DEPARTMENT OF APPLIED ECONOMICS AND COMMERCE, PU,

CLASS:- M COM (SEM 4)

PAPER:- (COMEC-1) CORPORATE TAX PLANNING AND MANAGEMENT,

UNIT(3):- TAX PLANNING AND FINANCIAL MANAGEMENT DECISION.

CAPIATL STRUCTURE DECISION AND TAX PLANNING :-

Capital structure decisions are likely to affects companies tax payments, since corporate taxation typically distinguishes between different source of finance. Interest payment can generally be deducted from taxable profit while such a deduction is not available in the case of equity financing. Taxation of capital income at the shareholder level often differentiate between the types of capital as well. Therefore, it can be expected that the relative tax benefits of different sources of finance have an impact on financing decisions.

In addition to above theory suggests that corporate profit tax and personal capital income taxes should be consider in order to analyse the tax consequences of capital structure choices more accurately. Tax incentives for using a particular source of finance differ significantly among different countries. Given that interest payments and dividends are taxed differently at the company level, this could lead to effective unequal treatment of debt and equity.

Therefore, we are interested in how flexible capital structure decisions are with respect to taxation, given a bunch of non-tax determinants of capital structure. If companies capital structure are significantly restricted by non-tax factors, distortions of financial decision due to taxation may lead to inefficiencies in investment decision and risk allocation. A higher tax benefit of debt has expected significant positive impact on companies financial leverage. Debt shares are positively affected by the level of dividend taxes and corporate profit taxes, whereas the taxation of personal interest income has only minor impact.

While suggesting a fundamental irrelevance of financial decision for firm value, modigiliani and miller already refer to company taxation as a reason for preferring debt to equity. Within their framework of perfect capital markets, the value of a permanently leveraged firm arises from adding the corporate tax shield of debt to the value of an identical but unleveraged company. Empirically, this proposition would imply a corner solution due to the tax shield which adds up to the corporate tax rate times the market value of debt.

SCOPE OF TAX PLANNING AS PER THE PROVISIONS GIVEN IN INCOME TAX ACT 1961 :-

- Dividend on shares is not deductible ,
- Distributed profit is subject to dividend tax,
- Interest paid on borrowed capital is allowed as deduction u/s 36(1)(111),
- Cost of raising fund through borrowing is deductible in the year in which it is incurred,
- Cost of issue of shares is allowed as deduction in 5 years under section 35D.

Because of the above provisions, tax planning plays an important role in determining the capital structure decision.

TAX PLANNING RELATING TO CAPITAL STRUCTURE DECISION :-

- If the return on investment is greater than the rate of interest, maximum debt fund may be used, since it shall increase the rate of return on equity. However, cost of raising debt fund should be kept in mind.

- If rate of return on investment is less than the rate of interest, minimum debt funds should be used.

- The capital may be utilized for acquisition of non-depreciable assets like land, goodwill, etc. and borrowed funds may be utilized to acquire depreciable assets. The interest on loans for the period after setting up of business but before the assets was put to use will be capitalized and a higher amount of depreciation will be allowed.

From this it may be concluded that the borrowings contribute to tax saving resulting a higher rate of return on owner equity. But this does not hold good in every case. If the rate of return on total capital is more than the rate of interest, definitely the borrowing would increase the rate of return on owners equity. Otherwise it would reduce his rate of return. It is clear from the following illustration…….

QUESTION.(1)

Y Ltd wants to raise Rs 200,000 which is required to meet the expansion of the business. It has three options (1) issue of share capital only, (2) Rs 160000 through issue of share capital and Rs 40000 loan from bank at 10% interest. (3) Rs 40000 by issue of share capital and Rs 160000 through loan from bank 10%interest. You are required to advise the management regarding the best option in following cases. Case(1) Rate of Return 25%, Case(2) Rate of Return 10%, case(3) Rate of Return 8% and Rate of tax 30%.

