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TAX PLANING - NATURE AND FORMS OF BUSINESS, SEC 10A OF INCOME TAX ACT OF 1961 Conti…….

FORMS OF ORGANIZATION

The selection of particular form of organisation depends not only on the magnitude of financial requirements and owner's liability, but also on the tax considerations. In the case of a company the law interferes with the corporate planning process from the moment it comes into existence. At times, tax laws affect even the periods prior to the existence of a company and it can also extend upto the point of time when the company ceases to exist. Normally, depending upon the level of operation expected profitability need for external financing and expected requirements of technical expertise a suitable form can be chosen. But in view of the continuity of business, the benefits arising out of limited liability, organized accounting and the overall long-term tax benefits flowing to the company form of organisation, the corporate enterprise may be regarded as an effective instrument of tax planning. The company being a separate legal entity confers certain valuable benefits in the matter of tax planning to its shareholders and the persons connected with the management of the company. Tax liability is an important consideration guiding the choice of a legal form of business organisation. In some circumstances however this consideration is of no significance. For example large business is generally compelled to organize itself in the form of a company as this form of organisation makes it possible to raise large amounts of capital required. Similarly retail business of small size can only be economically operated as proprietorship or partnership firm. When there is freedom of choice taxation becomes an important consideration.

Sole proprietorship:

The most common form of ownership found in the business world is sole proprietorship. In this form of organization, the proprietor is the only owner of the business assesed and he is solely responsible for the affairs of the business. — A sole proprietorship is easy to establish because of little interference of government regulations. — The cost of adopting this form of organization is small because of there being no legal requirement. — All the profits of the business go in the hands of proprietor himself. — In case of persons carrying on business on small scale and having small income from other sources, this form of organization would be suitable because the proprietor can avail of the ceiling of exempt income as under:

For assessment year 2020-21:

(a) in case of individuals in India below 60 years of age. 2,00,000

(b) in case of individual resident in India who is of the age of 60 years or 2,50,000 but below the age of 80 years at any time during the previous year

(c) in case individual who is the age of 80 years or above 5,00.000 The tax liability of the individual will be minimum as the individual is subject to income-tax at slab rate and the maximum marginal rate of income-tax in his case is 30% plus education cess @2% plus SHEC @1% for the assessment year 2020-21.

— Besides the deductions which are allowed to all assesses under Chapter VIA, a sole proprietor, being assessed as individual, is entitled to get certain deductions under the following sections:

(i) Section 80C relating to contributions to provident fund, life insurance premium, subscription to certain equity shares or debentures, etc.

(ii) Section 800CC relating to contribution to certain pension funds.

(iii) Section 8000D relating to contribution to notified pension scheme of the Central Government.

(iv) Section 800 relating to medical insurance premia.

(v) Section 80DD relating to maintenance of a dependent who is a person with disability.

(vi) Section 80DDB relating to expenditure on medical treatment, etc.

(vii) Section 80E relating to interest taken for higher education.

(viii) Section 80GG relating to rent paid.

(ix) Section 8000B relating to royalty income, etc. of authors of certain books other than text books.

(x) Section 8ORRB relating to royalty on patents.

(xi) Section 80U relating to persons with disability.

However, this form of organization is also not suitable due to: The liability of the proprietor is unlimited and it can extend even to his personal assets. When the proprietor incurs losses and business assets are not sufficient enough to meet the liabilities of business, his personal assets can be used for discharging the business liabilities. The proprietor does not get deduction on account of remuneration payable to him attributable to the rendering of services. It is felt that it is the capital contributed and risk taken by the proprietor for which he is rewarded in profits and that he must be given remuneration for the service rendered by him which should be allowed as deductible expenditure. But this is not so in income-tax law. Another main drawback of this form of organization is that it does not provide opportunities to finance the expanding business activities. In the case of a partnership firm, on the other hand. finance can be raised by the existing partners or by entering another partner.

