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TAXALOGUE

Volume 1 I Issue 1

Dialogue on Tax

Building a network to share and discuss

Directorate of Legal & Research
Central Board of Direct Taxes

General Information

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TAXALOGUE

MISSION

To provide a platform and build a network amongst tax officers, tax practitioners, eminent personalities, tax payers etc., for sharing and discussing matters related to tax issues, administrative best practices, such other matters as deemed to be of educational/professional value etc., with a view to promote effective and litigation-free tax administration, voluntary compliance and tax payer service.

EDITORIAL POLICY

1) To invite and publish articles relevant to tax policy, legal issues and tax administration from the fellow officers, tax practitioners, eminent personalities and tax payers;

2) To disseminate the best practices in tax administration, e-governance initiatives, innovation in administrative matters, newer tax-payer friendly initiatives etc.,

3) To update the knowledge of the officers about latest and important legal/judicial developments in the field of direct taxation;

4) To provide a knowledge sharing space for the Officers to raise current and critical issues with a view to facilitate live discussions on-line and to share experiences;

5) To publish any other material relevant for improving the effectiveness and efficiency of Income Tax Department, enhancing professions competency and developing human resources;

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निर्मला सीतारामन
वित्त एवं कार्पोरेट कार्य मंत्री
भारत सरकार

सत्यमेव जयते

Nirmala Sitharaman
Minister of Finance and Corporate Affairs
Government of India

Message

The Tax Policy, which feels the pulse of the public and addresses their concerns while raising taxes for the Government is considered as the most progressive one. On the other hand, if it ignores the ground reality, it arouses adverse public sentiments. Therefore, to avoid such a scenario, it is important to hear-out all the stakeholders during the making of the Tax Policy. In a democratic regime, it is expedient to have a continuous and progressive dialogue with all the stakeholders, namely, the tax-payers, the tax advisors, the taxmen and the jurists.

The Directorate of Legal and Research, under the Audit and Judicial Division of Central Board of Direct Taxes, the Apex tax policy making body, is starting a quarterly e-journal 'Taxalogue' to provide a platform to all the stakeholders to express their views through their researched articles on taxation matters. I am sure that this e-journal participative forum, which will go a long way in increasing the domain knowledge and professional expertise of the Department. The authors will examine the best practices of various countries and customize those for our country, so that the policy makers will benefit from the wisdom and the experience of the eminent jurists, tax experts, tax payers and the taxmen. This will help in reducing the litigation in the Income Tax Department, as it will attempt to bring convergence of views and create a healthy eco-system for taxation in the country.

Wishing all the success for such an effort of the Audit and Judicial Division of Central Board of Direct Taxes and hope that 'Taxalogue' becomes a torch-bearer for the innovative and responsive taxation policies.

(Nirmala Sitharaman)

अनुराग सिंह ठाकुर
Anurag Singh Thakur

वित्त एवं कारपोरेट कार्य राज्य मंत्री
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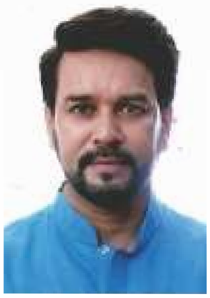
सत्यमेव जयते



Message

Central Board of Direct Taxes, the apex tax policy making body constantly tries to take new initiatives, be it e-filing of returns or be it e-assessment, or better services to taxpayers. It is important to create a platform on judicial and legal issues which captures the views of the taxmen, the eminent jurists and the tax advisers. This will not only help all the stakeholders to better appreciate the tax policy and its nuances, it will also bring convergence of views and reduce litigation.

I am happy that the Audit & Judicial Division of CBDT is coming up with 'Taxalogue', a quarterly e–journal shall provide an interactive forum to analyse the various burning issues of taxation, from all angles and will reduce the vexing issues. A large number of litigations can be avoided, if there is healthy exchange of views among all the stakeholders and there is osmosis of ideas and analysis in tax policy.

