

Different Aspects of Tax Planning 6

This Module includes:

- 6.1 Tax Planning, Tax Evasion and Tax Avoidance**
- 6.2 Tax Planning**
- 6.3 Distinguish between Tax Planning, Tax Evasion, Tax Avoidance and Tax Management**
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Different Aspects of Tax Planning

SLOB Mapped against the Module:

To attain abilities to apply the acquired understanding for solving complex taxation problems and taking tax efficient business decision and execution thereof.

Module Learning Objectives:

After studying this module, the students will be able to -

- ✦ Identify and evaluate the various managerial options
- ✦ Analyse and interpret the cost and benefit of such options
- ✦ Apply the skill in ascertaining best of available options

“How can I reduce my tax liability?” is the question that goes through every taxpayer’s mind. Tax liability can be reduced through proper tax planning. The obvious benefit of tax planning is to reduce tax liabilities, which by extension means the individual or the company retaining more money for their own needs. Businesses reducing their tax liability through tax planning can provide better returns to their investors and better wages to their employees. It can also spend the money otherwise payable as tax to increase working capital and thereby improve performance efficiency, or spend more on capital expansion and thereby expand market share.

Individuals applying tax planning will have more disposable income in their hands. Very often, tax planning provides individuals with money to spend for their personal benefit or enjoyment, and failure to apply tax planning may lead to such money being paid as tax.

Tax planning also provides an indirect benefit of allowing sound control over finances. It provides a valuable road map to planning finances in the most optimal manner. It allows for streamlining cash outflows, making a planned expenditure, and committing to an informed investment decision.

Reducing tax liability is not always a bad or illegal exercise. There are legitimate ways to reduce taxes through proper tax planning and such methods are always encouraged. But unfortunately, there is also a tendency to reduce taxes through illegal methods. They are not accepted practice and can invite problems. There are three methods that are commonly used by the taxpayers to reduce their tax liabilities:

- Tax Planning;
- Tax Avoidance; and
- Tax Evasion

The Apex Court in *McDowell & Co. Ltd. –vs.- CTO (1985)* has observed that “tax planning may be legitimate provided it is within the framework of the law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honorable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay tax honestly without resorting to subterfuges.” In deciding whether a transaction is a genuine or colourable device, it is open for the tax authorities to go behind the transaction and examine the “substance” and not merely the “form”.

Doctrine of form and substance in the context of tax planning

The following are certain principles enunciated by the Courts on the question as to whether it is the form or substance of a transaction, which will prevail in income-tax matters:

- 1. Form of transaction is to be considered in case of genuine transactions:** It is well settled that when a transaction is arranged in one form known to the law, it will attract tax liability whereas, if it is entered into in another form which is equally lawful, it may not. Therefore, in considering whether a transaction attracts tax or not, the form of the transaction put through is to be considered and not the substance. This rule cannot naturally

apply where the transaction, as put through by the assessee, is not genuine but colourable or is a mere device. For here, the question is not one between 'form' and 'substance' but between appearance and truth. [Motor and General Stores (P) Ltd. -vs.- CIT (1967)]

2. **True legal relation is the crucial element for taxability:** A firm transferred its business assets to a company formed for its purposes. The same business was carried by the company consisting of the erstwhile partners as its shareholders. The Income-tax Officer sought to withdraw the depreciation allowed (the difference between the sale price and written-down value) on machinery. Tribunal and High Court has held that there was a change only in the form of ownership as persons behind both firm and company were the same. The Apex Court has held that it is open for the authorities to pierce the corporate veil and look behind the legal facade at the reality of the transaction. The taxing authority is entitled as well as bound to determine the true legal relation resulting from a transaction. The true legal relation arising from a transaction alone determines the taxability of a receipt arising from the transaction [CIT -vs.- B.M. Kharwar (1969) (SC)]
3. **Substance (i.e. actual nature of expense) is relevant and not the form:** Where the authorities are charged under the Act with the duty of determining the nature or purpose of and payment or receipt on the facts of a case, it is open to them to work at the substance of the matter and the formal aspect may be ignored.
 - 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 [Swadeshi Cotton Mills Co. Ltd. -vs.- CIT (1967) (SC)].
 - In order to determine whether a particular item of expenditure is of revenue or capital nature, the substance and not merely the form should be looked into. [Assam Bengal Cement Co. Ltd. -vs.- CIT (1955) (SC)]. Where the terms of a transaction are embodied in a document, it should not be construed only in its formal or technical aspect. While the words used should be looked at, too much importance should not be attached to the name or label given by the parties and the document should be interpreted so as to accord with the real intention of the parties as appearing from the instrument.
 - Certain shares were held in the name of others, but the deceased was the real owner of the shares as was found with reference to evidence. The High Court had held that the shares were not includible in the estate of the deceased as they were not in his name. The Supreme Court pointed out that, in substance, the deceased was the owner though only beneficially and upheld the inclusion for estate duty purposes [CED -vs.- Aloke Mitra (1980)]

Formation of Tax Laws

Article 265 of the Constitution of India states that no tax shall be levied or collected except by authority. In Murthy Match Works case, it is stated that:

“It is well established that the modern State, in exercising its sovereign power of taxation, has to deal with complex factors relating to the objects to be taxed, the quantum to be levied, the conditions subject to which the levy has to be made, the social and economic policies which the tax is designed to subserve, and what not.”

Though wide latitude is given to the legislature in the matter of levy of taxes, what is needed, firstly, is that the tax statute should be constitutionally valid to pass the muster of Article 14 of the Constitution of India.

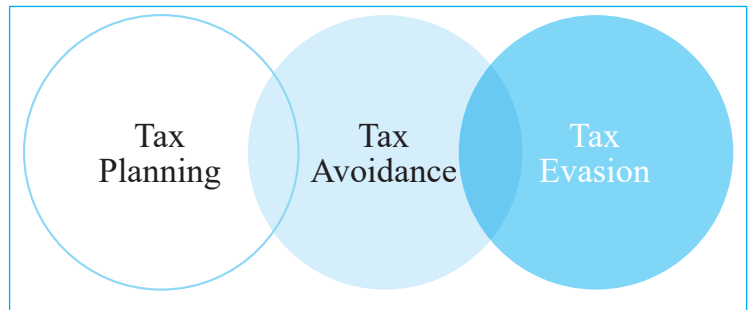
Secondly, liability of tax depends upon the charging section. No tax is complete nor a charge can raise under a fiscal statutes unless the subject, the object and the quantum of tax are prescribed. In the case of State of Tamil Nadu -vs.- M K Kandaswami, the Apex Court has held that the essence of tax laws depends upon three inter-related and distinct concepts which are:

- a. Who is a taxable person;
- b. What is a taxable event; and
- c. What is the subject matter of taxation.

