

## **CHAPTER II**

### **AUDIT IMPACT**

## Chapter Summary

- ◆ In the last five years, the Government introduced six legislative amendments to correct the anomalies pointed out by us. This included two amendments to Section 80-IA of the Income Tax Act, 1961, in the Finance Act 2009.

**(Paragraph 2.2)**

- ◆ In 2008-09, the department recovered Rs. 165.2 crore in cases pointed out by us.

**(Paragraph 2.3)**

- ◆ Incidence of errors in scrutiny assessments completed by the department in 2007-08 was 6.7 *per cent*. Tax effect of the erroneous demands, was Rs. 7,450.3 crore, which would impact the total tax demand raised by the department by 14 *per cent*.

**(Paragraph 2.4 and Appendix-3)**

- ◆ Delay in taking timely action on erroneous cases led to loss of revenue of Rs. 5,612.8 crore in 16,557 cases seen by audit which were rendered time-barred.

**(Paragraph 2.5.4)**

## CHAPTER II

### AUDIT IMPACT

#### 2.1 STATUTORY AUDIT

Our audit involves examination of individual assessments in field offices of the Income Tax Department to seek an assurance on:

- Accuracy in tax demands and;
- Efficacy and adequacy of systems and procedures in tax administration.

#### 2.2 LEGISLATIVE IMPACT

In the last five years, the Government introduced six legislative amendments to correct the anomalies pointed out by us. The amendment made in the Finance Act 2009 is mentioned below:

Our report on 'Assessments relating to infrastructure development (Deductions under section 80-IA of the Income Tax Act)' showed that there were no clear directions for determination of reasonable profits. Deductions under section 80-IA of the Act are based on profits, fostering a tendency among eligible assesseees to artificially inflate profits. For instance: captive power plants reported return on investment of 92 per cent<sup>24</sup>. *The Act was amended (July 2009) to cap the eligible profits within statutory or regulatory restrictions in the sector.*

The concessions in section 80-IA were meant to spur investment in infrastructure development. But we found that the benefits were being extended to contractors executing works on behalf of the Government departments. *The explanation below Section 80-IA was modified to clearly disallow such contractors.*

#### 2.3 RECOVERY AT THE INSTANCE OF AUDIT

The department recovered Rs. 2557.5 crore in the last five years from demands raised to rectify the errors in assessments pointed out by us. This includes Rs. 165.2 crore recovered in 2008-09.

### Incidence of errors

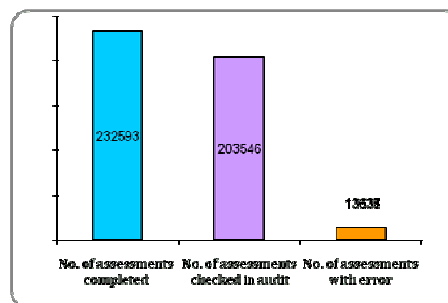
2.4 It was our attempt to audit all scrutiny assessments completed by assessment units that fall in the audit sample selected for field

<sup>24</sup> as against 16% prescribed by the statutory authority i.e., Central Electricity Regulatory Commission.

audit on the basis of pre-defined parameters of risk analysis. We found that the incidence of errors in the scrutiny assessments completed during 2007-08 averaged to 6.7 per cent. The

The establishment cost of our audit in 2008-09 is 0.03 per cent of the tax effect of cases pointed out by us. Further, the cost would be 0.55 per cent of the total demand raised on our findings (details at Appendix 4).

Chart No. 2.1



revenue impact of these errors works out to 14 per cent of the total demand raised by the department<sup>25</sup> (Appendix-3).

**2.4.1** The tax effect of the errors was Rs. 9645.4 crore<sup>26</sup> as shown below:

**Table no. 2.1: Tax wise details of errors**

Sl. No.	Category	No. of cases	Tax effect (Rs. in crore)
1	Corporation tax & Income tax	18483	9615.5
2	Wealth tax	1011	28.3
3	Other Direct taxes	137	1.6
	<b>Total</b>	<b>19631</b>	<b>9645.4</b>

**2.4.2** High value and important cases among the errors detected in local audit are included in the Audit Report. The present Audit report contains 342 cases reported to the Ministry of Finance. While 93 of these cases which were accepted by the Ministry have been included in this chapter<sup>27</sup>, remaining cases have been discussed in detail in Chapters III and IV of this Report. In respect of twelve of these 342 cases, provisions of the Act were open to interpretation, while in all the other cases, the AOs issued erroneous assessment orders despite clear provisions. 66 per cent of the errors occurred while granting ineligible concessions to assessee; 16 per cent of them were arithmetical errors (Table 2.2).

<sup>25</sup> The total demand includes demands raised in scrutiny assessment and additions, if any, in summary assessments. It also includes penalties, education cess etc. included in the tax demand.

