreciation	
2021-22	50000

Summary

Profits and losses are the two sides of the same coin. Losses, of course, are difficult to accept. However, the Income-tax Act of India does afford some benefits to taxpayers in the event of a loss.

The law includes provisions for loss set-off and carry-forward, which are explained in depth in this Unit.Set off of losses refers to the process of offsetting losses against the profit or income of that particular year. Losses that are not set off against income in the same year can be carried forward and set off against income in later years. An intra-head set-off or an inter-head set-off are two types of set-offs.Losses from one source of income can be set off against gains from another source of income under the same head of income.After the intra-head adjustments, the taxpayers can set off remaining losses against income from other heads.There may still be unadjusted losses after making the appropriate and allowable intra-head and inter-head adjustments. These unadjusted losses can be carried forward to future years for use in making adjustments to income in those years. Carry forward regulations fluctuate slightly for different types of income.

Keywords

- Intra-head Adjustment:Adjustment of Income and loss from all sources covered under one head of Income is called Intra-head Adjustment [Rules are prescribed in Sec. 70]
- Inter-head Adjustment:Adjustment of Income under one head and loss from another head of Income is called [Rules are prescribed in Sec. 71]
- Carry Forward: In case where the income of an assessment year is insufficient to set off the losses of the year then such losses (which could not be set off) can be carried forward to subsequent assessment year(s) for set off against income of such subsequent year(s).
- Accumulated Loss Under section 72 A: "Accumulated Loss" means so much of the loss of the predecessor firm or the proprietary concern or the private company or unlisted public company before conversion into limited liability partnership or the amalgamating company or the demerged company, 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 predecessor firm or the proprietary concern or the company or amalgamating company or demerged company, would have been entitled to carry forward and set off under the provisions of section 72 if the reorganisation of business or conversion or amalgamation or demerger had not taken place
- "Unabsorbed Depreciation"Under section 72 A: means so much of the allowance for depreciation of the predecessor firm or the proprietary concern or the private company or unlisted public company before conversion into limited liability partnership 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 the company or amalgamating company or demerged company, as the case may be, under the provisions of this Act, if the reorganisation of business or conversion or amalgamation or demerger had not taken place.
- Industrial undertaking under section 72 A:

  means an undertaking engaged in—

  • manufacture or processing of goods; or

  • manufacture of computer software; or

  • business of generation or distribution of electricity or any other form of power; or

  • business of providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service, network of trucking, broadband network and internet services; or The Institute of Cost Accountants of India 377 Set Off and Carry Forward of Losses

  • mining; or

  • the construction of ships, aircrafts or rail systems

Self Assessment

1. The practise of adjusting a loss from one source under one head of income against income from another source under the same head of income is referred to as:

A. Inter-head adjustment
B. Intra-head adjustment
C. Carry forward of loss
D. Clubbing of income

2. Loss from the business of owning and maintaining race horses can only be set off against ______when making intra-head adjustments.

A. Income from winnings from lotteries
B. Income from crossword puzzles
C. Income from business of owning and maintaining race horses
D. Income from card game

3. If a loss under the heading "Income from home property" cannot be fully adjusted in the year in which it is incurred, the unadjusted loss can be carried forward for ------years after the year in which the loss is incurred.

A. 2
B. 5
C. 8
D. 7

4. Which of these is not an exception in case of carry forward & set off of loss in case of closely held companies [sec. 79]?

A. Transfer due to death
B. Transfer by way of gift
C. Amalgamation or demerger of an Indian company which is not a subsidiary of a foreign company
D. Insolvency and Bankruptcy Code, 2016

5. In the assessment year 2022-23, Capital losses prior to the assessment year ____ cannot be set off.

A. 2014-2015
B. 2015-2016
C. 2016-2017
D. 2017-2018

6. In case of CARRY FORWARD & SET OFF OF LOSS FROM SPECIFIED BUSINESS COVERED u/s 35AD [SEC. 73A], the period for which carry-forward shall be allowed:

A. 2
B. 5
C. 8
D. No time limit is prescribed

7. Losses from speculative transactions or business can be carried forward for ___ assessment years immediately succeeding the assessment year in which such loss is first computed.

A. 4

B. 6

C. 8

D. 10

8. Loss under the head "Profits and gains of business or profession" (other than speculation loss) can be carried forward and set off against income under the same head. Which of these is not the condition?

A. Business needto be continued:

B. Filing of return in time

C. Unabsorbed depreciation, unabsorbed scientific research expenditure, and unabsorbed family planning expenditure are not covered by sec. 72. Such losses can be carried forward for any number of years.

D. The assessee must be same who incurred the loss(except in Amalgamation, Succession, Inheritance, Demerger)

9. In case of carry forward & set off of losses on conversion of proprietary concern or partnership firm into company [sec. 72a(6)], Accumulated loss of such firm or concern can be carried forward for further _____ years.

A. 3

B. 5

C. 8

D. 10

10. Which of the following is not a condition to be fulfilled by the amalgamating company.

A. The amalgamating company should have been engaged in a business in which the accumulated loss occurred or depreciation remained unabsorbed for 3 or more years.

B. The amalgamating company held continuously, as on the date of amalgamation, at least 3/4th of the book value of the fixed assets held by it for 2 years prior to the date of amalgamation.

C. The amalgamated company should hold at least 3/4th of 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.

D. The amalgamated company continues the business of the amalgamating company for at least 6 years.

11. Losses From the Activity of Owning and Maintaining Race Horses [Section 74a(3)] can be carried forward for followingyears:

A. 4

B. 7

C. 8

D. 10

12. In case of intra-head adjustments of losses,

A. short-term capital loss cannot be set off against long-term capital gain

B. short-term capital loss can be set off against long-term capital gain
C. Long-term capital loss can be set off against Short-term capital gain
D. Long-term capital loss cannot be set off against long-term capital gain

13. In the case of a company that is not an eligible start-up as defined in section 80-IAC but is a company in which the public is not substantially interested,, if the person beneficially holding _______of the voting power on the last day (i.e. 31st March) of the year in which the loss was incurred and the person beneficially holding of the voting power on the last day (i.e. 31st March) of the year in which the company wants to set off the brought forward loss are different, then the company cannot set off such brought forward loss.
A. 20
B. 25
C. 50
D. 51

14. Restriction of section 78 viz. provisions relating to carry forward and set off of loss in case of change in constitution of a partnership firm due to death or retirement of a partner is applicable only in case of
A. loss
B. unabsorbed depreciation,
C. unabsorbed capital expenditure on scientific research
D. family planning expenditure.

15. With effect from the assessment year 2018-19, losses under the head "house property" may be set off against any other head of income up to a maximum of _______every assessment year.
A. Rs. 2,00,000
B. Rs. 4,00,000
C. Rs. 6,00,000
D. Rs. 8,00,000

Answers for Self Assessment

1.	B	2.	C	3.	C	4.	C	5.	A
6.	D	7.	A	8.	A	9.	C	10.	D
11.	A	12.	B	13.	D	14.	A	15.	A

Review Questions

1. Explain the provisions of carry forward & set off of business loss other than speculation loss [SEC. 72] in detail.
2. Explain the provisions relating to carry forward of loss under the head 'income from house property' [sec. 71b].
3. Explain the provisions of carrying forward of loss under the head 'Capital gains'.

4. Explain the provisions of set-off and carry forward of Loss from speculation business [Sec. 73]
5. Explain the provisions of carry forward & set off of loss in case of closely held companies [sec. 79].

Further Readings

- https://www.icsi.edu/media/webmodules/16112021_Advance_Tax_Laws.pdf
- A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications
- Study Material on Direct Tax Laws and International Taxation by ICAI
- Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta

Web Links

- https://www.incometaxindia.gov.in/Tutorials/21-%20MCQ%20set%20off%20and%20carry%20frwrd.pdf

Unit 04: Computation of Taxable Income and Tax Liabilities of Companies and MAT

CONTENTS

Objectives

After studying this unit, you will be able to:

- compute Taxable income & Tax Liability of Companies,
- understand various provisions relating to MAT.

Introduction

Direct taxes and indirect taxes are the two types of taxes that exist in India. When it comes to direct taxes, they are levied on the earnings of various sorts of business entities over the course of a fiscal year. There are various sorts of taxpayers registered with the Income tax department, each of whom pays taxes at a particular rate. An individual and a corporation, for example, are not taxed at the same rate. As a result, direct taxes are divided into two categories: Individual Income Tax: which is the income tax paid by individual taxpayers. Individuals are taxed at varying rates depending on their tax slab. Corporate Income Tax: Which is the tax paid by domestic and foreign companies on their income in India (CIT). The corporate income tax is set at a certain rate set by the income tax statute, which is subject to annual rate changes in the union budget.

4.1 Corporate Tax in India

A company is a legal body that is separate and distinct from its shareholders. Under the Income-tax Act, both domestic and foreign companies must pay corporate tax. A domestic company is taxed on its total universal income, whereas a foreign company is only taxed on income earned in India, that is, money that is earned or received in India. A domestic company is defined as one that is registered under the Companies Act of India, as well as one that is registered in another country but has its control and management based entirely in India. Private and public companies both fall within the definition of a domestic corporation. Before we can comprehend the tax rate and how the tax will be computed on a company's income, we must first understand the many forms of income that a company might receive. It's as follows:

The types of income which a company earns:

- Profits earned from the business
- Capital Gains
- Income from renting property
- Income from other sources like dividend, interest etc

4.2 Income Tax Rates Applicable to Company for FY 2020-21 & FY 2021-22

Domestic Company: turnover Criteria

Where its total turnover or gross receipt during the previous year 2018-19 does not exceed Rs. 400 crore:

- Assessment Year 2021-22 25%
- Assessment Year 2022-23 NA

Income Tax Rates applicable to Company for FY 2020-21 & FY 2021-22

Where its total turnover or gross receipt during the previous year 2019-20 does not exceed Rs. 400 crore:

- Assessment Year 2021-22 NA
- Assessment Year 2022-23 25%

Income Tax Rates applicable to Company for FY 2020-21 & FY 2021-22

Any other domestic company

- Assessment Year 2021-22 30%
- Assessment Year 2022-23 30%

Surcharge :

The amount of income-tax shall be increased by a surcharge at the specified rate percentage of such tax:-

Range of Income

- Rs. 1 Crore to Rs.10 Crore 7%
- Above Rs. 10 Crore Surcharge Rate 12%

Health and Education Cess

The amount of income-tax and the applicable surcharge, shall be further increased by health and education cess calculated at the rate of 4 percent of such income-tax and surcharge.

Special Tax rates applicable to a domestic company

The special Income-tax rates applicable in case of domestic companies are as follows:

Domestic Company Tax Rate

♦ Where it opted for section 115BA 25%

♦ Where it opted for Section 115BAA 22%

♦ Where it opted for Section 115BAB 15%

Surcharge

The rate of surcharge in case of a company opting for taxability under Section 115BAA or Section 115BAB shall be flat 10% irrespective of amount of total income.

Health and Education Cess

The sum of income tax and the applicable surcharge shall be raised more by a health and education cess calculated at 4% of such income-tax and surcharge.

Foreign Company

Nature of Income: Royalty received from Government or an Indian concern in pursuance of an agreement made with the Indian concern after March 31, 1961, but before April 1, 1976, or fees for rendering technical services in pursuance of an agreement made after February 29, 1964 but before April 1, 1976 and where such agreement has, in either case, been approved by the Central Government :

Tax rate: 50%

Any other income:40%

- Surcharge: The amount of income-tax shall be increased by a surcharge at the specified rate percentage of such tax:-Range of Income
- Rs. 1 Crore to Rs.10 Crore 2%
  Above Rs. 10 Crore Surcharge 5%
- However, the surcharge shall be subject to marginal relief.
- Health and Education Cess : The amount of income-tax and the applicable surcharge, shall be further increased by health and education cess calculated at the rate of 4 percent of such income-tax and surcharge.

Illustration 1

Business Income from sale of securities	800000
Business income under 80IB(2012-13))	900000
STT	100000
Business Income (800000-100000+900000)	1600000
LTCG	600000
GTI	2200000

SOLUTION

GTI	2200000
Deduction u/s 80 IB 30% of 9,00,000	270000
TI	1930000

4.3 Deeded Incomes

1. **Deemed Incomes-Section 68**

Any sum found in an assessee's books of account in any previous year for which the assessee has not provided any explanation of source or for which the assessee's explanation is not satisfactory in the opinion of an Assessing Officer, may be charged to income tax as the assessee's income for that previous year.

However, where the assessee is a company (not one in which the general public has a significant interest) and the sum so credited consists of share application money, share capital, share premium, or any other amount by whatever name called, any explanation provided by such assessee-company shall be deemed insufficient., unless—

A. the resident in whose name such credit is recorded in such company's books additionally submits an explanation about the nature and source of such money thus credited; and
B. such explanation has been deemed satisfactory by the aforementioned Assessing Officer

2. **Section 69**

   Whenever an assessee makes investments in the financial year immediately preceding the assessment year that is not documented in his books of account, if any, for any source of income, and the assessee offers no explanation about the nature and source of the investments, or the assessee's explanation is not acceptable in the Assessing Officer's opinion, the value of the investments may very well be deemed to be the assessee's income for that financial year.

3. **Section 69A**

   Where the assessee is discovered to be the owner of some money, bullion, jewellery, or another valuable article in any fiscal year, but such money, bullion, jewellery, or other valuable article is not documented in the assessee's books of account, if any, for any income source, and the assessee gave no clarification about the nature and source of obtaining of the money, bullion, jewellery, or another valuable article, and the assessee provides no explanation about the nature and source of acquiring.

4. **Section 69B**

   Where the assessee has invested money or is discovered to be the owner of some bullion, jewellery, or another he valuable article in any financial year, and the Assessing Officer identifies that the amount spent on making such investments or acquiring such bullion, jewellery, or other valuable article is exceeding the amount documented in the assessee's account books for any income source, and the assessee gave no explanation for such excess amount.

5. **Section 69C**

   If an assessee incurs any expenditure during a financial year and does not explain the origin of that expenditure or portion of it, or if his clarification, if any, is not acceptable in the viewpoint of the Assessing Officer, the amount covered by such expenditure or portion of this might be deemed to be the assessee's income for said financial year. However, notwithstanding anything stated in any other provision of this Act, such unexplained expenditure that is regarded as the assessee's income shall not be recognized as a deduction under any head of income.Year in which a person becomes taxable

   The amount determined under the preceding sections is taxable in the Financial Year in which it is credited (Section 68), invested (Section 69, 69A, 69B), or incurred (Section 69, 69A, 69B) (Section 69C).

Tax Rate:In accordance with Section 115BBE, income tax is determined at 60% of the assessee's total income, which includes the following income:

- Income made reference to in Sections 68, 69, 69A, 69B, 69C, or 69D and taken into account in the return of income furnished under Section 139; or
- Which is ascertained by the Assessing Officer and contains any income referred to in Sections 68, 69, 69A, 69B, 69C, or 69D, if such income is not covered under clause(a).

The initial tax rate of 60% will be enhanced by a 25% surcharge and a 6% penalty, bringing the total tax rate to 83.25 percent (including cess).

Provided, however, that such 6% penalty shall not be imposed if the income under Sections 68, 69, and so on has been been included in the income return and tax has been paid on or before the close of the financial relevant previous year.

The assessee shall not be allowed any deduction in reference of any expenditure or allowance [or set off of any loss] in determining his income as defined in clause (a) of sub-section (1) of Section 115BBE.

4.4 Tax Treatment of Dividend

Received From A Foreign Company

Dividends received by a domestic company from a foreign company in which the domestic company has a 26 percent or greater equity shareholding are taxable at a rate of 15% plus Surcharge and Health and Education Cess under Section 115BBD.

Dividends received by a domestic company from a foreign company are taxable at the normal tax rate if the domestic company's equity shareholding is less than 26 percent. The domestic corporation may deduct any expenses incurred for the purpose of earning such dividend income.Domestic co. receives dividend from another domestic co

Illustration

- Business Income: 30,00,000
- Dividend Received form Foreign Company: 6,00,000
- Income from other sources: 2,00,000

Solution

Tax on Business Income @25%	7,50,000
Tax on Dividend Received form	
Foreign Company @15%	90,000
Tax on Income from other sources@25%	50,000
Total tax	8,90,000
Add: H&EC	35,600
Tax Payable	9,25,600

4.5 Meaning and Objectives of MAT

AMT is for Alternate Minimum Tax, while MAT stands for Minimum Alternate Tax. The concept of MAT was first adopted for companies, and it was gradually extended to all other taxpayers in the form of AMT. This section will teach you about the many provisions relevant to MAT. We'll start with the basic provisions of MAT and then go on to the advanced provisions of MAT. It is possible that a taxpayer, such as a company, generated income during the year but was able to decrease its tax liability or avoid paying any tax at all by utilizing various provisions of the Income-tax Law (such as exemptions, deductions, depreciation, and so on). The Finance Act of 1987, having effect from the assessment year 1988-89, established MAT in response to a rise in the number of zero-tax-paying companies. It was afterwards repealed by the Finance Act of 1990, and then reinstated by the Finance (No. 2) Act of 1996, wef1-4-1997. The goal of MAT is to bring "zero tax corporations" into the tax net, which, despite earning considerable book profits and paying large dividends, do not pay any tax due to various tax concessions and incentives offered by the Income-tax Law. Since its inception, various amendments have been made to the provisions of MAT, and it is now imposed on companies under the provisions of section 115J

4.6 MAT's Basic Provisions

According to the MAT principle, a company's tax liability will be greater of the following: The firm's tax liability is calculated according to the normal rules of the Income-tax Law, i.e., tax is computed on the taxable income of the company by employing the applicable tax rate. The tax liability estimated in the aforesaid manner is known as normal tax liability.

On book profit, tax is calculated at 15% (plus relevant surcharges and cess) (method of computing book profits is considered in subsequent section). MAT is a tax calculated by employing 15% (plus surcharge and cess if applicable) to book profit. Note: In the case of a company that is a unit of an International Financial Services Centre and derives its revenue primarily in convertible foreign currencies, MAT is collected at a rate of 9% (plus surcharge and cess as applicable).

Example 1: AB Pvt. Ltd.

The taxable income calculated in accordance with the provisions of the Income-tax Act is Rs. 8,40,000.

The company's book profit, calculated in accordance with Section 115JB, is Rs. 18,40,000.

What could AB Pvt. Ltd.'s tax liability be (ignoring cess and surcharge)?

Solution

The normal tax Liability:

30% tax on Rs. 8,40,000 = Rs. 2,52,000 (plus cess).

MAT liability (excluding cess and surcharge)= 15% on Rs.18,40,000

=Rs. 2,76,000.

Hence, the tax liability of AB Pvt. Ltd. = Rs. 2,76,000 (plus cess as applicable)

This is higher than the normal tax liability.

Example 2

According to the provisions of the Income-tax Act, SK Pvt. Ltd.'s taxable income is Rs. 28,40,000.

The company's book profit, calculated in accordance with Section 115JB, is Rs. 18,40,000.The tax liability of SK Pvt. Ltd.=? (ignoring cess and surcharge)?

Solution

Tax at the rate of 30% on Rs. 28,40,000 equals Rs. 8,52,000 (plus cess).

MAT liability (excluding cess and surcharge) @ 15% on Rs.18,40,000 equals Rs.2,76,000.

Thereby, SK Pvt. Ltd.'s tax liability would be Rs. 8,52,000 (plus cess as applicable), which is greater than the MAT liability.

4.7 MAT's Applicability and Non-Applicability

As per Section 115JB, every taxpayer who is a company is required to pay MAT if the income tax (including surcharge and cess) payable on total income calculated in line with the requirements of the Income-tax Act for any year is less than 15% of its book-profit + surcharge (SC) + health and education cess. The MAT regulations, on the other hand, do not apply to: a) domestic companies that have preferred tax regimes under Section 115BAA or Section 115BAB; b) any income accruing or arising to a company from the life insurance business referred to in Section 115B; and c) shipping companies with tonnage taxed income.

Furthermore, it is clarified in Explanation 4 to section 115JB as amended by Finance Act, 2016 with retrospective effect from 1/4/2001 that the MAT provisions shall not be applicable and shall be deemed never to have been applicable to an assessee, being a foreign company, if—

(i) the assessee is a resident of a country or a specified territory with which India has an agreement referred to in sub-section (1) of section 90 or the Central Government has adopted any agreement

(ii) the assessee is a resident of a country with which India does not have an agreement of the type referred to in clause I and the assessee is not required to seek registration under any company law currently in force.

(iii) Furthermore, according to Explanation 4A to section 115JB as inserted by the Finance Act of 2018, MAT provisions do not apply to a foreign company whose total income consists of profits and gains arising from business referred to in sections 44AB, 44BB, 44BBA, or 44BBB and such income has been offered to tax at the rates specified in those sections.

4.8 The Definition of Book Profit

According to Explanation 1 to Section 115JB(2), "book profit" means net profit as shown in the statement of profit and loss prepared in accordance with Schedule III to the Companies Act, 2013, as increased and decreased by certain items prescribed in this regard. The following items will be increased and decreased:

Computation of book profit (Table A)

Particulars	Amount
Net profit as per statement of profit and loss prepared in accordance with Schedule III to the Companies Act, 2013	

Add : Following items (if they are debited to the statement of profit and loss)	
Income-tax paid/payable and the provision thereof (*)	
Amounts carried to any reserves by whatever name called (Other than reserve specified under Section 33AC)	
Provisions for unascertained liabilities	
Provisions for losses of subsidiary companies	
Dividends paid/proposed	
Expenditure related to incomes which are exempt under section 10 [other than section 10(38)] section 11 and section 12	
The amount or amounts of expenditure relatable to, income, being share of the taxpayer in the income of an association of persons or body of individuals, on which no income-tax is payable in accordance with the provisions of section 86	
The amount or amounts of expenditure relatable to income accruing or arising to a taxpayer being a foreign company, from : (a) the capital gains arising on transactions in securities; or (b) the interest, dividend royalty or fees for technical services chargeable to tax at the rate or rates specified in Chapter XII if the income-tax payable on above income is less than the rate of MAT	
The amount representing notional loss on transfer of a capital asset, being share or a special purpose vehicle to a business trust in exchange of units allotted by that trust referred to in clause (xvii) of section 47 or the amount representing notional loss resulting from any change in carrying amount of said units or the amount of loss on transfer of units referred to in clause (xvii) of section 47	
Expenditure relatable to income by way of royalty in respect of patent chargeable to tax under section 115BBF	
Amount of depreciation debited to P & L A/c	
Deferred tax and the provision thereof	
Provision for diminution in the value of any asset	
The amount standing in revaluation reserve relating to revalued asset on the retirement or disposal of such an asset if not credited to statement of profit and loss	

The amount of gain on transfer of units referred to in clause (xvii) of section 47 computed by taking into account the cost of the shares exchanged with units referred to in the said clause or the carrying amount of the shares at the time of exchange where such shares are carried at a value other than the cost through statement of profit and loss as the case may be;	
Less : Following items (if they are credited to the statement of profit and loss)	
Amount withdrawn from any reserve or provision if credited to P&L account (**)	
Incomes which are exempt under section 10 [other than section 10(38)] section 11 and section 12	
Amount of depreciation debited to statement of profit and loss (excluding the depreciation on revaluation of assets)	
Amount withdrawn from revaluation reserve and credited to statement of profit and loss to the extent it does not exceed the amount of depreciation on revaluation of assets	
The amount of income, being the share of the taxpayer in the income of an association of persons or body of individuals, on which no income-tax is payable in accordance with the provisions of section 86, if any such amount is credited to the statement of profit and loss	
The amount of income accruing or arising to a taxpayer being a foreign company, from : (a) the capital gains arising on transactions in securities; or (b) the interest, dividend royalty or fees for technical services chargeable to tax at the rate or rates specified in Chapter XII if such income is credited to the statement of profit and loss and the income-tax payable on above income is less than the rate of MAT	
The amount (if any, credited to the statement of profit and loss) representing (a) notional gain on transfer of a capital asset, being share of a special purpose vehicle to a business trust in exchange of units allotted by that trust referred to in clause (xvii) of section 47; or (b) notional gain resulting from any change in carrying amount of said units; or (c) gain on transfer of units referred to in clause (xvii) of section 47, The amount representing notional gain on transfer of units referred to in clause (xvii) of section 47 computed by taking into account the cost of the shares exchanged with units referred to in the said clause or the carrying amount of the shares at the time of exchange where such shares are carried at a value other than the cost through statement of profit and loss, as the case may be;	
Income by way of royalty in respect of patent chargeable to tax under section 115BBF	

Aggregate amount of unabsorbed depreciation and loss brought forward in case of: a) A company and its subsidiary and the subsidiary of such subsidiary, where, the Tribunal, on an application moved by the Central Government under Section 241 of the Companies Act, 2013 has suspended the Board of Directors of such company and has appointed new directors who are nominated by the Central Government under Section 242 of the said Act; A company against whom an application for corporate insolvency resolution process has been admitted by the Adjudicating Authority under Section 7 or Section 9 or Section 10 of the Insolvency and Bankruptcy Code, 2016	
Amount of brought forward loss or unabsorbed depreciation, whichever is less as per books of account (in case of a company other than the company undergoing insolvency proceedings)	
Profits of a sick industrial company till its net worth becomes zero/positive	
Deferred tax, if credited to statement of profit and loss	
Book profit to be used to compute MAT	

(*) The amount of income tax wil encompass:

i. any tax on distributed profits under section 115-O (dividend distribution tax - i.e., DDT) or tax on distributed income under section 115R;
ii. any interest charged under this Act;
iii. any surcharge imposed by the Central Acts from time to time;
iv. any Education Cess on Income-tax levied by the Central Acts from time to time; and
v. Secondary and Higher Education Income-tax cess, if any, imposed by Central Acts from time to time. (**) Withdrawals made from reserves generated or provisions made on or after 1-4-1997 may be deducted only if the book profit of the year of creation of such reserve has been increased by the amount transferred to such reserve or provisions (out of which the said amount was withdrawn). Governmental grants, for instance, relating to depreciable assets are credited to special reserve (rather than to the statement of profit and loss) in the year of receipt, and a part of such grant is transferred from that reserve to the statement of profit and loss over the asset's life in ratio to depreciation charged.

These grants had not been added to net profit for the calculation of book profit subject to MAT in the year in which they were credited to special reserve. As a result, in the year of transfer to P&L, the amounts transferred are not deducted from net profit when calculating book profit for MAT purposes.

The definition of book profit for companies that follow Indian Accounting Standards (Ind AS).

1. According to newly inserted section 115JB(2A) of the Finance Act, 2017, "book profit" for an Ind AS compliant company for the purposes of section 115JB means the book profit computed in accordance with Explanation 1 to section 115JB(2) as:

- enhanced by all amounts credited to other comprehensive income (OCI) in the statement of profit and loss that will not be re-classified to profit or loss;
- reduced with all amounts debited to other comprehensive income (OCI) in the profit and loss statement that can not be reclassified to profit or loss;
- enhanced with all amounts or aggregate of amounts debited to the profit and loss statement on distribution of non-cash assets to shareholders in a demerger of companies in accordance with Appendix A of Ind AS 10; and
- reduced with all amounts or aggregate of amounts credited to the profit and loss statement

2. When an item is credited or debited to OCI but would not be reclassified to profit or loss, it must be excluded from the calculation of book profit.
   - Revaluation surplus for fixed and intangible assets under Ind AS 16 and Ind AS 38; or
   - Gains or losses from equity investments assessed at fair value through other comprehensive income (FVTOCI) under Ind AS 109.

However, the book profit of the previous year when the asset or investment referred to in points (i) and (ii) is retired, disposed of, realized, or otherwise transferred must therefore be raised or lowered by the amounts made reference to in points I and (ii) to the level that they are pertaining to the disposed asset or investment.

3. Any adjustment in the value of the assets and liabilities of the undertaking or undertakings received by the resulting company that differs from the values showing up in the demerged company's account books immediately before demerger must therefore be ignored in computation of the resulting company's book profit.
4. Therefore, to calculate the book profit of an Ind AS compliant company, follow these steps:

Particulars	Amount
Book profit as computed in Table A	
Adjustments as mentioned in point (3) above	
Adjustments for revaluation gain/loss for fixed assets & intangible assets in the year of their disposal or transfer	
Adjustments for gains or losses from investments in equity instruments measured at FVTOCI in the year if their disposal or transfer	
Adjustments for any other OCI items that will not be re-classified to profit or loss	
Book profit to be used to compute MAT	

5. Adjustments resulting from the transition to Ind AS from existing Indian GAAP must be recorded in the balance sheet under Other Equity. The transition amount is the amount of these adjustments. The amount of such adjustments that will not be reclassified should be included in the computation of book profit over a five-year period, beginning with the year of first-time adoption of Ind AS and subject to certain exclusions.

1.6. MAT credit

As previously stated, a firm must pay the higher of its normal tax liability or its MAT liability. If a firm pays liability as per MAT in any year, it is entitled to a credit for the MAT paid over and above the standard tax liability in the following year (s). Section 115JAA contains requirements relating to MAT credit carry forward and adjustments. If the amount of Foreign Tax Credit ('FTC') granted against the MAT exceeds the amount of FTC admissible against the tax payable by the assessee under normal provisions of the Income-Tax Act, then the excess amount shall be omitted for computing the amount of FTC under this subsection.

Example

- K Ltd.'s tax liability for the financial year 2021-22:
- • the liability under normal provisions of the Income-tax Act is Rs. 8,40,000; and • the liability under MAT provisions is Rs. 10,000,000.
- Should the company be able to claim MAT credits in the following year(s) under the virtue of Section 115JAA?

  Solution

- The company must pay Rs. 10,00,000, i.e., the liability under the MAT terms and conditions.

  Rs. 1,60,000 MAT credit

  Adjustment of carried forwardMAT credit

- The credit can be adjusted if the company's liability under normal provisions exceeds the MAT liability during the financial year.
- The set-off for carried forward MAT credit shall be permitted in the subsequent year(s) to the level of the difference between the tax on its total income as per normal provisions and the tax on its total income as per MAT provisions.I

Example

PK Ltd.'s tax liability for the fiscal year 2021-22

The liability under the normal provisions of the Income-tax Act is Rs. 18,40,000, and the liability under the MAT provisions is Rs. 18,00,000. It has advanced MAT credit of Rs. 200,000.

Is it possible for the company to change the MAT credit? If yes, how much and what will the company's tax liability be after MAT credit adjustment?

Solution

Out of the credit of Rs. 2,00,000, the company can claim only Rs. 40,000, and the remaining credit of Rs. 1,60,000 can be carried forward to the following year (s).

For a limited time, MAT credit can be carried forward.

As previously stated, the corporation can carry forward the MAT credit for future year(s) of adjustment; however, the MAT credit can only be carried forward for 15 years before it expires. In other words, if a corporation does not use MAT credit within 15 years (immediately following the assessment year in which the credit was generated), the credit will expire. There is no interest paid to the taxpayer in the case of such a credit.

Chartered accountant's report

Every company subject to the provisions of section 115JB must obtain from a chartered accountant a report in Form No. 29B certifying that the book profit has been computed in accordance with section 115JB. The report must be obtained by the deadline specified in Section 44AB. Form 29B, the audit report, must be submitted electronically.

4.9 Tax Planning in Relation to MAT

1. **Formation of Partnership Firm**

   Mat provisions are not applicable to Partnership firms. As a result, a partnership firm can be formed by two or more companies. The firm's income is exempt under Section 10(2A) of the Income Tax Act. This would lower the MAT tax liability.

2. **Profitable and loss-making assets to be sold in the same year.**

   When a corporation wants to sell some of its assets and expects to make a profit on some of them while losing money on others, both types of assets should be sold in the same year to keep the book profits as low as feasible.

3. **Higher Depreciation to be claimed**

   A company cannot depreciate at a rate that is less than the allowed percentage in the Companies Act, but it can depreciate at a rate that is greater than the prescribed rates. As a result, a bigger depreciation may be claimed to reduce book profits.

4. **Income tax Adjustment account to be prepared**

Income tax paid or payable that has been deducted in the P&L statement is added back to book profits, but the income tax refund that has been added to the P&L statement is not deducted to arrive at the book profits. As a result, an Income Tax Adjustment A/c should be created to reduce the book profits, and the net amount of income tax should be deducted from the P&L statement.

Summary

The corporate tax, also known as corporation tax or company tax, is paid by companies operating in India on their worldwide income. The tax rate varies depending on whether the company is incorporated in India or abroad. With the government lowering the headline corporate tax rate for domestic companies from 30% to 22% beginning in the fiscal year 2019-20, the disparity between the rates applicable to foreign and domestic companies has broadened. Further, exemptions, deductions, depreciation, and other provisions of the Income-Tax Act allow businesses to reduce their tax liability. Due to various tax concessions and incentives, some companies have even managed to show nil taxable income despite making substantial profits and paying out dividends. The Minimum Alternate Tax (MAT) was enacted to bring these "zero-tax paying companies" well within the scope of income tax and force them to pay a minimum amount of tax to the treasury.

Keywords

- MAT: MAT stands for Minimum Alternate Tax (Companies).MAT to bring into the tax net "zero tax companies" which in spite of having earned substantial book profits and having paid handsome dividends, do not pay any tax due to various tax concessions and incentives provided under the Income-tax Law.
- AMT: The provisions relating to AMT are applicable to non-corporate taxpayers in a modified pattern in the form of Alternate Minimum Tax, i.e., AMT.
- Book Profits: Book profit" for the purposes of section 115JB means the net profit as shown in the statement of profit and loss prepared in accordance with Schedule III to the Companies Act, 2013 as increased and decreased by certain items prescribed in this regard.
- Deemed Income: Deemed income under sections 68, 69, 69A, 69B, 69C, and 69D include tax Treatment of Cash Credit, Unexplained investments, Unexplained money, Amount of investments not fully disclosed in books of account, Unexplained expenditure, and Amount borrowed or repaid on hundi in cash.
- Section 115BAA : This section states that domestic companies have the option to pay tax at a rate of 22% plus surcharge of 10% and cess of 4%. The Effective Tax rate is 25.17% from the FY 2019-20 (AY 2020-21) onwards if such domestic companies adhere to certain conditions specified. The company need not pay tax under MAT if it opts for Section 115BAA.
- Section 115BAB: The Taxation Laws (Amendment) Ordinance, 2019 passed on 20 September 2019 has inserted Section 115BAB offering a low tax rate of 15% (plus surcharge and cess) to new manufacturing companies. This is done to promote the new manufacturing start-ups.
- Section 115BA: Tax for certain domestic manufacturing companies subject to other provisions of Chapter XII (other than Section 115BAAA & Sec 115BAB) Is 25%. There is no time limit for the domestic manufacturing company to opt for lower-income tax under Section 115BAB. So, the companies can opt for the benefit of Section 115BAB once they set- all the brought forward losses and MAT credit under the regular tax regime.

Self Assessment

1. Tax credit in respect of MAT paid as per Section 115IB will be allowed only in the previous year in which the tax payable on the total income at the normal rate is

A. Greater than the tax payable under section 115JB

B. Less than the tax payable under section 115JB

C. Equal to the tax payable under section 115JB

D. All of the above

2. For computing the Book Profit under section 115 JB, which of the following is not added back to the profits?

A. Income-Tax

B. Provision for Tax

C. Deferred Tax u/s 115-0

D. STT

3. For computing the Book Profit under section 115 JB, which of the following is added back to the profits?

A. Amount withdrawn from any reserve or provision if credited to P&L account (**).

B. Incomes which are exempt under section 10 [other than section 10(38)] section 11 and section 12.

C. gain on transfer of units referred to in clause (xvii) of section 47.

D. Expenditure relatable to income by way of royalty in respect of patent chargeable to tax under section 115BBF.

4. ABC Limited's total income comprises dividends of fifteen lakhs paid by a foreign company situated in the United Kingdom in which XYZ Limited owns 30 percent of the equity share capital. A total of 60,000 has been spent to receive such a dividend.The dividend income received by the company from the foreign company based in the United Kingdom, as well as the tax rate, are as follows:

A. Exempted u/s 10(34)

B. Taxable @ 15% of 15 lakhs

C. Taxable @ 15% of 14.4 lakhs

D. Taxable @ 10% of 15 lakhs

5. While calculating Book Profits under section 115JB of Income-tax Act, 1961, which of the following is not to be added?

A. Expenditure related to incomes which are exempt under section 10 [other than section 10(38)] section 11 and section 12

B. Provision for diminution in the value of any asset

C. The amount standing in revaluation reserve relating to revalued asset on the retirement or disposal of such an asset if not credited to statement of profit and loss

D. All of these to be added

6. While calculating Book Profits under section 115JB of Income-tax Act, 1961, which of the following is to be deducted?

A. The amount of income accruing or arising to a taxpayer being a foreign company, from the capital gains arising on transactions in securities

B. The amount of income accruing or arising to a taxpayer being a foreign company, from the capital gains arising on transactions in securities the interest, dividend royalty or fees for technical services chargeable to tax at the rate or rates specified in Chapter XII

C. Profits of a sick industrial company till its net worth becomes zero/positive

D. All of the above

7. Which of the following statement is not true about MAT?
A. Initially the concept of MAT was introduced for companies and progressively it has been made applicable to all other taxpayers in the form of AMT
B. MAT was introduced by the Finance Act, 1987 with effect from assessment year 1988-89.
C. Later on, it was withdrawn by the Finance Act, 1990 and then reintroduced by Finance (No. 2) Act, 1996, wef1-4-1997.
D. Since the introduction of MAT, several changes have been introduced in the provisions of MAT and today it is levied on companies as per the provisions of section 113JB.

8. Which of the following statement is true about MAT?
A. MAT is levied at the rate of 10% (plus surcharge and cess as applicable) in case of a company, being a unit of an International Financial Services Centre and deriving its income solely in convertible foreign exchange.
B. every taxpayer being a company is liable to pay MAT, if the Incometax(including surcharge and cess) payable on the total income, computed as per the provisions of the Income-tax Act in respect of any year is less than 15% of its book-profit + surcharge (SC) + health & education cess.
C. MAT are applicable on the domestic companies which have opted for tax regimes under Section 115BAA or Section 115BAB.
D. MAT are not applicable on the shipping company, the income of which is subject to tonnage taxation.

9. When an Indian company holds 30% of the nominal value of equity capital of a foreign company, the amount of dividend received from the foreign company in the hands of the Indian company is:
A. Exempt from Tax
B. Taxable @15%
C. Taxable @10%
D. Taxable @ 30%

10. ABC Ltd., a domestic company having a turnover of 350 crores has computed its total income for the year 2020- 21 of 102 lakh. The tax payable by the company on such income in A.Y. 2021- 22 shall be:
A. 33,05,168
B. 25,50,000
C. 28,37,640
D. 27,28,500

11. The maximum number of years for which credit of MAT excess paid u/s 115JB can be carried forward is

A. ten assessment years
B. eight assessment years.
C. fifteen assessment years.
D. fifteen assessment years.

12. To be eligible for a reduced tax rate on dividends received from a foreign company, the Indian company must hold the following minimum shareholding in the foreign company
A. 10 percent
B. 25 percent
C. 26 percent
D. 51 percent

13. Section 115JB is applicable in the case of
A. Domestic companies only
B. Foreign companies only
C. All companies
D. Closely held companies

14. Provisions of Minimum Alternate Tax (MAT) are applicable to the companies which are:
A. Indian companies
B. Foreign companies in certain conditions
C. Limited Liability Partnership
D. A and B

15. Which of the following statements is wrong about adjustment of carried forward MAT credit?
A. a company is entitled to claim MAT credit i.e. excess of MAT paid over the normal tax liability
B. The credit of MAT can be utilised by the company in the preceeding year(s)
C. The credit can be adjusted in the year in which the liability of the company as per the normal provisions is more than the MAT liability
D. The set off is allowed in the subsequent year(s) to the extent of the difference between the tax on its total income as per the normal provisions and as per the MAT provisions.

Answers for Self Assessment

1 A	2 D	3 D	4 B	5 D
6 D	7 D	8 B	9 B	10 C
11 C	12 C	13 C	14 D	15 B

Review Questions

1. What is Minimum Alternate Tax?
2. Who is liable to pay MAT?

3. What is MAT credit?
4. What is the difference between Minimum Alternate Tax (MAT) and Alternate Minimum Tax (AMT)?
5. How is MAT calculated?
6. Which companies are the most likely to gain from the changes in corporation tax rates?
7. What are the new sections 115BAA and 115BAB and what do they cover?
8. Differentiate between a domestic and a foreign company. Are they treated the same in terms of income tax rates?

Further Readings

- https://cleartax.in/s/corporate-tax
- https://www.incometaxindia.gov.in/tutorials/10.mat-and-amt.pdf
- A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications.
- Corporate Tax planning by Dr. J. C. Varshney and Nikhil Gupta (Chartered Accountant)
- Practical problems in Corporate Tax planning by Dr. R.K. Jain, SBPD publications
- Study Material on Direct Tax Laws and International Taxation by ICAI
- Study Material on Direct Tax Laws and Practice by ICSI

Web Links

- https://taxguru.in/income-tax/corporate-tax-rate-applicable-ay-2021-2022-ay-2022-2023.html

Dr. Rupinder Katoch, Lovely Professional University

Unit 05: Tax Planning for Newly Set-Up Business

CONTENTS

Objectives

After studying this unit, you will be able to:

- understand Implications of Tax Concessions and Incentives for Corporate Decisions,
- understand tax planning with reference to location, size and nature of business,
- understand tax effects of Nature, Size and Location of Business in respect of certain assesses engaged in certain businesses.

Introduction

Tax planning is important from a geographical standpoint. Certain locations receive preferential tax treatment.Tax planning is also important when determining the nature of a business. Certain businesses are given preferential tax treatment.Setting up a business within the scope of the act is a specific item to consider for tax planning purposes. It is not the same as starting a business. During the period between the company's formation and the commencement of business, it may incur various revenue-generating expenses (production). The tax laws state that general expenses incurred prior to the date of establishment are inadmissible, but those incurred after the date of establishment and before the commencement of the business may be deducted for tax purposes if they are of a revenue nature and incurred wholly and exclusively for the purpose of business.

5.1 Concessions and Incentives

a. Concessions and Incentives for Setting Up

b. Concessions and Incentives for Expansion and Contraction of business

5.2 Tax Planning with Respect to Setting up and Commencement of Business:

a. Setting up a business is different from the commencement of business.

b. General expenses prior to the date of setting up are inadmissible.

c. Expenses incurred from the date of setting up and before the commencement of the business may be allowed as deduction for tax purposes provided they are of revenue nature and are incurred wholly and exclusively for the purpose of business.

d. Achievement of setting up at the earliest.

   Enabling the company to avail the benefit of tax holiday, investment allowance, carry forward of unabsorbed losses and depreciation for a longer period.

e. Expenditure revenue in nature and incurred exclusively for business.

f. Certain tax holidays operative from commencement of business.

   The tax holiday under the provisions of Section 80-IA and 80-IB of the Act also becomes operative from the point of time production is commenced and continues up to the prescribed period.

g. Preliminary expenditure allowable from year of commencement.

   Under the provisions of Section 35 of the Act, any expenditure whether capital or revenue, incurred on scientific research, during the three accounting years immediately preceding the year of commencement of business is allowed as deduction in the year of commencement of business.

5.3 Whether a Business has Commenced or not is a Question of Fact?

Agreement is a very wide term: An agreement may be a social or legal in nature. A social agreement does not give rise to any legal obligation and is unenforceable by law. Thus, only those agreements that are legally enforceable can be considered as a valid contract.

5.4 Concessions and Incentives for Setting up

According to Section 10, "All agreements are contracts if they are made by the free consent of the parties competent to contract, for a lawful consideration and with a lawful object, and are not hereby expressly declared to be void". As per the above section, a contract must have the following elements.

a) Form of business

b) Nature of Business

There are certain businesses which are granted special tax treatment. Some of these are as follows :

1. Newly established units in SEZ [Section 10AA];
2. Tea Development Account, Coffee Development Account and Rubber Development Account [Section 33AB];
3. Site Restoration fund [Section 33ABA];
4. Specified business eligible for deduction of Capital Expenditure [Section35AD];
5. Amortization of certain preliminary expenses [Section 35D];
6. Expenditure on prospecting for certain minerals [Section 35E]; g. Special reserve created by a financial corporation under Section 36(1)(viii);
7. Special provisions for deduction in the case of business for prospecting for mineral oil [Section 42 and 44BB]; i. Special provisions for computing profits and gains of business on presumptive basis [Section 44AD];
8. Special provisions in the case of business of plying, hiring or leasing goods carriages [Section 44AE];
9. Special provisions in the case of shipping business in the case of non-residents [Section 44B];
10. Special provisions in the case of business of operation of aircraft [Section 44BBA];
11. Special provisions in the case of certain turnkey power projects [Section 44BBB];
12. Special provisions in the case of royalty income of foreign companies [Section 44D];

c) Location of business

Tax planning is relevant from location point of view. There are certain locations which are given special tax treatment. Some of these are as under:

a. Newly established units in SEZ: Full exemption under Section 10AA for initial five years, 50% for subsequent five years and further deduction of 50% for a further period of five years in case of a newly established units in SEZ on or after 1.4.2005.
b. Developer of SEZ: Deduction under Section 80-IAB in respect of profits and gains by an undertaking or an enterprise engaged in the development of SEZ.
c. Industrial undertaking in industrially backward State or district: Deduction under Section 80-IB is allowed in the case of a newly set up industrial undertaking in an industrially backward state or district.

d. Industrial undertaking in certain special category states:
Deduction under Section 80-IC is available in case of newly set up industrial undertaking or substantial expansion of an existing undertaking in certain special category states.

e. Hotels and convention centers in specified area: Deduction under Section 80-ID is allowed in respect of profits and gains from business of hotels and convention centers in specified area or a hotel at world heritage sites.

f. North-eastern States: Deduction under Section 80-IE is allowed in respect of certain undertakings in North-Eastern States.

g. Extra Depreciation in notified backward areas: With effect from AY 2016-17, any assessee setting up a new manufacturing undertaking in the states of Andhra Pradesh, Telangana, Bihar or West Bengal will be eligible for an extra depreciation of 15% of the cost of the new asset.

5.5 India Corporate - Tax Credits and Incentives

Tax incentive provisions normally have conditions applicable for the period within which the preferred activity should be undertaken and the period for which the tax incentive is available.

It may also be necessary to fulfil certain other conditions, such as 'forming' of a 'new' undertaking.

5.6 Tax Planning with Respect to Expand or Contract of Business

A. Expansion without business Restructuring mechanism.

i. Additional depreciation of new plant and machinery
ii. Deduction for preliminary expenses u/s sec 35 D
iii. Deduction in respect of employment of new workmen u/s 80JJAA
iv. Section 80 I Deductions (Sec 80IA, Sec 80IAB,Sec IAC. Sec 80IB,Sec 80IBA,Sec 80IC,Sec 80ID,Sec 80IE).

B. Expansion through business Restructuring mechanism.

I. Amalgamation of Companies.

I. Tax issues relating to Amalgamation of Companies CONDITIONS
If the following conditions are satisfied, then we may call it as Amalgamation of Companies as per Sec 2(IB) OF Income Tax Act 1961

1. All the properties of the Amalgamating Company become the properties of the Amalgamated Company.
2. All the liabilities of the Amalgamating Company become the liabilities of the Amalgamated Company.
3. 3/4 of the Shareholders of the Amalgamating Company become the shareholders of the Amalgamated Company.

A. From the point of view of Amalgamating Company;

1. Proportionate depreciation can be claimed on transferred assets.
2. No capital Gain Tax on transfer of Capital Assets to Indian Company.
3. No capital Gain Tax on transfer of shares held in Indian Company by the amalgamating Foreign Company to a foreign amalgamated Company.

B. From the point of view of Shareholders of Amalgamating Company

Surrender of shares of Amalgamating Company against the receipt of shares of amalgamated Company does not attract capital gain tax. On Subsequent sales of these shares definitely attract capital gain tax.

Following terms are to be understood at this juncture

1. Cost of Acquisition of shares of Amalgamating Company Will be the Cost of Acquisition of shares of amalgamated Company.
2. Holding period is to be calculated by taking into consideration the date of acquisition of shares of Amalgamating Company.

C. From the point of view of Amalgamated Company.

1. Assets transferred (block of assets) from amalgamating company to be included in the block of assets of amalgamated Company at WDV at the beginning of the in the hands of the Amalgamated Company.
2. Proportionate depreciation can be claimed on transferred assets.
3. Brought forward business loss and unabsorbed depreciation of amalgamating can be enjoyed by the amalgamated company subject to conditions u/s 72A. Condition u/s 72A.
   A. The amalgamating company has been engaged in the business in which the accumulated loss occurred or depreciation remains unabsorbed for last three years or more.
   B. The amalgamating Company has held continuously as on the date of amalgamation at least 3/4 of the book value of fixed assets held by it two years prior to the date of amalgamation.
   C. The amalgamated company continues the business of the amalgamating company for at least five years etc.
4. Unabsorbed Scientific Research Expenditure as per Sec 35– Can be carried forward.
5. Unamortized Capital expenditure on Telecommunication Licence can be written off by the Amalgamated Company—- (Sec 35 ABB).
6. The deduction under section 35 AD shall continue to be available to the Amalgamated Company for remaining number of years.
7. Amortization of expenditure in case of amalgamation is allowed for 20 percent per annum for next five years (Sec 35DD).
8. Sec 35 DDA —-amortization of VRS Expenditure –The remaining period can be enjoyed by the amalgamated company.
9. Sec 35E Amortization of expenditure on prospecting etc for development of certain minerals – The remaining period can be enjoyed by the amalgamated company.
10. Sec 36(1) (ix) —Capital Expenditure on Family Planning – The remaining period can be enjoyed by the amalgamated company.
11. Sec 10AA-SEZ– The remaining period can be enjoyed by the amalgamated company 12. sec 80 I Deductions— The remaining period can be enjoyed by the amalgamated company.