I would like to extend my best wishes to Audit & Judicial Division of Central Board of Direct Taxes on publication of first issue of 'Taxalogue'.

(Anurag Singh Thakur)

New Delhi
11.07.2019

Ms. Swati Joshi,

Additional Director General (Legal & Research)

Welcome to the inaugural issue of e-journal 'Taxalogue', a platform for all stakeholders of tax matters to express their views and share experiences. The journal is dedicated to providing a means to taxmen including officers, staff, jurists, and all other stakeholders to share their experiences and wisdom to enable a more responsive and analytical approach to taxation matters and its various nuances.

Indian economy has been integrating with global economies very fast in recent years. Not only big corporates but also small traders have export/import portfolios. Also, a fast growing domestic Indian economy along with initiatives in tax administration has ushered large number of new taxpayers into the economy. With these opportunities come challenges of legal disputes as some issues have never been faced by taxmen or taxpayers, or some confusion exists. It is important to have a forum for dialogue with all stakeholders to ensure that India's tax administration maintains its taxpayer friendly reputation in word and spirit. CBDT in its constant endeavor to provide taxpayer services and healthy exchange of ideas with taxpayers, has come out with this initiative in form of the e-journal, 'Taxalogue'. It aims to be an evolutionary, robust and flexible platform to share and exchange ideas for the stakeholders.

The articles which find place in the first edition are selected from a wide spectrum of issues concerning taxmen and taxpayers. The wisdom and knowledge of eminent jurists, tax practitioners and senior officers having a wide range of experience over tax matters should make the e-journal widen the horizons of the readers. Further, some case studies to showcase the analysis of issues and innovative solutions are also included to enable broader learning and generate interest in best practices. Articles on taxation of Digital economy and new issues like cloud computing will provide an insight into the new frontiers in taxation.

We extend our thanks to Smt. Nirmala Sitharaman, Honourable Finance Minister, Government of India and to Sh. Anurag Singh Thakur, Honourable Minister of State (Finance), Government of India, whose messages have boosted our morale. We pay special thanks to Honourable Justice (Retd.) Arijit Pasayat, for providing us his words of wisdom. We are grateful to Chairman, Central Board of Direct Taxes, Sh. P.C. Mody for his support in this endeavor. We remain indebted to Sh. P K Dash, Member (A & J), CBDT who envisaged this idea and without whose active supervision, this forum would have remained a dream. We thank Sh. Prabhash Shankar, former Principal Director General of Income Tax (L & R), for his support. Special thanks are due to Sh. K M Prasad, Principal Director General of Income Tax (L & R), for guiding us and lending his support, suggestions and encouragement for this e-journal.

We hope that the readers will find this e-journal interesting and use it extensively for healthy discussion, capacity building and for enriching their skills.

Swati Joshi

Swati Joshi,
Additional Director General (L&R)
On behalf of the Editorial Team, 'Taxalogue'
Central Board of Direct Taxes

Leaderspeak

Assessment

Best Practices

Dispute Resolution

Exemptions

International Taxation

Penalty

Tax History

Tax Policy

TDS

Transfer Pricing

The Articles are grouped subject wise and arranged alphabetically.

Editorial Board

Assessment of Bogus Purchases

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Surinder Jit Singh is graduate in Mechanical Engineering from Punjab Engineering College in 1981 and joined Income Tax Department in 1984 as an IRS officer and has worked at Chandigarh, Ludhiana, Pune, Bombay, Amritsar and at Delhi in various capacities including on the post of Principal DG(L&R) and has acquired rich experience in dealing with issues that arises in assessment proceedings. Article on "Bogus Purchases" is intended to provide guidance to AO as this issue is frequently encountered in assessment proceedings and there is pressing need that AO should adopt uniform approach in dealing this is issue.

