Some aspects of non-resident taxation with reference to double taxation avoidance agreements

3.1. Introduction

3.1.1 Developing nations look to the developed ones for better technology, large capital and specific expertise in various fields and sectors of economy. Similarly, the developed nations are interested in the markets, investment opportunities, increased and profitable use of their capital and technology in the developing nations. Liberalization and opening up of the economy since 1990s has rendered India one of the attractive destinations for foreign investments. A comparative position of foreign investment since 1990-91 is detailed in **Table 1** below:

Table 1: Foreign investment inflows

Year	Direct investment		Portfolio investment		Total	
	Rs. in crore	US $ Million	Rs. in crore	US $ Million	Rs. in crore	US $ Million
1990-91	174	97	11	6	185	103
1991-92	316	129	10	4	326	133
1992-93	965	315	748	244	1713	559
1993-94	1838	586	11188	3567	13026	4153
1994-95	4126	1314	12007	3824	16133	5138
1995-96	7172	2144	9192	2748	16364	4892
1996-97	10015	2821	11758	3312	21773	6133
1997-98	13220	3557	6696	1828	19916	5385
1998-99	10358	2462	(-) 257	(-) 61	10101	2401
1999-00	9338	2155	13112	3026	22450	5181
2000-01	18406	4029	12609	2760	31015	6789
2001-02	29240	6131	9639	2021	38879	8152
2002-03	22552	4660	4738	979	27290	5639
2003-04	21482	4675	52279	11377	73761	16052

Source: Handbook of Statistics on the Indian Economy 2003-04, RBI Publication

3.1.2 Mauritius was topping foreign direct investment in India during the last four years. **(Table 2)**

US $ Million

Table 2: Country wise foreign direct investment in India*

Country	2000-01	2001-02	2002-03	2003-04 (Prov.)
Mauritius	843	1863	534	381
USA	320	364	268	297
UK	61	45	224	157
Germany	113	74	103	69
Netherlands	76	68	94	197
Japan	156	143	66	67
France	93	88	53	34
South Korea	24	3	15	22
Others	224	340	301	238

Source: RBI Annual Reports

* Data exclude FDI inflows under the NRI direct investment route through RBI and inflows due to acquisition of shares under Section 5 of the FEMA 1999.

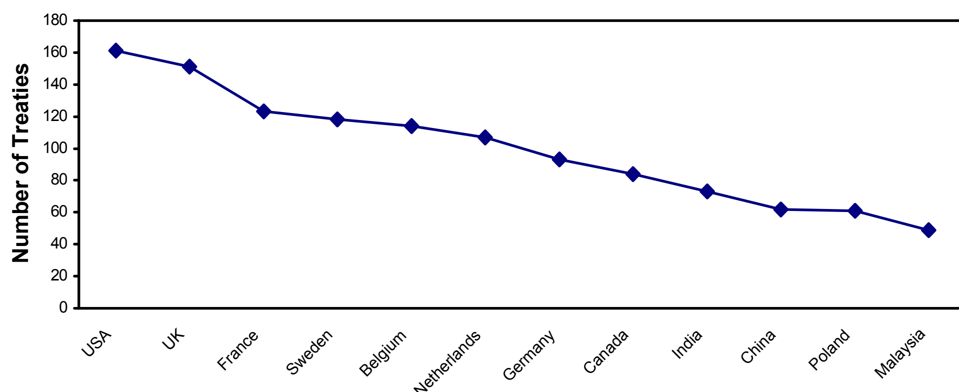
3.1.3 Globalization and increased transnational investment and trade imply a potential conflict of tax jurisdictions. Central to the question of jurisdictional conflict is the issue of sovereign right of two or more jurisdictions to levy tax on one and the same event or one and the same taxpayer. Where there are mismatches between national tax laws, the jurisdictional conflict can get aggravated by improper conduct by taxpayers. Jurisdictional conflicts can be resolved unilaterally under national tax laws, or bilaterally and even multilaterally under "tax treaties" or "Double taxation avoidance agreements" (DTAA).

3.1.4 The paramount issue underlying all international tax considerations is how to appropriately allocate income and equitably divide or share the revenues between host and home countries. The resolution of this issue is the main purpose of DTAAs, which seek, inter-alia, to set out detailed allocation rules between the "source" and "resident" countries for different categories of income.

3.1.5 DTAAs are generally expected to fulfill the following objectives.

- Facilitate investment and trade flow
- Prevent discrimination between taxpayers
- Provide fiscal certainty to cross border transactions and
- Contribute to attainment of national development goals.

The following graph gives the comparative position of DTAAs among countries, with USA leading the block.



Source : UNCTAD database

3.1.6 There are 'two' models popularly known as, the United Nations model (UN) and Organisation for Economic Cooperation and Development model (OECD), which are widely followed by the countries while entering into DTAAs. OECD model is generally regarded as being geared to the interests of developed countries and recognizes the priority of the country of residence to tax income. On the other hand, the UN model appreciates the needs of the developing countries and reserves the right of tax to the country of its source. India has comprehensive DTAAs with more than 65 countries and limited DTAAs covering income from airlines and merchant shipping business with more than 10 countries.

3.1.7 In pursuance of Section 90 of the Income Tax Act (the Act), the Government of India through the Central Board of Direct Taxes (the Board) have entered into DTAAs with various countries for

- granting relief in respect of income on which tax has been paid under the Income Tax Act of both the countries; or
- the avoidance of double taxation of income under the Act, and under the corresponding law in force in that country; or
- exchange of information for the prevention of evasion or avoidance of income tax chargeable under this Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance; or
- recovery of income tax under the Act, and under the corresponding law in the other country in respect of the income, profits or gains; or
- promoting mutual economic relations, trade and investment (**clause inserted with effect from April 2004).**

3.1.8 Issues relating to Indo-Mauritius DTAA

DTAAs being country specific, the contours of taxation and concessions granted vary based on the comparative advantage that India enjoys with them. In this context Indo-Mauritius DTAA has been of considerable concern. A study of the articles dealing with residency and taxation of capital gains reveals that special consideration was bestowed to business entities of Mauritius in view, perhaps of the fact that Mauritius was a less developed country than India and has had longstanding special relationship with India. Coinciding with the liberalization of Indian economy, the Government of Mauritius promulgated the Mauritius Offshore Business Activities Act 1992(MOBAA) to regulate the offshore business in that country. A body corporate registered under the laws in Mauritius would be a resident in Mauritius and thus "subject to taxation" as a resident. Income Tax Act of Mauritius provided that offshore companies were liable to pay 'zero percent' tax. Thus, by bringing an offshore company within the definition of resident, not only was the benefit of offshore company extended to it but also the benefits of residency allowable under DTAA bestowed on it. This led to establishment of conduit companies in Mauritius through which investors of third countries routed their investment, which led to concern among tax authorities in India about the loss of rightful revenue. In effect, the whole exercise of avoidance of double taxation turned out to be avoidance of taxation altogether.

3.1.9 Follow up action on Joint Parliamentary Committee's recommendation on Stock Market Scam

Foreign institutional investors (FIIs), realizing the opportunity, also channelised their investment into India through the Mauritius route. A few stockbrokers were considered to have exploited the same and contributed to huge inflow of monies to create undue fluctuations in the stock markets, which was identified as one of the causants of the securities scam, which was investigated by the "Joint

Parliamentary Committee" (JPC). The Board in its action taken note on the report of JPC informed that, MOBAA, which restricted the exchange of information between India and Mauritius, had been repealed in November* 2001. Further, it was also stated that a Memorandum of Understanding with the Financial Services Commission of Mauritius was contemplated for exchange of information as a safeguard against the practices of money laundering.

3.1.10 The JPC had noted in its 'Report on the stock market scam' presented to Parliament on 21 December 2003, that the 'Special Cell' constituted to examine the role of industrial houses with respect to the stock scam and the close nexus between industrial houses, banks and stockbrokers was not effectively functioning. The Director General (Investigation) of Income Tax Department in Mumbai, who headed the Special Cell had noted that 'each of the organizations (i.e. RBI, SEBI, CBI, DCA, CBDT, etc) had already a mass of information and what was required was a sifting to establish the wrong doings if any'.

3.1.11 The JPC in its observation on the Indo-Mauritius DTAA had noted that RBI did not have information on FII inflows country wise. The External Affairs Ministry deposing before the JPC had brought out that there were similar problems pertaining to taxation of long-term capital gains with 17 other countries, to which the Ministry of Finance also agreed. Based on the deposition by various Ministries, the Committee had observed, "there could be substantial revenue loss due to the 'residency clause' in the Indo-Mauritius DTAA". It, therefore, recommended that Companies investing in India through Mauritius should be required to file a declaration of ownership with RBI, to the effect that all the Directors and effective management was in Mauritius.

3.1.12 Adequacy and status of action taken by the Board to streamline procedures for assessments and allowing benefits under Indo-Mauritius DTAA following the JPC recommendations was identified as a priority area for examination in audit.

3.1.13 Landmark Judgement of Supreme Court on Indo-Mauritius DTAA

The tax authorities in India, recognizing the need to curtail the 'abuse' of the Indo-Mauritius treaty denied the benefit of the treaty (March 2000) to some offshore business companies (OBC) registered in Mauritius that had claimed exemption from tax under the Income Tax Act, by rejecting the certificate of residence furnished by them. Such OBCs were claiming exemption of capital gains from stock market operations, which gave the right of taxation of such capital gains to Mauritius.

3.1.14 At around the same time, there were fluctuations in the stock markets and general perception that the action of the department denying the benefit of Mauritius residency to some Mauritius based FIIs was the root cause for such fluctuations. It was projected that this would have or had resulted in huge

* replaced by Financial Services Development Act promulgated with effect from 1 December 2001

outflows of foreign investment from India. To clear the doubts, as also clarify the intent of the Indo-Mauritius DTAA, the Board issued Circular 789 dated 13 April 2000, inter alia, requiring the assessing officer to accept the certificate of residence granted under the local legislation of Mauritius to OBCs operating from third countries including India.

3.1.15 Considering a 'public interest litigation' (PIL), Delhi High Court quashed the above circular as bad in law on the grounds that the income tax officer was entitled to lift the corporate veil in order to ascertain whether a company was actually resident of Mauritius or not in exercise of his quasi-judicial powers and any attempt by the Board to interfere with this would be contrary to the intendment of the Act.

3.1.16 However, the honourable Supreme Court in their judgment in the case of Azadi Bachao Andolan on 7 October 2003 upholding the issue of circular by the Board as also the Indo-Mauritius DTAA, held that

- ***Indo-Mauritius DTAC[ϕ] (1983) is not 'ultra vires' of the powers of the Central Government under section 90, on account of its susceptibility to "treaty shopping[*]".***
- ***Circular 789 of April 2000 issued by the Board falls within the parameters of the powers exercisable by the Board under section 119. The circular does not in any way crib, cabin or confine the powers of the assessing officer with regard to any assessment. It merely formulates guidelines to be applied in the matters of assessment of assessees covered by the provisions of Indo-Mauritius DTAA.***
- ***Merely because, at a given time there may be an exemption from income tax in respect of particular head of income, it is not correct to say that the taxable entity is not liable to taxation.***

3.1.17 During the pendency of the proceedings before the Supreme Court, the Board issued a circular on 10 February 2003 clarifying that where an assessing officer finds and is satisfied that an entity is resident of both India and Mauritius, he would be free to proceed to determine the residential status under the DTAA by invoking what is otherwise also known as the 'tie-breaker' clause. It further stated that where it was found that the company had its place of effective management in India, then, notwithstanding it being incorporated in Mauritius, ***it would be taxed under the DTAA in India***. Adequacy and consistency of action taken by the assessing officers to safeguard interests of revenue in pursuance of the above developments in relation to Indo-Mauritius DTAA was an important issue for examination in audit.

