

CHAPTER - 1

TAX PLANNING

TAX PLANNING

It 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.

TAX EVASION

It is 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. 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 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

It is an exercise by which the assessee legally takes advantages, 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 a 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 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 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 -

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 honourable 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.”

TAX MANAGEMENT

Tax Management involves regular and timely compliance of law as well as the arrangement of the affairs of the business in such manner that it reduces the tax liability. Functions under tax management includes maintenance of accounts, filing of return, deduction and deposit of TDS on timely basis, payment of tax on time, appear before the Appellate authority etc. Poor tax management can lead to imposition of interest, penalty, prosecution. Losses may not be allowed to be carried forward and set off, if return of loss is not filed by due date.

Tax management emphasizes on compliance of legal formalities for minimization of taxes while tax planning emphasis on minimization of tax burden.

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 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 sale price and written-down value) on machinery. Tribunal and High Court has held that there was 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 an 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.- Alope Mitra (1980)*]

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.

OBJECTIVE OF TAX PLANNING

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 result 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.

ESSENTIALS OF TAX PLANNING

Following are the essentials of tax planning:

- Up to date Knowledge of tax laws along with circulars, notifications, clarifications and Administrative instructions issued by the CBDT.
- Disclosure of full and true material information
- Avoid sham transactions or make-believe transactions or colourable devices
- Foresight of future development or changes and enterprise's goal.

TYPES OF TAX PLANNING

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's 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 -

AREAS OF TAX PLANNING

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;

(a) 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.
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 dealt in proper meeting and requires a long procedure. Thus, decision on any important business matter can be delayed	Since partners of the firm meet 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 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 in raising capital.
Loan-fund	Since the company has perpetual succession, lender is happy to lend 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.
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 50 partners. Thus, it is not suitable for large scale business.	It is not suitable for large scale business.

(b) Locational aspects

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

- a. Unit located in special economic zone is eligible for exemption u/s 10AA for several numbers of years.
- b. Enterprise engaged in the development of Special Economic Zone is eligible for deduction u/s 80-IAB.
- c. New industrial undertaking located in an industrially backward State or district is eligible for deduction u/s 80-IB.
- d. New industrial undertaking or substantial expansion of an existing undertaking in certain special category States is eligible for deduction u/s 80-IC.
- e. Profits and gains from business of hotels and convention centres in specified area or a hotel at world heritage site is eligible for deduction u/s 80-ID.
- f. In respect of certain undertakings in North-Eastern States is eligible for deduction u/s 80-IE.

(c) Nature of business

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

- Newly established units in special economic zones [Section 10AA].
- 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 of an undertaking or an enterprise engaged in development of Special Economic Zone. [Section 80-IAB].
- Profits and gains from certain industrial undertaking other than infrastructure development undertaking [Section 80-IB].
- Special provisions in respect of certain undertakings or enterprises in certain special category States [Section 80-IC].
- Deduction in respect of profits and gains from business of hotels and convention centres in specified area or a hotel at world heritage site. [Section 80-ID].
- Special provisions in respect of certain undertakings in North-Eastern States. [Section 80-IE].
- 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, 115BB, 115BA and 115D

(d) 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.

(e) Tax planning in respect of financial management

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]

(f) 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.

(g) 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 leased 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.

ORGANISATION OF TAX PLANNING CELLS

Various organisations have separate tax planning departments to plan their transactions with a view to attract 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 provides various options for entering into a transactions. 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.

DIVERSION OF INCOME v/s APPLICATION OF INCOME

The Supreme Court decision in case of *CIT v. Sitaldas Tirthdas* (1961) 41 ITR 367 is the authority for the proposition that where by an obligation, income is diverted before it reaches the assessee, it is deductible from his income as for all practical purposes it is not his income at all (as it is diversion of income by overriding title).

But where the income is required to be applied to discharge an obligation after it reaches the assessee, it is not deductible (as it is called as application of income).

Thus, there is the difference between the diversion of income by an overriding title and application of income as the former is deductible while the latter is not.

Thus, when management of a company is taken over by another person from the existing team in consideration of percentage of future profit to the latter, in computing the business income of the former, such percentage of profits is diversion of income and hence, deductible [*CIT v. Travancore Sugars and Chemicals Ltd.* (1973) 88 ITR 1 (SC)].