Tax Planning, Tax Evasion and Tax Avoidance

6.1

Tax evasion is the illegal way to reduce tax liability by deliberately suppressing income or sales or by increasing expenses, etc., which results in the reduction of the total income of the assessee. Dishonest taxpayers try to reduce their taxes by concealing income, inflation of expenses, submitting misleading information, falsification of accounts, and willful violation of the provisions of the Income-tax Act. Such unethical practices often create problems for the tax evaders. Tax department not only imposes huge penalties but also initiate prosecution in such cases. It is illegal, both in script & moral. It is the cancer of modern society and work as a clog in the development of the nation. It is a grave problem in a developing country like ours as it leads to a creation of a ‘resource crunch’ for developmental activities of the State.



Tax avoidance is an exercise by which the assessee legally takes advantage, with malafide motive, of loopholes in the Act. Tax avoidance is minimizing the incidence of tax by adjusting the affairs in such a manner that although it is within the four corners of the laws, it is done with the purpose to defraud the revenue. It is a practice of dodging or bending the law without breaking it. It is a way to reduce tax liability by applying the script of law only. E.g. if A gives gift to his wife, the income from the asset gifted will be clubbed in the hand of A. But to avoid this clubbing provision “A” decides to give gift to B’s wife and B reciprocates it by giving gift to A’s wife. This is not tax planning but tax avoidance. Most of the amendments are aimed to curb such loopholes.

The Direct Taxes Enquiry Committee (Wanchoo Committee) has tried to draw a distinction between the two items in the following words.

“The distinction between ‘evasion’ and ‘avoidance’, therefore, is largely dependent on the difference in methods of escape resorted to. Some are instances of merely availing, strictly in accordance with law, the tax exemptions or tax privileges offered by the government. Others are maneuvers involving an element of deceit, misrepresentation of facts, falsification of accounting calculations or downright fraud. The first represents what is truly tax planning, the latter tax evasion. However, between these two extremes, there lies a vast domain for selecting a variety of methods which, though technically satisfying the requirements of law, in fact circumvent it with a view to eliminate or reduce tax burden. It is these methods which constitute “tax avoidance”.

The Royal Commission on Taxation for Canada has explained the concept of tax avoidance as under:

“Tax Avoidance” will be used to describe every attempt by legal means to prevent or reduce tax liability which would otherwise be incurred, by taking advantage of some provisions or lack of provisions of law. It excludes fraud, concealment or other illegal measures.

The line of demarcation between tax avoidance and tax planning is very thin and blurred. There are two thoughts about tax avoidance –

- a) As per first thought it is legal. Such thought is also supported by various judgments of the Supreme Court, some of them are as follows -

Helvering vs. Gregory (1934)

“Anyone may so arrange his affairs that his taxes shall be as low as possible. He is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”

IRC vs. Duke of Westminster (1936)

“Taxpayer is entitled to so arrange his affairs that the tax under the appropriate Act is less than what otherwise it could be.”

Inland Revenue Commissioners vs. Fishers Executors (1958)

“The highest in authority, have always recognized that the subject is entitled so to arrange his affairs as not to attract taxes imposed by the Crown, so far he can do so within the law, and that he may legitimately claim the advantage of any express terms or any omissions that he can find in his favour in taxing Act. In doing so, he neither comes under liability, nor incurs blame.”

CIT vs. Raman & Co. (1968)

“Avoidance of tax liability by so arranging commercial affairs that the charge of tax is distributed, is not prohibited. A taxpayer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the Income-tax Act.”

Smt. C. Kamala vs. CIT (1978)

“It is quite possible that when a transaction is entered into in one form known to law, the amount received under that transaction may attract liability under the Act and if it is entered into in another form which is equally lawful, it may not attract such tax liability. But when the assessee has adopted the latter one, it would not be open to the court to hold him liable for tax.”

CWT vs. Arvind Narotham (1988)

“It is true that tax avoidance in an underdeveloped or developing economy should not be encouraged on practical as well as ideological grounds. One would wish.... that one could get the enthusiasm that taxes are the price of civilization and one would like to pay that price to buy civilization. But the question which many ordinary taxpayers very often, in a country of shortages with ostentatious consumption and deprivation for the large masses, ask is, does he with taxes buy civilization or does he facilitate the waste and ostentation of the few. Unless ostentation and waste in Government spending are avoided or eschewed, no amount of moral sermons would change people’s attitude to tax avoidance.”

- b) As per second thought it is not a legal way to reduce tax burden and it should be prohibited.

McDowell & Co. Ltd. vs Commercial Tax Officer (1985)

Supreme Court observed - “we think time has come for us to depart from Westminster principle....tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honorable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the honestly without resorting to subterfuges.”

CIT vs B.M. Kharwar (1969)

Supreme Court held – “the taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction. If the parties have chosen to conceal by a device the legal relation, it is open to the taxing authorities to unravel the device and to determine the true character of relationship. But the legal effect of a transaction cannot be displaced by probing into substance of the transaction.”

Justice O. Chinnappa Reddy of Supreme Court has, while briefing the evil consequences of tax avoidance in *Mc.Dowell & Co. Ltd. -vs.- CTO*, observed that one such evil consequence is the ethics (or the lack of it) of transferring the burden of tax liability to the shoulders of the guideless, good citizens from those of artful dodgers. As regards the ethics of taxation, he observed:

“We now live in a welfare State whose financial needs, if backed by law, have to be respected and met. We must recognize that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less moral plane than honest payment of taxation”.

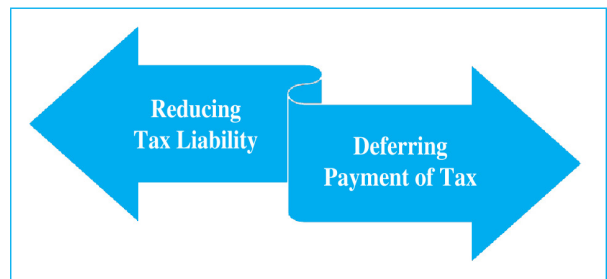
A similar observation was made by Lord Chancellor in *Latilla vs. Inland Revenue Commissioner (1943) 011 ITR (E.C) 0078*:

“There is, of course no doubt that they are within their legal rights but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of the good citizenship. On the contrary, one result of such methods, if they succeed, is of course to increase pro tanto the load of tax on the shoulder of the body of good citizens who do not desire or do not know how to adopt these maneuvers.”