Executive Summary

There is tendency on the part of tax payers to reduce their taxable income for which they are resorting to various innovative methods. To reduce taxable income, tax payers inflate expenses on the debit side of manufacturing as well as profit & loss account. To inflate expense, tax-payers often shows expenses on account of purchase of goods which have actually not been purchased. Such purchases are generally referred as "Bogus Purchases". This article is intended to guide assessing officers how to deal with the issue of 'Bogus Purchases' encountered during assessment proceedings.

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(A) What are Bogus Purchases?

In layman's language, Bogus Purchase are entries made in books of accounts for purchases made, when infact, no purchases have been made. As stated above, aim of the tax payer is to reduce taxable income by inflating expenses on account of purchases. Though it is generally easy to identify such purchases, process to establish that purchases are bogus is very difficult. This is due to the facts that it is extremely difficult to bring on record admissible evidences which may stand the test of judicial scrutiny. There is no hard and fast rule with regard to the kind of evidences that will be required to prove that purchases made are bogus in a particular case. However, an effort must be made to bring following types of evidences on record.

1. Whether seller of goods is an existing party and is traceable? If party is not existing at the given address, report of inspector must be obtained and placed on record.

2. If the seller of goods is available at the given address, his statement must be recorded. If he accepts the fact that he is only providing accommodation entries, statement should be made part of the record.

3. What are the modes of payments? If payments are made by banking channels, how the recipients of payments dealt

with the amounts received must be brought on record. In cases where accommodation entries are provided, generally the amount received is immediately withdrawn in cash.

4. Mode of transportation of goods.

5. Existence of Transporter and his reliability.

If these facts are properly investigated by Assessing Officer and evidences collected, it will be possible to establish that purchase are made are Bogus Purchases. Assessing Officer should take care that all evidences collected, including statements relied upon, are duly confronted to the taxpayers before same are utilized in the assessment order.

(B) Additions to be made on issue of Bogus Purchases

Case I: Entire amount of bogus purchases to be disallowed.

After it is established that certain purchases are bogus, generally taxpayers take the stand that since corresponding sales are shown, no addition can be made as sales cannot be made without there being purchases. This stand of the tax payers needs to be rejected. The taxpayer cannot take advantage of its failures as held by Bombay High Court in the case of Shri. Arun kumar J. Muchhala in ITA 363 of 2015. An addition should be made equal to the amount of bogus purchases even if there are corresponding sales. Delhi High Court in the case of CIT Vs La Medical(250 ITR 575) held that once it is held that purchases are not made from the party shown in the books of accounts, the fact that purchases are made from some other sources is not relevant and entire amount is required to be disallowed. Further, Allahabad High Court in the case of Kaveri Rice Mills, (157 Taxman 376) held that once purchases were bogus addition has to be made to the extent of purchases found to be fictitious. In this case Hon'ble High Court further held that “To neutralize the effect of inflation in purchases, the only course open to the AO is to add back the amount of purchases to the income irrespective of the fact whether the rate of GP goes up and whether the resultant GP is higher than the GP normally shown in yester years.”

There is another important decision of ITAT Bombay Bench in the case of M/s. Lifeline Drugs and Intermediates Pvt. Ltd. (5535/Mumbai/2007). In this case ITAT held that when the assessee has no explanation to offer for the bogus purchases, the same has to be added to the total income. It cannot be said that no addition can be made since the assessee might have made purchases from Grey Market. An assessee can't be given an opportunity to legalize its illegal transaction through accommodation entries.

