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SPECIAL ISSUE ON DIRECT TAX SYSTEM

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The Institute of Public Auditors of India (IPAI) was established in 1996, with the Comptroller and Auditor General of India as its ex officio patron, primarily with the objective of spreading public awareness on accountability in governance and tapping the experience and expertise of audit and accounts professionals in assisting public authorities to improve accounting, auditing and financial management practices.

IPAI has established its credentials in the areas of inquiries, internal audit and investigative examination, regulatory inspections, monitoring and evaluation of programmes/schemes /projects, Outcome studies, internal controls and governance appraisals, management consultancy on behalf of the Union and State governments, autonomous organizations and local bodies.

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CONTENTS

FROM THE DESK OF EDITOR-IN-CHIEF

A sovereign's power to tax is the ability to extract a share from the earnings (in cash or kind) of sub-sovereigns and ordinary subjects. Taxes are compulsory imposts to be paid voluntarily, without demur, under threat of coercive State power, and without expecting a direct and matching personal benefit to the taxpayer by the State. The *quid pro quo* is at a community level as the State provides security and order.

History of taxation is a chronicle of growth of democracy worldwide. Popular resistance and quest for legitimacy by the taxing sovereign have resulted in a steady pursuit of fair, reasonable, predicable, rule-based tax system that limits the arbitrary powers of taxation. Efficiency, equity and ease of collection from a large well-spread out tax base are widely recognised principles of prudent taxation.

The British monarch conceded limits on taxing power ("*No scutage nor aid shall he imposed in our kingdom, unless by the common council of our kingdom; excepting…. unless a reasonable aid shall be demanded.*" - Carta Libertatum of King John, 1215[1]). Popular protests against unjust tax policies of colonising powers have had profound influence on eventual downfall of colonialism. The Boston Tea Party protests and 'No taxation without representation' becoming a war cry in the American War of Independence are apt to note. Closer home, defiance of salt tax laws (Dandi March by Gandhiji) under civil disobedience movement ushered mass mobilisation against colonial rule.

In SATYUGA, the era of reigning virtue, Raja Harishchandra was tasked to implement rather simple and strict rules to collect certain levies, with no exemptions and concessions. However, modern taxation systems create room for differential tariffs, exemptions and concessions in search for equity. The 'District Collector' once entrusted to collect all types of taxes continues to be one of the most important governance institutions with a mutated role; the central taxes being collected by dedicated cadres. The taxpersons face enormous risks of being overpowered and outsmarted by scheming tax evaders. They also face resistance against what is perceived as unjust and oppressive tax demands under unclear tax laws.

Differential rates create room for disputes and tax planning, both tax avoidance and tax evasion. If incidence of tax burden differs for income originating in different geographies, enough smart brains will scheme up to try to show on paper how most of the income is actually emanating from low-tax geographies. If agricultural income is taxed at lower rates, many will be scheming to show non-agricultural income as 'agricultural income' by concocting stories.

We have had fine legal brains arguing in our top court whether coconut is a vegetable, fruit or oilseed! We still live in times where a recent judicial verdict dwells upon the issue whether mobile towers are 'immovable property' as per legal definition. The weight of issue is

[1] CARTA LIBERTATUM (THE CHARTER OF LIBERTIES) OF KING JOHN Granted June 15th AD. 1215 https://www.bsswebsite.me.uk/History/MagnaCarta/magnacarta-1215.html

such that it can decide whether government can demand some Rs.5000 crore in GST arrears for 'wrong availment of input tax credit' or not. We have taxed differently the tyres used in cars and bullock carts without enough taxmen to chase and inspect bullock carts.

We expect tax collectors to act like Raja Harish Chandra, ruthlessly demanding payment of due levies, sparing none. On the other hand, there is increasing realisation that a heavy handed approach in taxation can scar / scare investors and may even kill the goose that lays the golden eggs.

The subject of taxation is vast, enriched by the intellect and experience of policymakers, taxmen, tax dodgers, lawyers, accountants, auditors and jurists, whose collective and cumulative wisdom and perhaps vested interests have kept the tax laws and their implementation system incredibly puzzling, complex and verbose, as seen by the proverbial common man.

The tax reforms have been one of the most successful aspects of public finance reforms in India and the audit by the CAG of India has also played a key role in these reforms. We have provided an overview of the evolution of 'Revenue Audit' by the CAG and the major issues for Audit together with a hyperlinked list of CAG Reports on direct taxes.

Another article in this monograph provides a macro view and commentary on the trend and profile of Central government' total tax revenue from 1970-71 onwards. The share of direct taxes in total tax revenue is a prime indicator of how progressive a country's tax system is. We find that the tax system has become broad based and relies more on direct taxes – from 17% share in total tax kitty in FY71 to 56% in FY24 which is set to increase to 59% in BE25-26 despite major relief to small taxpayers. In fact, the direct taxes overtook indirect taxes after 2007-08. We attempt to fathom the reasons for the relative increase in the share of Corporate Income Tax and decline in the share of Customs Duty in recent years in the total tax collections by the Union government.

Then we present a synoptic overview of the journey of reforms in the system of direct taxes - highlighting how the direct tax policy, law and administration has evolved over decades. Technology has played a major role in reforming our direct tax system improving tax yield and taxpayer facilitation.

The corporate incomes are typically characterised as large but uncertain. The taxation of corporate income implies taxation of the shareholders of the corporates. The reforms in recent years have led to a reduction in the burden and share of corporate tax and an increase in the contribution of personal income tax with overall moderation in the incidence of tax on the corporate shareholders providing the 'risk capital'. An article dwells upon how the differences between the personal and the corporate tax regime have played out in arriving at this scenario, having regard to the inherent risk and uncertainty in business profits.

Other articles focus on taxation of foreign companies having business interests in India. Aggressive tax planning by transnational companies becomes a global concern in a world where Tax:GDP ratios range from 5 percent to 50 percent reflecting different levels tax-and-spend political ideologies across countries, wide variation in per capita incomes within countries and among countries. India along with other developing countries have had to contend with foreign companies making profits in provision of goods and services to Indian consumers directly or through a web of intermediary companies as convenient to resort to what can be called tax evasion, avoidance or smart tax planning depending on the side taken by the commentator. There have been instances where foreign companies bought controlling stake in Indian companies through transactions effected in tax heaven countries, thereby gaining control on revenue stream from Indian consumers. Indian subsidiaries and joint venture companies of foreign companies have also sought to reduce their tax liability by claiming excessive expenses by way of their foreign expenses including royalty / license fee for intellectual property and license to manufacture payable to overseas parent companies.

The Organisation for Economic Co-operation and Development (OECD) has for decades been continuing with a campaign against tax dodgers who devise ways and means of shifting their income/profits from high tax jurisdictions to low-tax jurisdictions, register companies and ships in zero-tax 'tax heaven' countries. The 2021 treaty sponsored by the OECD that *inter alia* requires the countries to impose a tax at the minimum rate of 15 per cent of corporate profits is yet to materialise.

We have attempted to highlight how the direct tax system has evolved to reach the current level of maturity; the extensive use of digital technologies in how the taxes are assessed, collected and accounted for; and how the economy, efficiency and effectiveness of the system of tax administration in meeting the tax policy goals is audited by the Comptroller and Auditor General of India. Some niche areas of corporate taxation have been spotlighted. Who and what should be taxed, at what rate and what exemptions and concessions should be there for any class of taxpayers is not the primary focus of this monograph. These are all matters of tax policy debates, with copious data and arguments that would require another monograph.

We hope that this volume would provide useful takeaways to our members auditing Union taxes as well as to the researchers of public finance in India.

The Governing Body of the Institute does not bear any responsibility for the contents or views expressed in the articles. That responsibility lies mainly with the authors.

SUBHASH CHANDRA PANDEY

REVENUE AUDIT MANDATE OF THE COMPTROLLER AND AUDITOR GENERAL OF INDIA

SHUBHA KUMAR[2]

The tax reforms have been one of the most successful aspects of public finance reforms in India and the audit by the CAG of India has also played a key role in these reforms. This article briefly outlines the evolution of 'Revenue Audit' mandate of the CAG; major issues and concerns in the audit of direct and indirect taxes. Findings and recommendations of the CAG in the area of audit of direct taxes over last two decades are highlighted in an Annexure.

1. The Revenue Audit by the Comptroller and Auditor General of India (the CAG) mainly started after 1960 with audit of income tax. Prior to 1971, the CAG of India had no mandate to audit the government receipts *suo moto*. A sea change was ushered in 1960 when the resistance from the Income Tax Department to audit by the CAG was overcome through agreement. The evolution of the mandate of the CAG over time is interesting to recall.

2. In 1858, a separate department under an Accountant General responsible for accounting and auditing financial transactions of East India Company was created. The first Auditor General of India under the British crown was appointed in 1860. The Auditor General of India was re-designated as Comptroller General of Accounts in 1866 and as the Comptroller and Auditor General (CAG) of India, with responsibilities for both audit and accounts, in 1884. The Government of India Act, 1919 gave statutory recognition to the CAG as the final audit authority in India and was designated as Auditor General in India. The Auditor General's Rules 1921 made specific provision for audit of receipts and in 1924, audit of Customs revenue was entrusted to the Auditor General.

3. The Government of India Act, 1935 strengthened the CAG's independence and status by providing for (i) appointment of the CAG by the King of England, (ii) removal of the CAG from office in like manner and on the like grounds as a judge of the Federal Court and (iii) debarring the CAG from holding any office under Crown in India on vacating the office. The Government of India (Audit and Accounts) Order, 1936 was promulgated detailing the auditing and accounting functions of the CAG. It contained the following provision to allow scope for further expansion in the scope of Revenue Audit by the CAG:-

   (2) The Auditor-General may with the approval of, and shall if so required by, the Governor-General or the Governor of any Province audit and report on-(i) the receipts of any department of the Federation or, as the case may be, of the Province;

4. The Comptroller and Auditor General (Duties, Powers and Conditions of Service) Act 1971 (The CAG's DPC Act), a comprehensive legislation, was enacted to supersede

[2] Ms. Shubha Kumar, IAAS(1985), superannuated as a Deputy Comptroller and Auditor General. She is the Vice President of IPAI and a member of the Editorial Board of IPAI.

the Government of India (Audit and Accounts) Order, 1936 under which the duties of the CAG of India were being governed. Section 16 of The CAG's DPC Act stipulates the following duty of the CAG of India:

> *"16 Audit of receipts of Union or of States- It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit and reports thereon."*

5. The Income tax was introduced in 1860 and underwent major legislative overhaul with the enactment of Income Tax Act, 1922 when the Income Tax was shifted from the provincial to the central government. Another notable feature of the act was that the rules would be outlined by annual Finance Acts instead of the act itself. A new Income-tax Act was passed in 1939.

6. In 1946, for the first time a few Group A officers were recruited directly by the income tax department. Later on in 1953, the Group 'A' Service was formally constituted as the 'Indian Revenue Service'. In 1957, I.R.S. (Direct Taxes) Staff College started functioning in Nagpur, now called National Academy of Direct Taxes.

7. Central Board of Revenue Act, 1963 replaced the 1924 Act and bifurcated the Central Board of Revenue into two distinct Boards to manage the direct and indirect taxes. For the first time an officer from the department became Chairman of the Central Board of Direct Taxes (CBDT) w.e.f. 1-1-1964.

8. CBDT, responsible for direct tax administration, perceived income tax assessments as quasi-judicial functions, arguing that external audits by CAG would undermine their authority and confidentiality. CBDT viewed any external audit of their decisions as encroachments on their quasi-judicial functions. This stance led to prolonged resistance against the inclusion of income tax assessments in CAG's audit mandate.

9. CBDT's reluctance was rooted in concerns over the sanctity of its quasi-judicial functions. Officials feared that CAG audits might lead to unwarranted interference in assessment decisions and compromise taxpayer confidentiality. Additionally, there was scepticism about CAG's expertise in handling the complexities of tax assessments. This stance led to prolonged resistance against the inclusion of income tax assessments in CAG's audit mandate

10. The status quo ante was disturbed when Mr. A.K. Roy, former Revenue Secretary and Chairman of the Central Board of Revenue, was appointed as the CAG of India on15 August 1960. Realising the importance of auditing revenue receipts for comprehensive oversight on government finances, he took up several strategic initiatives. His efforts and persuasion led to dilution of prolonged resistance against the inclusion of income tax assessments in the CAG's audit mandate. A Memorandum of Understanding for audit of income tax receipts and refunds was agreed between the CAG and the Government of India in 1960.

11. With the first-hand experience in tax administration, Mr Roy secured the secondment of a seasoned officer of the Indian Revenue Service, Mr V. Gauri Shankar, to his office and they proceeded to train audit personnel and developing methodologies tailored to revenue audits. Audit of IT assessments & refunds by AsG started in 1961.

12. A comprehensive Revenue Audit Manual was prepared (1962) for capacity building of audit personnel for tax audits. The manual provided standardized procedures and guidelines, ensuring that audits were conducted systematically and effectively, thereby addressing concerns about the CAG's preparedness to undertake such audits. A full-fledged Revenue Audit Wing in the CAG's office was established and from 1963, the CAG started to send separate receipt audit reports.

13. Mr. Roy's strategy emphasized building internal capacity within the CAG's office. By relying predominantly on audit personnel and minimizing dependence on officers from the Revenue Department, he instilled confidence in the department's ability to conduct revenue audits independently. Specialized training programs were initiated to equip auditors with the necessary skills to handle the complexities of tax assessments.

14. To mitigate resistance, Roy introduced pilot audits of income tax assessments. These initial audits were closely monitored, and their reports were vetted at the CAG headquarters. The success of these pilot audits demonstrated the feasibility and importance of revenue audits, gradually reducing apprehensions within the CBDT.

15. The solid foundation laid during 1960-66 under the stewardship of Mr A. K. Roy led to the broad mandate given to the CAG under the 1971 Act – of Systems Audit of government revenues -CAG "*to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue.*"

16. In its early stages, CAG's audit mainly examined individual assessments and pointed out under-assessment of due taxes due to misapplication of law or omission to factor all relevant facts resulting in recovery of taxes short collected. Gradually, the CAG's regular audits have gone beyond pointing out individual instances of under-assessments and mistakes or errors in application of tax statute and rules by assessing officers and looked at broader systemic issues, including gaps and loopholes in the tax laws, rules, regulations and administrative system that were exploited by tax dodgers. Audit comments and recommendations ushered in crucial amendments to prevent leakages or tax avoidance, though not always explicitly attributed to the CAG's audits.

17. The CAG audits gradually progressed to challenging domains culminating in audit products on very specialised areas and sensitive subjects such as Voluntary Disclosure of Income Scheme, 1997; Double Taxation Avoidance Agreements; Restructuring of Income tax department; Efficiency of assessments of subjects like Minimum Alternate Tax; tax refunds and tax arrears; and taxation in specific sectors such as Gems and Jewellery, Charitable Institutions, Hospitals, Entertainment, Goods and Service tax, Mining, exemptions under custom duty and so on.

18. In planning; execution and reporting in revenue audit, there have been two enduring issues. First is about giving due consideration to quasi-judicial and judicial pronouncements in tax matters and the second is about having access to all the records and information connected with tax administration and the ability to extract/analyse digital data. The CAG Reports have done well on both counts.

19. The role of Audit in taxation vis-à-vis that of judiciary and quasi-judicial authorities has often been a matter of contention and source of initial resistance to audit. The assessment of tax liability of a particular taxpayer may be based on self-assessment or based on 'summary assessment' or 'scrutiny assessment' by the Departmental officers. The level of scrutiny varies in all the three scenarios and a taxpayer whose income tax

return has been accepted on the basis of reduced level of scrutiny or no scrutiny at all would not like his assessment to be reopened by the Audit. On the other hand, if the Audit accepts the level of scrutiny by the Department, it limits the sample to be audited.

20. The CAG of India is a Constitutional Authority who assumes office after taking the same oath as administered to any Judge of the Supreme Court including the Chief Justice of India to "uphold the Constitution and the laws". As mentioned above, the CAG's (DPC) Act, 1971 enjoins upon the CAG a duty "*to audit all receipts which are payable into the Consolidated Fund* "and "*to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed." The CAG renders Reports to the President which are placed before the Parliament.*

21. What will be taxed at what rate is the prerogative of the Legislature and Audit has no view on that. It is apt to recall that during the British period several British legislators, independent commentators and leaders steering popular protest had raised voice against unjust levy of statutory levies on salt. However, it was never the call of Auditor General to express any such view. Likewise, interpreting laws is the prerogative of Constitutional courts. The CAG is not authorized to give any binding decisions in tax matters but is nevertheless duty-bound under Section16 of the CAG's (DPC) Act quoted above to bring to the notice of the Parliament the gaps and deficiencies in the taxation system which work against the interest of public exchequer so that appropriate remedial action is taken. While discharging such a mandate, it is quite possible that there may be divergence of opinion of the CAG with any decision taken by any quasi-judicial authority like the tax assessing officers and appellate tribunals. The stand taken by Audit in any matter may not be accepted by a High Court or the Supreme Court. Notwithstanding this, the CAG is authorised and duty-bound to inform the Legislature about the professional opinion of the CAG on any particular aspect of tax laws or administration.

22. For proper sample selection by auditors, it is important that the profile of complete information is known to the auditors. Otherwise, they would be selected sample only from the presented lot which may be limited by administrative expediency (this is readily available) or by design (we do not want you to look beyond).

23. For direct tax audit, there is no need to interact or visit the premises of the tax assessee, something extensively done, on a dwindling scale over the years, on indirect tax side. Both direct and indirect tax authorities are gradually and systematically being told to minimize their direct interaction with tax assessees. For Income Tax, it has led to the development of a Faceless Assessment system which is a double-blind interface between the assesses and assessors. Both are mutually anonymous operating behind and through a faceless IT system.

24. Such a reduction in direct contact is not just because there is mistrust in the integrity of tax assessors. It is also to shield honest assessors from undue influence, inducement and coercion in a scenario of very high-stake assessments requiring the will and full-scope capacity of the State to come into play to enforce tax laws against powerful tax offenders; not just one or few taxpersons. Auditors are likewise not immune from these risks and are similarly being insulated.

25. Both for Income Tax and GST, there are large digital databases. Systematic scanning of entire databases and drawing appropriate risk-based samples for detailed examination requires specialized skills in understanding the IT systems and extraction/analysis of digital data. These have been developed in-house and the extensive coverage of diverse subjects in Revenue Audit reports speaks volume about the capabilities developed by the officers and staff of the CAG.

26. Maintaining confidentiality of information about tax assessees is also important and the CAG auditors have shown exemplary professionalism in this regard.

27. One of the conventional ways of quantifying the contribution of the CAG Audit to tax administration is to highlight the amount of additional tax recoverable or actually recovered at the instance of Audit. The performance Report of the Indian Audit and Accounts Department for 2023-24 brings out that 2,145 recommendations were made in the 115 Audit Reports approved during 2023-24, of which 1,115 recommendations were accepted by the audited entities. Rs.6,266.68 crore was recovered based on Audit observations.

Impact of Audit recommendations : Recoveries at the instance of Audit: 2023-24

(Rs. in crore)

	Recoveries accepted	**Recoveries effected**
Union Government	18,375.31	4,558.07
State Government	44,057.79	1,708.61
Total	**62,433.10**	**6,266.68**

CAG Reports on audits on direct taxes

28. **Annexure I** lists out Reports of the CAG on compliance and performance audits in the audit of Direct Taxes spread over last two decades with highlighted findings from some major performance audits.

AN OVERVIEW OF THE TAX REVENUES OF THE UNION GOVERNMENT

MEENAKSHI SHARMA[3]

We provide a macro view and commentary on the trend and profile of Central government' total tax revenue from 1970-71 onwards. The share of direct taxes in total tax revenue is a prime indicator of how progressive a country's tax system is. We find that the tax system has become broad based and relies more on direct taxes – from 17% share in total tax kitty in FY71 to 56% in FY24 which is set to increase to 59% in the Budget 2025-26 despite major relief to small taxpayers. In fact, the direct taxes overtook indirect taxes after 2007-08. We attempt to fathom the reasons for the relative increase in the share of Corporate Income Tax and decline in the share of Customs Duty in recent years in the total tax collections by the Union government. The data on tax collections has been taken from the Union Budget documents.

1. The Constitution of India provides for specific Taxes and Duties to be levied, collected and appropriated by the Union, State and Union Territory governments as authorised by their respective legislatures. There are Stamp Duties on specified financial transactions which are levied by the Union (for the purpose of all-India uniformity) but collected and retained by the States (Art.268). The Goods and Services Tax (GST) introduced w.e.f.1st July 2017 under a Constitutional Amendment empowers both the Union and the States to concurrently levy GST at a common rate uniform across India on intra-State (Central GST and State GST) or inter-State (Integrated GST) trade and commerce in specified goods and services. All supplies of goods & services made as imports into India are treated as an inter-State supply(Art.269A). The taxes on inter-State sale, purchase or consignment of goods not covered by the GST are levied and collected by the Union but their net proceeds are assigned to the States (Art.269). Major exclusions from the GST net are petroleum products, alcoholic liquor for human consumption and electricity. Alcoholic liquor for human consumption is subject to value-added tax (VAT) by the State governments while 'extra neutral alcohol' sold for industrial use is subject to Central and State GST. Agricultural Income Tax and a limited Professional Tax is leviable by the States. The taxes and duties remaining after these carve-outs and special arrangements (mainly non-agricultural Income Tax, Central Excise Duty and Customs Duties) are levied and collected by the Union.
2. The Constitution of India further provides for the mechanism of a Finance Commission appointed by the President once in 5 years or earlier, if need be, to

[3] Ms. Meenakshi Sharma, IAAS(1988), superannuated as a Deputy Comptroller and Auditor General. She is a member of the Editorial Board of IPAI.

recommend the share in total collection of Union Taxes and Duties which should be distributed among States (Vertical Devolution) and also the share of each State in the total divisible pool (Horizontal Devolution). The Cesses are special taxes whose proceeds are earmarked by legislation to be used for specific purposes. Likewise, the Constitution permits the Union to levy a Surcharge on Union Taxes and Duties whose proceeds are exclusively used by the Union. The Cesses and Surcharges do not form part of the divisible pool of Union Taxes and Duties to be shared with the States. Currently, 41 per cent of the Union Taxes and Duties excluding Cesses and Surcharges is distributed among States during the period FY2020-21 to FY2025-26. There is thus a standard budgetary term of 'gross tax revenue' of the Centre to denote the total tax collection including the States' share as distinct from 'net tax revenue' of the Centre to denote the tax collection remaining with the Centre after deducting the States' share. (On a technical note, even the 'gross tax revenue' is computed as net of tax refunds though GTR may include tax collected in excess but yet to be refunded.)

Trend in collection of major Union taxes and duties since 1970-71

3. **Table 1** below provides year-wise trend in nominal values of tax collections by the Union government from 1970-71 to the latest Budget estimates for FY2025-26 under four groupings: Corporate Income Tax(CIT), Personal Income Tax (PIT), Tax on domestic goods/service (Central Excise Duty/Service Tax/GST) and Customs duty on imported goods. The 'Gross Tax Revenue' (GTR) is the total tax collected by the Union government (net of tax refunds) without deducting States' share in Union taxes/duties. The purpose of presenting GTR data is to highlight the efficiency and efficacy of the Union government's efforts in steering the tax laws and tax administration and not the net tax revenue technically available for financing the Union expenditure. Which receipt finances what expenditure and what are the expenditure controlled by the Union and by the State government are functions of wider fiscal policy issues that are beyond the mandate of the Department of Revenue. The GTR data has been extracted from the "Receipts Budget" documents of the Union government **(https://www.indiabudget.gov.in/)**. The taxes collected under the Income Tax Act, 1961 are broadly categorised as income tax on corporates (CIT-Corporate Income Tax) and on individuals and non-corporate entities like Partnership Firms, LLPs, Hindu Undivided Families, Trusts, Societies etc. (PIT-Personal Income Tax).

Table 1: Tax Profile of Central Government's Gross Tax Revenues (Rs. in crore)

Items /Year	Corporate Income Tax (CIT)	Personal Income Tax (PIT)	Central Excise / Service Tax/ GST	Customs Duty	Other taxes	Gross Tax Revenue
1970-71	371	114	1,759	524	17	2,785
1971-72	472	536	2,061	696	107	3,872
1972-73	557	629	2,324	857	142	4,509
1973-74	583	745	2,602	996	147	5,073

Items /Year	Corporate Income Tax (CIT)	Personal Income Tax (PIT)	Central Excise / Service Tax/ GST	Customs Duty	Other taxes	Gross Tax Revenue
1974-75	709	874	3,231	1,333	175	6,322
1975-76	862	1,214	3,844	1,419	269	7,608
1976-77	984	1,194	4,221	1,554	318	8,271
1977-78	1,221	1,002	4,448	1,824	364	8,858
1978-79	1,251	1,177	5,367	2,423	306	10,525
1979-80	1,392	1,340	6,011	2,924	307	11,974
1980-81	1,377	1,440	6,500	3,409	198	12,924
1981-82	1,970	1,476	7,421	4,300	372	15,539
1982-83	2,185	1,570	8,059	5,119	407	17,340
1983-84	2,493	1,699	10,222	5,583	333	20,330
1984-85	2,556	1,928	11,151	7,041	342	23,018
1985-86	2,865	2,511	12,956	9,526	276	28,134
1986-87	3,160	2,879	14,470	11,475	854	32,838
1987-88	3,433	3,192	16,426	13,702	913	37,666
1988-89	4,407	4,241	18,841	15,805	1,179	44,474
1989-90	4,729	5,010	22,406	18,036	1,455	51,636
1990-91	5,335	5,371	24,514	20,644	1,712	57,576
1991-92	7,853	6,731	28,110	22,257	2,410	67,361
1992-93	8,899	7,888	30,832	23,776	3,242	74,637
1993-94	10,060	9,123	31,697	22,193	2,670	75,743
1994-95	13,822	12,025	37,754	26,789	1,904	92,294
1995-96	16,487	15,592	41,049	35,757	2,339	1,11,224
1996-97	18,567	18,231	46,067	42,851	3,046	1,28,762
1997-98	20,016	17,097	49,548	40,193	12,367	1,39,221
1998-99	24,529	20,240	55,203	40,668	3,157	1,43,797
1999-00	30,692	25,647	64,030	48,419	2,964	1,71,752
2000-01	35,696	31,764	71,139	47,542	2,462	1,88,603
2001-02	36,609	32,004	75,857	40,268	2,322	1,87,060
2002-03	46,172	36,866	86,432	44,852	1,944	2,16,266
2003-04	63,562	41,387	98,665	48,629	2,105	2,54,348
2004-05	82,680	49,268	1,13,325	57,611	2,074	3,04,958
2005-06	1,01,277	57,308	1,34,281	65,067	9,541	3,67,474
2006-07	1,44,318	75,093	1,55,211	86,327	12,563	4,73,512
2007-08	1,92,911	1,02,644	1,74,912	1,04,119	18,561	5,93,147
2008-09	2,13,395	1,06,046	1,69,554	99,879	16,425	6,05,299
2009-10	2,44,725	1,22,475	1,61,413	83,324	12,591	6,24,528
2010-11	2,98,688	1,39,069	2,08,717	1,35,813	10,785	7,93,072
2011-12	3,22,816	1,64,485	2,42,410	1,49,328	10,138	8,89,177

Items /Year	Corporate Income Tax (CIT)	Personal Income Tax (PIT)	Central Excise / Service Tax/ GST	Customs Duty	Other taxes	Gross Tax Revenue
2012-13	3,56,326	1,96,512	3,08,446	1,65,346	9,605	10,36,235
2013-14	3,94,678	2,37,817	3,24,233	1,72,085	9,920	11,38,733
2014-15	4,28,925	2,58,326	3,56,097	1,88,016	13,522	12,44,886
2015-16	4,53,228	2,87,628	4,99,487	2,10,338	4,967	14,55,648
2016-17	4,84,924	3,49,436	6,36,255	2,25,370	19,837	17,15,822
2017-18	5,71,202	4,19,880	7,82,623	1,29,030	16,273	19,19,008
2018-19	6,63,572	4,72,983	8,19,508	1,17,813	6,589	20,80,465
2019-20	5,56,876	4,92,593	8,44,230	1,09,282	7,078	20,10,059
2020-21	4,57,719	4,87,139	9,40,059	1,34,750	7,437	20,27,104
2021-22	7,12,037	6,96,238	10,89,934	1,99,728	11,379	27,09,316
2022-23	8,25,834	8,33,233	11,68,563	2,13,372	13,190	30,54,192
2023-24	9,11,055	10,44,722	12,62,995	2,33,119	13,628	34,65,519
2024-25RE	9,80,000	12,57,000	13,66,999	2,35,000	14,456	38,53,455
2025-26BE	10,82,000	14,38,000	14,95,100	2,40,000	15,133	42,70,233

Note: 2024-25RE refers to Revised Estimates for FY2024-25 and 2025-26BE refers to the Budget Estimates for FY2025-26.

4. **Table 2** below is a different presentation of the data in Table 1, with % shares in total tax collections being tabulated rather than actual amount of tax collection under each category.

Table 2: Tax Profile of Central Government's Gross Tax Revenues (% share in total GTR)

Items/ Year	CIT	PIT	Central Excise/ Service Tax/ GST	Customs	Other taxes
1970-71	13	4	63	19	1
1971-72	12	14	53	18	3
1972-73	12	14	52	19	3
1973-74	11	15	51	20	3
1974-75	11	14	51	21	3
1975-76	11	16	51	19	4
1976-77	12	14	51	19	4
1977-78	14	11	50	21	4
1978-79	12	11	51	23	3
1979-80	12	11	50	24	3
1980-81	11	11	50	26	2
1981-82	13	9	48	28	2
1982-83	13	9	46	30	2

Items/ Year	CIT	PIT	Central Excise/ Service Tax/ GST	Customs	Other taxes
1983-84	12	8	50	27	2
1984-85	11	8	48	31	1
1985-86	10	9	46	34	1
1986-87	10	9	44	35	3
1987-88	9	8	44	36	2
1988-89	10	10	42	36	3
1989-90	9	10	43	35	3
1990-91	9	9	43	36	3
1991-92	12	10	42	33	4
1992-93	12	11	41	32	4
1993-94	13	12	42	29	4
1994-95	15	13	41	29	2
1995-96	15	14	37	32	2
1996-97	14	14	36	33	2
1997-98	14	12	36	29	9
1998-99	17	14	38	28	2
1999-00	18	15	37	28	2
2000-01	19	17	38	25	1
2001-02	20	17	41	22	1
2002-03	21	17	40	21	1
2003-04	25	16	39	19	1
2004-05	27	16	37	19	1
2005-06	28	16	37	18	3
2006-07	30	16	33	18	3
2007-08	33	17	29	18	3
2008-09	35	18	28	17	3
2009-10	39	20	26	13	2
2010-11	38	18	26	17	1
2011-12	36	18	27	17	1
2012-13	34	19	30	16	1
2013-14	35	21	28	15	1
2014-15	34	21	29	15	1
2015-16	31	20	34	14	..
2016-17	28	20	37	13	1
2017-18	30	22	41	7	1
2018-19	32	23	39	6	..
2019-20	28	25	42	5	..
2020-21	23	24	46	7	..
2021-22	26	26	40	7	..

Items/ Year	CIT	PIT	Central Excise/ Service Tax/ GST	Customs	Other taxes
2022-23	27	27	38	7	..
2023-24	26	30	36	7	..
2024-25RE	25	33	35	6	..
2025-26BE	25	34	35	6	..

5. **Chart 1** below graphically presents the data in Table 2, with % shares in total tax collections being tabulated for the 5 broad categories of taxes.

Chart 1 Profile of Central Government's Gross Tax Revenues (% share in total)

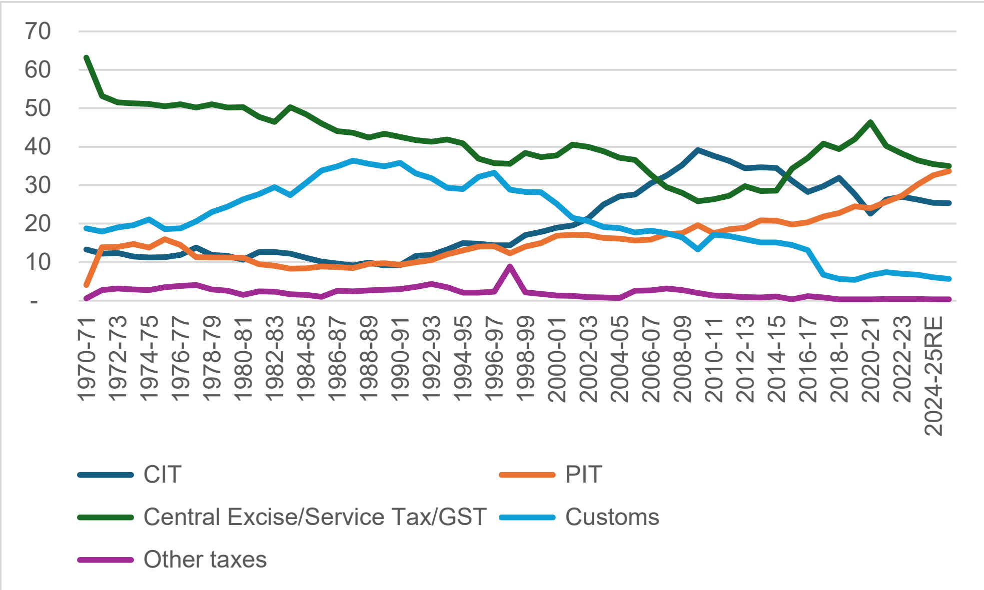
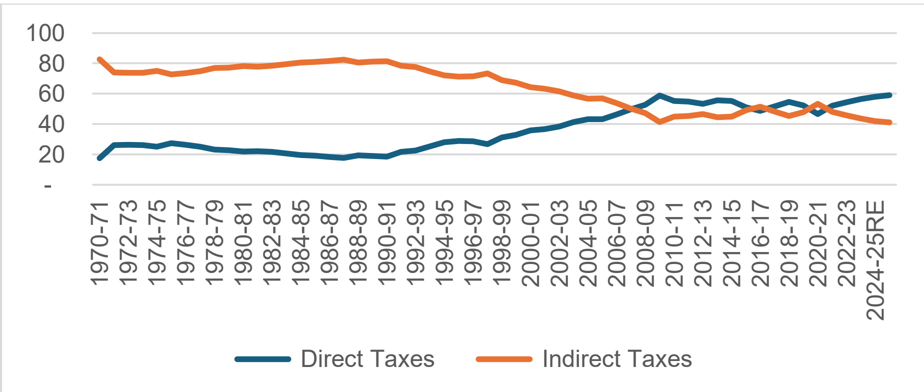


Chart 2 below graphically presents the data in Table 2, with % shares of direct and indirect taxes in total tax collections.

Chart 2 Direct/indirect taxes (% share in Central Government's Gross Tax Revenues)



Sharp increase in the share of non-corporate income tax collections and sharp fall in share of Customs Duties

6. The above Table/Chart show the varying composition of the total tax kitty of the Union government. The most dramatic change in last 10 years or so has been the increase in share of non-corporate income tax (from 20 per cent to 34 per cent) and sharp fall in share of Customs Duties (from 14 per cent to 6 per cent). The Black Money Act (2015), remonetization of high value currency notes (2016), introduction of Goods and Services Taxes (2017) and a host of measures to promote use of digital transactions and extensive use of technology in tax enforcement has seen the upsurge in tax collections despite the disruption caused by the Covid pandemic and its lingering effects.

7. Decline in the share of Customs Duties is attributable to a large quantum of imports being used as inputs for exported goods. Under internationally accepted rules, a country is allowed or rather expected not to export its taxes to foreign consumers of goods it produces. Hence, duty-free imports are allowed where the imported items are for exclusive use in production of exported goods. Any taxes and duties paid on inputs of manufacture of exported goods are also refunded. Domestic industries can import raw materials, intermediates and components under the Advance Authorisation Scheme on a duty free basis for production of items for exports. Over the past two decades, the import intensity of India's manufactured exports has been on the rise, reflecting the country's growing integration into global value chains (GVCs) as intermediate goods are imported, processed, and then re-exported. The import intensity is particularly high in export of petroleum products, mobile phones, telecom equipment, other electronics and engineering goods, gold and diamond jewellery exports. All crude petroleum oil – whether for manufacture of petrol/diesel etc for export or domestic use is subjected to a token amount of import duty. (Basic Customs Duty (BCD) is Rs.1/- MT and Additional Customs Duty (ACD) is also Rs.1/- MT on imported crude oil.)

Decline in share of corporate tax

8. As seen from Table 2 above, the share of personal income tax in total tax revenue of Central government has increased from 20% to 34% in last decade while during the same period, the share of corporate income tax has come down from 34% to 25%. The number of companies filing income tax returns has increased from 6,36,023 for FY2013-14 to 10,27,200 for FY2022-23, the latest year for which the data is publicly available[4]. The increase in the number of individual IT return files has seen more dramatic increase from 3,04,97,487 for FY2013-14 to 6,96,90,925 or FY2022-23. A record number of 7.28 crore Income Tax Returns filed for Assessment Year 2024-25 by the normal last date of 31st July 2024.