PRACTISE QUESTIONS

Question 1 : Mr. X is liable to pay ₹ 10,000 per month to Ms. X (his ex-wife) as alimony. Mr. X, being an employee of ABC Pvt. Ltd., instructs the HR department to pay ₹ 10,000 per month out of his salary to Ms. X directly and remit the remaining salary in his account. Determine is it application of Income or Diversion of Income

Solution : In this case, the amount of ₹ 10,000 per month is an obligation of Mr. X to pay to Ms. X out of his income and not an income in which Ms. X had overriding entitlement.

In other words, this is the income of Mr. X, which is applied by him to fulfill an obligation and hence, includible in his total income and a mere arrangement to pay a sum directly to Ms. X would not make it a case of diversion of income.

Question 2 : M/s ABC is a partnership firm in which Mr. A and his two sons, Mr. B & Mr. C are partners. The partnership deed provides that after the death of Mr. A, Mr. B & Mr. C shall continue the business of the firm subject to a condition that 20% of profit of the firm shall be given to Mrs. D (wife of Mr. A). Determine is it application of Income or Diversion of Income

Solution : In the instant case, after the death of Mr. A, 20% of profits of the firm payable to Mrs. D gets diverted at source by the charge created in her favour as per the terms of the partnership deed. Such income does not reach the assessee-firm. Rather, such income stands diverted to the other person as such other person has a better title on such income than the title of the assessee. The firm might have received the said amount, but it so received for and on behalf of Mrs. D, who possesses the overriding title. Therefore, the amount payable to Mrs. D after the death of Mr. A would be excluded from the income of M/s ABC.

Question 3 : Mr. A, aged 32 years, is employed with XYZ (P) Ltd. on a basic salary of ₹ 50,000 p.m. He has received transport allowance of ₹ 15,000 p.m. and house rent allowance of ₹ 20,000 p.m. from the company for the P.Y. 2020-21. He has paid rent of ₹ 25,000 p.m. for an accommodation in Delhi. Mr. A has paid interest of ₹ 2,10,000 for housing loan taken for the construction of his house in Mumbai. The construction of the house is completed in March, 2021 and the house is vacant.

Other Information

- Contribution to PPF - ₹ 1,50,000
- Contribution to pension scheme referred to in section 80CCD - ₹ 50,000
- Payment of medical insurance premium for father, who is of the age of 65 - ₹ 55,000
- Payment of medical insurance premium for self and spouse - ₹ 32,000

Compute the total income and tax liability of Mr. A for the A.Y 2021-22

Solution : Computation of total income and tax liability of Mr. A for A.Y. 2021-22

Particulars	₹
Salaries	
Basic Salary [₹50,000 x 12]	6,00,000
Transport allowance [₹15,000 x 12]	1,80,000
HRA received	2,40,000
Less: Least of the following exempt u/s 10(13A)	2,40,000
HRA Received	2,40,000
Actual rent paid – 10% of salary [₹3,00,000 – ₹ 60,000]	2,40,000
50% of salary	3,00,000
Gross salary	7,80,000
Less: Standard deduction u/s 16(ia)	(50,000)
	7,30,000
Income from house property	
[Annual Value is Nil. Deduction u/s 24(b) for interest on housing loan would be restricted to ₹ 2,00,000, in case of self-occupied property, which would represent loss from house property]	(2,00,000)
Gross Total Income	5,30,000
Less: Deductions under Chapter VI- A	
Section 80C	
Contribution to PPF	1,50,000
Section 80CCD(1B)	
Own contribution to pension scheme	50,000
Section 80D	
Mediclaime insurance premium	
For self and spouse, restricted to	25,000
For father, who is a senior citizen, restricted to	<u>50,000</u>
	75,000
Total Income	2,55,000
Tax liability	
Tax @ 5% on ₹5,000 [₹2,55,000 - ₹2,50,000]	250
Less: Rebate u/s 87A	250
Total Tax Liability	-

Computation of total income and tax liability of Mr. A for A.Y. 2021-22 in accordance with the provisions of section 115BAC