5.7 Tax Planning for Contraction of Business

A. Contraction of business without business restructuring mechanism: No tax incentives is available.

B. Contraction through business restructuring mechanism: Demerger and Slump sale.

Demerger

It means ,in relation to the companies ,means the transfer ,pursuant to a scheme of arrangement under the companies act, by a demerged company of its one or more undertakings to any resultant company.

TAX INCENTIVES

From the point of view of demerged company

Benefit of deduction u/s 32 AD shall not be withdrawn.

No capital Gain Tax on transfer of Capital Assets to Indian Company.

No capital Gain Tax on transfer of shares held in Indian Company by the demerged Foreign Company to the resulting foreign Company.

From the point of view of Shareholders of Demerged Company

1. Beneficial provision regarding counting of period of holding of new shares.
2. Calculation of cost of shares of the resulting company (Sec 49(2) C). The cost of acquisition of shares of resulting company as a result of demerger shall be:

Cost of acquisition of shares held by the assesse in the demerged Company× Net Book value of assets transferred÷ Net worth of demerged company before demerger.

From the point of view of Shareholders of Demerged Company

3.Calculation of cost of shares held in demerged company(Sec 49(2D) The cost of acquisition of original shares held by the shareholder in the demerged company shall be deemed to have been reduced by the amount as so arrived at under sec 49(2C).

From the point of view of Resultant Company

1. Proportionate depreciation can be claimed on transferred assets.
2. Brought forward business loss and 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 resulting company.
3. Unamortized Capital expenditure on Tele Communication Licence can be written off by the resulting company —- (Sec35-ABB).
4. Amortization of expenditure in case of Demerger is allowed for 20 percent per annum for next five years (Sec 35DD).
5. Sec 35 DDA amortization of VRS Expenditure –The remaining period can be enjoyed by the resultant company.
6. Sec 35E Amortization of expenditure on prospecting etc for development of certain minerals – The remaining period can be enjoyed by the resultant company.
7. Sec 36 (1) (ix) Capital Expenditure on Family Planning – The remaining period can be enjoyed by the resultant company.

5.8 Tax Planning for Indian Collaborators

II. Care should be taken to see that the cost of installation, including the supervision expenses charged by the collaborator, are also capitalized and depreciation claimed thereon.

III. other expenses relating to the collaboration agreement must be incurred after the date of setting up of the business, because only then it would be entitled to be capitalized as other expenses.

- For the purchase of spares for the plant, the Indian collaborator should plan to receive the spares subsequent to the year of commissioning of the plant and preferably execute a separate contract in this behalf.
- It will enable the Indian company to treat the whole of the amount of spares as revenue expenditure.

Treating plans and drawings etc. as Plant for availing full value as depreciation:

- Know how acquired on or after 1.4.1998, owned wholly or partly by the assessee and used by such assessee for the purpose of his business or profession, will form a separate block of the asset along with other intangible assets and will be eligible for depreciation under Section 32(1) @ 25% on written down value.

Simplified Version of Tax Planning with respect to Managerial decisions:

- The survival of a organization depends up on the efficiency of its management.
- Whatever decisions taken by the management directly or indirectly affects all activities of an organization.
- The general considerations which area applicable in the

case of Managerial decisions are

- o Expenses allowed as deduction
- o Year in which it is allowable
- o To what extend it is allowed
- o To what extend it can be carried forward

5.9 Special Cases

a. Shut down or continue operations.
b. Retain, Replacement ,Renewal of Asset.
c. Own or lease.
d. Tax Planning With respect to make or buy.
e. Sale of Assets used for Scientific Research

5.10 Sale of Assets Used for Scientific Research

Selling the asset without using it for business purposes There may be Two Incomes;

a. Business Income—Cost of asset or Selling Price whichever is less is deemed business income u/s 41(3)
b. Long-term Capital gain/loss=Selling Price—-Indexed cost of acquisition or Shot term capital gain or loss

Selling the asset after using it for business purposes Then there will be no deemed business income u/s 41(3).The entire selling price should be the short-term capital gain.

5.11 Make or Buy

- If a new industrial undertaking is established to make the product, the following deductions are to be considered;
  - o Tax holiday-sec 10AA
  - o Deductions U/S I.80 IAC II. 80IBA III. 80ID IV. 80IA V. 80IB VI. 80IC VII. 80IE
- If the product is a consumable one, raw material is required to replace a worn out part at the time of repair, its cost will be treated as revenue expense and deductible in computing the income.

5.12 Tax Benefits

I. Agriculture Income – Section 10(1) of Income Tax Act, 1961.

II. Special provisions in respect of newly established Units in Special Economic Zones u/s 10AA.

III. Tax Deductions for Infrastructure Development Under Section 80IA.

IV. Deductions In Respect Of Profits And Gains By An Undertaking Or Enterprise Engaged In Development Of Special Economic Zone 80IAB.

V. Deductions in respect of profits and gains from certain industrial undertakings other than infrastructure development (80IB).

VI. Tax incentives for new start-ups under Section 80IAC.

VII. Deductions in respect of profits and gains from housing projects [Section 80- IBA].

VIII. Special provisions for specific undertakings or enterprises in certain special category states [Section 80-IC].

IX. Profits and gains from eligible businesses of certain undertakings in the North-Eastern States are exempt from taxation [Section 80-IE].

5.13 Agriculture Income – Section 10(1) of Income Tax Act, 1961

Meaning of Agricultural Income

I. Rent or revenue earned from agricultural land situated in India.

II. Income derived from agricultural land.

III. Income derived from farm building required for agricultural operations.

Income is derived from agricultural land in the following ways:

- Agriculture
  - basic operations and subsequent operations.
- Through the performance of a process by the cultivator or the receiver of rent in kind that results in the agricultural produce being fit to be taken to the market.
- Through sale of such agricultural produce.

Income derived from farm building required for agricultural operations

- The building should be on or in the immediate vicinity of the agricultural land and
- which the receiver of rent or revenue or the cultivator, by reason of his connection with the land, requires the building as a house to stay in or as a storehouse, or uses it for these kinds of situations.

If the above condition is not satisfied, the land should not be located within the following region:

Aerial distance from municipality*	**Population as per last preceding census**

Within 2 kms	10,000 to 1,00,000
Within 6 kms	1,00,000 to 10,00,000
Within 8 kms	> Rs. 10,00,000

Taxation of agricultural income

- Exemption from income tax
- Partial integration of agricultural income with non-agricultural income when
  - Net agricultural income is greater than Rs. 5,000 during the year; and
  - non-agricultural income should be greater than the maximum amount not chargeable to tax
- Taxing the non-agricultural income at higher rates of tax.

5.14 Special Provisions in Respect of Newly Established Units in Special Economic Zones U/S 10AA

Eligible Assesses: All categories of assesses being entrepreneurs, viz., individuals, firms, companies, etc. who derive any profits or gains from an undertaking being a unit engaged in the export of articles or things or providing any service.

Begin to manufacture or produce articles or things or provide any service during the previous year relevant to any assessment year commencing on or after 1.4.2006 but before 1.4.2021 in any Special Economic Zone.

Essential conditions to claim Deduction under Section 10AA:

- It will not be formed by splitting up or reconstruction of a business already in existence.
- Not to be formed by the transfer of machinery or plant, previously used for any purpose, to a new business.
- Chartered accountant's report.

Period for which Deduction is available under Section 10AA:

- Total period of 15 relevant assessment years.
- For the first 5 consecutive assessment years beginning with the assessment year relevant to the previous year in which the unit begins to manufacture such articles or things or provide services: 100%
- Next 5 consecutive assessment years:50%
- Next 5 consecutive assessment years: So much of the amount not exceeding 50% of the profits as is debited to profit and loss account of the previous year in respect of which the deduction is to be allowed and credited to Special Economic Zone Reinvestment Reserve Account to be created and utilised for the purpose of the business of the assesse.

Conditions to be satisfied for claiming deduction for further 5 years (after 10 years) [Section 10AA(2)]

The amount credited to the Special Economic Zone Reinvestment Reserve Account is to be utilised as follows:

- for the purposes of acquiring machinery or plant which is first put to use before the expiry of a period of 3 years following the previous year in which the reserve was created; and
- 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.
- Form No. 56FF

Consequences of mis-utilisation/non-utilisation of reserve [Section 10AA(3)]:

- Deemed to be the profits

5.15 Deduction Allowable in Case of Amalgamation and Demerger [Section 10AA(5)]:

- The deduction shall be allowable in the hands of the resulting or amalgamated company.

5.16 Tax Deductions for Infrastructure Development Under Section 80IA

- Infrastructure resources
- Telecommunication services
- Industrial Parks
- Reconstruction of power plant
- Natural Gas Distribution

Conditions for claiming deduction under section 80IA:

- The owner of the industrial undertaking should be-A single Indian company or a consortium of Indian companies; or
- A board, corporation, authority, or other bodies established as per any State or Central Act.
- A statutory body, local authority, or the government should approve the development of the new infrastructure facility
- Maintenance or operation of such a facility should have commenced after April 1, 1995.

Deduction Amount

- Gains and profits of up to 100%.
- 10 consecutive years in the last 20 years.
- Gains or profits for 10 consecutive years from the last 15 years for airports, ports, inland ports, inland waterways, and navigational channels
- The initial assessment year is the initial year from when the assessee begins claiming a tax deduction.
- The undertaking is not formed by splitting up or reconstruction of an existing unit.
- The undertaking is not formed by the transfer of machinery or plant previously used for any purpose (usage of upto 20% of previously used plant and machinery is allowed).
- Accounts Audit.
- Withdrawal of deductions.

5.17 Deductions In Respect Of Profits and Gains By an Undertaking or Enterprise Engaged in Development of Special Economic Zone 80IAB

Conditions: developer of a Special Economic Zone (SEZ).

a. The gross total income of the taxpayer includes profits and gains derived by an undertaking from any business of developing a special economic zone.

b. Such a special economic zone was notified on or after April 1, 2005, and the development of the special economic zone should begin on or before March 31, 2017.

c. 100% of the profits and gains derived from such business for 10 consecutive assessment years out of 15 years beginning from the year in which a Special Economic Zone has been notified by the Central Government.

Eligible Assesse:

- 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 under the SEZ Act, 2005 on or after April 1, 2005.

Deduction to transferee in case of transfer of operation and maintenance of such SEZ:

- 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.

5.18 Deductions in Respect of Profits and Gains from Certain Industrial Undertakings other than Infrastructure Development 80IB

applicable to assessees, whose gross total income includes any profits and gains derived from any of the following business activities -

An undertaking which begins commercial production of mineral oil or commercial production of natural gas in licensed blocks.

a. The deduction will be allowed at 100% of the profits and gains from such business for 7 consecutive assessment years including the initial assessment year i.e. the assessment year relevant to the previous year in which the undertaking commences the **commercial production of mineral oil.**

An undertaking deriving profits from the business of processing, preservation and packaging of fruits or vegetables or meat and meat products or poultry or marine or dairy products or from the integrated business of handling, storage and transportation of foodgrains.

b. In order to claim deduction, the undertaking should fulfill the following conditions:

   i. It should be deriving profits from the business of processing, preservation and packaging of fruits or vegetables or meat or meat products or poultry or marine or dairy products or from the integrated business of handling, storage and transportation of foodgrains.

   ii. It should begin to operate such business on or after 1.4.2001.

   iii. It should begin operates such business on or after 1.4.2009 in case of an undertaking deriving profit from the business of processing, preservation and packaging of meat or meat products or poultry or marine or dairy products.

   iv. The amount of deduction shall be 100% of the profits and gains derived from such business for 5 assessment years beginning with the initial assessment year i.e. the assessment year relevant to the previous year in which the undertaking begins such business. Thereafter, the deduction allowable is 25%. In the case of a company, the rate of 25% shall be substituted by 30%. The total period of deduction should not exceed 10 consecutive assessment years.

Audit of Accounts

- Audit by CA is necessary and the assese is to send the audit report along with the return of Income

Withdrawal of deduction

- The government may withdraw the deduction in respect of certain undertakings after making enquiry.

5.19 Deductions in Respect of Profits and Gains from Housing Projects [Section 80- IBA]

Quantum of deduction: 100%

Conditions to be fulfilled for claim of deduction:

(a) the project is approved by the competent authority after 1st June, 2016 but on or before***31st March, 2021;***

(b) the project is completed within a period of **five years** from the date of approval by the competent authority:

(c) However, in a case where the approval in respect of a housing project is obtained more than once, the project shall be deemed to have been approved on the date on which the building plant of such housing project was first approved by the competent authority and the project shall be deemed to have been completed when a certificate of completion of project as a whole is obtained in writing from the competent authority.

(d) the carpet area of the shops and other commercial establishments included in the housing project does not exceed 3% of the aggregate carpet area(not applicable for projects approved on or after 1/9/2019);

(e) Size of the plot: Chennai, Delhi, Kolkata or Mumbai-Minimum one thousand meters.Others: Minimum Two thousand square meters

- projects approved on or after 1/9/2019 carpet area of residential unit does not exceed 60 sq m in metro and 90 sq meters in other places.
- No other residential unit in the housing project individual shall be allotted to the individual or the spouse or the minor children of such individual.

No deduction for person executing the housing project as a works contract:

- An assessee who merely executes the housing project as a works-contract awarded by any person (including the Central Government or the State Government) would not be eligible for deduction under this section.

Consequence of non-completion of housing project within 5 years:

- In a case where the housing project is not completed within the period of five years from the date of approval by the competent authority and in respect of which a deduction has been claimed and allowed under this section, the total amount of deduction so claimed and allowed in one or more previous years, shall be deemed to be the income of the assessee chargeable under the head “Profits and gains of business or profession” of the previous year in which the period for completion so expires.

No deduction under any other provision of the Act in respect of such profits

5.20 Deductions in Respect of Profits and Gains from Housing Projects [Section 80- IBA]

- Quantum of deduction: 100%
- Conditions to be fulfilled for claim of deduction
- No deduction for person executing the housing project as a works contract:
- Consequence of non-completion of housing project within 5 years:
- No deduction under any other provision of the Act in respect of such profits

5.21 Special Provisions in Respect of Certain Undertakings or Enterprises in Certain Special Category States [Section 80-IC]

- Applicability

  a. undertakings which manufacture or produce specified article or thing or existing undertakings on their substantial expansion in the states of Himachal Pradesh, Sikkim, North-Eastern States and Uttaranchal.

  i. Between 23rd December 2002 to 1st April 2007 in Sikkim
  ii. Between 7th January 2003 to 1st April 2012 in Himachal Pradesh or Uttaranchal
  iii. Between 24th December 1997 to 1st April 2007 in any North-Eastern states.

- Meaning of "substantial expansion":

  a. increase in the investment in plant and machinery by at least 50% of the book value of the plant and machinery

- Rate of deduction: 100% for the first five assessment years and 25% (30% in the case of a company) for the next five assessment years.

- industrial zones

  Following will be counted as industrial zones :

  - Export Processing Unit
  - Integrated Infrastructure Development Centre
  - Industrial Growth Centre
  - Industrial Estate
  - Industrial park
  - Software Technology Park
  - Industrial Area
  - Theme Park

  The above-mentioned areas have been notified by way of notification.

- No deduction under any other section of Chapter VIA of the Act in respect of such profits:

- the period for which the benefit under section 80IB has already been availed, included.

5.22 Tax Holiday in Respect of Profits and Gains from Eligible Business of Certain Undertakings in North-Eastern States [Section 80-IE]

- Applicability

  a. 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) -

  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

- Quantum of deduction and period.

  a. 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

  b. There is no deduction under any other section of Chapter VIA or section 10AA of the Act in respect of such profits.

- Conditions:

(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.

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 :—
    a. 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;
    b. pan masala as covered under Chapter 21 of the First Schedule to the Central Excise Tariff Act, 1985 (5 of 1986);
    c. 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; and
    d. 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,—
    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.'.

5.23 Tax Incentives for New Start-UpsSection 80IAC

A deduction of 100% of the profits and gains derived by an eligible start-up from an eligible business is allowed for three consecutive assessment years out of ten years beginning from the year in which the eligible start up is incorporated.

Eligible Assesse

1. Company

2. LLP.

Meaning of eligible start-up

- Incorporated during the period 1.4.2016-31.3.2021
- Total turnover ≤ 100 crores in the P.Y. relevant to the A.Y. for which deduction is claimed
- Holds a certificate of eligible business from the notified IMBC

Conditions to be fulfilled

i. The undertaking is not formed by the splitting up or reconstruction of an existing unit.

ii. The undertaking is not formed by the transfer of machinery or plant previously used for any purpose(usage of up to 20% of previously used plant and machinery is allowed).

ii. Audit of Accounts

Audit by CA is necessary and the assesse is to send the audit report along with the return of Income.

Withdrawal of deduction

The government may withdraw the deduction in respect of certain undertakings after making an enquiry.

5.24 Tax Planning for Tea, Coffee or Rubber Industry

- Rules 7, 7A, 7B and 8 of Income Tax Rules, 1962
- Income from Growing and Manufacturing of any product other than Tea [Rule 7]
- Income from Growing and Manufacturing of Rubber [Rule 7A]
- Income from Growing and Manufacturing of Coffee [Rule 7B]
- Income from Growing and Manufacturing of Tea [Rule 8]

Corp	Rule	Agricultural Income	Business Income
Growing and Manufacture of Tea	8	60%	40%
Rubber manufacturing business	7A	65%	35%
Coffee grown and cured by seller	7B(1)	75%	25%

Coffee grown, cured, roasted and grounded by the seller in India with or without mixing chicory or other flavouring ingredients	7B(1A)	60%	40%

Other Applicable tax benefits:

- Tea board subsidy [Section 10(30)]: Exempted
- Amount received as subsidy from or through the concerned Board [Section 10(31)]:Exempted
- Section 33AB Tea, Coffee & Rubber Development Account

Section 33AB Tea, Coffee & Rubber Development Account:

- An amount deposited into 'Deposit Account' or 'Special Account' for utilization of the same for the specified purpose is allowed as a **deduction under section 33AB**.
- Carrying on business in India of growing and manufacturing tea, coffee or rubber.

The time period of deposit of amount for claiming **deduction under section 33AB–**

- The amount is to be deposited within earlier of the following dates-
- Before the completion of six months from the end of the previous year; or
- Before the due date of filing of the income tax return.

Quantum of deduction

- Lower of the following amount is allowed as a **deduction under section 33AB–**
    - The amount deposited; or
    - 40% of the profit computed under the head '**Profits and gains of business or profession**'.

Withdrawal of amount

- The amount deposited in a special account or deposit account can be withdrawn under the following circumstances only-
- For the purposes as specified in the scheme,
- On the closure of the business,
- On the death of the assesse,
- On dissolution of the firm or liquidation of the company,
- On the partition of the **Hindu Undivided Family**.

Deemed income

- Circumstances under which the withdrawal will be deemed to be income and taxed accordingly-
- Under the following cases, any amount withdrawn from the deposit/ special account will be charged to income tax under the head 'Profits and gains of business or profession'
- When the amount standing to the credit in a deposit account or special account is utilized for the purchase of-
    - Plant/ machinery which is to be installed in office premises or residential accommodation (including guest house),

- Office appliances (other than computers).
- Plant/ machinery, wherein, the actual cost is allowed as a deduction under 'Profit and gains of business or profession'.
- Plant/ machinery which is to be installed in an industrial undertaking for the purpose of the business of manufacture, construction or production of any article/ thing specified in the eleventh schedule.

- When the amount is withdrawn either on the closure of the business or dissolution of the firm.
- When the amount is withdrawn for an approved specified purpose. However, the whole or part of the amount is not utilized within the end of the relevant previous year.
- When the asset acquired as per the scheme is sold/ transferred before the expiry of eight years from the end of the previous year in which the asset was acquired. However, sale/ transfer in the following circumstances are exempted-
  - The asset is sold/ transferred to Government or a local authority or a corporation or a Government company; or
  - Sale/ transfer on account of the succession of a firm by a company. Wherein, the applicability of scheme continues with the company.

Accounts to be audited

The assesse is required to submit the report of audited accounts in Form No. 3AC.

Tax planning for Hospitals Sec. 35AD

As per provisions of section 35AD, the deduction is available towards any capital expenditure, wholly and exclusively, incurred for carrying on a specified business.

Conditions for claiming deduction under section 35AD-

- The specified business should not have been set up by splitting up/ reconstruction of the already existing business.
- Commenced after 31/3/2010.
- Capital expenditure incurred prior to commencement of the specified business.
- Capitalised in books of account.
- not available towards expenditure incurred for acquisition of any land or financial instrument or goodwill.
- Accounts to be audited.

Sale or Transfer of asset not allowed within 8 years

- The asset against which deduction is claimed under section 35AD should be used exclusively for the specified business for a period of eight years starting from the previous year in which the asset is acquired.
- If the asset is not so used for such period, deduction allowed as reduced by depreciation allowable u/s 32 shall be deemed to be the business income for the year in which asset sold or transferred.

Carry forward and set-off provisions

Unabsorbed loss to be carried forward and set-off against income of such hospital or any other specified business.

Conditions

It has during the period beginning on 1.4.2007 and ending before 1.4.2017 begun or begins in any of the North-Eastern States:

1. It is not formed by splitting up, or the reconstruction, of a business already in existence
2. It is not formed by the transfer to a new business of machinery or plant(exceeding 20%) previously used for any purpose.

Tax Planning for Hotels

- Quantum of deduction: 100% of profits and gains derived from such business for 10 consecutive years.

Deduction regarding Capital expenditure

- Assessee commences the operations of the said hotel on or after 1st April, 2010, deduction available in respect of capital expenditure incurred.
- The specified business should not have been set up by splitting up/ reconstruction of the already existing business.
- Commenced after 31/3/2010.
- Capital expenditure incurred prior to commencement of the specified business.
- Capitalised in books of account.
- not available towards expenditure incurred for acquisition of any land or financial instrument or goodwill.
- Accounts to be audited.

Carry forward and set-off provisions

- Unabsorbed loss to be carried forward and set-off against income of such hospital or any other specified business.

Audit

- Audit report needs to be submitted in Form No. 10CCBBA
- Moreover, income tax return needs to be filed on time as per section 139(1).
- No deduction shall be allowed under any other section contained in Chapter VIA or section 10AA.

Sale or Transfer of asset not allowed within 8 years

- The asset against which deduction is claimed under section 35AD should be used exclusively for the specified business for a period of eight years starting from the previous year in which the asset is acquired.
- If the asset is not so used for such period, deduction allowed as reduced by depreciation allowable u/s 32 shall be deemed to be the business income for the year in which asset sold or transferred.

5.25 Tax Planning for the Business of Generation or Generation and Distribution of Power

A. Depreciation(section 32): Actual cost basis instead of Written down value.

- Additional depreciation@ 20% on actual cost.

Essential Conditions of undertaking which is engaged in Generation, Transmission, Distribution of Power, etc. [Section 80-IA(4)(iv)]

- It is an undertaking which:—
- is set up in any part of India for the generation or generation and distribution of power if it begins to generate power at any time during the period beginning on 1.4.1993 and ending on 31.3.2017;
- starts transmission or distribution by laying a network of new transmission or distribution lines at any time during the period beginning on 1.4.1999 and ending on 31.3.2017.

Other Conditions for Undertaking referred to in clause (B) above [Section 80-IA(3)]

- Such undertaking should not be formed by splitting up, or the reconstruction, of a business already in existence.

- However, this condition shall not apply to an undertaking which is formed as a result of the re-establishment or revival of an undertaking, in circumstances specified u/s 33B.
- It should not be formed by the transfer to a new business of machinery or plant previously used for any purpose.
- However, plant and machinery, already used for any purpose, can be transferred to the new industrial undertaking, provided value of such plant and machinery does not exceed 20% of the total value of plant and machinery of the new industrial undertaking. It may be noted that it is not essential that the building in which the undertaking carries on the business should also be new.
- Deduction u/s 80-IA will be available even if the industrial undertaking is set up in an old building.

Amount and Period of Deduction under Section [Section 80-IA(4)(iv)]

- 100% of profits and gains derived from such business for 10 consecutive assessment years out of 15 years beginning with the year in which undertaking or the enterprise develops and begins to operate any infrastructure facility or generates power or commences transmission or distribution of power or undertakes substantial renovation or modernisation.

5.26 Tax planning for Business of Natural Gas

- The assessee carrying on the business of prospecting, extraction or production of petroleum or natural gas in India and depositing the amount in 'Special account' or 'Site Restoration account' is eligible to claim deduction under section 33ABA of the Income Tax Act.

Conditions for claiming deduction under section 33ABA of the Income Tax Act–

In order to claim **deduction under section 33ABA**, the assessee needs to satisfy the following list of conditions-

1. The assessee should be engaged in carrying on any of the following business-
   a. Prospecting for petroleum or natural gas in India; or
   b. Extraction of petroleum or natural gas in India; or
   c. Production of petroleum or natural gas in India.
2. The assesse engaged in carrying on any of the above business should deposit an amount into any of the following accounts-
   a. A special account maintained with the State Bank of India; or
   b. Site Restoration Account.
3. The amount should be deposited before the end of the respective previous year.
4. The amount deposited in the account can be withdrawn only for the specified purposes.

Amount of deduction available under section 33ABA–

Lower of the following amount is available as a **deduction under section 33ABA–**

- The amount deposited under 'special account' and/ or 'site restoration account'; or
- 20% of the profit (before deduction) chargeable under the head 'Profits and gains of business or profession'.

5. Withdrawal amount taxable under the head 'Profits and gains of business or profession'-

Under the following circumstances, the amount withdrawn or not utilized will be deemed to be profits and gains of business or profession and taxed accordingly-

1. The amount withdrawn is utilized for purchase of the following-
   a. Installation of plant or machinery in office premises or residential accommodation (including accommodation in the nature of guest house),
   b. Office appliances (excluding computers),

   c. Installation of plant or machinery, wherein, the entire amount is allowed as a deduction under the head 'Profits and gains of business or profession'.
   d. Installation of new plant or machinery in an industrial undertaking for the purposes of the business of construction or manufacture or production of article/ thing as specified in the Eleventh Schedule.
2. The amount withdrawn on the closure of the account. However, the amount payable, if any, to the Government in the form of profit or production share will not be included here.
3. The amount withdrawn but not utilized (wholly or partly), within the respective previous year, for the specified purpose.
4. The amount is utilized for the acquisition of an asset. However, the said asset is sold/ transferred before the expiry of eight years from the end of the previous year in which the asset was acquired. An exception to the same are-
   a. Cases, wherein, the asset is sold/ transferred to Government, a Government Company, a local authority or a corporation; or
   b. Cases, wherein, the asset is sold/ transferred during the succession of a firm by a company and the deposit account continues to apply to the company.

Some important notable points related to Withdrawal amount taxable under the head 'Profits and gains of business or profession'-deduction under section 33ABA

- interest credited in the 'special account' or 'site restoration account' available as a **deduction under section 33ABA**.
- books of accounts to be audited from the practising chartered accountant.
- When the amount is withdrawn and utilized for specified expenditure. Notably, such expenditure will not be allowed while calculating the income under the head 'Profits and gains of business or profession'.

5.27 Tax planning for Eligible Business

Eligible assessee engaged in eligible business.

income shall be computed at the rate of 6% instead of 8% if turnover/gross receipt is received by an account payee cheque or an account payee bank draft or use of electronic clearing system through a bank account or through such other electronic mode as may be prescribed during the previous year or before the due date of filing of return under section 139(1).

Eligible Assesse

- the benefit of section 44ADA is eligible only in case of assesse who is an:

a) Individual; and

b) Partnership firm other than a Limited Liability Partnership as defined under clause (n) of sub-section (1) of section 2 of Limited Liability Partnership Act, 2008.

Businesses not covered under the presumptive taxation scheme of section 44AD

- The scheme of section 44AD is designed to give relief to small taxpayers engaged in any business, except the following businesses:
- Business of plying, hiring or leasing of goods carriages referred to in section 44AE.
- A person who is carrying on any agency business.
- A person who is earning income in the nature of commission or brokerage.

Depreciation

- separate deduction on account of depreciation is not available.
- written down value of any asset used in such business shall be calculated as if depreciation as per section 32 is claimed and has been actually allowed.

Consequences if a person opts out from the presumptive taxation scheme of section 44AD

- If a person opts for presumptive taxation scheme then he is also require to follow the same scheme for next 5 years. If he failed to do so, then presumptive taxation scheme will not be available for him for next 5 years.

Maintenance of books of accounts

- Further, he is required to keep and maintain books of account and he is also liable for tax audit as per section 44AB from the AY in which he opts out from the presumptive taxation scheme.

Provisions of section 44Ad not applicable to:

- A person who is earning income in the nature of commission or brokerage.
- A person engaged in a profession as prescribed under section 44AA(1).
- A person who is carrying on any agency business.

Example

Gross Receipts from business	2,40,00,000
Assumed Income u/s 44AD=8%	19,20,000
WDV of P&M on 31/3/2020	20,00,000
Deemed Depreciation@15%	3,00,000
WDV of P&M on 1/4/2021	17,00,000

Example

Sale by ECS	1,00,00,000	Presumed Income=6% of sale	6,00,000

other sale	80,00,000	Persumed Income=8% of sale	6,40,000

5.28 Tax Planning for Business of Plying, Hiring or Leasing Goods Carriages

Assessee should not more than 10 goods carriages in any case at any time during the previous year for availing the benefit of this section.

Computation of profit

If assesse owns a "heavy good vehicle"*: The profit shall be an amount equal to Rs. 1000 per ton of gross vehicle weight or unladen weight, as the case may be, for every month or part of a month during which the heavy goods vehicle is owned by the assesse in the previous year

or

an amount claimed to have been actually earned from such vehicle,

whichever is higher.

- **If assesse owns a "light good vehicle":** The profit shall be an amount equal to Rs. 7500 for every month or part of a month during which the heavy goods vehicle is owned by the assesse in the previous year

  or

- an amount claimed to have been actually earned from such vehicle,
- **whichever is higher.**

Condition

- the assessee should not more than 10 goods carriages in any case at any time during the previous year for availing the benefit of this section.
- The expression "heavy goods vehicle" means any goods carriage, the gross vehicle weight of which exceeds 12 tons.

Some other provisions of this section:

- No deduction for depreciation
- no deduction shall be granted.
- **However, where the assessee is a partnership firm, the remuneration or interest paid to partners can be claimed as a deduction under section 40(b).**
- Not required to maintain books of accounts u/s 44AA
- Not required to get the accounts audited u/s 44AB
- Scheme is optional

Example

8 light goods vehicles(2 purchased on 20/1/2021)	
Deemed income of LGV@7500 p.m.=6*7500*12	5,40,000
Deemed income of LGV@7500 p.m.=2*7500*3	45,000
Buisness Income of the firm	5,85,000

Example

Purchased on 23/4/2020	Date of Plying 2/6/2020	
HGV	2(Gross weight 17 tons each vehicle)	
LGV	6	
Does not own more than 10 goods carriages		
Does not maintain proper books of accounts applicable		
Section 44AE		
Income		
LGV	6*7500*12	40000
HGV	2*1000*17*12	08000
Income u/s Section 44AE		48000

Example

Actual receipts	80 Lakhs				

Section 44AD Presumed income(8%)	6.4Lakhs	Tax	42,120	Net Income	6.4Lakhs-42,120
Income if books of accounts maintained(after deducting books maintenace expenses)=5.6lakhs-.30Lakhs	5.3lakhs	Tax	19,240	Net Income	5.3lakhs-19,240
He should assess his income u/S 44AD					

5.29 Tax Planning for Shipping Companies

Qualifying Company – Section 115VC:

(a) it is an Indian company;

(b) the place of effective management of the company is in India;

(c) its own at least one qualifying ship; and

(d) the main object of the company is to carry on the business of operating ships.

Qualifying Ships- Section 115VD:

(1) Sea going ship/vessel of Net tonnage Equal or more than 15 .

(2) Ship registered under Merchant shipping Act or Licensed obtained from DGS.

Exclusion from the definition of Qualifying Ships-

(1) a sea going ship or vessel if the main purpose for which it is used is the provisions of goods or services of a kind normally provided on land;

(2) fishing vessel;

(3) factory Ship- the ship providing processing services in respect of fishing produce;

(4) pleasure craft- the ship whose primary use is for the purpose of sport and recreation;

(5) harbour and river ferries;

(6) offshore installations;

(7) a qualifying ship used as a fishing vessel for a period of more than thirty days during a previous year.

Option

A company may opt for the scheme by making application to Joint Commissioner (in form no. 65) within three months of the date of its incorporation or the date on which it becomes a qualifying company.

Once option exercised, lock in period of 10 years.

If opted out, debarred for 10 years from re entry.

Maintenance of accounts and audit

- The business of operating ships is considered to be separate business and separate books are to be maintained.
- Audited by CA, report to be furnished electronically.

Calculation of deemed income

- The tonnage income of each qualifying ship shall be the daily tonnage income of each such qualifying ship multiply by-

(a) the number of the day in previous year; or

(b) the number of days in part of the previous year in case the ship is operated by the company as a qualifying ship for only part of the previous year, as the case may be.

- The tonnage shall be rounded off to the nearest multiple of hundred tons and for this purpose any tonnage consisting of kilograms shall be ignored.
- Notwithstanding anything contained in any other provision of this Act, no deduction or set off shall be allowed in computing the tonnage income under this chapter.

Tonnage income

Qualifying ship having Net tonnage	**Amount of daily tonnage Income**
(1)	(2)
Upto 1,000	Rs. 70 for each 100 tons
Exceeding 1,000 but not more than 10,000	Rs. 700 plus Rs. 53 for each 100 tons exceeding 1,000 tons
Exceeding 10,000 but not more than 25000	Rs. 5,470 plus Rs. 42 for each 100 tons exceeding 10,000 tons
Exceeding 25,000 tons	Rs. 11,770 plus Rs. 29 for each 100 tons exceeding 25,000 tons.

General Exclusion of Deduction and Set off, ETC- Section 115 VL:

- Notwithstanding anything contained in any other provision of this Act, in computing the tonnage income of tonnage tax company for any previous year (Relevant previous year) in which it is chargeable to tax in accordance with this chapter –
- (i) section 30 to 43B shall apply as if every loss, allowance or deduction referred to therein and relating to or allowable for any of the relevant previous year, had been given full effect to for that previous year itself;
- (ii) no loss referred to in **section 70 or section 71 or section 72** or section 72A, in so far as such loss relates to the business of operating qualifying ships of the company, shall be carried forwarded or set off where such loss relates to any of the previous years when the company under the tonnage tax scheme;
- (iii) no deduction shall be allowed under Chapter VI-A in relation to the profit and gain from the business of operating qualifying ship; and
- (iv) in computing the depreciation allowances under section 32, the written down value of any assets used for the purpose of the tonnage tax business shall be computed as if the company has claimed and has been actually allowed the deduction in respect of depreciation for the relevant previous years.
- **Period for which tonnage tax option remain in force – Section 115VQ:**

    (i) An option for tonnage tax scheme, after it has been approved shall remain in force for a period of ten years from the date on which such option has been exercised and shall be taken into account from the assessment year relevant to the previous year in which such option is exercised.

    (ii) An option for tonnage scheme shall cease to have effect from the assessment year relevant to the previous year in which-

    (a) the qualifying company cease to be qualifying company;

    (b) a default is made in complying with the provision regarding transfer of profit to Tonnage Tax Reserve Account and minimum training requirement for tonnage company;

    (c) the qualifying company furnishes to the Assessing officer, a declaration in writing to the effect that the provision of this chapter may not be applicable to it;

    (d) the tonnage tax company is excluded from the tonnage tax scheme under section 115VZC.

- **Period for which tonnage tax option remain in force – Section 115VQ:**
- An amount not less than 20%(percent) of the book profit derived from the business of qualifying ships shall be credited to the Tonnage Tax Reserve Account.
- Further, please note that, the amount credited to the Tonnage Tax Reserve Account shall be utilised by the company before the expiry of a period of eight years next following the previous year in which the amount was credited—

Example 7

	Ship I	Ship II
Net tonnage	26744	15755
Rounded off	26700	15800
Run for days	360	155
Deemed Income		

First 1000 tons(70 for each 100 tonnes)	700	700
Next 9000(53 for each 100tones exceeding 1000)=53*90	4770	4770
Next 15000(42*150)	6300	
5800(42*58)		2436
Next 1700ton(29*17)	493	
Daily Tonnage Income	12263	8326
Days used	360	155
Deemed income	4414680	1290530

Summary

Tax breaks are typically implemented to encourage companies to invest in sectors that are critical to the nation's economic development. Any company engaging in such specified business would be eligible for a tax holiday or deduction on earnings earned from such operation for a specified period of time. However, it is crucial to note that many of the earlier incentives are now being phased out.Some of the companies that will gain from this are those engaged in creating, maintaining, and managing infrastructure facilities, performing scientific and industrial research and development, and so on.

Keywords

- 'Initial Assessment Year' for the purpose of Section 80IA Initial assessment year, for this purpose, means the assessment year specified by the assessee at his option to be the initial year. But it should not fall beyond the fifteenth* of assessment year starting from the previous year in which the enterprise begins operating and maintaining the infrastructure facility.

  Section 80-IA(4)(iv)]"Substantial renovation and modernisation": shall mean an increase of plant and machinery by atleast 50% of the book value of such plant and machinery as on 1.4.2004.

- Composite income: comprising of agricultural income and non-agricultural income. The income attributable to agricultural operations (i.e., raising of sugarcane) is agricultural income and the income attributable to industrial operations (i.e., manufacturing sugar from sugarcane) is non-agricultural income.

  Eligible start-up: Incorporated during the period 1.4.2016-31.3.2021, Total turnover ≤ 100 crores in the P.Y. relevant to the A.Y. for which deduction is claimed and Holds a certificate of eligible business from the notified IMBC

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Self Assessment

1. Which of the following statements is wrong in regard to Tax Planning for Indian collaborators?

A. Care should be taken to see that the cost of installation, including the supervision expenses charged by the collaborator, are not capitalized and depreciation not claimed thereon.

B. other expenses relating to the collaboration agreement must be incurred after the date of setting up of the business, because only then it would be entitled to be capitalized as other expenses.

C. For the purchase of spares for the plant, the Indian collaborator should plan to receive the spares subsequent to the year of commissioning of the plant and preferably execute a separate contract in this behalf.

D. Know how acquired on or after 1.4.1998, owned wholly or partly by the assessee and used by such assessee for the purpose of his business or profession, will form a separate block of the asset along with other intangible assets and will be eligible for depreciation under Section 32(1) @ 25% on written down value.

2. Deductions In Respect Of Profits And Gains By An Undertaking Or Enterprise Engaged In Development Of Special Economic Zone is covered under which section?

A. 80IAB

B. 80IAC

C. 80IAD

D. 80IAE

3. Which of the following statement is true about Tax Deductions for Infrastructure Development Under Section 80IAB?

a. 100% of the profits and gains derived from such business for 10 consecutive assessment years out of 15 years beginning from the year in which a Special Economic Zone has been notified by the Central Government.

b. 100% of the profits and gains derived from such business for 10 consecutive assessment years out of 20 years beginning from the year in which a Special Economic Zone has been notified by the Central Government.

c. 100% of the profits and gains derived from such business for 10 consecutive assessment years out of 25 years beginning from the year in which a Special Economic Zone has been notified by the Central Government.

d. 100% of the profits and gains derived from such business for 10 consecutive assessment years out of 30 years beginning from the year in which a Special Economic Zone has been notified by the Central Government.

4. Which of the following is wrong about Deductions in respect of profits and gains from housing projects [Section 80- IBA]?

A. Quantum of deduction: 100%

B. Quantum of deduction: 150%

C. Quantum of deduction: 200%

D. Quantum of deduction: 300%

5. Which of the following is not a Qualifying Ships under Section 115VD:?
A. Sea going ship/vessel of Net tonnage Equal or more than 20 .
B. Sea going ship/vessel of Net tonnage Equal or more than 15 .
C. Sea going ship/vessel of Net tonnage Equal or more than 25 .
D. Sea going ship/vessel of Net tonnage Equal or more than 35 .

6. Which of the following statement is wrong about Tax Deductions in respect of profits and gains from certain industrial undertakings other than infrastructure development 80IB?
A. The deduction will be allowed at 50% of the profits and gains from such business for 7 consecutive assessment years including the initial assessment year i.e. the assessment year relevant to the previous year in which the undertaking commences the commercial production of mineral oil.
B. The deduction will be allowed at 70% of the profits and gains from such business for 7 consecutive assessment years including the initial assessment year i.e. the assessment year relevant to the previous year in which the undertaking commences the commercial production of mineral oil.
C. The deduction will be allowed at 80% of the profits and gains from such business for 7 consecutive assessment years including the initial assessment year i.e. the assessment year relevant to the previous year in which the undertaking commences the commercial production of mineral oil.
D. The deduction will be allowed at 100% of the profits and gains from such business for 7 consecutive assessment years including the initial assessment year i.e. the assessment year relevant to the previous year in which the undertaking commences the commercial production of mineral oil.

7. Which of the following statement is wrong about Tax Deductions for Infrastructure Development Under Section 80IA which is available for
A. The owner of the industrial undertaking should be-A single Indian company or a consortium of Indian companies; orA board, corporation, authority, or other bodies established as per any State or Central Act.
B. A statutory body, local authority, or the government should approve the development of the new infrastructure facility
C. Maintenance or operation of such a facility should have commenced after April 1, 2010.
D. Deduction Amount is Gains and profits of up to 100%.

8. Tax Deductions for Infrastructure Development Under Section 80IA is not available for
A. Infrastructure resources
B. Industrial Parks
C. Reconstruction of power plant
D. Artificial Gas distribution

9. Partial integration of agricultural income with non-agricultural income is done when net agricultural income is greater than Rs. _________ during the year:

A. 4000
B. 5000
C. 10000
D. 15000

10. Deduction under Section 10AA is available for

A. Total period of 15 relevant assessment years.
B. Total period of20 relevant assessment years.
C. Total period of 25 relevant assessment years.
D. Total period of 15 relevant assessment years.

11. Which of the following is wrong about newly established Units in Special Economic Zones u/s 10AA?

A. Eligible Assesses are all categories of assesses being entrepreneurs, viz., individuals, firms, companies, etc. who derive any profits or gains from an undertaking being a unit engaged in the export of articles or things or providing any service.
B. Begin to manufacture or produce articles or things or provide any service during the previous year relevant to any assessment year commencing on or after 1.4.2006 but before 1.4.2021 in any area.
C. not be formed by splitting up or reconstruction of a business already in existence.
D. Not to be formed by the transfer of machinery or plant, previously used for any purpose, to a new business.

12. Which of the following is wrong about the meaning of agricultural income?

A. Rent or revenue earned from agricultural land outside India.
B. Income derived from agricultural land from basic operations and subsequent operations.
C. Income derived from farm building required for agricultural operations.
D. Income is derived from agricultural through the performance of a process by the cultivator or the receiver

13. Which of the following statements is wrong about Agricultural Income?

A. Partial integration of agricultural income with non-agricultural income when Net agricultural income is greater than Rs. 5,000 during the year; andnon-agricultural income should be greater than the maximum amount not chargeable to tax
B. the non-agricultural income at higher rates of tax.
C. Agricultural income not exempted from income tax
D. Income is derived from agricultural land by basic operations and subsequent operations.

14. Which of the following statements is wrong about Make or Buy decisions?

A. If a new industrial undertaking is established to make the product, then Tax holiday-sec 10AA to be considered.

B. If a new industrial undertaking is established to make the product, then Deductions U/S I.80 IAC II. 80IBA III. 80ID IV. 80IA V. 80IB VI. 80IC VII. 80IE can be considered.

C. If the product is a consumable one, raw material is required to replace a worn-out part at the time of repair, its cost will be treated as a revenue expense and deductible in computing the income.

D. If the product is a consumable one, raw material is required to replace a worn-out part at the time of repair, its cost will be treated as a capital expense and is not deductible in computing the income.

15. Which of the following statements is wrong about the Sale of Assets used for Scientific Research?

A. In case of selling the asset without using it for business purposes, the cost of asset or Selling Price whichever is less is deemed business income u/s 41(3)

B. In case of selling the asset without using it for business purposes, long- Shot term capital gain or loss.

C. In case of selling the asset after using it for business purposes, then there will be no deemed business income u/s 41(3).

D. In case of selling the asset after using it for business purposes, the entire selling price should be the long-term capital gain.

Answers for Self Assessment

1.	A	2.	A	3.	A	4.	A	5.	B
6.	D	7.	C	8.	D	9.	B	10.	A
11.	B	12.	A	13.	C	14.	D	15.	D

Review Questions

1. Compare the different locational aspects from a tax liability point of view.
2. Compare the different naturesof businesses from a tax liability point of view.
3. Explain tax planning forbusiness of plying, hiring, or leasing goods carriages.
4. What is meant by the term acceptance? Explain the legal rules of a valid acceptance?
5. Write a note on Tax incentives for new start-ups Section 80IAC

Further Readings

- https://www.icsi.edu/media/webmodules/16112021_Advance_Tax_Laws.pdf
- A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. Goyal. Sahitya Bhawan Publications
- Study Material on Direct Tax Laws and International Taxation by ICAI
- Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta
- www.incometaxindia.gov.in

Dr. Rupinder Katoch, Lovely Professional University

Unit 06: Tax Planning with Regard to Financial Management Decisions

CONTENTS

Objectives

After studying this unit, you will be able to:

- understand tax planning relating to capital structure decisions,
- understand Tax treatment of dividend received from company,
- understand tax treatment and planning aspects of Bonus Issue,
- understand the circumstances wherein capital gains arising from the transfer of certain capital assets are exempt from tax.

Introduction

- Capital structure decisions also play an important role in tax planning.
- The mixture of debt and equity funds should be balanced to maximize the return on capital and minimize the tax liability.
- Interest on debt is allowed as a deduction, whereas dividends on equity funds are not allowed as a deduction.

6.1 Optimum Capital Structure

A capital structure is said to be optimum when it has a mix of debt and equity that will yield the lowest possible weighted average cost of capital to the company or gets maximum return on equity share capital.

At the same time, the capital mix should not have a high debt equity ratio.

Factors affecting optimum capital structure

- Cost of Capital.
- Expectation of shareholders.

- Expansion need of the business.
- Taxation policy.
- Rate of return on investment.

Tax Consideration

- Tax deductibility of Interest on debt fund.
- Dividend on equity fund is the appropriation of profit.
- Tax deductibility of Interest on debt fund may increase the rate of return on owner's equity.
- The Cost raising owner's fund is treated as capital expenditure therefore not allowed as deduction. However, if conditions of Sec. 35D is satisfied then specified expenditures can be amortized.
- The Cost of raising debt fund is treated as revenue expenditure. It can be claimed as deduction in computing the total income.
- Where the assesses is entitled to incentives u/s 10A etc. maximum equity fund should be utilized
- Where interest on debt fund is payable outside India, tax should be deducted at source otherwise deduction is not allowed.

Miller and Modigliani Approach

- Miller and Modigliani assume that in a perfect market, firms will borrow at the same interest rate as individuals, there are no taxes, and that investment decisions are not changed by financing decisions. This leads to the conclusion that the capital structure should not affect value.
- When the theory is extended to include taxes and risky debt, things change. Under a classical tax system, the tax deductibility of interest makes debt financing valuable; that is, the cost of capital decreases as the proportion of debt in the capital structure increases. The optimal structure, then, would be to have virtually no equity at all.

Tax Planning

- If the return on investment > the rate of interest, maximum debt funds may be used.
- If the rate of return on investment < the rate of interest, minimum debt funds should be used.
- Where an assesse enjoys tax holidays under various provisions of the Income-Tax, in such a case, a minimum debt fund should be used.
    - For non depreciable assets: Equity Preference
    - Depreciable Assets: Borrowed Capital Preferred
- Gestation Period
    - longer: Equity Preference
    - (Interest will be paid out of capital. C/F of interest payment as business loss which might not be set off within 8 years)
- TDS if interest paid out of India.

Example1

Particulars	Option A	Option B	Option C
Equity Share Capital	2400000	1200000	800000
Loan from Bank@12%	0	600000	800000
Debentures issued@14%	0	600000	800000

Total investment	2400000	2400000	2400000
EBIT(@ 18 % of capital employed)	432000	432000	432000
Less: Interest on loan@ 12%		72000	96000
Less: Interest on debentures@14%		84000	112000
EBT	432000	276000	224000
Tax@26% including cess	112320	71760	58240
PAT	319680	204240	165760
Rate of Return	0.1332	0.1702	0.2072

- DECISION-As the return on equity employed is highest (20.72%) in Option C, i.e. Rs. 800000 from each source, namely, equity, debentures, and loan from the bank, it is the best alternative and the company should go for it.

Example 2

IF RETURN ON CAPITAL EMPLOYED IS 12%?

Particulars	Option A	Option B	Option C
Equity Share Capital	2400000	1200000	800000
Loan from Bank@12%	0	600000	800000
Debentures issued@14%	0	600000	800000
Total investment	2400000	2400000	2400000
EBIT(@ 12 % of capital employed)	288000	288000	288000
Less: Interest on loan@ 12%		72000	96000
Less: Interest on debentures@14%		84000	112000
EBT	288000	132000	80000
Tax@26% including cess	74880	34320	20800
PAT	213120	97680	59200
Rate of Return	0.0888	0.0814	0.074

- DECISION:-As the return on equity employed is highest (8.81%) in Option A, i.e., the entire Rs.2400000 raised from the issue of equity shares, it is the best alternative and the company should go for it.