9. The dip in share of corporate tax was particularly marked in the FY2020-21 (from 28% in 2019-20 to 23% in 2020-21). The profile of gross total income declared by different categories of taxpayers for Assessment Year 2023-24 is the latest available from CBDT. It is seen that more than 99.5% of all the companies report less that Rs.100 crore gross total income and the corporate tax regime for small companies has in a way become more beneficial than for even individual taxpayers. Out of total 10,70,924 corporate tax returns filed declaring gross total income of Rs.34,58,217 crore for AY23-24, 605,562 companies filed nil returns, while 140,351 companies

[4] Income Tax Return statistics for Assessment Year 2023-24

declared a gross total income of only Rs.612 crore . Bulk of the gross total income - Rs.27,27,295 crore was declared by just 3637 companies, each declaring Rs.100 crore or more. [842 companies declared gross total income of Rs.500 crore or more aggregating to total of Rs.2145,364 crore]

10. The share of corporate tax contribution can decline due to multiple reasons like decline in corporate profitability, decline in corporate tax rates and relatively higher growth in personal income tax and GST. The healthy growth in personal income tax and GST shows robust economic growth and impact of stricter tax enforcement. Persistent inflation howsoever moderate indicates lack of competition and increased power to set market rate. Although a robust and detailed analysis is beyond the scope of this article, gradual reduction in corporate tax rates has is the main cause for decline in share of corporate taxes. In announcing a special package of corporate tax reduction in September 2019, the Government had estimated that the revenue foregone would be about Rs.145,000 crore.

11. The standard corporate tax rate was 30% (plus cesses and surcharges) for domestic companies and 40% for foreign companies when in Budget 2016-17, a beginning was made to reduce tax burden on small domestic companies which account for almost 99% of total. Budget 2016-17 stipulated that the tax rate would be reduced from 30% to 29% for domestic companies 'if the total turnover or gross receipts of the company in the previous year 2014-15 does not exceed five crore rupees'. Further, as incentive to Startup companies, the tax rate was reduced from 30% to 25% subject to certain conditions being met. In Budget 2017-18, the 25% rate was extended to domestic companies with total turnover or gross receipts being less than Rs.50 crore. In Budget 2018-19, the 25% tax rate was extended to domestic companies with total turnover or gross receipts in 2016-17 not exceeding Rs.250 crore, threshold being raised to Rs.400 crore in Budget 2019-20.

12. Under the Taxation Laws (Amendment) Ordinance and Bill, 2019, a new tax regime was put in place for companies offering major tax concessions to corporates. Domestic companies with annual turnover of up to Rs 400 crore pay income tax at the rate of 25%. For other domestic companies, the tax rate is 30%. The Bill provides The domestic companies were given an option to pay tax at the rate of 22%, provided they do not claim certain deductions under the Income Tax Act. This offer was available to both under the 25% tax obligation (annual turnover not exceeding Rs 400 crore) and 30% tax obligation (annual turnover exceeding Rs 400 crore). In a further incentive to new manufacturing companies, new domestic manufacturing companies were given an option to pay income tax at the rate of 15%, provided they do not claim certain deductions. These new domestic manufacturing companies must be set up and registered on or after the 1st day of October, 2019 and start manufacturing before April 1, 2023, with the date extended to April 1, 2024. It was further stipulated that provisions regarding payment of Minimum Alternate Tax (MAT) will not apply to companies opting for the new tax rates. MAT is the minimum amount of tax required to be paid by a company, in case its normal tax liability after claiming deductions falls below a certain limit. A company can choose to opt for the new tax rates in the financial year 2019-20 (i.e. assessment year 2020-21) or in any other financial year in the future. Once a company exercises this option, the chosen provision will apply for all subsequent years. Of course, being an optional arrangement, a company would migrate to new tax regime only when it is beneficial to it. The total revenue foregone for the reduction in corporate tax rate and other relief was estimated by the government to be Rs. 1,45,000 crore (September 2019).

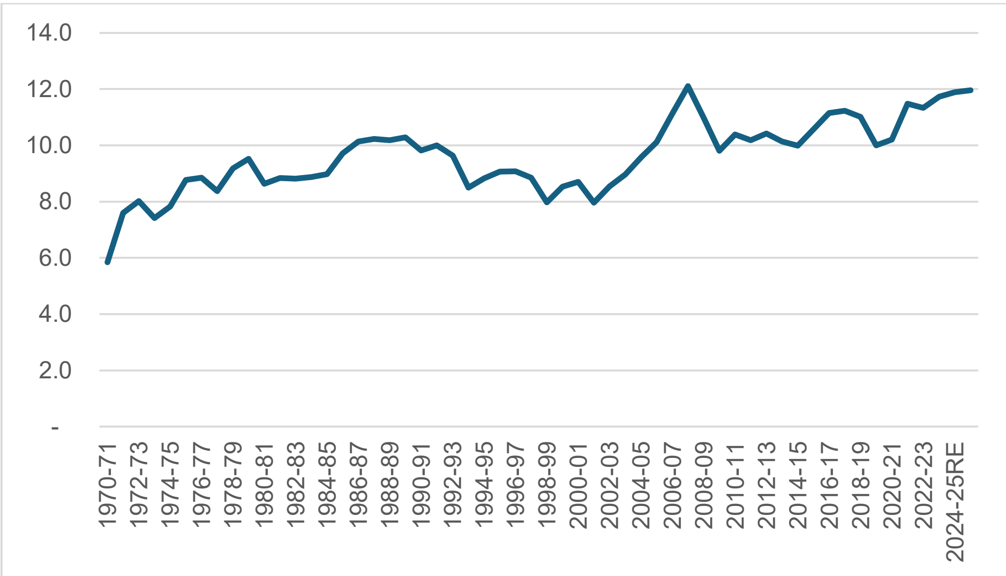
13. Extending the ongoing programme of gradual reduction in corporate tax on companies, the tax rate on foreign companies was reduced from 40% to 35% in Budget 2024-25, on income other than income chargeable at special rates. This is in line with the policy to attract foreign investment in manufacturing sector that will create new avenues of economic growth and job creation.

14. It may thus be seen that the marginal tax rate for over 99% of domestic companies (25%, 22% or 15%) is less than the marginal tax rate for non-corporate taxpayers (30%) excluding Cess and Surcharge. Such wide differential may be an incentive to corporatise to convert 'personal income' into 'corporate income' and reduce tax liability for smart taxpayers. This is discussed in detail in another article.

Tax : GDP ratio shows improvement in recent years

15. Chart 3 below provides the trend in the ratio of the Gross Tax Revenue of the Union government as a % of the Gross Domestic Product at current market prices, a metric typically used for inter-country comparisons of the incidence of taxation on national economy. One has to be mindful of the fact whether the Tax:GDP ratio being used for a particular country refers to only the tax collections by the federal/national level government or also include the taxes collected by sub-national entities also.

Chart 3 Trend in the Gross Tax Revenue of the Union government as a % of the GDP at current market prices



16. The following table extracted from IMF's database (https://www.imf.org/en/Topics/fiscal-policies/world-revenue-longitudinal-database?utm_source=chatgpt.com) shows the Tax:GDP ratio for different countries whose data was available to IMF for the year 2022 (arranged in descending order):

Table 3: Tax: GDP ratio(2022)

Country	Tax: GDP ratio	Country	Tax: GDP ratio	Country	Tax: GDP ratio
Nauru	37.3	Maldives	19.9	Egypt	12.6
Lesotho	36.8	Mauritius	19.8	Tanzania	12.6
Norway	35.7	Nepal	19.8	Brunei Darussalam	12.5
New Zealand	32.7	El Salvador	19.6	Ghana	12.5
Iceland	31.9	Bulgaria	19.6	Liberia	12.3
Finland	31.0	Albania	19.1	Singapore	11.9
France	30.9	Colombia	18.7	Guinea	11.7
Belgium	29.7	Uzbekistan	18.7	Malaysia	11.7
Italy	29.0	Suriname	18.6	Uganda	11.6
United Kingdom	29.0	Uruguay	18.6	Bhutan	11.5
Greece	28.8	St. Lucia	18.6	Benin	11.5
Jamaica	28.7	Cabo Verde	18.5	Guatemala	11.4
Canada	28.4	Korea	18.3	Cote d'Ivoire	11.3
Austria	28.2	San Marino	18.3	Djibouti	11.2
Australia	27.5	Kazakhstan	18.2	Papua New Guinea	11.1
Luxembourg	27.4	Bolivia	18.0	The Gambia	11.0
Barbados	27.3	North Macedonia	17.9	Sao Tome and Principe	10.6
Seychelles	26.8	Jordan	17.7	Pakistan	10.4
Croatia	26.3	Palau	17.7	Gabon	10.4
Montenegro	26.1	Senegal	17.7	Indonesia	10.4
Namibia	25.7	UAE	17.5	Paraguay	10.2
Portugal	25.6	**India**	**17.3**	Lao P.D.R	9.7
Serbia	25.5	Ireland	17.2	Madagascar	9.7
Samoa	25.3	Peru	17.0	Sierra Leone	9.6
Cyprus	25.1	Zimbabwe	16.8	Guyana	9.5
Hungary	25.0	The Bahamas	16.8	Niger	9.4
Kosovo	24.8	Romania	16.7	Guinea-Bissau	9.3
Tunisia	24.7	Burundi	16.4	Turkmenistan	9.0
Brazil	24.7	Antigua and Barbuda	16.2	Democratic Republic of the Congo	8.9
Spain	24.6	Zambia	16.1	Sudan	8.7
Germany	24.4	Kiribati	16.0	Timor-Leste	8.6

Country	Tax: GDP ratio	Country	Tax: GDP ratio	Country	Tax: GDP ratio
Georgia	23.9	Trinidad and Tobago	15.8	Algeria	8.5
Chile	23.8	Thailand	15.8	Comoros	8.3
Malta	23.4	Philippines	15.6	Bangladesh	8.0
Kyrgyz Republic	23.4	Vanuatu	15.6	Angola	7.9
Eswatini	23.3	Fiji	15.2	Saudi Arabia	7.9
Dominica	23.2	Cambodia	14.7	Republic of Congo	7.8
West Bank and Gaza	22.1	St. Kitts and Nevis	14.6	Sri Lanka	7.7
Tonga	22.1	Mexico	14.5	Panama	7.6
Japan	22.0	Tuvalu	14.4	Equatorial Guinea	7.5
United States	21.6	Hong Kong SAR	14.2	Ethiopia	7.5
Armenia	21.5	Mauritania	14.1	Central African Republic	7.2
Lithuania	21.4	Costa Rica	14.1	Myanmar	5.5
Poland	21.4	Vietnam	13.9	Chad	5.2
Estonia	21.2	Togo	13.9	Haiti	5.1
Solomon Islands	21.0	Marshall Islands	13.9	Iran	4.8
Bosnia and Herzegovina	21.0	China	13.9	Nigeria	4.1
Moldova	20.9	Dominican Republic	13.8	Oman	3.5
Nicaragua	20.7	Ecuador	13.6	Yemen	3.2
Latvia	20.5	Azerbaijan	13.5	Qatar	3.1
Mozambique	20.3	Rwanda	13.5	South Sudan	1.8
Mongolia	20.2	Kenya	13.2	Somalia	1.7
Botswana	20.1	Mali	13.1	Kuwait	1.0
Slovak Republic	20.0	Malawi	12.9	Iraq	1.0

17. The following Charts graphically illustrate international comparison of Tax to GDP ratio of India (Central and State Taxes combined):

Chart 4: Trend in Tax Revenues as percentage of GDP

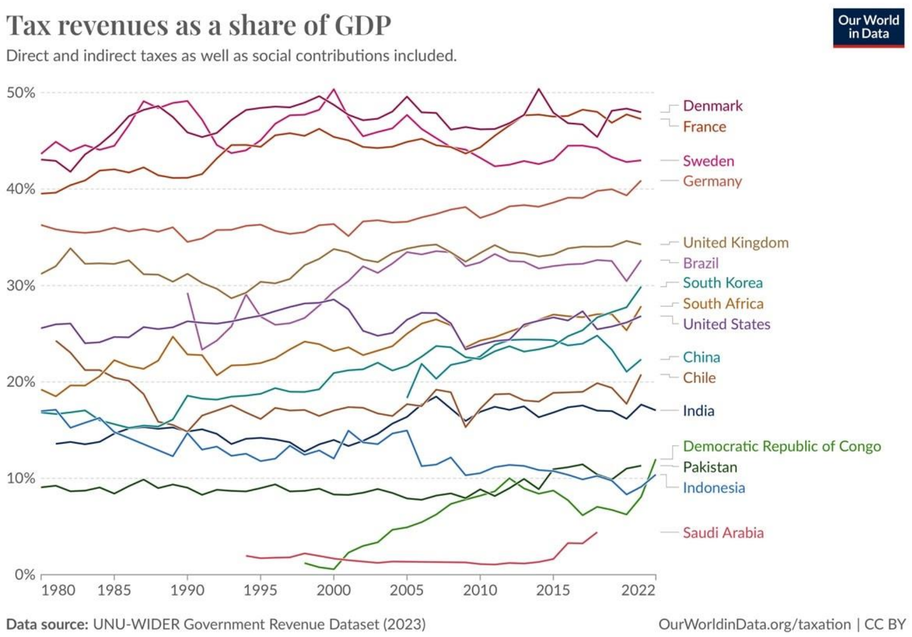
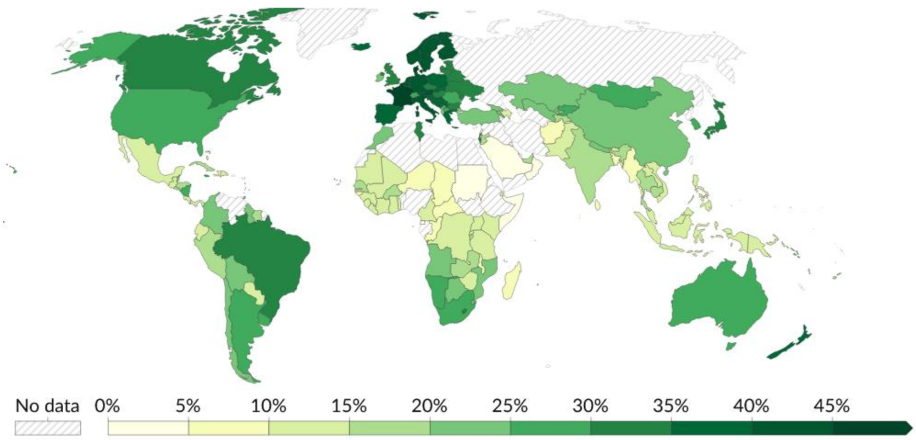


Chart 5 Tax Revenue as per cent of GDP (2022)



Source: https://ourworldindata.org/grapher/tax-revenues-as-a-share-of-gdp-unu-wider

18. According to provisional data provided by OECD countries[5], tax revenues as a percentage of GDP were 33.9% on average in 2023, a marginal decrease of just 0.1 percentage points (p.p.) of GDP relative to 2022. This was the second consecutive small decline in the OECD's tax-to-GDP ratio following a drop of 0.04 p.p. in 2022. France had the highest tax-to-GDP ratio among OECD countries for the second consecutive year in 2023, at 43.8%. Denmark had the second-highest tax-to-GDP ratio (43.4%) while Mexico had the lowest tax-to-GDP ratio (17.7%). The tax-to-GDP

5 OECD Revenue Statistics 2024 on global tax revenues https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-tax-revenues/revenue-statistics-highlights-brochure.pdf

ratio increased in 18 of the 36 countries for which a full set of preliminary data for 2023 are available, declined in 17 and remained the same in one. However, the declines were larger than the increases on average (-1.4 p.p. versus 1.1 p.p.). The largest increases occurred in Luxembourg (2.7 p.p.), Colombia (2.6 p.p.) and Türkiye (2.5 p.p.). The largest decline in 2023 occurred in Chile, whose tax-to-GDP ratio fell by 3.2 p.p., while declines also exceeded 2.0 p.p. in Korea (3.1 p.p.), Israel (3.0 p.p.) and the United States (2.4 p.p.).

19. Long-term average Tax:GDP ratio for only Union Government taxes has been about 10 per cent of GDP, with occasional spikes above the 10 percent level, due to special tax efforts or slower economic growth or both in particular years. The Tax : GDP ratio of the Union government has shown improvement in recent years after post-pandemic revival of the economy and improved tax enforcement. It is now about 12 per cent of GDP, last achieved in 2007-08. On its own and even after accounting for State level taxes of about 7 per cent of GDP to compare with federated economies of the world, India's Tax:GDP ratio of about 17 per cent of GDP (for both the Central and the State taxes combined) is lagging far behind the Tax:GDP ratios in Advanced Economies. India has followed a middle path between the two extremes of tax-and-spend OECD countries and the 'tax heaven' countries having very low level of taxes on incomes. IN FY2023–24, India's direct tax-to-GDP ratio reached a 24-year high of 6.64%, marking a significant increase from 5.55% in 2014–15. It is hoped that with rationalisation of GST rates; increased formalization and digitalisation of economy; and continuing use of technology in tax enforcement; the Tax:GDP ratio is likely to improve further in coming years as part of the broader agenda of pursuing prudent fiscal management and macro-economic stability.

20. If the Tax : GDP ratio of the Union government is hovering around 12 per cent of GDP and the typical tax rates are higher than 12 per cent – say more than double also - on incomes, consumption and capital gains, the inevitable conclusion is that a large part of the GDP is not "tax-bearing" due to policy choices or tax evasion/avoidance.

21. The tax reforms agenda, one of the most successful aspects of public finance reforms, has been the subject of continuous experimentation and improvement. Widening and deepening the tax base by tackling tax evasion (concealment of taxable income through dealings in cash or sham bank transactions) or tax avoidance (finding innovative workarounds to show that the income is not taxable as per the 'letter of law'; reducing the multiplicity of tax rates if it creates opportunities to misclassify and taxpayer facilitation remain the topline agenda for reforming the tax policy and administrative systems.

JOURNEY OF REFORMS: REVAMPING AND MODERNIZING THE DIRECT TAX SYSTEM IN INDIA

MEENAKSHI GUPTA[6]

"It was only for the good of his subjects that he collected taxes from them, just as the Sun draws moisture from the Earth to give it back a thousand fold". (The epic poet Kalidasa eulogizing King Dilip in 'RAGHUVANSH')

The modern income tax system introduced in India in 1860 is a marked departure from a predominantly land-linked direct tax system. We present a synoptic overview of the journey of reforms in the system of direct taxes - highlighting how the direct tax policy, law and administration has evolved over decades.

Technology has played a major role in reforming our direct tax system; improving the tax yield and taxpayer facilitation and reaching a stage of maturity where a record number of 7.28 crore Income Tax Returns filed for Assessment Year 2024-25 by the normal last date of 31st July 2024 with the income tax being the biggest contributor to the Union government's total tax revenues.

Introduction

1. The Constitution of India empowers the Union government to tax non-agricultural incomes[7] and the Income Tax Act, 1961 enacted by the Parliament is the principal legislation governing the direct tax system in India. The States are empowered to levy Agricultural Income Tax. The States are also empowered to levy 'Professional Tax' - taxes for the benefit of the State or of a municipality, district board, local board or other local authority therein in respect of professions, trades, callings or employments - with annual ceiling of Rs.2500 per person. [8]

2. In common parlance, the income tax on companies is called the CIT-Corporate Income Tax and the remaining income Tax is referred to as PIT-Personal Income Tax. The PIT thus covers not only natural persons but also all non-corporate legal persons like deities, Hindu Undivided Family HUF, charitable trusts, societies, local authorities, Association of Persons AOP, partnership firms and Limited Liability Partnerships.

3. As per the latest data provided by the Central Board of Direct Taxes, Department of revenue, Ministry of Finance for the FY2022-23 (Assessment Year 2023-24), there were 10,41,13,847 'Taxpayers' (including 9,91,75,656 individuals, 17,22,629 Firms, 13,32,135 Hindu Undivided Families and 11,36,751 companies). A "Taxpayer" is a person who has either filed a return of income or in whose case tax has been deducted at source but the taxpayer has not filed the return of income.

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[6] Ms. Meenakshi Gupta, IAAS(1984), superannuated as a Deputy Comptroller and Auditor General and later served as Member, Telecom Regulatory Authority of India. She is a member of the Editorial Board of IPAI.

[7] Income tax is governed by Entry 82 of the Union List of the Seventh Schedule to the Constitution of India, empowering the central government to tax non-agricultural income

[8] Art 276 of the Constitution: The total amount payable in respect of any one person to the State or to any one municipality, district board, local board or other local authority in the State by way of taxes on professions, trades, callings and employments shall not exceed rupees 2500 per annum

4. The trend and profile of PIT/CIT collections since 1970-71 show that after 2007-08 the share of direct taxes in gross tax collections of the Union government has overtaken that of indirect taxes. In FY2024-25 (Revised Estimates), the government estimated to collect Rs.9,80,000 crore as CIT and Rs.12,57,000 crore as PIT, contributing 25% and 33%, respectively, to the total tax revenue of the Union government. These numbers look astronomical compared to Rs.30 lakhs collected in 1860-61, Rs.1.36 crore in 1886-87, Rs.11 crore in 1918-19, Rs.19.82 crore in 1939-40 and Rs.287.47 crore in 1960-61. (The Income Tax Act, 1961 is a variant of the Income Tax Act 1860 which was replaced by the IT Acts of 1886, 1918, 1922 and 1939 and 1961). The huge nominal growth combines both substantive growth and accumulated inflationary impact on the direct tax collections.

5. We focus on 1860 as the starting point to discuss modern income tax system though the surviving palm leaf scribbles and stone inscriptions tell us about prevalence of taxation in Ancient and Medieval India; the Mahajanapada period, the Mauryan Empire, the Chola Empire, the Mughal Empire, the Maratha Empire etc. The kings would collect a share of produce, typically one-sixth of agricultural produce, earning them the sobriquet of "Shadhipati", the owner of one-sixth of the produce. Some kings not just collected taxes from their subjects but also paid taxes/tributes to their super lords. For example, Chauth (one-fourth levy) was collected by the Maratha Empire from protected princely States.

6. Both the MANUSMRITI and the ARTHASHASTRA refer to an elaborate tax system. Most of the premodern tax system was linked to compulsory levies linked to land holdings though Acharya Kautilya's ARTHASHASTRA refers to direct taxes on individuals, trade and commerce, i.e., taxes without any land link. The motto of the Income Tax Department - कोष मूलो दण्ड" (Kosh Mulo Dand) meaning the Treasury is the backbone of State power – is borrowed from the ARTHASHASTRA.

7. The history of Medieval India and British India shows heavy reliance upon land-linked taxes and elaborate systems of record keeping of lands by the type of productivity. In the British India, the 'District Collector' continued to be the officer in charge of all revenue collections, whether land revenue or income tax, till 1922 when the income tax administration was shifted from the provincial to the central government and a separate central bureaucracy evolved to manage the income tax. Another important feature of premodern taxation system was extensive use of intermediaries, the local lords, who collected taxes from locals and the audit trail of what was collected from locals and what was paid to overlords was poor resulting in injustice and extortionate taxation that caused agrarian crisis and led to land reforms, establishing a deep nexus between tax reforms and land reforms.

8. We provide below a synoptic overview of thematic cum chronological account of important developments in shaping the current direct tax system in India -the evolution of tax policy, tax laws, tax administration and quasi-judicial institutions.

9. The income tax as we know today, unhinged from the land nexus, was introduced in 1798 in Britain as a special resource raising exercise to pay for weapons and equipment in preparation for the Napoleonic Wars. It was abolished in 1802 and reintroduced 1803 and again abolished in 1816, one year after the Battle of Waterloo and reintroduced in 1842.

10. Income Tax was introduced in India by Sir James Wilson (British India's first finance minister) on 24 July 1860; due to the strained financial situation in which the British

Crown assumed direct sovereignty over British India from the East India Company following India's first war of Independence (1857). It was a tax selectively imposed on the rich, royalty and Britishers. In its first year, the exchequer collected a princely sum of Rs.30 lakh.

11. The Income Tax Act 1860 lapsed in 1865 and was re-introduced in 1867. The Act was replaced by IT Acts of 1886, 1918, 1922 and 1939 and 1961. A newly redrafted Draft Income Tax Bill, 2025 has been tabled in the Parliament on 13th February, 2025. (The new Act is a redraft version of the Income Tax Act 1961 as amended up to and including of the Finance Act 2024 and also incorporating the changes in the Act proposed by the government on 1st February 2025 through Budget 2025-26. The redrafted version cuts the length to nearly half and makes the Act more reader-friendly through use of Formulae, Tables, Schedules, removal of redundant provisions, conversion of provisos and explanations into regular subsections and clauses. It also does away with mentioning three different definitions of 'years'- 'previous year' financial year' and 'assessment year'.

12. The tax reforms agenda, one of the most successful aspects of public finance reforms, has been the subject of continuous experimentation and improvement. Widening and deepening the tax base by tackling tax evasion (concealment of taxable income through dealings in cash or sham bank transactions) or tax avoidance (finding innovative workarounds to show that the income is not taxable as per the 'letter of law'; reducing the multiplicity of tax rates if it creates opportunities to misclassify and taxpayer facilitation remain the topline agenda for reforming the tax policy and administrative systems.

13. Direct tax laws have been subject to extensive changes responding to developing socio-economic system. New institutions like the Settlement Commission and the Authority for Advance Ruling were created and modified to address tax disputes along with incentive schemes to expedite recovery of arrears and out of court settlement of tax disputes. Laws have further sought to widen the tax base and encourage/facilitate voluntary tax compliance. Lowering of tax rates; withdrawal and phasing out of tax exemptions/concessions, introduction of measures for presumptive taxation; simplification of tax laws, have all been part of efforts at widening the tax base.

14. When India gained Independence in 1947, additional resource mobilisation to bolster weak finances was a high priority area. The tax system was highly concentrated to a few urban areas. Taxation on Income (Investigation) Commission was set up under Taxation of Income (Investigation Commission) Act, 1947 (declared ultra vires by the Supreme Court in 1956). Estate Duty Act, 1953 was enacted to give effect to the recommendations (1951) of Commission (Vardhachari Commission). In 1954, Taxation Enquiry Commission (John Mathai Commission) was set up.

15. In 1956, Nicholas Kaldor was appointed to investigate the Indian tax system and his Report for a coordinated tax system to augment income tax led to enactment of the Wealth-Tax Act 1957, the Expenditure Tax Act, 1957, and the Gift Tax Act, 1958. While taxation of gifts continues as part of the Income Tax subject to exceptions, the Estate Duty, Wealth Tax and Expenditure Tax were later abandoned.

16. The Report of the Direct Taxes Administration Enquiry Committee (Chairman: Mahavir Tyagi) 1959 led to the enactment of enactment of the Income-tax Act, 1961 to replace the 1922 Act w.e.f. 1-4-1962. Since the enactment of IT Act, 1961, a

number of committees and commissions have examined the tax laws and tax administration like the Committee on rationalisation and simplification of tax structure (Bhoothalingam Committee) 1968; Direct Taxes Enquiry Committee (Justice K N Wanchoo Committee) 1971; Direct Taxes Laws Committee (Chokshi Committee) 1978, Tax Reforms Committee 1992/1993 (Chairman : Dr. Raja J. Chelliah), Task Force on Direct Taxes (Chairman : Dr. Vijay L. Kelkar) 2002; Tax Administration Reforms Commission (Chairman : Parthasarthy Shome) 2014/2015 and Committee on Direct Tax Matters, Report on Applicability of Minimum Alternate Tax on FIIs/FPIs for the Period Prior to 01.04.2015, 24 (Chairman: Justice(Retd) A. A. Shah) 2015. Based on the directions of the Hon. Supreme Court, a two-member Special Investigation Team on black money was constituted by the Government in 2014 with Mr. Justice M. B. Shah (Retd.) Chairman and Dr. Justice Arijit Pasayat (Retd.) Vice–Chairman. The SIT's interim reports are submitted to the Hon. Supreme Court. The SIT's interim reports are submitted to the Hon. Supreme Court. (Links to available reports is given in Annexure II).

17. Reports of all these Committees, Commissions, Expert Groups specifically tasked with review of the tax system have helped shape the tax reform agenda so far for the direct tax system evolve to the current level of maturity. The Reports of the successive Finance Commissions and the Reports of the CAG of India have also been instrumental in reshaping our direct tax system. To summarise all the recommendations, action taken and impact of all these Reports is beyond the scope of the present work. We summarise major developments under two broad headings: (A). Tax policy and legislative developments and (B). Institutional / administrative developments without necessarily attributing to each to any particular recommendation of any particular committee or commission.

Tax policy and legislative developments

18. As expected, the tax policy and legislative developments have been focussed on additional resource mobilisation by widening and deepening the tax base, forcing/nudging increased voluntary compliance, tackle black money by pushing for increased use of digital payments, discourage cash transactions that facilitates concealment of taxable incomes. Besides Tax Evasion, focus has also shifted to Tax Avoidance especially by foreign companies.

19. The developing nature of the economy of the country brought with it both steep rates of taxes and (resultant) black incomes, tax-evaded incomes, concealed/unreported income, not necessarily proceeds of crime. Demonetisation of high denomination notes (1946), Voluntary Disclosure Scheme (1951), Voluntary Disclosure Scheme (1965), Voluntary Disclosure Scheme for Income and Wealth(1975), Smugglers and Foreign Exchange Manipulators (Forfeiture of Property) Act, 1976, Special Bearer Bonds (Immunities & Exemptions) 1981, Benami Transactions Prohibition Act 1988, Voluntary Disclosure Scheme (VDIS) 1997, Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015, The Income Declaration Scheme, 2016 along with other changes in the Income Tax Act to discourage cash transactions and unexplained credits in bank accounts have all been legislative efforts to curb the generation of black money, to curb tax evasion. Demonetization of Rs.500/1000 currency notes and consequent big push to digitalisation further deepened with GST and during the pandemic has resulted in major growth in the number of taxpayers and direct tax collections.

20. In 2006, tax law was changed to regulate anonymous donations to wholly charitable or religious trusts or institutions or partly charitable or religious trusts or institutions. Curbs were put on large cash transactions. In 2008, income tax law stipulated that any cash payments aggregating beyond Rs.20000 in a day to a single payee would be disallowed as eligible tax-deductible expense. (per transaction limit changed to per day per payee limit).

21. Banking Cash Transaction Tax was introduced as a measure to check tax evasion in 2006 (to curb cash withdrawals) but the tax was abolished in 2008. The 2012 Finance Act stipulated 'measures to prevent generation and circulation of unaccounted money'. No exemptions/deductions were to be allowed to curb the practice of laundering of unaccounted money by taking advantage of basic exemption limit by laundering money through unexplained credits and cash receipts. Compulsory filing of income tax return in relation to assets located outside India was mandated. Prohibition was imposed on cash donations in excess of ten thousand rupees.

22. Based on the directions of the Hon. Supreme Court, a two-member Special Investigation Team on black money was constituted by the Government in 2014 with Mr. Justice M. B. Shah (Retd.) Chairman and Dr. Justice Arijit Pasayat (Retd.) Vice–Chairman. The SIT's interim reports are submitted to the Hon. Supreme Court. The Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 ushered several measures to curb black money stashed abroad. The Income Declaration Scheme, 2016 provided yet another opportunity to tax evaders to come forward and declare the undisclosed income and pay tax, surcharge and penalty totalling in all to forty-five per cent of such undisclosed income declared. The scheme was brought into effect from 1st June 2016. The scheme was made applicable in respect of undisclosed income of any financial year up to 2015-16. Tax was proposed to be charged at the rate of thirty per cent on the declared income as increased by surcharge at the rate of twenty five per cent of tax payable (to be called the Krishi Kalyan cess). A penalty at the rate of twenty five per cent of tax payable was also proposed to be levied on undisclosed income declared under the scheme. It was proposed that following cases shall not be eligible for the scheme:

    a) where notices have been issued under section 142(1) or 143(2) or 148 or 153A or 153C, or
    b) where a search or survey has been conducted and the time for issuance of notice under the relevant provisions of the Act has not expired, or
    c) where information is received under an agreement with foreign countries regarding such income,
    d) cases covered under the Black Money Act, 2015, or
    e) persons notified under Special Court Act, 1992, or
    f) cases covered under Indian Penal Code, the Narcotic Drugs and Psychotropic Substances Act, 1985, the Unlawful Activities (Prevention) Act, 1967, the Prevention of Corruption Act, 1988.

23. Demonetization of Rs.500/1000 currency notes and consequent big push to digitalisation further deepened with GST and during the pandemic has resulted in major growth in the number of taxpayers and direct tax collections.

24. **TDS/ TCS, PAN/Aadhaar, SFT/AAR :** Very few people paying income tax does not make for an equitable tax system. The rates of tax remain high and the high stakes for

tax evaders brings unacceptably high risks to taxmen as coercive search and seizure, the ‘raid-raj’ becomes inevitable. We have come a long way where almost all the direct tax collection comes from systematic tax compliance ensured by a large number of persons outside the income tax department collecting taxes on behalf of the department(TDS/TCS) and information sharing mechanisms (AAR/SFT) aided by spread of digital technology creating appropriate psychological effect for ordinary folks. Host of return filing mandates and mandated linkages of financial transactions trackable through PAN-AADHAAR-MOBILE herd most of the ordinary folks likely to astray from the compliant flock. Statutory obligations on persons making payments to effect recovery of TDS (Tax Deducted at Source) and TCS (Tax Collected at Source) is an important mechanism to forcing potential tax evaders to file tax returns and pay the balance tax due. The obligation was introduced under the Income Tax Act, 1922. Extensive expansion of TDS/TCS requirements have ensured that that over 85 percent of total income tax collection comes from TDS/TCS and voluntary tax compliance through Advance Tax and Self-Assessment Tax paid by the taxpayers. In 2021, Government brought legislative change to mandate that persons for whom tax is deducted through TDS/TCS but who do not file tax returns would be subjected to higher rates of TDS/TCS. However, the stipulation of higher TDS/TCS for non-filers of return of income introduced in 2021 has been removed in Budget 2025-26 keeping in view representations from various stakeholders that it was difficult for the deductor/collector, at the time of deduction/collection, to verify whether returns have been filed by the deductee/collectee, resulting in application of higher rates of deduction/collection, blocking of capital and increased compliance burden.

25. **Taxpayer Registration and Return filing mandates :** To systematize interface of the Income tax Department with the taxpayers, a system of Permanent Account Number (PAN) was introduced in 1972 to create a registry of taxpayers with the Income Tax Department to improve two-way communication. New PAN was introduced in 1994. Income Tax Department’s Permanent Account Number (PAN) 2.0 Project was approved on November 25, 2024. This initiative is set to revolutionize how PAN and Tax Deduction and Collection Account Number (TAN) are issued and managed, creating a simpler, more user-friendly, and efficient system for all taxpayers. PAN 2.0 aims to revolutionize the existing system by integrating all PAN/TAN services into a unified portal, ensuring a seamless and paperless process. Free e-PAN services and simplified updates enhance convenience for taxpayers.

26. Return filing mandates were imposed on persons showing conspicuous signs of being potential income taxpayers. In 1998, ‘one-by-six scheme’ was introduced requiring persons satisfying certain indicators of having taxable income to mandatorily file income tax returns or face penalties, irrespective of the fact whether his total income falls within or outside the exemption limit. (The six criteria were (i) “*in occupation of an immovable property exceeding a specified floor area, whether by way of ownership, tenancy or otherwise, as may be specified by the Board in this behalf*” (ii) Ownership of a motor car (iii) financing or undertaking a foreign trip. (iv) Holder of a credit card (v) Subscriber to a cellular phone (vi) Member of a club where the entrance fees being more than twenty five thousand rupees). This Return filing obligation imposed in 1998 on any person satisfying one of six specified consumption expenditure/asset criteria was withdrawn in 2006 for those having income below exemption limit.

27. In 2019, another set of criteria were set and the persons fulfilling these criteria are required to mandatorily file income tax returns or face penalties. These are focussed

on promotion of digital payments and promote lesscash economy. (Criteria: if during the previous year, he (i) has deposited an amount or aggregate of the amounts exceeding one crore rupees in one or more current account maintained with a banking company or a co-operative bank; or (ii) has incurred expenditure of an amount or aggregate of the amounts exceeding two lakh rupees for himself or any other person for travel to a foreign country; or (iii) has incurred expenditure of an amount or aggregate of the amounts exceeding one lakh rupees towards consumption of electricity; or (iv) fulfils such other prescribed conditions, as may be prescribed.)

28. **Presumptive Taxation** A scheme of Presumptive Taxation was introduced as a measure to widen tax base in 1992 where a person could pay a flat tax of Rs.1400. A presumptive tax system in respect of shop keepers and other retail traders with an annual turnover below Rs. 5 lakhs. In order to enable them to avoid the difficulty of maintaining detailed account books, filing a complicated tax return and going through the normal assessment procedure, a simplified scheme has been worked out under which the taxpayer will give only brief particulars of his turnover and pay just Rs.1400 as tax for that year. This should enable potential taxpayers in this category to overcome their psychological hesitation of getting into the tax system. This scheme was discontinued in 1997 and instead legal measures to widen tax base on certain economic indicators were introduced in selected cities. In 2011, a new scheme of presumptive taxation was introduced allowing computation of profits and gains of business on presumptive basis. It was later extended to professionals as well.

29. **Information gathering by the Income Tax Department:** The Tax Department has armed itself with powers to gather information to profile potential tax evaders. *Annual Information Return* (*AIR*) of high value financial *transactions technically called SFT-Specified Financial Transactions* - is required to be furnished under section 285BA of the Income-tax Act, 1961 as an innovation introduced in 2003. In 2004, the Government agencies were also mandated to furnish Annual Information Returns (AAR) for Specified Financial Transactions (SFT). Through the Finance Act of 2014, the obligation was repurposed and expanded as 'duty to produce a statement of financial transaction or reportable account'. This mechanism enables the Department to gather information on high value purchases and investments from banks and other financial sector intermediaries. The Income Tax Department also gathers information from the Central Board of Indirect Taxes and Customs (CBIC[9]) and from the tax authorities in other countries through information exchange agreements.

