Chapter VII : Integrated Audit of assessments of a Group Company

7.1 Introduction

Assessment of Large Tax Payer assessees is a complex issue and has become vexatious to Income Tax Department (ITD) due to the diversified nature of business, numerous deductions, transactions with related parties, different accounting policies followed and its consequential impact on taxable income.

We conducted integrated audit of assessments of a large company along with group companies[113] and its various subsidiaries on test check basis. The flagship company (FC) was carrying out a number of financial transactions of amalgamation/demerger which has huge impact on tax revenue and significant area for audit. FC at present is assessed in CIT(LTU), Mumbai charge and its group companies/entities are assessed across various charges like CIT-II, CIT-III, CIT-VIII, CIT-XVII, CIT-(Exem.) etc. The group could be primarily classified into various segments like the flagship company carrying on the business of extraction of oil and gas, refining, petrochemicals, treasury operations and the group associates primarily operating in verticals like oil retail, gas transportation, investments etc. The primary objective of this integrated audit was to ascertain whether there was exchange of relevant information relating to companies of a group amongst the various assessment charges of the ITD for accomplishing quality assessment.

Audit Findings

7.2 Cross linking of records of companies of a group

Section 143(3) provides that AOs have to determine and assess the income correctly and determine the tax payable or refundable, as the case may be. Different types of claims together with accounts, records and all documents enclosed with the return are required to be examined in detail in scrutiny assessments. CBDT has also issued instructions from time to time in this regard.

A test check of assessment records of related parties[114] assessed in other charges like CIT-III, CIT-VIII, CIT-XVII and CIT(Exemption) revealed that FC had made numerous transactions with related parties in the form of sale and purchase of investment/fixed assets, extending of loans and advances, sale and purchase of goods and services, other income, donations etc. We noticed gaps in few sample transactions recorded in the books of FC and books of related parties as shown in Table7.1 below:

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[113] Group company is collection of companies controlled by a common apex company

[114] As per Companies Act, related party with reference to a company means any company which is a holding, subsidiary or an associate company of such company

Table 7.1: Cross linking of records of group companies (₹ in crore)

Sl. No.	Name of the related party	AO in charge	AY	Nature of transactions	Amount in FC's books	Amount recorded in related party's books	Difference
1	Group Company (GC)-1	DCIT-3(3)(1), Mumbai	2012-13	Loans extended by FC during the year	2,625	2,113	512
2	GC-1	DCIT-3(3)(1), Mumbai	2013-14	Loans extended by FC during the year	7,684	7,735.14	51.14
3	GC-2	DCIT-3(3)(1), Mumbai	2012-13	Payment of professional fees by FC	9.0	18.63	9.63
4	GC-2	DCIT-3(3)(1), Mumbai	2013-14	Payment by FC on account of purchases	68.49	52.51	15.98

It is seen from the assessment records that ITD had not made any efforts to cross link the above material transactions with related parties to ensure the correctness/genuineness as desired by CBDT. This indicates that ITD may explore feasibility of integrated assessment of such group companies.

ITD while accepting (April 2018) the importance of sharing of information and cross linking of transactions across different assessment charges stated that during the course of assessment proceedings of AY 2015-16, the reconciliation of the books of the assessee for the purpose of Related Party Transactions (RPT) has been scrutinized. ITD further submitted the reconciliation of transactions which were showing gaps in related parties books of accounts.

ITD stated with reference to sl. no. 1 and 2 that the assessee company was asked to reconcile the difference between figures reported in RPT Schedule of FC vis-à-vis figures reported in RPT Schedule of GC-1. In response, the assessee company FC submitted that the difference in the related party transactions (RPT) was on account of 'interest accrued but not due'.

In this regard, it is stated that though the ITD furnished the reason of difference of amounts, it did not give details of assessment years in which the said item, i.e. 'interest accrued but not due' will be chargeable to tax.

