Corporate Tax Planning
## Index

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Content</td>
<td>II</td>
</tr>
<tr>
<td>II. List of Figures</td>
<td>VII</td>
</tr>
<tr>
<td>III. List of Tables</td>
<td>VIII</td>
</tr>
<tr>
<td>IV. Abbreviations</td>
<td>IX</td>
</tr>
<tr>
<td>V. Case Study</td>
<td>132</td>
</tr>
<tr>
<td>VI. Bibliography</td>
<td>137</td>
</tr>
<tr>
<td>VII. Self Assessment Answers</td>
<td>139</td>
</tr>
</tbody>
</table>

**Book at a Glance**
# Contents

Chapter I: Basic Concepts of Income Tax ................................................................................................................. 1

1.1 Aim .................................................................................................................................................................. 1

1.2 Objectives ....................................................................................................................................................... 1

1.3 Learning outcome ............................................................................................................................................ 1

1.4 1.1 Introduction ............................................................................................................................................... 2

1.5 1.2 Income Tax .................................................................................................................................................. 2

1.6 1.3 Components of Income Tax Act .............................................................................................................. 3

1.7 1.3.1 Income .................................................................................................................................................... 3

1.8 1.3.2 Capital and Revenue Receipts ............................................................................................................. 5

1.9 1.3.2.1 Receipts Bereft of Revenue Element ............................................................................................... 6

1.10 1.3.3 Rates of Tax ......................................................................................................................................... 6

1.11 1.3.4 Defining ‘Person’ ..................................................................................................................................... 6

1.12 1.3.5 Assessee ................................................................................................................................................. 7

1.13 1.3.6 Assessment Year (AY) [Sec. 2(9)] ................................................................................................... 8

1.14 1.3.7 Previous Year [Sec. 2(34) and Sec. 3] ............................................................................................... 8

1.15 1.4 Coverage Under Income ....................................................................................................................... 8

1.16 1.4.1 Computation of Total Income ........................................................................................................... 9

1.17 1.4.2 Computation of Tax Liability on Total Income ................................................................................ 10

1.18 1.5 Charging Section ..................................................................................................................................... 10

1.19 1.6 Meaning of Total Income in the Context of Residential Status - Sec. 5 .............................................. 10

1.20 1.7 Scope and Orbit of Business Connection in the Case of Non-resident ........................................... 11

Summary ................................................................................................................................................................. 13

References ................................................................................................................................................................. 13

Recommended Reading ............................................................................................................................................. 13

Self Assessment .......................................................................................................................................................... 14

Chapter II: Taxation of Companies, Tax Planning and Tax Evasion ................................................................. 16

2.1 Aim ............................................................................................................................................................... 16

2.2 Objectives ..................................................................................................................................................... 16

2.3 Learning outcome .......................................................................................................................................... 16

2.4 2.1 Introduction ............................................................................................................................................... 17

2.5 2.2 Definitions of Company ........................................................................................................................ 17

2.6 2.3 Residence of a Company ........................................................................................................................ 18

2.7 2.4 Carry Forward and Set Off of Losses .................................................................................................... 19

2.8 2.5 Assessment of Companies ....................................................................................................................... 19

2.9 2.5.1 Rates of Income Tax ........................................................................................................................... 19

2.10 2.5.2 Surcharge ............................................................................................................................................. 20

2.11 2.6 Deemed Income ..................................................................................................................................... 20

2.12 2.7 Allowing Tax Credit ............................................................................................................................. 20

2.13 2.8 Computing Book Profits ...................................................................................................................... 21

2.14 2.9 Tax Planning and Tax Evasion .............................................................................................................. 23

2.15 2.10 Tax Avoidance and Not Tax Planning ............................................................................................... 24

2.16 2.11 Tax Management ............................................................................................................................... 24

2.17 2.12 Objectives of Tax Planning ................................................................................................................ 26

2.18 2.13 Types of Tax Planning ......................................................................................................................... 26

2.19 2.13.1 Factors Affecting Tax Planning ....................................................................................................... 26

2.20 2.13.2 Areas of Tax Planning ....................................................................................................................... 27

Summary ................................................................................................................................................................. 28

References ................................................................................................................................................................. 28

Recommended Reading ............................................................................................................................................. 28

Self Assessment .......................................................................................................................................................... 29
6.4 Quantum of Depreciation ................................................................. 83
   6.4.1 Computation of Depreciation ......................................................... 83
   6.4.2 Notional Written Down Value ....................................................... 83
6.5 Amortisation of Expenditure in the Case of Amalgamation/Demerger ......................................................... 84
   6.5.1 Scientific Research ................................................................................ 84
   6.5.2 Transfer of Capital Asset in Case of Amalgamation/Merger/Demerger ......................................................... 84
6.6 Computation of Capital Gains (Section 48 to 51) ........................................................................................................ 84
6.7 Carry Forward and Set Off of the Accumulated Losses and Unabsorbed Depreciation Allowance ......................................................... 85
   6.7.1 In Case of Amalgamation ........................................................................ 85
   6.7.2 In Case of Demerger .............................................................................. 85
   6.7.3 In Case of Demerger .............................................................................. 86
   6.7.4 In Case of Reorganisation of Business .................................................. 86

Summary ........................................................................................................ 88
References ....................................................................................................... 88
Recommended Reading .................................................................................. 88
Self Assessment ............................................................................................... 89

Chapter VII ..................................................................................................... 91
Employees' Remuneration ................................................................................ 91
   Aim .................................................................................................................. 91
   Objectives ....................................................................................................... 91
   Learning outcome ............................................................................................. 91
7.1 Introduction .................................................................................................. 92
7.2 Factors Requiring Consideration .............................................................. 92
   7.2.1 Deduction of Remuneration in the Hands of Employer ......................................................... 92
7.3 Taxation of Perquisites in the Hands of Employees ............................................. 93
7.4 Valuation of Perquisites ................................................................................. 95
   7.4.1 Valuation of Accommodation ........................................................................ 95
7.5 Other Perquisites for Specified Employees ....................................................... 96
   7.5.1 Motor Car Facility: Rule 3(2) ................................................................. 96
   7.5.2 Gas, Electricity or Water Supply Provided: Rule 3(4) ................................................. 97
   7.5.3 Domestic Servant: Rule 3(3). ................................................................. 97
   7.5.4 Education Facility: Rule 3(5) ................................................................... 98
   7.5.5 Medical Facilities ..................................................................................... 98
   7.5.6 Value of other Perquisites ........................................................................ 99
7.6 Notified Fringe Benefits ............................................................................... 99
7.7 Profit in Lieu of Salary ............................................................................... 102
   7.7.1 Exemptions from Salary Income .................................................................. 103
7.8 Fringe Benefit Tax ....................................................................................... 105
   7.8.1 Deemed Fringe Benefits and their Valuation .............................................. 105
   7.8.2 Value of Fringe Benefits .......................................................................... 106
7.9 Employer’s Obligations ............................................................................... 106
7.10 Propositions for Tax Planning .................................................................... 107

Summary ........................................................................................................ 109
References ....................................................................................................... 109
Recommended Reading .................................................................................. 109
Self Assessment ............................................................................................... 110

Chapter VIII .................................................................................................. 112
Non Residents ................................................................................................. 112
   Aim .................................................................................................................. 112
   Objectives ....................................................................................................... 112
   Learning outcome ............................................................................................. 112
8.1 Introduction ................................................................................................ 112
8.2 Main Categories of NRIs .............................................................................. 113
8.3 Tax Planning Concerning Residential Status

8.3.1 Interest Income to Non-residents

8.4 Salaries of Other Foreign Citizens

8.5 Technical Services in Projects Connected with the Security of India

8.6 Shipping Business in the Case of Non-residents

8.7 Provisions Relevant for NRIs

8.8 Operations of Aircraft

8.9 Foreign Companies Engaged in Civil Construction

8.10 Head Office Expenditure

8.11 Income by Way of Royalties

8.11.1 Computation of Income and Tax under Section 115A, 115AB, 115AC, 115AD, 115BBA and 115D

8.12 Taxation of International Transactions

8.12.1 Conditions for Applicability of Arm’s Length in the International Transaction

8.12.2 Deemed Associated Enterprises

8.12.3 Deemed International Transaction

8.12.4 Computation of the Arm’s Length Price

8.12.5 Methods of Arm’s Length Price Computation

8.12.6 Comparability of Transaction

8.12.7 Most Appropriate Method

8.12.8 Determination of Arm’s Length Price by the Assessing Officer in Certain Cases

8.12.9 Determination of Total Income After Computing Arm’s Length Price

8.12.10 Maintenance of Books of Accounts

8.13 Support by Authentic Documentation

8.14 Computation of Capital Gains

8.15 Tax Treaties: The Elimination of Double Taxation

8.15.1 Double Taxation Avoidance Agreement

8.15.2 Countries without Agreement

8.16 The Scheme of Advance Ruling

Summary

References

Recommended Reading

Self Assessment
List of Figures

Fig. 1.1 History of income tax act.................................................................................................................. 3
Fig. 1.2 Total income of a person for computation......................................................................................... 8
Fig. 1.3 Income computations for each income head ....................................................................................... 9
Fig. 2.1 Steps to compute book profits ....................................................................................................... 21
Fig. 3.1 Computation of total income and tax liability .................................................................................. 34
Fig. 3.2 Special provisions based on business location ................................................................................ 41
Fig. 5.1 Process of capital structure decisions ............................................................................................. 62
Fig. 5.2 Relation between value of the firm, investment decisions and capital structure decisions............ 65
Fig. 7.1 Rent free unfurnished accommodation ......................................................................................... 95
Fig. 7.2 Gas, electricity or water supply provision ....................................................................................... 97
Fig. 7.3 Requisites for domestic servants .................................................................................................. 98
Fig. 7.4 Medical facility provision ............................................................................................................. 98
Fig. 7.5 Credit cards .................................................................................................................................... 100
Fig. 7.6 Club facility rule ................................................................................................................................ 101
Fig. 7.7 Value of prerequisite (a) ................................................................................................................ 101
Fig. 7.8 Value of prerequisite (b) ................................................................................................................ 102
List of Tables

Table 1.1 Taxability of income based on residential status................................................................. 10
Table 2.1 Rates of income tax........................................................................................................... 19
Table 2.2 Difference between tax planning and tax evasion............................................................. 25
Table 2.3 Differences between tax avoidance and tax evasion........................................................ 25
Table 2.4 Differences between tax planning and tax management.................................................... 25
Table 3.1 Merits and demerits of sole proprietorship ....................................................................... 32
Table 3.2 Merits and demerits of partnership .................................................................................. 37
Table 3.3 Merits and demerits of company form of organisation .................................................... 40
Table 3.4 Amount of deductions (special provisions)....................................................................... 42
Table 5.1 Bonus shares to equity shareholders .................................................................................. 71
Table 7.1 Motor car facility: rule 3(2)............................................................................................. 97
Table 7.2 Salary definitions .............................................................................................................. 107
Table 8.1 Provisions relevant for NRIs............................................................................................ 116
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>AOP</td>
<td>Association of Persons</td>
</tr>
<tr>
<td>AY</td>
<td>Assessment Year</td>
</tr>
<tr>
<td>BOI</td>
<td>Board of Investment</td>
</tr>
<tr>
<td>CBDT</td>
<td>Central Board of Direct Taxes</td>
</tr>
<tr>
<td>EBIT</td>
<td>Earnings Before Interest and Taxes</td>
</tr>
<tr>
<td>EPZ</td>
<td>Export Processing Zone</td>
</tr>
<tr>
<td>FAAS</td>
<td>Firm Assessed As Such</td>
</tr>
<tr>
<td>FTZ</td>
<td>Free Trade Zone</td>
</tr>
<tr>
<td>HUF</td>
<td>Hindu Undivided Family</td>
</tr>
<tr>
<td>MAT</td>
<td>Minimum Alternate Tax</td>
</tr>
<tr>
<td>MF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>NABARD</td>
<td>National Bank for Agricultural and Rural Development</td>
</tr>
<tr>
<td>NRI</td>
<td>Non Resident Indian</td>
</tr>
<tr>
<td>OCI</td>
<td>Overseas Citizen of India</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>PIO</td>
<td>Person of Indian Origin</td>
</tr>
<tr>
<td>PY</td>
<td>Previous Year</td>
</tr>
<tr>
<td>RBI</td>
<td>Reserve Bank of India</td>
</tr>
<tr>
<td>SEBI</td>
<td>Securities and Exchange Board of India</td>
</tr>
<tr>
<td>SEZ</td>
<td>Special Economic Zone</td>
</tr>
<tr>
<td>u/s</td>
<td>Under Section</td>
</tr>
<tr>
<td>UNO</td>
<td>United Nations Organisation</td>
</tr>
<tr>
<td>VCC</td>
<td>Venture Capital Tax Credit</td>
</tr>
<tr>
<td>VCF</td>
<td>Venture Capital Fund</td>
</tr>
<tr>
<td>VCU</td>
<td>Venture Capital Undertakings</td>
</tr>
<tr>
<td>WDV</td>
<td>Written Down Value</td>
</tr>
</tbody>
</table>
Chapter I
Basic Concepts of Income Tax

Aim
The aim of this chapter is to:

• examine the basic taxes in India
• give an integrated view of the history of income tax
• explain important components of the Income tax act

Objectives
The objectives of this chapter are to:

• determine receipts of ‘income’
• view categories defined under ‘person’
• familiarise with the meaning of ‘assessee’
• understand basis of charge and residential status

Learning outcome
At the end of this chapter, the students will be able to:

• identify ‘previous year’ and ‘assessment year’
• understand computation of total income
• comprehend computation of tax liability on total income
1.1 Introduction

The most important source of government revenue is from taxes. A tax is a compulsory charge imposed by a public authority, like, income tax. Sometimes description of taxes covers penalties for offences. The distinction between taxes and penalties is one of the motive; a public authority imposes taxes mainly to obtain revenue and resorts to penalties mainly to deter people from doing certain things. Therefore, a tax is a compulsory contribution imposed by a public authority, irrespective of the exact amount of services rendered to the tax payer in return and not imposed as a penalty for any legal offence.

Taxes are generally divided into direct taxes and indirect taxes. Direct taxes are those which are levied directly on the entity meant to bear the burden. In the case of indirect taxes, the tax burden is shifted from where they are initially imposed. In India, Personal Income Tax and Corporate Income Tax are the important direct taxes levied by the central government.

As a first step towards understanding income tax law in India, it would be appropriate to begin with acquiring knowledge about the structure of tax regime in the country.

Income Tax, Corporation Tax, Capital Gains Tax, Estate Duty, Gift Tax, Wealth Tax come under the category of direct taxes. In case of direct taxes, the liability is determined with direct reference to the taxpayer's tax-paying ability, while in the case of indirect taxes, this ability is assessed indirectly. For instance, in case of income tax which is a direct tax, the amount of tax to be payable by a person, is determined on the basis of that person's income.

1.2 Income Tax

- Income tax is one of the direct taxes levied by the Central Government. It is considered direct as it is payable in the Assessment Year, directly by the Individual, Hindu Undivided Family, Firms and Corporate Bodies on the income earned during the previous year (financial/accounting) year

- Every entity whose income (computed in accordance with the Income Tax Act and the Income Tax Rules etc.) is more than the tax free limit as prescribed by the relevant Finance Act, is required to pay tax.

- The income tax read along with the Income Tax Rules and the Finance Act provides for all the possible situations that are likely to arise in the administration of income tax law. The diagram depicts the brief history of the income tax act.
1.3 Components of Income Tax Act

- The Income Tax Act is a self-contained Act. Sections 2 and 3 define the terms/expressions used in the Income Tax Act. The word ‘means’, ‘includes’ are used in the definitions and the significance of these terms needs to be understood.

- When a definition uses the word ‘means’, the definition is self-explanatory, restrictive and in a sense, exhaustive. It implies that the term or expression so defined means only as to what it is defined as and nothing else. For example, the terms ‘Agricultural Income’, ‘Assessment year’, ‘Capital Asset’ is exhaustively defined.

- When the legislature wants to widen the scope of the term or expression and where an exhaustive definition cannot be given, it uses the word ‘includes’ in the definition. Hence, the inclusive definition provides an illustrative meaning and not an exhaustive meaning. In practical application, the definition could include what is not specifically stated or mentioned in the definition as long as the stipulated criteria are satisfied. To illustrate, reference is drawn to the definition of the terms ‘Inclines,’ ‘Person’, ‘Transfer’.

- When the legislature intends to define a term or expression to mean something and also intends to specify certain items to be included, both the words ‘means’ as well as ‘includes’ are used. Such a definition is not only exhaustive but also illustrative. Example: the terms ‘assessee’, ‘Indian company’, ‘Recognised Provident Fund’.

- Since income tax is levied on the ‘income’ of an entity, it is important to know what income is and how it is computed.

1.3.1 Income

- Though the term income is not defined in an exhaustive manner under the Act, generally speaking, it includes receipts in the shape of money or money’s worth which arise with certain regularity or expected regularity from a definite source.

- The expression ‘income’, according to the dictionary, means ‘a thing that comes in’. Income may also be defined as the gain derived from land, capital or labour or any two or more of them.

- ‘Income’ in this Act connotes a periodical monetary return ‘coming in’ with some sort of regularity or expected regularity. The word ‘income’ is not limited by the words ‘profits’ and ‘gains’. Anything which can properly be described as ‘income’, is taxable under the Act unless expressly exempted.
Section 2(24) gives a statutory meaning of the term ‘Income’. The section does not define the term Income but merely describes various receipts as income. At present the following items of receipts are included in income u/s 2 (24):

- Profits and gains
- Dividends
- Voluntary contributions received by a trust/institution created wholly or partly for charitable or religious purposes or by an association or institution covered by Section 10 (21) or (23) or (23C) (iv) or (v).
- The value of any perquisite or profit in lieu of salary taxable and Section 17.
- Any special allowance or benefit other than the perquisite included above, specifically granted to the assessee to meet expenses wholly, necessarily and exclusively for the performance of the duties of an office or employment for private purposes.
- Any allowance granted to the assessee to meet his personal expenses at the place where the duties of his or employment of profit are ordinarily performed by him or at a place where he ordinarily resides or to compensate him for the increased cost of living.
- The value of any benefit or perquisite whether convertible into money or not, obtained from a company either by a director or by a person who has a substantial interest in the company or by a relative of the director or such person and any sum paid by any such company in respect of any obligation which, but for such payment would have been payable by the director or other person aforesaid.
- The value of any benefit or perquisite, whether convertible into money or not, which is obtained by any representative assessee mentioned in clauses (iii) and (iv) of Section 60(1) or by any beneficiary or any amount paid by the representative assessee for the benefit of the beneficiary which the beneficiary would have ordinarily been required to pay.
- Value of any benefit or perquisite, whether convertible into money or not arising from business or exercise of profession.
- Any sum chargeable to income tax under Section 41 and Section 59.
- Any sum chargeable to income tax under (ii), (iii), (iii-a), (iii-b), (iii-c), (iv) and (v) of Section 28.
- Any sum chargeable to tax v/s 28(v) [interest, salary, bonus, commission or remuneration to a partner of a firm].
- Any capital gains chargeable under section 45.
- The profits and gains of any insurance carried on by Mutual Insurance Company or by a co-operative society, computed in accordance with section 44 or any surplus taken to be such profits and gains by virtue of the provisions contained in the first Schedule to the Act.
- Any winnings from lotteries, cross-word puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever.
- Any sum received by the assessee from his employees as contribution to any provident fund or superannuation fund or employees state insurance fund or any other fund for the welfare of such employees.
- Any sum received under a Lump sum Insurance policy including sum allocated by way of bonus in such policy.
- Any sum received/receivable as specified in Sec. 28 (va) [i.e., Sum received in cash or kind under an agreement for not carrying out any activity in relation to business or not to share any knowhow, patent, etc.] 
- Gifts: Taxability of certain receipts/credits to be regarded as income if received on or after 1st September 2004. Interestingly, the provision does not use the word ‘Gift’.
- The definition of ‘income’ of an individual or HUF will now include any sum received from any person on or after 1 September 2004 in cash or cheque or by any other mode or credit, otherwise than as consideration for goods or services. However, this would not include the following:
  - Amounts received by an individual from a relative out of natural love and affection. The term ‘relative’ has been specifically defined for this purpose.
  - Amounts received by an individual or HUF under a will or by way of an inheritance.
Amounts received by an employee/dependant of a deceased employee from an employer by way of bonus, gratuity or pension or insurance or any other sum solely in recognition of services rendered.

Amounts received in contemplation of death of an individual or Karta or member of HUF.

Any income exempt under section 10 or otherwise or which is excluded from total income.

Amounts received on transactions not regarded as ‘transfer’ for the purpose of capital gains.

- A general exemption of Rs. 25,000 per year in the aggregate will be available in respect of the receipts/credits mentioned above. In addition, gifts received on marriage will be exempted.
- The income of the nature described above will be taxable under the head ‘Income from other sources’.
- Based on the above, gifts received on any occasion other than marriage, unless specifically excluded will be treated as income.

1.3.2 Capital and Revenue Receipts

The Income Tax Act charges tax on income and not on capital and hence it is very essential to distinguish between capital and revenue receipts.

The Income Tax Act does not define the term “Capital Receipts” and “Revenue Receipts”. Therefore, whether a certain receipt is capital or revenue would be a mixed question of law and fact. It is to be determined on the basis of the particular facts and circumstances of each case.

The following are some of the important rules which guide in making a distinction between them.

- A receipt referable to fixed capital would be a capital receipt whereas a receipt referable to circulating capital would be a revenue receipt: Circulating capital is the capital which is turned over and in the process of being turned over, yields profit or loss e.g., fixed capital is also involved in this process but remains unaffected by the process. A capital asset in the hands of one person may be a trading asset in hands of another. Thus, while determining the nature of receipt, one has to consider the nature of trade in which the asset is employed.

- A receipt in substitution of a source of income is a capital receipt whereas a receipt in substitution of an income is a revenue receipt: Compensation for loss of employment is a capital receipt; whereas compensation for temporary disablement is a revenue receipt.

- Compensation received from Government in respect of stock in trade destroyed or damaged by enemy action constitutes revenue receipts. On the contrary, compensation paid for acquisition of land or property which constituted capital asset in the hands of the lessee would be a capital receipt.

- An amount received as a compensation for the surrenders of certain rights under an agreement is a capital receipt: E.g., If a director/partner receives an amount from the company in consideration of giving up his right to carry on competitive business similar to that of a company/ firm; it will be a capital receipt. An amount received as a compensation for loss of future profits is a revenue receipt.

- Receipt to be of a revenue nature need not necessarily be repetitive or recurring: Thus, a bulk purchase followed by bulk sale or a series of retail sales would constitute an adventure in the nature of trade and consequently income arising there from would be taxable.

- **Nature of receipt in the hands of recipient:** The easiest example to understand is the case of a builder. If he sells a particular property or a flat, he would be receiving the monies on revenue account as they constitute his stock in trade, whereas it does not matter that the person making the payment would consider the payment on capital account.

- **Annuity:** For annuities which are payable in specified sums at periodic intervals of time, the receipt would be of a revenue nature. The fact that annuity is contingent or variable in amount does not in anyway affects its charter as income. An annuity received from an employer is taxable as “income from salaries” whereas all other annuities are chargeable under the head - income from other sources irrespective of the fact whether or not they are payable: (i) Under a deed of family arrangement (ii) Under a deed of separation to a wife or (iii) Under a degree for alimony or (iv) To the estate of the deceased partner by the remaining partners for the use of firm’s name and goodwill. Annual payments (i.e., annual instalments) as distinguished from annuities are in the nature
of capital. Thus, the amount of instalment received by the assessee would be of capital nature and hence not liable to tax. In order to ascertain whether a certain payment is an annuity or annual instalment, regard must be had to the true nature and character of a transaction, for example,

- If the sale of property/business is for a price which is to be paid in instalments, the instalments would be capital receipts.
- If the property is sold for an annuity payable regularly, the property disappears and the annuity assumes the character of definite income and hence chargeable to tax.

- **Lump sum receipts:** In order to determine whether a receipt is capital or revenue in nature, the fact that it is a lump sum payment, large payment or periodic payment is not relevant. A lump sum paid in commutation of salaries, pension, royalties or other periodic payments would be income, taxable under the respective heads. Similarly, royalties received for use of patents, whether paid in lump sum or in instalments of fixed or varying amounts would be taxable as income. However, if the payment received is in lieu of total or partial assignment of patent under which the owner ceases to own patent as a capital asset, it would constitute a capital receipt.

1.3.2.1 **Receipts Bereft of Revenue Element**

All receipts are not income. Particular receipt cannot be taxed because they cannot be proved to be a taxable income at all. Knowledge of such receipts is essential to understand the meaning of the term ‘Income’.

- Surplus arising to mutual concerns (concept of mutuality): One cannot make a profit from dealing with oneself. Income should be received from outside. If a person re-values his goods/assets and shows a higher value in books, he cannot be considered as having sold the goods and make a profit thereon. Similarly, in case of mutual concerns (Clubs, associations and society) if subscription from members exceeds its expenditure on its members, excess cannot be treated as taxable income.
- Pin Money: Pin money received by wife for her dress/personal expenses and small savings made by a woman out of money received from her husband for meeting household expenses is not treated as her income.

1.3.3 **Rates of Tax**

Income tax is to be charged at the rates fixed for the year by the annual Finance Act. The Finance Act consists of three schedules at the end of it. The last schedule consists of four parts. Let us take the example of Finance Act, 2005 –

- Part I consists of rates of tax applicable to income of various types of assessee for the assessment year
- Part II. consists of rates of deduction of tax in certain cases.
- Part III consists of rates for deduction of tax from salary and also for computing advance tax.
- Part IV gives rules for the computation of Net Agricultural income.

1.3.4 **Defining ‘Person’**

The term ‘person’ includes:

- An individual
- A Hindu Undivided Family
- A company
- A firm
- An association of persons or body of individuals whether incorporated or not
- A local authority and
- Every artificial juridical person not falling within any of the preceding categories

The definition is inclusive and not exhaustive. Therefore any person not falling in the above seven categories may still fall in the term person and accordingly may be liable to Income tax

- **Individual:** The expression ‘individual’ as a unit of assessment refers only to a natural person i.e., a human being; deities and statutory corporations are assessable as ‘juridical person’. Individual includes a minor and a
person of unsound mind.

- **Hindu Undivided Family**: Family connotes a group of people related by blood or marriage. The word family always signifies a group. Plurality of persons is an essential attribute of a family. A single person, male or female, does not constitute a family. He or she would remain, what is inherent in the very nature of things, an individual, till per chance he or she finds a mate. The expression ‘Hindu Joint family’ in the Income Tax Act is used in the sense in which a Hindu joint family is understood under the various schools of Hindu law. The word ‘Hindu’ preceding the words ‘undivided family’ signifies that the undivided family should be of those to whom Hindu law applies.

- **Company**: Under Sec. 2(17), the expression ‘Company’ is defined to mean the following:
  - An Indian company or
  - Any body corporate incorporated under the laws of a foreign country or
  - Any institution, association or a body which is assessed or was assessable as a company for any assessment year commencing on April 1, 1970 or
  - Any institution, association or a body, whether incorporated or not and whether, Indian or non-Indian which is declared by general or special order of the Central Board of Direct Taxes to be a company.

- **Firm**: ‘Firm’ is a collective noun, a compendious expression to designate an entity, not a person. Under the Income tax Act, ‘firm’, ‘partner’ and ‘partnership’ have been given the same meaning as assigned to them in the Indian Partnership Act. But the expression ‘partner’ has been extended to include any person who, being a minor, has been admitted to the benefits of a partnership. Only the members who have entered into partnership are to be regarded as partners and collectively a firm and the name under which their business is carried on, is called the firm’s name.

- **Association of Persons (AOP)**: An association of persons must be one in which two or more persons join in a common purpose or common action and as the word occurs in section 3 of the 1922 Act, which imposes a tax on income, profits or gains, the association must be one the object of which is to produce income, profits or gains.

- **Body of Individuals**: The expression ‘body of individuals’ includes a combination of individuals who have a unity of interest but who are not actuated by a common design and one or more of whose members produce or help to produce income for the benefit of all. Distinction between Association of Persons and Body of Individuals
  - An Association of Persons may consist of non-individuals but a Body of Individuals has to consist only of individuals. If two or more persons (like firms, company, HUF, individual, etc.) join together, it is called an Association of Persons.
  - An Association of Persons implies a voluntary getting together for a common design or combined will to engage in an income producing activity, whereas a Body of Individuals may or may not have such common design as well.

- **A Local Authority**: This includes,
  - Panchayat as referred to in Article 243(a) of the Constitution; or
  - Municipality as referred to in Article 243 P of the constitution.
  - Municipal Committee and Dish net Board, legally entitled or entrusted by the Government with, the Central or management of a Municipal or local funds.
  - Cantonment Board as defined in Sec. 3 of the Cantonment Act, 1924.
  - Artificial person: Artificial persons are entities, which are not natural persons but are separate entities in the eyes of law. Though they may not be sued directly in a court of law, but they can be sued through the persons managing them e.g., gods, idols and deities are artificial persons.

1.3.5 Assessee

An assessee is a person by whom any tax or any other sum of money (for example interest, penalty, fine, etc.) is payable under the Income Tax Act and includes:

- A person in whose respect proceedings for determining income or for assessment of fringe benefits or of the income of any other person in respect of which he is assessable or of the loss sustained by him or by such other
person or of the amount of refund due to him or to such other person; have been commenced by the Income Tax Department.

- Thus, a person may become an assessee even if no amount is payable by him under the Income Tax Act.
- A deemed assessee is a person who is himself not an assessee but is treated as an assessee for the purposes of the Income Tax Act. For example, the trustee of a trust is a deemed assessee in respect of the trust. The income earned is the income of the trust but is assessed in the hands of the trustee as his income.
- An assessee in default is a person on whom certain obligations have been imposed under the Income Tax Act but who has failed to carry out those obligations. For example, any person who employs another person has to deduct income tax at source from the taxable salary of the employee and pay the tax deducted at source to the government within the prescribed time as income tax paid on behalf of the employee. In case the employer fails to carry out these obligations, he becomes an assessee in default.

1.3.6 Assessment Year (AY) [Sec. 2(9)]

- Assessment year (AY) means the financial year (1\textsuperscript{st} April to 31\textsuperscript{st} March of next year) in which the income is taxed or assessed. Income of the previous year is taxed in the assessment year (next year) at the rates prescribed by the relevant finance Act.

1.3.7 Previous Year [Sec. 2(34) and Sec. 3]

- Previous year (PY) means the financial year immediately preceding the assessment year. In case of a business or profession which is newly started, the previous year commences from the date of commencement of the new business or profession up to the next 31\textsuperscript{st} day of March.

1.4 Coverage Under Income

- The aggregate income under these heads is termed as “gross total income”. In other words, gross total income means total income computed in accordance with the provisions of the Act before making any deduction under Chapter VI A (Section 80 CCC to 80 U).
- Further Section 14 A provides that no deduction shall be made in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act.
- As per Section 14, income of a person is computed under the following five heads:

![Fig. 1.2 Total income of a person for computation](image-url)

Total income of an assessee is gross total income as reduced by the amount permissible as deduction under Sections 80 CCC to 80 U.
1.4.1 Computation of Total Income

The steps in which the total income for any assessment year is determined as follows:

- Determine the residential status of the assessee to find out which income is to be included in the computation of his total income (residential status and need for determining residential status are given in the next chapter).
- Classify the income under each of the following five heads. Compute the income under each head after allowing deductions prescribed for each head of income are illustrated in the figure.

<table>
<thead>
<tr>
<th>Income from salaries</th>
<th>Income from House Property</th>
<th>Income from Profits and gains of business and profession</th>
<th>Income from capital gains</th>
<th>Income from other sources:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary / Bonus / Commission, etc.</td>
<td>Net annual value of house property</td>
<td>Net profit as per P &amp; L A/c</td>
<td>Capital gains as computed</td>
<td>Gross income</td>
</tr>
<tr>
<td>Taxable Allowance</td>
<td></td>
<td>Less/Add: Adjustments required</td>
<td>Less exemptions u/s 54/54B/54D etc.</td>
<td>Less: Deductions</td>
</tr>
<tr>
<td>Value of Taxable perquisites</td>
<td></td>
<td>to be made to the profit as per provisions of Income Tax Act</td>
<td></td>
<td>Net income from other sources</td>
</tr>
<tr>
<td>Gross salary</td>
<td></td>
<td>Net profit and gains of business and profession</td>
<td></td>
<td>Gross Total Income [(a)+(b)+(c)+(d)+(e)]</td>
</tr>
<tr>
<td>Less: Deductions u/s 16</td>
<td></td>
<td></td>
<td></td>
<td>Less: Deductions available under chapter VI A Sections 80 CCC to 80 U</td>
</tr>
<tr>
<td>Net taxable income from salary</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Fig. 1.3 Income computations for each income head
1.4.2 Computation of Tax Liability on Total Income

On the total income, tax is to be calculated according to the rates prescribed under the relevant Finance Act. Certain rebates are allowed from the tax payable on account of:

- Certain eligible savings covered under section 88 in the case of individuals and HUF. No deduction to be allowed w.e.f. A.Y beginning on 1st April 2006 onwards.
- Rebate for senior citizens when they satisfy certain conditions u/s 88B
- Rebate for women who are less than 65 years of age under sec. 88 C.
- For assessee having total income upto Rs. 100,000 u/s/ 88D.
- Rebate in respect of securities transaction tax u/s 88E.

1.5 Charging Section

Section 4 of the Income Tax Act is the charging section. It provides that:

- Income tax shall be charged at the rate prescribed for the year by the Annual Finance Act.
- The charge is on every person including the assessable entities specified in Section 2 (31).
- The income taxed is that of the previous year and not of assessment (subject to exceptions provided by sec. 172, 174, 174A, 175 and 176) year.
- The levy of tax shall be made on the total income of the assessable entity. Computed in accordance with and subject to the various provisions for the levy of additional income tax contained in the Act.
- It also provides that in respect of income chargeable under the above proviso, the income tax shall be deducted at source or paid in advance, where it is so deductible or payable under any provision of the Act.

This charging section is the backbone of the law of income tax. By this section, tax is imposed on every person on total income. Section 5 of the Act provides the meaning of total income in relation to resident status of the assessee since the incidence of tax depends upon its residential status.

1.6 Meaning of Total Income in the Context of Residential Status - Sec. 5

Sec. 5 (1) incidence of tax in case of resident and ordinary resident – the total income of a resident assessee would consist of:

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

<table>
<thead>
<tr>
<th>S. No</th>
<th>Status</th>
<th>Income liable to tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Resident and ordinarily resident</td>
<td>Global or world income</td>
</tr>
</tbody>
</table>
| 2     | Resident but not ordinarily resident| a) All incomes realised within resident India (i.e., received/deemed to be received and accrued/deemed to accrue in India.)  
b) Income from business or profession outside India if this business is controlled in or profession set up in India. |
| 3     | Non-resident                        | All income realised within India (i.e., received/deemed to be received and accrued/deemed to accrue in India.)                   |

Table 1.1 Taxability of income based on residential status
1.7 Scope and Orbit of Business Connection in the Case of Non-resident

In case of income deemed to accrue or arise in India, scope and ambit of ‘business connection’ of a non-resident can be explained with the help of following illustrative instances:

- Maintaining a branch office in India for the purchase or sale of goods or transacting other business
- 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
- Erecting a factory in India, where the raw produce purchased locally is worked into a form suitable for export abroad
- Forming a local subsidiary company to sell the products of the non-resident parent company
- Having financial association between a resident and a non-resident company

The following clarifications regarding applicability of provisions of section 9 are made in respect of certain specified situations:

Non-resident exporters selling goods from abroad to Indian importer:

- No liability will arise on accrual basis to the non-resident on the profits made by him where the transactions of sale between the two parties are on a principal-to-principal basis.
- If the non-resident makes over the shipping documents to a bank in his own country which discounts the documents and sends them for collection to the bankers in India, who present the sight or usance draft to the resident importer and deliver the documents to him against payment or acceptance by the latter, the non-resident will not be liable to tax on the profit arising out of the sales on receipt basis.

Non-resident company selling goods from abroad to its Indian subsidiary:

- In such a case, if the transactions are actually on a principal-to-principal basis and are at arm’s length and the subsidiary company functions and carries on business on its own, instead of functioning as an agent of the parent company, the mere fact that the Indian company is a subsidiary of the non-resident company will not be considered a valid ground for invoking Section 9 for assessing the non-resident. Where a non-resident parent company sells goods to its Indian subsidiary, the income from the transaction will not be deemed to accrue or arise in India under section 9, provided that
  - the contracts to sell are made outside India,
  - the sales are made on a principal-to-principal basis and at arm’s length and
  - the subsidiary does not act as an agent of the parent company.

