**Capital Structure Decisions**

Before commencing a new project, a vital managerial decision regarding selecting right type of capital structure has to be taken. An optimum capital structure is one which maximise shareholders’ return. The advantage of having an optimum capital structure are two-fold. It maximizes the value of the assets of the company and wealth of its owner and minimises the cost of capital, in turn, raises its ability to find in built additional investment opportunities. Problem of planning capital structure is of crucial importance and has long-term implications.

The Tax planner should properly balance risk, cost, control and tax consideration. In capital structure decision, the cost of capital is an important consideration along with risk factor.

One of the main reasons for raising finance through (as against issue of equity shares) is to increase earning on equity share capital. But excessive use of debt capital increases the financial risk of the company.

Under the tax laws, dividend on shares is not deductible, while interest paid on borrowed capital is allowed as deduction under section 36(1)(iii). Cost of raising finance through borrowings is deductible in the year in which it is incurred. if however, it is incurred during pre-commencement period, it has to be capitalised. Cost of issue of shares is allowed as deduction in five years under section 35D. Because of the aforesaid provisions, corporate taxation plays an important role to determining the choice between different source of financing.

Example

Tuktak ltd is a widely-held company. It is currently considering a major expansion of its production facilities and the following alternatives are available:

|  |  |  |  |
| --- | --- | --- | --- |
| Particulars | Alterntive-1₹ | Alternative-2 ₹ | Alternative-3 ₹ |
| Share capital | 5,00,00,000 | 2,00,00,000 | 1,00,00,000 |
| 14% Debentures | - | 2,00,00,000 | 1,50,00,000 |
| 18% loan from Banks | - | 1,00,00,000 | 2,50,00,000 |

Expected rate of return before tax is 25%. The rate of dividend of the company since 1990 is not less than 20% and the date of dividend declaration is June 30 every year. Suggest which alternative is the best for the Tuktak ltd for the tax point of view?

Solution

Capital Structure Decision

|  |  |  |  |
| --- | --- | --- | --- |
| Particulars | Alterntive-1₹ | Alternative-2 ₹ | Alternative-3 ₹ |
| Return on 5 Crore | 1,25,00,000 | 1,25,00,000 | 1,25,00,000 |
| Less: Interest on debenture | Nil | 28,00,000 (14% of 2 crore) | 21,00,000 |
| Less Interest on Loan | Nil | 18,00,000 | 45,00,000 |
| Taxable Profit (A) | 1,25,00,000 | 79,00,000 | 59,00,000 |
| Tax@30%  Add surcharge 7%  Total  Health & Education cess 4%  Total Tax Payable (B) | 37,50,000  2,62500  40,12,500  1,60,500  41,73,000 | 23,70,000  nil  23,70,000  94800  24,64,800 | 17,70,000  Nil  17,70,000  70,800  18,40,800 |
| Earning available to equity shareholders before dividend tax(A-B) | 83,27,000 | 54,35,200 | 40,59,200 |
| Rate of return on equity share capital | 83,27,000/5,00,00,000\*100  16.65% | 27.18% | 40.59% |

The company should, therefore, opt for the third alternative because here highest rate of return.