

CHAPTER 2

OVERSIGHT ON FOREX

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CHAPTER 2

Oversight on forex flows

Chapter Overview

An oversight on remittances envisages a close coordination between the banking sector and tax administration, which is obtuse currently. Un-reconciled figures in BoP are pointers to forex flows, the purpose behind which are unknown or unaccounted. Our computation of the tax gap shows that the tax actually deducted is a miniscule fraction of the collectible tax. The taxable base increased 2.5 times during 2004-08 but the TDS collections have substantially dipped in 2005-08. There is a need for a non-intrusive framework through automation which does not constrict business but at the same time sifts out potentially high risk transactions for scrutiny.

2.1 The RBI is the nodal agency for channelizing remittances to non-residents through ADs. ADs mainly comprise private, public and foreign banks. There are about 4300 branches of ADs across the country listed under A and B category¹¹. The RBI collects data from the ADs under 99 purpose codes¹². Payments under 34 purpose codes have been identified as liable for TDS.

A The process

2.2 Resident individuals are permitted to remit upto US \$ 25,000 for certain purposes¹³ on the basis of a self declaration. For remittances higher than this limit, additional documentation towards establishing the remittance as bonafide is insisted upon. The Exchange Control Manual¹⁴ states that “*the Reserve Bank trusts that ADs will ensure that the Exchange Control regulations are observed by themselves and their constituents both in letter and in spirit*”. Thus ADs have the primary responsibility to ensure the legality of the remittance and conformity to FEMA Rules¹⁵ as well as with the various Acts that govern the business of the remitter (the person who pays) and the receiver (the person receiving the money).

¹¹ Depending on the quantum and nature of business, banks categorise their branches under category A, B and C based on the guidelines issued by RBI.

- Category A: Offices and Branches maintaining independent foreign currency accounts in their own names.
- Category B: Do not maintain independent foreign currency accounts but have powers of operating on the accounts maintained abroad by their Head/ Principal Office or any other link office.
- Category C: All other offices excluding branches of Categories A & B.

¹² For easy compilation and to enable comparison between countries, the IMF has prescribed a set of purpose codes under which remittances - payments and receipts in foreign exchange have to be classified. Accordingly the RBI has adopted the same set of classification which the remitters have to indicate to the authorized dealer and the same is compiled by them and reported to the RBI for Balance of Payments purposes. For eg.: S0403 captures payments under telecommunication services and P0205 reflects purchases on account of operational leasing by Shipping Companies.

¹³ The purposes being (i) employment abroad (ii) emigration (iii) maintenance of close relatives abroad (iv) education abroad and (v) medical treatment.

¹⁴ Paragraph 1.19 of the Exchange Control Manual

¹⁵ AP (DIR Series) Circular No 56 dated 26.11.2002 and Circular No 3 dated 19.07.2007.

B Oversight & Reconciliation

2.3 Reconciliation of aggregate level data across different sources would be an indicator on the controls on illicit flows. Two sets of reconciliation conducted by RBI for this purpose include:

- Imports data on Balance of Payments (BoP) with that on foreign trade reported by Director General of Commercial Intelligence and Statistics (DGCIS).
- Net Errors and Omissions in BoP.

Reconciliation of imports

2.4 BoP is compiled by the RBI from the data collected by ADs while the foreign trade data of DGCIS relate to merchandise trade through all the recognized seaports, airports, land customs stations and inland container depots. The two figures differ widely. RBI in its Reconciliation of Import Data¹⁶ had attributed the difference to the fact that the DGCIS data does not capture defence imports. However, even after factoring defence imports, the un-reconciled balance averaged annually around ₹ 23000 crore in 2005-07. The difference stands for remittances that are not backed by corresponding imports and which the reconciliation process is yet to account for.