Particulars	₹
Salaries	
Basic Salary [₹50,000 x 12]	6,00,000
Transport allowance [₹15,000 x 12]	1,80,000
HRA received	2,40,000
Income from house property	10,20,000
Interest on housing loan	-
Gross Total Income	10,20,000
Less: Deductions under Chapter VI- A	
Section 80C	
Contribution in PPF	-
Section 80CCD	
Contribution to pension scheme	-
Section 80D	
Mediclaim insurance premium for self and parents	-
Total Income	10,20,000
Tax liability	
Tax @20% on ₹20,000 [₹10,20,000 – ₹10,00,000]	4,000
Tax @15% on ₹2,50,000 [₹10,00,000 - ₹7,50,000]	37,500
Tax @10% on ₹2,50,000 [₹7,50,000 - ₹5,00,000]	25,000
Tax @5% on ₹2,50,000 [₹5,00,000 - ₹2,50,000]	12,500
Add: Health & Education cess @ 4%	3,160
Total Tax Liability	82,160

Since tax payable as per the regular provisions of the Act is lower than the tax payable under the provisions of section 115BAC, it would be beneficial for Mr. A **not** to opt for section 115BAC.

Note: In this case, Mr. A is entitled to exemption u/s 10(13A), benefit of interest on housing loan in respect of self-occupied property and Chapter VI-A deductions, owing to which his total income is reduced by ₹ 7,65,000. His total income under the regular provisions of the Act is less than ₹ 5,00,000, owing to which he becomes entitled to rebate u/s 87A. Hence, in this case, it is beneficial for Mr. A not to opt for section 115BAC.

Question 4 : Mr. Gavaskar sought voluntary retirement from a Government of India Undertaking and received compensation of ₹ 40 lacs on 28th February, 2020. He is planning to use the money as capital for a business dealership in electronic goods. The manufacturer of the product requires a security deposit of ₹ 15 lacs, which would carry interest at 8% p.a. Gavaskar's wife is a graduate and has worked as marketing manager in a multinational company for 15 years. She now looks for a change in employment. She is willing to join her husband in running the business. She expects an annual income of ₹ 5 lacs. Mr. Gavaskar would like to draw a monthly remuneration of ₹ 40,000 and also interest @ 10% p.a. on his capital in the business. Mr. Gavaskar has approached you for a tax efficient structure of the business.

Discuss the various issues, which are required to be considered for formulating your advice. Computation of income or tax liability is not required.

Solution : The selection of the form of organisation to carry on any business activity is essential in view of the differential tax rates prescribed under the Income-tax Act, 1961 and specific concessions and deductions available under the Act in respect of different entities. For the purpose of formulating advice as to the tax efficient structure of the business, it is necessary for the tax consultant to consider the following issues:

(i) In the case of sole proprietary concern, interest on capital and remuneration paid to the proprietor is not allowable as deduction under section 37(1) as the expenditure is of personal nature. On the other hand, in the case of partnership firm, both interest on capital and remuneration payable to partners are allowable under section 37(1) subject to the conditions and limits laid down in section 40(b).

The partnership should be evidenced by an instrument and the individual share of partners should be specified in the instrument. Remuneration and interest should however, be authorised by the instrument of partnership and paid in accordance with such instrument. Such interest and salary shall be taxable in the hands of partners to the extent the same is allowed as deduction in the hands of the firm under section 40(b).

Interest to partners can be allowed upto 12% on simple interest basis, while the limit for allowability for partners' remuneration is based on book profit under section 40(b). As per section 40(b)(v), partners' remuneration shall be allowed to the extent of aggregate of -

- (a) On the first ₹ 3,00,000 of book profit or in case of loss – ₹ 1,50,000 or at the rate of 90% of book profits, whichever is more
- (b) On the balance of book profit – at the rate of 60%

Note – However, if the firm is eligible to opt for presumptive taxation under section 44AD, 8% of gross receipts or 6% of gross receipts, as the case may be, would be deemed as its income. All deductions under section 30 to 37 are deemed to be allowed. No deduction is allowable, including deduction for partner's remuneration and interest on capital.

- (ii) Partner's share in the profits of firm is not taxed in the hands of the partners by virtue of section 10(2A).
- (iii) If a proprietary concern is formed, the salary of Mrs. Gavaskar shall be allowed as deduction under section 37(1).
- (iv) The possibility of invoking section 40A(2) cannot be ruled out as salary is payable to a relative, who is an interested person within the meaning of section 40A(2). However, it can be argued successfully that salary of ₹ 5 lacs is justified in view of her long experience as marketing manager of a multinational company and the fair market value of services to be rendered by her to the concern.
- (v) An issue arises as to whether remuneration of Mrs. Gavaskar would be includible in the total income of Mr. Gavaskar. Under section 64(1)(ii), remuneration of the spouse of an individual working in a concern in which the individual is having a substantial interest shall be included in the total income of the individual. However, the clubbing provision does not apply if the spouse possesses technical or professional qualification and the income is solely attributable to the application of his or her technical or professional knowledge and experience.

