CHAPTER 3

ESCALATION OF DISPUTES

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Chapter 3 Escalation of disputes

The outcomes of the appellate mechanism provide reasonable level of satisfaction to the taxpayer. Overall success rate achieved by the Department at various levels of appeals was low and appeals go decidedly in favour of the taxpayers. The tendency to escalate the disputes to higher levels even on cases where the Department is on a shaky ground, strain the system and the resources besides adding to the inconvenience of the taxpayer, especially the small taxpayer. On the other hand, we found cases of inaction on such cases where a second appeal would have safeguarded revenue. There is lack of consistency while considering a case for second appeal; divergent actions weakening the departmental stand in appeals. The AO's work on appeal is not subjected to internal audit. The absence of independent evaluation of decisions for escalation leaves an unchecked avenue for arbitrary use of discretionary powers by the AOs.

Satisfaction index

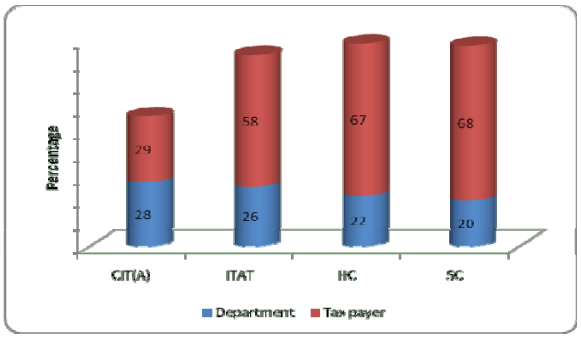
3.1 Appeals must provide satisfactory solutions especially in the first tier, to reduce the incidence of escalation of the dispute to the higher levels of the appellate system. We used the satisfaction index as a parameter to evaluate achievement of this goal.

3.2 On the assumption that the Department has no control on the disposal of appeals by the ITAT or higher levels, we restricted the analysis to CIT (A). On an average, nearly 36 *per cent* of the orders of the CIT (A) were escalated to the ITAT during 2006-09 (Table 3.1). Less than 10 *per cent* of the appeals decided by CIT (A) are escalated by the taxpayer, which shows that the taxpayer gets a reasonable level of satisfaction from the first tier of appeals.

Table 3.1: Aggregate satisfaction index

Year	Percentage of appeal instituted in ITAT against the cases disposed by CIT (A)		Aggregate satisfaction index
	By Department	By taxpayer	
2006-07	23	9	32
2007-08	31	11	42
2008-09	26	9	35

Chart 3.1: Success rate achieved by the Department and Taxpayers



3.3 The Department escalated the dispute to ITAT on 26 *per cent* of the appeals decided by CIT (A). Overall, the success rate achieved by the Department at various levels of appeals was low (Chart 3.1) and appeals go decidedly in favour of the taxpayer.

The "appealititis" syndrome

3.4 The Law Commission of India in its 126th Report on "Government and Public Sector Undertaking litigation policy and strategies" coined the word "appealititis". The Report while lamenting the burgeoning litigations, quoted (paragraph 2.12 of the report) a Kerala HC judgment which said that "The State is no ordinary party trying to win a case against one of its own citizens by hook or crook; for the State's interest is to meet honest claims, vindicate a substantial defence and never to score a technical victory or over-rule a weaker party, to avoid just liability or score an unfair advantage simply because legal devices provide such an opportunity".

3.5 The Task Force on Direct Taxes (Kelkar Committee) had observed that "assessment is one sided, high pitched, completed in a hurry and when it is close to getting time barred by limitation, ignoring the contentions of the assessee. When the case goes through first and second appeal, the additions are deleted". A common perception is that the cause of unsustainable high pitched assessments is the fear among AOs of not achieving internal targets of tax collection[22].

Charge: CIT-2 Mumbai, Maharashtra; AY: 2003-04
Assessee: Tata Petrodyne Limited

The AO disallowed depreciation of Rs. 7.5 crore, which was disputed by the assessee. The CIT (A) while allowing (May 2008) the depreciation inadvertently mentioned the amount as Rs. 7,979 instead of Rs. 7.5 crore. The AO, instead of seeking a clarification from CIT (A), opined that the CIT (A) "*erred*" in allowing the appeal but "s*ince, the tax is very meager, second appeal is not recommended on this ground".* The assessee approached the CIT (A) once again who rectified the order (September 2008) by directing the AO to allow the deduction of Rs. 7.5 crore on account of depreciation. This time the AO recommended not to file second appeal on the rectification order since "*it arose from a mistake apparent from the records*".