30. **Use of technology plus psychology plus deterrent punitive actions to promote voluntary tax compliance:** A whole armoury of anti-evasion and enforcement/compliance measures have been developed over the years (imposing return filing mandates on big spenders, tax deducted at source/tax collected at source (TDS/TCS) mandates, mandatory tax audits, double tax avoidance agreements and information sharing agreements with foreign governments, presumptive taxation, Minimum Alternate Tax, faceless assessment, expansion of trust-based self-assessment, obligations on banks and companies to file Annual Information Returns enabling identification of tax dodgers, taxpayer facilitation and felicitation.

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[9] 'CBIC & CBDT sign MoU to facilitate smoother bilateral exchange of data' Press release dated 21 July 2020 https://pib.gov.in/PressReleasePage.aspx?PRID=1640147

31. It is evident that the enhanced compliance measures implemented by the government after the introduction of GST and demonetization of 500/1000 currency notes are bearing fruits as seen in the rise of Tax: GDP ratio in recent years despite moderation in corporate tax rates. There is still a sizeable economy out of the tax net and fight against tax evasion, avoidance and tainted money will continue unabated. There is scope for further reduction in tax rates with continuing expansion of the taxbase for both direct and indirect taxes. Cutting down the scope for uncertainty of tax liability and resultant tax litigation through appropriate and timely legislative amendments can pre-empt and even extinguish a lot of tax litigation in which revenues and efforts are stalled for all the stakeholders. This is particularly true of classification disputes in GST.

New Tax regime for bridging the gap between statutory and effective tax rate

32. **New Tax regime for Corporate Tax:** Progressivity, equity, certainty and ease/efficiency of collection are universally accepted norm of good tax systems and providing guiding principles for tax reforms worldwide. It implies enhancing the tax base and lowering the tax rate except for the super-rich. For long, the more populist action of lowering the tax rates was preferred without removal of plethora of tax exemptions and concessions which reduce the effective tax rate much below the statutory tax rate. Straightaway lowering tax rates and scrapping exemptions for all taxpayers in one go would have been part of a standard playbook in tax reforms. However, the Central government adopted an innovative path of nudging the taxpayers to move towards lower tax rates with voluntary foregoing of some tax exemptions.

i. The beginning was first made for corporate taxpayers. In an unusual move for tax matters, the Taxation Laws (Amendment) Ordinance, 2019 was promulgated to make certain amendments in the Income-tax Act 1961 and the Finance (No. 2) Act 2019. These amendments ushered in some major changes in corporate income tax without awaiting for Budget 2020-21 to be presented in February 2020. It was a bold move to attract fresh investment to boost the economy stricken by the covid pandemic to supplement previously announced fiscal stimulus measures.

ii. Prior to the promulgation of the Ordinance, the domestic companies with annual turnover of up to Rs 400 crore were required to pay income tax at the rate of 25%. For other domestic companies, the tax rate was 30%.

iii. In order to promote growth and investment, a new provision was inserted in the Income-tax Act through this Ordinance with effect from FY 2019-20 which allows any domestic company an option to pay income-tax at the rate of 22% subject to condition that they will not avail any exemption/incentive. The effective tax rate for these companies shall be 25.17% inclusive of surcharge & cess. Also, such companies shall not be required to pay Minimum Alternate Tax.

iv. In order to attract fresh investment in manufacturing and thereby provide boost to ‘Make-in-India’ initiative of the Government, another new provision was inserted in the Income-tax Act through this Ordinance in the Income-tax Act with effect from FY 2019-20 which allows any new domestic company incorporated on or after 1st October 2019 making fresh investment in manufacturing, an option to pay income-tax at the rate of 15%. This benefit was available to companies which do not avail any exemption/incentive and commence their production on or before 31st March, 2023. The effective tax rate for these companies shall be 17.01%

inclusive of surcharge & cess. Also, such companies shall not be required to pay Minimum Alternate Tax.

v. The Ordinance further gave new domestic manufacturing companies an option to pay income tax at the rate of 15%, provided they do not claim certain deductions.

vi. A company which does not opt for the concessional tax regime and avails the tax exemption/incentive shall continue to pay tax at the pre-amended rate. However, these companies can opt for the concessional tax regime after expiry of their tax holiday/exemption period. After the exercise of the option, they shall be liable to pay tax at the rate of 22% and option once exercised cannot be subsequently withdrawn. A company could choose to opt for the new tax rates in the financial year 2019-20 (i.e. assessment year 2020-21) or in any other financial year in the future but once a company exercises this option, the chosen provision will apply for all subsequent years.

vii. Further, in order to provide relief to companies which continue to avail exemptions/incentives, the rate of Minimum Alternate Tax was reduced from existing 18.5% to 15%.

viii. These new domestic manufacturing companies were required to be set up and registered after September 30, 2019, and start manufacturing before April 1, 2023 (the cut off date extended to April 1, 2024).

ix. This path to voluntary foregoing of exemptions has opened the long awaited expectation to minimize the gap between the statutory and effective tax rate. The corporate income tax rate may be 30% on statute book but due to exemptions etc, the effective rate burdening the net profits could have been typically just about 20% for some corporates due to plethora of tax exemptions for which checking eligibility compliance and assessing intended benefits has been a challenge for the taxpersons and tax auditors.

x. **New Tax regime for non-Corporate Tax:** Following up on the government's move (September 2019 Ordinance) to incentivise corporates giving up several exemptions to avail lower corporate tax rate, the government introduced a similar scheme for non-corporate taxpayers in Budget 2020-21 in February 2020.

xi. Beginning April 1, 2020 (FY 2020-21), the Government of India implemented a new optional tax rate system for individuals and Hindu undivided families (HUF). Consequently, Section 115 BAC was added to the Income Tax Act of 1961 (the Act), which mandated lower tax rates for respective taxpayers and HUFs who did not take certain tax deductions or exemptions. Through successive budgets, the effective tax rates under the new tax regime are being lowered with a view to incentivise more and more taxpayers to switch to the New Tax Regime. Drawing lessons from behavioural economics and Realising the importance of default nudge in influencing general public behaviour, the Finance Minister announced in Budget 2023-24 that the new tax regime would be the default choice in the return filing system and thus taxpayers would need to consciously choose the old tax regime, if they decide to stick with it.

xii. The New Tax Regime has received enthusiastic response. Out of a record number of 7.28 crore Income Tax Returns filed for Assessment Year 2024-25 by the normal last date of 31st July 2024, as many as 5.27 crore returns (72% of total) were filed under the New Tax Regime.)

Institutional developments of modern direct tax system: Revamping, reforming and modernising direct tax administration

33. It is now well accepted that “tax administration is tax policy”. A tax administration designed to foster voluntarily compliance yields higher revenue than a sound tax policy administered by an inefficient tax administration. An efficient tax administration collects taxes remotely; rarely having the need to pay a visit to the taxpayer. This credo is now reflected in the present system of faceless assessment, appeal and penalty being the norm and physical contact, search and seizure being a rare exception. The Income-tax Department has seen major transformation since the immediate precursor to modern income tax was introduced in 1860. The standards of its service and transparency in its functioning has been steadily improving over the years, which is reflected in the dramatic increase in the share of personal income tax in the overall tax revenue of the Union government.

34. The IT Act 1886 was the first comprehensive Act of its kind in modern India that was a combination of 'Licence Tax' and 'Income Tax'. All the taxes were collected in the same manner as land revenue, recovery being entrusted to the officers of the Revenue Department.

35. Under the Income Tax Act, 1922, specific nomenclature was given, for the first time, to various Income-tax authorities and Commissioners of Income- tax with supporting Assistant Commissioners and Income-tax Officers were appointed separately for each province. Appellate functions were separated from inspecting/administrative functions in 1939. Directorate of Inspection (Income-tax) came into being in 1940. The executive and judicial functions were separated, and the Appellate Tribunal was set up in 1941.

36. The Act of 1922 significantly changed the Act of 1918 by shifting income-tax administration from the provincial to the central government. Another notable feature of the Act was that the rules would be outlined by annual Finance Acts instead of amending the Act itself. The Central Board of Revenue Act, 1924 created the Board as a statutory body.

37. In 1946, for the first time a few Group A officers were recruited directly by the income tax department. Later on in 1953, the Group 'A' Service was formally constituted as the 'Indian Revenue Service'. In 1957, I.R.S. (Direct Taxes) Staff College started functioning in Nagpur, now renamed as the National Academy of Direct Taxes.

38. In 1952, the Directorate of Inspection (Investigation) was set up and a new cadre known as Inspectors of Income Tax as an I.T. authority was created. The increase in 'large income' cases necessitated checking of the work done by departmental officers. Thus in 1954, the Internal Audit Scheme was introduced in the Income-tax Department.

39. In 1960, an MoU was signed for audit of direct taxes by the CAG of India and Directorate of Inspection (Research, Statistics & Publications) was set up. Under the Central Board of Revenue Act, 1963 which superseded the 1924 Act, the Central Board of Revenue was split into two, separately handling direct and indirect taxes. (Central Board of Direct Taxes (CBDT) and the Central Board of Excise and Customs (CBEC) which was renamed as the Central Board of Indirect Taxes and Customs (CBIC) in 2018 after the roll out of Goods and Services Tax (GST)). For the first

time, an officer from the department became Chairman of the Central Board of Direct Taxes (CBDT) w.e.f. 1-1-1964.

40. Since the creation of CBDT in 1963, the income tax department has undergone significant organisational changes by way of restructuring of cadres and in-house business process reengineering to improve efficiency and service delivery to a growing number of taxpayers. Intelligence Wing created and placed under the charge of Directorate of Inspection (Investigation). Valuation Cell came into existence in the Income tax Department. Tax Recovery Officers and under a Tax Recovery Commissioners started functioning from 1-1-1972. This was a very important administrative change, shifting the responsibility of income tax recovery, which till 1970 was the function of State authorities, to the departmental officers.

41. A new institution of Income-Tax Settlement Commission (ITSC) was created in 1976 as recommended by the Direct Taxes Enquiry Committee (Justice K N Wanchoo Committee) in 1971. The Committee *inter alia* recommended for the establishment of Income-Tax Settlement Commission, as an empowered quasi-judicial body, to serve as an alternative dispute resolution body in the administration of fiscal laws. Settlement is a concept that works and has worked well in other countries too for example the Hansard procedure of confession in the UK IRS and the Compromise Procedure of the US IRS. Income Tax Settlement Commission was created w.e.f.1-4-1976 under Taxation Laws (Amendment) Act,1975. ITSC is a quasi-judicial body whose decisions are only subject to Writ Jurisdiction of the High Courts and the Supreme Court. ITSC is empowered to grant immunity from prosecution for any offence and immunity from imposition of any penalty under the Income Tax and Wealth Tax Acts. The all proceedings before the ITSC are confidential and defaulting tax payer is given an opportunity to come clean through compromise and settlement to avoid protracted legislation and facilitate recovery of tax. However, after offering voluntary disclosure of income schemes in 1997 and 2016 and institutionalising direct settlement of disputes with the Department under various schemes to reduce litigation, the government decided to discontinue the Settlement Commission w.e.f. 1st February 2021 and constituted an Interim Board of settlement comprising of Departmental officers to deal with pending cases. Authority for Advance Rulings (AAR) is another quasi-judicial institution that was created in 1993. Given the Legislative intent that tax disputes should not be an impediment to investments, the Legislature in its wisdom, *vide* the Finance Act, 1993, had introduced scheme of advance ruling in Chapter XIX-B of the Act. The AAR, headed by a former Supreme Court judge or former Chief Justice of a High Court or Judge of a High Court for at least 7 years, with a member each from law and tax administration background, was empowered to pronounce its ruling on the taxability of the transaction undertaken or proposed to be undertaken by a non-residents. In 1998, this scheme was expanded to cover applications filed by the residents as well. The rulings were binding on the Tax Department but not on the High Courts and the Supreme Courts.

42. After a review of the AAR mechanism, AAR has now been replaced with three Boards for Advance Rulings (BAR) w.e.f. September 2021 constituted by the Central Board of Direct Taxes. A non-resident investor can obtain certainty on its liability towards income tax even before undertaking the investment in India. Further, even a resident entity can obtain a Ruling on the taxability of a transaction and avoid long-drawn litigation, as the Scheme is also available to a resident taxpayer seeking an advance ruling concerning its tax liability arising out of one or more transactions, valuing Rs.100 crore or more in total. Public Sector Undertakings can take advantage

of getting advance rulings on questions of facts or law pending before any income-tax authority or Appellate Tribunal. Mechanisms like the Board for Advance Rulings help in dispute prevention.[10]The most significant development in direct tax administration is deep and wide use of digital technology for last 25 years to tackle tax evasion and manage taxpayer interface culminating to a stage where assessments and appeals are now handled through a 'faceless' system with the tax assessee and the tax department officers remaining anonymous to each other. Deep level computerisation of departmental processes has resulted in substantial reduction in direct human interface with taxpayers.

43. Computerised processing of income tax returns all over the country started in 2002 was an epochal event in departmental history that took almost 20 years after the setting up of the Directorate of Income tax (Systems) in 1981. Today the online return filing system has developed to a maturity level where information gathered through Annual Information Returns is auto-populated and the taxpayers are presented with a near-filled form to check and file with online facility to pay tax.

44. In October 2019, National e-Assessment Centre (NeAC) was launched to implement the Budget announcement of a new assessment mode in 'faceless' interface between the taxpayer and the tax department. The faceless E-Assessment system will bring about a paradigm shift by eliminating human interface in income tax assessment. E-Assessment System based on algorithms and data-analytics and has no human element, cases of international taxation and those requiring searches and surveys kept outside purview of the scheme:

45. ITD's ambitious programme of computerization of various business processes starting electronic returns being filed by taxpayers and centralised processing of returns, e-filing on TDS/TCS returns by tax deductors/collectors and annual information returns by banks and companies etc. has substantially removed direct human interface.

46. **Document Identification Number (DIN) system:** In order to curb the practice of unauthorised unofficial, undocumented tax notices and communications to taxpayers and possibility of resultant misuse, the department decided to introduce a system of Document Identification Number (DIN) for each document officially emanating from the Department to a taxpayer / assessee and facility for electronic communication. Therefore, in 2009 ITD proposed to introduce a computer based system of allotment and quoting of Document Identification Number (DIN) in each correspondence sent or received by it so as to enable tracking of documents and minimize taxpayers grievances. The Finance Act, 2009 brought enabling changes in law. However, the DIN system was rolled back in Budget 2011-12 retrospectively due to non-availability of requisite infrastructure on an all-India basis. Later, with the introduction of Faceless Assessment in 2020, the relevance of DIN stands whittled down. Under the faceless assessment and appeal system, the communication of the department with the assessee has become highly controlled. Of course, the interface does not remain faceless once the tax dispute reaches the courts.

47. CBDT's achievements in the year 2024 demonstrate the power of digital transformation of direct tax administration. Speedy processing of returns and refunds remained a priority, with over Rs. 2.35 lakh crore refunded and more than 3.87 crore

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[10] Operationalisation of the Board for Advance Rulings
https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1950361

Income Tax Returns (ITRs) processed within 7 days. Innovations like TIN 2.0, pre-filling of ITRs, and updated returns continued to streamline processes, resulting in 47.52 lakh updated returns filed. More than 1.62 crore ITRS filed during F.Y. 2024-25 were processed in a single day. Approximately 21% of the ITR were processed in a single day during F.Y. 2024-25. Approximately 26.35% of ITRs were processed within a week of filing during F.Y. 2024-25 in comparison to 22.56% in F.Y. 2023-24.

TAXATION OF RISK CAPITAL AND UNCERTAIN INCOME FLOWS

SUBHASH CHANDRA PANDEY[11]

"*In this world, nothing is certain but death and taxes*" (Musings of the USA President Benjamin Franklin, 1789 on the permanency of the US Constitution): Ironical that the tax is certain whatever is the uncertainty about sustainability of the taxed income !

The corporate incomes are typically characterised as large but uncertain. The taxation of corporate income implies taxation of the shareholders of the corporates. The reforms in recent years have led to a reduction in the burden and share of corporate tax and an increase in the contribution of personal income tax with overall moderation in the incidence of tax on the corporate shareholders providing the 'risk capital'. We explore how the differences between the personal and the corporate tax regime have played out in arriving at this scenario, having regard to the inherent risk and uncertainty in business profits.

1. In this article, we briefly discuss the special considerations that have guided the taxation of corporate incomes vis – a- vis that of non-corporates mainly from the standpoint of uncertainty of income and gains to the shareholders of the corporates who are joint owners and beneficiaries of the corporate profits. Income-tax rates applicable in case of domestic companies for Assessment Year 2025-26 are as follows:

Where its total turnover or gross receipt during the previous year 2022-23 does not exceed Rs. 400 crore 25%

Companies having turnover up to Rs 400 crore which opted for Section 115BA	25% tax plus 7% surcharge on tax due for companies having a total income in the range Rs.1 crore to Rs. 10 crore and 12% in case companies having a total income exceeding Rs.10 crore plus 4% "Health and Education Cess on income-tax" of such income-tax and surcharge
Where it opted for Section 115BAA	22% tax plus 10% surcharge on tax due plus 4% "Health and Education Cess on income-tax" of such income-tax and surcharge
Where it opted for Section 115BAB	15% tax plus 10% surcharge on tax due plus 4% "Health and Education Cess on income-tax" of such income-tax and surcharge
Any other domestic company	30% tax plus 7% surcharge on tax due for companies having a total income in the range Rs.1 crore to Rs.

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	10 crore and 12% in case companies having a total income exceeding Rs.10 crore plus 4% "Health and Education Cess on income-tax" of such income-tax and surcharge

Provided that in the case of every company having a total income exceeding one crore rupees but not exceeding ten crore rupees, the total amount payable as income-tax and surcharge on such income shall not exceed the total amount payable as income-tax on a total income of one crore rupees by more than the amount of income that exceeds one crore rupees.

Provided further that in the case of every company having a total income exceeding ten crore rupees, the total amount payable as income-tax and surcharge on such income shall not exceed the total amount payable as income-tax and surcharge on a total income of ten crore rupees by more than the amount of income that exceeds ten crore rupees.

A company shall be liable to pay MAT @ 15% of book profit (plus surcharge and health and Education Cess as applicable) where the normal tax liability of the company is less than 15% of book profit.

Minimum Alternate Tax (MAT): Alternatively, all the companies (including foreign companies) are required to pay minimum alternate tax at the rate of 15% on book profits if the tax calculated as per above rates are less than 15% of book profits. This will be applicable if the company does not opt for Section 115BAA or Section 115BAB.

The following rates are applicable to foreign companies from AY 2025-26 based on their turnover :

Nature of Income	Tax Rate
Royalty received or fees for technical services from government or any Indian concern under an agreement made before April 1, 1976 and approved by central government	50%
Any other income (From AY 2020-21 to AY 2024-25, this is taxed at 40%)	35%

If total income exceeds Rs. 1 crore but not Rs. 10 Crore, a surcharge is payable @ 2 % of tax. If total income exceeds Rs. 10 crore, the surcharge payable is 5 % of tax. Further **Health & education Cess** is payable @ 4% of income tax and surcharge.

2. The taxes on incomes are now fairly well-established globally though the level of taxation varies widely. From time to time, the ideas of taxing consumption rather than income or taxing unearned income and wealth or taxing or additional taxation undistributed corporate profits keep recurring. Even in the developed world with very high degree of taxation, there is active discussion on rolling back income tax in favour of consumption tax.

3. What generates special excitement is the taxation of corporate profits especially when these are seen are fruits of concentration of dominant market power and resultant pricing power accumulated by large corporates. The counter argument that business

income is uncertain income prone to fluctuations is dismissed as baseless exaggeration of risk which are in any case covered by carry forward of loss provisions of the Income Tax Act.

4. If the uncertainty of income (or related consideration of limited earning life for particular professions) were to be given any special consideration, the incomes of film stars, other performing artists, sportspersons, new age influencers and informal sector workers facing income uncertainty on a daily or seasonal basis can all cite the same to demand special tax regime for ‘uncertain income’. Of course, the government taxes ‘casual income’, non-recurring windfall gains from winnings in lottery or any game of skill-cum-luck at flat rate of 30% [31.2%. with cess] without any set off of any loss. Certain business gains may be no different than gains from lottery/speculation.

5. The argument of business income being uncertain, carrying risk of fluctuation, indeed gets weakened when the corporates and their promoters are seen as not really absorbing the risk themselves but distributing it to debt and equity markets or to government.

6. If there is only a tax on personal income and no tax on corporate profits, undistributed profits would escape taxation until they are realised through the sale of shares; even then the tax burden would be less than what falls on regular income since capital gains are generally given concessional treatment. For reasons of equity, therefore, companies have also to be subjected to income tax along with the tax on unincorporated entities. Such a tax would prevent the use of incorporation as a device to minimise personal income tax.

7. There are two theories of taxation of corporate profits. One view is that corporations are distinct legal entities and that they can be taxed in their own right, apart from the tax that may be levied on the shareholders according to their respective ability to pay. This view is the implicit basis of the classical system of corporate taxation under which a separate tax is levied on the total profits of a corporation and neither the shareholder not the company is given any relief in respect of dividends on which the shareholders have to again pay tax. The other view that corporations could be treated as entirely independent entities on whom substantial additional tax liability could be levied is not generally accepted. Corporate profits belong to shareholders and strictly speaking the companies themselves have to be treated as conduits. Ideally, the mode of tax on company profit should be such as will apportion it among the different shareholders according to their respective income including their share in the profits of the corporation concern in practice it is difficult to achieve this result. The only way to approximate it would be to apply a modified partnership method by combining two rules: one, a rule that gives the corporation a deduction for dividends distributed, and two, a rule that gives corporations and shareholders the right to opt for a dividend to be deemed as distributed although the corporation has kept the money. This may be referred to as the full integration system where and the tax on the corporation is fully transformed into a tax on the respective shareholders.

8. No country has attempted to apply these rules to the taxation of corporate profits. The practical difficulty in applying these rules arises from the fact that shares are constantly being traded and their ownership changes hands frequently and deeming distribution would be an extremely difficult task in practice. Besides, the requirement to pay tax on profits not actually received would create liquidity problem for shareholders other than the rich ones. Also, every reopening of corporate tax assessment would entail concomitant reopening of shareholders individual tax liability.

9. Full integration is not feasible, the classical system provides for no integration at all. As a result, there is the so-called economic double taxation of dividends, i.e., taxation first in the hands of the corporations and again in the hands of the shareholders. This results in differentially high taxation of income from equity investment which could be criticized on grounds of efficiency and equity. The economic double taxation of dividend also implies differential tax treatment of dividend and retained earning which gives a bias towards non distribution inhibiting the flow of shareholders' savings into new companies which in turn works in favour of the existing companies. The classical system also discriminates in favour of debt finance as interest payments are deductible from gross profits for corporate tax purposes.

10. While full integration is not feasible, attempts have been made to devise a system which would reduce the dividends/retained earnings differential. These systems can be divided into two categories: (a) those which provide for the reduction at the company level and (b) those which provide for it at the shareholder level. Reduction at the company level can be in either of the two ways: (i) through a lower rate of corporation tax on distributed profits than on retained profits (split rate system). This is the system which is applied in Austria, Germany, etc.; or (ii) through exempting a proportion of the distributed profits from the corporation tax (partial dividend deduction). This system has been applied in Finland, Iceland, Spain, etc.

11. There are two methods followed by different countries for providing reduction in the dividend/retained earnings differential at the shareholder level: (i) A tax credit is given to the shareholder which is added to the dividend received by him and his personal tax liability is calculated on the basis of the grossed up amount against which the tax credit can be set off. Usually, the amount of credit granted is a function of the corporation tax actually paid by the company (imputation system). If the tax credit exceeds the shareholder's income tax liability, he will receive a refund from the Tax Department. (ii) A tax relief is given against the dividend income to resident shareholders investing in the equity of domestic companies, irrespective of whether or not the corporation tax has been paid on the profits (partial shareholder relief). The allowance is generally a proportion of the shareholder's dividend.

12. Partial integration can be carried further by exempting the entire distributed profits from corporate tax as in Greece and Norway or, at the shareholder's level, by giving credit to the shareholder to the full extent of the tax paid by the company on its

distributed profits. The partial integration systems are conceived of as devices to mitigate the deficiencies of the classical system, namely

a) it discourages distribution of corporate profits with the consequence that companies with large cash flows expand at the expense of new companies.

b) it tends to encourage mergers and accentuate monopolistic tendencies to the disadvantage of the new enterprises.

c) it puts a premium on debt as opposed to equity financing, thereby discouraging risk taking while increasing the possibility of insolvency; and

d) the dividends/retained earnings differential also tends to distort the choice between the corporate and non-corporate forms of doing business, implying a distortion in the allocation of capital.

13. While it cannot be denied that the classical system tends to create the above non-neutralities, it has been argued that these disadvantages are outweighed by other factors. The first argument is that the classical system has the merit of simplicity (but that argument may be untenable in the current state of digital technology in corporate and tax-related record-keeping and digital payments). Second, it has been argued that the non-neutralities are resulting more from other aspects of the tax system, such as the deductibility of nominal interest ·payments, the special treatment of capital gains and the relative effective rates of tax on corporate and personal income. Third, it is pointed out that it would not be justifiable to provide relief to the owners of existing shares, if that would provide them with big windfall gains, in view of the fact that while purchasing the shares, the factor of tax liability on dividends would have been discounted. Finally, it has been considered that the lowering of corporate tax rates significantly would ·render the dividends/retained earnings differential relatively unimportant in terms of affecting economic choices. If revenue considerations would permit only either reduction of the corporate tax rate or reduction in the dividends/retained earnings differential, the former should be preferred.

14. All these arguments are generic in nature and need to be tested under the specific tax regime in force in the country at the time of reckoning. The relative merits and demerits of the different partial integration systems, particularly the split rate system· and the imputation system have been discussed extensively in the literature. Developed countries which have been experimenting with these systems have· often moved from one system to another in the light of their experiences. A form of imputation system was in force in India with respect to the income tax on companies until 1960-61. It led to considerable administrative and compliance problems, because it in effect tied up the assessment of the tax liability of the shareholders with that of the company, so that whenever there was a reassessment of the tax on the profits of the company, the assessments of the shareholders had often to be reopened.

15. There has been some rethinking on the split rate system by countries which had earlier adopted it because it was felt that this system tended to give benefit to foreign investors or foreign companies which was really not intended. This system was also

felt to give undue benefit to tax exempt entities who would not have suffered in any case from the double taxation of dividends. The simplest and fairest method that would also not create any administrative problem to provide relief from the double taxation of dividends should be for a proportion of the distributed profits to be exempted from the corporation tax.

16. In Indian context, the system of taxation of corporate profits – both distributed or undistributed profits – and the related system of capital gains tax on sale of shares (which technically transfers the right to receive share of profits, accumulated, distributed, undistributed) has undergone significant changes in last few years. The classical system used to hold sway. The companies paid high tax at rather high corporate tax rates which basically meant the same flat tax rate applied to all shareholders, big or small. The corporate tax rates were equal or higher than the personal income tax rates prior to 2016 when the process of reducing corporate tax on small companies was set in motion. Secondly, before the 2018 budget, the long-term capital gains on the sale of shares in India and equity-oriented funds were exempted from tax under section 10(38). However, Budget 2018 removed this exemption. Dividend Distribution Tax (DDT) was introduced in in 1997, levied at a rate of 15% (plus applicable surcharge and cess) on the gross amount of dividend declared. DDT was first abolished in 2002, but it was reintroduced in 2003. DDT was abolished w.e.f. April 1, 2020 and dividends were made taxable in the hands of shareholders at their respective income tax rates. Large shareholders receiving dividends in excess of Rs.10 lakhs are subject to additional taxation. The burden of dividend taxation has now been shifted from corporations to individuals and from a flat rate to the actual slab rate applicable to individual shareholders. The net result of reduction of tax burden as corporate level and increased tax burden on individual shareholders. So, there is a general shift of tax burden from corporate tax (flat fixed common rate for all shareholders) to personal income tax for individual shareholders (different rates for different shareholders according to their applicable personal income tax slab. The result is visible in the tax collection figures of corporate tax and the personal income tax over the years.

17. Theoretically, each shareholder should be required to pay personal income tax on his proportionate share of corporate profit of which he is a part owner and the corporate entity itself should not be required to pay any extra tax separately: One Income, One Tax, no double taxation! This would be in the interest of equity because different shareholders fall in different tax brackets for personal income tax purposes. With the advent of digital technology implementing this should also not be a major challenge when the shares are all held in demat form and the corporate accounts are maintained in digital form and the taxation demand and payments are made in digital form. The tax would still need to be paid by the company but by calculating and apportioning it to different shareholders in proportion to their shareholding on the record date.

18. However, such an arrangement would be in the interest of public revenues only if the shareholders actually pay the personal income tax. If the shareholders enjoy any

exemptions and deductions under the personal income tax law, then shifting the corporate tax to such shareholders would mean revenue loss to public exchequer. For example, if a tax-exempt charitable trust is a shareholder in a company and the company pays corporate tax, the trust also gets implicitly taxed qua shareholder but if the company were to compute personal income tax for each shareholder, exchequer would lose revenue. Of course, rightfully tax-exempt shareholders should get what they are entitled to under the law. The problem is only if the charitable character is questionable, a sham arrangement.

19. Wide differential between rates of non-corporate and corporate tax creates opportunities for tax avoidance. In a country where there was no personal income tax, only corporate tax, it was noted that the promoters siphoned off profits from the companies by becoming highly paid employees of their companies, by lending to their companies at usurious rates of interest and by renting out their private properties at hefty rent to their companies. In this manner, they siphoned off corporate profits (which were taxable) as salaries, rents and interest in their own hands (not taxable). Similarly, if corporate tax rate is lower than personal income tax rate, there may be incentive to 'corporatise' otherwise personal income.

20. As the journey of tax reforms shows, constant vigil is required for tax enforcers to win the race against tax dodgers who will keep investing newer methods of tax avoidance.

TAXING MULTINATIONAL CORPORATIONS: GLOBAL MINIMUM TAX

DR. GOVINDA BHATTACHARJEE[12]

The global multinational companies have long been using the "base erosion and profit shifting" strategy to shift their profits from high tax jurisdictions to low tax ones, depriving the countries they earn their profit from of the taxes on such profits. All countries have been losing revenue but it hurts the developing countries more because of their low tax base. 136 countries agreed to impose a global minimum tax on such companies to be paid to the jurisdictions wherein they earn their profits under the International Tax Agreement of 2021 piloted by the Organisation for Economic Co-Operation and Development (OECD). The rules and laws in this regard are being framed in different countries after negotiating the complexities of international taxation and geopolitical ramifications.

1. The advent of globalisation and internet have gradually led to a world order where the world economies became so inextricably linked together that it is impossible to tackle tax evasion and avoidance by the multi-national corporations (MNCs) operating in multiple jurisdictions. While the tax-to-GDP ratio of industrialised countries remains well above 30%, developing economies often find it difficult to raise it above 15%; in India, it has been hovering around 17% for the last several years. This limits the capacity of the State to fulfil its core tasks to provide public goods and services to reduce poverty and accelerate economic development. The taxation of multinational corporate income can be an important source of government revenues for all developing countries.

2. Many studies have suggested that multinational firms engage in tax planning activities to avoid taxation in high-tax economies by shifting income from high-tax to low-tax jurisdictions. While this happens in both developing and developed countries, developing economies are especially prone to multinational profit shifting due to their lack of resources to implement effective anti-tax avoidance strategies. Also, shifting income from developing countries may be facilitated by a lack of anti-avoidance legislation, transfer price documentation requirements or thin-capitalization rules, or their weak enforcement.

3. In general, and for too long, taxing MNCs, especially the digital MNCs like Google, Facebook etc., have always been problematic even for the most advanced countries, because these companies are better equipped to shift profits across border to tax heavens. The rich G7 or OECD nations have equally struggled in vain for decades to make the MNCs operating within their jurisdictions to pay taxes to them. Using a tax avoidance strategy called Base Erosion and Profit Shifting, MNCs have been artificially 'shifting' their profits year after year from higher-tax jurisdictions to tax-havens where they pay little or no tax, or avail tax deductions on interest etc., 'eroding' the 'tax-bases'. Countries like Ireland, Luxembourg, Cyprus, Caribbean countries like British Virgin Islands, Bahamas or Cayman Islands, and Central American countries like Panama have used their tax rate arbitrage to attract the

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MNCs. About 40 percent of MNCs' overseas profits are estimated to be shifted to low-tax countries in this way. The tax losses are stupendous - estimated to be $50 billion for the USA and over $10 billion for India. Globally, MNCs are estimated to avoid $240 billion in fiscal revenues every year by following this strategy and Global South is disproportionately affected because of their limited revenue sources.

4. In a globalised and digital economy, MNCs operate through centrally managed business models, with their global profits coming from their global subsidiaries. But the current international tax rules, developed nearly a century ago, treat these subsidiaries as legally independent entities which trade between each other using "arm's length" prices to transfer goods and services, prices which are easy to manipulate to hide the actual income by inflating costs. MNCs then exploit this system by shifting their profits to jurisdictions with low or zero tax rates, enticing them with investments and employment. An IMF study in 2019 found that such "phantom" investments by MNCs had pushed Luxembourg's stock of FDI to $4 trillion, "an improbable one-tenth of the global total". Many small countries like Ireland, Cyprus, Hong Kong and Singapore have also benefited in this manner. These tax loopholes cannot be plugged without concerted action by all governments. The scale of the profit earned by them globally can be seen from Table 1, which lists only the five top multinational companies, all of them tech giants, whose market cap exceeds the GDP of most countries, giving them tremendous lobbying power and influence over many governments.

Table 1: Market cap and profit of five largest multinational companies

	Company	Sector	Market Cap (11/24)	Revenues (2024)	Profit (2024)
1	Nvidia	Semiconductors	$3.6 trillion	$113 billion	$73 billion
2	Apple	Technology	$3.4 trillion	$391 billion	$122 billion
3	Microsoft	Technology	$3.1 trillion	$254 billion	$108 billion
4	Amazon	E-commerce	$2.2 trillion	$620 billion	$63 billion
5	Alphabet (Google)	Technology	$2.2 trillion	$340 billion	$102 billion

Source: Largest Companies In The World - Global Finance Magazine https://gfmag.com/data/biggest-company-in-the-world/

5. Big MNCs not only run global economy but also the global political system. In his 2019 book "People, Power and Profits: Progressive Capitalism for an Age of Discontent", Nobel laureate Joseph Stiglitz said that the money power of MNCs "translates into political power" – ultimately "evolving into an economy and democracy of the 1%, for the 1% and by the 1%". The big US multinationals - the Silicon Six (Amazon, Facebook, Google's owner, Alphabet, Netflix, Apple and Microsoft) and many others - pay little or no tax – even after the massive corporate tax cut under the Tax Cuts and Jobs Act 2017 (from a tiered tax rate ranging from

15% to as high as 39% depending on taxable income to a flat 21%). The EU Tax Observatory's Global Tax Evasion Report of 2024 pointed that as much as $1 trillion of profits were shifted to tax havens in 2022, "equivalent of 35% of all the profits booked by multinational companies outside of their headquarter country". India, the report said, could generate $2.4-7.3 billion in 2023 from MNCs operating from its territory.[13]

6. Under a mandate from the G20, in 2015, the OECD countries agreed on a series of actions to address BEPS by large MNCs. These actions included measures to address mismatches between tax systems that were being exploited through aggressive tax planning and to ensure there was a floor under intense tax competition by countries to curb further erosion of tax bases globally.[14] In 2021, as a first step towards a fair and just tax system, through an International Tax Agreement, the G7 countries agreed to plug the cross-border tax loopholes used by the MNCS to evade taxes by reforming the global tax system based on two pillars: first, to distribute the profits equitably among countries where these are generated, enabling them to tax such profits, and second, adoption of a corporate global minimum tax (GMT) rate of at least 15%. A global common rate would preclude countries from undercutting each other, while still giving Governments the sovereign power to set their own higher corporate tax rates but not below the floor rate of 15%. If the MNCs still continue to shift their profits to a country with a lower tax rate, their home governments can 'top-up' their taxes to the minimum rate to eliminate the benefits from shifting profits. The GMT is the internationally agreed-upon minimum that would be a "top-up" tax between the jurisdiction's corporate tax rate and the GMT minimum, which is 15%. Pillar One thus focusses on where taxes will be paid, while Pillar Two focuses on how the taxes will be paid through the GMT.

7. Pillar One of the International Tax Agreement will re-allocate the taxing rights over MNCs from their home countries to the markets where they earn profits, regardless of whether they have a physical presence there. Specifically, MNCs with global sales above EUR 20 billion and profitability above 10% will be covered by the new rules, with 25% of profit above the 10% threshold to be reallocated to market jurisdictions. Pillar One also seeks to simplify transfer pricing rules for baseline marketing and distribution activities. Two parameters are defined for Pillar One: (1) 'Amount A' which is the amount of profit to be reallocated to countries where're they earn their profits from; and (2) 'Amount B' which aims to standardize the transfer pricing between different subsidiaries of an entity located in different countries in a manner that is aligned with the arm's length principle. Its purpose is two-fold: to simplify the administration of transfer pricing rules for tax administrations and reduce compliance costs for taxpayers and to enhance tax certainty and reduce controversy between tax administrations and taxpayers. Pillar Two of the International Tax Agreement imposes the Global Minimum Tax of 15% and the Subject to-Tax Rule (STRR).[15] The STRR rule denies treaty benefits when members apply nominal corporate income tax rates

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[13] https://www.fortuneindia.com/opinion/mnc-taxation-and-indias-dilemma/117379

[14]https://documents1.worldbank.org/curated/en/099500009232217975/pdf/P169976034c92506a0a1190bc5e3a05e3ed.pdf

The BEPS Actions included four minimum standards that serve as key cornerstones of the BEPS project: Action 5—Combatting harmful tax regimes; Action 6—Prevention of tax treaty abuse and countering treaty shopping; Action 13—Country-by-Country Reporting; and Action 14—Mutual Agreement Procedures (MAP).

