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Treasury Management – A Key to Taxation & Earnings Management

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Abstract

Treasury Management consisting of management of Cash, Fund, Currency, Bank and Financial risk is an imperative tool of finance. Under this one has to check the Cash flows, position of receivables and payable, investment policies, foreign currency transactions if any and to shape them properly, whereby the treasury of the organization can be enriched and satisfactory compliance of external parties may be made easy simultaneously.

Cash may be a small fragment of the total Current Assets but it is the most liquid and lucrative one for any firm having its unique significance. Cash Management is an important function for each and every unit because there is hardly any synchronization between inflows and outflows of cash and hence very difficult to predict the same. However, both inflows and outflows of cash carry severe impact on the financial statements not only from the Accounting point of view but from the angle of Taxation as well. It is because Taxation laws, particularly Income Tax Law thoroughly administers the nature of cash receipts and payments, mode of receipts and payments, purpose of receipts and payments made at internal and external levels for determining the incidence and volume of tax liabilities on each and every category of assessee. One cash inflow of a particular nature with a definite mode, is legal up to a certain extent but it becomes illegal and attracts heavy penalty if its volume exceeds the prescribed limit. In this context Sec. 269 SS and 271D of the Income Tax Act 1961 play a vital role. Same thing also happens in case of cash payments.

Change in the mode of payments, nature of payments or volume of payments and periodicity of payments determines the admission or denial of such payments as expenses/deductions resulting in to increase or decrease in Profitability/Earnings having a direct link with the tax liability. Sections like 40A(3), 43B and many more sections of the Income Tax Act 1961 are taken in to consideration to justify the link between Treasury Management Vrs. Taxation and Earnings Management.

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INTRODUCTION

Treasury Management is defined as the Corporate handling of all Financial matters, the generation of external and internal funds for business, the Management of Currencies and Cash flows and the Complex Strategies, policies and procedures of Corporate finance. Tight Money, escalating interest rates and economic volatility have called for this specialized skill of Treasury Management. Treasury Management includes Basic Cash Management. Specially, Treasury Management handles actual Cash Management at Companies and one of its main functions is to establish the optimum cash level so that payments can be made and received as necessary for the proper operation of the Organization. The Second Concept includes not only treasury management per se but also other tasks such as treasury forecasting, negotiation and establishment of relationship with financial institutions and financial risk management. However, Treasury Management consisting of Management of Cash, Fund, Currency, Bank and Financial risk is an imperative tool of finance. Under this, one has to check the Cash Flows, position of receivables and payables, investment policies, Foreign Currency transactions if any and other financial risks, whereby the treasury of the Organization can be enriched and satisfactory compliance of external parties and internal people be made easy simultaneously.

NEED & IMPORTANCE

As basic Cash Management, Treasury Management propitiates the development of administrative techniques conducive to optimizing the level of disposable assets to be maintained by a Company. To prevent breaks or gaps in the trading cycle due to lack of cash, administrators must calculate the cash amount best suited to their level of activity, plan the timing of the relevant payments and collections and draw up a policy of investment in assets with high liquidity that can be converted to cash at a low transactional cost to serve as support for the treasury funds maintained by the Company. Treasury Management is seen as "administration of the treasury circuits", entailing chiefly the analysis, study and review of the three circuits i.e. Payments, Collections and Cash Holding. This three Circuits principle raises the importance of Treasury Management both from the view points of Accounts and Finance in one hand and from Taxation on the other.

From Accounting point of view any payment i.e. outflow of Cash is either in the nature of capital or revenue. If the payment is revenue in nature then it must be an expense which shall find its place in Debit side of the Income Statement.

If the payment is capital in nature then either it is an asset or reduction in any liability, which would ultimately go to the Balance Sheet. Hence, in Accounting all revenue payments ultimately affect the profitability of the concern either by reducing the profit or by increasing the loss. The mode of such payment i.e through Cash or Cheque, timing or date of payment i.e. within due date or beyond, nature of payment i.e. Statutory or non-statutory dues and to whom paid i.e. relative or otherwise of the payer, have no role to play in affecting profitability of the Organization so far as Accounting is concerned. From Income Tax point of view all such items are having tremendous effect in determining the taxable profit of the Organization.