[ϕ]Double taxation avoidance agreements are also known as 'double taxation avoidance conventions' or 'double taxation avoidance treaties'.

[*] Treaty shopping means the advantage taken of a DTAA between two countries by a resident of a third country.

3.1.18 Assessment of income from maritime business of non-residents

Maritime transport is a critical infrastructure for the social and economic development of a country. There are 12 major ports in the country, which handled a total traffic of 344.55 million tones of traffic during 2003-04 as against 313.53 million tones during 2002-03*. The share of Indian ships in total overseas trade was around 16 percent during 2002-03, the remaining 84 percent being handled by foreign vessels. Thus, overseas trade of India was a major source of revenue to foreign vessels. Audit sought to examine the adequacy of rules and procedures for taxation of income accruing to non residents on account of shipping business as this had to be examined carefully by the assessing officer with reference to applicable DTAAs.

3.1.19 As a related subject, other important aspects of administration and implementation of DTAAs in general, such as mutual agreement procedure (MAP) and exchange of information were chosen for examination.

3.1.20 Audit also decided to scrutinise whether any 'cost benefit' analysis was conducted in respect of various DTAAs and also whether there were adequate reasons for bestowing different treatment to similar issues in various DTAAs, through a limited study of selected DTAAs, with special interest to India.

3.1.21 Role of regulatory bodies

Securities & Exchange Board of India (SEBI) has been empowered to register and issue licenses to foreign institutional investors (FIIs) who intend to invest in the Indian stock market and fulfill the laid down conditions. One such condition, which is intended to safeguard the interest of revenue, is nomination of an agent including a person who may be treated as an agent under section 163 of the Income Tax Act. Section 115AD is the charging section for taxation of income arising to FIIs from securities or shares. Press Note of March 1994, issued by Department of Economic Affairs under Ministry of Finance clarifies the issue of taxation of FIIs. Adequacy of arrangements to discharge the above requirements and their enforcement/utilization by the Income Tax Department for taxation of non-residents were also considered for scrutiny in audit.

3.2 Law and Procedure

3.2.1 Sections 90 and 91 under Chapter IX of the Act deal with powers of the Central Government to enter into agreement with foreign countries for granting relief for doubly taxed income. Section 172 deals with taxation of non-residents from occasional shipping business. Chapter XII A details the ‘special provisions relating to certain incomes of non-residents under sections 115 C to 115 I’.

* Annual Report 2003-04 of Ministry of Shipping, Government of India

3.2.2 Provisions on taxation of maritime business

Section 172 of the Act, provides for levy and recovery of tax in case of any ship, belonging to or chartered by a non-resident, which carries passengers, livestock, mail or goods shipped from a port in India. The master of the ship shall furnish a return of the amount paid or payable on account of such carriage before departure from any port in India. The assessing officer may, however allow the ship to depart by issuing 'no objection certificate' (NOC), if the master of the ship makes satisfactory arrangement for filing of the return within 30 days of the departure of the ship and payment of tax. The assessing officer shall assess the income and determine the tax payable, if any, as envisaged in the Act.

3.2.3 The Board vide instruction 838 dated 3 June 1975 laid down that where it was not possible for the master of the ship to furnish the return before the departure of ship, arrangements could be made in the form of suitable bond or bank guarantee to safeguard the interest of revenue.

3.2.4 The Board vide circular 732 dated 20 December 1995 laid down that the assessing officer may issue annual NOC where ships are owned by an enterprise belonging to a country with which India has entered into DTAA and the agreement provides for taxation of shipping profits only in that country of which the enterprise is resident and no tax is payable by them at the Indian ports. The assessing officer is required to ensure before issue of NOC that all the requisite documents or evidence such as proof of residence, details of loading port and discharge port, freight payable as per charter agreement, have been submitted.

3.2.5 DTAA provisions on taxation of maritime business

DTAAs provide that profits derived by an enterprise of a contracting state from the operation of ships in international traffic shall be taxable only in that state. DTAAs concluded with Netherlands, Mauritius and Sri Lanka provide that profit from the operation of ship in international traffic shall be taxable only in the contracting state in which the effective management of enterprise is situated. DTAAs concluded with Japan, Jordan and Kenya, however, provide that profits may be taxed in the other contracting State also, but the tax so charged shall not exceed 50 percent of tax otherwise imposed by the internal law of that state, subject to the conditions provided therein.

3.3 Objectives of the review

The review seeks through a limited and selective test check of records in the Board and assessments in the selected field offices, to

- derive an assurance of adequacy of measures and procedures in the income tax department for ensuring effective co-ordination with the regulatory bodies like SEBI and RBI for utilizing the information available with them on FIIs in particular and safeguard interests of revenue,

- assess adequacy of action in cases involving Indo-Mauritius DTAA consequent to JPC recommendations, Board's circular of February 2003 , landmark judgment of Supreme Court in the case of Azadi Bachao Andolan in October 2003 and amendment to section 90 of the Act,
- attempt a comparative analysis of provisions of DTAA with selected countries with reference to criteria for determining "permanent establishment" (PE) and taxation of business profits, with a view to identifying areas of inconsistency, if any, and seeking an assurance that an adequate mechanism exists to ensure that costs did not outweigh benefits,
- examine adequacy of the mechanism for monitoring and implementation of significant provisions of DTAA like mutual agreement procedure (MAP) and exchange of information etc.,
- examine adequacy of systems and procedures and correctness of allowance of DTAA relief in respect of taxation of shipping business to non-residents, and related aspects of taxation of non-residents and
- examine the extent of uniformity in application of various articles in the DTAAs and identify ambiguity, if any, so that there is no loss of revenue to the exchequer

3.4 Audit methodology

3.4.1 Scope of the Review:

DTAAs of 12 countries viz. USA, UK, Japan, Germany, Kenya, Mauritius, Malayasia, Oman, South Africa, Singapore, UAE and Uzbekistan were selected to examine the consistency or otherwise and effectiveness of their execution and implementation in respect of Permanent Establishment, Business profit, Dividend, Interest, Royalties and Fees for technical services, Capital gains, Shipping and Air transport, Anti treaty-shopping provision, exchange of information, Mutual Agreement Procedure, Treaty limitation and so on. Assessments involving DTAAs with a few other countries like Sri Lanka and Greece were also checked.

3.4.2 Audit coverage

Review covered assessments concluded during the financial years 1999-2000 to 2003-04 and up to July 2004.

3.5 Sample Size

The review covered all scrutiny assessments and 50% summary assessments selected on random basis concluded under the Director of Income tax (DIT) (International Taxation) charges in Bangalore, Chennai, Delhi, Kolkata and Mumbai[†] and other charges in Andhra Pradesh, Gujarat, Kerala and Uttaranchal which had preponderance of cases of non-residents. Audit examined 1732 assessments completed after scrutiny and 12,937 summary assessments in 130 assessing units.

[†] Selection percentage being 20 percent for summary assessments

3.6 Audit findings

Audit noticed mistakes in 314 cases involving non-levy or short levy of tax of Rs.440 crore. Mistakes related to irregular exemption of capital gains under Indo-Mauritius DTAA and incorrect application of provisions of DTAA as well as provisions of the Act. Also, irregular grant of relief to maritime business of non-residents in 405 cases resulted in non-levy or short levy of tax of Rs.18.54 crore.

Apart from inadequate coordination by departmental authorities with regulatory bodies like SEBI and RBI with regard to monitoring the tax liabilities of FIIs, audit also noticed instances of loss of rightful revenue due to treaty shopping by residents of third countries, unquantifiable tax expenditure due to exemptions under DTAAs, blockade of revenue due to delay in processing/finalizing MAP cases, ambiguities with relation to taxation of software payments and so on in 63 cases involving tax revenue of Rs.1350 crore.

Audit findings are described in detail in the following paragraphs.

3.6.1 Adequacy of institutional arrangements for taxation of nonresidents

SEBI is the nodal authority for registering and monitoring the activities of the FIIs and their sub accounts[♦]. There are more than 600 FIIs registered with SEBI and over 4000 sub accounts relating to the same, which are active in the Indian stock market[‡]. FIIs registered with SEBI are automatically recognized for the purposes of section 115 AD of the Act and can avail concessional rate of taxation. Since, no deduction of tax shall be made from any income by way of capital gains arising from the transfer of securities by such FIIs, the Ministry of Finance in their press note of 1994 had stated that nomination of an agent, who could be held responsible under section 163 of the Act in India, was a prerequisite for granting registration. Further, FIIs were required to file the details of their transactions in the stock markets, periodically with SEBI. It is, therefore essential that the income tax department have the details of representative assessees of all FIIs operating in India so as to safeguard the interests of revenue.

3.6.2 Audit examined whether FIIs were specifying an agent and whether the department was monitoring and pursuing taxation of such income/agents through a well designed, coordinated and effective strategy and action plan. Audit noticed that the department was not having any centralized or alternate effective mechanism to correlate or utilize the details available with SEBI relating to inflows and outflows of FIIs. Audit was given to understand from SEBI that application for registration did not have details of an agent as provided under section 163 of the Act and no details such as local address were available relating

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[♦] Sub account includes foreign corporate or foreign individuals and those institutions established or incorporated outside India and those funds or portfolios established outside India, whether incorporated or not, on whose behalf investments are proposed to be made in India by an FII

[‡] Source :SEBI Data

to FIIs. SEBI have also informed that neither had any information been periodically furnished to the department nor was it called for.

3.6.3 An impression was sought to be created that denial of DTAA relief to some Mauritius based entities by rejecting residency certificate had led to flight of capital and investment from India. However, an appraisal of the transactions in the capital markets during November 1999 to October 2000 as highlighted in the Annual Reports of SEBI indicated that there were 'inflows' with respect to FIIs in this period (Column 2 of Table 3 below). During January 2000 to March 2000, when returns in some cases were being processed by the departmental officers in Mumbai for denial of relief under Indo-Mauritius DTAA, there was a net increase in investment. Subsequent to the issue of circular there was, in fact, a net outflow of investment (Column 4, ibid). Thus, there was neither substantial decrease in investment consequent to denial of benefits to a few third country based companies investing through Mauritius nor marked increase after issue of Circular 789 in April 2000 as shown in **Table 3**.

(Rs. in crore)

Table 3: Inflows/Outflows through FIIs

Month	Gross purchases (Column 2)	Gross sales (Column 3)	Net investment (Column 4)
November 1999	3934.47	2705.44	1229.03
December 1999	4556.19	2938.57	1617.62
January 2000	6129.73	5933.16	196.57
February 2000	9761.57	6677.47	3084.10
March 2000	9890.07	8691	1198.83
April 2000	8354.50	5767.80	2586.70
May 2000	6307.4	6054.70	252.70
June 2000	5398.80	6333.60	(-) 934.80
July 2000	5857.60	7259.40	(-) 1401.80
August 2000	5134.00	3875.20	1258.90
September 2000	7149.60	6931.30	218.30
October 2000	4440.70	4659.30	(-) 218.50

3.6.4 Operations by FIIs in Indian stock markets can be through 'sub-accounts' as approved and registered by SEBI who would be held responsible as representative assessees under section 163 of the Act. Whether this arrangement would constitute a 'permanent establishment' under the treaty needed to be clarified by the Board, as more than 4000 sub-accounts were operating on behalf of about 600 FIIs.

