PREFACE

The Report for the year ended March 2010 containing the results of the performance audit of Taxation of payments to non residents has been prepared for submission to the President under Article 151(1) of the Constitution of India.

The audit of Revenue Receipts – Direct Taxes of the Union Government is conducted under Section 16 of the Comptroller and Auditor General of India (Duties, Powers and Conditions of Service) Act, 1971.

Our findings are based on mainly test audit conducted during the period 2009-10. Some findings of audit conducted in earlier years, but could not be covered in previous Reports, have also been included.

Executive Summary

Executive Summary

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 The Foreign Exchange *Regulation* Act (FERA) was repealed and replaced by the Foreign Exchange *Management* Act (FEMA) in June 2000 with a view to facilitate external trade and payment and for promoting the orderly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.

Summary of Recommendations

Summary of recommendations

We recommend:

- a 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;

- that a significant step towards transparency will be the submission of tax gap analysis to the Parliament. This will also provide an estimate on revenue leakages in forex remittances;

- 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;

- that a flat and lower tax rate applied to all payments regardless of their purpose or destination will be a more viable alternative to administer- for the ITD as well as the banking sector;

- an automated solution that sifts out error reports from e-filed undertakings. This would require that the purpose codes of RBI are adopted by the ITD and integrated into the automation. We are of the opinion that this will also facilitate reconciliation of data with RBI;

- that the e-TDS returns must also provide data on all remittances, even those with null value for TDS and must also capture the purpose codes;

- that adequate safeguards may be built into the system to protect revenue on account of thin capitalization. ITD needs to strengthen monitoring of non-filers among liaison offices;

- that sectoral studies may be conducted by ITD to identify the avenues of revenue leakage as well as flag ambiguities in emerging areas.

CHAPTER 1

INTRODUCTION

Why we chose the topic

Objectives of the study

Legal Provisions and procedures

Scope of audit and methodology

Acknowledgement

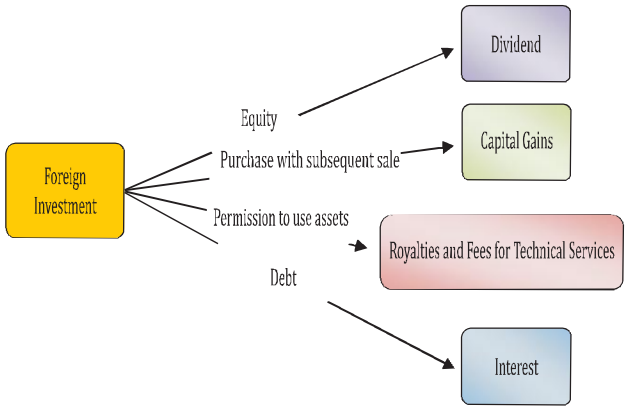
CHAPTER 1

Introduction

1.1 Tax administration recognizes a taxpayer as non-resident depending on the duration of his/her residence[1] in India in the relevant period of assessment.

1.2 Growing integration with 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 considerably eased the restrictions on flow of foreign exchange transactions. The policy intent is to "eschew micro-management and control of forex transactions and shift to monitoring the flows, the endeavor being to provide seamless, hassle-free services"[2]. The Foreign Exchange *Regulation* Act (FERA) which formed the statutory basis for exchange control in India was repealed and replaced by the new Foreign Exchange *Management* Act (FEMA) with effect from June 2000. Shifting from the need for "regulating foreign exchange for conservation of foreign exchange resources of the country" in the FERA regime, the stated object of FEMA was for "facilitating external trade and payment and for promoting the orderly development and maintenance of foreign exchange markets in India." This shift has necessitated delegation of authority to the remitting banks (called *authorized dealers* of foreign exchange) to vouchsafe the legality of the forex transactions.

Chart1: Investment and Returns



1.3 The Banking Sector including the RBI and Authorised Dealers as well as the Central Board of Direct Taxes with their field formations are responsible for managing the risks associated with foreign remittances and taxation on them.

1.4 Foreign investment can be in the form of business/ productive capital being Foreign Direct Investment (FDI); or money/ financial capital i.e., Foreign

[1] An individual is a resident in India if he has been in India during the previous year for 182 days or more; has been in India during the previous year for less than 182 days but has been in India for an aggregate of 365 days or more in the four years preceding and his stay in India during the previous year is 60 days or more. A company is a non-resident if it is neither an Indian company nor the control and management of whose affairs during the previous year, is situated wholly in India. Every other person is a non-resident if, during a previous year the control and management of its affairs are situated wholly outside India.

[2] Report of the Committee (2004) on Procedures and Performance Audit on Public Services (CPPAPS) of Ministry of Finance

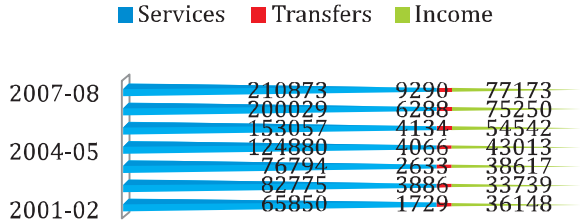
Institutional Investment (FII). The returns from foreign investments can be broadly classified as active or passive income.

1.5 Active income includes profits from business and demands a physical presence of the taxpayer in the country. Subsumed in the concept of business connection is the one of a *Permanent Establishment* (PE). It essentially means a physical existence: fixed place of business or relationship through a branch office, an agent or a local subsidiary company. Thus a PE involves the concept of control, supervision or an activity of continuous nature. The 'active' business income of a PE will be subject to taxation in India as per the Income Tax Act read with provisions of Double Taxation Avoidance Agreements (DTAA)[3]. The multiplicity of players involved and the labyrinthine relationships between the parent and its affiliates smudge clarity on ownership and control[4] and make taxation of such business income very complex.

1.6 On the other hand, passive income[5] can be said to have deemed to arise or accrue in the country, even without such physical presence. Tax is deducted at source (TDS) on all such income before it is remitted abroad. The taxability of passive income is established on the principle that it was generated from a *business connection* in India, even if such a connection is a 'virtual' one, i.e., without a physical presence.

Why we chose the topic

Chart 2: Invisible payments by category of transactions
₹ in crore



1.7 The country has witnessed a robust growth in outward remittances[6] fuelled by private transfers and software exports. Year 2009 witnessed a consensus particularly among the G20 countries to use the global economic downturn to close loopholes that are costing them hundreds of billions in lost revenues. This was followed by crack down on tax havens to press for greater information sharing and co-operation in tracking tax evasion. We felt that it would be topical to conduct a study on the

[3] Through the DTAAs, respective jurisdiction is so identified that a particular income is taxed in one country only or, in case it is taxed in both the countries, suitable relief is provided in one country to mitigate the hardship caused by taxation in another jurisdiction. DTAAs in addition to avoidance of double taxation of the same income in the two Contracting States, cover other areas of co-operation in prevention of fiscal evasion, exchange of information, recovery of tax and promotion of mutual economic relations, trade and investment.

[4] In some cases the remitter may be a branch or a subsidiary of the service provider non-resident. In other cases the remitter may simply be an agent with no direct relation with the non-resident. Quantification and valuation of the profit is also complicated owing to the level of relations between the remitter and the non –resident as also some third party which may be the final recipient of the remittance.