With respect to sl. no. 3, ITD replied that assessee company was asked to reconcile the difference and assessee submitted that GC-2 had received ₹ 27.63 crore from FC which comprises ₹ 9 crore on account of Revenue from Operations and ₹ 18.63 crore being reimbursement of expenses. Since FC in its RPT Schedule shows transactions excluding reimbursement, the *reimbursement of expenses of ₹18.63 crore is not reflected in the RPT Schedule of FC. The reimbursement of expenses has been netted off against expenditure on account of Professional Fees details of which were verified during the course of assessment proceedings of GC-2. With respect to sl. no. 4, ITD while taking the stand of assessees' submission, stated that GC-2 had received ₹ 61 crore from FC which comprises of Income from Operations of ₹ 52.51 crore and Principal Portion of lease rent of ₹ 8.29 crore offered to tax separately rounding off difference of ₹ 0.2 crore.*

In this regard, it is stated that though ITD furnished the reason of difference as stated by assessee, however, the records on which ITD relied while accepting the assessees' version were not furnished to audit. As such, audit could not verify the details of related party transactions and hence unable to offer any comment.

For the cross linking/verification of related party transactions, an Information Technology (IT) driven mechanism for sharing of information within the ITD which will enable utilization of information effectively, is required to be evolved and put in place to bring in reconciliation of significant related party transactions as it would act as a deterrence and would also minimise the possibility of escapement of taxable income. Though, reconciliation of gaps in transactions is furnished by the ITD, it is felt that such exercise should have been carried out regularly.

7.3 Earning of huge dividend disproportionate to Investment

Audit also cross verified the records on test check basis of four shareholders (SH), having the status of Limited Liability Partnership[115](LLP) (incorporated in April 2010), each holding more than one *per cent* of FC shares namely SH-1 (3.93 *per cent*), SH-2 (3.93 *per cent*), SH-3 (4.17 *per cent*), and SH-4 (3.86 *per cent*). The majority of shares of above LLPs were further held by other LLPs which are part of the group. As the cases of above LLPs were not selected for scrutiny, a copy of Income Tax Returns (ITRs) of AY 2012-13 to 2014-15 were called for from the ITD. It was observed from the ITRs that the registered office of these LLPs and partners LLPs were same. In this context, it was observed from sources (as per Registrar of Companies data in public domain) that on the above address, more than 350 companies and LLPs were found registered but it was not known whether these entities were filing their ITRs regularly and regular business activities were being carried on by these entities. As such, the whole universe of such companies and the combined income offered/losses claimed by them was not known. Thus, the genuineness of companies should have been verified by the ITD.

[115] LLP is an alternative corporate business form that gives the benefits of limited liability of a company and the flexibility of a partnership. It is a separate legal entity, is liable to the full extent of its assets but liability of the partners is limited to their agreed contribution in the LLP

Verification of ITRs for AY 2012-13 in respect of two LLPs namely SH-1 and SH-2 by audit indicated that they had received dividend of ₹ 102.14 crore each. However, balance sheet of the LLPs showed that partners' capital were ₹ 0.09 crore and ₹ 0.12 crore and investments were at ₹ 0.09 crore and ₹ 0.11 crore respectively. Thus, it appeared that the assessees' investment as reflected in balance sheet were not commensurate with huge dividend received. Even going by the face value of ₹ 10 per share, the assessees' investment portfolio should ideally reflect investment of more than ₹ 125 crore. It is pertinent to mention that during the relevant period, the market price of FC share ranged between ₹ 885 to ₹ 1,149. In view of above apparent discrepancies, ITD should have initiated action to verify the source of investment and reasons for not reflecting the same in the books. Further, despite receipt of huge dividend (more than ₹ 100 crore per year) in two successive years, the above cases have also escaped scrutiny under CASS selection. The above audit findings are in respect of test checked cases only. Such disproportionate dividend receipts could be present in remaining cases as well which needs to be verified by the ITD.

ITD in reply stated that cases of SH-1, SH-2 and SH-3 were not selected for scrutiny, however, cases have now been selected for scrutiny and reopened under section 147 (April 2019).