[15]https://documents1.worldbank.org/curated/en/099500009232217975/pdf/P169976034c92506a0a1190bc5e3a05e3ed.pdf

below the agreed STTR rate to interest, royalties, and a defined set of other payments. The taxing right is to be limited to the difference between the minimum rate and the tax rate on the payment. The minimum rate for the STTR is set at 9%. The implementation of this rule requires changes to domestic legislation and tax treaties.[16] Obviously Pillar One requires the member countries to adjust their domestic taxation rules to align with the requirements of GMT, which may be complex, problematic and time-consuming.

8. Currently, more than 140 countries have committed to implement the GMT domestically and 90% of the large MNCs are expected to be brought under the scope of GMT by the end of 2025. Companies with earnings above 750 million Euro ($800 million) are now subject to the new 15% rate. GMT is estimated to reduce under-taxed profits by 80% as it applies across geographies, national income boundaries and tax haven structures. As a result, shifted profits will fall by around 50% resulting in tax base gains in the corresponding jurisdictions.

9. Studies show that corporate income shifting include distortions of transfer prices, the group's debt-equity structure, and the location of valuable assets. MNCs often arrange group's debt-equity structure so that their low-tax affiliates provide loans to subsidiaries in high-tax jurisdictions. The interest payments are deductible for the high-tax affiliates and add to the taxable profit of low-tax subsidiaries. The strategy allows them to shift taxable profits from high-tax to low-tax countries, so that the overall tax burden of the group declines. When an MNC uses this kind of profit shifting, the ratio of intra-firm loans to total assets of an MNC affiliate would be increasing in the corporate income tax rate of the host economy, and evidence supports this. Studies also point that the effects are different for affiliates in industrialised economies as against those in developing economies. It is seen that the intra-group debt ratio in developing economies reacts significantly more sensitively to changes in the corporate tax rate than in developed economies, the effect in developing economies being twice as high as that in developed economies.[17]

10. Profit shifting reflects a separation between actual economic activity and where those activities are recorded for tax purposes, and is especially feasible for highly profitable tech giants like such as Apple, Amazon, Facebook, or Google, but they are also widely practiced by traditional companies with retail outlets like Starbucks and McDonalds to generate large post-tax profits. In 2017, the USA enacted the Tax Cut and Jobs Act (TCJA), slashing corporate tax rate from 35 percent to 21 percent. It was hoped that TCJA would spur investment in the USA particularly by MNCs. But the fact remains that the actual tax rates paid by US MNCs are far below the statutory rate (e.g. 35% before the TCJA, 21% after) because of a range of available deductions and other tax benefits. Large US companies pay no current-year income taxes at all in years when they report high profits to shareholders, due to legal deductions and exemptions in the tax code. At least 55 of the largest corporations in the United States paid zero dollars in federal corporate income taxes in 2020.[18] Non-enforcement of

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[16] Ibid.

[17] Fuest, Clemens et.al., "International Profit Shifting and Multinational Firms in Developing Economies", Working paper, IGC, LSE, January 2011.

[18] Shaviro, Daniel N., "Taxing Multinational Corporations", New York University School of Law, July 10, 2021, https://econofact.org/taxing-multinational-corporations.

certain transfer pricing rules against just ten major MNCs alone has cost the US as much as $600 billion in revenue, and an underfunded IRS is helpless to track them.[19]

11. Like numerous other countries' international tax systems, the US international tax rules framed in 1962, which have remained unchanged in TCJA, also allow taxing US companies' foreign income. However, these taxes can be avoided by non-resident MNCs, giving rise to an incentive for "inversion" whereby US companies can effectively reclassify themselves as foreign companies. TCJA sought to address this by provisioning for (1) a "Global Intangible Low-Taxed Income", with 10.5% tax on a US-based MNC's income from foreign sources (above 10 percent return on all of its tangible assets abroad); and (2) a "Base Erosion anti-Abuse Tax", addressing the use of deductible payments to shift reported profits outside the US by both US-based and foreign-based MNCs. However, it was found that the TCJA failed to make a significant dent in corporate profit-shifting. The 2021 15% GMT is expected to address this, though it remains too early to tell how these efforts will turn out in the end, in view of the challenges including the refusal by a set of countries to sign onto the deal.[20] Many countries model their economies around low tax rates and minimal compliances to attract MNCs and create local jobs, which results in major corporations not paying any taxes or paying minimal taxes in the multiple jurisdictions where they operate. The lower-income countries may employ low tax regimes to attract MNCs to set up bases locally which creates positive externalities for them, through the growth of local service industries, reducing out-migration of talent, and attracting the much-needed labour, capital etc.

12. As many as 138 countries signed the Outcome Statement for Pillar One of the Global Minimum Tax (GMT) in July 2023. India was not among these, and neither was China nor the USA. The stakes are rather high - failure to reach agreement on final terms could prompt several countries to reinstate their taxes on US tech giants and risk punitive duties on billions of dollars in exports to the US. Many countries are already implementing Pillar Two, which sets the 15% global minimum tax on multinationals, although it has not been ratified by the US. On Pillar Two, India has set up a panel to frame rules for its implementation.[21] Eighteen of the EU's 27 nations have put in place domestic laws for the 15% global minimum tax. Indian MNCs are being charges this in the EU. But it is the Pillar One, the top-up tax that, because of its inherent complexities explained earlier, is creating problems for the USA, India and China. The top-up tax is the difference between the globally agreed minimum tax rate of 15% and the effective tax rate (ETR) the entity in the low-tax jurisdiction is subject to. If the low-tax country does not neutralise its tax advantage by introducing what is called a Qualified Domestic Minimum Top-up Tax (QDMTT), the intermediate holding company or the ultimate parent in other jurisdictions will be subject to a top-up tax. Even in cases where the intermediate holding company or the ultimate parent is in a low-tax jurisdiction, the global tax deal allows a way of neutralizing the tax advantage by subjecting MNC-group entities in countries with above 15% tax rates to

[19] https://thefactcoalition.org/facts-principles-for-taxing-u-s-multinational-corporations-after-2025/

[20] Shaviro, Daniel N., "Taxing Multinational Corporations", New York University School of Law, July 10, 2021, https://econofact.org/taxing-multinational-corporations.

[21] https://www.business-standard.com/economy/news/india-not-to-sign-global-corporate-tax-deal-until-concerns-addressed-124072501205_1.html

additional tax.[22] A decision on Pillar Two may come this year, but several aspects of Pillar One have yet to be resolved and agreed upon.

Specific issues and challenges in the taxation of Digital MNCs

13. With the tech giants like Google or Meta, there is another issue – that of digital advertisement revenue. Unlike the subscription-based revenues whereby a user obtains the digital services, say, to watch the streaming videos from Netflix, and may opt to switch to another if he is not satisfied by their contents or quality, the tech giants like Google, Facebook or Amazon, derive most of their revenues from targeted digital advertisements while users access their services free of cost. To put things in the proper perspective, the global digital advertising universe is estimated to generate revenues of around $600 billion in 2024. 42% of it accrues to Alphabet (Google's parent company), 23% to Meta (Facebook), and 9% to Amazon. For Meta, digital ads account for over 95% of its global revenue; for Alphabet, around 77%. Unlike conventional advertising, digital advertising increases impact by individualising ads while also reducing businesses' advertising costs. The firms generate such colossal revenues by prioritizing automation, surveillance and addiction over people's welfare, and collecting and monetizing data by fuelling people's anger which attract more viewers generating mire revenues from ad, and thus also helping governments to disempower their citizens through greater surveillance. It would be wishful thinking to expect responsible behaviour from them - blinded by wealth, they would stop at nothing to garner more profits.

14. In 2021, Nobel laureate economist Paul Romer proposed a progressive tax on such revenue. Progressivity offsets the increasing returns on investments that give bigger firms an advantage over their smaller rivals. Revenue is a better base than income for taxing transnationals because unlike income, sources of revenue cannot be shifted to a low-tax jurisdictions. Thus, taxing revenue from digital advertising is the best way to encourage companies to switch to the less dangerous and more acceptable way to shift to a subscription-based model where users pay only for the services they provide. Romer wanted it to target monopolies like Facebook or Google which have the power to influence our policy decisions. In their 2024-book "Power and Prestige: Our Thousand-Year Struggle Over Technology and Prosperity", Nobel laureates in economists, Daron Acemoglu and Simon Johnson, also proposed imposing a hefty tax on digital advertising revenue, to be paid not on the profits as is the usual commercial practice, but on digital ad revenues. It is too easy for these powerful multinational companies to hide profits by shifting their income or profits from high-tax to low-tax jurisdictions, hence the tax has to be on revenues earned as revenue sources cannot be shifted like profits. They proposed a flat tax of 50% when their annual digital ad revenue exceeds $500 million, the high threshold to prevent unintended negative effects on new entrants in digital economy. The steep tax can push all forms of media/communication away from an ad-based business model towards a subscription-based one, where revenues will be dependent on the quality of content and user experience. This may then nudge the social media and search engines move away from digital advertisement towards more meaningful and useful contents.

15. Of course, a sufficiently aggressive tax can always drive firms to engage in tax avoidance, which is counterproductive if the objective is to raise revenue. But the

[22] https://www.india-briefing.com/news/new-g7-proposals-on-taxing-multinationals-implications-for-foreign-entities-digital-companies-in-india-22397.html/

objective of a tax on digital ad revenue is only to encourage such avoidance by disincentivising the firms to expand their stranglehold of digital ads. Such avoidance can happen in two ways – bigger firms may split themselves into smaller ones but they will now be open to more competition from other similar sized firms, or they shift to the usual business model where price depends on the value provided by the seller – in short, a model based on subscriptions, like that used by Microsoft, Netflix or Duolingo. Such firms have no need to track all online activities of their users, or, as Romer said, "to turbocharge animosity as a way to get people to spend more using their services." Google already offers several subscription-based services like a premium subscription for access YouTube. A tax on digital advertising can to be so designed as to make the subscription-based model more attractive than the ad-based model, hence the tax has to be sufficiently aggressive. Romer suggested a tax system that starts with a 5% marginal tax rate (tax on the highest sab of income) for revenues between \$5-\$10 billion that progressively increases to 72.5% for advertising revenue exceeding \$60 billion a year, which means only the tech-titans - Google, Facebook, Amazon and Microsoft – will attract a marginal tax rate above 60%, with an average tax rate of 30% – 40%.

16. Apart from addressing the evils that social media today are unleashing on people, like addiction to digital contents and games, fuelling mental health issue and fomenting hatred, anger and extremism online, a sufficiently high digital ad tax rate would also stimulate innovation by encouraging new business models that allow good ideas to scale up, something that the digital behemoths today are ruthlessly suppressing using their money power through acquisition or other methods, attacking and eliminating anything that doesn't fit into their business model. As Governments globally struggle with the challenge of taxing the digital economy, digital advertising revenue is emerging as a key target and countries are exploring ways to tax such revenues from tech giants that operate with minimal local tax obligations despite generating huge profits in their markets. The idea is to establish a level playing field between digital and non-digital businesses and bringing tech companies under the tax net. While implementing such taxes presents significant challenges in terms of assessing revenue generated within a tax jurisdiction, some governments have already taken steps towards this. In 2020, UK introduced a Digital Services Tax to tax revenues generated by search engines, social media platforms and online marketplaces that includes digital advertising within its scope from their domestic users; in 2019, France had also enacted its Digital Services Tax on large tech firms based on their domestic revenues, including those that provide digital advertising services. Some US states have also done the same.

Digital MNCs and Indian Scenario

17. From the above discussion, we note that digitization has allowed businesses to generate cross-border revenues without physical presence in a particular country, raising concerns in market jurisdictions where customers/users reside. Outdated tax rules that were designed for a non-digitised world are currently depriving these jurisdictions of a fair share of taxes. The international tax debate has focused on this aspect, with the OECD proposing interim solutions under the BEPS Action Plan 1, including options like Significant Economic Presence, Withholding Tax on digital transactions and Equalization Levy. In response, many countries including India have unilaterally adjusted domestic laws to tax modern businesses.

18. Beginning April 1, 2020, India expanded the scope of its digital tax by imposing a two percent equalization levy on foreign entities selling goods and services online to customers in the country if they earned annual revenues more than Rs 2 crore. Earlier in 2016, India had introduced a six percent equalization levy on the online advertising revenues of large MNCs like Google and Facebook. This levy was significantly expanded in 2020 to include the online sale of goods and services within its scope. These Equalisation Levies imposed in 2016 and 2020 have been rolled back. The 2% Levy on specified non-advertising digital services was abolished under the Finance Act 2024 and the 6% Levy on online advertising has also been removed through official amendments to the tax proposals contained in the Finance Bill 2025 forming part of the Budget 2025-26.

19. In the Finance Act of 2018, India amended its tax law to widen the scope of the existing term 'business connection' to include the concept of "significant economic presence" (SEP), effective April 1, 2021. SEP primarily targets digital MNCs operating without a permanent establishment in the country. It stipulates the user base as a threshold for taxation: "Any transaction involving goods, services, or property conducted by a non-resident with any person in India, including the provision of downloading data or software in India, if the total payments from such transaction(s) during the previous year surpass INR 20 million; or the systematic and continuous solicitation of business activities or interaction with 300,000 users in India."[23]

20. India will be able to tax large MNCs doing business in the country – without a physical presence or permanent establishment – at 20 percent of their profits (exceeding a 10 percent margin). Thus, the measure will impact large digital companies mostly from G7 countries especially, when make profits based on their online presence in India. However, the G7 countries have also called for the elimination of the digital services tax or equalization levy. Tax experts are doubtful; they think if the equalization levy has to be rolled back, "taxing 20% of total net profits" may not be enough.

21. In taxing MNCs, it is also important to understand the concept of permanent establishment (PE), which is the foundation for the taxing MNCs globally. However, PE norms are not applied uniformly in all international tax jurisdictions.[24] Since the start of 2023, income tax authorities have been implementing measures to monitor international business establishments operating in the country. Section 92F (iiia) of the Income Tax Act 1961 deals explicitly with the concept of permanent establishment. In May 2023, the tax authorities, citing a draft order, attributed income of approximately Rs.55.25 crore (US$6.73 million) to Netflix's permanent establishment in India for the assessment year 2021-22.[25]

[23] The Income-tax Act, 1961, deals with permanent establishment of the assessee. Section 5(2) of the deals with the total income of non-residents, while Section 9 addresses income deemed to accrue or arise in India. The definition of 'business connection' is outlined in Explanation 2 of Section 9(1) of Income-tax Act, 1961, aligning with the Multilateral Instrument of OECD Model (MLI), which influences the interpretation and application of treaty clauses related to agency business connections.

[24] https://www.india-briefing.com/news/permanent-establishment-in-international-taxation-and-indian-tax-law-30295.html/

[25] https://www.businesstoday.in/technology/news/story/netflix-under-i-t-scanner-facing-tax-liability-in-india-for-streaming-services-income-report-380970-2023-05-12

Issues in audit of GMT

22. As the GMT framework will likely be operational within a year's time, it is time to start getting for the audit. Tax audit under it will be extremely complex involving many issues. Just as GMT cannot be implemented without collaboration of all countries, these issues related tax audit of MNCs, and especially digital MNCs, cannot be successfully handled without international cooperation and collaboration. It is imperative that every country improves the tax transparency of multinationals based within it. Aggressive profit shifting thrives in secrecy; therefore, in addition to the global minimum tax rules, public access to country-based tax information will help to deter aggressive profit shifting. To achieve greater transparency, countries should move to adopt strong public country-by-country reporting (CbCR) requirements for their multinationals.[26] The disclosure of critical tax information for each jurisdiction of operation will enable investors, legislators, and policy makers to assess material risks and design better tax policies. They must also improve how to exchange critical tax-relevant information with other countries. Since the USA is home to the largest number of MNCs, it should take a lead in this.[27] Digital asset reporting and country-by-country tax reports of MNCs would help improve transparency and improve revenue efficiency.

23. Objectives of tax audit, i.e. risk assessment and compliance to ensure that the tax liability is correctly determined and paid, remains unchanged for auditing taxes payable by the MNCs, though it will require much more sophistication in terms of infrastructure, technology and capacity. To be able to do a good job, it is important to initiate dialogue among the SAIs through available forums like INTOSAI or regional associations of SAIs to identify implementation challenges and strategize about requisite research, resources and response.

[26] Under BEPS Action 13, all large multinational enterprises (MNEs) are required to prepare country-by-country reports with aggregate data on the global allocation of income, profit, taxes paid, and economic activity among tax countries in which it operates. The OECD publishes aggregate CbCR data, including the number of MNE entities within a country, the number of employees, revenue, profit, and effective tax rates.

[27] https://thefactcoalition.org/facts-principles-for-taxing-u-s-multinational-corporations-after-2025/

AUDIT OF THE APPLICATION OF SAFE HARBOUR RULES AND TRANSFER PRICING

P. SESH KUMAR[28]

Safe Harbour Rules, introduced under Section 92CB, provide predefined conditions under which tax authorities accept declared transfer prices or margins, particularly in international transactions, to reduce litigation and compliance burdens. The SHRs provide tax certainty, mitigates dispute and simplify compliance for businesses, while also addressing potential concerns regarding revenue loss and tax avoidance by multinational enterprises (MNEs). It also explores Advance Pricing Agreements (APAs) as an alternative to SHR, allowing businesses to pre-negotiate transfer pricing methodologies with tax authorities. The integration of SHR with APAs under the Union Budget 2025 reforms aims to enhance tax certainty and reduce litigation by extending transfer pricing assessments over multiple years and expanding Safe Harbour provisions. However, issues related to transfer pricing abuses, profit shifting, and tax avoidance remain challenges that necessitate rigorous oversight.

The audit of Safe Harbour Rules (SHR) and Transfer Pricing under the Income Tax Act should seek to evaluate the efficacy and compliance of these regulatory mechanisms in India's tax framework. The audit framework includes a comprehensive review of SHR applications, transfer pricing compliance, and APA effectiveness. Key focus areas include verifying compliance with Rule 10TD, assessing revenue impacts, ensuring adherence to the arm's length principle, and identifying potential misuse of tax provisions. A structured audit methodology, including case studies and comparative international analysis is recommended to benchmark best practices and enhance transparency in India's tax administration.

Safe Harbour Rules and Advance Pricing Agreements in Income Tax administration

1. In income tax parlance, *Safe Harbour Rules (SHR)* refer to *a set of presumptive provisions that specify circumstances under which tax authorities would normally accept the declared income, expenses, or pricing of a taxpayer without scrutiny or adjustment*. These rules are particularly relevant in *transfer pricing* and other tax compliance situations, reducing litigation and compliance burdens.

2. The *primary objective* of SHR is to provide taxpayers with *certainty* regarding their tax obligations and *reduce disputes* by setting predefined margins or criteria that, if followed, prevent further questioning by tax authorities. Table 1 gives the position at a glance.

Table 1: Examples of Safe Harbour Rules in Income Tax

Situation	Example	Outcome
Safe Harbour in Transfer Pricing (International Transactions)	Suppose an Indian subsidiary of a U.S. multinational provides IT-enabled services (ITES) to its parent company. The Indian tax authorities require that the pricing of such	If the company follows this margin, no further audit or detailed scrutiny is required.

[28] P. Sesh Kumar, IAAS(1982), superannuated as a Director General of Audit.

Situation	Example	Outcome
	services meets the **Arm's Length Principle (ALP)**. To reduce disputes, Safe Harbour Rules(SHR) specify that **if the operating profit margin of the Indian subsidiary is at least 17% of total operating costs**, the tax authorities will not question the pricing methodology.	
Safe Harbour for Interest Rate on Loans to Foreign Affiliates	An Indian company lends money to its foreign subsidiary at **LIBOR + 3% interest**. Safe Harbour Rules may specify that if the interest rate charged is at least **LIBOR + 3.5%**, the transaction will not be subject to transfer pricing adjustments.	The company can charge this interest rate and avoid litigation over pricing disputes.
Safe Harbour in Domestic Transactions (Presumptive Taxation)	Safe Harbour principles also exist for **small businesses and professionals** under **presumptive taxation schemes**. A small trader with an annual turnover of ₹1.5 crore opts for **presumptive taxation** under **Section 44AD of the Income Tax Act**. The law allows the taxpayer to declare **8% of turnover (6% if digital receipts) as taxable income**, without the need to maintain books of accounts.	If the trader declares this income, the tax department will **not question the actual profits**, providing certainty and reducing compliance burdens.
Safe Harbour for Startups – Angel Tax Exemption	Under **Section 56(2)(viib) of the Income tax Act,** startups were previously subject to **Angel Tax** if they raised funds above their fair market value. However, SHR now allow **DPIIT-recognized startups** to receive investments without tax scrutiny, provided the investments comply with specified conditions.	Startups that meet the Safe Harbour criteria avoid unnecessary tax adjustments on fundraising.

3. Key Takeaways from SHR are that these *offer predefined conditions where tax authorities will not challenge the declared income, transfer pricing, or expenses. They provide certainty, reduce litigation, and ease compliance for businesses and professionals. These rules apply extensively in Transfer Pricing, Presumptive Taxation, and Startup Funding. Taxpayers following Safe Harbour provisions can avoid audits and scrutiny, leading to faster compliance and reduced legal costs.* As of February 2025, the Safe Harbour Rules (SHR) in the Income Tax Act provide predefined conditions under which the tax authorities accept declared transfer prices or margins by taxpayers, particularly in international transactions, without further scrutiny. These rules aim to offer certainty, reduce litigation, and simplify compliance for businesses.

4. The Safe Harbour provisions, introduced under Section 92CB of the Income Tax Act, empower the Central Board of Direct Taxes (CBDT) to frame rules specifying the circumstances in which the authorities shall accept the transfer price declared by the

assessee. These rules cover various transactions, including provision of software development services, information technology-enabled services (ITES), knowledge process outsourcing (KPO) services, provision of contract research and development services related to software development and generic pharmaceutical drugs, manufacture and export of core and non-core auto components and financial transactions such as intra-group loans and corporate guarantees.

5. Receipt of low-value-adding intra-group services under the existing SHR, such as an Indian company providing software development services to its foreign parent is deemed to have complied with the arm's length principle (ALP) if it declares a minimum operating profit margin of 17% on operating costs.

Changes Introduced in Budget 2025:

6. The Union Budget 2025-26 has proposed significant enhancements to the Safe Harbour framework to further reduce litigation and provide greater certainty to taxpayers. The scope of SHR is being broadened to include additional categories of international transactions and specified domestic transactions. This expansion aims to cover a wider range of industries and transaction types, thereby providing more taxpayers with the option to benefit from these provisions.

7. A new mechanism allows taxpayers to apply the outcome of a transfer pricing assessment for one financial year to the next two years. If a taxpayer opts for this, the arm's length price determined for one year can extend to the following two years, simplifying compliance and reducing the frequency of audits. To promote electronics manufacturing, a presumptive taxation regime is proposed for non-residents providing services or technology to resident companies setting up or operating electronics manufacturing facilities. Under this proposal, 25% of the gross receipts will be chargeable to tax, resulting in an effective tax rate of less than 10%. A safe harbour provision is introduced for non-residents who store components in India for supply to specified electronics manufacturing units, providing tax certainty and encouraging investment in the electronics sector.

8. Let us take the example of an Indian subsidiary of a U.S.-based multinational corporation which provides IT-enabled services (ITES) to its parent company. Under the existing SHR, if the subsidiary declares an operating profit margin of at least 17% on its operating costs, the transfer price is accepted by the tax authorities without further scrutiny. Post-Budget 2025, with the proposed expansion, if the subsidiary engages in additional services or transactions not previously covered under Safe Harbour, it may now benefit from the extended provisions, provided it meets the specified conditions. If the subsidiary opts for the block transfer pricing assessment mechanism, the arm's length price determined for one year can be applied to the subsequent two years, reducing compliance efforts and providing greater certainty. These changes aim to create a more taxpayer-friendly environment, encouraging compliance and reducing disputes between taxpayers and the tax authorities.

9. The Union Budget 2025 has introduced measures aimed at reducing transfer pricing disputes. Taxpayers now have the option to determine the Arm's Length Price (ALP) for a particular year and apply it to similar transactions for the subsequent two years as explained in the example above. This approach minimizes repetitive analyses and offers greater certainty, thereby reducing the potential for disputes. The scope of SHRs has been broadened to encompass a wider array of transactions and industries.

This expansion encourages more taxpayers to adopt these provisions, simplifying compliance and decreasing the likelihood of litigation.

10. Let us examine SHR in other jurisdictions. The US employs safe harbour provisions in specific contexts, such as inter-company services. For instance, the Services Cost Method allows certain low-margin services to be priced at cost without a markup, provided they meet specific criteria, thereby reducing compliance burdens and audit risks. The UK does not have formal safe harbour rules. Instead, it emphasizes detailed transfer pricing documentation and encourages the use of Advance Pricing Agreements (APAs) to achieve certainty and minimize disputes. Nearer home, Bangladesh has yet to implement specific safe harbour provisions within its transfer pricing regulations. The country follows general transfer pricing principles without simplified measures for compliance. While Sri Lanka's Inland Revenue Act provides a legal basis for safe harbour rules, no specific guidelines have been issued to date. Consequently, taxpayers must adhere to standard transfer pricing regulations without the benefit of simplified compliance options.

11. In summary, the 2025 Budget reforms aim to streamline transfer pricing compliance and reduce litigation by introducing block assessments and expanding safe harbour provisions. Internationally, the adoption and implementation of safe harbour rules vary, with some countries offering specific provisions to simplify compliance, while others rely on detailed documentation and agreements to manage transfer pricing issues.

12. A discussion on SHR would be incomplete without understanding the position of Advance Pricing Agreements (APAs) in India. *Advance Pricing Agreements (APAs)* and *SHRs* are both mechanisms designed to reduce transfer pricing disputes, but they serve slightly different purposes. While *SHRs* provide *predefined margins* for specified transactions, *APAs allow businesses to negotiate and agree on transfer pricing methodologies with tax authorities in advance*. Under the *Budget 2025*, India aims to integrate *Safe Harbour provisions with APAs*, enabling businesses to *choose the best compliance mechanism* based on their operations.

13. For this, we need to know how APAs work under SHR which can be *a benchmark for APA negotiations.* Taxpayers can opt for SHR if their *margins meet the predefined threshold*. If they operate *below Safe Harbour margins* or have complex transactions, they can negotiate an APA. For *example, if* the Safe Harbour margin for IT services is *17%*, but a company operates at *15%*, they may opt for an APA to justify their pricing instead of accepting a *higher margin* under Safe Harbour. APAs allow businesses to *agree on transfer pricing methodologies for multiple years*. This aligns with *block transfer pricing assessments* introduced in Budget 2025, which allows an agreed price to apply *for up to three years*.

14. Following examples will illustrate Safe Harbour vs. APA for IT Services. A multinational company (MNC) operates an IT support centre in India, providing services to its U.S. parent. *SH*R requires a *17% operating profit margin*. The company earns *15%* and finds *17% too high* due to lower costs in India. Instead of opting for Safe Harbour, it negotiates an *APA with the tax department* and agrees on a *15.5% margin for five years*. The company thus avoids yearly disputes while maintaining a *lower* but *agreed* transfer pricing margin.

15. Let us see a case of APA for cross-border loans, now. An Indian subsidiary receives a loan from its foreign parent at *LIBOR + 2%*. SHR requires a *minimum LIBOR + 3.5% interest rate*. The company may argue that *its credit rating justifies a lower rate*. It

enters into an *APA* where it agrees with tax authorities on a *LIBOR + 2.5% rate for five years*. The company avoids litigation and ensures compliance without artificially inflating interest costs.

16. *SHR and APAs work together*. Safe Harbour offers *predefined margins*, while APAs allow *customized pricing agreements*. *APAs help taxpayers avoid litigation* when they operate *outside Safe Harbour limits*. *Multi-year certainty* under APAs aligns with the new *block transfer pricing assessments* in Budget 2025. *Industries like IT services, KPOs, and financial transactions benefit most* from these mechanisms.

17. Let us now try to understand what exactly is an APA. It is a voluntary arrangement between a taxpayer and the tax authority that predetermines the transfer pricing methodology for specific international transactions over a set period. In India, the APA program was introduced in 2012 to provide tax certainty and minimize disputes related to transfer pricing. There is a unilateral APA which is an agreement between the taxpayer and the Income tax Department, without involving foreign tax authorities. A bilateral APA involves the taxpayer, the Income tax Department, and the tax authority of the associated enterprise's country, facilitated under the Mutual Agreement Procedure (MAP) of tax treaties. Multilateral APA includes multiple tax authorities, covering complex transactions involving several jurisdictions.

18. The APA Process in India starts with pre-filing consultation. This is a mandatory, non-binding meeting between the taxpayer and the APA team to discuss the scope, transfer pricing issues, and the feasibility of an APA. It follows submission of a detailed application outlining the proposed transfer pricing methodology, supported by relevant documentation. The APA team reviews the application, conducts site visits if necessary, and engages in discussions with the taxpayer to finalize the terms. Once terms are agreed upon, the APA is formalized, specifying the agreed transfer pricing methodology and critical assumptions. The taxpayer must file an annual compliance report to demonstrate adherence to the APA terms. Table 2 will explain the scenarios.

Table 2: Examples of APAs

Aspect	**Unilateral APA in the IT Sector**	**Bilateral APA in the Manufacturing Sector**
Scenario	An Indian subsidiary of a U.S.-based multinational provides software development services to its parent company.	An Indian manufacturer exports goods to its associated enterprise in Germany.
Challenge	The subsidiary seeks certainty on the transfer pricing methodology to avoid potential disputes.	Differences in transfer pricing regulations between India and Germany lead to potential double taxation.
Solution	The company enters into a unilateral APA with the Indian tax authority, agreeing on a Cost-Plus Method with a specified markup for its services.	The company pursues a bilateral APA, involving both Indian and German tax authorities, to agree on the Transactional Net Margin Method (TNMM) for pricing its exports.
Outcome	The subsidiary achieves tax certainty for the agreed period, reducing the risk of future transfer pricing audits.	The bilateral APA provides a harmonized transfer pricing approach, eliminating double taxation and ensuring compliance in both jurisdictions.

19. Benefits of APAs are many. It provides upfront agreement on transfer pricing methodologies, reducing future disputes. It minimizes the risk of transfer pricing audits and associated legal costs and allows for tailored solutions considering the taxpayer's specific circumstances. In certain cases, APAs can be applied retrospectively to previous years, subject to conditions. In summary, APAs serve as a proactive tool for taxpayers in India to achieve certainty and mitigate risks associated with transfer pricing, thereby contributing to a more stable and predictable tax environment.

20. The Income tax Department would like to project that India's APA program has seen significant success, with over 500 APAs signed by March 2023, reflecting its effectiveness in providing tax certainty and fostering a non-adversarial tax environment. Before we proceed to discuss the strategy for examination by CAG of the performance and effectiveness of SHRs and APAs, it would be useful to broadly understand issues relating to Transfer Pricing which is inextricably linked to SHR and APA. *Transfer pricing* refers to the *pricing of goods, services, and intellectual property transferred between related entities within a multinational group*. Since these transactions occur between associated enterprises (AEs), tax authorities regulate them to prevent tax avoidance and profit shifting.

21. An example will illustrate this. A company, *ABC India Ltd*, is a subsidiary of *ABC Inc., USA*. ABC India manufactures automobile components and sells them to its parent company in the U.S. at *₹500 per unit*. If the market price for similar components is *₹800 per unit*, ABC India is *under-pricing* its exports, potentially shifting profits to the U.S., where tax rates might be lower. To prevent such tax base erosion, tax laws require that *ABC India must price its sales as if they were conducted between unrelated parties*—this is the *arm's length principle* (ALP). The *Arm's Length Principle (ALP)* states that *the price charged for a transaction between related parties should be the same as what would be charged between unrelated, independent parties under similar conditions*. This principle is embedded in *OECD Transfer Pricing Guidelines* and is enforced in India under *Section 92C of the Income Tax Act, 1961*. Using the previous example, if an independent Indian manufacturer sells similar components to an unrelated U.S. company for *₹800 per unit*, then *₹800 is the arm's length price*. ABC India Ltd must price its exports to ABC Inc. USA at or near *₹800*, failing which Indian tax authorities may adjust its taxable income.

22. The Income Tax Act and OECD prescribe *five primary methods* for determining ALP.

   i. Under the *Comparable Uncontrolled Price (CUP) Method we* compare the price charged in a controlled transaction with the price in an *uncontrolled transaction*. If ABC India sells to an unrelated U.K. company for ₹800, that price serves as a benchmark.

   ii. *Resale Price Method (RPM) is* used when an associated enterprise *buys goods and resells them without adding significant value*. If ABC Inc. USA buys from ABC India at ₹500 and resells to third parties at ₹1000, after deducting normal resale margins, the arm's length price is determined.

   iii. *Cost Plus Method (CPM)* adds a markup to the cost incurred by the supplier. If ABC India manufactures a component at ₹400 and independent companies apply a 20% markup, then the ALP is *₹480*.

   iv. Under the *Transactional Net Margin Method (TNMM) we* compare the net profit margin from related transactions with that of independent transactions. If ABC

India's operating margin is 15%, but independent companies earn 18%, an adjustment may be required.

v. Lastly, *Profit Split Method (PSM) is* used in cases where *both entities contribute significantly to value creation*. For instance, ABC India and ABC USA jointly develop patented technology. Profits are allocated based on their contributions.

23. Companies engaging in international transactions must maintain *Transfer Pricing Documentation* (TPD), file *Form 3CEB* (Certified Report by a Chartered Accountant) and transactions comply with *arm's length pricing (ALP)*, or risk adjustments and penalties. Thus, *Transfer Pricing* governs transactions between related parties to ensure tax fairness. *Arm's Length Pricing* ensures these transactions are priced as if they were between unrelated entities. Various *ALP methods* exist to benchmark pricing, avoiding tax avoidance concerns. Non-compliance leads to *adjustments, penalties, and litigation*.

24. Over the past 12 years, Income Tax Department has intensified its scrutiny of transfer pricing practices to prevent tax base erosion and profit shifting by multinational enterprises (MNEs). Despite the establishment of regulatory frameworks such as Transfer Pricing (TP) regulations, Advance Pricing Agreements (APAs), and the enforcement of the Arm's Length Principle (ALP), instances of misuse and abuse have been identified.

25. Transfer pricing involves setting prices for transactions between associated enterprises within a Multi-National Enterprise or Entity (MNE). While legal, it becomes problematic when used to shift profits to low-tax jurisdictions, thereby minimizing tax liabilities in India. The Income Tax Department has observed cases where MNEs manipulate transfer prices to underreport income or inflate expenses, leading to significant revenue losses.

26. Introduced in 2012, APAs were designed to provide tax certainty by allowing taxpayers to agree in advance on the transfer pricing methodology for their international transactions. However, there have been concerns about potential misuse. The APA process has faced challenges such as prolonged negotiation periods and inconsistent application across similar cases, which can undermine the program's effectiveness. While rollback provisions aim to apply agreed methodologies to prior periods, there is a risk that taxpayers may exploit these to retroactively legitimize aggressive transfer pricing practices.

27. The ALP mandates that transactions between related parties be conducted as if they were between unrelated parties. Taxpayers may select inappropriate comparables that do not reflect true market conditions, leading to distorted pricing. In cases involving unique intangibles or complex financial arrangements, determining an arm's length price becomes challenging, providing opportunities for manipulation.

28. The Income Tax Department has taken some steps to address these issues. In August 2024, the Department issued a pre-demand notice to Infosys suggesting that its overseas operations have led to substantial under-reporting of tax due by approximately $4 billion.

29. The department's approach to tackling aggressive tax planning strategies. Investigations have revealed that companies like Aviva allegedly used fake invoices and secret cash payments to evade taxes, highlighting the department's focus on diverse sectors.

30. To curb misuse and enhance compliance, the Income Tax Department has implemented several measures such as Safe Harbour Rules, APA Program Expansion and Enhanced Documentation Requirements. It introduced simplified compliance options for taxpayers, where rules specify circumstances under which transfer prices are automatically accepted by tax authorities, thereby reducing disputes.

31. The department has expanded the APA program, signing a record 125 APAs in the fiscal year 2023-24, to provide greater certainty and reduce litigation. Taxpayers are mandated to maintain detailed transfer pricing documentation to substantiate their pricing methodologies, ensuring greater transparency. While regulatory frameworks like TP regulations, APAs, and ALP enforcement have been established to ensure fair taxation, the Income Tax Department's experience over the past 12 years indicates ongoing challenges due to misuse and abuse. Continuous monitoring, enforcement actions, and the implementation of mitigating measures are essential to uphold the integrity of India's tax system. Unless the efficacy and usefulness of these initiatives are assessed independently say, by CAG, their effectiveness would not be known.

32. Now we come to the possibilities and strategy for audit of the application of SHR and transfer pricing under the Income Tax Act by the CAG. Such an audit has not been attempted before possibly as the subject was evolving, was complex and also as the CAG audit establishment was comfortable with easier audits of routine assessments.