3.6.5 Revenue foregone on account of exemptions under domestic law

Section 10 of the Act, inter alia, details the exemptions available to non-residents on income arising or accruing to them in India. The Working Group of the Board (January 2003) in its 'Report on Non-resident Taxation' had recommended, withdrawal of such exemptions granted to non residents.

3.6.6 Department did not conduct any study to ascertain the extent of revenue foregone by the Government by exempting incomes of non residents under section 10 of the Act. Test check of assessments in **Mumbai DIT (IT)** charge revealed that revenue foregone on account of exemptions allowed in only 'seven' cases aggregated **Rs.1.48 crore** as detailed in **Table 4** below.

(Rs. in crore)

Table 4: Revenue foregone under section 10

Sl No	No of cases	Category of income	Section involved	Tax foregone
1	2	Fees for technical services	10 (6A)	0.20
2	5	Aircraft lease payments	10 (6BB)	1.29
Total				**1.48**

3.6.7 Ministry may initiate measures to assess the budgetary or revenue sacrifice as also the real benefits flowing from these exemptions so that incentives granted to non-residents actually accrue to them instead of the exchequer of the other contracting State.

3.7 Adequacy of follow up action involving Indo-Mauritius DTAA

3.7.1 Irregular exemption of capital gains under Indo – Mauritius DTAA

The peculiar problems associated with administration of Indo-Mauritius DTAA and the background of related issues have been mentioned in paragraphs **3.1.8 to 3.1.17** above. Audit scrutiny of assessments of entities that were stated to have been incorporated in Mauritius and deriving income from capital gains on sale of shares in India revealed that the benefit of exemption under Article 13 of Indo-Mauritius DTAA was allowed based on incomplete data.

3.7.2 In **Mumbai DIT (IT)** charge, assessment of **M/s. Pathfinder Investment Ltd**. (owned by Shri Dhananjay Agarwal) for the assessment year 2001-02 was completed after scrutiny in March 2004 denying the benefit of exemption of capital gains as the assessee could not prove that the effective place of management was in Mauritius. Further, the tax residency certificates furnished by the assessee related to a different company (i.e. Lloyds Securities Overseas Ltd).

3.7.3 Similar benefit was not denied in respect of similarly placed two other assessees (**M/s. Discover Investment Ltd. & M/s. Euro Discovery Tech. Ventures Ltd)** who had produced tax residency certificates of Mauritius, which did not relate to them. Exempting capital gains of Rs.222.31 crore for assessment years 2000-01 and 2001-02 entailing a tax levy of **Rs.29.59** crore without examining effective place of management was irregular.

3.7.4 Board may also, in this connection, for ensuring consistency in assessments, like to clarify to its assessing officers as to whether profits arising to FIIs would be assessable as business profits or capital gains, as FIIs are investment companies. This would ensure that interests of revenue are safeguarded.

3.7.5 Loss of revenue due to misuse of Indo-Mauritius treaty by residents of third countries

JPC in their report in December 2003 on the stock market scam had observed that though the exact amount of revenue loss due to 'residency clause' of the Indo-Mauritius treaty could not be quantified, but taking into account the huge inflows/outflows, it could be assumed to be substantial. They had concluded that the problem with the Indo-Mauritius treaty was not as much with residents engaging in 'round tripping'[*], routing their investments through Mauritius, but with residents of third countries exploiting the favourable dispensation sought to be granted to 'bonafide' residents of Mauritius through 'post box companies'.

3.7.6 The Committee had, therefore, recommended that in order that the benefits of Indo-Mauritius treaty were available only to bonafide residents, 'companies' investing in India through Mauritius should file details of 'ownership' with RBI and furnish a declaration that effective place of management was in Mauritius. Board's circular of February 2003 clarified taxability of Indian companies involved in 'round tripping' through Mauritius. However, similar action was not taken with reference to residents of third countries availing the benefits.

3.7.7 It is interesting to note that the Ministry in July 1995 had opined ***"for Indian investors to be globally competitive, facilities available to foreign investors to use the relative advantages of Mauritius should also be available to Indian investors"***. However, Board's circular of February 2003 negated the above advantage by providing that 'tie breaker' clause for deciding the residence, would be applicable only in respect of resident Indians investing through Mauritius. Reasons that prompted the Ministry to exclude residents from India availing the benefits of DTAA while simultaneously allowing residents of third countries to avail the same, were not ascertainable.

3.7.8 It is also relevant to note that the Ministry in its submission to JPC had stated that there were problems in DTAAs with 17 other countries as well pertaining to taxation of long-term capital gains. Whether, exempting capital gains from taxation in India was a conscious policy of the Ministry as reflected in the Indo-Mauritius DTAA or the Ministry have been caught totally unawares of the adverse implications of changes in domestic laws in Mauritius on the Indian tax situation was not verifiable in Audit. The admission of the Ministry before the JPC, mentioned at paragraph **3.1.11** indicates, that the situation had become one of 'fait accompli' and progress, if any, to remedy the situation has been slow.

3.7.9 Audit noticed that the department did not have any proactive strategy or action plan to identify investors belonging to third countries routing their transactions/investments through Mauritius for the sole purpose of enjoying treaty benefits, to the detriment of revenues. Audit also found that relief claimed by

[*] wherein domestic companies take money out of the country and then bring it back as overseas contribution to equity.

assessees under Indo-Mauritius DTAA was being allowed by assessing officers without proper scrutiny.

3.7.10 Audit noticed that in **Mumbai DIT (IT)** charge, in six cases, relating to assessment year 1997-98, the assessing officers had denied exemption to capital gains on the grounds that effective place of management or the actual control of management was not in Mauritius but in third countries. However, consequent to issue of circular 789 in April 2000 by the Board which was, perhaps, construed to mean that the assessing officer had no choice but to accept the residency certificate granted by Mauritius even when the actual control was exercised from outside Mauritius, the assessments were, subsequently revised in favour of the assessees under section 264 of the Act nullifying the tax demand of **Rs.8.40 crore**.

3.7.11 The Supreme Court in their judgement in October 2003 had clearly decided that circular 789 of April 2000 did not in any way crib, cabin or confine the powers of the assessing officer with regard to any assessment. The assessing officers ought to have examined the assessment/revision orders 'denovo' in these cases especially as it was already established 'ab initio' that the effective place of management of these companies was not in Mauritius. Ministry may like to initiate action to get the assessments and the issue of effective place of management examined in case of all FIIs and their sub accounts in respect of Mauritius based units so as to safeguard interests of revenue

3.7.12 Audit noticed an instance of Indo-Mauritius DTAA being availed by a non-resident of a third country, USA. In **Mumbai DIT (IT)** charge, **Vodafone International Inc (VII), USA** had divested its share holding in favour of two Indian companies through its 100% subsidiary, M/s Air Touch International Mauritius Ltd. (AIML) in Mauritius. AIML earned long-term capital gain amounting to Rs.79.59 crore and short-term capital gain of Rs.42.69 crore for the assessment year 2001-02 from the above transaction. AIML claimed exemption from capital gain tax under Indo-Mauritius DTAA, which was allowed after scrutiny in January 2004. Thus, VII, by divesting through Mauritius saved capital gain tax of **Rs.20.77 crore** by taking shelter of Indo-Mauritius DTAA. Had the shares been directly sold by VII USA, the entire capital gain would have been subjected to tax in India under Indo-US DTAA.

3.7.13 Ministry may, therefore, have to put in place an effective mechanism to ensure that the benefit of residency and taxation of capital gains are availed of only by bonafide residents of the countries with which DTAAs have been concluded and not extended to residents of third countries as a matter of course in a routine manner. Ministry may undertake a transparent cost benefit analysis of extension of such benefits through 'treaty shopping' so that it would become a recognized and clearly thought out policy of the Government to permit the same. Ministry may also take urgent action to include specific clause for enforcing 'limitation of treaty benefits' in all identified 'problem DTAAs' so that the consequential benefits are not availed by default.

3.7.14 Revenue forgone due to exemption under DTAAs

Audit attempted to quantify the tax expenditure or indirect subsidy granted to FIIs resident in UAE under the Indo-UAE DTAA and enjoying exemption from capital gains tax as available in Indo-Mauritius DTAA. Details of 10 companies at random, to which Indo-Mauritius and Indo-UAE DTAAs applied were obtained from SEBI to quantify the possible tax expenditure to the Indian exchequer on account of favorable dispensation granted to them with regard to taxation of long term capital gains. In the absence of specific data, the calculations were based on details of sale of equity furnished by SEBI. Tax has been worked out on the premise that all sales had resulted in long-term capital gains attracting a levy of 10%. Long-term capital losses incurred if any, are assumed to be offset by the fact that short-term capital gains are not being factored into the estimate. Revenue foregone in respect of Mauritius and UAE for 10 companies would amount to **Rs.76.14 crore** and **Rs.532.63 crore** respectively during the years 2001-02 to 2003-04 as detailed in **Table 5** below.

(Rs. in crore)

Table 5: Equity Investment : Mauritius (Sales)

Sl No	Name of FII	2001-02	2002-03	2003-04	Total
1	India Capital Management Inc	Nil	Nil	97.6	97.6
2	Maxwell (Mauritius) Pvt Ltd	Nil	Nil	94.4	94.4
3	BNP Paribas South Asia Investment Co. Ltd	42.4	52.7	114.6	209.7
4	South Asia Regional Fund	Nil	17.8	Nil	17.8
5	JF India Fund	Nil	127.7	204.8	332.5
6	CDC Financial Services (Mauritius)	Nil	Nil	9.4	9.4
	Total	**42.4**	**198.2**	**520.8**	**761.4**
	Equity Investment : United Arab Emirates (Sales)				
1	Citicorp Banking Corporation	Nil	Nil	8.9	8.9
2	HSBC Financial Services (Middle East) Ltd	Nil	131.9	1424.6	1556.5
3	Abu Dhabi Investment Authority	903.2	940.5	1603.5	3447.2
4	TAIB Bank E.C.	77.2	115.5	121	313.7
	Total	**980.4**	**1187.9**	**3158**	**5326.3**

3.7.15 Incorrect carry forward of capital losses

As Indo-Mauritius DTAA provides that capital gains arising to Mauritius based FIIs are assessable to tax only in Mauritius, losses on account of the same are similarly to be adjusted or claimed only in Mauritius. In **Mumbai, DIT (IT)** charge, audit noticed assessing officers had accepted the claims of carry forward of capital losses of six companies amounting to **Rs.478.95 crore** arising from sale of shares by Mauritius based FIIs though losses were not assessable in India which would have entailed a potential tax levy of **Rs.48 crore**.

3.7.16 Loss of revenue due to non-selection of cases for scrutiny

In **Mumbai DIT (IT)** charge, assessments of **M/s. Empire International Holdings Ltd. and M/s. Lotus India Investments Ltd.** for the assessment year

2001-02 were completed in summary manner allowing the benefit of exemption of capital gains under Indo-Mauritius treaty without production of tax residency certificate or other document evidencing effective management in Mauritius. M/s. Lotus India Investments Ltd was allowed exemption of tax on capital gains of Rs.3.99 crore involving a potential tax levy of **Rs.0.34 crore** which was irregular, while in the case of M/s. Empire International Holdings Ltd, no details of capital gain were mentioned. In view of the incomplete information in the returns, the cases should have been selected for scrutiny to ensure that exemption was correctly availed by the assessees.