Tax law reflects the complexity of modern life and the multitude of choices and options available to all taxpayers when legitimately seeking to structure their affairs. This necessary offer of options within tax legislation creates the opportunity for choice on the part of the tax payer and means that determining the right amount of tax (but no more) that they seek to pay does necessarily requires the exercise of judgement on occasion. So long as the exercise of that judgement seeks to ensure that the taxpayer makes choices that exercise options clearly allowed by law and that they do not exploit unintended loopholes created between laws then that process of a taxpayer choosing how to structure their affairs is the process of tax planning, which is a legitimate, proper and socially acceptable act.

Thus, tax planning is a systematic evaluation of finances and investments, to reduce the tax burden in a legitimate way. It involves understanding the tax implications of various cash inflows and outflows such as salary composition, property income, home loan, investments, sale or purchase of assets, gifts and interest-bearing deposits, to draw up an appropriate investment strategy that allows realization of financial goals while at the same time reducing tax liability to minimum.

It is a way to reduce tax liability by taking full advantages provided by the Act through various exemptions, deductions, rebates & relief. In other words, it is a way to reduce tax liability by applying script & moral of law. The two basic approaches of tax planning are:



- 1. Reducing taxable income:** As a rule, higher the income or profit, higher the tax liability on such income or profit. Gross income is total profits or income from all sources, and taxable income is such gross income less adjustments allowable under various tax laws and other provisions. Such adjustments bases itself on the nature of income and expenditure. Opting for the income or expenditure heads that allows maximum set-offs from the gross income reduces taxable income, and by extension tax liability.
- 2. Deferring payment of taxes to the extent possible:** An underestimated dimension of tax planning is timing investments and financial transactions so that the tax liability for such transactions arises at the farthest possible time. While this does not reduce the amount of tax payable, it delays tax outgo, thereby effectively providing interest-free cash on hand. Individuals may not need to resort to such a strategy, but delayed pay-out is valuable for small businesses that very often face cash flow difficulties.

The goal of tax planning is to arrange your financial affairs so as to minimize your taxes. It is the planning so as to attract minimum tax liability or postponement of tax liability for the subsequent period by availing various incentives, concessions, allowance, rebates and relief provided in the Act.

Distinguish between Tax Planning, Tax Evasion, Tax Avoidance and Tax Management

6.3

Difference between tax planning, tax avoidance, tax evasion & tax management

Points of distinction	Tax planning	Tax Avoidance	Tax Evasion	Tax Management
Definition	It is a way to reduce tax liability by taking full advantages provided by the Act through various exemptions, deductions, rebates & relief.	It is an exercise by which the assessee legally takes advantage of the loopholes in the Act.	It is the illegal way to reduce tax liability by deliberately suppressing income or sale or by increasing expenses, etc., which results in reduction of total income of the assessee.	It is a procedure to comply with the provisions of the law.
Feature	Tax planning is a practice to follow the provisions of law within the moral framework.	Tax avoidance is a practice of bending the law without breaking it.	Tax evasion is illegal, both in script & moral.	It is implementation or execution part of taxation department of an organisation.
Object	To reduce tax liability by applying script & moral of law.	To reduce the tax liability to the minimum by applying script of law only	To reduce tax liability by applying unfair means.	To comply with the provisions of laws.
Approach	It is futuristic and positive in nature. The planning is made today to avail benefits in future.	It is futuristic but short term in nature, as loophole of the law will be corrected in future by amendments of the law.	It is concerned with past and applied after the liability of tax has arisen. It is done with negative approach to avail benefits by killing the moral of law.	It is a continuous approach, which is concerned with past (rectification, revisions etc.), present (filing of return, etc.) & future (corrective action).
Benefit	Generally, arises in long run.	Generally, arises in short run.	Generally, benefits do not arise but it causes penalty and prosecution.	Penalty, interest & prosecution can be avoided.
Treatment of Law	It uses benefits of the law.	It uses loopholes in the law.	It overrules the law.	It implements the law.
Practice	It is tax saving.	It is tax hedging.	It is tax concealment.	It is tax administration.
Need	It is desirable	It is avoidable	It is objectionable	It is essential.
Morality	It is moral in nature.	It is immoral in nature	It is illegal.	It is duty.

Tax planning is an exercise undertaken to minimize tax liability through the best use of all available allowances, deductions, exclusions, exemptions, etc. The objectives of tax planning cannot be regarded as offending any concept of the taxation laws and subjected to reprehension of reducing the inflow of revenue to the Government's coffer, so long as the measures are in conformity with the statute laws and the judicial expositions thereof. The basic objectives of tax planning are:

a. Reduction of Tax liability

Tax law provides multiple choices and options to taxpayers. This necessary offer of options within tax legislation creates the opportunity for choice on the part of the tax payer. However, due to lack of awareness of legal requirements, in many a cases, a taxpayer may suffer heavy taxation. Through proper tax planning and awareness, a tax payer may reduce such heavy tax burden.

b. Minimisation of litigation

In the matter of taxation, the tax payers will try to pay the least tax and on the other hand, the tax administrator will attempt to extract the maximum. This conflict behaviour may results into litigations. However, where proper tax planning is adopted by the tax payer in conformity with the provisions of the taxation laws, the incidence of litigation can be minimised. This saves him from the hardships and inconveniences caused by the unnecessary litigations.

c. Productive investment

A tax payer may reduce heavy tax burden through proper tax planning. Such reduction results into reduction in cash-outflow. In the days of credit squeeze and dear money conditions, even a rupee of tax decently saved may be taken as an interest-free loan from the Government, which perhaps, an assessee need not repay. Such retained cash can be utilised in other productive venture which also provide additional earning to the taxpayer. That means, proper tax planning is a measure of proper utilisation of available resources which in turn maximise the cash-inflow and minimise the tax burden.

d. Healthy growth of economy

The growth of a nation's economy is synonymous with the growth and prosperity of its citizens. In this context, a saving of earnings by legally sanctioned devices fosters the growth of both, because savings by dubious means lead to generation of black money, the evils of which are obvious. Conversely, tax-planning measures are aimed at generating white money having a free flow and generation without reservations for the overall progress of the nation. Tax planning assumes a great significance in this context.