Example 3

- Existing Equity Share Capital 1 crore
- Further Expansion needs 50 lakhs
- Options to raise further money:

  a) Fully through Equity Share Capital
  b) Fully Through 10% debentures

- Rate of Return:20%
- Income tax :26% including taxes

Solution

Particulars	Issue of shares	Issue of debentures
Return@20% on 1.5 cr	3000000	3000000
less: int on deb		500000
PBT	3000000	2500000
Tax	780000	650000
PAT	2220000	1850000
Rate of return	0.148	0.185

Example 4

Particulars	Option A	Option B	Option C
Equity Share Capital	**10000000**	**4000000**	**2000000**
10% debentures	**0**	**4000000**	**3000000**
Loans from FI@12%	**0**	**2000000**	**5000000**
Total investment	**10000000**	**10000000**	**10000000**
EBIT(@ 25 % of capital employed)	**2500000**	**2500000**	**2500000**
Less: Interest on debentures@10%		**400000**	**300000**
Less: interest on Loan@12%		**240000**	**600000**
EBT	**2500000**	**1860000**	**1600000**
Tax@25%	**625000**	**465000**	**400000**
Add:surcharge@7%	**43750**	**32550**	**28000**
Total Tax including surcharge	**668750**	**497550**	**428000**
Add:Health and eductaion cess@ 4%	**26750**	**19902**	**17120**
Profit available for equity shareholders	**1804500**	**1342548**	**1154880**
Rate of Return	**0.18045**	**0.335637**	**0.57744**

Example 5

Three companies Raised capital as follows

Particulars	Compnay 1	Compnay 2	Company 3
Capital	200000	160000	40000
Loans(10%)		40000	160000
Total Capital Employed	200000	200000	200000
Rate of Return	(25%,10%,8%)		
Tax	26% including cess		

Solution

Rate of Return=25%			
Particulars	Company 1	Compnay 2	Company 3
Return	50000	50000	50000

Less: Interest on loans@10%		**4000**	**16000**
PBT	**50000**	**46000**	**34000**
Less: Tax@ 26%	**13000**	**11960**	**8840**
PAT	**37000**	**34040**	**25160**
Rate of Return	**0.185**	**0.21275**	**0.629**

Rate of Return=10%			
Return	**20000**	**20000**	**20000**
Less: Interest on loans@10%		**4000**	**16000**
PBT	**20000**	**16000**	**4000**
Less: Tax@ 26%	**5200**	**4160**	**1040**
PAT	**14800**	**11840**	**2960**
Rate of Return	**0.074**	**0.074**	**0.074**

Rate of Return=8%			
Return	**16000**	**16000**	**16000**
Less: Interest on loans@10%		**4000**	**16000**
PBT	**16000**	**12000**	**0**
Less: Tax@ 26%	**4160**	**3120**	**0**
PAT	**11840**	**8880**	**0**
Rate of Return	**0.0592**	**0.0555**	**0**
Rate of Return=8%			
Return	**16000**	**16000**	**16000**
Less: Interest on loans@10%		**4000**	**16000**
PBT	**16000**	**12000**	**0**

Less: Tax@ 26%	**4160**	**3120**	**0**
PAT	**11840**	**8880**	**0**
Rate of Return	**0.0592**	**0.0555**	**0**

6.2 Impact of Capital Structure on Exemption or Deduction

- Return on Equity increases
- Claiming any deduction is especially available for units established in special economic zones under section 10AA.
- Deduction under Section 80IA or 80IAB or 80IB or 80IC or 80IE.
- Borrowed capital reduces PBT, hence exemption is also reduced. Minimum possible loans to be taken at the time of commencement of an industrial undertaking.

6.3 Understand Tax Treatment of Dividend Received from Company

Dividend Taxability before AY 2021-22

- Dividend is taxable in the hands of distributor (i.e. Assessee distributing dividend) @ 15% + Surcharge applicable + Education Cess @ 4% in form of CDT/DDT
- Assessee receiving dividend gets Exemption up to Rs. 10 Lakhs of dividend income, above Rs.10 lakhs, taxable @ 10% on excess amount
- A dividend is nothing but a distribution of a portion of a company's earnings.
- A dividend distributions tax is nothing but a tax levied on the profits distributed by Indian Companies to its investors or shareholders. As per the provisions of the income tax act, the tax is levied on the company before distributing dividends.

Example

- Dividend declared of Rs 10,00,000 grossed up as shown below:
- Rs 10,00,000 + [100/85*100] * Rs10,00,000 = Rs 11,76,500
- Dividend distribution tax :
- Rs 11,76,500 * 15% = Rs 1,76,475
- Remember that the above calculation rate of 17.65% does not include surcharge and cess.

Amendment made by Finance Act 2020- Abolition of DDT for Indian Companies

- the Finance Act 2020 has introduced the abolition of DDT for the companies.
- Now the dividends are taxed in the hands of the investors.

- Up to Assessment Year 2020-21, if a shareholder gets a dividend from a domestic company, it is exempt in the hands of the shareholder.
- In this case, Companies were required to pay dividend distribution tax.
- However, the Finance Act 2020 has introduced the abolition of DDT for the companies. Now the dividends are taxed in the hands of the investors.
- The dividend income is taxed in the hands of the investors only if the dividend is distributed on or after 01-04-2020. In this case, the entire amount will be taxable in the hands of the investors and they will be liable to pay tax on dividends. The companies will not be required to pay DDT.

Revival of Certain provisions

- Allowability of expenses from dividend income,
- Deductibility of tax from dividend income,
- Treatment of inter-corporate dividend, etc.

Meaning of Dividend

- Dividend usually refers to the distribution of profits by a company to its shareholders.
- However, in view of Section 2(22) of the Income-tax Act, the dividend shall also include the following:

(a) Distribution of accumulated profits to shareholders entailing release of the company's assets;

(b) Distribution of debentures or deposit certificates to shareholders out of the accumulated profits of the company and issue of bonus shares to preference shareholders out of accumulated profits;

(c) Distribution made to shareholders of the company on its liquidation out of accumulated profits;

(d) Distribution to shareholders out of accumulated profits on the reduction of capital by the company; and

(e) Loan or advance made by a closely held company to its shareholder out of accumulated profits.

Dividend" does not include

(*i*) a distribution made in accordance with sub-clause (*c*) or sub-clause (*d*) 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;

(*ia*) a distribution made in accordance with sub-clause (*c*) or sub-clause (*d*) in so far as such distribution is attributable to the capitalised profits of the company representing bonus shares allotted to its equity shareholders after the 31st day of March, 1964, and before the 1st day of April, 1965;

(ii) any advance or loan made to a shareholder or the said concern by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company;

(iii) any dividend paid by a company which is set off by the company against the whole or any part of any sum previously paid by it and treated as a dividend within the meaning of sub-clause (e), to the extent to which it is so set off;

(iv) any payment made by a company on purchase of its own shares from a shareholder in accordance with the provisions of section 77A of the Companies Act, 1956 (1 of 1956);

(v) any distribution of shares pursuant to a demerger by the resulting company to the shareholders of the demerged company (whether or not there is a reduction of capital in the demerged company).

Example

- Private Company
- Four Registered Shareholders: W,X,Y,Z
- Shareholdings: 25% each

- Loans and advances granted in the year and outstanding were 13,00,000 including:
    - Trade Deposit of 2 lacs given to W.
    - Loan of 2 Lacs given to X, out of which repaid 1 lac.
    - Loan of 3.5 Lacs to Mrs. Y at request of Mr. Y.
    - Loan of 2.5 lacs to Z(HUF), beneficial owner of shares registered in name of Z.

Solution

1. Not deemed dividend.

2. Deemed Dividend

3. Not Deemed Dividend

4. Deemed Dividend

Example

- D, a shareholder took a loan from company: 50000
- Closely held company
- Insurance premium paid by company on behalf of D shareholder: 2500
- D's Shareholdings: 25%
- Accumulated Profits on date of loan: 40,000
- Actual dividend declared to D: 7500 set-off against loan

Solution

- Total amount taken from the company: 52,500
- Accumulated Profits of the company: 40,000
- Deemed dividend: 40,000
- Actual dividend of 7500 set-off against loan, not treated as dividend distributed by company u/s 115-O.

Example

- Share capital: 30000 shares of 100 each
- Reduction in the capital: 3000 shares at 10 each
- Profits of company: 1,50,000
- Mr. R sharelodings: 500 shares
- Deemed dividend: 2500
- Amount received by shareholder:
- 3,00,000*500/30000= 5,000
- Accumulated profits attributable: 1,50,000*500/3000= 2500

Tax Planning

- Shareholder in closely held company should reduce his shareholdings(voting power) below 10% before taking loan from company or asking company to make payment on his behalf.
- A concern in which aforesaid shareholder has a substantial interest should also not borrow from closely held company.
- However, loan taken should not be repaid . It should be adjusted against dividend declared in future.

Example

- ABC Pvt Ltd. is a company, the public is not substantially interested in. Hari is one of the company shareholders, who hold 15% shares. The company has accumulated profits of Rs.25 lakhs as on 31 March 2018. The company granted a loan of Rs.100,000 to Hari, by way of an account payee cheque. He repaid the amount on 5 May 2018.
- In this case, even if the loan has been repaid by Hari, the loan amount granted to the extent of accumulated profits are treated as deemed dividend.

Taxability of dividend received on or after 01-04-2020

- Obligation of the domestic companies
- Taxability in hands of shareholders

Obligation of the domestic companies

- Deduct tax at the rate of 10% from dividend distributed to the resident shareholders if the aggregate amount of dividend distributed or paid during the financial year to a shareholder exceeds Rs. 5,000. under Section 194.
- No tax shall be required to be deducted from the dividend paid or payable to Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC) or any other insurer in respect of any shares owned by it or in which it has full beneficial interest.
- However, where the dividend is payable to a non-resident or a foreign company, the tax shall be deducted under Section 195 in accordance with relevant DTAA.

Taxability in hands of shareholder

- Section 10(34), is withdrawn from Assessment Year 2021-20.
- Dividend received during the financial year 2020-21 and onwards shall now be taxable in the hands of the shareholders.
- Section 115BBDA has no relevance.
- The taxability of dividend and tax rate thereon shall depend upon many factors like residential status of the shareholders, relevant head of income.
- In case of a non-resident shareholder, the provisions of Double Taxation Avoidance Agreements (DTAAs) and Multilateral Instrument (MLI) shall also come into play.

Taxable in the hands of resident shareholder

- Trader: business income.
- Investor: other sources.

Types of Dividend

Normal Dividend

- As per **sec 8(a)**, any dividend declared or distributed or paid within the meaning of sub-clauses (a), (b), (c), (d), (e) of sec 2(22) is deemed to be the income of the previous year in which such dividend is **declared, distributed or paid** as the case may be.

Deemed Dividend

- Deemed to be the income of the previous year in which it is so distributed or paid.

Interim dividend

- As per **sec 8(b)**, any **interim dividend** declared by the company shall be deemed to be the income in the previous year in which it is **unconditionally made available to the member who is entitled** there to.

Place of accrual u/s 9(1) (iv)

- A dividend paid by an Indian company outside India deemed to accrue arise in India.
- Foreign dividend paid by a foreign company outside India is not deemed to accrue or arise in India.

- In case of dividend received by an Indian shareholder from a foreign company which has deducted tax at source; but has not paid deducted amount of tax to the government of India, the amount deducted as tax at source shall not be included in the dividend income of the Indian shareholder.
- In case of Double taxation relief/s 91, gross dividend shall be included.

Income, taxable under the head PGBP

- Section 8 of the Act provides
- **Final dividend** including deemed dividend shall be taxable in the year in which it is declared, distributed or paid by the company, whichever is earlier.
- **Interim dividend** : Tax on receipt basis.

Deductions from dividend income

- Business income : as collection charges, interest on loan etc.
- Other sources: interest expenditure which has been incurred to earn that dividend income to the extent of 20% of total dividend income

Tax rate on dividend income

- Tax at normal tax rates
- Where a resident individual, being an employee of an Indian company or its subsidiary engaged in Information technology, entertainment, pharmaceutical or bio-technology industry, receives dividend in respect of GDRs(Purchased in foreign currency) issued by such company under an Employees' Stock Option Scheme:
  - Dividend shall be taxable at concessional tax rate of 10% without providing for any deduction under the Income-tax Act.

Taxability in case of non-resident shareholders including FPI

- private equity investors as an Investment: taxable under the head other sources
- FPIs: taxable under the head other sources

Section 115AC Non-resident

- Dividend on GDRs of an Indian Company or Public Sector Company (PSU) purchased in foreign currency 10%

Section 115AD FPI

- Dividend income from securities (other than units referred to in section 115AB) 20%
- Investment division of an offshore banking unit Dividend income from securities (other than units referred to in section 115AB) 10%

Section 115E Non-resident Indian

- Dividend income from shares of an Indian company purchased in foreign currency. 20%

Section 115A Non-resident or foreign co.

- Dividend income in any other case 20%

Withholding tax

Section 195 :

- Dividend is distributed to a non-resident shareholder
- Withholding tax rate on dividend shall be as specified in the Finance Act of the relevant year or under DTAA, whichever is applicable in case of an assessee.

Withholding tax

- Section 195 :
    - Dividend is distributed to a non-resident shareholder
    - Withholding tax rate on dividend shall be as specified in the Finance Act of the relevant year or under DTAA, whichever is applicable in case of an assessee.
- Section 196C and section 196D :
    - Dividend is distributed or paid in respect of GDRs of an Indian Company or Public Sector Company (PSU) purchased in foreign currency or to Foreign Portfolio Investors (FPIs),
    - Withholding tax rate under section 196C and 196D is 10% and 20%, respectively
- Where the dividend is distributed to a non-resident shareholder, the tax shall be required to be deducted as per section 195 of the Income-tax Act. However, where the dividend is distributed or paid in respect of GDRs of an Indian Company or Public Sector Company (PSU) purchased in foreign currency or to Foreign Portfolio Investors (FPIs), the tax shall be required to deducted as per section 196C and section 196D, respectively. As per section 195, the withholding tax rate on dividend shall be as specified in the Finance Act of the relevant year or under DTAA, whichever is applicable in case of an assessee. Whereas, the withholding tax rate under section 196C and 196D is 10% and 20%, respectively

Taxability under DTAA

- Dividend income shall be taxable in India as per provisions of the Act or as per relevant DTAA, whichever is more beneficial.
- As per most of the DTAAs India has entered into with foreign countries, the dividend is taxable in the source country in the hands of the beneficial owner of shares at the rate ranging from 5% to 15% of the gross amount of the dividends.
- In DTAA with countries like Canada, Denmark, Singapore, the dividend tax rate is further reduced where the dividend is payable to a company which holds specific percentage (generally 25%) of shares of the company paying the dividend.
- Article 8 (Dividend Transfer Transactions) of MLI provides for a minimum period of 365 days for which a shareholder, receiving dividend income, has to maintain its shareholding in the company paying the dividend to get the benefit of the reduced tax rate on the dividend.

Inter-corporate dividend

- Government has introduced a new section 80M under the Act to remove the cascading effect
- However, nothing has been prescribed where a domestic company receives dividend from a foreign company and further distribute the same to its shareholders.
- As the taxability of dividend is proposed to be shifted from companies to shareholders, the Government has introduced a new section 80M under the Act to remove the cascading effect where a domestic company receives a dividend from another domestic company. However, nothing has been prescribed where a domestic company receives dividend from a foreign company and further distribute the same to its shareholders. The taxability in such cases shall be as under:
- Domestic co. receives dividend from another domestic co:
    - intercorporate dividend shall be reduced from total income of company receiving the dividend if same is further distributed to shareholders one month prior to the due date of filing of return
- Domestic co. receives dividend from a foreign co.
    - Dividend received by a domestic company from a foreign company, in which such domestic company has 26% or more equity shareholding, is taxable at a rate of 15% plus Surcharge and Health and Education Cess under Section 115BBD. Such tax shall be computed on a gross basis without allowing deduction for any expenditure.

- Dividend received by a domestic company from a foreign company, in which equity shareholding of such domestic company is less than 26%, is taxable at normal tax rate. The domestic company can claim deduction for any expense incurred by it for the purposes of earning such dividend income.

No MAT on dividend income of a foreign company

- Provisions relating to MAT apply to a foreign company only when it is a resident of a country with which India has DTAA and it carries on business through a PE situated in India.
- However, it should not be taxable under the presumptive taxation schemes of Section 44B, Section 44BB, Section 44BBA or Section 44BBB.
- Once it is determined that the foreign company is liable to pay MAT, certain adjustments are made from its profits. However, the following incomes (and expenses claimed in respect thereof) are added back to (or reduced from) the net profit if same is credited (or debited) in the profit and loss account, if such income is taxable at a rate lower than the rate of MAT

(a) Capital gain from securities; (b) Interest; (c) Royalty; (d) FTS.

- Dividend income shall be taxable in the hands of a foreign company in accordance with the provisions of the Act or relevant DTAA, whichever is more beneficial.
- The Finance Bill, 2021 has amended section 115JB to provide that dividend income and expenses claimed in respect thereof to be added back or reduced from the net profit if such income is taxed at lower than MAT rate due to DTAA.

Advance tax liability on dividend income

- No interest under section 234C shall be charged provided the assessee has paid full tax in subsequent advance tax instalments.
- Benefit shall not be available in respect of the deemed dividend as referred to in Section 2(22)(e)
- If the shortfall in the advance tax instalment or the failure to pay the same on time is on account of dividend income, no interest under section 234C shall be charged provided the assessee has paid full tax in subsequent advance tax instalments. However, this benefit shall not be available in respect of the deemed dividend as referred to in Section 2(22)(e)

6.4 What are Bonus Shares?

- Bonus shares are new shares issued to existing shareholders of a company.
- These shares are issued to the shareholders in proportion of their current holdings.
- Bonus shares are considered free shares as their cost of acquisition is taken as zero.
- When a company issues shares to its existing shareholders in lieu of dividend such shares are termed as Bonus Shares.
- By issue of Bonus shares a company capitalizes its profit in computing income.
- Such an offer is given when the company is short of cash, and the shareholders expect regular income. Bonus issue does not involve cash flow in the company. It does not increase the net assets of the company but only the share capital.

Purpose of bonus shares

- Improving the liquidity of a share
- Increase the equity base

Tax Considerations for Company

- Generally issue of Bonus shares can be taxed under the dividend distribution tax.
- Dividend distribution tax has been abolished since 2020.

Impact on Taxability of an individual

- Issue of bonus shares to equity shareholders does not amount to distribution of dividend, as there is no release of assets. Therefore, bonus shares received by an equity shareholder are not taxable as deemed dividend.
- Where Bonus Shares are issued to the Preference Shareholders, on their issue it is deemed to be dividend and liable to tax.
- When Bonus Shares are issued to the equity shareholders, the value of the shares is not taxed as dividend.
- However, where redeemable preference shares are issued as Bonus shares, on their redemption, the amount shall be taxed as dividend.
- Cost of acquisition of bonus shares is taken as zero hence the capital gain on selling a bonus share is equal to its selling price.
- Redemption proceeds of bonus preference shares amounts to dividend, which is now taxable in investor hands, along with the dividend on the preference shares.
- The definition of dividend refers to the distribution of accumulated profits by a company, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company.

Gujarat high court on redemption of bonus preference shares

- Way back in 1964, the Gujarat high court analysed a case of redemption of bonus preference shares and held that, when bonus preference shares were issued, it did not amount to dividend as there was no release of assets of the company.
- However, the Gujarat high court held that, at the time of redemption, there was a release of assets by the company, resulting in taxation as dividend.

Impact on Taxability of an individual

- Original allottee of the bonus preference shares: if sold before redemption, the entire sales proceeds would be taxed as a capital gain, and not as a dividend.
- Holder of such bonus preference shares, should sell these shares before maturity.
- Gift them before maturity to family members.
- Where bonus shares are issued to the preference shareholders, on their issue it is deemed to be dividend and liable to tax when a shareholder sells the bonus shares, the cost of bonus shares is taken as nil.

Bonus preference shares

- If the preference shares have been issued by the company at an issue price through subscription: purchase decision on the basis of the post-tax internal rate of return (IRR).
- However, if these preference shares have been issued by the company to its equity shareholders by way of bonus, you need to pause and do the math again.

Allotment of bonus shares is not taxable: Karnataka HC,2021

"On allotment, there shouldn't be any taxability. However, when the individual transfers or sells those shares, he will need to pay tax on the gains."

Important takeaways from the case:

- Intention behind Section 56 of ITA is to tax the benefits received by shareholders on allotment of shares.
- In case of bonus shares, there is no extra benefit.
- When a shareholder receives a bonus share, the intrinsic value of the existing shares held by them will go down as the value of the shares is lowered in the market.
- When a company allots bonus shares, it does not result in any change in the capital structure of the company
- The value after the bonus shares are added will be the same.

- According to a note from PwC India, an individual taxpayer had received 10 million bonus equity shares from a private limited company without the payment of any consideration.
- The tax officer invoked Section 56(2)(vii) of the Act.
- The high court agreed with ITAT's orders. It observed that post the issuance of bonus shares, the market value and the intrinsic value of the original shares and bonus shares put together, will be nearly the same as per the value of the original share before the issue of bonus shares.
- here is no material on record to infer that bonus shares have been transferred with an intention to evade tax, which is the objective of Section 56(2)(vii) of the Income-Tax Act.
- When bonus shares are sold, the buying price is considered nil, which means the entire selling price of bonus shares is considered as gains.

No tax implications on either the company issuing it or on the recipient of bonus units

- Bonus issue is done by way of profit appropriation (allocation).
- Bonus issue does not have any tax implications on either the company issuing it or on the recipient of bonus units.

Tax Planning

- Transfer Bonus shares after one year from allotment to a firm or an association of persons as capital contribution.
- A preference shareholder may convert first preference shares into equity shares and thereafter receive Bonus shares. This will reduce the tax liability at least at the time of issue of bonus shares.
- Converting partly paid shares into fully paid up shares instead of issue of Bonus Share.
- Bonus Share are received by a firm it may transfer such shares to partners by sale.

Bonus Stripping

- Bonus stripping a mechanism to evade income taxes.
- Purchase or sale of units of a mutual fund is transacted in a manner, which would result in short term capital loss that can be adjusted against any other capital gains.
- Short term capital loss for the sale of original units, which is available for set off against any capital gains.
- Concessional rate of tax of 10%

Factors to Consider Before Investment in Bonus shares

1. Shareholders can choose to sell the shares to meet their liquidity needs at the time of emergency.
2. Not taxable at the time of issue in the hands of shareholders.
3. A shareholder might have to pay capital gains tax if they sell them.
4. More affordable for retail investors.

6.5 Exemptions from Capital Gains [Section 54 to 54h]

Exemptions from capital gains [section 54]

- Section 54 : Transfer of Residential Property
- Assessee: Individual or HUF
- Capital Asset Transferred: Residential House
- Nature of CA: LTCA

- New Asset: One Residential house in India Provided that where the amount of the capital gain does not exceed two crore rupees, the assessee may, at his option, purchase or construct two residential houses in India.
- Time period of New Asset: Within 1 year before or within 2 years after transfer or construct within 3 yrs after transfer.
- Capital Gain Account Scheme [CGAS]: Deposit in CGAS on or before Due Date of Return (DDR) u/s.139(1).
- Exemption: LTCG invested in New Asset + Deposited in CGAS up to DDR.
- Transfer of New Asset: If New Asset transferred within 3 years from date of purchase/ construction, then Cost of acquisition of new asset Reduced by Capital Gain exempted earlier.

Section 54B :Transfer of Agricultural Property

- Assessee: Individual or HUF
- Capital Asset Transferred: Urban Agricultural Land used by assessee/parent for agricultural for min 2 years prior to transfer.
- Nature of CA: STCA or LTCA
- New Asset: Agricultural Land (any area)
- Time period of New Asset: Within 2 yrs after transfer.
- Capital Gain Account Scheme [CGAS]: Deposit in CGAS on or before Due Date of Return (DDR) u/s.139(1).
- Exemption: LTCG invested in New Asset + Deposited in CGAS up to DDR.
- Transfer of New Asset: If New Asset transferred within 3 years from date of purchase/ construction, then Cost of acquisition of new asset Reduced by Capital Gain exempted earlier.

54EC :Transfer of LTCA

- Assessee: Any Assessee
- Capital Asset Transferred: land or building or both [Finance Act,2018]
- Nature of CA: LTCA
- New Asset: Bonds redeemable after 3 years issued by
- National Highway Authority of India or § Rural electrification corporation of India.
- Power Finance Corporation ltd.
- Indian Railway Finance Corporation Ltd.
- Time period of New Asset: Within 6 months of transfer
- Capital Gain Account Scheme [CGAS]: NA
- Exemption: LTCG invested in Specified Bonds up to 6 months of transfer.
- Transfer of New Asset: If New Asset is transferred or converted into money within 3 years from date of acquisition., then exempt LTCG taxable in p/y of transfer/ conversion of new asset.

Exemptions from capital gains [section 54ee]

- Section 54EE : Investment in units of specified funds.
- Assessee: Any Assessee.
- Capital Asset Transferred: Any Capital Asset.
- Nature of CA: LTCA
- New Asset: Units of start up fund. Max Investment in F/Y of Transfer & Subsequent F/Y is 50 lakhs.

- Time period of New Asset: Within 6 months of transfer.
- Capital Gain Account Scheme [CGAS]: NA
- Exemption: LTCG invested in units of start fund up to 6 months of transfer.
- Transfer of New Asset: If New Asset is transferred or converted into money within 3 years from date of acquisition., then exempt LTCG taxable in p/y of transfer/ conversion of new asset.

Section 54G: Transfer under shifting of Industrial Undertakings

- Assessee: Any Assessee
- Nature of CA: STCA or LTCA
- Capital Asset Transferred: Plant & Machinery / Land & Building used for Industrial undertaking in Urban Area
- Conditions: Above undertaking shifted (to non-urban Area)
- New Asset & Time period: 1 year before or within 3 yrs of transfer on Purchase Plant/Machinery, Purchase /Construct Land/ Building and Including expenses on transfer
- Lock in period: Newly acquired asset must be held for 3 Years.
- Quantum of Exemption : If CG> amount spent on on Purchase Plant/Machinery, Purchase /Construct Land/ Building and Including expenses on transfer then excess taxable as CG.
- Transfer of New Asset: If New Asset transferred within 3 years from date of purchase/ construction, then Cost of acquisition of new asset Reduced by Capital Gain exempted earlier.
- Treatment of unutilized Capital Gains: Taxable as capital gain of P/Y in which specified time expires depending upon the original capital gain.

Section 54F : Transfer of LTCA

- Assessee: Individual or HUF
- Capital Asset Transferred: Any Capital Asset (Other than Residential house)
- Nature of CA: LTCA
- New Asset: Purchased 1 year before or within 2 yrs after transfer or constructed within 3 yrs after transfer One Residential house in India.
- Time period of New Asset: Purchased 1 year before or within 2 yrs after transfer or constructed within 3 yrs after transfer One Residential house in India.
- Capital Gain Account Scheme [CGAS]: Available
- Exemption: LTCG X (Cost of new asset + Amount deposit in CGAS) /Net Consideration
- Transfer of New Asset: If New Asset t/f within 3 yrs from date of purchase/ construction, then Exempt Capital Gains taxable in P/Y of transfer of new asset.

Section 54GB : Capital gain on transfer of residential property not to be charged in certain cases [up to 31/3/21].

- Assessee: Individual or HUF
- Capital Asset Transferred: Residential property (a house or a plot of land).
- Nature of CA: LTCA
- New Asset:
- Subscription in Equity shares of an Eligible company & company has within 1 year from date of subscription in Equity shares by assessee, utilised this amount for purchase of New asset.
- Eligible Company means
- Indian Company incorporated between 1st April of P/Y of capital gain up to due date of return u/s 139(1).

- Engaged in eligible business (manufacture of any article or thing).
- company in which assessee has more than 50% share capital(30%, applicable from the assessment year 2020- 21).
- Company qualifies to be an eligible start-up.
- New Asset means new plant and machinery but does not include:-
- P&M which, before its installation by assessee, was used by any other person.
- P&M installed in any office premises or any residential accommodation, including guest-house.
- New Asset means new plant and machinery but does not include:-
- any office appliances including computers or computer software
- any vehicle or
- P&M the whole of the actual cost of which is allowed as 100% deduction (by depreciation or otherwise) under PGBP.
- Capital Gain Account Scheme [CGAS]: Available
- Exemption: LTCG X (Cost of new asset + Amount deposit in CGAS)/Net Consideration.
- Transfer of New Asset: If Equity shares or New Asset t/f within 5 yrs from date of purchase/ construction, then Exempt Capital Gains taxable in P/Y of transfer of Equity shares/New asset 'Provided that in case of a new asset, being computer or computer software, acquired by an eligible start-up, the lock in period will be 3 years.

Section 54D: Compulsory Acquisition of Land & Building

- Assessee: Any Assessee
- Capital Asset Transferred: Compulsory acquisition of Land & Building used for Industrial undertaking in Any Area.
- Nature of CA: STCA or LTCA.
- Conditions: Used by Assessee for Business for 2 years immediately prior to date of acquisition. Above undertaking shifted (in any area).
- New Asset & Time period: Within 3 years after transfer, Purchase/Construction of other Land/Building.
- Treatment of unutilized Capital Gains: Same as Section 54.
- Exemption: Same as Section 54.
- Transfer of New Asset: Same as Section 54.

Section 54GA: : Transfer of industrial undertaking to SEZ.

- Assessee: Any Assessee
- Capital Asset Transferred: Plant & Machinery / Land & Building used for Industrial undertaking in Urban Area.
- Nature of CA: STCA or LTCA
- Conditions: Above undertaking shifted to SEZ (in any area). Should have been used for purpose of the business of industrial undertaking.
- New Asset & Time period: 1 year before or within 3 yrs of transfer,Purchase Plant/Machinery, Purchase /Construct Land/Building Including expenses on transfer.
- Treatment of unutilized Capital Gains: Same as Section 54.
- Exemption: Same as Section 54.
- Transfer of New Asset: Same as Section 54.
- Taxable as short-term capital gain/long term capital gain of P/Y in which specified time expires depending upon the original capital gain.

Summary

Simply explained, a capital gain is any profit or gain derived from the sale of a "capital asset." This gain or profit falls under the category of 'income,' and as such, you must pay tax on it in the year in which the capital asset is transferred. This is known as capital gains tax, and it can be either short-term or long-term. Because there is no sale, only a transfer of ownership, capital gains are not applicable to an inherited property. The Income Tax Act expressly exempts assets obtained as gifts as a result of an inheritance or will. If the individual who inherited the asset decides to sell it, capital gains tax will apply. Dividend taxation is moved to shareholders beginning in fiscal year 2020-21. The dividend distribution tax levied on Indian corporations has been repealed. Dividend income received by a shareholder from shares held for investment purposes is taxable under the heading 'Income from Other Sources.' The taxpayer may deduct interest expense up to a maximum of 20% of total dividend income.If the total amount of dividends paid to shareholders exceeds Rs 5,000 throughout the fiscal year, the companies must deduct 10% TDS. Capital structure also significantly responds to changing tax incentives.

Keywords

Capital asset: Property of any kind held by an assesse, whether or not connected with his business or **profession.**

Its includes

Movable and Immovable assets

Tangible and intangible assets

Fixed and floating asset

It includes

goodwill,

leasehold rights

jewelery

shares

a manufacturing license etc.

Does not include—

i. Any stock-in-trade, consumable stores or raw materials held for the purposes of his business or profession ;

ii. Personal effects, that is to say, movable property (including wearing apparel and furniture) held for personal use by the assessee or any member of his family dependent on him, but excludes—

a. jewellery;
b. archaeological collections;
c. drawings;
d. paintings;
e. sculptures; or
f. any work of art.

These are all Taxable under Capital Gain.

- Short Term Capital Asset: Capital asset held for not more than 36 months immediately prior to the date of transfer shall be deemed as short-term capital asset.
- Long Term Capital Asset: Capital Asset that is held for more than 36 months or 24 months or 12 months, as the case may be, immediately preceding the date of transfer is treated as a long-term capital asset.
- **Transfer [Section 2(47)]:**

- Transfer includes the following types of transactions—
  1. the sale, exchange or relinquishment of the asset; or
  2. the extinguishment of any rights therein; or
  3. the compulsory acquisition thereof under any law; or
  4. the owner of a capital asset may convert the same into the stock-in-trade of a business carried on by him. Such conversion is treated as transfer; or
  5. the maturity or redemption of a zero coupon bond; or
  6. part-performance of the contract: Sometimes, possession of an immovable property is given in consideration of part-performance of a contract.
  7. there are certain types of transactions which have the effect of transferring or enabling the enjoyment of an immovable property.

- Indexed Cost of Improvement

Cost of Improvement

X

Cost inflation index (of financial year in which asset transferred) / Cost inflation index (of financial years in which improvement has taken place by Assessee or/and previous Owner

Indexed Cost of Acquisition

Cost of Acquisition of Capital Asset

X

Cost inflation index (of financial year in which asset transferred) / Cost inflation index (of the 1 st financial year in which asset held by Assessee) or (of financial year 2001 – 02), whichever is later

Full Value Consideration For Real Estate Transactions [Section 50c]

Sale consideration on transfer of Land or Building or both

Is Less than

Value determined by Stamp valuation authority for payment of stamp duty

then value so assessed or assessable shall be • Deemed to be FVC

Self Assessment

1. Which of the following is wrong about the Bonus issue?

A. Shareholders can choose to sell the shares to meet their liquidity needs at the time of emergency.

B. Taxable at the time of issue in the hands of shareholders.

C. A shareholder might have to pay capital gains tax if they sell them.

D. More affordable for retail investors.

2. Which of the following is wrong about dividends taxability?

A. Up to Assessment Year 2020-21, exempt in the hands of the shareholder.

B. the Finance Act 2020 has introduced the abolition of DDT for companies.

C. Currently dividends are taxed in the hands of the investors.

D. Currently dividends are taxed in the hands of the companies in form of dividend distribution tax.

3. Deduct tax at the rate of 10% from dividend distributed to the resident shareholders if the aggregate amount of dividend distributed or paid during the financial year to a shareholder exceeds Rs__________. under Section 194.

A. 5000

B. 10000

C. 15000

D. 20000

4. Where a resident individual, being an employee of an Indian company or its subsidiary engaged in Information technology, entertainment, pharmaceutical or bio-technology industry, receives dividend in respect of GDRs(Purchased in foreign currency) issued by such company under an Employees' Stock Option Scheme: Dividend shall be taxable at concessional tax rate of _______% without providing for any deduction under the Income-tax Act.

   A. 10

   B. 15

   C. 20

   D. 25

5. Under Section 115AC in case of Non-resident , Dividend on GDRs of an Indian Company or Public Sector Company (PSU) purchased in foreign currency is ______%.

A. 5

B. 10

C. 15

D. 20

6. Under Section 115Ein case of Non-resident Indian ,Dividend income from shares of an Indian company purchased in foreign currency is taxable at_______%

A. 5

B. 10

C. 15

D. 20

7. Withholding tax rate under section 196C and 196D is --------% and-------- %, respectively.

A. 5,10

B. 10,15

C. 15,20

D. 10,20

8. As per most of the DTAAs India has entered into with foreign countries, the dividend is taxable in the source country in the hands of the beneficial owner of shares at the rate ranging from _% to ___% of the gross amount of the dividends.

A. 5,10

B. 5,15

C. 15,20

D. 10,20

9. Which of the following statements is wrong about tax liability on dividend income?

A. Dividend income shall be taxable in the hands of a foreign company in accordance with the provisions of the Act or relevant DTAA, whichever is more beneficial.

B. Provisions relating to MAT apply to a foreign company only when it is a non-resident of a country with which India has DTAA and it carries on business through a PE situated in India.

C. The Finance Bill, 2021 has amended section 115JB to provide that dividend income and expenses claimed in respect thereof to be added back or reduced from the net profit if such income is taxed at lower than MAT rate due to DTAA.

D. Once it is determined that the foreign company is liable to pay MAT, certain adjustments are made from its profits.

10. Unlisted shares held for a period Upto ___months preceding date of transfer are considered as Short Term Capital Asset.

A. 12

B. 20

C. 24

D. 28

11. Listed Security* (other than unit of MF) on recognised stock exchange in India Held for a period Up to ----- months preceding date of transfer are considered as Short Term Capital Asset.

A. 12

B. 20

C. 24

D. 28

12. Which of the following is wrong about Capital gains?

A. In case of Long Term Capital Assets, Indexed cost of Acquisition and Indexed cost of Improvement should be taken.

B. Where Long Term Capital Asset consists of Bonds (other than capital indexed bonds of Government & gold sovereign bonds) &Debentures, indexation is to be done

C. Base year for the purpose for calculation of Indexed cost of acquisition or improvement has been shifted from 1981-82 to 2001-2002.

D. Cost of improvement incurred by assesse or previous owner prior to 1-4-2001 shall taken as NIL.

13. CII for the year 2021-22 is

A. 280
B. 289
C. 301
D. 317

14. Dividend received by a domestic company from a foreign company, in which such domestic company has ------% or more equity shareholding, is taxable at a rate of 15% plus Surcharge and Health and Education Cess under Section 115BBD. Such tax shall be computed on a gross basis without allowing deduction for any expenditure.
A. 25
B. 26
C. 27
D. 28

15. The government has introduced a new section _____ under the Act to remove the cascading effect .
A. 80M
B. 80L
C. 80K
D. 80H

Answers for Self Assessment

1.	B	2.	B	3.	B	4.	A	5.	B
6.	D	7.	D	8.	B	9.	B	10.	C
11.	A	12.	B	13.	D	14.	B	15.	A

Review Questions

1. Write a note on inter-corporate dividends?
2. What are the tax considerations of bonus for a company?
3. Explain the Taxability of dividend in hands of the shareholder.
4. What is Impact of Capital structure on Exemption or Deduction
5. Write a note on Miller and Modigliani Approach.

Further Readings

- https://www.icsi.edu/media/webmodules/16112021_Advance_Tax_Laws.pdf
- A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications
- Study Material on Direct Tax Laws and International Taxation by ICAI
- Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta
- www.incometaxindia.gov.in

Dr. Rupinder Katoch, Lovely Professional University

Unit 07: Tax Planning with Regard toManagerial Decisions I

CONTENTS

Objectives

After studying this unit, you will be able to:

- understand tax planning in respect of ownership or lease/ Purchasing of an Asset out of own funds or out of Borrowed Capital,
- understand tax planning in respect of acquisition of assets on Hire Purchase Basis or Instalment Basis.

Introduction

Assets can be purchased or rented. If these are purchased and depreciable, such as a building, plant and machinery, or furniture, the assessee can claim depreciation on the cost and over time. The entire cost can be claimed as a profit deduction. However, if you are hired, the fee for hiring becomes an allowable deduction. In light of the fact that the acquisition of an asset necessitates a larger initial outlay than hiring, in some cases, the company may choose to hire rather than acquire. Take, for example, the business renting premises rather than purchasing them may be a better option.

However, two additional considerations may arise in the case of plant and machinery. In certain industries, new plant and machinery may allow a company to claim a deduction for depreciation and additional depreciation, which may outweigh other considerations. Similarly, if there can be a new industrial undertaking, substantial tax benefits may be available by way of tax holiday benefit, etc. but that would require employment of new plant and machinery to a large extent.

These considerations are out and out tax considerations which may prompt an assessee to make two choices (i) not to hire plant and machinery but to purchase them and (ii) not to purchase second hand plant and machinery but to purchase them new.

1.1 Factors Which are Required to be Considered Before Making 'Own or Lease' Decision

- Cost of asset to be owned
- Rent of the asset to be taken on lease
- Source of financing the asset
- Risk involved in the alternatives
- Impact of tax concessions such as depreciation, tax holiday benefit, etc.

1.2 Tax advantages of Lease

- If the asset is taken on lease, the firm can deduct, for income-tax purposes, the entire rental payment. If the rate of tax is 30%, then the effective rent obligation is reduced to that extent.
- The life of the lease can be shortened compared to the depreciable life otherwise allowed if the assesse purchased the asset.
- Opportunity to depreciate otherwise non-depreciable assets.
- Since the entire lease rental is chargeable to revenue, the lessee could claim tax benefits on even the principal investment in the equipment.

1.3 Tax Advantage when Assets are Purchased

Depreciation on specified assets can be claimed as a deduction u/s 32. The assets may be purchased outrightly or may be taken on loan.

Where the asset is taken on loan, the interest amount can either be claimed as revenue expenditure or can be capitalized.

But where interest is paid after the asset is first put to use, the deduction on account of interest shall be claimed as a revenue expenditure, i.e., such interest can not be capitalized.

1.4 Tax Planning in Respect of Own or Lease

- Cash Position.
- Depreciation.
- Obsolescence risk.
- Residual Value.
- Profit Margin.
- Profit after Tax.

Cash position

Buy it

- If have sufficient Cash/can borrow funds at reasonable rate of Interest/can acquire under Hire purchase or Instalment system.

Depreciation

- When an asset is bought or acquired under hire purchase/installment system: Depreciation is allowed.
- When an asset is taken on lease: Depreciation is not allowed to the lessee.

- In case of non-depreciable asset: Consider future increase/decrease in value.

Obsolescence risk

- When the plant is purchased and is subject to the risk of becoming obsolete earlier than its expected working life, it has to be replaced.
- Replacement cost can be met out of depreciation fund and partly by arranging further cash.

Residual Value

If an asset has a larger residual value, it is better to purchase it.

Profit margin

In case of a less profit margin, it is better to buy the asset as lease rental would be equal to the part of the cost of the asset to the lessor, interest on investment, and profit to the lessor.

Profit after Tax

- Consider profit after tax in tax planning.
- Profit after tax should be greater.
- Some suggest that own funds should not be used in the purchase of assets as interest on own funds is not deductible.

Present Value:Where the Asset is Purchased on Loan

1. Compute Repayment of loans spread over a number of years.
2. Compute Interest on a loan spread over a number of years.
3. Compute each outflow (Interest + repayment of loan) spread over a number of years.
4. Compute Depreciation on assets spread over a number of years.
5. Compute Tax saved on deductions claimed (Interest + depreciation) spread over a number of years.
6. Compute adjusted cash outflow which is (3 – 5)
7. Compute the present value of the adjusted cash outflow.

Present Value: Where the Asset is Leased

1. Compute the time processing fees in zero years.
2. Computer Lease Rental spread over a number of years.
3. Compute Cash Outflow (processing fees + lease rental) spread over a number of years.
4. Compute Tax saved on deductions claimed (processing fees + lease rental) spread over a number of years.
5. Compute adjusted cash outflow which is (3 – 4)
6. Compute the present value of the adjusted cash outflow.

Example 1

- Cost of asset: 1lakh
- Depreciation: 15%
- Interest rate: 10%
- Loan instalment: 20,000 p.a.
- Tax: 26%
- Residual value after 5 years: 20,000
- PBDIT/PBLT:1,00,000
- Lease rent: 30,000 p.a.

Solution: Asset Purchased( )

Life of asset	Profit before Depreciation and Interest	Depreciation	Interest	PBT	Tax@ 26%	PAT
I	100000	15000	10000	75000	19500	55500
II	100000	12750	8000	79250	20605	58645
III	100000	10838	6000	83162	21622	61539
IV	100000	9212	4000	86788	22564	64223
V	100000	7830	2000	90170	23444	66725
Total	500000	55630	30000	414370	107736	306633
Loss on sale of assets(100000-55630-20000)						24370

Lease option

Life of asset	Profit before lease Rent	Rent	PBT	Tax@ 26%	PAT
I	100000	30000	70000	18200	51800
II	100000	30000	70000	18200	51800

III	100000	30000	70000	18200	51800
IV	100000	30000	70000	18200	51800
V	100000	30000	70000	18200	51800
Total	500000	150000	350000	91000	259000

Profit

- When asset is purchased: 306634- 24370= 282264
- When asset is taken on lease: 259000

Discount factor

P.V factor at 10%

Year	PV Factor
1	0.909
2	0.826
3	0.751
4	0.683
5	0.621
6.	.456
7	.400
8	.351
9	.308

Net Cash Outflows: lease

Life of asset	Rent	Tax Saving@26%	cash Outflow	PV factor	PV of cash Outflows
I	30000	7800	22200	0.909	20179.8
II	30000	7800	22200	0.826	18337.2
III	30000	7800	22200	0.751	16672.2
IV	30000	7800	22200	0.683	15162.6
V	30000	7800	22200	0.621	13786.2
Total NPV of cash outflows					84138

Net Cash Outflows: Purchase

Particulars	1	2	3	4	5	6		7	8
year	**Loan Repayment**	**Interest**	**Cash Outflow**	**Depreciation @15%**	**Total(2+4)**	**Tax saving on 5@26 %**	**Net cash Outflow(3-6)**	**PV factor**	**PV of net cash outflow**
I	20000	10000	30000	15000	25000	6500	23500	0.909	21362
II	20000	8000	28000	12750	20750	5395	22605	0.826	18672
III	20000	6000	26000	10838	16838	4378	21622	0.751	16238
IV	20000	4000	24000	9212	13212	3435	20565	0.683	14046

V	20000	2000	22000	7830	9830	2556	19444	0.621	12075

Evaluation of present value

On purchase:

Cash outflows 82393

Less:

PV of cash inflows on account of sale in the end of life:

(.621*20000) 12420

Net Cash outflow 69973

On lease:

cash outflows: 84138

Example 2(Buy or Lease)

ABC Ltd has sufficient cash reserves.

New machinery to be acquired at 1Lakh.

Income Tax @26%

Depreciation@25%

Discount Rate@14%

Life of asset: 9 Years

Lease Rent: 31000 p.a. (1-5 years)

300 p.a. (after 5 years)

Solution

Buy Option:

Years	Depreciation	PV factor	Discounted Value
1	**25000**	**0.877**	**21925**
2	**18750**	**0.769**	**14419**
3	**14062**	**0.675**	**9492**
4	**10547**	**0.592**	**6244**
5	**7910**	**0.519**	**4105**

6	**5933**	**0.456**	**2705**
7	**4450**	**0.4**	**1780**
8	**3337**	**0.351**	**1171**
9	**2503**	**0.308**	**771**
Total	**92492**		**62612**

Lease Option

Years	Lease rent	PV factor	Discounted Value
1	31000	0.877	27187
2	31000	0.769	23839
3	31000	0.675	20925
4	31000	0.592	18352
5	31000	0.519	16089
6	300	0.456	137
7	300	0.4	120
8	300	0.351	105
9	300	0.308	92
			106847

Evaluation

Buy option

Cash outflow 100000

Less:

Tax saving on account

of depreciation on 62616@26% 16279

Net cash outflow 83721

Lease option

Cash outflow 106846

Less:

Tax saving on account

of rent on 106846@26% 27780

Net cash outflow 79066

Example 3(Buy or Lease)

New machinery to be acquired at 1Lakh.

Income Tax @26%

Depreciation@25%

Cost of capital: 12%

Life of asset: 5 Years

Lease Rent: 32000 p.a. (1-5 years)

Residual value: 5000

STCL is set off against STCG at the end of 5 years.

Solution

Buy option

Cash outflow 100000

PV of tax savings on account

of depreciation on 58474@ 26% 15203

PV of machine sold(.567* 5000) 2835

PV of tax savings on STCL

(1,00,000-76269-5000)=

18371*.567*.26 2761

Net cash outflow 79201

Lease option

Years	Lease rent	PV factor	Discounted Value
1	32000	0.893	28576
2	32000	0.797	25504
3	32000	0.712	22784
4	32000	0.636	20352
5	32000	0.567	18144
			115360

Lease option

PV of cash Outflows		115360
Less: PV of tax-saving on 115360@ 26%	29994	
Net cash Outflow		85366

Conclusion: asset should be purchased

1.5 Own Funds or Borrowed Funds

Example

- The company could either purchase the machinery with its own fund or borrowed funds
- cost of machinery: Rs. 60 lakhs
- expected useful life of 5 year
- scrap value will be Rs.10,000
- PBDT:4.50 crore every year
- Depreciation is charged @ 15% on written down value.
- Besides, additional depreciation is available in the first year

- Average rate of tax may be taken at 32.445%

Borrowed funds

- rate of interest will be 11.5% per annum
- loan will be repayable at the end of 5 years

Solution

Purchasing Machine out of own fund

Life of asset	**PBDT**	**Less Depreciation**	**PBT**	**Tax@ .3245%**	**PAT**	**Add Dep (Including Additional)**	**Cash Inflows after tax**	**Add scrap value**	**Less cash outflow**	**Net cash flow**	**PV Factor**	**PV**
0				-		-			6000000	-6000000	1	-6000000
I	45000000	2100000	42900000	13918905	28981095	2100000	31081095			31081095	0.91	28252715
II	45000000	585000	44415000	14410447	30004553	585000	30589553			30589553	0.83	25266971
III	45000000	497250	44502750	14438917	30063833	497250	30561083			30561083	0.75	22951373
IV	45000000	422663	44577337	14463117	30114220	422663	30536883			30536883	0.68	20856691
V	45000000	359263	44640737	14483687	30157050	359263	30516313	10000		30526313	0.62	18956840
											NPV	11,02,84,591

Purchasing Machine out of borrowed fund

Life of asset	PBDT	Less Dep	Interest (60 Lakhs*11.5 %)	PBT	Tax	PAT	Add Dep (Including Additional)	Cash Inflows after tax	Add scrap value	Less cash outflow	Net cash flow
I	45000000	2100000	690000	42210000	13695035	28514966	2100000	30614966			30614966
II	45000000	585000	690000	43725000	14186576	29538424	585000	30123424			30123424
III	45000000	497250	690000	43812750	14215047	29597703	497250	30094953			30094953
IV	45000000	422663	690000	43887337	14239246	29648091	422663	30070754			30070754
V	45000000	359263	690000	43950737	14259817	29690920	359263	30050183	10000	6000000	24040183

Net cash flow	PV Factor	PV
3,06,14966	0.909	2,78,29004
3,01,23424	0.826	2,48,81948

3,00,94953	0.751	2,26,01310
3,00,70754	0.683	2,05,38325
2,40,40183	0.621	1,49,28954
	NPV	11,07,79540

Take Machine on lease

Life of asset	PBDT	Less rent	PBT	Tax@ .3245%	Net inflow	PV Factor	PV
I	45000000	1600000	43400000	14081130	29318870	0.909	26650853
II	45000000	1600000	43400000	14081130	29318870	0.826	24217387
III	45000000	1600000	43400000	14081130	29318870	0.751	22018471
IV	45000000	1600000	43400000	14081130	29318870	0.683	20024788
V	45000000	1600000	43400000	14081130	29318870	0.621	18207018
						NPV	11,11,18,517

Advice:

From a purely financial perspective, Beaker Ltd. should take the machine on lease instead of borrowing funds or on lease as the Net Present Value in that case is the highest.