3.7.17 In **Mumbai DIT (IT)** charge, the assessments of **M/s. Abacus International Pvt Ltd**, for the assessment years 2001-02 to 2003-04 were completed in summary manner accepting ‘nil’ income. Audit scrutiny for the assessment year 1999-2000 revealed that the assessing officer in his scrutiny order of March 2002 did not accept the claim of exemption under Article 5. It was held that income of the assessee was taxable as business income under Article 7 of Indo-Singapore DTAA. For ensuring consistency in denial of exemption, the returns of income for the subsequent years should have been selected for scrutiny. Omission to do so, resulted in loss of revenue of **Rs.1.15 crore**

3.8 Comparative analysis of selected DTAAs

3.8.1 Permanent Establishment (PE)

PE is defined as a "fixed place through which the business of an enterprise is wholly or partly carried on". A building site or construction or installation project, or any structure used for exploration or development of natural resources constitutes a PE if it lasts more than 12 months as per OECD Model and 6 months as per UN Model. India generally follows UN Model.

3.8.2 A comparative study of articles on PE in respect of 12 selected DTAAs (**USA, U.K., Japan, Germany, Kenya, Mauritius, Malaysia, Oman, South Africa, Singapore, UAE and Uzbekistan)** revealed that there is no uniformity or consistency in defining the existence of a PE based on the minimum threshold period of existence as given in **Table 6** below:

Table 6: Period for reckoning PE in DTAAs

Name of the country	Building site installation or structure	Supervisory activity	Finishing services	Exploration of natural resources
USA	120 days	120 days	90 days	120 days
UK	6 months	6 months	90 days	Not mentioned
Uzbekistan	Not mentioned	Not mentioned	Not mentioned	Not mentioned
Germany	6 months	6 months	Not mentioned	Not mentioned
Japan	6 months	6 months	6 months	6 months
Singapore	183 days	183 days	183 days	183 days
Mauritius	9 months	9 months	Not mentioned	Not mentioned
South Africa	6 months	6 months	Not mentioned	Not mentioned
UAE	9 months	9 months	9 months	Not mentioned

3.8.3 Audit noticed that in DTAA with USA, the period adopted is 120 days instead of 6 months. Reasons for adopting different periods in DTAAs with Mauritius, Singapore and UAE were not ascertainable in audit, as no supporting records were made available. Revenue implications were thus not known.

3.8.4 Business Profits

UN Model convention, inter alia, states that in the determination of profits of a PE, no deduction shall be allowed for amounts paid (otherwise than towards reimbursement of actual expenses) by the PE to the head office of the enterprise or any of its other offices by way of royalties, fees or other similar payments in return for the use of patents or commission for specific services performed.

3.8.5 Audit noticed that except in respect of DTAAs with USA and UK, above provision of UN Model convention has not been considered in any other DTAA. Consequently, in respect of at least 10 DTAAs scrutinized in audit, expenditure incurred by the PE towards royalty, fee for technical services would become an allowable expenditure, thereby reducing the taxable income leading to loss of revenue. Audit could not quantify loss of revenue on this score, as the field offices of the department did not have any specific mechanism or procedure designed to watch and prevent the same.

3.8.6 Income from dividends, interest, royalty and technical fees

India generally follows UN Model for taxation of various sources of income like dividends, interest, royalty, and technical fee. Rates of taxes, which may be withheld from dividends, interest, royalty are to be negotiated bilaterally, unlike the OECD Model which specifies the maximum rate. However, where a DTAA provides for a particular mode of computation of income, the same shall be followed irrespective of the provisions of the Act.

3.8.7 Benefits accruing to India by agreeing to different rates of taxation and cost involved or opportunities foregone were not ascertainable in audit. With new trade arrangements coming into force on account of WTO obligations, it becomes imperative that the DTAAs that India had entered into are also appropriately revised in consonance with the comparative advantage arising there from. A conscious and well planned cost benefit analysis would need to be attempted to quantify revenue foregone on account of taxation rights conceded to other contracting states and exemptions granted by way of preferential tax treatments accorded to non residents, especially as DTAAs are not being placed before Parliament.

3.8.8 Taxation of receipts on sale of software by non residents

Computer software means a computer programme recorded on an information storage device containing instructions to the computer. It would contain a source code and an object code, the authorship of which is protected by copyright. The

transfer of software may involve mixed contracts wherein the ratio between various heads of income like capital gains or business or royalty need to be carefully determined so that interest of revenue is safeguarded.

3.8.9 Examination in audit revealed that while in the case of DTAAs with Russia and Morocco, payment for transfer of computer software is treated as 'royalty', in the case of other DTAAs especially Indo-US DTAA there is no such specific mention. Audit examined assessments of 10 companies in the charge of **DIT (IT) Bangalore** to which the Indo-US DTAA applied, relating to the assessment years 1999-2000 to 2003-04. The assessees had preferred an appeal against the assessments, which sought to tax the payments for computer software as 'royalty', on the ground that the DTAA did not clearly specify that payment should be categorized as royalty. The aggregate tax demand involved in these 10 cases was **Rs.54.78 crore** which could have been realized if the Indo-US DTAA had contained specific provisions on the lines of other DTAAs or an amendment was proposed and effected to the DTAA safeguarding interests of revenue.

3.8.10 Assistance for recovery

One of the purposes for entering into DTAAs is providing assistance for recovery of taxes under the respective statutes of the contracting states. While specific provisions exist in DTAAs with South Africa, Belgium and Denmark, these are conspicuous by their absence in DTAAs concluded with USA, UK and Singapore.

3.8.11 In **Delhi, DIT (IT) and CIT XII** charge, recovery of demands aggregating **Rs.1.53 crore** pertaining to non-residents belonging to USA (**Mr. Eugene Theroux and Mr. Vikram Vadhera**) could not be enforced in the absence of provisions of assistance of recovery in Indo-US DTAA. Similarly, in another case **(M/s. Classic Enterprises)** under **DIT(IT) Bangalore** charge, tax demand of **Rs.1.15 crore** could not be realized due to absence of the required provisions in Indo-Singapore DTAA. Ministry may consider effecting an amendment to the DTAAs for safeguarding interests of revenue.

3.8.12 DTAAs with OECD countries

Audit scrutiny of Indo-Belgium DTAA revealed that if India limits its taxation on royalties or fees for technical services to a rate lower or a scope more restricted in the DTAA with a third state which is a member of the OECD, then the benefit of such limitation /rate would automatically apply to Indo-Belgium DTAA. Similar provision exists in DTAAs with Netherlands and France.

3.8.13 Audit noticed that similar or corresponding privilege or benefit is not automatically available to India from the OECD countries. With the prospect of entry of new countries into OECD, Ministry will have to take utmost care in negotiating rates of tax, as these will have multi lateral implications affecting the existing DTAA with OECD countries.

3.8.14 Precautions will also have to be taken after conducting a transparent cost benefit analysis even in cases of countries (with which India has already concluded DTAA), becoming members of OECD subsequently, which could claim the benefit of lower rates or preferential treatment available to existing OECD countries. Even the converse may apply, as existing OECD countries could claim lower rates that India might confer to the other country that would become member of OECD, subsequently. Ministry may review the practice of extending preferential tax treatment to all OECD member countries automatically especially in the absence of corresponding provisions and reciprocity available to us.

3.8.15 Relief under the Act and DTAA simultaneously allowed.

As per the Act, where the Central Government has entered into a DTAA, then in relation to the assessee to whom such agreement applies, the provisions of the Act shall apply to the extent they are more beneficial to the assessee.

In **DIT (IT) Mumbai** charge, assessment of **M/s Abu Dhabi Investment Authority** for the assessment year 2001-02 was completed in summary manner. Income returned by the assessee comprised capital gains, which were claimed exempt under Indo-UAE DTAA and dividend income of Rs.19.69 crore which was claimed exempt under the Act.

3.8.16 When the assessee had opted for assessment under the provisions of the treaty, exempting dividends under the provisions of the Act, would become irregular. Audit scrutiny revealed that dividends would be taxable at the rate of 15 percent under the Indo-UAE DTAA and tax of **Rs.2.94 crore** was leviable. In this context, Ministry may need to clarify whether provisions of the Act and the treaty would apply simultaneously during the same assessment year and assessee could toggle between them for each item of income, as DTAA is an not an exercise in tax avoidance but avoidance of double taxation.

3.8.17 Irregular grant of exemption under DTAA

In case of a non resident engaged in the business of providing facilities or plant and machinery on hire for prospecting for or extraction of mineral oil, a sum equal to ten percent of aggregate amounts paid or payable whether in or out of India to the assessee shall be deemed to be income chargeable to tax. Board Instruction 1767 of July 1987 had laid down that ten percent of income on work done in India and one percent of all activities outside India relating to the above activities be adopted as income for three years beginning from assessment year 1987-88.

3.8.18 In **Uttaranchal, Dehradun** charge, the assessment of **M/s. Hyundai Heavy Industries Company Ltd.** for the assessment year 1999-00 was completed after scrutiny in March 2002. Audit scrutiny revealed that income from sources outside India was computed at one percent of gross receipts as per Board's instruction, which was applicable only for three years from assessment

year 1987-88 as against ten percent provided in the Act. This resulted in income of Rs.64.02 crore escaping tax involving a short levy of tax of **Rs.46.86 crore**.

3.8.19 The Ministry replied that income was computed under the Indo-Korea DTAA and the assessing officer had estimated the profits at one percent of the gross receipts from abroad. The reply is not tenable, as DTAA only specified the jurisdiction which would be competent to tax the profits arising to the PE, and not the quantum of profit, whereas it is the Act, which specifies the quantum of income chargeable to tax. Further, as the income arising abroad to the assessee has been attributed to the PE in India, computation of income chargeable to tax at one percent instead of ten percent of gross receipts was irregular.

3.9 Mutual Agreement Procedure

DTAAs lay down a mutual agreement procedure (MAP) for resolving disputes arising out of their application. The taxpayer may approach the competent authority of the contracting state of which he is a resident where he feels that the assessment to be made or order passed is not in accordance with the terms of the DTAA. The competent authority shall endeavor to resolve the dispute by mutual agreement with the competent authority of the other country. MAP is an additional mechanism for settling tax disputes and shall be given effect to notwithstanding any time limits under the domestic law of the contracting states.

3.9.1 The Board, vide instruction of November 2002, laid down the following procedure for giving the effect to the resolution of dispute under MAP.

- applicant shall be required to give an acceptance to the decision arrived at under MAP and that he will forego any right to appeal on the same issue.
- where the issue is under appeal, the assessing officer shall also obtain an undertaking from the assessee regarding withdrawal of appeal on the issue.
- where the appeal has been decided by the CIT (A) but the appeal is pending with the ITAT, MAP decision will be implemented only after the assessee withdraws his appeal from the ITAT. And where department has filed an appeal before the ITAT, the same shall also be withdrawn on the points on which the decision has been arrived at under MAP.

3.9.2 The Board issued instructions in April 2003 and March 2004 to the effect that the assessing officer shall keep the enforcement of collection of outstanding taxes in abeyance in respect of tax payers resident in the USA and UK who had furnished bank guarantee for the amount of tax under dispute in respect of whom MAP had been activated. Where no resolution is possible, intimation to this effect shall be given to the assessing officer who shall be entitled to conclude the assessment as per law in force and also invoke the guarantee in case the assessee fails to pay the demand.