(B)Undivided Family: A joint Hindu family pays tax on its total income at prescribed rates on the basis of slab system. The family can pay reasonable remuneration to the Karta and other family members for their services to the business and it is allowed as a deduction in computing the business income. However, interest on capital contributed by the family for the business is not deductible in computing business income. The member of the family, who has received the remuneration from the family will include it in his income under the head Salaries. A Hindu undivided family will also get a basic exemption of 2,00,000 from assessment year 2013-14. Besides the deductions which are allowed to all assesses, it is allowed certain deductions under Sections 800, 80D, 80DD, 800DB and 80GG like individuals. The tax rates in case of HUF are same as applicable to individual. The demerits of HUF, however, are similar to that of individuals.

Partnership Firm: A partnership form of organization is easy to establish. The only procedure for the formation of partnership is to draw up a partnership deed and a nominal charge in terms of cost of stamps for the deed is to be incurred. This form of organization is suitable due to the following factors:

— The decision making on important business matter is quick as compared to a company form of organization because partners meet frequently together. Therefore, decision on any important business matter cannot be delayed.

— The chance of getting involved in risky activities is very less because every important decision is made with the concurrence of all the partners.

— As compared to sole proprietorship, the problem of raising additional resources is much less.

Whenever the business expands and it is necessary to raise finance, it will be easy to raise it by admitting a new partner or raising it by way of borrowings because of number of partners and their joint and several liability to pay the debts of the firm, the lenders will be more interested in lending.

— The firm can pay interest on capital and loan to partners at the maximum rate of 12% p.a. Further it can also give remuneration to its working partners subject to the limits mentioned in Section 40(b).

— This form of organisation is suitable from income-tax point of view in such cases where the amount of profit is not large and the partners of the firm do not have any other additional income except by way of remuneration and interest from the partnership firm. In such a case the profit of the firm shall be lower and the individual partners can also avail of the maximum ceiling of income exempt under the Income-tax Act.

— The share in the profit of the partnership firm is exempt form tax under Section 10(2A) of the Income-tax Act.

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

— As in the case of company form of organization where the change of business requires a long procedure, there is no tedious procedure in the partnership form of organization. The business can be changed only with the consent of partners.

— The firm is taxable at a flat rate of 30% + education cess @2% + SHEC @1% for assessment year 2013-14 after allowing interest and remuneration to working partners (if provided in the partnership deed and subject to Section 40(b) of the Income-tax Act.

However this form of organization is not suitable due to the following reasons:

1. The risk taking capacity of the partners becomes limited. Every decision relating to important business matters is made with the consultation of other partners, which restricts the risk taking activities which may yield much higher profits.

2. As far as the operations of business are limited to small or medium scale, there is no problem in financing the expansion of business operation. But when business gets expanded to a large scale. then it will be suitable to adopt a company form of organization because partnership can be formed up to maximum number of 20 partners.

3. One of the main drawbacks is that one partner becomes liable for the acts of another. Therefore, a partner is liable for the wrongs of another partner if it is done within the legal limits.

4. In the new scheme of assessment of partnership firms, the share of partners is exempt from tax under Section 10(2A) but the partners remuneration and interest, subject to limit mentioned in Section 40(b), is taxable in the hands of the partners under the head profits and gains of business or profession. Also, the firm cannot claim deduction in respect of interest payable to partners in excess of 12% per annum.

5. Where the partnership firm does not comply with the requirements of Section 184 of the Income Tax Act, although the firm shall be assessed as firm, it shall not be allowed any deduction on account of interest and remuneration to its partners.

6. A partnership firm may come to a sudden closure of business on account of death. lunacy or insolvency.

In the case of a business running efficiently and profitably, such as happening will cause a great loss. Also, dissolution will attract Section 45(4) which imposes tax liability in respect of capital gain arising on transfer of capital assets from the firms to partners. Entrepreneurs now have an alternative and innovative form of business organization i.e. Limited Liability Partnership (LLP) which combines the benefits of company and general partnership form of business organizations. LLP has separate legal entity, perpetual succession and limited liability of partners. From income tax point of view it is treated same as general partnership firm therefore its profits will be taxed in the hands of the LLP not in the hands of its partners.