1.6 Purchase by Instalment

- Depreciation on entire purchase price.
- Interest payable on unpaid purchase price not deductible.

1.7 Purchase by Hire

- Depreciation is allowed on cash down price of asset.
- Interest is allowable as an expense.
- Hire charges claimed as deduction.

Purchase by Hire Purchase Vs. Instalment

- Compare the present value of cash inflows in both situations.

Example

5 annual Instalments(each payable in beginning of year)	2,00,000
Hire charges(P.a., Beginning of the year for 8 years)	1,50,000
Residual u at the end of 8 years	50000
Depreciation	15%
Cost of Capital	10%
Tax	30%
PV	
PV@10%	
1	0.909
2	0.826
3	0.751
4	0.683
5	0.621
6	0.564
7	0.513
8	0.467
Loss on sale of Machinery set off against STCG	

Solution (Cash outflows)

Cash Outflows	Payments	PV Factor	PV@10%
Down Payment	200000	1	200000
Instalment I	200000	0.909	181800
Instalment II	200000	0.826	165200
Instalment III	200000	0.751	150200
Instalment IV	200000	0.683	136600
		PV of Cash Outflows	833800

Solution(Cash Inflows)

1. Residual value at the end of 8 years	50000	0.467	23350		
Original cost	1000000				
2. Depreciation@15%on wdv method	Depreciation@.15on wdv	WDV	Tax savings on depreciation(.30)	PV factor	PV of Tax savings
1	150000	850000	45000	0.909	40905
2	127500	722500	38250	0.826	31594.5
3	108375	614125	32512.5	0.751	24416.89
4	92118.75	522006.3	27635.625	0.683	18875.13
5	78300.9375	443705.3	23490.28125	0.621	14587.46

6	66555.79688	377149.5	19966.73906	0.564	11261.24
7	56572.42734	320577.1	16971.7282	0.513	8706.497
8	48086.56324	272490.5	14425.96897	0.467	6736.928
	727509.475		218252.8425		157083.6

Solution(Cash Inflows)

Tax saving on account of STCL in 8th year	.30*222490	66747.16	0.467	31170.92
STCL				
Original cost(A)	1000000			
Depreciation(B)	727509.475			
scrap value(C)	50000			
STCL=A-B-C	222490.525			

Hire Purchase Option NPV

Hire charges payment	Hire	PV factor	PV	PV of tax savings(.30)
1	150000	1	150000	45000
2	150000	0.909	136350	40905
3	150000	0.826	123900	37170
4	150000	0.751	112650	33795

5	150000	0.683	102450	30735
6	150000	0.621	93150	27945
7	150000	0.564	84600	25380
8	150000	0.513	76950	23085
	1200000		880050	264015
	PV of cash outflow		880050	
	PV of cash inflow		264015	
	NPV		616035	

Decision

- NPV Hire Purchase Option: 616035
- NPV Instalment Option: 622195
- Asset should be taken on Hire Purchase basis.

Summary

The critical consideration is whether to buy or lease (or sale and lease back). Leasing has both advantages and disadvantages. Leasing avoids ownership and the risks of obsolescence and terminal value loss that come with it. The immediate payment of capital costs is avoided in leasing, but a fixed rental obligation arises. Many factors must be considered before making a 'own or lease' decision, such as the cost of the asset to be owned, the rent of the asset to be leased, the source of financing the asset, the risk involved in the alternatives, the impact of tax concessions such as depreciation, tax holiday benefit, and so on.

Leasing can also provide significant tax advantages. If the asset is leased, the company can deduct the entire rental payment for income tax purposes. If the tax rate is 30%, the effective rent obligation is reduced by that amount. Another tax benefit of leasing is that the lease life can be reduced in comparison to the depreciable life that would otherwise be allowed if the assessee purchased the asset. As a result, there is a delay in paying taxes and, in effect, an interest-free loan from the government to the extent of the delay in taxes.

Another tax advantage of leasing is the ability to depreciate otherwise non-depreciable assets. This type's primary asset is land. The lease rental covers the cost of the land, making it deductible. This arrangement may be especially appealing if the land value is a high percentage of the total value of the real estate or if the building has already been fully depreciated. Leasing is becoming increasingly popular in India.

For the purpose of making a decision in a lease or own situation, the lease rentals for each separate year should be converted into the present value of today's cost.

Wherever possible or appropriate, the concept of sale and lease back can be used as a tool for tax planning, with all of the benefits that entails.

Keywords

- Depreciation: "Depreciation" usually means loss or decline in value which occurs gradually over useful life of a material thing, due to physical wear, tear and decay, and is generally limited to losses or decline in value which cannot be restored by current repairs and maintenance.

  Condition 1 Asset must be owned by the assessee.

  Condition 2 It must be used for the purpose of business or profession.

  Condition 4 Depreciation is available on tangible as well as intangible asset

- Sale and Leaseback transaction:SLB is a simple financial transaction which allows selling an asset and then taking it back on lease.
- Present value (PV): is the concept that states an amount of money today is worth more than that same amount in the future.

Self Assessment

1. which of the following is wrong in regard to lease or own decisions?

A. ability to depreciate otherwise non-depreciable assets.
B. The lease rental covers the cost of the land, making it non deductible.
C. For the purpose of making a decision in a lease or own situation, the lease rentals for each separate year should be converted into the present value of today's cost.
D. Wherever possible or appropriate, the concept of sale and lease back can be used as a tool for tax planning, with all of the benefits that entails.

2. which of the following is wrong in regard to lease or own decisions?

A. Leasing can also provide significant tax advantages.
B. If the asset is leased, the company can notdeduct the entire rental payment for income tax purposes.
C. If the tax rate is 30%, the effective rent obligation is reduced by that amount.
D. Another tax benefit of leasing is that the lease life can be reduced in comparison to the depreciable life that would otherwise be allowed if the assessee purchased the asset. As a result, there is a delay in paying taxes and, in effect, an interest-free loan from the government to the extent of the delay in taxes.

3. which of the following is wrong in regard to lease or own decisions?

A. Leasing avoids ownership and the risks of obsolescence and terminal value loss that come with it.
B. The immediate payment of capital costs is not avoided in leasing,
C. a fixed rental obligation arises.
D. Many factors must be considered before making a 'own or lease' decision, such as the cost of the asset to be owned, the rent of the asset to be leased, the source of financing the asset, the risk involved in the alternatives, the impact of tax concessions such as depreciation, tax holiday benefit, and so on.

4. which of the following is wrong in regard to the Purchase by installment or the Hire-purchase system?

A. In case of Purchase by Instalment, Depreciation on entire purchase price can be claimed.
B. In case of Purchase by Instalment, Interest payable on unpaid purchase price not deductible.
C. In case of Purchase by Hire, Depreciation is allowed on cash down price of asset.
D. In case of Purchase by Hire, Interest is not allowable as an expense.

5. which of the following is wrong in regard to own or buy decision?

A. In case of a less profit margin, it is better to buy the asset as lease rental would be equal to the part of the cost of the asset to the lessor, interest on investment, and profit to the lessor.
B. Consider profit after tax in tax planning.
C. Profit after tax should be greater.
D. purchase of assets as interest on own funds is deductible.

6. Which of the following statements is wrong in case of buy decisions.

A. Buy the asset If having sufficient Cash
B. Buy the asset If can't borrow funds at a reasonable rate of Interestin case of insufficiency of cash.
C. When an asset is bought or acquired under hire purchase/installment system: Depreciation is allowed.
D. In case of non-depreciable asset: Consider future increase/decrease in value.

7. Which of the following statements is not a Tax Advantage when Assets are Purchased?
A. Depreciation on specified assets can be claimed as a deduction u/s 32.
B. Where the asset is taken on loan, the interest amount can either be claimed as revenue expenditure or can be capitalized.
C. But where interest is paid after the asset is first put to use, the deduction on account of interest shall be claimed as a revenue expenditure, i.e., such interest can not be capitalized
D. But where interest is paid after the asset is first put to use, the deduction on account of interest shall not be claimed as revenue expenditure, i.e., such interest can be capitalized.

8. Which of the following statements is not a Tax Advantage when Assets are Purchased?
A. If the asset is taken on lease, the firm can deduct, for income-tax purposes, the entire rental payment.
B. The life of the lease can be shortened compared to the depreciable life otherwise allowed if the assesse purchased the asset.
C. No opportunity to depreciate otherwise non-depreciable assets.
D. Since the entire lease rental is chargeable to revenue, the lessee could claim tax benefits on even the principal investment in the equipment.

9. Which of the following is awrong statement?
A. In certain industries, new plant and machinery may allow a company to claim a deduction for depreciation and additional depreciation, which may outweigh other considerations.

B. Similarly, if there can be a new industrial undertaking, substantial tax benefits may be available by way of tax holiday benefit, etc. but that would require employment of new plant and machinery to a large extent.

C. Allowances of depreciation and additional depreciation, may prompt to hire plant and machinery and not to purchase them

D. Allowances of depreciation and additional depreciation, may prompt not to purchase second hand plant and machinery but to purchase them new.

10. Which of the following statements is wrong in regard to purchase or hire?

A. If assets are purchased and depreciable, such as a building, plant, and machinery, or furniture, the assessee can claim depreciation on the cost and over time.

B. If assets are purchased and depreciable, the entire cost can not be claimed as a profit deduction.

C. However, if you are hired, the fee for hiring becomes an allowable deduction.

D. In light of the fact that the acquisition of an asset necessitates a larger initial outlay than hiring, in some cases, the company may choose to hire rather than acquire.

11. Which of the following is not a feature of hire purchase?

A. Ownership of goods is transferred after the payment of the final installment.

B. Ownership of goods remains with the seller until the full price is paid

C. Ownership of the goods passes to the buyer just signing the agreement.

D. The buyer can not sell, destroy or transfer the goods.

12. Which of the following is not a feature of the installment system?

A. It is an agreement of sale. System of credit sale in which a sum of money or debt is paid regularly in installment.

B. Ownership of the goods passes to the buyer just signing the agreement. Ownership is transferred immediately after the first installment

C. he buyer can sell, destroy or mortgage or transfer as his/her wish.

D. Ownership of goods is transferred after the payment of the final installment. Ownership of goods remains with the seller until the full price is paid

13. Which of the following is wrong in regard to Lease rent paid?

A. As regards the consideration for the lease, there could be two types of receipts in the hands of the lessor-receipt on capital account termed 'premium' in respect of the transfer of rights and receipts on revenue account termed 'rent' for the right or liberty to use the property for a term of years.

B. The lease rental paid is not chargeable to revenue every year.

C. The lease rental may be split into three components—the recovery of principal, cost, the interest chargeable and an element of profit.

D. Since the entire lease rental is chargeable to revenue the lessee could claim tax benefits on even the principal investment in the equipment.

14. Which of the following is wrong in calculation of Present Value, where the Asset is Purchased on Loan?

A. Compute each outflow (Interest + repayment of loan) spread over a number of years.

B. Compute Tax saved on deductions claimed (Interest + depreciation) spread over a number of years.

C. Compute adjusted cash inflow

D. Compute the present value of the adjusted cash outflow.

15. Which of the following is the wrong step in the calculation of Present Value where the Asset is Leased?

A. Computer Lease Rental spread over a number of years.

B. Compute Cash Outflow (processing fees + lease rental) spread over a number of years.

C. Compute Tax saved on deductions claimed (processing fees + lease rental) spread over a number of years.

D. Compute adjusted cash outflow which is (A – B)

Answers for Self Assessment

1.	B	2.	B	3.	B	4.	D	5.	D
6.	B	7.	D	8.	C	9.	C	10.	B
11.	C	12.	D	13.	B	14.	C	15.	D

Review Questions

1. Explain the Factors which are required to be considered before making 'own or lease' decisionin detail
2. What are the Tax Advantage when Assets are Purchased?
3. Explain Tax advantages of Lease?
4. What factors affect tax Planning in respect of Own or Lease
5. Write a note on the steps for calculating Present Value, where the Asset is Purchased on Loan?

Further Readings

- https://www.icsi.edu/media/webmodules/16112021_Advance_Tax_Laws.pdf
- A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications
- Study Material on Direct Tax Laws and International Taxation by ICAI
- Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta
- www.incometaxindia.gov.in

Dr. Rupinder Katoch, Lovely Professional University

Unit 08: Tax Planning with Regard to Managerial Decisions-II

CONTENTS

Objectives

After studying this unit, you will be able to:

- understand tax considerations regarding "Make or Buy" decision,
- understand tax planning issues regarding Repair, Replace, Renewal or Renovation of an asset,
- understand the provisions of tax planning regarding "Shut down or Continue" of a loss-making unit.

Introduction

Make-or-buy decisions involve the assessment of whether an organization should continue manufacturing a product or service 'in-house', or if it should just buy those from an outside supplier.Make-or-buy decisions must be based on the relevant cost of each option. The assesse while making such a decision should try to get the tax benefits arising from allowances such as depreciation, tax holiday benefit, and deduction in respect of profits from new industrial undertakings, wherever they are applicable.

Lossesco-exist with profits in business. Shut down decisions involves no buying or selling, no manufacturing, assets to be sold or disposed of, returning capital to owners, etc. Before electing to close a business, two things must be well understood: the first is the numerous tax laws that must be followed after opting to close a firm, and the second is the tax ramifications of the choice to close.

Similarly, repair, replacement, and renewal decisions also have tax implications.

8.1 Reasons for Outsourcing

- Focus on core products
- Lower cost offered by outside suppliers
- Overcoming production constraints
- Higher quality.

8.2 Non-Tax Considerations

- Availability of Manufacturing Infrastructural facilities
- Capacity Utilization.
- Adequate Funds.
- Market.
- Availability of products in the market at cheaper rates.
- Cost of Manufacture Vs Cost of Purchase.
- Import restrictions.
- Technology.

Costing and Tax considerations

When making a decision, the following factors should be taken into account.

- total cost
- variable cost

Where applicable, tax benefits stemming from allowances such as depreciation, tax holiday benefit, and deduction for profits from new industrial enterprises should be examined.

Following considerations should be given due weightage in arriving at a decision.

- 'Saving after tax'.
- The long-term advantages.

Relevance of cost

Incremental cash flows.

- Calculating the relevant cost is the first step in finding the most cost-effective option

Examples of Relevant Costs

Relevant Costs	Examples
Variable costs	• Cost of labor involved in the production. • Cost of material used in manufacturing. • Variable production overheads such as the cost of electricity used in production.
Direct fixed costs	• Rent of production facility. • Salary of factory supervisor.
Opportunity cost	• Rental income from machinery that is given up for manufacturing in-house.
Non-Relevant Costs	**Examples**

Indirect fixed costs	• General and administrative expense.
Non-cash expenses	• Depreciation.
Sunk costs	• Cost of machinery already paid.
Committed costs	• The rental expense of a factory building whose lease agreement does not allow termination until the end of the lease term.

Decision on basis of relevant cost

- If the internal cost exceeds the external price, it is better to buy
- If the external price exceeds the internal cost, it is better to make.

Taxes

- Taxes such as GST, customs duty etc., payable in the process of manufacture should be taken into account.
- All taxes to be borne by the purchaser should be added for the purpose of comparison and cost of purchasing.

Tax Considerations

- Capital Gain
- 80-IB/80-IC
- Depreciation
- Deductibility

Example 1:

Requirement 20000 units

- Direct Material Cost 40000
- Direct Labor Cost 160000
- Factory Overheads
  - Variable 80000
  - Fixed 160000
- Can be purchased from market at 20 per unit

Solution

Total Cost 4,40,000

P.U. TC=4,40,000/20000= 22

P.U. VC=4,40,000- 160000

= 2,80,000/20000= 14

Purchasing Cost = 20

Compared with its variable cost, it should be manufactured.

Example 2

Requirements 40000 units

Material Cost P.U. 8

Labor cost P.U. 12

Variable Overhead Cost P.U. 4

Net Cash Outflow in respect of financing of machine to be bought in manufacturing option for 10 years= 4,00,000p.a.

Market price (a) 25 (b) 28

Solution

Requirements 40000 units

Total Material Cost (8*40000) = 3,20,000

Labor cost P.U.(12*40000) = 4,80,000

Variable Overhead Cost (4*40000)= 1,60,000

Bank Loan instalments 40,000

Total cost of 40000 units 10,00,000

P.U. Cost 10,00,000/40000 25

Conclusion: If Market price 22 better to buy. If Market price 28 better to manufacture

Example 3

Cost of Purchasing New Machinery: 10,00,000

Scrap Value after 5 Years 2,00,000

Depreciation 20%

Manufacturing cost

1	1400000
2	1500000
3	1600000
4	1700000
5	1800000

Buying cost

1	2000000

2	2100000
3	2200000
4	2300000
5	2400000

Solution

Alternative 1 Making (Tax=30%)

Year	Depreciation	WDV
1	200000	800000
2	160000	640000
3	128000	512000
4	102400	409600
5	81920	327680
STCL	127680	=327680-2,00,000

Alternative 1 Making (Tax=30%)

Year	Manufacturing cost	Depreciation	TC	Tax Saving	Net Cost

0					1000000
1	1400000	200000	1600000	480000	920000
2	1500000	160000	1660000	498000	1002000
3	1600000	128000	1728000	518400	1081600
4	1700000	102400	1802400	540720	1159280
5	1800000	81920	1881920	564576	1235424
				Sale of Machine	-200000
					6198304

Net cost of manufacturing the component

- STCL: 127680
- Tax saving on STCL=30% of STCL

= .30* 127680

=38304

- Net cost : 6198304-38304= 6160000

Alternative 2 Buying The component

Year	cost of purchase	Tax saving	Net Cost
1	2000000	600000	1400000
2	2100000	630000	1470000
3	2200000	660000	1540000

4	2300000	690000	1610000
5	2400000	720000	1680000
		Total Net Cost	7700000

Conclusion

- The cost of making the component is less than the cost of buying it.
- Component should be manufactured.

8.3 Meaning of Repairs,Replacement, Current Repairs

"Repair" implies the existence of a thing that has malfunctioned and can be set right by effecting repairs.

"Replacement" implies the removal or discarding of the things that were in use in favour of a different or new thing capable of performing the same function with the same or greater efficiency.

"Current Repair" implies the expenditure must have been incurred to 'preserve and maintain' an already existing asset.

Tax Consideration: Capital vs Revenue expenditure

- Whether the repair, replacement, or renewal expense is deductible as a revenue expenditure under sections 30, 31, or 37(1).
- If such an expenditure is not allowable as a deduction under Sections 30, 31, or 37(1), then depreciation is available on the capitalized amount.

Section 30

Repairs for buildings.—

- In respect of repairs for premises, used for the purposes of the business or profession, the following deductions shall be allowed—
    - where the premises are occupied by the assessee as a tenant, if he has undertaken to bear the cost of repairs to the premises, the amount paid on account of such repairs.
    - otherwise,then as a tenant, the amount paid by him on account of current repairs to the premises.
    - Explanation. —amount paid shall not include any expenditure in the nature of capital expenditure.

Section 31

Repairs of machinery, plant and furniture. —

- In respect of repairs of machinery, plant or furniture "used for the purposes" of the business or profession, the following deductions shall be allowed—
    - the amount paid on account of current repairs thereto;

- Explanation.—amount paid on account of current repairs shall not include any expenditure in the nature of capital expenditure.

Section 38

- Where any building, plant and machinery, furniture is not exclusively used for the purposes of business or profession, the deduction on account of expenses on account of current repairs to the premises, current repairs of machinery, plant and furniture in respect of these assets shall be restricted to a fair proportionate part thereof, which the Assessing Officer may determine having regard to the user of such asset for the purposes of the business or profession.

Section 37

General.—

- Any expenditure (not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head ―Profits and gains of business or profession.
- Explanation —Expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure.

Deduction of expenses incurred on Repairs

- The repair expenses or replacement expenses are debited to profit and loss a/c.
- Current repairs can be debited to p & L a/c.
- Current repairs to rented buildings can be charged against P & L a/c.
- Replacement expenses can be capitalized.
- Expenditure on replacement of parts of machinery is deductible.
- Replacement of whole machinery is treated as capital expenditure on which depreciation is allowed.

Examples

- Repairs to building can be capital or revenue, depending on nature of change brought about.
- Replacement of Assets as a whole is not 'Repair'.
- Repair and replacement of false ceilings in cinema buildings is a revenue expenditure.

Examples

- Expenditure on repairs to cars damaged during riots is deductible.
- Expenditure on repair damage to a car in which the director of the company was travelling.
- Expenditure on renovation and modernization of hotel premises is Revenue Expenditure:

Case Study

New Shorrock Spinning And ... vs Commissioner Of Income-Tax, ... on 27 February, 1956

- To preserve and maintain an already existing asset.
- Not for the purpose of bringing into existence a new asset or obtaining a new advantage.
- expenditure that is of a revenue nature rather than a capital nature.
- The assessee should be able to make current repairs.
- Commercial expediency test.

Case Study

CIT vs. Maha Lakshmi Ji Textile Mills Ltd. (1967)

- The decision of the Supreme Court in the case of CIT vs. Mahalakshmi Textile Mills Ltd. (1967) 66 ITR 710 (SC) held that the expenditure incurred was only for replacement of part of the textile machinery and, therefore, was allowable as revenue expenditure.
- The assessee carried on the business of manufacture and sale of cotton yarn.
- In the previous year relevant to assessment year 1956-57, the assessee spent approximately Rs.93,000 on the introduction of the "Casablanca conversion system" in its plant.
- The Income-Tax Officer disallowed the claim of the assessee.
- The appellate authority agreed with the Income-Tax Officer.
- Before the Tribunal, the assessee contended that the amount expended for introducing the Casablanca conversion system was current expenditure under section 10 (2) (v) of the Indian Income-tax Act, 1922 (section 31 (i) of the 1961 Act).
- Tribunal held that on account of the stress and strain of production over a long period there was a need for change and that the assessee had replaced old parts by introducing the said System.
- the Tribunal treated the expenditure incurred for introducing the Casablanca Conversion System as allowance under Section 10(2)(v) of the Indian Income Tax Act, 1922.
- where the old parts were not available in the market or where the old parts had worked for 50 to 60 years, replacement can, in such cases of exception, fall within the expression "current repairs".

Case Study:CIT v: Saravana Spinning Mills (P) Ltd

- In order to determine whether a particular expenditure amounts to "current repairs", the test is "whether the expenditure is incurred to "preserve and maintain" an already existing asset and not to bring a new asset into existence or to obtain a new advantage."
- The entire textile mill machinery cannot be regarded as a single asset, replacement of parts of which can be considered to be for the mere purpose of "preserving or maintaining" this asset.
- The judgement of this Court in the Saravana Mills (supra) case mentions two exceptions in which replacement could amount to current repairs, namely:
- "Where old parts are not available in the market (as seen in the case of CIT v. Mahalakshmi Textile Mills Ltd., AIR 1968 SC 101, or
- Where old parts have worked for 50-60 years."
- For `current repairs' determination, whether expenditure is revenue or capital is not the proper test." It is our opinion that the entire textile mill machinery cannot be regarded as a single asset, the replacement of parts of which can be considered to be for the mere purpose of `preserving or maintaining' this asset.
- All machines put together constitute the production process and each separate machine is an independent entity. Replacement of such an old machine with a new one would constitute the bringing into existence of a new asset in place of the old one and not repair of the old and existing machine.

Case Study:

Travancore Cochin Chemicals Ltd. v. CIT

- The Court held that expenditure is of a capital nature when it amounts to an enduring advantage for the business, and repair is different from bringing in a new asset for the business.
- The source or the manner of the payment would then be of no consequence.

- The appellant assessee is a public limited company that spent Rs.26,100/-on the construction of a new road to improve transport facilities in the area where its factory is located and sought to deduct this amount from its total income, claiming it as revenue expenditure for the year.
- The claim was disallowed by the Income-tax Officer and the Appellate Assistant Commissioner. The Appellate Tribunal held that the amount could be deducted as revenue expenditure, but at the instance of the respondent, referred the matter to the High Court under section 256 (1) of the Income Tax Act, 1961, where it was decided against the appellant.
- The line of demarcation between capital expenditure and revenue expenditure has been found to be very thin. According to the test suggested in Atherton's case by Vis- count Cave, L.C. by having the new road constructed for the improvement of transport facilities, the assessee acquired an enduring advantage for its business.
- The expenditure incurred was, therefore of a capital nature.

Case Study:

Lakshmi ji Sugar Mills (P) Co. v. CIT

- **In the facts and circumstances of the case, the expenditure was incurred by the assessee for reasons of commercial expediency apart from statutory compulsion.**
- The development of the roads was necessarily meant for facilitating the carrying on of the assessee's business with a view to produce profits. In the absence of any finding by the Tribunal that the roads were to be altogether newly made and that the assesses would get an enduring benefit, the expenditure was allowable as an admissible deduction.
- The appellant assessee is a private limited company carrying on the business of manufacturing and selling sugar.
- During the accounting period relating to the assessment year 1956- 57, sums of Rs. 75,000/- and Rs. 37,000/- were paid by the assessee to the Cane Development Council of the Sugarcane Department of U.P. (under the U.P. Sugarcane Regulation and Sugar and Purchase Act, 1953) by way of contribution for road development between various sugarcane producing centres and the sugar factories of the assessee.
- The roads were originally the property of the government and remained so after improvements had been made.
- The improved roads facilitated the transportation of cane to the factories of the assessee, and the expenditure was incurred for commercial expediency and for the benefit of the day to day business of the assessee.
- The Revenue Authorities, the Appellate Tribunal and the High Court found that these contributions constituted capital expenditure and could not be allowed as an admissible deduction in computing the total income of the Assessee.

Case Study:

Modi Spinning& Weaving Mills Co.Ltd

- Current repairs must necessarily mean repairs which are required to be carried out from time to time as and when a defect arises. If there has been wear and tear on an item, like the floors in the present case, over a number of years, and ultimately, they are replaced, then such replacement cannot be regarded as current repair.
- Rs. 28,247 on repairs and renovation of its administrative block. Rs. 6,359 was spend for providing sanitary installation.
- The authority had found that the sum of Rs. 14,472 was the cost of marble, Rs. 9,949 were charges for cutting stones, Rs. 2,061 were spent on wages and Rs. 1,029 were expenses incurred towards polishing and connected with fixing of stones.
- Besides this, a sum of Rs. 960 was spent of re-plastering work which was incidental to the above activity.

- The claim of the assessed was that this amount had been spent on carrying out current repairs and should be allowed as a deduction under section 30 (a) (ii) of the Act. The claim was disallowed by the Income-tax Officer while relying upon the decision of the Calcutta High Court in the case of Humayun Properties Ltd. v. CIT [1962] 44 ITR 73.
- Facts as found by the Tribunal are that the administrative block had been built in 1948 and required repairs and improvement in the relevant assessment year in question.
- Repairs were long overdue.
- If there has been wear and tear on an item, like the floors in the present case, over a number of years and ultimately they are replaced, than such replacement cannot be regarded as current repairs.

Tax Planning

- Less income, if expected, spread over repair and replacement expenses over several years.
- If the income is high, the pace can be increased.
- Replace part of the asset.

8.4 "Shut Down or Continue" of a Loss-Making Unit.

Reasons for Business Losses

- Demand Fall
- Financial problems
- High Tax rates
- Poor Management

Main considerations

- Treatment of losses and unabsorbed depreciation
- Withdrawal of certain deductions
- Deemed incomes
- Sale of depreciable assets
- Sale of other assets

Shut Down or Discontinue

Profitable business with unabsorbed depreciation and past losses:

- Business should be continued till the past losses and unabsorbed depreciation are not fully set off.

Loss generating business:

- temporary losses, then business should be continued.
- Permanent losses, then the business should be discontinued.

Impact of Income Tax Provisions

- Business Losses of discontinued business can be carried forward and set off against profits and gains of business or profession.
- Unabsorbed depreciation of discontinued business :
  - set off against income from business and profession or any other head.
  - C/f and set off for an indefinite period.

Carry Forward and Set-off of Business Losses

The person who has incurred the loss, alone has the right to carry it forward.

Exceptions

1. The successor, except in succession by inheritance (business passing from father to son), cannot claim to carry forward the loss incurred by his predecessor in business.
2. Where a company merges with another under the scheme of amalgamation, the past loss of the amalgamating company can be carried forward by the new company.

3. Income clubbed u/s 64 (1), the assessee is entitled to set off his carried forward loss from the previous year against the income of his wife and minor child included in his income.
4. In the case of amalgamation, if businesses are not the same, carry forward of losses sustained by amalgamating companies is not allowed.
5. In the event of a demerger, the demerged company's accumulated business loss and unabsorbed depreciation may be carried forward and set off in the hands of the resulting company if certain conditions are met.
6. Accumulated business losses can be carried forward indefinitely and unabsorbed depreciation can be carried forward indefinitely.
7. Accumulated loss and unabsorbed depreciation of a demerged company can be carried forward by the resulting company for set off against its profits (Section 72A(4)):

- Where it is directly relatable to the undertaking transferred, it should be a relatable amount.
- Where it is not directly relatable to the undertaking transferred, it should be apportioned in the ratio of assets retained by the demerged company and transferred to resulting company.

8. Where a firm is succeeded by a company, the accumulated loss and unabsorbed depreciation of the partnership firm is deemed to be the loss and depreciation of the successor company for the previous year in which the conversion was effected.

Thus, such a loss can be carried for a further eight years in the hands of the successor.

Conditions are:

All of the assets and liabilities of the firm [or of the association of persons or body of individuals] relating to the business immediately preceding the succession become the assets and liabilities of the company.

On the date of conversion, all partners will become shareholders of the company in proportion to their capital contribution in the partnership firm.

A minimum of two directors are required(For conversion into a private company). The existing partner may become the director.

There should not be a revaluation of the assets of the partnership firm in the previous three years.

NOC from all the secured creditors.

9. Conversion of Sole Proprietary Business Into Company : The accumulated loss and the unabsorbed depreciation of the predecessor firm or the proprietary concern, as the case may be, shall be deemed to be the loss or allowance for depreciation of the successor company for the purpose of previous year in which business reorganization was effected and other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly.

Conditions are:

- 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 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 so remain as such for a period of 5 years from the date of the succession;
- The sole proprietor does not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company;

If any of the conditions set out in the proviso to clause (xiii) or the proviso to clause (xiv) to section 47 are not met, 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 company's chargeable income in the year in which such conditions are not met.

10. While corporate group reorganization or share acquisition, section 79 is one of the significant provisions of the Income-tax Act, 1961 which comes into play as soon as there

is a change in more than 51% of shareholding of a closely held company with unabsorbed losses. Section 79 provides that where there is a change in the shareholding of a closely held company,

No loss incurred in any year prior to the previous year shall be carried forward and set off against the income of the previous year, unless the shares of the company carrying not less than 51% of the voting power were beneficially held by the persons who beneficially held shares of the company carrying not less than 51% of the voting power as on the last day of the year or years in which the loss was incurred.

Carry Forward and Set-off Business Losses

Discontinued Speculation Business Loss

- The carry forward loss of speculation business which is discontinued, is eligible for setting off against the assessee's income of another speculation business.

If any industrial undertaking carried on in India is discontinued in any previous year by reason of extensive damage to, or destruction of, any building, machinery, plant or furniture owned by the assessee and used for the purposes of such business as a direct result of:

i. a flood, typhoon, hurricane, cyclone, earthquake, or other natural disaster; or

ii. riot or civil unrest; or

- As a result, if a business suffers a loss and is re-established, reconstructed, or revived within three years, the loss is carried forward to the assessment year in which the business is re-established, reconstructed, or revived and set off against the business income, if any.

Assessment of Firm Dissolved or Business Discontinued [Section 189]

In the event of the death or retirement of a partner, his share of the loss is not C/F and set-off by the reconstituted firm.

Example1

- PGBP before setting off brought forward depreciation and brought forward losses(31.3.2021) 8,00,000
- Brought forward losses of Assessment Year 2018-19 3,00,000
- Brought forward Depreciation of Assessment Year 2018-19 1,00,000
- There were four partners A, B, C and D sharing profits and losses equally.
- On 30th June, 2020, the partner A had retired from the firm. Compute the total income of the firm

Solution

Retiring partner share in the current profits for 3 months:

8,00,000/4=2,00,000*3/12= 50000

Retiring partner share in brought

forward losses= 75000

Therefore, Rs. 25,000 cannot be carried forward and set off by the firm.

Section 78(1) is not applicable for B/F depreciation.

Income of the firm for Assessment Year 2021-22 is as under:

Current Year PGBP 8,00,000

Less: Brought Forward Losses

(3,00,000 - 25,000) = 2,75,000

Less: Brought Forward

Depreciation = 1,00,000

Income 4,25,000

Withdrawal of Certain Deductions

How can a tea/coffee/rubber business house avoid the withdrawal of deduction claimed u/s 33AB ?

- Benefits are withdrawn and liable to tax in the year of discontinuance:

– Tax planning can avoid withdrawal of deduction claimed u/s 33AB

– However, sales/ transfers in are exempted-if the asset is sold/ transferred to Government or a local authority or a corporation or a Government company;

or

– -sales/ transfers in are exempted if sale/ transfer on account of the succession of a firm by a company. Wherein, the applicability of scheme continues with the company.

Withdrawal of the amount deposited in a special/ deposit account-

– The amount deposited in a special account or deposit account can be withdrawn under the following circumstances only-

– For the purposes as specified in the scheme,

– On the closure of the business,

– On the death of the assessee,

– On dissolution of the firm or liquidation of the company,

– On the partition of the **Hindu Undivided Family**.

Circumstances under which the withdrawal will be deemed to be income and taxed accordingly-

Under the following cases, any amount withdrawn from the deposit/ special account will be charged to income tax under the head 'Profits and gains of business or profession'-

– When the amount is withdrawn either on the closure of the business or dissolution of the firm.

Circumstances under which the withdrawal will be deemed to be income and taxed accordingly-

- When the amount is withdrawn for an approved specified purpose. However, the whole or part of the amount is not utilized within the end of the relevant previous year.
- When the asset acquired as per the scheme is sold/ transferred before the expiry of eight years from the end of the previous year in which the asset was acquired.

Tax Planning in tea/coffee/rubber business house

– In the case of a firm :- If assets acquired u/s 33AB are required to be sold before the expiry of 8 years, then such a firm is advised to sell/ transfer such assets to a company in connection with the succession of a firm by company arrangement, subject to fulfilment of the prescribed conditions given for this.

These conditions are :

(a) all the properties of the firm relating to the business or profession immediately before the succession become the properties of the company;

(b) all the liabilities of the firm relating to the business or profession immediately before the succession become the liabilities of the company; and

(c) all the partners of the firm before the succession become all the shareholders of the company.

Tax Planning in petroleum or natural gas business houses

So, petroleum or natural gas business houses can avoid the withdrawal of the deduction claimed u/s 33AB, same as suggested for the tea/coffee/rubber business of the company.

If assets acquired by withdrawing an amount from 'Special Account' are to be sold before the expiry of the stipulated period of 8 years, then, if possible, such assets should be sold to any of the following persons:

a. Government (Central or state)

b. Local Authority

c. A corporation established by or under a Central, State or Provincial Act

d. A government company as defined in Sec 617 of the Companies Act, 1956.

If this is done, then the incentive deduction shall not be withdrawn and, hence, the assessee shall not be liable to pay tax on deemed business profits.

Business is not said to be discontinued when:

- Shifted from one premises to another.
- One of the departments closed.
- Business of running tea plantations, manufacturing tea, and selling tea. Manufacturing of tea was discontinued for three years but employees were retained.

Deemed Income

If the business is discontinued and the assets used for scientific research and family planning are sold, the selling price equal to deductions claimed shall be deemed as profits of the PY in which such assets are sold.

Sale of depreciable assets-

- Sale of depreciable assets-the assets on which the assesse has claimed depreciation are sold in the event of discontinuance of business. The difference between the net consideration and WDV shall be treated as STCG/loss.
- If it is a gain, it is subject to capital gains tax and, in the case of a loss, it is adjusted against the capital gains if any.

Sale of Other Assets-

When other assets except the above mentioned assets are sold, there may be a short-term or long-term capital gain or loss. Such a gain is subject to tax, whereas the loss is adjusted against capital gains.

Tax planning

- If a person has more than one business, he should not discontinue the loss-making business but should operate at a low key for some time and claim the losses and expenses against the profit-making business, like retrenchment compensation, interest on borrowed funds, and bad debts.
- See the possibility of its amalgamation with some other company.
- Consider a "slump sale". Beneficial or not?

Summary

When making a 'make or buy' decision, the variable cost of producing the product or a part/component of a product is weighed against its market purchase price. If the former is more than the latter, the article is brought. Alternatively, if the option includes the development of a distinct industrial unit for this purpose, the total cost rather than variable cost may be considered.In such a case, the assessee would also be eligible for tax benefits resulting from allowances such as depreciation, tax holiday benefit, and deduction for profits from new industrial enterprises, if they are relevant.Many additional costing and non-cost considerations are taken into account when making the decision, such as capacity utilisation, supply position of the object to be purchased, terms of purchase, and so on. The basis for making or buying a decision should be 'saving after tax.' After deducting the income tax payable on the amount saved from the gross savings, the net saving may be calculated. The long-term benefits of a decision should be given significant consideration while making a decision.

In a down situation, a business shrinks, generates losses and causes tension to owners. Such a situation occurs when any/ some/ all of the above factors go against the business. i.e. (i) Low demand/ falling demand of product (ii) Falling profit margin (iii) Withdrawal of government support (iv)No encouraging future prospects etc. Such situations are normally described as industrial sickness. Generally under such a situation, a business house faces a problem whether the business should be continued or shut down.

All such situations involve decision making which has tax implications.

Keywords

- "Repair" implies the existence of a thing that has malfunctioned and can be set right by effecting repairs.
- "Replacement" implies the removal or discarding of the things that were in use in favour of a different or new thing capable of performing the same function with the same or greater efficiency.
- "Current Repair" implies the expenditure must have been incurred to 'preserve and maintain' an already existing asset.
- ' Shut down' or 'discontinuance of business for Income tax purposes: It refers to a complete cessation or closing down of the business. It involves
- Incremental cash flow: The increased operating cash flow that an organisation obtains as a result of starting a new project is referred to as incremental cash flow.

Self Assessment

1. In case of conversion of Sole Proprietary Business Into Company, the accumulated loss and the unabsorbed depreciation of the predecessor firm or the proprietary concern, as the case may be, shall be deemed to be the loss or allowance for depreciation of the successor company for the purpose of previous year in which business reorganization was effected and other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly. This is subject to certain conditions. Which of these is not a condition.

A. 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;

B. 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 so remain as such for a period of 5 years from the date of the succession;

C. The sole proprietor does not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company;

D. The shareholding of the sole proprietor in the company is not less than 51% of the total voting power in the company and his shareholding continues to so remain as such for a period of 5 years from the date of the succession;

2. While corporate group reorganization or share acquisition, section _____is one of the significant provisions of the Income-tax Act, 1961 which comes into play as soon as there is a change in more than 51% of shareholding of a closely held company with unabsorbed losses

A. 78
B. 79
C. 80
D. 81

3. Which of the following is right about Carry Forward and Set-off Business Losses in case of Discontinued Business Loss?

A. The carry forward loss of speculation business which is discontinued, is eligible for setting off against the assessee's income of any other business.

B. If any industrial undertaking carried on in India is discontinued in any previous year by reason of extensive damage to, or destruction of, any building, machinery, plant or furniture owned by the assessee and used for the purposes of such business as a direct result of:a flood, typhoon, hurricane, cyclone, earthquake, or other natural disaster; orriot or civil unrest; orAs a result, if a business suffers a loss and is re-established, reconstructed, or revived within five years, the loss is carried forward to the assessment year in which the business is re-established, reconstructed, or revived and set off against the business income, if any.

C. If any industrial undertaking carried on in India is discontinued in any previous year by reason of extensive damage to, or destruction of, any building, machinery, plant or furniture owned by the assessee and used for the purposes of such business as a direct result of:a flood, typhoon, hurricane, cyclone, earthquake, or other natural disaster; orriot or civil unrest; orAs a result, if a business suffers a loss and is re-established, reconstructed, or revived within three years, the loss is carried forward to the assessment year in which the business is re-established, reconstructed, or revived and set off against income from other sources, if any.

D. The carry forward loss of speculation business which is discontinued, is eligible for setting off against the assessee's income of another speculation business.

4. Where a firm is succeeded by a company, the accumulated loss and unabsorbed depreciation of the partnership firm is deemed to be the loss and depreciation of the successor company for the previous year in which the conversion was effected. Thus, such a loss can be carried for a further ____ years in the hands of the successor.

A. 3
B. 5
C. 8
D. 10

5. Where a firm is succeeded by a company, the accumulated loss and unabsorbed depreciation of the partnership firm is deemed to be the loss and depreciation of the successor company for the previous year in which the conversion was effected. Which of these is not a condition?Conditions are:

A. All of the assets and liabilities of the firm [or of the association of persons or body of individuals] relating to the business immediately preceding the succession become the assets and liabilities of the company.
B. On the date of conversion, all partners will become shareholders of the company in proportion to their capital contribution in the partnership firm.
C. There should be a revaluation of the assets of the partnership firm in the previous three years.
D. There should not be a revaluation of the assets of the partnership firm in the previous three years.

6. Which of the following statement is wrong about Carry Forward and Set-off of Business Losses?

A. The successor, except in succession by inheritance (business passing from father to son), cannot claim to carry forward the loss incurred by his predecessor in business.

B. Where a company merges with another under the scheme of amalgamation, the past loss of the amalgamating company can not be carried forward by the new company.

C. In the case of amalgamation, if businesses are not the same, carry forward of losses sustained by amalgamating companies is not allowed.

D. In the event of a demerger, the demerged company's accumulated business loss and unabsorbed depreciation may be carried forward and set off in the hands of the resulting company if certain conditions are met.

7. Which of the following is not considered to be a rational decision in case of shut down or discontinuance?

A. In the case of Profitable business with unabsorbed depreciation and past losses, Business should be continued till the past losses and unabsorbed depreciation are not fully set off.

B. In the case of Loss generating business, iftemporary losses are there, then a business should be continued.
C. In the case ofLoss generating business if permanent losses are there, then the business should be discontinued.
D. In the case of Profitable business with unabsorbed depreciation and past losses, Business should be discontinued.

8. Which of the following is a tax consideration to arrive at the decision of make or buy?
A. Availability of Manufacturing Infrastructural facilities
B. Capacity Utilization.
C. Adequate Funds.
D. Saving after tax

9. Which of the following is not a relevant cost for make or buy decision?
A. Cost of machinery already paid.
B. Rent of production facility.
C. Salary of factory supervisor.
D. Cost of material used in manufacturing.

10. Which of the following is not a condition in Section 30?

A. repairs are for premises used for the purposes of the business or profession.

B. where the premises are occupied by the assessee as a tenant, if he has undertaken to bear the cost of repairs to the premises, the amount paid on account of such repairs will be allowed as deduction;

C. otherwise than as a tenant, the amount paid by assessee on account of current repairs to the premises will be allowed as deduction;

D. amount paid shall include any expenditure in the nature of capital expenditure.

11. Which of the following is not a condition in Section 31?

A. repairs of machinery, plant or furniture “used for the purposes” of the business or profession

B. the amount paid on account of current repairs theretoshall be allowed.

C. amount paid on account of current repairs shall not include any expenditure in the nature of capital expenditure.

D. repairs of machinery, plant or furniture “used for the purposes” of the business or profession or personal

12. Which of the following is not a condition in Section 38?

A. Where any building, plant and machinery, furniture is not exclusively used for the purposes of business or profession,

B. the deduction on account of expenses on account of current repairs to the premises,

C. current repairs of machinery, plant, and furniture in respect of these assets shall be taken in full amount irrespective of the proportion used for the business,

D. which the Assessing Officer may determine having regard to the user of such asset for the purposes of the business or profession.

13. Which of the following is not a condition in Section 37?

A. Any expenditure (not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee),

B. laid out or expended wholly and exclusively for the purposes of the business or profession

C. shall be allowed in computing the income chargeable under the head ―Income from other sources.

D. Expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure.

14. Which of the following is not true in regard to the ddeduction of expenses incurred on Repairs?

A. Current repairs can be debited to p & L a/c.

B. Replacement expenses can be capitalized.

C. Expenditure on replacement of parts of machinery is deductible.

D. Replacement of whole machinery is deductible

15. Which of the following is not true to makerepairs deductible under New Shorrock Spinning And ... vs Commissioner Of Income-Tax, ... on 27 February, 1956

A. To preserve and maintain an already existing asset.

B. for the purpose of bringing into existence a new asset or obtaining a new advantage.

C. expenditure that is of a revenue nature rather than a capital nature.

D. Commercial expediency test.

Answers for Self Assessment

1.	D	2.	B	3.	D	4.	C	5.	C
6.	2	7.	D	8.	D	9.	A	10.	D
11.	D	12.	C	13.	C	14.	D	15.	B

Review Questions

1. Explain the Tax considerations in make or buy decision in detail.
2. Explain main tax consideration for "Shut down or Continue" of a loss-making unit.
3. Explain the Meaning of Repairs,Replacement, Current Repairs with suitable examples.
4. Explain main tax consideration for "Shut down or Continue" of a profit-making unit.
5. Explain Carry Forward and Set-off of Business Losses provision in discontinued business.

Further Readings

- https://www.icsi.edu/media/webmodules/16112021_Advance_Tax_Laws.pdf
- A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications
- Study Material on Direct Tax Laws and International Taxation by ICAI
- Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta
- www.incometaxindia.gov.in

Dr. Rupinder Katoch, Lovely Professional University

Unit 09: Tax Planning regarding Restructuring of Business

CONTENTS

Objectives

After studying this unit, you will be able to:

- understand the tax implications of conversion of Firm/Sole proprietorship into Company,
- comprehend the provisions related to Transfer of Assets between Holding and Subsidiary Company.

Introduction

The act of reforming a company's legal, ownership, operational, or other structures in order to make it more profitable or better organised for its current needs is known as restructuring. In an ever-changing business environment, companies are turning to acquisitions to consolidate and grow quickly. As a result, the level of restructuring activities in numerous sectors has increased. Transactions involving a change in ownership or operational structure have tax implications. The goal of a good restructuring strategy is to boost efficiency, consolidate operations, gain market share, aid in turnaround, raise market capitalization, and create barriers to entrance for competitors. In this case, proper tax planning will help to lower the cost of restructuring.

9.1 Conversion of Sole ProprietorshipintoCompany

Where a sole proprietary concern is succeeded by a company in the business carried on by it as a result of which the sole proprietary concern sells or otherwise transfers any capital asset to the company, subject to following conditions – a) All assets and liabilities of the sole proprietary concern relating to the business immediately before the succession become the assets and liabilities of the company; b) Proprietor holds not less than 50% of the total voting power in the company and his shareholding continues to remain as such for a period of 5 years from the date of succession; and c) The sole proprietor does not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company.

Tax point

The transfer must have taken place because ofa succession of the proprietorship concern to a company.

All assets and liabilities related to the business must have been transferred.

The whole consideration shall be paid by allotment of shares in the company.

The proprietor must hold at least 50% of the total voting power of the company.

The Lock-in period for the above share is 5 years from the date of succession.

Note: Sec. 47(xiii) & (xiv) exempts the capital gain on transfer of capital asset and not stock in trade. Therefore, if stock is transferred at profits, it will be taxable as business income

In the year of - Succession [referred in sec. 47(xiii), (xiiib) & (xiv) or sec. 170]

9.2 Depreciation in Case of Amalgamation, Demerger or Succession

Depreciation is allowable in the hands of the predecessor and successor, in case of succession of a firm, proprietary concern, by a company, or predecessor company and successor LLP, in case of conversion of Pvt. Ltd. Co. to LLP., in case of amalgamation or demerger, and that shall not exceed the depreciation that would have been allowed if the succession, demerger, amalgamation had not taken place and such depreciation shall be apportioned between them proportionate to use.

depreciation u/s 32 shall be apportioned between the predecessor and the successor - in the ratio of number of days for which the asset was used by them

Example

Illustration 1: M/s Siddhant & Co., a sole proprietary concern is converted into a company, Siddhant Co. Ltd. with effect from November 29, 2020. The written down value of assets as on April 1, 2020 is as follows:

Further, on 15-10-2020, M/s Siddhant & Co. purchased a plant for ` 1,00,000 (rate of depreciation 15%). After conversion, the company added another plant worth ` 50,000 (rate of depreciation 15%). Compute the depreciation available to (i) M/s Siddhant & Co. and (ii) Siddhant Co. Ltd. for the A.Y. 2021-22

Computation of depreciation on assets if there were no succession

It is assumed that the assessee is not entitled for additional depreciation. * Without considering assets acquired after succession. ** [(`2,00,000 * 15%) + (`1,00,000 * 15% * ½)]

Allocation of depreciation between sole proprietary concern and the successor company the depreciation is to be allocated in the ratio of number of days the assets were used by the sole proprietary concern and the successor company. Calculation of allowable depreciation to sole proprietary concern

Note: Charity is not a case of reciprocal promise, because a person doing charity, does not expect anything in return.