[5] In addition to the income from foreign investment, the taxable base of non-residents includes passive income from services (such as customer service or shipping); intellectual property; and patents.

[6] Source: RBI

effectiveness of institutional mechanisms in the tax department to maintain oversight on outflows and bridge the tax gap.

Objectives of the study

1.8 We sought an assurance through our study that:

- *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 effectiveness of the risk mitigation measures are monitored;*
- *The systems and control measures are effective to ensure that all taxable remittances are taxed accurately;*
- *The Department is geared to meet the new challenges in international taxation owing to globalization and the attendant complexity in transactions.*

Legal provisions and procedures

1.9 Section 5 of the Income Tax Act, 1961(Act) provides for taxation of income in India. Section 9 provides the circumstances under which an income accrues or arises in India.

1.10 Sections 190 to 206 of the Act deal with TDS. Any person making deduction of tax from payments made to non-residents is required to electronically file quarterly returns to the Department. Sections 201, 221, 271(C) and 272(A) deal with default, interest and penalty provisions in respect of TDS. Section 40a (i) provides that if TDS is not deducted on a remittance which warranted such deduction, then such expenditure shall not be tax deductible to the remitter.

1.11 Authorized dealers (ADs) remit money abroad on submission of an undertaking by the remitter[7], along with a certificate from a Chartered Accountant (CA) in duplicate. One copy is sent to the assessing officer (AO) in the ITD; the other copy is kept on record for verification during audit by the Reserve Bank of India.

1.12 Taxation of non-residents is centralised under the Directors of International Taxation (DIT) at Delhi, Kolkata, Chennai, Mumbai and Bangalore. In other places, the designated Chief Commissioners of Income Tax (CCsIT) exercise jurisdiction over non-residents within their region.

[7] CBDT Circular no. 10 of 2002 dated 9 October, 2002

Scope of audit and methodology

1.13 The payments made to non-residents during the financial years 2005-06 to 2008-09, formed the basis of our study. We also covered income tax assessments of resident assesses' who had claimed expenditure towards payments to non-residents to verify whether the applicable taxes had been deducted in respect of these payments.

1.14 Selection of the actual assessment units was made based on the risk analysis of each unit[1]. Scrutiny assessments and summarily processed cases of non- residents for the financial years 2005-06 to 2007-08 were selected by us. 25 *per cent* of the total certificates and undertakings (C&U) filed by the remitters and forwarded by the ADs to the ITD during this period were requisitioned; these remittances were correlated with the assessment records. We stood hampered in selection of cases due to the absence of any centralized database regarding assessment of non residents in the Income Tax Department. Details of records produced to us are given in table 1.

Table 1: Details of records checked in 21 offices

Assessments	C&U	Concessions[9]	eTDS[10] Returns
12000	19993	355	2013

1.15 We also drew a sample of 1240 specific high remitters extracted from the database of Centre for Monitoring Indian Economy (CMIE). Data on remittances was also collected from Reserve Bank of India (RBI) for macro-level correlation with tax collections.

Acknowledgement

1.16 Indian Audit and Accounts Department acknowledges the cooperation provided by the Central Board of Direct Taxes (CBDT) and the field formations of the ITD in providing the necessary records and information for audit. An entry conference was held with the CBDT in March 2009 to discuss the objectives, modalities and scope of the audit study.

1.17 The exit conference was held (October 2010) with the Ministry/Board wherein the report was discussed. The views expressed by the Ministry/Board in the exit conference have been suitably incorporated in this report.

1.18 We also acknowledge the cooperation rendered by the RBI and by the ADs including public, private and foreign banks in providing us with valuable inputs.

[8] Several factors such as materiality of assessments in a unit, assessment profile of a unit and previous audit observations in respect of a unit etc., form the risk matrix for evaluation of a unit.

[9] The Act allows lower rate of TDS or for complete exemption of certain categories of remittances/ remitters from TDS.

[10] Returns furnished by the deductors of tax to the Income Tax Department using electronic filing.

CHAPTER 2

OVERSIGHT ON FOREX

A The process

B Oversight and Reconciliation

Reconciliation of imports

Net Errors and Omissions in BoP

Tax gap

C Oversight: Risk analysis

D Oversight: Risk mitigation

Thin Capitalisation

Liaison Offices

Recommendations

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 category[11]. The RBI collects data from the ADs under 99 purpose codes[12]. 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 purposes[13] 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 Manual[14] 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 Rules[15] 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).

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[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 Data[16] 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.

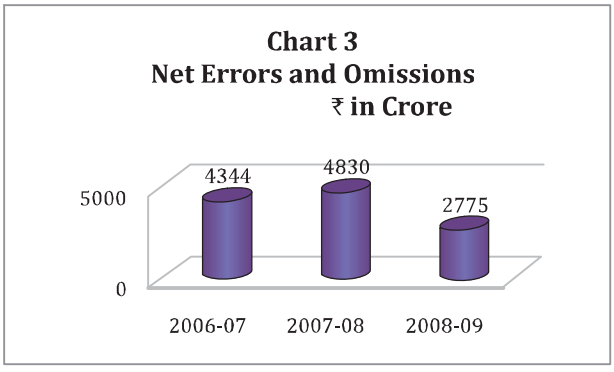
Table 2: Reconciliation between DGCIS and RBI

(₹ in crore)

Year	Imports as per DGCIS	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

**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 cent*[17] of the total debt raised is in the form of concessional debt[18] ; 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 equipment[19] 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;

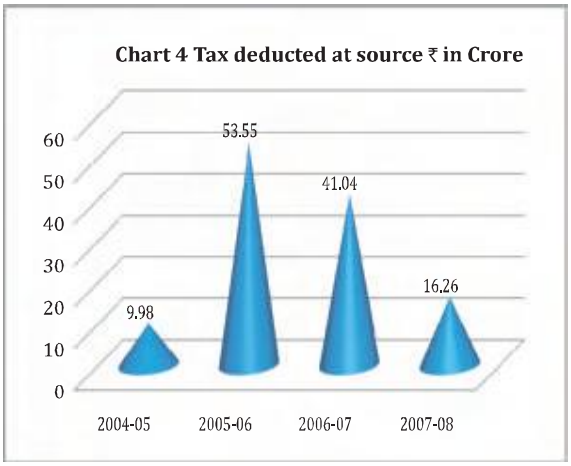
[17] India's External Debt-A Status Report, Ministry of Finance, August 2006

[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 DTAAs. 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 assessees or was simply, leakage of revenue.



C Oversight: Risk Analysis

2.9 A study by the Global Financial Integrity[20] published in 2008 estimates illicit financial flows[21] 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 OECD[22] reports speak of the weak regulatory mechanisms for information-sharing between countries, even within the OECD. Information can be shared under tax treaties (DTAAs) 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 DTAAs with India; 50 out of the 74[23] DTAAs 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 DTAAs, the procedure is long drawn and often unfruitful[24].

[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.

Table 4 Analysis of remittances made towards royalties, fees for technical services and interest ₹ *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 shopping[25] 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 sharing[26]. 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 DTAAs 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 principle[27].

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 ratio[28] 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.

Table 5: Tax returns filed by LOs

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 DTAAs 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.