The AO's response in this case, illustrates the symptom that the Kelkar Committee pointed out, where high pitched assessment was made and then defended without a feeling of responsibility.

The Ministry stated (July 2010) that steps are being taken to amend the grounds of appeal incorporating the additional ground raised by the Audit.

[22] Source: Report on "The compliance Cost of the Personal Income Tax and its determinants" by Planning Commission (1999)

Charge: CIT-III Delhi; AY: 2005-06
Assessee: Nainital Bank Limited

The assessee was assessed (December 2007) on best judgment[23] by adding "undisclosed" income of Rs. 46.1 crore. The assessee repeatedly pleaded that its Head Office being registered in Nainital, it was filing the returns with the ACIT, Nainital. On appeal, CIT (A) deleted the addition of Rs. 46.1 crore (March 2008) on the ground that the AO did not have legal jurisdiction.

The Ministry stated (July 2010) that the assessee did not respond to the cited notices issued to them and submitted full facts only to the CIT(A) after which it was transferred to the jurisdictional ACIT in Nainital. However, departmental records show that the assessee had earlier also informed the AO in Delhi that the Bank had been filing return with the office of Asstt. Commissioner, Nainital. Issuance of notice in the first place itself was not proper as the Department should have known that the assessee had been an income tax assessee for the last 40 years and was filing its return in Nainital.

3.6 There is also a perception that the Department has a tendency to opt for appeals even when it is on a weak wicket, partly because the decisions are prompted by ITAT counsels, who stand to gain from them[24]. It could also be fuelled by the officers deciding to play safe rather than judge a case on its merits and save the system of the strain that weak cases place on it.

3.7 The "appealititis" in the Department, is more detrimental when applied on small taxpayers who constitute a large chunk of appellants (paragraph 2.6; Chapter-2). The prescribed[25] monetary floor levels for filing appeals are Rs. 2 lakh, Rs. 4 lakh and Rs. 10 lakh with ITAT, HC and SC respectively. We found eight appeals filed before ITAT on tax demands ranging between Rs. 0.25 lakh and Rs. 1.8 lakh. Two other appeals filed with the HC were on demand of Rs. 1 lakh and Rs. 2.4 lakh. Of these, the ITAT and HC dismissed four appeals on the ground that the tax effect was below the floor level.

3.8 We found instances of escalation of appeals on feeble and indefensible cases as illustrated below:

Charge: CIT-II Kolkata, West Bengal; AY: 2003-04
Assessee: Orient Paper & Industries Limited

[23] Made under section 144 when the assessee does not submit the income tax return.
[24] Source: Income Tax Compliance Cost of Corporations in India, 2000-01 by Arindam Das Gupta; Study conducted by NIPFP
[25] vide, Instruction No.2/2005 dated 24 October 2005 and Instruction No.5/2008 dated 15 May 2008 . It is also specified that adverse judgment in a case where Revenue Audit objection has been accepted by the Department, should be challenged in appeal irrespective of the tax effect.

The assessment (March 2006) was challenged by the assessee before the CIT (A), on three issues (total tax effect: Rs. 1.3 crore) who decided in favour of the assessee.

Sl. No.	**Appeal issues: disallowance of**	**CIT(A)'s ruling**	**Further appeal by the Department in ITAT on the grounds that**
(i)	Rs. 9.2 lakh spent on plantation, which the AO held, was not for business purposes;	On a similar issue, the ITAT had decided in favour of the assessee for AY 1993-94.	It was not known whether the ITAT decision (on AY 1993-94) had been challenged.
(ii)	Provision of gratuity of Rs. 1.15 crore;	Kerala High Court[26] had ruled that if the approved gratuity fund had been credited by the provisional amount, it would be allowable as a deduction under Section 40 A (7)[27].	There was a favourable decision[28] of jurisdictional (Calcutta) High Court in favour of the Department.
(iii)	Cess of Rs. 2.20 crore paid to M.P. Electricity Board.	The liability had accrued irrespective of the fact that the assessee has challenged its imposition. CIT (A) at the same time observed that Gujarat[29] and Kerala[30] High Court had ruled that if the assessee is entitled to a particular relief provided in the law it is obligatory on the part of the assessing officer to draw the attention of the assessee to the lawful relief or deduction although the assessee did not claim it.	The claim of assessee was premature.

