

Chapter I

Introduction

- ◆ **Audit of Direct Taxes**
- ◆ **Replies of Ministry**
- ◆ **Recoveries at the instance of audit**
- ◆ **Result of Test Audit**
- ◆ **Outstanding audit observations**
- ◆ **Remedial action time barred**
- ◆ **Internal audit**
- ◆ **Non production of records**

Chapter Summary

Comptroller and Auditor General of India conducts audit of revenues from direct taxes of the Union Government under section 16 of the Comptroller and Auditor's General of India (Duties, Powers and Conditions of Service) Act, 1971 through test check of assessments and other records maintained by the Income Tax Department and Ministry of Finance. He examines the systems and procedures laid down by the department/Government in critical areas of tax administration to assess the effectiveness of their working and evaluates the degree of compliance with tax laws, rules and judicial pronouncements in the assessment, demand and collection of tax revenues from various assessees.

(Para 1.2)

Field offices under the Comptroller and Auditor General of India issued 15,809 audit observations on underassessment involving tax effect of Rs. 6,101.69 crore and 121 cases of over assessments involving tax effect of Rs. 1,549.16 crore during 2005-06 to the assessing officers of the department relating to corporation tax, income tax and other direct taxes. A total of 905 cases with tax effect of Rs. 1,971.33 crore were issued to the Ministry as individual draft paragraphs out of which 862 cases involving tax effect of Rs. 1,770.30 crore are included in this report.

(Para 1.4 & 1.7)

During 2005-06, Department made recoveries of Rs. 305.63 crore in respect of 2,517 audit observations included in local audit reports/system reviews during 2005-06.

(Para 1.6.1)

Out of a target of 12.78 lakh cases for disposal during 2005-06, only 4.72 lakh cases were seen by internal audit leaving a balance of 63.07 percent.

(Para 1.11.1)

Over 66 percent of 59,996 records not produced to audit in earlier years and requisitioned again during 2004-05, were not produced to audit in 2005-06.

(Para 1.13)

This report has been prepared after considering the response of the Ministry of Finance to the audit observations, wherever received.

(Para 1.6)

CHAPTER I: INTRODUCTION

General

1.1 Direct taxes levied by Parliament comprise:

- **Corporation tax**
- **Income tax**
- **Wealth tax**
- **Gift tax**
- **Interest tax**
- **Expenditure tax**
- **Fringe Benefit tax**
- **Securities Transactions tax and**
- **Banking Cash Transactions tax**

Laws relating to direct taxes are administered by the Central Board of Direct Taxes (hereinafter called 'the Board'). The Board is under the overall control of Department of Revenue, Ministry of Finance. Revenue from direct taxes during 2005-06 was Rs. 1,65,216 crore. Time series data on revenue from various direct taxes and other related statistical information on tax administration are presented in Chapter II.

Statutory Audit

1.2 Audit of direct taxes by the Comptroller and Auditor General of India is carried out under section 16 of the Comptroller and Auditor General of India (Duties, Powers and Conditions of Service) Act, 1971. Audit covers the field offices and the Board and involves examination of

- (a) assessments through test check;
- (b) rationale for issue of instructions and circulars;
- (c) decisions taken in particular cases, and
- (d) efficacy and adequacy of systems and procedure of tax collection, appeals, and overall tax administration.

1.3 After completion of audit of each assessment unit, audit observations are conveyed to the department through a local audit report. In the case of important observations, a statement of facts is issued to the department for verification of facts and obtaining their comments. Important audit findings are forwarded to the Board and Ministry of Finance. Finally, the Audit Report on direct taxes is forwarded to Parliament through the President of India.

Present Report

1.4 The preface describes the arrangement of this report. The Ministry's response, where furnished is indicated in each case. Where the reply of the Ministry is not acceptable, the reasons have been mentioned alongwith the gist of the reply of the Ministry.

1.4.1 The present report contains 862 out of 905 audit observations referred to Ministry of Finance. Table 1.1 below contains the details of draft paragraphs¹ issued to Ministry and included in the report.

(Rs. in crore)

TABLE 1.1: DRAFT PARAGRAPHS (DPs) ISSUED TO MINISTRY DURING 2005-06				
Category of tax	Number of Draft Paras issued to Ministry	Tax effect (Rs. In crore)	Number of draft paras included in the Report	Tax effect (Rs. In crore)
1	2	3	4	5
Corporation Tax	665	1910.31	632	1714.86
Income Tax	182	54.17	174	50.27
Wealth Tax	42	2.65	42	2.65
Gift Tax	2	1.68	0	0
Interest Tax	14	2.52	14	2.52
Total	905	1971.33	862	1770.30

1.4.2 Out of the above, five hundred and seventeen observations involving tax effect of Rs. 1440.68 crore had arisen out of local audit conducted during 2005-06 and the remaining 388 observations involving tax effect of Rs. 530.65 crore were noticed during local audit conducted in earlier years.