RECURRING CASH OUTFLOW AFFECTING TAXATION & EARNINGS

Let us first see as to how the mode of payment affects the situation, which would be clear from the following example. Suppose an Organization has purchased goods worth Rs. 1,00,000/- from another firm on credit. Payment is made to the supplier in two equal installments of Rs. 50,000/- each with a gap of ten days and the mode of payment is through cash. In Accounting the transactions can safely be debited to the Income Statement i.e. Trading & Profit and Loss Account under the head purchase and Profit/Loss for the period is to be determined accordingly. But for determining the taxable profit such purchase of Rs. 1,00,000/- cannot be allowed as an admissible expense although the purchase is genuine and the payments through cash of Rs. 50,000/- each are also genuine. The reason of such an in-admissibility is due to the provision u/s 40A(3) of the Income Tax Act 1961 which reads as under

"where the assessee incurs any expenditure in respect of which a payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, exceeds twenty thousand rupees, no deduction shall be allowed in respect of such expenditure".

In the instant case since the amount paid exceeds Rs. 20,000/- and the mode of payment is through cash it will not be allowed as an admissible expenditure. Had it been paid through Account payee or crossed cheques then the same would have been allowed as expenditure or had the amount of each/daily payment remain within Rs. 20,000/- it would have been allowed even if the mode of such payments are made through cash. Hence for admissibility of expenditure two things are noteworthy. Either the amount of single payment to any party or summation of all the payments to a party made in a day, remain within Rs. 20,000/- which shall be allowed irrespective of the mode of payment.

Secondly, if the amount of payment exceeds Rs. 20,000/- the mode of payment must be either through Account payee cheque or bank draft in order to be an admissible expenditure. The law has stretched its relaxations in case of payments made for plying, hiring or leasing goods carriage by extending the limit of Rs. 20,000/- to Rs. 35,000/-. Hence in case of such types of payments only, single amount of cash payment upto Rs. 35,000/- can be allowed as expenditure. One more thing is also required to be discussed here having relevance with the admissibility of expenditure. Suppose the same purchase as explained earlier is effected in one financial year and the payments in the same cash mode are made in the next year. In the year of purchase it would be allowed as expenditure because there is no scope for applicability of Section 40A(3) in absence of payments during that year. When the payments are made in the next year through cash beyond the prescribed limit, the amount so paid shall be deemed to the profit in the year of payment and accordingly tax liability is to be determined. It is therefore pertinent for the Treasury Manager to monitor the modality of payment failing which a controlled Net Profit may even bring uncontrolled tax liability. To keep it within track it does not require any extra funding or adoption of any cost cutting measures. Simply by modulation of payment structure through Treasury Management tax liability can be managed alongwith earnings too.

Second aspect relating to payment is the timing or date of payment i.e. whether paid within the due date or beyond, which may not have much impact on Accounting Profit but matters a lot for Taxation and Earnings Management. In this connection Section 43B of the Income Tax Act plays a vital role. Take the example of VAT collected at the time of effecting Sale. When collected VAT during any particular month is more than the cumulative input credit available then it is to be deposited by 21st day of the succeeding month. If it is not deposited till the end of the financial year it will be shown as VAT payable under the head Current Liabilities & Provisions. The amount of VAT payable is debited to the Profit & Loss Account and hence adversely affect the Profitability of the concern. Provisions of Section 43B of the Income Tax Act 1961 says that any tax, duty or cess like VAT will not be allowed as an admissible expenditure during the year of occurrence unless it is paid by the assessee. The payment, even if it is not made either by the due date i.e. 21st or within the financial year and remaining as outstanding, shall be allowed as deduction, provided the payment is made by the assessee before the due date of filing of the Income Tax Return as prescribed u/s 139(1) of the Act, which may be either 31st of July, 30th of September or 31st of the October depending upon the type of assessee.

If such VAT is not paid within the specified date and proof of such payment is not produced then the same will be treated as an inadmissible expenditure during the year of its occurrence. Only in the year of actual payment of such VAT, it will be considered as an admissible expenditure. Hence, timing of payment should be properly dealt with by the Treasury department in order to avail the benefit of Taxation.