The departmental grounds for escalation of issues (i) and (iii) were feeble; yet, it opted for appeal on all the three issues to ITAT, which dismissed the appeal (February 2007). A further appeal in the HC was also dismissed (June 2007) on the ground that there was no substantial question of law involved. The matter was taken to the SC (November 2007) which dismissed (November 2008) the appeal on the ground of delay.

The Ministry stated (July 2010) that the issue (iii) was a question of law; hence, it was required to be decided on merit by higher judicial authorities. The fact that the case was dismissed by the HC on the grounds that 'no question of law was

[26] CIT vs Common Wealth Trust Pvt. Ltd 269 ITR 290
[27] The special provisions of section 40A (7) would overrule the non-obstante clause of section 43B; the latter states that the amount should have been paid within the due date.
[28] Shree Kamakhya Tea Co. Pvt. Ltd. 199 ITR 714
[29] Chokshi Metal Refinery vs CIT [1977] 107 ITR 63
[30] Parekh Bros. vs CIT [1984] 150 ITR 105

involved' shows that decision of the Department to appeal to HC was not based on sound footing.

Charge: CIT-Gwalior, Madhya Pradesh; AY: 2005-06
Assessee: Cardinal Drugs Limited

The CIT(A) rejected (March 2008) addition of Rs. 8.3 crore by treating interest waived by banks, as the assessee's income. CIT (A) held that since the asseessee had not claimed the interest as deductions in earlier assessment years, it cannot be treated as his deemed income[31]. Despite clear provisions in the Act, the matter was taken to ITAT; the decision was awaited as of August 2009.

Charge: CIT Shillong, Assam; AYs: 1990-91 to 2000-2001
Assessee: Executive Engineer, P H E, Water Supply Division, Lunglei

Interest was levied on delay in deposit of TDS[32]. CIT (A) rejected the appeal on the ground that the Department did not bring on record the actual date of deposit of tax. The case was escalated to ITAT without this detail, to be once again rejected on the very same ground.

3.9 The Department has at times, taken divergent stand over the same provision, rendering its own position vulnerable. A case reported by us earlier[33], is being re-visited as an illustration.

Section 80IB allows exemption from income tax, of profits earned in production or refining of mineral oil. Hindustan Petroleum Corporation Ltd. (HPCL) claimed (for AY: 2004-05) and was allowed deduction on marketing margin. When we raised the issue[34], the Department sought to justify the assessment on the ground that the Bombay High Court[35] had ruled (July 2006) that 80IB benefit would be available on marketing margin. The Department also assured the Public Accounts Committee that it was following the Bombay High Court's judgment.

However, it disallowed deduction on marketing margin claimed by Indian Oil Corporation Ltd. (IOC), which was contested by IOC on the strength of the above judgment, with CIT (A). CIT (A) ruled in favour of the assessee which was further escalated to the ITAT by the Department. Needless to emphasise, such an inconsistent stand erodes the Department's credibility as much as it weakens its case in appeals.

[31] Under the provisions of section 41(1)(a)/43B of the Act
[32] Tax deducted at source by the EE from bills paid to contractors but not deposited to the Government account on time.
[33] Paragraph 2.7.2 of Report of the CAG on Union Government (Direct Taxes) No. PA 25 of 2009
[34] The grant of deduction was objected to by us as the marketing margin was only a trading profit and not a profit derived out of manufacturing activities.
[35] In the assessee's own case for the assessment year 1989-90

Inaction on appeals with merit

3.10 On the other hand, we found that despite being on a strong wicket, the Department did not escalate or committed errors in framing the grounds in 32 appeals disputing aggregate tax of Rs. 43.1 crore. Few such cases are illustrated below:

Charge: CIT-I Ahmedabad, Gujarat; AY: 2002-03
Assessee: Atul Limited

AO recommended acceptance of CIT (A)'s decision rejecting additions on the issue of "non-inclusion of sales tax and excise duty in the total turnover[36]" while computing exemptions on exports, since this issue had already been settled by the SC[37]. Instead, the AO recommended that an appeal may be filed on another issue viz., disallowance of double deduction[38] on which a demand of Rs. 2.3 crore had been raised. The Department inexplicably preferred an appeal on the 1st issue, on which it had no case.