1.5 A separate Report 8 of 2007 (performance audit) containing the results of reviews or system appraisals has been prepared on the following subjects

- Assessment of selected companies in the selected sectors of computer software, automobiles and ancillaries, steel and trading.
- Implementation of TDS/TCS schemes.
- Assessment of sports associations/ institutions and sports personalities.

**Board's
comments on
draft
paragraphs**

1.6 Cases with substantial tax effect are brought to the notice of Income Tax Department and the Ministry in the form of 'draft paragraphs'. The replies of the Board to the draft paragraphs are considered before finalization of this report. Table 1.2 below contains the position of replies received from the Ministry along with follow up action taken on them and recoveries made in respect of them till the finalization of the Report.

¹ An audit observation issued to the Ministry seeking their comments

(Rs. in crore)

TABLE 1.2: FOLLOW UP ACTION ON DPs BY THE MINISTRY AND RECOVERIES MADE IN RESPECT OF THEM

Year of Audit Report	DPs issued to Ministry		Paragraphs accepted				Replies not received		Recoveries made					
	No	Amount	Pre Printing		Post Printing		No	Amount	Pre Printing		Post Printing		Total	
			No	Amount	No	Amount			No	Amount	No	Amount	No	Amount
	2005-06	905	1971.33	340	328.28	-	-	422	1556.68	29	13.75	-	-	29
2004-05	688	3490.55	36	9.28	268	751.43	377	2662.39	9	1.29	47	213.37	56	214.66
2003-04	931	1852.65	74	59.68	498	809.46	175	748.42	16	4.62	77	34.33	93	38.95
2002-03	980	1419.20	168	64.07	634	667.86	97	404.44	33	3.64	77	19.96	110	23.60
2001-02	918	1503.37	112	54.54	551	558.02	92	204.69	18	4.11	64	23.73	82	27.84

1.6.1 During 2005-06, Department made recoveries of Rs. 305.63 crore in respect of 2,517 audit observations included in local audit reports/systems reviews during 2005-06 and earlier years.

Results of test audit in general

1.7 Audit of assessments of all direct taxes conducted between 1 April 2005 to 31 March 2006 revealed 15,809 cases of under assessment and 121 cases of over assessment involving revenue effect of Rs. 6101.69 crore and Rs. 1549.16 crore respectively. Assessing officers accepted 3,485 audit observations (22.04 percent), did not accept 6,764 observations (42.79 percent) and did not respond to 5560 observations (35.17 percent) involving tax effect of Rs. 749.32 crore, Rs. 2141.39 crore and Rs. 3210.98 crore respectively of under assessment.

Corporation tax and Income tax

1.7.1 The number of audit observations during 2005-06 relating to different status of assessees with their tax effect on corporation and income tax is shown in Table 1.3 below

TABLE 1.3: AUDIT OBSERVATIONS DURING 2005-06 ON CORPORATION AND INCOME TAX

S. No.	Status of assessees	No. of audit observations	Tax effect (in crore)
1	Companies	6389 (41.88)	5755.17 (94.90)
2	Individuals	5544 (36.34)	138.72 (2.29)
3	Firms	2713 (17.78)	118.32 (1.95)
4	Other assessees	611 (4.00)	52.48 (0.86)
	Total	15257 (100)	6064.69 (100)

(Figures in bracket represent percent)

1.7.2 Table 1.4 below contains an analysis of audit observations on underassessment in terms of nature of mistakes and other omissions that audit noticed.

(Rs. in crore)

TABLE 1.4: CATEGORIES OF OMISSIONS IN INCOME TAX/CORPORATION TAX

Sl. No	Category of audit observations	No. of cases	Tax effect
1.	Avoidable mistakes in computation of income and tax	1193	415.59
2.	Failure to observe the provisions of the Finance Acts	624	195.00
3.	Incorrect status adopted in assessments	36	4.29
4.	Incorrect computation of salary income	271	6.90
5.	Incorrect computation of income from house property	358	36.15
6.	Incorrect computation of business income	3971	3411.42
7.	Irregularities in allowing depreciation	1178	238.01
8.	Irregular computation of capital gains	246	30.33
9.	Mistakes in assessments of firm	170	3.04
10.	Omission to club the income of spouse/minor child etc.	10	1.10
11.	Income not assessed	1530	390.89
12.	Irregular set-off of losses	443	216.28
13.	Mistakes in assessments while giving effect to appellate orders	67	5.33
14.	Irregular exemptions and excess relief given	1903	664.92
15.	Excess or irregular refunds	350	32.51
16.	Non-levy/incorrect levy of interest for delay in submission of returns, delay in payment of tax etc.	1241	164.50
17.	Avoidable or incorrect payment of interest by Government	134	42.20
18.	Omission/short levy of penalty	422	20.84
19.	Other topics of interest (miscellaneous cases)	1110	185.39
	Total	15257	6064.69