CHAPTER 3

CONTROLS ON REMITTANCES

Collection and transfer of documents

Controls in tax administration

Correlation with authorized dealers

Use of C & Us in regular assessments

Electronic filing of undertakings

Processing of TDS returns

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CHAPTER 3

Controls on remittances

Chapter Overview

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 a disarray especially in heavy assessment charges. Stacks of C&Us lay dumped in rooms making their retrievability, a near impossibility. No reconciliation of C&Us is possible between ADs and ITD in this scenario. 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.

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.

3.1 The ADs play a pivotal role in providing an assurance on the conformity of forex remittances to sovereign Acts. We examined the ability of the ADs to discharge their functions with reference to the volume of transactions and the nature of the responsibilities placed on them.

3.2 Data on the total volume of forex transactions handled by ADs was not available. On an average, each AD remits around ₹ 700 crore every year. The number of checks and the nature of checks make the process cumbersome. With the introduction of FEMA, RBI decided not to prescribe the documents which should be verified by the ADs. Instead it was left to the ADs to satisfy themselves on the nature and purpose of the remittance. However, the guidelines prescribing onerous checks by the ADs continue and a viable alternative is yet to emerge.

The checks prescribed by RBI in respect of remittances relating to foreign shipping companies or their agents in India, illustrate the rigours expected of ADs. The ADs are required to check that collection of freight is duly supported by details (contained in the 'freight manifest') of the cargo carried, the port of embarking and of discharge. They are also required to check in detail the entries in respect of 10 to

15 *per cent* of the freight manifest and to cross reference the same with the export tally sheet certified by the surveyors of the shipping companies towards actual loading. The bills of lading (document given by the carrier to the shipper acknowledging that specified goods have been received on board) in respect of imports are to be verified. In respect of receipts other than freight, suitable documentary evidence is to be verified in detail. ADs are required to watch the voyage-wise details from foreign shipping companies/agents for crediting freight/ passage collections.

Similarly, remittances towards refunds of Income tax are required to be preceded by cumbersome checks by the ADs: they are required not only to verify the original assessment order, the source of funds of investments, profits arising thereof, income tax returns etc. ₹ 544 crore[30] was remitted towards refunds during 2007-08 to 66 countries; in 2008-09, the figure was ₹ 1988 crore[31] remitted to 73 countries.

3.3 Innovative solutions are required that meet the need for control without making the controls cumbersome and ineffective. We are of the opinion that the rigours of checks at the level of the AD impinge on the effectiveness of such controls, which makes the need for co-ordination with the ITD even greater. We also feel that ITD is a key partner in the framework of governmental oversight and its performance would need to be assessed not only in its ability to collect tax but also its role as a deterrent in money laundering.

Collection and transfer of documents

3.4 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 ADs send a copy of the certificate and undertaking (C&U) *on each individual remittance* to the assessing officer (AO) in ITD. We approached about 1688[32] ADs in order to correlate the receipt and transfer of C&Us to the ITD. 253 responded to our queries, of which 129 ADs reported nil remittances during the period under review. Our findings on the remaining 124 ADs are illustrated below:

A Collection of C&Us

The process does not provide an assurance that C&Us with respect to each remittance are collected by the ADs from the remitter. For instance, we found that during 2004-06, there has been import of merchandise to the extent of ₹ 40445 crore. However, the ADs did not collect C&Us for remittances made for the above import of merchandise[33].

[30] Includes remittances of ₹ 32.03 crore to unspecified countries and remittances of ₹ 1.62 crore to 15 countries with whom India does not have DTAA

[31] Includes remittances of ₹ 1258.84 crore to unspecified countries and remittances of ₹ 20.76 crore to 21 countries with whom India does not have DTAA

[32] 115 under category A and 1573 under category B

[33] RBI/A. P. (DIR Series) Circular No. 03 dated 19.07.2007 specifies that C & Us are to be submitted even in respect of import of goods.

B Completeness of C&Us

We found instances where the C&Us did not mention vital data on remittances. For instance in Karnataka, C&Us supporting seven remittances aggregating to ₹ 13.5 crore made through three ADs during 2005-08, did not mention the purpose and no tax was deducted from the remittances.

Capital gains tax is not deductible on a remittance relating to sale of shares if Securities Transactions Tax (STT) has already been levied. We found that tax was not deducted from 13 remittances worth ₹ 9.8 crore in 2006-08 in Andhra Pradesh, CIT Hyderabad although the C&Us were not supported with the details of transaction such as date of acquisition of share, sale and demat account. These details were required towards verifying the admissibility of the exemption of capital gains tax.

C Transfer of C&U to ITD

Our study across 16 branches of ADs showed that they had not forwarded C&Us in respect of 16305 transactions involving a remittance of ₹ 5613 crore to the ITD. We correlated the receipt of C&Us in ITD in detail in two States. We found that the *ITD was not receiving C&Us from 73 per cent of the ADs in Tamil Nadu; the figure was 75 per cent in Karnataka.* In Madhya Pradesh, the assessment records of 31 assessees showed foreign remittances, but the ITD could not produce the C&Us supporting the remittances. The liaison of ITD with ADs was clearly deficient and the gap remains to be effectively bridged even after we raised the issue with ITD.

Calyon Bank, Tamil Nadu, made 22 remittances of ₹ 3.5 crore relating to Saint Gobain Glass and Air Liquid Engineering Pvt Ltd during 2004-06 towards 'fees for technical services', on which tax amounting to ₹ 44.2 lakh was leviable. However, the AD did not transfer the C&Us and did not deduct the TDS either.

D Transfer of C&Us to unrelated AOs

We found 72 C&Us relating to remittance of ₹ 18.2 crore in 3 States[34] which were forwarded to officers other than the AO where the remitters were assessed.

E Deduction of tax on remittances

We attempted to cross-check a sample of C&Us received in ITD for the tax deductibility of remittances. This was no mean task given the state of record management of C&Us in ITD (refer paragraph 3.10). In all, we found that TDS of ₹ 44.7 crore was not deducted from remittances made during the period 2005-09 in 4 States[35]. In addition, ₹ 2.9 crore was deducted less than the TDS leviable in 3 States[36]. Income Tax Act disallows deduction of those items of expenditure on which

[34] Delhi, Tamil Nadu, West Bengal
[35] Andhra Pradesh, Delhi, Karnataka, Tamil Nadu
[36] Karnataka, Mumbai , Tamil Nadu

tax had not been deducted. We found 8 cases where remittances amounting to ₹ 114.4 crore were disallowed by the AOs; the TDS that was not collected on these remittances amounted to ₹ 42.4 crore. The process is unable to provide an assurance that the ADs collect the TDS at the time of remittance.

Charge: DIT (IT), Chennai, Tamilnadu; AY: 2003-04 to 2005-06
Assessee: Cairn Energy India Pvt Ltd

The assessee made remittances towards acquiring and processing of seismic data/geological data and charter hire charges. As these payments partake the character of royalty and fees for technical services, tax ought to have been deducted. Failure resulted in short levy of tax of ₹ 21.1 crore. The proportionate disallowance under Section 40(a)(i) worked out to be ₹ 90.4 crore involving a short levy of ₹ 37.7 crore.