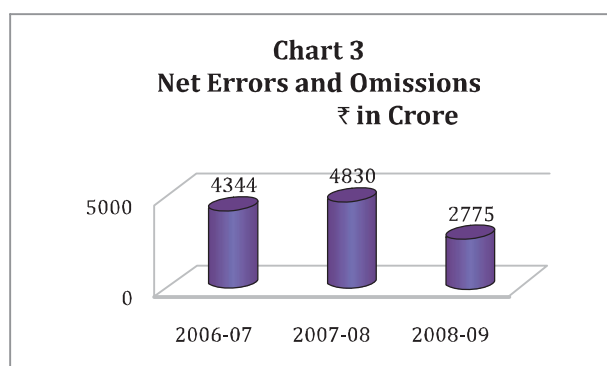
Table 2: Reconciliation between DGCIS and RBI

Year	Imports as per DGCIS	as Defence imports*	Total	Payments as per RBI	Difference of Column (4) & (5)
(1)	(2)	(3)	(4)	(5)	(6)
2005-06	660409	7511	667920	695412	27492
2006-07	838048	5541	843589	862833	19244

(₹ in crore)

**Source: 29th Report of Standing Committee on Defence (Fourteenth Lok Sabha) Demand for Grants 2007-08, April 2008*

Net Errors and Omissions in BoP



2.5 BoP has two components: Capital Account that captures the movement of assets and Current Account which captures the corresponding flow of funds. The two accounts should balance out once the transaction is completed and when added under the 'Net Errors and Omissions (NEO)' should ideally yield a sum of zero. In practice,

however, the resulting balance inevitably shows a net credit or a net debit which would mean unaccounted inflow or outflow of forex respectively. On an average, the annual 'unaccounted' forex flow as captured in NEO in three years 2006-09 was ₹ 3983 crore; the accumulating credit balance (flowing from transactions in the three years) being ₹ 11949 crore as of 2009. The gaps in reconciliation are pointers to

¹⁶ India's BoP Developments during July-September 2007 released on 31.12.2007:RBI

forex flows, the purpose behind which are unknown or unaccounted. Thus the NEO balances require analysis towards arresting the unaccounted transactions for deriving a greater assurance on forex flows.

Tax Gap

2.6 The tax gap captures the gap between the collectible tax and the tax collected by the government. We sought to correlate the invisibles account in the BoP data (remittances which are broadly classifiable as taxable) with the tax collected.

2.7 The following bases were used in the calculation of the tax gap:

- Investment income under the BoP includes interest, dividend and profits. Dividends are arrived at after payment of taxes and dividend income is exempt from tax under the Income Tax Act. Profits accruing to Permanent Establishments are a post tax entity. Therefore, we considered only interest payments as the taxable base;
- Almost 31 per cent¹⁷ of the total debt raised is in the form of concessional debt¹⁸; we factored this amount while working out the tax base as the interest payments in this regard are subject to various levels of tax concessions;

Table 3: Details of payments made to non-residents

(₹ in crore)

	2003-04	2004-05	2005-06	2006-07	2007-08
Payments on Miscellaneous Account#	37894	62396	71962	108793	105674
Payments on Transportation Account#	459	389	369	383	595
Payments on Insurance Account#	397	346	1237	674	994
Payments of Investment Income #	20928	18538	26971	37522	39745
Total	59678	81669	100539	147372	147008
Tax deductible @ 10%	5967	8166	10054	14737	14700
TDS from remittances *	NA	10	54	41	16
Tax gap	5967	8156	10000	14696	14684

* The Principal Chief Controller of Accounts, Ministry of Finance
Balance of Payments, RBI

- Charter hire charges for ships (captured under the transportation account of BoP) are to be treated as payment of royalties or payment for use of equipment¹⁹ liable for TDS. Commission paid on insurance business, captured under the insurance account of BoP would be liable for TDS. Almost all the remittances under miscellaneous account of the BoP are liable for TDS as fees for technical services or royalties;

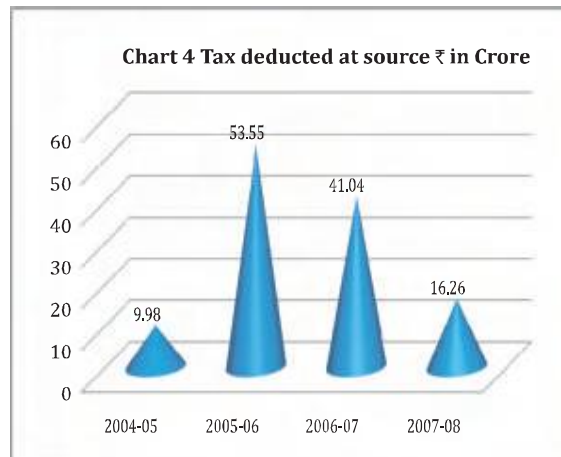
¹⁷ India's External Debt-A Status Report, Ministry of Finance, August 2006

¹⁸ Loans from multilateral institutions such as International Development Agency (IDA), International Fund for Agriculture Development (IFAD) and Organisation of Petroleum Exporting countries (OPEC) which have long maturity and relatively low service/interest charges are treated as concessional. Loans from certain multilateral sources such as IBRD, ADB etc whose terms are close to market rates are classified under non concessional.