In the case of N.K. Industries Ltd. Vs DCIT [2016] 72 taxmann.com 289 (Gujarat)

entire purchases shown on basis of fictitious invoices was debited in trading account. Assessing Officer made addition of 25 per cent of total purchase. Tribunal came to a categorical finding that there were purchases from bogus suppliers and, thus, Tribunal made addition of total purchases. Hon'ble Gujarat High Court upheld Tribunal's finding as follows:

6. The Tribunal in the case of Vijay Proteins Ltd. (supra) has observed that it would be just and proper to direct the Assessing Officer to restrict the addition in respect of the undisclosed income relating to the purchases to 25% of the total purchases. The said decision was confirmed by this Court as well. On consideration of the matter, we find that the facts of the present case are identical to those of M/s. Indian Woollen Carpet Factory (supra) or Vijay Proteins Ltd. (supra) In the present case the Tribunal has categorically observed that the assessee had shown bogus purchases amounting to Rs. 2,92,93,288/- and taxing only 25% of these bogus claim goes against the principles of Sections 68 and 69C of the Income Tax Act. The entire purchases shown on the basis of fictitious invoices have been debited in the trading account since the transaction has been found to be bogus. The Tribunal having once come to a categorical finding that the amount of Rs. 2,92,93,288/- represented alleged purchases from bogus suppliers it was not incumbent on it to restrict the disallowance to only Rs. 73,23,322/-.”

Above case of N K Proteins Ltd (earlier N.K. Industries Ltd.) Vs CIT has been confirmed by Hon'ble Supreme Court vide SLP(C) No. 769 of 2017

Case II: Alternative additions

Some courts have taken a different view that sales shown by taxpayers are not possible without there being purchases which are being held as bogus and hence,no addition can be made except addition on account of inflation in the price of goods if any. Therefore, the Assessing Officer must incorporate in the body assessment order alternate additions without prejudice. Amount of addition to be made on alternative basis will depend upon the nature of business under taken by the Tax Payer.

Following approach is suggested:-

(1) The case before Assessing Officer can be purely the case of taxpayer doing trading of operation only or cases of manufacturing where it is possible to quantify inputs required for goods traded or produced. Such cases can be cases of car dealers, cases of trading in high value electronic goods etc. In such cases Tax-Payers may be having difficulty in obtaining bills for the goods purchased. These will be cases where goods are purchased by the tax-payers in the grey market and bills are obtained from parties engaged in providing accommodation entries. In such cases it will be difficult for the Assessing Officer to modify trading results. However, Assessing Officer can enquire as to whether tax payer has resorted to inflation of value of goods purchased. He can make addition by adjusting the inflation of value of goods resorted to by the tax payers.

(2) There can be cases before Assessing Officer where there is no relation between goods produced and quantity of inputs and, therefore, it is not possible to estimate the exact quantity of inputs required for goods traded or production of goods. In such cases, the Assessing Officer should resort to addition by estimating GP Rate of the business undertaken by of the taxpayer. For estimating the GP rate,the Assessing Officer should take into account GP rate of the assessee in earlier years and GP Rate of persons doing similar business.

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Case III: Applicability of section 40A(3)

v There is a dispute about whether any addition, with or without prejudice, can be made on account of bogus purchases? If evidences are collected that payment for bogus purchases are made in cash then there is no doubt that provisions of section 40A(3) are applicable. However, difficulty arises where Assessing Officer assumes that payments are made in cash. In the case of M/s Vijay Proteins 58 ITD 428 it was heldthat the provision of s.40A(3) would not be applicable and even if they are held to be applicable, the expenditure would be covered by the exceptions provided in r.6DD(j) of the Rules." However it may be mentioned that this decisions was overruled by Gujarat High Court in the case of Hynoup Food & Oil India (P) Ltd (290 ITR 702). Hon'ble High Court held as follows:

"In the light of what is stated hereinbefore, it is not possible to accept the findings of the Tribunal. The Tribunal has committed an error in law in holding that the case of the assessee would be covered by the exceptions provided in r. 6DD(j) of the Rules. The Tribunal has apparently lost sight of the distinction between an entire business which is illegal and a business which is otherwise lawful wherein the assessee resorts to unlawful means to augment his profits. In this connection the following observations made by the Apex Court may be fruitfully reproduced from the case of MaddiVenkataraman& Co. (P) Ltd. Vs. CIT (1998) 144 CTR (SC) 214: (1998) 229 ITR 534 (SC):"