9.3 Conversion of Firm into Company [Section 47 (Iii)]

Transfer of a capital asset or intangible asset on conversion of Firm into a Company is not treated as Transfer if following conditions are satisfied and hence not Capital Gain arises. Conditions are:

a) all the assets and liabilities of the firm [or of the association of persons or body of individuals] relating to the business immediately before the succession become the assets and liabilities of the company;
b) all the partners of the firm immediately before the succession become the shareholders of the company in the same proportion in which their capital accounts stood in the books of the firm on the date of succession.
c) the partners of the firm do not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company; and
d) the aggregate of the shareholding in the company of the partners of the firm is not less than 50% , of the total voting power in the company and their shareholding continues to be as such for a period of 5 years from the date of the succession;

9.4 Provisions Relating to Carry Forward and set off of Accumulated Loss and Unabsorbed Depreciation Allowance in Case of Succession [Section 72a(6)]

1. Where there has been reorganisation of business,
2. whereby, a firm is succeeded by a company or a proprietary concern is succeeded by a company ,
3. the accumulated loss and the unabsorbed depreciation of the predecessor firm or the proprietary concern, as the case may be,
4. shall be deemed to be the loss or allowance for depreciation of the successor company for the purpose of previous year in which business reorganization was effected and

1. other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly.
2. Provided that if any of the conditions laid down in the proviso to clause (xiii) or the proviso to clause (xiv) to section 47 are not complied with, the set off of loss or allowance of 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.

The above exemption shall be withdrawn in the following case[section 47a(3)]:

- Where any of the conditions laid down in the proviso to clause (xiii) or the proviso to clause (xiv) of section 47 are not complied with, then
- the amount of profits or gains arising from the transfer of such capital asset or intangible asset,
- shall be deemed to be the profits and gains chargeable to tax of the successor company for the previous year in which the requirements of the proviso to clause (xiii) or the proviso to clause (xiv), as the case may be, are not complied with.

Example 2*:* Firm converted into company on 1/08/2020.

- W.D.V. of plant and machinery(1/4/2020): 5 lakhs
- Rate of depreciation: 15%
- W.D.V. of plant and machinery for the company on 1/4/2021?

Solution:

- W.D.V. on 1/4/2020 : 5,00,000
- Less:
- Depreciation allowable to firm
- from 1/4/2020 to 31/7/2020- 122 days: 25068
- Depreciation allowable to company
- from 1/8 /2020 to 31/3/2021- 243 days: 49932
- W.D.V. for the company on 1/4/2021: 4,25,000

Meaning of Accumulated Losses

- Means so much of the loss of the predecessor firm or the proprietary concern or the private company or unlisted public company before conversion into limited liability partnership or the amalgamating company or the demerged company, 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 predecessor firm or the proprietary concern or the company or amalgamating company or demerged company,

- would have been entitled to carry forward and set off under the provisions of section 72 if the reorganization of business or conversion or amalgamation or demerger had not taken place;

Meaning of Unabsorbed depreciation

- Means so much of the allowance for depreciation of the predecessor firm or the proprietary concern or the private company or unlisted public company before conversion into limited liability partnership 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 the company or amalgamating company or demerged company, as the case may be, under the provisions of this Act, if the reorganisation of business or conversion or amalgamation or demerger had not taken place.

Case Study:

Ahmedabad bench of the Income-tax Appellate Tribunal (Tribunal)

Facts

- o The taxpayer (an existing company) succeeded two partnership firms and had acquired the firm's assets and liabilities as they stood in the balance sheet immediately before succession.
- o The taxpayer had issued its shares as consideration to the partners of the firms.
- o There was a change in constitution of the firms and new partners were added to the firms immediately before the succession.
- o The taxpayer claimed that no capital gains arose on such succession as it complied with the provisions of section 47(xiii) of the Act.
- o The assets included selfgenerated technical knowhow and trademark which were valued at Nil by the firms. Based on the valuation report, the taxpayer had considered cost of acquisition of such assets and claimed depreciation thereon.
- o The Tax Officer (TO) rejected the taxpayer's claim for exemption under section 47(xiii) of the Act and determined capital gains on transfer of land by the firm.
- o The TO consider the value of intangibles as 'Nil' and rejected the depreciation claim

Issues before the Tribunal:

- o Whether the taxpayer was eligible to claim exemption under section 47(xiii) of the Act?
- o Whether the taxpayer was eligible to claim depreciation on intangible assets on the basis of cost determined by the taxpayer?

Revenue's contentions:

- o The taxpayer is not eligible to claim exemption under section 47(xiii) of the Act on the following grounds:
- o An existing company has succeeded the firm.
- o Same proportion of shareholding is not achieved as intangibles are valued at 'Nil'
- o There has been a change in the constitution of the firms immediately before succession.
- o Gain on transfer of land from the firms is taxable in the hands of the taxpayer, being the successor.
- o The claim of depreciation was rejected on the following grounds:
- o Valuation of intangible assets was assessed as 'Nil'.
- o The brand cannot fetch any goodwill as the nature of business of the firms and the taxpayer was same and the brand name was in common use.
- o Valuation of the intangibles is highly inflated.

Taxpayer's contentions:

- o All the conditions prescribed under section 47(xiii) are complied with and the tran should not be subject to capital gains tax.
- o The claim for depreciation was to be allowed on the following grounds:
- o The intangible assets were developed by the partnership firms over a period of

years and are crucial for the taxpayer's business.

- The intangible assets were recognised on the basis of valuation report of a qualified chartered accountant.
- The assets were acquired for a consideration in form of issue of shares.

Tribunal's ruling:

- The benefit of exemption under section 47(xiii) of the Act cannot be denied and capital gain on transfer of land cannot be liable to tax on the following grounds:
- There is no requirement under section 47(xiii) of the Act for firm to be converted into a company. It is sufficient if an existing company acquires all assets and liabilities and complies with the conditions laid under section 47(xiii) of the Act.
- The valuation of technical know-how and trademarks as 'Nil' does not violate conditions specified under section 47(xiii) of the Act
- There is no prohibition under the Act on introduction of new partners before the date of succession. Such introduction does not create an estoppel on operation of exemption provided under section 47(xiii) of the Act.
- The claim for depreciation was allowed on the following grounds:
- There is no dispute about cost of acquisition incurred by the taxpayer which was allocated on the basis of a valuation report.
- If the TO disagreed with the valuation of the intangibles, he should have referred it to the departmental Valuation Officer, which was not done in this case

The Tribunal also relied on the judgment of the Mumbai bench of the Tribunal2 and observed that depreciation on revalued assets could not be disallowed if the assets are acquired in terms of section 47(xiii) of the Act.

The takeaways

This ruling distinguishes cases of conversion and succession under the Act and provides clarity on interpretation of conditions specified in section 47(xiii) of the Act.

Case Study: ITAT PANAJI BENCH

S. 47, r/w s. 45 of IT Act, 1961 — Capital gains — As per s. 47(xiv) it is apparent that where the sole proprietorship concern is succeeded by a company in the business carried on by it as a result of which some proprietary concern sells or otherwise transfers any capital asset or intangible asset to the company, the transactions are not treated as transfer subject to the three conditions laid down therein. Clause (c) of proviso to s. 47(xiv) does not prohibit receipt of higher value of shares because of re-valuation of the assets at the time of succession — ACIT vs. Joe Marcetinho

According to Section 47(xiv), when a sole proprietorship concern is succeeded by a company in the business carried on by it, as a result of which some proprietary concern sells or otherwise transfers any capital asset or intangible asset to the company, the transactions are not treated as transfers subject to the three conditions set forth therein. The revenue does not deny that all of the assets and liabilities of a single proprietorship concern connected to business immediately before to the succession became the company's assets and liabilities. It is also undeniable that the same proprietor held more than half of the overall voting power in the company. The revenue's only objection is that the Assessee did not comply with condition no. 3 since the Assessee got consideration in the form of allotment of shares in the firm, the value of which is substantially more than the value of the assets as declared in the proprietary concern's records. The Assessee has, in our opinion, complied with the condition set out in clause (c) of Section 47. (xiv). This condition simply states that the same proprietor does not receive any consideration or advantage, directly or indirectly, in any form or manner other than through the issuance of company shares. 'other than by way of allotment of shares in the company'. This plainly indicates that proviso (c) allows for the receipt of consideration or benefit directly or indirectly through the issuance of company shares. It is not a scenario in which the Assessee received any other consideration or advantage beyond the allotment of company shares. In light of this understanding, we do not see any illegality in the order of the CIT(A) removing the Assessing Officer's addendum. Section 47(xiv) clause (c) does not preclude receiving a larger number of shares as a result of the revaluation. Receiving a greater value of shares as a result of a revaluation of the assets at the time of succession cannot be construed as consideration or benefit obtained in any other way than through the allotment of shares. Our position is supported by the decision of the Mumbai bench in the matter of Asstt. CIT v. Nayan L. Mepani (above), in which the Hon'ble Tribunal, in dealing with a similar situation, held as follows:

"With regard to proviso (c) of section 47(xiv), the revenue has not challenged that the Assessee received no payment other than the allotment of shares in the company." The revenue's only complaint is that previous to the transfer of the firm to the Limited Company, revaluation of assets had occurred, as well as revaluation of intangible assets. According to the revenue, by doing so, shares were issued at a higher cost to the Assessee, and when the Assessee transfers those shares in the future, the cost of purchase will be higher, resulting in a lower capital gain on the transfer of those shares. We are initially unconvinced by this line of reasoning. To begin with, we are not convinced by the AO's rationale. The section only allows for a denial of the exemption under section 47(xiv) under proviso (c) if the considerable benefit for the transfer of the business is not received in the form of allotment of company shares. The revenue does not contend that the Assessee got any other consideration or benefit, directly or indirectly, other than the allotment of shares, and the section does not envisage a future advantage that the Assessee is likely to receive (even such benefit is only contingent and not certain).

9.5 Transfer of Assets Between Holding and Subsidiary Company

Under the existing provisions of section 47 of the Income-tax Act, 1961 ("Act"), any transfer of a capital asset from a holding company to its wholly owned subsidiary company or vice-versa is exempted from the charge of capital gains tax, subject to certain conditions.

The exemption is, however, withdrawn under section 47A of the Act,

- if such capital asset is converted by the transferee company into, or
- is treated by it as stock-in-trade of its business; or
- the parent company or its nominee or the holding company ceases to hold the whole of the share capital of the subsidiary company, before the expiry of a period of 8 years from the date of transfer.

Transactions not Regarded as Transfer

- section 47 of the Act specifies certain transactions which are transfers in ordinary meaning but are not regarded as transfers for the purpose of computation of capital gains.
- Clause (iv) and Clause (v) of Section 47 specify that any transfer of capital assets between a holding company and its 100% subsidiary Indian company and vice-versa will not be regarded as a transfer and, consequently, no income from such transfer is chargeable to capital gain tax.
- Section 47(iv) provides that any transfer of a capital asset by a company to its subsidiary company shall not be regarded as transfer if—
  - the parent company or its nominees hold the whole of the share capital of the subsidiary company, and
  - the subsidiary company is an Indian company.
- However, the capital asset must be transferred as a capital asset by the holding company to its wholly owned subsidiary. The capital asset shall not be transferred as stock-in-trade after the 29th day of February 1988.

Nature of Capital Gains Exempt Under Section 47(iv)/(v)

- Any nature of capital gains - long term capital or short-term capital gain is exempted under section 47(iv/(v).

Conditions for Exemption Under Section 47(iv) and 47(v)

- The exemption under section 47(iv) and 47(v) is subjected to certain conditions which are enumerated in section 47A.
- Section 47A provides two conditions which must be satisfied for a period of 8 years from the date of transfer of capital assets by a holding company to its wholly owned subsidiary and vice-versa under section 47(iv) and section 47(v).
- Condition 1: The transferee company must hold the capital asset as a capital asset for a period of 8 years from the date of transfer of the capital asset. This does not mean that the subsidiary cannot transfer the capital asset within the lock-in period.
  - The transferee company is only prohibited from converting the capital asset into stock-in-trade of its business or treat the same as stock-in-trade in its books.
  - The consequences of converting or treating the capital asset so received from the transferor company into stock-in-trade is discussed separately under section 47A.
- Condition 2: The parent company or its nominees shall not cease to hold the whole of the share capital of the subsidiary company for a period of 8 years from the date of transfer of the capital asset. The consequences of diluting the shareholding of the subsidiary company are discussed separately under section 47A.
- Both the conditions must be satisfied for a period of 8 years from the date of transfer of the capital asset between the holding and wholly owned subsidiary company and vice versa.
- If both the conditions or any one of the condition is violated by the transferee company in any year within the period of 8 years from the date of transfer then the amount of profits or gains arising from the transfer of such capital asset not charged to capital gains under section 45 by virtue of the provisions contained in section 47(iv) or section 47(v) of shall be deemed to be income chargeable under the head "Capital gains" of the previous year in which such transfer took place.

Retrospective Effect

- Please note that the income will be charged to capital gains in the year in which transfer of capital asset was made by the transferor company and not in the previous year in which conditions are violated. Hence, this provision has retrospective effect.
- In order to avail and continue the exemption, both the conditions of section 47A must be adhered to for a lock-in period of 8 years without any fail, else the income on transfer of capital assets which was not taxed in the hands of the transferor company, will be charged to tax under the head capital gains with retrospective effect in the hands of the transferor company.

Cost of Acquisition

- It should be noted that there is no restriction on the transferee company regarding the transfer of the capital asset as a capital asset. The transferee company can transfer the capital asset within the lock-in period of 8 years.
- If this happens then there will be no consequence to the income, which was not charged to tax by virtue of section 47(iv) or section 47(v), and the same will remain exempted from tax in the hands of the transferor company.
- The rationale is that there will be no loss to the revenue by allowing the exemption to the transferor company if a capital asset is transferred as a capital asset by the transferee company.
- Under section 49, the cost of acquisition of capital asset which becomes the property of the assesse under a gift or will, or by succession, inheritance or devolution, under any transfer referred to in clause (iv) or clause (v) of section 47., is deemed to be
  - the cost for which the previous owner of the property acquired it,
  - as increased by the cost of any improvement of the assets incurred by the previous owner or the assesse, as the case may be.

However, it is possible that the previous owner of the capital asset may have acquired the asset under a gift or will or by any other mode of acquisition referred to in section 49.

Incidence of Capital Gains Tax

- the income from the capital gains shall arise in the hands of the transferee company in the year in which the capital asset is actually transferred by the transferee company.
- In computing the capital gains in the hands of the transferee company, the cost of acquisition of the capital asset shall be the actual cost of the asset to the transferor company.
- The exemption earlier provided to the transferor company under section 47(iv)/(v) will not be withdrawn because there is no violation of section 47A.

Example 1: HK Ltd. transferred a capital asset being land to its wholly owned Indian subsidiary SK Ltd. for Rs. 1,50,000 against the book value of Rs. 1,00,000 in FY 2018-19. Capital asset (acquired in FY 2017-18 by transferor company), the capital gains of Rs. 50,000 arising from such transfer to 100% Subsidiary company will be exempt in the hands of HK Ltd. by virtue of section 47(iv). After three years in FY 2021-22, SK Ltd. sells the land to another person for Rs. 3,15,000.

Solution

Computation of Capital Gains in FY 2021-22 in the hands of SK Ltd.

Full Value of consideration	Rs. 3,15,000
Less: Indexed Cost of acquisition (1,00,000 x 317/272)	Rs. 1,16544.1
Long term capital gains	Rs. 1,98,455.9

Example: HK Ltd. transferred a capital asset being land to its wholly owned Indian subsidiary SK Ltd for Rs. 1,50,000 against the book value of Rs. 1,00,000 in FY 2018-19. Assuming the asset is a short-term capital asset (acquired in FY 2017-18), the capital gains of Rs. 50,000 arising from such transfer to 100% Subsidiary company will be exempt in the hands of H Ltd. by virtue of section 47(iv).

In FY 2020-21, HK Ltd. diluted its stake in SK Ltd. and sold 25% of its stake in SK Ltd. to another person.

Hence, the conditions of section 47A are violated in FY 2020-21. Hence, the exemption given to H Ltd. in FY 2018-19 will be withdrawn. The Short Term Capital Gains of Rs. 50,000, which were not charged tax in that year, will be deemed to be the income of FY 2018-19.

In FY 2021-22, S Ltd. sold the land to another person for Rs. 3,15,000.

In this case the capital gain shall be taxable in the hands of S Ltd. and is computed as given below-

Computation of Capital Gains in FY 2021-22 in the hands of S Ltd.

Full Value of consideration	Rs. 3,15,000

Less: Indexed Cost of acquisition (**1,50,000** x 317/280)	Rs. 169821.4
Long term capital gains	Rs. 145178.6

- As per section 49(3), the cost of acquisition for SK Ltd. shall be the cost of acquisition shall be the cost at which the asset was acquired by SK Ltd. which is Rs. 1,50,000.
- The period of holding for SK Ltd. shall be counted from the date when the asset was acquired by SK Ltd. It will not include the period of holding of the previous owner HK Ltd. in this case, since there is a violation of section 47A.
- Since the holding period of the land exceeds 24 months from the date of acquisition which is FY 2018-19, the capital gains are Long term capital gains. Further, indexation shall begin from FY 2018-19 itself.
- Cost Inflation Index (CII) for FY 2021-22 is 317
- The exemption from capital gains tax allowed to HK Ltd. in FY 2018-19 will be withdrawn since there is a violation of section 47A and will be deemed to be income of that year in the hands of HK Ltd.

Example2: A wholly owned subsidiary company transferred an asset to its Indian holding company on 1st July 2017 for 2,00,000. The subsidiary company acquired this asset in 2011 for 1,20,000. The holding company sells 25% shares of the subsidiary company on 15th September 2020. Find out the cost of acquisition of the asset to the holding company.

It is Not considered as transfer.

Gain of Rs. 80,000 not taxable as capital gain in the assessment year 2018-19.

In F.Y. 2020-21, condition violated.

80,000 deemed to be capital gain for assessment year 2018-19.

Cost of acquisition: 2,00,000.

Notes:

- As per section 49(1)(iii)(e), the cost of acquisition for S Ltd. shall be the cost to the previous owner. In this case, the cost of H Ltd. shall be the cost of acquisition for S Ltd.
- As per section 2(42A), the period of holding for S Ltd. shall include the period of holding of the previous owner H Ltd.in the case of a capital asset which becomes the property of the assesse in the circumstances mentioned in section 49(1). Section 49(1)(iii)(e) covers a transaction of transfer under section 47(iv)/(v).
- Since the holding period of the land exceeds 24 months from the date of acquisition which is FY 2017-18, the capital gains is Long term capital gains.
- Cost Inflation Index (CII) for FY 2021-22 is 317. The Central Board of Direct Taxes (CBDT) notified the cost inflation index (CII) for FY 2021-22 as 317 via a notification dated June 15, 2021, CII is used to calculate the inflation adjusted cost price of an asset. The inflation adjusted price is then used to arrive at long-term capital gains or long-term losses.
- The CII number is used to calculate inflation adjusted price of assets such as land, building, house, gold jewellery, debt mutual funds etc. However, it cannot be used for equity shares and

equity mutual funds whose gains are taxable at the rate of 10 per cent without any indexation benefit.

- At the time of income tax returns filing next year, this CII number will be helpful to you to ascertain the long-term capital gains on which you are liable to pay taxes
- In case the period of holding of the previous owner is taken into consideration, the indexation should also be computed from the period in which the asset was first held by the previous owner and not from the period in which the capital asset is owned by the current transferor. If an asset is acquired in the manner specified in section 49 (1), then the indexed cost of acquisition is to be computed with reference to the year in which the previous owners first held the assets and not the year in which the assesse became the owner of the asset.
- The exemption from capital gains tax allowed to H Ltd. in FY 2018-19 will not be withdrawn since there is no violation of section 47A. It is taken that the twin conditions of section 47A are adhered to in FY 2021-22.
- Where a holding company transfers any capital asset to its 100% wholly owned Indian subsidiary company or vice versa and the transfer is exempted from capital gains tax under section 47(iv)/(v), in such a case the period of holding of the capital asset shall be reckoned from the date when the previous owner of the asset acquired the asset
- Hence, in the example 1, when SK Ltd. sells the capital asset in FY 2021-22, the period of holding of its holding company, H,k Ltd., is also included in computing the period of holding and determining the nature of capital gain.

After the period of 8 years, if the holding company dilutes its stake in the subsidiary company or the transferee company converts or treats the capital asset into stock-in-trade, then the above-mentioned rules will follow for determining the cost of acquisition and period of holding.

Cost of Acquisition- Conditions of section 47A violated within 8 Years

- The cost of acquisition of such asset to the transferee-company shall be the cost for which such asset was acquired by it.
- Once the transfer is charged to capital gains income by virtue of the applicability of section 47A, the transfer is not regarded as a transfer within the meaning of section 47 (iv)/(v) of the Act and it goes out of the purview of such provisions.
- The transfer shall be treated as a normal transfer and all the provisions of the Act shall apply as if it was a transfer of assets between two independent companies.
- In this case, the period of holding should not include the period of holding of the transferor company but should be counted from the date when the asset was acquired by the transferee company. Explanation 1 (i) (b) to section 2 (42) read with section 49 (1) (iii) (e) will not apply in this case.

Example 3: S ltd Wholly owner subsidiary of H ltd.

Both companies are Indian companies.

H ltd facts:

- Purchased land: May.2009 at 3,00,000
- Transferred land to S ltd at 5,62,000

S ltd facts:

- Sold Land: Aug,2020 at 12,00,000

Situations:

- H ltd neither ceases to hold 100% shares of S ltd, nor S Ltd converts land into stock.
- S Ltd converted land into stock in trade on 1st July,2020: FMV 7,50,000
- H ltd sold 10% shares of S ltd to public in May,2020

- CII
    - 2009-10 148
    - 2012-13 200
    - 2020-21 301

Solution

Situation I:

P. Y. 2012-13

- H ltd is not chargeable to LTCG

P.Y. 2020-21

- S ltd is assessable to LTCG
- LTCG=12,00,000-[(3,00,000*301)/148]=5,89,865

Situation 2

a) H ltd Liable to pay LTCG for p.Y.2012-13

5,62,000-[3,00,000*200/148]=1,56,595

Such gains are assessable in the year of transfer of land(2012-13).

b) During P.Y. 2020-21 S Ltd S ltd. is assessable on LTCG and Business profits

FMV 7,50,000		
Indexed cost of acquisition(562000*301/200)	8,45,810	
LTCG		95,810
Sale proceeds		12,00,000
FMV	7,50,000	
Business Income	4,50,000	

Situation C

a. H ltd liable to pay LTCG tax 1,56,595 for P.Y. 2012-13

b. S Ltd assessable on LTCG for the previous year 2021-22

Sale proceeds	12,00,000
Less:	
Indexed cost of acquisition	
(5,62,000*30/200)	8,45,810
LTCG	3,54,190

Summary

Globalization has made business reorganisation increasingly necessary for building a worldwide competitive edge, and this process must be given the necessary push. As a result, the group believes that reorganisation should be supported where it is in line with the goal of economic development, rather than when it is purely a mechanism designed to get a tax advantage. The necessity for reorganisation to increase the scale of the operation, sharpen the technological edge, stoke the desire to improve core competence, and so on should not be hampered by consideration of taxes legislation restrictions. As a result, suitable protections will be given to avoid exploitation of the rules while allowing for reorganisation without tax consequences.

Keywords

Capital Asset: 'Capital Asset' has been defined under Section 2(14) to mean property of any kind held by the Assessee whether or not connected with the business or profession.

Transfer: The transfer in relation to the capital asset has been defined under Section 2(47) which gives an inclusive definition. Sale or exchange of an asset falls within the definition of transfer.

Transactions are not regarded to be transfer: When a capital gain occurs and is subject to tax under Section 45, Section 47 allows for certain exclusions in which some transactions are not considered transfers and hence are exempt from the rules of Section 45. The transactions would have been taxable if Section 47 had not been included, because of the specific provisions of Section 45.

Self Assessment

1. Which of the following is wrong where there has been a reorganization of business?
A. whereby, a firm is succeeded by a company, or a proprietary concern is succeeded by a company,
B. the accumulated loss and the unabsorbed depreciation of the predecessor firm or the proprietary concern, as the case may be,
C. shall be deemed to be the loss or allowance for depreciation of the predecessor company for the purpose of the previous year in which business reorganization was affected and
D. other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly

2. Which of the following statements is wrong in regard to the withdrawal of exemption?
A. Provided that if any of the conditions laid down in the proviso to clause (xiii) or the proviso to clause (xiv) to section 47 are not complied with,
B. the set-off of loss or allowance of depreciation made in any previous year in the hands of the successor company,
C. shall be deemed to be the income of the company
D. chargeable to tax in the year succeeding the year in which such conditions are not complied with.

3. Which of the following statements is wrong in regard to the withdrawal of exemption?
A. Where any of the conditions laid down in the proviso to clause (xiii) or the proviso to clause (xiv) of section 47 are not complied with, then
B. the amount of profits or gains arising from the transfer of such capital asset or intangible asset,
C. shall be deemed to be the profits and gains chargeable to tax of the predecessor company
D. for the previous year in which the requirements of the proviso to clause (xiii) or the proviso to clause (xiv), as the case may be, are not complied with.

4. Which section deals with provisions relating to carry forward and set off of accumulated loss and unabsorbed depreciation allowance in case of succession?
A. [SECTION 72A(6)]
B. [SECTION 73A(6)]
C. [SECTION 74A(6)]
D. [SECTION 79A(6)]

5. Which section and clause deal with the conversion of sole proprietorship into the company?
A. [SECTION 47(xiv)]
B. [SECTION 47(xv)]
C. [SECTION 47(xvi)]
D. [SECTION 47(xvii)]
6. Which section and clause deal with the conversion of firm into the company?
A. [SECTION 47(xiii)]
B. [SECTION 47(xv)]
C. [SECTION 47(xvi)]
D. [SECTION 47(xvii)]

7. As per the provisions of section 49 of the Income-tax Act to provide that in case of conversion of sole proprietorship or firm into a company which is not regarded as a transfer, the cost of acquisition of an asset in the hands of the company would be

A. the same as that in the hand of the sole proprietary concern or the firm, as the case may be.
B. Fair market value
C. More than that in the hand of the sole proprietary concern or the firm, as the case may be.
D. Less than that in the hand of the sole proprietary concern or the firm, as the case may be.

8. Which section provides that any transfer of a capital asset by a company to its subsidiary company shall not be regarded as a transfer?

A. [SECTION 47(iii)]
B. [SECTION 47(iv)]
C. [SECTION 47(vi)]
D. [SECTION 47(vii)]

9. Any transfer of a capital asset by a company to its subsidiary company shall not be regarded as a transfer if certain conditions are satisfied. Which of the following is not the condition?

A. the parent company or its nominees hold the majority of the share capital of the subsidiary company
B. the subsidiary company is an Indian company
C. the capital asset must be transferred as a capital asset by the holding company to its wholly owned subsidiary.
D. The capital asset shall not be transferred as stock-in-trade after the 29th day of February 1988.

10. Which section provides that transfer of a capital asset by a subsidiary company to its 100% holding company shall not be regarded as a transfer?

A. [SECTION 47(iii)]
B. [SECTION 47(v)]
C. [SECTION 47(vi)]
D. [SECTION 47(vii)]

11. Nature of Capital Gains exempt under section 47(iv)/(v) is

A. Any nature of capital gains
B. long term capital
C. short term capital gain
D. No capital gain is exempt

12. The exemption under sections 47(iv) and 47(v) are subject to certain conditions. Which of the following is wrong in this?

A. The transferee company must hold the capital asset as a capital asset for a period of 8 years from the date of transfer of the capital asset.
B. This means that the subsidiary cannot transfer the capital asset within the lock-in period.
C. The transferee company is prohibited from converting the capital asset into stock-in-trade of its business or treating the same as stock-in-trade in its books.
D. The parent company or its nominees shall not cease to hold the whole of the share capital of the subsidiary company for a period of 8 years from the date of transfer of the capital asset.

13. Which of the following is wrong in regard toWithdrawal of exemption under section 47A?

A. If both the conditions or any one of the condition is violated by the transferee company in any year within the period of 8 years from the date of transfer
B. then the amount of profits or gains arising from the transfer of such capital asset not charged to capital gains under section 45 by virtue of the provisions contained in clause section 47(iv) or section 47(v)
C. of shall be deemed to be income chargeable under the head "Income from other sources"
D. of the previous year in which such transfer took place.

14. Which of the following is truein regard towithdrawal of exemption under section 47A?

A. the income will be charged to capital gains in the year in which transfer of capital asset was made by the transferor company and

B. The income will be charged to capital gains in the previous year in which conditions are violated.
C. This provision does not have a retrospective effect.
D. the income will not be charged to capital gains in the year in which transfer of capital assets was made by the transferor company.

15. Which of the following is wrong in regard to Cost of acquisition for the transferee company?
A. where the capital asset became the property of the assessee under any such transfer covered by section 47(iv) or section 47(v), the cost of acquisition of the asset shall be deemed to be the cost for which the previous owner of the property acquired it, as increased by the cost of any improvement of the assets incurred or borne by the previous owner or the assessee, as the case may be.
B. where the capital asset became the property of the assessee under any such transfer covered by section 47(iv) or section 47(v), the cost of acquisition of the asset shall be deemed to be the cost for which the previous owner of the property acquired it, not including the cost of improvement of the assets incurred or borne by the previous owner or the assessee, as the case may be.
C. previous owner of the property" in relation to a capital asset owned by an assessee means the last previous owner of the capital asset who acquired it by a mode of acquisition other than that referred to in section 49.
D. The cost of acquisition of the capital asset so transferred by the transferee company shall be determined as per the provisions of section 49(1)(iii)(e) of the Act in the hands of the transferee company.

Answer for Self Assessment

1.	C	2.	D	3.	C	4.	A	5.	A
6.	A	7.	A	8.	B	9.	A	10.	B
11.	A	12.	B	13.	C	14.	A	15.	B

Review Questions

1. When a firm is converted into a company, capital gains in the hands of the firm is not chargeable to tax. What are the requirements for claiming the advantages of exemption?
2. What will the acquisition cost of an asset be if it is transferred from a holding company to a subsidiary company?
3. Define the status of the asset transfer between the holding company and the subsidiary company.
4. What are the circumstances in which profits and gains deriving from asset transfers between a holding company and a subsidiary company are subject to capital gains tax?
5. when a sole proprietorship is converted into a company, capital gains in the hands of the sole proprietorshipare not chargeable to tax. What are the requirements for claiming the advantages of exemption?

Further Readings

- https://www.icsi.edu/media/webmodules/16112021_Advance_Tax_Laws.pdf
- A Textbook Of Corporate tax planning and management by Dr. H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications
- Study Material on Direct Tax Laws and International Taxation by ICAI
- Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta
- www.incometaxindia.gov.in
- Study material on Direct Tax Laws and International taxation by ICMAI.

Dr. Rupinder Katoch, Lovely Professional University

Unit 10: Tax Planning with Regard to Restructuring of Business-II

CONTENTS

Objectives

After studying this unit, you will be able to:

- understand tax planning relating to amalgamation,
- understand tax planning relating to slump sale,
- understand tax planning issues in regard to demerger.

Introduction

While deciding on amalgamation/merger concessions given and effect of provisions of Income Tax Act, 1961 will pay a very important factor

10.1 Definition of Amalgamation [Section 2(1B)]

In the context of companies, "amalgamation" refers to

a. the merger of one or more companies with another company or

b. the merger of two or more companies to form one company.

(The company or companies that merge are regarded to as the amalgamating company or companies, and the company with which they merge or that is produced as a result of the merger is referred to as the amalgamated company) in such a way that –

i) all of the assets of the amalgamating company or companies immediately prior to the amalgamation becomes the asset of the amalgamated company by consequence of the amalgamation.

ii) all of the liabilities of the amalgamating company or companies immediately prior to the amalgamation are becoming the liabilities of the amalgamated company by consequence of the amalgamation.

iii) Shareholders who own at least three-fourths of the shares in the amalgamatingcompany or companies (other than shares held therein immediately before the amalgamation by the amalgamated company or its subsidiary or a nominee for the amalgamated company or its subsidiary) become shareholders of the amalgamated company as a result of the amalgamation.

otherwise, then as a consequence of the acquiring of one company's property by another company as a result of the purchase of such property by the other company or as a consequence of the distribution of such property to the other company following the liquidation of the first-mentioned company.

From above we can say that in case of amalgamation one company mixes or blends with another company both being companies carrying on the business whereas merger means two or more companies mix or blend to form a third company and thus merge with each other. The conditions mentioned under Section 2(1B) (i), (ii) and (iii) must be fulfilled in order to get Income Tax benefit under the Income-tax Act,1961. If one of the conditions are not fulfilled, then consequently it may not be treated as amalgamation and so we need to take care while framing a scheme of amalgamation

10.2 No Amalgamation for Income Tax Purposes

a. acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or

b. as a result of the distribution of such property to the other company after the winding up of the first mentioned company.

From above we can say that in case of amalgamation one company mixes or blend with another company both being companies carrying on the business whereas merger means two or more companies mixes or blend to form a third company and thus merge with each other. The conditions mentioned under Section 2(1B) (i), (ii) and (iii) must be fulfilled in order to get Income Tax benefit under the Income Tax Act,1961. If one of the conditions are not fulfilled, then consequently in may not be treated as amalgamation and so we need to take care while framing a scheme of amalgamation.

10.3 Tax Incentives for Amalgamation

A. Tax incentives to amalgamating company

1. Capital gains tax exemption
   Because the transfer is not considered a transfer for the purposes of capital gain, capital gain emerging out of the transfer of assets by the amalgamating companies to the Indian Amalgamated Company is exempted from tax under section 47(vi) of the Income-tax Act.
   Tax concession to foreign company
   The transfer of shares held in an Indian company by an amalgamating foreign company to an amalgamated foreign company is exempted from tax under Section 47(via) if the succeeding two conditions are met:
   i. At least 25% of the shareholders of the amalgamating foreign company remain shareholders of the amalgamated foreign company; and
   ii. The transfer is exempted from tax in the country where the amalgamating company is incorporated.

Exemption from taxation on the transfer of a telecommunications licence, etc. If plant and machinery is transferred(investment allowance under 32AD not withdrawn)

B. Tax incentives to shareholders of amalgamating company

1. Period of holding of shares of the amalgamated company.
   Shares in the Indian Resulting Company procured in the event of a demerger also include Assessee's hooding period of shares in the Demerged Company.
2. Exemption from tax on exchange of shares

Capital gains emerging from the transfer of shares by a shareholder of the amalgamating companies are exempted from tax under section 47(vii) of the Income-tax Act, because these transactions are not considered as a transfer for capital gain reasons if:

The transfer is made in exchange for the allocation of shares in the amalgamated company to him; and the amalgamated company is an Indian company.

C. Tax incentives to amalgamated company

1. Capital expenditure on scientific research
   i. Whenever the amalgamating company sells or somehow transfers any asset portraying capital expenditure on scientific research to the amalgamated company (an Indian company) as part of a plan of amalgamation, the specific provisions apply to the amalgamated company in much the same way that they'd have adhered to the amalgamating company if the latter had not sold or somehow transferred the asset.
2. Expenditure incurred to obtain license to operate telecommunication services etc.[Sec.35ABB(6)]:
3. When an amalgamating company sells or otherwise transfers its licence to the amalgamated company (which is an Indian company) as part of a scheme of amalgamation, the provisions of Section 35ABB that applied to the amalgamating company apply to the amalgamated company as well. As a result:
   i. the expenditure on licence acquisition that has not yet been written off shall be allowed to the amalgamated company in the same number of balance instalments.
   ii. If the merged company sells the licence, the deficiency/surplus is treated the same as if the merged company had sold it.
4. Preliminary expenses
   Whenever an amalgamating company merges with an amalgamated company underneath a plan of amalgamation, the portion of the amalgamating company's preliminary expenses which have not been written off is permitted to the amalgamated company as a deduction in just the same manner that the amalgamating company was permitted
5. Expenses for amalgamation
   During the amalgamation or demerger of any undertaking, a significant amount of money is spent. Section 35DD of the Income Tax Act allows a deduction for such expenses to make it easier for the company to claim them. Under section 35DD, any expense incurred solely for the purpose of amalgamation or demerger is allowable as a deduction.
   The provisions of section 35DD of the Income Tax Act are simplified hereunder-
   1. Eligible expenditure-
      i. The assessee, claiming the deduction, should be an Indian company.
      ii. The expenditure shall have been made solely and exclusively for the purpose of amalgamation or demerger of an undertaking.
      iii. The expenditure must have occurred on or after April 1, 1999. The allowable amount of deduction
   2. The allowable amount of deduction-
      i. The entire eligible expenditure will be amortized.
      ii. The amortised amount is deducted in five equal instalments.
      iii. The first deduction would be obtainable from the previous year of amalgamation/demerger.
   3. The deduction permitted under section 35DD of the Income Tax Act would not be allowed under any other provision of the Act.

6. Amortisation of expenditure incurred under voluntary retirement scheme. 35DDA

   1. When an assessee pays a sum to an employee in link with his voluntary retirement under any arrangement or arrangements of voluntary retirement in any previous year, 1/5th of the amount paid is allowed to deduct in the computation of the profits and gains of the business for that previous year, and the balance is allowed to deduct in equal installments for each of the four immediately succeeding previous years.

   2. When the assessee, is an Indian company, is allowed to deduct as per sub-section (1) and the undertaking of such Indian company permitted to the deduction under sub-section (1) is transferred, prior to the expiry of the period specified in that sub-section, to another Indian company in an arrangement of amalgamation, the provisions of this section shall, as far as may be, pertain to the amalgamated company as they would have applied to the amalgamating company if the amalgamation was not materialsed.

   3. Where the undertaking of an Indian company allowed to the deduction under sub-section (1) is transferred, prior to the expiration of the period mentioned in that sub-section, to

another company in an arrangement of demerger, the provisions of this section shall, as far as may be, apply to the resulting company, as they would have applied to the demerged company, if the demerger had not materialised.

4. When there has been a reorganisation of business, whereby a firm is succeeded by a company meeting the conditions laid down in clause (xiii) of section 47 or proprietary concern is succeeded by a company meeting the conditions laid down in clause (xiv) of section 47, the provisions of this section apply to the successor company in the same way that they would have applied to the firm or proprietary concern if the reorganisation of business had not occurred.
5. Where there has been reorganisation of business, whereby a private company or unlisted public company is succeeded by a limited liability partnership satisfying the conditions laid down in the proviso to clause (xiiib) of section 47, the requirements of this section shall, as far as may be, be relevant to the successor limited liability partnership, as they would have affected the said company, if the reorganisation of business had not taken place.
6. No deduction permitted in regards to the expenditure referenced in sub-section (1) in the case of the amalgamating company mentioned in sub-section (2), in the case of the demerged company discussed in sub-section (3), in the case of a firm or proprietary concern referenced in sub-section (4), and in the case of a company referenced in sub-section (4A) of this section, for the previous year in which amalgamation, demerger, or succession, as the case may be, take place.
7. Under any other provision of this Act, no deduction permitted for the expenditure referenced in sub-section (1).

7. Expenses on prospecting etc. of certain minerals.35E.

   1. Where an assessee, being an Indian company or a person (other than a company) resident in India, is involved in any activities relating to prospecting for, or extraction or production of, any mineral and incurs any expenditure indicated in sub-section (2) after the 31st day of March, 1970, the assessee shall, in conformance with and pursuant to the terms of this section, be permitted a deduction of an amount equal to 1/10th for each of the relevant previous years.
   2. The expenditure made reference to in sub-section (1) is that expensed by the assessee after the date specified in that sub-section, at any time during the year of commercial production and any one or more of the four years immediately preceding that year, wholly and exclusively on any operations involving prospecting for any mineral or group of associated minerals stated in Part A or Part B, respectively, of the Seventh Schedule, or on the development of a mineor other natural deposit of any such mineral or collection of associated minerals :

   Provided, however, that any portion of such expenditure that is met directly or indirectly by any other person or authority, as well as any sale, salvage, compensation, or insurance moneys realised by the assessee in respect of any property or rights created as a result of the expenditure, shall be excluded from such expenditure.

   3. Any expenditure—

      i) on the acquiring of the site of the source of any mineral or group of associated minerals referred to in sub-section (2)or of any rights in or over such site;
      ii) on the acquiring of the deposits of such mineral or group of associated minerals or of any rights in or over such deposits; or of a capital nature in regard of any building, machinery, plant or furniture for which allowance by way of depreciation is allowable under section 32,

      shall not be deemed to be expenditure suffered by the assessee for any of the objectives specified in sub-section (2).

4. The deduction to be permitted under sub-section (1) for any relevant previous year will be—

a) an amount equal to one-tenth of the expenditure mentioned in sub-section (2) (such one-tenth being hereafter under this sub-section mentioned to as the instalment); or
b) such amount as is adequate to diminish to nil the income (as computed prior to making the deduction under this section) of that previous year happening from the commercial exploitation [whether or not such commercial exploitation is as a consequence of the operations or development mentioned in sub-section (2)] of any mine or other natural deposit of the mineral or any one or more of the minerals in a group of associated minerals as aforementioned in context of which the expenditure was incurred,

whichever amount is less:

The proportion of any relevant previous year's instalment, to the extent that it remains unallowed, will be carried forward and incorporated to the instalment referring to the previous year next following and deemed to be component of that instalment, and so on, for succeeding previous years; provided, however, that no portion of any instalment shall be carried forward after the tenth previous year as counted from the year of commercial production.For the purposes of this section, —

a) "Prospecting operation" refers to any operation performed for the aim of exploring, finding, or proving mineral deposits, and contains any such operation that confirms infructuous or abortive.
b) "year of commercial production" means the previous year in which commercial production of any mineral or any one or more minerals in a group of associated minerals stipulated in Part A or Part B, respectively, of the Seventh Schedule begins as a result of any prospecting operation;
c) "relevant previous years" means the ten previous years starting with the year of commercial production.

5. Where the assessee is not a company or a co-operative society, no deduction shall be acceptable under sub-section (1) except if the assessee's accounts for the year or years in which the expenditure specified in sub-section (2) is expensed have been audited by an accountant as explained in the Explanation below sub-section (2) of section 288, and the assessee simply provides, along with his Income tax return for the first year in which the deduction under this section is claimed,the audit report in the prescribed form55, duly signed and verified by such accountant, and containing such particulars as may be stipulated.
6. Where the undertaking of an Indian company which is entitled to the deduction under sub-section (1) is transferred, before the expiry of the period of ten years specified in sub-section (1), to another Indian company in a scheme of amalgamation—

i) no deduction shall be allowable under sub-section (1) in the case of the amalgamating company for the previous year in which the amalgamation occurs; and
ii) the provisions of this section shall, as far as may be applicable to the amalgamated company as they would have applied to the amalgamating company if the amalgamation had not occurred.

[(7A) Where the undertaking of an Indian company which is entitled to the deduction under sub-section (1) is transferred, before the expiry of the period of ten years specified in sub-section (1), to another Indian company in a scheme of demerger,—

i) no deduction shall be admissible under sub-section (1) in the case of the demerged company for the previous year in which the demerger takes place; and
ii) the provisions of this section shall, as far as may be, apply to the resulting company as they would have applied to the demerged company, if the demerger had not taken place.]

7. Where a deduction under this section is claimed and allowed for any assessment year in respect of any expenditure specified in sub-section (2), the expenditure in respect of which deduction is so allowed shall not qualify for deduction under any other provision of this Act for the same or any other assessment year.]

8. Capital expenses on family planning.

If Asset representing capital expenditure on family planning is transferred by the amalgamating company to the amalgamated company under a scheme of amalgamation, such expenditure shall be allowed as deduction to the amalgamated company in the same manner as would have been allowed to the amalgamating company

9. Expenses on prospecting etc. of petroleum and natural gas.

1. For the purpose of computing the profits or gains of any business consisting of the prospecting for or extraction or production of mineral oils in relation to which the Central Government has entered into an agreement with any person for the association or participation of the Central Government or any person authorised by it in such business (which agreement has been laid on the Table of each House of Parliament), there shall be made in lieu of, or in addition to, the allowances admissible under this Act, such allowances as are specified in the agreement in relation—

   a) to expenditure by way of infructuous or abortive exploration expenses in respect of any area surrendered prior to the beginning of commercial production by the assessee ;
   b) after the beginning of commercial production, to expenditure incurred by the assessee, whether before or after such commercial production, in respect of drilling or exploration activities or services or in respect of physical assets used in that connection, except assets on which allowance for depreciation is admissible under section 32 :

   Provided that in relation to any agreement entered into after the 31st day of March, 1981, this clause shall have effect subject to the modification that the words and figures "except assets on which allowance for depreciation is admissible under section 32" had been omitted; and

   c) to the depletion of mineral oil in the mining area in respect of the assessment year relevant to the previous year in which commercial production is begun and for such succeeding year or years as may be specified in the agreement;

   and such allowances shall be computed and made in the manner specified in the agreement, the other provisions of this Act being deemed for this purpose to have been modified to the extent necessary to give effect to the terms of the agreement.

2. Where the business of the assessee consisting of the prospecting for or extraction or production of petroleum and natural gas is transferred wholly or partly or any interest in such business is transferred in accordance with the agreement referred to in sub-section (1), subject to the provisions of the said agreement and where the proceeds of the transfer (so far as they consist of capital sums)—

   a. are less than the expenditure incurred remaining unallowed, a deduction equal to such expenditure remaining unallowed, as reduced by the proceeds of transfer, shall be allowed in respect of the previous year in which such business or interest, as the case may be, is transferred;
   b. exceed the amount of the expenditure incurred remaining unallowed, so much of the excess as does not exceed the difference between the expenditure incurred in connection with the business or to obtain interest therein and the amount of such expenditure remaining unallowed, shall be chargeable to income-tax as profits and gains of the business in the previous year in which the business or interest therein, whether wholly or partly, had been transferred :

   Provided that in a case where the provisions of this clause do not apply, the deduction to be allowed for expenditure incurred remaining unallowed shall be arrived at by subtracting the proceeds of transfer (so far as they consist of capital sums) from the expenditure remaining unallowed.

   Explanation.—Where the business or interest in such business is transferred in a previous year in which such business carried on by the assessee is no longer in existence, the provisions of this clause shall apply as if the business is in existence in that previous year;

   c. are not less than the amount of the expenditure incurred remaining unallowed, no deduction for such expenditure shall be allowed in respect of the previous year in which the business or interest in such business is transferred or in respect of any subsequent year or years:

   Provided that where in a scheme of amalgamation or demerger, the amalgamating or the demerged company sells or otherwise transfers the business to the amalgamated or the resulting company (being an Indian company), the provisions of this sub-section—

   i) shall not apply in the case of the amalgamating or the demerged company; and

ii) 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 latter had not transferred the business or interest in the business.

Explanation.—For the purposes of this section, "mineral oil" includes petroleum and natural gas.

10. Bad debts.

When due to amalgamation debts of the amalgamating company has been taken over by amalgamated company, and subsequently, such debts turn out to be bad, it shall be allowed as deduction to the amalgamated company.

11. Actual cost of an asset (Section 43(1) Explanation 7).

Where, in a scheme of amalgamation, any capital asset is transferred by the amalgamating company to the amalgamated company and the amalgamated company is an Indian company, the actual cost of the transferred capital asset to the amalgamated company shall be taken to be the same as it would have been if the amalgamating company had continued to hold the capital asset for the purposes of its own business.

12. Actual cost of depreciable asset(section 43(6) explanation 2(b).

Where in any previous year, any block of assets is transferred by an amalgamating company to the amalgamated company in a scheme of amalgamation, and the amalgamated company is an Indian company, then the actual cost of the block of assets to the amalgamated company shall be the W.D.V.of the assets to the amalgamating company for the immediately preceding previous year as reduced by the amount of depreciation actually allowed in relating to the said preceding previous year.

13. Carry Forward and set off of Accumulated Loss and Unabsorbed Depreciation Allowance in Case of Amalgamation(72A)

Section 72A provides for carry forward and set off of accumulated loss and unabsorbed depreciation allowance in case of Amalgamation of companies [Section 72A(1), (2) and (3)]

1. Where there has been an amalgamation of—

   a. a company owning an industrial undertaking or a ship or a hotel with another company; or
   b. a banking company referred to in clause (c) of section-5 of the Banking Regulation Act, 1949 (10 of 1949) with a specified bank; or
   c. one or more public sector company or companies engaged in the business of operation of aircraft with one or more public sector company or companies engaged in similar business,

   then, notwithstanding anything contained in any other provision of this Act, the accumulated loss and the unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or, as the case may be, allowance for unabsorbed depreciation of the amalgamated company for the previous year in which the amalgamation was effected, and other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly.

2. Notwithstanding anything contained in sub-section (1), the accumulated loss shall not be set off or carried forward and the unabsorbed depreciation shall not be allowed in the assessment of the amalgamated company unless—

   a. the amalgamating company—

(i) has been engaged in the business, in which the accumulated loss occurred or depreciation remains unabsorbed, for three or more years;

(ii) has held continuously as on the date of the amalgamation at least three-fourths of the book value of fixed assets held by it two years prior to the date of amalgamation.

b. the amalgamated company—

(i) holds continuously for a minimum period of five years from the date of amalgamation at least three-fourths of the book value of fixed assets of the amalgamating company acquired in a scheme of amalgamation.

(ii) continues the business of the amalgamating company for a minimum period of five years from the date of amalgamation.

(iii) fulfils such other conditions as may be prescribed to ensure the revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purpose.

3. In a case where any of the conditions laid down in sub-section (2) are not complied with, the set off of loss or allowance of depreciation made in any previous year in the hands of the amalgamated company shall be deemed to be the income of the amalgamated company chargeable to tax for the year in which such conditions are not complied with.