7.4 Loans and advances among group companies

7.4.1 We noticed that there were numerous transactions of loans, advances and share subscriptions amongst the group companies. In CIT-III charge, while completing assessment of GC-3 for AY 2014-15, ITD had inter-alia allowed to carry forward capital loss of ₹ 90.24 crore from redemption (October 2013) of 9.20 lakh preference shares of GC-4. Audit examination revealed that these preference shares so received (January 2012) from GC-5 were carrying huge premium of ₹ 4,990 per share i.e. 499 times of the face value even though there was no identifiable business of the GC-4 and had shown meagre income over the years and had negative basic earnings per share (₹ 76.44) after exception items. Further GC-4 was under the process of amalgamation with the assessee.

ITD replied (May 2017) that above preference shares were received by the assessee on demerger of investment division of GC-5 and the said shares were redeemed at its cost of acquisition by GC-4. *These shares being long term capital asset, the cost of acquisition was indexed which led to capital loss of ₹ 90.24 crore.*

ITD's reply is not acceptable as the objection was regarding huge premium paid (₹ 4990 per share) by the group companies which was not commensurate with the underlying business or net worth of GC-4.

Incidentally it was also observed that during the relevant period, the shares of FC having huge turnover and profits were quoted around ₹ 800 per share. In this backdrop the payment of huge premium to preference shares of GC-4 having negative net worth was not justifiable. Therefore, ITD was expected to verify the complete audit trail of the shares so received/subscribed in order to disallow excessive premium paid by the group companies. Even though transaction was layered through different group companies, the same was not referred to concerned charges and it therefore appeared that the different assessment charges of ITD acted as if they were working in standalone manner rather than as a cohesive unit.

7.4.2 In another case, it was noticed that GC-6 had invested (during the period November 2012 to April 2013) ₹ 8,304 crore for purchase of equity shares of GC-7 from FC & related parties (RP) RP-1, RP-2. Upon the merger of GC-7 into GC-8 w.e.f. April 2012 (vide HC order of June 2013), GC-6 transferred shares of GC-8 (received upon merger) to GC-9, with a capital loss of ₹ 3,321.60 crore subsequent to which GC-6 merged (September 2013) into GC-1. Thus with a web of companies shares were purchased, swapped and short term capital loss (STCL) was created under the garb of corporate restructure.

ITD while not accepting (May 2017) the audit observation stated that both the amalgamating (creator of the loss) and the amalgamated company are not industrial undertaking and as such amalgamated company is not eligible for carry forward of losses of amalgamating company as per provisions of section 72A of the Act. Also, GC-1 *had neither set off nor carried forward this short term capital loss.*

ITD's reply was not tenable since section 72A only deals with the carry forward of business losses and unabsorbed depreciation and does not debar assessee from carry forward of capital losses. The fact that such losses have not been claimed by amalgamated company in first year does not debar assessee from claiming such STCL in remaining seven succeeding years[116]. Further in this case, ITD should have questioned the transaction, where shares of GC-7 were swapped with GC-8 in adverse ratio of 5:3, thus creating loss for GC-6 which was holding shares of GC-7.

7.4.3 We noticed from FC's assessment records that during FY 2011-12, it had extended interest free loans of ₹ 6,615 crore to GC-1. We further noticed from assessment records of GC-1 that it had extended ₹ 2,261.85 crore loan to RP-3. However, ITD had not made any effort to verify the genuineness of loan transactions. In order to verify the

[116] Section 74 of the Income Tax Act provides that short term capital loss (STCL) can be carried forward for eight assessment years (AY) immediately succeeding the AY in which the loss was first computed. Further STCL can be set-off against any capital gains.

genuineness of loan, records of RP-3 were called for by audit from the ITD. In response, ITD replied that RP-3 had not filed its ITR for AY 2012-13 to AY 2014-15 as there was no taxable income.

In this regard, we also observed that non filer management system (NMS) data was not utilised effectively to ensure filing of return which indicates that the high money value transaction was either not captured or even if it had been captured the same was not utilised by DIT/CIB/FIU[117] for further investigation. Therefore, a system needs to be put in place where non-filers involved in high money value transaction are tracked and their sources and application of funds are verified. Reply from ITD is awaited (March 2019).