1.7.3 Categories depicted at Sl. No. 6 and 14 of Table 1.4 namely '*Incorrect computation of business income*' and '*Irregular exemptions and excess relief given*' account for the maximum number of audit observations and tax effect which is depicted in Table 1.5 below

TABLE 1.5: REVIEW OF THE CATEGORY WISE OBJECTIONS

Category of omission	Percent of total audit observations	Percent of total tax effect	Two charges with maximum number of audit observations & their tax effect		
			Charges	No. (percentage)	Tax effect (percentage)
Incorrect computation of business income	26	56	Maharashtra & Delhi	36	77
Irregular exemptions and excess relief given	12	11	Tamil Nadu & Maharashtra	40	70

1.7.4 Audit observations under category at Sl. No. 6 are on incorrect allowance of capital expenditure, provisions, liabilities, prior period expenses etc. Audit observations under category at Sl. No.14 relate to incorrect allowance of exemptions, reliefs etc.

Wealth tax

1.7.5 Similarly, 534 observations relating to wealth tax were issued involving tax effect of Rs. 33.74 crore. Table 1.6 below contains an analysis of omissions in terms of nature of irregularities.

(Rs. in crore)

TABLE 1.6: CATEGORIES OF OMISSIONS IN WEALTH TAX			
1	2	No. of Cases	Amount
1	2	3	4
1.	Wealth not assessed	425	31.08
2.	Incorrect valuation of assets	27	0.60
3.	Mistakes in computation of net wealth	17	0.20
4.	Incorrect status adopted	1	0.01
5.	Mistakes in calculation of tax	2	0.03
6.	Non-levy or incorrect levy of additional wealth tax	10	0.10
7.	Non-levy or incorrect levy of penalty and non-levy of interest	14	1.44
8.	Miscellaneous	38	0.28
Total		534	33.74

Other direct taxes

1.7.6 Eighteen observations relating to other direct taxes i.e. gift tax, interest tax etc were issued involving tax effect of Rs. 3.26 crore as mentioned in Table 1.7 below.

(Rs. in crore)

TABLE 1.7: OTHER DIRECT TAXES			
S. No.	Category of tax	No. of cases	Tax effect
1	Gift tax	1	0.06
2	Interest tax	15	2.93
3	Expenditure tax	2	0.27
Total		18	3.26

Outstanding statutory audit observations

1.8 According to departmental instructions, observations of statutory audit are to be replied to within a period of six weeks. The Public Accounts Committee (Ninth Lok Sabha) in their 20th Report underscored the fact that responsibility for settlement of audit observations rests with the department and it cannot remain content merely with sending replies to audit observations. In their action taken note, the Ministry of Finance had stated that they would endeavour to see that targets for settlement of audit observations were achieved. However, large number of audit observations made in 2005-06 and earlier years are still to be settled.

1.8.1 As on 31 March 2006, 71,256 observations involving revenue effect of Rs. 23223.47 crore were pending. This does not include the audit observations communicated between 1 April 2005 to 31 March 2006. The year-wise particulars of the pendency are given in Table 1.8.

(Rs. in crore)

TABLE 1.8: OBSERVATIONS PENDING WITH DEPARTMENT FOR FINAL ACTION

Year	Income Tax and Corporation Tax		Other Direct Taxes (Wealth Tax, Gift Tax, Interest Tax, Expenditure Tax and Estate Duty)		Total	
	Items	Revenue effect	Items	Revenue effect	Items	Revenue effect
1	2		3		4	
Upto 2002-03	43261	12307.85	5340	159.81	48601	12467.66
2003-04	8667	4496.96	525	145.99	9192	4642.95
2004-05	12858	6068.46	605	44.40	13463	6112.86
Total	64786	22873.27	6470	350.20	71256	23223.47

1.8.2 A total of 9,534 audit observations relating to income tax and corporation tax where tax involved in each case exceeded Rs. 10 lakh, were pending as on 31 March 2006 with revenue effect of Rs. 17001.08 crore (as against 9,207 cases with a revenue effect of Rs. 14516.80 crore in 2004-05). Cases in respect of different charges are shown below in Table 1.9.