14. **Rule 9C of the Income Tax Rules, 1962**

- For the purposes of section 72A(2)(iii), Rule 9C of the Income Tax Rules, 1962 prescribes the following conditions for carrying forward or set-off of accumulated loss and unabsorbed depreciation allowance in the case of amalgamation:
- By way of amalgamation, the amalgamated company shall achieve a level of production equal to at least 50% of the installed capacity of the said undertaking before the end of 4 years from the date of amalgamation and shall continue to maintain the said minimum level of production until the end of 5 years from the date of amalgamation.
- In this context, "installed capacity" refers to the capacity of production that existed on the date of amalgamation.
- The amalgamated company shall provide the Assessing Officer with a certificate in Form No. 62, duly verified by an accountant, with reference to the books of account and other documents showing particulars of production, as well as the return of income for the assessment year relevant to the previous year during which the prescribed level of production is achieved, and for subsequent assessment years relevant to the previous year's falling within 5 years from the date of a certificate.

15. Section 72AA

After section 72A of the Income-tax Act, the following section shall be inserted, namely: —

'72AA: Provisions relating to the carry forward and set-off of accumulated loss and unabsorbed depreciation allowance in certain banking company amalgamation schemes. — Regardless of anything contained in sub-clauses I to (iii) of clause (1B) of section 2 or section 72A, where a banking company has amalgamated with any other banking institution under a scheme sanctioned and brought into force by the Central Government under sub-section (7) of section 45 of the Banking Regulation Act, 1949 (10 of 1949), the accumulated loss and unabsorbed depreciation of such banking company shall be deemed to be the loss or, as the case may be, allowance for depreciation of such banking institution for the previous year in which the scheme of amalgamation was brought into force and other provisions of this Act relating to set-off and carry forward of loss and allowance for depreciation shall apply accordingly.

Explanation.—For the purposes of this section,—

a. " For the purpose of the section, "accumulated loss" refers to the portion of the amalgamating banking company's loss under the heading "Profits and gains of business or profession" (other than a loss sustained in a speculation business) that the amalgamating banking company would have been entitled to carry forward and set-off under the provisions of section 72 if the amalgamation had not occurred.
b. "banking company" shall have the same meaning assigned to it in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
c. "banking institution" shall have the same meaning assigned to it in sub-section (15) of section 45 of the Banking Regulation Act, 1949 (10 of 1949);

d. "Unabsorbed depreciation" refers to the portion of the amalgamating banking company's depreciation allowance that remains to be allowed and would have been allowed to such banking company if the amalgamation had not occurred.

Example 1 Company X is proposed to be merged with company Y. The following are the particulars of the former company. Unabsorbed depreciation: Rs. 2,50,65,000 Unabsorbed business losses: Rs. 1,15,10,000 Consider which of the benefit can be availed by company Y and advise the latter on the condition to be fulfilled to claim each such benefit

Solution: There is no indication in the question whether merger of company A and B satisfy conditions of section 2(1B) and 72A. Answer to the given question can be given under following three situations:

(a) If merger is not amalgamation within the meaning of section 2(1B) or

(b) If merger is an amalgamation within the meaning of section 2(1B) but it does not fulfill the conditions of section 72A or

(c) If merger satisfies conditions of section 2(1B) as well as 72A

Under the aforesaid situations, the position regarding t:he set off of unabsorbed loss/allowances by company B will be as under:

Situation (a): Company Y can not set off the unabsorbed loss/ allowances of company X

Situation (b): Company Y can not set off the unabsorbed loss/ allowances of company X

Situation (c): Company Y can set off the unabsorbed loss/ allowances of company X

Note: As is evident from the aforesaid, all unabsorbed business losses/allowances can be set off if the merger satisfies requirement of section 72A. Alternatively, in order to retain the advantage of claiming set-off of unabsorbed loss / allowances, the business of company Y may be taken over by Company X in that case, all unabsorbed loss / allowance can be set off by company X, even if the merger does not satisfy the condition of section 2(1B) and 72 Charity is not a case of reciprocal promise, because a person doing charity, does not expect anything in return.

Example 2: Whether amalgamation or not? All assets and liabilities of A ltd are transferred to B ltd.

A. 40% shares in value in company A are held by company B.

B. 60% shares in value in company A are held by company B.

The other shareholders holding 40% shares in value in company A become the shareholders of company B.

Law of contract creates jus in person am and not just in rem. Here jus in rem means the right against a thing at large and jus in persona means the right against a specific person

10.4 <u>Tax Planning:</u>

Where some assets are not proposed to be taken over by the amalgamated company, the same may be disposed off or paid off by the amalgamating companybefore the scheme of amalgamation takes effect.

Where shareholders holding more than 25% shares of the amalgamatingcompany are not willing to become shareholders of the amalgamated company, the shares of some of the dissenting shareholders may be purchased by the other shareholders of the amalgamated company before amalgamation, so that the condition shareholders holding at least 75% of the shares of the amalgamating company become shareholders of the amalgamated company is complied with.

Where amalgamation does not satisfy the conditions laid down in Section 72A, the benefit of set-off unabsorbed depreciation and carrying forward losses is not available to the amalgamated company. In such a case it is better that a profit-making company merges with loss incurring company rather than vice-versa. It would help in continuing to carry forward and set off the unabsorbed depreciation and losses against the profits derived from the business of the profit-making company.

The amalgamated company should not give composite consideration(shares and debentures or shares and cash) to the shareholdersf the amalgamating company in lieu of shares held by them in amalgamating company. They should be given shares in lieu of shares held by them inamalgamating company. In the case of composite consideration, the tax incentive u/s 47(vii) will not be available.

10.5 Meaning of Slump Sale

Existing definition of Slump Sales:

Section 2(42C) of Income Tax Act, 1961 defines "slump sale" to mean the transfer of one or more undertakings as a result of the sale for lump sum consideration without value being assigned to individual assets and liabilities in such sales.

Three main ingredients

- Firstly, there should be a transfer of one or more **undertakings.**
- Secondly, the said transfer should be as a **result of sale.**
- Thirdly, the said transfer should be for **lump sum consideration** without value being assigned to individual assets and liabilities.
- It has been clarified in explanation 2 to section 2(42C) that, the determination of the value of an asset or liability for the sole purpose of payment of stamp duty, registration fees or other similar taxes or fees shall not be regarded as assignment of values to individual assets or liabilities.
- In the case of **CIT v. Max India Ltd. [2009] 319 ITR 68 (Punj. &Har.)**, it was held by the Punjab & Haryana High Court that it is not necessary that all the assets are transferred for a transaction to qualify as a slump sale. However, it is essential that the assets being transferred are an undertaking in itself and can function without any interruption.
- Thus, in order to constitute a slump sale, the assets/liabilities that are transferred should be able to form an undertaking or part of an undertaking or a unit or division of an undertaking or a business activity taken as a whole by themselves.
- section 2(42C) defined slump sales to mean the transfer of one or more undertakings **as a result of a sale,** some courts have interpreted that other means of transfer given under section 2(47) in relation to a capital asset like an exchange, relinquishment, etc. are excluded from the definition of slump sale.
- Thus, in order to make the intention of law clear, the recently enacted **Finance Act 2021** has amended section 2(42C) to expand the scope of the term "slump sale" so that all types of "transfer" as defined in 2(47) are included within its scope.

10.6 Capital Gains inRespectof SlumpSale [Section 50b]

Long term capital gains/Short term capital gains

Any profits or gains arising from the slump sale of one or more undertakings held for more than 36 months are chargeable to income tax as capital gains arising from the transfer of long-term capital assets and are deemed to be income for the previous year in which the transfer occurred.

Short term capital gains –

Any profits and gains resulting from the transfer of one or more undertakings held by the assessee for a period of not more than thirty-six months are considered short-term capital gains [Subsection (1)].

Deemed cost of acquisition and cost of improvement

For the purposes of sections 48 and 49 in relation to capital assets of such undertaking or division transferred by way of such sale, the net worth of the undertaking or division, as the case may be, shall be deemed to be the cost of acquisition and the cost of improvement, and the provisions contained in the second proviso to section 48 shall be ignored [Sub-section (2)]. This implies that no indexation benefit would be available.

Report of a Chartered Accountant

In the case of a slump sale, every assessee shall furnish, in the prescribed form, on or before the specified date referred to in section 44AB, i.e., one month before the due date for filing return of income under section 139(1), a report of a chartered accountant indicating the computation of net worth of the undertaking or division, as the case may be, and certifying that the net worth of the undertaking or division has been correctly arrived at in accordance with the provisions of this section [Sub-section (3)].

Explanation 1

Net worth:

- 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 the books of account.
- However, any change in the value of assets on account of revaluation of assets shall not be considered for this purpose.

Explanation 2

- Aggregate value of total assets of undertaking or division
- In the case of depreciable assets: The written down value of block of assets determined in accordance with the provisions contained in sub-item (C) of item (i) of section 43(6)(c);
- Capital asset in respect of which 100% deduction is claimed: In case of capital assets in respect of which the whole of the expenditure has been allowed or is allowable as a deduction under section 35AD: Nil;
- For all other assets: Book value

Illustration 1

Liabilities	**Total ( )**	**Assets**	**Total ( )**
Own Capital	13,00,000	Building Land(Bought on 1.6.2014)	**5,00,000**
Revaluation Reserve(on Land revaluation)	6,00,000	Machinery	**10,00,000** **3,00,000**
Bills Payable	1,50,000	Debtors	**2,00,000**
Trade creditors	2,50,000	Stock B/R	**2,50,000** **50,000**
Total **Solution**	**23,00,000**	**Total**	**23,00,000**

Net worth= 13,00,000

Sales Consideration= 20,00,000

LTCG= 7,00,000

Illustration 2

Liabilities	Total ( )	Assets	Unit 1( )
Own Capital	12,00,000	Building Land	**4,00,000** **8,50,000**
Revaluation Reserve (for Land)	2,00,000	Machinery	**2,00,000**
B/P	1,00,000	Debtors	**1,50,000**
Trade creditors	2,80,000	Other assets	**1,80,000**
Total	**17,80,000**	**Total**	**17,80,000**

Extra Information

- Slump Sale on 1.5.2020 at 20,00,000
- Unit Started in 2014
- Slump sale consideration: 17,00,000
- Expenses of Transfer:1,00,000

Solution

- Net Consideration= 16,00,000
- Net Worth= 12,00,000
- LTCG= 4,00,000
- Net Worth: 12,00,000
- Total assets= 17,80,000
- Less: Liabilities and Revaluation Reserve= 5,80,000
- (B/P+ Creditors+ RR)

Illustration3(in Lakhs)

Liabilities	UNIT I	UNIT II	Assets	UNIT I	UNIT II
Share Capital	100		Land	50	20
General Reserve	50		Building	30	14
Share Premium	40		P&M	15	10
Bills Payable	10	5	B/R	20	12
Creditors	20	10	Debtors	30	8
			Stock	20	6
Total	220	15		165	70

Business Commenced : 2014-15

Extra Information

- Note: WDV as per income tax of plant and machinery: 12 Lakhs
- Slump sale consideration 80 Lakhs for Unit B on 1/4/2020

Solution

Net Worth(Unit B): 57 Lakhs

Selling Price: 80 Lakhs

LTCG 23 Lakhs

Illustration 4

Liabilities		**Assets**	
Own Capital	12,82,500	Building	**13,00,000**
Revaluation Reserve (for building)	5,00,000	Machinery	**4,00,000**
Bank loan	2,80,000	Debtors	**4,00,000**
Trade creditors	87,500	patents	**50,000**
Total	**21,50,000**	**Total**	**21,50,000**

Extra Information

- Unit started in 2005-06
- Slump sale consideration is 35 lakhs
- Expenses on sale 38,000
- On patents no depreciation is charged since its acquisition on 1/7/2018

Solution

Particulars	`
Sale value	**35,00,000**
Less: Expenses on sale	**38,000**
Net sale consideration	**34,62,000**
Less: Net worth	**12,60,625**
LTCG Calculation of net worth	**22,01,375**
Building(Excluding Revaluation Reserve)	**800000**
Machinery	**400000**
Debtors	**400000**

Patents	**28,125**
(50,000-25% 50,000=37500-25% of 37500=28125)	
Total Assets	**1628125**
Less Liabilities(27500+280,00)	
Net Worth	**12,60,625**

10.7 Section 2(19AA) Income Tax: Demerger – Meaning

Unless the context requires otherwise, the term "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 of the undertaking's property, transferred by the demerged company immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;
ii. all of the undertaking's liabilities, 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 liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at the 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 except where the resulting company itself is a shareholder of the demerged company;
v. shareholders holding not less than three-fourths of the value of the demerged company's shares (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, other than as a result of the resulting company's acquisition of the demerged company's property or assets or any undertaking thereof;
vi. the undertaking is being transferred as a going concern;
vii. the demerger is in accordance with the conditions, if any, notified by the Central Government in this regard under sub-section (5) of section 72A.

It may be noted that capital gains arising under an amalgamation/ demerger scheme to the amalgamated/ resulting Indian Company are exempt. Besides, there are other benefits under Income Tax, like set-off and carry-forward of losses, etc.

10.8 Reconstruction of Public Sector Company

With effect from the assessment year 2021-22

the reconstruction or splitting up of a public sector company into separate companies shall be deemed to be a demerger, if

- such reconstruction or splitting up has been made to transfer any asset of the demerged company to the resultant company.
- the reconstruction or splitting up is done to transfer any asset of the demerged company to the resultant company.
- and the resulting company is a public sector company on the appointed date mentioned in the scheme approved by the government or any other authority authorised under the terms of the Companies Act, 2013 or any other Act controlling such public sector companies in this regard; and
- and meets any other conditions set down by the Central Government in the Official Gazette.

10.9 Tax Benefits of Demerger

Tax Benefits Available to Demerged Company:

Tax on Capital Gain is not attracted: The transfer of any capital asset by the demerged company to the resulting company will not be considered a transfer for the purposes of capital gain under section 47 (vib) of the Income Tax Act.

Tax relief to Foreign Demerged Company

According to section 47 (vic), if a foreign company owns any shares in an Indian company and transfers them to the resulting company during a demerger, the transfer will not be considered a capital gain transfer if the following requirements are met:

75 percent of the demerged foreign company's owners are also shareholders in the resulting foreign company.

The demerged foreign company will not be subject to capital gains tax in the nation of its incorporation, and Sections 391 to 394 of the Companies Act would not apply. Exemption from tax liability on the transfer of license to operate telecommunication services etc.

In case of demerger, the same will not be treated as transfer, if the resulting company is an Indian company.

Tax incentives to Resulting company

- Expenditure incurred to obtain license to operate telecommunication services etc.

  When a telecom licence is transferred to an Indian company under a scheme of amalgamation or demerger, the provisions of section 35ABB continue to apply to the transferee-company. The following are the conditions of section 35ABB:

  Conditions –

  If the following conditions are met, a deduction under Section 35ABB is available:

  Condition 1: This is a capital expense.

  Condition 2: It is incurred in the process of obtaining any right to operate telecommunication services.

  Condition-3: The expense was incurred prior to the commencement of the business or afterward at any time during the previous year.

  Condition #4: Payment for the aforesaid was made in order to receive the licence.

  If all of the preceding conditions are met, a deduction under section 35ABB can be claimed. If these conditions are not met, however, no deduction under section 35ABB is possible [a deduction under section 37(1) is available].

- Preliminary expenses
- If a demerger occurs, the merged company of the resultant company will be permitted to amortize the remaining amount of preliminary expenses over the remaining years.
- Expenses for demerger
- Section 35DD(1) of the Income Tax Act of 1961 states that if an assessee, which is an Indian company, incurs any expenditure solely and exclusively for the purpose of demerge ring an undertaking on or after April 1, 1999, the assessee is entitled to 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 demerger occurs.
- Amortization of expenditure incurred under the voluntary retirement scheme
- Expenses incurred through the voluntary retirement scheme are deductible under section 35DDA of the Income Tax Act.
- The amount of the section 35DDA deduction, as well as the conditions for deductions in the case of a merger, demerger, or reorganisation::
  - If the assessee claiming a deduction under section 35DDA is transferred to another firm by a scheme of amalgamation, demerger, or reorganisation (before to the

expiration of the five-year deduction period). The remaining deduction will then be allowed as indicated below-

- When an Indian company's undertaking is transferred to another Indian company via a demerger arrangement, the resulting company is eligible for a section 35DDA deduction.
- It's also worth noting that the amalgamating/ demerged/ firm, proprietary concern, or company will be ineligible to claim the section 35DDA deduction for the previous year in which the amalgamation/ demerger/ succession occurred

- Expenses related to mineral prospecting, etc.
  - Section 35E allows Indian companies and resident assessee other than companies to deduct expenditures incurred wholly and exclusively on prospecting for the minerals or group of associated minerals specified in the Seventh Schedule, or on the development of a mine or other natural deposit of any such minerals or group of associated minerals.The qualifying expenditure should be incurred during the “year of commercial production” and four years immediately preceding that year.
  - "Qualifying expenditure" means any expenditure incurred fully and exclusively on prospecting for any mineral (or group of associated minerals) listed in the Seventh Schedule, or on the development of a mine or other natural deposit of any such mineral or group of associated minerals. A few expenses (such as those paid by another person, site acquisition costs, and expenses for acquiring a building, plant, machinery, and furniture) are, however, not included.

Qualifying expenditures may be amortised in ten equal instalments over a ten-year period. The following amounts are deductible each year:
1/10th of "qualified expenditure"; or
Income (before section 35E deduction) from commercial exploitation of any mine or deposit of minerals of any other sort in the preceding year.

• In the event of an amalgamation or demerger of Indian companies, the transferee will be eligible for the foregoing benefit for the remaining period. Expenses for prospecting, extraction, and production of petroleum and natural gas:
Where a demerged company sells or transfers its business to the resulting company (which is an Indian company) before claiming the full deduction for expenditures incurred on prospecting for, extraction, or production of petroleum and natural gas, the resulting company is entitled to claim the deduction.

An asset's actual cost

Subsection (1) of Section 43 of the Income Tax Act of 1961, Explanation 7A

When a demerged company transfers a capital asset to the resulting company in a demerger and the resulting company is an Indian company, the actual cost of the transferred capital asset to the resulting company is taken to be the same as it would have been if the demerged company had kept the capital asset for its own business.

However, such actual cost cannot exceed the demerged company's written-down value of such capital asset.

Written down value of assets transferred to the resulting company:

- Explanation 2A and 2B to Clause (ii) of Sub- section (6) of Section 43 of the Income Tax, 1961
  - Explanation 2A.—If a demerged company transfers any asset that is part of a block of assets to the resulting company in a previous year, the written down value of the demerged company's block of assets for the immediately preceding previous year is reduced by the written down value of the assets transferred to the resulting company pursuant to the demerger.
  - Explanation 2B—If a demerged company transfers any asset forming part of a block of assets to the resulting company in a previous year, the written down value of the block of assets in the case of the resulting company shall be the written down value of the demerged company's transferred assets immediately before the demerger, notwithstanding anything in clause (1).

- Deduction in respect of profits and gains from undertakings

- If certain requirements are met, a deduction for profits and gains from undertakings u/S 80IAB/80IB/80IC/80IE is allowed.
- •If the resulting company meets those requirements, it is eligible for a deduction for the portion of the term that has not yet elapsed.
- Carry Forward and Set-Off of the Accumulated Business Losses and Unabsorbed Depreciation Allowance in Amalgamation or Demerger, etc. (Section 72A)
  - In the event of a demerger, the demerged company's cumulative business loss and unabsorbed depreciation may be carried forward and set off in the hands of the successor company if certain conditions are met.
  - The unabsorbed depreciation can be carried forward indefinitely and the accumulated business loss can be carried forward for an extended period.
  - A demerged company's accumulated loss and unabsorbed depreciation can be carried forward and offset against profits by the resultant entity (Section 72A(4)):
  - It should be such a relatable quantity that it is immediately related to the undertaking transferred. Where it is not directly relatable to the undertaking transferred, it should be apportioned in the ratio of assets retained by the demerged company and transferred to the resulting company.
  - It should be distributed in the ratio of assets held by the demerged company and transferred to the resulting company if it is not directly related to the undertaking transferred.

Tax Liability of resulting company in respect of demerged company

- Sec 41(1)
- •The resulting organisation is taxed as a business successor under Section 41(1) of the Income Tax Act of 1961.By virtue of Section 41(1)(a), when there is deduction or allowance made in any assessment year in respect of loss, trading or expenditure liability suffered by the assessee (first-mentioned individual) and subsequently during any previous year; the assessee has gained any amount whether in cash or in any other way in respect of such expenditure or loss or some benefit in respect of such business liability by way of revocation or termination thereof, the amount gained by such individual or the value of benefit arising to him shall be deemed to be gains and profits of the profession or business and chargeable accordingly to income tax as the income of that previous year, whether the profession or business in respect of which the deduction or allowance has been made is in existence in that year or not; or the successor in business (resulting organization) has gained any amount whether in cash or in any other way in respect of which loss or expenditure was suffered by the assessee (first mentioned individual) or some profit in respect to business liability referred to in clause (a) by way of revocation or termination thereof, the amount gained by the resulting organization or the value of profit arising to the resulting organisation shall be deemed to be gains and profits of the profession or business, and chargeable accordingly to income tax as the income of that previous year.

Example AA 1

- AB ltd an Indian company having two units A and B hived off B unit to an Indian company C Ltd by way of demerger.
- Net worth of AB ltd before Demerger: 40 crores
- Mr. K is allotted 50000 shares against 25000 in demerged company. He bought shares in demerged company in 2004 for 600000
- Mr. K sold 50000 shares in March 2021 for 800000
- The net book value of assets transferred to RV(P) Ltd. was 10 crores
- Date of demerger: January 2021
- Scheme of demerger: 2 shares in resultant company against 1 share in demerged company. FV (10 each)

Calculate

(i) income tax liability in the hands of demerged and resulting company?

(ii) capital gain in the hands of Mr. K. when he received shares in resulting company .

(iii) capital gain in the hands of Mr. K. when he sold shares of resulting company. Effect on tax benefits of demerged and resulting company because of sale.

(iv) Capital gain in the hands of Mr. K on sale of shares of C Ltd for AY 2021-22

CII 2004-05(113)

2020-21(301)

Solution

i. No, the transaction of demerger would not attract any income-tax liability in the hands of any of the above companies.
ii. There would be no capital gains liability in the hands of Mr. K on receipt of shares of resulting company, In case he sells these shares than Capital gains would arise.
iii. No, sale of shares by Mr. K would not affect the tax benefits availed by AB Limited or by C Limited
iv.

Sales consideration 800000

COA= 6,00,000*10/40= 150000

Indexed COA= 3,99,558

(1,50,000 × 301/113)

Long-term capital gain= 4,00,442

Summary

Companies all over the world are focusing attention on downsizing and merging in order to be more internationally competent. Some of the restructuring mechanisms to survive in a competitive market include developing core competencies for global/domestic competition, technological development through collaboration and joint venture, divesting non-profitable businesses, and closing down non-operating companies. The Indian Income Tax Act, 1961 ("ITA") includes numerous measures that address the taxation of various types of mergers and acquisitions. In the Indian context, M&As can be structured in a variety of ways, and the tax consequences differ depending on the structure used for a specific acquisition. The acquisition can be accomplished through the following methods: merger, which involves a court-approved procedure in which one or more companies merge with another company or two or more companies merge together to form one company; demerger, which involves a court-approved procedure in which one company's business/undertaking is demerged into a resulting company; A slump sale is the sale of a business or undertaking by a seller to an acquirer as a going concern, with no particular values pertaining to individual assets. This unit discusses the tax consequences of every approach of acquisition.

Keywords

- Demerger: 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 .
- Undertaking for the purpose of Section 2(19AA): “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.
- Section 2(41A) Income-tax: Resulting Company – Meaning: As per Section 2(41A) of Income Tax Act, 1961, unless the context otherwise requires, the term “resulting company” means one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger and, the resulting company in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company and includes any authority or body or local authority or public sector company or a company established, constituted or formed as a result of demerger.

- As per Sec 2(19AAA) of the Income-Tax Act,1961 a 'demerged company': means the company whose undertaking is transferred, pursuant to a demerger, to a resulting company.
- Slump sale: means transfer of one or more undertakings, by any means, for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales.

Self Assessment

1. Which of the following statements is true in regard to slump sale?

A. No indexation benefit would, however, be available, even if the slump sale has taken place of an undertaking held for morethan36months,resultinginalong-termcapitalgain.
B. indexation benefit would be available, if the slump sale has taken place of an undertaking held for morethan36months,resultinginalong-termcapitalgain.
C. indexation benefit would, however, be available, even if the slump sale has taken place of an undertaking held for lessthan36months,resultinginalong-termcapitalgain.
D. Cost of improvement will be indexed

2. Which of the following statements is wrong regarding the submission of the chartered accountant report in case of slump sales?

A. Every assessee in the case ofslump sale shall furnish in the prescribed form on or before the specified date referred under section 44AB
B. i.e. the date 15 days prior to the due datefor filing return of income under section 139(1),
C. a report of a chartered accountant indicating the computation of net worth of the undertaking or division, as the case may be, and
D. certifying that the net worth of the undertaking or division has been correctly arrived at in accordance with the provisions of this section [Sub-section(3)].

3. Which of the following is wrong in regard to demerger?

A. the transfer of the undertaking is on liquidation basis.
B. the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger.
C. the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis except where the resulting company itself a shareholder of is the demergedcompany;
D. all the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of thedemerger.

4. Which of the following is true in regard to tax incentives from Preliminary expenses to the amalgamated company?

A. When an amalgamating company merges with an amalgamated company under a scheme of amalgamation, the amount of preliminary expenses of the amalgamated company to the extend not yet written off shall be allowed as deduction to the amalgamated company in the same manner as would have been allowed to the amalgamating company.
B. When an amalgamating company merges with an amalgamated company under a scheme of amalgamation, the amount of preliminary expenses of the amalgamating company to the extend not yet written off shall be allowed as deduction to the amalgamated company in the same manner as would have been allowed to the amalgamating company.
C. When an amalgamating company merges with an amalgamated company under a scheme of amalgamation, the amount of preliminary expenses of the amalgamating company to the extend written off shall be allowed as deduction to the amalgamated company in the same manner as would have been allowed to the amalgamating company.
D. When an amalgamating company merges with an amalgamated company under a scheme of amalgamation, the amount of preliminary expenses of the amalgamating company to the extend not yet written off shall be allowed as deduction to the amalgamating company in the same manner as would have been allowed to the amalgamated company.

5. Which of the following is wrong in regard to tax incentives from Expenses for amalgamation to the amalgamated company?

A. Any expenditure, wholly and exclusively, incurred for the purpose of amalgamation/ demerger is allowed as a deduction under section 35DD.

B. The assessee, claiming the deduction, should be an Indian company.

C. Expenditure should have been incurred, wholly and exclusively, for the purpose of amalgamation or demerger of an undertaking.

D. The first deduction will be available from the tenth year from the year of in which the amalgamation/ demerger took place.

6. Which of the following is wrong in regard to tax incentives from Amortisation of expenditure incurred under voluntary retirement scheme. 35DDA?s

A. Where an assessee incurs any expenditure in any previous year by way of payment of any sum to an employee in connection with his voluntary retirement, in accordance with any scheme or schemes of voluntary retirement, one-fifth of the amount so paid shall be deducted in computing the profits and gains of the business for that previous year, and the balance shall be deducted in equal instalments for each of the four immediately succeeding previous years.

B. Where there has been reorganisation of business, whereby a private company or unlisted public company is succeeded by a limited liability partnership fulfilling the conditions laid down in the proviso to clause (xiiib) of section 47, the provisions of this section shall, as far as may be, apply to the successor limited liability partnership, as they would have applied to the said company, if reorganisation of business had not taken place.

C. Deduction shall be allowed for the previous year in which amalgamation, demerger or succession, as the case may be, takes place.

D. No deduction shall be allowed in respect of the expenditure mentioned in sub-section (1) under any other provision of this Act.

7. Which of the following is wrong in regard to tax incentives from Expenses on prospecting etc. of certain minerals under section 35E?

A. deduction of an amount equal to one-fifth of the amount of such expenditure is allowed.

B. The expenditure is that incurred by the assessee after the date specified in that sub-section at any time during the year of commercial production and any one or more of the four years immediately preceding that year,

C. The expenditure is that incurred by the assessee wholly and exclusively on any operations relating to prospecting for any mineral or group of associated minerals specified in Part A or Part B, respectively, of the Seventh Schedule or on the development of a mine or other natural deposit of any such mineral or group of associated minerals

D. "year of commercial production" means the previous year in which as a result of any operation relating to prospecting, commercial production of any mineral or any one or more of the minerals in a group of associated minerals specified in Part A or Part B, respectively, of the Seventh Schedule, commences.

8. Which of the following is not the main ingredient of slump sale?

A. there should be a transfer of one or more undertakings;

B. the said transfer should be as a result of sale;

C. the said transfer should be for lump sum consideration

D. value being assigned to individual assets and liabilities.

9. Which of the following is wrong regarding Tax incentives in form of Expenditure incurred to obtain license to operate telecommunication services to the Resulting company under section 35ABB?

A. The expenditure is revenue in nature.

B. It is incurred for acquiring any right to operate telecommunication services.

C. The expenditure is incurred either before the commencement of business or thereafter at any time during any previous year.

D. The payment for the above has been actually made to obtain licence.

10. Which of the following is wrong regarding Tax incentives in form of determination of actual cost to the Resulting company?
A. Where, in a demerger, any capital asset is transferred by the demerged company to the resulting company and the resulting company is an Indian company, the actual cost of the transferred capital asset to the resulting company shall be taken to be the same as it would have been if the demerged company had continued to hold the capital asset for the purpose of its own business.
B. such actual cost shall exceed the written down value of such capital asset in the hands of demerged company.
C. such actual cost shall not exceed the written down value of such capital asset in the hands of demerged company.
D. Explanation 7A to Subsection (1) of Section 43 of the Income Tax, 1961 explains the tax incentives in regard to determination of actual cost to the Resulting company.

11. Which of the following is right about written down value of assets transferred to the resulting company?
A. Where in any previous year, any asset forming part of a block of assets is transferred by a demerged company to the resulting company, then, the written down value of the block of assets of the demerged company for the immediately preceding previous year shall be increased by the written down value of the assets transferred to the resulting company pursuant to the demerger.
B. Where in any previous year, any asset forming part of a block of assets is transferred by a demerged company to the resulting company, then, the written down value of the block of assets of the demerged company for the immediately preceding previous year shall be reduced by the written down value of the assets transferred to the resulting company pursuant to the demerger.
C. Where in a previous year, any asset forming part of a block of assets is transferred by a demerged company to the resulting company, then, the written down value of the block of assets in the case of the resulting company shall be the written down value of the transferred assets of the demerged company immediately after the demerger
D. Where in a previous year, any asset forming part of a block of assets is transferred by a resulting company to the demerged company, then, the written down value of the block of assets in the case of the demerged company shall be the written down value of the transferred assets of the resulting company immediately after the demerger

12. Which of the following is right about tax Liability of resulting company in respect of demerged company?
A. Sec 41(1) deals with tax Liability of resulting company in respect of demerged company?
B. Sec 42(1) deals with tax Liability of resulting company in respect of demerged company?
C. Sec 43(1) deals with tax Liability of resulting company in respect of demerged company?
D. Sec 44(1) deals with tax Liability of resulting company in respect of demerged company?

13. Which of the following is wrong in regard to Tax relief to Foreign Demerged Company?
A. As per section 47 (vic), where a foreign company holds any shares in an Indian company and transfer the same to resulting company in the course of demerger, such transfer will not be regarded as a transfer for the purpose of capital gain, if certain conditions are satisfied.
B. 75% of the shareholders of the demerged foreign company should continue to remain shareholders of the resulting foreign company.
C. 50% of the shareholders of the demerged foreign company should continue to remain shareholders of the resulting foreign company.
D. Capital gains tax is not attracted on the demerged foreign company in the country of its incorporation

14. Which of the following is wrong in regard toTax incentives to shareholders of amalgamating company?
A. Shares in Indian Resulting company acquired in case of demerger *include* the holding period of shares in the Demerged Company by the Assessee
B. Shares in Indian Resulting company acquired in case of demerger ex*clude* the holding period of shares in the Demerged Company by the Assessee
C. capital gains arising from the transfer of shares by a shareholder of the amalgamating companies are exempt from tax as such transactions will not be regarded as a transfer for

capital gain purpose, if the transfer is made in consideration of the allotment to him of shares in the amalgamated company; and Amalgamated company is an Indian company

D. Under section 47(vii) of the Income-tax Act, capital gains arising from the transfer of shares by a shareholder of the amalgamating companies are exempt from tax as such transactions will not be regarded as a transfer for capital gain purpose, if certain conditions are satisfied.

15. Which of the following is true about tax incentives to amalgamating company?

A. If Asset representing capital expenditure on family planning is transferred by the amalgamating company to the amalgamated company under a scheme of amalgamation, such expenditure shall be allowed as deduction to the amalgamated company in the same manner as would have been allowed to the amalgamating company.
B. If Asset representing capital expenditure on family planning is transferred by the amalgamating company to the amalgamated company under a scheme of amalgamation, such expenditure shall not be allowed as deduction to the amalgamated company in the same manner as would have been allowed to the amalgamating company.
C. When due to amalgamation debts of the amalgamating company has been taken over by amalgamated company, and subsequently, such debts turn out to be bad, it shall not be allowed as deduction to the amalgamated company.
D. When due to amalgamation debts of the amalgamating company has been taken over by amalgamated company, and subsequently, such debts turn out to be bad, it shall be allowed as deduction to the amalgamating company.

Answer for Self Assessment

1.	A	2.	B	3.	A	4.	B	5.	D
6.	C	7.	A	8.	D	9.	A	10.	B
11.	B	12.	A	13.	C	14.	B	15.	A

Review Questions

1. Explain the provisions related to tax Implication on Amalgamation / De-merger of companies.
2. What is a slump sale?
3. What are the points/criteria for falling of a transaction under slump sale?
4. Explain the provisions related to the computation of capital gains in case of slump sale transactions.
5. Differentiate between Slump sale and demerger.

Further Readings

- https://www.icsi.edu/media/webmodules/16112021_Advance_Tax_Laws.pdf
- A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications
- Study Material on Direct Tax Laws and International Taxation by ICAI
- Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta
- https://www.incometaxindia.gov.in

Dr. Rupinder Katoch, Lovely Professional University

Unit 11: Tax Planning with Regard to Employees Remuneration

CONTENTS

Objectives

After studying this unit, you will be able to:

- understand taxability of allowances and perquisites,
- understand deductions from gross salary.

Introduction

Tax Planning aims to minimize the tax-incidence of both employer and employee. Compensation should be designed in such a manner that minimizes the tax burden of both employer and employee. If any constituent part of employee compensation is not deductible as a business expense for the employer, it will be an additional burden on the employer. It will certainly reduce the profitability of the employers. Employees also want concessions in tax so as to have maximum after-tax income.It’s only after-tax income which is the real income of the employee.

11.1 Types of Allowances

A. Fully Taxable

B. Partly Taxable

C. Fully Exempt

A. Fully Taxable

(i) Entertainment Allowance
(ii)Dearness Allowance
(iii)Overtime Allowance
(iv)Fixed Medical Allowance
(v) City Compensatory Allowance (to meet increased cost of living in cities)
(vi) Interim Allowance
(vii) Servant Allowance
(viii) Project Allowance
(ix) Tiffin/Lunch/Dinner Allowance
(x) Any other cash allowance
(xi) Warden Allowance
(xii) Non-practicing Allowance
(xiii) Transport allowance to employee other than blind/ deaf and dumb/ orthopedically handicapped employee

- City Compensatory Allowance is normally intended to compensate the employees for the higher cost of living in cities.
- Entertainment allowance is given to employees to meet the expenses towards hospitality in receiving customers etc.
- Transport allowance: Transport allowance granted to an employee to meet his expenditure for the purpose of commuting between the place of his residence and the place of his duty is fully taxable.

B. Allowances which are partially taxable

1. House rent allowance [Section 10(13A)]: Exempt to the extent of least of the following:
   - Metro Cities (i.e. Delhi, Kolkata, Mumbai, Chennai):
     - HRA actually received for the relevant period
     - Rent paid (-) 10% of salary for the relevant period
     - 50% of salary for the relevant period
   - Other Cities
     - HRA actually received for the relevant period
     - Rent paid (-) 10% of salary for the relevant period
     - 40% of salary for the relevant period
2. Special allowances to meet expenses relating to duties or personal expenses [Section 10(14)]:

- whatever amount is received should be fully utilized for the purpose for which it was given to him

Special allowances granted to the assessee either 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 the place where he ordinarily resides or to compensate him for the increased cost of living. [Section 10(14)(ii)]:

i. Special Compensatory (Hilly Areas) Allowance etc

- Any Special Compensatory Allowance in the nature of Special Compensatory (Hilly Areas) Allowance or High Altitude Allowance or Uncongenial Climate Allowance or Snow Bound Area Allowance or Avalanche Allowance:
  - 800 or 300 per month depending upon the specified locations(Exempted Amount)
  - 7,000 per month in Siachen area of Jammu and Kashmir(Exempted Amount)

ii. Any Special Compensatory Allowance in the nature of border area allowance or remote locality allowance or difficult area allowance or disturbed area allowance:

- 1,300or
- 1,100or
- 1,050 or
- 750 or
- 300 or 200 per month (Exempted Amount)

depending upon the specified locations

iii. Special Compensatory (Tribal Areas/Schedule Areas/Agency Areas) Allowance [Specified States]

- 200 per month(Exempted Amount)

iv. Any allowance granted to an employee working in any transport system to meet his personal expenditure during his duty performed in the course of running such transport from one place to another, provided that such employee is not in receipt of daily allowance:

  o 70% of such allowance upto a maximum of 10,000 per month (Exempted Amount)

v. Children Education Allowance:
- 100 per month per child upto a maximum of two children (Exempted Amount)

vi. Any allowance granted to an employee to meet the hostel expenditure on his child

- 300 per month per child upto a maximum of two children (Exempted Amount)

vii. Compensatory Field Area Allowance [Specified areas in the Specified States]
- 2,600 per month (Exempted Amount)

viii. Compensatory Modified Field Area Allowance [Specified areas in Specified States]

- 1,000 per month (Exempted Amount)

ix. Any special allowance in the nature of counter insurgency allowance granted to the members of the armed forces operating in areas away from their permanent locations.

- 3,900 per month (Exempted Amount)

x. Any transport allowance granted to an employee who is blind or deaf and dumb or orthopedically handicapped with disability of the lower extremities of the body, to meet his expenditure for commuting between his residence and place ofduty

- 3,200 per month. (Exempted Amount)

xi. Underground Allowance granted to an employee who is working in uncongenial, unnatural climate in underground mines.

- 800 per month (Exempted Amount)

xii. Any special allowance in the nature of high Altitude allowance granted to the member of the armed forces operating in high altitude areas

- For altitude of 9,000 to 15,000 feet: 1,060 per month
- For above 15,000 feet: 1,600 per month (Exempted Amount)

xiii. Any special allowance in the nature of special compensatory highly active field area allowance granted to the member of the armed forces

- 4,200 per month (Exempted Amount)

xiv. Any special allowance in the nature of Island (duty) allowance granted to the member of the armed forces in Andaman & Nicobar and Lakshadweep Group of Islands

- 3,250 per month (Exempted Amount)

C. Allowances which are fully exempt

i. Allowance to Supreme Court/ High Court Judges:
ii. Allowance received from United Nations Organisation (UNO):
iii. Compensatory allowance under Article 222(2) of the Constitution:
iv. Sumptuary allowance:
v. Allowances payable outside India [Section 10(7)]:

11.2 Perquisites

- In cash or in kind
- Reimbursement of expenses incurred in the official discharge of duties is not a perquisite.
- Perquisite arise in the course of employment: is taxable as salary.
- Perquisite arises during the course of profession: chargeable as profits and gains of business or profession
- legal origin.

Types of Perquisites

A. Perquisites taxable in the case of all employees

B. Tax free perquisites in case of all employees

C. Perquisites taxable only in the hands of specified employees

A. Perquisites taxable in the case of all employees

1. **Rent Free Accommodation:**

Exception: Rent-free official residence provided to a Judge of a High Court or to a Judge of the Supreme Court is not taxable

2. **Payment by the employer in respect of an obligation of employee:**

   Amount paid by an employer in respect of any obligation which otherwise would have been payable by the employee

3. **Amount payable by an employer directly or indirectly to effect an assurance on the life of the assessee**

   Amount payable by an employer directly or indirectly to effect an assurance on the life of the assessee or to effect a contract for an annuity, other than payment made to RPF or approved superannuation fund or deposit-linked insurance fund established under the Coal Mines Provident Fund and Miscellaneous Provisions Fund, 1948 or Employees' Provident Fund and Miscellaneous Provisions Act, 1952 [Section 17(2)(v)].

4. **Specified security or sweat equity shares allotted or transferred, by the employer**

   The value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer or former employer, free of cost or at concessional rate to the assessee [Section 17(2)(vi)] [Refer discussion on valuation of perquisite].

5. **Amount or the aggregate of amounts of any contribution made to the account of the assessee by employer in a recognised provident fund, in NPSin an approved superannuation fund:**

   The amount or aggregate of amounts of any contribution madein a recognised provident fund in NPS referred to in section 80CCD(1)in an approved superannuation fundby the employer to the account of the assessee, to the extent it exceeds **7,50,000** [Section 17(2)(vii)].

6. **Any other fringe benefit or amenity"**

   a. Interest free or concessional loan
   b. Travelling, touring and accommodation
   c. Free or concessional food and non-alcoholic beverages
   d. Gift, voucher or token in lieu of such gift
   e. Credit card expense
   f. Club expenditure
   g. Use of movable assets
   h. Transfer of movable assets
   i. Other benefit or amenity

B. Exempt from tax in the hands of all employees

- Telephone
- Privilege passes and privilege ticket
- Perquisites allowed outside India by the Government
- Employer's contribution to staff group insurance scheme;
- Annual premium by employer on personal accident policy
- Refreshment
- Subsidized lunch
- Recreational facilities
- Amount spent on training of employees
- Sum payable by employer to a RPF or an approved superannuation fund
- Leave travel concession
- Medical facilities

• Rent-free official residence

• Conveyance facility

• Telephone	• Telephone provided by an employer to an employee at his residence
• Transport Facility	• Transport facility provided by an employer engaged in the business of carrying of passengers or goods to his employees either free of charge or at concessional rate;
• Privilege passes and privilege ticket	• Privilege passes and privilege ticket orders granted by Indian Railways to its employees;
• Perquisites allowed outside India by the Government	• Perquisites allowed outside India by the Government to a citizen of India for rendering services outside India;
Employer's contribution to staff group insurance scheme;	Employer's contribution to staff group insurance scheme;
Annual premium by employer on personal accident policy	Payment of annual premium by employer on personal accident policy effected by him on the life of the employee;
Refreshment	Refreshment provided to all employees during working hours in office premises;
Subsidized lunch	Subsidized lunch provided to an employee during working hours at office or business premises provided the value of such meal is upto 50;
Recreational facilities	Recreational facilities, including club facilities, extended to employees in general i.e., not restricted to a few select employees;
Amount spent on training of employees	Amount spent by the employer on training of employees or amount paid for refresher management course including expenses on boarding and lodging;
Sum payable by employer to a RPF or an approved superannuation fund	Sum payable by an employer to a RPF or an approved superannuation fund or deposit-linked insurance fund established under the Coal Mines Provident Fund and Miscellaneous provisions Act, 1948 or the Employees' Provident Fund and Miscellaneous Provisions Act, 1952 upto the limit prescribed;
Leave travel concession	Leave travel concession, subject to the conditions specified under section 10 (discussed below)
Medical facilities	Medical facilities subject to certain prescribed limits;
Rent-free official residence	Rent-free official residence provided to a Judge of a High Court or the Supreme Court;
Conveyance facility	Conveyance facility provided to High Court Judges under section 22B of the High Court Judges (Conditions of Service) Act, 1954 and Supreme Court Judges under section 23A of the Supreme Court Judges (Conditions of Service) Act, 1958.

Note: Value of Leave travel concession provided to the High Court judge or the Supreme Court Judge and members of his family are completely exempt without any conditions.

C. **Perquisites taxable only in the hands of specified employees [Section 17(2)(iii)]**

(i) Provision of sweeper, gardener, watchman or personal attendant

(ii) Facility of use of gas, electricity or water supplied by employer

(iii) Free or concessional tickets

(iv) Use of motor car

(v) Free or concessional educational facilities

11.3 Valuation of Residential Accommodation

a) **Where the accommodation is provided by the Central Government or any State Government to the employees either holding office or post in connection with the affairs of the Union or of such State:**

- Licensefee determined by the Central Government or any State Government in respectof accommodation in accordance with the rules framed by such Government **as reduced by** the rent actually paid by the employee.

Thevalueof perquisiteas determinedshould be **increased by**

If furniture is owned by employer,

- 10% per annum of the cost of furniture (including television sets, radio sets, refrigerators, other household appliances, air-conditioning plant or equipment).

If such furniture is hired from a third party,

- The actual hire charges payable for the same
- **as reduced by**
- any charges paid or payable for the same by the employee during the previous year

b) **Where the accommodation is provided by any other employer**

1. **where the accommodation is owned by the employer**
   - 15% of salary in cities having population > 25 lakhs as per 2001 census;
   - 10% of salary in cities having population > 10 lakhs ≤ 25 lakhs as per 2001 census;

   Thevalueof perquisiteas determined should be increased by

   (i) If the furniture is owned by the employer,

   - 10% per annum of the cost of furniture (including television sets, refrigerators,
   - Other household appliances,air- conditioning plant or equipment or other similar appliances or gadgets).

   (ii) If such furniture is hired from a third party,

   · the actual hire charges payable for the same as reduced by any charges paid or payable for the same by the employee during the previous year

2. **where the accommodation is taken on lease or rent by the employer**
   - Actual amount of lease rental paid or payable by the employer or
   - 15% of salary whichever is lower, as reduced by the rent, if any, actually paid by the employee.

The value of perquisite as determined should be increased by

- If furniture is owned by employer,
- 10% per annum of the cost of furniture (including television sets, radio sets, refrigerators, other household appliances, air-conditioning plant or equipment or other similar appliances or gadgets).
- If such furniture is hired from a third party,
  - the actual hire charges payable for the same reduced by any charges paid or payable for the same by the employee

3. **Where the accommodation is provided by any employer, whether Government or any other employer, ina hotel.**

   24% of salary paid or payable for the previous year or

   the actual charges paid or payable to such hotel, **whichever is lower,** for the period during which such accommodation is provided

   as reduced by

   the rent, if any, actually paid or payable by the employee.

   However, where the employee is provided such accommodation for a period not exceeding in aggregate fifteen days on his transfer from one place to another, there would be no perquisite

11.4 Concession in the Matter of Rent Respecting any Accommodation Provided to the Assessee by the Employer

In case of unfurnished accommodation provided to employees other than Government employees:

a) **If accommodation owned by the employer:**
   - **Specified rate minus rent recoverable from the employee**
   - In cities having a population > 25 lakh**:**15% of salary minus rent recoverable from the employee.
   - In cities having a population > 10 lakh ≤ 25 lakh**:**10% of salary minus rent recoverable from the employee
   - In other cities:7½% of salary minus rent recoverable from employee.

b) **If accommodation taken on lease or rent by the employer:**
   - Rent paid by the employer or 15% of salary, whichever is lower, minus rent recoverable from the employees.

"Salary" includes pay, allowances, bonus or commission payable monthly or otherwise or any monetary payment, by whatever name called, from one or more employers, as the case may be. However, it does not include the following, namely–

(1) dearness allowance or dearness pay unless it enters into the computation of superannuation or retirement benefits of the employee concerned;

(2) employer's contribution to the provident fund account of the employee;

(3) allowances which are exempted from the payment of tax;

(4) value of the perquisites specified in section 17(2);

11.5 Motor Car

1. **Where the motor car is owned or hired by the employer and –**

   (a) is used wholly and exclusively in the performance of his official duties:

   - **Where the cubic capacity of the engine does not exceed 1.6 litres:**

   Not a prerequisite, provided the documents specified are maintained by the employer

   - **Where the cubic capacity of the engine exceeds 1.6 litres:**

   Not a prerequisite, provided the documents specified are maintained by the employer.

2. **Where the motor car is owned or hired by the employer and –**

(b) isused exclusively for theprivateor personal purposes of the employee or any member of his household and the running and maintenance expenses are met:

Where cubic capacity of engine does not exceed 1.6 litres

The actual amount of expenditure incurred by the employer on the running and maintenance of motor car during the relevant previous year including remuneration, if any, paid by the employer to the chauffeur as increased by the amount representing normal wear and tear of the motor car and as reduced by any amount charged from the employee for such use.

c) Is used partly in the performance of duties and partly for private or personal purposes of his own or any member of his household and-the expenses on maintenance and running are met or reimbursed by the employer

Where cubic capacity of engine does not exceed 1.6 litres

1,800 (plus 900, if chauffeur is also provided to run the motor car)

Where cubic capacity of engine does exceed 1.6 litres

2,400 (plus 900, if chauffeur is also provided to run the motor car

d) Is used partly in the performance of duties and partly for private or personal purposes of his own or any member of his household and-

e) the expenses on running and maintenance for private or personal use are fully met by the Assessee

f) Where cubic capacity of engine does not exceed 1.6 litres

g) 600 (plus 900, if chauffeur is also provided by the employer to run the motor car)

h) Where cubic capacity of engine does not exceed 1.6 litres

i) 900 (plus 900, if chauffeur is also provided by the employer to run the motor car)

11.6 Valuation of Benefit of Provision of Domestic Servants [Sub-rule (3) of Rule 3]

If servants are engaged by the employee and employer paid or reimbursed the employee for the wages of such servants, it will be perquisite in the hands of all employees.