¹⁹ Hire charges paid by Indian charterers for hiring ships on bare -boat charter- cum- demise basis to a non resident are taxable in India as 'royalty' and hence liable for TDS - West Asia Maritime Ltd v. ITO(2008) 297 ITR(AT) 202 Chennai

- We applied a flat rate of 10 per cent for TDS which is the lowest rate as applicable under the DTAA's. The calculations are thus essentially conservative estimates of the tax gap.

2.8 The remittances have steadily increased by 2.5 times during the period 2004-08 but the TDS collections have shown a substantial dip during 2005-08. In all the years, the tax collected was only a miniscule fraction of the collectible tax. In absence of further details, we could not make an assessment on whether the increasing gap has been due to better tax management by assessee's or was simply, leakage of revenue.



C Oversight: Risk Analysis

2.9 A study by the Global Financial Integrity²⁰ published in 2008 estimates illicit financial flows²¹ out of developing countries in the range of US \$850 billion to US \$1 trillion a year. India was ranked 5th in the list with an estimated annual illicit flow of US \$ 22.7 billion.

2.10 OECD²² reports speak of the weak regulatory mechanisms for information-sharing between countries, even within the OECD. Information can be shared under tax treaties (DTAA's) based on specific queries relevant to the tax proceedings and engender prolonged consultations. The framework for such co-operation in sharing information on money laundering is even weaker. The risk is heightened as novel ways of money laundering emerge. Tax needs to be deducted at the first instance as more than 90 countries are not covered under DTAA's with India; 50 out of the 74²³ DTAA's do not provide for assistance for recovery of tax undercharge after the remittance is made; even though the provision for such assistance is incorporated in 24 DTAA's, the procedure is long drawn and often unfruitful²⁴.

²⁰ Illicit Financial Flows from Developing Countries, 2002-2006

²¹ Illicit financial flows involve the transfer of money earned through activities such as corruption, transactions involving contraband goods, criminal activities, and efforts to shelter wealth from a country's tax authorities. It does not include major forms of value drainages not represented by money, viz. trade mispricing that is handled by collusion between importers and exporters within the same invoice, not picked up in mispricing models based on IMF Direction of Trade Statistics, a technique utilized extensively by multinational corporations; proceeds of criminal and commercial smuggling such as drugs, minerals, and contraband goods; and mispriced asset swaps, where ownership of commodities, shares, and properties are traded without a cash flow.

²² Access for Tax Authorities to information gathered by Anti Money Laundering Activities – Centre for Tax Policy and Administration: Organisation for Economic Cooperation and Development (OECD)

²³ Comprehensive Agreements as listed on the ITD website

²⁴ Source: Para 3.14 CAG Audit Report No 13 of 2005 Direct Taxes (Systems Appraisals)

2.11 We conducted a destination-wise analysis of the pattern of remittances relating to invisibles in two years 2007-09. The aggregate data puts the spot light on high risk remittances (illustrative):

- The destination of remittances (towards invisibles) aggregating to ₹ 8762.5 crore and representing 5.4 per cent of the total, was “unspecified” in the RBI’s data. A 360 degree check of the remittances with the purpose i.e., services received in India is difficult without data on destination of the remittances. ₹ 2147.3 crore was remitted to non-DTAA countries.
- | | ₹ in Crore | |
|-----------------------|----------------|----------------|
| Countries | 2007-08 | 2008-09 |
| DTAA countries | 77460.2 | 73613.5 |
| Non-DTAA countries | 754.1 | 1393.2 |
| Unspecified countries | 3099.3 | 5663.2 |
| Total | 81313.6 | 80669.9 |
- Of particular concern were remittances made to under developed jurisdictions, for services which these countries appear ill-equipped to deliver. For instance, ₹ 1.5 crore to Guernsey for architectural, engineering and other technical services in 2008-09; ₹ 7.5 lakh was remitted to Ecuador for research and development expenses in 2008-09. There is also the risk of treaty shopping²⁵ by residents of third countries.
 - ₹ 56676 crore was remitted during 2007-08 to Offshore Financial Centers (OFCs) which are recognized by the World Bank as jurisdictions that are opaque to regulations and are not conducive for information sharing²⁶. This constitutes about 19 per cent of the amounts being remitted out of India under the invisibles account. Once again, remittances to OFCs are not put under the scanner-at the time of the remittance or thereafter.

