M Com Sem -4

Taxation-2

Chapter 2

Capital Structure and Tax Planning

Lecture-2

Learning Topics

- ✓How to Determine Project Cost ?
- ✓How to determine capital employed ?
- ✓Use Of Finance Leverage and Tax Planning

❖ Determining Project Cost

Project cost refers to the total expenses incurred to establish, expand, or modernize a business. It includes direct and indirect costs related to asset acquisition, financing, and regulatory compliance.

Components of Project Cost:

1. Fixed Capital Cost:

- Land and Building
- Plant and Machinery
- Office Equipment and Furniture
- Vehicles (if used for business operations)

2. Preliminary & Pre-Operative Expenses:

- Feasibility studies
- Legal & registration fees
- Consultant charges
- Market research

❖ Determining Project Cost

3. **Working Capital:**
   - Raw materials
   - Salaries & Wages
   - Overheads (Rent, Utilities, Admin Expenses)
4. **Interest During Construction (IDC):**
   - Interest on loans taken before operations begin
5. **Contingency & Miscellaneous Expenses:**
   - Reserves for unexpected expenses

❖ Determining Project Cost

Example Calculation:

Expense Category	Amount (INR)
Land & Building	50,00,000
Machinery	30,00,000
Working Capital	10,00,000
Preliminary Expenses	5,00,000
IDC	2,00,000
Contingencies	3,00,000
Total Project Cost	**1,00,00,000**

Determining Capital Employed

- Capital Employed represents the total amount of funds used for business operations. It includes both equity and debt financing.

- Generally, capital employed in the business of company means the aggregate of the issued (1) Share Capital (2) Debenture (3) Long-Term Borrowing as on the last day of the previous year in which the business of the company commence or undertaking is completed or new unit commence production.

- Premium Collected by the assessee company on the subscribed share capital is not capital employed.

Determining Capital Employed

Sources of Capital Employed:

1 Equity Financing (Owner's Contribution)

- Share Capital (Equity or Preference)
- Retained Earnings (Profits reinvested in business)

2 Debt Financing (Borrowed Capital)

- Term Loans from Banks & Financial Institutions
- Debentures & Bonds
- External Commercial Borrowings (ECBs)
- Government Grants & Subsidies

3 Working Capital (Short-Term Funds)

- Trade Credit (Credit from Suppliers)
- Bank Overdraft & Cash Credit
- Short-term Loan

Determining Capital Employed

Sources of Long-Term Borrowing for Companies

1 Term Loans from Banks & Financial Institutions

- Secured or unsecured loans with repayment over 5-10 years
- Used for purchasing machinery, infrastructure, or expansion

2 Debentures & Bonds

- Companies issue debentures or corporate bonds to raise funds from investors
- Can be secured or unsecured, convertible or non-convertible

3 External Commercial Borrowings (ECBs)

- Loans borrowed from foreign financial institutions or investors
- Regulated by RBI and suitable for infrastructure and large-scale projects
- Lower interest rates than domestic loans

❑ Determining Capital Employed

Sources of Long-Term Borrowing for Companies

4 Loans from Financial Institutions (SIDBI, NABARD, etc.)

- Sector-specific funding available for manufacturing, agriculture, and MSMEs
- Special schemes provide long-term, low-interest loans

5 Lease Financing (Financial Lease)

- Instead of purchasing assets, companies opt for long-term leasing
- Suitable for machinery, IT infrastructure, and heavy equipment

6 Inter-Corporate Loans or Promoter Loans

- Funds borrowed from parent companies, promoters, or other group companies
- Must comply with Companies Act, 2013 (Section 185 & 186)

❖ Use Of Finance Leverage and Tax Planning

◆ What is Financial Leverage?

- Financial leverage refers to using **borrowed funds (debt)** instead of equity to finance business operations, investments, or expansion.
- It helps in increasing **return on equity (ROE)** when the company earns more from investments than the cost of debt

◆ Formula for Financial Leverage

$$\text{Financial Leverage} = \frac{\text{Total Debt}}{\text{Total Equity}}$$

OR

$$\text{Degree of Financial Leverage (DFL)} = \frac{\%\text{Change in Net Profit}}{\%\text{Change in Operating Profit (EBIT)}}$$

❖ Use Of Finance Leverage and Tax Planning

◆ How Financial Leverage is Used?

- ✅ **Increases Return on Investment (ROI):**
  If debt is used efficiently, the company can generate higher profits without diluting ownership.
- ✅ **Enhances EPS (Earnings per Share):**
  When a company finances expansion through debt instead of equity, existing shareholders retain ownership, increasing EPS.
- ✅ **Helps in Business Expansion:**
  Companies with stable cash flow prefer debt financing for rapid growth.
- ✅ **Fixed Cost Financing:**
  Unlike equity, debt comes with fixed obligations (interest payments), which are tax-deductible.

❖ Use Of Finance Leverage and Tax Planning

◆ Tax Planning with Financial Leverage

1. Interest on Debt is Tax-Deductible

- As per **Section 36(1)(iii) of the Income Tax Act**, interest on business loans is allowed as a deduction from taxable income.
- **Lower taxable income = Lower tax liability**

2. Reducing Cost of Capital

- Since debt interest is tax-deductible, the **after-tax cost of debt is lower than equity financing**.
- **Formula:**
- After-Tax Cost of Debt=Interest Rate×(1−Tax Rate
- Example: If a company pays **10% interest** on loans and the tax rate is **30%**,
- Effective Cost of Debt=10%×(1−0.30)=7

❖ Use Of Finance Leverage and Tax Planning

◆ Tax Planning with Financial Leverage

3. Capital Structure Optimization

- A balanced mix of debt and equity helps minimize the company’s Weighted Average Cost of Capital (WACC).
- More debt = Lower tax burden, but higher financial risk.

4. Depreciation & Interest Tax Shield

- Combining **debt financing with asset purchases** (eligible for depreciation) creates a **double tax shield**.
- Example: A company buys **machinery using borrowed funds**, benefiting from **both depreciation and interest deductions**.

❖ Use Of Finance Leverage and Tax Planning

◆ Tax Planning with Financial Leverage

- ✅ **Moderate leverage = Tax benefits + Higher returns for shareholders**
- ✅ **Too much leverage = High financial risk & debt burden**
- ✅ **Best strategy**:

  Maintain an **optimal debt-to-equity ratio** and use **tax planning techniques** to maximize returns.

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