Charge: DIT (IT), Mumbai, Maharashtra; AY: 2005-06
Assessee: Citi Bank NA.

TDS was not collected on interest of ₹ 47.2 crore paid by the assessee to the head office/foreign branches. The payment was therefore disallowed by ITD and was brought to tax. However, it was taxed at the rate of 10 *per cent* instead of normal rate of tax at the rate of 40 *per cent* with surcharge and education cess. This resulted in short levy of tax of ₹ 26.9 crore including interest. The department accepted (February 2009) our findings and rectified the assessment in May 2009.

F Misclassification of remittances

We found that ₹ 78.74 crore and ₹ 71.35 crore remitted through one AD[37] during the years 2007-08 and 2008-09 had been incorrectly classified under the purpose code for Miscellaneous Remittances(S1019) as against the correct head relating to payment for shipping freight for import and export.

3.5 We are also concerned about forex transactions which are not covered under the requirement of C&U. For instance Income Tax Act[38] exempts income from export of goods or computer software subject to certain conditions, one of which is repatriation of sale proceeds into India in convertible foreign exchange. The sale proceeds shall be deemed to be received in India if they are credited to a separate account maintained for the purpose with any bank outside India with the approval of RBI. Whenever payments are made from this account, there would be no undertaking or certificate as applicable to remittances from India. Thus the veracity and taxability of the transaction would not be available for verification in India.

Controls in tax administration

3.6 The C&Us are received by the AO in charge of the tax assessment of the remitter (deductor who deducts the tax from the payments made to the non-resident) or with the DIT (IT), wherever located. The AO is required to check from

[37] State Bank of India, SP Commercial Branch Indore
[38] Section 10A/10B

the C&U that TDS was deducted as required; if not, the payment (remittance) may be disallowed as deduction during assessment. The remitter is also required to file a quarterly tax return (Form No 27Q) with the jurisdictional TDS Officer. The AO (TDS) is required to co-relate the TDS return (reporting the transactions on which TDS was deducted) with the actual TDS deposited and the interest payable, if any, for delay in such tax deposit.

3.7 The remittances under the invisible account have increased three-fold during 2002-2008. As every remittance is to be backed by a C&U, the quantum of C&Us being received by the Department is gargantuan. The volume has rendered micro check of individual remittances in ITD very difficult. The manual receipt and collation of C&Us was in disarray and we found that stacks of C&Us lay dumped in rooms, with their retrievability a near impossible task, especially in heavy assessment charges. In such a scenario, a system of periodic reconciliation of receipt of C&Us in ITD with those sent by ADs was rendered difficult.

3.8 The tax administration is currently stretched, ill-equipped to handle the flow of records (C&Us) manual or automated. The risks are neither identified nor are they placed on a hierarchy to enable the authorities to be able to either sift risky transactions or mitigate the risks that flow from them.

Correlation with authorized dealers

3.9 We approached the ADs to cross-link the C&Us collected by them with the remittances reflected in assessment records of the remitters. Our findings illustrate the risks that crept into the system in absence of co-ordination between ADs and ITD, as well as due to inadequate monitoring of the C&Us in ITD. Such correlation will not only throw up inadmissible deductions but also put the spotlight on "hidden" remittances.

Charge: CIT, Kochi, AY 2005-06; Assessee: Kochi Shipyard Ltd

The assessee reported an expenditure of ₹ 57.1 crore, which was remitted abroad. The C&Us collected by the AD also showed that the money had been remitted abroad.

We found that the assessee had paid the sum as fees for technical services, on which tax was not deducted at source. When queried, the Department stated that of the total, ₹ 12.5 crore was accounted twice and actual payment was ₹ 44.57 crore only. The balance of ₹ 12.5 crore actually remitted by the assessee through the AD was

unexplained[39] and would have remained undetected but for the correlation attempted by us. This unexplained income involved a short levy of ₹ 4.6 crore.

We found three other instances (of private companies) where the assessees declared (in the tax returns) remittances short of the actual remittance as reflected in the C&Us collected by the ADs. This unexplained income involved a short levy of ₹ 2.7 crore.

Use of C&Us in regular assessment: Analysis of top remitters

3.10 As mentioned in previous paragraphs, even though the AOs fail to get all the C&Us, they need to correlate the C&Us at the time of assessment because remittances (i.e., expenditure) on which TDS has not been deducted is disallowable as deduction and should be brought to tax. The data contained in an undertaking is largely the same as in the certificate and need for two documents is not clear. Given the large volume of certificates, the ITD is currently unable to link the certificates to each remittance, leave alone identify those CAs who have erred or initiate concerted action against them.

3.11 We collected data from CMIE[40], which lends itself to segregation of forex remittances across four categories *viz.,* interest, royalties, fees for technical services and others to identify top remitters whose remittances were liable for taxation. The assessment records of these remitters were used as a base to determine whether the remittances reflected in their tax returns, were supported by C&Us received in the ITD. Given the poor record management of C&Us, this exercise could be conducted only in select charges.

3.12 The assessment charges in Karnataka and Mumbai reported a high level of processing the C&Us received from ADs. But when we asked for C&Us in support of expenditure claimed by the remitters and allowed by the AOs in regular assessment, we were told that the C&Us were not available with either the AO or the DIT (IT). We could not link the C&Us with the assessments in other charges also because they could not be retrieved. Clearly, the ITD is not equipped to cross-link the TDS deductions on remittances with the C&Us; the processing of e-TDS returns is in difficulty (paragraph 3.16-3.18); the AOs are permitting expenditure incurred in forex without assuring themselves that the tax obligations have indeed been discharged.

Charge: DIT (IT), Chennai AY: 2003-04 & 2005-06
Assessee: Shri Narain Karthikeyan
The assessee, a sports person, remitted training fees of ₹ 2.8 crore and ₹ 10.1 crore to non-residents without making TDS. But the remittance was not disallowed as expenditure.

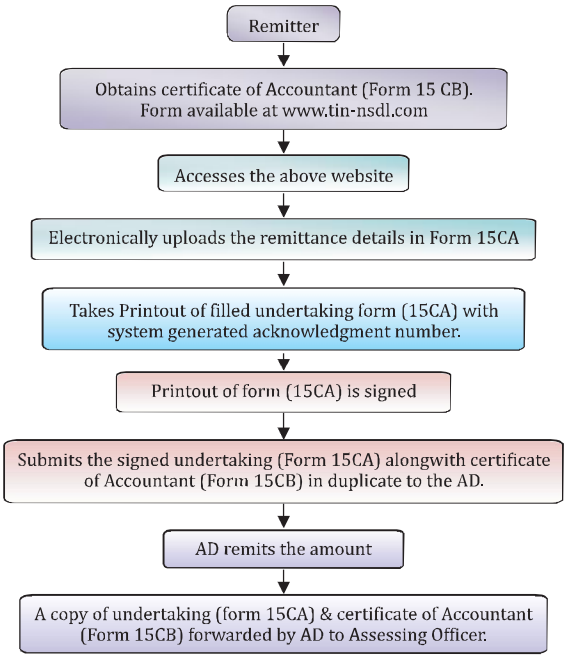
[39] Section 69 of the Act provides that where any expenditure is not explained by the assessee, such amounts may be brought to tax
[40] Centre for Monitoring Indian Economy

3.13 The documentation sought by ITD is two fold: an undertaking from remitter and a certificate from a CA for every transaction. The certificate from a CA is essentially a substitute to the earlier requirement of a no-objection certificate[41]. The requirement adds to the cost of compliance of the remitter as also to the bulk of documents without seeming to serve any effective purpose.