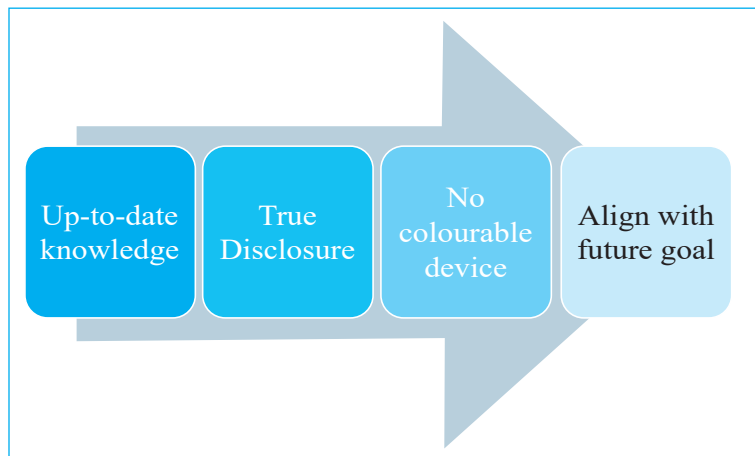
e. Economic stability

Tax planning results in economic stability by way of:

- (i) productive investments by the tax payers; and
- (ii) harnessing of resources for national projects aimed at general prosperity of the national economy and reaping of benefits even by those not liable to pay tax on their incomes.

Following are the essentials of tax planning:

- Up-to-date Knowledge of tax laws alongwith circulars, notifications, clarifications and Administrative instructions issued by the CBDT.
- Disclosure of full and true material informatio
- Avoid sham transactions or make-believe transactions or colourable devices
- Foresight of future development or changes and enterprise's goal. The planning should be flexible enough to adjust statutory negation.

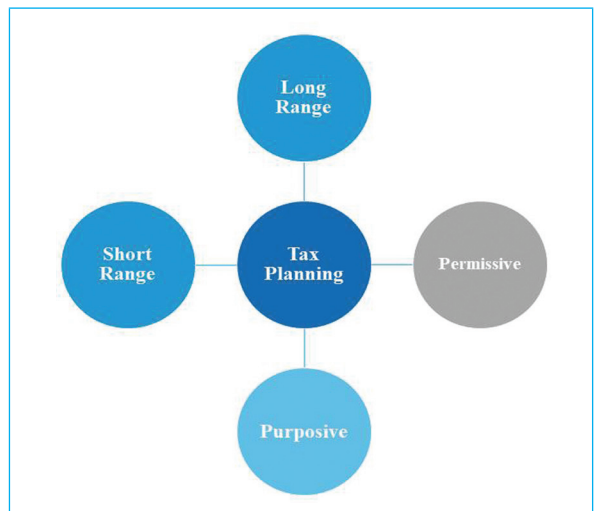


Types of Tax Planning

6.6

The tax planning exercise ranges from devising a model for specific transaction as well as for systematic corporate planning. These are:

(a) **Short-range and long-range tax planning:** Short-range planning refers to planning to achieve some specific or limited objective of particular fiscal year. E.g., an individual assessee whose income is likely to register unusual growth in particular year as compared to the preceding year, may plan to subscribe to the PPF/NSC's¹ within the prescribed limits in order to enjoy substantive tax relief. By investing in such a way, he is not making permanent commitment but is substantially saving in the tax. Long-range planning on the other hand, involves entering into activities, which may not pay-off immediately. E.g., when an assessee transfers his equity shares to his minor son, he knows that the Income from the shares will be clubbed with his own income. But clubbing would also cease after his son attains majority.



- (b) **Permissive tax planning:** Permissive tax planning is tax planning under the express provisions of tax laws. Tax laws of our country offer many exemptions and incentives.
- (c) **Purposive tax planning:** Purposive tax planning is based on the basis of circumvention of the law. The permissive tax planning has the express sanction of the Statute while the purposive tax planning does not carry such sanction. E.g., If an assessee manages his affairs in such a way that his income is taxable in hands of other person without attracting clubbing provision, such a plan would work in favour of the tax payer because it would increase his disposable resources.

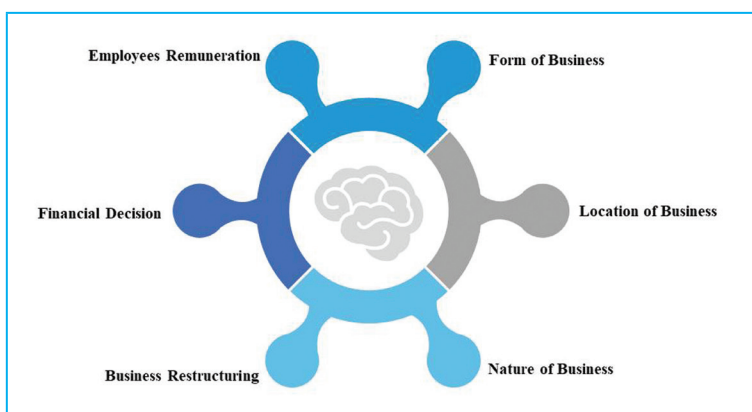
¹ If he has opted for old tax regime

Areas of Tax Planning

6.7

Some of the important areas where planning can be attempted in an organised manner are as under:

- (a) Form of organisation/ownership pattern;
- (b) Locational aspects;
- (c) Nature of business.
- (d) Tax planning in respect of corporate restructuring;
- (e) Tax planning in respect of financial management;
- (f) Tax planning in respect of employees remunerations;
- (g) Tax planning in respect of specific managerial decisions;
- (h) Tax planning in respect of Non-Residents



Form of organisation

A snapshot of features of different forms of business:

Particulars	Form of Business		
	Company	Firm or LLP	Sole proprietorship
Tax rates	Company is liable to pay @ 30% (in some cases at lower rate) + surcharge + cess @ 4%. Further, whatever amount of tax is paid by a company is not deemed to have been paid on behalf of the shareholders. Therefore, no rebate is allowed to shareholders.	Firm is liable to pay @ 30% + surcharge + cess @ 4%. Share of profit distributed to the partner is exempt from tax.	Sole proprietor is liable to tax at slab rate.