(Rs. in crore)

TABLE 1.9: PENDING IT/CT CASES WHERE TAX INVOLVED IN EACH CASE EXCEEDED RS. 10 LAKH

Sl. No.	Name of charge	Items	Amount
1	2	3	4
1.	Andhra Pradesh	266	259.15
2.	Assam	213	381.19
3	Bihar	56	17.00
4	UT Chandigarh	67	99.92
5	Chhattisgarh	100	87.98
6	Delhi	1787	3689.26
7	Goa	44	55.35
8.	Gujarat	452	437.36
9	Haryana	109	106.02
10	Himachal Pradesh	25	20.88
11.	Jammu & Kashmir	43	24.29
12	Jharkhand	111	88.88
13.	Karnataka	322	462.83
14.	Kerala	403	409.17
15	Madhya Pradesh	213	417.94
16	Maharashtra	2388	6666.66
17.	Orissa	155	216.80
18.	Punjab	310	339.59
19.	Rajasthan	292	626.23
20.	Tamil Nadu	836	818.33
21.	Uttar Pradesh	592	399.62
22	Uttaranchal	42	580.79
23	West Bengal	708	795.81
	Total	9534	17001.08

1.8.3 Table 1.10 contains data on pending audit observations relating to other direct taxes where the tax involved in each case exceeded Rs.5 lakh.

(Rs. in crore)

TABLE 1.10: PENDING CASES OF OTHER DIRECT TAXES

Sl. No.	Category of tax	Number of audit observations	Tax effect
1	2	3	4
1.	Wealth tax	260	60.40
2.	Gift tax	30	9.42
3.	Interest tax	75	64.09
4.	Expenditure tax	4	0.93
5.	Estate Duty	6	7.02
	Total	375	141.86

1.8.4 Nine thousand nine hundred and nine audit observations indicated in Table 1.9 and 1.10 above constituted 13.91 percent of total observations and accounted for Rs. 17,142.94 crore (73.82 percent) of revenue effect of the total pending cases. Department needs to assign priority to settle observations of higher tax effect.

1.9 Table 1.11 below indicates targets for settlement of major statutory audit observations for the year 2003-04 according to action plan and actual achievements:

TABLE 1.11: ACTION PLAN & ACTUAL ACHIEVEMENTS OF THE DEPARTMENT

Nature of observations	Audit observations				
	For disposal	To be settled as per targets fixed	Settled	Targets (percent)	Achievements with reference to the targets fixed (percent)
1	2	3	4	5	6
Current	4988 (22996.28)	3990 (18397.02)	1583 (20419.81)	80	31.74
Arrear	12700 (5266.00)	11430 (4739.40)	5561 (1912.99)	90	43.78

(Figures in brackets represent money value of rupees in crore)

1.9.1 The action plan of the department for 2005-06 provided for 90 percent disposal in terms of numbers of major audit observations in arrears and 80 percent for current major audit observations. The actual achievement was only 43.78 percent and 31.74 percent respectively of the targets fixed. However in terms of money value achievement exceeded target in case of current major audit observations but fell short of target in case of arrear major audit observations.

Remedial action time barred

1.10 The Board have issued specific instructions for taking timely action on audit observations so as to avoid cases becoming barred by limitation of time and leading to loss of revenue. The Public Accounts Committee (150th Report-Eighth Lok Sabha) had also recommended that the Board review old outstanding observations in consultation with Audit.

1.10.1 In some charges where the status of audit observations issued between 1979-80 and 1997-98 was reviewed in 2005-06, several cases where remedial action had become time barred were noticed. Details of these cases have been forwarded to the respective Commissioners. Table 1.12 contains the number of such cases along with tax effect.

(Rs. in crore)

Sl. No.	Name of the State	Income Tax	
		Number	Tax effect
1.	Andhra Pradesh	243	28.64
2.	Assam	4	0.07
3.	Bihar	168	19.96
4.	Jharkhand	206	31.57
5.	Gujarat	223	40.79
6.	Harayana	80	0.70
7.	Jammu & Kashmir	7	0.22
8.	Kerala	17	0.31
9.	U.T.Chandigarh	110	10.52
10.	Madhya Pradesh	315	31.90
11.	Maharashtra	598	520.75
12.	Orissa	86	4.90
13.	Punjab	28	0.13
14.	Rajasthan	180	220.81
	Total	2265	911.27

Internal Audit

1.11 As per action plan of the Department, all arrear auditable cases pending as on 1 April 2005 were required to be internally audited by 30 November 2005 and all auditable cases due for audit upto 31 December 2005 were to be audited by 31 March 2006.