3.9.3 Non production of MAP cases

In April 2004, audit requisioned details of all MAP cases, which were pending with or resolved during the period 1999-2000 to 2003-04 by the competent authority[§]. The Board in June 2004 stated that they did not have any record or details of action being taken by the assessing officers during the pendency of the issue or after the case was resolved under MAP. Audit called for further details of 36 MAP cases (October 2004) collected by the audit team from the list given by the Board. However, neither details of all the cases nor the connected records like correspondence with other competent authorities, reminders issued and reports were made available to audit despite repeated request. The Board in December 2004 forwarded the same list of 36 MAP cases without giving details of action taken. Audit attempted to selectively and independently examine the status of MAP cases in terms of cases resolved and cases under appeal from the assessing officers. Audit could examine only 28 cases.

3.9.4 Outstanding MAP cases

Audit noticed that MAP cases being pursued by the Board were pending resolution for periods ranging from two to five years as given in **Table 7** below.

(Rs. in crore)

Table 7: Outstanding MAP cases

No of MAP cases	Countries involved	Assessment Year involved	Status of cases	Revenue involved
5	USA	1996-97 to 2002-03	Two cases were pending from 1999, two from 2002 and one from 2003	88.48
2	UK	1996-97 to 2002-03	One case was pending from 1999 and other case from 2000	112.27
3	Japan	1997-98 to 2002-03	One case was pending from 2000 and two cases from 2001 &2002	176.98
1	Belgium	1999-2000	Pending from 2000	3.82
1	Sweden	1997-98	Pending from 2002	43.53
1	Spain	1996-97	Pending from 2003	0.34
Total				**425.42**

3.9.5 Further scrutiny of the above cases revealed the following:

- These cases were being simultaneously processed in appeal of which the appellate authorities were unaware.
- The assessing officers had not obtained requisite bank guarantees in three cases (**M/s Clifford Chance and M/s Link Laters and M/s INMARSAT, UK**), In one case, bank guarantee was obtained for Rs. 0.90 crore against demand of **Rs.1.99 crore** (**M/s Herbal Life International of America, USA**). In 6 other cases relating to Japan, Belgium, Sweden and Spain, no measures like obtaining bank guarantees, were taken to safeguard the interest of revenue.

[§]Joint Secretary(JS), Foreign Tax Division (FTD) in the Board

- Pendency of cases had resulted in not only blockade of revenue to the tune of **Rs.425.42 crore** but also could result in avoidable payment of interest on refunds due to delay in completion of MAP proceedings.

3.9.6 Inadequacy in implementing MAP resolutions

Audit noticed inadequacies in implementation of MAP resolution as indicated in the following paragraphs.

3.9.7 The assessing officer in the case of **M/s Delta Air Lines, USA** under the charge of **DIT (IT), Mumbai** sought to tax the income derived from servicing other airlines and providing personnel and equipment in India under article 5 of Indo-US DTAA for the assessment years 1992-93 to 1997-98. The assessee went in appeal against the above order in March 2000. Simultaneously, the assessee preferred an application in January 2001 to resolve the issue under MAP, which was accepted and taken up by the Board. In February 2002, MAP case was resolved in favour of revenue and the Board informed the assessing officer that the activity was rightly taxable in India. In the meantime, CIT (A) on 5 March 2002 issued a contrary decision favouring the assessee and a refund of **Rs.3.15 crore** was granted to the assessee.

3.9.8 In the case of **M/s Motorola, USA** under the charge of **DIT (IT), Delhi,** the issue under consideration was allocation of profits attributable to sales by Indian PE *vis a vis* global profits and taxability of certain payments as royalty. When Department sought to tax the same, the assessee sought relief by activating MAP. In December 2003, the competent authorities agreed that the receipts of the assessee were taxable in India. The resolution under MAP was yet to be given effect to by the assessing officer. In the meantime, assessee preferred an appeal with CIT (A), which is pending. Tax demands for the assessment years 1998-99 to 2001-02 amounting to **Rs.98.75 crore** were pending recovery.

3.9.9 In the case of **M/s Badger Energy, USA,** {**CIT (IT) Bangalore**}, the assessing officer concluded assessment for the assessment year 1997-98 determining a total tax of **Rs.0.49** crore treating certain expenditure incurred outside India as head office expenses. The assessee contested the above action before CIT (A). Simultaneously, the assessee sought redressal by activating MAP in May 2001, which was accepted and taken up by the Board. In the meantime, CIT (A) ruled in favour of the assessee. Department filed second appeal with ITAT, which was pending. Though the MAP case was resolved in favour of revenue in December 2003, no such communication was available with the assessing officer (July 2004). Non-availability of communication from the Board with the assessing officer regarding the resolution resulted in appellate authority taking a contrary view in favour of the assessee to the detriment of revenue.

3.9.10 Audit scrutiny revealed that in the above cases, when the competent authorities of the other states had agreed that certain streams of income were

indeed taxable in India, a contrary decision by the appellate authorities could have been avoided by better coordination amongst various authorities in the department which would have prevented loss of revenue. This not only indicated lack of coordination between the departmental officers and the appellate authorities on the one hand but also lack of effective monitoring by the Board.

3.9.11 Further, DTAAs being contractual in nature, the scope of taxation as negotiated by competent authorities in the contracting states shall be final, and the scope of such taxation may not be amenable to further interpretation or dispute before the appellate authorities. Thus, in so far as taxability of income arising from specific activities is concerned, the understanding of the competent authorities shall have precedence and such decisions arrived at after prolonged negotiations may, perhaps, be beyond the jurisdiction of departmental appellate authorities. Further, as the non residents paying tax in India have the option of availing credits in their home countries, any relief contemplated by appellate authorities may only result in shifting of tax base out of India. Hence, the mechanism of MAP needs to be appropriately redesigned to not only prevent double taxation but also collect revenue, which rightfully belongs to India.

3.9.12 Delay in implementation of MAP resolution

In **Delhi DIT (IT)** charge, the case of **VISA Service International Association, USA,** was taken up under MAP in 1999 to resolve the issue of taxability of receipts accruing to permanent establishment (PE) from business activities in India for assessment years 1997-98 and 1998-99. The competent authorities resolved in September 2003 that certain streams of income were indeed taxable in India, which was communicated to the assessing officer with instructions to give effect to the resolution within 90 days (i.e. by December 2003). The resolution which resulted in a refund was however, given effect to only in March 2004, after a delay of three months resulting in avoidable payment of interest on refund aggregating **Rs.11.23 lakh.**

3.9.13 Closure of MAP cases without any resolution

In **Delhi DIT (IT)** charge, cases pertaining to **M/s Galileo International, and American Airlines Inc USA** (of **M/s SABRE Group)** for the assessment years 1996-97 to 2001-02 involving a tax revenue of **Rs.36.23 crore and Rs.17.99 crore, respectively,** were closed without a mutually acceptable settlement. Assessees had preferred appeal under domestic law and demands were stayed. In the absence of specific clause for assistance for recovery of taxes in the Indo-US DTAA, bank guarantees ought to have been obtained. Failure to do so had jeopardized the interests of revenue to the extent of **Rs.54.22 crore**.

3.9.14 Deficiencies and inconsistencies in MAP

Audit noticed the following deficiencies and inconsistencies.

- There is no prescribed time limit within which the MAP cases are to be resolved leading to prolonged negotiations and blockade of revenue
- There are no instructions on the action to be taken by the assessing officer when the case is being simultaneously processed under MAP and appeal
- Except in the case of UK and USA, there are no instructions to obtain bank guarantee to safeguard the interest of revenue for disputed demands.
- The option given to the assessee for accepting or rejecting the resolution, has rendered the dispute resolution mechanism totally ineffective, as the assessee would still have the option of taking up the case under normal appellate channels in spite of resolution by competent authorities being in favour of revenue.
- Incidentally, Ministry may like to note that the Revenue Procedure 2002-52 of Inland Revenue Service (IRS) of USA, specifically provides for coordination between the appellate authorities and IRS. The US competent authority will not, without the consent of appellate authorities accept or continue to consider a taxpayer's request for assistance if the matter is already agitated in the Courts. Further, in case of simultaneous process under MAP and appeal, the concerned representatives will consult each other so that the terms of resolution and the principles and facts upon which it is based are compatible with the position that the competent authority intends to present to the foreign competent authority with respect to the issue. However, in India, no such procedure has been adopted.

3.10 Exchange of Information

3.10.1 DTAAs provide that competent authorities of contracting states shall exchange such information as is necessary for applying the provisions of DTAAs or of domestic laws of the contracting states.

3.10.2 Audit made efforts to examine the system of exchange of information in the Board, with a view to analyzing whether the information sought from foreign countries were received promptly and 'follow up' action being taken by the assessing officers was being monitored. Board did not make available the relevant records and only furnished a list of 123 cases of "exchange of information" processed between January 2000 and March 2004 which indicated that 61 were finalized and 62 were pending.

3.10.3 Only a few cases could be examined as complete details like assessment years, tax implications and details of the representation received from the field offices were not made available by the Board. Audit noticed that there was no monitoring of the action taken by the assessing officers in respect of the cases where information had been received. Details of pursuance with the corresponding authorities in these countries were not available for verification in audit. A perusal of records with the assessing officers revealed the following.

3.10.4 In **Kerala, Ernakulam** charge, information was sought to verify the genuineness of gifts received by an assessee, **Mr. John George Vettath** and his family members from a non-resident, (Mr. John Paulose Vettath). The information called for from four countries (Malaysia, UAE, Indonesia, and Singapore) in July 1998 was yet to be received. Audit scrutiny revealed that the assessment was concluded in October 2003 without disallowing gift of Rs.90 lakh involving tax effect of **Rs.60.58 lakh**. Thus, efforts at exchange of information proved unfruitful.

3.10.5 In **Gujarat, Ahmedabad-I** charge, an assessee **(Shri Kamal Galani, Mumbai**) had made investments out of foreign remittance of Rs.3.78 crore. The assessing officer had made a reference to the Board in October 2002 who, however, forwarded the same to the UAE authorities only in January 2004 after more than one year of receipt of reference from the assessing officer. The assessment was finalized in July 2004 pending receipt of information from the Board without disallowing or adding back the amount of Rs.3.78 crore involving a tax effect of **Rs.2.45 crore**. Here also, the efforts of utilizing the facility of exchange of information proved unsuccessful.

3.10.6 In **Gujarat, Ahmedabad, DIT (Investigation)** charge, two assessees (**Shri Atul Sheth & Mukesh Sheth, Rajkot**), had received gift of Rs.4.70 crore from non-residents in UAE. The assessing officer had made a reference to the Board on 25 November 2002 who in turn forwarded the same to UAE authorities in December 2002. No information had been received so far. The assessment was concluded without adding the above amount of Rs.4.70 crore jeopardizing the interest of revenue involving a tax effect of **Rs.3.05 crore**.

3.10.7 In **Gujarat, Ahmedabad DIT (Investigation)** charge**, Shri Chitra Publicity Company, Ahmedabad** & its managing partners had received gifts of more than Rs.2.17 crore from non -residents in USA. The assessing officer had made a reference to the Board in November 2002 reply to which was received in May 2004. In the meantime, assessing officer concluded the assessment in December 2003, adding bogus gift involving tax revenue of Rs.1.15 crore. Assessee went in appeal. Audit scrutiny revealed that the information received in May 2004 confirming the apprehension of revenue that it was a case of bogus gift was not conveyed to CIT (Appeal) resulting in appellate authority deleting the additions made in the assessment on account of bogus gifts in July 2004. The department filed further appeal to ITAT. The department could have collected tax of **Rs.0.46 crore** (at the rate of 40 percent of Rs.1.15 crore) and saved the effort of appealing in ITAT, if the information confirming the bogus gift received in May 2004 was promptly and properly produced before CIT (Appeals).