Further, technical or professional qualification would not necessarily mean the qualifications obtained by degree or diploma of any recognized body [Batta Kalyani vs. CIT (1985) 154 ITR 0059 (AP)]. The experience of Mrs. Gavaskar as a marketing manager in a multinational company for 15 years may reasonably be considered as a professional qualification for this purpose.

- (vi) If Mrs. Gavaskar joins the proprietary concern or partnership concern of her husband as employee, remuneration of ₹ 5 lacs shall be taxed in her hands under the head "salary".
- (vii) If she joins as partner in the business, remuneration shall be taxed in her hand as business income under section 28 to the extent such remuneration is allowed in the hands of the firm under section 40(b).
- (viii) The tax rate applicable to an individual depends on the level of his/her income, whereas for partnership firms it is flat rate at 30%. Surcharge @12% would be attracted only if total income exceeds ₹ 1 crore. For individuals, the rate of tax is 5% on income exceeding ₹ 2.50 lakhs but not exceeding ₹ 5 lakhs; 20% for total income exceeding ₹ 5 lakhs but not exceeding ₹ 10 lakhs and @ 30% in respect of income exceeding ₹ 10 lakhs for the assessment year 2021-22. The surcharge for total income exceeding ₹ 50 lakhs but not exceeding ₹ 1 crore is 10% of tax payable; for total income exceeding ₹ 1 crore but not exceeding ₹ 2 crore is 15% of tax payable; for total income exceeding ₹ 2 crore but not exceeding ₹ 5 crore is 25% of tax payable and for total income exceeding ₹ 5 crore is 37% of tax payable. Health and Education cess @ 4% on income-tax plus surcharge, if applicable, is attracted in all the cases.
- (ix) If a sole proprietary concern is formed, Mr. Gavaskar has an option to pay income-tax in respect of his total income (other than income chargeable to tax at special rates under Chapter X-II) at concessional rates under section 115BAC. However, if he exercises such option in the P.Y. 2020-21, the said provisions would apply for all subsequent previous years.

Question 5 : ABC Ltd., a pharmaceutical company incorporated in year 2000-01, purchased a new plant and machinery for ₹ 10 lakhs on 01-04-2020. The total income of the company for Assessment Year 2021-22 before allowing additional depreciation in respect of new plant and machinery is ₹ 20 lakhs. ABC Ltd. has not opted for the concessional tax regime under section 115BAA or 115BA so far. Compute the tax liability of ABC Ltd. for A.Y. 2021-22 assuming its turnover for the previous year 2018-19 was ₹350 crores. Ignore the provisions of MAT.

Solution : Computation of tax liability of ABC Ltd. for A.Y. 2021-22 under regular provisions of the Act

Particulars	₹
Total Income before allowing additional depreciation	20,00,000
Less: Additional Depreciation u/s section 32(1)(iia) [₹10 lakh x 20%]	2,00,000
Total Income	18,00,000
Applicable Tax Rate (since turnover of P.Y. 2018-19 < ₹400 crores)	25%
Tax payable	4,50,000
Add: Health & Education cess@4%	18,000
Tax Liability	4,68,000

Computation of tax liability of ABC Ltd. for A.Y. 2021-22 under section 115BAA

Particulars	₹
Total Income before allowing additional depreciation	20,00,000
Less: Additional Depreciation u/s section 32(1)(iia) [not allowable as deduction while computing income u/s 115BAA]	-
Total Income	20,00,000
Applicable Tax Rate	22%
Tax payable	4,40,000
Add: Surcharge@10%	44,000
	4,84,000
Add: Health & Education cess@4%	19,360
Tax Liability	5,03,360

Since tax payable as per the regular provisions of the Act is lower than the tax payable under the provisions of section 115BAA, it would be beneficial for ABC Ltd. not to opt for section 115BAA.

