

## Chapter Summary

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

**(Para No. 1.1 & 1.2)**

Field offices under the Comptroller and Auditor General of India issued 15874 audit observations on underassessment involving tax effect of Rs.6,522.34 crore and 112 cases of over assessments involving tax effect of Rs.144.64 crore during 2004-05 to the assessing officers of the department relating to corporation tax, income tax and other direct taxes. A total of 688 cases with tax effect of Rs.3,490.55 crore were issued to the Ministry as individual draft paragraphs out of which 683 cases involving tax effect of Rs.3,486.38 crore are included in this report.

**(Para No. 1.4, 1.7)**

Although the manpower made available for audit had increased by over 1000 percent after introduction of the chain system of internal audit, the percentage shortfall with reference to the total auditable cases in 2004-05 was 56.81.

**(Para No.1.11.3)**

Over 67 percent of 55,821 records not produced to audit in earlier years and requisitioned again during 2003-04, were not produced to audit in 2004-05.

**(Para 1.13)**

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

**(Para No. 1.6)**

## CHAPTER I: INTRODUCTION

### General

**1.1** Direct taxes levied by Parliament comprise:

- **Corporation tax**
- **Income tax**
- **Wealth tax**
- **Gift tax**
- **Interest tax and**
- **Expenditure tax**

Laws relating to direct taxes are administered by the Central Board of Direct Taxes (hereinafter called 'the Board'). The Board is under the overall control of Department of Revenue, Ministry of Finance. Revenue from direct taxes during 2004-05 was Rs.1,32,771 crore. Time series data on revenue from various direct taxes and other related statistical information on tax administration are presented in Chapter II.

### Statutory Audit

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

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

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

### Present Report

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

**1.4.1** The present report contains 683 out of 688 audit observations referred to Ministry of Finance. Table 1.1 below contains the details of draft paragraphs<sup>1</sup> issued to Ministry and included in the report.

(Rs. in crore)

<b>TABLE 1.1: DRAFT PARAGRAPHS (DPs) ISSUED TO MINISTRY DURING 2004-05</b>				
<b>Category of tax</b>	<b>Number of Draft Paras issued to Ministry</b>	<b>Tax effect</b>	<b>Number of Draft Paras included in the Report</b>	<b>Tax effect</b>
<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
Corporation Tax	486	3434.65	484	3433.88
Income Tax	119	42.68	118	39.33
Wealth Tax	46	1.69	44	1.64
Gift Tax	6	0.28	6	0.28
Interest Tax	29	11.06	29	11.06
Expenditure Tax	2	0.19	2	0.19
<b>Total</b>	<b>688</b>	<b>3490.55</b>	<b>683</b>	<b>3486.38</b>

**1.4.2** Out of the above, three hundred and eighty observations involving tax effect of Rs.3,061.48 crore had arisen out of local audit conducted during 2004-05 and the remaining 308 observations involving tax effect of Rs.429.07 crore were noticed during local audit conducted in earlier years.

**1.5** A separate Report 7 of 2006 (performance audit) containing the results of reviews or system appraisals has been prepared on the following subjects

- Efficiency of summary assessment scheme and process of selection of cases for scrutiny.
- Effectiveness of search and seizure operations.

**1.5.1** A stand alone Report of 2006 (performance audit) has also been prepared containing the results of a CoBit audit of the Assessment Information System (AST) of the Income Tax Department.

**Non-receipt of Board's comments on draft paragraphs**

**1.6** Cases with substantial tax effect are brought to the notice of Income Tax Department and the Ministry in the form of 'draft paragraphs'. Sufficient time is allowed thereafter for their response so that these could be considered before finalisation of this report. However, despite Board's instructions that all 'draft paragraphs' cases should receive the personal attention of the Commissioners of Income Tax (CITs) for expeditious action, inordinate delays continue to occur in receipt of departmental responses.

**1.6.1** Table 1.2 below contains the position of replies received from the Ministry till the finalisation of the Audit Report.