Particulars	Form of Business		
	Company	Firm or LLP	Sole proprietorship
Remuneration to owner-director	Remuneration to the persons who are managing the affairs of the company and also owning its shares is allowed	Remuneration to the working partners is allowed. However, such remuneration is subject to sec. 40(b)	Remuneration to owner of the business is not an allowable expenditure.
Distribution of income	Distributed income is taxable in hands of the shareholder	Share of profit distributed to the partner is exempt from tax.	NA
Specific business expenditure allowed	Certain expenditure is allowed only in hands of company assessee. E.g., expenditure covered u/s 36(1)(ix) are allowable only in hands of company assessee only.	Apart from sec. 40(b), no other provision contains such restriction.	Expenditure like interest on loan provided to the business by the owner or remuneration to proprietor is not an allowable expenses.
Different assessee	Company is treated as a separate assessee apart from its shareholders	Firm is treated as a separate assessee apart from its partners.	Proprietorship business is not treated as a separate assessee.
Decision making	Any important business matter required to be deal in proper meeting and requires a long procedure. Thus, decision on any important business matter can be delayed	Since partners of the firm meets more frequently, decision on any important business matter cannot be delayed	As owner is the only person to take decisions, thus decision on any important business matter cannot be delayed
Risk taking capacity	Once approved by the governing body, the chance of getting involved in risky activities is comparatively high.	The chance of getting involved in risky activities is very less because every important decision is made with the concurrence of all the partners.	The chance of getting involved in risky activities is depends on the owner's ability to take risk.
Raising of additional capital	Company can raise large capital by way of issuing shares to large number of public ¹ .	Capital can be raised by introducing new partner or by existing partners.	There is personal limitation is raising capital.
Loan-fund	Since the company has perpetual succession, lender is happy to lent money to company form of business.	Money can be raised by way of borrowings easily, in compared to sole-proprietorship business, because of number of partners and their joint and several liability to pay the debts of the firm, the lenders will be more interested in lending.	There is personal limitation in raising capital.
Limited liability	Shareholder is not liable to pay more than his shares amount.	Partners have unlimited liability, subject to certain case.	Proprietor have unlimited liability.

¹ Not in case of private limited company.

Particulars	Form of Business		
	Company	Firm or LLP	Sole proprietorship
Liability of owner	Owners are not liable for act of governing body.	Partners are liable for act of another partner	N.A.
Size of business	In case of public company, there is no such limitation.	Partnership can be formed up to maximum number of 20 partners. Thus, it is not suitable for large scale business.	It is not suitable for large scale business.

Locational Aspects

There are certain locations which are given special tax treatment. Some of these are as under:

- Unit located in special economic zone is eligible for exemption u/s 10AA* for several numbers of years.
- In respect of certain undertakings in North-Eastern States is eligible for deduction u/s 80-IE.
- In respect of unit located in SEZ deduction is available u/s 80-LA

Nature of Business

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

- Tea Development Account, Coffee Development Account and Rubber Development Account [Section 33AB].
- Site restoration fund [Section 33ABA].
- Specified business eligible for deduction of Capital Expenditure [Section 35AD].
- 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 [Sections 42 and 44BB].
- Special provisions for computing profits and gains of business on presumptive basis [Section 44AD].
- Special provisions in the case of business of plying, hiring or leasing goods carriages [Section 44AE].
- Special provisions in the case of shipping business in the case of non-residents [Section 44B].
- Special provisions in the case of business of operation of aircraft [Section 44BBA].
- Special provisions in the case of certain turnkey power projects [Section 44BBB].
- Special provisions in the case of royalty income of foreign companies [Section 44D].
- Special provisions in case of royalty income of non-residents [Section 44DA].
- Certain income of offshore Banking Units and international Financial Service Centre [Section 80-LA].
- Profit and gains of industrial undertakings or enterprises engaged in infrastructure development, etc.
- Profits and gains from the business of collecting and processing of bio-degradable waste [Section 80JJA].
- Special tax rate under Sections 115A, 115AB, 115AC, 115AD, 115B, 115BBA, 115BAC, 115BB, 115BA, 115D, etc.

* available only to units that commenced manufacture/provision of services on or before 31-03-2021.

Tax Planning relating to Corporate Restructuring

Corporate Restructuring is a process of redesigning one or more aspects of a corporate for achieving certain objectives. The objectives of restructuring may be achieving economies of scale or surviving in an adverse economic climate or restructuring of debt or for any other objectives. Such restructuring can be done through various tools. Some of them are as follow:

- ◉ Amalgamation
- ◉ Demerger
- ◉ Slump sale of business
- ◉ Buy back of shares
- ◉ Capital Reduction
- ◉ Conversion of debentures into shares
- ◉ Redemption of preference shares
- ◉ Conversion into company
- ◉ Conversion of an Indian branch of foreign company into an subsidiary company
- ◉ Conversion of company into LLP, etc.

Tax Planning relating to Financial Management Decisions

Fund can be obtained from various sources thus their procurement is always considered as a complex problem by a business organisation. Fund procured from different sources have different characteristics in terms of risk, cost and control. Some of the sources for funds for a business enterprise are:

Equity: The funds raised by the issue of equity shares are the best from the risk point of view for the firm, since there is no question of repayment of equity capital except when the firm is under liquidation. From the tax point of view, dividends are an appropriation of profit, thus the same is not allowed as an expense under the Income Tax Act.

Debentures: Debentures as a source of funds are comparatively cheaper than the shares because of their tax advantage. The interest the company pays on a debenture is tax deductible.

In this regards, following sections are relevant:

- ◉ Amortisation of preliminary expenses [Sec. 35D]
- ◉ Interest on borrowed capital [Sec. 36(1)(iii)]
- ◉ Actual cost of assets [Sec. 43(1)]
- ◉ General Deductions [Sec. 37]
- ◉ Depreciation [Sec. 32]

Capital Structure

The optimum capital structure is a mix of equity capital and debt funds. Following should be considered in this regard:

- a) Interest on debt fund is allowed as deduction as it is a business expenditure. Therefore, it may increase the rate of return on owner's equity.
- b) Dividend on equity fund is not allowed as deduction as it is the appropriation of profit.
- c) The cost of raising owner's fund is treated as capital expenditure therefore not allowed as deduction. However, if conditions of sec. 35D is satisfied then such cost can also be amortized.
- d) The cost of raising debt fund is treated as revenue expenditure.