3.10.8 In **Andhra Pradesh, Hyderabad** charge, information sought from the Board in five cases **(Lanco Group, United Exports, Oil Country Tubular Ltd, Harmahendar Singh Bagga & KGR Exports, Vizag)** from foreign countries was pending for periods ranging from one to three years. Assessments were concluded without adding back the amounts involving tax levy of **Rs.67.13 crore**

3.10.9 In the above cases, the assessing officers had suspected the bonafides of certain transactions involving substantial revenue implication. Verification through the Board however was not forthcoming in time and assessing officers had to complete the assessments without having been satisfied regarding the genuineness of investments or expenditure in order, perhaps to meet the deadline of limitation of time of completion of assessments. Tax involved in the above test checked cases aggregated **Rs.73.69 crore**.

3.11 Mistakes in application of DTAA provisions

3.11.1 Incorrect allowance of loss relating to Branch operations outside India

Indo-USA DTAA provides that income/loss of the branch office is assessable in USA and to that extent the same shall not be considered for taxation in India.

In **Karnataka, Bangalore-I** charge**,** the assessment of M/s **Aditi Technologies (P) Ltd** for the assessment year 2001-02 was completed in summary manner in October 2002 at 'nil' income after allowing deductions in respect of losses pertaining to branch operations in U.S.A. The assessee incorrectly claimed the loss of Rs.17.52 crore of U.S.A. branch operations in India, despite stating in enclosures to the return of income, that the loss pertaining to USA branch office was not considered for claiming deductions. This resulted in excess allowance of deduction amounting to Rs.17.52 crore involving short levy of tax **Rs.6.13 crore**.

3.11.2 Business profits taxed as royalty

DTAAs provide that where fees for technical services and interest are paid to a non-resident, tax shall be withheld at the prescribed rates on gross basis[*]. In case, the payments of the nature referred to above are related or connected to a PE, then such income is taxable as 'Business profits' at rates specified in the Act.

In **Andhra Pradesh, Hyderabad** charge, the assessment of **M/s Louis Berger International Inc USA**, for the assessment year 2002-2003 was completed in summary manner in March 2003 accepting the income returned. The assessee provided engineering consultancy for infrastructure projects in India through a PE. Hence income accruing to the assessee was taxable as 'business profit' at the rate of 20 percent as prescribed in the Act, as against 15 percent paid by the assessee. Incorrect application of provisions of DTAA resulted in short levy of tax of **Rs.1.12 crore** including interest.

3.11.3 Incorrect allowance of Double Taxation relief

Under the Act, a person resident in India is entitled to relief on his foreign income taxed both in India and in a foreign country. The quantum of relief is governed by DTAA entered into by the two countries.

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[*] Gross basis means total receipts without allowing for any expenditure.

In **Karnataka, Bangalore-I,** charge, the assessment of M/s **Infosys Technologies Ltd**. for the assessment year 2001-02 was completed after scrutiny in March 2004. Audit scrutiny revealed that while allowing double taxation relief of Rs.17.99 lakh, lower figures of total turnover as available in the original return of income were adopted instead of revised and higher total turnover worked out in the assessment order. Actual relief worked out to Rs.11.65 lakh. This resulted in excess grant of double taxation relief of Rs.6.34 lakh involving short levy of tax of **Rs.12.38 lakh** including interest.

3.11.4 Incorrect exemption of interest income under DTAA

As per Article 8 of Indo-US DTAA, where an enterprise derives profits from operation of ships or aircraft in international traffic or interest on funds connected with such operations, the same shall be taxed in the contracting state. However, interest arising to an enterprise from any other source shall be taxed in the contracting state in which interest arises, at 15 percent of gross amount.

In **Mumbai, DIT (IT)** charge, assessment of **M/s Delta Airlines**, a foreign company, for the assessment year 2003-04 was completed in summary manner in February 2004. The assessee had claimed exemption of interest of Rs.70.38 lakh under Article 8 of Indo- US DTAA. Audit scrutiny revealed that interest income comprised interest on income tax refund of Rs.60.96 lakh and interest on fixed deposit of Rs.9.43 lakh. Interest received on refund and fixed deposit cannot be considered as part of profits derived from the operation of aircraft in international traffic eligible for exemption under Article 8 of the Indo-US DTAA. Assessee had also claimed similar exemption for assessment year 2001-02 which was allowed while processing the return in summary manner in January 2003. Incorrect allowance of exemption resulted in short levy of tax aggregating **Rs.13.12 lakh**.

3.11.5 Incorrect taxation of income from royalty and fees from technical services under DTAA provisions

Tax is leviable on interest, royalty and fees for technical services on gross basis. Income arising on account of the above in a contracting state and paid to resident of the other contracting state may be taxed in either of the contracting states subject to conditions specified in the DTAAs. In **DIT (IT) Mumbai** charge, audit noticed that in seven cases there was short levy of tax of **Rs.1.95 crore** as royalty was not taxed on gross basis. Details are shown in **Appendix 29 at Sl. No. 1 to 7.**

3.11.6 Non-levy of surcharge

DTAAs concluded with several countries like USA and UK while defining taxes covered under the treaty mention not only income tax but also surcharge levied thereon. In respect of payment made towards royalty, fees for technical services and interest by a resident to foreign companies, the Finance Acts 2002 and 2003,

provided for levy of surcharge at the rate of 5 percent and 2.5 percent respectively, on tax deducted at source.

Test check of the assessments of non-residents revealed that surcharge was not being levied. Loss of revenue due to inconsistency in levy of surcharge in 97 cases amounted to Rs.1.32 crore as indicated in **Table 8** below:

(Rs. in crore)

Table 8: Non levy of surcharge

Name of charge	No. of cases	Assessment year	Tax effect
DIT(IT), Bangalore	35	2002-03	0.53
--do--	41	2003-04	0.37
DIT(IT), Chennai	95	2003-04/2004-05	0.42
Total			**1.32**

3.11.7 Board during Exit Conference (February 2005) did not accept the audit observation on the ground that the rates prescribed by DTAA were inclusive of surcharge and treaty law overrode domestic law. Board's view is not acceptable as DTAAs provide that taxes covered in India are income tax 'including' any surcharge thereon. Further, 'relief from double taxation' as enshrined in DTAA affords credit for income tax as well as surcharge levied thereon. Assessees can also claim credit for surcharge paid in the country of residence, where return of income is filed. The Working group on non-resident taxation in its report of January 2003 had also highlighted the need for clarification by the Board on levy of surcharge.

3.11.8 Mistakes in application of minimum alternate tax provisions (MAT)

It has been held[**] by Authority for advance rulings (AAR) that the MAT provisions under section 115JA/115JB of the Act are also applicable to foreign companies. Double taxation relief will be allowable under normal provisions of the Act and not under MAT provisions.
In **Mumbai, DIT (IT)** charge, audit noticed mistakes in four cases involving tax effect of **Rs. 5.49 crore** where double taxation relief was allowed on tax payable under MAT. Details are shown in **Appendix 29 at Sl No. 8 to 11.**

3.11.9 Income escaping assessment

As per DTAAs, income of foreign companies having PE in India would be assessed to tax in accordance with normal provisions of the Act. Audit examination revealed that there was short levy of tax of **Rs.33.20 crore** as such income was not taxed under the Act. Few instances are detailed below and the remaining are highlighted in **Appendix 29 at Sl. No. 12 to 24.**

3.11.10 In **Chennai, DIT (IT)** charge, a foreign company, **M/s Kier International**, incorporated in UK set up a project office at Chennai to execute marine works. For the assessment year 2000-01, the assessee returned a loss of

[**] 234 ITR 335 & 234 ITR 828

Rs.18.69 crore which was accepted after scrutiny. Audit scrutiny revealed that the assessee had not offered an income of Rs.18.34 crore to tax which had accrued on account of activities by the project office in India, but received directly by the Head Office in UK. Omission to include income of Rs.18.34 crore resulted in short assessment involving tax effect of **Rs.8.80 crore.**

3.11.11 In **Chennai, DIT (IT)** charge, the promoters of an Indian company **M/s ST CMS Electric Company Pvt. Ltd** were from USA and Netherlands. The company was incorporated to build, own and operate a thermal power plant in Neyveli, Tamil Nadu and hence it had a PE in India. The company had made payments in foreign currency to entities abroad towards engineering, design, equipment supply, civil and infrastructure services during the assessment years 2000-01 to 2002-03 totalling Rs.60.37 crore without deducting tax of **Rs.9.06 crore** at source.

3.11.12 In **Kolkata, DIT (IT)** charge, the assessment of **M/s Price Waterhouse Coopers Ltd, USA**, for the assessment year. 2000-01 was completed in summary manner in March 2003 at a total income of Rs.85.35 lakh. The assessee had received Rs.1.95 crore from M/s. Reliance Industries Ltd. (RIL) Mumbai on account of consultancy work carried out in India. This amount was remitted directly by RIL to the assessees' principal in USA on the basis of 'no objection certificate' obtained from the department in Mumbai without withholding required tax. This income was not offered to tax by the assessee, leading to underassessment of income of Rs.1.95 crore involving short levy of tax of **Rs.0.59 crore**.

3.11.13 In **Kolkata, DIT (IT)** charge, an assessee company, **Leonhardt Andra Und Partner GMBH** registered in West Germany, had entered into a contract in July 1974 with Hoogly River Bridge Commissioners (HRBC), West Bengal in connection with the design and supervision of construction of the bridge. Payments made by HRBC to the assessee on the above activities were taxed. On appeal by the assessee, CIT (A) set the assessments aside and allowed relief for the assessment years 1983-84 to 1991-92. Department approached ITAT which also favoured the assessee. On further appeal by the department, Kolkata High Court held that supervision charges being in the nature of technical services were taxable in India as provided in Indo-German DTAA. However, department failed to act upon the judgement of the High Court.

3.11.14 Audit scrutiny revealed that the assessee had received a sum of Rs.7.91 crore for the said assessment years as supervision charges (excluding 1988-89). Failure to give effect to High Court order resulted in non-levy of tax of **Rs.0.79 crore**. Department stated that the copy of the High Court order dated 12 December 2000 had not been received. The reply is not tenable as the judgement was widely available including in the Income Tax Reports (ITRs).

3.11.15 In **Mumbai, DIT (IT)** charge, the assessment of **M/s. A.P. Moller**, a partnership firm resident in Denmark, for the assessment year .2001-02 was

completed after scrutiny in March 2004. Income from shipping business was computed at 7.5 percent of gross receipts of Rs.1382.80 crore at Rs 103.71 crore under section 44 B of the Act. It was noticed that an amount of Rs.9.85 crore towards rebate was deducted from the gross receipts, which was irregular. This resulted in short computation of income of Rs.73.86 lakh (7.5 percent of Rs.9.85 crore) involving short levy of tax of **Rs.41.69 lakh** including interest.

3.11.16 Mistake in allowing credit for taxes paid abroad

Relief from double taxation shall be provided through the exemption method or the credit method. In the former method, income from the country of source is treated as fully exempt in the country of residence whereas in the latter, the country of residence grants a credit of tax paid in the country of source against the tax chargeable under its own laws.