Electronic filing of undertakings

3.14 The process of submission of C&Us has been partly automated since July 2009[42]. The new process (summarized in Chart 5) provides for electronic uploading of the undertaking by the remitter on the ITD's server. The ADs will remit the moneys only on submission of the system generated undertaking. However, the ADs will continue to manually send a copy of the C&Us to the ITD. In our opinion, this step towards automation can help in tracing a particular remittance as also in correlation of remittances with TDS returns. However, a few gaps in the process limit the correlation. Exception reports on the tax rates or quantum of tax that was to be deducted can be generated from a database of undertakings only if the undertaking captures the purpose of remittance (each purpose attracting different rates of taxation) and on whether the remittance is covered under DTAAs. The purpose (of remittance) is not captured under alphanumeric codes in the undertaking. Synchronizing this field with the RBI allotted purpose codes could facilitate such correlation. In addition, the linkages designed to integrate the electronically filed undertaking with the e- filed TDS returns, currently not defined, must be established.

Chart 5: Flow chart of filing undertaking form u/s 195 of IT Act 1961



3.15 We found that the departmental formations in Assam, Punjab, UT Chandigarh and Chennai were unable to access the undertakings which had been electronically filed by the remitters and there was no mechanism for the department to process the same. In Gujarat there were no access issues but they were not being used.

[41] Previously, the remitter was required to obtain the ITCC (Income Tax Clearance Certificate) for each and every forex remittance, which was even more cumbersome. The requirement of C&U was a step towards voluntary compliance by the remitters.
[42] Circular No. 4 of 2009, dated 29.06.2009

Processing of TDS returns

3.16 Though there is no specific time period for processing and assessment of the TDS returns filed, it has been judicially held[43] that action is to be initiated by the competent authority under the Act within a period of four years.

3.17 We found that several field formations[44] in ITD are unable to process the e-filed TDS returns mainly because of problems in online matching of the tax deposit (after the TDS deduction) with the PAN of the remitter. There were also problems of access to AOs in newly created posts. For instance in Kerala access to the TDS returns was given only to officers under regular assessment charges whereas jurisdiction of non-residents had been transferred to the newly created DIT (IT) office.

3.18 e-TDS application is designed to verify the fulfillment of conditions prescribed in the direct tax laws, and throw up mismatch reports where the data filed by the deductors is incomplete or incorrect to enable department to initiate further action. We found that all the parameters necessary for processing of e-returns involving application of DTAA provisions, are yet to be made functional. The Department replied (June 2009) that owing to the complexities of DTAA provisions, it has not been possible to build in all the parameters in the existing e-TDS software.

Streamlining the process: Issues and solutions

3.19 Our assessment on the controls on taxation of forex remittances is that it is currently weak. The burden placed on the ADs would become more difficult with the increasing volume of transactions. It is evident from Chart 2 that the transactions are increasing at a substantial rate. The controls in ITD are unviable too as the C&Us are too voluminous to be correlated to detect tax evasion. The huge tax gap (discussed in paragraph 2.6) further vindicates this assessment. The Committee on Procedures and Performance Audit on Public Services (CPPAPS) constituted by the Ministry of Finance[45] also concluded (2007) that the provisions for TDS are "very onerous and are met only in the breach". Add to this the issues thrown up in the DTAAs and judicial decisions; taxability of an international transaction is a virtual conundrum to be solved.

3.20 The amount of tax gap is too huge to be ignored and calls for an assessment of the contributing factors. The IT Act and the DTAAs together provide for various exemptions to incomes arising to non-residents which are currently, un-quantified in terms of revenue foregone. In an earlier study, we had pointed out the need for a re-look on the exemptions. The Working Group for 'Study of Non-Resident Taxation' had in its report[46] also recommended deletion of various exemptions being extended to non- residents. As incomes exempt arising to non-residents in India would be liable for

[43] CIT Vs NHK Japan Broadcasting Corporation [2008] 305 ITR 137(Delhi)
[44] Andhra Pradesh, Assam, Chandigarh, Delhi, Karnataka, Kerala, Madhya Pradesh, Punjab, Rajasthan and Tamil Nadu
[45] Report No 1 for Examining Exchange Control relating to individuals
[46] Submitted in 2003

tax in the host country/country of residence of the recipient, these exemptions would not affect the recipient but mainly benefit the host country. And India has DTAAs with all the major investing countries.

3.21 We compared the tax rates in different countries to assess whether the tax differential is leading to greater tendency among foreign investors to escape taxation in India and opt for it in their resident country. The corporate tax rates in countries range from 20 to 30 *per cent* (of their net business income). The TDS rates in India of 10-20 *per cent* (on gross receipts) would be much higher than the tax rates in resident countries.

3.22 We feel that a lower flat rate of tax applicable across streams of incomes irrespective of destinations would be workable alternative. This would be easier to implement on the part of ADs as well as the ITD. It would facilitate greater taxpayer compliance, reduce cost of doing business in India and also reduce disputes. This lower rate if incorporated in the Direct Tax Code (DTC), would thus override all other rates provided in the DTAA and would not require re-negotiations with other countries.

Recommendations

- *We are of the opinion that a flat and lower tax rate applied to all payments regardless of their purpose or destination, will be a more viable alternative to administer- for the ITD as well as the banking sector;*

  The CBDT stated that under the existing provisions of domestic law and DTAAs the income liable to tax and the rate of tax varies from case to case. The decision of withholding flat and lower rate of tax to all the payments cannot be taken up unilaterally as most of withholding tax is governed by DTAAs. It was further emphasized that there is a limit to simplification of the statutes and oversimplification in the direction of taxation on gross basis would not be feasible in the domestic context and would not be appreciated in the international context.

  We are of the opinion that CBDT may simplify and rationalize the procedures to the extent possible so that they are easily understandable and implementable. As non residents can opt for the domestic law (Income Tax Act, 1961 or DTC, 2010) or DTAA which ever is beneficial, a clause in DTC would in no way need renegotiation of DTAAs with other countries.

- *Since processing each C&U is not feasible, an automated solution that sifts out error reports from e-filed undertakings is recommended. This would require that the purpose codes of RBI are adopted by the ITD and integrated into the automation. We are of the opinion that this will also facilitate reconciliation of data with RBI;*

The CBDT stated that the suggestion requires further analysis considering the practicability of harmonizing purpose codes of RBI with DTAAs and tax rates contained therein. Electronic filing of C&Us has been introduced only during the last year. Feedback from all stakeholders would be obtained before streamlining the process.

We are of the opinion that the automated system may be made more robust so as to enable field based exception reporting instead of limiting itself to being a view based database of C&Us.

- *The e-TDS returns must also provide data on all remittances, even those with null value for TDS and must also capture the purpose codes;*

The CBDT stated that the integration process would require change in rules and agreed to consider the suggestion while framing rules under the DTC.