<sup>1</sup> An audit observation issued to the Ministry seeking their comments

**TABLE 1.2: DRAFT PARAS ISSUED TO MINISTRY AND THEIR ACCEPTANCE**

Year of Report	Number of draft paragraphs issued	Replies received before finalisation of Audit Report	Percentage of cases in which replies were received	No. of cases accepted by Ministry	Percentage of cases accepted by Ministry with reference to column 3
1	2	3	4	5	6
2001-02	918	134	15	112	84
2002-03	980	178	18	170	95
2003-04	931	96	10	74	77
2004-05	688	40	6	36	90

**Results of test audit in general**

**1.7** Audit of assessments of all direct taxes conducted between 1 April 2004 to 31 March 2005 revealed 15,874 cases of under assessment and 112 cases of over assessment involving revenue effect of Rs.6,522.34 crore and Rs.144.64 crore respectively. Assessing officers accepted 3,216 audit observations (20.26 percent), did not accept 5,709 observations (35.97 percent) and did not respond to 6,949 observations (43.77 percent) involving tax effect of Rs.2,604.83 crore, Rs.1,198.06 crore and Rs.2,719.45 crore respectively of under assessment.

**Corporation tax and Income tax**

**1.7.1** The number of audit observations during 2004-05 relating to different status of assessees with their tax effect on corporation and income tax is shown in table 1.3 below

**TABLE 1.3:- AUDIT OBSERVATIONS DURING 2004-05 ON CORPORATION AND INCOME TAX**

S. No.	Status of assessees	No. of audit observations	Tax effect (in crore)
1	Companies	6,879 (44.63)	6,086.95 (92.03)
2	Individuals	5,105 (33.12)	180.74 (2.73)
3	Firms	2,797 (18.15)	161.59 (2.44)
4	Other assessees	631 (4.10)	184.65 (2.79)
	<b>Total</b>	<b>15,412 (100)</b>	<b>6,613.93 (100)</b>

Figures in bracket represent percent

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

(Rs. in crore)

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

Sl. No	Category of audit observations	No. of cases	Tax effect
1.	Avoidable mistakes in computation of income and tax	1,270	761.22
2.	Failure to observe the provisions of the Finance Acts	409	486.13
3.	Incorrect status adopted in assessments	31	20.38
4	Incorrect computation of salary income	314	7.34

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

Sl. No	Category of audit observations	No. of cases	Tax effect
5.	Incorrect computation of income from house property	292	4.26
6.	Incorrect computation of business income	3,916	2,767.76
7.	Irregularities in allowing depreciation	988	124.37
8.	Irregular computation of capital gains	204	123.58
9.	Mistakes in assessments of firm	298	5.98
10.	Omission to club the income of spouse/minor child etc.	11	0.43
11.	Income not assessed	1,344	481.02
12.	Irregular set-off of losses	404	465.66
13.	Mistakes in assessments while giving effect to appellate orders	41	5.05
14.	Irregular exemptions and excess relief given	1,914	422.52
15.	Excess or irregular refunds	346	63.66
16.	Non-levy/incorrect levy of interest for delay in submission of returns, delay in payment of tax etc.	1,484	248.23
17.	Avoidable or incorrect payment of interest by Government	200	44.54
18.	Omission/short levy of penalty	390	113.32
19.	Under-assessment of surtax	811	71.81
20.	Other topics of interest (miscellaneous cases)	633	252.03
	<b>Total</b>	<b>15,300</b>	<b>6,469.29</b>

**1.7.3** Categories depicted at Sl. No. 6 and 1 of Table 1.4 namely ‘*Incorrect computation of business income*’ and ‘*Avoidable mistakes in computation of income and tax*’ account for the maximum number of audit observations and tax effect which is depicted in Table 1.5 below

**TABLE 1.5: REVIEW OF THE CATEGORY WISE OBJECTIONS**

Category of omission	Percent of total audit observations	Percent of total tax effect	Two charges with maximum number of audit observations & their tax effect		
			Charges	No. (percentage)	Tax effect (percentage)
Incorrect computation of business income	26	43	Maharashtra & Tamil Nadu	40	71
Avoidable mistakes in computation of income and tax	12	12	Delhi & Maharashtra	23	82

**1.7.4** Audit observations under category at Sl. No. 6 are on incorrect allowance of capital expenditure, provisions, liabilities, prior period expenses etc. Audit observations under category at Sl. No.1 relate to incorrect adoption of figures, arithmetical error, double allowance, non-levy of surcharge etc.