3.11.17 Audit noticed that assessees from India having operation in foreign countries with which India has DTAAs have been declaring losses from operation in such foreign countries under the Indian Income Tax Act in addition to availing incentives under section 10A/10B of the Act. Tax credits had been claimed even when there was a loss from business activities abroad in addition to claiming disproportionate tax credits. Further, audit noticed inconsistencies in affording credit to taxes paid abroad due to variation in definition of assessment years as also instances where refund had been granted in India though corresponding tax had been deducted at source abroad. These irregularities resulted in short levy of tax of **Rs.20.19 crore** in 7 cases. Few instances are highlighted below, other cases being noted in **Appendix 29 at Sl No 25 to 27.**

3.11.18 In **Andhra Pradesh, Hyderabad** charge **M/s Satyam Computer Services Company Limited (SCSCL)** claimed credit of tax of Rs.44.72 crore paid in USA in the assessment year 2003-04 on its income of Rs.108.32 crore from USA Branch office and the rate of tax worked out to 41.28 percent. As per Article 25 of Indo-US DTAA, the credit for taxes paid in USA shall not exceed that part of income tax, which is attributable to the income, which may be taxed in USA. However, it was seen from the returns for the assessment years 1998, 1999 and 2000 filed in USA, that the rate of tax applicable was 34 percent. Hence the credit of tax had to be restricted to 34 percent instead of 41.28 percent. The excess tax credit worked out to **Rs.7.88 crore**. In this context, it may be pointed out that as per US tax laws, losses arising abroad shall be set off only when there is taxable income from foreign sources.

3.11.19 In the case of the same assessee, for the assessment years 1998-99 to 2003-04, interest on account of default in payment of advance tax on the income returned in India was worked out treating taxes paid abroad as advance tax. There is no provision in the DTAAs to treat the tax paid in USA or any other country as advance tax. Hence, interest on account of default in payment of advance tax is to be worked out and levied before giving credit to taxes paid abroad. Failure to do

so resulted in short levy of interest of **Rs.6.55 crore** for the assessment years 1998-99 to 2003-04 apart from non-levy of interest for deferment of advance tax of **Rs.4.80 crore** for the assessment year 2003-04.

3.11.20 The same assessee **(SCSCL)** filed return of income for the assessment year 2003-04 in November 2003, which included a loss of Rs.1.04 crore from its Australian branch and claimed credit of Rs.47.69 lakh being tax paid in Australia. When the assessee had returned loss from Australian Branch, the credit of tax paid in Australia was not to be allowed, as there was no double taxation of the same income. Further, as per Indo-Australia DTAA, credit for tax on income arising in Australia shall not exceed the proportion of Indian tax, which such income bears to the entire income chargeable to tax in India. Incorrect allowance of tax credit resulted in short demand of **Rs.47.69 lakh**.

3.11.21 **SCSCL** also claimed tax credit of Rs.1.59 crore on its UK Branch income of Rs.1.28 crore which works out to **124 per cent** of taxable income for the assessment year 2003-04. Similarly, the assessee paid tax of Rs.27.64 lakh on its Canada Branch income of Rs.10.74 lakh, which works out to **257 per cent** of taxable income. Although, the credit of taxes claimed was abnormally high, the same was allowed by the assessing officer without proper examination.

3.11.22 Inadequacies in allowing tax credit

Audit examination revealed that the following issues would need to be clarified by the Board to ensure that the assessing officers adopt a consistent practice in allowing tax credits.

- Method and quantum of tax credit allowable when there is difference between tax assessment year in the foreign country and India.
- Documents necessary for claiming tax credits, such as, proof of return filed in foreign country, non claiming of refund of foreign taxes paid etc.,
- Stage at which credit is to be allowed in assessments i.e. as advance tax or TDS or self-assessment tax, etc.
- Tax credit allowable where incomes are not liable to tax in India as per DTAA or as per domestic law such as income exempt u/s 10A and
- Tax credit allowable to companies, which are taxable under special provisions of the Act (MAT).

3.11.23 Some assessees were declaring losses from operations of branches set up abroad, which were being carried forward for adjustment in subsequent years under the Indian Income Tax Act and were also given credit for taxes paid abroad through these branches. Ministry may examine the rationale for bestowing such multiple benefits to the same assessee and consider a review of the existing practice so that excessive and misplaced claims of relief are not allowed.

3.12 Mistakes in taxation of maritime business of non-residents

Provisions relating to taxation of shipping business of non-residents have been described in paragraphs **3.2.2 to 3.2.5** above.

Audit noticed inconsistencies in issue of 'no objection certificate' (NOC) and instances of allowance of DTAA relief where there were no agreements but exemption was allowed to Indian ships. In some cases, tax relief was allowed invoking provisions of inapplicable DTAAs, which was irregular. These mistakes resulted in short levy of tax of **Rs.18.53 crore**. Few instances are illustrated below while the remaining are noted in **Appendix 30.**

3.12.1 NOCs were to be issued and DTAA relief allowed only after verifying the eligibility criteria of non-residents, which, inter alia, included scrutiny of non-resident's nationality, charter party agreements, nomination of agent, freight movement particulars and ownership of the ship. In **Gujarat, Jamnagar, Ahmedabad, Surat and Baroda** charges in 235 cases, tax relief aggregating **Rs.10.95 crore** had been granted without due scrutiny of requisite details which was irregular. Further, in **Jamnagar** charge, relief of **Rs.5.47 crore** had been granted in 105 cases without confirming authenticity of agent's particulars. Thus, it was not clear as to how the assessing officers had satisfied themselves that NOCs were issued only in bonafide cases.

3.12.2 In 17 cases in **Goa, Madgaon and Andhra Pradesh Kakinada** charge, tax of **Rs.96 lakh** was not levied on shipping profits by incorrectly invoking DTAA applicable to nationality of owner of the ship as against the DTAA applicable to nationality of freight beneficiary.

3.12.3 In 9 cases in **Ahmedabad, Madgaon and Kakinada** charges relief of **Rs.66.45 lakh** was irregularly allowed to non-residents of countries with which there were no agreements by invoking DTAAs of third countries where shipping profits were exempt.

3.12.4 Default in filing /non-assessment of returns filed by non-residents

Though subsequent to obtaining NOCs a prescribed return was to be filed and duly assessed by the assessing officer, adequate attention was not being bestowed for ensuring the same. Audit attempted an analysis of the effectiveness of the procedure adopted and the promptness of the assessment completed under section 172(4) of the Act in the CIT charges of Goa, Mumbai and Gujarat. Audit noticed that the returns were either not filed or were filed after the prescribed time limit and no follow up action was initiated by the assessing officer as envisaged in Board instruction of June 1975, as detailed in **Table 9** below:

Table 9: Default in filing of returns and non completion of assessments of returns filed

Charge	Period	Number of NOCs issued	Number of returns filed	Number of assessments made	Percentage of returns filed	Percentage of assessments completed
Goa, Madgaon	2000-01 to 2003-04	1328	Not indicated in records	688	Not known	52
Gujarat, Jamnagar Ahmedabad Surat & Baroda	-do-	9846	5341	2133	54	40
Mumbai DIT(IT)	2001-02 to 2003-04	4032	3672	76	91	2

3.12.5 There was thus, a substantial short fall in the number of returns filed in comparison to NOCs issued. The position of final assessments made under section 172(4) was rather alarming as only around 2 percent of the returns filed were assessed in Mumbai and 52 percent and 40 percent in Goa and Gujarat charges respectively. Audit could not assure itself that required seriousness was being bestowed by assessing officers on monitoring receipt and more importantly on completing assessments promptly. The Board could have ensured this by prescribing periodical reports from assessing officers regarding disposal of returns filed by nonresidents involved in shipping business. In none of the previous five years had assessments been concluded under section 172 (4) of the Act, by selecting the same for scrutiny in accordance with instructions issued by the Board. It would appear that essential responsibility of assessing officers for safeguarding interests of revenue was not being discharged and the department ended up considering issue of NOCs as an end in itself. The loss of revenue if any, on this score is completely unascertainable as monitoring mechanism left much to be desired.

3.12.6 Inadequacies in law in respect of taxation of shipping business by non residents

Audit examination revealed that there were several inadequacies in monitoring mechanism and lacunae in the Act in respect of taxation of shipping business of non-residents, which would have adverse implication on revenue.

3.12.7 Since there is neither any return under section 139 nor any assessment year involved where an assessment is made under section 172, neither can reassessment proceedings under section 147[*] nor rectificatory proceedings under section 154[@] be initiated. For similar reasons, the CIT is barred from reopening the assessment under section 263 of the Act. Further no interest is leviable in cases of default in payment of taxes or non-filing of returns as available under

[*] [1995] 215 ITR 103 (Pune AT) South India Corporation (A) Ltd.
[@] [1991] 371 ITD 356 (AHD) MV Belstar

sections 234A and 234B of the Act. These ambiguities need to be rectified by suitable amendment to safeguard interests of revenue especially as required seriousness is not being bestowed by assessing officers for completing assessments

3.12.8 Board's circular of June 1975 states that if the non-resident makes suitable arrangement for filing of returns and payment of taxes, and assessing officer is satisfied of the same, he will advise all the jurisdictional income tax officers dealing with ports, to grant 'port clearance' to ships during the financial year. Though the system of issuing multiple NOCs to the same ship was sought to be curbed, it was only during December 1995 the Board issued another circular after a lapse of 20 years.

3.12.9 Board's circular of December 1995 states that annual NOCs shall be issued after obtaining an undertaking from the shipping company to the effect that during the period of currency of NOC, no ship belonging to it will be engaged in any traffic other than international traffic. Annual certificates were being issued by applying DTAA based on nationality of owner. However, no mechanism is available to monitor activities of such ships when nationals of other countries were chartering the same and where shipping profits were taxable in India.

3.12.10 The system of taxation under section 172 was intended for occasional shippers. Occasional[*] or casual means accidental or fortuitous, suggesting absence of any entertained object or intention. Ministry may, under the circumstances, like to review as to how entities that were engaged in regular shipping business could be allowed the benefit of section 172.

3.13 Mistakes in application of various provisions of the Act

Examination of assessments of non-residents or assessments involving payments to non-residents, which were taxable in India, revealed various mistakes such as excess allowance of deduction in respect of head office expenditure, incorrect deduction in respect of provision for bad and doubtful debts and for payments made outside India without deducting tax at source, incorrect deduction of receipts for services rendered in India, incorrect taxation of capital gains, irregularities in deduction of tax at source and completion of assessment proceedings, incorrect application of exchange rates while computing taxable income and non levy of applicable interest for default in filing of returns or for shortfall in payment of advance tax as also deferment in payment of advance tax. Instances involving short levy of tax in excess of Rs.25 lakh each are highlighted below.

[*] Ramanathan Chettiar Vs CIT (1967) 63 ITR 458 (SC)

3.13.1 Excess allowance of deduction in respect of head office expenditure

Under section 44 C of the Act, an assessee, being a non-resident, is entitled to a deduction on account of head office expenditure to the extent of five per cent of the adjusted total income or actual expenditure whichever is less.
In **DIT (IT) Mumbai** charge, audit noticed that in four cases, assessee's claims for deduction of head office expenditure were incorrectly allowed involving short levy of tax of **Rs.6.37 crore** as shown in **Appendix 29 at Sl No. 28 to 31.**

3.13.2 Incorrect deduction in respect of provision for bad and doubtful debts

A bank incorporated outside India is entitled to deduction on account of provision for bad and doubtful debts at five per cent of total income before making any deduction under Chapter VI. The deduction allowable in respect of bad debts written off in such cases is to be restricted to the amount, which is in excess of the credit balance in the provision of doubtful debts account.