7.5 Quality of assessment of Flagship Company and its group companies

7.5.1 Incorrect allowance of deduction under section 80-IA

As per section 80-IA(1) of the Income Tax Act, where the gross total income of an assessee includes any profits and gains derived by an undertaking or an enterprise from any eligible business, a deduction shall be allowed in computing the total income of the assessee, of an amount equal to hundred per cent of the profits and gains derived from such business for ten consecutive assessment years subject to the other conditions prescribed in the section. Further it applies to any enterprise carrying on the business of (i) developing or (ii) operating and maintaining or (iii) developing, operating and maintaining any infrastructure facility which fulfils inter-alia the condition that the entity has entered into an agreement with the Central Government or a State Government or a local authority or any other statutory body for (i) developing or (ii) operating and maintaining or (iii) developing, operating and maintaining a new infrastructure facility.

7.5.1.1 In CIT-III, Mumbai, charge while completing scrutiny assessment for AY 2014-15 in the case of GC-2**,** ITD allowed deduction of ₹ 6.87 crore under section 80-IA. The assessee was engaged in the business of raw water supply through pipeline from river 'X' to petrochemical complex of FC, against a tripartite agreement executed by FC with other parties. Audit examination revealed that during the relevant period, the assessee had received product transportation services charges of ₹ 19.53 crore and ₹ 17.31 crore as support services from FC. Moreover, entire revenue of ₹ 84.83 crore was received either from FC or related companies. It emerged from the facts available on the record that the assessee was primarily a sub-contractor for FC as it was not party to tripartite agreement entered with municipal body and hence was ineligible for deduction under section 80-IA. Omission to disallow the same

[117] DIT-Directorate General of Income Tax (Investigation) , CIB-Central Information Branch, FIU- Financial Intelligence Unit

had resulted in underassessment of ₹ 6.87 crore involving short levy of tax of ₹ 2.23 crore. Similar observation on deduction under section 80-IA for period prior to AY 2012-13 was already reported in Performance Audit Report of C&AG on section 80-IA.

ITD replied (May 2017) that the assessee company is owner of infrastructure facility and had charged transport charges to beneficiary of facility i.e. FC*. Further as per agreement dated 25 April 2008 between* FC *and assessee company, the assessee was providing services to* FC *by using its transport system, thus the assessee cannot be called a subcontractor of* FC*.*

Reply of ITD was not tenable as the assessee had not entered into tripartite agreement with the municipal body as required. Further, reply was silent on the issue of private facility whereas for development of infrastructure, concept of public utility is always embedded. The assesse, in instant case, had not made any investment for creating infrastructure for wider public use and was merely transporting raw water to its sister concern FC.

7.5.1.2 In CIT-III, Mumbai, charge in the case of GC-10**,** for the AY 2012-13, ITD allowed deduction under section 80-IA on gross total income which was inclusive of capital gain of ₹ 6.23 crore and Income from other sources of ₹ 111.29 crore. Omission to restrict deduction under section 80-IA to the income under the head 'Profits and Gains of Business' resulted in excess allowance of deduction of ₹ 117.52 crore leading to excess carry forward of MAT credit of ₹ 38.13 crore.

The ITD replied (July 2018) that total eligible deduction under section 80-IA is of ₹ 1,748.67 crore and it was restricted to the Gross total income of ₹ 1,226.22 crore.

Reply of ITD was not tenable since out of the eligible deduction under section 80-IA of ₹ 1,748.67 crore, the assesses' income under the head 'Income from Business and Profession' was only ₹ 1,108.71 crore and the income of ₹ 6.23 crore relates to income from capital gains and ₹ 111.29 crore to income from other sources which were not related to earning of income from infrastructure development. Allowance of ₹ 1,226.22 crore deduction would result in allowance of deduction against capital gain and income from other sources which was not the legislative intent meant for income from developing, operating and maintaining infrastructure facilities under section 80-IA.

7.6 Mistakes in assessment of Book Profit

Section 115JB of the Act provides that all income shall be routed through profit and loss account for the purposes of computation of book profit. It has *been judicially[118] held that interest received on Income Tax refund is to be accounted for in the year of receipts.*

7.6.1 In the scrutiny assessment of FC of AY 2009-10 to 2013-14 under CIT(LTU), Mumbai charge, we noticed that the assessee offered the interest on Income Tax refund under normal provisions of the Act, but did not route it through profit and loss account, resulting in short computation of book profit of ₹ 346.57 crore with consequential short levy of tax under MAT of ₹ 64.80 crore for the above five assessment years.