Lease or Buy

When a person needs an asset for his business purposes, he has to decide whether the asset should be purchased or taken on lease. Following should be considered in this regard:

- a) Lease rental can be claimed as deduction as revenue expenditure. However, depreciation on leases asset is not allowed.
- b) Depreciation on depreciable assets can be claimed as deduction u/s 32.
- c) In case, the asset is purchased from the amount taken on loan, interest paid for the period after the asset is first put to use, the deduction on account of interest shall be claimed as revenue expenditure. However, interest paid for the period before the asset is first put to use shall be capitalized.
- d) Any gain on transfer of capital asset is subject to capital gain. In this regard, it is to be noted that in case of depreciable asset, asset shall be merged in the respective block of asset.

Tax Planning relating to Employee's Remuneration

The following aspects should be considered:

- a. The salary should not be a consolidated one and on the other hand, it should be divided into basic pay and several allowances as some of the allowance may be fully or partially exempt from tax.
- b. There should be an option to the employee for commuted pension up to the maximum limit permissible in the Act as it is exempt from tax to certain specific limit
- c. There should be a provision for encashment of leave on retirement as it is exempt from tax up to a prescribed limit
- d. The employer's contribution to the provident fund should be atleast upto 12% of the salary as the same is exempt from tax. However, upper cap should be kept in mind.
- e. Perquisites are preferable to fixed allowances as the lower valuation of many perquisites helps in the reduction of tax liability

- f. Commission payable should be based on turnover and it must form part of the salary. This will help in reducing the incidence of tax in respect of House Rent Allowance, etc.
- g. The component of the salary should be available as deduction while computing business income of the employer.

*These are illustrative aspects

Tax Planning relating to Non Resident

Some of the important aspects, which should be considered:

- a. Meaning of non-resident as per sec. 6
- b. Scope of income of non-resident – Sec. 5
- c. Income deemed to be accrued or arise in India – Sec. 9
- d. Various exemptions available u/s 10
- e. Presumptive income in case of certain business – Sec. 44B, 44BBA, etc.
- f. Deduction in respect of head office expenditure – Sec. 44C
- g. Special tax treatment of income covered u/s 115A, 115AB, etc.
- h. Method of computation of capital gain in certain cases of non-resident – Sec. 48
- i. Special provision relating to non-resident Indians – Sec. 115C to Sec. 115-I
- j. Provision of Double Tax Avoidance Agreement
- k. Applicability of GAAR

Various organisations have separate tax planning departments to plan their transactions with a view to attracting the least incidence of tax. Organisation of such a cell can be justified on the following grounds:

- a. **Complexity and volume of work:** Where the volume of tax work to be handled is large and highly complex, then it is required to appoint a special tax expert along with the required staff.
- b. **Separate Documentation:** Documentation is an indispensable ingredient of tax management. An assessee has to keep reliable, complete and updated documentation for all the relevant tax files so that the documentary evidence can be made available at a short notice whenever it is required. In absence thereof, an assessee may lose a case for want of proper documentary evidence. Not only that the company has to maintain proper account books, records, vouchers, bills, correspondence and agreements, etc. as a part of tax management. In the case of new industrial undertaking it is better to keep separate accounts for the same.
- c. **Data Collection:** The staff concerned with taxation has to collect and keep on collecting data relating to latest circulars, case laws, rules and provisions, and other government notifications to keep abreast of the current developments.
- d. **Integration:** Tax planner should be consulted by all the departments of the company to know the impact of taxation on their decisions. It would be necessary to integrate and properly link all the departments of the company with the tax planning department.
- e. **Constant Monitoring:** In order to obtain the intended tax benefits, persons connected with tax management should ensure compliance of all the pre-requisites, like procedures, rules etc. Besides, there should be constant monitoring, so that all the tax obligations are discharged and penal consequences avoided.
- f. **Developing Tax effective Alternatives:** Tax laws provide various options for entering into a transaction. A tax planner could guide management in taking important decisions, by considering varieties of alternatives and choices.
- g. **Take advantage of variance allowances and deductions:** An expert tax manager has to keep track of the provisions relating to various allowances, deductions, exemptions, and rebates so as to initiate tax planning measures.

Illustration 1.

Naresh, who is neither a director nor has a substantial interest in any company, is offered employment by Freewheel Ltd., Mumbai with the following two alternatives:

Particulars	I	II
Basic pay	17,66,000	17,66,000
Bonus	90,000	90,000
Education allowance for 2 children	30,200	-
Education facility for 2 children in school maintained by employer	-	30,200
Sweeper allowance	10,000	-
Sweeper facility	-	10,000
Entertainment allowance	6,000	-
Club facility	-	6,000
Transport allowance for personal use	1,800 pm	-
Free car (1200 cc) facility for performing journey between office to home and vice versa (car owned by employer)	-	12,000
Medical allowance	18,000	-
Medical bills reimbursement facility	-	18,000
Allowance for gas, electricity and water supply	4,500	-
Free gas, electricity and water supply (bills will be in the name of the employer)	-	4,500
Holiday home allowance	8,000	-
Holiday home facility	-	8,000
Lunch allowance	18,000	-
Free lunch (₹ 70 x 200 days + ₹ 80 x 50 days)	-	18,000
Diwali gift allowance	7,500	-
Gift on Diwali	-	7,500
A rent-free unfurnished home – lease rent	2,40,000	2,40,000

Which of the two alternatives Naresh should opt for on the assumption that both employer and employee will contribute 10% of salary towards unrecognized provident fund? Interest free loan of ₹ 20,000 will be given to him for purchasing household items. Assume that he has opted for the old tax regime

Solution:

As both the options are yielding equivalent facilities, hence the option where tax liability can be minimized is the better choice for the assessee. Accordingly, computation of taxable salary of Naresh under both options are as under

Particulars	Working	Option 1		Option 2	
		Details	Amount	Details	Amount
Basic salary			17,66,000		17,66,000
Bonus			90,000		90,000
Allowances					
Children education allowance		30,200			
Less: Exemption u/s 10(14) Rule 2BB	100 x 2 x 12	2,400	27,800		
Transport allowance		21,600			
Less: Exemption u/s 10(14)		Nil	21,600		