<sup>26</sup> Rs. 7450.3 crore related to observations raised on assessments completed under scrutiny and the balance related to observations raised on assessments completed under other sections.

<sup>27</sup> Paragraphs 2.5.6, 2.5.8, Appendices 6, 7 and 8.

**Table no. 2.2: Category-wise details of errors**

Sl. No.	Category	No. of cases	Tax effect (Rs. in crore)
1	Arithmetical errors	40	274.8 (16%)
2	Ineligible concessions given to assessees	141	1137.9 (66%)
3	Income/Wealth not assessed	37	24.2 (1%)
4	Others	124	297.4 (17%)
	<b>Total</b>	<b>342</b>	<b>1734.3</b>

**2.4.3** Only 17 cases i.e., 5 per cent of the erroneous cases pointed out by audit had been seen by the internal audit wing of the department. Even in those 17 cases, internal audit failed to detect the mistakes.

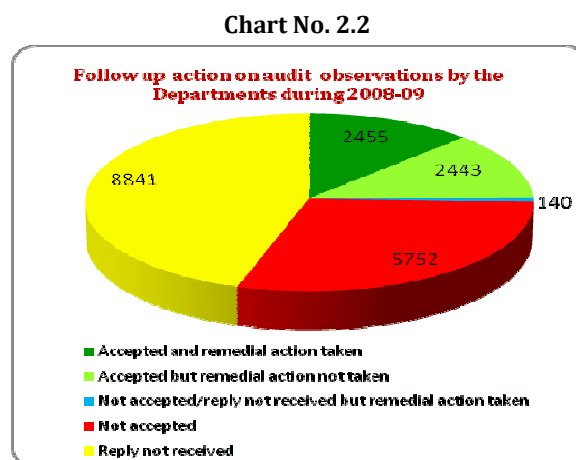
### Response to audit

**2.5** We elicit response from the audited entities at different stages of audit. On completion of field audit, we issue the local audit report (LAR) to the department for comments. Important and high value cases are referred to the Ministry for comments before inclusion in the Audit Report.

**2.5.1** The Board issued instructions (2006) that replies to a LAR should be provided within six weeks. The Assessing officers (AO) are required to initiate remedial action within two months of receipt of a LAR to correct errors in demands lest the case should become time-barred leading to loss of revenue.

### Response: initial audit

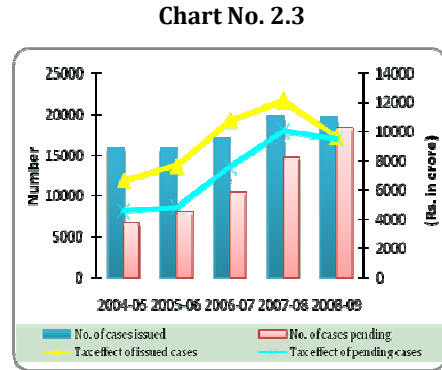
**2.5.2** We received replies to 55 per cent of the cases included in LARs issued this year (2008-09). Of these cases, 45 per cent were accepted by the department and remedial action was completed<sup>28</sup> in 24 per cent of the cases (Details are at Appendix-5).



<sup>28</sup> The Assessing Officer (AO) initiates remedial action by issuing a notice to the assessee, who is then given an opportunity to present his case. After considering all the facts, the AO issues a rectificatory order raising the rectified demand for tax/refund, whichever be the case. At this stage, remedial action is said to have been taken.

### 2.5.3 REMEDIAL ACTION TIME-BARRED

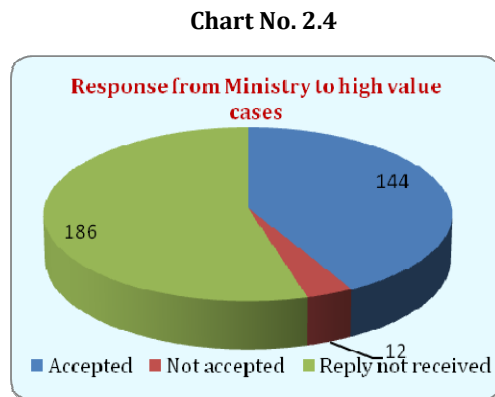
The accretion in pendency in replies to audit findings each year has resulted in a mounting pile-up of 86,558 cases involving revenue effect of Rs. 47,298 crore as of 31 March 2009. The Chart depicts the increasing trend of pendency of observations.



2.5.4 We conducted a review of the above pending cases and found that 16,557 cases<sup>29</sup> with tax effect of Rs. 5,612.8 crore have become time-barred for remedial action.

#### **Response: High value cases**

2.5.5 We provide six weeks to the Ministry to offer their comments on high value cases, prior to their inclusion in the Audit Report. 42 per cent of the cases were accepted by the Ministry; on 54 per cent, we were yet to receive the response as of January 2010.