Let us take a second example in this connection which is very often seen in the Society. Organization like firms, companies and others are taking huge loan from Public Financial Institutions and not repaying the loan either intentionally or otherwise. When the loan is not repaid, interest component will go up by compounding and penal interest etc. From Accounting point of view Interest on borrowed capital is an expense and to be debited to the profit & Loss Account. To be more particular as per Accrual concept of accounting, interest on loan whether paid or payable can be treated as an item charged against profit and debitable to Profit & Loss Account without any discrimination. The willful defaulters were taking advantage of this and getting benefit in two ways. They were able to rotate the fund (loan amount) within their Organization due to its non-payment and reducing their profitability by claiming the outstanding interest on borrowed capital as expense. Thereby the tax liability of the organization was being reduced. Due to such attitude of the unscrupulous borrowers the banks and Public Financial Institutes were being victimized resulting into a multiple adverse effect on the Govt. as a whole. Non-collection of loan from borrowers brings shortage of liquidity in the hands of the banks and Financial Institutions and with a time gap such advances became NPA (Non performing Assets).

NPA accounts need provisioning for Bad and doubtful debts, which adversely affect their profitability, ultimately resulting into reduction in tax liability. In this juncture the Govt. was losing tax revenue from the borrower in one hand and from the bankers on the other. When this situation was quite rampant Section 43B of the Income Tax Act 1961 was introduced w.e.f. 01.04.1984. Provisions of Section 43B states that the interest on loan from Bank or Public Financial Institutions shall be allowed as admissible expense only on the event of payment and not on the basis of accrual. Thus, non payment of interest on loan shall increase profitability leading to higher tax liability. This accrual concept of accounting, undoubtedly very much helpful for Earnings Management but so far as Taxation or Tax Liability is concerned proper modulation of payments are required through Treasury Management in order to take full advantage of the statute.

Observing the status of the payee is too relevant for purpose of Treasury Management because payments to certain specified persons mentioned u/s 40A (2) can have consequential effect on Taxation & Earnings Management. Section 40A(2) reads as under:-

(a) Where the assessee incurs any expenditure in respect of which payment has been or is to be made to any person referred to in clause (b) of this sub-section, and the Assessing Officer is of opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the goods, services or facilities for which the payment is made or legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to him therefrom, so much of the expenditure as is so considered by him to be excessive or unreasonable shall not be allowed as deduction.

(b) The persons referred to in clause (a) are the following, namely :-

i) Where the assessee is an invidivual…	*any relative of such assessee;*
ii) Where the assessee is a Company, Firm, Association of person, or HUF …	*any director of the company, partner of the firm or member of the association or family or any relative thereof.*

iii) Any individual who has a substantial interest in the business or professions of the assessee, or any relative of such individual.

iv) a company, firm, association of persons or HUF having a substantial interest in the business or profession of the assessee or any director, partner or member of such company, firm, association or family or any relative of such director, partner or member;

v) a company, firm, association of persons or HUF of which a director, partner or member, as the case may be, has a substantial interest in the business or profession of the assessee or any director, partner or member of such company, firm, association or family or any relative of such director, partner or member;

vi) any person who carries on a business or profession :-

(A) where the assessee being an individual, or any relative of such assessee, has a substantial interest in the business or profession of that person; or

(B) where the assessee being a company, firm, AOP or HUF or any director, partner or member or any relative thereof has a substantial interest in the business or profession of that person."

From the contents of the provisions of Para(a) u/s 40A(2) it is crystal clear that payment to specified persons may be disallowed by the Assessing Officer. In this context the following example shall provide a clear understanding.

Suppose a School is running under a company registered u/s 25 of the Companies Act 1956. The Managing Director of the company has given appointment to his wife as the Headmistress of that School who does not have requisite qualification to be a teacher and fixed-up her remuneration @ Rs. 40,000/- P.M. and payments are made through account payee cheques. Salary & allowance of Headmistress is definitely an expense in the hands of the School and absolutely there is no anomaly in Accounting by taking such payment into Debit side of the Profit and Loss Account. Since the payments are made through account payee cheques the question of its disallowbility u/s 40A(3) also does not arise. But still then the payment of such remuneration to the Headmistress can be disallowed u/s 40A (2) because, the headmistress being the wife of the Managing Director comes under the category of specified person. Had she been a qualified and trained person being befitting for the post of headmistress the remuneration paid to her would have been quite an allowable expense. Hence it is the duty of the Treasury Manager to judge the Status and relationship of the payee so that non of the payments shall go waste being disallowed by the tax authorities. This simple care of the Treasury department shall help a lot in taxation & Earnings Management.