1.11.1 An analysis of the working of internal audit as given below indicates that internal audit is ineffective and needs strengthening. Out of a target of 12.78 lakh cases for disposal during 2005-06, only 4.72 lakh cases were seen by internal audit leaving a balance of 63.07 percent. Details are given in Table 1.13.

Financial Year	Total auditable cases	Target for disposal	Total cases audited	Shortfall with reference to total auditable cases	
				No.	Percentage
2003-04	18,40,561	18,40,561	6,90,841	11,49,720	62.47
2004-05	13,87,549	13,87,549	5,99,243	7,88,306	56.81
2005-06	12,77,910	12,77,910	4,71,777	806,133	63.07

1.11.2 The number of observations raised in internal audit was 6,876 in 2003-04, 8,392 in 2004-05 and 6,133 in 2005-06 involving money value of Rs. 159.23 crore, Rs. 274.05 crore and Rs. 608.28 crore respectively.

1.11.3 Out of the 905 draft paras issued to the Ministry during 2005-06, only 71 (7.85 percent of draft paras issued) had been seen by internal audit of the department and the mistakes pointed out by statutory audit had not been detected by internal audit in the cases checked by them.

1.11.4 As per the data furnished by Directorate of Income Tax (Income tax & Audit), the closing balance of auditable cases as on 31-03-2005 was 7.88 lakh which did not tally with the opening balance of auditable cases as on 01-04-2005 which was shown as 6.97 lakh.

Outstanding audit observations of internal audit

1.12 According to departmental instructions, internal audit observations are to be attended to by the assessing officer within three months. However, as on 31 March 2006, 8,965 audit observations of internal audit involving a tax effect of Rs. 689.16 crore were pending for settlement. This included 2,898 observations with money value of Rs. 366.10 crore made during 2005-06.

1.12.1 Table 1.14 below contains information on major observations of internal audit and their settlement.

Financial year	No. of cases for disposal	No. of cases settled	Percentage of total cases disposed	No. of pending cases
2001-02	5,375(814.84)	1,111(216.79)	21	4,264(598.05)
2002-03	6,635(1,430.33)	2,348(452.13)	35	4,287(978.20)
2003-04	5,151(1,936.90)	1,466(275.63)	28	3,685(1,661.27)
2004-05	5,333(941.02)	2,296(485.17)	43	3,037(455.85)
2005-06	3592(849.58)	1533(170.79)	43	2059(678.79)

(Figures in brackets indicate money value of rupees in crore)

1.12.2 The major cases settled during 2005-06 were only 1533(43 percent). Opening balances for 2002-03 to 2005-06 do not tally with the closing balances for 2001-02 to 2004-05, which were still under reconciliation in the department.

Audit observations					
	For disposal	To be settled as per targets fixed	Settled	Target (percent)	Achieved (percent)
1	2	3	4	5	
Current	1,479(263.31)	1,479(263.31)	494(39.68)	100	33.40
Arrears	3,854(677.71)	3,854(677.71)	1,802(445.49)	100	46.76

(Figures in brackets indicate money value of rupees in crore)

Achievements thus fell short of the targets fixed.

Records not produced to audit

1.13 With a view to securing an effective check on the assessment, collection and proper allocation of taxes and examining that regulations and procedures are being observed, assessment records are scrutinized in revenue audit. It is incumbent on the Department to expeditiously produce records and furnish relevant information to audit.

Appendix-1 contains details of records not produced to audit in previous audit cycles which were requisitioned again in 2004-05. Over 66 percent of cases not produced during earlier audits and requisitioned again in 2004-05, were not produced to audit. Consequently, audit of such cases could not be carried out. Risk of loss of revenue in such cases cannot be ruled out.

Table 1.16 Contains state wise details where records were not produced to audit in three or more consecutive audit cycles. Consequently, audit of such cases also could not be carried out.

TABLE 1.16 RECORDS NOT PRODUCED TO AUDIT IN THREE OR MORE AUDIT CYCLES				
S.No.	State	Number of records not produced		
		IT/CT	W.T.	Total
1	2	3	4	5
1	Andhra Pradesh	26	3	29
2	Karnataka	17	11	28
3	Madhya Pradesh	11	0	11
4	Orissa	26	0	26
5	Rajasthan	3	0	3
6	Maharashtra	0	13	13
	Total	83	27	110