CHAPTER 4

SECTORAL ANALYSIS

Foreign Institutional Investors

Telecom Payments

Shipping Sector

Recommendations

CHAPTER 4

Sectoral Analysis

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.

4.1 The taxation of payments to non-residents involves monitoring the tax liability of assesses operating in different sectors of the economy. We selected three sectors to seek an assurance that the ITD is alive to the new challenges in these sectors.

Foreign Institutional Investors

4.2 As on 31.12.2009, there are 1651 Foreign Institutional Investors (FIIs)[47] registered in India. FIIs can participate in the primary and secondary capital markets and acquire shares/debentures of Indian companies through the stock exchanges in India.

4.3 Classification of income earned by FIIs as capital gains or business income has been a contentious issue. The preferred option of the tax payer FII would depend on the tax residency of the FII and the applicable DTAA. FIIs operating through Mauritius, Singapore, UAE and Cyprus would prefer their incomes to be treated as capital gains as against business income. This is because these countries exempt capital gains from tax while the DTAAs with these countries provide that the capital gains will be taxed only in the country where the assessee is resident. On the other hand, a FII resident in other countries would prefer to have its income treated as business income since it will be liable for taxation only if it has a PE, i.e., a physical existence, in India. When operating without a PE, it can escape taxation.

4.4 The departmental instructions do not provide clarity on this issue. The ITD circular of 2007 had directed that while ordinarily trading in shares would yield capital gains and not business profits, the AO must use his judgment to segregate the stock holding of the FIIs into those for 'investment' and those as 'stock-in-trade'. But

[47] Source Securities & Exchange Board of India (SEBI)

a FII operates in India within the ambit of permission granted by SEBI, which is for investment activities and not for business. We are therefore of the opinion that income of FIIs must be treated as capital gains regardless of whether the FII categorizes its stock holding as investment or stock-in-trade. Simultaneously, the Department needs to safeguard the loss of revenue in respect of the FIIs operating from Mauritius, Singapore, UAE and Cyprus who are going out of the tax net on account of the DTAA provisions.

Charge: DIT (IT), Delhi, AY: 2005-06, Assessee: ITF Mauritius

The assessee made 27 remittances of ₹ 190 crore to Mauritius. Since the remittance was treated as capital gains, no tax was deducted at source. We found that the assessee was a sub-account[48] of a foreign institutional investor-Venus Capital Management Inc[49], a tax resident of USA. If the beneficial owner was from USA and capital gains is taxable in India under the Indo-US DTAA, the grounds for exempting the remittance from TDS by treating the company as a resident of Mauritius, is not clear.

4.5 We found that FIIs use this ambiguity to get advance rulings[50] for treating gains from capital markets as business income. ITD had argued for their treatment as capital gains in AAR but had not appealed against these rulings. The department went further and applied the AAR ruling to other assessments (although AAR was for a particular transaction), resulting in under-charge of tax of ₹ 87.8 crore in 5 cases[51]. ITD accepted our opinion and levied ₹ 40.3 lakh in one case[52] ; replies on the other cases were awaited.

4.6 In respect of those assessments of FIIs where the income was treated as capital gains, we found errors in 7 cases[53] in Mumbai charge that led to under-charge of tax of ₹ 23.6 crore. ITD accepted our opinion and rectified two assessments. One case is illustrated:

Charge: DIT (IT), Mumbai, Maharashtra; AY: 2006-07
Assessee: Platinum Asset Management LTD. (A/C Platinum Asia Fund)

The loss of ₹ 93.3 crore arising from speculative activity to the assessee was incorrectly set-off against taxable short term capital gains resulting in short levy of tax of ₹ 10.6 crore including interest.

[48] Sub-account includes those foreign corporates, foreign individuals, and institutions, funds or portfolios established or incorporated outside India on whose behalf investments are proposed to be made in India by a FII.
[49] Registration No 2006514. The Company is registered with the Securities & Exchange Commission in the United States as a Registered Investment Advisory Company in 2000.
[50] In order to provide the facility of ascertaining the Income-tax liability of a non-resident, to plan their Income-tax affairs well in advance and to avoid long drawn and expensive litigation, a scheme of Advance Rulings has been introduced under the Income-tax Act, 1961. The Authority for Advance Rulings (AAR) consists of a Chairman who is a retired Judge of the Supreme Court and two members of the rank of Additional Secretary to the Government of India, one each from the Indian Revenue Service and the Indian Legal Service.
[51] Name of Assessee and nature of assessment: Prudential Assurance Co Ltd(Scrutiny), Indivest Pvt Ltd,18 sub accounts of Fidelity Group(Annexure)Summary, BNL Global Emerging Markets(Summary), Prudential Pension Ltd(Summary)
[52] Prudential Pension Ltd
[53] Platinum Asset Management Ltd A/c Platinum Asia Fund; A/c Platinum International Brands Fund; A/c The Platinum Master Portfolio; Carlson Fund Equity; Tennessee Consolidated Retirement System; Bank of America Singapore Ltd; Citicorp Investment Bank (Singapore) Ltd.

Telecom Payments

4.7 Increased trans-country travel has introduced complex revenue sharing arrangements between telecom companies. A phone call between subscribers to two different networks usually means that both networks require a payment for carrying the call. The charges include:

Table 6: Forex payments towards telecom usage

₹ *in crore*

Year	2003-04	2004-05	2005-06	2006-07	2007-08
	3547	3298	1285	3589	3459

Source: RBI Monthly Bulletin March 2009

- *Roaming charges*: Charge paid by the local telecom company for extending the connectivity service to its customer in the foreign country
- *Termination charges*: Since the originator of the call pays the full cost, the network from which the call originates pays the termination charge to the network on which the call terminates
- *Connectivity charges*: Charges payable by the local telecom company to the foreign service provider for usage of the network elements for origin, transit and termination of calls
- *Bandwidth charges*: The charge for signal transmission through satellite transponders for uplinking and downlinking[54] of signal and data.

4.8 The disputes have arisen on whether these payments to foreign telecom companies are liable to TDS in India. This has led to conflicting approaches within ITD. The Department has not issued clarificatory orders to remove ambiguities or approached the higher courts to overrule prejudicial AAR rulings.

4.9 In the recent past, the Income-tax Appellate Tribunals (ITAT) have provided greater clarity on the taxability of telecom payments. ITAT, Hyderabad held (October 2008) that connectivity charge was paid for use of equipment and not a 'rendition of service'; hence, it falls within the ambit of royalty. A special Bench of ITAT constituted to resolve two[55] conflicting decisions of the Delhi ITAT also held (October 2009) that bandwidth charges also fall within the ambit of 'royalties'. It is interesting to note that the Department before the AAR (in the case of Dell International Services Pvt Ltd[56] and in the case of Cable & Wireless India Private Limited[57]) had also contended that services provided by telecom companies were in the nature of technical services liable for taxation in India as fees for technical services. Nevertheless, conflicting approaches continue within ITD.

[54] Uplinking is the portion of the communication link used for transmission of signals from an earth terminal to a satellite. A downlink is the inverse of an uplink

[55] Asia Satellite Telecommunications Co. Ltd. *v* DCIT(2003)85 ITD 478(Delhi ITAT) and DCIT *v* Pan Am Sat International Systems Inc.(2006) 9 SOT 100(Delhi ITAT)

[56] Authority for Advance Ruling vide a ruling dated 18th July 2008 AIT-2008-236-AAR has held that amount of fixed monthly recurring charges payable under Agreement, for the circuit between America and Ireland and for the circuit between Ireland and India is not liable to be treated as fee for included services or royalty under DTAA between India and USA.