2.5.6 Seventy one observations with tax effect of Rs. 728.2 crore were accepted by the Ministry and remedial action had been taken by the department (details are at Appendices 6 and 7). One case is illustrated:

### 2.5.7 CHARGE: CIT-I, PUNE, MAHARASHTRA, AY: 2001-02 AND 2002-03<sup>30</sup>

It has been judicially held in the case of Chellapalli Sugars Ltd. Vs CIT (1975) (98 ITR 167) (SC) that interest liability upto the stage of commencement of commercial production should be capitalised.

Maharashtra Krishna Valley Development Corporation Ltd., a company, did not capitalise the finance costs and interest payments in respect of incomplete and ongoing projects. This resulted in underassessment

<sup>29</sup> Details of these cases have been forwarded to the respective Commissioners.

<sup>30</sup> Assessed at a loss of Rs. 735.4 crore and Rs. 767.7 crore in February 2003 and March 2005.

of income of Rs. 35.5 crore<sup>31</sup> and overassessment of loss aggregating to Rs. 1432.4 crore involving short levy of tax of Rs. 17.8 crore and potential<sup>32</sup> tax effect of Rs. 511.4 crore<sup>33</sup> including interest. The Ministry accepted and the department rectified the mistake.

**2.5.8** Twenty two cases with tax effect of Rs. 88.5 crore were accepted by the Ministry and remedial action had been initiated by the department (details are at Appendix-8). One case is illustrated below:

**2.5.9 CHARGE: CIT-I, CHENNAI, TAMIL NADU, AY 2004-05<sup>34</sup>**

Section 80-IA allows 100 per cent deduction from gross income, of profits from power generating units.

Servalakshmi Paper & Boards Pvt. Ltd., a company, included profit earned from sale of steam to a sister concern in the profit, for the purpose of computing concessions under Section 80-IA.

Since this sale does not amount to activity of power generation, the profits thereof were inadmissible. This resulted in excess allowance of deduction of Rs. 2.6 crore with short levy of tax of Rs. 1.4 crore. The Ministry accepted the mistake and the department initiated remedial action.

**Response: Audit Report**

**2.5.10** The Audit Report once presented in the Parliament, stands referred to the Public Accounts Committee. The Ministry intimates to us the status of these cases, through Action Taken Notes (ATN). Replies on 1683 cases, representing 51 per cent of the cases included, were yet to be received as of December 2009. In addition, 565 cases with tax effect of Rs. 2973.5 crore, included in the Audit Reports during 1999-2004 on which no replies were received/no remedial action was taken, would have become time-barred by now. Two cases are given below :

**2.5.11 CHARGE: CIT-VI, MUMBAI, MAHARASHTRA, AY 1999-2000<sup>35</sup>**

The Bangalore unit of IMR Global Ltd., a company, was allowed exemption under Section 10 of the Act, even though the value of plant and machinery shifted from existing units was more than 20 per cent

<sup>31</sup> Loss was Rs. 767.7 crore. Amount to be capitalised was Rs. 803.2 crore, ie. Rs. 35.5 crore in excess of loss.

<sup>32</sup> In cases where the assessment is completed at a loss, the excess deductions lead to excess carry forward of loss. In future assessment years where the assessee registers a profit, this excess carried forward loss would be set off against the taxable profit leading to potential short levy of tax.

<sup>33</sup> For A.Y. 2001-02, and 2002-03, overassessment of loss was Rs. 664.7 crore and Rs. 767.7 crore respectively. Tax effect of this works out to Rs. 511.4 crore.

<sup>34</sup> Assessed at an income of Rs. 3.8 crore in November 2006.

<sup>35</sup> Assessed at nil income in August 2000.

Section 10 provides 100 per cent tax holiday on profits derived by an exporter situated in a notified Software Technology Park. It is subject to the condition that a minimum of 75 per cent of total sales in terms of value is exported and the unit is not formed by transfer of machinery i.e., value of transferred machinery should not exceed 20 per cent of the cost of machinery used in the business.

of the value of plant and machinery installed at Bangalore. Further, export sales from Bangalore were less than 75 per cent of the total turnover. The incorrect allowance of exemption resulted in underassessment of income of Rs. 26.9 crore with short levy of tax of Rs. 14.6 crore.

#### 2.5.12 CHARGE: CIT-II, DELHI, DELHI, AY 1998-1999<sup>36</sup>

An assessee is entitled, under Section 80HHC, to a deduction equal to the export profits if sale proceeds are received in convertible foreign exchange. Profits of the business means the profits worked out after deducting 90 per cent of other income.

Maruti Udyog Ltd., a company, netted interest income with interest payment and posted the net figure as income in the profit & loss account. In order to work out eligible profits for deduction under section 80HHC, 90 per cent of gross income from other receipts should have been reduced from the profits. Instead 90 per cent of the net income only was deducted, leading to short levy of tax of Rs. 1.2 crore.

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<sup>36</sup> Assessed at an income of Rs. 1142.7 crore in February 2002.