Sale of plant and machinery to an Indian importer on instalment basis:

- Where the transaction of sale and purchase is on a principal-to-principal basis and the exporter and the importer have no other business connection, the fact that the exporter allows the importer to pay for the plant and machinery, instalments will not, by themselves, render the exporter liable to tax on the ground that the income is deemed to arise to him in India.

Foreign agents of Indian exporters:

- Where a foreign agent of Indian exporter operates in his own country and his commission is usually remitted directly to him and is, therefore, not received by him or on his behalf in India. Such an agent is not liable to income tax in India on the commission.

Non-resident person purchasing goods in India:

- A non-resident will not be liable to tax in India on any income attributable to operations confined to purchase of goods in India for export, even though the non-resident has an office or an agency in India for this purpose.
Sales by a non-resident to Indian customers either directly or through agents:
- Where non-resident allows an Indian customer facility of extended credit for payment, there would be no assessment merely for this reason provided that
  - the contracts to sell were made outside India; and
  - The sales were made on a principal-to-principal basis
- Where a non-resident has an agent in India and makes sales directly to Indian customers, section 9 of the Act will not be invoked, even if the resident pays his agent an overriding commission on all sales to India, provided that
  - the agent neither performs nor undertakes to perform any service directly or indirectly in respect of these direct sales;
  - the contracts to sell are made outside India; and
  - the sales are made on a principal-to-principal basis.
- Where a non-resident’s sales to Indian customers are secured through the services of an agent in India, the assessment in India of the income arising out of the transaction will be limited to the amount of profit which is attributable to the agent’s services, provided that (i) the non-resident principal’s business activities in India are wholly channelled through his agent, (ii) the contracts to sell are made outside India and (iii) the sales are made on a principal-to-principal basis.
- Where a non-resident principal’s business activities in India are not wholly channelled through his agent in India, the assessment in India will be on the sum total of the amount of profit attributable to his agent’s activities in India and the amount of profit attributable to his own activities in India, less the expenses incurred in making the sales.

The income tax act is a vast topic. The headings covered in this chapter are a few important ones. Referring to ‘http://law.incometaxindia.gov.in/DIT/Income-tax-acts.aspx’ would give details on all aspects of the act.
Summary

- A tax is a compulsory contribution imposed by a public authority, irrespective of the exact amount of service rendered to the taxpayer in return and not imposed as a penalty for any legal offence.
- Taxes are generally divided into direct taxes and indirect taxes. Direct taxes are those which are levied directly on the entity meant to bear the burden. In the case of indirect taxes, the tax burden is shifted from where they are initially imposed. In India, Personal Income Tax and Corporate Income Tax are the important direct taxes levied by the central government.
- Income tax is one of the direct taxes levied by the Central Government. It is considered direct as it is payable in the Assessment Year, directly by the Individual, Hindu Undivided Family, Firms and Corporate Bodies on the income earned during the previous year (financial/accounting) year.
- Though the term income is not defined in an exhaustive manner under the Act, generally speaking, it includes receipts in the shape of money or money’s worth which arise with certain regularity or expected regularity from a definite source.
- The Income Tax Act charges tax on income and not on capital and hence it is very essential to distinguish between capital and revenue receipts.
- The Income Tax Act does not define the term ‘Capital Receipts’ and ‘Revenue Receipts’. Therefore, whether a certain receipt is capital or revenue would be a mixed question of Law and fact. It is to be determined on the basis of the particular facts and circumstances of each case.
- The term ‘person’ includes: an individual, a Hindu Undivided Family, a company, a firm, an association of persons or body of individuals whether incorporated or not, a local authority and, every artificial juridical person not falling within any of the preceding categories. The definition is inclusive and not exhaustive. Therefore, any person not falling in the above seven categories may still fall in the term person and accordingly may be liable to income tax.

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- Direct Taxes. IGNOU. Available at: <http://egyankosh.ac.in/bitstream/123456789/9966/1/Unit%2011en.pdf> [Accessed 15th March 2011].
- Dr. Singhania, V.K., Dr. Singhania, K., 2005. Direct Taxes Planning and Management, 9th edition, Taxman’s.
- Sources of Revenue: Tax and Non-tax. IGNOU. Available at: <http://egyankosh.ac.in/bitstream/123456789/25382/1/Unit-13.pdf> [Accessed 15th March 2011].

Recommended Reading

Self Assessment

1. Tax is imposed irrespective of the exact amount of service rendered to the tax payer in return and not imposed as a ___________ for any legal offence.
   a. penalty
   b. rule
   c. law
   d. cost

2. Which types of taxes are levied directly on the entity meant to bear the burden?
   a. Indirect tax
   b. Direct tax
   c. Custom tax
   d. Export duty

3. Income tax is levied on the "income" of a/an ____________.
   a. total amount
   b. capital
   c. entity
   d. living being

4. In order to recover the expenses/losses of the great revolt, the ______________ introduced the ‘Law of taxation on income.’
   a. Swedish Government
   b. American Government
   c. Indian Government
   d. British Government

5. ________ is the capital which is turned over and in the process of being turned over, yields profit or loss.
   a. Compensating capital
   b. Revenue capital
   c. Non-revenue capital
   d. Circulating capital

6. Receipt to be of a ____________ need not necessarily be repetitive or recurring.
   a. capital nature
   b. non-revenue nature
   c. revenue nature
   d. expenditure nature

7. ____________ must be one in which two or more persons join in a common purpose or common action.
   a. Firm
   b. An association of persons
   c. Company
   d. Body of individuals
8. ____________ is a person by whom any tax or any other sum of money is payable under the Income Tax Act.
   a. An assessee
   b. An individual
   c. An employee
   d. A manager

9. Income of the previous year is taxed in the ____________ at the rates prescribed by the relevant finance Act.
   a. assessment year
   b. previous year
   c. action year
   d. last year

10. What is the person known when no amount is payable by him under the Income Tax Act?
    a. Individual
    b. Assessee
    c. Tax payer
    d. Non tax payer
Chapter II

Taxation of Companies, Tax Planning and Tax Evasion

Aim

The aim of this chapter is to:

• state company tax acts
• analyse computing book profits
• explore taxation of venture capital companies

Objectives

The objectives of this chapter are to:

• give the definitions of ‘company’
• provide a perspective of the rules to carry forward losses in case of certain companies
• acquaint with Minimum Alternate Tax

Learning outcome

At the end of this chapter, the students will be able to:

• understand difference between types of companies
• discuss rules used to decide residence of companies
• identify criteria for assessment of companies
2.1 Introduction

In most countries with income taxation, corporate entities are subject to tax on their profits and, in addition, dividends are taxed in the hands of shareholders (subject to exemption up to a point). The base of the corporate income tax, however, is commonly the accounting profits derived with reference to historical costs.

Company is a voluntary association of persons formed for the purpose of doing business having a distinct name and limited liability. It is a juristic person having a separate legal entity distinct from the members who constitute it, capable of rights and duties of its own and endowed with the potential of perpetual succession. The Companies Act, 1956, states that 'company' includes company formed and registered under the Act or an existing company i.e., a company formed or registered under any of the previous company laws. However, company is not a citizen so as to claim fundamental rights granted to citizens.

Company is a ‘juristic person’ and it can file a suit as an 'indigent person'

An expression 'person' includes not merely a natural person but also other juridical persons. A company being a juristic person would be represented before a Court of law or any other place by a person competent to represent it. It is enough that the person competent to represent a company presents the application on behalf of the company. Minors, lunatics or person under any disability are also entitled to file a suit either through guardian or the next friend. In such a case it is the guardian or next friend who is competent to represent the petitioner.

Company is a separate legal entity

Company is a separate legal entity distinct from its shareholders. The major constituents of a company are its members, who are the ultimate owners and its directors. It is an important feature of the company form of business, that there is a gap between the ownership and control over the affairs of the company. In real sense the members are the owners of a company, but it is being managed by the directors who are elected representatives of its members, because it is absolutely necessary for it to have a human agency called as the Company's board of directors. The Board of Directors comprises the directors.

The tax levied on a company’s income is based on its legal residence. Companies of Indian origin are levied tax in India, while International companies are levied tax on earnings from their Indian operations. For International companies’ royalty, interest, gains from sale of capital assets within India, dividends from Indian companies and fees for technical services are all treated as income arising in India.

2.2 Definitions of Company

Company: As per section 2(17), company means:

- Any Indian company, or
- Any body corporate incorporated by or under the laws of a country outside India, or
- Any institution, association or body which was assessed as a company for any assessment year under the Income Tax Act, 1922 or was assessed under this Act as a company for any assessment year commencing on or before 1.4.1970, or
- 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 CBDT to be a company.

- A company in which the public are substantially interested: Section 2(18) of the Income Tax Act has defined “a company in which the public are substantially interested” includes:
  - A company owned by Government or Reserve Bank of India.
  - A company having Government participation i.e., a company in which not less than 40% of the shares are held by Government or the RBI or a corporation owned by the RBI or a corporation owned by the RBI.
  - Companies registered under section 25 of the Indian Companies Act, 1956: Companies registered under section 25 of the Companies Act, 1956 are companies which are promoted with special object such as to promote commerce, art, science, charity or religion or any such useful object and these companies do not have profit motive. However, if at any time these companies declare dividend, they would lose the status of a company in which the public are substantially interested.
A company declared by the CBDT: It is a company without share capital and which having regard to its object, nature and composition of its membership or other relevant consideration is declared by the Board to be a company in which public are substantially interested.

Mutual benefit finance company, where principal business of the company is acceptance of deposits from its members and which has been declared by the Central Government to be a Nidhi or a Mutual Benefit Society.

A company having co-operative society participation: It is a company in which at least 50% or more equity shares have been held by one or more co-operative societies.

A public limited company: A company is deemed to be a public limited company if it is not a private company as defined by the Companies Act, 1956 and is fulfilling either of the following two conditions:
- Its equity shares were listed on a recognised stock exchange, as on the last day of the relevant previous year; or
- Its equity shares carrying at least 50% of the voting power (in the case of an industrial company the limit is 40%) were beneficially held throughout the relevant previous year by government, a statutory corporation, a company in which the public is substantially interested or a wholly owned subsidiary of such a company.

Widely held company: It is a company in which the public are substantially interested.

Closely held company: It is a company in which the public are not substantially interested.

Indian company [Section 2(26)]: Indian Company means a company formed and registered under the Companies Act, 1956 and includes -
- A company formed and registered under any law relating to companies formerly in force in any part of India (other than the State of Jammu and Kashmir and the union territories).
- A corporation established by or under a Central, State or Provincial Act
- Any institution, association or body which is declared by the Board to be a company.

Domestic company [Section 2(22A)]: A domestic company means an Indian company or any other company which in respect of its income, liable to tax under the Income Tax Act, has made the prescribed arrangements for the declaration and payment within India, of the dividends (including dividends on preference shares) payable out of such income.

Foreign company [Section 2 (23A)]: Foreign Company means a company which is not a domestic company.

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

### 2.3 Residence of a Company

[Section 6(3)]
A company is said to be a resident in India during the relevant previous year if:
- it is an Indian company or
- if it is not an Indian company then, the control and the management of its affairs is situated wholly in India.
The company is said to be non-resident in India, if it is not an Indian company and some part of the control and management of its affairs is situated outside India.
The total income of a company is also computed in the manner in which income of any other assessee is computed
2.4 Carry Forward and Set Off of Losses

(Section 79)

- In the case of closely held companies, 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 on the last day of the previous year in which loss is set off and on the last day of the previous year in which the loss was incurred), the shares of the company carrying not less than 51% of the voting power were beneficially held by the same persons.

- Where a change in voting power of more than 49% of the shareholding of a closely held company has taken place between two relevant dates (viz. the last day of the previous year in which set off is claimed and the last date of the previous year in which the loss is incurred) the assessee will not be entitled to claim set off of such losses. This provision shall not apply to a change in the voting power consequent upon:
  - the death of a shareholder; or
  - on account of transfer of shares by way of gifts to any relative of the shareholder making such gift.

- Further, section 79 shall not apply to any change in the shareholding of an Indian company, which is subsidiary of a foreign company arising as a result of amalgamating or demerged foreign company continue to remain the shareholders of the amalgamated or the resulting foreign company.

2.5 Assessment of Companies

The principal officer of the company is required to file the return of total income of the company on or before 31st October of the assessment year. A company is assessed like any other assessee. However, its liability differs in two respects:

- **No exemption limit:** A company does not enjoy any exemption limit.
- **Flat rate of tax:** A company pays income tax at a flat rate instead of slab rate.

2.5.1 Rates of Income Tax

The rates of tax which will be applicable to companies for the assessment (E.g., year 2006-07) are as under:

<table>
<thead>
<tr>
<th>Description</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term capital gains on equity shares in a company or units of an equity oriented fund where the transaction is chargeable to securities transaction tax.</td>
<td>10%</td>
</tr>
<tr>
<td>Tax on long-term capital gains (Where the long-term capital gain is covered by section 115E, it is taxable at 10%)</td>
<td>20%</td>
</tr>
<tr>
<td>Tax on winnings from lotteries, crossword puzzles, races including horse races, etc.</td>
<td>30%</td>
</tr>
<tr>
<td>Tax on any other income, a) Domestic company, b) Foreign company</td>
<td>30%</td>
</tr>
<tr>
<td>i. For all income other than given under (ii) below</td>
<td>40%</td>
</tr>
<tr>
<td>ii. Royalty received from Govt. or an Indian concern in pursuance of an agreement made by it 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 by it after February 29, 1964 but before 1st April 1976 and where such agreement has in either case been approved by the Central Government</td>
<td>50%</td>
</tr>
</tbody>
</table>

**Table 2.1 Rates of income tax**
2.5.2 Surcharge

- The amount of income tax computed as above shall be increased by a surcharge of 10% in case of every domestic company and in the case of every company other than a domestic company at the rate of 2.5%.
- Education cess-Education cess @2% shall be levied on the total tax (including surcharge payable by the assessee).

2.6 Deemed Income

(Also known as Minimum Alternate Tax (MAT))
Provisions of MAT for payment of tax by certain companies [Section 115JB]
- Tax payable for any assessment year cannot be less than 7.5% of book profit: Where in the case of a company, the income tax payable on the total income as computed under the Income Tax Act in respect of the previous year e.g., 2000-2001 and thereafter, is less than 7.5% of its book profit, such book profit shall be deemed to be the total income of the assessee and the tax payable by the assessee on such total income (book-profit) shall be the amount of the income tax at the rate of 7.5%.

2.7 Allowing Tax Credit

Allowing tax credit in respect of tax paid on deemed income under MAT Provision against tax liability in subsequent years [Section 115JAA] (w.e.f. Assessment Year 2006-07). Other provisions of section 115JB [Section 115JB]
- Profit and loss of the company to be prepared as per provisions of the Companies Act. Every company shall for the purpose of this section, prepare its profit and loss account for the relevant previous year in accordance with the provisions of Parts II and III of Schedule VI to the Companies Act, 1956.
- Profit and loss account prepared for section 115JB (2) and annual accounts including profit and loss account prepared and placed before AGM should have same accounting policies, standards, etc. [Proviso to section 115JB(2)]. While preparing the annual accounts including profit and loss account:
  - the accounting policies of the company;
  - the accounting standards followed by the company for preparing such accounts including profit and loss account;
  - the method and rates adopted for calculating the depreciation by the company shall be the same as have been adopted for the purpose of preparing such accounts including profit and loss account as laid before the company at its annual general meeting in accordance with the provisions of section 210 of the Companies Act, 1956.
- Further, where the company has adopted or adopt s the financial year under the Companies Act, 1956, which is different from the previous year under the Income Tax Act, the above three (i.e., accounting policies, accounting standards and method of calculating depreciation) shall correspond to the accounting policies, accounting standards and the method and rates for calculating the depreciation which have been adopted for preparing such accounts including profit and loss account for such financial year or part of such financial year falling with the relevant previous year.
2.8 Computing Book Profits

[Explanation to 115JB (1) and (2)]

Step 1: The net profit as shown in the profit and loss account (prepared as per Part II and III of schedule VI) for the relevant previous year, shall be increased by the following, if debited to the Profit and Loss Account:

- The amount of income tax paid or payable and the provision therefore; or
- The amounts carried to any reserves by whatever name called other than a reserve specified under section 33AC; or
- The amount or amounts set aside to provisions made for meeting liabilities, other than ascertained liabilities; or
- The amount by way of provision for losses of subsidiary companies; or
- The amount or amounts of dividends paid or proposed; or
- The amount or amounts of expenditure relatable to any income to which section 10, (other than the provisions contained in clause 23G), 10A, 10B, 11 or 12 applies.

Step 2: The profit as per the Profit and Loss Account shall be reduced by the following:

- The amount withdrawn from any reserves or provisions, if any, such amount is credited to the profit and loss account: A clarificatory amendment has been made by the Finance Act, 2002, i.e., assessment year 2001-02 to section 115JB to provide that the amount withdrawn from the reserve or provision, created not out of profits before 1.4.1997, if credited to the profit and loss account, shall not be deducted while computing book profit. Similarly, the amount withdrawn from the reserve created on or after 1.4.1997 and credited to the profit and loss account shall not be deducted while computing book profit unless the book profit in the year of creation of such reserve was increased by such reserve at that time.
- The amount of income to which any of the provisions section 10 (other than the provisions exclaimed in clause 23G) 10A, 10B, 11 or 12 applies, if any such amount is credited to the profit and loss account; or
- The amount of loss brought forward or unabsorbed depreciation, whichever is less as per books of account. The loss shall, however, not include depreciation. Further the provision of this clause shall not apply if the amount of brought forward loss or unabsorbed depreciation is Nil; or
- The amount of profits of sick industrial company for the assessment year commencing from the assessment year relevant to the previous year in which the said company has become a sick industrial company under sub-section (1) of section 17 of the Sick Industrial Companies (Special Provisions) Act, 1985 and ending with the assessment year during which the entire net worth of such company becomes equal to or exceeds the accumulated losses.
- For the purposes of this clause, net worth shall have the meaning assigned to it in clause (ga) of sub section...
According to section 3(1)(ga) of the Sick Industrial Companies (Special Protection) Act, 1985 net worth means the sum total of the paid up capital and free reserves. “Free reserve” means all reserve credited out of the profits and share premium account but does not include reserves credited out of revaluation of assets, write back of depreciation provisions and amalgamations.

- The amount of profit derived from the activities of a tonnage tax company [Sec 115VO].

The amount computed after increasing or decreasing the above in Step 1 and Step 2, respectively is known as book-profit.

**Furnishing of report of an accountant [Section 115JB (4) and rule 40B]**

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

- It may, however, be noted that the company shall have to file such report even if it furnishes the return of income under section 139(4) instead of section 139(1) or in response to which notice section 142(1)(i).

**Unabsorbed depreciation or losses which can be carried forward [Section 115JB (3)]**

- Although, the assessee is liable to pay tax @ 7.5% (plus surcharge as applicable) of the book profits if its total income computed as per Income Tax Act is less but it is entitled to determine unabsorbed depreciation u/s 32(2), business loss u/s 72(1), speculation loss u/s 73 and capital loss u/s 74 and loss u/s 74A and shall be allowed to carry forward the same to the subsequent years for claiming set off as per the normal provisions of the Income Tax Act.

**Other provisions of the Act shall continue to apply to such companies [Section 115JB (5)]**

- Same as otherwise provided in section 115JB, all other provisions of the Income Tax Act shall apply to such companies. Hence, all other provisions relating to advance tax, interest chargeable in certain cases shall apply to such companies also.

**Tax credit in respect of tax paid on deemed income relating to certain companies [Sec 115JAA]**

Where any amount of tax is paid under section 115JB(i) by an assessee being a company for the A.Y. commencing on 1st April 2006 and any subsequent assessment year, then credit in respect of tax so paid shall be allowed to him as below:

- The tax credit to be allowed shall be the difference of the tax paid for any A.Y. and the amount of tax payable by the assessee on his total income computed as in income tax law. No interest shall be payable on the tax credit allowed.

- The amount of tax credit shall be carried and set off in a year when tax becomes payable on the total income computed in accordance with the provisions of this Act, but such carry forward shall not be allowed beyond the 5th year immediately succeeding the assessment year in which tax credit becomes allowable.

- Set off in respect of brought forward tax credit shall be allowed for any A.Y. to the extent of the difference between the tax on his total income and the tax which would have been payable under the provisions of sec. 115 JB(1).

- Whereas as a result of order under section 143, section 144, section 147, section 154, section 155, section 245 D (4), section 250, section 254, section 260, sec. 262, sec. 263 or section 264, the amount of tax payable under this Act is reduced or increased as the case may be. The amount of tax credit allowed under this section shall be increased or reduced accordingly.

**Tax on income from units of an open-ended equity oriented fund of the unit trust of India or of mutual funds (Section 115BBB)**
Where the total income of an assessed includes any income from units of an open-ended equity oriented fund of the Unit Trust of India or of a Mutual Fund, the income-tax payable shall be the aggregate of:

- The amount of income tax calculated on income from units of an open-ended equity oriented fund of the Unit Trust of India or of a Mutual Fund, at the rate of 10% and;
- The amount of income tax with which the assessed would have been chargeable had his total income been reduced by the amount of income referred to in clause (a).

Nothing contained in sub-section (1) shall apply in relation to any income from units of an open-ended equity oriented fund of the Unit Trust of India or of the Mutual Fund arising after the 31st day of March 2003.

Tax on the income received from venture capital companies/venture capital funds [Section 115U and Rule 12C]

- Notwithstanding anything contained in any other provisions of this Act, any income received by a person out of investments made in a venture capital company or venture capital fund shall be chargeable to income tax in the same manner as if it were the income received by such person had he made investments directly in the venture capital undertaking.
- The person responsible for making payment of the income on behalf of a venture capital company or a venture capital fund and the venture capital company or venture capital fund shall furnish, by 30th November of the Financial Year following the previous year during which such income is distributed, to the person receiving such income and to the jurisdictional Chief Commissioner/Commissioner, a statement in Form No. 64 and duly verified by an accountant in the manner indicated therein, giving details of the nature of income paid during the previous year and such other relevant details as may be prescribed.
- The income paid by the venture capital company and the venture capital fund shall be deemed to be of the same nature and in the same proportion in the hands of the person receiving such income as it had been received by or had accrued to, the venture capital company or the venture capital fund, as the case may be, during the previous year.

‘Venture Capital Company’ means such company:

- which has been granted a certificate of registration under the Securities and Exchange Board of India Act, 1992 and regulations made hereunder;
- which fulfils conditions as may be specified, with the approval of the Central Government, by the Securities and Exchange Board of India, by notification in the Official Gazette, in this behalf;

‘Venture Capital Fund’ means such fund:

- operating under a trust deed registered under the provisions of the Registration Act, 1908;
- which has been granted a certificate of registration under the Securities and Exchange Board of India Act, 1992 and regulations made hereunder;
- which fulfils the conditions as may be specified, with the approval of the Central Government, by the Securities and Exchange Board of India, by notification in the Official Gazette, in this behalf.

‘Venture Capital Undertaking’ means a domestic company:

- whose shares are not listed in a recognised stock exchange in India;
- which is engaged in the business for providing services, production or manufacture of an article or thing but does not include such activities or sectors which are specified, with the approval of the Central Government, by the Securities and Exchange Board of India, by notification in the Official Gazette.

2.9 Tax Planning and Tax Evasion

- Tax planning is an essential part of your financial planning. Efficient tax planning enables you to reduce your tax liability to the minimum. This is done by legitimately taking advantage of all tax exemptions, deductions, rebates and allowances while ensuring that your investments are in line with your long term goals.
The Indian Income Tax law is a highly complicated piece of legislation. Hence knowledge about its key features is useful for business managers and others because under the law, a taxpayer is legitimately entitled to plan his taxes in such a manner that his tax liability is minimal and net income from the business and other sources is maximum.

Tax planning thus can be defined as an arrangement of the financial affairs within the scope of law in a manner that derives maximum benefit of the exemptions, deductions, rebates and relief and reduces tax liability to the minimal.

As long as one is within the framework of law, one can plan financial affairs in such manner which keeps tax liability at its minimum. However, in the name of tax planning, one should not indulge in tax evasion and the line between tax planning and tax avoidance is very thin, so one needs to tread carefully. Tax evasion is sheer non-payment of tax even when it is due to be paid in the circumstances of the case. It should be remembered that while tax planning is perfectly legal, Tax Evasion is illegal and can result into penalties and prosecution for the perpetrator.

When financial transactions are arranged in a way that it becomes obvious that they were entered with a malaise intention of either not paying taxes or with a view to defeat the genuine spirit of law, they cannot be accepted as legitimate tax planning.

Twisting of facts or taking a very strict and literal interpretation of law without understanding the basic purpose of the law can only lead to punishable offence.

### 2.10 Tax Avoidance and Not Tax Planning

Tax avoidance is minimising the incidence of tax by adjusting the affairs in such a manner that although within the four corners of the taxation laws, advantage is taken by finding out loopholes in the laws. The evil consequences of tax avoidance are manifold and can be summarised as follows:

- Substantial loss of much needed public revenue, particularly a welfare state like ours.
- Serious disturbance caused to the economy of the country by piling up of black money directly causing inflation.
- Large hidden loss to the community by some of the best brains in the country being involved in the perpetual war waged between tax avoider and his expert team of advisers, lawyers and accountants on one side and the Tax adviser and his perhaps not so skilful advisers on the other side.
- Sense of injustice and inequality which tax avoidance arouses in the breasts of those who are unwilling or unable to profit by it.
- Ethics (or lack of it) of transferring the burden of tax liability to the shoulders of guideless, good citizens from those of artful dodgers.

### 2.11 Tax Management

- Tax management refers to the compliance with the statutory provisions of law. While tax planning is optional, tax management is mandatory. It includes maintenance of accounts, filing of return, payment of taxes, deduction of tax at source, timely payment of advance tax, etc.
- Poor tax management may lead to levy of interest, penalty, prosecution, etc. In some cases it may lead to heavy financial loss if proper compliance is not made, e.g., if a loss return is not filed in time it will result in a financial loss which will not be allowed to be carried forward.
Tax planning is an act within the permissible range of the Act conducted to achieve social and economic benefits.

Tax planning is a legal right which enables the tax payer to achieve social and economic objectives.

Tax planning accelerates the development of the economy of a country by generating funds for investment in the desired sector.

Tax planning promotes professionalism and strengthens economic and political situation of the country.

Tax evasion is an attempt to avoid tax by misrepresentation of facts and falsification of accounts.

Tax evasion is a legal offence which may lead to penalty and prosecution.

Tax evasion retards the development of economy of a country by generating black money which works as a parallel economy.

Tax evasion encourages bribery and weakens economic and political situation of the country.

### Table 2.2 Difference between tax planning and tax evasion

<table>
<thead>
<tr>
<th>Tax Avoidance</th>
<th>Tax Evasion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax avoidance means planning for minimisation of tax according to legal requirements but it defeats the basic intention of the legislature.</td>
<td>Tax evasion means avoiding of tax liability illegally.</td>
</tr>
<tr>
<td>Tax avoidance takes into account various lacunae of law.</td>
<td>Tax evasion involves use of unfair means.</td>
</tr>
<tr>
<td>Tax avoidance is lawful but involves the elements of malafide intentions.</td>
<td>Tax evasion is unlawful.</td>
</tr>
<tr>
<td>Tax avoidance is planning before the actual liability before tax comes in to existence.</td>
<td>Tax evasion involves avoidance of payment of tax after the liability of tax has arisen.</td>
</tr>
</tbody>
</table>

### Table 2.3 Differences between tax avoidance and tax evasion

<table>
<thead>
<tr>
<th>Tax Planning</th>
<th>Tax management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax planning is a wider term and includes tax management</td>
<td>Tax management is a narrower term and is first term towards tax planning</td>
</tr>
<tr>
<td>Tax planning emphasises on minimisation of tax burden</td>
<td>Tax management emphasises the compliance of legal formalities for minimisation of tax</td>
</tr>
<tr>
<td>Every person may not require tax planning</td>
<td>Tax management is essential for every person</td>
</tr>
<tr>
<td>Tax planning helps in decision making</td>
<td>Tax management helps in complying with the conditions for effective decision making</td>
</tr>
</tbody>
</table>

### Table 2.4 Differences between tax planning and tax management
2.12 Objectives of Tax Planning

The prime objectives of tax planning may be summarised as follows:

- **Reduction of tax liability**: By proper tax planning, a tax payer can oblige the administrators of the taxation laws to keep their hands off from his earnings.

- **Minimisation of tax liability**: Proper tax planning in conformity with the provisions of the taxation laws, the chances of unscrupulous litigations are certainly minimised and the tax payer is saved from the hardships and inconveniences caused by the unnecessary litigations.

- **Productive investment**: Taxation laws offer large avenues for the productive investment of earnings, granting absolute or substantial relief from taxation. A taxpayer has to be constantly aware of such legal avenues as are designed to open the floodgates of his well-being, prosperity and happiness.

- **Healthy growth of economy**: A savings of earnings by legally sanctioned devices is the prime factor for the healthy growth of the economy of a nation and its people. An income saved and wealth accumulated in violation of law are the scourge on the economy and the people. Generation of black money darkens the horizons of the national economy and leads the nation to avoidable economic destruction.

- **Economic stability**: Under tax planning, taxes legally due are paid without any headache either to the tax payer or to the tax collector. Avenues of productive investments are largely availed of by the tax payers. Productive investments increase contours of the national economy embracing in it the economic prosperity of not only the taxpayers but also of those who earn the income not chargeable to tax. The planning thereby creates economic stability of the nation and its people by even distribution of economic resources.

2.13 Types of Tax Planning

Tax planning can be broadly divided into two parts:

- **Short-term tax planning**: It planning is normally for a period of up to a year and it is done from year to year to achieve some particular objective.

- **Long-term tax planning**: This will be for a longer period and it may not pay off immediately.

2.13.1 Factors Affecting Tax Planning

The following factors are essential for effective tax planning:

- **Residential status and citizenship of the assessee**: We know that a non-resident in India is not liable to pay income-tax on incomes which accrue or arise and are also received outside India, whereas a resident in India is liable to pay income-tax on such incomes. Therefore, every assessee would like to be a non-resident in India, if he has any income which accrues or arises outside India.

- **Heads of income/assets to be included in computing net wealth**: Before the tax-planner goes in for his task; he has to have a full picture of the sources of Income of the tax payer and the members of his family. Though total income includes all income from whatever source derived, the scope of tax planning is not similar in respect of all sources of income. The assessee can avail the benefits of exemption and deductions under each head of income. Further he can avail the benefit of rebate and relief under the Act.

- **Latest legal position**: It is the foremost duty of a tax - planner to keep him fully conversant with the latest position of the taxation laws along with the allied laws and also the judicial pronouncements in respect thereof. For this purpose he must have a thorough and up-to-date understanding of the Annual Finance Acts, the Taxation Laws Amendments, the amendments, if any, of the allied laws, the latest judicial pronouncements of the High Courts and the Supreme Court, various Circulars of the Central Board of Direct Taxes which seek to clarify the legal position in so far as the Revenue is concerned.

- **Form vs. substance**: A tax planner has to bear in mind the following principles enunciated by the courts on the question whether form or substance of a transaction should prevail in Income-tax matters.
  - **Form of transaction**: When a transaction is arranged in one form known to law, it will attract tax liability while, if it is entered into another form which is equally lawful, it may not.
  - **Genuineness of transaction**: In deciding whether the transaction is a genuine or colourable one because in such a situation, it is not the question of form and substance but of appearance and truth. It will be open to the
authorities to pierce the corporate veil and look behind the legal façade, at the reality of the transaction.

- **Expenditure:** In the case of expenditure, the mere fact that the payment is made under an agreement does not preclude the department from enquiring into the actual nature of the payment.

### 2.13.2 Areas of Tax Planning

Important areas where planning may be attempted are:

- Tax planning with reference to form of organisation
- Tax planning with reference to location of a business
- Tax planning with reference to nature of business
- Tax planning with reference to financial management decisions
- Tax planning with reference to managerial decisions
- Tax planning in respect of amalgamation, merger or demerger of companies
- Tax planning in respect of employees’ remuneration-
- Tax planning in respect of non-residents
Summary

- In most countries with income taxation, corporate entities are subject to tax on their profits and, in addition, dividends are taxed in the hands of shareholders (subject to exemption up to a point). The base of the corporate income tax, however, is commonly the accounting profits derived with reference to historical costs.
- The Companies Act, 1956, states that 'company' includes company formed and registered under the Act or an existing company i.e., a company formed or registered under any of the previous company laws. However, company is not a citizen so as to claim fundamental rights granted to citizens.
- Company is separate legal entity distinct from its shareholders. The major constituents of a company are its members, who are the ultimate owners and its directors.
- The tax levied on a company’s income is based on its legal residence. Companies of Indian origin are levied tax in India, while International companies are levied tax on earnings from their Indian operations. For International companies’ royalty, interest, gains from sale of capital assets within India, dividends from Indian companies and fees for technical services are all treated as income arising in India.
- A domestic company means an Indian company or any other company which in respect of its income, liable to tax under the Income Tax Act, has made the prescribed arrangements for the declaration and payment within India, of the dividends (including dividends on preference shares) payable out of such income.
- Foreign company means a company which is not a domestic company. Investment company means a company whose gross total income consists mainly of income which is chargeable under the heads Income from house property, capital gains and income from other sources.

References

- Corporate tax reform. Available at: <finmin.nic.in/kelkar/chp5dt.pdf> [Accessed 15th March 2011].
- Dr. Singhania, V.K., Dr. Singhania, K., 2005. Direct Taxes Planning and Management, 9th edition, Taxman’s.

Recommended Reading

1. In most countries with income taxation, corporate entities are subject to tax on their profits and, in addition, _________ are taxed in the hands of shareholders.
   a. surcharges
   b. dividends
   c. shares
   d. assets

2. The base of the corporate income tax is commonly the accounting profits derived with reference to __________.
   a. historical costs
   b. records
   c. registers
   d. databases

3. Company is not a citizen so as to claim __________ granted to citizens.
   a. profits
   b. shares
   c. fundamental rights
   d. asset

4. What is the tax levied on a company’s income based?
   a. Company name
   b. Company profile
   c. Industry type
   d. Legal residence

5. Which of the following is true?
   a. International companies are levied tax on earnings from their Indian operations.
   b. Indian companies are levied tax on earnings from their Indian operations.
   c. International companies gain profits on earnings from their Indian operations.
   d. International companies are levied tax on earnings from their foreign operations.

6. A company is deemed to be a __________ company if it is not a private company as defined by the Companies Act, 1956.
   a. corporate
   b. non-profit
   c. public limited
   d. non-government

7. __________ of the company is required to file the return of total income of the company on or before 31st October of the assessment year.
   a. Director
   b. Principal officer
   c. Chairman
   d. Employee
8. ___________ means all reserve credited out of the profits and share premium account but does not include reserves credited out of revaluation of assets.
   a. Free reserve
   b. Credit reserve
   c. Premium reserve
   d. Asset reserve

9. ___________ means a domestic company where the company’s shares are not listed in a recognised stock exchange in India.
   a. Private company
   b. Non profit organisation
   c. Venture Capital Undertaking
   d. Firm

10. ___________ means a company whose gross total income consists mainly of income which is chargeable under the heads Income.
    a. Domestic company
    b. Investment company
    c. Foreign company
    d. Venture capital company
Chapter III
Form of Organisation and Location of a Business

Aim
The aim of this chapter is to:

- analyse sole proprietorship
- determine salient features of assessment of firm
- highlight laws for tax planning with reference to business location

Objectives
The objectives of this chapter are to:

- examine rules for assessment of sole proprietorship
- understand computation and assessment of Hindu Undivided Family
- familiarise students with essential conditions and assessment of a firm

Learning outcome
At the end of this chapter, the students will be able to:

- state merits and demerits of partnerships
- discuss advantages and disadvantages of company form organisation
- explain special provisions for businesses based on its location
3.1 Introduction

The form of ownership is an important tool of tax planning. There are different forms of organisations having different tax incidences at a given level of operation. The form of ownership may be sole proprietorship, partnership, company, co-operative society, etc. It is the form of ownership which determines the sharing of profits, responsibilities of the activities of third parties, etc.