33. The *audit of transfer pricing and the application of Safe Harbour Rules (SHR) under the Indian Income Tax Act, 1961* requires a robust framework to assess compliance, effectiveness, and risks associated with the administration of these provisions. The *CAG*, as part of its mandate under section 16 of the CAG's, DPC Act, is empowered to examine to seek an assurance that there is transparency and efficiency in revenue administration which includes examination of the functioning of the *Income Tax Department (ITD)* in regulating transfer pricing, the effectiveness of SHR, and the issues and risks in *Advance Pricing Agreements (APAs)* and *Arm's Length Pricing (ALP)* determinations.

Audit of Safe Harbour Rules (SHR)

34. As explained earlier *SHR*, introduced under *Section 92CB of the Income Tax Act, 1961*, are designed to provide certainty to taxpayers by prescribing fixed margins for specified international transactions. These rules aim to reduce *litigation and compliance burdens* while ensuring that transactions with related parties adhere to *fair pricing norms*.

35. The audit of SHR application involves examining verification of whether the taxpayer meets the conditions prescribed under *Rule 10TD* of the Income Tax Rules, 1962. It should review transaction types declared under *Safe Harbour provisions* and assessment of their qualification under the prescribed limits. Scrutiny of *margins declared* by taxpayers under SHR is required to ensure they meet the prescribed thresholds.

36. Audit would analyse whether the Safe Harbour pricing has been applied correctly without manipulation or undue benefit. Examination of tax department records would be required to assess the number of *cases where Safe Harbour was availed versus those that proceeded to litigation*. Review of tax revenue trends post-SHR implementation is necessary to check whether the provisions have prevented revenue loss. The more important check would be to assess whether SHR is being *misused by MNEs* to shift profits without facing scrutiny. The challenge would be Identification

of cases where *business models could have been artificially restructured* to fit into Safe Harbour criteria. Lastly, it should involve review of *any loss of tax revenue* due to SHR application and whether these losses were justified in light of reduced litigation costs.

Audit of Transfer Pricing Mechanism

37. Transfer pricing provisions under *Sections 92 to 92F* of the Income Tax Act mandate that international and specified domestic transactions be conducted at *Arm's Length Prices (ALP)*. The *CAG's audit of transfer pricing compliance* should focus on reviewing whether the taxpayer has selected the *most appropriate method* from the five prescribed under *Section 92C*. It has to verify supporting documentation for ALP determination. Audit has to ensure that the selection of *comparable companies* for benchmarking follows industry norms and economic reality. It would be the highlight of the audit if it could identify *manipulative selection of comparables* to justify non-arm's length pricing.

38. The less challenging part of the audit would be verifying compliance with *Rule 10D*, which mandates the maintenance of *transfer pricing documentation* and checking whether the documentation sufficiently explains the pricing policy and related-party transactions. The last step would be to assess *tax revenue impact and litigation trends* analysis of transfer pricing disputes raised by the tax department and whether they resulted in revenue recovery or loss. The audit should culminate in comparison of *revenue collection trends before and after transfer pricing assessments*.

39. Let us now come to audit issues and risks in Advance Pricing Agreements (APAs) as all these initiatives are inextricably intertwined and inter-related.

40. The *APA mechanism*, introduced under *Section 92CC of the Income tax Act*, allows taxpayers to pre-determine transfer pricing methodologies with the tax department for up to five years (plus rollback for four years). However, several risks arise in APA administration such as *delays and inconsistencies in APA processing.* Examination of the *timeline of APA approvals* would be necessary to determine inefficiencies besides reviewing the consistency of APA terms across similar industries to ensure fair treatment. Audit has to examine whether *agreed transfer pricing margins* had led to artificial profit shifting besides assessing whether *APA concessions* have led to a reduction in taxable profits beyond reasonable limits.

41. Audit would need to review cases where rollback APAs have been applied and their *impact on past tax assessments* while ensuring that rollback agreements have *not resulted in undue refunds or revenue leakage*. It has to examine whether *taxpayers continue to adhere* to agreed APA terms in subsequent years. The challenge is identification of cases where *APA conditions were violated post-approval* without penal consequences.

42. Risk areas for audit in Arm's Length Pricing (ALP) determination would be *inappropriate selection of ALP Methods, possible manipulation of comparables for ALP Justification, use of multiple ALP Methods to justify pricing and inconsistent ALP Adjustments by tax authorities. Table 3 is a sample check list for possible use in the audit by CAG.*

Table 3: Sample Audit Checklist for Safe Harbour Rules and Transfer Pricing

Audit check points	Observations	Compliance (Yes/No)	Remarks
Is the taxpayer eligible for SHR?			
Have prescribed margins under SHR been correctly applied?			
Has the taxpayer availed SHR for multiple years?			
Has SHR implementation led to significant reduction in litigation?			
Does transfer pricing documentation comply with Rule 10D?			
Has the most appropriate ALP method been applied?			
Are comparable companies properly selected and justified?			
Are APA agreements executed within reasonable timelines?			
Have rollback APAs resulted in potential revenue loss?			
Have APAs been monitored for compliance post-approval?			
Have transfer pricing assessments led to significant tax adjustments?			

43. The audit of SHR and transfer pricing could play a crucial role in ensuring fair tax practices, preventing revenue loss, and minimizing litigation in an evolving and challenging area of direct taxes administration The increasing use of APAs, ALP adjustments, and Safe Harbour Provisions makes it imperative for tax authorities to ensure fair pricing mechanisms while balancing the need to attract foreign investment and maintain India's tax base.

44. The introduction of Safe Harbour Rules (SHR) and Advance Pricing Agreements (APAs) has been a significant step in India's transfer pricing regime, aiming to provide tax certainty, reduce litigation, and facilitate compliance. However, the effectiveness of these provisions must be periodically assessed to ensure that they do not lead to unintended revenue losses or facilitate tax avoidance.

45. The audit of SHR and transfer pricing can serve as a critical tool in evaluating the fairness and transparency of these mechanisms. Given the complexity and evolving nature of international taxation, a well-planned audit strategy is essential to assess whether SHR is being misused by MNEs for profit shifting, whether transfer pricing methods are appropriately applied, and whether APAs are effectively negotiated and enforced. The findings from such an audit can provide valuable insights into improving tax administration, enhancing revenue collection, and minimizing disputes. It can also ensure that India's tax system remains robust and competitive while

maintaining fairness in cross-border transactions. As India continues to refine its tax policies to attract foreign investment while safeguarding domestic tax revenues, independent audits will play a crucial role in maintaining transparency and accountability within the system.

ISSUES AND CHALLENGES IN TAXATION OF TRANSNATIONAL COMPANIES

P. SESH KUMAR[29]

Aggressive tax planning by transnational companies becomes a global concern in a world where Tax:GDP ratios range from 5 percent to 50 percent reflecting different levels tax-and-spend political ideologies across countries, wide variation in per capita incomes within countries and among countries. India along with other developing countries have had to contend with foreign companies making profits in provision of goods and services to Indian consumers directly or through a web of intermediary companies as convenient to resort to what can be called tax evasion, avoidance or smart tax planning depending on the side taken by the commentator.

India's preference for source-based principle of international taxation over the residence-based taxation principle stems from its need to safeguard revenue interests while promoting foreign investment. The Report No. 13 of 2005 of the Comptroller and Auditor General (CAG) of India (the only report so far on the subject) had highlighted significant revenue losses and treaty abuse under the India-Mauritius Double Taxation Avoidance Agreement (DTAA). Subsequent amendments to this DTAA, including the 2016 protocol are compared with similar provisions in the DTAAs with Singapore and the UAE are discussed here to highlight the questionable business practices like treaty shopping through shell companies and under-taxation of non-share instruments. These may be minimised by providing definitions and examples for clarity in the laws, rules and regulations.

We examine recent amendments, such as the introduction of source-based taxation, Limitation of Benefits (LOB) clauses, and exchange of information protocols. By identifying remaining loopholes, such as the limited scope of non-share instruments and challenges in enforcing economic substance regulations and by integrating policy, regulatory analysis, and data-driven insights, we can hope to curb treaty shopping and offshore tax evasion.

1. The taxation of transnational companies is a vexed issue for developing countries whose markets are used to generate profits by these companies on which they pay tax to their home country. Every country asserts its sovereign right to tax its citizens and residents who avail the protection of the State. Countries also assert right to tax foreigners/non-residents who are earning from the residents of the country. When a resident of one country earns income from an income source in another country, the possibility of double taxation arises if the Residence Country seeks to tax the income following the residence based taxation and the Source Country also asserts the right to tax the income arising therein under source based taxation. The Residence Country mitigates the effect of double taxation either by way of tax exemption or by way of tax credit. The conflict between the two principles - two grand norms of income tax-based on location of source of income or the residence of income earner - has been at the root of developing countries struggle with MNCs in tax matters.

[29] P. Sesh Kumar, IAAS(1982), superannuated as a Director General of Audit.

2. The United Nations Model Double Taxation Convention between Developed and Developing Countries (the United Nations Model Convention) forms part of the continuing international efforts aimed at eliminating double taxation. These efforts were begun by the League of Nations and pursued in the Organisation for European Economic Co-operation (OEEC) (now known as the Organisation for Economic Co-operation and Development (OECD)) and in regional forums, as well as in the United Nations, and have in general found concrete expression in a series of model or draft model bilateral tax conventions. These Models, particularly the United Nations Model Convention and the OECD Model Tax Convention on Income and on Capital (the OECD Model Convention) have had a profound influence on international treaty practice and have significant common provisions.

3. According to Article 7 of the "United Nations Model Double Taxation Convention between Developed and Developing Countries"[30] The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a **"permanent establishment"** situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment. Article 5 defines PE as a fixed place of business where the enterprise conducts its activities wholly or partly. This fundamental rule encompasses five key elements: **Existence of a place of business**: Demonstrating a physical location for business operations.; **Location criteria**: The place of business must have a specific geographic presence.; **Right to use**: The taxpayer must possess the authority to utilize the place of business; **Duration of use**: The utilization of the place of business must be for unmistakable period of time and **Business activity**: Activities carried out at the place of business must align with treaty or domestic law definitions of business activities. Each criterion holds its distinct benchmarks for verification.

4. The concept of Permanent Establishment(PE) is common to all the three model conventions- UN (United Nations) Model, OECD Model and US Model to establish taxing jurisdiction over a foreigner's business activities. It is a departure from pure residence-based taxation (the taxed entity paying tax to its country of its own residence). Since most MNCs have developed countries as their home countries, the idea of Permanent Establishment (PE) provides for a source (of income) country to tax a foreign seller of goods or service provider on its business profits attributed to its Permanent Establishment (PE) in the source country.

5. India along with other developing countries have had to contend with foreign companies making profits in provision of goods and services to Indian consumers directly or through a web of intermediary companies as convenient to resort to what can be called tax evasion, avoidance or smart tax planning depending on the side taken by the commentator. The foreign companies buy controlling stake in Indian companies in transactions effected in tax heaven countries thereby gaining control on revenue stream from Indian consumers. They also resort to imposing excessive burden on their Indian subsidiaries (or companies under their effective control with or

[30] United Nations Model Double Taxation Convention between Developed and Developing Countries 2017 https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf

without subsidiary tag) of expenses charges to cover foreign headquarter expenses and royalty / license fee for intellectual property and license to manufacture.

6. OECD – the Organisation for Economic Co-operation and Development – has for decades been continuing with a campaign against tax dodgers who devise ways and means of shifting their income/profits from high tax jurisdictions to low-tax jurisdictions, register companies and ships in zero-tax 'tax heaven' countries. OECD has created awareness about the phenomenon of "Erosion and Profit Shifting (BEPS)" which refers to tax planning strategies that multinational enterprises use to exploit loopholes in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity or to erode tax bases through deductible payments such as interest or royalties as a way to reduce their total tax liability.

7. OECD has been trying to build consensus around a global minimum corporate tax to disincentivize transnational corporation shifting profits to low-tax/no-tax jurisdictions. The International Tax Agreement of 2021 negotiated under the aegis of OECD that seeks a minimum corporate tax of 15 per cent by all countries is awaiting implementation.

Base Erosion and Profit Shifting (BEPS) Action Plan - Multilateral Instrument (MLI) and Principal Purpose Test (PPT)

8. *The OECD Base Erosion and Profit Shifting (BEPS) Action Plan:-* Action 7 provides changes to the definition of permanent establishment in the OECD Model Tax Convention to address strategies used by MNCs to avoid having a taxable presence in a jurisdiction under tax treaties." BEPS Action Plan 7 introduces mechanisms for states dealing with situations where companies artificially create a permanent establishment to evade establishing a taxable presence in a jurisdiction under tax treaties, leading to untaxed or low-taxed cross-border income. Various articles under the OECD model of international taxation address 'agency PE' – essentially not a direct presence but presence through agents technically not answering to the description of 'Permanent Establishment'. Wherein an enterprise may be considered as a permanent establishment in a country even without a fixed place of establishment in case of an agent action on behalf of the enterprise, to an extent, such agency shall lead to creation of a dependent agency under PE.

9. The Multilateral Instrument (MLI) is a legal framework developed by the Organisation for Economic Co-operation and Development (OECD) under its Base Erosion and Profit Shifting (BEPS) Action Plan. It allows countries to modify their existing bilateral tax treaties to include anti-abuse provisions without renegotiating each treaty individually. In the case of the India-UAE DTAA, the MLI introduced key measures to prevent treaty abuse, including Principal Purpose Test (PPT). The PPT clause ensures that the benefits of the DTAA are denied if the principal purpose of an arrangement or transaction is to obtain treaty benefits inappropriately. For example, if a company in the UAE is created solely to route investments into India and claim tax exemptions, the PPT allows India to deny these treaty benefits. The MLI provides for a mechanism to resolve disputes between the two countries through mandatory arbitration, ensuring faster resolution of tax disagreements. It also provides enhanced exchange of information by strengthening provisions for the exchange of information between tax authorities in India and the UAE, promoting transparency and helping prevent tax evasion. The MLI includes measures to ensure the treaty meets the OECD's minimum standards for curbing treaty abuse and double non-taxation.

10. Double Tax Avoidance Treaties (DTAA) between two taxing jurisdictions provide for mutual understanding on the incidence of tax on residents of one Party deriving income form activities in the other Party. Tax treaties typically stipulate that the business profits of a foreign enterprise are subject to taxation in a jurisdiction only if the enterprise has a permanent establishment to which the profits can be attributed. The precise definition of permanent establishment in these treaties is pivotal in determining whether a non-resident enterprise is liable to pay income tax in another jurisdiction.

11. Common tax avoidance tactics are like replacing traditional distributors with commissionnaire arrangements, allowing for a shift of profits out of the jurisdiction where sales occurred without a substantial change in the functions performed in that jurisdiction. To review and change the definition of 'Permanent Establishment' under each DTAA requires re-negotiation of each DTAA which is a tedious process and would be stalled by the Party whose interest are adversely affected.

12. Under Indian Income Tax Act, the provisions pertaining to permanent establishment encompass several key sections in the Income-tax Act, 1961. Under the Act, Section 5(2) delves into the total income of non-residents, while Section 9 addresses income deemed to accrue or arise in India. The definition of 'business connection' is outlined in Explanation 2 of Section 9(1) of Income-tax Act, 1961, aligning with the Multilateral Instrument of OECD Model (MLI). The MLI influences the interpretation and application of clauses under various DTAA related to agency business connections. Finally, Section 92F(iiia) of the Income-tax Act deals explicitly with the concept of permanent establishment.

Taxing Digital MNCs providing services remotely without Permanent Establishment

13. Introduction of Significant Economic Presence (SEP) criteria for digital platforms in the OECD framework allows a country to tax a foreign entity generating income from users or activities within the country's jurisdiction even without a physical presence.

14. The United States of America(USA), home to some of the leading BigTech digital companies providing digital services answering to the acronym FANG or GAFA, opposed these Digital Services Tax imposed by France, Italy, India etc. If the BigTech companies pay taxes in various countries, their global incomes which are taxed by their home country - USA – would get depressed adversely affecting the tax revenue of the USA government. The USA would prefer to perpetuate an income tax system based on the RESIDENCE or rather NATIONALITY of the income earner rather than the geography where the source of income lies. OECD on the other hand has been trying to evolve a global consensus around a new principle whereunder the incomes are taxed in jurisdictions containing the SOURCE of income.

15. Through the Finance Act, 2016, India imposed a 6% EQUALIZATION LEVY to be deducted while making payments for online advertisement and related services to non-resident foreign corporations in Business-to-Business transactions. The levy was intended to tax these companies foreign e-commerce companies earning income from Indian market. Since the Levy was not made part of the Income Tax Act, there were reported complications in claiming tax credit under double tax avoidance agreements India had with the host countries of the foreign advertising service providers. The Finance Act 2020 amended the Finance Act 2016, expanding the scope of the Equalisation Levy to include @2% on the consideration received/receivable by a non-resident e-commerce operator on certain non-advertising services such as online sale

of goods owned by the operator or online provision of services provided by the operator; or online sale of goods or provision of services or both, facilitated by the operator. These Equalisation Levies were classified as Direct Taxes and in addition to the Goods and Services Tax, ass applicable on online sale/service.

16. If the operator had transacted business through an Indian subsidiary, the subsidiary would have been subject to GST, Income Tax etc. By directly selling goods or giving online services without physical presence in India, these foreign companies have in a way evading Indian taxes and disturbing the level playing field for Indian sellers and service providers. Hence, the name Equalization Levy. An analogy is irresistible in this situation. If one catches fish from a private pond, he may have to pay something to the pond owner. It is no defence to deny the liability by fishing from a distance using a very long fishing rod or other contraptions. The Equalization Levy is not an income tax. It is not under Income Tax Act and it is imposed on revenue, not on profit. Hence, it is closer to GST than to Income Tax though technically it is neither GST nor Income Tax . It is a new tax, sui generis. In a post-covid world, digital economy assumes even higher role. International relations are an interplay of complex multi-layered, multi-faceted interactions and a fair share of public posturing. Even between friendly countries, there remain some points of disagreements.

17. In the debate on taxing cross-border digital services providers, the USA's position of resisting change is understandable as the USA is home to biggest MNCs/BigTech. The 2% Levy on specified non-advertising digital services was abolished under the Finance Act 2024 and the 6% Levy on online advertising has also been removed through official amendments to the tax proposals contained in the Finance Bill 2025 forming part of the Budget 2025-26. This is a reflection of the deep divide not just between the developed and developing countries but even within the developed world and the wait for international consensus is getting longer.

Taxation issues in Foreign Direct Investments (FDI) and Foreign Portfolio Investments(FPI)

18. India has been seeking to attract foreign savings to augment its pool of investible financial resources as well as to benefit from access to improved technology through FDI. While welcoming foreign capital, we have this persistent concern about inflow of black money through use of Shell Companies for round tripping of investments, misuse of exemption on Long Term Capital gains tax for money laundering, misuse of 'Participatory Notes' for money laundering, and beneficial ownership. Based on the directions of the Hon. Supreme Court, a two-member Special Investigation Team on black money was constituted by the Government in 2014 with Mr. Justice M. B. Shah (Retd.) Chairman and Dr. Justice Arijit Pasayat (Retd.) Vice–Chairman. A number of action points were suggested by the SIT for different agencies. The SIT's interim reports are submitted to the Hon. Supreme Court. (Please see Recommendations of SIT on Black Money as Contained in the Third SIT Report [31])

19. We mention here challenges of misuse of India's Double Taxation Avoidance Agreements (DTAAs) with Mauritius, Singapore, and the UAE, the major sources of inflow of FDI for treaty shopping and tax base erosion. **Mauritius:** *Mauritius has historically been the largest source of Foreign Direct Investment (FDI) into India with the tax concessions contemplated under the tax treaty, raising concerns about*

[31] Ministry of Finance Press Release dated 24-July-2015 on " Recommendations of SIT on Black Money as Contained in the Third SIT Report" https://pib.gov.in/newsite/printrelease.aspx?relid=123677

*the nationality of ultimate investors. However, amendments to the treaty in 2016 led to a decline in inflows. (***2016-17***: USD 15.72 billion.;* **2022-23***: USD 6.13 billion and* **2023-24***: USD 7.97 billion.)* . **Singapore:** *Singapore replaced Mauritius as the top FDI source post-2016 amendments, benefiting from a similar DTAA. (***2022-23***: USD 17.3 billion and* **2023-24***: USD 11.77 billion.).* **UAE:** *The UAE has shown a consistent upward trend in investments into India, facilitated by the DTAA and strengthened economic ties. (***2023-24***: USD 2.9 billion.)*

The CAG's Report No. 13 of 2005 on *India's DTAA with Mauritius*

20. *The CAG's Report No. 13 of 2005 provided a detailed critique of India's DTAA with Mauritius, highlighting how treaty shopping had eroded India's tax base.* It found substantial *revenue leakage due to exemption on capital gains tax for Mauritian residents. Entities with no substantive operations in Mauritius exploited the treaty for tax avoidance. Regulatory gaps and weak enforcement of residency criteria allowed shell companies to misuse the treaty. The report recommended introduction of anti-abuse clauses, such as the 'Limitation of Benefits' (LOB) clause besides strengthening information-sharing mechanisms to prevent misuse.*

21. *Treaty shopping and shell companies:* Treaty shopping refers to the practice of exploiting the benefits of a tax treaty between two countries by routing investments *through* a third country that has a favourable tax treaty (often with zero or nil tax) with the destination country. It typically involves using shell companies or intermediaries in a low-tax jurisdiction to avoid higher taxes in the source country. (Example of Treaty Shopping : Let us say Country A (India) taxes capital gains on investments made in its markets. Country B (Mauritius) has a tax treaty with India that exempts capital gains tax for its residents. Example of Shell Company: *A shell company is a legal entity without substantial business operations or assets, often used to channel investments for tax avoidance.* Let us say Country C (USA) does not have such favourable tax treaty terms with India and the resident would have to pay capital gains tax in India. A company from Country C (USA), instead of directly investing in India, sets up a shell company in Country B (Mauritius). This shell company does not have real business operations or employees in Mauritius—it only exists on paper. The company invests in Indian markets and claims the capital gains tax exemption under the India-Mauritius DTAA. This way, the company avoids paying taxes in India, even though the actual investor is based in the USA.)

22. Treaty shopping undermines the intent of tax treaties, which are designed to prevent double taxation—not to facilitate tax avoidance. It shifts tax benefits to entities that do not genuinely belong to the treaty-signing countries. *While DTAAs like the Mauritius treaty focus on taxing capital gains from shares, non-share instruments often remain untaxed, creating potential loopholes.* **Non-Share Instruments** *are financial instruments other than equity shares. Examples include* **Debentures** *or Fixed-income instruments issued by companies,* **Bonds** *or Debt securities issued by corporations or governments and* **derivatives** *or contracts deriving value from underlying assets, such as futures or options.*

Evolution of India's DTAAs

23. **India-Mauritius DTAA, of pre-2016** *vintage exempted Mauritian residents from capital gains tax, leading to treaty shopping and revenue losses. However,* **2016 Protocol** *brought in* **source-based taxation** *for shares acquired after April 1, 2017. Limitation of benefits clause* (**LOB)** *ensured entities had substantive presence in*

Mauritius. It provided for **mandatory exchange of information** *for enhanced transparency and cooperation.*

24. **India-Singapore DTAA : Pre-2005** *regime was similar to Mauritius and the treaty allowed residence-based taxation for capital gains.* **2005 and 2016 protocols** *incorporated source-based taxation and LOB clauses and grandfathered investments before April 1, 2017.*

25. **India-UAE DTAA : Pre-2020 system** *lacked robust anti-abuse provisions.* **2020 Reforms via Multi Lateral Instrument (MLI)** a*dopted the* **Principal Purpose Test (PPT)** *to deny treaty benefits in case of abuse and strengthened exchange of information mechanisms.*

26. The inclusion of the MLI in the India-UAE treaty ought to have reduced opportunities for treaty shopping and tax evasion besides bringing improved transparency in cross-border transactions while ensuring that the treaty benefits are available only to entities with genuine business operations and economic substance. These amendments, effective from 2020, align the UAE-India DTAA with global standards, balancing the objectives of preventing tax abuse and fostering legitimate investments.

27. India chose bilateral amendments with Mauritius and Singapore over the MLI to address specific challenges (e.g., high levels of FDI through these countries), avoid broader, uniform changes that might disrupt investment flows and most important retain diplomatic flexibility in managing relationships with these key partners. The India-UAE DTAA includes MLI provisions because the UAE signed and adopted the MLI framework and the UAE's treaty framework required broader, uniform measures for alignment with global standards.

Comparison of Treaty Provisions (Pre- and Post-Amendments): Table below gives a bird's eye view of the comparative position of significant provisions of DTAA that India has had with Mauritius, Singapore and the UAE.

Aspect	Mauritius 2005/2016	Singapore 2005/2016	UAE Pre 2020/2020
Capital Gains Tax	Exempt/Source Based	Exempt/Source Based	Source Based/MLI
LOB clause	Absent/Introduced	Introduced(2005)/Revised(2016)	Introduced 2020
PPT clause	Not applicable/not added	Not applicable/not added	Introduced (2020)
Exchange of Information	Limited/Mandatory	Limited/Mandatory	Strengthened(2020)

Challenges and Remaining Loopholes:

28. Under DTAA with Mauritius, determining genuine business presence remains subjective, allowing potential misuse by shell companies and non-share instruments like derivatives are not addressed. Under DTAA with Singapore, minimal operational substance requirements may still allow treaty benefits to be claimed by non-genuine entities. Also, Indirect transfers of Indian assets remain an unresolved issue. As far as the UAE is concerned, effective enforcement of the Principal Purpose Test (PPT) requires significant oversight while economic substance regulations are in early stages, limiting their effectiveness.

29. India’s approach to international taxation, rooted in the source-based principle, reflects its commitment to balancing investment promotion with revenue protection. Amendments to DTAAs with Mauritius, Singapore, and the UAE have been designed to strengthen anti-abuse measures, but challenges persist. Addressing gaps in non-share instruments, operational substance and enforcement mechanisms is essential to curbing treaty shopping and protecting India’s tax base. Another evaluation by the CAG of the revenue performance under the DTAA with these three countries with the 2005 Report providing a baseline to measure advancement. Ensuring efficacy in protecting revenue leakages giving unintended benefits to unintended beneficiaries while balancing diplomatic relations and economic growth.

30. MNC taxation continues to be an area of high focus as we are looking forward to higher inflow of foreign investment to augment domestic resources for our economic growth. To provide certainty to foreign investors while keeping a check on unscrupulous transfer pricing mechanisms to shift profits out of India, mechanisms of Safe Harbor Rules, Advance Pricing Agreements, Advance Rulings etc. have been designed. The digital services tax introduced in 2016 and expanded in 2020 has been recently rolled back. We continue to work with the countries which are principal sources of inflow of Foreign Direct Investment and Foreign Institutional Investments to maintain appropriate balance between ensuring inflow of investments while addressing the enduring concern on tax evasion by foreign entities, inflow/outflow/round tripping of black money/tainted money though trade misinvoicing etc.

Annexure – I

Highlights from the Reports of the CAG of India on Direct Taxes

1. **Report of the Comptroller and Auditor General of India on Compliance Audit Report -II for the year ended March 2022 (Report No. 3 of 2024)**

- This Report contains 16 illustrative audit paragraphs, relating to non/short levy of taxes, interest, non/short levy of excise duty, stamp duty, etc., one Subject Specific Compliance Audit (SSCA) on Department's oversight on GST payments and Return Filing and one IT Audit of Integrated Financial Management System (IFMS) with revenue implications of ₹ 724.46 crore.
- The total revenue receipts of the State Government for the year 2021-22 were ₹ 78,091.69 crore as compared to ₹ 67,561.01 crore during the year 2020-21. Test check of the records of 104 units of Sales Tax/Value Added Tax, State Excise, Stamp Duty and Registration Fees conducted during the year 2021-22 brought out under-assessments/short levy/ loss of revenue aggregating ₹1,103.94 crore in 2,552 cases.
- The cases relating to input tax credit, under assessment, excess benefit, evasion of tax/short and non-levy of interest and Department's Oversight on GST Payments and Return Filing of ₹ 691.00 crore. An illustrative case that resulted in non/short recovery of breach case penalties, interest on delayed payment of license fee and pending license fee of ₹ 7.46 crore. Some significant cases involving ₹ 26.00 crore relating to short/ non levy/irregular exemption of stamp dury and registration fee. IT audit of Integrated Financial Management System (IFMS) to measure the achievements of various IT objectives.

2. **Report No. 4 of 2023 - Subject Specific Compliance Audit on Attachment of Property of an assessee by ITD under Section 281B, Union Government Department of Revenue - Direct Taxes.**

- Provisional Attachment of properties prior to the completion of assessment is a critical tool with the Income Tax Department to facilitate recovery of tax demands from those assessees who attempt to evade tax and thwarting collection of tax demand by using unfair means and to prevent accumulation of arrears of tax demand.
- There has been a steady increase (₹ 5,75,340 crore in FY 2013-14 to ₹ 11,14,182 crore in FY 2017-18) in the accumulation of arrears of tax demand during the past several years and the percentage of tax demand termed as 'difficult to recover' (categorised by the Department) over total arrear tax demands continued to be abnormally high ranging from 96 *per cent* in FY 2013-14 to 98.2 *per cent* in FY 2017-18. Hence, this topic was selected to assess the robustness and effectiveness of the procedures in place in the ITD with regard to provisional attachment.
- The SSCA covered 350 Provisional Attachment orders issued during the Financial Years 2017-18 to 2019-20. Out of the these 350 cases, the scrutiny assessments had been completed in 291 cases as of July 2022, raising a net tax demand aggregating to ₹ 12,621.23 crore (comprising tax, interest and penalty). Out of this, in 103 cases, an

amount of ₹ 407.09 crore (3.22 *per cent*) had been recovered (July 2022). The balance tax amounting to ₹ 12,214.14 crore was outstanding for various reasons viz. stay of demand, appeals etc.

- There was no prescribed format for issuing Provisional Attachment orders resulting in missing essential information such as estimated tax liability, validity period and not providing assessees with the option of furnishing Bank Guarantee in *lieu* of the attached property etc.. Notification of Provisional Attachment orders to Registering Authorities was found to be inadequate, which eventually defeated the purpose of such notification in a few cases.

- As per available records, the AOs did not comply with the Board's instructions of ascertaining details of all assets in the possession of assessees that could be considered for provisional attachment. In the majority of the cases for which records were made available, the list of assets prepared by the Investigation Wing as reflected in the Appraisal Report was not shared with Audit. Therefore, Audit could not verify the role of the Investigation Wing in supplementing the efforts of the AO in selection of appropriate property for provisional attachment. Audit also noticed deficiencies in respect of list of assets provided in the Appraisal Report which resulted in incorrect attachment of a property. The process of identification of assets was found to be deficient, thereby reducing the effectiveness of the provisional attachment. In certain cases, the savings/current bank accounts of assessees were provisionally attached by the jurisdictional AOs without establishing that they were attached only as a last resort. The AOs did not establish evaluation of property of assessees for their ownership requirements as well as for their non-encumbrance status before considering them for provisional attachment in majority of cases. Sufficiency of properties attached could be analysed only in certain cases, as proposals for Provisional Attachment under Section 281B did not indicate either estimated tax liability or value of the attached property or both.

- Audit also observed that the validity period of several orders under Section 281B lapsed either before the tax demands raised were fully recovered or even before completion of assessments, which was in violation of the prescribed provisions. Audit further observed that in certain cases, the orders under Section 281B were extended with a time gap ranging between two and 166 days from the date of expiry of previous order under Section 281B.

- Audit observed that absence of enabling provisions under Section 281B to exclude periods of pendency of assessee's application before the Settlement Commission or during a Court stay against an assessment while reckoning the validity period of order under Section 281B (as available prior to 01/10/2014) or during the assessee's appeal, has led to a situation where the interest of revenue remain unprotected during the periods of appeal and injunction/stay granted by the Courts or when cases are pending before the Settlement Commission.

- Audit further observed that the time gap from the date of search to the date of initial order under Section 281B ranged between 208 days and 1220 days. Absence of a prescribed time limit for issuing order of provisional attachment has an inherent risk of the assessee alienating property(ies), which are being considered for attachment, in the intervening period in case of abnormal delay in issuance of orders under Section 281B. Audit also noticed certain cases wherein the assessee was able to dispose off the attached property inspite of notification of the order under Section 281B to the concerned Registering authority.
- Overall, the tax demands raised on completion of assessments continued to be in arrears and the provisional attachment of the assessee's property did not have a significant impact on actual recovery of tax *post*-assessment.

3. **Report No. 29 of 2022 - Union Government, Department of Revenue – Direct Taxes**

- **Direct Taxes Administration** Direct taxes receipts of Union Government in the financial year (FY) 2020-21 amounting to ₹ 9,47,174 crore decreased by 9.9 per cent over the FY 2019-20 (₹ 10,50,686 crore). Direct taxes represented 4.8 per cent of the Gross Domestic Product (GDP) in FY 2020-21. The share of direct taxes in gross tax revenue decreased to 46.7 per cent in FY 2020-21 from 52.3 per cent in FY 2019-20. Despite decrease in the direct tax collection in FY 2020-21, there was an increase of 41.6 per cent in refunds issued during FY 2020-21 (₹ 2,59,715 crore). A possible reason for this higher refund could be exaggerated demands raised by the Department during the previous financial years to meet their revenue collection targets. However, Audit could not establish this as the Department did not furnish the complete information with regard to refunds. Of the two major components of direct taxes, collections from
- **Corporation Tax -** decreased by 17.8 per cent, from ₹ 5.56 lakh crore in FY 2019-20 to ₹ 4.58 lakh crore in FY 2020-21. Collections from Income Tax decreased by 4.0 per cent from ₹ 4.80 lakh crore in FY 2019-20 to ₹ 4.71 lakh crore in FY 2020-21. The number of non-corporate assessees increased from 6.39 crore in FY 2019-20 to 6.63 crore in FY 2020-21, registering an increase of 3.67 per cent. The number of corporate assessees increased from 8.38 lakh in FY 2019-20 to 9.21 lakh in FY 2020-21, registering an increase of 9.9 per cent. The arrears of demand decreased from ₹ 16.19 lakh crore in FY 2019-20 to ₹ 15.12 lakh crore in FY 2020-21. The net collectible demand decreased to ₹ 26,473 crore in FY 2020-21 as compared to ₹ 38,734 crore in FY 2019-20. The Department indicated that more than 98.3 per cent of uncollected demand would be difficult to recover. There had been a year-on-year increase in the absolute number of PAN allotments in all the categories of taxpayer from FY 2018-19 to FY 2020-21. However, the percentage increase in PAN allotment witnessed a year-on-year decline during FY 2018-19 to FY 2020-21.
- There had been a year-on-year increase in the absolute number of persons filing Income Tax Return from FY 2017-18 to FY 2020-21. However, the percentage increase in number of persons filing Income Tax Returns witnessed a year-on-year decline during the respective financial years with the exception of FY 2020-21.

- The number of appeals pending with CIT (Appeals) increased slightly from 4.58 lakh in FY 2019-20 to 4.59 lakh in FY 2020-21. However, the amount locked up in these cases increased to ₹ 24.65 lakh crore in FY 2020-21 from ₹ 8.83 lakh crore in FY 2019-20.
- The CBDT raised the monetary limit for filing appeals by the Department before ITAT, High Court, and the Supreme Court from ₹20 lakh to ₹ 50 lakh, ₹ 50 lakh to ₹ one crore and ₹ one crore to ₹ two crore respectively. The total cases pending therein decreased by 17.9 per cent i.e. from 1.24 lakh cases in FY 2019-20 to 1.02 lakh in FY 2020-21.
- **Products and Impact** - During FY 2019-20, the Income Tax Department (ITD) had completed 1.55 lakh scrutiny assessments in the units audited as per the audit plan of FY 2020-21, out of which ITD produced 1.48 lakh cases. Apart from this, the ITD also produced 0.16 lakh cases of scrutiny assessments completed in the earlier financial years, during FY 2020-21. The incidence of errors in assessments checked in audit during FY 2020-21 was 5.97 per cent (9,839 cases).
- There have been irregularities noticed by Audit in respect of the Corporation Tax and the Income Tax assessments cases over the years. Recurrence of irregularities, despite being pointed out repeatedly in Audit Reports and even after the implementation of ITBA, is indicative of the need to institute appropriate controls in the systems to prevent the recurrence of such mistakes. The Department is also required to ensure effective monitoring as in the absence of a strong institutional mechanism to respond to the systematic and structural weaknesses, the risk of leakages of revenue is quite high. We have covered 467 high value cases reported to the Ministry in Chapter III and IV of this Report. Of these, we received replies in respect of 315 cases as on 31st July 2022, of which, the Ministry/ITD accepted 305 cases (96.82 per cent) having a tax effect of ₹ 6,440.9 crore (98.22 per cent) while it did not accept 10 cases having tax effect of ₹ 116.26 crore. Replies to the remaining 152 cases having a tax effect of ₹ 1,855.94 crore were not received. (July 2022). We analysed the impact of Audit resulting in amendments to the Income Tax Act and Rules framed thereunder, based on our observations/ recommendations. During FY 2017-18, FY 2019-20, and FY 2020-21, Performance Audit Reports viz. Report No. 27 of 2017 – 'Assessment of Private Hospitals, Nursing Homes/Medical Clinics, Medical Colleges/Research Institutes, Diagnostic Centres, Pathological labs and other Medical supplies agencies/stores', Report No. 1 of 2019 - PA on Assessment of Assessees in Entertainment Sector and Report No. 14 of 2020 – PA on Search and Seizure Assessments in ITD were placed in the Parliament respectively. Report No. 27 of 2017 - 'Assessment of Private Hospitals, Nursing Homes/Medical Clinics, Medical Colleges/Research Institutes, Diagnostic Centres, Pathological labs and other Medical supplies agencies/stores'.
- In the last three years, the ITD recovered ₹ 415.37 crore from demands raised to rectify the errors in assessments that we had pointed out. There are 62,709 cases involving revenue effect of ₹ 1.54 lakh crore pointed out in audit which remained

unsettled as of 31 March 2021 for want of replies from the ITD. During FY 2020-21, 3,754 cases with tax effect of ₹ 6,189.11 crore became time-barred for initiating any remedial action.