(D)Company Form of Organisation

The important tax privileges and advantages to a company over the other forms can be summarized as under:

(i)Allowability of remuneration for the persons who are managing the affairs of the company and also owning its shares.

(ii) The provisions relating to clubbing of income under Section 64 of the Income Tax Act, 1961 do not apply even if the business is carried on by family members through a company, which ultimately leads to reduction in liability to tax on the part of the individual members. However, if spouse of an individual having a substantial interest in a company receives remuneration from the same company, such remuneration is added to the income of the individual unless the spouse is technically or professionally qualified. [Section 40A (2)(b) of the Income Tax Act. 1961].

(iii) Any income by way of dividend referred to in Section 115-0 is exempt under Section 10(34).

(iv) Companies are subjected to flat rate of tax, regardless of the quantum of their income. The domestic companies now pay tax @ 30% plus surcharge @ 5% (surcharge is applicable if their total income exceeds 1 Crore), if applicable and education cess @ 3%.. This, however, may not seem to be an advantage in view of low slab rates applicable to sole proprietorships, but when we look at the total incidence of tax after taking into account the various deductions allowed to companies and the scheme of perquisites, the real owners of companies stand to benefit.

(v)There are certain special tax concessions, allowances and deductions given under the Income Tax Act, 1961 available to the company form of business enterprises such as deductions allowed under Section 33AC and Sections 36(1)(ix) and 35D of the Income Tax Act, 1961 etc.

(vi) Incorporation of a company has the incidental advantage of attracting large capital since the shareholder, who has to contribute only a miniscule part of the capital requirements, is assured of limited liability and free transferability of his shares. That shares in companies are treated as long term capital assets qualifying for considerable leniency in taxation even if they are held by the assessee for a small time as 12 months, has made investment in the shares of companies all the more attractive. This helps the companies to generate the funds required for their development as well as furtherance of their objects.

(vii) There is no wealth tax on shares of company w. e. f. Assessment Year 1993-94.

In case there is every likelihood of growth of business in future years a partnership firm or sole proprietorship business may be formed initially and may be converted into a company later, on growth of business as the average rate of tax applicable for non-corporate assessee is less than the flat rate applicable to corporate assessees. The relative tax burden of conducting business can be assessed by paying attention to the provisions of the Income-tax Act, 1961, Incometax Rules. 1962 and various other notifications and circulars issued from time to time by concerned authorities.An individual pays tax on his income on the basis of slab system. He gets the benefit of minimum taxable limit laid down by the respective Finance Acts. Income received by an individual in different capacities, i.e. as a member of a firm is not taxable in hand of partner. Because firm has paid tax on it. The owner of a proprietorship firm is treated as an individual for tax purposes. A company is regarded as a separate legal entity. The minimum limit does not apply in its case. It is required to pay tax on every rupee of its income. Besides the usual income tax at the flat rate prescribed by the respective Finance Acts, 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 in this regard as is the practice in advanced countries. Free Trade Zone (FTZ) – Special Provision in respect of Newly Established Undertaking in Free Trade Zone. Section 10A In India there are at present six free trade zones, namely, the Kandala Free Trade Zone, Santa Cruz Electronics Export Processing Zone, Falta Export Processing Zone, Madras Export Processing Zone, Cochin Export Processing Zone and Noida Export Processing Zone. These free zones play an important role on the export front. With a view to encouraging establishment of export-oriented industries in the free trade zones, Section 10A provides complete tax exemption in respect of profits and gains derived from industrial undertakings set up in these zones for a period of ten consecutive years beginning with assessment year relevant to the previous year in which the undertaking starts its production activity.

