

ACTIVITY ASPECT & TAX PLANNING

A business owner should consider the following activity aspect from taxation point of view –

I. MAKE OR BUY DECISION

The leasing or buying decision is taken only when it is finalised that a particular assets is to be acquired. In most of the industries, the conception of establishing a new project itself involves acquisition of fixed assets. In assembling industry different components are assembled to make a product. Now a decision regarding the manufacturing of these components is to be taken. It is decided whether the product/part/component of product should be bought from the market or should be manufactured by having necessary manufacturing facilities. The main consideration affecting such a decision is cost. In a make or buy decision, the variable cost of making the product or part / component of product is compared with its purchase price prevailing in the market.

In this decision making process, it may be possible that the decision to manufacture does not result in increasing the fixed cost and the existing manufacturing facilities cannot be otherwise utilised profitably. Thus, where no fixed costs are incurred for producing the product or component, the main criterion is that it would be more profitable to manufacture than to purchase, if the variable cost is lower than the purchase price.

For example, if a particular component can be acquired at a cost of ₹ 20 from the market then it will be profitable for the project to produce that component if the variable cost is below ₹ 20. Here it is assumed that no extra fixed costs are to be incurred on the manufacturing of these components.

However, where the component manufacturing involves additional fixed expenditure, purchase of any plant and machinery or establishment of a new separate unit, then total cost will have to be considered. In such special situations the following tax consideration must be kept in mind.

Before an enterprise goes into the business of selling a product, it has to decide whether it should make the product itself (i.e. go into manufacturing) or whether it should buy it from the market (i.e. go into trading). This decision is also required to be taken by an existing enterprise (whether manufacturing or trading), when it expects an additional demand for the product.

Various factors have to be taken into account before making this make or buy decision. Some of these are :

1. Cost– The total cost of manufacture has to be compared with the total cost of purchase. A decision to buy the product may be taken if the total cost of purchase is less and vice-versa. Where an enterprise is already manufacturing the product and

no fixed cost is required for additional units, the variable cost of additional units is required to be compared with the purchase price of additional units, before making the "make" or "buy" decision. While comparing the manufacturing cost and the purchase price, tax factor may also be taken into account. Due consideration should be given to various benefits (such as depreciation and benefits under Secs. 80I A or 80IB, etc.) which are available to a manufacturer –

2. Capital investment in fixed assets– Manufacturing may require huge investment in plant and machinery and factory building, etc. A buy decision may be taken if the funds are easily available and vice-versa

3. Present capacity utilisation– A decision to manufacture the product may be taken if the present capacity is under utilised and vice-versa.

4. Availability of raw material– A decision to manufacture the product may be taken if the raw material is easily available and vice versa.

5. Availability of the product– A decision to buy may be taken if the product is easily available in the market and vice-versa.

6. Technology- A decision to make the product can be taken only if the technology for manufacturing is easily available at reasonable terms.

II. REPAIR / RENEWAL OR REPLACEMENT OF AN ASSETS

The old and worn out assets need to be either repaired / renewed or replaced at regular intervals. Sometimes, even a good machine requires upgradation or replacement so as to compete in the market. The main tax consideration in these cases shall be whether the assessee, while computing his business income, shall be allowed deduction on account of such expenditure or not.

Repairs / Renewal- Deduction for expenditure on repairs / renewal will be allowed as revenue expenditure in computation of business income as under –

If the building is a rented building, any expenditure on repairs shall be allowed as deduction. On the other hand, if the building is owned, only current repairs shall be allowed as deduction.

As regards plant & machinery, only current repairs shall be allowed as deduction.

Replacement of assets– If the assets has to be replaced, the expenditure incurred on replacement shall be capital expenditure and the assessee shall only be entitled to depreciation on such assets and as such, the entire expenditure cannot be claimed as deduction which was allowed in case of repairs. The capital expenditure incurred on construction of super structure on rented building is also eligible for depreciation under section 32.

III. LEASE OR BUY DECISIONS

In recent years, leasing has become a popular source of financing in India. From the lessees point of view, leasing has the attraction of eliminating immediate cash outflow and the lease rentals can be claimed as admissible expenditure against the business income. On the other hand, buying has the advantages of depreciation allowance and interest on borrowed capital is tax-deductible. Thus, an evaluation of the two alternatives is to be made in order to take a decision.

The following factors affect the decision of owning or leasing :

1. Purchasing cost : Cost of purchasing an assets is not deductible in computing taxable profits because it is capital expenditure. Besides, it increases the cash outflow.

Cost of leasing, that is, lease rent is deductible in computing taxable profits as it is revenue expenditure. Besides, it reduces cash outflow.

2. **Obsolescence risk** : Purchasing an assets bears the obsolescence risk. If the assets becomes obsolete earlier than its expected working life, it has to be replaced and will increase cash outflow. Leasing avoids risk of obsolescence. If assets becomes obsolete, it may be replaced by new assets.
3. **Depreciable assets** : Where an asset is entitled to depreciation, it may be purchased. Depreciation is an admissible deduction in computing taxable profits. It will reduce tax incidence.
If the assets is taken on lease, no depreciation is allowed as the assets is not owned by the assessee. However, in the case of low rate depreciable assets, like residential building with 5% rate of depreciation, leasing may be beneficial to avoid huge investment in building.
4. **Non-depreciable assets** : Leasing may be preferred in the case of non-depreciable assets to reduce cash outflow and to reduce incidence of tax.
5. **Special tax benefits** : Tax benefits under Sec. 80IB is available if at least 80% of plant and machinery have been taken on lease no deduction is available under Sec. 80IA. However, if the undertaking is entitled to tax holiday benefit under Secs. 10A or 10B, leasing may be preferred as the entire profits would be exempt for 10 assessment years.
6. **Gestation period** : Where gestation period is sufficiently long, say 5 or 6 years, leasing may be preferred. Special tax benefits, available on ownership basis, may not be of any help as there would be no profits during gestation period.
7. **Fund position** :
 - (a) Where the funds are sufficient, a decision to buy through own funds may be taken.
 - (b) Where own funds are not sufficient, but loan can be taken at reasonable interest rate, a decision to buy through loan fund or through hire purchase / instalment system may be taken.
 - (c) Where own funds are not sufficient and loan also cannot be arranged at reasonable interest rate, a decision in favour of the lease may be taken.
8. **Residual value** : Residual value of an assets belongs to the owner. A higher residual value will tilt the balance in favour of owning an assets.
9. **Future returns** : Where future returns (after tax) are low, the decision to buy the assets through own funds may be taken. This will overcome the likely difficulties to be faced in making payments of lease-rent / interest payment / loan repayment etc. as the case may be.