There are different tax treatments under different forms of ownership. Individuals and HUFs are assessed at a slab system while a company is assessed at a flat rate with no exemption limit. Taxation of a firm does not have a particular shape as part of the income attributable to interest and salary to partner may be taxed at normal rates relating to such partner and the remaining part is taxed at a flat rate as for companies. These forms of ownership are also allowed different tax concessions and rebates under tax laws. Therefore tax implications on the project under different forms of ownership at a certain level of profit are to be analysed and a form of ownership suitable to those circumstances is selected.

3.2 Sole Proprietorship

It is a business owned by one person. The individual is entitled to all Profits and Losses and is liable for all obligations of the business. Proprietorship represents the largest number of businesses and is normally the first form of setting up a business.

<table>
<thead>
<tr>
<th>Demerits of Sole Proprietorship</th>
<th>Merits of Sole Proprietorship form of Organisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The liability of the proprietor is unlimited and can extend even to his personal assets.</td>
<td>A sole proprietorship is easy to establish because of the little interference of government regulations.</td>
</tr>
<tr>
<td>When the proprietor incurs losses and the business assets are not sufficient enough to meet the liabilities of business, his personal assets can be used for discharging the business liabilities</td>
<td>The cost of adopting this form of organisation is small because there being no legal requirement</td>
</tr>
<tr>
<td>The proprietor does not get deduction on account of remuneration payable to him attributable to the rendering of services and interest on account of capital contributed by him</td>
<td>All the profits of the business go to the proprietor himself</td>
</tr>
<tr>
<td>Another main drawback of this form of ownership is that it does not provide opportunities to finance the expanding business activities.</td>
<td>In case of a person carrying on on small scale and having small income from other sources, this form of organisation would be suitable because the proprietor can avail of the ceiling of exempt income as given below.</td>
</tr>
<tr>
<td>In case of a business growing at a higher speed and yielding higher profits, the sole proprietor organisation may not be beneficial. As salary paid to the proprietor and interest paid on capital are not allowable, the profits are higher and the tax incidence goes higher.</td>
<td></td>
</tr>
</tbody>
</table>

Table 3.1 Merits and demerits of sole proprietorship
3.2.1 Assessment of Sole Proprietorship/Individual

- For income-tax purposes, the sole proprietor is considered as an individual. An individual means a natural person i.e., human being. Individual includes a male, female, minor child and a lunatic or an idiot.
- In the case of male/ female who are a major, income-tax will be levied on his/her total Taxable Income separately, unless the income is to be clubbed under provisions of sections 60 – 64.
- As regards a minor child, the income of a minor after giving exemption up to Rs. 1500/- per minor child, will be clubbed with the income of that parent whose Total Income, before clubbing such income, is greater.
- However, there are certain incomes which are not to be clubbed. Such income of the minor, which is not to be clubbed, will be assessable in the hands of the representative assessee on behalf of the minor.
- Income of a lunatic or an idiot will be assessed in the hands of the representative assessee.

An individual is liable to pay tax in respect of the following incomes:

- Income earned by an individual himself: i.e., incomes earned by an individual in his individual capacity.
- Income earned as a partner of a firm assessed as a firm: The following types of incomes can be earned by an individual as partner of a firm:
  - Share of profit of the firm: The share of profit from a partnership firm assessed as such, is exempt from tax at the time of individual assessment of the partner; [Section 10(2A)]
  - The remuneration by way of salary, bonus, commission, etc. received by a partner, is taxable as business income in the hands of a partner [Section 28(v)];
  - Interest on capital/loans to a firm, in which he is a partner, is also assessed as income from business.
- As a member of an association of persons, etc.: Where an individual is member of an association of persons or body of individuals, his share of income from such AOP/BOI shall be taxed as under:
  - Where the income of AOP or BOI is chargeable at maximum marginal rate: share of income of a member from such AOP or BOI will not be included in his taxable income at all.
  - Where the income of AOP or BOI is taxed at normal rates i.e., the rates applicable to an individual: Share of income of a member from such AOP or BOI will be included in the taxable income of the individual only for rate purposes and a relief under section 86 shall be allowed.
  - Where no income tax is chargeable on the income of the AOP or BOI: Share of income of a member from such AOP / BOI will be chargeable to tax as part of his Total Income.
- Share of Income from HUF: A HUF is a separate assessee. Therefore, any share of income received by a member from such HUF will be exempt in the hands of the individual and will not be included in his Total Income [Section 10(2)].
- Income from impartible estate of HUF: Any income from an impartible estate of Hindu Undivided Family is taxable in the hands of the Karta.
- Income of the other person included in the income of the individual (Sections 60 to 65): As already discussed under the chapter on ‘clubbing of income’, the income of other persons will also be included in the individual’s total income under respective heads of income.
Step 1: Compute the income of an individual under 5 heads of income on the basis of his residential status.

Step 2: Income of any other person, if includible u/secs. 60 to 64, will be included under respective heads.

Step 3: Set off of the losses if permissible, while aggregating the income under 5 heads of income.

Step 4: Carry forward and set off the losses of past years, if permissible, from such income.

Step 5: The income computed under Steps 1 to 4 is known as Gross Total Income. However, no deduction under these sections will be allowed from long-term capital gain / winning of lotteries, etc., though these incomes are part of gross total income.

Step 6: The balance income after allowing the deductions is known as Total Income which will be rounded off to the nearest Rs. 10

Step 7: Compute tax on such total income at the prescribed rates of tax.

Step 8: Allow rebate of income tax u/secs. from the tax computed in step 7.

Step 9: The balance tax shall be increased by a surcharge of 10% on such tax.

Step 10: Allow relief under section 89(1), if any, and the balance tax shall be rounded off to nearest Re. 1.

Step 11: Deduct the TDS and advance tax paid for the relevant assessment year. The balance is the net tax payable, which must be paid as self-assessment tax before submitting the return of income.

Fig. 3.1 Computation of total income and tax liability

3.3 Hindu Undivided Family

- Under section 4 of the Income Tax Act, income-tax is payable by ‘every person’. ‘Person’ as defined in section 2(31) includes a Hindu Undivided Family. The expression ‘Hindu Undivided Family’ finds reference in the
provisions of the 1961 Act, but that expression is not defined in the Act. The reason of the omission evidently is that the expression has a well-known connotation under the Hindu law and being aware of it, the legislature did not want to define the expression separately in the Act.

- Therefore, the expression ‘Hindu Undivided Family’ must be construed in the sense in which it is understood under the Hindu law. A Hindu Undivided Family or a joint Hindu Family both terms speak of the same entity. It consists of all males lineally descended from a common ancestor, their wives and unmarried daughters and daughters-in-law. A daughter is a member of the family till her marriage and on being married; she ceases to be a member of the HUF in which she was born only to become a member of the HUF of her husband on her marriage.

### 3.3.1 Assessment of Hindu Undivided Family

- HUF is a separate and distinct tax entity. The income of a HUF can be assessed in the hands of the HUF alone and not in the hands of any of its members, unless specifically provided by law.
- However, any sum received by an individual as a member of a HUF, where such sum has been paid out of the family or income of the impartible estate belonging to the family shall be exempt in the hands of the member of the HUF as per Section 10(2).
- The liability of income tax in case of HUF also depends upon its residential status in India. As already discussed, HUF can be (a) resident and ordinarily resident in India; (b) Resident but not ordinarily a resident of India; or (c) Non-resident in India.
- The scope of total income i.e., which incomes will be taxable in the case of Residents and which incomes will be taxable in the case of Non-residents, etc. has already been discussed.

### 3.3.2 Steps for Computation of Income Tax of HUF

- Step 1: The Gross Total Income of HUF, like any other person, shall be computed under four heads of income, on the basis of their residential status. There can be no income under the head income from salaries in the case of HUF.
- Step 2: Sections 60 to 63 relating to income of other person included in the assessee’s total income are applicable in case of HUF but section 64 is not applicable to HUF as it is applicable only in case of individual assessee.
- Step 3: Set off of losses is permissible while aggregating the income under different heads of income.
- Step 4: Carry forward and set off of losses of past years, if permissible, is allowed.
- Step 5: The income computed in steps 1 to 4 is known as gross total income from which the following deductions u/s 80C to 80 U will be allowed
- Step 6: The balance income after allowing the deductions is known as Total Income which will be rounded off to the nearest Rs. 10/-.
- Step 7: Compute the tax on such total income at the prescribed rates of tax.
- Step 8: Allow rebate u/s 88 and 88E.
- Step 9: The balance is the total tax payable which will be increased by a surcharge at 10% on such income tax and it will be rounded off to nearest Re. 1.
- Step 10: Education cess @2% on the tax plus surcharge if any shall be allowed.
- Step 11: Deduct the TDS and advance tax paid for the relevant assessment year. The balance is the net tax payable which must be paid as self-assessment tax before submitting the return of income. In computing the income under the head Capital gains, the HUFI is also entitled to the certain exemptions under section 54.

### 3.4 Partnership Form of Organisation

A partnership is like a proprietorship in many ways except that it has two or more co-owners. The partners share the profits and losses according to a sharing pattern already agreed. A partnership must be dissolved if the ownership changes, as when a partner leaves or dies. If the business is to continue as partnership, a new partnership must be formed. Both, Sole
Proprietorship and partnership are convenient ways of separating the business owner’s commercial activities from their personal activities. But legally, there is no economic separation between the owners and the businesses. In India, partnership is restricted to 10 partners in case of business in Banking and to 20 persons in other cases.

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Merits of Partnership</th>
<th>Demerits of Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>A partnership form of organisation is also easy to establish in as much a partnership deed has to be drawn up and a nominal charge in terms of cost of stamps for the deed is to be incurred.</td>
<td>Every decision relating to important business decision with the consultation of other partners restricts the risk taking abilities which may lead to higher profits.</td>
</tr>
<tr>
<td>2</td>
<td>The decision is quick and fast as compared to the corporate form since the partners meet frequently.</td>
<td>In case of small or medium scale of operations, financing is possible but when business expands to a large scale, it will not be suitable to adopt this form of organisation.</td>
</tr>
<tr>
<td>3</td>
<td>The chances of getting involved in risky activities are very low because every important decision is made with the concurrence of all the partners.</td>
<td>One of the drawbacks is that one partner becomes liable for the acts of the other. Therefore; a partner is liable for the wrongs of another partner if it is done within the legal limits.</td>
</tr>
<tr>
<td>4</td>
<td>Raising additional finance is easy as compared to sole proprietorship, where the business expands and it is necessary to raise finance, it will be easy to raise it by admitting a new partner or raising it by way of borrowings because of the number of partners and their joint and several liabilities to pay the debts of the firm, the lenders will be more interested in lending.</td>
<td>Where the partnership firm does not comply with the requirements of section 184 of the Income Tax Act, although the firm will be assessed as a firm, it shall not be allowed any deduction on account of interest and remuneration to its partners.</td>
</tr>
<tr>
<td>5</td>
<td>The firm can pay interest on capital and loan to partners at the maximum rate of 12% pa. Further it can also give remuneration to its working partners subject to the limits mentioned in section 40(b).</td>
<td>A partnership firm may come to sudden closure of business on account of death, lunacy or insolvency. Also dissolution will attract section 45(4) which imposes tax liability in respect of capital gains arising on transfer of capital assets from the firms to partners.</td>
</tr>
</tbody>
</table>
This form of organisation is suitable from the income-tax point of view in cases where the amount of profit is not large and the partners of the firm do not have any other additional income except by way of remuneration and interest from the partnership firm. In such a case the profit of the firm shall be lower and the individual partners can also avail of the maximum ceiling of income exempt under the Income Tax Act.

The share in the profit of a partnership firm is exempt from tax U/s 10(2a) of the Income Tax Act.

The risk as to losses and liability is divided amongst the partners.

In case of change of business, this form of business does not require tedious procedure; it can be changed easily with the consent of the partners.

### Table 3.2 Merits and demerits of partnership

<table>
<thead>
<tr>
<th>No.</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.5</td>
<td>Position of Firm Under the Income Tax Act</td>
</tr>
</tbody>
</table>

Legally, a partnership firm does not have a separate entity from that of the partners constituting the firm as the partners are the owners of the firm. However, a firm is treated as a separate tax entity under the Income Tax Act.

Salient features of the assessment of a firm are as under:
- A firm is treated as a separate tax entity.
- While computing the income of the firm under the head ‘Profits and gains of business or profession’, besides the deductions which are allowed u/s s 30 to 37, special deduction is allowed to the firm on account of remuneration to working partners and interest paid to the partners. However, it is subject to certain limits laid down u/s 40 (b).
- Share of profit which a partner receives from the firm (after deduction of remuneration and interest allowable) shall be fully exempt in the hands of the partner. However, only that part of the interest and remuneration which was allowed as a deduction to the firm shall be taxable in the hands of the partners in their individual assessment under the head ‘profits and gains of business or profession.’
- The firm will be taxed at a flat rate of 30% plus 10% surcharge as applicable after allowing deduction for interest on capital and loan of the partners and remuneration to working partners.
- The firm will be assessed as a firm provided conditions mentioned under section 184 are satisfied. In case these conditions are not satisfied in a particular assessment year, the firm will be assessed, for that assessment year, as an Association of Persons (AOP).

#### 3.5.1 Assessment of Firm

From point (5) stated above, it can be concluded that for taxation purposes, a firm can be of two types:
- Firm assessed as firm (provided conditions mentioned u/s 184 are satisfied).
- Firm assessed as Association of Persons if the prescribed conditions are not satisfied.

**Essential conditions to be satisfied by a firm to be assessed as firm (Section 184)**
- In the first assessment year: The firm will be assessed as a firm, also known as ‘Firm Assessed As Such’ (FAAS) if the following conditions are satisfied:
  - Partnership is evidenced by an instrument i.e., there is a written document giving the terms of
partnership.

- The individual share of the partners is specified in that instrument.
- Certified copy of partnership deed must be filed: A certified copy of the said instrument of partnership shall accompany the return of income in respect of the assessment year for which the assessment as a firm is first sought.
- Where certified copy is not filed with the return, there is no provision for condonation of delay. However where the return itself is filed late then there is no problem if the certified copy is filed along with such return as the condition that it shall accompany the return of income is satisfied.

- In the subsequent assessment years: If the above 3 conditions are satisfied, the firm will be assessed as such (FAAS) in the first assessment year. Once the firm is assessed as firm for any assessment year, it shall be assessed in the same capacity for every subsequent year if there is no change in the constitution of the firm or the share of the partners. Where any such change had taken place in the previous year, the firm shall furnish a certified copy of the revised instrument of partnership along with the return of income for the assessment year relevant to such previous year.

3.5.2 Computation of Total Income of the Firm

- Total income of the partnership firm will be determined as a separate entity and it will be computed under various heads of income. However, while computing taxable profits under the head ‘profits and gains of business or profession’, a deduction is allowable to the firm on account of interest and remuneration payable to the partners. Deduction of interest to a partner is allowable u/s 36 and remuneration to a working partner (Working partner: As per Explanation 4 to section 40(b) “working partner” means an individual who is actively engaged in conducting the affairs of the business or profession of the firm of which he is a partner.) will be allowed u/s 37.

- Section 40 (b) deals with the amounts, which are not deductible in case of a firm assessable as such. Therefore, deductions on account of interest and remuneration to the partners can be claimed under sections 36 or 37, as the case may be, but these will be subject to the conditions prescribed by section 40(b), which are as under:
  - Payment of salary, bonus, commission or remuneration by whatever name called, to a non-working partner shall not be allowed as deduction.
  - Payment of remuneration to working partners and interest to any partner will be allowed as deduction only when it is authorised by and is in accordance with partnership deed.
  - Payment of remuneration / interest, although authorised by the partnership deed but which relates to a period prior to the date of such partnership deed, shall not be allowed.
  - Interest payable to a partner, although authorised by the partnership deed shall be allowable as a deduction subject to a maximum of 12% simple interest per annum. If the partnership deed provides for interest at less than 12% p.a., the deduction of interest shall be allowed to the extent provided by the partnership deed.
  - The payment of remuneration to working partner, although relates to a period after the date of the partnership deed and authorised by the partnership deed, shall be allowed as a deduction only to the extent of the limits as per the law.

3.5.3 Computation of Book Profit [Explanation 3 to section 40 (b)]

Book Profit, will be computed as under:

- Step 1: Compute the income of the firm under the head ‘profit and gains of business or profession’ as per sections 28 to 44D i.e., start with the net profit as per profit and loss account and make additions and deductions as per sections 28 to 44D already explained under the chapter Business or Profession. Interest paid / payable to partners in excess of 12% shall also be disallowed as per section 40(b).
- Step 2: Add aggregate amount of remuneration paid / payable to all the partners (whether working or non-working) of the firm, if it has been debited to profit and loss account. The aggregate of Step 1 and Step 2 is Book Profit.
- For purpose of book profit, only income under the head Business or Profession is to be computed. Therefore, if there is income chargeable to tax under the heads “Income from House Property”, ‘Capital gains’ and “Income
from other sources”, credited to profit and loss account that will be deducted from the net profit to compute book profit. Similarly expenses on such incomes which are taxable under other heads will be added back if they are debited to profit and loss account.

- Brought forward business loss will not be deducted for computation of book profit but unabsorbed depreciation brought forward from earlier years will be deducted as unabsorbed depreciation is allowable as deduction under section 32(2). However, for allowing unabsorbed depreciation, brought forward business loss shall have to be notionally allowed first from the current business income.
- Computation of Book Profit when there is unabsorbed depreciation and brought forward business loss. and the carry forward and set off of losses in case of change in constitution of firm [Section 78] are computed separately.

3.5.4 Computation of Total Income of Firm

- Step 1: Compute the income of the firm under different heads of income viz., ‘Income from house property’; ‘Profits and gains of business or profession’; ‘Capital gains’ and ‘Income from other sources’. However, while computing business income, remuneration and interest paid to the partners will be allowed subject to Section 40(b) already discussed.
- Step 2: Apply section 60 and 61 relating to clubbing of income, if applicable.
- Step 3: Make adjustment on account of brought forward loss, unabsorbed depreciation, etc. if any.
- Step 4: From Gross Total Income, allow the deductions allowable to a firm under Chapter VIA which are specified in the act.
- Step 5: Gross Total Income as calculated under Step 3 minus deductions under Step 4 shall be the total Income of the Firm and the same is taxable as per the act.

Treatment of share of profit, interest and remuneration received by a partner from a firm:

- Share of profit in the hands of the partner shall be fully exempt under section 10 (2A).
- Interest received / receivable by a partner shall be included in the Total Income of the partner under the head ‘Profits and gains of business or profession’ to the extent deduction of interest was allowed to the firm as per section 40 (b), which cannot exceed 12%.
- Remuneration to a working partner shall also be included in the Total Income of the partner under the head ‘profits and gains of business or profession’ to the extent deduction of remuneration was allowed to the firm as per section 40(b). For example, if the partner was paid a remuneration of Rs. 60,000 by the firm, but as per section 40(b) deduction was allowed to the firm on account of such remuneration to the extent of Rs. 50,000. Only Rs. 50,000 will be included in the total Income of the partner. Balance Rs. 10,000 may be treated as share of profit which is exempt.

3.6 A Corporate Form

- A corporate form, on the other hand, is a business unit that is legally separable from its owners (the shareholders). The shareholders, whose ownership is represented by shares/stock, do not directly control the company’s operations. Instead, they elect a Board of Directors to run the entity.
- In exchange for their limited involvement in the company’s actual operations, shareholders’ liability is limited to the amount paid on their shares. If they wish, shareholders can sell their shares without affecting corporate operations.
- The Board of Directors sets company policies and chooses corporate officers who in turn carry out the corporate policies by managing the business. Besides being responsible for running the business, management has the duty of reporting the financial results to the Board of Directors and the shareholders.
The company form is a good medium of investment before the modern lending financial institutions. The investment can take the form of shares, debentures and loans.

The first drawback is the formation of the company which requires a long procedure to be adopted. In addition, a large amount on account of fees on share capital with which the company is being incorporated and many other expenses are to be incorporated.

Lack of profit motive mindset amongst the persons handling the affairs of the company is also one of the drawbacks.

Despite the strict legal requirements, the chances of defrauding the innocent public are quite real. In many cases, the management indulges in manipulating the figures of the results and invites public to invest therein.

Decisions on important business matters cannot be taken immediately. For this, the meeting of the Board of Directors is to be arranged which requires some time. Some of the decisions require approval by the shareholders which also requires further time.

Many a times, it is found that there may be clashes in the interests of two classes of shareholders or groups of shareholders.

### Table 3.3 Merits and demerits of company form of organisation

<table>
<thead>
<tr>
<th>Merits of the Company Form of Organisation</th>
<th>Demerits of the Company Form of Organisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The company form is a good medium of investment before the modern lending financial institutions. The investment can take the form of shares, debentures and loans.</td>
<td>The first drawback is the formation of the company which requires a long procedure to be adopted. In addition, a large amount on account of fees on share capital with which the company is being incorporated and many other expenses are to be incorporated.</td>
</tr>
<tr>
<td>This form of organisation has also gained society’s attention. Since the capital of these companies comprises a big amount divided into a large number of shares of small value, a person with limited resources also takes interest in investing in such shares.</td>
<td>Lack of profit motive mindset amongst the persons handling the affairs of the company is also one of the drawbacks.</td>
</tr>
<tr>
<td>The activities carried on by a corporate entity are generally on a large scale. This brings complexities in the day-to-day affairs and requires managerial professionals having special skills, techniques, etc. A company form therefore develops managerial professionals.</td>
<td>Despite the strict legal requirements, the chances of defrauding the innocent public are quite real. In many cases, the management indulges in manipulating the figures of the results and invites public to invest therein.</td>
</tr>
<tr>
<td>This form of organisation has also received social recognition because of the disclosure of some information. This social recognition helps in boosting the industrialisation of an economy.</td>
<td>Decisions on important business matters cannot be taken immediately. For this, the meeting of the Board of Directors is to be arranged which requires some time. Some of the decisions require approval by the shareholders which also requires further time.</td>
</tr>
<tr>
<td>The company is subject to income-tax at the flat rate of 30% + surcharge 210% + 2% education cess for the assessment year 2006-07.</td>
<td>Many a times, it is found that there may be clashes in the interests of two classes of shareholders or groups of shareholders.</td>
</tr>
</tbody>
</table>

### 3.7 Location of Business

Many factors affect the location of a new business. The impact of tax incentives needs to be considered while determining the viability of the project. These are given in the subsequent paragraphs. There are certain special provisions that are important. They are illustrated below:
3.7.1 Free Trade Zones

Special provisions in respect of newly established undertakings in Free Trade Zones [Section 10A]

- Profits of an industrial undertaking situated in a Free Trade Zone such as Kandla Free Trade Zone, Santa Cruz Electronics Export Processing Zone, Falta Export Processing Zone, Madras Export Processing Zone, Cochin Export Processing Zone, Noida Export Processing Zone or situated in an Electronic Hardware Technology Park or in a Software Technology Park are exempt.

- This exemption is available for a period of 10 consecutive years beginning from the year in which the unit begins to manufacture or produce such article or things or computer software. No deduction under this section is being allowed after financial year 2009-2010.

- Therefore, any unit set up after financial year 2000 – 2001 is eligible to claim exemption for less number of years i.e., units set up in 2001-2002 can claim this deduction for 9 years, units set up in 2002-2003 can claim this deduction for 8 years and so on. In case of existing units which are already claiming this exemption, deduction is being allowed only for the unexpired period of the aforesaid 10 years. This benefit is also being extended to units initially located in a Free Trade Zone or Export Processing Zone and subsequently located in a Special Economic Zone due to conversion of the FTZ / EPZ into a SEZ, such that the period of 10 years is to be reckoned from the year in which the unit was first set up in a FTZ/EPZ. The following are the main conditions for claiming this deduction:
  i) The undertaking has begun or begins to manufacture or produce articles or things or computer software on or after 1/4/1981 in any FTZ or on or after 1.4.94 in any Electronic Hardware Technology Park or Software Technology Park or on or after 1.4.2001 in any SEZ.
  ii) It is not formed by splitting or re-construction of an existing unit.
  iii) It is not formed by transfer of used plant and machinery.
  iv) The Asseesee will have to bring the sale proceeds into India in convertible foreign exchange within six months from the end of the financial year in order to avail of the exemption. This period of six months may be extended by the RBI on application made in this behalf. The deduction is being proportionately reduced in case the entire sales proceeds are not brought into India as mentioned above.

- The assesseep should furnish audit report in Form No. 56F along with the return of income. The audit report must certify that the deduction has been correctly claimed in accordance with the provision of Section 10A.

- **Amount of deduction:** If the aforesaid conditions are satisfied, the deduction u/s 10A may be computed as under:

\[
\text{Profits of the business of the undertaking} \times \frac{\text{Export Turnover}}{\text{Total turnover of the business carried on by the undertaking}}
\]

- For this purpose ‘export turnover’ means the consideration in respect of export by the undertaking of articles or
things or computer software received in (or brought into) India by the assessee in convertible foreign exchange within the prescribed period but not including the following: freight, telecommunication charges, insurance attributable to the delivery of the article or things or computer software outside India, expenses if any, incurred in foreign exchange in providing the technical services outside India.

- **Amount of deduction special provisions:** In case of undertakings which begin to manufacture or produce articles of things or computer software during the previous year relevant to the A.Y. 2003-04 [or any subsequent year] in any special economic zone, is available for first 10 A.Ys years as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Amount of Deduction Special Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>First 5 years</td>
<td>100% of profits and gains desired from the export of such articles or things or computer software for a period of 5 consecutive assessment years is deductible.</td>
</tr>
<tr>
<td>Next 2 years</td>
<td>50% of such profits and gains is deductible for further two assessment years.</td>
</tr>
<tr>
<td>Nest 3 years</td>
<td>50% of such profits and gain is deductible provided an equivalent amount debited to the P/L account of the previous year and credited to special economic zone Re-Investment Allowance Reserve A/c.</td>
</tr>
</tbody>
</table>

| Table 3.4 Amount of deductions (special provisions) |

### 3.7.2 Special Economic Zones

**Special provisions in respect of newly established units in Special Economic Zones - Section 10AA**

- Subject to the provisions of this section, in computing the total income of an assessee, being an entrepreneur as referred to in clause (v) of Section 2 of the Special Economic Zones Act, 2005 for this unit which begins to manufacture or produce articles or things or provide any service during the previous year relevant to any assessment year commencing on or after the 1st day of April 2006, a deduction of:
  - 100% profits and gains desired from the export of such articles or things or computer software for a period of five consecutive years from the year it begins to manufacture or produce such articles or things or provide services as the case may be and 50% of such profits and gains for further 5 years and thereafter
  - For the next 5 years, so much of the amount not exceeding of the profit as is debited to the P/L account of the previous year in respect of which deduction is to be allowed and credited to a reserve (to be called the “Special Economic Zone Re-Investment Reserve A/c) to be created and utilised for the purposes of the business of the assessee.

- The provision relating to utilisation of Reserve A/c is the same as provided in Section 10A.

- It should be noted that an undertaking which had already availed, before the commencement of Special Economic Zones Act, 2005, the deductions referred to in Section 10A for 10 consecutive years, such unit shall not be eligible for deduction under this section.

- Provided that wherein computing the total income of unit for any A.Y its profits and gains had not been included by application of subsection 7B of Sec 10A, the unit shall be entitled to deduction under this section for the unexpired period of ten consecutive Assessment Years and thereafter it shall be eligible for deduction from income after fulfilling the creation of Special Economic Zone Re-investment Reserve Account.

- Provided further that where a limit initially located in any Free Trade Zone or export processing zone is subsequently located in a Special Economic Zone by reason of conversion of such free trade zone or export processing zone into a Special Economic Zone, the period of 1- consecutive assessment year referred to above shall be reckoned from the A.Y. relevant to the previous year in which the unit began to manufacture or produce or process. Such articles or things or services in such free trade zone in export processing zone. Once that period of 10 consecutive years is completed, further deduction under this section shall not be available w.e.f. 1.11.2006.
3.7.3 Hundred Percent Export Oriented Units

Special provisions in respect of newly established hundred percent Export Oriented Units [Section 10B]

- Profits of a 100 percent Export Oriented Unit are exempt provided it is a new unit. This exemption is available for a period of 10 consecutive years beginning from the year in which the unit commenced production. No deduction under this section is being allowed after financial year 2009-2010. Therefore, any unit set up after financial year 2000–2001 is be eligible to claim exemption for less number of years i.e., units set up in 2001–03 can claim deduction for 9 years, units set up in 2002–03 can claim this deduction for 8 years and so on.
- In case of existing units which are already claiming this exemption, deduction is to be allowed only for the unexpired period of the aforesaid 10 years. The following are the main conditions for claiming this deduction:
  - The unit manufactures or produces any articles or things or computer software.
  - It is not formed by splitting or re-construction of an existing unit.
  - It is not formed by transfer of used plant and machinery.
  - The Assessee will have to bring the sale proceeds into India in convertible foreign exchange within 6 months from the end of the financial year in order to avail of the exemption. This period of 6 months may be extended by the RBI on application made in this behalf. The deduction will be proportionately reduced in case the entire sale proceeds are not brought into India as mentioned above.
  - Audit report should be submitted in Form No. 56C.
  - Amount of deduction – The deduction will be computed as follows:

\[
\text{Profits of the business of the undertaking } \times \frac{\text{Export Turnover}}{\text{Total turnover of the business carried on by the unit}}
\]

- Period of deduction – 10 consecutive A.Ys beginning with the AY relevant to previous year in which the undertaking begins manufacture or produces such articles or things or computer software.
- Special Provisions in Respect of Export of Certain Articles or Things as per Section 10BA

3.7.4 North Eastern Region

Special Provisions in Respect of Newly Established Industrial Undertakings in the North Eastern Region [Section 10C]

- Profits and gains of an undertaking set up in the North Eastern Region in any Integrated Infrastructure Development Centre or Industrial Growth Centre on or after 01.04.1998 are exempt from Income Tax provided:
  - It is not formed by splitting or re-construction of an existing unit.
  - It is not formed by transfer of used plant and machinery.
  - Exemption is available for 10 years commencing from the year in which the industrial undertaking begins to manufacture or produce articles or things.
- Integrated Infrastructure Development Centre means such centres located in the states of the North-Eastern Region which the Central Government may by notification in the official gazette specify for the purposes of this section.
- Industrial Growth Centres means such centres located in the states of the North Eastern Region which the Central Government may by notification in the Official Gazette, specify for the purpose of this section.
Summary

- The form of ownership is an important tool of tax planning. There are different forms of organisations having different tax incidences at a given level of operation. The form of ownership may be sole proprietorship, partnership, company, co-operative society, etc. It is the form of ownership which determines the sharing of profits, responsibilities of the activities of third parties, etc.
- Tax implications on the project under different forms of ownership at a certain level of profit are to be analysed and a form of ownership suitable to those circumstances is selected.
- Sole proprietorship is a business owned by one person. The individual is entitled to all Profits and Losses and is liable for all obligations of the business. Proprietorship represents the largest number of businesses and is normally the first form of setting up a business.
- For income-tax purposes, the sole proprietor is considered as an individual. An individual means a natural person i.e., human being. Individual includes a male, female, minor child and a lunatic or an idiot.
- HUF is a separate and distinct tax entity. The income of a HUF can be assessed in the hands of the HUF alone and not in the hands of any of its members, unless specifically provided by law.
- A partnership is like a proprietorship in many ways except that it has two or more co-owners. The partners share the profits and losses according to a sharing pattern already agreed. A partnership must be dissolved if the ownership changes, as when a partner leaves or dies. If the business is to continue as partnership, a new partnership must be formed.
- Both, sole proprietorship and partnership are convenient ways of separating the business owner’s commercial activities from their personal activities.
- A Corporate Form is a business unit that is legally separable from its owners (the shareholders). The shareholders, whose ownership is represented by shares/stock, do not directly control the company’s operations.
- Many factors affect the location of a new business. The impact of tax incentives needs to be considered while determining the viability of the project.

References

- Dr. Singhania, V.K., Dr. Singhania, K., 2005. Direct Taxes Planning and Management, 9th edition, Taxman’s.

Recommended Reading

1. The form of ownership is an important _______ of tax planning.
   a. form
   b. part
   c. tool
   d. aspect

2. Sole proprietorship is a business owned by how many people?
   a. Four people
   b. Single person
   c. Three people
   d. Group of people

3. Proprietorship represents the largest number of businesses and is normally the _______ form of setting up a business.
   a. primary
   b. first
   c. last
   d. common

4. HUF is a separate and distinct ____________.
   a. person
   b. assessee
   c. family
   d. tax entity

5. For income-tax purposes, the sole proprietor is considered as a/an ____________.
   a. individual
   b. assessee
   c. business
   d. firm

6. State which of the following is true.
   a. A partnership must be dissolved if the business changes, as when a partner leaves or dies
   b. A partnership must be dissolved if the ownership changes, as when a product changes
   c. A partnership must be dissolved if the ownership changes, as when a partner leaves or dies
   d. A partnership must be renewed if the ownership changes, as when a partner leaves or dies

7. A corporate form is a business unit that is legally __________ from its owners.
   a. distinct
   b. separable
   c. inseparable
   d. indivisible
8. The ___________ of tax incentives needs to be considered while determining the viability of the project
   a. zone
   b. rates
   c. laws
   d. impact

9. The __________, whose ownership is represented by shares/stock, do not directly control the company’s operations.
   a. shareholders
   b. stakeholders
   c. partners
   d. employees

10. Legally, a partnership firm does not have a separate entity from that of the partners constituting the firm as the partners are the ___________ of the firm.
    a. assessee
    b. owners
    c. shareholders
    d. employee
Chapter IV

Nature of Business

Aim

The aim of this chapter is to:

• investigate nature of new business
• analyse income of venture capital funds
• understand amortisation of telecom license fee

Objectives

The objectives of this chapter are to:

• explain income of an infrastructure capital fund
• acquaint with acts for tea and coffee developers
• examine conditions for site restoration fund

Learning outcome

At the end of this chapter, the students will be able to:

• recall special provisions for civil construction
• discuss special provisions for leasing goods carriages
• recognise special provisions for biodegradable waste
4.1 Introduction

Activities connected with the production or purchase and sale of goods or services with the object of earning profit are called business activities. Mining, manufacturing, trade, transportation, insurance, banking are business activities. Thus, business may be defined as an economic activity involving regular production or purchase and distribution of goods and services with the object of earning profits.

The nature of business is best understood on the basis of its characteristics or features, which are as follows:

- Business is an economic activity.
- It includes the activities of production or purchase and distribution.
- It deals in goods and services.
- It implies regularity of transactions.
- It aims at earning profits through the satisfaction of human wants.
- It involves risk; it is not certain that adequate profit will be earned.
- It creates utilities.
- It serves a social purpose by improving people’s standard of living.

4.2 Nature of New Business

Many incentives are available under the Act which are directly co-related to the nature of business. Some of these incentives are given as follows:

- Newly established undertakings in Free Trade Zones [Section 10A]
- Newly established 100 percent Export Oriented Units [Section 10B]
- Export of artistic hand-made wooden articles [Sec 10BA]
- Venture capital companies [Sec. 10(23 FB)]
- Infrastructure capital companies [Sec.10 (23G]
- Tea Development account [Sec.33AB]
- Site restoration fund [Sec.33ABA]
- Reserves for shipping business [Sec33AC]
- Telecommunication services [Sec.35ABB]
- Amortisation of certain preliminary expenses [Sec35D]
- Expenditure on prospecting for certain minerals [Sec.35E]
- Special reserve created by a financial corporation under section 36(1) (viii)
- Special provision for deduction in the case of business for prospecting for mineral oil [Sec.42 and 44BB]
- Special provision for computing profits and gains of civil construction [Sec44AD-]
- Special provision in the case of business of plying, hiring or leasing goods carriages Sec. 44AE
- Special provision for computing profits and gains of retail business [Sec.44AF]
- Special provisions in the case of shipping business [sec.44 B]
- Special provision in the case of business of operation of aircraft [sec.44BBA]
- Special provisions in the case of certain turnkey power projects [sec. 44BBBBb]
- Special provisions in the case of royalty income of foreign companies [sec.44D]
- Profits and gains from industrial undertakings engaged in infrastructure, etc. [sec-80-IA]
- Profits and gains from industrial undertakings other than infrastructure development undertakings [sec-80-IB].
- Profits and gains of certain undertakings in certain undertakings in certain special category of States, [sec-80-IC]
- Profits and gains from business of collecting and processing of biodegradable waste [Sec.80JJA]
- Employment of new workmen [Sec80 JJAA]
- Certain incomes of Offshore Banking Units [Sec.80LA]
- Royalty from certain foreign enterprises [Sec80-0]
- Special tax provision under [section 115A, 115AB, 115AC, 115AD, 115B, 115BB, 115BBA and 115D]

### 4.3 Income of a Venture Capital Fund

**[Section 10(23FB)]**

- Any income of a VCF or a Venture Capital Tax Credit (VCC) set up to raise funds for investment in a Venture Capital Undertakings (VCU) is exempt subject to certain conditions. VCC means a company which has been granted a certificate of registration by SEBI and which fulfils the conditions laid down by SEBI with the approval of the Central Government.
- VCF means a fund operating under a trust deed registered under the Registration Act, 1988, which has been granted a certificate of registration by SEBI and which fulfils the conditions laid down by SEBI with the approval of the Central Government.
- VCU means a domestic company whose shares are not listed in a recognised stock exchange in India and which is engaged in the business for providing services, production or manufacture of an article or thing but does not include activities or sectors which are specified by SEBI with approval of the Central Government.