Question 6 : Distinguish between Tax planning and Tax Evasion

Answer : Tax planning is carried out within the framework of law by availing the deductions and exemptions permitted by law and thereby minimizing tax liability. Tax planning is an arrangement by which full advantage is taken of the concessions and benefits conferred by the statute, without violation of legal provisions. Tax evasion on the other hand is an attempt to reduce tax liability by dubious or artificial methods or downright fraud. It is illegal and denies the State its legitimate share of tax.

Question 7 : Specify with reason, whether the following acts can be considered as (i) Tax planning; or (ii) Tax management; or (iii) Tax evasion.

- (i) Mr. P deposits ₹ 1,00,000 in PPF account so as to reduce his total income from ₹ 5,90,000 to ₹ 4,90,000.
- (ii) SQL Ltd. maintains register of tax deduction at source effected by it to enable timely compliance.
- (iii) An individual tax payer making tax saver deposit of ₹ 1,00,000 in a nationalised bank.
- (iv) A partnership firm obtaining declaration from lenders/depositors in Form No. 15G/15H and forwarding the same to income-tax authorities.
- (v) A company installed an air-conditioner costing ₹ 75,000 at the residence of a director as per terms of his appointment but treats it as fitted in quality control section in the factory. This is with the objective to treat it as plant for the purpose of computing depreciation.
- (vi) RR Ltd. issued a credit note for ₹ 80,000 as brokerage payable to Mr. Ramana who is the son of the managing director of the company. The purpose is to increase the total income of Mr. Ramana from ₹ 4,20,000 to ₹ 5,00,000 and reduce the income of RR Ltd. correspondingly.
- (vii) A company remitted provident fund contribution of both its own contribution and employees' contribution on monthly basis before due date.

Answer **Tax Planning / Tax Management / Tax Evasion**

	Answer	Reason
1.	Tax planning	Depositing money in PPF and claiming deduction under section 80C is as per the provisions of law.

2.	Tax management	Maintaining register of payments subject to TDS helps in complying with the obligations under the Income-tax Act, 1961.
3.	Tax planning	Making a tax saver deposit of ₹ 1,00,000 in a nationalized bank for claiming deduction under section 80C by an individual is a permitted tax planning measure under the provisions of income-tax law.
4.	Tax management	Obtaining declaration from lenders/depositors in Form No. 15G/15H by a partnership firm and forwarding the same to Income-tax authorities is in the nature of compliance of statutory obligation under the Income-tax Act, 1961.
5.	Tax evasion	An air conditioner fitted at the residence of a director as per the terms of his appointment would be a furniture qualifying for depreciation @10%, whereas an air conditioner fitted in a factory would be a plant qualifying for a higher depreciation @15%. The wrong treatment unjustifiably increases the amount of depreciation and consequently, reduces profit and consequent tax liability. Treatment of air-conditioner fitted at the residence of a director as a plant fitted at the factory would tantamount to furnishing of false particulars with an attempt to evade tax.
6.	Tax evasion	<p>Issuance of a credit note for ₹ 80,000 by RR Ltd. as brokerage payable to Mr. Ramana, the son of the Managing Director, to increase his total income from ₹ 4.2 lakh to ₹ 5.00 lakh and to correspondingly reduce the company's total income is a method of reducing the tax liability of the company by recording a fictitious transaction.</p> <p>The company is liable to tax at a flat rate of 30%/25%/22%, as the case may be, whereas Mr. Ramana would not be liable to pay any tax, since his total income does not exceed ₹ 5,00,000, consequent to which he would be eligible for tax rebate of ₹ 12,500 under section 87A. Reducing tax liability by recording a fictitious transaction would tantamount to tax evasion.</p>
7.	Tax management	Remitting of own contribution to provident fund and employees contribution to provident fund on a monthly basis before due date is proper compliance of the statutory obligations.

Question 8 : Examine the doctrine of form and substance in the context of tax planning.

Answer

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:

- (i) **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 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. **However, this rule applies only to genuine transactions.** [CIT v. Motor and General Stores (P) Ltd. v. CIT (SC). Moreover, with General Anti Avoidance Rules coming into force with effect from A.Y.2017-18.

- (ii) **True legal relation is the crucial element for taxability** - 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 v. B.M. Kharwar (SC)]
- (iii) **Substance (i.e. actual nature of expense) is relevant and not the form –**
 - (a) In the case of an 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. v. CIT (SC)].
 - (b) 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. v. CIT (SC)].