However if there are evidences that purchases are made in cash and are taken into account while computing business profits, then provisions of section 40A(3) can be invoked to disallow purchases as held by Punjab and Haryana High Court in the case of M/s Sai Metal Works (241 CTR 377). In this case it was held as follows:

"If the estimated income impliedly takes into consideration the expenditure incurred, the said principle may apply. If the expenditures which are legally not permissible have been taken into account, the same can certainly be disallowed,"

"Borrowed Satisfaction" for "Reason to believe" for reopening U/s 148 of I.Tax Act 1961

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TPO manual on "Financial Transactions".

Executive Summary

Many a time reassessment proceedings are quashed or additions made in such proceedings are deleted by the Appellate Authorities much to the dismay of the Assessing Officers. One prime reason for such adverse appellate orders are on the ground of 'borrowed satisfaction' in much as the drafting of recorded reason to initiate the proceedings does not bring out satisfaction of the Assessing Officer himself . Rather , the recorded reason shows complete reliance on reports of the Investigation Wing of the Department and the like. This article seeks to analyse where the Assessing Officers go wrong by juxtaposing the cases which have been confirmed by the courts and the cases where the department has failed. The revenue favourable cases of AGR Investment Ltd. v. Additional Commissioner of Income Tax and Highgain Finvest (P) Limited, both of Delhi High Court have been taken up in detail . The article has also contains a list of cases from which the Assessing Officers may derive a few learning points in the matter of recording of proper reasons for proceedings under section 147 of the Income Act,1961. The illustrations and the actionable steps to be taken by the Assessing Officers are expected to guide them and remove the scourge of 'borrowed satisfaction' to a great extent.

1.1. *The Assessing Officers receive a lot of information on bogus loan/credit /purchase and other useful information from the directorate of investigation as well as from other agencies.*

1.2. *While taking action on such information the Sec 148 is utilised to reopen the cases. Unfortunately most of the cases are struck down by the Honble ITAT or High Courts for improper drafting of Satisfaction Note (i.e. Reason to Believe) . The Assessing Officers, due to lack of time or knowledge ,simply quote the information received from the third party agency and conclude that "Income has escaped assessment".*

1.3.1. *In the case of Principal Commissioner of Income Tax Vs Meenakshi Overseas Pvt Ltd (Delhi High Court) Appeal Number : ITA 692/2016 , the Hon'ble Delhi High court beautifully explained the lacuna of the reason recorded by the Assessing Officers . This order of Hon'ble Delhi high court order is against the department. But*

Assessing Officers can take guidelines for drafting the foolproof "reason to believe"

1.3.2. *In this case the reason recorded is quoted below.*

"Reasons for the belief that income has escaped assessment":

In this case, information has been received from the Director of Income Tax, (Investigation) New Delhi that the Assessee has received amount of Rs. 5,00,000/- as follows:

Beneficiary"s Name – Meenakshi Overseas P. Ltd.

Beneficiary Bank Name – State Bank of Hyderabad

Beneficiary Bank Branch – Karol Bagh

Value of entre taken – 500,000

Instrument no. by which entry taken – 8628

Date on which entry taken – 31.03.2004

Name of A/c Holder of entry giving account – Shubham Electronic & Electric

Bank from which entry given – SBH

Branch of entry given bank – KB

A/c No. Entry giving account – 50038

Information so received has been gone through. The above said instruments are in the nature of accommodation entry, which the Assessee has taken after paying unaccounted cash to the accommodation entry given, who is a known entry operator as per the report of the Investigation Wing. In view of these facts, the alleged transaction is not the bonafide one. Therefore, I have reason to believe that an income of Rs. 5,00,000 has escaped assessment in the AY 2004- 05 due to failure on the part of the Assessee to disclose fully and truly all material facts necessary for its assessment so far as this amount is concerned. Therefore, this case is fit for issuing notice under Section 148 of the Income Tax Act, 1961 . In this case the assessment was made under Section 143 (1) not under Section 143 (3) of the IT Act, 1961.