NON-RECURRING CASH OUTFLOW AFFECTING TAXATION & EARNINGS

So far we have confined our discussion to payments which are recurring or revenue in nature. Payments of capital nature too carry severe impact in determining the tax liability and penalty. Here Section 269 T of the Income Tax Act 1961 shall come into play a vital role. Provision u/s 269 T reads as under –

"No branch of a banking company or a Co-operative bank and no other company or Co-opt. Society and no firm or other person shall repay any loan or deposit made with it otherwise than by an account payee cheque or bank draft drawn in the name of the person who has made the loan or deposit if –

a) the amount of the loan or deposit together with the interest, if any, payable thereon, or

b) the aggregate amount of the loans or deposits held by such person with the branch of the banking company or Co-operative bank or, as the case may be, the other company or co-operative Society or the firm, or other person either in his own name or jointly with any other person on the date of such repayment together with the interest, if any, payable on such loans or deposits,is twenty thousand rupees or more."

Repayment of loan is obviously a capital expenditure because this outflow of cash resulted into reduction in the volume of liability. It does not have any effect on profitability outwardly. But, if such repayment is more than twenty thousand rupees either single or cumulative amount of such repayment during the entire financial year and the mode of payment is other than account payee cheque or bank draft, then it will attract penalty u/s 271E of the Income Tax Act on the person making repayment. The contents of provision u/s 271E reads as under :-

"If a person repays any loan or deposit referred to in Section 269T otherwise than in accordance with the provisions of that section, he shall be liable to pay by way of penalty, a sum equal to the amount of the loan or deposit so repaid." The volume of penalty as prescribed u/s 271E amounts to a sum equal to the amount repaid or deposited i.e. if the repayment is made in cash amounting to Rs. 1,00,000/- then the penalty u/s 271E would also be Rs. 1,00,000/-. What a harsh approach? When an Organization is downed with imposition of penalty it is a seer loss to the Organization and nothing else. The only way out to avoid this huge penalty is to adopt specified mode of payment i.e. through account payee cheque or bank draft by the Treasury Department. A slightest lapse by the Treasury Manager in this regard shall resulted into heavy pecuniar losses to the organization and this would obviously put the Taxation & Earnings Management into jeopardy.

REVENUE CASH INFLOW AFFECTING TAXATION & EARNINGS

Let us now move to the side of cash inflows having severe impact on Taxation & Earnings Management. Cash collections which is either an income or liability also need careful consideration from the view point of Treasury Management which would be clear from the following discussions.

While collecting cash, if the items are not dealt with properly it may bring heavy tax liability even in the hands of the religious and charitable units enjoying exemption u/s 11 & 12 of the Income Tax Act. For the purpose we can consider here anonymous donation in the hands of charitable organizations which is explained under section 115BBC of the Income Tax Act. Under Section 115BBC anonymous donations to be taxed in following cases:-

(1) where the total income of an assessee being a person in receipt of income on behalf of any university or other educational institution referred to sub-clause (iiiad) or Sub-clause (vi) or any hospital or other institution referred to in sub-clause (iiiae) or sub-clause (via) or any fund or institution referred to in sub-clause (iv) or any trust or institution referred to in sub-clause (v) of clause (23c) of Section 10 or any trust or institution referred to in section 11, includes any income by way of any anonymous donation, the income tax payable shall be aggregate of –

i) the amount of income tax calculated on the income by way of any anonymous donation @ 30%; and

ii) the amount of income tax with which the assessee would have been chargeable and his total income been reduced by the amount of income referred to in clause (i).