- ITD did not produce 11,946 out of 1,80,627 records (6.61 per cent) requisitioned by us during FY 2020-21, of which 6 records pertaining to the same assesses were not produced in three or more consecutive audit cycles.

- **Corporation Tax** - We pointed out 319 high value cases pertaining to Corporation Tax with tax effect of ₹ 7,788.98 crore. We classified these cases into four broad categories as follows:(a) Quality of assessments (124 cases); (b) Administration of tax concessions/exemptions/deductions (126 cases); (c) Income escaping assessment due to errors (51 cases); and (d) Over-charge of tax/interest (18 cases). Out of 319 high value cases cited, we have illustrated 57 instances of significant errors/ irregularities in corporation tax assessments involving tax effect of ₹ 6,304.56 crore. The irregularities illustrated in this chapter include: incorrect adoption of figure of taxable income as ₹ 110.40 crore in the tax computation form instead of the correct figure of ₹ 7,995.06 crore involving tax effect of ₹ 4,430.13 crore including interest; incorrect allowance of carry forward of long- term capital loss of ₹ 1,285.03 crore on account of redemption and acquisition of Cumulative Redeemable Preference Shares involving a potential tax effect of ₹ 79.58 crore; incorrect allowance of deduction under Section 32AC involving tax effect of ₹ 180.22 crore; incorrect allowance of MAT credit even though the ITBA system exhibited MAT credit as 'zero', involving tax effect of ₹ 34.90 crore including interest; incorrect allowance of business expenditure towards provisions for doubtful debts and advances and corporate debt restructuring recompense, being an unascertained liability, involving tax effect of ₹ 118.57 crore; not taking cognizance of the difference between the value for which stamp duty was paid and actual value for land or building sold involving tax effect of ₹ 34.69 crore; and adding back only 15 per cent of unsecured loan on account of failure to furnish confirmation of unsecured loan instead of the entire aforesaid unsecured loan involving tax effect of ₹ 22.67 crore.

- **Income Tax** - We pointed out 148 high value cases of income tax with tax effect of₹ 624.12 crore. We classified these cases into four broad categories as follows:

  (a) Quality of assessments (108 cases);

  (b) Administration of tax concessions/exemptions/deductions (17 cases);

  (c) Income escaping assessments due to errors (18 cases); and

  (d) Overcharge of tax/interest (five cases).

- Out of 148 high value cases cited, we have illustrated 47 instances of significant errors/irregularities in income tax assessments involving tax effect of ₹ 505.68 crore. The irregularities illustrated in this chapter include: incorrect computation of demand due to incorrect adoption of assessed income at ₹ 79.29 crore instead of correct income of ₹ 122.05 crore involving consequent short levy of tax of ₹ 32.45 crore; and incorrect levy of interest for delay in furnishing of return charged under section 234A for one month only at ₹ 0.47 crore instead of 79 months at ₹ 37.09 crore involving tax effect of ₹ 36.62 crore.

4. **Report No. 12 of 2022- Performance Audit on Exemptions to Charitable Trusts and Institutions, Union Government Department of Revenue - Direct Taxes .**

- During this Performance Audit, Audit checked 6,260 assessment records and noticed Rs. 1,580 errors, related to various systemic and compliance issues having tax effect of Rs 1,983.34 crore. Further, Audit also reviewed the action taken by the ITD through its Action Taken Note (ATN) relating to earlier PA findings in Report No. 20 of 2013 and Chapter VI of the Compliance Audit Report No. 9 of 2019 (Direct Taxes) and the recommendations of the Public Accounts Committee (PAC). A summary of the main audit findings is given below:

- Audit noticed that certain irregularities relating to internal audit of the registration process, ineffective monitoring of accumulation of income and its utilization, ineffective monitoring of receipts and utilization of foreign contribution, the inadequacy of survey of educational Trusts, absence of provision for disclosure of TDS in the audit report, etc. which were highlighted in the earlier Performance Audit Report No. 20 of 2013 and some of the specific recommendations of the Public Accounts Committee (PAC) against such irregularities were not satisfactorily addressed by the ITD. Audit noticed an increasing trend in number of Trusts/Institutions claiming exemptions from AYs 2014-15 to 2016-17; however, the number of Trusts/Institutions claiming exemptions for AY 2017-18 slightly decreased. Analysis of data of 6.89 lakh cases pertaining to ITRs for AY 2014-15 to AY 2017-18 revealed that the ITD scrutinized only 0.25 lakh (3.7 per cent) of the total cases while 6.30 lakh (91.4 per cent) cases were processed under summary manner in an automated environment. However, Audit noted certain deficiencies in the ITD system which led to incorrect claims of exemption along with the possibility of revenue leakage such as: Due to wrong input of data required for selection criteria in CASS, several cases were incorrectly selected for scrutiny by the ITD system. There is an absence of adequate checks and validations to match the registrations/approvals data provided in the ITR Form-7 with the ITD systems database before allowing exemptions in case the returns were processed in summary manner. In 42 assessment cases, exemption was allowed although assessees did not mention their registration details under Section 12A/10(23C) of the Act in the ITR Form-7. In 10 assessment cases, the assessees claimed exemptions for years together prior to its registration or having no registration under the Act, and the same was allowed by the Department in the summary assessment. Analysis of data of 6.89 lakh cases provided by the Pr.DGIT (Systems) revealed that exemption was allowed in 0.21 lakh cases although registration under Section 12AA was not available. In case of foreign contribution, Audit noticed that in 347 cases, foreign contribution was received by the assessee though the registration details under FCRA were not available. Thus, field validations in the above related field were not available in the ITR Form-7. Out of 6.89 lakh cases processed/assessed/ rectified by the ITD during the FY 2014-15 to FY 2018-19, in 5.12 lakh cases (74.3 per cent) the income returned was zero. Analysis of 580 high value exemption cases (having gross income of ` 50 crore or above) revealed that 186 cases, which pertained to government entities, were granted 50.8 per cent of total exemptions (Rs. 1.31 lakh crore) whereas the remaining 394 cases, which pertained to private entities, were granted 49.2 per cent of total exemptions. An analysis of data of the top 200 audit sampled cases (involving 169 Trusts/Institutions) where gross income for each case was ` 167.9 crore or above, revealed that out of the 169 Trusts/Institutions, 101 Trusts/ Institutions were Government entities while 66 were private entities (records of two entities were not produced to audit). Activity-wise analysis of data revealed that in case of Government entities, the top 30 entities (29 per cent) were engaged in other activities (like pension and gratuity fund, welfare board etc.) whereas in case of the top private entities, 28 entities (42 per cent) were engaged in educational activities. Audit observed that there is no clarity on allowing deduction under Section 80G for donations out of CSR fund. As a significant amount is spent by the companies toward CSR activities through the Trusts claiming exemptions under Section 80G, it requires urgent attention of the Department to bring clarity to the issue to ensure that the provisions are interpreted uniformly by the AOs and to minimise the possibility of litigation. The IT Act has no clarity regarding allowance of various expenses under the head “administrative and establishment expenses” for the purpose of determining application of income. Since administrative and establishment expenses could be of various categories, some part of which may be directly attributable for generation of income while some part may be towards charitable and religious purpose, the ITD needs to bring more clarity in the Act for this purpose. The IT Act has no provision to restrict donations by a Trust to another Trust out of current years’ income. Therefore, certain Trusts/Institutions are taking undue benefits by availing of the permissible accumulation of 15 per cent out of the current year’s income and then transferring the rest of the income to others trusts, and thereby making a chain of multiple donations. Audit noticed in four assessment cases that the Trusts/Institutions, which had received donations of ` 203.29 crore, had transferred ` 164.81 crore to other Trusts/Institutions by way of donations after claiming deduction of 15 per cent as accumulation. The recipient Trusts/Institutions also transferred the amounts to other trusts after claiming accumulation of 15 per cent. This chain of donation resulted in denial of charity to the beneficiaries and helped in accumulation in the hands of Trusts/Institutions. There was no parameter to verify the identity of the donors for detection of anonymous donation. Audit noticed six assessment cases where the department did not verify genuineness of the donors and therefore, did not tax the anonymous donation(s) as per provisions of the Act. The Ministry has since addressed this issue through the Finance Act 2020. The ITD did not produce registration/approval records of 194 cases (45 per cent) out of 425 cases registered/approved for exemptions during the FY 2014-15 to 2018-19. Further, Audit noticed deficiencies in following the prescribed procedure(s) relating to registration/approval such as delay in grant of registration/approval, irregular grant of registration, grant of registration/approval without submission of prescribed documents, grant of registration without verification etc. Audit noticed deficiencies in the Audit Report in Form 10B applicable to charitable Trusts/Institutions such as absence of details of break-up of receipt under different heads, details of corpus donation, deemed application of income etc. which impacted the quality of assessment, incorrect claim made by the assessee and loss of revenue. Audit observed that the ITD allowed accumulation in 66 assessment cases in contravention to the provisions stipulated under Section 11(2) of the Act. Audit noticed 22 assessment cases where the assessees utilised their income or property for the benefit of persons specified under Section 13(3) (i.e., related parties), but the ITD did not levy tax on such amount of income or property utilised for the benefit of the specified persons. Audit observed non-compliance of various provisions of the Income Tax Act in the assessment orders, which culminated in irregular allowance of double benefits to the assessees. In eight assessment cases, depreciation on assets was allowed as application of income, even though the relevant capital expenditure to acquire such assets had already been treated as application of income. In 11 assessment cases, the AO had allowed claims, pertaining to application of income incurred from the corpus fund, or other specific purpose funds. In 65 assessment cases, the AO while finalizing the assessment adopted incorrect figures, computed short demand, charged tax at a lower rate than the prescribed rate, levied interest/surcharge incorrectly, or granted excess interest on refund etc. The ITD has not allocated specific codes to different charitable activities linked with Section 11 and sub-Sections of 10(23C) under which exemption is being claimed. Further, the data relating to exemption claimed by the Government/Private Trust under different Sections were not being captured in ITR Form 7. The ITD needs to ensure activity wise monitoring of these private charitable entities, to mitigate the risk of ineligible claims. Although the PAC in its 104th Report (16th Lok Sabha) had recommended that the process of registration/approval of the Charitable Trusts/Institutions should be brought under the purview of Internal Audit of the ITD, it was not until FY 2019-20 that the Internal Audit commenced in respect of the registration applications processed. Moreover, Audit noticed that the instructions issued with regard to Internal Audit of registration process was not uniformly implemented in all the states. Audit further noted that the circular issued by the ITD regarding Internal Audit is applicable to registration granted under Section 12AA only but does not cover cases approved under Section 10(23C) and 80G(5). Audit noticed that very few surveys were conducted by the Department in comparison to the number of assessees claiming exemption under the Act to monitor the activities of the Trusts/Institutions. Further, in spite of specific recommendation of the PAC that survey of all educational trusts be conducted in a time-bound manner, Audit observed that the ITD conducted surveys of only 0.3 per cent of the total 2,686 educational trusts (2,105 assessees) included in the audit sample during 2014-15 to 2018-19. Further, no survey was conducted in respect of 46 high value educational trusts (having receipt of ` 200 crore or more) during the aforesaid period. There was inconsistency in allowing exemption to Trusts/Institutions having activities not charitable in nature. Audit observed in 10 assessment cases where the AO assessed that the activities of the Trusts were not charitable in nature for one or more AYs but took no action to review exemptions for the other AYs although the objects of the trust were similar during the respective AYs which resulted in irregular grant of exemptions. Audit observed in eight cases that the status of the Trusts/Institutions was not reviewed by the competent authority as per provisions of Section 12AA(3) and 12AA(4), although the AO had denied the exemption under Section 11 of the Act for either holding that the activities of trusts were not genuine or the properties or income of the trusts were continuously utilised by the trust for the benefit of related persons. Audit noticed that due to lack of monitoring of the activities of Trusts/Institutions engaged in scientific research, there were bogus claims of exemption by the trusts as well as issue of bogus certificates under Section35(1)(ii) to the donors. Audit noticed deficiencies of the ITD in effective monitoring of accumulation and its utilizations by Trusts/Institutions in the manner laid down in the Act. In 32 assessment cases, the Department did not effectively monitor utilization of past accumulated income as provided in Section 11(2). Further, there is no provision in the Act for declaration of the purpose/period of accumulation under Section 10(23C).

- Audit observed that the ITD has no mechanism to verify receipt and utilization of foreign contribution shown in the ITR Form-7 and that disclosed with Ministry of Home Affairs (MHA) under the FCRA Act. Although the PAC had made specific recommendation that the ITD should formulate a data sharing mechanism with the MHA to keep a track of foreign contribution received and its application, the ITD has yet to take any action on the issue. The deficiency resulted in incorrect claim of exemption on foreign contribution in 35 cases.

5. **Report No. 6 of 2022- Performance Audit on Assessment of Assessees of Gems and Jewellery Sector, Union Government Department of Revenue - Direct Taxes .**

a. The Gems and Jewellery sector is one of the fastest growing sectors and it is extremely export oriented and labour intensive. The industry has a primary position in economic activities and has tremendous potential for growth. Given the high value of the transactions and foreign exchange involvement due to large amount of diamond and gold imports, the Gems and Jewellery sector is susceptible to misuse and money laundering. various irregularities reported from time to time in respect of Gems and Jewellery sector. This Performance Audit on the 'Assessment of assessees in Gems and Jewellery Sector' was taken up for examination from the perspective of the assessment of direct taxes.

b. The Performance Audit covered the assessments completed during the financial years 2015-16 to 2018-19.

c. Audit noticed irregular trends in growth of quantity and value of imports and exports of rough diamonds during 2010 to 2020. Audit noticed unusual trend in import of pearls into India.

d. Audit observed that no time limit is prescribed under the Income Tax Act, 1961 for timely remittance of export proceeds in the country for claiming deduction under section 10AA. No Standard Operating Procedure or instructions/ guidelines has been prescribed by the CBDT for assessment of assessees of assessment of assessees specific to Gems and Jewellery Sector.

e. While examining cases in respect of seven assessees under 360-degree analysis, Audit observed various irregularities like non-examination of suspicious business activities; unexplained excess output, short accounting of stocks, and non-verification of differences in claims made by assessee as per records of the assessee vis-a-vis the records of the related party in 33 significant issues involving tax effect of ₹ 37,909.38 crore. Such irregularities had the underlying risk of tax evasion that require further probing and detailed examination.

f. Audit noticed instances of incorrect allowance of business expenditure in 40 cases involving tax effect of ₹188.40 crore, failure to consider various provisions under the Income tax Act in 34 cases involving tax effect of ₹58.86 crore and mistakes in computation of tax, surcharge, interest etc. in 58 cases involving tax effect of ₹112.31 crore.

g. There was no uniformity or consistency across assessments in additions made towards bogus entries and purchases despite there being similar grounds of additions. Audit noted that there is no guidelines/SOP for disallowances of accommodation entries/ bogus purchases.

h. Audit noticed issues indicative of weak monitoring mechanism in the ITD with respect to the Gems and Jewellery sector. The areas included non-verification of correctness of business codes filled in by the assessees in the ITRs, non-verification of quantitative disclosure of inventory in ITR and TAR during scrutiny assessment and lack of SOP or instructions/ Guidelines for assessment of assessees specific to the Gems and Jewellery sector. These areas require stricter monitoring as Gems and Jewellery sector involves significant risk of money laundering, round tripping, mis-invoicing, and risk of routing of black money in the garb of transactions and claims.

6. <u>Report of the Comptroller and Auditor General of India on Revenue, Economic, Social and General Sectors and PSUs for the year ended 31 March 2019</u>

- This Report comprises three chapters containing audit findings pertaining to Revenue, Economic, Social and General Sectors and Public Sector Undertakings (PSUs). Chapter I relating to Revenue Sector contains seven compliance audit paragraphs involving Rs. 137.77 crore on under-assessment, short levy of tax, interest and penalty. Chapter II relating to PSUs contains an overview on functioning of power and non-power sector PSUs and four compliance audit paragraphs involving Rs. 30.23 crore and Chapter III relating to Social and General Sectors contains three compliance audit paragraphs involving Rs. 29.76 crore.

Revenue Sector

- The total revenue receipts of the Government of National Capital Territory of Delhi (GNCTD) for the year 2018-19 were Rs. 43,112.60 crore as compared to Rs. 38,667.27 crore in the year 2017-18. Out of this, 86 *per cent* was raised through tax revenue (Rs. 36,624.67 crore) and non-tax revenue (Rs. 644.16 crore).
- The compliance audit paragraphs points out short levy/ short realisation of stamp duty and registration fee, short levy of tax, etc.

Public Sector Undertakings (PSUs)

- As on 31 March 2019, there were 19 State PSUs which included 17 Government companies and two statutory corporations. The working PSUs registered an annual turnover of Rs. 9,318.69 crore which was equal to 1.20 per cent of Gross State Domestic Product for the year 2018-19.
- The profit earned by Power Sector Undertakings was Rs. 806.48 crore in 2018-19 against Rs. 297.55 crore in 2014-15. The overall accumulated profits of five power sector undertakings were Rs. 869.91 crore. The PSUs (other than power sector) incurred overall losses during the five year period from 2014-15 to 2018-19. Out of the 14 PSUs, five PSUs earned profit of Rs. 68.42 crore and five PSUs incurred losses of Rs. 4,366.95 crore (of which loss of DTC was Rs. 4,329.41 crore).
- The audit of operation and maintenance of Industrial Areas at Bawana and Narela revealed serious deficiencies on the part of Delhi State Industrial Infrastructure Development Corporation with respect to ensuring proper discharge of functions by the two concessionaires as per the concession agreement such as unauthorised collection of water and sewer connection charges, improper monitoring, inadequate grievance redressal mechanism etc. Apart from this the report also brings out loss due to undervaluation of assets and failure to recover service tax by PSUs.

Social, General and Economic Sectors (Non-PSUs)

- This portion of the Report contains three paragraphs with financial implication of Rs. 29.76 crore relating to Functioning of Delhi Building and Other Construction Workers Welfare Board, Government of National Capital Territory of Delhi, excess expenditure on electricity charges by Delhi Technological University and excess payment of transport allowance to employees by Indraprastha Institute of Information Technology Delhi.

7. **Report No. 8 of 2021 - Union Government, Department of Revenue – Direct Taxes**

   This Report primarily discuss compliance to the provisions of the Income Tax Act, 1961 and the associated rules, procedures, directives etc. as applied to all aspects related to the administration of direct taxes. Direct taxes receipts of Union Government in FY 2019-20 amounting to Rs 10,50,686 crore. Share of direct taxes in gross tax revenue decreased to 52.3 *per cent* in FY 2019-20 from 54.7 *per cent* in

FY 2018-19. We pointed out 356 high value cases pertaining to Corporation Tax with tax effect of Rs 12,476.53 crore and 222 high value cases of income tax with tax effect of Rs 416.60 crore.

8. **<u>Report No. 16 of 2020 - Performance Audit on Assessment of Co-operative Societies and Co-operative Banks, Union Government Department of Revenue - Direct Taxes</u>**

- The Co-operative Sector witnessed a significant growth in terms of number of entities registered as Co-operative Societies and Co-operative Banks. During 2009-10 to 2016-17, Co-operative Societies registered a growth of 39.84 *per cent*. This topic was selected for performance audit with a view to examine the extent of: Coverage of Co-operative Societies in Income Tax net; Widening and deepening of the tax base; and Compliance of the statutory provisions.
- The performance audit covered the assessments of Co-operative Societies and Co-operative Banks completed during the financial years 2014-15 to 2018-19.
- Audit noticed that the number of Co-operative Societies and Co-operative Banks as per records of respective States/ Regional regulatory authorities/ Registering authorities was much higher as compared to the numbers as per ITD indicating that many Co-operative Societies and Banks were not in the tax net of ITD.
- Audit noticed that the verification of registration of the entity as Co-operative Societies/ Co-operative Banks was inadequate and evidential proof of a certificate of registration by Registrar as well as the details of members of the societies was either not available in the assessment records or not verified by the Assessing Officers.
- There were instances of irregular allowance of deductions under sections 36(1)(viia), 36(1)(viii), 36(1)(xvii) of the Act and various subsections of section 80P of the Act., where, conditions specified under the said provisions were not fulfilled, involving tax effect of Rs.694.50 crore in 649 cases.
- Audit noticed instances of non-compliance to provisions laid down in the Act with respect to allowances of deductions/ expenses/ set-off and carry forward of losses, mistakes in computation of tax and interest, non-deduction of TDS, non-levy of penalty etc. involving tax effect of Rs.12,328.40 crore, in 858 cases.

9. **<u>Report No.14 of 2020 - Performance Audit on Search and Seizure Assessments in Income Tax Department, Union Government, Department of Revenue - Direct Taxes</u>**

- Search and Seizure is a very powerful tool available to Income Tax Department to unearth any concealed income or valuables and to check the tendencies of tax evasion thereby mitigating the generation of black money. The Income Tax Department resorts to search and seizure only in cases where there is sufficient reason to believe that the person concerned would not disclose the true picture of his income in the normal course of filing of return and regular assessment.

- The Performance Audit (PA) covered the search assessments completed during the financial years 2014-15 to 2017-18. Audit checked 24,869 assessment records pertaining to 185 Groups with assessed income of Rs 1,71,503.78 crore during the PA. Audit issued 1659 observations. having tax effect of Rs 4150.02 crore.
- The Income Tax Department did not centralise all cases in respect of certain groups for assessments due to which issues relating to the assessees pointed out in Appraisal Report could not be addressed.
- 76.5 *per cent* of additions made in search assessments did not stand the test of judicial scrutiny in appeals at the level of CIT (A)/ITAT. There were cases where sustainability of additions made in the assessment orders was nil at appellate stage.
- Assessing Officers did not take uniform stand in making additions on account of bogus purchases, accommodation entries and in adoption of figures of assessed income/revised income. The additions were made arbitrarily either on lump sum amount basis or different percentage ranging from five *per cent* to 50 *per cent* under similar circumstances without proper justification. There were cases of non-compliance of CBDT's instructions/orders. Provisions related to levy of penalty, allowances of deductions/expenses/set off and carry forward of losses/ MAT etc. were not followed correctly.
- There was a delay ranging from one month to 14 months in handing over of Appraisal Report along with seized material to the AO.
- Verification of source/genuineness of the transaction pointed out in Appraisal Report was not done and undisclosed income recommended in the Appraisal Report was not added. Coordination with other wings of ITD to resolve the issues pointed out in Appraisal report was not there. Useful information was not shared by ITD with other government agencies/authorities or vice versa either directly or through REIC.
- Action Notes based on comprehensive and methodical examination of seized material, were not prepared by the AO. Separate Narrative Reports were not prepared and sent to the Member (Investigations).

10. Report No.11 of 2020 - Compliance Audit of Union Government, Department of Revenue – Direct Taxes

This Report primarily discuss compliance to the provisions of the Income Tax Act, 1961 and the associated rules, procedures, etc. as applied to all aspects related to the administration of direct taxes. Direct taxes receipts of Union Government in FY 2018-19 amounting to Rs 11,37,718 crore. Share of direct taxes in gross tax revenue increased to 54.7 per cent in FY 2018-19 from 52.2 per cent in FY 2017-18. Voluntary compliance by assessees accounted for 82.6 per cent of the total collections of Corporation and Income Tax in FY 2018-19. This Report includes 393 high value cases having tax effect of Rs 8,380.79 crore. More than 82 per cent individual taxpayers faced the TDS mismatch problem due to the difference in the amount available in Form 26AS and that claimed by the assessees through their ITR, majority being salaried taxpayers. The interest was wrongly computed either due to systemic deficiencies in Assessment Information System (AST) or due to incorrect interventions/ computation by the assessing officers (AOs). Availability of facility for manual intervention in AST was misused by AOs by way of modifying the interest at excess amount which led to blockade of refund to the assessee. The ITRs of the assessees who traded in the shares of penny stock companies were neither selected for scrutiny nor reopened for scrutiny despite the ITD having information of claiming LTCG. The ITD failed to issue notices for filing ITRs, to the assessees who were involved in trading penny stocks, but have not filed their ITRs. The AOs had no uniformity in making additions of exempt LTCG, despite the fact that the grounds of additions were same.

11. **Report No.9 of 2019 - Compliance Audit of Union Government, Department of Revenue - Direct Taxes**

This Report primarily discuss compliance to the provisions of the Income Tax Act, 1961 and the associated rules, procedures, directives, etc. as applied to all aspects related to the administration of direct taxes. Direct taxes receipts of Union Government in FY 2017-18 was 6.0 per cent of the GDP. Share of direct taxes in Gross Tax Revenue increased to 52.2 *per cent* in FY 2017-18 from 49.5 *per cent* in FY 2016-17. The uncollected demand in FY 2017-18 Rs 11.1 lakh crore of which 98.2 *per cent would be* difficult to recover. This Report includes 472 high value cases having tax effect of Rs 5,197.72 crore. The ITD allowed Exemption for agricultural income without verification of supporting documents such as the land records, proof of agricultural receipts and expenses and cross examination of documentary evidence where available. In a follow-up test check of Exemptions to Charitable Trusts and Institutions during FY 2017-18, Audit noticed instances of irregularities such as diversion of income/property by trusts to related group trusts/institutions as application of income, exemptions to assessees whose activities were not 'charitable' in nature, allowance of expenditure and accumulation where exemption was denied, lack of monitoring the investment of accumulated money by the trusts in the forms or modes other than those specified in the Act, exemptions granted to trust on application of funds given to foreign universities, exemption to assessee where voluntary contribution including foreign currency donation was considered as corpus fund without specific direction of donor, non-cancellation of registration where activities of the Trust and Institutions are not in accordance with the provisions of the Act, Failure of the Assessment Information System to levy surcharge. The ITD did not cross link material transactions with related parties to ensure the correctness/ genuineness during the assessment of related companies in a group and lacked a system of information sharing amongst its various charges leading to assessments of group companies getting completed in standalone manner.

12. **<u>Report No.1 of 2019 - Performance Audit on Assessment of Assessees in Entertainment Sector, Union Government, Department of Revenue - Direct Taxes</u>**

- Entertainment sector consists of different segments such as television, radio, music, event management, films, animation and visual effects, broadcasting, sports and amusement etc. This sector has witnessed a strong growth in the last five years making it one of the fastest growing sectors in India.
- The PA report covers the scrutiny assessments completed during the financial years 2013-14 to 2016-17. Audit checked 6516 assessment records (approx. 50 *per cent*) with assessed income of Rs.47979.44 crore. Audit noticed 726 mistakes (approx. 11 *per cent* of the audited sample) concerning systemic and compliance issues involving tax effect of Rs.2267.82 crore.
- Useful information of the assessee was not shared amongst different charges of Income Tax Department (ITD). Despite specific film circles/wards in dedicated units, sufficient efforts were not made by the ITD to assess them in the designated circles/wards. Surveys, were not conducted at all in some states.
- Verification of the expenses on account of production cost paid to foreign line producers was not done. Verification of the incentive/subsidy received from Foreign Governments was not done. Inter-related parties of the entertainment sector were following different accounting methods, impacting proper cross verification of transactions. There was no monitoring mechanism to examine the details of revenue earned from overflow and from various movie rights by the film producers.
- There was lack of uniformity in applying provisions of withholding tax in respect of foreign line producers. There was no uniformity in allowance of franchisee fee, paid by Indian Premier League (IPL) to Board of Control for Cricket in India (BCCI). Submission of Form 52A was not monitored and production cost disclosed by film producer in Form 52A was not properly verified.
- Additions made by the assessing officers on ad hoc basis by applying varying percentage ranging from five per cent to 20 per cent despite the grounds of additions were same. Provisions related to allowances of deductions/expenses/set off and carry forward of losses/ MAT etc. were not followed correctly.

13. **<u>Report No.23 of 2018 - Performance Audit on Assessment of Assessees in Real Estate Sector, Union Government, Department of Revenue - Direct Taxes</u>**

- Real estate can be segregated into three broad categories - i) Residential comprising developed land, residential houses and condominiums; ii) Commercial comprising office buildings, warehouses and retail store buildings and iii) Industrial which includes factories, mines and farms, on the basis of its use. There are various players involved in this sector such as land owners, developers, contractors, sellers/buyers and real estate agents etc.

- The performance audit covered the scrutiny assessments completed during the financial years 2013-14 to 2016-17. Audit checked 17,155 assessment records (approx. 22 *per cent*) with assessed income of ` 1,02,106 crore. Audit noticed 1,183 mistakes (approx. 7 *per cent* of the audited sample) having tax effect of ` 6,093.71 crore, thus causing loss of revenue to the Government.
- Audit noticed several companies outside the tax net. There is no mechanism with ITD to ensure that all the registered companies have PAN and are filing their ITRs regularly. The system in the ITD to ensure compliance of filing of ITRs by the sellers of high value immovable properties was not effective. The enforcement of provisions of the Act in respect of filing AIRs by Registrar/Sub-Registrar of properties in respect of sale or purchase of an immovable property by the ITD was weak.
- There is no provision in the Income Tax Act to deal with the share application money which is pending for allotment of shares for long period which is a lacunae in the Act. The assessing officers were not following the provisions of the Act meticulously and committed mistakes in adopting the correct figures, applying provisions of the Act and in admitting expenditures/ deductions/ exemptions.
- Enforcement of conditions for allowing deductions under section 80-IB(10) was weak, leading to benefits being availed by non-eligible persons/ unintended groups. Thus, the targeted groups could not be benefited and the revenue foregone on this count year after year by the Government may have benefitted unintended persons.

14. **Report No.40 of 2017 - Compliance Audit of Department of Revenue – Direct Taxes Union Government**

This Report primarily discuss compliance to the provisions of the Income Tax Act, 1961 and the associated rules, procedures, directives, etc. as applied to all aspects related to the administration of direct taxes. Direct tax receipts of the Union Government in FY 2016-17 grew by 14.5 *per cent* over the previous year. Share of direct taxes in gross tax revenue decreased to 49.5 *per cent* in FY 2016.17 from 51 *per cent* in FY 2015-16. The arrears of tax demand in FY 2016-17 was of ₹10.4 lakh crore of which 98.6 *per cent* would be difficult to recover. Number of appeals pending with CIT (Appeals) were 2.9 lakh in FY 2016-17 in which amount locked up was ₹ 6.1 lakh crore. This Report includes 457 high value cases having tax effect of ₹4,186.85 crore. ITD raised exaggerated demands to achieve its revenue collection targets which was refunded in the next financial year along with the interest, putting a burden on the exchequer in the form of avoidable interest paid on refunds. Assessing officers were allowing or disallowing amounts pertaining to bogus transactions arbitrarily, applying discretion that was not available to them. In some of the cases, reports of the Investigation Wing regarding bogus donations were not taken cognizance of. While giving effect to the appellate orders mistakes on account of non-consideration of the refund already issued to the assessee and short/ non levy of interest, etc. were noticed. There were delays in implementation of appellate orders resulting in avoidable payment of interest on refunds. No action was taken to implement the decisions given by the appellate authorities in favour of the revenue resulting in unrealized revenue.

15. Report No.41 of 2017 - Compliance Audit of Department of Revenue – Customs Union Government

- This report contains audit observations on significant revenue losses and/ or under assessment noticed in different Customs Commissionerates audited by the Comptroller and Auditor General of India. Audit findings are summarised in four chapters, namely *Irregularities in duty exemption/remission schemes, Incorrect application of general exemption notifications, Short/Non-recovery of applicable levies and other charges and Misclassification of goods. Chapter I of the Report provides an overview of growth trends of Customs Revenue, analysis of revenue foregone, cost of collection of taxes and department's internal control mechanism.*
- The total revenue implication of the Audit Report is ` 85 crore, out of which recovery of ` 19 crore has been effected and the Government has reported initiating rectificatory action in cases involving revenue implication of ` 30 crore.
- According to the revenue figures reported in the Union Finance Accounts for the year 2016-17 and data maintained by Central Board of Excise and Customs (CBEC) imports have registered a growth of 4 per cent during FY 2016-17 over previous year, while exports moved up by 8 percent during the same period. Customs Revenue was 13 percent and 26 percent respectively as percentage of Gross Tax Revenue and Indirect Taxes. Revenue forgone as a percentage of Customs Receipts was 172 percent in FY 16-17. Six export promotion and remission schemes accounted for 96 per cent (` 87732 crore) of total revenue foregone under the Schemes.

16. Report No.30 of 2017 - Performance audit Union Government Payment of tax by certain companies under special provisions of section 115JB Reports of Department of Revenue – Direct Taxes

- The corporate assessees, irrespective of their income level are required compulsorily to file their income tax returns annually. However, total number of corporate assessees filing returns with the ITD was much less as compared to the number of working companies registered with Registrar of Companies. The ITD's efforts to bring such assessees into the tax net /Certain ambiguities in the interpretation of legislative provisions/ adjustments to net profit or loss as per profit and loss account for the computation of book were examined during audit.
- The performance audit covered cases of scrutiny assessments, appeal and rectification completed during the financial years 2012-13 to 2015-16. We also checked summary assessment records in respect of the selected cases where scrutiny assessment was not completed till the date of audit. We identified 195assessment cases where systemic issues including ambiguities/lacunae in provisionsof section 115JB of the Actwere noticed. Audit came across several issues/instancesof non-compliance to the provisions of Act/Rules in 589 assessment cases.In 34 assessment cases,ITD levied

tax under normal provisions of the Act though tax was leviable under special provisions

- The difference between thenumber of working companies registered with Registrar of companies (ROC) and those reported by DGIT (Logistics, Research & Statistics) ranged from 2.94 lakh (33.3 per cent) to 3.94 lakh (36.4 per cent) during FYs 2012-13 to 2015-16 which indicated the extent of non filing/stop filing of the return of income by the companies. About one third of the companies registered with the ROC were not in the database of the ITD.

17. **Report No.27 of 2017 - Performance audit Union Government Assessment of Private Hospitals Reports of Department of Revenue - Direct Taxes**

- The performance audit covered the achievement of objectives behind the introduction of tax incentives specific to the healthcare sector and deriving an assurance that the existing systems and controls are adequate for compliance of provisions specific to the healthcare institutions and medical professionals under the Income Tax Act. It also included the examination whether all types of healthcare institutions were effectively covered in the tax net of the Income Tax Department (ITD), and assessment of the adequacy of efforts made by ITD towards this.
- Deficiencies were noticed in the monitoring and control of Tax base of assessees engaged in private healthcare sector, Tax incentives available under the Income Tax Act for Private Healthcare Facilities. Audit found deficiencies in application of other provisions of Income Tax Act availed by healthcare sector assessees.
- Systems and mechanism operating within ITD could not be used to link third party datafor cross verification to extract potential assessees.Mechanism available with ITD for widening of tax base needed modification to be more effective.Lack of measurable definition of “charitable Purpose obviates ineligible assessees to avail exemption.Lacuna in section 35AD of Income Tax Act resulted in excess deduction and loss of revenue. Donations were not being watched properly due to absence of provision in ITD module to enable validation of section 80G certificates. Expenditure which were held as disallowable and unethical had been allowed by the ITD.

18. **Union Report 1 of 2017 - Revenue Customs**

During the financial year 2015-16 the Custom Receipts of Rs. 2,10,338 crore grew by 12 percent over the previous financial year. The ratio of Customs duty collected to GDP was 1.55 percent. Duty foregone on account of export promotion schemes and on commodities was Rs. 3,40,420 crore in the financial year 2015-16. The report has 101 paragraphs with revenue implication of Rs. 495 crore and two subject specific compliance paragraphs of Rs. 568 crore. In addition systemic and internal control deficiencies involving revenue of Rs. 6430 crore have been included in the report. In 70 paragraphs involving money value of Rs. 19 crore rectificatory action has been taken by the department/Ministry in the form of issuing show cause notices, adjudicating of show cause notices and recovery of Rs. 15 crore has been effected till date. A few significant findings included in this Report are mentioned in the following paragraphs. The cases which have been accepted by the department and recoveries made/recovery proceedings initiated are mentioned in Annexures to the report.

19. **Report 2 of 2017 - Revenue Direct Taxes**

- The instances mentioned in this Report are those, which came to notice in the course of test audit for the period 2015-16 as well as those which came to notice in earlier years but could not be reported
- In the previous Audit Reports; instances relating to the period subsequent to 2015-16 have also been included, wherever necessary

20. **Report 4 of 2017 - Revenue Direct Taxes**

- The Report contains significant results of the performance audit of Implementation of TDS/TCS Schemes of the Department of Revenue – Direct Taxes of the Union Government in 2012-13 to 2014-15.
- The instances mentioned in this Report are those, which came to notice in the course of test audit for the period 2012-13 to 2014-15 conducted duringthe period November 2015 to March 2016

21. **Report 42 of 2016 - Performance Audit Customs on Project Imports**

The Report contains significant results of the performance audit on 'Project Imports'. The instances mentioned in this Report are those which came to notice in the course of test audit conducted during the period 2016-17, and covering transactions of the period 1st April 2011 to 31st March 2016. The audit has been conducted in conformity with the Performance Auditing Standards issued by the Comptroller and Auditor General of India.