[57] AAR No 786 of 2008.The AAR has held that in carrying telecom signals, Cable & Wireless Networks India Private Ltd UK had not provided any managerial, technical or consultancy service, nor is it providing the services of its technical or other personnel to the applicant and hence the same is not taxable as fees for technical services. The arrangement between Cable & Wireless Networks India Private Ltd and Cable & Wireless Networks India Private Ltd, UK was for rendition of services and telecom services were standard services.

Charge: CIT I Chennai, Tamilnadu, AY: 2004-05 to 2006-07
Assessee: Aircel Cellular Ltd
The assessee was exempted by ITD from TDS on remittances towards roaming charges. The tax along with interest amounting to ₹ 4.7 crore was not deducted at source. The AO justified the exemption on the ground that payments made were for services rendered abroad and would not fall under the ambit of 'royalty' or 'fees for technical services'.

Similarly, TDS of ₹ 12.8 crore was not deducted (by **Dishnet DSL Limited** for three AYs 2003-06) though the certificate issued to the assessee clearly stated that bandwidth charges were classifiable under 'fees for technical services' and hence, tax was deductible

4.10 Our checks on C&Us threw up 5 other cases where remittances aggregating to ₹ 172.5 crore were made without deducting TDS of ₹ 19.8 crore.

Shipping sector

4.11 A non-resident shipping company is taxed on a presumptive basis (whereby 7.5 *per cent* of the charges received by the company will be taxed). The master of the ship is required to submit tax returns before setting sail from the Indian port. Alternatively, he could undertake to submit tax returns within 30 days and collect a no-objection certificate (NOC) from ITD before the journey. ₹ 20879 crore and ₹ 30103 crore were remitted to non-residents engaged in shipping during 2007-08 and 2008-09 respectively.

4.12 Our earlier study on taxation of the shipping sector[58] had raised concerns on tax evasion in the absence of effective co-ordination between various government authorities. We referred our findings to the Departments of Revenue and Shipping in the Government of India; an assurance that the risks have been addressed is yet to be received. Our main findings were:

- *The ITD's records on the number of ships leaving Indian ports were substantially lower than that in the records of the Port Trusts. There was wide variation between ITD's data and of the Customs authorities on the tonnage carried in these ships. Such reconciliation was also important to segregate domestic cargo (cargo that will be offloaded within India) from those that embark in foreign seas. DTAA relief can be claimed only for international cargo;*
- *We found instances where ships were cleared for voyage without having applied for NOC or filed tax returns; and where NOCs were issued without proper documentation or proof of payment of TDS;*
- *Relief under DTAAs should be based on the provisions of the specific DTAA and after clearly establishing the nationality of the freight beneficiary. The labyrinthine trails of ownership and of transactions make this process difficult. Foreign ships obtain NOCs by invoking nationality of the flag or the shipper or the charterer or the sub-*

[58] Review on exemptions, deductions and allowances to shipping and related sectors : Performance Audit Report No.25 of 2009

charterer or the owner of the ship- whichever is most beneficial. We found several instances of incorrect relief leading to tax evasion;

- *It is logical that a taxpayer can claim relief under DTAA if he is liable for taxation in the country of residence*[59]*. We found that there was no consistency in the taxation of shipping profits arising to residents of countries where there is no tax on shipping income.*

4.13 In 3 cases[60] in Kolkata, Mumbai and Chennai charge, there was an undercharge of ₹ 14.5 crore owing to incorrect treatment of shipping income. One case is illustrated below:

Charge: DIT (IT), Mumbai, Maharashtra: AY 2006-07
Assessee Delmas France
The assessee carried out operation through a PE in India and therefore its income from shipping activities was brought to tax in AY 2001-02. However, the same was not done in AY 2006-07 resulting in escapement of income of ₹ 4.1 crore and short levy of tax of ₹ 2.3 crore. Department accepted the observation and initiated remedial action (February 2009).

Recommendation

- *We recommend that sectoral studies may be conducted by ITD to identify the avenues of revenue leakage as well as flag ambiguities in emerging areas;*

  The CBDT stated that sectoral studies are an ongoing process and suggestions in the report have been noted.

[59] AAR ruling in the case of Cyril Eugene Periera also held that "a taxpayer cannot claim relief from a non-existent burden of double taxation (which would be the case, if he is not liable to pay tax in the country). DTAA is meant only for the benefit of taxpayers who are liable to pay tax twice on the same income".
[60] Delmas France(Mumbai DIT (IT) charge), Diamond Shipping Company Limited(CIT Kolkata charge) and Bengal Tiger Line India (Pvt) Ltd. (BTL India) (CIT-I, Chennai)

CHAPTER 5

MISTAKES IN ASSESSMENTS

Relief under DTAA

Other mistakes in assessments

Recommendations

CHAPTER 5

Mistakes in assessment

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.

I Relief under DTAA

Double Taxation Avoidance Agreements entail tax benefits to assesses of other countries. This needs to be weighed against the principle of reciprocity. Several instances of incorrect allowance of the benefits under DTAA by the Department have come to light during audit.

5.1 Relief to entities that are not taxed in the resident country

Charge: DIT (IT), Mumbai, Maharashtra; AY: 2006-07
Assessee: Chiron Behring Gmbh & Company KG

DTAA is meant only for the benefit of taxpayers who are liable to pay tax twice on the same income. A taxpayer cannot claim relief under DTAA if he is not liable for taxation in the country of residence

The assessee was a limited partnership firm which was not liable to tax in Germany. In AY 2005-06, the AO denied the benefit of Indo-German DTAA relief to the assessee on this ground and taxed royalty income. However this principle was not followed in AY 2006-07 resulting in short levy of tax of ₹ 48 lakh.

Charge: CIT I, Chennai, Tamilnadu; AY: 2005-06
Assessee: West Asia Maritime Ltd.

The assessee paid ₹ 193.3 crore to Emirates Trading LLC UAE, for chartering vessels on which tax was not deducted at source. Payments towards charter hire charges partake the character of royalty under Section 9. Further, Emirates Trading Agency LLC, UAE is a company incorporated in UAE. There is effectively no tax on shipping income derived from shipping business in UAE. Tax deductible at source along with interest worked out to ₹ 59.8 crore.

5.2 Treatment of companies with a PE

Charge: DIT (IT), Chennai, Tamilnadu; AY: 2003-04
Assessee: Qualcom India Inc

Article 7 of the Indo-US DTAA provides that profits attributable to a PE in India will be taxed in accordance with the Indian tax laws. Under the Income Tax Act, a foreign company with a PE in India will be taxed on a presumptive basis on its gross receipts.

The assessee did not offer any business income, but debited expenditure relating to engineering and technical services in the accounts. Instead of being taxed on a

presumptive basis on the gross receipts, the assessment was completed by invoking the normal provisions of the Income Tax Act and the assessee was allowed to carry forward business loss of ₹ 3.1 crore. This led to potential undercharge of ₹ 1.3 crore.