Particulars	Working	Option 1		Option 2	
		Details	Amount	Details	Amount
Holiday home allowance			8,000		
Medical allowance			18,000		
Sweeper allowance			10,000		
Entertainment allowance			6,000		
Lunch allowance			18,000		
Gas, electricity & water allowance			4,500		
Diwali gift allowance			7,500		
Perquisites u/s 17(2)					
Rent free accommodation (Being minimum of the following):					
Rent paid by employer		2,40,000		2,40,000	
10% of salary*		1,97,740	1,97,740	1,85,600	1,85,600
Car facility for performing journey between office to home and vice versa	Exempted				Nil
Education facility				30,200	
Less: Exempted				24,000	6,200
Interest free loan exempted up to ₹ 20,000			Nil		Nil
Sweeper facility					10,000
Club facility					6,000
Holiday home facility					8,000
Medical facility					18,000
Gift	7,500 – 5,000				2,500
Gas, electricity & water facility					4,500
Free lunch facility	(20×200)+(30×50)				5,500
Gross Taxable Salary			21,75,140		21,02,300
Less: Standard Deduction u/s 16(ia)			50,000		50,000
Taxable Salary			21,25,140		20,52,300

* Salary for the purpose of -

Particulars	Rent free accommodation	
	Option 1	Option 2
Basic	17,66,000	17,66,000
Bonus	90,000	90,000
Children education allowance	27,800	-
Transport allowance	21,600	-
Holiday home allowance	8,000	-
Medical allowance	18,000	-
Sweeper Allowance	10,000	-
Entertainment allowance	6,000	-

Particulars	Rent free accommodation	
	Option 1	Option 2
Lunch allowance	18,000	-
Gas, electricity & water allowance	4,500	-
Diwali gift allowance	7,500	-
Total	19,77,400	18,56,000

Note: Contribution to URPF is not taxable.

Conclusion: Option 2 is better.

Illustration 2.

Star Gas Ltd. commenced operations of the business of laying and operating a cross-country natural gas pipeline network for distribution on 1st April, 2025. The company incurred capital expenditure of ₹ 1,490 lakh (including the cost of financial instrument ₹ 2 lakh) during the period January to March, 2025 exclusively for the above business and capitalized the same in its books of account as on 1st April, 2025.

Further, during the financial year 2025-26, it has incurred capital expenditure of ₹ 6,600 lakh (including the cost of land ₹ 1,100 lakh) exclusively for the above business. Compute the amount of deduction u/s 35AD for the A.Y. 2026-27, assuring that the company has fulfilled all the conditions specified in sec. 35AD.

Solution:

Computation of the Amount of Deduction under Section 35AD for the Assessment Year 2026-27

Particulars	₹ in lakh
Capital expenditure incurred during the Year (excluding cost of land) [₹ 6,600 lakh – ₹ 1,100 lakh]	5,500
Capital expenditure incurred prior to commencement of business & capitalized (excluding cost of Financial Instrument) [₹ 1,490 lakh – ₹ 2 lakh]	1,488
Total Deduction u/s 35AD	6,988

Illustration 3.

Lucent Ltd. purchased machinery on 1st April, 2025 for ₹ 10 crores by availing loan facility from the bank. The machine was put to use in effective production on 1st February, 2026. The interest on the loan works out to 12% per annum. Advise Lucent Ltd. on the treatment of interest payment made on this loan and depreciation allowable for the previous year 2025-26. You may assume that this is the only machine in its block.

Solution:

Computation of Depreciation

Particulars	Amount (₹ in Crore)	Amount (₹ In Crore)
Block: Plant & Machinery (Rate 15%)		
W.D.V. as on 1/4/2025		Nil
Add: Purchase	10	
Interest on loan upto Jan. 2026 (₹ 10 cr x 12% x 10/12)	1	11
		11
Depreciation [₹ 11 cr. * 15% * ½]		0.825

Interest cost from Feb 2026 shall be allowed as deduction u/s 36(1)(iii).

Illustration 4.

Mr. A owned two residential house for his own residential purpose, details of which are as follows –

Particulars	House 1	House 2
Gross Annual value	4,00,000	5,00,000
Municipal tax (paid)	2,000	10,000
Interest on loan taken for construction of house	20,000	25,000

On 1/4/2025, Mr. A gifted ₹ 25,00,000 to her wife. Out of such money, she acquired a house property for her own residential purpose. The new house has a gross municipal value of ₹ 2,50,000. She paid a corporation tax of ₹ 2,000. Compute income from house property of Mr. & Mrs. A. (Assume that Mrs. A does not own any other property). Assume that he has opted for the old tax regime.

Solution:

Computation of income from house property of Mr. A for the A.Y. 2026-27

Particulars	Amount
Self-occupied house properties	
Net Annual Value	Nil
Less: Deduction u/s	
24(b) Interest on loan [₹ 25,000 + ₹ 20,000]	45,000
	(45,000)
Add: Income of Mrs. A clubbed u/s 64(1)(iv)	Nil
Income from house property	(45,000)

Computation of income from house property of Mrs. A for the A.Y. 2026-27

Particulars	Amount
Self-occupied house	
Net Annual Value	Nil
Less: Deduction u/s	
24(b) Interest on loan	Nil
	Nil
Less: Income clubbed u/s 64(1)(iv) with the income of Mr. A	Nil
Income from house property	Nil

Illustration 5.

Sure Success Ltd. wants to acquire an asset costing ₹ 1,00,000. It has two options are available, the first one is buying the asset by taking a loan repayable in five instalments of ₹ 20,000 each with 14% interest per annum. The second is leasing the asset for which the annual lease rental charge is ₹ 30,000 up to 5 years. The lessor charges 1% as a processing fee in the first year. Assume the internal rate of return to be 10%. The present value factors are:—

Year	1	2	3	4	5
P/V Factor	.909	.826	.751	.683	.621

Assuming that the payments are made at the end of the year, suggest which alternative is better for the company. The rate of depreciation is 15% while the tax rate is 33.22%.

Solution:

Cost of Ownership

Year	Instalment (a)	Interest (b)	Depreciation (c)	Tax Benefit (d) = (b+c)*33.22%	Net Outflow (a+b-d)	P/V	Net	
1	20,000	14,000	15,000	9,634	24,366	.909	22,151	
2	20,000	11,200	12,750	7,956	23,244	.826	19,210	
3	20,000	8,400	10,838	6,391	22,009	.751	16,536	
4	20,000	5,600	9,212	4,921	20,679	.683	14,124	
5	20,000	2,800	7,830	3,531	19,269	.621	11,965	
Total								83,985

It is assumed that salvage value is Nil after 5 years.