(2) The provisions of sub-section (1) shall not apply to any anonymous donation received by –

a) any trust or institution created or established wholly for religious purposes;

b) any trust or institution created or established wholly for religious and charitable purpose other than any anonymous donation made with a specific direction that such donation is for any university or other educational institution or any hospital or other medical institution run by such trust or institution.

(3) For the purposes of this section, "anonymous donation" means any voluntary contribution referred to in sub-clause (iia) of clause (24) of Section 2, where a person receiving such contribution does not maintain a record of the identity indicating the name and address of the person making such contribution and such other particulars as may be prescribed".

From analysis of the aforesaid provision of section 115BBC it is crystal clear that even if any organization covered u/s 11 & 10(23)C, enjoying the benefit of exemption from Income Tax, shall come to the tax net at the maximum marginal rate of 30% on account of receipt of anonymous donations. So the role of Treasury Manager is not confined to commercial organizations only, they should be more vigilant in case of non-profit making organization because the need for Taxation and Earnings Management through Treasury Management has much more relevance & significance for religious and charitable organizations too.

CAPITAL CASH INFLOW AFFECTING TAXATION & EARNINGS

Collection of cash may take the form of capital receipts. When receipts are in the nature of capital it may be resulted into creation of a liability or reduction in the value of any asset. All such collections of capital nature do not have any impact in determining the profitability of the concern but if such collections are not properly modulated then the same would be resulted into heavy pecuniar losses.

In this connection Section 269SS may be referred to which reads as under:-

" No person shall, after the 30th day of June 1984, take or accept from any other persons (hereinafter in this section referred to as the depositor), any loan or deposit otherwise then by an account payee cheque or bank draft if –

a) the amount of such loan or deposit or the aggregate amount of such loan and deposit; or

b) on the date of taking or accepting such loan or deposit, any loan or deposit taken or accepted earlier by such person from the depositor is remaining unpaid (whether payment has fallen due or not), the amount or the aggregate amount remaining unpaid; or

c) the amount or the aggregate amount referred to in clause (a) together with the amount or the aggregate amount referred to in clause (b), is twenty thousand rupees or more."

A plain reading of the provisions of this section says that if any loan or deposit is accepted exceeding rupees twenty thousand either in lump sum or in aggregate of all sums, from any person other than Government, Banking Company, Govt. Company or Corporation established by Central, State or Provincial Act, where the mode of collection is other than account payee cheque or bank draft it will attract penalty u/s 271D of the Act. The amount of penalty is equal to the amount of the loan or deposit so taken or accepted. It means if the amount of loan taken is Rs. 2,50,000/- in form of cash which is in contravention of the provisions u/s 269SS then it will attract penalty of the like amount of Rs. 2,50,000/- u/s 271D. Just imagine how stringent the provision of the law is, as regards accepting loans other than the specified mode. Only to arrest the clandestine transactions the law has become so harsh in its approach.

In view of the harshness of the law because of the activities of certain unscrupulous people the importance of Treasury Management became manifold not only in regulating the inflows and outflows of cash rather each flow of cash either inflow or outflow require proper modulation in order to satisfy the need of the statutes and thereby one can shape the Taxation and Earnings Management properly.

CONCLUSION

All these things i.e. Treasury Management, Earnings Management and Taxation Management are interconnected, which generates an overall model of Treasury Management with a policy aimed at obtaining profits and reducing tax liability to generate value for the firms and in short, help to attain the general goals of the organisations. Treasury Management in a broad sence not only involves financial tools and techniques for managing liquidity but entails an entire corporate culture to strengthen the present and future of the organization as well.

If one will go by hierarchy, it is found that “Tax” is imposed on “Earnings”. “Earnings” are the resultant of “Accounting” i.e. excess of incomes over expenses and origin of Accounting starts from flow of cash from “Treasury” As long as the cash is only kept in the volt, whatever may be its volume, it does not require any iota of Accounting. No Accounting means no Earnings and no Earnings means no Taxation.

Hence, origin of everything is the Treasury and when its management is done properly, other subsequent stages would ultimately be fair and proper because, all are tagged in one and the same thread. A well filtered Treasury Management automatically manages the 'Earnings' of any organization and once the 'Earnings' are perfectly managed it will take care of the "book-tax gaps" ultimately resulting into a sophisticated Tax Management.

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