The ITD replied (May 2018) that the AO does not have power to go beyond the certified books of accounts maintained by the assessee. It further stated that as per decision of ITAT Mumbai in 100 ITD 131, the interest on income tax refund would be assessable in the year in which it is granted and not in the year in which it becomes due holds good only for normal provisions and not MAT provisions. It further stated that as the finality in case of proceedings were not reached; the income was offered under normal provisions but not credited to books of accounts.

The reply of the ITD was not tenable as interest on income tax refund is to be categorised under income from other sources and that being so should have been part of Profit and Loss (P&L) accounts. Further, the books of accounts were not prepared in accordance with the clause 2 (b) of Part-II of Schedule VI of the Companies Act which, inter-alia, states that P&L account shall disclose every material feature including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of exceptional nature as it was held by the Hon'ble Bombay High Court in the case of CIT vs. Veekaylal Investment Co. (P) Ltd., 116 Taxman 104. Hence, the AO had the option to reject the accounts which were not prepared in accordance with provisions of the Act.

7.6.2 In CIT-III, Mumbai, charge while completing assessment in the case of GC-11 for AY 2014-15, ITD omitted to add back provision for standard asset, and income from other sources to book profit. The omission led to short computation of book profit by ₹ 0.86 crore involving short levy of tax of ₹ 0.18 crore.

ITD stated (May 2017) that assessee being an NBFC had created provision for standard assets as per RBI guidelines. However, as section 115JB is a separate code, the above provision not being contingent in nature is required to be added to book profit. As regards not routing of income from other sources through Profit & Loss account, it was contended that the said income

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[118] ITAT Mumbai special bench in the case of M/s Avada Trading Company Trading Ltd. (100 ITD 131)
ITAT Mumbai in the case of Growth Avenue Securities Vs. DCIT

was booked in FY 2014-15 since the intimation from venture fund in respect of the same was received after the end of financial year.

Reply of the ITD was not acceptable as it was held by Hon'ble Supreme Court in the case of M/s Southern Technologies Ltd. vs. Joint CIT Coimbatore 187 Taxman 346 that RBI guidelines cannot override the provisions of the Act. Further, it has been held by ITAT Mumbai in the case of M/s Growth Avenue Securities vs DCIT that even exempt capital receipt should be routed through Profit & Loss Account.

7.7 Mistakes in computation of Capital gain

7.7.1 In CIT(LTU), Mumbai charge, in the scrutiny assessment of FC for AY 2013-14, the Transfer Pricing Officer (TPO) held that the transaction of transfer of preference shares by FC to foreign Associate Enterprises (AEs) was basically loan transaction and made adjustment of ₹ 104.60 crore towards interest chargeable on the said loan transaction. However, the Assessing Officer (AO) did not take cognizance of findings of TPO and allowed LTCL ₹ 566.86 crore arising out of transfer of preference shares of these AEs. The mistake had potential tax impact of ₹ 122.61 crore.

ITD while not accepting the audit objection contended (May 2018) that as per section 92CA(4) of the Act AO has to compute total income in conformity with ALP determined by TPO. Since, transaction value on redemption of preference shares was accepted by TPO, there was no occasion to disallow LTCL of ₹ 566.85 crore claimed by asseessee. Further, investment in non-cumulative compulsorily convertible preference shares (NCCPs) was made in AY 2009-10 was accepted by TPO without re-characterization.

The reply was not tenable as the issue of investment in NCCPs was examined in detail by TPO after considering all facts of the case and it was inferred that investment in NCCPs of AEs was nothing but mutual arrangement of advancing loan under the garb of preference shares to avoid taxability of interest income. As per Hon'ble SC decision in the case of M/s Mcdowell co Ltd. vs CTO 154 ITR 148, the AO should have initiated the logical action of disallowing the fabricated LTCL which was a colourable device resorted to by assessee. Hence, ITD may re-examine the issue in the interest of revenue.