22. **Report No. 28 of 2016 - Performance Audit on Allowance of deduction to the assessees Direct Tax Union Government**

- The performance audit on Allowance of deduction to the assessees engaged in infrastructure development covered assessments completed by the Assessing officers (AOs) during financial years 2012-13 to 2014-15 and up to the date of audit. Audit noticed systemic issues in 229 cases involving tax effect of ` 27.17 crore which comprised deduction allowed to ineligible assessees/business not specified in the Act, incorrect computation of Minimum Alternative Tax, valuation of transient goods, aggregation of income/loss of business vs undertaking, inconsistency in setting off brought forward losses and unabsorbed depreciation relating to eligible units, treatment of receipts from sale of carbon credits, and deduction on Infrastructure facility developed for captive/private use etc. Besides, mistakes in assessments were noticed in 146 cases involving tax effect of ` 21.53 crore.
- The CBDT did not have any established mechanism to assess the impact of revenue foregone on account of deduction under section 80 IA on the economic and industrial growth of the country. There is no existing system to ascertain from the sponsoring ministries as to whether the tax holidays had the desired impact on the growth of the

economy. Therefore, the audit was unable to ascertain whether the very purpose of introducing the deductions in the Act had been achieved. The CBDT also failed to produce any records to give an assurance that Government has put in any system to do the cost-benefit analysis of the scheme so as to assess the benefits to the society derived out of the concessions/disallowances given to the assessee companies.

23. Report 24 of 2016 - Compliance Audit on Union Territories without Legislatures - Civil

- There are seven Union Territories (UTs) specified under Part II of the First Schedule to the Constitution of India, viz., Andaman and Nicobar Islands, Chandigarh, Dadra and Nagar Haveli, Daman and Diu, Lakshadweep, National Capital Territory of Delhi and Puducherry. Except for the National Capital Territory of Delhi and Puducherry, UTs do not have Legislature.
- This Report contains compliance audit observations of the five Union Territories without legislatures. Audit sought to examine the transactions relating to expenditure, receipts, assets and liabilities of audited entities to ascertain compliance to provisions of the Constitution of India, applicable laws, rules, regulations and various orders and instructions issued by competent authorities. The observations pointed out in this Report relates to Irregular/Avoidable payments, injudicious release of funds, Blocking of funds, embezzlement of government money, Deficiencies in the working of Panchayati Raj Institutions etc.

24. Report No.3 of 2016 - Compliance Audit on Direct Taxes Department of Revenue Union Government

- This Report for the year ended March 2015 has been prepared for submission to the President under Article 151 of the Constitution of India. The Report contains significant results of the compliance audit of the Department of Revenue-Direct Taxes of the Union Government. The instances mentioned in this Report are those, which came to notice in the course of test audit for the period 2014-15 as well as those which came to notice in earlier years but could not be reported in the previous Audit Reports; instances relating to the period subsequent to 2014-15 have also been included, wherever necessary.
- The audit has been conducted in conformity with the Auditing Standards issued by the Comptroller and Auditor General of India. This Report discusses direct taxes administration, audit mandate and findings of compliance audit including transfer pricing and write-off of arrears of tax demand.

25. Report No. 25 of 2015 - Performance Audit on Functioning of Internal Audit in Income Tax Department Union Government, Department of Revenue - Direct Tax

- Income Tax Department (ITD) is subjected to Internal Audit of assessment and accounting functions. Internal audit of assessment work in ITD is undertaken by the Additional Commissioners of Income Tax (Addl. CsIT), Special Audit Parties (SAPs) and Internal Audit Parties (IAPs) of ITD and internal audit of accounting and financial matters is undertaken by Internal Audit wing of Principal Chief Controller of Accounts (Pr. CCA) of Central Board of Direct Taxes (CBDT).

- Internal Audit of assessment functions in ITD has evolved over the years and has assumed significance as an independent function with no overlapping between assessment and audit functions. A new Internal Audit System was introduced in ITD with effect from 1 June 2007 providing for a separate audit structure in the ITD to perform the audit work assigning well defined roles to various authorities for effective functioning and management of Internal Audit. The roles of Supervisory Authorities have been defined in Central Board of Direct Taxes (CBDT) Instruction Number 3 of 2007 and Number 15 of 2013.

- We conducted Performance Audit on "Functioning of Internal Audit in Income Tax Department'' with the objective to derive the following assurance (a) whether Internal Audit is effective in providing reasonable assurance to the CBDT and Senior Management regarding achievement of objectives relating to compliance, assessment and other inter-related activities, as determined by CBDT; (b) whether internal audit is playing an effective role in enhancing the quality of assessments and (c) whether there is effective and efficient follow-up mechanism of internal audit findings and recommendations.

26. Report No. 5 of 2015 - Performance Audit on Assessment of Assessees in Pharmaceuticals Sector Union Government, Department of Revenue - Direct Taxes

- Pharmaceuticals industry has witnessed robust growth in last five-six years, taking its turnover from Rs.71,000 crore in 2007 to Rs.1,21,015 crore in 2013 and thereby making it a vital economic sector with corresponding potential for the Government revenue. Government provides support to this sector by way of various area based tax exemptions, weighted deductions on expenses towards Research and Development (R&D) and other deductions against business profits in the Income Tax Act 1961 (Act), concessional rate of excise duties, State VAT etc. It is important to ensure that such fiscal incentives given to this sector under the Act are allowed as per prescribed conditions and seek assurance that proper machinery to exercise necessary checks/controls in the area of probable misuse of these provisions relating to tax concessions exists and operates effectively.

- We conducted Performance Audit on "Assessment of Assessees in Pharmaceuticals Sector" with the objectives to focus on whether (a) the exemptions and deductions allowable to Pharmaceutical Sector have been allowed as per entitlement (b) the administrative and procedural adequacy for taxation of pharmaceutical sector exists (c) the allowance of deduction of Research and Development expenditure to the assessees in Pharmaceuticals Sector has contributed to the growth in industry as well as in tax revenues.

- The Performance Audit covered assessments completed during the period from 2010-11 to 2013-14 and up to the date of audit (September 2014) of assessees dealing in Pharmaceuticals sector. In case of major audit observations assessment records of previous assessment years were also checked/linked wherever found necessary. We held an entry conference with CBDT in July 2014 wherein we explained the audit objectives, scope and the main focus areas of audit examination.

27. <u>Report No. 3 of 2015 - Compliance Audit on Direct Taxes Union Government, Department of Revenue</u>

- The Comptroller and Auditor General of India conducts the audit of Receipts from Direct Taxes of the Union Government under section 16 of the Comptroller and Auditor General of India's (Duties, Powers and Conditions of Service) Act, 1971. This Report discusses direct taxes administration, audit mandate and findings of compliance audit. Direct taxes receipts of Union Government in FY 2013-14 was RS 6,38,596 crore which represented 5.6 per cent of the GDP.

- Share of direct taxes in Gross Tax Revenue increased from 53.9per cent in FY 2012-13 to 56.1 per cent in FY 2013-14. Two major components of Direct taxes viz. Corporation Tax increased from RS 3.56 lakh crore in FY 2012-13 to RS 3.95 lakh crore in FY 2013-14 and Income Tax increased from RS 1.97 lakh crore in FY 2012-13 to RS 2.38 lakh crore in FY 2013-14.

- The revenue foregone on account of tax exemptions increased from RS 1.02 lakh crore in FY 2012-13 to RS 1.16 lakh crore in FY 2013-14. It is increasing in absolute terms since FY 2010-11.The number of non-corporate assessees decreased from 367.87 lakh in FY 2012-13 to 304.03 lakh in FY 2013-14 registering a decrease of 17.4 per cent.

28. <u>Report No. 10 of 2014 - Compliance Audit on Direct Taxes Union Government, Department of Revenue</u>

- This Report discusses trends, composition and systemic issues in direct taxes using data from Finance Accounts, departmental accounts, departmental MIS and findings of compliance audit.Gross tax receipts (GTR) of Union Government in FY 2012-13 was Rs.10,36,460 crore which represented 10.25 per cent of the GDP. Share of direct taxes in GTR decreased from 55.16 per cent (Rs.3.34 lakh crore) in FY 2008-09 to 53.93 per cent (Rs.5.59 lakh crore) in FY 2012-13.Two major components of Direct taxes viz. Corporation Tax increased from Rs.2.13 lakh crore in FY 2008-09 to Rs.3.56 lakh crore in FY 2012-13 and Income Tax increased from Rs.1.06 lakh crore in FY 2008-09 to Rs.1.97 lakh crore in FY 2012-13.

- Voluntary compliance declined for corporate assessees from 83.1 percent to 77.5 per cent; however, it increased for non-corporate assessees from 87.0 per cent to 92.4 per cent during FY 2008-09 to FY 2012-13.We noticed that the actual collection of direct tax exceeded the budget estimates in FY 2009-10 and FY 2010-11. The revised estimates were found realistic in all years as variation in actual collection ranged from (-) 3.23 per cent to zero per cent of revised estimates.

- The revenue forgone on account of tax exemptions is increasing in absolute terms over the years (except FY 2010-11) but tax expenditure as a percentage of GDP, Direct Taxes and GTR is declining.The uncollected demand increased from Rs.2.01 lakh crore in FY 2008-09 Rs.4.86 lakh crore in FY 2012-13. The Department indicated that more than 96 percent of uncollected demand is difficult to recover in FY 2012-13.Scrutiny assessments pending for disposal decreased to 2.8 lakh in FY 2012-13 from 4.1 lakh in FY 2011-12. Out of total 5.9 lakh scrutiny assessment cases, the Department had disposed of 3.1 lakh (51.9 per cent) cases in FY 2012-13.Appeals pending with CIT(A) increased from 1.58 lakh in FY 2008-09 to 1.99 lakh in FY 2012-13. Only 85,049 appeals (29.9percent) were disposed of by the CIT(A) in FY 2012-13. The amount locked up in appeal cases with CIT(A) was Rs.2.59 lakh crore in FY 2012-13.We noticed that the number of pending direct refund cases has come down from 15.5 lakh in FY 2008-09 to 11.2 lakh in FY 2012-13.

29. Report No. 32 of 2014 - Performance Audit on Appreciation of Chartered Accountant Reporting in Assessment Proceedings of Union Government, Department of Revenue - Direct Taxes

- The Income Tax Act, 1961 (Act) contains several provisions which mandate the assessees to furnish audit reports and certificates issued by the 'Accountant' in the prescribed Form for meeting the specific objectives. Tax audit under Section 44AB under the Act was introduced in 1984 in order to ensure that the books of account and other records of the assessees are properly maintained and faithfully reflect the true income of the taxpayer. The objective of reporting/certification is to discourage tax avoidance and tax evasion.
- The Act defines an 'Accountant' as a Chartered Accountant (CA) within the meaning of the Chartered Accountants Act, 1949 under explanation to Section 288(2) of the Act. Audit reporting and certification by CAs under the Act are thus Third Party Reporting. The CAs are regarded as facilitators for the Income Tax Department (ITD) in administering the provisions of the Act correctly. The Tax Audit Reports (TARs)/certificates issued by them serve as a valuable reference guide to the Assessing Officers (AOs) while making assessments.
- We conducted Performance Audit on "Appreciation of Third Party (Chartered Accountant) Certification in Assessment Proceedings" with the objectives to see whether (a) all the requisite reports/certificates were obtained and kept on record at the time of assessments; (b) tax audit reports were complete to provide sufficient and requisite information to the AO, thereby, aiding him in completing the assessment as required under the Act; (c) the AO had evaluated and utilized the information while completing assessments, (d) in case of professional negligence of the Accountant, the matter has been taken up by the Commissioners with the Institute of Chartered Accountant of India (ICAI) and (e) there are lacunae or ambiguities in the provisions of the Act/reports.

30. **<u>Report No. 20 of 2014 - Performance Audit on Allowance of Depreciation and Amortisation</u>**

- Income Tax Act, 1961, (Act) lays down diverse provisions on depreciation and/or amortisation for tax purposes as deduction to an assessee/ a company in the course of its business with the intention for promoting economic growth within the Country. It is important to ensure that these provisions are properly utilised as per the existing tax laws to avoid any major revenue loss. The objective of this study was to focus on whether the systems and procedures are sufficient and in place to ensure compliance with the provisions of the Act/Rules and instructions issued by Central Board Direct Taxes (CBDT) in this regard. The study also seeks assurance that adequate internal control mechanism exists within the Income Tax Department (ITD) for monitoring the allowance of depreciation in general and under special circumstances viz., amalgamation, demerger, reconstruction etc.

- We audited assessments completed during the period FY 10 to FY 13 and all cases of scrutiny assessments, appeal and rectification cases etc, within the selected units. We covered all circles/wards taken up for regular audit during the period from July to September 2013. We checked 87,023 records of the assessees. This report contains 725 cases of deficiencies in the implementation of provisions of the Act with tax effect of RS 2,464.06 crore.

- Rates of depreciation on different assets/ block of assets as provided in the Act differ from those prescribed under the Companies Act 1956 for the same assets. We found that depreciation as per the Act was higher in 6,267 cases and lower in 5,926 cases by a difference aggregating RS 57,665.41 crore and RS 11,754.80 crore respectively. We suggested harmonising these rates as assessees and ITD make additional efforts in computation of taxable income. The intended purpose for allowing depreciation in the Act has also not been evaluated. Due to non-existence of proportionate allowance of depreciation depending upon the use of assets, assessees have claimed unintended benefits. We observed that 986 assessees made additions of various assets worth RS 1,41,725.45 crore in the month of March and claimed depreciation of RS 15,617.86 crore instead of allowable depreciation of RS 2,602.61 crore on pro rata basis for the month of March only, the assets being purchased in the month of March itself. Besides this, there are inconsistencies in allowance of depreciation on assets owned by Charitable/Religious Trusts and Association of Persons.

31. **<u>Report No. 7 of 2014 - Performance Audit on Assessment of Firms Union Government, Department of Revenue - Direct Taxes</u>**

- Partnership Firms (Firms) along with Association of Persons (AOPs) and Body of Individuals (BOIs) constitute one of the major businesses apart from the corporate sector in India. Firms are governed by India Partnership Act, 1932. The Income Tax Act, 1961 (Act) provides various exemptions and deductions to the Firms. Income Tax Department (ITD) has the responsibility to oversee that the conditions specified in provisions of the Act for availing exemptions/ deductions are fulfilled. The main objective of the present review is to seek an assurance that system and procedures of the ITD are sufficient relating to provisions of the Firms vis-a-vis existence of proper machinery within the ITD to exercise necessary checks/controls in the area of potential misuse of the provisions of the Act.

- The returned income of the Firms1 2 has increased from RS 36,942 crore in Assessment Year (AY) 09 to RS 51,482 crore in AY 12. Firms pay income tax at the rate of 30.90 percent1, however, effective tax rate in their case is only 23.80 percent3 as number of tax concessions are given to Firm assessees. This necessitates examination of the veracity of exemptions/deductions allowed to the partnership Firms vis-a-vis the claims made by the Firms.
- We requisitioned 27,944 assessment records relating to Firms, out of which ITD produced and we audited 26,328 records. We have highlighted 1,497 cases involving a tax effect of RS 328.04 crore relating to systemic, compliance and control issues in assessment.

32. <u>Report No. 14 of 2013 - Compliance Audit on Customs Union Government, Department of Revenue</u>

- The Report has a total revenue implication of RS 31.48 crore covering 31 paragraphs. We had issued another 90 paragraphs involving money value of RS 30.80 crore on which rectificatory action was taken by the Department/Ministry in the form of issuing show cause notices, adjudicating show cause notices and recovery of RS 27.76 crore. Customs revenue as a ratio of GDP has been stagnant at around 1.7 percent.
- Department of Revenue does not have a results framework document with objectives, activities, performance and success indicators in line with the subjects of its business allocation, for clearer performance monitoring and evaluation. Fluctuating gap between Revised Estimates/ Budget Estimates suggests that the department did not adopt any rational method for pre budget analysis and forecasting.
- The Customs Revenue forgone is increasing exponentially without commensurate increase in the exports. There was no outcome analysis of the SEZ Scheme at the macroeconomic level. ICT based solutions (ICES) and self assessment were not extended to all customs transactions. In the last ten audit reports, we had included 1709 audit paragraphs involving RS 2129.73 crore. Of these, the Government had accepted audit observations in 1390 audit paragraphs involving RS 1177.03 crore and had recovered RS 156.89 crore.

33. <u>Report No. 15 of 2013 - Compliance Audit on Direct Taxes-Union Government, Department of Revenue</u>

- This Report discusses important issues in direct taxes using data from Finance Accounts, departmental accounts, departmental MIS, Economic Survey and findings of compliance audits.Share of direct taxes in gross tax receipts increased from 38.42 per cent (RS 0.83 lakh crore) in FY 03 to 55.56 per cent (RS 4.94 lakh crore) in FY 12 indicating progressive tax system.

- Two major components of Direct taxes viz. Corporation Tax increased from RS 46,172 crore in FY 03 to RS 322,816 crore in FY 12 and Income Tax increased from RS 36,866 crore in FY 03 to RS 164,525 crore in FY 12.Voluntary compliance declined for corporate (from 84 to 79 per cent) as well as non-corporate (from 94 to 90 per cent) assessees during FY 03 to FY 12. During the same period, average annual growth of corporate and non-corporate assessees' base was 6.7 per cent and 3.0 percent respectively.
- We noticed that the actual collection of direct taxes exceeded the budget estimates in all the years except in FY 03, FY 05, FY 06, FY 09 and FY 12. The extent of actual collection exceeding the budget estimates ranged from 2.0 per cent in FY 10 to 16.7 per cent in FY 08. However, the revised estimates were found realistic.

34. **Report No. 28 of 2013 - Performance Audit on Administration of Penalty and Prosecution of Union Government, Department of Revenue - Direct Taxes**

- The Income Tax Act, 1961 (Act) proposes imposition of penalty on an assessee, if the Assessing Officer (AO)/Commissioner of Income Tax-Appeals/Commissioner of Income Tax (CIT) is satisfied that there has been non-compliance with or violation of law and there is no reasonable cause for failure. Chapter XXII of the Act declares certain acts of omission and/or commission as punishable offences. Offences and Prosecution under the Act are read in conjunction with other laws such as Indian Penal Code (IPC), Code of Criminal Procedure (Cr PC) and Indian Evidence Act (IEA).
- The Wanchoo Committee Report of 1975 recommended that Income Tax Department (ITD) needs to evolve and pursue vigorous prosecution policies and emphasized that monetary penalties may always not be enough. The White Paper on Black Money of May 2012 by Ministry of Finance (Ministry) described that taxpayers may be willing to take a calculated risk of tax evasion and it may be more effectively deterred by effective prosecution. A committee headed by the Chairman of Central Board of Direct Taxes (CBDT) constituted in May 2011 recommended establishment of special judicial set up within the existing framework as also amendments to various fiscal statutes so that they become stronger. In response to these, ITD has also taken several efforts to streamline and strengthen the deterrent mechanisms against tax evasion in general and income tax in particular.
- As penalty and prosecution are important deterrent mechanisms, we felt it necessary to examine the administration and implementation of penalty and prosecution machinery, by the CBDT and its field formations for combating tax evasion. We sought to achieve this by examining current structures, its utilization and effectiveness. Our objective for examining penalty provisions inter alia was to whether the mechanism for administration and levy of penalties for various defaults existed and is functional and had a deterrent effect on tax evasion. In respect of prosecution, our focus was to examine the functional efficiency of the prosecution mechanism at various levels in ITD.

35. **Report No. 20 of 2013 - Performance Audit of Exemptions to Charitable Trusts and Institutions of Union Government, Direct Taxes**

- Income Tax Act, 1961 (Act) provides various tax exemptions to charitable trusts & institutions (Trusts) to fulfill their objectives. Income Tax Department (ITD) has the responsibility to oversee that the provisions of Act are duly complied by Trusts. The main objective of the present review is to seek assurance that registrations are given to Trusts involved in charitable activities only, and exemptions are allowed to eligible Trusts. Our study also seeks assurances that proper monitoring mechanism exists for utilization of accumulations and inadequacies in the provisions of Act relating to exemptions.

- We have pointed out lapses In registration process, allowance of exemptions during assessment, non-monitoring of accumulations of surplus income and Foreign Contributions (FCs) received. Besides, we have highlighted inconsistencies in Act which led to incorrect assessment and non-levy of taxes.Our report also touched upon the issue of under utilization of resources placed at the disposal of ITD.

- ITD received 1.75 lakh applications of Trusts during FY 09 to FY 11 for granting registrations/approvals or issuing notifications for claiming exemption. ITD granted registrations/approvals/notifications in 0.90 lakh cases while it denied approval in 0.36 lakh cases and 0.49 lakh cases were pending. We scrutinized all the 0.90 lakh cases where ITD granted registrations/approvals/notifications and noticed procedural mistakes in 6,948 cases (7.72 per cent).

36. **Report No. 4 of 2013 - Performance Audit of Strengthening the Tax base through use of Information-Union Government, Department of Revenue - Direct Taxes**

- Strengthening the tax base is arguably one of the most important aspects of the direct tax management. The Income Tax Department (ITD) uses 'pieces of information' arising from different sources to strengthen the tax database, in addition to the information available in the income tax returns/provided by the assessee during assessment.

- Central Information Branch (CIB) of ITD collects, uploads information to the ITD Systems and disseminates to the Assessing Officers (AOs). There are 17 formations of CIB across the Country under the Director General of Income Tax (Intelligence and Criminal Investigation). Agencies submit information to CIB or TIN Facilitation Centres of National Securities Depository Limited (NSDL) on behalf of ITD. This flows through CIB Module of ITD Systems software administered by the Director General of Income Tax (Systems).

- Annual Central Action Plans of ITD target an increase of 15 per cent per year in assessee base. Against this, annual increase during the ten year period from FY 02 to FY11 was only 3.1 percent (from 262 lakh to 336 lakh assessees).

37. **Report No. 23 of 2012 - Performance Audit of IT Applications in Income Tax Department**

- The main objectives of the IT Applications in Income Tax Department (ITD) were to improve the efficiency and effectiveness of the tax administration and provide management with reliable and timely information towards effective planning as also broaden the tax base. We reviewed four modules of ITD Applications namely, AST for processing returns, OLTAS for providing tax accounting and payment information, e-TDS for providing AST with information on details of payment of taxes under TDS scheme and IRLA for maintaining a ledger account of each individual assessees in respect of demand and refunds of tax for each assessment year (AY).
- ITD has spent RS 790 crore on computerisation during FY 06 to FY 11. Yet ITD has not utilized important functionalities of modules. AST/CPC applications do not link up assessee's legacy details (paragraph 2.16 to 2.20). It does not record scrutiny assessment details nor does it record penalty proceedings and appeals. All non filers identified by AST are not being issued notices, (paragraph 2.11). ITD did not reconcile the revenue collections as reported by Banks and as accounted by Zonal Accounts Office, with implications on correctness of Government Accounts, (paragraph 2.26). Deauthorised bank branches are collecting taxes (paragraph 2.31 to 2.32). Large amounts of unposted credits are lying in OLTAS (paragraph 2.42). The Individual Running Ledger Accounts are not being populated completely (paragraph 2.52 to 2.53). Multiple uses of same Challans have been found which accorded inadmissible tax credit to assessees. ITD has already confirmed 3089 cases amounting to RS 153 crores of extra credit through the system at our instance (paragraph 2.58). IT applications do not generate important MIS reports like CAP-1 and CAP-II online (paragraphs 2.66 to 2.69); and, do not co-relate Certificate for deduction of tax at lower/nil rate while processing returns.
- Outsourcing contracts are not comprehensive towards ensuring third party security audit / audit by ITD (paragraphs 3.16 to 3.22). We could not obtain adequate assurance towards the system for handling records for digitization by outsourced vendors (paragraph 3.25 to 3.27).There were deficiencies in physical and logical access controls (paragraph 3.29). Contractors defaulted on their deliverables without attracting penalties.

38. **Report No. 27 of 2011-12 - Compliance Audit on Direct Taxes Union Government, Department of Revenue**

- o The Comptroller and Auditor General of India conducts the audit of revenues from direct taxes of the Union Government under section 16 of the Comptroller and Auditor General of India (Duties, Powers and Conditions of Service] Act, 1971.Direct taxes levied by the Parliament mainly comprise Corporation Tax on companies. Personal Income Tax and other direct taxes including Fringe Benefit Tax, Securities

Transactions Tax and Wealth Tax etc, Corporation Tax constituted 66,8 per cent of net direct tax collection in 2010-11.

- In the Budget 2010-11, the Government amended the provisions relating to direct taxes in order to: (i) lower the tax burden on individual taxpayers by widening the tax slabs; (ii) facilitate small businesses; (iii] promote investment in Research and Development (R&D] to enhance the competitive ability of the economy and [iv] encourage savings for funding infrastructure by providing a tax deduction on investment in long-term infrastructure bonds.

o We noticed that the direct tax collection exceeded the budget estimates in all the years over the period 2006-07 to 2010-11 except 2008-09. The extent of actual collection exceeding the budget estimates ranged from 2.2 percent in 2009-10 to 16.7 percent in 2007-08.

39. <u>Report No. 23 of 2011 - Performance Audit of Recovery of Arrears of Tax Demand</u>

- Direct tax collections, amounting to RS 4.35 lakh crore accounted for three-fourth of revenue receipts of the Government of India in 2009-10. At the same time the uncollected portion of tax demand was RS 2.29 lakh crore in March 2010 equivalent to 54 per cent of total direct tax collections. The arrears of demand also registered a steep hike in last five years.

- This review was undertaken to evaluate the reasons for huge build-up of income tax arrears and the measures being taken by the Department to liquidate arrears. The main objectives of our audit were to seek an assurance that the Department: has an effective internal control mechanism and monitoring system and has made all efforts provided in the Act for expeditious recovery of arrears of tax demand; has complied with the instructions issued by the Central Board of Direct Taxes from time to time; is diligently pursuing the disposal of appeals by Appellate Authorities; is liaising with the Settlement Commission for early disposal of cases involving high tax demand.

- We employed two tier sampling for selection of assessment units and tax recovery wards and for identification of cases within those units. We also analyzed high value arrear demand cases of RS 10 crore and above available with the Directorate of Income Tax (Recovery).

40. <u>Report No. 12 of 2011-12 - Performance Audit of Business of Civil Construction</u>

- The construction industry has emerged as an important driver of India's economic growth - both in terms of its share of GDP and its contribution towards employment generation. A number of tax concessions are given to entities in this sector. An earlier performance audit conducted during the year 2002-03 by us revealed systemic and compliance deficiencies and several irregularities in assessment of entities in the sector.

- The main objectives of our study were to ascertain whether the Income Tax Department has made significant efforts to widen and deepen the tax base in this potential area and ensured proper compliance of the provisions of the Act by the entities engaged in this sector.

- In the aftermath of the 26/11 terrorist attack on the Western coast, Audit sought to assess whether the Indian Coast Guard is equipped to handle its role in an effective and efficient manner in terms of enabling legislation, force levels, manpower and infrastructure.

41. <u>Report No. 26 of 2010-11 - Compliance Audit Report on Direct Taxes, Union Government</u>

The Report highlighted following:-

- Direct tax collections increased from RS 1,65,216 crore in 2005-06 to RS 3,78,063 crore in 2009-10 at an average annual rate of growth of 32.2 per cent. The rate of growth of tax collection has decelerated in 2008-09 and has since marginally improved in 2009-10. Tax-Gross Domestic Product (GDP] ratio increased from 4.6 per cent in 2005-06 to 6.1 per cent in 2009-10. However, there was a slight decline as compared to 6.6 per cent in 2007-08. For every unit growth in GDP, direct taxes grew from 1.7 per cent in 2005-06 to 2.6 percent in 2007-08. The buoyancy slowed down to 0.8 per cent in 2009-10 through 0.5 per cent in 2008-09. The decline in buoyancy is a matter of concern.

- The assessee base grew over the last five years from 297.9 lakh taxpayers in 2005-06 to 340.9 lakh taxpayers in 2009-10 at the rate of 14.4 percent. Voluntary compliance by assessees (pre-assessment stage) accounted for 82.8 per cent of the gross collections in 2009-10. Only 65 per cent of the total demand raised in 2009-10 was collected registering a decline as compared to 74 per cent collected in 2007-08. Out of the total 8.7 lakh scrutiny assessment cases, the Department had disposed off 4.3 lakh (49.3 per cent) cases in 2009-10. The pendency of scrutiny assessments increased from 45.7 per cent in 2005-06 to 50.7 per cent in 2009-10.

- The certified demand remaining uncollected was RS 95,122.4 crore (96.6 per cent) in 2009-10 as compared to RS 27,461 crore in 2008-09 registering an increase of 246.4 per cent. Total cost of direct tax collection increased to 0.73 per cent in 2009-10 mainly due to increase in establishment cost. The Government refunded RS 57,101 crore including interest of RS 12,951 crore (22.7 per cent) in 2009-10. Interestingly number of pending direct refund cases has gone up from 5.7 lakh in 2005-06 to 19.4 lakh in 2009-10.

42. <u>Report No. 15 of 2010 - Performance Audit of Natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal and articles thereof, imitation jewellery, coin</u>

- The performance audit on the levy of customs duty on 'natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal and articles thereof, imitation jewellery, coin (chapter 71 of Customs Tariff Heading)' was conducted to evaluate the adequacy of the provisions of the relevant Acts, Rules and instructions in ensuring proper assessment and collection of revenues.

- The estimated duty foregone in this sector during 2005-06 to 2007-08 amounted to Rs. 68,192 crore. We found that the revenue earned from gems and jewellery by eleven audited commissionerates, during 2005-06 to 2007-08 was Rs. 2,023 crore, while the duty foregone was Rs. 20,864 crore. As against the import growth of 16 per cent, the growth in exports was only 13 per cent during the three years. Thus, despite the substantial revenue foregone and the various benefits and exemptions extended to this sector, the exports growth has not yet caught up with the rate of growth of imports.

43. <u>Report No. 36 of 2010-11 - Performance Audit of Taxation of assessees engaged in the Film and Television Industry</u>

- India, producing more than 1,000 feature films per year, is the largest film producing country in the world. During the period 2005-2009, film production registered a growth of 5 per cent per annum. The film industry registered growth of 9.7 per cent during the period 2005-2009 and generated revenues of around RS 9,500 crore in 2009. The television (TV) industry grew at 16.9 per cent per annum during the period 2005-2009 generating revenue of RS 26,550 crore in 2009. By the end of December 2009, there were 12.9 crore TV households with 8.9 crore subscribers to pay channels. Number of approved private channels at the end of December 2009 were 515 - 251 news channels and 264 other than news channels. The Film & TV industry is expected to grow at 16.5 per cent per annum in next five years to reach RS 65,850 crore by 2014.

- Production of films is financed mainly from private sources. Banks started financing the films after 'industry' status was accorded to the film industry in May 1998. In addition NFDC and film development corporations promoted by many states' governments also provide financial support in the form of loan, grant, subsidy, etc.

- The main objectives of our study were to ascertain that: the Department had broadened its tax base vis-a-vis film related personalities to increase tax collection commensurate with the growth of the industry; systems and procedures were sufficient and in place to ensure compliance with the provisions of the Act/Rules; mandatory information as required under the provisions of the Act as due from the assessees related to the film and TV sector were being received regularly in time; there was a system to utilize the information for assessment, available with the Department in Income Tax Returns of film/TV related assessees and in mandatory statements filed by the producers; there was a proper co-ordination between the Department and outside agencies for gathering information to detect undisclosed or incorrect information; the Department had taken action on the recommendations of the Public Accounts Committee (PAC).

44. **Report No. 18 of 2010 - Performance Audit of Taxation of Payments to non residents**

- 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.

45. **Report No. 4 of 2009-10 - Compliance Audit on Direct Taxes-Union Government**

- Direct taxes collections increased from Rs. 2,30,181 crore in 2006-07 to Rs. 3,33,818 crore in 2008-09 at an average annual rate of growth of 27.3 per cent. Global recession and economic slowdown in 2008-09 had an impact on actual collections which were lower (by 8.5 per cent) than the budget estimates. Tax-Gross Domestic Product [GDP] ratio in 2008-09 also reduced from 6.6 per cent in 2007-08 to 6.3 per cent in 2008-09. For every unit growth in GDP, direct taxes grew by 0.6 per cent only in 2008-09 reversing the trend of buoyancy in excess of one in earlier years. The deceleration in tax collection was thus sharper than that of GDP.
- The taxpayer base grew over the last five years from 271.8 lakh taxpayers in 2004-05 to 326.5 lakh taxpayers in 2008-09. However, in 2008-09, the total number of direct tax assessees declined by 3.0 per cent as compared to an increase by 7.6 per cent in 2007-08. The decline was sharper among corporate assessees. Inability to retain the existing tax base was a matter of concern.84 per cent of gross collections in 2008-09 were by way of voluntary compliance by assessees (pre-assessment stage], moving towards international principles of tax administration. 65 per cent of the demand raised in the year was collected in 2008-09, registering a decline from 74 per cent achieved in 2007-08.
- The department achieved greater efficiency in completion of scrutiny assessment cases, bringing down pendency from 54 per cent in 2006-07 to 44 per cent in 2008-

09.Cost of collection rose from 0.6 per cent in 2007-08 to 0.7 per cent in 2008-09 because of deceleration in tax collection and increase in establishment cost.84 per cent of the targeted audits were completed by Internal Audit. Mistakes detected in the assessments previously checked in Internal Audit indicate a need for improvement in the quality of Internal Audit. Departmental response to Internal Audit was clearly inadequate.

46. <u>Report No. 7 of 2009 - Performance Audit of Income Tax Refunds</u>

- A taxpayer becomes eligible for a refund if the tax paid by him was higher than the tax due in the year. The refund process gets initiated with the claim contained in the annual tax returns submitted by the taxpayer, which is then examined by the assessing officer for eligibility. The claim is finally disposed when the refund voucher is prepared and issued to the assessee through the authorized banks.
- Timely disposal of refund claims is a key measure of the operational efficiency of tax administration. Prompt refunds instill confidence among taxpayers and increase tax compliance. Automation was aimed to speed up the disposal and thus reduce the pendency of claims.
- We conducted performance review of income tax refunds processed during 2005-06 to 2008-09 in order to seek an assurance that the systems and procedures were geared towards timely and accurate processing of refund claims and that internal controls provide for effective monitoring. While the department largely cooperated with our efforts, access to records was a major constraint with the department not producing 20 per cent of the records asked for by us.

47. <u>Report No. 20 of 2009-10 - Performance Audit of The Appeal Process-Union Government-Direct Taxes</u>

- An aggrieved tax payer has the right to dispute a tax demand with the Income Tax Department through the Commissioner of Income Tax (Appeals). Second appeal against the orders of CIT (A) lies in the Income Tax Appellate Tribunal (ITAT) which functions under the Ministry of Law. On any question of law arising out of an order of ITAT, a taxpayer may appeal progressively to the High Court and the Supreme Court. Analogous right to appeal is also available to the Department against the orders of CIT (A) and onwards.
- The dimensions of disputes in income tax are staggering. Rs 2.2 lakh crore is the amount locked up in appeals at various levels, which can almost wipe off the revenue deficit of the Union Government in 2008-09. On an average, 48 per cent of tax demands remain uncollected and disputes account for 45 per cent of uncollected demands. These factors, we felt, merited a performance evaluation of the appeal process. This is the first time we have attempted a holistic study of appeals. The topic was also suggested by the Central Board of Direct Taxes (Board) during our consultations on areas of concern in the Department.

- In our study covering the period 2006-09, we sought an assurance that the processes ensure speedy resolution of disputes; they also identify litigious provisions in the Act for correction; the decisions for escalation of disputes to higher levels in the appellate hierarchy are based on a fair assessment of cost-benefit; the appeals are filed by the Department within the prescribed timeframe to avoid dismissal due to limitation; and the appellate orders are implemented accurately and timely to avoid inconvenience to the taxpayer as well as avoidable payment of interest.

48. Report No.CA 8 of 2008 for the Period ended March 2007 - Direct Taxes

- Nine hundred and sixty one observations with a tax effect of Rs. 1,749.97 crore were issued to the Ministry as individual draft paragraphs, including 542 observations involving revenue impact of Rs. 1,085.32 crore that has arisen from local audit conducted in earlier years. Nine hundred and eighteen observations involving revenue impact of Rs. 1,663.50 crore have been included in this report. There was loss of revenue of Rs. 1,354.33 crore due to timely remedial action not being taken in 3,593 cases.
- Application of statistical sampling techniques revealed that most likely estimates of proportion of scrutiny and non-scrutiny assessments with mistakes in Maharashtra were 7 percent and 1 percent respectively whereas those in Delhi were 12 percent and 7 percent for assessments completed during 2005-06. The total revenue effect of audit observations observed in the sample of the assessments completed during 2005-06 in Maharashtra and Delhi were Rs. 5,247.47 crore and Rs. 2,407.17 crore respectively, which were 8.65 percent and 9.19 percent of the total direct taxes revenue collection in the respective state for the financial year 2005-06.
- Recovery of Rs. 1,462.16 crore was made at the instance of audit in respect of 1,348 cases during 2006-07.
- Out of a target of 12.33 lakh cases for disposal during 2006-07 only 3.67 lakh cases were seen by internal audit, leaving a balance of 70.27 percent. Department did not produce to audit 69,054 cases or 54 percent of cases not produced during earlier audits and requisitioned again in 2006-07 which included 213 cases not produced in three or more consecutive audit cycles in Andhra Pradesh, Gujarat, Karnataka, Madhya Pradesh, Maharashtra, Orissa and Tamil Nadu charges. Consequently, these cases could not be audited.
- Total collections from direct taxes increased from Rs. 83,088 crore in 2002-03 to Rs. 2,30,181 crore in 2006-07 at an average annual rate of growth of 27.33 percent. In the case of corporate assessees, 75.78 percent of gross collections was made at pre-assessment stage, of which 55.20 percent was by way of advance tax. In the case of non-corporate assessees, 89.55 percent of the gross collection was made at pre-assessment stage, of which 50.96 percent was by way of TDS. Total number of assessees grew from 2.85 crore to 3.13 crore during 2002-03 to 2006-07 at a compound annual growth rate of 2.40 percent which was lower than the growth rate of 3.24 percent during 2001-02 to 2005-06. The number of cases selected for scrutiny

during 2006-07 was higher at 3.41 lakh as compared to 2.03 lakh in 2005-06. There has been a progressive decline in completion of assessments from 89.87 percent in 2002-03 to 66.44 percent in 2006-07, and a corresponding increase in pendency over the last five years. The decrease in the number of officers deployed on assessment duty could be one of the reasons for the increased pendency. Uncollected amount of Rs. 1,17,370 crore out of the total demand of Rs. 3,37,007 crore in respect of corporation tax/income tax and wealth tax comprised demand of Rs. 86,203 crore of earlier years and current demand of Rs. 31,167 crore outstanding as on 31 March 2007. The outstanding demand of corporation tax increased from Rs. 55,098 crore in 2005-06 to Rs. 64,683 crore in 2006-07 and that for income tax from Rs. 40,289 crore to Rs. 51,771 crore. For wealth tax, the outstanding demand decreased from Rs. 9,491 crore in 2005-06 to Rs. 916 crore during 2006-07. Since the wealth tax collection during 2006-07 was only Rs. 240.33 crore, this sharp reduction seems inexplicable and merits investigation by the Ministry. The percentage of recovery of certified demand increased from 14 percent of total certified demand during 2005-06 to about 24 percent during 2006-07.