### 4.4 Income of an Infrastructure Capital Fund or Company

**[Section 10(23G)]**

- Any income by way of dividends, interest or long term capital gains of an infrastructure capital fund or an infrastructure capital company or a cooperative bank from investments made by way of shares or long term finance in any enterprise wholly engaged in the business of (i) developing, (ii) maintaining and operating, (iii) developing, maintaining and operating any infrastructure facility approved by the Central Government in this connection is exempt from tax.
- Infrastructure Capital Company means a company which has made investments in shares or long term finance to enterprises wholly engaged in the business of developing, maintaining and operating infrastructure facility.

#### 4.4.1 Infrastructure Facility

- A road, highway, bridge, airport, port, rail system, water supply project, irrigation project, water treatment system, solid waste management system, sanitation and sewerage system or any other public facility of a similar nature as may be notified:
  - An industrial undertaking set up in any part of India for the generation or generation and distribution of power if it begins generation of power between 1.4.1993 and 31.3.2003.
  - An industrial undertaking, which starts transmission or distribution by laying a network of new lines for this purpose between 1.4.99 to 31.3.2003, a project for providing telecommunication services on or after 1.4.1995.

### 4.5 Development Account (Tea, Coffee, Rubber)

**Section 33 AB**

An assessee carrying on business of growing and manufacturing tea or coffee in India is entitled for deduction to the extent of least of the following:

(a) Amount deposited in special A/c with NABARD within a period of 6 months from the end of the previous year or before due date of furnishing return of income, whichever is earlier.

(b) 40% profits of such business as computed before making deduction v/s 33 AB and before adjusting brought forward business loss v/s 72.

- For claiming deduction u/s 33 AB, assessee must get accounts audited by a Chartered Accountant and furnish the report of such audit in prescribed form along with his return of income.
- The amount standing to the credit of special account with NABARD is to be utilised as per the specified scheme.
of Tea Board. In no case shall it be utilised for the purpose of the following:

- any machinery/plant installed in any office premises/residential accommodation including guesthouse
- any office appliances (Other than computer)
- any machinery or plant entitled for 100% write-off by way of depreciation or otherwise
- any new machinery or plant installed for production of any low priority item specified in the Eleventh Schedule

• Deduction allowed under this provision will be withdrawn if the asset acquired in accordance with the scheme, is sold or other wise transferred within 8 years from the end of the previous year in which it was acquired. However, it shall not be withdrawn in the following cases:
  - Transfer to Government, Local Authority or Statutory Corporation or Government Company.
  - In case of Sale of business by partnership firm to a company, if company has taken overall assets and liabilities of the firm and all the shareholders of the company were partners of the firm before such sale.

• Assessee is however, allowed to withdraw any amount standing to his credit in special account with NABARD in the following circumstances:
  - Closure of business
  - Dissolution of firm
  - Death of an assessee
  - Partition of a HUF
  - Dissolution of a company

• Where the withdrawal is made in the circumstances stated above in (a) and (b), the amount withdrawn in such business shall be taxable as business profit of that previous year, as if the business had not been closed or the firm had not been dissolved.

### 4.6 Site Restoration Fund

#### Section 33ABA

This section has been inserted in the act to allow deduction to an assessee who is carrying on business consisting of the prospecting for or extraction or production of petroleum or natural gases or both in India.

#### Essential conditions

- This deduction will be allowed to any assessee who is carrying on business consisting of prospecting for or extraction or production of petroleum or natural gas or both in India and in relation to which the Central Government has entered into an agreement with such assessee for such business.

- The assessee has before the end of the previous year
  - Deposited with the State Bank of India any amount(s) in a special account maintained by the assessee with that bank, in accordance with and for the purposes specified in a scheme approved in this behalf by the Ministry of Petroleum and Natural Gas of the Government of India; or
  - Deposited any amount in the Site Restoration Account opened by the assessee in accordance with and for the purpose specified in a scheme framed by the aforesaid Ministry. This scheme is known as Deposit Scheme.

- The assessee must get its accounts audited by a Chartered Accountant and furnish the report in the prescribed form (Form No.3AD) along with the return of income. In a case where the assessee is required by or any other law to get its accounts audited, it shall be sufficient compliance if such assessee gets the account of such business audited under such law and furnishes the report of the audit as required under such other law and a further report in the form prescribed. Quantum of deduction – Quantum of deduction shall be: -
  - The amount deposited in the scheme referred to above; or
  - 20% of the profit of such business computed under the head “profits and gains of business or profession”, whichever is less.

- The profits are to be computed before making any deduction under this section i.e., section 33ABA and before
making adjustment for brought forward losses under section 72.

4.6.1 Restriction on Utilisation of the Amount Deposited

The amount standing to the credit of the assessee, in the Special Account of State Bank of India or the Site Restoration Account, is to be utilised for the business of the assessee in accordance with the scheme specified. However, no deduction shall be allowed in respect of any amount utilised for the purchase of:

- any machinery or plant to be installed in any office premises or residential accommodation, including any accommodation in the nature of a guest house;
- any office appliances (not being computers);
- any machinery or plant, the whole of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income chargeable under the head “Profits and gains of business or profession” of any one previous year;
- any new machinery or plant to be installed in an industrial undertaking for purposes of business of construction, manufacture or production of any article or thing specified in the list in the Eleventh Schedule. Consequence if new asset is transferred within 8 years: - Same as in Sec 33 AB.

Withdrawal of deposits: Any amount deposited in the special account maintained with State Bank of India or the Site Restoration Account shall not be allowed to be withdrawn, except for the purposes specified in the scheme or as the case may be, in the deposit scheme.

4.7 Amortisation of Telecom License Fee

[Sec. 35ABB]

Where any capital expenditure is incurred by the assessee for acquiring any right to operate telecommunication services either before the commencement of the business to operate telecommunication service or thereafter any time during any previous year and for which payment has actually been made to obtain a license, a deduction will be allowed in equal instalments over the period for which the license remains in force, subject to the following:

- If the fee is paid for acquiring any right to operate telecommunication services before the commencement of such business, the deduction shall be allowed for the previous years beginning with the previous year in which such business commenced.
- If the fee is paid for acquiring such rights after commencement of such business, deduction shall be allowed for the previous years beginning with the previous year in which the license fee is actually paid.

4.7.1 Sale of License

Sale of license can be understood with the following facts:

- **Where the entire license is transferred:**
  - If the sale proceeds and the deductions already allowed are less than the cost of acquisition, such deficiency shall be allowed as deduction in the year in which the license is transferred.
  - If the sale proceeds and the deductions already allowed exceed the cost of acquisition of the license, then the amount of such excess or the aggregate of the deductions already allowed in the past, whichever is less, shall be taxable as business income of the year in which the license is transferred.

- **Where a part of the license is transferred:**
  - Where a part of the license is transferred for a sum less than the written down value of the total license, the balance amount not yet written off shall be allowed as deduction in the balance number of equal instalments.
  - If part of the license is transferred for a sum exceeding the written down value of the license, the sale proceeds minus the written down value of the full license shall be the profit from such sale. Out of such profit, an amount equal to the amount already written off in the earlier years shall be deemed to be the business income. It may be mentioned that the license constitutes a capital asset and as such there will be capital gain/loss on sale of entire part of the license.
4.8 Amortisation of Preliminary Expenses

Section 35 D
Where an Indian company or a resident non-corporate assessee in India incurs any expenditure of the nature specified either:

- Before the commencement of business
- OR
- After the commencement of business, in connection with extension of his industrial undertaking or setting up a new industrial unit, a deduction u/s 35 D is available.

**Quantum of Deduction:** Amount equal to 1/5 of eligible expenditure is deductible over a period of five years beginning with the previous year in which the extension of the industrial undertaking is completed or new industrial unit commences production or operation.

4.8.1 Eligible Expenditure
Eligible expenditure is considered in the following situations:

- Expenditure in connection with:
  - preparation of feasibility report;
  - preparation of project report;
  - conducting market survey or any other survey necessary for the business if assessee;
  - engineering services relating to the business of the assessee.

- Legal charges for drafting any agreement between the assessee and any other person for any purpose relating to the setting up or conduct of the business of the assessee.

- Where the assessee is a company, also expenditure:
  - By way of legal charges for drafting the Memorandum and Articles of Association of the Company;
  - On printing of the Memorandum and Articles of Association;
  - By way of fees for registering the company under the provisions of the Companies Act, 1956;
  - In connection with the issue, for public subscription, of shares in or debentures of the company, being underwriting commission, brokerage and charges for drafting, printing and advertisement of the prospectus. Expenses incurred in connection with refund of amount over subscribed, are entitled to deduction u/s 35 D.

- Such other items of expenditure as may be prescribed. Limit on eligible expenditure:

  In case of non-corporate resident assessee – 5% of project cost.
  In case of Indian company – 5% of or project cost or 5% of capital employed (at the option of the assessee).

4.9 Deduction for Expenditure on Prospecting for Minerals

Section 35E
This section has been inserted with a view to encouraging investment in high risk areas especially in exploiting amortisation of expenditure incurred wholly and exclusively on any operations relating to prospecting for certain specified minerals or groups of minerals or on developing mines, etc. The following points are to be noted:

- Deduction is available only to an Indian resident or an Indian company but not to any foreign citizen or foreign company.

- 1/10 of the amount of expenditure would be allowed as a deduction for the 10 years beginning with the years in which commercial production starts.

- Expenses to be amortised will be expenses incurred under the specified heads during the five years period ending with the year of commercial production.

- If in any year, income arising out of commercial exploitation of wasting asset is NIL or insufficient to absorb, the allowance under this section of the unabsorbed allowance is to be carried forward to next year(s). However,
this process of carry forward cannot be continued beyond 10 years as reckoned from the year of commercial production.

Transfer to a Special Reserve [Sec. 36(1) (viii)]

- A public financial corporation engaged in long term finance for industrial or agricultural developments or infrastructure development in India and a public company formed and registered in India with the main object of providing long term finance for industrial or agricultural developments or infrastructure development in India and a public company formed and registered in India with the main object of providing long term finance for construction or purchase of residential housing in India are entitled for deduction of the amount transferred by them to a special reserve account subject to a maximum of 40% of profit from such business (Computed before making any deductions under chapter VI A).

- However, where the aggregate amounts carried to such reserves from time to time exceed twice the paid up share capital and reserves, no allowance is further allowed. If any amount is withdrawn from the aforesaid reserve account [in respect of which deduction was allowed under section36 (1) (viii), it will be chargeable to tax in the year in which the amount is withdrawn, under section 41(4A) regardless of the fact whether the business is in existence in that year or not.

### 4.10 Civil Construction

**Section 44AD: Special provisions for computing profits and gains of business of civil construction**

A special scheme has been introduced w.e.f. assessment year 1994-95, for estimating the profits and gains of assessee’s engaged in the business of civil construction and the broad features of the scheme are as under:

- In the case of an assessee engaged in the business of civil construction or supply of labour for civil construction, a sum equal to eight percent of the gross receipts paid or payable to the assessee in the previous year on account of such business shall be deemed to be the profits and gains of such business chargeable to tax under the head 'Profits and gains of business or profession'. The assessee can however voluntarily declare higher income in his returns.
- This scheme shall not be applicable if the aforesaid gross receipts paid or payable exceed an amount of Rs. 40,00,000.
- 'Gross Receipts' are the amount paid/payable to the assessee by the clients for the contract and will not include the value of the material supplied by the client.
- Any deduction allowable under the provisions of Sections 30 to 38, shall, for the purpose of above income, be deemed to have been already given full effect to and no further deduction under those Sections shall be allowed.
- The Finance Act, 1997 has clarified that w.e.f. Assessment Year 1994-95, remuneration and interest paid/payable to partners shall be allowed as deduction from the income computed under this Section. Such deduction shall, however, be subject to the conditions and limits specified u/s 40(b).
- The written down value of any asset used for the purpose of the business shall be deemed to have been calculated as if the assessee had claimed and had been actually allowed the deduction in respect of the depreciation for each of the relevant assessment years.
- The provisions of Sections 44AA regarding maintenance of accounts and 44AB regarding tax audit shall not apply in so far as they relate to this business and in computing the monetary limits under those sections for other business/profession, the gross receipts or, as the case may be, the income from the said business shall be excluded.
- The assessee may choose not to opt for the scheme and may declare an income lower than 8% of the gross receipts. In this case, w.e.f. Assessment Year 1998-1999, the assessee shall have to keep and maintain books of accounts and get his accounts audited by a Chartered Accountant.

### 4.11 Business of Plying, Hiring or Leasing Goods Carriages

**Section 44AE: Special provisions for computing profits and gains of business of plying, hiring or leasing goods carriages**
Notwithstanding anything to the contrary contained in sections 28 to 43C, the scheme u/s 44AE also provides for a system for estimating the income of an assessee engaged in the business of plying, hiring or leasing of goods carriages. The broad features of the scheme are:

- **The scheme is applicable to an assessee who owns not more than 10 goods carriages at any time during the previous year and who is engaged in the business of plying, hiring or leasing of such goods carriages;**

- **The profits and gains of each goods carriage owned by the above assessee in the previous year shall be estimated as under:**
  - For heavy goods vehicle – Rs. 3,500/- for every month or part of a month during which the heavy vehicle is owned by the assessee in the previous year.
  - For goods carriage other than heavy goods vehicle — Rs. 3,150/- for every month or a part of a month during which the goods carriage is owned by the assessee in the previous year. The assessee may declare a higher income than that specified above.

- **Any deduction allowable under the provisions of Sections 30 to 38 shall, for the purpose of the above income, be deemed to have been already given full effect to and no further deduction under those Sections shall be allowed.** The Finance Act, 1997 has clarified that w.e.f. assessment year 1994-95, remuneration and interest paid / payable to partners, shall be allowed as deduction from the income computed under this Section. Such deduction shall, however, be subject to the conditions and limits specified u/s 40 (b).

- **The Written down Value of any asset used for the purpose of the business shall be deemed to have been calculated as if the assessee had claimed and had been actually allowed the deduction in respect of the depreciation for each of the relevant assessment years.**

- **The provisions of Sections 44AA and 44AB shall not apply in so far as they relate to this business. And in computing the monetary limits under those Sections for other business, the gross receipts or, as the case may be, the income from the said business shall be excluded.**

- **The assessee may choose not to opt for the scheme and may declare an income lower than the specified amount.** In this case, w.e.f. assessment year 1998–99, the assessee shall have to maintain books of accounts and get his accounts audited by a Chartered Accountant.

### 4.12 Retail Business Section

**Section 44AF: Special provisions for computing profits and gains of retail business**

A special scheme has been introduced w.e.f. assessment year 1998-99 for estimating the profits and gains of assessee engaged in retail trade and the broad features of the scheme are as under:

- **In the case of an assessee engaged in retail trade in any goods or merchandise, a sum equal to 5% of the total turnover in the previous year on account of such business shall be deemed to be profits and gains of such business chargeable under the head profits and gains of business or profession.** The assessee can however voluntarily declare a higher income in his return. The scheme shall not be applicable if the total turnover of such retail trade exceeds Rs. 40 lakh in the previous year.

- **Any deduction allowable under the provisions of sections 30 to 38 shall for the purpose of above income be deemed to have been already given full effect to and no further deduction under these sections shall be allowed.** However, remuneration to working partner and interest paid or payable to partner shall be allowed as deduction from the income computed under this section. Such deduction shall however be subject to conditions and limits specified under section 40(b).

- **The written down value of any asset used for the purpose of the business shall be deemed to have been calculated as if the assessee had claimed and had been actually the deduction in respect of depreciation for each of the relevant assessment years.**

- **The provisions of sections 44AA and 44 AB shall not apply in so far as they relate to this business and in computing the monetary limits under these sections, the total turnover or as the case may be, the income from said business shall be excluded.**

- **The assessee may choose not to opt for this scheme and may declare an income lower than the specified amount.** In this case, the assessee shall have to keep and maintain books of accounts as per Section 44AB.
4.13 Infrastructure Development

Section 80IA: Deduction in respect of profits and gains from industries, undertakings or enterprises engaged in infrastructure development, etc.

Deduction under section 80IA is available only to the following businesses carried on by an industrial undertaking:

- provision of infrastructure facility [which includes – road, highways, water supply project, irrigation project, sanitation and sewerage system, water treatment system, solid waste management system, ports, airports and inland waterways]
- telecommunication services
- industrial parks or special economic zones
- power generation, transmission and distribution

4.14 Certain Industrial Undertakings Other than Infrastructure Development

Section 80IB: Deduction in respect of profits and gains from certain industrial undertakings other than infrastructure development undertakings

Deduction under section 80IB is available to different industrial undertakings as follows:

- business of an industrial undertaking
- operation of ship
- hotels
- industrial research
- production of mineral oil
- developing and building housing projects
- integrated handling, storage and transportation of food grain units
- multiplex theatres
- convention centre
- operating and maintaining a hospital in a rural area
- processing, preservation and packaging of fruits and vegetables

4.15 Business of Processing of Biodegradable Waste

Section 80 JJA: In respect of profits from the business of processing of biodegradable waste – how to determine

- Section 80JJA is applicable where gross total income of an assessee includes any profits and gains derived from the business of collecting, processing or treating of biodegradable waste for generating power or producing bio fertilisers, bio-pesticides or other biological agents or for producing bio-gas or making pellets or briquettes for fuel or organic manure.
- Amount of deduction: The whole of the profits and gains of the above activities shall be deductible for a period of five consecutive assessment years beginning with the assessment year relevant to the previous year in which such business commences.

Section 80JJAA: In respect of employment of new workmen

Section 80JJAA has been inserted to encourage employment with effect from the assessment year 1999-2000.

Condition: The following conditions should be satisfied to avail deduction under section:

- The taxpayer is an Indian company.
- Income of the taxpayer includes any profits and gains derived from any industrial undertaking engaged in the manufacture or production of article or thing.
- The industrial undertaking is not formed by splitting up or reconstruction of an existing undertaking or amalgamation with another industrial undertaking.
• The assessee furnished along with the return of income the report of Chartered Accountant.

4.16 Offshore Banking Units and International Financial Service Centre

Section 80LA: Deduction in respect of certain incomes of Offshore Banking Units and International Financial Service Centre by the Specific Economic Zone Act, 2005

• The deduction will be allowed to an assessee:
  • being a scheduled bank (not being a bank incorporated by or under the laws of a country outside India);
  • owning an Offshore Banking Unit in a Special Economic Zone.

• Income in respect of which deduction will be allowed: the deduction will be allowed on account of the following income included in the gross total income of such banks:
  • from an offshore banking unit in a special economic zone;
  • from the business, referred to in section 6(1) of the Banking Regulation Act, 1949, with an undertaking which develops, develops and operates and maintains a special economic zone.
  • received in convertible foreign exchange in accordance with the regulations made under the Foreign Exchange Management Act, 1999.

4.17 Tax Incentives for Shipping Business - Tonnage Tax

[Sections. 115V to 115VZC]

To make the Indian shipping industry more competitive, a tonnage scheme of taxation of shipping profits has been introduced from the Assessment Year 2005-06. Many maritime nations have introduced tonnage based taxation. Some of the basic features of the tonnage tax scheme are as follows:

• It is a scheme of presumptive taxation whereby the notional income arising from the operation of a ship is determined based on the tonnage of the ship.
• The notional income is taxed at the normal corporate tax applicable for the year.
• Tax is payable even if there is loss in an year.
• A company may opt for the scheme and once such option is exercised, there is a lock-in period of 10 years. If the company opts out, it is debarred from re-entry for ten years.
• Since this is a preferential regime of taxation, certain conditions like creation of reserves, training, etc. are required to be met.
• A company may be expelled in certain circumstances.

A new chapter-G has been inserted in the Income Tax Act containing sections 115V to 115 VZC, which provides for special provisions relating to taxation of the income of the shipping companies.

The salient features of this section are as follows:

• A company owning at least one qualifying ship may join. A qualifying ship is one with a minimum tonnage of 15 tons and having a valid certificate. The company has to opt for the scheme within 3 months, i.e., any time between October 1, 2004 to December 31, 2004 by making an application in the prescribed form to the concerned Joint Commissioner who may pass an appropriate order. A new company can make an application within three months of the date of its incorporation or the date on which it became a qualifying company, as the case may be.
• Certain types of ships like fishing vessels, pleasure craft, harbour and river ferries, etc., are excluded interims of section 115VD which gives details of as to what ships will qualify for the scheme.
• The business of operating qualifying ships is to be considered a separate business and separate accounts are to be maintained.
• The daily tonnage income shall be multiplied by the number of days the ship operated. The resulting amount would be the annual tonnage from the ships. A company owning at least one ship may charter subject to certain limits for the purpose of operation. Relevant shipping income, which replaces the actual income from operations,
is defined in section 115VL. Section 115VJ gives the treatment of common costs.

- The company opting for the scheme is not allowed any set-off loss nor is any depreciation allowed. However, both loss and depreciation are deemed to have been allowed and notional adjustments are made against the relevant shipping income. Although depreciation is not allowed, it is necessary to bifurcate the qualifying ships and non-qualifying ships at the time company joins the scheme.

- Section 115VK lays down the method for allocating the written down value amongst qualifying and non-qualifying ships.

- The profits from the business of operating qualifying ships will not be taken into consideration for the purpose of MAT as per section 115VO.

- Section 115V plays down the procedure for the option and the manner of granting approval. Section 115Vq lays down that once the company opts for the scheme, the option remains in force for 10 years, except in certain circumstances.

- Section 115VS provides for the circumstances in which the tonnage tax company is prohibited from opting the scheme. Such prohibition is for a period of 10 years.

- Sections 115VT, 115VU, 115VV, 115VS and 115VW lay down the conditions for the applicability of the scheme. In terms of Section 115VT, a tonnage tax company has to create a reserve of at least 205 of its book profits to be utilised for the purpose of acquisition of new ships.

- As per section 115VU, a tonnage tax company has to comply with the minimum training requirement in accordance with the guidelines to be issued by the DG (Shipping). The company will be expelled if the training requirements are not met for 5 consecutive years.

- Section 115Vv lays down that every company which has opted for tonnage tax scheme, not more than 49 percent of the net tonnage of the qualifying ships operated by it during any previous year shall be chartered. In terms of section 115VW, maintenance of separate books of account and the audit of same is compulsory for a company opting for the scheme.

- Section 115VX lays down the details regarding valid certificate which indicates the net tonnage of ships. Section 115VY and Section 115VZ provide for the contingencies of amalgamation and demerger. Section 115VZB enjoins upon a company not to abuse the preferential tax regime and section 115VZC provides for expulsion of a company in case of abuse.
Summary

- Activities connected with the production or purchase and sale of goods or services with the object of earning profit are called business activities. Mining, manufacturing, trade, transportation, insurance, banking are business activities. Thus business may be defined as an economic activity involving regular production or purchase and distribution of goods and services with the object of earning profits.

- Many incentives are available under the Act which is directly co-related to the nature of business. Some of these incentives are given as follows: Newly established undertakings in Free Trade Zones [Section 10A], newly established 100 percent Export Oriented Units [Section 10B], Export of artistic hand-made wooden articles [Sec 10BA], Venture capital companies [Sec. 10(23 FB)]

- VCF means a fund operating under a trust deed registered under the Registration Act, 1988, which has been granted a certificate of registration by SEBI and which fulfils the conditions laid down by SEBI with the approval of the Central Government.

- VCU means a domestic company whose shares are not listed in a recognised stock exchange in India and which is engaged in the business for providing services, production or manufacture of an article or thing but does not include activities or sectors which are specified by SEBI with approval of the Central Government.

- The amount standing to the credit of the assessee, in the Special Account of State Bank of India or the Site Restoration Account, is to be utilised for the business of the assessee in accordance with the scheme specified.

- Where an Indian company or a resident non-corporate assessee in India incurs any expenditure of the nature specified either: before the commencement of business OR after the commencement of business, in connection with extension of his industrial undertaking or setting up a new industrial unit, a deduction u/s 35 D is available.

- Section 80JJA is applicable where gross total income of an assessee includes any profits and gains derived from the business of collecting, processing or treating of biodegradable waste for generating power or producing bio fertilisers, bio-pesticides or other biological agents or for producing bio-gas or making pellets or briquettes for fuel or organic manure.

References


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Recommended Reading

- Palit, A., Bhattacharjee, S., 2008. Special Economic Zones in India: Myths and Realities (Anthem Press India). Publisher: Anthem Press India; 1st edition.


1. Activities connected with the production or purchase and sale of goods or services with the object of earning profit are called ________________.
   a. production activities
   b. sales activities
   c. profit activities
   d. business activities

2. ________ may be defined as an economic activity involving regular production or purchase and distribution of goods and services with the object of earning profits.
   a. Capital
   b. Business
   c. Profit
   d. Finance

3. What are available under the Act which is directly co-related to the nature of business?
   a. Rules
   b. Policies
   c. Incentives
   d. Profits

4. ________ means a fund operating under a trust deed registered under the Registration Act, 1988.
   a. VAF
   b. VVF
   c. VFF
   d. VCF

5. What is a domestic company whose shares are not listed in a recognised stock exchange in India known as?
   a. VCU
   b. VCF
   c. CVU
   d. CPU

6. ________ is applicable where gross total income of an assessee includes any profits and gains derived from the business of biodegradable waste for generating power or producing bio fertilisers.
   a. Section 80B
   b. Section 44F
   c. Section 80JJA
   d. Section 44AB

7. Certain incomes of ____________ are under Sec. 80LA.
   a. Onshore Banking Units
   b. Offshore Banking Units
   c. Offshore Finance Units
   d. Onshore Business Units
8. __________ means a company which has made investments in shares or long term finance to enterprises wholly engaged in the business of infrastructure facility.
   a. Infrastructure Capital Company
   b. Independent Capital Company
   c. Infrastructure Facility Company
   d. Investment Infrastructure Company

9. A/An __________ carrying on business of growing and manufacturing tea or coffee in India is entitled for deduction.
   a. employee
   b. manager
   c. assessee
   d. farmer

10. The assessee must get its accounts audited by a __________ and furnish the report in the prescribed form.
    a. lawyer
    b. chartered accountant
    c. accountant
    d. manager
Chapter V
Financial Management and Managerial Decisions

Aim

The aim of this chapter is to:

• give an integrated view of capital structure
• explain dividend policies
• explore purchase of assets vs. lease

Objectives

The objectives of this chapter are to:

• highlight features of an appropriate capital structure
• examine factors affecting dividend policies
• view value of the firm and capital structure

Learning outcome

At the end of this chapter, the students will be able to:

• recall factors determining capital structure
• discuss bonus shares, stock split and stock repurchase
• identify types of dividend policies
5.1 Introduction

The capital structure of a company refers to the long-term finances used by the firm. The theory of capital structure is closely related to the firm’s cost of capital. The decision regarding the capital structure or the financial leverage or the financing wise is based on the objective of achieving the maximisation of shareholders wealth. To design capital structure, we should consider the following two propositions:

- Wealth maximisation is attained
- Best approximation to the optimal capital structure

Factors determining capital structure

- Minimisation of risk:
  - Capital structure must be consistent with business risk.
  - It should result in a certain level of financial risk.

- Control: It should reflect the management’s philosophy of control over the firm.

- Flexibility: It refers to the ability of the firm to meet the requirements of the changing situations.

- Profitability: It should be profitable from the equity shareholders point of view.

- Solvency: The use of excessive debt may threaten the solvency of the company.

5.2 Optimum Capital Structure

- The capital structure is said to be optimum when the firm has selected such a combination of equity and debt so that wealth of the firm (shareholder) is maximum. At this capital structure, the cost of capital is minimum and market price per share is maximum.

- It is very difficult to find out the optimum debt and equity mix where capital structure would be optimum because it is difficult to measure a fall in the market value of equity shares on account of increase in risk due to high debt content in capital structure. Hence, in practice, the expression “appropriate capital structure” is a more realistic expression than ‘Optimum Capital Structure’.

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**Fig. 5.1 Process of capital structure decisions**
5.2.1 Features on an Appropriate Capital Structure

- **Profitability**: The most profitable capital structure is one that tends to minimise cost of financing and maximise earning per equity share.
- **Flexibility**: The capital structure should be such that company can raise funds whenever needed.
- **Conservation**: The debt content in the capital structure should not exceed the limit, which the company can bear.
- **Solvency**: The capital structure should be such that firm does not run the risk of becoming insolvent.
- **Control**: The capital structure should be so devised that it involves minimum risk of loss of control of the company.

5.3 Major Considerations in Capital Structure Planning

In planning the capital structure, one should keep in mind that there is no one definite model which can be suggested/used as an ideal for all business undertakings. This is because of varying circumstances of business undertakings.

The capital structure depends primarily on a number of factors like the nature of industry, gestation period, certainty with which the profit will accrue after the undertaking goes into commercial production and the likely quantum of return on investment. It is therefore important to understand that, different types of capital structure would be required for different types of business undertakings. However, the finance manager should take into consideration the following factors while planning the capital structure:

- **Risks**: Risks are of two kinds, i.e., financial risk and business risk. In the context of capital structure planning, financial risk is relevant. Financial risks are of two types:
  - **Risk of cash insolvency**: As a firm raises more debt, its risk of cash insolvency increases. This is due to two reasons. Firstly, higher proportion of debt in the capital structure increases the commitments of the company with regard to fixed charges. This means that a company stands committed to pay a higher amount of interest irrespective of the fact whether it has cash or not. There is a possibility that the supplier of funds may withdraw the funds at any given point of time. Thus the long-term creditors may have to be paid back in instalments, even if sufficient cash to do so does not exist. This risk is not there in the case of equity shares.
  - **Risk of variation in the expected earnings available to equity shareholders**: In case a firm has higher debt content in capital structure, the risk of variations in expected earnings available to equity shareholders will be higher. This is because of trading on equity. Financial leverage works both ways, i.e., it enhances the shareholders' return by a high magnitude or brings it down sharply depending upon whether the return on investment is higher or lower than the rate of interest.

- **Cost of capital**: Cost is an important consideration in capital structure decisions. It is obvious that a business should be at least capable of earning enough revenue to meet its cost of capital and finance its growth. Hence along with risk as a factor, the Finance Manager has to consider the cost aspect carefully while determining the capital structure.

- **Control**: Along with cost and risk factors, the control aspect is also an important consideration in planning the capital structure. When a company issues further equity shares, it automatically dilutes the controlling interest of the present owners. Similarly, preference shareholders can have voting rights and thereby affect the composition of the Board of Directors in case dividends on such shares are not paid for two consecutive years. Financial institutions normally stipulate that they shall have one or more directors on the Board. Hence, when the management agrees to raise loans from financial institutions, by implication it agrees to forego a part of its control over the company. It is obvious therefore, that decisions concerning capital structure are taken after keeping the control factor in mind.

- **Trading on equity**: A company may raise funds either by the issue of shares or by borrowings. Borrowings carry a fixed rate of interest and this interest is payable irrespective of the fact whether there is profit or not. Of course, preference shareholders are also entitled to a fixed rate of dividend but payment of dividend is subject to the profitability of the company. In case the rate of return (ROI) on the total capital employed i.e., shareholders’ funds plus long term borrowings, is more than the rate of interest on borrowed funds or rate of dividend on
preference shares, it is said that the company is trading on equity. One of the prime objectives of a finance manager is to maximise both, the return on ordinary shares and the total wealth of the company. This objective has to be kept in view while making a decision on a new source of finance and its impact on the earnings per share has to be carefully analysed. This helps in deciding whether funds should be raised by internal equity or by borrowings.

- **Corporate taxation**: Under the Income Tax law, dividend on shares is not deductible while interest paid on borrowed capital is allowed as deduction for computing taxable income. Cost of raising finance through borrowing is deductible in the year in which it is incurred. If it is incurred during the pre-commencement period, it is to be capitalised. Cost of issue of shares is allowed as deduction. Owing to these provisions, corporate taxation plays an important role in determining the choice between different sources of financing.

- **Government policies**: Government policies are a major factor in determining capital structure. For example, a change in the lending policies of financial institutions may mean a complete change in the financial pattern to be followed in the companies. Similarly, the Rules and Regulations framed by SEBI considerably affect the capital issue policy of various companies. Monetary and fiscal policies of the Government also affect the capital structure decisions.

- **Legal requirements**: The finance manager has to keep in view the legal requirements while deciding about the capital structure of the company.

- **Marketability**: To obtain a balanced capital structure it is necessary to consider the ability of the company to market corporate securities.

- **Manoeuvrability**: Manoeuvrability is required to have as many alternatives as possible at the time of expanding or contracting the requirements of funds. It enables use of the proper type of funds available at a given time and also enhances the bargaining power when dealing with prospective suppliers of funds.

- **Flexibility**: Flexibility refers to the capacity of the business and its management to adjust to expected and unexpected changes in circumstances. In other words, management would like to have a capital structure which provides maximum freedom to make changes at all times.

- **Timing**: Closely related to flexibility is the timing for the issue of securities. Proper timing of a security issue often brings substantial savings because of the dynamic nature of the capital market. Intelligent management tries to anticipate the climate in the capital market with a view to minimise the cost of raising funds and also to minimise the dilution resulting from an issue of new ordinary shares.

- **Size of the company**: Small companies rely heavily on owner’s funds while large companies are generally considered to be less risky by investors and therefore, they can issue different types of securities.

- **Purpose of financing**: The purpose of financing also to some extent affects the capital structure of the company. In case funds are required for productive purposes like manufacturing, etc., the company may raise funds through long-term sources. On the other hand, if funds are required for non-productive purposes, like welfare facilities to employees such as schools, hospitals, etc., the company may rely only on internal resources.

- **Period of finance**: The period for which finance is required also affects the determination of capital structure. In case such funds are required for long-term requirements, say 8-10 years, it will be appropriate to raise borrowed funds. However, if funds are required more or less permanently, it will be appropriate to raise them by the issue of equity shares.

- **Nature of enterprise**: The nature of enterprise also to a great extent affects the capital structure or the company. Business enterprises which have stability in earnings or which enjoy monopoly in their products may go for borrowings or preference shares, since they have adequate profits to pay interest/fixed charges. On the contrary, companies which do not have assured income should preferably rely on internal resources.

- **Requirement of investors**: Different types of securities are issued to different classes of investors according to their requirement.

- **Provision for the future**: While planning capital structure, provision for future requirement of capital should also to be considered.
5.4 Value of the Firm and Capital Structure

- Value of the firm depends on the earnings of the firm and earnings of the firm depend upon the investment decisions of the firm. Investment decision influences the size of the EBIT. The EBIT is shared among three main claimants:
  - The Debt holders, who receive their share in the form of interest.
  - The Government, which receives its share in the form of taxes.
  - The Shareholders, who receive the balance.

- Thus, the investment decisions of the firm determine the size of the EBIT pool while the capital structure mix determines the way it is to be sliced. The total value of the firm is the sum of the value to the debt holders and its shareholders. Therefore investment decisions can increase the value of the firm by increasing the size of the EBIT whereas capital structure mix can affect the value only by reducing the share of the EBIT going to the government in the form of taxes.

- Thus, the value of the firm, investment decisions and capital structure decisions are closely related and are depicted by the following diagram.

![Diagram](image)

Fig. 5.2 Relation between value of the firm, investment decisions and capital structure decisions

5.5 Dividend Policy

Two possible approaches to dividend decisions:

- As a long term financing decision: In this approach, all the firm’s after tax profits can be considered as a source of long-term financing. Thus, the payment of cash dividends reduces the funds available to finance growth and either restricts growth or forces the firm to find out other financing sources. Thus, the firm might accept a
guideline to retain earnings as long as either of the conditions exists.