I.**CONDITIONS TO BE SATISFIED:** In order to get deduction, an undertaking must satisfy the following conditions: Condition 1 It must begin manufacture or production in free trade zone : It has begun or begins to manufacture or produce during the previous year relevant to the assessment year— (a) commencing on or after 1-4-1981, in any free trade zone; or (b) commencing on or after 1-04-1994, in any software technology park or electronic hardware technology park or; (c) commencing on or after the 1- 04-2001 in any special economic zone; Condition 2 It should not be formed by splitting / reconstruction of business. It should not be formed by transfer of old machinery: It should not be formed by the transfer to a new business of machinery or plant previously used for any purpose. 20% of second value machinery allowed : Where in the case of an undertaking, any machinery or plant or any part thereof previously used for any purpose is transferred to a new business and the total value of the machinery or plant or part so transferred does not exceed 20% of the total value of the machinery or plant used in the business, then, the condition specified therein shall be deemed to have been complied with. Condition 3 Imported Machinery allowed: Any machinery or plant which was used outside India by any person other than the assessee shall not be regarded as machinery or plant previously used for any purpose, if the following conditions are fulfilled, namely : a)such machinery or plant was not previously used in India b) such machinery or plant is imported into India from any county outside India; and no deduction on account of depreciation in respect of such machinery or plant has been allowed or it allowable under the provisions of the Act in computing the total income of any person for any period prior to the date of the installation of machinery or plant by the assessee. (Value of imported machine can exceed 20% of the Total Value of Machine) Condition 4 Sale construction should be remitted to India in convertible foreign exchange. Sale consideration should be remitted to India in convertible foreign exchange, within a period of six months from the end of the previous year or, within such further period as the competent authority may allow in this behalf. Condition 5 Report of Chartered Accountant : The deduction under [this section] shall not be admissible for any assessment year beginning on or after the 1st day of April, 2001, unless the assessee furnishes in the prescribed Form 56, along with the return of income, the report of an Chartered Accountant, as defined in the Explanation below sub-section (2) of section 288, certifying that the deduction has been correctly claimed in accordance with the provisions of this section. Condition 6 Return of income should be submitted in time.

II.AMOUNT OF DEDUCTION – GENERAL PROVISIONS: If the aforesaid conditions are satisfied, the deduction u/s 10A may be computed as under: Profits of the business of eligible undertaking=Export Turnover of the eligible undertaking Total Turnover of eligible undertaking 'Export Turnover": means the consideration of articles or things or computer software received in, or brought into India by the assessee in convertible foreign exchange in accordance with sub-section (3), but does not include… freight, telecommunication charges or insurance attributable to the delivery of the articles or things or computer software outside India or expenses, if any, incurred in foreign exchange in providing the technical services outside India.

III**. PERIOD AND RATE OF DEDUCTION:** Out of the total income of an assessee a deduction of 90% of such profits and gains as are derived by an undertaking from the export of articles, or things or computer software shall be allowed. Rate of deduction for unit set up in Special Economic Zone on or after 1-4-2003 shall be as follows for first 10 assessment years: ? First 5 Years – 100 % of profits and gains derived from the export of such articles or things or computer software for a period of five consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce such articles or things or computer software, as the case may be, and thereafter, ? Next 2 Years : 50% of such Profit and Gains is deductible for further 2 assessment years. ? Next 3 Years : for the next three consecutive assessment years, so much of the amount not exceeding 50% of the profit as is debited to the profit and loss account of the previous year in respect of which the deduction is to be allowed and credited to a reserve account (to be called the "Special Economic Zone Reinvestment Allowance Reserve Account") to be created and utilised for the purposes of the business of the assessee.

IV .TRANSFER UNDER A SCHEME OF AMALGAMATION OR DEMERGER: In case an undertaking eligible for deduction under this section is transferred, before the expiry of the specified period, to another Indian company in a scheme of amalgamation or demerger –

(a) no deduction shall be admissible under this section to the amalgamating or the demerged company for the previous year in which the amalgamation or demerger takes place ; and

(b) the provisions of this section shall apply to the amalgamated or the resulting company as if the amalgamation or demerger had not taken place.