11.7 Valuation of gas, Electricity or Watersupplied by Employer [Sub-rule (4) of Rule 3]

If gas, electricity or water connections are taken by the employee and employer paid or reimbursed the employee for such expenses, it will be perquisite in the hands of all employees. But if the gas, electricity or water connections are taken in the name of employer and facility of such supplies are provided to the employee, it will be perquisite in the hands of specified employees only

11.8 Valuation of free or Concessional Educational Facilities [Sub-rule (5) of Rule 3]

Iftheeducational institutionis maintained and owned by the employer

The value of perquisite is:

- cost of such education in a similar institution in or near the locality.

However, there would be no perquisite if the cost of such education or thevalue of such benefit per child does not exceed 1,000 p.m.

11.9 Interest-free or Concessional Loan

Value of perquisite in case of Interest-free or concessional loan exceeding 20,000:

- Interest computed at the rate charged by SBI as on 1st day of relevant P.Y. in respect of loans for similar purposes on the maximum outstanding monthly balance (-) interest actually paid by employee

11.10 Value of Gift, Voucher

Value of perquisite is:

- Sum equal to the amount of such gift
- [If the value of gift, the voucher is below 5,000, there would be no perquisite]

11.11 Use of Movable Assets

Value of perquisite is:

- Useoflaptopsand computers: Nil
- Movable assets, other than -laptops and computers: 10% p.a. of the actual cost of such asset, or the amount of rent or charge paid, or payable by the employer, as the case may be

11.12 Transfer of Moveable Assets

Assets transferred	Value of perquisite
Computers and electronic items	Depreciated value of asset [depreciation is computed @50% on WDV for each completed year of usage]
Motor cars	Depreciated value of asset [depreciation is computed @20% on WDV for each completed year of usage]
Any other asset	Depreciated value of asset [depreciation is computed @10% on SLM for each completed year of usage]

11.13 Tax Planning Regarding Employee Remuneration

Because the focus of this chapter is limited to corporate tax planning, we will only discuss tax planning for employee remuneration from the perspective of the employer. A company is permitted to deduct the full amount of salary, allowances, and bonuses,or other remuneration paid to employees in accordance with the company's accounting method

In terms of employee remuneration, a corporate employer should consider the following factors:

a) Employee residential accommodation:

1. Employer-owned housing-the following expenses are allowable:
    - Current repairs, insurance premiums, and rates and taxes levied on the premises under Section 30.
    - Section 43B, on the other hand, governs the deduction of rates and taxes.
    - Depreciation of such premises under Section 32.

2. Following expenses are allowed if accommodation is hired:

Current repairs, rent, Insurance premium and rates and taxes. Rates and taxes deduction is subject to section 43B. •

If it is a furnished accommodation then depreciation is allowed in the case of owned furniture and in the case it is hiredfurniture then actual hire charges paid or payable are allowed

2. Employee bonuses or commissions are deductible under section 36(1)(ii) if they are not otherwise payable as a distribution of profits to employees.This deduction is also subject to Section 43B.
3. Salary to research personnel (excluding perquisites) for three years prior to the date of business commencement is allowable as a deduction in the year of business commencement to the extent permitted by prescribed authority. In this case, the research should be related to the assessee's business.
4. Amounts contributed by an employer to an employee's RPF or Approved superannuation fund account, or to a National pension scheme or Approved Gratuity fund account, are deductible if made by the due date. (Section 43B applies.)
5. Any amount deducted by the employer from an employee's salary for the purpose of contributing to an employee benefit scheme, such as EPF, shall be added to the employer's income under Section 2(24). (x). However, if the employer deposits this amount into the employee's benefit fund on time, the amount is allowable as a deduction under Section 36(1). (va).
6. Any payment made under the head salaries to an employee outside India or to a non-resident shall not be allowed as a deduction under section 40(a)(iv) if no tax is paid or deducted as TDS on it.
7. If the employer pays tax on non-monetary benefits provided to the employee (which are chargeable in the hands of the employee), such tax paid by the employer is exempt in the hands of the employee u/s 10(10CCC), but the employer is not allowed a deduction u/s 40(a)(v) in respect of such tax paid by the employer on behalf of the employee.

11.14 Deductions from Salary

1. Standard deduction [Section 16(ia)]

   A standard deduction of 50,000 or the amount of salary whichever is lower
2. Entertainment allowance [Section 16(ii)]
   a. In case of Government employees only. The amount of deduction will be lower of:
      i. One-fifth of his basic salary or
      ii. 5,000 or
      iii. Entertainment allowance received.
3. Professional tax [Section 16(iii)]
   a. Allowed as deduction only when it is actually paid by the employee during the previous year.
   b. The total amount by way of professional tax payable in respect of any one person shall not exceed 2,500 per annum.
   c. If professional tax is reimbursed or directly paid by the employer on behalf of the employee, the amount so paid is first included as salary income and then allowed as a deduction u/s 16.

Example

a. Basic Salary 10,000 p.m.

b. D.A.	4,000 p.m
c. Entertainment Allowance	600 p.m.
d. Professional tax paid by employee	1200
e. LIC Premium paid by employer	7,200
f. Income tax paid by employee	2,000
g. Professional tax paid by employer on behalf of employee	1,600

Solution

a. Basic Salary		1,20,000
b. D.A.		48,000
c. Entertainment Allowance		7,200
d. Professional tax paid by employer		3,200
e. LIC Premium paid by employer	7,200	
Gross Salary		18,5600
Deduction u/s		
16(ia) Standard Deduction	50,000	
16(iii) Professional Tax (3200 + 1200)		4400
Taxable salary		131,200

Example 2

Entertainment allowance in case of Government employee

Particulars	
Basic Salary	80000
Dearness Allowance	30000
Commission	20000
Entertainment Allowance received	8000
Medical expenses reimbursed	50000
Professional tax paid by the employer	2000
Gross Salary	190000

Example3

Gross Salary	
Less: Deductions under section 16	
under section 16(ia) - Standard deduction of upto 50,000	
under section 16(ii) - Entertainment allowance being lowest of :	
(a) Allowance received	8000
(b) One fifth of basic salary [1/5 × 80,000]	16000

(c) Statutory amount	5000
under section 16(iii) - Professional tax paid	

Example4: EA in case of non-government employee

Particulars		
Basic salary [25,000 × 12]		3,00,000
Commission [1,000 × 12]		12,000
Entertainment allowance [1,000 × 12]		12,000
Rent free accommodation	48,600	
Add : Value of furniture [2,40,000 × 10% p.a. for 8 months]	16,000	64,600
Interest on personal loan		22,500
Gross Salary		4,11,100
Less : Deduction under section 16		
Under section 16(ia) – Standard deduction	50,000	
Under section 16(iii) - Professional tax paid	2,000	52,000
Income from Salary		3,59,100

Example5: Professional tax paid 2,500 of which 2,000 was paid by the employer.

Particulars	
Basic salary [(50,000 × 7) + (60,000 × 5)]	6,50,000
Dearness Allowance (40% of basic salary)	2,60,000
Bonus (50,000 + 40% of 50,000)	70,000
Employers' contribution to recognized provident fund in excess of 12% of salary = 4% of 6,50,000	26,000
Professional tax paid by employer	2,000
Perquisite of Motor Car (2,400 for 5 months)	12,000
Gross Salary	10,20,000

Gross Salary

10,20,000

Less: Deduction under section 16

Standard deduction u/s 16(ia) 50,000

Professional tax u/s 16(iii) 2,500

Taxable Salary 9,67,500

Example 6

- Basic salary 8,000 p.m.
- D.A. 2,000 p.m.

- Taxable perquisite 35,000
- Entertainment Allowance 4,000 p.m.
- Out of such allowance 20,000 is expended and balance amount is saved.

Assuming he is:

a. Government employee

b. b. non-Government employee

Sol: Government employee

Basic salary	96,000
D.A.	24,000
Taxable perquisite	35,000
Entertainment Allowance	48,000
Gross Salary	203,000
Less: Deductions	
Standard deduction	50,000
Entertainment Allowance	5,000

Note:

Entertainment Allowance is exempted to the extent of a minimum of the following:

a. Actual Entertainment Allowance	48,000
b. 20% of Basic Salary	19,200
c. Statutory amount	5,000

Solution: Non-Government employee

Basic salary	**96,000**
D.A.	**24,000**
Taxable perquisite	**35,000**
Entertainment Allowance	**48,000**
Gross Salary	**203,000**

Summary

Most employers make the best use of the aforementioned provisions in order to minimise the tax incidence in the case of their employees, thereby making their pay-package the most appealing. In a given case, the basic salary, allowances, and perquisites can be structured in such a way that the incidence of taxation is minimised. In other words, a salaried tax-pay payer's package can be planned in such a way that, within the confines of the law, the income-tax payable is kept to a bare minimum.

Keywords

SALARY [SECTION 17(1)]:Salary would include wages, allowances, annuity, pension, gratuity, fees, commission, advance, leave encashment and also perquisites and profits in lieu of salary etc.

Allowances: An allowance is defined as a fixed amount of money given on a regular basis in addition to the salary for the purpose of meeting some specific requirements related to the employee's service or as compensation for some unusual working conditions. It is taxable on a due/accrued basis, regardless of whether it is paid in addition to or in lieu of salary. These allowances are generally taxable and must be included in the gross salary unless a specific exemption is provided for allowances provided under the Act.

Annuity: Annuity is a yearly payment made to an employee after he retires on the basis of funds saved by him through subscription to an annuity fund with his salary while he was employed.

Prerequisite: A perquisite is any extraneous emolument or benefit attached to a position or office in addition to salary or wages. It also refers to something that benefits a man by going directly into his pocket. Perquisites can be in cash or in kind. Perquisites, on the other hand, are taxable under the heading "Salaries" only if they are a. granted by an employer to his employee; b. granted during the course of employment; c. directly dependent on service; d. resulting in the nature of personal advantage to the employee; and e. derived by virtue of the employer's authority.

Specified employees:

- **Director employee:**
- **An employee who has substantial interest in the company:**
- **Beneficial and legal ownership**
- **Employee drawing in excess of 50,000:**

Note: For computing the limit of 50,000, the following items have to be excluded or deducted:

- all non-monetary benefits
- monetary benefits which are exempt under section 10.
- Standard deduction upto **50,000**

Self Assessment

1. For the purposes of calculating income under the heading "Salaries," the definition of Salary is Basic + Dearness Allowance + Commission as a percentage of Turnover?

A. Always

B. In some instances

C. The definition is meaningless

D. Neither

2. Conveyance Allowance is exempt up to___p.m.

A. 800;

B. 1600;

C. Nil; and

D. None of the above.

3. Fixed Medical Allowance is exempt up to___p.m.

A. 800;

B. 1600;

C. Nil; and

D. None of the above.

4. Allowances payable outside India [Section 10(7)] are taxable upto__p.m.

A. 800;

B. 1600;

C. Nil; and

D. None of the above.

5. Any special allowance in the nature of Island (duty) allowance granted to the member of the armed forces in Andaman & Nicobar and Lakshadweep Group of Islands is exempt upto__p.m.

A. 800;

B. 1600;

C. 3250; and

D. None of the above.

6. Any Special Compensatory Allowance in the nature of Special Compensatory (Hilly Areas) Allowance or High Altitude Allowance or Uncongenial Climate Allowance or Snow Bound Area Allowance or Avalanche Allowance is eexemptupto_______p.m.

A. 7,000 per month in Siachen area of Jammu and Kashmir

B. 8,000 per month in Siachen area of Jammu and Kashmir

C. 9,000 per month in Siachen area of Jammu and Kashmir

D. 10,000 per month in Siachen area of Jammu and Kashmir

7. Any allowance granted to an employee working in any transport system to meet his personal expenditure during his duty performed in the course of running such transport from one place to another, provided that such employee is not in receipt of daily allowance is exempt upto:

A. 70% of such allowance upto a maximum of 10,000 per month
B. 80% of such allowance upto a maximum of 10,000 per month
C. 90% of such allowance upto a maximum of 10,000 per month
D. 100% of such allowance upto a maximum of 10,000 per month

8. Special Compensatory (Tribal Areas/Schedule Areas/Agency Areas) Allowance [Specified States] is exempt upto_____
A. 100 per month per child upto a maximum of two children
B. 150 per month per child upto a maximum of two children
C. 200 per month per child upto a maximum of two children
D. 300 per month per child upto a maximum of two children

9. Children Education Allowance is exempt upto_____p.m.
A. 100 per month per child upto a maximum of two children
B. 150 per month per child upto a maximum of two children
C. 200 per month per child upto a maximum of two children
D. 300 per month per child upto a maximum of two children

10. Anyallowancegrantedtoan employee tomeet thehostelexpenditure on his child is exempt upto:

A. 100 per month per child upto a maximum of two children
B. 150 per month per child upto a maximum of two children
C. 200 per month per child upto a maximum of two children
D. 300 per month per child upto a maximum of two children

11. Any special allowance in the nature of counter insurgency allowance granted to the members of the armed forces operating in areas away from their permanent locations.

A. 3,900 per month
B. 1,060 per month
C. 3,200 per month
D. 800 per month

12. Any transport allowance granted to an employee who is blind or deaf and dumb or orthopedically handicapped with disability of the lower extremities of the body, to meet his expenditure for commuting between his residence and place of duty is exempt upto

A. 1,060 per month
B. 3,200 per month
C. 800 per month
D. None of the above

13. Underground Allowance granted to an employee who is working in uncongenial, unnatural climate in underground mines is exempt upto_______p.m.
A. 1,060 per month
B. 1,600 per month
C. 800 per month
D. None of the above

14. Any special allowance in the nature of high Altitude allowance granted to the member of the armed forces operating in high altitude areas ,for altitude of 9,000 to 15,000 feet is exempt upto___p.m.:

A. 1,060 per month
B. 1,600 per month
C. Nil
D. None of the above

15. Any special allowance in the nature of special compensatory highly active field area allowance granted to the member of the armed forces is exempt upto_______p.m. :
A. 800;
B. 1600;
C. 4200; and
D. None of the above.

Answers for Self Assessment

1	B	4	C	7	A	10	D	13	C
2	C	5	C	8	C	11	A	14	A
3	C	6	A	9	A	12	B	15	C

Review Questions

1. Write a note on taxable allowances.
2. Explain partially taxable allowances.
3. Explain deductions from gross salary.
4. Give your viewpoints on tax planning in regard to employee compensation from employer point of view.
5. Explain Entertainment allowance provisions.

Further Readings

- https://www.icsi.edu/media/webmodules/16112021_Advance_Tax_Laws.pdf
- A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications
- Study Material on Direct Tax Laws and International Taxation by ICAI
- Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta
- www.incometaxindia.gov.in

Unit 12: International Taxation

Contents

Objectives

After studying this unit, you will be able to:

- understand Foreign Collaborations and Incidence of Taxation on Domestic Companies.

Introduction

When entering into a foreign collaboration agreement, the Indian collaborator should consider aspects that will allow him to plan his tax affairs in a way that ensures maximum after-tax profits and return on investment.

Foreign Collaborations and Joint Ventures provide

- Technical Know-how
- Plant machinery and other equipment's
- Foreign personnel
- Capital

In this case, the Indian collaborator may be advised to take the some tax planning steps.

12.1 Provisions Relating to Taxation

The collaborator or joint ventures get income in following forms which has income tax implications

A. Remuneration to Foreign Personnel
B. Dividends
C. Interest
D. Royalty or fees for technical services
E. Capital Gains

A. Remuneration to Foreign Personnel

- Daily allowance and rent-free accommodation to employees of foreign concern providing technical services in India are not perquisites.

• Section 10(6)(vi) – Remuneration received as an employee of the foreign enterprise.

Eligible exemption-

- The amount of remuneration received, by an individual who is not a citizen of India, as an employee of the foreign enterprise is available as an exemption under section 10(6)(vi).
- The said remuneration should have been received for services rendered during his stay in India.

Conditions to be satisfied to avail the exemption-

- The foreign enterprise, paying the remuneration, should not have been engaged in any type of trade or business in India.
- The stay of the employee should not exceed a period of 90 days in the previous year in aggregate.
- 3. The remuneration should not be liable to be deducted from the income of the employer chargeable under the Act.

B. Dividends

- Section 115A (On other dividends) tax: 20%
- However, where the dividend is payable to a non-resident or a foreign company, the tax shall be deducted under Section 195 in accordance with relevant DTAA.
- A non-resident person generally hold shares of an Indian company as an Investment and, therefore, any income derived by way of dividend is taxable under the head other sources except where such income is attributable to Permanent Establishment of such non-resident in India.

TDS rate applicable on payments of Dividend

	Range of Dividend			
Category of Dividend Recipient	TDS (Dividend < 50 lakhs)	TDS (Dividend > 50 lakhs but < 1 crore	TDS (Dividend > 1 crore but < 10 crores	TDS (Dividend > 10 crores)
NRI	20.80%	22.88%	23.92%	23.92%
Foreign company	20.80%	20.80%	21.22%	21.84%

Tax rates as per IT Act vis a vis Tax Treaties

Country	Dividend	
	Tax Treaty	I-T Act
Albania	10%	20%/10%
Armenia	10%	20%/10%
Australia	15%	20%/10%
Austria	10%	20%/10%
Bangladesh	a) 10% (if at least 10% of the capital of the company paying the dividend is held by the recipient company);	20%/10%
	b) 15% in all other cases	
Belarus	a) 10%, if paid to a company holding 25% shares;	20%/10%
	b) 15%, in all other cases	
Belgium	15%	20%/10%
	Tax Treaty	I-T Act
Bhutan	10%	20%/10%
Botswana	a) 7.5%, if shareholder is a company and holds at least 25% shares in the investee-company;	20%/10%

	b) 10%, in all other cases	
Brazil	15%	20%/10%
Bulgaria	15%	20%/10%
Canada	a) 15%, if at least 10% of the voting powers in the company, paying the dividends, is controlled by the recipient company;	20%/10%
	b) 25%, in other cases	

Analysis of DTAA Provisions for Dividend Taxable in the hands of Non-Residents:

- Abolition of DDT has brought a huge compliance burden on Indian companies having non-resident investors.
- Since deducting TDS plus applicable surcharge and cess will make the shareholders unhappy and result in reduction of market cap since share will be sold by such Investors due to their funds getting blocked because of management of the company.
- Further if the company decides for opting lower rate under DTAA then first condition is that company should be able to obtain all necessary documents.
- Considering a case of listed company, there may be a lot of non-resident shareholders. Thus obtaining documents from all such non-resident shareholders shall be a cumbersome process.
- Further the time frame within which such 15CA / CB are to be prepared will pose another headache for these corporates as the withholding rate may vary investor wise due to they being from different country or few of them unable to provide certain documents and further there can be a huge number of non-resident investors as well.

C. Interest

Tax charged from Foreign Collaborator on interest received:

- Rate of tax shall be 20% under Section 115A on interest received by a foreign company or a non-resident non-corporate assessee from Government or an Indian concern on moneys borrowed or debt incurred by Government or the Indian concern in foreign currency.
- Rate of tax shall be 10% under Section 115AC on income from bonds of an Indian company issued in accordance with such scheme as the Central Government may, by notification in the Official Gazette, specify in this behalf, or on bonds of a public sector company sold by the Government, and purchased by non-resident in foreign currency.
- Rate of tax shall be 5% in following cases:
  - i. Interest received from an infrastructure debt fund as referred to in section 10(*47*)
  - ii. Interest received from an Indian company specified in section 194LC.
  - iii. Interest of the nature and extent referred to in section 194LD (applicable from the assessment year 2014-15).
  - iv. Distributed income being interest referred to in section 194LBA(2) (section 194LBA is inserted by the Finance (No. 2) Act, 2014 w.e.f. 01-10-2014)

Tax rates as per IT Act vis a vis Tax Treaties

Country	Interest	
	Tax Treaty	I-T Act
Albania	10%	20%/10%/5%
Armenia	10%	20%/10%/5%
Australia	15%	20%/10%/5%
Austria	10%	20%/10%/5%

Bangladesh	10%	20%/10%/5%
Belarus	10%	20%/10%/5%
Belgium	15% (10% if loan is if granted by a bank)	20%/10%/5%
Bhutan	10%	20%/10%/5%
Botswana	10%	20%/10%/5%
Brazil	15%	20%/10%/5%
Bulgaria	15%	20%/10%/5%
Canada	15%	20%/10%/5%
China	10%	20%/10%/5%

D. Royalty or fees for technical services

- Tax will be charged at 10%.
- No deduction in respect of any expenditure or allowance u/s 28 to 44C and 57.
- No deduction u/s 80C to 80U.

Fee for Technical ServicesTax rates as per IT Act vis a vis Tax Treaties

Country	**Fee for Technical Services**	
	Tax Treaty	I-T Act
Albania	10%	10%
Armenia	10%	10%
Australia	10%/15% [Note 2]	10%
Austria	10%	10%
Bangladesh	No separate provision	10%
Belarus	15%	10%
Belgium	10%	10%
Bhutan	10%	10%
Botswana	10%	10%
Brazil	No separate provision	10%
Bulgaria	20%	10%
Canada	15%-20%	10%
China	10%	10%
Columbia	10%	10%

Royalty Tax rates as per IT Act vis a vis Tax Treaties

Country	Royalty	
	Tax Treaty	I-T Act
Albania	10%	10%
Armenia	10%	10%
Australia	10%/15%	10%
Austria	10%	10%
Bangladesh	10%	10%

Belarus	15%	10%
Belgium	10%	10%
Bhutan	10%	10%
Botswana	10%	10%
Brazil	25% for use of trademark; 15% for others	10%
Bulgaria	15% of royalty relating to literary, artistic, scientific works other than films or tapes used for radio or television broadcasting; 20% in other cases	10%
Canada	15%-20%	10%

Computation of Income by way of royalty or fees for technical services in case of non-resident

SECTION 44DA OF INCOME TAX ACT – ELIGIBLE ASSESSEE

Section 44DA of Income Tax Act provides method of computation of "income by way of royalty or fees for technical services" in case of non-resident. It is applicable, when the following conditions are satisfied: –

a. Royalty or FTS arises from the **agreement made** by the non-resident with the Indian company or Government of India **after 31.03.2003**.
b. Such non-resident carries on **business in India through permanent establishment** or profession in India through fixed base.
   - The right, property or contract in respect of which the royalty or fees for technical services are paid is **effectively connected with such permanent establishment** or fixed base. The time effectively connected implies, that royalty fee for Technical Services arises due to activities that are connected to the permanent establishment in India.

E. Capital Gains

If foreign collaborator transfers equity shares of an Indian company.

- o LTCG 20%:
- o STCG 40%(without STT)
- o STCG 15%(with STT)

No deduction shall be allowed u/s 80C to 80U.

12.2 Tax Planning for Indian Collaborator

1. Acquisition of Technical Knowhow
   - If purchased: Claim of Depreciation.
   - If taken on regular fee basis: Deduction as business expense.

   Considering technology obsolescence, its better to acquire on regular fee basis.

2. Deduction of Tax at Source
   - When payment made in form of interest, royalty, fee for technical services to foreign collaborator the tax should be deducted at source and deposited in Government account within prescribed time.

3. Capitalization of installation expenses:

- It goes without saying that the purchase of capital goods from a foreign collaborator is a capital expenditure that can be depreciated. It is also important to ensure that the cost of installation, including any supervision fees charged by the collaborator, is capitalised and depreciation is claimed.
- Other expenses related to the collaboration agreement must be incurred after the date of business establishment in order to be capitalised as other expenses by the Indian company.

4. Treating spares purchases as revenue expenditure:

   For the purchase of plant spares, the Indian collaborator should plan to receive the spares after the plant's commissioning year and, preferably, execute a separate contract in this regard. It will allow the Indian firm to treat the entire amount of spares as revenue expenditure.

   In this regard, the Madras High Court's decision in CIT v. Rama Sugar Mills Ltd. (21 ITR 191) is noteworthy. At one of its factories, a sugar manufacturing company had three boilers. Two of these were constantly in use, and the third was kept as a "spare" to be used when one of the other two boilers needed cleaning at regular intervals. One of the boilers' productive capacity deteriorated, necessitating the purchase of the other for Rs. 85,000.

   The Madras High Court ruled that this expenditure was deductible on revenue account because "the boiler that was substituted was exactly similar to the old one and by this expenditure, the assessee company did not bring any additional advantage to the trade or business that they were carrying on and there is no improvement." It cannot be argued that by substituting a new boiler for an old one, the sugar manufacturing unit's production capacity was increased in any way."

5. Treating plans and drawings, for example, as Plant in order to obtain the full value as depreciation:

   According to the decision of the Supreme Court in the case of CIT v. Alps Theatre (65 ITR 177), plant includes ships, vehicles, books, scientific apparatus, and surgical equipment used for business or profession.

   However, know-how acquired on or after 1.4.1998, owned wholly or partly by the assessee, and used for the purpose of his business or profession by such assessee, will form a separate block of asset along with other intangible assets and will be eligible for depreciation under Section 32(1) @ 25% on written down value.

12.3 Tax Planning for Foreign Collaborator

1. Sale of technical Know-how
   - Should be sold for lump-sum consideration: Not liable to pay tax in India.
   - Should not be transferred for a fee: Income is deemed to accrue or arise in India.
2. Sale of Capital Goods by foreign collaborator
   - If goods are supplied on a FOB through L/C: Tax liability avoided.
   - If goods are supplied on a CIF basis: Tax liability arises.

Summary

India needs the latest technical know-how and funds for its industrial development. This can be made possible by foreign collaborations and joint ventures. These collaborators or joint venturers when receiving income in form of remuneration, dividend, interest, fee, royalty must pay tax on these incomes. This unit discusses provisions relating to the taxation of such incomes. Indian

collaborator must plan tax while acquiring technical know-how and deducting tax at source. Foreign collaborator must plan tax while deciding about the sale of technical know-how and capital goods. All these decisions affect the tax liability.

Keywords:

- FOB:

FOB is an abbreviation for free on board, also known as freight on board. It is a term that is frequently used in international shipping. It denotes a transportation term indicating that the selling price of the goods includes delivery at the seller's expense only up to a certain point. As soon as the goods leave the specified location, the buyer assumes responsibility for shipping. These terms are commonly found in commercial invoices.

- CIF:

CIF is an abbreviation for cost, insurance, and freight. The reseller is responsible for goods in transit until the buyer receives them under the CIF agreement. It is regarded as an expensive option for buyers because the seller selects the forwarder of his choice, which may be costly and may even charge more in order to increase profits. In this case, the seller has the upper hand.

- Letter of Credit:

It is a letter issued by a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. If the buyer is unable to make a payment on the purchase, the bank is obligated to cover the entire or remaining purchase price. This can be provided as a service. Because of the complexities of international relations, including factors such as distance, different laws in each region, and the difficulty in understanding each party personally, letters of credit have become an important part of international trade.

Self Assessment

1. What is the TDS rate in case of NRI when Dividend < 50 lakhs?

A. 20.80%
B. 22.88%
C. 23.92%
D. 21.22%

2. What is the TDS rate in the case of foreign company when Dividend < 50 lakhs?

A. 20.80%
B. 22.88%
C. 23.92%
D. 21.22%

3. What is the TDS rate in case of NRI when Dividend > 50 lakhs but < 1 crore?

A. 20.80%
B. 22.88%
C. 23.92%
D. 21.22%

4. What is the TDS rate in case of Foreign company when Dividend > 50 lakhs but < 1 crore?

A. 20.80%
B. 22.88%

C. 23.92%

D. 21.22%

5. What is the TDS rate in case of NRI when Dividend > 1 crore but < 10crore?

A. 20.80%

B. 22.88%

C. 23.92%

D. 21.22%

6. What is the TDS rate in case of Foreign companyDividend > 1 crore but < 10 crore?

A. 20.80%

B. 22.88%

C. 23.92%

D. 21.22%

7. What is the TDS rate in case of NRI when Dividend > 10 crores?

A. 20.80%

B. 22.88%

C. 23.92%

D. 21.22%

8. What is the TDS rate in case of foreign company when Dividend > 10 crores?

A. 20.80%

B. 22.88%

C. 23.92%

D. 21.84%

9. What is the dividend Tax rates (%) as per the IT Act in Belgium?

A. 7.5

B. 10

C. 15

D. 20

10. What is the dividend Tax rates (%) as per the IT Act in Belgium?

A. 7.5

B. 10

C. 15

D. 20

11. What are the dividend Tax rates (%) as per the IT Act in Canada if at least 10% of the voting powers in the company, paying the dividends, is controlled by the recipient company;?

A. 7.5

B. 10

C. 15

D. 20

12. What is the dividend Tax rates (%) as per the IT Act in Canada if at least 10% of the voting powers in the company, paying the dividends, is not controlled by the recipient company?

A. 7.5

B. 10

C. 15

D. 25

13. What are the dividend Tax rates (%) as per the IT Act in Australia?

A. 7.5

B. 10

C. 15

D. 20

14. What are the dividend Tax rates (%) as per the IT Act in Austria?

A. 7.5

B. 10

C. 15

D. 20

15. Which of the following statements is wrong while doing aanalysis of DTAA Provisions for Dividend Taxable in the hands of Non-Residents?

A. Abolition of DDT has brought a huge compliance burden on Indian companies having non-resident investors.

B. Since deducting TDS plus applicable surcharge and cess will make the shareholders unhappy and result in reduction of market cap since share will be sold by such Investors due to their funds getting blocked because of management of the company.

C. Further if the company decides for opting lower rate under DTAA then the company need notobtain all necessary documents.

D. Considering a case of listed company, there may be a lot of non-resident shareholders. Thus obtaining documents from all such non-resident shareholders shall be a cumbersome process.

Answers for Self Assessment

1	A	4	A	7	C	10	B	13	C
2	A	5	C	8	D	11	C	14	B
3	B	6	D	9	C	12	D	15	C

Review Questions

1. Write your perspectives on tax planning from a Foreign Collaborator point of view.

2. Write your perspectives on tax planning from the Indian Collaborator point of view.
3. Do the analysis of DTAA Provisions for Dividend Taxable in the hands of Non-Residents.
4. Write income tax provisions in regard to remuneration paid to Foreign Personnel.
5. Write income tax provisions in regard to royalty payments.

Further Readings

- https://www.icsi.edu/media/webmodules/16112021_Advance_Tax_Laws.pdf
- A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications
- Study Material on Direct Tax Laws and International Taxation by ICAI
- Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta
- www.incometaxindia.gov.in

Unit 13: Double Taxation

CONTENTS

Objectives

After studying this unit, you will be able to:

- comprehend the necessity for double taxation relief.
- recognize various types of double taxation reliefs.
- implement the provisions practically relating to double taxation relief in problem solving.
- acknowledge the process to claim deduction in case of absence of taxation avoidance agreement.
- understand international tax avoidance and evasion channels and anti-avoidance strategies.

Introduction

- Tax avoidance by multinational corporations (MNCs) has been on top of the international tax policy agenda since the global financial crisis.
- MNCs pay very low effective tax rates by base erosion and profit shifting. .
- These concerns have led to major new international initiatives to curb international tax avoidance.

- The aim is to develop approaches that limit the opportunities for MNCs to artificially shift profits and thus to enhance revenue mobilization.

The application of sections 90/90A and 91 for Income earned outside India

Resident:

Agreement with Foreign Country(section 90/90A)

No Agreement with Foreign Country(section 91)

Non- Resident:

Not taxable

13.1 Concept of Double Taxation Relief

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.

Reason

the source rule and

the residence rule

Therefore, DTAAs are entered into by the countries to address double taxation arising in two countries and thereby encourage mutual trade and investment.

DTAA rules

- Interest
- Dividend
- Royalties
- Capital gains
- Business income etc.

Each such category is dealt with by separate article in the DTAA.

Double taxation means taxing the same income twice

Forms of Relief

Bilateral

- Agreement with foreign countries or specified territories

India has entered into agreements for relief against or avoidance of double taxation with more than 100 countries which include Sri Lanka, Switzerland, Sweden, Denmark, Japan, Federal Republic of Germany, Greece, etc.

13.2 Exemption Method

13.3 Tax Credit Method

The Central Government may enter into an agreement with the Government of any country outside India or specified territory or specified association outside India [Section 90A

Unilateral Relief

- Countries with which no agreement exists
- Relief unilaterally by a country to its resident for the taxes paid in the other country.
- India grants unilateral relief through credit method under section 91.
- Where Government of India has not entered DTAA with a foreign Government. It may grant unilateral relief to its residents.

Conditions for unilateral relief

- Assesse, who is a resident in India during the PY

- The income accrues or arises to him outside India and the income is not deemed to accrue or arise in India during the PY.
- The income in question has been subjected to income-tax in the foreign country in the hands of the assesse.
- The assesse has paid tax on the income in the foreign country.
- There is no agreement for relief from DT between India and the other country where the income has accrued or arisen

Computation of relief

- Doubly taxed income x Indian rate of tax. or
- Rate of tax in the said country, whichever is lower.

Concept of Permanent Establishment

13.4 Unilateral Relief in Case of Agricultural Income in Pakistan Sec.91(2)

As per section 91(2) the unilateral relief is also available in respect of agricultural income in Pakistan on which income-tax is levied in India and income tax is levied in Pakistan on such agricultural income.

Of the amount of the tax paid in Pakistan or of a sum calculated on that income at the Indian rate of tax , whichever is less.

13.5 Unilateral Relief in Case of Foreign Exempted Agricultural Income

Where a resident derives income from business in India and in foreign country and agricultural income from foreign country which is not taxable there. He is liable to pay tax on whole income in India.

Entitled to DT relief.

If loss from agriculture in foreign country, DT relief on for income without setting off loss.

13.6 Unilateral Relief in case of Foreign Dividend

Where assesse claims DT relief in respect of foreign dividend, the gross dividend will be included in income.

13.7 Unilateral Relief Country Wise

Relief u/S 91(1) to be allowed country wise and not on aggregation of income of all countries.

13.8 Unilateral Relief in Case Assesse is Entitled to Deduction from Foreign Income

Where assesse is entitled to deduction from GTI in relation to foreign income, DT relief will be allowed on foreign income less deduction from such income.

13.9 Deduction for Royalty Income of Authors

Amounts Included in Royalty Income

Amount of Deduction

Conditions for claiming

80QQB

- Individual is allowed deduction on income earned outside India when the income is brought to India in convertible foreign exchange within 6 months from the end of the year or within the period allotted by RBI or other competent authority for this purpose. Individual must obtain a certificate in FORM 10H.

Example 1: Interest on Govt Securities 50,000

- HP income(computed) 1,40,000
- Business Income 1005000
- Income from Country with which no DTAA agreement: 2,00,000(Income tax paid=20000)

Solution

Computation of relief

- Doubly taxed income x Indian rate of tax. or
- Rate of tax in the said country, whichever is lower.

Interest on Govt Securities	50,000
HP income(computed)	1,40,000
Business Income	1005000
Income from Country with which no DTAA agreement	2,00,000
GTI	13,95,000
Less Deduction	0
TI	13,95,000
Total Tax Payable	231000
Tax Surcharge @ 10%/15%/25%/37% (Income more than 50 Lakh	0
Add; Edn Cess + Health Cess @ 4%	9,240
Net Tax Payable	2,40,240
Advance Tax Paid	0
Tax Remianing to be Paid	2,40,240
Tax to Total Income Ratio	17%

Relief on foreign income

- **=17% of 2,00,000 or 20,000 whichever is less**
- **=20000**
- **Income Tax payable: 2,40,240 -20000**

Example 2:

Resident

- Income from business outside India: 6,00,000
- Loss from business in India: 60,000
- Income from other sources in India: 40,000
- AO provided relief on 5,40,000
- Assesse claim for relief on 5,80,000

Example 3:

Resident

- Foreign Income from concerts: 5,00,000
- TDS in the foreign country: 37,500
- Indian income: 6,00,000

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Solution

Gross Total Income	11,00,000
Deduction	0
TI	11,00,000
Tax Rebate of Rs. 12,500 (For Income of less than 5 lakhs) (Budget 2019)	0
Total Tax Payable	1,42,500
Tax Surcharge @ 10%/15%/25%/37% (Income more than 50 Lakhs/1 cr/2 cr/5 cr respectively) (Budget 2019)	0
Add; Edn Cess + Health Cess @ 4%	5,700
Net Tax Payable	1,48,200
Advance Tax Paid	0
Tax Remaining to be Paid	1,48,200
Tax to Total Income Ratio	13%

- Relief on foreign income =13% of 5,00,000 or 37,500 whichever is less =37,500
- Income Tax payable: 1,48,200- 37,500

Example 4

- Income from Business in India: 7,00,000
- Income from Business in abroad(tax=48000): 2,00,000
- PPF:60,000

Solution

Gross Total Income	900000
Deduction	60,000
TI	8,40,000

Tax Rebate of Rs. 12,500 (For Income of less than 5 lakhs) (Budget 2019)	0
Total Tax Payable	80,500
Tax Surcharge @ 10%/15%/25%/37% (Income more than 50 Lakhs/1 cr/2 cr/5 cr respectively) (Budget 2019)	0
Add; Edn Cess + Health Cess @ 4%	3,220
Net Tax Payable	83,720
Advance Tax Paid	0
Tax Remaining to be Paid	83,720
Tax to Total Income Ratio	9%

- Relief on foreign income =9% of 2,00,000 or 48,000 whichever is less =18,000
- Income Tax payable: 83,720- 18,000

Example 5

Resident
Indian Income: 5,00,000
Net Foreign Income: 40,000(Tax deducted-5000)
No DTAA

Solution

Gross Total Income	545000
Deduction	0
TI	545000
Total Tax Payable	21500
Tax Surcharge @ 10%/15%/25%/37% (Income more than 50 Lakhs/1 cr/2 cr/5 cr respectively) (Budget 2019)	0
Add; Edn Cess + Health Cess @ 4%	860
Net Tax Payable	22360
Advance Tax Paid	0
Tax Remaining to be Paid	22360
Tax to Total Income Ratio	0.04

- Relief on foreign income =4% of 45000 or 5000 whichever is less = 1800
- Income Tax payable: 22360-1800

Example 6

- Salary from Indian University for 9 months 6,00,000
- Salary from foreign University for 3 months 5,50,000
- Foreign exchange brought in India 3,00,000
- TDS(foreign Salary) 90,000

Solution

Salary Income	11,50,000
Standard Deduction	50,000
Total Income	1100000
Tax Rebate of Rs. 12,500 (For Income of less than 5 lakhs) (Budget 2019)	0
Total Tax Payable	142500
Tax Surcharge @ 10%/15%/25%/37% (Income more than 50 Lakhs/1 cr/2 cr/5 cr respectively) (Budget 2019)	0
Add; Edn Cess + Health Cess @ 4%	5700
Net Tax Payable	148200
Advance Tax Paid	0
Tax Remaining to be Paid	148200
Tax to Total Income Ratio	0.1347

- Relief on foreign income = 13% of 5,50,000 or 90,000 whichever is less
- Income Tax payable: 148200-71500

Example 7:

Resident

- Income from Business in India: 4,00,000
- Income from Business in abroad from country A (tax=70,000): 2,50,000
- Loss from Business in abroad from Country B: 90,000

Solution

Calculation of relief country wise

income from India	4,00,000
Income from Abroad	2,50,000
Total Income	6,50,000

Tax Rebate of Rs. 12,500 (For Income of less than 5 lakhs) (Budget 2019)	0
Total Tax Payable	42,500
Tax Surcharge @ 10%/15%/25%/37% (Income more than 50 Lakhs/1 cr/2 cr/5 cr respectively) (Budget 2019)	0
Add; Edn Cess + Health Cess @ 4%	1,700
Net Tax Payable	44,200
Advance Tax Paid	0
Tax Remaining to be Paid	44,200
Tax to Total Income Ratio	7%

- Relief on foreign income = 7% of 2,50,000 or 70,000 whichever is less
- Income Tax payable: 44,200-17500

Computation of tax payable

Income from India	4,00,000
I Income from foreign country A	2,50,000
Loss from Foreign country B	-90000
Total Income	560000
Tax Rebate of Rs. 12,500 (For Income of less than 5 lakhs) (Budget 2019)	0
Total Tax Payable	24500
Tax Surcharge @ 10%/15%/25%/37% (Income more than 50 Lakhs/1 cr/2 cr/5 cr respectively) (Budget 2019)	0
Add; Edn Cess + Health Cess @ 4%	980
Net Tax Payable	25480
Advance Tax Paid	0
Tax Remaining to be Paid	25480
Relief	17500
Tax payable	7980

Example 8:

Resident

Indian Business Loss 1,00,000

Income from other sources 1,20,000

Foreign Business Income 6,00,000(Tax 1,00,000)

PPF 50,000

Solution

Indian Business loss	1,00,000
Income from other sources in India	120000
Foreign Income	600000
GTI	8,20,000
Deduction u/s 80C	50000
TI	7,70,000
Tax Rebate of Rs. 12,500 (For Income of less than 5 lakhs) (Budget 2019)	0
Total Tax Payable	66,500
Tax Surcharge @ 10%/15%/25%/37% (Income more than 50 Lakhs/1 cr/2 cr/5 cr respectively) (Budget 2019)	0
Add; Edn Cess + Health Cess @ 4%	2,660
Net Tax Payable	69,160
Advance Tax Paid	0
Tax Remaining to be Paid	69,160
Tax to Total Income Ratio	8%

- Relief on foreign income = 8% of 600000 or 1,00,000 whichever is less
- Income Tax payable: 69160-48000

Example 9: Resident

- Income from Indian Business: 5,00,000
- Income from Foreign Country(A) Business:80,000(Tax paid=16,000)
- Income from Foreign Country(B) Business: 50,000(Tax rate 15%)
- Income from other sources: 25,000

Solution

	Country A	Country B

Income from India	525000	525000
Foreign Income	80000	50000
Total Income	6,05,000	575000
Tax Rebate of Rs. 12,500 (For Income of less than 5 lakhs)	0	0
Total Tax Payable	33,500	27500
Tax Surcharge @ 10%/15%/25%/37% (Income more than 50 Lakhs/1 cr/2 cr/5 cr respectively)	0	0
Add; Edn Cess + Health Cess @ 4%	1,340	1100
Net Tax Payable	34,840	28600
Advance Tax Paid	0	0
Tax Remaining to be Paid	34,840	28600
Tax to Total Income Ratio	6%	4%
Tax Relief in case of Country A=6% of 80000 or 16000 whichever is less	4800	
Tax Relief in case of Country B=4% of 50000		2000

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Tax Liability

Total Income(Indian plus Foreign)	6,55,000
Tax Rebate of Rs. 12,500 (For Income of less than 5 lakhs) (Budget 2019)	0
Total Tax Payable	43,500
Tax Surcharge @ 10%/15%/25%/37% (Income more than 50 Lakhs/1 cr/2 cr/5 cr respectively) (Budget 2019)	0
Add; Edn Cess + Health Cess @ 4%	1,740
Net Tax Payable	45,240
Advance Tax Paid	0
Tax Remaining to be Paid	45,240
Relief(4800+2000)	6800
Tax payable	38,440

Example 10:

Income from India: 4,00,000

Income from Foreign country:5,00,000(Tax=27000)

Deduction u/s 80QQB 3,00,000

Solution

Indian income	400000
Foreign Income	500000
GTI	900000
Deduction	300000
Total Income	6,00,000
Tax Rebate of Rs. 12,500 (For Income of less than 5 lakhs) (Budget 2019)	0
Total Tax Payable	32,500
Tax Surcharge @ 10%/15%/25%/37% (Income more than 50 Lakhs/1 cr/2 cr/5 cr respectively) (Budget 2019)	0
Add; Edn Cess + Health Cess @ 4%	1,300
Net Tax Payable	33,800
Advance Tax Paid	0
Tax Remaining to be Paid	33,800
Tax to Total Income Ratio	6%

Tax relief

Foreign tax:

=27000*200000/500000

=10800

Or

Indian Tax

6% on (500000-300000)=12000

Whichever is less=10800

Tax liability

= 33,800-10800

=23000

Example11:

Resident

Indian Business Income: 4,00,000

Foreign Business Income: 2,00,000

ADT signed: Income taxable in the country of earning

Foreign Tax rate:20%

PPF 35000(10000 from Foreign income)

Income from other securities: 30000

Solution

income from business	400000
IFOS	30000
Deduction	35000
Indian Income	365000
Foreign Income	200000
Total Income	565000
Tax Rebate of Rs. 12,500 (For Income of less than 5 lakhs) (Budget 2019)	0
Total Tax Payable	25500
Tax Surcharge @ 10%/15%/25%/37% (Income more than 50 Lakhs/1 cr/2 cr/5 cr respectively) (Budget 2019)	0
Add; Edn Cess + Health Cess @ 4%	1020
Net Tax Payable	26520
Advance Tax Paid	0
Tax Remianing to be Paid	26520
Tax to Total Income Ratio	0.04

Tax liability

= 26520*365000/ 565000

Income of a Non-resident

Taxability under the Income-tax Act, 1961.

- Governed by Sec. 9.
- On the basis of business connection.

Taxability under the DTAA.

- Governed by DTAA.
- On the basis of permanent establishment.]

The PE concept is narrower than the business connection concept.

13.10 Double Taxation Relief by Entering into Agreements with Foreign Countries or Specified Territories [Section 90]

- For granting double taxation relief in respect of income on which tax has been paid both under the Income Tax Act, 1961 and the income tax prevailing in that country or definite territory.
- For granting relief in respect of income tax chargeable under the Income Tax Act, 1961, and according to the corresponding law in force in that country or specified territory, to boost mutual economic relations, trade and investment.
- To prevent double taxation on income, For exchange of information.
- The provisions of this Act shall apply to the extent they are more beneficial to that assessee.
- However, the provisions of General Anti-Avoidance Rule, shall apply to the assessee even if such provisions are not beneficial to him.
- Section 90(4) provides 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 declaring his residence of the country outside India or the specified territory outside India, as the case may be.
- The Central Government is empowered by section 90A to enter into an agreement with any specified association in the specified territory outside India and the Central Government has been authorized to make such provisions as may be necessary for adopting and implementing such agreement.

13.11 Adoption by Central Government of Agreement Between Specified Associations for Double Taxation Relief [Section 90A]

- For granting double taxation relief in respect of income on which tax has been paid both under the Income Tax Act, 1961 and the income tax prevailing in that country or definite territory.
- For granting relief in respect of income tax chargeable under the Income Tax Act, 1961, and according to the corresponding law in force in that country or specified territory, to boost mutual economic relations, trade and investment.
- To prevent double taxation on income, For exchange of information.
- In order to recover income taxes.

13.12 DT Relief under the Income-tax Act, 1961

Taxability of income would be based on DTAA or the Income-tax Act, 1961, whichever is more beneficial.

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 favorable charge or levy of tax in respect of such foreign company.

In order to claim DT relief, the non-resident to whom such DTAA applies, has to obtain a TRC from the Government of that country or specified territory.

13.13 Brief Overview of the International Tax Architecture

The tax treatment of MNCs is determined by the international tax framework, which is a myriad of domestic legislations and a wide network of bilateral and multilateral tax treaties.

The framework relies largely on *separate accounting*, which means that taxation of an MNC group is at the level of individual subsidiaries that operate in different countries.

Each country has a right to tax the income assigned, based on its domestic law and tax treaty obligations.

Channels of international tax avoidance

- Transfer mispricing,
- Strategic location of intellectual property (IP),
- Strategic location of intellectual property (IP),
- International debt shifting, and
- Treaty shopping.
- Corporate inversions/headquarter relocation, and tax deferral.

When can a country tax MNCs?

- Source of the income.
- Residence of the corporate taxpayer.
- Certain thresholds must be met to define a permanent establishment (PE), which determines whether a source country can tax a foreign company or not.

How does a country tax MNC earnings?

- Territorial system: residence countries exempt foreign earnings of MNCs so that their active business income is only taxed in the source country.
- Worldwide system: the residence country retains the right to tax active income from all source countries.
- Double taxation is typically avoided by the residence country granting a non-refundable foreign tax credit against its own tax, so that the residence tax is limited to the excess of the residence country's effective tax rate over that in the source country.
- Withholding taxes: Many source countries impose withholding taxes on outbound income payments, such as interest, royalties and dividends.

Main Channels of International Tax Avoidance

Avoidance of source country taxation:

(i) Transfer mispricing (stretching, violating or exploiting weaknesses in the arm's length

principle);

(ii) Strategic location of management of intellectual property (IP) to low-tax

countries to reduce taxes on associated income;

(iii) Debt shifting through intracompany loans

(excessive borrowing in high-tax countries and lending to low-tax countries);

(iv) Treaty shopping (exploiting treaty networks to route income so as to avoid tax);

(v) Risk transfer (conducting operations in high tax jurisdictions on a contractual basis to limit profits attributable there);

(vi) Avoiding PE status; and

(vii) locating asset sales in low-tax jurisdictions (to avoid taxes on the capital gains).

Transfer Mispricing

- Despite extensive OECD and UN Guidelines, there may be significant room for subjective interpretation.no "correct" arms-length price if there are no comparable third-party transactions.

- MNCs may be able to charge artificially low prices for exports sold from high-tax to low-tax countries, or artificially high prices for inputs coming from low-tax countries, to reduce their global tax liability.

Strategic Location of IP

- Companies can conduct their research and development (R&D) activities in one country, but transfer the ownership of the patent that is subsequently created to another country where the resulting income streams will be taxed at a lower rate.
- As, there is often no comparable transactions of IPs between unrelated parties, determining the arm's length price for company's intangible transactions is usually very difficult, leaving room for tax-induced manipulation of transfer prices.

International Debt Shifting

- A third way for an MNC to reduce its tax bill is through intracompany loans.
- Cross-country differences in rates of CIT create opportunities for lending from low-tax countries to affiliates in high-tax countries or by locating external borrowing in high-tax countries.
- This debt shifting reduces the group's tax bill without affecting the overall debt exposure of the group (and hence its bankruptcy risk).

Tax Treaty Shopping

- Considerable variation in the WHT rates in more than 3000 bilateral DTTs creates.
- Opportunities of treaty shopping.
- This enables MNCs to link different DTTs and divert cross border payments through the country with the lowest WHT rate.