**1.7.5** Similarly, 520 observations relating to wealth tax were issued involving tax effect of Rs.15.32 crore. Table 1.6 below contains an analysis of omissions in terms of nature of irregularities.

**Wealth tax**

(Rs. in crore)

<b>TABLE 1.6: CATEGORIES OF OMISSIONS IN WEALTH TAX</b>			
		<b>No. of Cases</b>	<b>Amount</b>
<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
1.	Wealth not assessed	384	8.47
2.	Incorrect valuation of assets	19	2.54
3.	Mistakes in computation of net wealth	20	2.57
4.	Incorrect status adopted	3	0.02
5.	Mistakes in calculation of tax	7	0.05
6.	Non-levy or incorrect levy of additional wealth tax	45	0.54
7.	Non-levy or incorrect levy of penalty and non-levy of interest	21	0.55
8.	Miscellaneous	21	0.58
<b>Total</b>		<b>520</b>	<b>15.32</b>

**Other direct taxes**

**1.7.6** Fifty four observations relating to other direct taxes i.e. gift tax, interest tax etc were issued involving tax effect of Rs.37.73 crore as mentioned in Table 1.7 below.

(Rs. in crore)

<b>TABLE 1.7: OTHER DIRECT TAXES</b>			
<b>S. No.</b>	<b>Category of tax</b>	<b>No. of cases</b>	<b>Tax effect</b>
1	Gift tax	8	2.80
2	Interest tax	40	33.89
3	Expenditure tax	6	1.04
<b>Total</b>		<b>54</b>	<b>37.73</b>

**Outstanding statutory audit observations**

**1.8** According to departmental instructions, observations of statutory audit are to be replied to within a period of six weeks. The Public Accounts Committee (Ninth Lok Sabha) in their 20<sup>th</sup> Report underscored the fact that responsibility for settlement of audit observations rests with the department and it cannot remain content merely with sending replies to audit observations. In their Action Taken Note, the Ministry of Finance had stated that they would endeavour to see that targets for settlement of audit observations were achieved. However, large number of audit observations made in 2004-05 and earlier years are still to be settled.

**1.8.1** As on 31 March 2005, 80,958 observations involving revenue effect of Rs.20,993.96. crore were pending. This does not include the audit observations communicated between 1 April 2004 to 31 March 2005. The year-wise particulars of the pendency are given in Table 1.8.

(Rs. in crore)

**TABLE 1.8: OBSERVATIONS PENDING WITH DEPARTMENT FOR FINAL ACTION**

Year	Income Tax and Corporation Tax		Other Direct Taxes (Wealth Tax, Gift Tax, Interest Tax, Expenditure Tax and Estate Duty)		Total	
	Items	Revenue effect	Items	Revenue effect	Items	Revenue effect
1	2		3		4	
Upto 2001-02	52,419	11,848.59	6,359	192.77	58,778	12,041.36
2002-03	7,876	3,763.74	577	23.85	8,453	3,787.59
2003-04	12,776	4,987.50	951	177.51	13,727	5,165.01
<b>Total</b>	<b>73,071</b>	<b>20,599.83</b>	<b>7,887</b>	<b>394.13</b>	<b>80,958</b>	<b>20,993.96</b>

**1.8.2** A total of 9,207 audit observations relating to income tax and corporation tax where tax involved in each case exceeded Rs.10 lakh, were pending as on 31 March 2005 with revenue effect of Rs.14,516.80 crore (as against 9,071 cases with a revenue effect of Rs.13,873.82 crore in 2003-04). Cases in respect of different charges are shown below in Table 1.9.

