

# M Com Sem -4

## Taxation-2

### Chapter 2

## Capital Structure and Tax Planning

### Lecture-4

## Learning Topics

- ✓ Decision On Additional Investment for expansion project
- ✓ Factor Influencing rate of return

## ❖ **Decision On Additional Investment for expansion project**

- ✓ Companies are execute expansion projects.
- ✓ The objective of such projects is to give maximum return to share holders in the form of dividend.
- ✓ The financial manager has to decide about
  - (1) Which source of finance should be used ?
  - (2) What should be earning ability of the project ?

## ❖ Decision On Additional Investment for expansion project

❑ First Step Calculate Expected Rate of return

Step No	Particular	Calculation
1	Rate of return of new project (EBIT) rate Assume $x$	Investment X $x\%$
2	Less : Interest on debts	xxxx
3	Less : Corporate Tax	xxxx
4	Necessary Earning for New Equity Add : Dividend on old Equity at old rate	xxxx xxxx
	a	
5	Expected Rate of Return	xx%
6	<u>Total Amount of Expected return</u> Old Capital + New Capital b	xxxx
7	Value of $x = a + b$	
8	Expected rate of return = $x \times 100$	xx%

## ❖ Decision On Additional Investment for expansion project

### ☐ Confirmation

Step No	Particular	Calculation
1	EBIT on new investment (Investment x ERR)	xxxx
	Less : Interest on debts	<u>xxxx</u>
2	Profit after Interest	xxxx
3	Less : Corporate Tax	xxxx
4	Earning for New Equity	xxxx
5	Add : Dividend on old Equity at old rate	xxxx
6	Earning for total share capital	xxxx
7	Divide : Old and New Capital	xxxx
8	Expected dividend	xx%

## ❖ Factors influencing rate of return

- ✓ Condition of money market.
- ✓ Economic policy of government.
- ✓ Expansion project implementation time period.
- ✓ Possibility of entry of competitors in the market.
- ✓ Future demand of the product.
- ✓ Substitute product of own product.
- ✓ Funds raising individual credit worthiness of the company
- ✓ Nature of product – new product – modification in old product
- ✓ Product quality

$$\begin{array}{rcl}
 \text{EBIT} & = & \checkmark \\
 - \text{Int.} & = & \checkmark \\
 \text{EBT} & & \checkmark \\
 - \text{Tax} & & \checkmark \\
 \text{PAT} & & \checkmark
 \end{array}
 \left. \vphantom{\begin{array}{rcl}} \right\} \begin{array}{l} \text{Rate of} \\ \text{Return} \\ \text{Profit Rate} \end{array}$$

Rate of Return  
 on Total cap  
 on Share cap.  
 ✓ Div. Rate

**Illustration: 5**

The management of the company is planning to undertake one expansion project, where total investment of ₹ 75 crores is required. At present company has total capital of ₹ 75 crores. Since last 10 years, company is paying 20% dividend to shareholders. Now company is planning to increase it upto 25%. The applicable tax bracket to the company is 30%. The following options are developed by the company. Give your opinion for best option.

Option 1 : Finance through equity capital 100%

Option 2 : Finance through 12% loan 100%

(1) Option-1

₹ 75 CR

Through Equity  
Share Capital

Tax = 30

Effective Tax Rate

= 33.384%

## Calculation of Expected Rate of Return

No.	Particulars	Calculation
1	Return on New Investment	75x
2	Less:- Interest.	—
		75x
3	Less:- Tax @ 33.384%	25.038x
	Necessary Earning for New Equity	49.962x
4	Add:- Dividend on old equity at old Rate (75 x 20%)	15
	$CL = 49.962x + 15$	
5	<u>Expected Rate of Return</u>	25%
6	<u>Total Amount of EPR</u> Old Capital = $75 \times 25\% = 18.75$ New Capital = $75 \times 25\% = \frac{18.75}{(b) \quad 37.5}$	
7	Value of x $\left. \begin{aligned} a &= 49.962x + 15 \\ b &= 37.5 \end{aligned} \right\} a = b$ $49.962x + 15 = 37.5$ $49.962x = 22.5$ $x = 0.4503$	
8	Expected Rate of Return (x x 100)	45.03%

## Confirmation

Particulars	Amt.
EBIT on New Investment (75 Cr x 45.03%)	33.7725
Less:- Interest	—
Profit After Interest	33.7725
Less:- Tax (33.7725 x 33.384%)	11.275
Earning for new equity	22.4925
Add:- Old Dividend [75 Cr x 20%]	15
Earning for Total sh. cap	37.4925
→ Total Share Capital [75 + 75]	150
	0.2499 x 100
Expected Dividend Rate	25%.

## Option-2 75 CR Finance Through 12% Loan Calculation For Expected Rate of Return

No.	Particulars	Calculation
1	Return on New Investment [EBIT]	$75x$
2	Less: Interest $[75 \times 12\%]$	9
	Profit After Interest	$75x - 9$
3	Less: Tax $(75x - 9) \times (33.38\%)$	$25.038x - 3$
	Necessary Earning for New Equity	$49.962x - 6$
4	Add: Old Dividend $(75 \times 20\%)$	15
	$a = 49.962x + 9$	
5	Expected Rate of Return	25%
6	Total Amount at ERR	
	$75CR \times 25\% \quad b = 18.75$	18.75
7	Value of $x$ : $a = b$	
	$49.962x + 9 = 18.75$	0.1951
8	Expected Rate of Return $x = 0.1951$	19.51

$$75x - 9 - 25.038x + 3$$

-

EPR

1    45.03    33.77

2 :    19.51    14.63



Option 2 is best

## Confirmation







Particular	Amnt.
EBIT on new Investment [75 x 19.51%]	14.6325
Less: Interest [75 x 12%]	9
Profit After Interest	5.6325
Less: Tax (5.6325 x 33.384%)	1.88
Profit After Tax/ Earning for new eq.	3.7525
Add!- old dividend (75 x 20%)	15
Earning for Total Sh. Cap.	18.7525
÷ Total Share Cap	75
	0.2500
	X 100
Expected Dividend Rate	25%

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