Charge: CIT-LTU Mumbai, Maharashtra; AY: 2004-05
Assessee: Reliance Industries Limited

CIT (A) ordered (October 2008) that the assessee, among other issues, should be allowed exemption on export profits under Section 80HHC (refer footnote 36) on book profit, which would provide the assessee benefit of tax of Rs. 22.6 crore. The AO had computed the exemption based on business profits which is consistent with the provisions of the Act. Despite a clear case, the Department did not include this issue in its appeal with the ITAT (March 2009). We also found that the Department had contested this issue in respect of assessments of AY 2001-02 to 2003-04 before the ITAT but chose to ignore it in AY 2004-05. We are of the view that this issue merited an appeal for a firm and consistent legal view.

The Ministry stated (July 2010) that mistake in leaving the ground mentioned by audit was a bonafide mistake and additional ground of appeal has been filed before the ITAT.

[36] Section 80 HHC of the Act allows tax exemption on profit earned in exports. The export profit is calculated by {(export turnover/ total turnover)* total profits}. The SC ruled in favour of the assessee that the tax and duties paid on total turnover may not be included in the total turnover (denominator); if included, it would have reduced the exemption available to the assessee.
[37] CIT vs Lakshmi Machine Works, 160 Taxman 404. Date of judgement: 25 April 2007
[38] The issue being that deduction under section 80IA and 80IB should be reduced from profits for the purpose of calculation of deduction under section 80HHC.

3.11 We noticed two cases[39] where the AO failed to offer his comments on the additional/new evidence produced by the assessee before the CIT (A), on the basis of which addition of Rs. 52 lakh was deleted by the CIT (A). One case was also dismissed by the HC on the ground that sufficient opportunity had been given to the Department to rebut the additional evidence.

Disputes with Public Sector Undertakings

3.12 It has been recognised that PSUs and the Government have to conserve their resources so that unproductive litigation is avoided at all costs. Apart from the litigation costs which the State and PSUs have to bear, the State has also to bear the expenses on setting up courts, provide personnel and bear other incidental expenditure[40]. The Committee on Disputes (COD) was constituted on the directions of the Supreme Court to provide a forum to the disputing parties both being arms of the Government) an opportunity for in-house reconciliation. The COD's decision becomes binding on both the parties in dispute. The SC observed[41] that even if the Department/PSU considers the decision of COD unpalatable, discipline requires that they abide by it. The SC further noted that 'every party against whom the decision is made will claim that they have been wronged and that their rights are affected. This is not to be allowed to be done'. A recent Delhi High Court's decision[42] held that if an application is not made to the COD within one month from the filing of appeal in the court, the appeal would have to be dismissed on that ground itself.

3.13 With respect to sheer numbers, the COD has been effective in reducing litigation. Out of 591 disputes referred to COD from Delhi during the period April 2006 to December 2008, it refused permission on 269, representing 46 *per cent* of the total. The decisions are by and large, being granted within 6 months to a year.

3.14 We found 12 cases where the Department did not seek COD's approval or the second appeal was filed without waiting for the approval, resulting in cases being dismissed by the appellate authorities with a tax effect of Rs. 161.5 crore.

Internal audit

3.15 We noticed[43] that internal audit does not check cases relating to filing and implementation of appellate orders in ordinary course. Denying the process an independent appraisal.

[39] Charge CIT 1, Guwahati (Shri Parimal Kanti Chandra and Assam Government Marketing Corporation Ltd.)
[40] Law Commission of India in its 126th Report on "Government and Public Sector Undertaking litigation policy and strategies"
[41] MTNL vs CBDT (2004) 267 ITR 647
[42] (2008) 296 ITR 693
[43] In Orissa, Punjab, Haryana and Rajasthan charges

3.16 Recommendations

We recommend a system of peer review at the AO level to examine the merits in escalation. The periodicity of such review may be such that it does not render the AO's workload unviable.

The Ministry stated (July 2010) that it may not be practical and feasible to have a system of peer review.

Kelkar Committee had recommended a stricter accountability structure within the Department. We recommend an independent evaluation of decisions for escalation as a check against the tendency to "appealititis".

The Ministry stated (July 2010) that AOs tendency to appeal further is partly due to AOs lack of confidence or knowledge. The National Judicial Reference System will provide data on the sustainability of the action against specific provisions of the Act and then empower the AOs to propose a closure, if so warranted. This would bring greater discipline and transparency in approach.

Internal audit should in its audit plan, include coverage of a prescribed percentage of appeals, to identify needless escalation or inaction where there is merit.

The Ministry felt (July 2010) that CsIT(A) provide an oversight and internal audit is not an effective remedy. We are of the opinion that it is not prudent to wish away internal audit; by doing so an important internal control is being compromised.