D Oversight: Risk mitigation

Thin capitalization

2.12 Foreign companies generally tend to bring in capital in the form of loans to the affiliates, rather than as equity. This is known as thin capitalization. Thin capitalization is frowned by host countries not only because it belies the commitment of the foreign investor to the domestic economy, but also because it allows the principal to receive regular interest regardless of the profits earned by

²⁵ Treaty shopping is a process by which entities resident of third countries seek to avail the benefits of DTAA between two Contracting States.

²⁶ The major source of information on banking activities of OFCs is reporting to the Bank of International Settlements (BIS) which is incomplete. The reporting is confined to the major OFCs. The smaller OFCs (for instance, Bermuda, Liberia, Panama, etc.) do not report for BIS purposes. Claims on the non-reporting OFCs are growing, whereas claims on the reporting OFCs are declining. Secondly, the BIS does not collect from the reporting OFCs data on the nationality of the borrowers from or depositors with banks, or by the nationality of the intermediating bank. Thirdly, for both offshore and onshore centers, there is no reporting of business managed off the balance sheet, which can be several times larger than on-balance sheet activity. In addition, data on the significant quantity of assets held by non-bank financial institutions, such as insurance companies, is not collected at all. Nor is there any information on assets held by mutual funds as well as private trusts and companies whose beneficial owners are normally not under any obligation to report. Source: IMF Background Paper on Offshore Financial Centers Prepared by the Monetary and Exchange Affairs Department (June 2000)

the affiliate. On the other hand, dividend from equity is distributed on the profits earned by the affiliate. TDS is withheld on interest at the rate of 10 *per cent*, while business profits (worked out after allowing interest payments as deductions from the incomes) are taxed at the rate of 30 *per cent*, thus providing a tax arbitrage.

2.13 Tax laws of several countries provide that if the company's debt equity ratio exceeds a certain threshold level, then some or all of the interest above that level are to be disallowed. However, neither the Companies Act nor the Income Tax Act addresses the problem of thin capitalization of foreign affiliates in India.

Canadian rules disallow interest where debt equity ratio exceeds three times the equity at any time during the year. In Japan thin capitalization rules apply only to related party debt; interest is excluded when amount borrowed is three times the amount of capital from lending shareholders. In UK, where interest paid to the related party is excessive, the interest is re-classified as deemed dividend. The acceptable debt-equity ratio is industry-specific under application of arm's length principle²⁷.

2.14 We analysed the capital structure and interest payments of 566 foreign companies for the assessment years 2005-06 to 2008-09. Using the benchmark of debt-equity ratio²⁸ in excess of 3:1 to categorise the affiliate as thinly capitalized, we found that 130 companies assessed in Delhi, Mumbai, Tamil Nadu, Andhra Pradesh and Karnataka were thinly capitalized. In the absence of specific provisions in the Act, the companies were entitled to claim deduction for the payment of interest on their borrowings without any restriction. The proportionate claim of deduction towards interest in excess of the debt equity ratio of 3:1 worked out to ₹ 8430.3 crore involving a tax impact of ₹ 3134.8 crore.

CBDT constituted (2009) a committee to examine the 'Investigation issues in abuse of tax treaties and tax havens'²⁹ which recommended the following:

- Separate investigation units to handle cases relating to tax havens, round tripping and electronic transfers.
- Need to initiate negotiations for tax information exchange agreement with all tax havens that have substantial international transactions with India.
- Introduce legal and anti-tax evasion measures such as thin capitalization rules, general tax avoidance rules etc.