SOLUTION

CASE 1 (Return 25%)

OPTION

PARTICULAR	1 Rs	2 Rs	3 Rs
Return	50000	50000	50000
Less:- Interest on loan @ 10%	---	4000	16000
Profit before Tax	50000	46000	34000
Less:- Tax @30%	15000	13800	10200
Profit after Tax	35000	32200	23800
Rate of Return on Capital before DDT	17.5%	20.125%	59.5%

CASE 2 (Return 10%)

OPTION

PARTICULAR	1 Rs	2 Rs	3 Rs
Return	20000	20000	20000
Less:- Interest on loan @ 10%	---	4000	16000
Profit before Tax	20000	16000	4000
Less:- Tax @30%	6000	4800	1200
Profit after Tax	14000	11200	2800
Rate of Return on Capital before DDT	7%	7%	7%

CASE 3 (Return 8%)

OPTION

PARTICULAR	1 Rs	2 Rs	3 Rs
Return	16000	16000	16000
Less:- Interest on loan @ 10%	---	4000	16000
Profit before Tax	16000	12000	---
Less:- Tax @30%	4800	3600	---
Profit after Tax	11200	8400	---
Rate of Return on Capital before DDT	5.6%	5.25%	---

CONCLUSION:-

1) When rate of return on capital is 25% (which is more than the rate of interest 10%) the capital structure of third option is the best.

2) When rate of return on capital is equal to rate of interest, the rate of return on capital is same, whether the company takes the loan or issue share capital.

3) When the rate of return is less than rate of interest it is better to raise more capital to maintain a minimum dividend rate.

TAX PLANNING WITH REFERENCE TO DIVIDEND POLICY :-

Dividend Policy :-

Dividend policies are the regulations and guidelines that companies develop and implement as the means of arranging to make dividend payments to shareholders. Establishing a specific dividend policy is to the advantage of both the company and the shareholder. In order to make sure the policy is workable, a company should

develop a viable policy and then run this policy through a number of test scenarios in order to determine what impact the dividend policy would have on the operation of the business. A dividend policy shows how a company determines the amount of earnings to be paid out as dividends to its shareholders on a regular basis. It is characterized by its dividend payout ratio, which is the percentage of net earnings paid out to shareholders.

The dividend payout ratio is the amount of dividends paid to stockholders relative to the amount of total net income of a company. The amount that is not paid out in dividends to stockholders is held by the company for growth. The amount that is kept by the company is called retained earnings.

Tax Implications on Dividend Policy:-

The decision to pay dividends to investors does not have an impact on a company's corporate tax. Large investors can sometimes pressure the corporate board of directors, influencing their decision to pay dividends or not. During years when dividend taxes are lower than capital gains taxes, more companies use their excess cash to pay investor dividends. During times when dividend taxes are high relative to capital gains tax, fewer companies pay investor dividends. When a company pays you a cash dividend, it reduces stockholder's equity for each share of stock. Stockholder's equity is calculated by subtracting company liabilities from assets. Paying dividends reduces cash, which is an asset. Reducing equity represented by each share of stock can have a negative impact on the stock's share price. In other words, paying dividends transfers some of the company's value directly to shareholders in the form of cash instead of capital gains. Because dividend taxes are lower than short-term capital gains taxes, companies can reduce the tax liability for some of their investors by issuing dividends. It must also be noted that the dividend policy of firm is also critically important as it affects both the corporate and personal taxes.

Dividend Distribution Tax (DDT) :-

Dividend distribution tax is the tax levied by the Government on companies according to the dividend paid to a company's investors. Every domestic company is liable to pay Dividend Distribution Tax @ 15% on the amount declared, distributed or paid by such company by way of dividends.

Special Provisions Relating to Tax on Distributed Profits of Domestic Companies :-

According to Section 115-O the Domestic Company shall, in addition to the income tax chargeable in respect of its total income, be liable to pay additional income tax on any amount declared, distributed or paid by such company by way of dividend (whether interim or otherwise), whether out of current or accumulated profits. Such dividend distribution tax shall be payable @ 15% plus surcharge @ 5% plus education cess @ 2% plus SHES @ 1% of amount so declared, distributed or paid. The amount referred to in Sec. 115-O (1) (as above) i.e. dividend to be distributed shall be reduced by 1. The amount of dividend, if any, received by the domestic company during the financial year, if— (a) such dividend is received from its subsidiary; (b) the subsidiary has paid tax under this section on such dividend; and (c) the domestic company is not a subsidiary of any other company. ! Caution However, it must be noted that the same amount of dividend shall not be taken into account for reduction more than once. A company shall be a subsidiary of another company, if such other company, holds more than 50% of nominal value of equity share capital of the company. 2. The amount of dividend paid to any person for, or on behalf of, the New Pension System Trust established on the 27th day of February, 2008 under the provisions of the Indian Trusts Act, 1882. The holding company should not be a subsidiary of any other company i.e. benefi t u/s 115-O (1A) is available only to the ultimate holding company. But ultimate holding company can claim the benefit on dividend received from multiple subsidiary companies. Dividend received from other type of subsidiaries i.e. subsidiaries having Controlling composition of board, sub-subsidiaries, joint venture, etc. shall not qualify benefit u/s 115-O(1A). The expression 'dividend' shall have the same meaning as is given in clause (22) of Section 2, but shall not

include sub-clause (e) of clause (22) of Section 2. Dividend u/s 2(22)(e) is not covered by this Chapter and the same shall be taxable in the hands of the shareholder and the company shall not pay tax on such dividend.