(Rs. in crore)

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

Sl. No.	Name of charge	Items	Amount
1	2	3	4
1.	Andhra Pradesh	198	177.30
2.	Assam	188	340.94
3	Bihar	85	159.58
4	Chandigarh (UT)	62	98.43
5	Chhattisgarh	89	82.27
6	Delhi	1,334	2,317.54
7.	Gujarat	498	484.07
8	Haryana	107	135.63
9	Himachal Pradesh	25	19.57
10.	Jammu & Kashmir	36	21.96
11	Jharkhand	107	87.07
12.	Karnataka	335	365.93
13.	Kerala	483	428.61
14	Madhya Pradesh	251	487.76
15	Maharashtra	2,959	6,643.81
16.	Orissa	147	213.56
17.	Punjab	302	301.28
18.	Rajasthan	238	478.81
19.	Tamil Nadu	702	652.74
20.	Uttar Pradesh	487	387.07
21	West Bengal	574	632.87
	<b>Total</b>	<b>9,207</b>	<b>14,516.80</b>

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

(Rs. in crore)

**TABLE 1.10: PENDING CASES OF OTHER DIRECT TAXES**

Sl. No.	Category of tax	Number of audit observations	Tax effect
1	2	3	4
1.	Wealth tax	284	82.14
2.	Gift tax	47	13.57
3.	Interest tax	80	48.22
4.	Expenditure tax	3	1.04
5.	Estate Duty	6	7.02
	<b>Total</b>	<b>420</b>	<b>151.99</b>

**1.8.4** Nine thousand six hundred and twenty seven audit observations indicated in table 1.9 and 1.10 above constituted 11.89 percent of total observations and accounted for Rs.14,668.79 crore (69.87 percent) of revenue effect of the total pending cases. Department needs to assign priority to settle observations of higher tax effect.

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

**TABLE 1.11: ACTION PLAN & ACTUAL ACHIEVEMENTS OF THE DEPARTMENT**

Audit observations					
Nature of observations	For disposal	To be settled as per targets fixed	Settled	Targets (percent)	Achievements with reference to the targets fixed (percent)
1	2	3	4	5	6
Current	4,586 (2,069.53)	3,669 (1,655.62)	1,069 (420.24)	80	23
Arrear	15,221 (3,941.14)	13,699 (3,547.03)	4,983 (995.25)	90	33

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

**1.9.1** The action plan of the department for 2004-05 provided for 90 percent disposal of all outstanding major audit observations, and 80 percent for current major audit observations. However the actual achievement was only 33 percent and 23 percent respectively of the targets fixed.



**Remedial action  
time barred**

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

**1.10.1** In some charges where the status of audit observations issued between 1978-79 and 1996-97 was reviewed in 2004-05 and cases where remedial action had become time barred were noticed. Details of these cases have been forwarded to the respective Commissioners. Table 1.12 contains the number of such cases along with tax effect.

(Rs. in crore)

Sl. No.	Name of the State	Income Tax	
		Number	Tax effect
1.	Andhra Pradesh	215	23.49
2.	Bihar	118	5.95
3.	Jharkhand	181	8.67
4.	Gujarat	216	23.39
5.	Harayana	135	13.17
6.	Kerala	35	1.68
7.	U.T.Chandigarh	59	59.83
8.	Madhya Pradesh	457	67.25
9.	Orissa	139	22.19
10.	Punjab	12	0.03
11.	Rajasthan	75	0.71
12.	Jammu & Kashmir	2	0.09
	<b>Total</b>	<b>1,644</b>	<b>226.45</b>

**Internal Audit**

**1.11** The Board have introduced a new 'chain' system of internal audit in 2001, which involved 5,397 officials drawn from all ranges and assessing offices as against only around 500 designated officials entrusted with the exclusive responsibility for internal audit earlier.

**1.11.1** All auditable cases where assessments are completed during a month are to be audited in internal audit by the end of the following month. Thus the disposal for the year ending 31 March 2005 should have been for all cases where assessments had been completed by 28 February 2005.

**1.11.2** An analysis of the working of the new chain system of internal audit as given below indicates that internal audit is ineffective and needs strengthening.

**1.11.3** Out of a target of 13.88 lakh cases for disposal during 2004-05, only 5.99 lakh cases were seen by internal audit leaving a balance of 56.8 percent. This was despite the manpower available for internal audit increasing by over 1,000 percent under the new chain system of internal audit after restructuring of Income Tax Department. Details are given in Table 1.13.

