



# Executive Summary

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Growing integration within the global economy has led to increased flow of capital, services and technology into the country. As an impetus to economic growth, the government has eased the restrictions on flow of foreign exchange transactions. The Foreign Exchange *Regulation* Act (FERA) was repealed and replaced by the Foreign Exchange *Management* Act (FEMA) in June 2000 with a view to facilitate external trade and payment and for promoting the orderly development and maintenance of foreign exchange markets in India. The shift has also necessitated delegation of authority to the remitting banks i.e., the authorized dealers to vouchsafe the legality of the forex transactions as also collection of applicable income tax.

Tax is deducted at source (TDS) on passive income i.e., income which accrues to a non-resident without a physical existence in the country (in the form of a branch office or a local subsidiary etc). The remittances that form the taxable base are captured in the “invisibles” account of the Balance of Payments (BoP) computed by the Reserve Bank of India.

The country has witnessed a robust growth in outward remittances. The global economic downturn has prompted countries to close loopholes in tax especially through tax havens. We felt that it would be topical to conduct a study on the effectiveness of institutional mechanisms in the tax department to maintain oversight on outflows and bridge the tax gap.

The objectives of our study were to seek an assurance that: the Income Tax Department (ITD) has established integration with the banking sector to provide an overarching oversight on foreign exchange remittances; the risks of illicit flows are identified, prioritized and communicated to the risk managers; the systems and control measures are effective to ensure that all taxable remittances are taxed accurately; ITD is geared to meet the new challenges in international taxation owing to globalization and the attendant complexity in transactions.

We drew our primary audit sample from assessment records in the ITD. This was correlated with the sample of top forex remitters culled out from database of Centre for Monitoring Indian Economy (CMIE). We cross-checked records of select ADs with that of ITD. The study also involved analysis of data on remittances collected from Reserve Bank of India (RBI) for macro-level correlation with tax collections.

We observed that oversight on remittances envisages a close coordination between the banking sector and tax administration. However, currently there is a lack of adequate coordination.

Balance of Payments is an accounting record of all monetary transactions between a country and the rest of the world. BoP comprises the Capital Account detailing the movement of assets and the Current Account capturing the corresponding flow of funds. Completion of a transaction should balance out these two accounts. Therefore, un-reconciled balances in these accounts indicate towards unaccounted transactions.

The taxable base increased 2.5 –fold during 2004-08 but the Tax Deducted at Source (TDS) collections have substantially dipped in 2005-08. This indicates towards an increasing tax gap. Our computation of the tax gap shows that the tax actually deducted is a miniscule fraction of the collectible tax.

In the absence of specific provisions towards regulating taxation, foreign companies are benefiting from Thin Capitalisation whereby they are investing more in terms of bringing in loans rather than investing through equity. Liaison Offices of foreign companies are not being monitored towards their taxable activities.

A remitter is required to submit an undertaking that he has abided by the FEMA requirements. He is also required to submit a certificate by a chartered accountant certifying the undertaking. The certificate and undertaking (C&U) form the basic documents that the AD must examine before the remittance. The rigours of checks expected from the ADs on each individual remittance are rendered unviable with the increase in the volume of remittances.

A copy of the C&U on every remittance is sent by the ADs to the assessing officers (AOs) in the ITD. The manual receipt and collation of C&Us in ITD are in disarray especially in heavy assessment charges. Stacks of C&Us lay dumped in rooms making their retrievability for use in assessment, a near impossibility. No reconciliation of C&Us is possible between ADs and ITD in this scenario. We could not draw an assurance that the ADs are collecting C&Us on each transaction; some C&Us examined by us were found incomplete with vital data missing from them; and the incidence of ADs not transferring C&Us to ITD were high. Our assessment of the tax gap on the remittances in the audit sample was severely constricted given the state of record management of C&Us in ITD. Even so, we found that ₹ 98.7 crore was not deducted during the period 2005-09.

We found that errors in assessments and failure to collect the applicable taxes involved a tax effect of ₹ 852.8 crore.

The huge tax gap adds grist to the conclusion drawn in 2007 by the Committee on Procedures and Performance Audit on Public Services (CPPAPS) of the Ministry of Finance that the provisions for TDS are “very onerous and are met only in the breach”. ITD introduced e-filing of undertakings but it meets the purpose only partially as it is yet to be harmonized with the returns to RBI or even integrated with the e-filed

quarterly TDS returns. The TDS returns are also not being processed in ITD. The weak controls across the government leave wide gaps for tax evasion.

Ambiguity in the classification of incomes in respect of Foreign Institutional Investors and Telecom Companies are leading to inconsistent assessments. Our earlier study on the shipping sector had also shown that inadequate co-ordination across various governmental bodies and weak controls within ITD plague the taxation in this sector and, which provide an unintended advantage to non-resident shipping industry over the domestic industry. Each sector deals with revenue streams that challenge the application of Income Tax Act. The ITD is yet to evolve an effective mechanism to provide clarity in these “green field areas” of taxation to mitigate the risk to revenue.

The provisions of DTAA were not being properly invoked or interpreted while assessing non-residents. There were also errors in assessments involving other provisions of the Act.