Cost of Lease

Year	Lease (a)	Tax Benefit (b)	Net Outflow (a-b)	P/V	Net	
0	1,000	332	668	1	668	
1	30,000	9,966	20,034	.909	18,211	
2	30,000	9,966	20,034	.826	16,557	
3	30,000	9,966	20,034	.751	15,052	
4	30,000	9,966	20,034	.683	13,683	
5	30,000	9,966	20,034	.621	12,440	
Total						76,611

Since net present value in case of lease is less; hence lease is benefited.

Illustration 6.

Specify whether the following acts can be considered as an act of (i) Tax management; or (ii) Tax planning; or (iii) Tax evasion:

- X has paid the premium of ₹72,000 for Life Insurance Policy so as to reduce Total Income.
- X has installed an air conditioner costing ₹60,000 at his residence but shows as it is fitted in a factory. This is with the objective to claim depreciation.
- Y Ltd maintains registers of tax deductions affected by it to enable timely compliance.
- Z Ltd issues a credit note for ₹36,000 for brokerage payable to A, who is the son of G, managing director of the company. The purpose is to reduce Z Ltd. income and increase A's income from ₹18,000 to ₹54,000.
- A is a working partner in ABC Firm. In such a capacity, he is entitled to a salary of ₹7,500 per month. He treats this as salary instead of business income.
- A is using a motor car for his personal purposes, but charges as business expenditure.
- X always pays advance tax on time

- h. Y sold his residential house and purchased another residential house to claim exemption u/s 54
- i. X had Fixed deposit interest amounting to ₹15,000 but did not disclose this amount in his Income Tax Return
- j. Y had Saving deposit interest amounting to ₹5,000, he disclosed this amount under other sources and claimed deduction u/s 80TTA

Solution:

- (a) Tax planning; (b) Tax evasion; (c) Tax management; (d) Tax evasion;
- (e) Tax evasion; (f) Tax evasion; (g) Tax management; (h) Tax planning;
- (i) Tax evasion; (j) Tax planning*.

* available only to units that commenced manufacture/provision of services on or before 31-03-2021.

Solved Case 1:

A business entity requires ₹50 lakhs for expansion of business. The entity has two options

Particulars	Option 1	Option 2	Option 3
	(₹)	(₹)	(₹)
Equity Share of ₹ 10 each	40,00,000	30,00,000	30,00,000
12% Debentures	10,00,000	10,00,000	20,00,000
18% Loan from Bank		10,00,000	

Expected rate of return is 15% (before tax). Tax Rate is 31.2% (including cess).

On the basis of aforesaid information, you are requested to choose correct options for the following:

1. What will be the profit after tax in Option 1?
2. What will be the profit after tax in Option 2?
3. What will be the profit after tax in Option 3?
4. Which option is better?

Solution:

Particulars	Option 1	Option 2	Option 3
Share Capital	40,00,000	30,00,000	30,00,000
12% Debentures	10,00,000	10,00,000	20,00,000
18% loan from Bank	—	10,00,000	
EBIT	7,50,000	7,50,000	7,50,000
Cost to Company			
Debenture Interest	1,20,000	1,20,000	2,40,000
Interest on loan from Bank	—	1,80,000	--
Net Profit before tax and dividend	6,30,000	4,50,000	5,10,000
Tax Payable @ 31.2%	1,96,560	1,40,400	1,59,120
Profit after tax	4,33,440	3,09,600	3,50,880
Return on capital	10.84%	10.32%	11.70%

Option 3 is better as in this option return on capital is maximum.

Exercise

Multiple Choice Questions

1. Countries that employ explicit policies designed to attract international trade oriented activities by minimization of taxes and reduction or elimination of other restrictions on business operations is described as _____.
 - A. Tax Havens
 - B. Tax Planning
 - C. Tax Evasion
 - D. Tax Management

2. A is using a motor car for his personal purposes, but charges as business expenditure. This is the case of
 - A. Tax Avoidance
 - B. Tax Planning
 - C. Tax Evasion
 - D. Tax Management

[Answer: 1 – A; 2 - C]

Short Essay Type Questions

1. State the difference between tax planning, tax evasion and tax avoidance.
2. What are the objectives of tax planning?
3. Describe the various type of tax planning.

Comprehensive Numerical Problems

XYZ Ltd. needs a component in an assembly operation. It is contemplating the proposal to either make or buy the aforesaid component.

1. If the company decides to make the product itself, then it would need to buy a second hand machine for ₹8 lakh which would be used for 5 years. Manufacturing costs in each of the five years would be ₹12 lakh, ₹14 lakh, ₹16 lakh, ₹20 lakh and ₹25 lakh respectively. The relevant depreciation rate is 15%. The machine will be sold for ₹1 lakh at the end of the 5th year. Capital loss is of no use
2. If the company decides to buy the component from a supplier the component would cost ₹18 lakh, ₹20 lakh, ₹22 lakh, ₹28 lakh and ₹34 lakh respectively in each of the five year.

The relevant discounting rate and tax rate are 14% and 32.445% respectively. Should XYZ Ltd. make the component or buy from outside?

[Ans. Make option is better]

Case Studies - Unsolved**Question: 1**

Virat Ltd. is a widely held company. It is currently considering a major expansion of its production facilities and the following alternative are available:

Particulars	Alt-1	Alt-2	Alt-3
	(₹)	(₹)	(₹)
Share capital	50,00,000	20,00,000	10,00,000
14% Debentures	—	20,00,000	15,00,000
18% Loan from Bank	—	10,00,000	25,00,000

EBIT will be ₹ 15,00,000/-. Tax Rate is 31.2%. Rate of dividend of the company since 1995 has not been less than 22% and date of dividend declaration is 30th June every year.

On the basis of aforesaid information, you are required to answer the following questions:

- (i) Calculate the profit after tax in Alternate 1
- (ii) Calculate the profit after tax in Alternate 2
- (iii) Calculate the profit after tax in Alternate 3
- (iv) Evaluate which one is better, Out of these 3 alternatives.

[Hint: (i) ₹ 10,32,000; (ii) ₹ 7,15,520; (iii) ₹ 5,77,920; (iv) Alternative 3]

Reference:

<https://www.incometaxindia.gov.in/>

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