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**TABLE 1.13: PERFORMANCE OF INTERNAL AUDIT**

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Financial Year	Total auditable cases	Target for disposal	Total cases audited	Shortfall with reference to total auditable cases	
				No.	Percentage
2002-03	15,57,231	15,57,231	3,60,748	11,96,483	76.83
2003-04	18,40,561	18,40,561	6,90,841	11,49,720	62.47
2004-05	13,87,549	13,87,549	5,99,243	7,88,306	56.81

**1.11.4** The number of observations raised in internal audit was 1,364 in 2001-02, 5,827 in 2002-03, 6,876 in 2003-04 and 8,392 in 2004-05 involving money value of Rs.63.76 crore, Rs.169.38 crore, Rs.159.23 crore and Rs.274.05 crore respectively. Details of internal audit observations accepted by assessing officers, amendments in law suggested, if any, to strengthen the tax administration or recoveries made as a result of internal audit during the period are not readily available with the department.

**1.11.5** Out of the 688 draft paras issued to the Ministry during 2005-06, only 96 (13.79 percent of draft paras issued) had been seen by internal audit of the department and the mistakes pointed out by statutory audit had not been detected by internal audit in the cases checked by them.

**1.11.6** As per the data furnished by Directorate of Income Tax (Income tax & Audit), the closing balance of auditable cases as on 31-03-2004 was 11.50 lakh which did not tally with the opening balance of auditable cases as on 01-04-2004 which was shown as 7.50 lakh.

**Outstanding audit observations of internal audit**

**1.12** According to departmental instructions, internal audit observations are to be attended to by the assessing officer within three months. However, as on 31 March 2005, 11,627 audit observations of internal audit involving a tax effect of Rs.472.76 crore were pending for settlement. This included 8,392 observations with money value of Rs.274.05 crore made during 2004-05.

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

**TABLE 1.14: PERFORMANCE OF IAD IN RESPECT OF MAJOR OBJECTIONS**

Financial year	No. of cases for disposal	No. of cases settled	Percentage of total cases disposed	No. of pending cases
2000-01	21,364(5,975.68)	7,738(576.59)	36	13,626(5,399.09)
2001-02	5,375(814.84)	1,111(216.79)	21	4,264(598.05)
2002-03	6,635(1,430.33)	2,348(452.13)	35	4,287(978.20)
2003-04	5,151(1,936.90)	1,466(275.63)	28	3,685(1,661.27)
2004-05	5,333(941.02)	2,296(485.17)	43	3,037(455.85)

**(figures in brackets indicate money value of rupees in crore)**

**1.12.2** The major cases settled during 2004-05 were only 2,296(43 percent) as compared to 1,466 (28 percent) in 2003-04. Further opening balance for 2001-02 to 2004-05 do not tally with the closing balance for 2000-01 to 2003-04, which were still under reconciliation in the department. Actual settlement achieved is thus likely to be much lower.

**TABLE 1.15: TARGET & ACTUAL SETTLEMENT OF INTERNAL AUDIT OBJECTIONS**

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

Figures in brackets indicate value Rs. in crore

Achievements thus fell short of the targets fixed.

**Records not produced to audit**

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

**Appendix-1** contains details of records not produced to audit in previous audit cycles which were requisitioned again in 2004-05. Over 67 percent of cases not produced during earlier audits and requisitioned again in 2004-05, were not produced to audit even after the lapse of more than two years after re-organization of the department. Consequently, audit of such cases could not be carried out. Risk of loss of revenue in such cases cannot be ruled out.

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

**TABLE 1.16 RECORDS NOT PRODUCED TO AUDIT IN THREE OR MORE AUDIT CYCLES**

S.No.	State	Number of records not produced		
		IT/CT	W.T.	Total
1	2	3	4	5
1	Andhra Pradesh	25	3	28
2	Karnataka	10	28	38
3	Orissa	13	-	13
4	Maharashtra	-----	12	12
	<b>Total</b>	<b>48</b>	<b>43</b>	<b>91</b>