7.7.2 *As per third proviso below section 48, the benefit of indexation is not admissible on bonds or debentures other than capital indexed bonds issued by the Government.*

In the case of FC, the ITD allowed the benefit of indexation on Bonds (other than capital indexed bonds) during AY 2012-13 in contravention of provision of the Act which led to irregular computation of LTCL of ₹ 123.78 crore involving potential tax impact of ₹ 26.78 crore. Reply from ITD is awaited.

7.8 Incorrect computation of Business Income

The Assessing Officers are expected to avoid mistakes while completing scrutiny assessments and exercise due care in implementing orders of appellate authority. Further, *the Board has issued instructions from time to time to all field formations to compute income and tax correctly while completing scrutiny assessment.*

7.8.1 In case of GC-12, (now merged with FC) ITD in AY 2003-04 held certain expenditure (₹ 102.28 crore) claimed as revenue expenditure, as capital expenditure and allowed depreciation on the same. However, in April 2015 decision of the Bombay High Court went in favour of GC-12 and the expenditure was allowed as revenue expenditure. We noticed that the said depreciation allowed from AY 2003-04 onwards remained to be withdrawn in AY 2007-08, 2010-11 and 2012-13 resulting in underassessment of income of ₹ 15.79 crore with consequent short levy of tax of ₹ 5.30 crore.

The ITD stated (May 2018) that the audit objection is acceptable. Further progress on remedial action taken is awaited.

7.8.2 We noticed that while working out depreciation for deduction under section 80-IB(9)[119] of a unit of FC during AY 2010-11 and 2011-12, ITD apart from allowing regular depreciation had also allowed additional depreciation in respect of additions to block of Plant and Machinery made during the relevant previous years. However, while working out above deduction during AY 2012-13 and 2013-14, ITD omitted to consider allowance of additional depreciation. The net additions under plant & machinery during the period relevant to AYs 2012-13 & 13-14 was at ₹ 2,066.40 crore and ₹ 2001.95 crore respectively.

ITD replied (May 2018) that even if additional depreciation is worked out , it will be tax neutral as deduction allowable under 80-IB(9) would be reduced however, there will be corresponding increase in depreciation allowance under section 32 and consequently there will be no change in total income and as such there is no loss to revenue.

The reply needs reconsideration as higher depreciation in initial years would lead to carry forward of reduced WDV in subsequent years and consequential higher taxable income once the deduction under 80-IB(9) is lapsed.

7.8.3 In CIT-VIII, Mumbai Charge, the assessee GC-13 for AY for 2013-14 had filed its original return of income for a loss of ₹ 27.97 crore and same was revised for a loss of ₹ 18.05 crore. However, while completing assessment, ITD omitted to take cognisance of revised return of income. As a result there

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[119] The amount of deduction to an undertaking shall be hundred *per cent* of the profits, if the undertaking is engaged in refining of mineral oil

was excess carry forward of loss of ₹ 9.92 crore involving potential tax impact of ₹ 3.22 crore. *The ITD accepted the para (September 2017) and rectified the mistake.*

7.9 Conclusion

We observed that there was an absence of effort by the ITD in cross linking material transactions with related parties to ensure the correctness/ genuineness. The ITD lacks a system of information sharing amongst its various charges leading to assessments of group companies getting completed in standalone manner thereby missing sight of important issues which have bearing on determination of taxable income. The problem further gets aggravated in case of merger/demerger on account of corporate restructuring of groups. Had there been robust/dedicated system in place, the quality of assessment would have been better.

ITD may also put in place an IT driven mechanism for sharing of information regarding group companies within the ITD so as to utilize information effectively and plug the leakage of revenue.

We referred this to the Ministry of Finance in July 2018 for its comments. Response of the Ministry was awaited (March 2019).

New Delhi **(Sanjay Kumar)**
Dated: 03 July 2019 **Principal Director (Direct Taxes-I)**

Countersigned

New Delhi **(Rajiv Mehrishi)**
Dated: 03 July 2019 **Comptroller and Auditor General of India**