- Sufficient profitable projects are available – acceptances of highly profitable projects represent a growth goal for most of the firms. As long as such projects are available, the firm can retain earnings to finance them.
- Capital structure needs equity funds: Among a variety of sources of long term funds and to avoid the high risk associated with excessive debt, the firm must have a balance of debt and equity financing. Because of the costs of floating common shares, retained earnings are profitable as equity financing. With either of the guidelines, cash dividends are viewed as a remainder.

- As maximisation of wealth – with this approach, the firm recognises that the payment of dividends has a strong influence on the market price of the common shares.

5.5.1 Factors affecting Dividend Decisions

Most investors have two forms of return from the purchase of common shares. These are:

- **Capital gains**: The investor expects an increase in the market value of the common shares over a period of time. E.g., if the stock is purchased at Rs. 40/- and sold for Rs. 60/-, the investor will realise a capital gain of Rs. 20/-. Capital gain may be defined as the profit resulting from the sale of capital investments, in this case, common shares.

- **Dividends**: The investor expects at some point, a distribution of the firm’s earnings. From mature and stable organisations, most investors expect regular dividends to be declared and paid on the common shares. This expectation takes priority over the desire to retain earnings to finance expansion and growth. Three major factors explain the investor’s priority of dividends over capital gains:
  - **Reduction of uncertainty**: The promise of future capital gains or a future distribution of earnings, involves more uncertainty than a distribution of current earnings.
  - **Indication of strength**: The declaration and payment of cash dividend carries some sort of confidence that the firm is reasonably strong and healthy.
  - **Need for current income**: Many shareholders require a regular flow of income through their investments for their day-to-day expenses.

5.5.2 Constraints on Paying Dividends

**From the firm’s point of view**

Though most firms recognise the investors’ demand for dividends, several factors may restrict the firm’s ability to declare and pay dividends. These are:

- **Insufficient cash**: Although a firm may have earned enough income to declare dividends, it may not have sufficient cash to pay the dividends. The firm’s liquid funds may have been tied up in receivables or inventory or may be short on liquid funds because of commitment to fixed assets.

- **Contractual restriction**: Like a bond indenture that restricts the dividend payout to 20% of earnings during the tenure of the bond or the firm, agreeing as a part of a contract with a creditor to restrict dividend payments.

- **Legal restrictions**: Occasionally a firm will be legally restricted from declaring and paying dividends unless a certain portion of current profits are ploughed back into business by way of retained earnings. Company’s Declaration of Dividend out of Reserves Rules, 1975 provides for such restrictions. Further dividends can be paid only out of the profits earned during the financial year after providing for depreciation (Sec. 205 of the Companies Act, 1956).

5.5.3 Importance of Stability of Dividends

A number of arguments can be given to underline the importance of steady dividend payments including:

- **Perception of stability**: When a firm pays regular dividend, it is considered as a sign of continued normal operations. On the other hand, a reduction in dividend payment will be treated as a sign of impending trouble for the company. Many investors will sell their shares, without checking further and this setup pressure will result in the loss of sentiment in the market and decline in the market price.

- **Preference of investors**: the common shareholders of mature firms generally prefer to receive steady
Dividends.

- **Dividend decisions as a routine**: By establishing a stable dividend policy, the board of directors avoids a lengthy discussion on dividend levels.

- **Flexibility of the extra dividend**: With a steady dividend policy, the firm can flexibly handle periodical temporary high earnings, by giving a slightly large distribution of earnings without raising the expectations of investors.

- **Desire for current income by the shareholders**: Desire for current income by some investors, such as retired persons and widows. Obviously, such group of investors may be willing to pay a higher share price to avoid the inconvenience of erratic dividend payment, which disrupts their budgeting. They would place positive utility on stable dividends.

- **The following elements should be considered**:
  - meaning of dividend under Section 2(22)
  - tax treatment in the hands of shareholders
  - tax deduction at source under Section 194
  - tax on dividend

- **Dividends can be of three types**:
  - dividends declared by a domestic company
  - dividends declared by a foreign company
  - dividends or any other income distributed by Unit Trust of India

Any amount declared, distributed or paid by a domestic company by way of dividends (whether interim or otherwise), on or after 1.6.1997 but up to 31.3.2002, whether out of current or accumulated profits, shall be exempt in the hands of shareholders under section 10(33). Dividend includes deemed dividend but shall not include deemed dividend mentioned in section 2(22) (e), i.e., loan/advance given by a closely held company to a specified shareholder/concern. Therefore w.e.f. assessment year 2003-2004, any dividend received by a domestic company is taxable.

### 5.5.4 Deemed Dividend

- **Dividend includes deemed dividend**: Section 2(22) defines the term “dividend” which includes the following:
  - any distribution of accumulated profits entailing the release of assets of the company;
  - any distribution by a company of debentures, debenture – stock, etc. to its shareholders and Distribution of bonus shares to preference shareholders to the extent of accumulated profits;
  - any distribution made to the shareholders on a company’s liquidation, to the extent of accumulated profit.
  - any distribution to its shareholders on the reduction of capital to the extent of accumulated profits that arose after 31.3.1933; and
  - any payment by a closely held company made after 31.5.1987 by way of advance or loan to a shareholder with substantial interest provided, lending of money is not a substantial part of the business of the company.

- **Section [2(22) (a)]**: Distribution Entailing Release, etc.: In order that a distribution may fall within this sub-clause, it must satisfy two conditions:
  - it must be a distribution of accumulated profits, whether capitalised or not; and
  - it must be such as entails the release of all or any of the assets of the company.

- It may be noted that these conditions are cumulative in nature and fulfilment of the first condition without the second would not be enough to constitute the distribution of a dividend.

- **Issue of bonus shares does not result in payment of cash. On bonus issue, there is no release of company’s assets because the assets, which were represented by the accumulated profits, continue to remain as part of the company’s assets; the only difference is that, instead of profits, they are the part of the capital of the company. Thus, there is no deemed dividend on issue + of bonus shares to the equity shareholders. However, if bonus shares were issued to preference shareholders, the distribution by such issue would be taxable as dividend under the specific provisions of section 2(22) (b).**
Section 2(22) (b): Distribution of debentures, deposit certificates, etc. to shareholders:

- The distribution of debentures, debenture stock or deposit certificates by a company to its shareholders will amount to divided distribution.
- Distribution of bonus shares to the preference shareholders will be taxed as dividend in the year when bonus shares are issued. But in both the cases, company must have accumulated profits to cover the above distributions.

Sec 2(22) (c): Distribution on liquidation of the company: In order that this section is attracted, it is important that there must be a liquidation and in such liquidation there is distribution and that distribution is attributable to the accumulated profits of the company immediately before its liquidation.

- In any distribution made to the shareholders by the liquidator, that part which is attributable to the accumulated profits of the company immediately before its liquidation, whether or not capitalised, would be treated as dividend and liable to tax under the Act. The amount distributed would have two components, viz. accumulated profits and capital in the accounts of the company at commencement of winding up and that part of the receipt which is attributable to the accumulated profit would be taxable.
- The following distributions on liquidation are, however, not includable:
  - any distribution in respect of shares issued for full cash consideration, if the holder thereof is not entitled to participate in surplus assets, that is, any distribution of preference shares for full cash consideration; and
  - any distribution, if such distribution is attributable to the capitalised profit of the company out of which bonus shares had been issued to the equity shareholders during the financial year 1964-65.

Section 2(22) (d): Distribution to shareholders on the reduction of capital:

Any distribution to its shareholders by a company on the reduction of its capital will be treated as dividend provided it is covered by the accumulated profits arising after the previous year ending 31.3.83 and upto the date of resolution of the company deciding on the reduction of capital.

The following distributions on reduction of capital are not includable in dividend:

- any distribution of preference shares for full cash consideration; and
- any distribution which is attributable to the capitalised profit of the company, representing bonus shares allotted to the equity shareholders during the financial year 1964-65.

Section [2(22) (e)]: Loan to a shareholder, etc.: The following conditions need to be fulfilled, if the payment is to be covered under this clause:

- Payment by a company in which the public are not substantially interested.
- It will be of a sum by way of advance or loan to a shareholder.
- The shareholder will be a person who is the beneficial owner of shares (not being share entitled to a fixed rate of dividend whether with or without or right to participate in profits) holding not less than 10% of the voting power.
- Loan and advance to a concern in which such shareholder is member or a partner and in which he has a substantial interest.
- There must be sufficient accumulated profits at the time of making the said payment to be treated as a dividend.

5.5.5 The Implications of the Working of Section 2(22)

- In case the company distributes its investment in shares to its shareholders, it will be considered dividend up to the maximum of accumulated profits.
- Where the company decides to allot bonus shares by capitalising reserve or profits, it will not amount to distribution of dividend because that will not involve release of assets.
- Issue of bonus shares to preference shareholders will amount to taxable dividends, even though it does not entail release of assets.
- Distribution of debentures to shareholders upto the maximum of accumulated profits amounts to taxable dividends,
even though it does not involve release of assets.

- If under the scheme of reduction of share capital, the company pays back to shareholders some amount, it will be treated as dividend up to accumulated profits.
- W.e.f. AY 2001-2002, the following shall not be treated as “Dividend”:
  - Payment made by a company on purchase of its own shares.
  - Distribution of shares made in accordance with the scheme of demerger by the resulting company to the shareholders of the demerged company.

5.5.6 Exemptions Regarding Dividends Received by a Shareholder

[Sec. 10(34) and Sec. 10(35)]

- Any income received by way of dividend from a domestic company covered under section 115(o) or from UTI or from a recognised mutual fund by a shareholder/unit holder is fully exempt from tax.
- Sec. 115(o) provides for tax (at the rate of 12½ percent) on distributed profits of domestic companies on the domestic companies in addition to income tax chargeable in respect of total income of a domestic company; on any amount declared, distributed or paid by such company by way of dividends (whether any income-tax has been paid on such income earned or not).

5.5.7 Deduction of Tax from Dividends (Section 194)

- **Liability to deduct tax:** The principal officer of an Indian Company or a company who has made the prescribed arrangements for the declaration and payment of dividend (including dividend or preference shares) within India.
- **TDS deduction:** TDS is required to be deducted before making any payments in cash or before issuing any cheque or warrant in respect of any dividend or before making any distribution or payment to a shareholder, who is resident of India if any dividend is within the meaning of sub-clause (a) or (b) or (c) or (d) or (e) of clause 22 of section 2.
- **Rate of TDS:** 10% plus surcharge at 5% with effect from 1-6-2002 to 31-3-2003. As dividend is exempt in the hands of the shareholders from the A.Y.2004-05, the Finance Act, 2003 has inserted a proviso to section 194 to provide that no such deduction shall be made in respect of any dividends referred to in section 115-O.

5.6 Alternative Forms of Dividends

In addition to cash dividends, the firm has other options for distributing profits to shareholders. These options are discussed below:

5.6.1 Bonus Shares (Stock Dividend)

- Bonus shares occur when new shares are issued on a pro-rata basis to the current shareholders while the firm’s assets, its earnings, the risk being assured and the investor’s percentage ownership in the company remain unchanged.
- For example, if a shareholder owns 100 shares of common stock at a time when the firm distributes bonus shares in the ratio of 1:20 (1 share for every 20 shares held), the shareholder will receive 5 additional shares. There are several favourable aspects of a bonus issue:
  - Conserves cash: the stock dividend (bonus shares) allows the firms to declare a dividend without using up cash that may be needed for operations or expansion.
  - Indicates higher future profits – Normally a bonus share is an indication of higher future profits.
  - Raises future dividends for investors – If the regular cash dividend is continued after the bonus issue, the individual shareholder will receive higher total dividends.
  - Has high psychological value – because of the positive aspects of bonus shares, issue of bonus shares receives positive response by the market.
  - Retains proportional ownership for shareholders: It helps the majority shareholders in retaining proportional
ownership as compared to rights issue of shares where shareholders are expected to pay for the shares including the premium as per issue criteria.

5.6.2 Stock (Share) Split

- A stock split is a change in the number of outstanding shares through a proportional reduction or increase in the par value of the shares. Only the face value (par value) and number of outstanding shares are affected. The market price of the stock will adjust immediately to reflect the stock split.
- As an example, a firm may have 20,00,000 outstanding shares selling for Rs. 20/- per share. The firm declares a 2 – for 1 stock split. After the split, the outstanding share will go up to 40,00,000 and will sell for approximately Rs.10/- per share. A shareholder with 100 shares worth Rs. 2,000 before the split will hold 200 shares worth Rs. 2,000/. Reasons for stock splits:
  - Reduction of market price of stock: The major objective behind most stock splits is to reduce the per share price of a firm’s common shares. A lower price per share makes the stock more affordable in marketable lots (usually 100 shares) to more investors.
  - Indication of future growth: The announcement of the stock split is perceived as favourable news by the investors in that with growing earnings, the company has bright prospects and the investors can reasonably look for increase in future dividends.
  - Reverse Split: an indication of trouble. In case of reverse split, the firm reduces the number of outstanding shares. The declaration of reverse split is an indication that the firm does not have good prospects.

5.6.3 Stock Repurchase

This occurs when a firm brings back outstanding shares of its own common shares. Firms repurchase stock for three major reasons:
- For stock option: A stock option is the right to purchase a specified number of shares of common shares during a stated time period and a stipulated price. Stock options are frequently given to senior officers of a company as an incentive to work to raise the value of the firm. As for example, a firm’s stock is currently selling for Rs. 20 per share when the president is given the option to buy 1000 shares for Rs. 22 at any time in the next three years. If the stock value rises to Rs. 40/- the president can exercise the option, purchase the stock for Rs. 22,000 (1000 shares @ Rs. 22) and sell it for Rs. 40,000 immediately. The capital gain arising on the sale will be a profit for the president as a direct result of the success of the firm.
- To have shares for acquisition: When a firm is seeking control of another firm, it may be willing to offer its own common shares for the shares of the other firm. In this exchange of shares, the firm can repurchase stock to make the acquisition. This allows takeover without increasing the number of outstanding shares and avoids a dilution of earnings.
- To retire the stock, thus increasing earnings per share – When a firm retires a portion of its shares or buys back its own shares (as per procedure laid down by Statute), the repurchase increases the firm’s earnings per share.

5.6.4 Stock Repurchase Viewed as Cash Dividend

- When common shares are repurchased for cancellation, the motive is to distribute excess cash to the owners. Generally, as long as earnings remain constant, the repurchase reduces the number of outstanding shares raising the earnings per share and therefore the market price per share.
- Besides, the advantage of an increase in per share earnings, certain tax benefits to owners also result. In case of cash dividend, the owner is required to pay income tax on it, whereas, the increase in market value of the shares that resulted from repurchase would not be taxed till the owner sells the shares. Of course, when the stock is sold, the capital gain is taxed at a favourable rate than one applied to ordinary income.

5.7 Types of Dividend Policies

The firm’s dividend policy is formulated with two basic objectives in mind providing for sufficient financing and maximising the wealth of the firm’s shareholders. Three of the more commonly used dividend policies are discussed
5.7.1 Constant Payout Ratio Dividend Policy

- The term payout refers to the ratio of dividend to earnings or the percentage of share of earnings used to pay dividend. With constant target payout ratio, a firm pays a constant percentage of net earnings as dividend to the shareholders. In other words, a stable dividend payout ratio implies that the percentage of earnings paid out each year is fixed.

- Accordingly, dividends would fluctuate proportionately with earnings and are likely to be highly volatile in the wake of wide fluctuations in the earnings of the company. As a result, when earnings of the firm decline substantially or there are losses in a given period, the dividends according to the target payout ratio would be low or nil. Example: if a firm has a policy of 50% target payout, its dividends will range between Rs. 5 and zero per share, if the earnings per share are Rs. 10 per share and zero (or less) per share respectively.

5.7.2 Regular Dividend Policy

- The regular dividend policy is based on the concept of a fixed rupee dividend in each period. This policy provides the owners with positive information, thereby minimising the uncertainty.

- Another variant of this policy is to increase the regular dividend once a proven increase in earnings has occurred. Often, a regular dividend policy is built around a target dividend payout ratio but without letting the dividends fluctuate, it pays a stated rupee dividend and adjusts that dividend towards the target payout as proven earnings happen.

5.7.3 Low Regular and Extra Dividend Policy

- Some firms have the policy of low regular and extra dividend meaning that the firms keep the regular earnings low which are supplemented by additional dividend when earnings are higher than normal in a given period.

- By terming the additional dividend as extra dividend, firms avoid giving shareholders false hopes. This policy is especially common among companies that experience cyclical shifts in earnings.

5.8 Bonus Shares

Tax considerations are given below:

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<tr>
<th>Situations</th>
<th>Tax treatment in the hands of the company including bonus shares</th>
<th>Tax treatments in the hands of the shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>At the time of issue of bonus shares</td>
<td>No tax liability</td>
<td>No tax liability</td>
</tr>
<tr>
<td>At the time of sale of bonus share by share holder</td>
<td>No tax liability</td>
<td>---</td>
</tr>
<tr>
<td>At the time of redemption of bonus shares or at the time of liquidation of the company</td>
<td>Under section 2 (22) (a) or 2 (22) (c) it will be treated as dividend distribution to the extent of accumulated profits and consequently the payer company will pay dividend tax</td>
<td>Out of the amount received at the time of redemption or liquidation amount treated as dividend under section 2 (22) (a)/ (c) will be exempt in the hands of the shareholders, balance will be sale consideration to compute capital gains</td>
</tr>
</tbody>
</table>

Table 5.1 Bonus shares to equity shareholders
5.8.1 Capital Gains on Bonus Shares

- Sec.55 provides that cost of acquisition of any additional financial asset as bonus shares or security or otherwise which is received without any payment by the assessee on the basis of his holding any financial asset shall be taken to be nil.
- Moreover, in the case of a capital asset being a share, security or unit which is allotted without any payment on the basis of holding of any other financial asset, the period for treating such share, security or unit as a short-term capital asset shall be calculated from the date of allotment of such share, security or unit, as the case may be.
- The areas of tax planning with reference to managerial decisions such as buying out of borrowed funds or from own funds, purchase vs. leasing/hire, make or buy, repairs/renewal/renovation, shut down vs. continue, etc. affect managerial decisions.

5.9 Purchase of Assets Out of Own Funds or Out of Borrowed Capital

In case of own funds, the factors that determine effective tax savings:

- Rate of depreciation
- Marginal tax rate: For the corporate, maximum marginal tax rate is 30% plus surcharge of 10% plus educational cess of 2% on income tax + surcharge = 30% +10% on 30% i.e.33% +2% on 33%-33.66% In case of borrowed funds used for purchase of plant and machinery, the following factors to be considered
  - Cash outflow will be made at the time of loan repayment
  - Interest on principal will be paid at regular interval
  - Tax savings will be on interest paid
  - Tax saving will be on depreciation
  - Effective tax savings on depreciation and interest will be on marginal tax rate. Maximum marginal tax rate will be 33.66% for the AY 2006-07

5.10 Purchase of an Asset vs. Lease

- Given the nature and the size of the investment decision, a firm has to evaluate whether it will purchase an asset or acquire it on lease basis. A lease represents a contractual arrangement whereby the lessor or grants the lessee the right to use an asset in return for periodic lease rental payments. There are two broad types of lease: finance lease and operating lease.
- A finance lease or capital lease is essentially a form of borrowing. On the other hand, the term of lease of the operating lease is less than the economic life of the equipment and the lessee enjoys the right to terminate the lease at short notice without any significant penalty. In India most of the leases are finance leases.
- Since lease rental payments are similar to payments of interest on debt, leasing in essence is an alternative to borrowing. Lease financing decisions, thus involve a choice between debt financing versus lease financing. If the asset is purchased, the assessee can claim depreciation.
- Besides, interest on capital borrowed to finance investment in plant and machinery can also be claimed. If the asset is purchased on lease option, deduction can be claimed on lease rental as well as on lease management fees but not on depreciation.

5.11 Purchase by Instalment vs. Hire

- The main features of hire-purchase arrangement are as follows:
  - The hirer purchases the asset and gives it on hire to the hirer.
  - The hirer pays regular hire-purchase instalments over a specified period of time. These Instalments cover interest as well as principal repayment. When the hirer pays the last instalment, the title of the asset is transferred from the hirer to the hirer.
  - The hirer charges interest on a flat basis.
  - The total interest collected by the hirer is allocated over various years.
  - The hirer is entitled to claim depreciation.
• In case of instalment purchase, the possession as well as ownership is transferred immediately to the user. The user can always claim depreciation even if the instalments are not paid.

• So far as income-tax provisions are concerned, if an asset is purchased by instalments, the tax payer can claim depreciation under section 32. Besides interest payable on unpaid purchase price can also be claimed as deduction.

• Depreciation is allowed on the machinery acquired on hire purchase agreement as if the assessee is the owner of such asset. The assessee can also claim deduction on account of interest on instalment payments. By comparing present value of each cash outflow, a correct decision can be taken.

5.12 Sale of Assets Used for Scientific Research

• Where any capital asset used in scientific research is sold without having been used for other purposes and sale proceeds together with the amount of deduction used for other purposes and sale proceeds, together with the amount of deduction allowed under section 35, exceed the amount of capital expenditure, such surplus or the amount of deduction allowed, whichever is less, is chargeable to tax, as business income under section 41(3) in the year in which sale took place.

• If however, the asset is sold after converting it as a business asset, then section 41(3) is not applicable and consequently tax incidence can be reduced.

5.13 Make or Buy

• The following considerations guide the decision-making relating to “make or buy”:
  - Utilisation of capacity
  - Inadequacy of funds
  - Latest technology
  - Variable cost of manufacturing vis-à-vis purchase price
  - Dependence on supplier
  - Labour problem in the factory, etc.

• In addition, the following tax considerations one has to consider:
  - Establishing a new unit - If the decision to manufacture a part or component involves setting up a separate industrial unit, then tax incentives available under sections 10A, 10B, 32,801A, 801B and 801C are available.
  - Exports - If make or buy decision is taken for export of goods, then tax incentives available under section 80HHC depend on whether goods manufactured by the tax payers themselves are exported or goods manufactured by others are exported by the tax payers.
  - Sale of Plant and Machinery consequent on buying - If buying is cheaper than manufacturing and assessee decides to ‘buy’ parts/ components for a longer period, he may like to sell the existing plant and machinery.

Tax implications under Section 50 need to be taken into consideration.

Section 50: Computation of capital gains in case of depreciable assets: Where the capital asset is an asset forming part of a block of assets in respect of which depreciation has been allowed, the provisions of section 48 and 49 shall be subject to the following modifications:

• Where the full value of consideration received or accruing for the transfer of the asset plus the full value of such consideration for the transfer of any other capital asset falling with the block of assets during the previous year exceeds the aggregate of the following amounts namely:
  - Expenditure incurred wholly and exclusively in connection with such transfer;
  - WDV of the block of assets at the beginning of the previous year;
  - The actual cost of any asset falling within the block of assets acquired during the previous year, such excess shall be deemed to be the capital gains arising from the transfer of short-term capital assets.
Where all assets in a block are transferred during the previous year, the block itself will cease to exist. In such a situation, if the aggregate of the above 3 items exceed the full value of consideration received / accruing for the transfer of asset(s), the loss shall be deemed to be short-term capital loss.

5.14 Repairs, Replacement, Renewal or Renovation

The deductions are covered in Sections 30 to 37 (i) of the Income Tax Act Section 30:

- Rent, Routine taxes, repairs and insurance for building: If the assessee is the owner of the premises and uses the premises for his business purposes, no notional rent would be allowed under this section. He can claim only the following expenses under this section.
  - Local rates, municipal taxes, Land revenue, etc.
  - Insurance premium covering the risk of the damage or destruction of premises
  - Current repairs to the building [Not including expenditure in the nature of capital expenditure].

- If assessee is a tenant, he can claim rent paid under this section. Besides this he can claim all expenses which he has undertaken to bear e.g., – cost of repairs [Not including expenditure in the nature of capital expenditure], local rates, municipal taxes, land revenue, insurance, etc.

Section 31: Repairs and Insurance of Machinery, Plant and Furniture: An assessee can claim the following deductions under this section:

- Insurance Premium paid (or payable by the assessee under mercantile system) Deduction for insurance of machinery, plant or furniture is allowable u/s 31 subject to the following conditions:
  - The assets must be used by the assessee for the purpose of his business or profession during the accounting year.
  - Insurance must be against the risk of damage or destruction of the machinery, plant or furniture.

- Repairs to Plant and Machinery are allowable subject to the following conditions:
  - Plant, Machinery, Furniture must have been used by the assessee for the purpose of his own business or profession. This deduction is available even if assessee is not the owner. What is essential is that assets must have been used by the assessee in his own business during the previous year though not continuously i.e., even if an asset is used for a part of the accounting year, the assessee is entitled to the deduction of the full amount of expenses on repairs and insurance charges and not merely an amount proportionate to the period of this use.
  - Under this section only current repairs are deductible. Current repairs refer to the expenditure incurred with a view to preserve and maintain an existing asset and not with a view to bringing a new asset into existence or obtaining any new or fresh advantage. The term ‘repairs’ under this section does not mean petty repairs. It includes renewal or renovation of an asset but not replacement or reconstruction. The following points are noteworthy in this connection:
    - This section is applicable to current repairs but not arrears of repairs for earlier years [though arrears of repairs are deductible u/s 37 (1)].
    - This section is not applicable to cost of replacing or reconstruction.

Deductions under Section 37

General deductions are expenses which are not covered by any other section and are allowed as a deduction under section 37 provided the following conditions are satisfied:

- Expenditure should not be covered specifically by any of the provisions of section 30 to 36.
- Such expense should be in respect of business carried out by the assessee and the profits of which are to be computed and assessed and should be incurred after the business is set up.
- It should not be in the nature of personal expenses of the assessee. d) Such expenses should not be in the nature of capital expenditure.
- Such expenses should have been incurred only and exclusively for the purpose of such business.
• Such expenses should not be incurred for any purpose which is an offence as prohibited by law.

• NO allowance shall be made in respect of expenditure incurred on advertisement in any souvenir, brochure, tract, pamphlet or the likes published by a political party.

Income-tax implication
• If expenses are allowable as revenue expenditure under the above sections, then cost of financing gets reduced to the extent of tax saved (At present i.e., 2006-07 corporate tax rate is 33.66%).

• On the other hand, if such expenditure is not allowed, then it may be capitalised and on the amount capitalised, depreciation is available if certain conditions are fulfilled.

5.15 Shut-down or Continue

Income-tax provisions are given below:

• Carry forward and set off of business losses (Section 72)
  • Where the loss under the head ‘profit and gains of business or profession’ other than loss from speculation business, could not be set off in the same assessment year because either the assessee had no income under any other head or the income was less than the loss, such loss which could not be set off in the same against the profit and gains of business or profession can be carried forward to the next year subject to the following conditions:
    • Business losses can be adjusted only against business income. The loss can be earned forward to the subsequent assessment year and set off only against business income of the subsequent year.
    • It may be observed that in the assessment year, loss from a business can be adjusted against income from any other head of income. However, when the loss is to be carried forward to the subsequent year, it can be adjusted only against business income.
    • Business income may be from the same business in which the loss was incurred or may be any other business. Certain income, though taxable under other heads, constitutes business income for set off of brought forward business loss: The carried forward business loss is to be adjusted against income from any business activity. Such an income may generally be taxed under the head, “profits and gains of business or profession”. However, in some cases income from a business activity may also be taxed under other heads. For example, if an assessee, carrying on the business of letting out of house properties received rent from such house properties, it would be an income from business activity though the rent would be taxable under the head “income from house property”.
    • Therefore, a business loss of an earlier year can be set off against rental income of house property, although the rental income falls under the head “Income from House Property.”

• Business in respect of which a loss is incurred need not be continued
  • The business or profession, for which the loss was incurred, should be continued to be carried on by him in the previous year in which such loss is sought to be set off. However w.e.f. Assessment Year 2000 – 2001, the Finance Act, 1999 has omitted these conditions and as such now business loss can be carried forward and set off in the subsequent assessment year(s) even if the business in respect of which the loss was originally computed is not carried on by him.
  • It may be noted that although for carrying forward and set off of business loss, it is now not necessary that the same business should be continued but for unabsorbed depreciation, the condition that the same business must be continued is still not omitted.

• Losses can be set off only by the assessee who has incurred loss [Section 78(2)]

The brought forward business losses can be set off only by the same assessee. The assessee, who has suffered the loss and in whose hands the loss has been assessed, is the person who can carry forward the loss and set off the same against his business income of the subsequent year. The following are the exceptions:
  • Where a business carried on by one person, is acquired by another person through inheritance. For example: X is carrying on a business and there are losses to the extent of Rs. 5,00,000 which can be carried forward and set off against the income of the subsequent years. X dies and his son S against the income from a business activity carried on by S:
• Business losses of an amalgamating company can be set off against the income of the amalgamated company if the amalgamation is within the meaning of section 72A of the Income Tax Act.

• Where there has been re-organisation of business whereby a proprietary concern or a firm is succeeded by a company and certain conditions are fulfilled, the accumulated business loss and the unabsorbed depreciation of the predecessor firm/proprietary concern shall be deemed to be the loss or allowance for depreciation of the successor company for the previous year in which business reorganisation was effected and carry forward provisions shall be applicable to the successor company.

• **Period of carry forward**

  Each year’s loss is a separate loss and no loss shall be carried forward for more than eight assessment years immediately succeeding the assessment year for which the loss was first computed. Therefore, a loss of previous year 1991–92 i.e., assessment year 1992–93 can be carried forward till assessment year 2000–2001. Besides the above, the following can also be carried forward for unlimited period:
  • Unabsorbed depreciation;
  • Unabsorbed scientific research expenditure;
  • Unabsorbed expenditure on family planning.

### 5.16 Order of Set Off

• Unabsorbed depreciation, unabsorbed capital expenditure on scientific research and family planning are not part of business losses and they can also be carried forward. However as per section 72(2), the business loss should be set off before setting off unabsorbed depreciation, etc.

• Such carried forward loss will be set off against business head only after the current year’s depreciation; current capital expenditure on scientific research and capital expenditure on family planning have been claimed.

• Therefore, the order of set off will be as under:
  • Current year capital expenditure on scientific research and capital expenditure on family planning to the extent allowed;
  • Current year depreciation [Section 32(1)];
  • Carried forward business or profession losses [Section 72(1)];
  • Unabsorbed expenditure on family planning [Section 36(1) (ix)];
  • Unabsorbed depreciation [Section 32(2)];
  • Unabsorbed capital expenditure on scientific research [Section 35(4)].
The decision regarding the capital structure or the financial leverage or the financing wise is based on the objective of achieving the maximisation of shareholders wealth.

To design capital structure, we should consider two propositions: wealth maximisation is attained, best approximation to the optimal capital structure.

The capital structure is said to be optimum when the firm has selected such a combination of equity and debt so that wealth of the firm (shareholder) is maximum. At this capital structure, the cost of capital is minimum and market price per share is maximum.

In planning the capital structure, one should keep in mind that there is no one definite model which can be suggested / used as an ideal for all business undertakings. This is because of varying circumstances of business undertakings.

Value of the firm depends on the earnings of the firm and earnings of the firm depend upon the investment decisions of the firm. Investment decision influences the size of the EBIT.

Though most firms recognise the investors’ demand for dividends, several factors may restrict the firm’s ability to declare and pay dividends.

Issue of bonus shares does not result in payment of cash. On bonus issue, there is no release of company’s assets because the assets, which were represented by the accumulated profits, continue to remain as part of the company’s assets; the only difference is that, instead of profits, they are the part of the capital of the company. Thus, there is no deemed dividend on issue + of bonus shares to the equity shareholders.

In addition to cash dividends, the firm has other options for distributing profits to shareholders. These options are: bonus shares (Stock Dividend), stock (Share) split, stock re purchase.

The firm’s dividend policy is formulated with two basic objectives in mind providing for sufficient financing and maximising the wealth of the firm’s shareholders. Three of the more commonly used dividend policies are: constant payout ratio dividend policy, regular dividend policy, low regular and extra-dividend policy.

The areas of tax planning with reference to managerial decisions such as buying out of borrowed funds or from own funds, purchase vs. leasing/hire, make or buy, repairs/renewal/ renovation, shut down vs. continue, etc. affect managerial decisions.

References

- Dr. Singhania, V.K., Dr. Singhania, K., 2005. Direct Taxes Planning and Management, 9th edition, Taxman’s.

Recommended Reading

1. The decision regarding the capital structure or the financial leverage or the financing wise is based on the objective of achieving the __________ of shareholders wealth.
   a. maximisation
   b. benefits
   c. minimisation
   d. neutralisation

2. State which of the following is true.
   a. To design capital structure, three propositions of wealth maximisation, best approximation and optimal capital structure are considered.
   b. To design profit structure, two propositions of wealth maximisation and best approximation to the optimal capital structure are considered.
   c. To design business plan, two propositions of wealth maximisation and best approximation to the optimal capital structure are considered.
   d. To design capital structure, two propositions of wealth maximisation and best approximation to the optimal capital structure are considered.

3. The capital structure is said to be _______ when the firm has selected such a combination of equity and debt so that wealth of the firm (shareholder) is maximum.
   a. minimum
   b. less
   c. optimum
   d. visible

4. Value of the firm depends on the earnings of the firm and earnings of the firm depend upon the __________ of the firm.
   a. profits
   b. investment decisions
   c. capital
   d. expenditure

5. Though most firms recognise the investors’ demand for _______, several factors may restrict the firm’s ability to declare and pay dividends.
   a. shares
   b. profits
   c. accounts
   d. dividends

6. The firm has other options for distributing _______ to shareholders like bonus shares, stock split and stock re purchase.
   a. gifts
   b. money
   c. profits
   d. shares
7. The hirer pays regular hire-purchase instalments over a specified period of time which cover interest as well as _________.
   a. profits
   b. principal repayment
   c. capital
   d. losses

8. The regular dividend policy is based on the concept of a _________ dividend in each period.
   a. fixed rupee
   b. floating rupee
   c. principal
   d. interest

9. _________ are similar to payments of interest on debt, leasing in essence is an alternative to borrowing.
   a. Lease rental payments
   b. Principal payments
   c. Capital payments
   d. Interest payments

10. Lease financing decisions; involve a choice between _________ versus lease financing.
    a. profit financing
    b. fixed financing
    c. regular financing
    d. debt financing
Chapter VI
Amalgamation, Merger or Demerger of Companies

Aim
The aim of this chapter is to:

- analyse legal definitions of amalgamation, merger and demerger
- determine the difference between amalgamation and mergers
- investigate income tax implications in case of amalgamation

Objectives
The objectives of this chapter are to:

- examine the quantum and computation of depreciation
- familiarise with notional written down value
- explain amortisation of expenditure in case of amalgamation and demerger

Learning outcome
At the end of this chapter, the students will be able to:

- discuss tax concession related to transfer of capital asset
- recall what is meant by accumulated loss
- understand unabsorbed depreciation
6.1 Introduction

The pursuit of growth and the need to access new markets have been and are propelling companies the world over to undertake mergers & acquisitions. Indeed, this phenomenon is becoming part of the strategic architecture of many corporate bodies seeking not only to exploit existing core competencies but also to build new ones for the future. However, in order to grasp the tax implications of mergers, acquisitions and demergers it is essential to familiarise oneself with the relevant definitions, both legal and commercial as the incidence of taxation depends upon the fulfilment of certain statutory criteria.

According to the Oxford Dictionary, the expression “merger” or “amalgamation” means “combining of two commercial companies into one” and “merging of two or more business concerns into one” respectively.

Furthermore, while ‘merger’ is a fusion between two or more enterprises, whereby the identity of one or more is lost and the result is a single enterprise; ‘amalgamation’ signifies blending of two or more existing undertakings into one undertaking, the blended companies losing their identities and forming themselves into a separate legal identity. In addition, an ‘acquisition’ is the process by which the stock or assets of a corporation come to be owned by the buyer. The transaction may take the form of a purchase of stock or a purchase of assets. ‘Demerger’ in simple words means split or division of a company.

