CHAPTER 1

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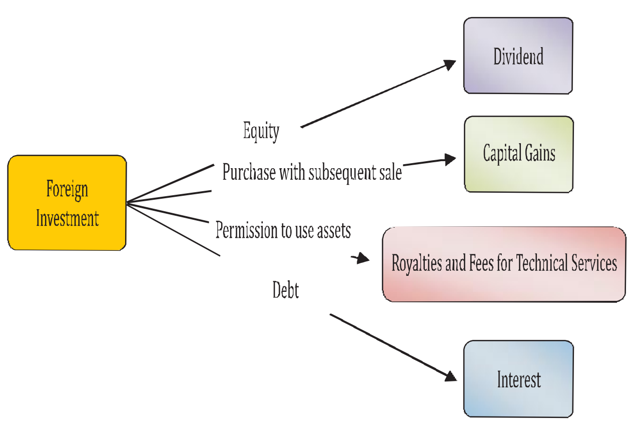
1.1 Tax administration recognizes a taxpayer as non-resident depending on the duration of his/her residence[1] in India in the relevant period of assessment.

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 The Foreign Exchange *Regulation* Act (FERA) which formed the statutory basis for exchange control in India was repealed and replaced by the new Foreign Exchange *Management* Act (FEMA) with effect from June 2000.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

Chart1: Investment and Returns



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

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

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

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

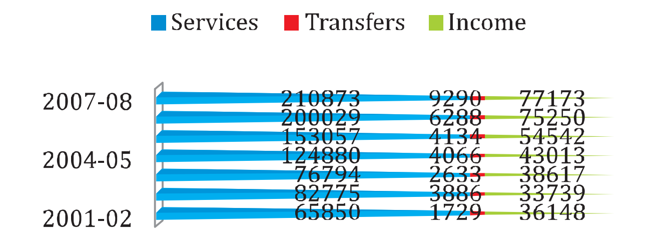
Institutional Investment (FII). The returns from foreign investments can be broadly classified as active or passive income.

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

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

Why we chose the topic

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



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

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

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

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

[6] Source: RBI

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

Objectives of the study

1.8 We sought an assurance through our study that:

- *Income Tax Department (ITD) has established integration with the banking sector, to provide an overarching oversight on foreign exchange remittances;*

- *The risks of illicit flows are identified, prioritized and communicated to the risk managers. The effectiveness of the risk mitigation measures are monitored;*

- *The systems and control measures are effective to ensure that all taxable remittances are taxed accurately;*

- *The Department is geared to meet the new challenges in international taxation owing to globalization and the attendant complexity in transactions.*

Legal provisions and procedures

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

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

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

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

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

Scope of audit and methodology

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

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

Table 1: Details of records checked in 21 offices

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

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

Acknowledgement

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

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

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

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

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

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