Charge: CIT I, Chennai, Tamilnadu; AY: 2003-04 to 2006-07
Assessee: CEX ONYX India Pvt. Ltd

Section 44DA of the Act provides for assessing income being fees for technical services as Business Income.

The assessee had remitted fees for technical services to Onyx Asia Services Ltd Singapore, a foreign company on which tax was deducted (@20/10%). But as this income arose from a PE, the income should have been assessed as business income under Section 44DA and taxed (@ 40%). Short levy worked out to ₹ 1.7 crore.

Charge: DIT (IT), Mumbai, Maharashtra; AY: 2005-06
Assessee: J. Mcdermott Eastern Hemisphere Ltd

Article 5 of Indo Mauritius DTAA provides that PE includes a mine or gas well and a site of assembly or supervisory activities. Section 44BB of the Income Tax Act provides that where a non-resident is engaged in the business of providing services or facilities used in the business of extraction or production of mineral oils then 10 *per cent* of the amounts received by it shall be liable for tax.

The assessee was in exploration business and its income was brought to tax in earlier AYs on the ground that it had a PE in the country. In AY 2005-06, its income was exempted from tax on the ground that income earned from execution of contracts was exempt from tax under Indo-Mauritius DTAA. This resulted in short levy of tax of ₹ 5.7 crore. Department initiated remedial action after we raised the issue.

5.3 Computation of capital gains

Charge: DIT (IT), Kolkata, West Bengal; AY: 2005-06
Assessee: Century Enka Ltd

Article 13 of Indo Netherlands DTAA provides for taxation on capital gains of a Dutch Company in India if the gains were made from transfer of shares in India. While computing the capital gains arising to a non-resident from transfer such shares, the benefit of indexation is not allowable.

Accordis Overseas Investment BV, Netherlands derived long term capital gains of ₹ 57.9 crore on buyback of shares by Century Enka Ltd. Assessee had made the remittance to the non resident after deducting tax of ₹ 12.1 crore at source. We found that the capital gains had been worked out by allowing cost of indexation which was against the provisions of section 48. The mistake resulted in short levy of tax of ₹ 8 crore.

5.4 Exemption from tax

Charge: DIT (IT), Chennai, Tamilnadu; AY: 2005-06
Assessee: Caterpillar India Pvt Ltd

Income Tax Act provides that the 'fees for technical services' received by foreign companies shall be taxed at 10 *per cent*. Reimbursement of payments to technical staff also forms fees for technical services. Article 23 of DTAA with USA & UK provides that incomes not covered under the articles of DTAA, will be charged under the head 'other income'

The assessee made payments to technical and non-resident staff belonging to Hong Kong, China, USA and UK without deduction of tax at source. Though these payments partake the nature of technical services[61], no tax was withheld on the basis of an exemption certificate from the ITD. The tax deductible was ₹ 1 crore. The department held that it is not possible to revoke an exemption order; hence no remedial action was possible. We are of the opinion that exemption certificate is only an interim measure and is subject to final assessment.

II Other Mistakes in Assessment

We found mistakes in 87 cases involving short levy/non levy of tax amounting to ₹ 250.8 crore. A few are illustrated below:

Charge: DIT (IT), Mumbai, Maharashtra; AY: 2004-05
Assessee: Unilever HPC Finance Services Inc. USA

The case of Vodafone, established the principle that even if the financial transactions occur abroad, if they relate to assets in India, they will be taxed in India.

The assessee purchased shares of an Indian company, Hindustan Lever Ltd from Conopco Inc. USA ₹ 1018.5 crore. The consideration was paid directly in USA by Unilever Finance Services Inc. USA to Conopco Inc. USA without deducting tax at source. This has resulted in non compliance of TDS provisions. Failure of the department to take cognizance of this fact resulted in non levy of tax recoverable of ₹ 181.6 crore including interest under section 201(IA) of ₹ 76.9 crore. On this being pointed out by audit, department issued notice to the assessee (March 2009).

[61] AAR in the case of AT & S India Pvt. Ltd.(2006) 157 Taxmann 198

Charge: DIT (IT), Mumbai, Maharashtra; AY: 2003-04
Assessee: Reliance Industries Ltd (RIL)

Section 10(15) of the Income Tax Act provides that interest payment is exempt from tax if (a)the loan is taken by an industrial undertaking in India, (b) the money is borrowed in foreign currency from sources outside India and (c) under a loan agreement approved by the Central Government

The assessee had, in the capacity of an agent of Deutsche Bank made interest payments to foreign financial institutions. An earlier exemption from income tax on such interest payments, was withdrawn (2002) by ITD owing to non fulfillment of conditions of section 10(15). Yet, the TDS deducted from the interest payments was quantified as refundable to RIL. When we raised the issue, ITD expressed its inability to rectify the assessment of RIL on the ground that it was only an agent. It instead reopened the assessment of the branch office of Deutsche Bank. Instead of taxing the payments afresh, ITD gave the credit for the TDS deducted by RIL without taking into account the fact that the TDS credit of ₹ 10.9 crore was allowed as credit to RIL. This has resulted in undercharge of tax of ₹ 10.9 crore.

Similarly in two other instances, the assessee (in the capacity of an agent of D.B Services and Credit Lyonnais) claimed the interest payments to foreign financial institutions as exempt under section 10(15) and claimed refund of ₹ 29.3 crore. The claim was accepted in the summary assessments. On being pointed out ITD reopened the assessments of the branch offices of D.B Services Tennesse Inc and Credit Lyonnais.

Charge: DIT (IT), Mumbai, Maharashtra; AY: 2003-04 to 2004-05
Assessee: B4U International Holdings Ltd

Section 72 allows carry forward and set off of business losses pertaining to an assessment year to the subsequent assessment years.

The assessee was allowed carry forward of ₹ 42.5 crore as unabsorbed loss of AYs 2001-02 and 2002-03. We found that there were no losses to be carried forward for these AYs. Of the total carried forward loss, ₹ 17.7 crore was set-off against profits of AYs 2003-04 and 2004-05 and the unadjusted loss of ₹ 24.9 crore was allowed to be carried forward. This led to short levy of tax of ₹ 20.0 crore including potential under-charge of ₹ 10.2 crore. Department rectified the assessment in July 2008.

Charge: DIT (IT); Mumbai, Maharashtra; AY: 2004-05 to 2005-06
Assessee: M. Fabrikant and Sons INC, Mumbai

Section 14A of the Act seeks to tax expenditure incurred on earning exempted income

The business expenses incurred in earning income that is exempt from income tax, is not deductible. However, the expenses were not disallowed resulting in excess carry forward of loss of ₹ 5.4 crore involving potential short levy of tax of ₹ 2.3 crore. Department accepted and rectified both the assessments in March 2009.

Recommendation

- *We recommend that responsibility for material errors in assessments should be clearly fixed to reduce their incidence;*

  The CBDT stated that the ITD has been making sincere efforts for proper training and skill development of its personnel to reduce incidence of mistakes.

New Delhi **(MEENAKSHI GUPTA)**

Dated **Director General (Direct Taxes)**

Countersigned

New Delhi **(VINOD RAI)**

Dated **Comptroller and Auditor General of India**