- Receipts from corporation tax amounted to Rs. 1,44,318 crore which constituted 62.71 percent of the total collection from direct taxes during 2006-07. The number of corporate assessees as on 31 March 2007 was around 4 lakh which represented an increase of 1.80 percent over the previous year. In respect of corporate asseesees, 665 audit observations involving undercharge of tax of Rs. 1,573.64 crore and 21 observations involving overcharge of tax of Rs. 95.74 crore on account of various irregularities in assessments, such as mistakes in computation, carry forward and set off of loss, implementation of appellate orders, computation of income under special provisions, allowance of depreciation, deductions not supported by actual payment, capital/non business expenditure, mistakes in adoption of correct figures/arithmetical errors, provisions, prior period expenses/deductions not admissible, reliefs, exemptions and deductions under chapter VIA, refunds/interest on refunds, non levy/short levy of interest, income not assessed, mistakes in summary assessments and the assessments involving overcharge of tax were issued to the Ministry of Finance for their comments. Six hundred twenty four cases involving undercharge of tax of Rs. 1,480.60 crore and 21 observations involving overcharge of Rs. 95.74 crore have been included in this chapter. The Ministry has accepted observations in 204 cases involving revenue impact of Rs. 712.44 crore, till the date of preparation of this report.

- Receipts from income tax amounted to Rs. 75,079 crore which constituted 32.62 percent of the total collection from direct taxes in 2006-07. The number of income tax assessees as on 31 March 2007 was 3.09 crore, which represented an increase of 5.10 percent over the previous year. One hundred and eighty audit observations involving revenue impact of Rs. 43.64 crore on account of various irregularities in income tax assessments such as mistake in computation of business income, incorrect allowances of deduction to undertakings engaged in developing and building housing projects, incorrect allowance of deductions in respect of export profits, application of incorrect rate of tax, non/short levy of interest, incorrect of computation of capital gains, incorrect allowance of liabilities, irregular refunds, mistake in adoption of correct figures, incorrect carry forward and set off of losses, incorrect allowance of depreciation, income not assessed, mistakes in summary assessments and cases of overassessment/ overcharge have been included in this chapter. The Ministry has accepted audit observations in 66 cases involving revenue impact of Rs. 12.80 crore till the date of preparation of this report.

- Sixty nine cases of irregularities involving revenue impact of Rs. 33.94 crore on account of various irregularities in wealth tax and interest tax assessments such as mistakes in wealth not assessed due to non correlation of records of different taxes, non/short levy of interest, non inclusion of taxable assets in the net wealth and mistakes in assessment of chargeable interest have been included in this chapter. The Ministry has accepted observations in 25 cases (22 in wealth tax and three in interest tax) involving revenue impact of Rs. 4.66 crore (Rs. 34.48 lakh in wealth tax and Rs. 4.31 crore in interest tax) till the date of preparation of this report.

49. <u>Report No. PA 7 of 2008 for the Period ended March 2007 - Direct Taxes</u>

Audit noticed 318 mistakes in 165 scrutiny assessments involving tax effect of Rs. 2781.38 crore. Audit observed areas with high revenue impact on account of systemic issues such as incorrect allowance of bad debts written off, incorrect allowance of provision for bad and doubtful debts, incorrect depreciation on valuation of investments made by banks etc. Audit also observed cases with potential impact on levy of tax such as non correlation of figures of bad and doubtful debts, deductions towards advances given by rural branches etc. Besides, other irregularities of non-compliance such as incorrect allowance of expense towards exempt income, deductions, income not offered to tax and incorrect set off of losses were noticed.

Review on Appreciation of Third Party Reporting/Certification in Assessment Proceedings

Audit reviewed the assessment records of corporate and non corporate assesses (excluding who are salaried) completed during the period from 2004-05 to 2006-07 with a view to (i) ensure that the tax audit reports were complete in themselves to provide sufficient and requisite information to the assessing officer, thereby aiding him in completing the assessment as required under the Act, (ii) determine the extent to which the assessing officers have evaluated and utilised information provided in prescribed reports while completing assessments, and (iii) determine the effectiveness of the Department's internal control mechanism in ensuring that

the objective of obtaining a report from a third party (the accountant) is fulfilled. Audit observed a total of 2874 cases of irregularities having a value of Rs. 849.16 crore with revenue impact of Rs. 665.67 crore (including penalty of Rs. 41.52 crore). Audit observed cases where action was not taken in terms of the provisions of the Act for furnishing of inadequate information in the tax audit reports. Audit also observed cases where the assessing officers did not take action to make additions or disallowances although there were omissions in the tax audit reports. Further, cases were noticed where the assessing officers did not utilise the information available in the tax audit reports/certificates while finalising assessments. Audit observed that the internal control mechanism in the Department to ensure that (i) the audit reports/certificates were complete and provided sufficient and requisite information to the assessing officer, (ii) information which is provided in the audit reports is being effectively utilised by the assessing officers and (iii) cases are selected for scrutiny assessment on the basis of tax audit reports, is not effective.

Review on assessments relating to infrastructure development (Deductions under section 80IA of the Income Tax Act)

Audit reviewed the assessment records of the assessees engaged in infrastructure development and claiming deduction under section 80IA of the Income Tax Act completed during the financial years 2003-04 to 2006-07 (upto the date of audit) with a view to (i) determine the extent of underassessment/loss of revenue due to mistakes in assessment, (ii) determine the degree of compliance by the specified undertakings or enterprises with the provisions of the Act, and (iii) derive an assurance that the systems and procedures are sufficient and promote compliance with the provisions of the Act/rules. During the review audit test checked 685 assessments in company and non company circles involved in the specified infrastructure activity for verifying the claims of deduction under section 80IA of the Act. Audit observed mistakes in 91 cases having a value of Rs. 2037.22 crore and revenue impact of Rs. 932.29 crore. Audit observed areas with high revenue impact on account of systemic issues such as incorrect allowance of deduction without adjustment of losses and depreciation relating to eligible units, incorrect allowance of deduction on other income, benefit of deduction allowed to ineligible assesses, etc. Audit also observed cases with potential impact on levy of tax such as excess deduction due to non restriction of profits to the reasonable profit derived from captive power plants, etc. Audit study also revealed that major companies providing telecommunication services had either not claimed or could not avail of the deduction under section 80IA provided in the Act as they were either operating under losses or were being assessed under special provisions of the Act which does not take into account deductions under section 80IA.

50. <u>Report No. 8 of 2007 for the period ended March 2006-Performance Audit of Direct Taxes</u>

- Nine hundred and five observations with a tax effect of Rs. 1,971.33 crore were issued to the Ministry as individual draft paragraphs, including 388 observations involving tax effect of Rs. 530.62 crore that has arisen from local audit conducted in earlier years. Eight hundred and sixty two observations involving tax effect of Rs. 1,770.30 crore have been included in this report. There was loss of revenue of Rs. 911.27 crore due to not taking remedial action in time in 2,265 cases. Recovery of Rs. 305.63 crore was made at the instance of audit in respect of 2517 cases during 2005-06. Out of a target of 12.78 lakh cases for disposal during 2005-06 only 4.72 lakh cases were seen by internal audit leaving a balance of 63.07 percent. Department did not produce 39,663 cases or 67 percent of cases not produced during earlier audits and requisitioned again in 2005-06 to audit which included 110 cases not produced in three or more consecutive audit cycles in Andhra Pradesh, Karnataka, Madhya Pradesh, Maharashtra, Orissa and Rajasthan charges. Consequently, audit of such cases could not be carried out. Total collections from direct taxes increased from Rs. 69,198 crore in 2001-02 to Rs. 1,65,216 crore in 2005-06 at an average annual rate of growth of 19.73 percent. In the case of corporate assessees, 74.98 percent of gross collections was made at pre-assessment stage, of which 53.37 percent was by way of advance tax. In the case of non-corporate assessees, 90.64 percent of the gross collection was made at pre-assessment stage, of which 51.89 percent was by way of TDS. Total number of assessees grew from 2.62 crore to 2.98 crore during 2001-02 to 2005-06 at a compound annual growth rate of 3.24 percent which was lower than 4.28 percent during 2000-01 to 2004-05. The number of cases selected for scrutiny during 2005-06 was lower at 2.03 lakh as compared to 2.46 lakh in 2004-05. The percentage of assessments completed in summary manner decreased as a result of which the total pendency increased from 22.57 per cent in 2004-05 to 31.18 per cent in 2005-06. Uncollected amount of Rs. 95,387 crore out of total demand of Rs. 2,60,603 crore comprised demand of Rs. 58,385 crore of earlier years and current demand of Rs. 37,002 crore outstanding as on 31 March 2006. The outstanding demand in corporation tax increased from Rs. 39,204 crore to Rs. 55,098 crore and that in income tax decreased from Rs. 83,977 crore to Rs. 40,289 crore during the year 2005-06 as compared to previous year. The percentage of recovery of certified demand to TROs has declined from 16 percent during 2004-05 to about 14 percent during 2005-06. The working strength of TROs however, also decreased to 329 from 356 during 2005-06.

- Receipts from corporation tax amounted to Rs. 1,01,277 crore which constituted 61.30 percent of the total collection from direct taxes during 2005-06. The number of corporate assessees as on 31 March 2006 was 3.93 lakh which represented an increase of 3.42 percent over the previous year. In respect of corporate asseesees, 653 audit observations involving under charge of tax of Rs. 1893.21 crore and 12 observations involving over charge of tax of Rs. 17.10 crore on account of various irregularities in assessments, such as, mistakes in adoption of correct figures, applying incorrect rate of tax and non-levy of surcharge, mistakes in computation of business income, allowing unentitled expenditure or provision and claims, incorrect computation of capital gains, carry forward and set off of losses, incorrect allowance of reliefs and exemptions, excess or irregular refunds and non levy/short levy of interest were issued to the Ministry of Finance for their comments. Six hundred twenty cases involving undercharge of tax of Rs. 1,697.76 crore and 12 observations involving overcharge of Rs. 17.10 crore have been included in this chapter. The Ministry accepted observations in 248 cases involving tax effect of Rs. 307.17 crore, till the date of preparation of this report.

- Receipts from income tax amounted to Rs. 55,985 crore which constituted 33.89 percent of the total collection from direct taxes in 2005-06. The number of income tax assessees as on 31 March 2006 was 2.94 crore, which represented a increase of 9.70 percent over the previous year. One hundred and seventy four audit observations involving revenue effect of Rs. 50.88 crore on account of various irregularities in income tax assessments such as adoption of incorrect figures, applying incorrect rate of tax, non-levy of surcharge, incorrect allowance of liabilities, mistakes in computation of business income, incorrect allowance of depreciation, incorrect computation of capital gains, allowing income to escape assessment, carry forward and set off of losses, incorrect allowance of deduction in respect of export profits, irregular refunds, short/non-levy of interest, over assessment/overcharge, omission to levy penalty and mistake in summary assessments have been included in this chapter. Ministry of Finance accepted observations in sixty five cases involving tax effect of Rs. 18.77 crore till the date of preparation of this report.

Other Direct Taxes

- Fifty six cases of irregularities involving tax effect of Rs. 5.18 crore on account of various irregularities in wealth tax and interest tax assessments such as mistakes in valuation of assets, non inclusion of taxable assets in the net wealth, wealth escaping assessment, non correlation of assessment records, mistakes in levy of interest, mistakes in application of rates of tax and mistakes in assessment of chargeable interest have been included in this chapter. Ministry of Finance accepted observations in 27 cases involving tax effect of Rs. 2.34 crore till the date of preparation of this report

51. <u>Report No. 8 of 2007 for the period ended March 2006 - Direct Taxes</u> (Review on assessment of selected companies in the selected sectors of computer software, automobiles and ancillaries, steel and trading)

- Audit reviewed the assessments of selected companies relating to the assessment years 2002-03, 2003-04 and 2004-05 belonging to selected sectors of computer software, automobiles and ancillaries, steel and trading to examine the application of the provisions of Income Tax Act, 1961 and to quantify the effective rate of tax and tax expenditures as well as voluntary tax compliance by the selected companies of these sectors.

- Audit noticed that the effective rate of tax of the selected companies assessed under the normal provisions of the Act for the assessment years 2002-03, 2003-04 and 2004-05 were estimated as 20 percent, 27 percent, 17 percent and tax expenditures in respect of all the benefits allowed under the Act were Rs. 915.3 crore, Rs. 768.7 crore and Rs. 2287.6 crore respectively. Voluntary compliance by the selected companies, which were assessed under the normal provisions of the Act, has improved during the period under consideration. Further, voluntary compliance is higher in respect of companies which have shown profits in all the three years under consideration and were assessed under the normal provisions of the Act as compared to the companies, which have shown profits in only one or two of the three years.

- Audit noticed 559 mistakes of various types involving tax effect of Rs. 1508.83 crore in the assessments of all the selected companies in the four selected sectors, whether assessed under the normal provisions or the special provisions of the Act. In computer sector, irregularities amounting to Rs. 266.73 crore were noticed relating to exemptions under section 10A/10B. In automobile including ancillaries and trading sector, irregularities amounting to Rs. 308.43 crore were noticed relating to allowance of depreciation and set off of losses. In steel sector, irregularities amounting to Rs. 91.60 crore were noticed in respect of computation of income under special provisions of the Act.

Review on implementation of TDS/TCS schemes

- In this review, audit attempted to verify the extent of identification of potential deductors/activities liable to tax deduction/collection at source and the application of the provisions of the Act relating to TDS/TCS with regard to both non residents and residents. Audit also verified issues relating to accounting and the implementation of e-TDS scheme.
- Two hundred forty six TDS units, 174 regular assessment units and 15 international taxation units were audited and 32,630 cases were test-checked. Audit noticed mistakes in 12814 cases involving revenue impact of Rs. 389.20 crore; of this penalty leviable was Rs. 63.23 crore. Mistakes were noticed in 82 cases of non-residents/foreign companies with revenue impact of Rs. 204.19 crore. Audit noticed mistakes relating to omission to collect tax at source in 16 cases involving a revenue impact of Rs. 3.90 crore.
- Data collected by audit indicated large potential for TDS and TCS from insurance commission, reinsurance commission, payments to non-residents and sale of liquor. Evaluation of e-TDS scheme revealed that e-TDS returns filed remained unprocessed for the past three years largely due to software related problems and inadequacy of trained manpower.

Review on assessment of sports associations/institutions and sports personalities

- Audit reviewed the assessments of sports associations/institutions and sports personalities completed during the period from 1999-2000 to 2005-06 with a view to ascertaining the correctness of exemptions given to sports associations and sports personalities, adequacy of the department's efforts to bring all sports associations and sports personalities into tax net, efficiency and effectiveness of internal audit and internal control mechanism in the department to avoid irregularities and errors in the assessments carried out.
- Audit observed a total of 158 cases of irregularities involving tax effect of Rs. 190.92 crore. Of these 130 cases of irregularities involving tax effect of Rs. 179.80 crore were in respect of sports associations/institutions and 28 cases involving tax effect of Rs. 11.12 crore were in respect of sports personalities.

- Audit noticed cases of irregular exemptions and deductions granted to sports associations/institutions and sports personalities, non deduction of tax at source from the payments made to sports persons, non filing of returns in case of sports associations/institutions and inconsistency in the decisions taken by the department.
- Audit also noticed large number of sports associations/institutions and sports clubs which require to be brought into tax net, weak internal audit and internal control mechanism in respect of accumulations made and its utilisation. In respect of sports persons, audit noticed cases where deductions were allowed in respect of income that was not earned in the capacity of sportsman.

52. <u>Report No. 10 of 2006 for the period ended March 2005 - Performance Audit of Direct Taxes</u> (Performance Audit of AST System using the CoBiT Framework)

- The AST module, a part of ITD Applications, was conceptualized as an on-line, menu driven software capable of carrying out all assessment and related functions. The objective of AST is to "assist the assessing officer in doing assessments and related proceedings". The system was to also monitor the progress and results of a case at various stages viz. assessments, re- assessments, appeal, revision, rectification, penalty, waiver, settlement commission, penalty proceedings as well as prosecutions and audit objections. In practice, however, the software is being used for processing Income Tax returns under section 143 (1) and rectification under section 154. This system was conceptualized in 1994 and development was completed in 1997. Audit evaluation focused on the activities and performance of the system from 2001-02 to 2004- 05.
- AST is currently operational at 60 stations of a total of 514 stations in the country. In terms of number of assessing officers 2571 out of 4436 are using the system. An in-house application called TMS is used at the other stations. Twelve out of these 60 stations, where AST is currently operational, were selected for audit. The selection covers approximately 50% of the total number of assessing officers using AST.
- The Audit of the AST system was conducted using the CoBiT framework of the IT Governance Institute, which has been adopted by the Comptroller and Auditor General of India as the framework for conducting Information Technology Audits. The Management was familiarized with the methodology used through an entry conference. SQL Query: The errors in the output thrown up in the sample selected, which were systemic in nature, were sought to be further validated by running queries on the entire data at the concerned RCCs. SQL queries were accordingly designed to substantiate systemic issues.

Major Audit Conclusions

- Inadequate technical feasibility study of AST system has limited the usefulness of the system and also delayed its implementation as AST is dependent on network connectivity and stabilization of PAN. The dependence of AST on network connectivity has affected its implementation as well as use as the system is not fully available to users on a 24/7 basis. All stations are yet to be brought on the network although eight years have passed since its commencement in 1997.

- In the absence of measurable parameters for benefits from the system and details of the cost of the project the economic feasibility of AST could not be assessed. The envisaged benefits of AST system in terms of increased efficiency have apparently not accrued as the country wide pendency has increased and the number of cases processed on the system had actually declined at two of the selected stations due to both problems of communication links and links with other modules AST application has been designed and developed without proper synchronization with the enterprise data model, which has a centralized data base of PAN (AIS) functioning as the index key between decentralized ITD applications like OLTAS, TDS and AST. This has led to problems in their implementation as inputs from OLTAS and e-TDS are not reaching AST.
- The heavy unreconciled balances in the OLTAS system indicated that the bank validated input regarding the payment of tax, is not available at the time of processing returns. The assessing officer cannot verify through the AST system whether the amount claimed to be paid by the assessee has actually been paid. A similar situation exists for tax deduction at source. Prior period data in respect of arrear demand is also unreliable. This entails a risk of loss of critical information relating to revenue due to the government. Inputs from OLTAS and e-TDS are not reaching AST through IRLA due to problems in the working of this index key of PAN, affecting the processing integrity of the system.
- Audit found that although the manual Blue Book and other Registers had been replicated in the AST Module they were not reengineered to take advantage of the information available in the systems environment. The functionalities of these registers were also not in general use leading to controls which had existed in the manual environment being discontinued in the systems environment. Input form design was not adequate to ensure integrity and completeness of data. The input form does not capture all the data which is required for processing of a return under section 143 (1).
- There is no system in the AST software to ensure that all the returns received are being included in the bundles and processed. Field audit reports indicate input controls are inadequate and issues relating to authorization are not adequately addressed.
- The control over data entry process was inadequate to detect errors indicating that the necessary verifications of input data were not being done. There was no check box for validation of the mandatory enclosures with a return of income.
- There may be data processing errors in the system as indicated by the SQL query run on the data. Data processing errors are also occurring due to the failure of linkages between modules and incorrect interfaces between modules. Data Processing Integrity was not ensured in the system as illustrated by errors thrown up by the control totals

calculated by Audit. The results included cases which would need verification and manual rectification, if necessary. The process of verifying the data processing by running control totals was not in place. Mistakes in the processed returns were being rectified subsequently, on being pointed out either by the assesse or noticed by the department at the time of scrutiny assessment. The system does not evaluate the integrity of the output data by any other check. A review of the changes carried out in AST revealed that majority of the changes were in the nature of rectifying design deficiencies. The fact that the system has required so many changes is indicative of the fact that there were weaknesses in communicating the User Requirements to the developer; inadequate scrutiny before acceptance of design; and incomplete User Acceptance Testing. No systematic/inbuilt monitoring in respect of time taken to execute changes by RCCs is available. This could lead to errors remaining un-rectified in the system with risk of loss of revenue. There is no method of impact assessment for the changes carried out in the system.

- In the absence of a system of categorization and prioritization of problems, there was a risk that problems of a critical nature, which may even have an impact on the core objectives of the department, may remain unresolved, or may be resolved symptomatically without addressing the cause.
- Although user manuals were prepared, these were not available to all the users. The user awareness of the system features was also limited. This resulted in the suboptimal utilization of the features of the software. The process of updating the manuals, as changes take place in computer systems due to changes in the business rules was not in place.
- The absence of an operating manual points to incomplete inputs given to operating personnel and a consequent lack of knowledge of procedures. The process of "Training Needs Identification" was weak. The users were generally not satisfied with the training and wanted more exposure to the features of the AST System. As a result, in most of the instances the full features of the AST software were not being used.
- Multiplicity of agencies in training organization led to a blurring of efforts and lack of focus. There was no coherent policy regarding identification of the areas where third party service providers should interface with the organization. There was no uniformity or clarity on the issue of third party contracts. The relationship with the third party service provider was not adequately safeguarded, with reference to security and confidentiality issues, by appropriate provisions in the contract and supporting processes in a standardized manner.

53. <u>Report No. - 8 of 2006 for the period ended March 2005 Direct Taxes</u>

- Six hundred and eighty eight observations with a tax effect of Rs.3,490.55 crore were issued to the Ministry as individual draft paragraphs, including 308 observations involving tax effect of Rs.429.07 crore that has arisen from local audit conducted in earlier years. Six hundred and eighty three observations involving tax effect of

Rs.3,486.38 crore have been included in this report. There was loss of revenue of Rs.226.45 crore due to not taking remedial action in time in 1,644 cases.

- Although the manpower for internal audit had increased by more than 1000 percent after introduction of the new chain system, there was a short fall of 56.81 percent with reference to total auditable cases. Department did not produce 37,471 cases or 67 percent of cases not produced during earlier audits and requisitioned again in 2004-05, to audit which included 91 cases not produced in three or more consecutive audit cycles in Andhra Pradesh, Karnataka, Orissa and Maharashtra charges. Consequently, audit of such cases could not be carried out.

- Total collections from direct taxes increased from Rs. 68,305 crore in 2000-01 to Rs.1,32,771 crore in 2004-05 at an average annual rate of growth of 18.41 percent. In the case of corporate assessees, 88.80 percent of gross collections was made at pre-assessment stage, of which 70.29 percent was by way of advance tax. In the case of non-corporate assessees, 91.64 percent of the gross collection was made at pre-assessment stage, of which 53.04 percent was by way of TDS. Total number of assessees grew from 2.30 crore in 2000-01 to 2.72 crore in 2004-05 at a compound annual growth rate of 4.28 percent which was lower than 10.06 percent of growth rate in 2003-04. Although the number of cases selected for scrutiny during 2004-05 increased to 2.46 lakh as compared to 1.90 lakh in 2003-04, the percentage of assessments completed after scrutiny as well as in summary manner declined during 2004-05. As a result the total pendency of both summary and scrutiny assessments increased during 2004-05. Uncollected amount of Rs.1,23,181 crore out of total demand of Rs.2,55,952 crore comprised demand of Rs.58,762 crore of earlier years and current demand of Rs.64,419 crore outstanding as on 31 March 2005. The outstanding demand in corporation tax increased from Rs.37,631 crore to Rs.39,204 crore and that in income tax increased from Rs.50,386 crore to Rs.83,977 crore during the year 2004-05 as compared to last year. The percentage of recovery of demand has declined from 19 percent during 2003-04 to about 16 percent during 2004-05. The working strength of TROs however, decreased to 356 during 2004-05 as compared to 462 in 2003-04.

Corporation Tax

- Receipts from corporation tax amounted to Rs.82,680 crore which constituted 62.27 percent of the total collection from direct taxes during 2004-05. The number of corporate assessees as on 31 March 2005 was 3.80 lakh which represented an increase of 1.95 per cent over the previous year. In respect of corporate asseesees, 472 audit observations involving under charge of tax of Rs.3,393.66 crore and 14 observations involving over charge of tax of Rs.40.99 crore on account of various irregularities in assessments, such as, mistakes in adoption of correct figures, applying incorrect rate of tax and levy of surcharge, computation of business income, allowing unentitled expenditure or provision and claims, computation of capital gains, carry forward and set off of losses, allowing reliefs and exemptions, excess or irregular refunds and non levy/short levy of interest were issued to the Ministry of Finance for their comments.

Four hundred seventy cases involving undercharge of tax of Rs.3,392.89 crore and 14 observations involving overcharge of Rs.40.99 crore have been included in this chapter. The Ministry accepted observations in 17 cases involving tax effect of Rs.8.27 crore, till the date of preparation of this report.

Income Tax

- Receipts from income tax amounted to Rs.49,268 crore which constituted 37.11 percent of the total collection from direct taxes in 2004-05. The number of income tax assessees as on 31 March 2005 was 2.68 crore, which represented a decrease of 6.94 percent over the previous year. One hundred and eighteen audit observations involving revenue effect of Rs.39.33 crore on account of various irregularities in income tax assessments such as adoption of incorrect figures, applying incorrect rate of tax, non-levy of surcharge, adopting incorrect status of the assessee, incorrect computation of income from house property and business, mistake in assessment of firms, incorrect computation of capital gains, depreciation, carry forward and set off of losses, allowing income to escape assessment, allowing reliefs and exemptions under Chapter VIA, excess or irregular refunds, short/non-levy of interest, non levy of penalty, overassessment and overcharge, non deduction of tax at source and irregular credits without corresponding income being taxed have been included in this chapter. Ministry of Finance accepted observations in four cases involving tax effect of Rs.41.17 lakh, till the date of preparation of this report.

Other Direct Taxes

- Eighty one cases of irregularities involving tax effect of Rs.13.17 crore relating to mistakes in computation of wealth tax, incorrect valuation of assets, non/short levy of/over charge of interest for default in filing of return, non levy of tax on deemed gifts, omission to make assessment of interest tax and mistakes in computation of chargeable expenditure tax have been included in this chapter. Ministry of Finance accepted observations in 15 cases involving tax effect of Rs.59.54 lakh till the date of preparation of this report.

54. <u>Report No. 7 of 2006 for the period ended March 2005 -Performance Audit of Direct Taxes</u>

Review on efficiency of summary assessment scheme and process of selection of cases for scrutiny

- In 31 CCIT and 61 CIT charges for which Audit could collect the data, total number of returns to be disposed off during the year declined from 2.17 crore in 2002-03 to 1.51 crore in 2003-04 and increased to 1.67 crore in 2004-05. The disposal of summary cases as a percentage of its disposable cases was 90.69 per cent, 71.88 per cent and 77.16 per cent in the years 2002-03, 2003-04 and 2004-05 whereas corresponding percentages of disposal of scrutiny cases were 43.51 per cent, 52.41 per cent and 51.83 per cent in these years respectively. Audit test checked 64,755 summary assessment cases pertaining to the period 2002-03 to 2004-05 and noticed various types of mistakes in 1,392 cases as a result of which assessees availed unentitled benefits involving revenue effect of Rs.390.51 crore. There is an inconsistency in the department on the issue of initiating remedial action on audit observations relating to summary assessments especially where assessment was completed after 1 June 1999. The department accepted audit observations on summary assessments in 210 cases involving tax effect of Rs.69.62 crore rectifying the mistakes in 53 cases with tax effect of Rs.34.16 crore and did not accept in 627 cases involving tax effect of Rs.135.11 crore essentially on the ground that assessments had been completed in summary manner. During 2004-05 total cases to be internally audited were 13.88 lakh, out of which only 5.99 lakh cases constituting 43 per cent of the total auditable cases were seen by the internal audit wing of the department, thus leaving a pendency of 57 per cent.

- There is no prescribed time schedule with the Board either for initiating proposals for selection of cases for scrutiny or for the issue of instructions to field formations in this regard. Besides, there was lack of uniformity of time period for which Board's instructions regarding selection of cases for scrutiny on random basis was applicable. The returns of non-corporate assessees for assessment year 2002-03 filing returns between 1 April 2003 and 30 September 2003 did not fall in the purview of getting selected for random scrutiny. Further, the returns of non-corporate assessees for assessment year 2002-03 and 2003-04 processed on TMS or manually were also out of the purview of random selection for scrutiny. Despite making an announcement in the Budget speech for the financial year 2003-04 by the Honourable Finance Minister of immediate abolition of the existing discretion based system for selection of returns for scrutiny, which would be replaced by a computer generated intelligent random selection of only 2 percent of the returns for scrutiny annually, several categories of cases were being selected manually even in 2004-05. Further, the number of returns selected for scrutiny was less than 2 percent of total assessments in 2003-04 and 2004-05. The number of assessments completed after scrutiny, as a percentage of total assessments due was less than 1 percent in all the years under review.

Review on the effectiveness of Search and Seizure operations

- Audit reviewed the effectiveness of search and seizure operations by examining searches conducted and consequential assessments completed during the financial years 2001-02 (from1.06.2001) to 2004-05 and upto September 2005. Audit selected 10 Directorates General out of a total of 14 for the purpose of review which covered 10 states. The overall position of the omissions/irregularities noticed in audit in respect of the 10 states involved tax effect of Rs.352.91 crore in 669 cases of the test check of 3320 cases. Audit noticed cases where the searches were not successful. In the absence of relevant satisfaction notes the basis on which the searches were carried out could not be ascertained. Audit also noticed that despite penal provisions of section 158 BFA(2) assessees returned far lower incomes than what was finally assessed to tax. Statements made under section 132(4) by the assessee during search were not correctly considered in the appraisal report/assessment. The reasons for variation between appraisal reports and assessment orders were not recorded in writing despite Board's instructions. An examination of the appeal process showed that only 15.16 per cent of the selected sample was upheld in favour of revenue whereas 44.77 per cent of the cases were decided in favour of the assessee. Audit analysis also revealed that the proportionate resources spent on the search and assessment process are approximately six times the benefits accruing from it.

55. **<u>Report No. - 12 of 2005 for the period ended March 2004 Direct Taxes</u>**

- Nine hundred thirty-one observations with a tax effect of Rs.1852.65 crore were issued to the Ministry as individual draft paragraphs, consisting of 450 observations involving tax effect of Rs.1129.39 crore that had arisen from local audit conducted in earlier years. Eight hundred eighty five observations involving tax effect of Rs.1761.12 crore have been included in this report. In addition, a limited test check in audit to assess the status and adequacy of follow up action in selected post VDIS 1997 assessments based on the comments in Audit Report No.12A of 2000, revealed short levy of tax of Rs.228.55 crore in only 1081 cases.

- Although the manpower for internal audit had increased by 1079 percent after introduction of the new chain system, there was a shortfall of 62.47 percent with reference to total auditable cases. Revenue of Rs.109.52 crore was lost in 1755 cases as remedial action was not taken in time.

- Department did not produce 25,227 cases representing 70.35 percent of cases not produced during earlier audits and requisitioned again in 2003-04, to audit which included 69 cases not produced in 3 or more consecutive audit cycles in Andhra Pradesh, Karnataka, Madhya Pradesh, Orissa, Tamilnadu and Maharashtra charges. Consequently, audit of such cases could not be carried out.

Tax Administration

- Total collections from direct taxes increased from Rs.57,959 crore in 1999-00 to Rs.1,05,089 crore in 2003-04 at an annual rate of 18.02 percent. Pre assessment collections amounted to 80.42 percent in the case of corporate assessees and 93.70 percent in the case of non corporate assesses, of gross collections in 2003-04. Total number of assessees increased at an annual rate of 10.06 percent from 1.99 crore in 1999-00 to 2.92 crore in 2003-04. Disposal of scrutiny assessments increased to 51 percent of the assessments due as compared to 19 percent in 2002-03 but disposal of summary cases had come down to 79 percent of total summary assessments due for disposal as compared to 92 percent in 2002-03. Uncollected amount of Rs.88,017 crore of the total demand of Rs.1,93,106 crore as on 31 March 2004 comprised demand of Rs.57,064 crore of earlier years and Rs.30,953 crore pertaining to 2003-04. Percentage of recovery of demand declined to 19 percent during 2003-04 as compared to 22 percent in 2002-03. Eighty one percent of the certified amount remained uncollected at the end 2003-04 as compared to 78 percent in 2002-03.

Corporation Tax

- Receipts from corporation tax amounted to Rs.63,561 crore which constituted 60 percent of the total collection from direct taxes during 2003-04. The number of corporate assessees as on 31 March 2004 was 3,72,483 which represented an increase of 2.02 per cent over the previous year. In respect of corporate asseesees, 559 audit observations involving under charge of tax of Rs.1769.97 crore and 15 observations involving over charge of tax of Rs.15.31 crore on account of various irregularities in assessments such as assessees' availing unentitled benefits in summary assessments, mistakes in adoption of correct figures, applying incorrect rate of tax and levy of surcharge, computation of business income, allowing unentitled expenditure or provision and claims, computation of capital gains, carry forward and set off of losses, allowing reliefs and exemptions, excess or irregular refunds and non levy/short levy of interest were issued to the Ministry of Finance for their comments. Five hundred thirty six cases comprising 521 observations involving undercharge of tax of Rs.1679.07 crore and 15 observations involving overcharge of Rs.15.31 crore have been included in this Chapter. The Ministry accepted observations in 43 cases involving tax effect of Rs.54.86 crore, till the date of preparation of this Report.

Income Tax

- Receipts from income tax amounted to Rs.41,387 crore which constituted 39.38 percent of the total collection from direct taxes in 2003-04. The number of income tax assessees as on 31 March 2004 was 2.88 crore, which represented an increase of 2.49 percent over the previous year. One hundred sixty eight audit observations involving revenue effect of Rs.36.70 crore on account of various irregularities in income tax assessments such as adoption of incorrect figures, applying incorrect rate of tax, non-levy of surcharge, incorrect computation of business income, incorrect set off of losses, allowing income to escape assessment incorrect deductions and short/non-levy of interest are included in this Chapter. Ministry of Finance accepted observations in 14 cases involving tax effect of Rs.4.11 crore, till the date of preparation of this Report.

Other Direct Taxes

- One hundred and eighty one cases of irregularities involving tax effect of Rs.30.04 crore relating to mistakes in computation of wealth tax, incorrect valuation of assets, non or short levy of interest for defaults in filing return, non levy of tax on deemed gifts, omission to make assessments of interest tax and mistakes in computation of chargeable expenditure are included in this Chapter. Ministry of Finance accepted observations in 17 cases involving tax effect of Rs.70.57 lakh, till the date of preparation of this Report.

Status and adequacy of 'follow up' action in selected post –VDIS-1997 assessments.

- Audit attempted an evaluation of the status and adequacy of 'follow up' action in selected post VDIS 1997 assessments based on audit comments on VDIS 1997 in the Audit Report 12A of 2000. Audit requisitioned assessment records in respect of 21,853 VDIS declarations that were either "invalid/non-est" or pertained to new assessees, out of which the department could produce only 4906 cases. The limited test check in audit revealed short levy of tax of Rs.228.55 crore in only 1081 cases.
- Audit noticed that the action taken by the department to bring such declarants to tax under normal provisions of the Act where certificates were issued even though tax was paid after the lapse of prescribed period of three months from the date of declaration, was inadequate. The department did not have a system to monitor whether the declarants who had declared under VDIS, 1997 had continued to file their income tax and wealth tax returns in subsequent years also.
- Audit could not ascertain whether the department had taken action to apply the normal provisions of the Income Tax Act in respect of ineligible persons involved in the 'cobbler scam' or in the 'loan hawala racket' in 9 out of 23 cases produced to audit which involved a tax effect of Rs.35.10 crore. Only one out of 25 cases of 'multiple' declarations produced to audit had been taxed under normal provisions of the Act.

Annexure II

List of official reports on Direct Tax System in public domain

- **Report of the Advisory Group on Tax Planning and Tax Administration for the Tenth Plan (Chairman: Dr. Parthasarathi Shome) Planning Commission, Government of India, 2001** https://library.niti.gov.in/cgi-bin/koha/opac-retrieve-file.pl?id=cab6bb957beb6537b37c5e319bf9c726
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