Did u know? Due Date of Tax Payment The principal officer of the domestic company and the company shall be liable to pay the tax on the dividend distribution profit within 14 days from the date of declaration or distribution or payment of any dividend, whichever is earlier. The tax on the dividend distribution profit shall be payable whether or not the domestic company is liable to pay income tax on its total income computed in accordance with the provision of this Act. The tax on dividend distribution profit shall be treated as the final payment of the tax in respect of the amount declared, distributed or paid as dividends and no further credit shall be claimed by the company or by any other person in respect of the amount so paid. The company or the shareholder shall not be allowed any deduction in respect of the amount which has been charges to tax or the tax thereon under Sec. 115-O(1).

The interpretation of this clause is that no deduction shall be allowed to the shareholder under any provision of the Income tax Act, 1961 in respect of any expenditure which he has incurred on collection or earning of the dividend (Sec. 14A). No deduction shall be allowed to the company under any provision of the Income tax Act, 1961 in respect of the dividend so paid or tax thereon. The distributed profit on which tax is paid u/s 115-O (1) shall be exempted in the hands of share holder u/s 10(34). The tax on distributed profits shall be payable by domestic company whether or not such profit is distributed out of current year profit or accumulated profit. Dividend received from a foreign company is not covered by Sec.115-O and shall not be exempted in the hands of shareholders u/s 10(34). Such dividend is taxable in the hands of shareholder at the normal tax rates. Dividend on both preference shares and equity shares shall be considered.

Exemptions for Companies Developing, Operating or Maintaining SEZ [Sec. 115-O (6)] :-

No tax on distributed profits shall be chargeable in respect of the total income of an undertaking or enterprise engaged in developing or developing and operating or developing, operating and maintaining a Special Economic Zone for any assessment year on any amount declared, distributed or paid by such Developer or enterprise, by way of dividends (whether interim or otherwise) on or after the 1st day of April, 2005 out of the current income either in the hands of the Developer or enterprise or the person receiving such dividend. The provision of this sub-section is done away with effect from 1-6-2011. Accordingly dividend distribution tax is chargeable on amount declared, distributed by way of dividend by the said undertaking or enterprise after 1-6-2011.

Section 115-P: Interest Payable for Non-payment of Tax by Domestic Companies :-

Where the principal officer of domestic company and the company fail to pay the whole or any part of tax on distributed profits within the time i.e. 14 days, he or it shall be liable to pay simple interest @ 1% for every month or part thereof on amount of such tax for the period beginning on the date immediately after the last date on which such tax was payable and ending with the date on which the tax is actually paid.

Section 115-Q: Consequences for Non-payment of Dividend Distribution Tax :-

If principal officer of a domestic company and the company does not pay tax on distributed profits in accordance with the provisions of Section 115-O, then, he or it shall be deemed to be an assessee in default in respect of the amount of tax payable by him or it and all the provisions of the Income Tax Act, 1961 for the collection and recovery of income tax shall apply. The assessee who is deemed to be in default in making the payment of tax on distributed profits is liable for penalty under section 221 of the Act.

Section 115-S: Interest Payable for Non-payment of Tax :-

Where the person responsible for making payments of the income distributed by the specified company or a Mutual Fund and the specified company or a Mutual Fund, as the case may be, fails to pay the whole or any part of the tax as is referred to in sub-section (1) or sub-section (2) of section 115R, within the 14 days mention above, he or it shall be liable to pay simple interest at the rate of 1% for every month or part thereof on the amount of such tax for the period beginning on the date immediately after the last date on which such tax was payable and ending with the date on which the tax is actually paid.

Section 115-T: Consequences for Non-payment of Additional Income Tax on Income Distributed to Unit Holders :-

Where any person responsible for making payment of income distributed defaults to pay tax on distributed profits in accordance with the provisions sub-section (1) and sub-section (2) of Section 115-R, then, he or it shall be deemed to be an assessee in default in respect of the amount of tax payable by him or it and all the provisions of the Income Tax Act, 1961 as applicable for the collection and recovery of taxes thereon shall apply accordingly.

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