I am therefore, satisfied that the said income, on account of accommodation entry worth Rs. 5,00,000 received by the Assessee has escaped assessment and accordingly after recording the above said reasons as laid down under the provisions of Section 148 (2) of the Income Tax Act, 1961 under Section 148 is being issued."

1.3.3. The Hon'ble Court observed that

"Perusing the reasons for re-opening of the assessment in the present case, the ITAT came to the conclusion that it was apparent that the Assessing Officer proceeded to send a notice under Section 147/148 of the Act "solely on the basis of information received from the DIT(I)." After writing about information received, the Assessing Officer "jumped to the conclusion that said tabulated instrument are in the nature of accommodation entry." This was done without further verification, examination or any other exercise. The ITAT also noted that the Assessing Officer "has not mentioned nature of transaction which was effected for alleged accommodation entry and even without mentioning the date of recording of reasons." Following the decision of this Court in Commissioner of Income Tax v. G&G Pharma (2015) 384 ITR 147 (Del.), the ITAT held that the Assessing Officer had not applied his mind at the time of initiating the proceedings of reassessment under Section 147 of the Act. The ground Nos. 1(a) to 1(d) of the Assessee"s appeal were, accordingly, allowed."

1.3.4. Thereafter, hearing the both the parties the Hon'ble court pointed out that ..

"19. A perusal of the reasons as recorded by the Assessing Officer reveals that there are three parts to it. In the first part, the Assessing Officer has reproduced the precise information he has received from the Investigation Wing of the Revenue. This information is in the form of details of the amount of credit received, the payer, the payee, their respective banks, and the cheque number. This information by itself cannot be said to be tangible material.

20. Coming to the second part, this tells us what the Assessing Officer did with the information so received. He says: "The information so received has been gone through." One would have expected him to point out what he found when he went through the information. In other words, what in such information led him to form the belief that income escaped assessment. But this is absent. He straight away records the conclusion that "the above said instruments are in the nature of accommodation entry *which the Assessee had taken after paying unaccounted cash to the accommodation entry given (sic giver)". The Assessing Officer adds that the said accommodation was "a known entry operator" the source being "the report of the Investigation Wing".*

21. The third and last part contains the conclusion drawn by the Assessing Officer that in view of these facts, "the alleged transaction is not the bonafide one. Therefore, I have reason to be believe that an income of Rs. 5,00,000 has escaped assessment in the AY 2004-05 due to the failure on the part of the Assessee to disclose fully and truly all material facts necessary for its assessment… "

22. As rightly pointed out by the ITAT, the 'reasons to believe' are not in fact reasons but only conclusions, one after the other. The expression 'accommodation entry' is used to describe the information set out without explaining the basis for arriving at such a conclusion. The statement that the said entry was given to the Assessee on his paying "unaccounted cash" is another conclusion the basis for which is not disclosed. Who is the accommodation entry giver is not mentioned. How he can be said to be "a known entry operator" is even more mysterious. Clearly the source for all these conclusions, one after the other, is the Investigation report of the DIT. Nothing from that report is set out to enable the reader to appreciate how the conclusions flow therefrom.

23. Thus, the crucial link between the information made available to the Assessing Officer and the formation of belief is absent. The reasons must be self evident, they must speak for themselves. The tangible material which forms the basis for the belief that income has escaped assessment must be evident from a reading of the reasons. The entire material need not be set out. However, something therein which is critical to the formation of the belief must be referred to. Otherwise the link goes missing.

24. The reopening of assessment under Section 147 is a potent power not to be lightly exercised. It certainly cannot be invoked casually or mechanically. The heart of the provision is the formation of belief by the Assessing Officer that income has escaped assessment. The reasons so recorded have to be based on some tangible material and that should be evident from reading the reasons. It cannot be supplied subsequently either during the proceedings when objections to the reopening are considered or even during the assessment proceedings that follow. This is the bare minimum mandatory requirement of the first part of Section 147 (1) of the Act.