6.2 Meaning of Terms as Per Tax Law Amalgamation, Demerger

- The term “amalgamation” under the Income Tax Act has been given a meaning different from what is the common understanding of the term.
- In order to avail of the benefits under the Income Tax Act the companies must satisfy the definition of ‘amalgamation’ under Section 2 (1B). The definition under the said act is both exhaustive and conclusive for the purposes of the application of the Act. In short, the definition envisages,
  - the acceptance, by the mated company, of the rights and liabilities of the mating company
  - incorporation of the corpus of the mating company into the structure of the mated company
  - shareholders stake in the mating company is transformed either in cash or stake in mated company
  - extinguishment of the distinct legal entity of the mating undertaking
- It is important to note that under the said Act, the definition of merger does not contemplate:
  - the acquisition of the property of one company by the other company pursuant to the purchase of the property
  - distribution of property to another company due to the winding up of the transferor company
- The definition under the said section was introduced by the Finance (No.2) Act of 1967 and prior to its introduction a definition of ‘amalgamation’ was contained in Section 33(3) of the Act.
- The new definition clarifies that the term ‘amalgamation’ includes not only the merger of two or more companies to form one company, but also the merger of one or more companies with another existing company.
- The travaux préparatoires along with subsequent clarifications of the Central Government clearly indicate the intention of the Govt. to extend the exemption from tax liabilities for other forms of amalgamation.
- However, it is pertinent to note that the act does not contemplate the extension of this definition to amalgamations of other forms of legal entities like partnership firms or sole proprietorship. It is only concerned with corporate bodies.
- Merger or amalgamation under the Income Tax Act is said to occur when two or more companies combine into one company. One or more companies may merge with an existing company or they may merge to form a new company. In legal terms, the term amalgamation is used to denote merger.
- Sec.2 (1B) of the Income Tax Act 1961 defines amalgamation as the merger of one or more companies with another company or the merger of two or more companies (called amalgamating companies) to form a new company (called amalgamated company) in such a way that all assets and liabilities of the amalgamating company or companies become assets and liabilities of the amalgamated company and shareholders holding not less than three-fourths in value of the shares in the amalgamating company or companies become shareholders
• The following cases subject to fulfilling the above conditions, fall within the definition of Section 2 (1B)-
  • Merger of A Ltd. with X Ltd. (A Ltd. goes out of existence)
  • Merger of A Ltd. and B Ltd. with X Ltd. (A Ltd. and B Ltd. go out of existence)
  • Merger of A Ltd. and B Ltd. into a newly incorporated X Ltd. (A Ltd. and B Ltd. go out of existence)
  • Merger of A Ltd., B Ltd. and C Ltd. into a newly incorporated X Ltd. (A Ltd., B Ltd. and C Ltd. go out of existence)

• In the aforesaid cases, A Ltd., B Ltd. and C Ltd. are amalgamating companies while X Ltd. is the amalgamated company.

Transactions not treated as amalgamation Section 2 (1B)
Section 2(1B) specifically provides that in the following two cases there is no amalgamation, for the purpose of income tax though, the element of merger exists:
  • Where the property of the company which merges is sold to the other company and the merger is the result of a transaction of sale.
  • Where the company which merges is wound up in liquidation and the liquidator distributes its property to another company.

6.2.1 Demerger
Sec 2(19AA)
Demerger in relation to companies, means the transfer, pursuant to a scheme of arrangement under section 391 to 394 of the companies Act, 1956 by a demerged company of its one or more undertakings to any resulting company in such a manner that:
  • All the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of demerger.
  • 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 demerger.
  • The property and liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in the books of accounts immediately before the demerger.
  • The resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis.
  • The shareholders holding not less than three-fourths in value of shares in the demerged company other than shares already held therein immediately before the demerger or by a nominee for, the result company or, its subsidiary become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company.
  • The transfer of the undertaking is on a going concern basis.
  • The demerger is in accordance with the conditions, if any, notified under Sub-section (5) of section 72A by the Central Government in this behalf.

6.3 Income Tax Implications in Case of Amalgamation or Demerger
Section 32: Depreciation: Deduction under this section is allowable subject to the following conditions:
• The assets in respect of which depreciation is claimed must be building, machinery, plant, furniture or intangible assets
• Assessee must be the owner of the assets: In case of buildings, the assessee must own super structure and not necessarily land.
• Assets must be used for business / profession: If the asset is partly used for the business or profession and partly used for personal purpose, cost of the asset attributable to the business use shall be taken as a base for
4. 50% depreciation only if the asset is acquired during the year and used for the period of less than 180 days depreciation shall be allowed to the extent of 50%.

- No depreciation on land
- No deduction under this section is allowable if:
  - The assessee is not the owner.
  - The assessee is not the user.
  - The asset is sold during the year.
  - The asset is an imported car which is purchased after 28/2/75 but before 1/4/2001.
- However, if such imported motor car is used in a business of running it on hire for tourists, depreciation is allowable. Also if the imported motor car is used outside India in the business carried on by the assessee in another country, depreciation will be allowed on the same.
  - The asset is used for scientific research.
  - The asset is used for exploitation of mineral oil u/s 42.
  - Depreciation is available for tangible as well as intangible assets.

### 6.4 Quantum of Depreciation

Deduction on account of depreciation has to be calculated on such percentage of actual cost as may be prescribed in case of assets of an undertaking engaged in generation and distribution of power and in case of any block of assets on the written down value as may be prescribed. The rates are prescribed under Rule 5 and part 1 of Appendix of the Income Tax Rules.

#### 6.4.1 Computation of Depreciation

Meaning of certain terms relevant for computation of depreciation:

- **Block of Assets:** The term, ‘block of assets’ has been defined by section 2(11) to mean a group of assets falling within a class of assets, being buildings, machinery, plant or furniture in respect of which the same percentage of depreciation is prescribed. Thus, under each of the four types of assets (viz. Buildings, Machinery, Plant, Furniture), several blocks of assets shall be formed on the basis of percentage of depreciation.

- **Written Down Value of Block of Assets:** Sec. 43(6):
  - Step 1 - Aggregate of WDV of the block of assets at the beginning of the year.
  - Step 2 - Actual cost of any asset falling within the block acquired during the year.
  - Step 3 - From Step 1 + Step 2; deduct the monies received/receivables in respect of that asset (falling within block of assets) which is sold, discarded, demolished or destroyed during the year.

- The resulting amount is the WDV of the block of assets at the end of the year.

#### 6.4.2 Notional Written Down Value

Notional written down value are as follows:

- **Transfer in a scheme of amalgamation:** In such a case the actual cost of block of assets in the case of amalgamated company shall be the WDV of block of assets as in the case of amalgamating company for the immediately preceding previous year as reduced by the amount of depreciation actually allowed in relation to the said previous year.

- **WDV when assets are transferred in demerger:** In such a case the WDV of the block of assets of the demerged company for the immediately preceding year shall be reduced by the WDV of assets transferred to the resulting company in order to get WDV in the hands of the demerged company.

- **WDV in the hands of the resulting company:** In such a case the WDV of the one block of assets in case of the resulting company shall be the WDV of the transferred assets appearing in the books of accounts of the demerged company immediately before demerger.
6.5 Amortisation of Expenditure in the Case of Amalgamation/Demerger

Section 35 DD
W.e.f. AY 2000-01, where an assessee, being an Indian Company, incurs expenditure (on or after 01.04.1999) wholly and exclusively for the purpose of amalgamation or demerger; the assessee shall be allowed a deduction equal to one-fifth (1/5th) of such expenditure for 5 successive previous years beginning with the previous year in which amalgamation or demerger takes place.

6.5.1 Scientific Research
Where amalgamating company transfers to the amalgamated company, (being an Indian Company), any asset representing capital expenditure on scientific research and provisions of section 35 would apply to the amalgamated company as if amalgamating company had not transferred the asset.

6.5.2 Transfer of Capital Asset in Case of Amalgamation/Merger /Demerger
Tax concessions relating to transfer of capital asset in case of amalgamation/merger /demerger

- **Section 45 (1):** Transfer of capital asset: Any profits and gains arising from the transfer of a capital asset effected in the previous year shall be deemed to be chargeable to income tax under the head ‘Capital Gains’ and shall be deemed to be the income of the previous year in which the transfer took place excluding the exemptions provided. Transfer is defined in **Section 2(47):** The liability to tax on capital gains arises only if there is a transfer of capital asset.

- **Section 47:** Transaction not regarded as transfer Any transfer in a scheme of amalgamation of a capital asset by the amalgamating company to the amalgamated company, if the amalgamated company is an Indian company [Section 47 (vi)]

6.6 Computation of Capital Gains (Section 48 to 51)

- Section 48: The income under the head “Capital Gains” shall be computed by deducting the following from the full value of the consideration received or accrued as a result of the transfer of the capital asset:
  - Expenditure incurred wholly and exclusively in connection with such transfer.
  - The cost of acquisition of the asset and the cost of any improvement thereto;

- However, Provision – 1 to Section 48 gives special concession to non-resident and Provision 2 gives special concession to residents in respect of long-term capital gains.

Under different circumstances, the cost of acquisition of a capital asset is determined in the following manner:

- Cost to the previous owner: [Sec. 49(1)]: Under any scheme of amalgamation by the amalgamating company to the amalgamated company;

- Cost of acquisition of shares in amalgamated company [Sec. 49(2)]: Where a share or shares in an amalgamated company which is an Indian company became the property of the assessee in consideration of a transfer of his share or shares held in the amalgamating company, the cost of acquisition of the asset (share) shall be deemed to be the cost of acquisition to him of the share or shares in the amalgamating company.

- Cost of acquisition of the original share of the demerged company. Under Section 49(2D), it shall be deemed to have been reduced by the amount as so arrived at under Sub-section (2C) above. “Net Worth” for this section shall mean the aggregate of the paid up share capital and general reserves as appearing in the books of accounts of the demerged company immediately before demerger.

- Cost of acquisition in the case of slump sale [Sec. 50 B]: Section 50B has been inserted with effect from the assessment year 2000-01. Provisions of Section 50 B, applicable for computation of capital gains in the case of slump sale are given below:
  - Any profits or gains arising from the slump sale affected in the previous year shall be chargeable as long term capital gains and shall be deemed to be income of the previous year in which the transfer took place.
  - Where however, any capital asset being one or more undertakings owned and held by the assessee for not
more than 36 months is transferred under the slump sale, then capital gain shall be deemed to be short term capital gain.

- In the case of slump sale of the capital asset being one or more undertaking, the “net worth” of the undertaking shall be taken as cost of acquisition and cost of improvement. “Net worth” for this purpose is the aggregate value of total asset of the undertaking of division as reduced by the value of liabilities of such undertaking or division as appearing in the books of accounts. Any change in the value of assets on account of revaluation of asset of such undertaking or division shall be the written down value of block of asset determined in accordance with the provisions contained in sub-item (C) of Section 43(6) (c) (i) in the case of depreciable assets and the book value for all other assets.
- The benefit of indexation will not be available.
- Every assesse in the case of slump sale, shall furnish along with the return of income, a report of a chartered accountant in form No. 3 CEA indicating the computation of the net worth of the undertaking or division as the case may be has been correctly arrived at.

### 6.7 Carry Forward and Set Off of the Accumulated Losses and Unabsorbed Depreciation Allowance

(Section 72A)
W.e.f. assessment year 2000 – 2001, section 72A has been substituted by a new section to provide for carry forward and set off of accumulated loss and unabsorbed depreciation allowance in case of:

- Amalgamation [Section 72A (1), (2) and (3)], or
- Demerger [Section 72A (4) and (5)] or
- Reorganisation of business [Section 72A (6)]

#### 6.7.1 In Case of Amalgamation

[Section 72A (1), (2) and (3)]
As per section 72A (1) where there has been an amalgamation of a company, the accumulated loss and the unabsorbed depreciation of the amalgamating company shall be deemed to be loss or as the case may be, allowance for depreciation of the amalgamated company for the previous year in which the amalgamation is effected and the other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly, if the following conditions are satisfied:

- There is an amalgamation of the 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.
- The following conditions laid down under section 72A (2) are satisfied:
  - The amalgamating company has been engaged in the business for at least 3 years during which the accumulated loss has occurred or the unabsorbed depreciation has accumulated.
  - The amalgamating company has held continuously as on the date of the amalgamation, at least three fourths of the book value of the fixed assets held by it 2 years prior to the date of amalgamation.
  - The amalgamating company holds continuously for a minimum period of five years from the date of amalgamation at least 75% in the book value of assets of the amalgamating company acquired in the scheme of amalgamation;
  - The amalgamated company continues the business of the amalgamating company for a period of 5 years from the date of amalgamation.
  - The amalgamated company 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 purposes laid down by section 72A (2).

#### 6.7.2 In Case of Demerger

[Sec. 72 (3)]
- In a case where the conditions laid down under clause (b) above 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.

• The carry forward and set off of loss and unabsorbed depreciation as per the above provisions shall be allowed only when amalgamation is as per the provisions of Section 2 (1B) of the Income Tax 1961.

6.7.3 In Case of Demerger
[Sec. 72 (A) (4) and (5)]

• Notwithstanding anything contained in any other provisions of this Act, in the case of demerger, the accumulated loss and the allowance for absorbed depreciation of the demerged company shall:
  • Where such loss or unabsorbed depreciation is directly relatable to the undertaking transferred to the resulting company, be allowed to be carried forward and set off in the hands of the resulting company;
  • Where such loss or unabsorbed depreciation is not directly relatable to the undertakings transferred to the resulting company, be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings have been retained by the demerged company and transferred to the resulting company, land be allowed to be carried forward and set off in the hands of the demerged company or the resulting company, as the case may be.

• The Central Government may, for the purpose of this Act, by notification in the Official Gazette, specify such conditions, as it considers necessary to ensure that the demerger is for genuine business purpose.

• The carry forward and set off of accumulated loss and unabsorbed depreciation as per the above provisions shall be allowed only when demerger as per the provisions of Section 2 (19AA) of Income Tax Act.

6.7.4 In Case of Reorganisation of Business
[Section 72 A (6)]

• Where there has been reorganisation of business, whereby, a firm is succeeded by a company fulfilling the conditions laid down in clause (Xiii) of section 47 or a proprietary concern is succeeded by a company fulfilling the conditions laid down in clause (Xiv) or Section 47, notwithstanding anything contained in any other provisions of this Act, 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 the previous year in which business reorganisation was effected and other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly.

The following sub-section (6A) shall be inserted after sub-section (6) of section 72A by the Finance Act, 2010, w.e.f. 1-4-2011:

• 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 (xiii b) of section 47, then, notwithstanding anything contained in any other provision of this Act, the accumulated loss and the unabsorbed depreciation of the predecessor company, shall be deemed to be the loss or allowance for depreciation of the successor limited liability partnership for the purpose of the previous year in which business reorganisation was effected and other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly:
  • Provided that if any of the conditions laid down in the proviso to clause (xiii b) of 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 limited liability partnership, shall be deemed to be the income of the limited liability partnership chargeable to tax in the year in which such conditions are not complied with.

Consequences if the conditions laid down under Section 47 (Xiii) and (Xiv) are not complied with [Proviso to section 72A (6)]:
If any of the conditions laid down under section 47 (Xiii) and (Xiv) 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.

- Accumulated loss means so much of the loss of the predecessor firm or the proprietary concern or the amalgamating company or the demerged company, as the case may be, under the head “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 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 amalgamation or demerger had not taken place.

- The following clause (a) shall be substituted for the existing clause (a) of sub-section (7) of section 72A by the Finance Act, 2010, w.e.f. 1-4-2011: (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 means so much of the allowance for depreciation of the predecessor firm or the proprietary concern or the amalgamating company or the demerged company, as the case may be, which remains to be allowed and which would have been allowed to the predecessor firm or the proprietary concern or amalgamating company or demerged company, as the case may be, under the provision of this Act, if the reorganisation of business or amalgamation or demerger had not taken place.

- The following clause (b) shall be substituted for the existing clause (b) of sub-section (7) of section 72A by the Finance Act, 2010, w.e.f. 1-4-2011: “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;

Provisions relating to carry forward and set off of accumulated loss and unabsorbed depreciation allowance in scheme of amalgamation of banking company in certain cases – [Section 72A]

- Notwithstanding anything contained in sub-clauses (1) to (iii) of Clause (IB) of section 2 or section 72 A, where there has been an amalgamation of a banking company with any other banking institution under a scheme sanctioned and brought into force by the Central Government under subsection (7) of Sec. 45 of the Banking Regulations Act, 1949, the accumulated loss and the 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.
Summary

- In order to grasp the tax implications of mergers, acquisitions and demergers it is essential to familiarize oneself with the relevant definitions, both legal and commercial as the incidence of taxation depends upon the fulfilment of certain statutory criteria.

- According to the Oxford Dictionary, the expression “merger” or “amalgamation” means “combining of two commercial companies into one” and “merging of two or more business concerns into one” respectively.

- While ‘merger’ is a fusion between two or more enterprises, whereby the identity of one or more is lost and the result is a single enterprise; ‘amalgamation’ signifies blending of two or more existing undertakings into one undertaking, the blended companies losing their identities and forming themselves into a separate legal identity.

- In addition, an ‘acquisition’ is the process by which the stock or assets of a corporation come to be owned by the buyer. The transaction may take the form of a purchase of stock or a purchase of assets.

- Merger or amalgamation under the Income Tax Act is said to occur when two or more companies combine into one company. One or more companies may merge with an existing company or they may merge to form a new company.

- Deduction on account of depreciation has to be calculated on such percentage of actual cost as may be prescribed in case of assets of an undertaking engaged in generation and distribution of power and in case of any block of assets on the written down value as may be prescribed.

References


- Dr. Singhania, V.K., Dr. Singhania, K., 2005. Direct Taxes Planning and Management, 9th edition, Taxman’s.


Recommended Reading


1. ________ is a fusion between two or more enterprises, whereby the identity of one or more is lost and the result is a single enterprise.
   a. Merger
   b. Amalgamation
   c. Demerger
   d. Union

2. ________ signifies blending of two or more existing undertakings into one undertaking.
   a. Demerger
   b. Amalgamation
   c. Union
   d. Merger

3. In order to avail of the benefits under the Income Tax Act the companies must satisfy the definition of ‘amalgamation’ under Section ________.
   a. 3 (1B)
   b. 2 (2B)
   c. 3 (2B)
   d. 2 (1B)

4. In case of amalgamation, state which of the following is false.
   a. The acceptance, by the mated company, of the rights and liabilities of the mating company.
   b. Incorporation of the corpus of the mating company into the structure of the mated company.
   c. Establishment of the distinct legal entity of the mating undertaking.
   d. Shareholders stake in the mating company is transformed either in cash or stake in mated company.

5. The term, ________ has been defined to mean a group of assets falling within a class of assets in respect of which the same percentage of depreciation is prescribed.
   a. assets
   b. capital assets
   c. basic assets
   d. block of assets

6. The liability to tax on capital gains arises only if there is a ________ of capital asset.
   a. addition
   b. substitution
   c. transfer
   d. loss

7. Deduction on account of ________ has to be calculated on such percentage of actual cost as may be prescribed in case of assets.
   a. appreciation
   b. depreciation
   c. profits
   d. loss
8. If the asset is partly used for the business or profession and partly used for personal purpose, cost of the asset attributable to the business use shall be taken as a base for _______________.
   a. calculation of loss
   b. calculation of profit
   c. computation of depreciation
   d. computation of appreciation

9. The shareholders holding not less than ______________ in value of shares in the demerged company other than shares already held therein immediately before the demerger.
   a. three-fourths
   b. one-fourths
   c. two-thirds
   d. one-fifths

10. Every assessee, in the case of slump sale, shall furnish along with the return of income, a/an ______________ of a chartered accountant.
    a. account
    b. report
    c. analysis
    d. verification
Chapter VII

Employees’ Remuneration

Aim

The aim of this chapter is to:

• analyse factors which require consideration for tax calculations on employee remuneration
• investigate deduction of remuneration in the hands of employer
• determine taxation of perquisites in the hands of employees

Objectives

The objectives of this chapter are to:

• familiarise with valuation of perquisites
• view definitions of salary for various purposes
• examine fringe benefit tax

Learning outcome

At the end of this chapter, the students will be able to:

• recall motor car, education, medical facilities as per act
• discuss employee stock option plans
• understand valuation of notified fringe benefits
7.1 Introduction

Employee remuneration refers to the reward or compensation given to the employees for their work performances. Remuneration provides basic attraction to a employee to perform job efficiently and effectively. Remuneration leads to employee motivation. Salaries constitute an important source of income for employees and determine their standard of living. Salaries affect the employee’s productivity and work performance. Thus the amount and method of remuneration are very important for both management and employees.

All gains and profits derived by an employee in respect of his employment are taxable, unless they are specifically exempt from income tax or are covered by an existing administrative concession. The gains or profits include all benefits, whether in money or otherwise, paid or granted to him in respect of employment. Where employers also extend the benefits to the employee's family members, relatives and friends, the benefits would be taxable in the hands of the employee as a benefit from employment.

7.2 Factors Requiring Consideration

First, while calculating business income of the employer, remuneration paid to employees is fully deductible while calculating Taxable Income, otherwise the tax bill goes up. Second, one has to ensure that remuneration received by the employees and in the form it is received, should enable minimum tax in the employee’s hands and maximise take home pay.

7.2.1 Deduction of Remuneration in the Hands of Employer

Tax provisions allowing deduction of remuneration in the hands of employers are given below:

- Payment of salary to research personnel engaged in scientific research, [Sec.35 (1)].
- Employees’ health insurance premium paid by cheque by an employer– assessee to effect or keep in force insurance of the health of his employees under an approved scheme will be avowed as a deduction in computing his business income. Sec. 36(1) (ib).
- Bonus and commission paid to an employee for services rendered by him will be allowed as a deduction subject to a primary condition that the amount has not been distributed by way of profits or dividends and such bonus or commission has been paid in the relevant previous year or on or before the due date of filing of the return of income of the assessee [Sec36 (1) (ii) read with section 43B].
- Employer’s contribution to a recognised provident fund or approved superannuation fund is allowed as deduction subject to the limit laid down for such payments and provided these payments have been made on or before the due date of making such payments by the employer [Sec. 36 (1) (iv) read with sections 40A (9) and 43B].
- Employer’s contribution to an approved gratuity fund will be allowed as a deduction provided these payments have been made on or before the due date of making such payments by the employer [Sec. 36(1) (v) read with sections 40A (9) and 43B].
- Employee’s contribution to approved or statutory staff welfare schemes will be allowed as a deduction from the income of the employer provided such amounts have been paid on or before the due date of making such payments [Sec. 36(1) (va)].
- Family Planning Expenditure – any expenditure bonafide incurred by the company for the purpose of promoting family planning among the employees is allowed as a deduction. If such expenditure is of a revenue nature, the entire amount will be allowed as a deduction. If it is of a capital nature (such as purchase of equipment or construction of a clinic or dispensary), 1/5th of the expenditure will be allowed as a deduction in each of the five years from the year in which such expenditure has been incurred in equal instalments [Sec. 36(1) (ix)].
- Payment of salary/allowance and perquisites [sec.37 (1)].
- Salary payable outside India or to a Non-resident in India without deducting tax at source or after deducting it has not been paid to the Government [Sec.40 (a) (iii)].
- Payment to Provident Fund or other fund established for the benefit of the employees of assessee, unless assessee has made proper arrangement to deduct tax at source on the payments made from the fund which are chargeable to tax under the head salaries [Sec.40 (a) (iv)].
• Tax on perquisites paid by the employer on behalf of the employee which is exempt u/s 10 (10CC) in the hands of the employee is not allowed as a deduction from business income in the hands of the employer (assessee) via Sec. 40 (a) (v).

• Any sum paid on account of fringe benefit tax under chapter XII.

• Section 40 (b) Deductions on account of remuneration to the partners can be claimed under section 36 or 37 as the case may be, but it will be subject to the conditions prescribed as under:
  - Payment of salary, bonus, commission or remuneration by whatever name called, to a non-working partner shall not be allowed as deduction.
  - Payment of remuneration to working partners will be allowed as deduction only when it is authorised by and is in accordance with partnership deed.
  - Payment of remuneration / interest, although authorised by the partnership deed but which relates to a period prior to the date of such partnership deed, shall not be allowed.
  - Remuneration to all working partners shall not exceed the following limits:
    - In case of a firm carrying on a profession:
      i) On the first Rs. 1,00,000 of the book profit (or loss) Rs. 50,000 or @ 9% of the book profit, whichever is more
      ii) On the next Rs. 1,00,000 of the book profit —> @ 60%
      iii) On the balance of book profit —> @ 40%
    - In the case of any other firm:
      i) On the first Rs. 75,000 of the book profit (or loss) Rs. 50,000 or @ 90% of the book profit, whichever is more
      ii) On the next Rs. 75,000 of book profit —> @ 60%
      iii) On the balance of book profit —>@ 40%

• Explanation: Such disallowance is not applicable where an individual is a partner in the capacity of:
  - Representative and payment is done in individual capacity.
  OR
  - Individual and payment is done in representative capacity.

• AOP/BOI Salary / bonus / commission or remuneration paid by 40 (ba) AOP / BOI will not be allowed as a deduction

• Payment of salary to relatives [Sec. 40A (2)].

• Section 40A (3): Disallowance out of cash expenditure including salary exceeding Rs.20,000 : Where the assessee incurs any expenditure, in respect of which payment is made, in a sum exceeding Rs.20,000 otherwise than by a crossed cheque drawn on a bank or a crossed bank draft, 20% of such expenditure shall not be allowed as a deduction. However, there are certain exceptions provided in rule 6DD, under which expenditure, even exceeding Rs.20,000 shall be allowed as deduction, even though the payment is not made by a crossed cheque/draft.

• Besides, the employer has to ensure that proper tax is deducted at source and paid to the Government.

7.3 Taxation of Perquisites in the Hands of Employees

• Perquisites- Section 17(2): Perquisites are all benefits or amenities whether in cash or kind provided by the employer to the employee in addition to the salary or wages under the contract of employment. Section 17(2) defines the term ‘Perquisite’ to include the following:
  - Section 17(2) (i): Value of rent free accommodation provided to the assessee by his employer.
  - Section 17(2) (ii): Value of any concession in the matter of rent respecting any accommodation provided to the assessee by his employer.
  - Section 17(2) (iii): The value of any benefit or amenity granted or provided free of cost or at concessional rate is taxable only in the case of specified employees.
  - Specified employees are:
• A director employee.
• An employee having substantial interest in the company i.e., having beneficial ownership of equity shares carrying 20% or more voting power.
• An employee drawing salary in excess of Rs. 50,000. For computing the sum of 50,000, the following are excluded/deducted:
  – All non-monetary benefits
  – Monetary benefits which are not taxable
  – Deductions u/s 16 (i.e., standard deduction, deduction for entertainment allowance and professional tax)

In simple words, all taxable monetary benefits received shall be considered.

Notes:
Aggregate salary from more than one employer shall be considered i.e., Income under the head ‘Salary’.
• Employer’s contributions to RPF, interest thereon are deemed to be received. But deeming provisions have limited applications. Hence, deemed receipts shall not be included. Proviso to section 17(2)(iii): The value of any benefit provided by a company free of cost or at concessional rate to its employees by way of allotment of shares, debentures or warrants directly or indirectly under Employee’s Stock Option plan of the company will not be regarded as perquisites.
• Section 17(2) (iv): Any sum paid by the employer in respect of any obligation,
• which otherwise would have been payable by the employee.
• Section 17(2) (v): Any sum payable by the employer whether directly or through a fund other than a recognised provident fund or approved superannuation fund or deposit linked insurance fund or to assure the life of the employee.
• Section 17(2) (vi): The value of any other fringe benefit or amenity (excluding the fringe benefits chargeable to tax under Chapter XII – H) as may be prescribed. It may be noted that a new chapter XII – H (containing section 115W to 115WL has been inserted for the financial year 2005-06 and onwards providing for the levy of additional income tax at the rate of 30 percent (excluding surcharge and education tax as applicable) in the hands of employees in fringe benefits. Employees would include individual or HUF having income under the head business or profession of firm, company, AOP, BOI, local authority and every artificial judicial person.
• Interest free loan
• Travelling, Touring and Accommodation
• Free meals during work hours
• Gift vouchers and tokens
• Credit cards
• Club expenditure
• Use of movable assets
• Transfer of movable assets
• Employees' stock option plan
• Residual claims
7.4 Valuation of Perquisites

Section 17(2) (i) Rent Free Accommodation [Rule 3(1)]:

- Where the accommodation is taken on lease or rent by the employer (i) lease rent up to 60% of salary, the perquisite value will be taken as 10% if the accommodation is taken at the four metropolitan cities of salary (ii) lease rent up to 50% in case of other cities.
- If the lease rent exceeds 60% or 50% of salary, the perquisite value on account of free house will be calculated as Actual Lease Rent minus 60% (or 50%) of salary as the case may be.

7.4.1 Valuation of Accommodation

Valuation of Accommodation provided at concession to employee 17(2) (ii):
- Step 1: Calculate value of accommodation provided free as per 17(2) (i) above.
- Step 2: Deduct amount of concessional rent recovered from employee.
- Step 3: Value of perquisite = Step 1 – Step 2.

Meaning of Salary: For the purpose of calculating the value of the rent-free house or the value of concession in rent,
salary means that salary which includes pay, allowances, bonus or commission payable monthly or otherwise but does not include the following, namely:

- Dearness allowance unless it enters into the computation of superannuation or retirement benefits of the employee concerned.
- Employer’s contribution to the provident fund account of the assessee.
- Allowances which are exempt from payment of tax, e.g., conveyance.
- Perquisites u/s 17(2).

### 7.5 Other Perquisites for Specified Employees

#### Section 17(2) (iii) other perquisites for specified employees

Section 17 covers perquisites for specified employees like motor car facility, education facility and medical facility etc., which are as described below:

### 7.5.1 Motor Car Facility: Rule 3(2)

The motor car facility section states the following rules:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Circumstances</th>
<th>Value of perquisites per calendar month</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>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 b) Is used exclusively for the private or the personal purposes of the employee or any member of his household and the running and maintenance expenses are met or reimbursed by the employer 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, i) The expenses on the maintenance and running are met or reimbursed the employer (ii) The expenses on running and maintenance for such private or personal use are fully met by the employee</td>
<td>No value provided the documents specified at the end of the table are maintained by the employer 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 (which will be 10% of the cost of the motor car or cars) and as reduced by any amount charged from the employee for such use Rs.1200 (plus Rs.600, if chauffeur is also provided to run the motor car) - where the cubic by capacity of the engine does not exceed 1.6 litres and Rs.1600 (plus Rs.600) in other cases Rs.400 (plus Rs.600, if chauffeur is also provided to run the motor car) - where the cubic capacity of the engine does not exceed 1.6 litres and Rs.600 (plus Rs.600) in other cases</td>
</tr>
</tbody>
</table>
Where the employee owns a motor car but the actual running and maintenance charges (including remuneration of the chauffeur, if any) are met or reimbursed to him by the employer and,-

(i) Such reimbursement is wholly and exclusively for official purposes

(ii) Such reimbursement is and partly for personal

No value provided that the documents specified below the table are maintained by the employer

The actual amount of expenditure incurred by the employer as reduced by the amount specified in col.(1)(c)(i) i.e., Rs.1200 or Rs.1600 (plus Rs.600 if chauffeur is also provided). However in this case if the actual expenses on running and maintenance for official purposes is more than Rs.1200 or Rs.1600 (plus Rs 600 if chauffeur is also provided) as the case may be, he can claim such actual amount as deduction by maintaining the documents as specified below

Where the employee owns any other automotive conveyance but the actual running and maintenance charges are met or reimbursed to him by the employer and,-

(i) Such reimbursement is for use of vehicle wholly and exclusively for official purposes

(ii) Such reimbursement is for use of vehicle partly for official purposes and partly for personal or private purposes of the employee.

No value provided the documents specified below this table are maintained by the employer

The actual amount of expenditure incurred by the employer as reduced by an amount of Rs. 600. However if actual expenses on running and maintenance for official purpose is more than Rs. 600, he can claim such actual amount of expenditure as deduction by maintaining the documents specified below the table

Table 7.1 Motor car facility: rule 3(2)

7.5.2 Gas, Electricity or Water Supply Provided: Rule 3(4)

[Diagram: Purchased from outside agency, Supplied from own sources]

17(2) (iv) Amount paid to outside agency

17(2) (iii) Manufacturing cost per unit incurred by employer

Fig. 7.2 Gas, electricity or water supply provision

7.5.3 Domestic Servant: Rule 3(3)

This includes sweeper, gardener, watchman or personal attendant, cook and so on.
7.5.4 Education Facility: Rule 3(5)
- Training of employees is not taxable.
- Fixed Education Allowances Exempt up to 100 Rs. P.M. per child Up to max. 2 children Hostel Rs. 300.
- Payment of School fees/reimbursement Perq. = cost to employer u/s 17(2) (iv).
- Education facility provided in Education Institution owned by owner 17(2) (iii).

7.5.5 Medical Facilities
7.5.6 Value of other Perquisites

- Taxable on the basis of cost to employer where the employer pays for the benefit or amenity. Otherwise it would be valued at the amount the employer could reasonably be expected to pay to acquire such benefit from the market.
- Above shall be reduced by the employee’s contributions if any.

7.6 Notified Fringe Benefits

Valuation of notified fringe benefits u/s 17(2) (vi) [Taxable for all employees]

- Interest free/concessional loans
  - It is a common practice particularly in financial institutions to provide interest free or concessional loans to employees. The value of such perquisite would be the excess of interest payable at prescribed interest rate over interest if any actually paid by the employee.
  - The prescribed rate would be 10% p.a. for loans for housing and conveyance and 13% p.a. for other loans. Perquisite value would be calculated on the basis of the maximum outstanding monthly balance by the simple interest method.
  - The concessional rate of interest of 10% is applicable only if such housing or conveyance loans, which have been used for ‘acquiring capital assets’, i.e., house or conveyance. In case of loan taken for repairs, renovations, etc. the higher interest rate of 13% would be applicable for calculation of perquisite.
  - Small loans up to Rs. 20,000 in the aggregate are exempt. Loans for medical treatment specified in Rule 3A of the Income Tax Rules are also exempt, provided the amount of loan for medical reimbursement is not reimbursed under any medical insurance scheme.

- Travelling, touring and accommodation (Holiday Home Facility): Rule 3(7) (ii)
  - The value of travelling, touring, accommodation, any other expenses paid/borne/reimbursed by the employer for any holiday availed of by the employee (or any member of his household) shall be the “amount of expenditure incurred by the employer”, i.e., Cost to employer.
  - Where this facility is maintained by the employer and is not available uniformly to all employees, the value of perquisite will be “value at which such facilities are offered by other agencies to the public”.
  - In case of official tour, the expenses incurred in respect of any member of employee’s household accompanying him, the amount of expenditure so incurred shall also be fringe benefit or amenity.
  - The amount determined as per above rules shall be reduced by amount if any paid or recovered from the employee for such benefit.

- Free meals during working hours: [Rule 3(7) (iii)]
  - The new rule does not treat as perquisite free meals if the cost of the meal does not exceed Rs. 50/-. Where any amount is recovered from the employee, such amount shall be reduced from the value of perquisite.
  - Such free or subsidised meal should however be provided at office premises or through non-transferable vouchers meant for only meals during working hours. Tea or similar non-alcoholic beverages and snacks in the form of light refreshments during working hours are not charged as perquisites.

- Gifts, vouchers and tokens: [Rule 3(7) (iv)]
  - The value of any gifts or vouchers or tokens for ceremonial occasions or otherwise shall be determined as the sum equal to the amount of such gift.
  - The perquisite is taxable in the hands of all employees whether specified or not.
  - Exception to Rule 3(7)(iv): Where the value of such Gift/voucher/token is below Rs. 5000/- in the aggregate during the previous year, the value of perquisite shall be NIL [Circular 15/2001 dated Dec. 12, 2001] and where value of gift > Rs.5000 then up to Rs. 5000/-exemption is granted, excess of which is taxable.
  - No exemption is given for gift in cash or convertible in cash (e.g., Gift Cheque) is available.
  - Credit Cards (Including Add on Cards) [Rule 3(7) (v)]:
**Club facility**

- Where the employee has obtained corporate membership of the club and the facility is enjoyed by the employee (or any member of his household) the value of perquisite shall not include the initial fee for acquiring such corporate membership. Circular No. 15/2001 dated 12 Dec. 2001.
- Health Club, sports facilities, etc. provided uniformly to all classes of employees by the employer are exempt.
- The value of perquisites is not taxable if such expenditure is incurred wholly for official purposes. The following 3 conditions have to be satisfied:
  - Complete details in respect of such expenditure are maintained by employer which includes date of expenditure, nature of expenditure, etc.
  - Certificate by employee that the expense was incurred wholly and exclusively for official purposes.
  - Certificate from the supervising authority of the employee that the expense was incurred wholly and exclusively for official purposes.
- Where an employee incurs expenditure on entertainment and claims the same to have been incurred wholly and exclusively for the performance of his duties, the value of perquisite is not taxable if he gives the details of such entertainment expenses including nature and purpose of entertainment, persons entertained and business expediency for such entertainment.
- The amount as determined to be value of perquisite can be reduced by any amount which is paid or recovered from the employee for such benefit.
Use of employer’s movable assets: [Rule 3(7) (vii)]
Movable Assets: Include all movable assets used by the employee (or any member of his household) whether owned by the employer or hired by him but includes:
- Assets already specified i.e., motor cars
- Laptops and Computers

Movable assets sold by an employer to his employee at a nominal price: [Rule 3(7) (viii)]
Movable Asset: Includes all movable assets belonging to the employer, transferred directly or indirectly to the employee (or any member of his household).
Prior to the Finance Act, 2000, stock options were taxed at two stages i.e., as perquisite (on the amount representing the difference between the exercise price and the fair market value on the date of exercise) and on capital gains at the time of transfer of the same. With effect from 1.4.2001 (relevant to Assessment year 2001-02), onward, stock options issued as per guidelines of the Central Government are to be taxed only once, at the time of sale, as capital gains.