Tax Deferral

- As worldwide taxation imposes residence tax only upon repatriation of the profit, MNCs can avoid repatriation taxes by retaining foreign earnings abroad.
- The tax deferral channel is different from the others in that with an unchanging tax rate, deferral affects only the present value of taxes paid instead of the total revenue.

Corporate Inversions and HQ Location

- MNCs in worldwide countries can also avoid repatriation taxes by changing the residence of the corporation or, stated differently, by "inverting" roles in the corporate group.
- Corporate inversion by US parents are generally associated with substantial tax savings.
- More broadly, corporate inversions are a special case of cross-border mergers and
- acquisitions (M&As) that are influenced by tax considerations.

Anti-Avoidance Regulations

- Adoption of transfer pricing regulations
- Thin capitalization rules,
- Controlled foreign corporations (CFC) rules or a
- General anti-avoidance rule (GAAR).
- G20-OECD initiative on BEPS(multilateral instrument, an OECD initiative under the BEPS project).
- European Union has also adopted an anti-tax-avoidance directive that requires its member states to implement a common set of rules to address tax avoidance.

Need for Transfer Pricing regulations

- .With the advent of globalization, multinational companies (MNCs) have established presence in all parts of the world and are conducting business seamlessly.
- They can enjoy the privileges of doing business with related parties whereas companies which deal with unrelated parties in an open market are not able to exploit such benefits.

- Therefore, in order to ensure safe and fair dealing among all companies and markets, the need to introduce regulations for transfer pricing was felt.
- Transfer pricing is one of the most important issues faced by MNCs as they attempt to fairly distribute their profits amongst the companies within the group.
- While on the other hand, the tax authorities implement transfer pricing regulations and strengthen the enforcement in order to prevent a loss of revenue for each regime where these companies are incorporated.
- The net result of this dichotomy is that transfer pricing has become a major tax issue for the companies.
- The principles governing the taxation of MNCs are embodied in the OECD Model Tax Convention of Income and Capital (OECD Model Convention),

Transfer Pricing Regulations

- Methods that can be used to calculate transfer prices,
- Determine documentation requirements,
- Specific requirements in its application needed to support the transfer prices used.
- Penalties if mispricing is detected or adequate documentation is not provided.

Documentation

- Documentation maintained to review Transfer Pricing arrangements for transactions taking place between different entities of the same group.
- To review the arm's length (fair price) nature of the transactions taking place between different entities of an Multi National Company.

Documentation compliances

- Persons responsible for keeping and maintaining prescribed information and document -
  - Who enters into international transaction
  - constituent entity of an international group
- Information and documents to be kept and maintained for prescribed period
- Assessing Officer & Commissioner (Appeals) empowered to require persons entering into international transaction to furnish prescribed information and documents
- Information and documents to be kept and maintained for prescribed period - The CBDT is empowered to prescribe the period for which the information and documents shall be kept and maintained
- The Assessing Officer or the Commissioner (Appeals) may, in the course of any proceedings under the Income-tax Act, require any person who has entered into an international transaction to furnish any such prescribed information or documents within a period of from the date of receipt of a notice issued in this regard.
- The requisition period may, on request, be extended further for a period not exceeding thirty days by the Assessing Officer or the Commissioner (Appeals).

Transfer pricing documentation requirement under section 92D(1)

- As per Rule 10D(1) of the Income-tax Rules, 1962, the transfer pricing documentation requirement under section 92D(1)(i) should contain the following details:
- Ownership structure of the assessee with details of shares or other ownership interest held therein by other enterprise
- Profile of the multinational group and basic details of associated enterprises with whom assessee has entered into international transaction
- Business description of the business of the assessee and associated enterprises and the industry in which the assessee operates
- Nature and terms (including price) of the international transactions, details of property transferred or services provided and quantum and value of each such transaction;

- Description of functions performed, risks assumed and assets employed by the assessee and associated enterprises.
- Records of economic and market analysis, budgets, forecasts, financial estimates for the business as a whole and for each division or product separately which may have a bearing on such transaction.
- Record of uncontrolled transaction (if any) for analysing comparability of international transaction with such uncontrolled transaction.
- Rule 10D(2) provides that in a case where the aggregate value of international transactions does not exceed ` 1 crore, it will not be obligatory for the assessee to maintain the above information and documents.

Penalties

- Stringent penalties are provided in various sections for non-compliance with the above provisions.
- **Penalty for failure to report any international transaction or any transaction deemed to be an international transaction:** Under section 270A, penalty@50% of tax payable on under- reported income is leviable.
- **Penalty for failure to keep and maintain information and documentation [Section 271AA]:** penalty@2% of the value of each international transaction
- **Penalty for failure to furnish information or document under section 92D [Section 271G]:**
    - The Assessing Officer or Commissioner (Appeals) may direct the person entering into an international transaction to pay a penalty@2% of the value of each international transaction entered into by him if the person:
    - fails to keep and maintain any such document and information as required by section 92D(1) or section 92D(2);
    - fails to report such international transaction which is required to be reported; or
    - maintains or furnishes any incorrect information or document.

- **Penalty for failure to report any international transaction or any transaction deemed to be an international transaction:**
    - Under Section 270A, penalty@50% of tax payable on under-reported income is leviable.
    - However, the amount of under-reported income represented by any addition made in conformity with the arm's length price determined by the Transfer Pricing Officer would not be included within the scope of under-reported income under section 270A.
    - Failure to report any international transaction or any transaction deemed to be an international transaction to which the provisions of Chapter X applies would constitute 'misreporting of income' under section 270A(9), in respect of which penalty@200% would be attracted.

	Penalty for failure to comply with TP provisions : A Summary	
Section	Nature of default	**Penalty**

270A(9)	Failure to report any International transaction or deemed International transaction to which the provision of Chapter X applies would constitute 'misreporting of income'	**200% of the tax payable on under-reported income**
271BA	**Failure to furnish a report from an accountant as required under section 92E**	**1 lakh**
271G	**Failure to furnish info or doc as required by Assessing Officer or CIT(A) u/s 92D(3) within 30 days from the date of receipt of notice or extended period not exceeding 30 days, as the case may be.**	**2% of the value of the international transaction for each failure**
271AA	**(1) Failure to keep and maintain any such document and information as required by section 92D(1)/(2);** **(2) Failure to report such international transaction which is required to be reported; or** **(3) Maintaining or furnishing any incorrect information or document.**	**2% of the value of each such international transaction**

Specific reporting requirements – country by country reporting

Requirements as per OECD report on Action 13 of BEPS Action Plan

- The report provides for:
  I. revised standards for transfer pricing documentation; and
  II. a template for country-by-country reporting of income, earnings, taxes paid and certain measure of economic activity.

Three-tier structure mandated by BEPS

The BEPS report recommends that countries adopt a standardised approach to transfer pricing documentation; it mandates the following three-tier structure:-

- Master File:Standardised information relevant for all multinational enterprises (MNE) group members.
- Local file:Specific reference to material transactions of the local taxpayer.
- Country-by- country report: Information relating to the global allocation of the MNE's income and taxes paid; and Indicators of the location of economic activity within the MNE group.

Specific reporting requirements – country by country reporting

a) Taxpayers will be required to articulate consistent transfer pricing positions;

b) Tax administrations would get useful information to assess transfer pricing risks;

c) Tax administrations would be able to make determinations about where their resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries.

The Country-by-Country (CbC) report has to be submitted by parent entity of an international group to the prescribed authority in its country of residence. This report is to be based on consolidated financial statement of the group.

a) MNEs have to report annually and for each tax jurisdiction in which they do business:

   (1) the amount of revenue;

   (2) profit before income tax; and

   (3) income tax paid and accrued.

b) MNEs have to report their total employment, capital, accumulated earnings and tangible assets in each tax jurisdiction.

c) MNEs have to identify each entity within the group doing business in a particular tax jurisdiction and provide an indication of the business activities each entity engages in.

Implementation of international consensus in India:

India is one of the active members of BEPS initiative and part of international consensus. For the purpose of implementing the international consensus, a specific reporting regime in respect of CbC reporting and also the master file has been incorporated in the Income-tax Act, 1961. The essential elements have been incorporated in the Income-tax Act, 1961 while remaining aspects would be dealt with in detail in the Income-tax Rules, 1962.

Need of Controlled Foreign Corporations (CFC) legislation in India

- There is a great need and importance of introducing CFC.
- In the current scenario, there are no such provisions existing in income tax act, 1961 but the same has been introduced in Direct tax code in lines with the Action Plan 3 of OCED tax avoidance model.
- Taxation of foreign passive income is at heart of CFC regulations.

CFC rules

- Controlled Foreign Corporation rules apply to certain income generated by foreign subsidiaries of a domestic firm.
- Disincentivize shifting income to low-tax jurisdictions by subjecting businesses that do so to domestic tax on that income, thus protecting the domestic tax base.
- Follow the same basic structure.
    - Ownership threshold
    - Subsidiary's income should be taxed domestically
    - What income earned by the foreign subsidiary is subject to tax

Controlled Foreign Corporation (CFC) Rules in European OECD Countries, as of 2021ntrolled Foreign Corporation (CFC) Rules in European OECD Countries, as of 2021

Country	Covered Type(s) of Income	CFC Rule Exemptions
Austria (AT)	Passive	CFC with substantive economic activities exempted

Belgium (BE)	All income associated with non-genuine arrangements	None
Czech Republic (CZ)	Passive	CFC with substantive economic activities exempted
Denmark (DK)	Passive	Foreign subsidiaries are exempt if less than 1/3 of their income is passive income

GAAR

- More and more countries are adopting GAAR to check aggressive tax planning and reduce incidence of tax avoidance.
- In India, GAAR came into effect from 1 April 2017.

Inbound investments: GAAR considerations

- Codification of anti-avoidance principles under the domestic tax law.
- The provisions of GAAR would trigger when an arrangement is regarded as an impermissible avoidance arrangement (IAA).
- Important to demonstrate that the main purpose of investing in India through a particular jurisdiction is motivated by commercial reasons and not merely to obtain tax benefits.

GAAR provisions would not apply to an arrangement where tax benefit, in aggregate, to all parties to the arrangement do not exceed INR 30 million (approximately $0.4 million) in a single financial year.

Consequences of triggering GAAR provisions

- Disregarding the whole arrangement or any step in an arrangement;
- Disregarding the corporate structure;
- Treating the place of residence of any party to the arrangement at a place other than the place of residence as provided under the arrangement;
- Denial of treaty benefit – while a taxpayer has an option to apply the provisions of domestic tax law or tax treaty whichever are more beneficial, GAAR under the domestic tax law overrides treaty provisions;
- Characterising equity as debt or vice-versa.

MLI Considerations-Principal purpose test

- Benefit under treaty shall not be granted if it is reasonable to conclude that obtaining such a benefit was one of the principal purposes of any arrangement that resulted directly or indirectly in that benefit, unless it is established that granting that benefit would be in accordance with the object and purpose of the relevant treaty provisions.
- Where it is established that granting a treaty benefit would be in accordance with the object and purpose of the relevant treaty provisions, a treaty benefit should not be denied.

MLI Considerations-simplified limitation of benefits (SLOB)

- India has opted for the SLOB provision in addition to the PPT. The SLOB provision will however apply only if both the treaty partners have opted for it, or where one treaty partner has opted for it and the other treaty partner allows its applicability asymmetrically.

Other MLI amendments

- The multilateral instrument, an OECD initiative signed by over 90 countries.
- Tax treaties entered by India with various countries have undergone changes on account of the MLI.
- The MLI has introduced changes to tax treaties to mitigate artificial avoidance of permanent establishments (PEs) through fragmentation of activities and through splitting up of contracts and also enhanced the scope of dependent agency PEs.
- There are also certain anti-abuse rules introduced in the articles relating to the taxability of dividends and capital gains in tax treaties.

Interplay between GAAR and the PPT

Particulars	**GAAR**	**PPT**
Main purpose test	Triggered where main purpose (and not one of the main purposes) of an arrangement is to obtain tax benefit	Wider scope – applicable where one of the main purposes of an arrangement is to obtain tax benefit
Additional test for applicability	In addition to main purpose test, one of the four tainted element tests needs to be met	No additional test to be met
Threshold for exemption	Not applicable where tax benefit arising from an arrangement in aggregate in a year is lower than INR 30 million	No threshold for exemption
Grandfathering benefit	**Not applicable to income from investment made before April 1 2017**	**No grandfathering benefit under the PPT**
Object and purpose of treaty	May apply even if obtaining tax benefit is in accordance with object and purpose of treaty	Not applicable where obtaining tax benefit is in accordance with object and purpose of treaty

Thin Capitalization Rules

- Deny interest deductibility above a certain threshold of either net Interest payment (as a ratio of income) or net debt (as a ratio to equity).
- The precise Conditions under these rules vary between countries and over time.
- Empirical evidence Suggests that, on average, well-designed thin capitalization rules are effective in reducing Debt shifting by multinationals, using data for MNCs in Germany.

Avoidance of residence country taxation

- Artificial use of tax deferral.

- Changing residence to escape repatriation taxes or CFC rules by choosing the location of a new residence in a country that operates a territorial system.

Summary

The international tax framework, which consists of a plethora of domestic legislations and a vast network of bilateral and multilateral tax treaties, governs the tax treatment of MNCs. The structure is mostly based on separate accounting, which implies that an MNC group's taxation is done at the level of individual subsidiaries that operate in multiple countries.Based on domestic law and tax treaty responsibilities, each country has the power to tax the assigned income.

Keywords

Permanent establishment: As per section 92F(ilia), the term “Permanent Establishment” includes a fixed place of business through which the business of an enterprise is wholly or partly carried on.

International tax avoidance: Defined as the international reallocation of profits by an MNC in response to tax differences between countries, with the aim to minimize the global tax bill.

Controlled Foreign Corporations:CFC’s are corporate entities incorporated in an overseas low tax jurisdiction and controlled directly or indirectly by residents of a higher tax jurisdiction (Parent State).

GAAR: empowers the revenue authorities to declare a transaction/arrangement as an impermissible avoidance arrangement, thereby determining and levying taxes as may be deemed appropriate, thereon denying benefits originally claimed (including those under the tax treaty).

IAA: An arrangement is regarded as an IAA where both primary test and secondary test are satisfied. The primary test is said to be met when the 'main purpose' of the arrangement is to obtain a tax benefit. The secondary test is considered to be satisfied for an arrangement if any of the following conditions are met

- MLI: An OECD initiative under the BEPS project.
- A multilateral convention signed by over 90 countries to implement tax treaty related measures to prevent base erosion and profit shifting.

Self Assessment

1. Which of the following is wrong in regard to Unilateral relief? It is applicable where:

A. Countries with which agreement exists

B. Relief unilaterally by a country to its resident for the taxes paid in the other country.

C. India grants unilateral relief through credit method under section 91.

D. Where Government of India has not entered DTAA with a foreign Government. It may grant unilateral relief to its residents.

2. Which of the following is not a condition for Unilateral relief?

A. Assesse, who is a non-resident in India during the PY

B. The income accrues or arises to him outside India and the income is not deemed to accrue or arise in India during the PY.

C. The income in question has been subjected to income-tax in the foreign country in the hands of the assesse.

D. The assesse has paid tax on the income in the foreign country.

3. Which of the following is wrong in regard to Unilateral relief?

A. the unilateral relief is also available in respect of agricultural income in Pakistan on which income-tax is levied in India and income tax is levied in Pakistan on such agricultural income.
B. Where a resident derives income from business in India and in foreign country and agricultural income from foreign country which is not taxable there. He is liable to pay tax on whole income in India. Entitled to DT relief.
C. Where assesse claims DT relief in respect of foreign dividend, the gross dividend will be included in income.
D. Relief u/S 91(1) to be allowed not country-wise but on the aggregation of income of all countries.

4. Which section deals with the Double taxation Relief by entering into Agreements with Foreign Countries or Specified Territories

A. Section 90
B. Section 94
C. Section 96
D. Section 99

5. Which of the following is wrong in regard to Double taxation Relief by entering into Agreements with Foreign Countries or Specified Territories?

A. For granting double taxation relief in respect of income on which tax has been paid both under the Income Tax Act, 1961 and the income tax prevailing in that country or definite territory.
B. For granting relief in respect of income tax chargeable under the Income Tax Act, 1961, and according to the corresponding law in force in that country or specified territory, to boost mutual economic relations, trade and investment.
C. To prevent double taxation on income, For exchange of information.
D. The provisions of this Act shall apply to the extent they are less beneficial to that assessee.

6. Which of the following is wrong in regard to Adoption by Central Government of Agreement between Specified Associations for Double Taxation Relief?

A. For granting double taxation relief in respect of income on which tax has not been paid both under the Income Tax Act, 1961 and the income tax prevailing in that country or definite territory.
B. For granting relief in respect of income tax chargeable under the Income Tax Act, 1961, and according to the corresponding law in force in that country or specified territory, to boost mutual economic relations, trade and investment.
C. To prevent double taxation on income, For exchange of information.
D. In order to recover income taxes.

7. Which of the following is wrong in regard to DT Relief under the Income-tax Act, 1961?

A. Taxability of income would be based on DTAA or the Income-tax Act, 1961, whichever is more beneficial.
B. 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 favorable charge or levy of tax in respect of such foreign company.

C. 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 be regarded as less favorable charge or levy of tax in respect of such foreign company.

D. In order to claim DT relief, the non-resident to whom such DTAA applies, has to obtain a TRC from the Government of that country or specified territory.

8. Which of the following is not a Channel of international tax avoidance?

A. Transfer pricing,

B. Strategic location of intellectual property (IP),

C. Strategic location of intellectual property (IP),

D. International debt shifting, and

9. Which of the following is wrong on how does a country tax MNC earnings

A. Residence countries exempt foreign earnings of MNCs so that their active business income is only taxed in the source country.

B. the residence country retains the right to tax active income from all source countries.

C. Double taxation is typically avoided by the residence country granting a non-refundable foreign tax credit against its own tax, so that the residence tax is limited to the excess of the residence country's effective tax rate over that in the source country.

D. No country imposes withholding taxes on outbound income payments, such as interest, royalties and dividends.

10. Meaning of Treaty Shopping is:

A. stretching, violating or exploiting weaknesses in the arm's length principle

B. Strategic location of management of intellectual property (IP) to low-tax countries to reduce taxes on associated income;

C. excessive borrowing in high-tax countries and lending to low-tax countries);

D. exploiting treaty networks to route income so as to avoid tax);

11. International Debt Shifting

A. A way for an MNC to reduce its tax bill through intracompany loans.

B. Cross-country differences in rates of CIT create opportunities for lending from low-tax countries to affiliates in high-tax countries or by locating external borrowing in high-tax countries.

C. This debt shifting reduces the group's tax bill without affecting the overall debt exposure of the group (and hence its bankruptcy risk.

D. This debt shifting increases the group's tax bill without affecting the overall debt exposure of the group (and hence its bankruptcy risk.

12. Which of the following is wrong in regard to Corporate Inversions and HQ Location?

A. MNCs in worldwide countries can also avoid repatriation taxes by changing the residence of the corporation by "inverting" roles in the corporate group.

B. Corporate inversion by US parents are generally associated with substantial tax savings.

C. More broadly, corporate inversions are a special case of cross-border mergers and acquisitions (M&As) that are influenced by tax considerations.

D. MNCs in worldwide countries can also avoid repatriation taxes by changing the residence of the corporation by "reversing" roles in the corporate group.

13. As per Rule 10D(1) of the Income-tax Rules, 1962, the transfer pricing documentation requirement under section 92D(1)(i) should contain some details. Which of the following is wrong in regard to Transfer pricing documentation requirement under section 92D(1)

A. Ownership structure of the assessee with details of shares or other ownership interest held therein by other enterprise

B. Profile of the multinational group and basic details of associated enterprises with whom assessee has entered into international transaction

C. Business description of the business of the assessee and associated enterprises and the industry in which the assessee operates

D. Rule 10D(2) provides that in a case where the aggregate value of international transactions does not exceed 5 crore, it will not be obligatory for the assessee to maintain the above information and documents.

14. Which of the following is not Anti-Avoidance Regulation?

A. Adoption of transfer mispricing regulations

B. Thin capitalization rules,

C. Controlled foreign corporations (CFC) rules or a

D. General anti-avoidance rule (GAAR).

15. Which of the following is wrong in regard to Documentation compliances

A. Persons responsible for keeping and maintaining prescribed information and document -

   a. Who enters into an international transaction

   b. constituent entity of an international group

B. Information and documents not to be kept and maintained for a prescribed period

C. Assessing Officer & Commissioner (Appeals) empowered to require persons entering into international transaction to furnish prescribed information and documents

D. The Assessing Officer or the Commissioner (Appeals) may, in the course of any proceedings under the Income-tax Act, require any person who has entered into an international transaction to furnish any such prescribed information or documents within a period of from the date of receipt of a notice issued in this regard.

Answers for Self Assessment

1.	A	2.	A	3.	D	4.	A	5.	D
6.	A	7.	C	8.	A	9.	D	10.	D
11.	D	12.	D	13.	D	14.	A	15.	B

Review Questions

1. Explain the concept of Unilateral relief in detail.

2. Explain the concept of bilateral relief in detail.
3. Explain international tax avoidance and evasion channels and anti-avoidance strategies with suitable examples.
4. What is necessity for double taxation relief ?
5. Explain the process to claim deduction in case of absence of taxation avoidance agreement.

Further Readings

- https://www.icsi.edu/media/webmodules/16112021_Advance_Tax_Laws.pdf
- A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications
- Study Material on Direct Tax Laws and International Taxation by ICAI
- Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta
- www.incometaxindia.gov.in
- https://taxguru.in/income-tax/general-anti-avoidance-rules-gaar.html
- https://taxguru.in/income-tax/controlled-foreign-corporations-cfc-legislation-india.html#:~:text=Taxation%20of%20foreign%20passive%20income,tax%20jurisdiction%20(Parent%20State).

Unit 14: The Indian Contract Act, 1872

CONTENTS

Objectives

After studying this unit, you will be able to:

- Understand the meaning and relevance of the arm's length principle, as well as the practical problems in its application,
- Determine the arm length price of an international transaction using the most appropriate transfer pricing method.

Introduction

As per OECD Transfer pricing guidelines the Arm's Length Price (ALP) of a transaction between two linked firms is the price that would be paid if the transaction had taken place between two equivalent independent and unrelated parties, with merely commercial consideration. The arm's length principle is used to determine the appropriate transfer pricing range between related firms. The arm's length principle aims to adjust the profits of two associated enterprises by comparing them to the same as if the transaction were carried out between two independent businesses.It views each enterprise as a distinct independent entity rather than as indivisible components of a cohesive business.

14.1 Meaning of Arm Length Price

"Where conditions are made or imposed between two associated enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises, then any profits that would have accrued to one of the enterprises but, due to those conditions, have not so accrued may be included in the profits of that enterprise and taxed accordingly."

Model Tax Convention of the OECD

14.2 Significance of Arm's Length Principle

Parity between MNCs and independent enterprises

One important factor is that the ALP provides extensive tax parity for MNCs and independent enterprises. Because the ALP places linked and independent firms on a more equal tax footing, it eliminates the formation of tax benefits and disadvantages that would otherwise distort these entities' relative competitive situations. By removing tax considerations from economic decisions, the ALP supports the expansion of international commerce and investment.

Determines real taxable profits

A multinational's transfer price has a direct impact on the proportional profit it earns in each country where it operates. If little or excessive consideration is paid for the transfer of commodities, services, or intangible property among members of an MNC group, the income calculated for each member will be inconsistent with their proportionate economic contributions. To determine taxable profits earned in each jurisdiction, a 'arm's length' pricing - a price that two independent enterprises operating at arm's length would agree on – is required. The arm's length doctrine allows the taxing authorities to adjust the enterprise's accounts so that they accurately reflect the income that the establishment would have received if it were an independent enterprise.

Reduction of artificial price distortion

If the ALP is not followed, an MNC will sell goods/provide services at a high price (which exceeds the market price) to a controlled entity in a high-tax regime and at a low price to a controlled entity in a low-tax regime or a tax haven (which is lower than the market price). This would cause severe price distortions in the international market for products and services.

Minimization of double taxation

The ALP is a global idea that reflects the international standard. The possibility of double taxation is reduced since, in international transfer pricing, an adjustment to the transfer price in one tax jurisdiction necessitates an adjustment in the other tax jurisdiction.

Accurate measurement of economic contribution

The ALP accurately measures the fair market value of an MNC's economic contribution units. The ALP's primary goal is to ensure that the correct amount of income is attributed to the location where it is earned. As a result, each MNC unit earns a return proportionate with its economic contribution and risk assumed.

14.3 Practical Difficulties in Application of

True comparison difficult in certain cases

The commercial and financial criteria regulating a transaction between independent firms are never identical to those governing a transaction between connected enterprises. As a result, a true comparison is impossible. The arm's length principle may fail to recognise the related enterprise's economies of scale and integration of multiple business activities. Furthermore, associated enterprises may engage in activities that independent enterprises may not, such as licensing of valuable intangibles or sharing the rewards of research. The owner of an intangible may be hesitant to get into licensing agreements with independent firms for fear of lowering the intangible's value. In contrast, because the usage of the intangible can be precisely monitored, he may be willing to give less restrictive terms to associated enterprises. Furthermore, a transaction of this type between members of an MNC group poses no risk to the entire company's earnings. In such cases, where independent enterprises rarely engage in transactions of the type entered into by linked enterprises, the ALP is difficult to apply because there is little or no clear proof of the conditions independent enterprises would have established.

Availability of data and reliability of available data

It may be difficult to obtain appropriate and trustworthy information and data in order to use the arm's length principle. A substantial amount of data is frequently required to compare controlled and uncontrolled transactions between associated and independent firms. Easily accessible information may be incomplete and difficult to interpret while the relevant and required information may be difficult to obtain due to geographical constraints or secrecy and confidentiality aspects. In other circumstances, information about a potentially significant independent firm may not exist at all. Due to these difficulties, the tax administration and tax payers may have to exercise reason and judgment when applying the ALP.

Absence of market price

There must be an uncontrolled market price that is reasonably reliable and comparable. Because of the nature of the market, the ALP does not meet this criteria. A market price is the result of one-of-a-kind negotiations. It is feasible to know the price range, but it is extremely impossible to determine the real market price unless a market transaction occurs.

Absence of comparable market price for "intangible" transactions

The ALP reaches a comparable uncontrolled market price that is reasonably reliable for standard transactions with a restricted price range and a certain market price. However, because intangibles are distinct, the ALP often fails to acquire a corresponding market price for them. Because of the one-of-a-kind character of these deals, the price range is extremely broad.

Administrative burden

In some circumstances, the arm's length principle may impose an administrative burden on both the taxpayer and the tax administrations by requiring considerable numbers and types of cross-border transactions to be evaluated.

Time lag

Although an associated enterprise generally defines the terms of a transaction at the time it is entered into, the enterprise may be required to demonstrate that these terms are consistent with the arm's length principle at some point. The tax administration may also be required to participate in the verification procedure, possibly years after the transactions have occurred. It may result in significant costs for both the taxpayer and the tax administration. It is also difficult to understand the commercial realities that existed at the time the transactions were made. This may result in a prejudice against the taxpayer.

Despite the practical issues described above, OECD member countries believe that the ALP provides a solid foundation for appreciating transfer pricing between associated enterprises. So far, it has delivered satisfactory solutions to both taxpayers and tax agencies. The knowledge gathered thus far should be put to good use in removing practical issues and improving administration.

14.4 Definition of Associated Enterprises

As per section 92A(1), associated enterprise refers to:

an enterprise which participates, directly or indirectly, or through one or more intermediaries, in:

a. management of the other enterprise, or
b. control of the other enterprise, or
c. capital of the other enterprise.

If one or more persons participates, directly or indirectly, or through one or more intermediaries in:

d. management of the two different enterprises
e. control of two different enterprises
f. capital of two different enterprises

Then, those two enterprises are associated enterprises

14.5 Definition of Deemed Associated Enterprises

Two enterprises are deemed associated if they fall into one or more of the scenarios listed in section 92A. (2).

Enterprise Ownership

Example: One enterprise owns 26 percent or more of the voting power in the other enterprise, either directly or indirectly.

For example, AK Ltd. has 40% voting power in BK Ltd., whereas BK Ltd. has 70% voting power in CK Ltd.

In the given scenario, AK Ltd. has 26 percent or more voting power in BK Ltd., both directly and indirectly, and in CK Ltd. (i.e. through BK Ltd.). As a result, both BK Ltd. and CK Ltd. are considered associated enterprises of AK Ltd.

Substantial voting power in two entities by common person

Any individual or enterprise that directly or indirectly owns 26 percent or more of the voting power in each of two different enterprises.

Example, Mr. AK has 44 percent voting power in both XK Ltd. and YK Ltd., despite the fact that XK Ltd. and YK Ltd. have no stake in each other.

X KLtd. and YK Ltd. shall be considered associated enterprises.

Advancing of substantial sum of money

One enterprise makes a loan to the other enterprise in the amount of 51 percent or more of the book value of such other enterprise's total assets.

Example.

YK LTD

Total assets have a book value of Rs. 200 crores.

XK Ltd. provided a loan. 120 billion rupees

X Ltd. and Y Ltd. are considered associated enterprises.

Guaranteeing borrowings

One enterprise guarantees 10% or more of the total borrowings of the other enterprise.

Example:

P L Ltd

- *loan is taken from ABC bank of America: USD 1 million*
- *Guaranteed 20% by AK Ltd., an Indian company,*

P L Ltd and AK Ltd. are deemed associated enterprises.

Appointment of majority directors of two different enterprises by same person(s)

More than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons.

Example:

- *Appointments made by Mr. AK inXK Ltd and Yk Ltd*
- *XK ltd*

    - *Total directors: 15*
    - *appointed by AK 9*
- *YK ltd*
    - *Appointed by AK ltd 2 executive directors*

XK Ltd. and YK Ltd. are deemed associated enterprises.

Dependence on intangibles

The manufacture or processing of goods or articles or business carried out by one enterprise is entirely dependent (i.e. 100 percent) on the know-how, patents, copyrights, trade-marks, licences, franchises, or any other business or commercial rights of a similar nature, or any data, documentation, drawing, or specification relating to any patent, invention, model, design, secret formula, or process, of which the other entity is the owner or in respect of which the other enterprise has exclusive rights.

Dependence on raw materials supplied by another enterprise

90% or more of raw materials and consumables required for the manufacture or processing of goods or articles or business carried out by one enterprise are supplied by the other enterprise, or by persons specified by the other enterprise, where the prices and other supply conditions are influenced by such other enterprise.

Dependence on sale

The goods or articles created or processed by one enterprise are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating to such goods or articles are affected by such other enterprise.

Control by the common individual–

Where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by suchindividual and his relatives.

Example:

- *Mr. AK and Mr. BK are relatives.*
- *Mr. AK has control over XK Ltd. and Mr. BK has control over YK Ltd.*
- *Therefore, both XK Ltd. and YK Ltd. will be deemed associated enterprises*

Interest in a firm, association of persons or body of individuals – Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds 10% or more interest in firm/AOPs/BOIs.

Mutual interest relationship - There exists between the two enterprises, any relationship of mutual interest, as may be prescribed

14.6 Meaning of Enterprise:

Section 92F(iii) defines "enterprise" as a person (including its certain specified Permanent Establishment) who is, or has been, or is proposed to be, engaged in any activity relating to the production, storage, supply, distribution, acquisition, or control of articles or goods, or know-how, patents, copy rights, trade-marks, licenses, franchises, or any other business or commercial rights of similar nature, or any data, documentation, drawing, or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or the provision of services of any kind, or the performance of any work in accordance with a contract, or investment, or lending, or the business of acquiring, holding, underwriting, or dealing with shares, debentures, or other securities of any other body corporate, whether such activity or business is carried out directly or through one or more of its units, divisions, or subsidiaries, or whether such unit, division, or subsidiary is located at the same place where the enterprise is located or at a different place.

14.7 Permanent Establishment

For this purpose, the term "Permanent establishment" is defined in section 92F(iiia) to include a fixed place of business through which the business of the enterprise is For this purpose, the term "Permanent establishment" is defined in section 92F(iiia) to include a fixed place of business through which the business of the enterprise is

14.8 Transfer Pricing Methods

- Traditional Transactional methods:
  - Comparable uncontrolled price method
  - Resale price method
  - Cost plus method

Comparable uncontrolled price(CUP) method	A comparable uncontrolled price is the price agreed upon by unrelated parties for the exchange of goods or services under similar conditions.
Mechanism to determine CUP	(i) Identification of price charged or paid for property transferred or services provided under any comparable uncontrolled transaction(s). (ii) Such price is adjusted to account for differences, if any, between theinternational transaction and comparable uncontrolled transactions or between the enterprises entering into such transactions which could materially affect the price in the open market canbe made. (iii) The adjusted price arrived at under ii) is taken to be Arm's Length Price in respect of the property transferred or services provided in an international transaction.
Suitability	CUP is applied when price is charged for a product or service. This is a comparison of prices charged for the property transferred or service provided in a controlled transaction to a price charged for property or services transferred in a comparable uncontrolled transaction.
Meaning of "Uncontrolled transaction"	Uncontrolled transaction means a transaction between enterprises other than associated enterprises, whether resident or non-resident.

Meaning of "Property"	It includes goods, article or things, and intangible property.
Requirements of comparable uncontrolled price method	High degree of comparability of products, services and functions. Adjustments, in respect of : • Quality of the product or service, • contractual terms, • credit terms, • transport terms, • level of the market (i.e. wholesale, retail, etc.), • geographic market in which the transaction takes place, etc

Example

INDIA Ltd., a subsidiary of UK Ltd., is based in INDIA. Computer monitors are sold by UK Ltd. to INDIA Ltd. for resale in INDIA. C Ltd., another computer reseller, buys computer monitors from UK Ltd. UK Ltd sells INDIA. Ltd. 60,000 computer monitors for $22,000 each. C Ltd. has been charged a price of $20,250 per unit. In the event that INDIA Ltd. sells monitors, the warranty is handled by INDIA Ltd. For monitors sold by C Ltd., however, UK Ltd. is responsible for the warranty for 3 months. Extended warranty is available from both UK Ltd. and INDIA Ltd. for a regular rate of $ 2,000 per year. How will the assessment of INDIA Ltd. be affected by these facts?

Solution

C Ltd. was charged a sale price by UK Ltd.	20,250
Less: Cost of warranty included in the price charged to C Ltd. (2,000 x 3 /12)	
	500
ALP	19,750
INDIA Ltd. was charged a sale price by UK Ltd.	22,000
Difference	2,250
No. of units supplied by UK Ltd. to INDIA Ltd.	
Addition in the computation of total income of INDIA Ltd. (2,250 × 60,000)	13,500,0000

Note: *It is assumed that INDIA Ltd. has not entered into an advance pricing agreement or opted to be subject to Safe Harbour Rules.*	

2. **Resale price method**	• Compares the gross margins (i.e. gross profit over sales) earned in transactions between related and unrelated parties for the determination of the ALP. • The RPM **requires high level of functional comparability** and is mainly applicable where the controlled party is a distributor. • The RPM evaluates whether the amount charged in a controlled transaction is at arm's length by reference to the gross margin realised in comparable uncontrolled transactions.
	I. Identification of resale price by tested party i.e., the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or provided to an unrelated enterprise. II. Resale price is reduced by normal gross profit margin with reference to uncontrolled transaction(s). III. Such price reduced by expenses incurred (customs duty etc.) in connection with purchase of the product/ services. IV. This price may be adjusted to account for functional and other differences, if any, including differences in accounting practices which could materially affect the gross profit margin in the open market. Adjusted price arrived above taken to be as arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise.

Suitability	RPM is generally used to test transactions involving distribution function, i.e. when the tested party purchases products/ acquires services from related party and resells the same to independent parties. The use of RPM is appropriate where the reseller does not add substantially to the value of the product/ services. Where the transactions are not comparable in all ways and the differences have a material effect on price, one has to make adjustments to eliminate the effect of those differences. For this purpose, consideration of operating expenses associated with functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses.

Example

- Mumbai-based Bharat(P) Ltd. trades in electronic items.
- It bought goods from Sam Ltd., a Singapore-based subsidiary, as well as Okale Ltd., a US-based unassociated entity.
- Mumbai-based Bharat(P) Ltd Ltd. had a gross profit margin of 15% on sales of products of Sam Ltd in FY2021-22, whilst sale of goods bought from Okale Ltd. had a gross profit margin of 30%.
- Sam Ltd. offered a 6-month after-sales warranty, whilst Okale Ltd. offered a one-year warranty.
- The warranty cost can be calculated as 3% of the sale price.
- Sam Ltd.'s brand value is well-known around the world, and the advantage of the brand value can be calculated as 2% of the sale price.
- It sold items from Bharat Ltd. For 40 crores and Okale Ltd. For 15 crores during F.Y.2021-22.
- There was no change in the cost of transportation for the goods purchased.

Particulars	Amount (In `)
Resale price of goods purchased from Sam Ltd.	40,00,00,000
Less: Profit margin with reference to uncontrolled transaction between Bharat Ltd and Okale Ltd(30%)	12,00,00,000
	28,00,00,000
Add: Brand value adjustement (2% of sale price)]	80,00,000
Less: Adjustment of cost of warranty (3% of sale price x 6/12)]	-6000000

ALP	28,20,00,000

3. **Cost plus method**	The Cost Plus Method ('CPM') determines an arm's-length price by adding an appropriate gross profit margin to an associated entity's costs of producing goods or services. The gross profit margin should reflect the functions performed by an entity and should include a return for capital used and risks assumed by the entity.
Suitability	This method probably is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.
Mechanism	I. Determination of direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise. II. Determination of amount of normal gross profit mark-up to such costs arising from the transfer or provision of the same or similar property or services by the enterprise or by an unrelated enterprise in comparable uncontrolled transaction or transactions. III. The normal gross profit mark-up determined above is adjusted to account for functional and other differences, if any, which could materially affect such profit mark-up in the open market. IV. Adjusted gross profit mark-up added to total costs determined in (i) above. V. Sum arrived above is taken to be arm's length price in relation to the supply of relation to the supply of property or provision of services by the enterprise.

Example

- AK Ltd. of UK owns 40 percent of LK Ltd. of India.
- LK Ltd. billed AK Ltd. UK for 140 man-hours at a rate of 1,500 per man-hour during the year.

- Total cost of completing this work (direct and indirect) was 2,00,000.
- LK Ltd., on the other hand, charged XK Ltd., India 2,800 per man hour for the same level Services.
- LK Ltd achieved a Gross Profit of 60% on its cost .
- LK Ltd.'s transactions with AK Ltd. and XK Ltd. are similar, with the following exceptions:
- Cost of providing technology assistance to LK Ltd. by AK Ltd:20% of revenues.
- LK Ltd. gave a quantity discount to AK Ltd. that might be worth 12% of regular gross profits.
- Cost of assuming all risk and marketing function by LK ltd for XK Ltd : 8% of normal gross profits.
- Cost of offering a one-month credit by LK Ltd. to AK Ltd: 2% of gross profits.

Solution

Computation of Arm’s Length Price as per Cost Plus Method		
Gross Profit mark-up on cost in case of XK Ltd. [an unrelated party]		60%
Less: Adjustments		
Value of technology support [20% of 60%, being gross profit]	12%	
Quantity discount to AK Ltd [12% of 60%, being gross profit]	7.20%	
Risk and cost associated with marketing [8% of 60%, being gross profit]	4.80%	24%
		36%
Add: Cost of credit to AK Ltd. [(1.67% of 60%, being gross profit]		1%
Arm’s length gross profit mark up to cost		37%

Cost incurred by LK Ltd. for executing AK Ltd.’s work 2,00,000

Add: Adjusted gross profit (2,00,000 x 37%) 74,000

Arm’s length billed value 2,74,000

Less: Actual Billed Income from AK Ltd.(1500 x 140man hours)2,10,000

Total Income of LK Ltd to be increased by 64,000

B. Contemporary methods

1. **Profit split method**
2. **Transactional net margin method**
3. **Other Method as may be prescribed by the CBDT**

1 **Profit split method**	Evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is at arm's length with reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most prominently identifiable businessactivity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).
Suitability	• Applicable primarily in international transactions involving the transfer of distinct intangibles or • In several international transactions that cannot be analysed individually for the purpose of calculating the arm's length price of any one transaction.
Mechanism	I. Determination of combined net profit of the associated enterprises arising out of international transaction in which they are engaged. II. Evaluation of relative contributions by each enterprise to the earning of such combined net profit on the basis of functions performed, risks assumed and assets employed by each enterprise. This evaluation is to be made on the basis of reliable external market data which can indicate how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances. III. Splitting of combined net profit amongst the enterprises in proportion to their relative contributions, as evaluated above. IV. Profit thus apportioned to the assessee is taken into account to arrive at the arm's length price in relation to the international transaction.

Example

Net profit margins from all transactions were USD 100M.

Income attributable to routine contributions by each AE (X=40%,Y=60%): USD 70

Residual profit of USD 30M will be distributed among AEs(X and Y) based on various factors assuming to be equal for both AEs (each party's ownership of non- routine intangibles, network reach, efficiency of sales and marketing team etc.).

Solution

Total profit for Related Party X:

Income for specific contribution=40% of 70USD

Income as residual profit = 50% of 30 USD

Total Arm's length profit of related party X=USD 43M (USD 28M + USD 15M)

2. **Transactional net margin method**	
Mechanism	I. Computation of net profit margin realized by the enterprise from the international

	transaction with an AE having regard to costs incurred or sales effected or assets employed or having regard to any other relevant base. II. Computation of net profit margin realized by the enterprise or an unrelated enterprise in a comparable uncontrolled transaction by applying the same base as above. III. Net profit margin realized from uncontrolled transaction is adjusted to account for differences, if any, which could materially affect the net profit margin in the open market. IV. The net profit margin realized by the enterprise referred in (i) above is established to be the same as net profit margin referred in (iii) above.

Example

- AK Inc., based in Malaysia, has provided BK Ltd. in India with a loan of MD 1,60,000.
- BK Ltd's total assets have a book value of 125 lakhs.
- AK Inc. receives software backup assistance from BK Ltd.
- During the fiscal year 2021-22, BK Ltd spent 60,000 man-hours providing services to AK Inc.
- The Cost for BK Ltd is MD 65 per manhour.
- AK Inc. has been billed at MD 80 per manhour by BK Ltd.
- OL Inc. in Malaysia, receives software backup assistance from GK Ltd. in India, which operates under a similar business model.

Solution

The cost and operational profitability of GK Ltd. are as follows.

Particulars	*in lakhs*
Direct Cost	800
Indirect Cost	400
Total cost	1200
Operating profits	400
Operating profits to cost (%) [400 x 100/1200] = 33%	

Operating margin of BK ltd when serving AK Inc:

Particulars	
Billing per manhour [MD 80/hour x 45]	**3600**
Cost per man hour [MD 65/hour x 45]	**2925**

Operating profit per manhour	**675**
Operating profits to cost (%) [675 x 100/2925] = 23%	**0.230769**

Computation of Arm's Length Price between AK Inc. and BK Ltd by applying TNMM:

Particulars	
Cost for AK inc Ltd. (per man hour) [MD 65x r 45/MD]	2925
Add: Arm's length operating profit margin as % of cost (**33% of 2925)**	965.25
Arm's length price (per manhour) in	3890.25
Arm's length price of total manhours spent by Andes Ltd. for providing software backup support to Andes Inc. 3890 x 60,000 man hours] = 23,34,15,000	233415000

Adjustment to be made to the total income of Andes Ltd.

Arm's length price of total manhours spent by BK Ltd. for providing software backup support to AK Inc: 233415000

Less: Amount actually billed [80 MD x 45/MD x 60,000 manhours]: 21,60,00,000

Arm's length adjustment to be made to the total income of Andes Ltd: 17,41,1500

3.**Other Method as may be prescribed by the CBDT**

The Other method allows the use of 'any method' which takes into account

I. the price which has been charged or paid or

II. would have been charged or paid for the same or similar uncontrolled transactions with or between non-associated enterprises, under similar circumstances.

Comparability of the International Transaction with an Uncontrolled Transaction

The various data which may possibly be used for comparability purposes under this method could be

- third party quotations,
- valuation reports,
- tender/Bid documents,
- documents relating to the negotiations,
- standard rate cards,
- commercial & economic business models; etc.

For applying the above methods, the comparability of the international transaction with an uncontrolled transaction is to be judged with reference to the following factors:

I. The specific characteristics of the property transferred.

II. The functions performed.

III. The contractual terms.

IV. Conditions prevailing in the markets.

Rule 10B(3) provides that an uncontrolled transaction shall be comparable to an international transaction

- if none of the differences between the transactions being comparable or between the enterprises entering into such transactions is likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market or;
- reasonably accurate adjustments can be made to eliminate the material effects of such differences.

14.9 Most Appropriate Method

I. The nature and class of the international transaction;

II. The class, or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;

III. The availability, coverage and reliability of data necessary for application of the method;

IV. The degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions.

V. The extent to which reliable and accurate adjustments can be made to account for difference, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;

VI. The nature, extent and reliability of assumptions required to be made in application of a method.

14.10 Application of Method and its Preferences on a General Basis

Transactions	**Comparable Uncontrolled Price Method**
Commodities/Oil	**Comparable Uncontrolled Price Method**
Payment of Interest	**Comparable Uncontrolled Price Method**
Distribution of goods	**Resale Price Method/Transactional Net Margin Method**

Provision of Services	**Cost- plus Method/Transactional Net Margin Method**
Contract manufacturing	**Cost- plus Method/Transactional Net Margin Method**
Manufacturing	**Cost- plus Method/Transactional Net Margin Method**
Payment of Royalty	**Comparable Uncontrolled Price Method**

Summary

Transfer pricing is a populated term defined in the Income Tax Act. It refers to the price at which a transaction is carried out. The reasonableness of transactions under Transfer Pricing, such as whether the transaction between the associate enterprise is executed at the correct value (Arm length Price) or not is verified. The Arm's Length Principle, as it is known internationally, serves as the foundation for transfer pricing. The price agreed in a transaction between two related parties must be the same as the price agreed in a comparable transaction between two unrelated parties, according to this principle. Arm's length price should be ascertained on a transaction-by-transaction grounds rather than on an overall basis when an assessee enters into multiple types of international transactions with associated enterprises,

Keywords

CUP Method: This method is applied where there are similar transaction(s) b/w unconnected parties.

Resale Price Method: This method is applied where an item obtained from AE is resold to an unrelated party.

Cost Plus Method (CPM): This method is generally applied where semi-finished goods are sold to AEs.

Profit Split Method (PSM; This method is applied where there is the transfer of unique intangibles or in multiple international transactions

Transactional Net Margin Method: Compute Net Profit (NP) margin of the enterprise from International Transaction with AE having regard to cost incurred/sales effected/assets employed.

Self Assessment

1. Which method is applicable primarily in international transactions involving the transfer of distinct intangibles?

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Profit split method

2. In which method an arm's-length price is determined by comparing the net profit margin in relation to an appropriate base (example costs, sales, assets) of the tested party with the net profit margin in relation to the same base, of an uncontrolled party engaged in comparable transactions?

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Transaction Net Margin Method

3. Which method determines an arm's-length price by adding an appropriate gross profit margin to an associated entity's costs of producing goods or services?

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Transaction Net Margin Method

4. Which method is generally used to test transactions involving distribution function?

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Profit split method

5. Which method isappropriate where the reseller does not add substantially to the value of the product/ services?

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Profit split method

6. Which method compares the gross margins (i.e. gross profit over sales) earned in transactions between related and unrelated parties for the determination of the ALP?

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Profit split method

7. Which method requires Adjustments, in respect of :Quality of the product or service, contractual terms, credit terms, transport terms?

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Profit split method

8. _________________ is the price agreed upon by unrelated parties for the exchange of goods or services under similar conditions.

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Profit split method

9. Which method evaluates whether the amount charged in a controlled transaction is at arm's length by reference to the gross margin realised in comparable uncontrolled transactions?

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Profit split method

10. which of these is not a traditional method of transfer pricing?

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Profit split method

11. which of these is not a traditional method of transfer pricing?

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Transaction Net Margin Method

12. Which rule provides that an uncontrolled transaction shall be comparable to an international transaction?

A. Rule 10B(3)

B. Rule 11B(3)

C. Rule 20B(3)

D. Rule 30B(3)

13. Which rule deals with the determination of most appropriate method?

A. Rule 10C

B. Rule 11C

C. Rule 12C

D. Rule 13C

14. For Payment of Interest which is the most appropriate method on a general basis?

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Transaction Net Margin Method

15. For Payment of Royalty which is the most appropriate method on a general basis?

A. Comparable uncontrolled price method

B. Resale price method

C. Cost plus method

D. Transaction Net Margin Method

Answers for Self Assessment

1	D	4	B	7	A	10	D	13	A
2	D	5	B	8	A	11	D	14	A
3	C	6	B	9	B	12	A	15	A

Review Questions

1. What is meant by Arm Length Price?
2. What are the practical difficulties in the implementation of Arm length Price?
3. What is the relevance of Arm length prices?
4. What are different Transfer Pricing Methods?
5. Which is the most appropriate transfer pricing method?

Further Readings

- https://www.icsi.edu/media/webmodules/16112021_Advance_Tax_Laws.pdf
- A Textbook Of Corporate tax planning and management by Dr H.C. Mehrotra and Dr. S. P. Goyal. Sahitya Bhawan Publications
- Study Material on Direct Tax Laws and International Taxation by ICAI
- Direct Tax Laws and Practice by Dr. Girish Ahuja & Dr. Ravi Gupta
- www.incometaxindia.gov.in

LOVELY PROFESSIONAL UNIVERSITY
Jalandhar-Delhi G.T. Road (NH-1)
Phagwara, Punjab (India)-144411
For Enquiry: +91-1824-521360
Fax.: +91-1824-506111
Email: odl@lpu.co.in