Liaison Offices

2.15 Foreign companies can operate in India through a liaison office (LO) with the approval of RBI. It is allowed to undertake only liaison activities, i.e. it can act as a channel of communication between the foreign head office and parties in India. LOs

²⁷ Section 92 of the Act provides tax authorities to make adjustments to the assessee's income on arm's length basis in case of transactions between residents and nonresidents having 'close connection'

²⁸ Debt equity ratio =Debt/Equity where Debt equals secured loans plus unsecured loans and Equity has been taken as paid up capital

²⁹ Background Paper – 25th Annual Conference of Chief Commissioners and Directors General of Income Tax, New Delhi

are not allowed to undertake any business activity in India; cannot earn any income in India; and their expenses are to be met through inward forex remittances from their foreign principals. Thus a LO should not constitute a taxable entity in India. It is in this context that the RBI endorses a copy of the approval letter of setting up a LO in India to the CBDT. This is necessary to ensure that the LOs are not indulging in activities which would have a tax impact.

2.16 We sought an assurance on the controls within ITD to monitor the activities of LO. We found that only 31 LOs out of 844 spread across select States, had filed their returns of income during the period 2006-09. There is no system for review of non-filers in the department; this applies to the LOs as well. The LOs who do not file returns are currently out of the radar of the ITD. After we raised the issue, few ITD charges informed us that notices had been issued to select LOs in their jurisdiction.

State	No of LOs	No filing returns
Karnataka	125	1
Andhra Pradesh	23	3
Tamil Nadu	59	4
Kerala	9	Nil
Mumbai	273	4
Haryana	37	Nil
Delhi	282	18
Rajasthan	3	1
Gujarat	15	Nil
West Bengal	18	Nil
Total	844	31

Recommendations

- *We recommend periodic reconciliation of aggregate data maintained by various government agencies that together should provide an oversight on forex transactions. Ministry of Finance could co-ordinate to institute a mechanism for such reconciliation;*

The CBDT (October 2010) stated that the electronic submission of certificates, since July 2009 has made the process of reconciliation easier. The electronic filing of returns would address the issue of reconciliation. CBDT is in active correspondence with the RBI based on which the procedures are being revised, the procedure of electronic reporting of undertakings and certificates being one such. As RBI is the nodal authority for movement of forex, CBDT felt that the control mechanisms would need to be addressed by RBI if they found the same to be inadequate. It was claimed that the reconciliation is restricted to the extent of withholding taxes and the systems are in place.

We are of the opinion that the reconciliation between CBDT and RBI needs to be strengthened.

- *A significant step towards transparency will be submission of tax gap analysis to the Parliament under the Fiscal Responsibility & Budgetary Management Act (FRBM), that will also provide an estimate on revenue leakages in forex remittances;*

The CBDT(October 2010) stated that gap is bound to exist between the total amount of remittances and remittances subject to withholding tax as the Income Tax Act and the DTAA provide very little scope for source based taxation. It has been stated that the tax gap analysis done by them is not throwing up any broad conclusion. Submission of tax gap analysis to Parliament is a policy issue which entails detailed deliberation.

We agree with CBDT that the tax gap is bound to exist. Yet the tax gap needs to be objectively analysed with respect to the specific items that are taxable and may be suitably followed up.

- *We recommend that the ITD conduct a macro-analysis of remittances. This analysis can form the basis for a risk-based tracking of high risk transactions by ITD in co-ordination with the banking sector. The data can also be used to further fine tune selection of tax returns for scrutiny- for eg: remitters with high volume of forex transactions with OFCs can be selected;*

The CBDT while noting the recommendation stated that they are conducting checks on the C&Us on the basis of due risk assessment. The electronic filing of U/Cs has helped in better management of records and their analysis. Exception lists are being prepared based on identified risk criteria like zero TDS which are acted upon by the jurisdictional assessing officers.

We are of the opinion that the risk assessment parameters may be institutionalised and be made applicable uniformly through centralized monitoring.

- *We recommend that adequate safeguards may be inbuilt to protect revenue on account of thin capitalization. ITD needs to strengthen monitoring of non-filers among liaison offices;*

The CBDT stated that these issues are under examination and will be taken care of in the Direct Tax Code Bill, 2010. With regard to liaison offices, the ITD receive information from RBI which is examined. Presently there is no mandatory requirement of filing of return of income by every liaison office. However, in our opinion, revising the statute to this effect would facilitate better oversight and monitoring.