In cases, where perquisites has been assessed with reference to exercise of the option by the employee u/s 17(2), the fair market value at the time of exercise of the option shall be the cost of acquisition of share for working out the capital gains. The relevant guidelines of the Central Government have been issued vide notification No. 1021 (E), dated 11.10.2001. Stock options not in conformity with the above guidelines [non-qualified stock options] shall continue to be taxed at both the stages.

**Residual clause**

- A benefit on amenity not included in the rules shall be valued at the cost under an arm’s length transaction to the employer where the employer pays for the benefit or amenity.
- However, the benefit of conveyance to and from residence to place of work, periodicals and journals required for discharge of work and expenses on telephone including a mobile phone shall not be included in calculating perquisites.

### 7.7 Profit in Lieu of Salary

**Section 17(3)**

Section 17(3) defines ‘profit in lieu of salary’ to include:

- The amount of compensation due to or received by an assessee from his employer or former employer at or in connection with
  - Termination of employment; or
  - Modification of the terms and conditions of employment.
- Any payment due to or received by the assessee from his employer or former employer or from provident or any other fund or any sum received under a key man insurance policy including the sum allocated by way of bonus on such policy (It does not include exempt payments from superannuation fund, gratuity, commuted pension, retrenchment compensation, house rent allowance, employee’s contribution to PF and interest thereon).
- Any amount due to or received whether in lump sum or otherwise, by any assessee from any person before his
joining any employment with that person or after cessation of his employment with that person.

7.7.1 Exemptions from Salary Income

Remuneration of employees of a foreign enterprise [Section 10(6) (vi)]:

- Remuneration received by an individual who is not a citizen of India as an employee of a foreign enterprise for service rendered by him during his stay in India is exempt, subject to the following conditions:
  - The foreign enterprise is not engaged in any trade or business in India.
  - His stay in India does not exceed in the aggregate a period of 90 days in the previous year, and
  - Such remuneration is not deductible from the income of the employer chargeable under this Act.

Remuneration of a member of crew on foreign ship: [Section 10(6) (viii)]:

- Salaries received by any non-resident individual for services rendered in connection with employment on a foreign ship are exempt provided that his total stay in India does not exceed in the aggregate, a period of 90 days in the previous year.

Remuneration of employees of foreign government [Section 10(6) (xi)]:

- Any remuneration received by any individual, who is not a citizen of India, as an employee of the Government of a foreign state during his stay in India is exempt, if the stay is in connection with his training in any establishment, office or undertaking which is owned by:
  - The Government, or
  - Any company in which the entire paid-up capital is held by the Central Government or by State Government or by both or any company, which is subsidiary of (ii) or
  - Any corporation, established by or under a Central, State or Provincial Act;
  - Any society, which is registered under the Societies Registration Act, 1860 or any corresponding law and which is wholly financed by the Central Government or by State Government or by both.

Travel concessions to a citizen of India or LTA [Section 10(5)]:

- Any travel concession or assistance received by an individual, from his employer for himself and his family for proceeding on leave to any place in India, from his employer or former employer for himself and his family for proceeding to any place in India after retirement or termination of his service is exempt to the extent of actual expenditure but limited to:
  - In case of journey by air, air economy fare of the national carrier by the shortest route will be exempt.
  - Where place of origin of journey and destination are connected by rail and the journey is performed by any mode of transport other than air, air-conditioned first class rail fare by the shortest route will be exempt.
  - Where rail link does not exist between place of origin of journey and place of destination, but a recognised public transport system exists, first class or deluxe class fare on such transport system will be exempt.
  - Where no such public transport system exists, air conditioned first class rail fare by the shortest route will be exempt.

- For this purpose, family means:
  - Spouse and children and parents, brothers and sisters, if they are wholly or mainly dependant on him.
  - The exemption is available to an individual in respect of 2 journeys performed in a block of 4 calendar years. These blocks have been counted since 1986 and the current block that is applicable is from 2002-2005.
  - Where such travel concession is not availed of by the employee during such block of 4 calendar years, he will be entitled to additional exemption of travel concession in the first year of the next block of 4 years. E.g., an employee has undertaken 3 journeys between 1994 and 1998. He is entitled to travel concession exemption only in respect of 2 journeys.
  - However, if he had not performed any journey during this period, then for the next block 1999 to 2003, he would be entitled to exemption in respect of 3 journeys provided the first journey takes place in 1999.
• Allowances and perquisites outside India: [section 10(7)] Any allowances or perquisites, which are paid outside India by the Government to a citizen of India for rendering services outside India, are exempt from Income Tax in India.

Remuneration under Co-op. Technical Assistance Programme [Sec. 10(8)]:

• In the case of an individual who is assigned duties in India in connection with any co-operative technical assistance programmes and projects in accordance with an agreement entered into by the Central Government and the Government of a foreign state (the terms whereof provide for the exemption given by this clause), the following income shall be exempt:
  • The remuneration received by him directly or indirectly from the Government of that foreign state for such duties and
  • Any other income of such individual which accrues or arises outside India, in respect of which such individual is required to pay any income or social security tax to the Government of that foreign state.

• Remuneration or fee received by non-resident ‘consultants’, their employees and their family members – [Sec 10(8A), (8B) and (9)]: Any remuneration or fees received by a consultant out of the funds made available to an international organisation under a Technical Assistance Grant Agreement between the agency and the government of the foreign state and any income which accrues or arises to him outside India shall be exempt from tax.

• Again, the remuneration received by an individual from the consultant referred to in section 10(8) as above shall also be exempt. Further, the income of any family member of the consultant or the employee of the consultant which accrues or arises outside India in respect of which tax is payable in the foreign state shall also be exempt from tax.

Retrenchment compensation [section 10(10B)]:

• Any compensation received by workmen under the Industrial Disputes Act, 1947 or under any other Act or Rules there under or any standing order or any award, contract of service or otherwise shall be exempt to the extent of minimum of the following:
  • Actual amount received.
  • Amount calculated in accordance with Sec. 25F(L) of the Industrial Disputes Act, 1947 which is equal to 15 days average pay for every completed year of service or part thereof in excess of 6 months.
  • Amount specified by the Central Government i.e., Rs. 500,000/-. It has been provided that the above referred limit will not apply at all, in respect of any compensation received by a workman in accordance with the scheme approved by the Central Government.

Compensation on –rement by certain employees [Section10(10C)]:

• Any amount received on voluntary retirement by an employee under any scheme of voluntary retirement is exempt from tax. This exemption is available only to employees of:
  • A public sector company
  • Any other company
  • A statutory corporation
  • A local authority
  • A co-operative society
  • A recognised university
  • An Indian Institute of Technology
  • The Central Government
  • Any State Government

• Such institute of management as Central Government may notify Institutions having importance throughout India or in any state or states This exemption is limited only to a maximum of Rs.5lakhs.

• This exemption is available only once to any individual employee.
The scheme for voluntary retirement to avail this exemption should be framed in accordance with the guidelines, which may be prescribed by the Central Government. It may be noted here that the above exemption is not available to any employee other than those specified above. Thus, if an employee of a partnership firm receives any amount on voluntary retirement, the same shall not be exempt under this clause:

- The main features of the guidelines for VRS are as follows: (Rule 2BA of Income Tax Rules):
  - It applies to an employee who has completed 10 years of service or completed 40 years of age.
  - It applies to all employees including workers and executives of a company or of an authority or of a co-operative society, as the case may be, excepting directors of a company or of a co-operative society.
  - The scheme of voluntary retirement has been drawn to result in overall reduction in the existing strength of other employees.
  - The vacancy caused by the voluntary retirement is not to be filled up.
  - The retiring employee of a company shall not be employed in another company or concern belonging to the same management.
  - The amount receivable on account of voluntary retirement of the employee does not exceed the amount equivalent to three months’ salary for each completed year of service or salary at the time of retirement multiplied by the balance months of service left before the date of his retirement on superannuation.

### 7.8 Fringe Benefit Tax

Fringe benefits have been defined to mean:

- Any privilege, service, facility or amenity directly or indirectly provided by an employer to employees including former employees whether by way of reimbursement or otherwise.
- Free or concessional tickets provided for private journeys of employees and their family members and the valuation is cost provided by employer to the general public fewer amounts recovered from employees.
- Contributions by employer to approved superannuation fund. The above do not include the perquisites, by way of privilege, service, facility or amenity, in respect of which tax is paid / payable by the employee. Fringe value will be actual amount of contribution.

#### 7.8.1 Deemed Fringe Benefits and their Valuation

The fringe benefits shall be deemed to have been provided by the employer to his employees, if the employee has in the course of business or profession (including any activity whether or not such activity is carried on with the object of deriving income, profits or gains) incurred any expense on or made any payment for, the following purposes namely:

- Entertainment
- Provision of hospitality of every kind by the employer to any person whether by way of provision of food or beverages or in any other manner whatsoever and whether or not such provision is made by reason of any express or implied contract or custom or usage of trade but does not include:
  - Any expenditure on or payment for, food or beverages provided by the employer to his employees in office or factory.
  - Any expenditure on or payment through paid vouchers which are not transferable and usable only at eating joints or outlets.
- Conference (other than fee for participation by the employee in any conference) For the purpose of this clause, any expenses on conveyance, tour and travel (including foreign travel) or hotel or boarding and lodging in connection with any conference shall be deemed to be expenditure incurred for the purposes of conferences.
- Sales promotion including publicity: Exceptions: any expenditure on advertisement:
  - Being expenses including rental on advertisement of any form in any print (including journals, catalogues or price lists) or electronic media or transport system.
• Being the expenditure on the holding or the participation in any press conference or business conventions, fair or exhibitions.
• Being expenses on sponsorship of any sports event or any other event organised by any government agency or trade association or body.
• Employees Welfare: Exemption – Any expenditure incurred or payment made to fulfil any statutory obligation or mitigate occupational hazards or provide first aid facilities in the hospital or dispensary run by the employer.
• Conveyance tour and travel (including foreign travel).
• Use of hotel, boarding and lodging facilities.
• Repair, running (including fuel) maintenance of motor cars and amount of depreciation.
• Repair, running (including fuel), maintenance of aircraft and the amount of depreciation.
• Use of telephone (including mobile phone) other than expenditure on leased telephone lines.
• Maintenance of any accommodation in the nature of guest house other than accommodation used for training purposes.
• Festival celebration.
• Use of health club and similar facilities.
• Use of any other club facilities.
• Gifts and
• Scholarships.

7.8.2 Value of Fringe Benefits
• 20% of the expenses referred to in clauses (A) to (K)
• 50% of the expenses referred to in clauses (I) to (P)

Special valuation
• In the case of an employer engaged in the business of hotel – the valuation under clause (B) above shall be 5% instead of 20%.
• In the case of employer engaged in the business of construction – the valuation under clause (F) above shall be 5% instead of 20%.
• In the case of employer engaged in the business of manufacture of production of pharmaceuticals the valuation under clause (F) and (G) shall be 5% instead of 20%.
• In the case of employer engaged in the business of manufacture and production of computer software, the valuation under clause (F) and (G) shall be 5% instead of 20%.
• In the case of employer engaged in the business of carriage of passenger goods by motor car, the value of fringe benefits under clause (H) above shall be 5% instead of 20%.
• In the case of employer engaged in the business of carriage of passenger or goods by aircraft, the value of fringe benefits under clause (I) shall be NIL.

7.9 Employer’s Obligations
• Fringe benefit tax will be payable by the employer, even if no income-tax is payable by an employer on his total income.
• Every employer who has paid or made provision for payment of fringe benefits will have to furnish a return of fringe benefits by 31st July or 31st October (if the employer is a company or is liable to tax audit).
• The fringe benefit tax will be payable as advance tax at 30% of the value of fringe benefits paid or payable in each quarter and shall be paid before the 15th of the month following the quarter. The advance tax for the March quarter shall be paid on or before 15th March.
• There are detailed provisions for filing return of Fringe Benefits assessment, Best Judgment assessment, fringe
benefits escaping assessment, interest for default in furnishing return of fringe benefits.

**No deduction to employer:**
A new sub-clause has been inserted in Section 40 to provide that any sum paid on account of fringe benefit tax will not be allowed as a deduction while computing income from business or profession.

**Definition of the Term “Salary” for Various Purposes**

<table>
<thead>
<tr>
<th>Allowance /Perquisites</th>
<th>Definition</th>
</tr>
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<tbody>
<tr>
<td>Entertainment allowance</td>
<td>Basic salary</td>
</tr>
</tbody>
</table>
| Gratuity for employees covered under the payment of Gratuity act | i. Basic salary  
| | ii. Dearness allowance |
| Gratuity for other cases | i. Basic salary  
| Contribution to RPF | ii. Dearness allowance if provided in terms of employment  
| Leave salary | iii. Commission as a percentage of turnover  
| House rent allowance |  
| Voluntary retirement |  
| Perquisite in terms of rent free accommodation | All pay, allowance, bonus or commission payable monthly or otherwise or any monetary payment by whatever name called from one or more employers but excludes  
| | a) Dearness allowance not forming part in computation of superannuation or retirement benefit  
| | b) Employer’s contribution to the PF a/c of the employee  
| | c) Allowances which are exempt from tax  
| | d) Value of taxable perquisites u/s 17(2)  
| | e) Any payment or expenditure in the nature of allotment of shares, debentures or warrants under ESOP or any other scheme  
| | f) Any allowances in the nature of medical facility to the extent not taxable  
| Specified Employee | Salary and allowances excluding non-monetary benefits, exempt allowance and deduction u/s 16  
| Standard deduction | i) Salary  
| | ii) All taxable allowances  
| | iii) All taxable perquisites excluding  
| | a) Entertainment allowance  
| | b) Professional Tax  

**Table 7.2 Salary definitions**

**7.10 Propositions for Tax Planning**

The propositions described here should be borne in mind in connection with tax planning under the head “Salaries”. It should be ensured that under terms of employment, dearness allowance and dearness pay form part of the salary. This will minimise tax incidence on house rent allowance, gratuity and commuted pension. Likewise, incidence of tax on employer’s contribution to recognised provident fund will be lesser if dearness allowance forms part of basic salary.

- The Supreme Court has held in Gestetner Duplicators (P) Ltd. vs. CIT [1979]1 Taxman 1/117 ITR 1 that commission payable as per terms of contract of employment at a fixed percentage of turn over achieved by an employee, falls within the expression ‘salary’ as defined in rule 2((h) of Part A of Fourth Schedule. Consequently, tax burden on house rent allowance; gratuity and commuted pension will be lesser if commission is paid at a
fixed percentage of turnover achieved by the employee.

- Commuted pension is fully exempt from tax in the case of Government employees and partly exempt from tax in case of Non-government employees who can claim relief under section 89. Hence employees should get their pension commuted.

- An employee being a member of recognised provident fund who leaves the job before completing five years, should ensure that his next employer also maintains a recognised provident fund since the accumulated balance of the provident fund with the former employer will be exempt from tax, provided the same is transferred to the new employer, who also maintains a recognised provident fund.

- Employer’s contribution toward recognised provided fund is exempt from tax up to 12% of salary; employers may give additional benefit to their employees by raising the contribution to 12% of salary without increasing any tax liability.

- Medical allowance payable in cash is taxable, whereas ordinary medical facilities are not taxable provided certain conditions are satisfied. Therefore employees should go for free medical facilities instead of fixed medical allowance.

- Since incidence of tax on retirement benefits like gratuity, commuted pension and accumulated balance of unrecognised provident fund is lower if they are paid at the beginning of the financial year, employer and employees should mutually plan their affairs in such a way that retirement, termination or resignation, as the case may be, takes place at the beginning of a financial year.

- An employee should take the benefit of relief available under section 89 wherever possible. Relief can be claimed even in the case of a sum received from an unrecognised provident fund so far as it is attributable to employer’s contribution and interest thereon. Although gratuity received during employment is not exempt from tax u/s 10(10), relief u/s89 can be claimed.

- Pension received in India by a non-resident assessee from abroad is taxable in India. If, however such pension is first received by or on behalf of the employee in a foreign country and later on remitted to India, it will be exempt from tax.

- Perquisite in respect of leave travel concession is not taxable in the hands of employees if certain conditions are fulfilled. It should be ensured that the travel concession should be claimed to the maximum possible extent without attracting any incidence of tax.

- All perquisites in respect of free refreshment during office hours, free residential telephone, providing use of computer/laptop, gift of movable assets (other than computer, electronic items, car, by employees after using for 10 years or more are not taxable, employees can claim these benefits without adding to their tax bill.

- For the purpose of valuation of perquisites in respect of rent free house, the term salary includes basic salary, bonus commission and all other taxable allowances; it is beneficial if an employee goes in for perquisites rather than for taxable allowances. This may reduce valuation of rent free house on the one hand and exempt employees from falling within the purview of specified employee u/s1792(iii).

- Optimum combination of allowances and perquisites depends upon the individual requirement of each employee taking into consideration present take home pay and future benefits of different items in salary structure.
Summary

- Employee Remuneration refers to the reward or compensation given to the employees for their work performances. Remuneration provides basic attraction to a employee to perform job efficiently and effectively. Remuneration leads to employee motivation. Salaries constitute an important source of income for employees and determine their standard of living.
- The gains or profits include all benefits, whether in money or otherwise, paid or granted to him in respect of employment.
- Where employers also extend the benefits to the employee's family members, relatives and friends, the benefits would be taxable in the hands of the employee as a benefit from employment.
- Meaning of Salary: For the purpose of calculating the value of the rent-free house or the value of concession in rent, salary means that salary which includes pay, allowances, bonus or commission payable monthly or otherwise but does not include the following, namely: dearness allowance unless it enters into the computation of superannuation or retirement benefits of the employee concerned, employer’s contribution to the provident fund account of the assessee, allowances which are exempt from payment of tax, e.g., conveyance, perquisites u/s 17(2).
- Taxable on the basis of cost to employer where the employer pays for the benefit or amenity. Otherwise it would be valued at the amount the employer could reasonably be expected to pay to acquire such benefit from the market.
- It is a common practice particularly in financial institutions to provide interest free or concessional loans to employees. The value of such perquisite would be the excess of interest payable at prescribed interest rate over interest if any actually paid by the employee. The prescribed rate would be 10% p.a. for loans for housing and conveyance and 13% p.a. for other loans.
- Movable Asset: Includes all movable assets belonging to the employer, transferred directly or indirectly to the employee (or any member of his household).
- The fringe benefits shall be deemed to have been provided by the employer to his employees, if the employee has in the course of business or profession (including any activity whether or not such activity is carried on with the object of deriving income, profits or gains) incurred any expense on or made any payment for, the following purposes namely: entertainment, provision of hospitality etc

References

- Dr. Singhania, V.K., Dr. Singhania, K., 2005. Direct Taxes Planning and Management, 9th edition, Taxman’s.

Recommended Reading

Self Assessment

1. Employee remuneration refers to the reward or compensation given to the employees for their _________.
   a. work performances
   b. salaries
   c. paid leaves
   d. motivation

2. All ______________ derived by an employee in respect of his employment are taxable, unless they are specifically exempt from income tax or are covered by an existing administrative concession.
   a. losses
   b. gains and profits
   c. money
   d. salaries

3. Employers extend the benefits to the employee's family members, relatives and friends, the benefits would be taxable in the hands of the employee as a benefit from__________.
   a. salary
   b. business
   c. employment
   d. relations

4. State which of the following is true.
   a. Employer’s contribution to a recognised provident fund or approved superannuation fund is not allowed as deduction subject to the limit laid down for such payments.
   b. Employer’s contribution to a recognised provident fund or approved superannuation fund is allowed as substitution subject to the limit laid down for such payments.
   c. Employer’s contribution to a recognised government fund or approved superannuation fund is allowed as deduction subject to the limit laid down for such payments.
   d. Employer’s contribution to a recognised provident fund or approved superannuation fund is allowed as deduction subject to the limit laid down for such payments.

5. If the lease rent exceeds 60% or 50% of salary, the perquisite value on account of free house will be calculated as __________ minus 60 % (or 50%) of salary as the case may be.
   a. perquisite lease
   b. perquisite rent
   c. actual calculated rent
   d. actual lease rent

6. It is a common practice particularly in __________ to provide interest free or concessional loans to employees.
   a. hospitals
   b. schools
   c. financial institutions
   d. NGOs
7. The ___________ shall be deemed to have been provided by the employer to his employees, if the employee has incurred any expense on or made any payment for, the purposes like entertainment, provision of hospitality etc.
   a. capital benefits
   b. fringe benefits
   c. profit benefits
   d. interest benefits

8. State which of the following is true.
   a. Family for travel concessions mean spouse and children and parents, brothers and sisters, if they are wholly or mainly dependant on employee.
   b. Relatives for travel concessions mean spouse and children and parents, brothers and sisters, if they are wholly or mainly dependant on employee.
   c. Family for medical concessions mean spouse and children and parents, brothers and sisters, if they are wholly or mainly dependant on employee.
   d. Family for travel concessions mean spouse and children and parents, brothers and sisters, if they are wholly or mainly dependant on company owner.

9. Fringe benefit tax will be payable by the employer, even if no ___________ is payable by an employer on his total income.
   a. money
   b. profit
   c. income-tax
   d. deduction

10. The gains or profits include all benefits, whether in money or otherwise, paid or granted to employee in respect of ____________.
    a. payment
    b. employment.
    c. taxes
    d. profits
Chapter VIII
Non Residents

Aim
The aim of this chapter is to:

• explore categories of NRIs
• investigate taxation of international transaction
• explain tax treaties

Objectives
The objectives of this chapter are to:

• examine strategy for tax planning concerning residential status
• explain about salaries of other foreign citizens
• familiarise students with deemed associate enterprises

Learning outcome
At the end of this chapter, the students will be able to:

• comprehend methods of computing arm’s length price
• recall scheme of advance ruling
• understand special provisions related to non residents
8.1 Introduction

India is a growing economy, but India is still termed ‘developing’. Investments by non-residents boost our economy, India thus progressing towards the concept of development. A non-resident is a person who is living abroad (temporarily or permanently) and is either a citizen of India (NRI) or a Person of Indian Origin (PIO) or an Overseas Citizen of India (OCI). In order to have investments by all of them, the Government of India, together with the Income Tax (I-T) Department, has formulated various relief and concessional tax rates while also simplifying the process of tax assessment. Non-residents have been given special status under I-T laws having special provisions for non-residents’ (certain) income. Tax is payable on income arising from bonds and/or Indian shares purchased using the NRI Dmat Account in foreign currency or capital gains from transfer, dividends, interest on foreign currency debt and income from Indian mutual funds.

Generally, NRI Income taxes come into various categories, but specifically he has to pay tax in India only if her/his income/salary/allowance etc., is amassed in/from the Indian Territory. This stands true for non-residents also, but there are exceptions to the general rule.

8.2 Main Categories of NRIs

The following are the main three categories of NRIs:-

- Indian citizens who stay abroad for employment or for carrying on a business or Vocation or any other purpose in circumstances indicating an indefinite period of stay abroad.
- Indian citizens working abroad on assignment with foreign government agencies like United Nations Organisation (UNO), including its affiliates, International Monetary Fund (IMF), World Bank etc.
- Officials of Central and State Government and Public Sector undertaking deputed abroad on temporary assignments or posted to their offices, including Indian diplomat missions, abroad.

8.3 Tax Planning Concerning Residential Status

For the purpose of tax planning, the following propositions should be borne in mind:

- In order to enjoy non-residential status, individuals who are visiting India on a business trip, in or in some other connection, should not stay in India for more than 181 days during one previous year and their total stay in India during any four previous years preceding the relevant previous year should in no case exceed 364 days.
- If individuals having been in India for more than 365 days during four years preceding the relevant previous year, desire to stay in India for more than 60 days they should plan their visit in such a manner that their total stay in India falls under two previous years. For e.g., a person can come to India anytime during first week of February and can stay upto May 29th without the risk of losing non-resident status.
- An Indian citizen or a person of Indian origin (whether rendering service outside India or not) can stay for a maximum period of 181 days on a visit to India without losing non-resident status. If however such persons wish to stay in India for more than 181 days, they should plan their visit in such a manner that their maximum stay for two previous years and their stay in each previous year should not exceed 181 days.
- Indian citizens going abroad for the purpose of employment can stay in India for 181 days without becoming resident in that year even if they were in India for more than 365 days during the four preceding years. This concession is available only to those who want to leave the country for the purpose of employment. However the term employment is not defined in the act and therefore one has to depend upon judicial pronouncements.
- A non-resident can escape tax liability in respect of income earned out of India if he makes arrangement in such a way that the income is first received out of India and then remittance in whole or part is made to India, even though the business is controlled from India.
- A person who is not ordinarily resident, earning income outside India from a business controlled outside India can avoid tax liability if he first receives income in a foreign country and then remits the whole or part of it to India, either in the same year or in the following year (s).
- Non-ordinarily, resident persons can claim a set of losses sustained in the business controlled outside India against their income taxable in India, provided they shift the control of their business to India.
8.3.1 Interest Income to Non-residents
The following interest incomes are exempt from tax [Sec. 10(4), (4B)]

- In the case of non-resident interest on bonds or securities notified by the Central Government including income by way of premium on the redemption of such bonds.
- In the case of person resident outside India (under section 2(q) of the foreign exchange regulation act income from interest on monies standing to credit in a non-resident (external) account in India, in accordance with the said act and
- In the case of an Indian citizen or a person of Indian origin who is non resident, the interest from notified Central Government securities. If such certificates are subscribed in convertible foreign exchange remitted from outside through official channels. A person shall be deemed to be of Indian origin if he or either of his parents or any of his grand parents, was born in undivided India.

8.4 Salaries of Other Foreign Citizens

- **Remuneration of foreign state representatives [Section 10(6) (ii)]:** Remuneration received by an individual who is not a citizen of India, as an official of an embassy, high commission,legation, commission, consulate or trade representation of a foreign state or as a member of the staff of any of these offices, for services in such capacity is exempt provided Indians are accorded similar benefits in that foreign country and the members of the staff are subjects of the country represented and are not engaged in any business or profession or employment in India otherwise than as members of such staff.

- **Remuneration of employees of a foreign enterprise [Section 10(6) (vi)]:** Remuneration received by an individual who is not a citizen of India as an employee of a foreign enterprise for service rendered by him during his stay in India is exempt, subject to the following conditions:
  - The foreign enterprise is not engaged in any trade or business in India.
  - His stay in India does not exceed in the aggregate a period of 90 days in the previous year and
  - Such remuneration is not deductible from the income of the employer chargeable under this Act.

- **Remuneration of a member of crew on foreign ship: [Section 10(6) (viii)]:** Salaries received by any non-resident individual for services rendered in connection with employment on a Foreign Ship are exempt provided that his total stay in India does not exceed in the aggregate a period of 90 days in the previous year.

- **Remuneration of employees of foreign Government [Section 10(6) (xi)]:** Any remuneration received by any individual, who is not a citizen of India, as an employee of the Government of a foreign state during his stay in India is exempt, if the stay is in connection with his training in any establishment, office or undertaking which is owned by:
  - The Government; or
  - Any company in which the entire paid-up capital is held by the Central Government or by State Government or by both or any company, which is subsidiary of (ii) or
  - Any corporation, established by or under a Central, State or Provincial Act.
  - Any society, which is registered under the Societies Registration Act, 1860 or any corresponding law and which is wholly financed by the Central Government or by State Government or by both.

- **Remuneration under Co-op. Technical Assistance Programme [Sec. 10(8)]:** In the case of an individual who is assigned duties in India in connection with any co-operative technical assistance programmes and projects in accordance with an agreement entered into by the Central Government and the Government of a foreign state (the terms whereof provides for the exemption given by this clause), the following income shall be exempt:
  - The remuneration received by him directly or indirectly from the Government of that foreign state for such duties and
  - Any other income of such individual which accrues or arises outside India, in respect of which such individual is required to pay any income or social security tax to the Government of that foreign state.

- Remuneration or fee received by non-resident ‘consultants’, their employees and their family members – [Sec 10(8A), (8B) and (9)]: Any remuneration or fees received by a consultant out of the funds made available to an
international organisation under a Technical Assistance Grant Agreement between the agency and the government of the foreign state and any income which accrues or arises to him outside India shall be exempt from tax.

Again, the remuneration received by an individual from the consultant referred to in section 10(8) as above shall also be exempt. Further, the income of any family member of the consultant or the employee of the consultant which accrues or arises outside India in respect of which tax is payable in the foreign state shall also be exempt from tax.

8.5 Technical Services in Projects Connected with the Security of India

Income of Foreign Companies Providing Technical Services in Projects Connected with the Security of India [Section 10(6C)]

Any income arising to a notified foreign company by way of fees for technical services rendered in pursuance of an agreement entered into with the government for providing service in or outside India in projects connected with the security of India, shall be exempt from tax.

8.6 Shipping Business in the Case of Non-residents

Section 44B: Special Provisions for Computing Profits and Gains of Shipping Business in the Case of Non-residents

In the case of an assessee, who is a non-resident and is engaged in the business of operation of ships, a sum equal to 7.5 percent of the aggregate of the following:

- The amounts paid or payable whether in or out of India to the assessee on account of carriage of passengers, livestock, mail or goods shipped at any port in India, and,
- Any amount received or deemed to be received in India on account of carriage of passengers, livestock, mail or goods shipped at any port outside India, shall be deemed to be the profits of such business. The carriage amount will also include amount paid or payable by way of demurrage charge or any other amount of similar nature.

8.7 Provisions Relevant for NRIs

Special provisions have been enacted to determine the business income of the NRIs, in case of certain business activities. These provisions are briefly explained below:

<table>
<thead>
<tr>
<th>Section</th>
<th>Nature of Business Turnover</th>
<th>Profit as % of turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>44B</td>
<td>Shipping business</td>
<td>7.5%</td>
</tr>
<tr>
<td>44BB</td>
<td>Business of supplying plant and machinery and used in extraction of mineral oils or business of providing services or facilities in connection with extraction of mineral oils</td>
<td>10%</td>
</tr>
<tr>
<td>44BA</td>
<td>Business of operation of aircraft</td>
<td>5%</td>
</tr>
</tbody>
</table>
Corporate Tax Planning

| 44BBB | Foreign company engaged in the business of civil construction, the business of erection of plant or machinery or testing or commissioning thereof in connection with power project approved by the central government | 10% |

Table 8.1 Provisions relevant for NRIs

- Notwithstanding anything to the contrary contained in Section 28 to 47 except Section 42, the income of a non-resident engaged in the business of providing services or liabilities in connection with or supplying plant and machinery on hire, used or to be used, in the prospecting for or extraction or production of mineral oils shall be computed at a flat rate of 10% of:
  - The amount paid or payable whether in or out of India to the assessee or someone on his behalf on account of the provision of such services and facilities and supply of plant and machinery on hire used or to be used in the prospecting for or extraction or production of mineral oils outside India and
  - The amount received or deemed to be received in India by or on behalf of the assessee on account of provision of services and facilities in connection with or supply of plant and machinery on hire used or to be used, in protecting for or extraction or production of mineral oils outside India.

- Provisions of Section 44BB not to apply to income to which the provisions of section 42, 115A or 293A apply for the purpose of computing profits or gains or any other income referred to in these sections.

8.8 Operations of Aircraft

Special provisions for computing profits and gains of business of operations of aircraft in the case of non-residents (Sec. 44BBA):

- Notwithstanding anything to the contrary contained in Sec. 28 to 43A, the income of a non-resident engaged in the business of operation of an aircraft shall be completed at flat rate of 5% of (a) the amount paid or payable whether in India or out of India to the assessee or to any person on his behalf on account of carriage of passengers, livestock, mail or goods from any place in India and (b) the amount received or deemed to be received in India, on account of carriage of such items from a place outside India.

8.9 Foreign Companies Engaged in Civil Construction

Special provisions for computing profits and gains of foreign companies engaged in the business of civil construction, etc. in certain turnkey power projects (Section 44BBB):

- Notwithstanding anything to the contrary contained in Sec. 28 to 44AA in the case of an assessee, being a foreign company, engaged in the business of civil construction or the business of erection of plant or machinery or testing or commissioning thereof, in connection with a turnkey power project approved by the Central Government in this behalf and financed under an international aid programme, a sum equal to 10% of the amount paid or payable (whether in or out of India) to the said assessee or to any person on his behalf on account of such civil construction, erection, testing or commissioning shall be deemed to be profits and gains of such business chargeable to tax under the head “Profits and gains of business or profession”.

- The following sub-section (2) shall be inserted after sub-section (1) of section 44BBB by the Finance Act, 2003, w.e.f. 1-4-2004:
  - (2) Notwithstanding anything contained in sub-section(1), an assessee may claim lower profits and gains than the profits and gains specified in that sub-section, if he keeps and maintains such books of account and other documents as required under sub-section (2) of section 44AA and gets his accounts audited and furnishes a report of such audit as required under section 44AB and thereupon the Assessing Officer shall
proceed to make and assessment of the total income or loss of the assessee under sub-section (3) of section 143 and determine the sum payable by or refundable to, the assessee.

8.10 Head Office Expenditure

Section 44C: Deduction of head office expenditure in the case of non residents

Notwithstanding anything to the contrary contained in sections 28 to 43A, in the case of an assessee, being a non-resident no allowance shall be made in computing the income chargeable under the head. Profits and gains of business or profession, in respect of so much of the expenditure in the nature of head office expenditure as is in excess of the amount computed as hereunder normally:

- An amount equal to five percent of the adjusted total income or
- The amount of expenditure in the nature of head office expenditure incurred by the assessee as is attributable to the business or profession of the assessee in India.

Whichever is the least:

Provided that in a case where the adjusted total income of the assessee is a loss, the amount under clause (a) shall be computed at the rate of five percent of the average adjusted total income of the assessee during the last three years so that loss of that particular year need not be accounted for computing average adjusted total income.

H.O. expenses means executive and general administration expenditure incurred by the assessee outside India including rent, rates, taxes, repairs or insurance of any premises outside India used for the purpose of business. Salary, wages, annuity, pension, fees, bonus, commission, gratuity, perquisites or profits in lieu of or in addition to salary of any office outside India, travelling by an employee or other persons employed in or managing the affairs of any office situated outside India and such other matters connected with executive and general administration as may be prescribed.

8.11 Income by Way of Royalties

Sec. 44 DA: Special provision for computing income by way of royalties, etc. in the case of non-residents –

- The income by way of royalty or fees for technical services received from the government or an Indian concern in pursuance of an agreement made by a non-resident (not being a company) or a foreign company with government of the Indian Concern after 31st day of March 2003, where such non-resident (not being a company) or a foreign company carries on business in India through a permanent establishment situated therein or perform professional services from a fixed place of profession situated therein and the right property or contract in respect of which the royalties or fees for technical services are paid is effectively connected with such permanent establishment or fixed place of profession, as the case may be, shall be computed under the head “Profits and gains of business or profession” in accordance with the provisions of this Act. Provided that no deduction shall be allowed:
  - in respect of any expenditure or allowance which is not wholly and exclusively incurred for the business of such permanent establishment or fixed place of professions in India or
  - in respect of amounts, if any, paid (other wise than towards reimbursement of actual expenses), by the permanent establishments to its head office or to any of its other offices.

- It may be noted that every non-resident (not being a company) or a foreign company shall keep and maintain books of accounts and other documents in accordance with the provisions contained in Sec. 44AA and get his accounts audited by an accountant as defined in Sec. 288 (2) and furnish along with the return of income, the report of such audit in the “prescribed form” duly signed and verified.

The following proviso shall be inserted after the existing proviso of sub-section (1) of section 44DA by the Finance Act, 2010, w.e.f. 1-4-2011 :

Provided further that the provisions of section 44BB shall not apply in respect of the income referred to in this section.

