E-Content for M.Com Semester-IV

SUBJECT-COMMERCE

COMEC -1

CORPORATE TAX PLANNING AND MANAGEMENT

UNIT-III

TOPICS- Tax Planning and Financial Management Decision.

Tax Planning with reference to Capital Structure.

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TAX PLANNING RELATING TO CAPITAL STRUCTURE DECISION

Every business the finance is the most important factor. Finance means Capital and it may be owned capital or loaned i.e., borrowed capital.

The planning for finance/capital arises at the time of requirement of capital. The demand of capital arises:

1. At the time of New Business Started
2. At the time of Expansion of Business
3. During the course of business to meet the working Capital Requirements.

Avenues of finance

The management of a company has to take decision as to:

A. Whether to have OWNED Capital or
B. To have BORROWED Capital or
C. Ploughing backs of profits.

A. Owned Capital

- Owned capital in the form of
  (a)Equity Capital
  (b)Preferential Capital- It can issue Preference Shares giving a fixed rate of dividend.
- Shares can be issued to the public financial Institution, Promoters etc.

B. Borrowed Capital

- Loan from financial institutions banks, government, agencies etc. Such loans can be short term or long terms loans.

- The rate of Interest payable will be the most important consideration for borrowing capital.

C. Ploughing Back of Profits.

- This is possible only for an existing profit earning company.
- It can create reserves out of its profits and later on these reserves can be utilized for future finance requirements.

According to Gerestenbeg “Capital Structure of a company refers to the composition or make-up of its capitalization and it includes all long-term capital resources viz: Loans, Reserves, Share and Bonds.”

Meaning of capital structure

Capital Structure refers to the proportion of various long-term sources of finances being used by a company. In other words, it represents the mixture of different sources of long term funds.

A new concern generally has only share capital in its capital structure. But with the passage of time, Preference Share Capital, Debentures, Retained earnings are also used for the business.

Now if a company has with itself a total long term finance of Rs.85, 00,000 then there can be different combinations or constituents of total funds as shown below:

	MIX-I	MIX-II	MIX-III
Equity Share Capital	70, 00,000	50, 00,000	40, 00,000
Reserve & Surplus	15, 00,000	5, 00,000	10, 00,000
Debentures	-	20, 00.000	23, 00,000
Preference Share Capital	-	10, 00,000	12, 00,000
	85, 00,000	85, 00,000	85, 00,000

An optimal capital structure is that capital structure which minimizes the overall cost of capital and maximizes the wealth of its owner.

From tax point of view expenses incurred on raising loans/debentures and interest payable on loans are deductible in computing taxable income of the assesse. However, any amount of interest paid, in respect of loan for acquisition of an assesse for extension of existing business (whether capitalized in the books of account or not) for any period beginning from the date on which loan was taken for acquisition of an asset till the date on which such asset was first put to use, shall not be allowed as a deduction. It will be added to the cost of the asset. On the other hand, the expenses incurred on raising capital/share capital and interest on capital/dividend on share capital is not deductible in computing the taxable income of the assesse. However, the following expenses in relation to capital are deductible:

- If the assesse is a firm, the interest payable to partners on their capital and loan capital, subject to a maximum of 12% p.a.
- If the assesse is an Indian company and in connection with the issue, for public subscription, of shares in or debentures of the company, incurs expenses (being under writing commission, brokerage and charges for drafting, typing, printing and advertisement of the prospectus) twenty percent of such expenses are allowed for each of the five successive previous years beginning with the previous year in which the business commences.

From this one may conclude that the borrowings contribute to tax savings resulting a higher rate of return on owner's equity. But this does not hold good in every case. If the rate of return on total capital is more than the rate on interest, definitely the borrowing would increase the rate of return on owner's equity. Otherwise it would reduce his rate of return.

Illustration 1

Three companies raised the capital as under:

	Companies		
	1	2	3
	₹	₹	₹
Capitals	2, 00,000	1, 60,000	40,000
Loans	-	40,000	1, 60,000
Total Investment	2, 00,000	2, 00,000	2, 00,000

Rate of interest on loans: 10%

Rate of return: 25%, 10%, 8%

Rate of tax: 30%

Explain whose capital structure is the best and why?