25. At this stage it requires to be noted that since the original assessment was processed under Section 143 (1) of the Act, and not Section 143 (3) of the Act, the proviso to Section 147 will not apply. In other words, even though the reopening in the present case was after the expiry of four years from the end of the relevant AY, it was not necessary for the Assessing Officer to show that there was any failure to disclose fully or truly all material facts necessary for the assessment.

26. The first part of Section 147 (1) of the Act requires the Assessing Officer to have "reasons to believe" that any income chargeable to tax has escaped assessment. It is thus formation of reason to believe that is subject matter of examination. The Assessing Officer being a quasi judicial authority is expected to arrive at a subjective satisfaction independently on an objective criteria. While the report of the Investigation Wing might constitute the material on the basis of which he forms the reasons to believe the process of arriving at such satisfaction cannot be a mere repetition of the report of investigation. The recording of reasons to believe and not reasons to suspect is the pre-condition to the assumption of jurisdiction under Section 147 of the Act. The reasons to believe must demonstrate link between the tangible material and the formation of the belief or the reason to believe that income has escaped assessment.

27. Each case obviously turns on its own facts and no two cases are identical. However, there have been a large number of cases explaining the legal requirement that requires to be satisfied by the Assessing Officer for a valid assumption of jurisdiction under Section 147 of the Act to reopen a past assessment."

1.4. It is evident that that the major mistake in writing the 'reasons to believe' was that, it was not in fact reasons but only conclusions, one after the other as mentioned by the Hon'ble High Court .The Hon'ble court also observed that the Assessing Officer has made no effort to set out the portion of the investigation report which contains the information specific to the Assessee. Also the Assessing Officer did not examine the return already filed to ascertain if the entry had been disclosed therein. Therefore it is imperative that the Assessing Officer must bring out the connection of investigation report and "reason to believe".

1.5. Interestingly, the Hon'ble High Court also discussed few cases, where the recording of reason were properly done by the Assessing Officer .

1.5.1. The case of AGR Investment Ltd. v. Additional Commissioner of Income Tax reported in (2011) 336 ITR 146 (Del.) can be cited as the first example. The following extract is relevant:

"29.1 The above decision can be contrasted with the decision in AGR Investment v. Additional Commissioner of Income Tax (supra), where the 'reasons to believe' read as under:

"Certain investigations were carried out by the Directorate of Investigation, Jhandewalan, New Delhi in respect of the bogus/accommodation entries provided by certain individuals/companies. The name of the assessee figures as one of the beneficiaries of these alleged bogus transactions given by the Directorate after making the necessary enquiries. In the said information, it has been inter-alia reported as under:

"Entries are broadly taken for two purposes:

1. To plough back unaccounted black money for the purpose of business or for personal needs such as purchase of assets etc., in the form of gifts, share application money, loans etc.

2. To inflate expense in the trading and profit and loss account so as to reduce the real profits and thereby pay less taxes.

It has been revealed that the following entries have been received by the assessee: "

29.2 The details of six entries were then set out in the above 'reasons'. These included name of the beneficiary, the beneficiary's bank, value of the entry taken, instrument number, date, name of the account in which entry was taken and the account from where the entry was given the details of those banks. The reasons then recorded:

"The transactions involving Rs. 27,00,000/-, mentioned in the manner above, constitutes fresh information in respect of the assessee as a beneficiary of bogus accommodation entries provided to it and represents the undisclosed income/income from other sources of the assessee company, which has not been offered to tax by the assessee till its return filed.

On the basis of this new information, I have reason to believe that the income of Rs. 27,00,000/- has escaped assessment as defined by section 147 of the Income Tax Act. Therefore, this is a fit case for the issuance of the notice under section 148."