- (2) Every non-resident (not being a company) or a foreign company shall keep and maintain books of account and other documents in accordance with the provisions contained in section 44AA and get his accounts audited by an
accountant as defined in the Explanation below sub-section (2) of section 288 and furnish along with the return of income, the report of such audit in the prescribed form 37 duly signed and verified by such accountant.

8.11.1 Computation of Income and Tax under Section 115A, 115AB, 115AC, 115AD, 115BBA and 115D

Non-resident person other than a company, having total income exceeding the maximum exemption limit is liable to pay tax at the same rate as in the case of a resident assessee except in the following cases:

- Income from certain specified assets/sources falling under Sections 115A, 115AB, 115AC, 115AD, 115BBA covered under Chapter XII of the Income Tax Act. In these cases, tax on such income is chargeable at a flat rate.
- Certain incomes of Non-resident Indians covered under Chapter XIIA of the Income Tax Act, consisting of Sections 115C to 115I. In this case, the non-resident Indian has been given an option to pay tax either under Chapter XIIA at a certain special flat rate or as per the other provisions of the Act.

Note 1- It is not necessary for an assessee referred to in section 115A (1), 115AC (1), 115BBA or 115D to furnish his return of income under section 139(1) if he has income in respect of which he is assessable under the Act during the previous year consisted only of income referred to in Section 115A(1)(a) or 115AC(1)(a), or 115BBA or Section 115D and Tax deductible at source under the Act has been deducted from such income.

8.12 Taxation of International Transactions

[Sections 92 to 92F]

The provisions under Sections 92 to 92F have been enacted to provide a statutory framework which can lead to computation of reasonable fair and equitable profit and tax in India so that profits chargeable to tax in India do not get diverted elsewhere. An income arising from an international transaction should be computed having regard to arm’s length price.

8.12.1 Conditions for Applicability of Arm’s Length in the International Transaction

**Condition 1**- Two or more enterprises-international transaction is subjected to arm’s length price only in case of transaction between two entities called associate enterprises.

Meaning of associated enterprises: Enterprise means a person who engages or has been engaged or proposed to engage in the following activities

- Any activity relating to production, storage, supply, distribution, acquisition or control of articles or goods.
- Know-how, patents, copyrights, 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.
- Any activity relating to the provision of services of any kind.
- Carting out any work in pursuance of a contract (e.g., construction contract).
- Investment activity.
- Activity relating to provision of loan.
- Business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any body corporate.
- A person would be an enterprise if it carries on the specified activity/business directly or through one or more of its units or divisions or subsidiaries.

**Condition 2**- Enterprise should be regarded as associated enterprise:

An enterprise should be regarded as associated enterprise of another enterprise, if

- It participates, directly or indirectly or through one or more intermediaries, in the management or control or capital of the other enterprise, or
- In respect of it, one or more persons who participate, directly or indirectly or through one or more intermediaries,
in its management or control or capital are the same persons who participate, directly or indirectly or through one or more intermediaries, in the management or control or capital of the other enterprise.

8.12.2 Deemed Associated Enterprises
Section 92A (2) provides that two enterprises shall be deemed to be associated enterprises, if, at any time during the previous year

• One enterprise holds directly or indirectly shares carrying not less than 26% of the voting power in the other enterprise [clause a] or
• Any person or enterprise holds directly or indirectly shares carrying not less than 26% of the voting power in each of such enterprises [clause b], or
• A loan advanced by one enterprise to the other enterprise constitutes not less than 51% of the book value of the total assets of the other enterprise [clause c], or
• One enterprise guarantees not less than 10% of the total borrowings of the other enterprise [clause d], or
• More than half of the directors or members of the governing board or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise [clause e] or
• 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 [clause f], or
• The manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, 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 [clause g], or,
• Ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise or by persons specified by the other enterprise and the prices and other conditions relating to supply are influenced by such other enterprise [clause h], or,
• The goods or articles manufactured 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 thereto are influenced by such other enterprise [clause i], or,
• Where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual [clause j] or
• Where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative [clause k], or
• Where one enterprise is a firm, association of persons or body of individuals the other enterprise holds not less than ten per cent interest in such firm association of persons or body of individuals [clause l], or
• There exists between two enterprises, any relationship of mutual interest, as may be prescribed [clause m], or

Condition 3-International transaction should be carried by the associated enterprise-
To constitute an international transaction, it should be:

• A transaction between two or more associated enterprises(whether or not both are non-residents) in nature of (a) purchase, sale or lease of intangible property, or(b) provision of services, or(c) lending or borrowing money.
• A transaction between two or more associated enterprises (whether or not both are non-residents) having a bearing on the profits, income, losses or assets of such associated enterprises.
• Mutual agreement or arrangement between two or more associated enterprises for (a) allocation or apportionment of or (b) contributing to, any cost or expense incurred (or to be incurred) regarding a benefit, service or facility provided (or to be provided) to any one or more of such associated enterprise.
8.12.3 Deemed International Transaction

Section 92B (2): Section provides that a transaction between an enterprise and another person is deemed as transactions entered between two associated enterprises if either of the following exists:

- There is a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or
- The terms of the relevant transaction are determined in substance between such other person

Transaction-meaning of- Sec.92F provides an inclusive definition. The transaction includes an arrangement, understanding or action in concert, whether or not such arrangement, understanding or action is formal or in writing or is intended to be enforceable by legal proceeding.

8.12.4 Computation of the Arm’s Length Price

Meaning-Arm’s length price as per section 92F is the price applied (or proposed to be applied) when two unrelated persons enter into a transaction in uncontrolled conditions.

The following points should be kept in mind while computing arm’s length price:

- Income whether includes Income net of expenses-income includes losses also and the word ‘income’ will constitute ‘Income net of expenses’.
- Section 92 overrides Sections 5 and 9-According to Section 5, a non-resident is liable to tax in respect of income which is received or deemed to be received in India by him or on his behalf or which accrues or arises or is deemed to accrue or arise in India during the previous year.
- Similarly, Section 9 provides for income which is deemed to accrue or arise in India. Section 5 reads as follows: “Subject to the provisions of this Act, the total income of any previous year of a person ____”.

Use of the phrase “Subject to other provisions of Act” implies that in considering what is total income under Section 5, one has to exclude such income, as is excluded from the scope of the total income by reason of any other provisions of the Income Tax Act and not that the other provision of the Income Tax Act, override the provisions of Section 5.

Therefore, Section 92 does not override Section 5.

- Having regard to meaning of- The use of the words ‘having regard to’ denote that it is not incumbent upon the Assessing Officer to compute the arm’s length price for each and every international transaction. Therefore, factors other than arm’s length price, like restrictions imposed by the government policy on free market play, should also be taken into account along with arm’s length price.
- Intent to deceive revenue or malafide motive to avoid/reduce tax in international transaction-Section 92 has to be applied in every such case where an international transaction has taken place and the price agreed to between the two enterprises is different from the arm’s length price, whether or not there is malafide motive. According to OECD guidelines, the need to make adjustment to approximate arm’s length dealings arises irrespective of any contractual obligations undertaken by the parties to pay a particular price or of any intention of the parties to minimise tax. Thus, a tax adjustment under the arm’s length principle would not effect the underlying contractual obligations.
  - Restrictions imposed by Government on free market play-If certain Government policies hinder the free market play by restricting, for instance, payment of interest or the rate charged thereupon, then the arm’s length price shall be computed by taking into account such restrictions of Government policies.

8.12.5 Methods of Arm’s Length Price Computation

(Section 92C)

- Comparable Controlled Price Method
  - The price charged or paid for property transferred or services provided in a comparable uncontrolled transaction i.e., a transaction between enterprises other than associated enterprises whether resident or non-resident or a number of such transactions, is identified,
Such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering such transactions, which could materially affect the price in the open market;

The adjusted price arrived at under (b) supra is taken to be arm’s length price in respect of the property transferred or services provided in the international transaction.

**Resale Price method**

- The price at which property purchased or services obtained by the enterprise is resold or are provided to an unrelated enterprise, is identified;
- Such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction or a number of such transactions;
- The price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services;
- The price so arrived at is adjusted to take into account the functional and other differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market;
- The adjusted price arrived at under (b) supra is taken to be an arm’s length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise;

**Cost Plus Method**

- The direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined;
- The amount of normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise or by an unrelated enterprise, in a comparable uncontrolled transaction or a number of such transactions is determined;
- The normal gross profit mark-up referred to in (b) supra is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market;
- The costs referred to in (a) supra are increased by the adjusted profit mark-up arrived at under (c) supra;
- The sum so arrived at is taken to be an arm’s length price in relation to the supply of the property or provision of services by the enterprise.

**Profit Split Method**

This method is applicable involving transfer of unique intangibles or multiple transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining arm’s length prices of any one transaction. As per profit split method, which

- The combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined;
- The relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;
- The combined net profits are then split amongst the enterprises in proportion to their relative contributions, as evaluated under (b) supra;
The profit thus apportioned to the assessee is taken into account to arrive at an arm’s length price in relation to the international transaction.

**Transactional Margin**
- The net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales affected or assets employed or to be employed by the enterprise or having regard to any other relevant base;
- The net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is compared having regard to the same base;
- The net profit margin referred to in b) supra arising in comparable uncontrolled transactions is adjusted to take into account the difference if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;
- The net profit margin realised by the enterprise and referred to in (a)(supra) is established to be the same as the net profit margin referred to in (c) supra;
- The net profit margin thus established is then taken into account to arrive at an arm’s length price in relation to the international transaction.

**8.12.6 Comparability of Transaction**

Comparability of transaction can be judged with reference to the following, namely
- The specific characteristics of the property or services transferred in each transaction;
- The functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transaction;
- The contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are divided between the respective parties to the transactions;
- Conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, costs of labour and capital in the markets, overall economic development and level of competition and whether markets are wholesale or retail.

When two transactions are deemed to be comparable-An uncontrolled transaction shall be comparable to an international transaction, if
- None of the differences (if any) between the transactions being compared or between the enterprises entering such transaction, are 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;
- The data to be used for comparison shall be the data relating to the financial year in which the international transaction has been entered into. However, the data relating to a period (not being more than two years prior to such financial year) may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

**8.12.7 Most Appropriate Method**

The most appropriate method shall be selected having regard to the following:
- The nature and class of the international transaction;
- The class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account the assets employed and the risks assumed;
- The availability, coverage and reliability of data necessary for application of the method;
- The degree of comparability existing between international transaction and the uncontrolled transaction and between the enterprises entering such transaction:
• The nature, extent and reliability of assumptions required to be made in application of a method.
• In a case where the factors referred to above indicate more than one method as the most appropriate method, the method providing the result obtainable by application of a method other than such methods may be taken as the most appropriate method.
• Mean of arm’s length price-To provide flexibility in adopting an arm’s length price, it is provided that where the most appropriate method results in more than one price, a price which differs from arithmetic mean by an amount not exceeding 5 per cent of such mean may be taken to be the arm’s length price at the option of the assessee.

8.12.8 Determination of Arm’s Length Price by the Assessing Officer in Certain Cases [Sec 92C (3)]
The Assessing Officer may determine the arm’s length price if the following conditions are satisfied
• There is proceeding for assessment of income.
• The assessing officer has material or information or document in his possession.
• On the basis of such material or information or document, the assessing officer is of the opinion that the
  • Arm’s length price charged or paid in international transaction has not been determined in accordance with Sub-section(1) or (2) of Section 92C, or
  • Assessee has not kept the prescribed information or document relating to an international transaction; or
  • Information or data used for computing the arm’s length price is not reliable or correct; or
  • Assessee has failed to furnish, within the time specified any information or document which was required to be furnished by the Assessing Officer;
• On satisfaction of the aforesaid conditions, the assessing officer may proceed to determine the arm’s length price.
• As the word ‘may’ has been used, there is no stringent rule that in every case where the price charged/ or avoided is not in accordance with Section 92C (1) and (2) the arm’s length price must be determined under section 92C (3) by the Assessing officer.

8.12.9 Determination of Total Income After Computing Arm’s Length Price
[Sec 92C (4)]
• The Assessing Officer may compute the total income of the assessee having regard to arm’s length price determined under Section 92C (3). However the assessing officer shall not make any adjustment to the arm’s length price determined by the taxpayer, if such price is up to 5 per cent less or up to 5 percent more than the price determined by the assessing officer. In such cases the price determined by the tax payer may be accepted- Circular No 12/2001, dated August 23, 2001.
• The Assessing Officer is empowered to re compute the total income of the assessee having regard to the arm’s length price. If the total income is enhanced, no deduction under section 10A, 10B or under Chapter 6A would be allowed.
• Speaking order-the Assessing Officer is required to provide the assessee with a copy of reasons supporting the inference drawn while computing the arm’s length price for the transaction.

8.12.10 Maintenance of Books of Accounts
Income chargeable under the act should not decrease on applying arm’s length price [Sec92 (3) and second proviso to sec. 92C (4)] Maintenance of Books of Accounts [Sec92D]
• Every person who has entered into an international transaction shall keep and maintain the following information and documents:
  • A description of ownership structure of the assessee enterprise with details of shares or other ownership interest held by other enterprises;
  • A profile of the multinational group of which asset enterprise is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international
transactions have been entered into by the assessee and the ownership linkages among them.

- A broad description of the business of the assessee and the industry in which the assessee operates and of the business of the associated enterprises with whom the assessee has transacted.
- The nature and terms (including prices) of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of transaction;
- A description of the functions performed, risks assumed and assets employed or to be employed by the enterprises involved in the international transaction;
- A record or market analysis, forecasts, budgets or any other financial estimates prepared by the assessee for the business as a whole or for each division or product separately, which may have a bearing on the international transaction;
- A record of uncontrolled transactions taken into account for analysing their comparability with the international transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions;
- A record of the analysis performed to evaluate comparability of the uncontrolled transactions with the relevant international transaction.

A description of the methods considered for determining arm’s length in relation to each international transaction or class of transaction, the method selected as the most appropriate method and adjustments, if any, which were made to account for differences between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions;

A record of the actual working carried on for determining the arm’s length price, including details of the comparable data and financial information used in applying the most appropriated method and adjustments if any, which were made to account for differences in the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions;

- The assumptions, policies and price negotiations, if any, which have critically affected the determination of above arm’s length price;
- Details of the adjustments, if any, made to transfer prices to align them with arm’s length prices determined under these rules and consequent adjustment made to total income for tax purposes;
- Any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the arm’s length price.

The information specified above should be available by the due date of submission of return of income. In case where the aggregate values of international transactions entered into by the assessee do not exceed Rs. 1 crore, the information and documents specified above may not be maintained.

However, such assessee shall be required to substantiate, on the basis of material available with him, that income arising from international transactions entered into by him has been computed in accordance with Section 92.

## 8.13 Support by Authentic Documentation

- The information specified above shall be supported by authentic documentation, which may include the following
  - Official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprises or of any other country;
  - Reports of market research studies carried out by recognised institutions;
  - Price publications including stock exchange and commodity market quotations;
  - Published accounts and financial statements relating to the business affairs of the associated enterprise;
  - Agreements and contracts entered into with associated enterprises or with unrelated enterprises, in respect of transactions similar to the international transactions;
  - Letters and other correspondence documenting any terms negotiated between the assessee and the associated
enterprise;
• Documents normally issued in connection with various transactions;
• The information specified above should be available before the due date of submission of return of income.

• Continuity of international transaction for more than a year—Where an international transaction continues to have effect over more than one previous year, fresh documentation need not be maintained separately in respect of each previous year, unless there is any significant change in the nature or terms of the international transaction in the assumptions made or in any other factor and in case of such significant change, fresh documentation as may be necessary shall be maintained detailing the impact of the change on pricing of the international transaction.

• Period for which information should be maintained—The information and documents referred to above shall be kept and maintained for a period of eight years from the end of the relevant assessment year.

• Report from accountant—The report from an accountant which is required to be furnished under section 92E by every person who has entered into an international transaction during the previous year shall be in Form No.3CEB and be verified in the manner indicated therein. It shall be furnished before the due date of submission of return of income.

8.14 Computation of Capital Gains
(In the case of non-resident)

• Section 48: Income under the head “Capital Gains” shall be computed by deducting the following from the full value of the consideration received or accrued as a result of the transfer of the capital asset:
  • Expenditure incurred wholly and exclusively in connection with such transfer;
  • The cost of acquisition of the asset and the cost of any improvement thereto.

• However, Proviso – 1 to Section 48 gives special concession to non-residents and Provision 2 gives special concession to residents in respect of long-term capital gains.

• Proviso-1 to Section 48: Concession to a non-resident: In order to give protection to non-residents who invest foreign exchange to acquire capital assets, Section 48 contains a provision. Accordingly, in the case of non-residents, capital gains arising from the transfer of shares / debentures of an Indian company are to be computed as follows:

  • The cost of acquisition, the expenditure incurred wholly and exclusively in connection with the transfer and full value of the consideration are to be converted into the same foreign currency with which such shares were acquired. The aforesaid manner of computation of capital gains shall be applied for every purchase and sale of shares or debentures in an Indian company.
  • Rule of computation - If the aforesaid conditions are satisfied, then the following procedure shall be followed to determine capital gains-
    - Capital gain shall be computed in the same foreign currency which was initially utilised in acquiring shares or debentures;
    - Capital gain so computed in foreign currency shall be reconverted into Indian currency; the benefit of indexation shall not be available;
    - The aforesaid manner of computation shall be applicable in respect of capital gain accruing or arising from every re-investment thereafter in (and sale of) shares in (or debentures of) an Indian company.
    - The aforesaid manner of computation is applicable only when the conditions abovementioned are satisfied. In no other case is the above procedure available.

Special provision relating to non-residents [secs.115C to 115-I]

• With a view to encourage the flow of foreign exchange remittances into India and investments in India by non-resident Indian citizens and foreign nationals of Indian origin, Sections 115C to 115-I make certain provisions relating to certain incomes of such non-residents.
Following are “non resident Indians” for this purpose: “non-resident Indian” means an individual, being a citizen of India or a person of Indian origin who is not a “resident”. (A person shall be deemed to be of Indian origin if he or either of his parents or any of his grand-parents, was born in undivided India)

**Incomes which are qualified for special treatment**

- Investment income (but other than income referred to in section 115-o) derived from foreign exchange assets, and
- Long-term capital gains on sale or transfer of ‘foreign exchange assets’.
- Foreign exchange assets - It means those ‘specified assets’ which the assessee has acquired or purchased with or subscribed to in, convertible foreign exchange.
  - Shares in an Indian company (public or private).
  - Debentures issued by an Indian company which is not a private company
  - Deposits with an Indian company which is not a private company it may be even deposit with SBI or any other banking company.
  - Any security of the Central Government; and
  - Such other assets as the Central Government may specify in this behalf by notification in the Official Gazette.

**How to calculate investment income**

In computing the investment income of a non-resident Indian, no deduction in respect of any expenditure or allowance shall be allowed under any provisions of the Act. Moreover no deduction under sections 80CCC to 80U shall be allowed in respect of investment income of non-resident Indians.

**How to calculate long-term capital gain**

It should be computed subject to the following points:

- The benefit of indexation under second proviso to section 48 is not available in respect of sale or transfer of foreign exchange assets.
- No deduction is permissible in respect of long-term capital gain under sections 80CCC to 80U.
- By investing sale consideration in another asset, the non-resident Indian can claim exemption under section 115-F.

**8.15 Tax Treaties: The Elimination of Double Taxation**

The primary purpose of tax treaties is to prevent international double taxation or to provide remedies when it occurs. The general pattern between two treaty countries is to grant reciprocal reductions on dividends withholding and to exempt royalties and some times interest payments from any withdrawing tax.

The US has withholding tax of 30% for owners (individuals and corporate) of US securities that are issued in countries with which it has no tax treaty. However, interest on portfolio obligation and in bank deposits is normally exempted from withholding. When a tax treaty is in effect, the US rate on dividends generally is reduced to 15% and the tax on interest and royalties is either eliminated or is reduced to a very low level.

**8.15.1 Double Taxation Avoidance Agreement**

- The Central Government under Section 90 of the Income Tax Act, 1961, has entered into double tax avoidance agreement (hereinafter referred to as Tax Treaties) with other countries. These tax treaties service the purpose of providing protection to tax payers against double taxation and thus preventing any discouragement which the double taxation may otherwise promote in the free flow of international trade, international investment and international transfer of technology.
- These treaties aim at preventing discrimination between the tax payers in the international field and providing a reasonable element of legal and fiscal certainty within a legal framework. In addition such treaties contain
provisions for mutual exchange of information and for reducing litigation by providing for mutual assistance procedure.

- Double taxation arises when the jurisdictional correction used by different countries overlap or the tax payers may have connections with more than one country.

Jurisdictional connections used by the countries are as follows:

- **Status Jurisdiction:** Jurisdictional connection is the personal status of the tax payer rather than source of the income.
  - In the case of companies, fiscal domicile (location of the seat of management and net legal domicile, place of incorporation) is the jurisdictional test.
  - Tax is paid on global income i.e., income from foreign and domestic sources are taxed.
  - Tax rates are applied on the total global income (cannon of equity).
  - Economically advanced countries like US, UK, Germany, Sweden and Netherlands follow this system.

- **Source Jurisdiction:** European countries follow Source Jurisdiction accruing or arising from each source in the country of origin is subject to taxation in that country. France, Latin American Countries and some Middle East countries follow this system.

- **Both Status and Jurisdiction:** India follows both the methods. However, unlike source jurisdiction countries, income from each source is not taxed separately, though it is computed under each source. The aggregate income from all sources is taxed applying the principle of progressive taxation, thus following the cannon of equity.

8.15.2 Countries without Agreement

[Sec.91] [Unilateral relief]

If any person who is resident in India in any previous year proves that, in respect of his income which accrued or arose during the previous years outside India (and which is not deemed to accrue or arise in India ), he has paid tax in any country with which there is no agreement under Section 90 for the relief or avoidance of double taxation, income tax by deduction or otherwise, under the law in force in that country, he shall be entitled to the deduction from the Indian income tax payable by him of a sum calculated on such doubly taxed income at the Indian rate of tax or the rate of tax of the said country, whichever is lower or at the Indian rate of tax if both the rates are equal.

8.16 The Scheme of Advance Ruling

- With a view to avoid a dispute in respect of assessment of income-tax liability, in the case of non-resident, a Scheme of Advance Ruling was introduced by incorporating Chapter XIX-B in the Income Tax Act, 1961 by the Finance Act, 1993.

- The scheme enables the non-resident to obtain, in advance, a binding ruling from the authority for Advance Ruling on issues which could arise in determining their tax liabilities so that time consuming and expensive appeals can be avoided. Such issues may relate to transactions undertaken or proposed to be under taken by the non-resident applicant. The Authority for Advance Ruling (procedure) Rules, 1996 provide detail procedure for obtaining advance ruling.

- The scheme in due course of time has been extended to:
  - Resident applicants for determining tax liability of a non-resident arising out of transaction entered into by a resident with such non-resident.
  - Determination or decision in respect of an issue relating to computing of total income which is pending before any income tax authority or the Appellate Tribunal.
Summary

- Tax is payable on income arising from bonds and/or Indian shares purchased using the NRI Dmat Account in foreign currency or capital gains from transfer, dividends, interest on foreign currency debt and income from Indian mutual funds.

- Generally, NRI Income taxes come into various categories, but specifically he has to pay tax in India only if her/his income/salary/allowance etc. is amassed in/from the Indian Territory. This stands true for non-residents also, but there are exceptions to the general rule.

- A non-resident can escape tax liability in respect of income earned out of India if he makes arrangement in such a way that the income is first received out of India and then remittance in whole or part is made to India, even though the business is controlled from India.

- Any income arising to a notified foreign company by way of fees for technical services rendered in pursuance of an agreement entered into with the government for providing service in or outside India in projects connected with the security of India, shall be exempt from tax.

- Notwithstanding anything to the contrary contained in Section 28 to 47 except Section 42, the income of a non-resident engaged in the business of providing services or liabilities in connection with or supplying plant and machinery on hire, used or to be used, in the prospecting for or extraction or production of mineral oils shall be computed at a flat rate of 10%

- The provisions under Sections 92 to 92F have been enacted to provide a statutory framework which can lead to computation of reasonable fair and equitable profit and tax in India so that profits chargeable to tax in India do not get diverted elsewhere. An income arising from an international transaction should be computed having regard to arm’s length price.

- The primary purpose of tax treaties is to prevent international double taxation or to provide remedies when it occurs. The general pattern between two treaty countries is to grant reciprocal reductions on dividends withholding and to exempt royalties and some times interest payments from any withdrawing tax.

- Advance ruling scheme enables the non-resident to obtain, in advance, a binding ruling from the authority for Advance Ruling on issues which could arise in determining their tax liabilities so that time consuming and expensive appeals can be avoided. Such issues may relate to transactions undertaken or proposed to be undertaken by the non-resident applicant. The Authority for Advance Ruling (procedure) Rules, 1996 provide detail procedure for obtaining advance ruling.

References


Recommended Reading

1. Tax is payable on income arising from bonds and/or Indian shares purchased using the ________ account in foreign currency.
   a. XLRI
   b. NRI re mat
   c. NRI L-mat
   d. NRI Dmat

2. A non-resident can escape ________ if he makes arrangement in such a way that the income is first received out of India and then remittance in whole or part is made to India.
   a. profits
   b. tax liability
   c. losses
   d. interest

3. The provisions under Sections ______ have been enacted to provide a statutory framework which can lead to computation of reasonable fair and equitable profit and tax in India.
   a. 32D
   b. 45
   c. 92 to 92F
   d. 115C

4. The primary purpose of ________ is to prevent international double taxation or to provide remedies when it occurs.
   a. taxes
   b. NRI
   c. acts
   d. tax treaties

5. __________ enables the non-resident to obtain, in advance, a binding ruling from the authority on issues which could arise in determining their tax liabilities.
   a. Advance ruling scheme
   b. Income tax act
   c. Finance act
   d. Finance treaties

6. Every non-resident or a foreign company shall keep and maintain ________ and other documents in accordance with the provisions contained in Sec. 44 AA.
   a. files
   b. data
   c. books of accounts
   d. records
7. Non-resident person other than a company, having total income exceeding the maximum exemption limit is liable to pay tax at the same rate as in the case of a ____________.
   a. companies
   b. resident assessee
   c. corporate client
   d. government employee

8. With which of these should an income arising from an international transaction be computed?
   a. Data bases
   b. RDMS
   c. Soft wares
   d. Arm’s length price

9. State which of the following is false.
   a. The most appropriate method shall be selected having regard to price of the international transaction.
   b. The most appropriate method shall be selected having regard to the availability, coverage and reliability of data necessary for application of the method.
   c. The most appropriate method shall be selected having regard to the degree of comparability existing between international transaction and the uncontrolled transaction and between the enterprises entering such transaction.
   d. The most appropriate method shall be selected having regard to the nature, extent and reliability of assumptions required to be made in application of a method.

10. __________ arises when the jurisdictional correction used by different countries overlap or the tax payers may have connections with more than one country.
    a. Overlap
    b. Double taxation
    c. Treaties
    d. Violation
**Case Study I**

The assessee is X Ltd. It is a company engaged in (a) manufacturing rice and (b) manufacturing chemicals. It has a factory in Himachal Pradesh for manufacturing rice and a factory in Andhra Pradesh for manufacturing chemicals. The manufacturing of rice was started in January 2004 whereas the company is in the business of manufacturing chemicals since 1960. Besides the company has dividend income from shares in Indian companies. X Ltd. approaches you for your opinion on the following issue regarding computation of taxable income and tax deduction at source –

**Whether company is supposed to deduct tax at source under section 194C or section 194-I.**

X Ltd. has appointed A Ltd. as clearing and forwarding agents (C&F agent). The appointment of A Ltd. as C&F agents is necessitated for a smooth and proper distribution of its goods over a particular area. In other words, A Ltd. is a link between the manufacturer and the consumers. It is a part of sales and distribution network of X Ltd. X Ltd dispatches goods to the C&F agents, who in turn forwards the same to various destinations either to wholesalers or stockiest for onward movement to retailers and consumers. In short, the essence of this arrangement is that the goods reach their ultimate destination smoothly without any interruption. It is just one of the modes of making available the goods in the market. However, there is a time-gap between the receipt of goods by the C&F agent and their onward dispatch. Obviously the C&F agent has to store these goods during the intervening period.

The head of the taxation department is of the opinion that tax is deductible under section 194-I. According to him, the dominant purpose of the above agreement is use of the premises for storage of goods. Some of the clauses of the agreement with A Ltd. are reproduced below -

- A Ltd. provides physical space for storing goods.
- The agreement is not an outright sale to A Ltd. but the property in goods remained with X Ltd.
- X Ltd. has free access to the property at all times and has powers to inspect the goods, to make inventory, to take charge of and remove the goods without any hindrance.
- Minimum guarantee is fixed to be paid to A Ltd.
- Expenses incurred for certain minor services are reimbursed by X Ltd. to A Ltd.
- Tax is deductible under section 194-I.

On the other hand, A Ltd., the C&F agent, is of the view that tax is deductible under section 194C and not under section 194-I.

According to A Ltd., the C&F agent has to store these goods during the intervening period. But then, simply because the C&F agent has to hold the goods in the interregnum, the distribution arrangement between the manufacturer and the C&F agent is not converted into an arrangement as may be obtaining between a landlord or tenant or between a tenant and a sub-tenant. In case of an arrangement which is a part of the distribution network, the payment made by the manufacturer to the C&F agent is for the services rendered by the latter to the former, the services being those of distribution of goods.

This also explains as to why service tax is levied on the C&F agents. Merely because the C&F agent stores the goods in the intervening period, the character of the payment made by the manufacturer to the agent does not undergo any change so as to call it rent either under general law or for the purposes of section 194-I.

**Questions:**

1. What is the issue faced by X Ltd company?

   **Answer**

   X Ltd. faces following issue regarding computation of taxable income and tax deduction at source: Whether company is supposed to deduct tax at source under section 194C or section 194-I.
2. Why there is a need for appointing clearing and forwarding agents?

Answer

The appointment of A Ltd. as C&F agents is necessitated for a smooth and proper distribution of its goods over a particular area. In other words, A Ltd. is a link between the manufacturer and the consumers. It is a part of sales and distribution network of X Ltd. X Ltd dispatches goods to the C&F agents, who in turn forwards the same to various destinations either to wholesalers or stockiest for onward movement to retailers and consumers.

3. What is the reason for the opinion of the tax department head that tax is deductible under section 194-I?

Answer

According to the tax department head, the dominant purpose of the agreement is use of the premises for storage of goods. Some of the clauses of the agreement with A Ltd. are reproduced below:

- A Ltd. provides physical space for storing goods.
- The agreement is not an outright sale to A Ltd. but the property in goods remained with X Ltd.
- X Ltd. has free access to the property at all times and has powers to inspect the goods, to make inventory, to take charge of and remove the goods without any hindrance.
- Minimum guarantee is fixed to be paid to A Ltd.
- Expenses incurred for certain minor services are reimbursed by X Ltd. to A Ltd.
- Tax is deductible under section 194-I.
Case Study II

An Indian Citizen who stays abroad for employment/carrying on business or vocation outside India or stays abroad under circumstances indicating an intention for an uncertain duration of stay abroad is a non-resident. (Persons posted in U.N. Organisations and Officials deputed abroad by Central/State Governments and Public Sector undertakings on temporary assignments are also treated as non-residents). Non-Resident foreign citizens of Indian Origin are treated on par with non-resident Indian Citizens (NRIs) for the purpose of certain facilities.

Main categories of NRIs
The following are the main three categories of NRIs:
(i) Indian citizens who stay abroad for employment or for carrying on a business or Vocation or any other purpose in circumstances indicating an indefinite period of stay abroad.
(ii) Indian citizens working abroad on assignment with foreign government agencies like United Nations Organisation (UNO), including its affiliates, International Monetary Fund (IMF), World Bank etc.
(iii) Officials of Central and State Government and Public Sector undertakings deputed abroad on temporary assignments or posted to their offices, including Indian diplomat missions, abroad.

NRIs are freely permitted to invest their funds in Government securities or Units of UTI through authorised dealers. Units can also be purchased directly from UTI.

NRIs are permitted to make direct investments in proprietary/partnership concerns in India as also in shares/debentures of Indian companies. They are also permitted to make portfolio investments i.e., purchase of shares/debentures of Indian companies through stock exchanges in India. These facilities are granted both on repatriation and non repatriation basis.

Mr. Singh (NRI and resident of UK) has earned following income in India during the previous year (2009-2010).

- Income from dividend (from Indian companies and mutual funds)
- Interest on loan given to his relative (resident in India)
- Interest on fixed deposits with banks and listed companies
- Short term and long term capital gains on sale of listed securities
- Long term capital gains on sale of flat in India
- Rental income in respect of house property and car hire charges

Questions:
1. Discuss the taxability of above income in India. Is he liable to file his return of income in India?
2. What will be the taxability if Mr. Singh is a resident of Mauritius?
3. What are the three main categories of NRIs?
4. Are NRIs permitted to invest in Indian companies?
Ordinarily acquisitions, demergers and mergers are possible by entering into agreements and arrangements between the parties and passing special resolutions, etc. This may require consents, arrangements, agreements and settlements with large number of parties, e.g., shareholders, creditors, lenders, debtors, employees, government departments etc., and may also involve substantial taxation and other operational constraints.

**Checklist of activities by amalgamating company**

- Internal consensus by top management
- Revaluation of assets
- Pass necessary entries in the books to effect
- Revaluation of assets
- Valuation of shares for exchange ratio
- Preparation amalgamation scheme
- Approval from Board of Directors
- Amendments in Memorandum and Articles
  - Approval from Stock Exchange
  - Approval from RBI (in case of NBFC/ Banking Company)
  - Approval from SIA (FIPB)
  - Approval from STP authority
  - Approval from labour unions
  - Approval from banks/ FI/ debenture holders
  - Approval/ Intimation to other stakeholders (if required as per terms of agreements with them)
- File application with High Court
- Convene meeting of shareholders & creditors after making necessary compliances
- File Chairman Report with High Court
- File confirmation petition (Form No-40) with High Court
- Publication of Notice in Newspapers
- Ensure filing of report by Official Liquidator
- Filing of High Court Order with ROC
- Transfer of employees
- Transfer of assets and liabilities
- Intimation to all stakeholders (Customers, Vendors, Govt. Depts., Banks etc.)
- Dissolution without winding up
- Preservation of books and papers

Jaya Sugar Limited has two sugar mills in the same premises having net book value of fixed assets of Rs.300 lakhs and Rs.100 lakhs respectively of ‘A’ unit and ‘B’ Unit as on 31st March, 2002. During the accounting year 2002-03, the financial institutions acquired and sold Unit-‘A’ to recover their dues. The company amalgamated with Hema Sugar Limited, w.e.f. 01.04.2003. The accumulated losses and carried forward depreciation of Jaya Sugar Limited for assessment year 2003-04 were Rs.200 lakhs. It has also carried forward book losses U/s-115JA of Rs.100 lakhs.

**Questions:**

1. If Hema Sugar Limited carries on the business of Jaya Sugar Limited, is it eligible to carry forward the unabsorbed losses and depreciation and book losses of Jaya Sugar Limited?
2. Would it make any difference if financial institution acquire and sell the Unit-‘A’ after amalgamation in December 2003?

3. What approvals should be checked by the amalgamating company?
References

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Recommended Reading


• Palit, A., Bhattacharjee, S., 2008 *Special Economic Zones in India: Myths and Realities* (Anthem Press India). Publisher: Anthem Press India; 1st edition.


Self Assessment Answers

Chapter I
1. a
2. b
3. c
4. d
5. d
6. c
7. b
8. a
9. a
10. b

Chapter II
1. b
2. a
3. c
4. d
5. a
6. c
7. b
8. a
9. c
10. b

Chapter III
1. c
2. b
3. b
4. d
5. a
6. c
7. b
8. d
9. a
10. b

Chapter IV
1. d
2. b
3. c
4. d
5. a
6. c
7. b
8. a
9. c
10. b
Chapter V
1. a
2. d
3. c
4. b
5. d
6. c
7. b
8. a
9. a
10. d

Chapter VI
1. a
2. b
3. d
4. c
5. d
6. c
7. b
8. c
9. a
10. b

Chapter VII
1. a
2. b
3. c
4. b
5. d
6. c
7. b
8. a
9. c
10. b

Chapter VIII
1. d
2. b
3. c
4. d
5. a
6. c
7. b
8. d
9. a
10. b