Solution

Rate of Return 25%

	Companies		
	1	2	3
	₹	₹	₹
Return	50,000	50,000	50,000
Less: Interest on loans @ 10%	-	4,000	16,000
Profit before tax	50,000	46,000	34,000
Less: Tax @ 30%	15,000	13, 800	10,200
Profits after tax	35,000	32,200	23,800
Rate of return on capital before DDT	17.5%	20.125%	59.5%

Rate of Return 10%

	Companies		
	1	2	3
	₹	₹	₹
Return	20,000	20,000	20,000
Less: Interest on loans @ 10%	-	4,000	16,000
Profit before tax	20,000	16,000	4,000
Less: Tax @ 30%	6,000	4,800	1,200
Profits after tax	14,000	11,200	2,800
Rate of return on capital before DDT	7%	7%	7%

Rate of Return 8%

	Companies		
	1	2	3
	₹	₹	₹
Return	16,000	16,000	16,000
Less: Interest on loans @ 10%	-	4,000	16,000
Profit before tax	16,000	12,000	Nil
Less: Tax @ 30%	4,800	3,600	Nil
Profits after tax	11,200	8,400	Nil
Rate of return on capital before DDT	5.6%	5.25%	Nil

Note: DDT denote dividend distribution tax

Conclusions:

(1) When rate of return on capital is 25% (which is more than rate of interest 10%) the capital structure of company 3 is the best. The company can declare dividend at a higher rate.
(2) When rate of return on capital is equal to rate of interest, the rate of return on capital is same, whether the company takes the loan or issues share capital.
(3) When rate or return is less than the rate of interest, if company takes a loan, it will reduce the rate on capital. In the given situation the capital structure of the company 1 is the best.

Illustration 2

The directors of a Domestic Company, Whose existing capital is Rs 1 crore all in Equity Shares, proposes to expand its business for which an additional investment of Rs 50 lakh would be needed. The entire money can be raised either by issue of Equity Shares or by issue of 10% debentures. They decide in favour of issue of Equity Shares. As a Tax Consultant do you approve the proposal? Assume that rate of return is 30%.

Solution Computation of Rate of Return on Capital

	Issue of Shares	Issue of debentures
	₹	₹
Return@20% on Rs 1.5 crore	30, 00,000	30, 00,000
Less: Interest on debentures:		
50, 00,000 @10%	-	5, 00,000
Profit before Tax	30, 00,000	25, 00,000
Less: Tax @ 30%	9, 00,000	7, 50,000
Profit after Tax	21, 00,000	17, 50,000
Rate of Return on Capital before DDT	14%	17.5%

Conclusion: For expansion of business, the company should have issued debentures instead of equity shares.

Impact of Capital Structure on Exemption or Deduction

The exemption/deduction under Section 10AA or deduction under Section 80IA or 80IAB or 80IC OR 80IE etc. of the Income Tax Act increases the profits after tax or in other words increases the rate of return on equity capital.

But the borrowed capital reduces the profits (profits less interest) before tax and to that extent the exemption is reduced or proportionately deduction is reduced. Therefore, minimum possible loans may be taken at the time of commencement of an industrial undertaking.

Tax Planning

1. Where rate of return on investment is less than the rate of interest, the minimum loan capital must be used.
2. Where rate of return on investment is more than the rate of interest, it will increase the rate of return of equity capital. However, the legal requirements for raising capital through any means of finance cannot be ignored.
3. The capital may be utilized for acquisition of non-depreciable assets like land, goodwill, etc. and borrowed funds may be utilized to acquire depreciable assets. The interest on loans for the period after setting up of business but before the asset was put to use will be capitalized and a higher amount of depreciation will be allowed.
4. If the gestation period in an industry is more it is better to use capital rather than loans. On the loans interest will be paid out of capital. This interest payment will be carried forward as business loss which the assesse may not be able to set off within the prescribed period period of eight years. On the other hand, the money-lenders have to pay tax on their interest income.
5. If interest is payable outside India tax must be deducted at source. If tax has not been deducted at source, the amount paid as interest will not be allowed as a deduction in computing business incomes.

6. The term ‘interest’ has been defined in Section 2(28A) of the Income Tax Act, liberally, ‘Interest’ means interest payable in any manner in respect of any money borrowed or debt incurred and includes any service fee or other charge in respect of the money borrowed or debt incurred or in respect of any credit facility which has not been utilized.

   Hence, not only interest but also service fee or other charge on loans, whether utilized or not, should be claimed as revenue expense in computing the business income.

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