In **DIT (IT) Mumbai** charge, audit noticed that in five cases, assessee's claims for deduction on account of bad debts written off were allowed without considering balance in provisions for bad and doubtful debts involving tax effect of **Rs.4.53 crore**. Details are shown in **Appendix No. 29 at Sl. No. 32 to 36.**

3.13.3 Incorrect deduction for payments made outside India without TDS

Where, in any financial year, assessee has paid interest, royalty, fees for technical services or other sum chargeable to tax, which is payable outside India, on which tax has not been paid or deducted at source as specified in the Act, such amounts shall not be deducted in computing the income chargeable to tax.

The assessment of **M/s. Standard Chartered Bank (Mumbai City 1** charge**)** and **M/s. H.C.C. Pati Joint Venture (Mumabi City 23** charge**)** for the assessment years 1999-00 and 2002-03 had been completed after scrutiny and in summary manner respectively, without disallowing payments, which had been made abroad on which tax had not been deducted at source. This resulted in under assessment of income involving a short levy of tax of **Rs.58.89 lakh**.

3.13.4 Incorrect deduction on receipts for services rendered in India

Where the total income of an assessee includes any income by way of commission or other similar payment received in convertible foreign exchange from a foreign enterprise and brought into India within specified period, a deduction equal to fifty percent of such income is allowed. The income qualifying for exemption shall include amounts on account of services rendered from India but shall not include services rendered in India.

In **Mumbai City II** charge, the assessment of **M/s Heartly and Gresham (I) Ltd** for the assessment year 1997-98 was completed after scrutiny in November 1999 after allowing deduction of Rs.63.97 lakh towards income from foreign enterprise. Audit scrutiny revealed that the assessee was not entitled to deduction, as service charges from the foreign enterprise were for supply of information regarding market conditions in India and for collecting strategic information to secure sales orders in India. Incorrect allowance of deduction of Rs.63.97 lakh resulted in short levy of tax of **Rs.43.49 lakh** including interest.

3.13.5 Incorrect taxation of capital gains

Long-term capital gain and short-term capital gain are to be considered as distinct sources of income and taxed at rate of 10 percent and 30 percent respectively (upto 1 October 2004).

In **Mumbai DIT (IT)** charge, the assessment of **M/s. Morgan Stanley Dean Witter Investment Management Inc**. for the assessment year 2001-02 was completed after scrutiny in February 2004. Short term capital gain of Rs.2.14 crore taxable at the rate of 30 percent was set off against long term capital loss which was not permitted under the Act. In the process, the assessing officer ended up applying lower rate of taxation involving short levy of tax of **Rs.42.86 lakh.**

3.13.6 In **Mumbai DIT (IT)** charge**,** two instances of application of incorrect rate of tax on long term capital gains involving short levy of tax of **Rs.27.20 crore** were also noticed details of which are noted in **Appendix 29 at Sl. No. 37 and 38.**

3.13.7 Issue of notice for assessment under an inapplicable provision

In **West Bengal, DIT** charge, the six non-resident companies were doing business in India through their Indian agent, **M/s. PILCOM**. No returns were initially submitted either by non-resident companies or by their agent for income taxable in India, for the assessment year 1996-97. The department issued notice on 30 March 1999 under section 148 of the Act directly to the non-resident companies whereas assessment was concluded in the name of Indian agent in March 2002 creating a demand of Rs.7.35 crore. On appeal by the assessee, CIT appeal set-aside the assessment since notice under section 148 was irregularly issued to the foreign companies, which should instead have been issued to their agent in India under section 163 of the Act. Departmental appeal in ITAT was also set aside on similar grounds. The Department have preferred an appeal in High Court of Kolkata which is pending. Failure of the department in following the correct procedure in issuing notice resulted in blockade of revenue of **Rs.7.35 crore,** which could turn into a loss of revenue, as well.

3.13.8 Irregularities in deduction of tax at source

Section 195 of Income Tax Act provides that tax shall be deducted at source on payments to non-residents. In **Chennai DIT (IT)** charge, the assessee (**M/s Satyam Infoway Ltd**) incurred an expenditure of Rs.77.44 crore in foreign currency towards share issue expenses, legal and professional charges, royalties and other related expenses for assessment years 2000-01 to 2003-04.

Tax had not been deducted at source on the above payments except for assessment year 2001-02. Audit scrutiny revealed that expenses incurred towards legal and professional charges, share issue expenses, etc were taxable as "fee for technical services" in the hands of recipients (non-resident). However, neither had the non-resident filed any return of income nor any assessment concluded on the assessee in representative capacity. The total short levy of tax on payments made to non-resident amount to **Rs.11.35 crore**.

3.13.9 In **Andhra Pradesh, Hyderabad** charge, returns of income of **M/s Nippon Koei Company Limited, Japan** for the assessment years 1999-2000 and 2000-01 were filed by the representative assessee viz. the Superintending Engineer (SE) Kurnool beyond the specified date in January 2003. Returns were treated as *non est* and the assessee was informed in March 2004. However, no assessment proceedings were initiated.

Audit scrutiny revealed that SE did not file annual return of TDS and remitted the entire TDS of Rs.1.50 crore in lump sum for the assessment years 1999-2000 and 2000-01 in January 2003. Since the representative assessee had filed the necessary returns beyond due date, he was liable to pay interest which was not levied. Further assessee's claim for deduction of head office expenses was not restricted as provided in the Act. Aggregate short levy of tax worked out to **Rs.96.88 lakh.**

3.13.10 In **Chennai, DIT (IT)** charge, tax had been deducted at source on payments made to non-residents at lower rates by applying incorrect provisions of the Act. This resulted in short deduction of tax of **Rs.31.51 crore** in addition to non levy of interest of **Rs.19.87 crore** as detailed in **Appendix 29 at Sl. No. 39 to 44**. In the same charge, in four other cases, tax of **Rs.1.54 crore** was not deducted at source on payments made to non-residents as detailed in **Appendix 29 at Sl. No.45 to 48**.

3.13.11 Other mistakes

Audit noticed in Delhi, Mumbai, Hyderabad and Kerala charges mistakes in computation of taxable income due to incorrect application of exchange rates, non levy of applicable interest for default in payment of advance tax and deferment of payment of advance tax as also taxation of income of non residents

at lower rates involving a short levy of **Rs.109.48 crore** as detailed in **Appendix 29 at Sl. No. 49 to 76.**

3.13.12 Miscellaneous

In **DIT (IT) Chennai, Mumbai and Karnataka** charges, audit noticed mistakes in **35** cases involving short levy of tax of amounting to **Rs.16.48 crore** due to errors in totalling of tax and incorrect computation of income under various provisions of Act.

3.14 Conclusion and recommendations

While audit realizes that revenue consideration is perhaps not the sole factor determining the contents of a DTAA and promotion of friendly relations and special interests with certain countries do play a significant role, limited examination of some of the important issues concerning the administration and implementation of DTAAs and taxation of non residents engaged in maritime business revealed shortcomings and inadequacies which needed to be removed and procedures strengthened.

3.14.1 A well-directed and clear strategy was not in place to remove inconsistencies and shortcomings in DTAAs especially those relating to definition of permanent establishment, limitation of treaty benefits, disallowing or consciously allowing 'treaty shopping', amendment of DTAAs and enforcing exchange of information clauses effectively. Cost benefit analysis of DTAAs had not been conducted. *Audit recommends that DTAAs may be examined critically through a phased and well monitored programme so that interests of revenue are safeguarded and one sided concessions are avoided. Audit recommends that the Board may assess the costs and benefits from each DTAA transparently and objectively, especially as DTAAs are not placed before Parliament.*

3.14.2 Monitoring and co-ordination of all aspects relating to mutual agreement procedure (MAP) cases, exchange of information (EOI) and assistance in tax recovery both in the Board and the field offices of the department, were not effective enough to safeguard interests of revenue and derive the optimum advantage from various DTAAs. *Audit recommends that procedures relating to MAP, EOI and recovery of tax be suitably codified and implementation monitored so that there is consistency and clarity in action being taken by assessing officers.*

3.14.3 A proactive action plan was not evolved to investigate cases of FIIs/sub accounts claiming residence in Mauritius so that effective place of management was investigated and determined in fulfilment of the spirit and intention of Indo-Mauritius DTAA. Ministry did not put in place a strategy to identify cases which attracted the 'tie breaker' clause to determine taxability of income in the case of India based entities claiming residence in Mauritius and prevent 'treaty shopping' in the case of entities based in third countries but availing the benefits under Indo-

Mauritius DTAA. Similar vigil was warranted but absent in respect of non residents claiming residence of Malta, Cyprus, UAE, Tanzania and other similarly placed DTAAs. This would have ensured that the Ministry was not caught in a state of *'fait accompli'* as had happened in relation to Indo-Mauritius DTAA with regard to taxation of capital gains from stock market operations. *Audit recommends that Board ensure that a database of FIIs and sub accounts relating to all entities operating in India is prepared and their liability to tax examined critically so that benefits of DTAA are availed only by assessees actually and rightfully entitled to the same*.

3.14.4 Income of FIIs/sub accounts engaged in the business of investment in stock markets was not being taxed under the specific provisions (section 115 AD) available in the Act or by treating them as business profits under DTAAs, which was detrimental to the interests of revenue. Though income of FIIs/sub accounts was to be treated as business profit and taxed accordingly, it was being erroneously categorized as capital gains and being exempted from tax by routinely invoking DTAAs. *Audit recommends that the Board may issue necessary clarification to ensure correct and proper taxation of income arising to FIIs/sub accounts.*

3.14.5 A proactive strategy for utilizing the information in respect of non resident's business activities available with regulatory bodies like SEBI and RBI was not evolved in the department. *Audit recommends that the Board strengthen the mechanism of coordination with regulatory bodies so that vital information relating to the income of FIIs/sub accounts is obtained regularly and acted upon promptly by assessing officers with a view to bringing the same to tax, if necessary by bringing in a suitable amendment to the Act*

3.14.6 Taxation of income of non residents from maritime business was not being bestowed serious attention especially in completion of regular assessments which require intelligent application of correct DTAAs and assessing officers were resting content only with issue of 'NOCs' to agents/shipping companies concerned. *Audit recommends that clear procedures be introduced and implementation monitored so that regular assessments of income from maritime business are seriously made and assessing officers do not treat issue of NOCs as an end in itself.*

3.14.7 Benefits were being allowed both under the Act and the DTAA separately for parts of income, as convenient to the assessee. Board may need to clarify that the Act or DTAA alone would need to be applied to all sources of income in a particular year. *Audit recommends that the Board unambiguously clarify issues such as incidence of surcharge and the option of availing concession under DTAA and the Act simultaneously, for the same assessment year for different sources of income, so as to ensure consistency in assessments and prevent loss of revenue.*

3.14.8 Assessees were availing multiple benefits under the Indian Income Tax Act with regard to income and taxes paid in foreign countries jeopardizing the interests of revenue. *Audit recommends that the Board may issue guidelines for regulating credit to taxes paid abroad and specifying the manner of treatment of tax credit, so that assessments are consistently made and interests of revenue are safeguarded.*

3.14.9 An Exit Conference was held with Member (A&J) in the Board in February 2005 to discuss audit conclusions and recommendations. The Board agreed to examine the same separately.

New Delhi	**(P. SESHKUMAR)**
Dated:	**Principal Director of Receipt Audit**
	(Direct Taxes)

Countersigned

New Delhi	**(VIJAYENDRA N. KAUL)**
Dated:	**Comptroller and Auditor General of India**