29.3 The Court was not inclined to interfere in the above circumstances in exercise of its writ jurisdiction to quash the proceedings. A careful perusal of the above reasons reveals that the Assessing Officer does not merely reproduce the information but takes the effort of revealing what is contained in the investigation report specific to the Assessee. Importantly he notes that the information obtained was 'fresh' and had not been offered by the Assessee till its return pursuant to the notice issued to it was filed. This is a crucial factor that went into the formation of the belief."

1.5.2. The case of Commissioner of Income Tax, New Delhi v. Highgain Finvest (P) Limited (2007) 164 Taxman 142 (Del) .may serve as a second example. The relevant extract is reproduced below:

"30.1 In Commissioner of Income Tax, New Delhi v. Highgain Finvest (P) Limited (2007) 164 Taxman 142 (Del) ***relied upon by Mr. Chaudhary, the reasons to believe read as under:***

"It has been informed by the Additional Director of Income Tax (Investigation), Unit VII, New Delhi vide letter No. 138 dated 8th April 2003 that this company was involved in the giving and taking bogus entries/ transactions during the financial year 1996-97, as per the deposition made before them by Shri Sanjay Rastogi, CA during a survey operation conducted at his office premises by the Investigation Wing. The particulars of some of the transaction of this nature are as under:

Date – 18.11.96

Particulars of cheque – 305002

Debit Amt. Credit Amt – 5,00,000

Through the Bank Account No. CA 4266 of M/s. Mehram Exports Pvt. Ltd. in the PNB, New Rohtak Road, New Delhi.

Note: It is noted that there might be more such entries apart from the above.

The return of income for the assessment year 1997-98 was filed by the Assessee on 4th March 1998 which was accepted under Section 143 (1) at the declared income of Rs. 4,200. In view of these facts, I have reason to believe that the amount of such transactions particularly that of Rs. 5,00,000 (as mentioned above) has escaped the assessment within the meaning of the proviso to Section 147 and clause (b) to the Explanation 2 of this section. Submitted to the Additional CIT, Range -12, New Delhi for approval to issue notice under Section 148 for the assessment year 1997-98, if approved."

30.2 The Assessing Officer was not merely reproducing the information received from the investigation but took the effort of referring to the deposition made during the survey by the Chartered Accountant that the Assessee company was involved in the giving and taking of bogus entries. The Assessing Officer thus indicated what the tangible material was which enabled him to form the reasons to believe that income has escaped assessment. It was in those circumstances that in the case, the Court came to the conclusion that there was prima facie material for the Assessing Officer to come to the conclusion that the Assessee had not made a full and true disclosure of all the material facts relevant for the assessment."

1.5.3. At the same time , the Hon'ble High court discussed few other cases where ,the Assessing Officer failed to record the reason to believe as per law . Two such discussions are reproduced below.

1.5.3.1."34. Recently in Agya Ram v. CIT (supra), it was emphasized that the reasons to believe "should have a link with an objective fact in the form of information or materials on record…" It was further emphasized that "mere allegation in reasons cannot be treated equivalent to material in eyes of law. Mere receipt of information from any source would not by itself tantamount to reason to believe that income chargeable to tax has escaped assessments."

1.5.3.2."35. In the decision of this Court dated 16th March 2016 in W.P. (C) No. 9659 of 2015 (Rajiv Agarwal v. CIT) it was emphasized that "even in cases where the ASSESSING OFFICER comes across certain unverified information, it is necessary for him to take further steps, make inquiries and garner further material and if such material indicates that income of an Assessee has escaped assessment, form a belief that income of the Assessee has escaped assessment."

1.5.4. Similarly, in the case of **CIT v. Indo Arab Air Services (2016) 130 DTR 78/ 283 CTR 92 (Delhi)(HC)** it was held that ...

"mere information that huge cash deposits were made in the bank accounts could not give the Assessing Officer prima facie belief that income has escaped assessment. The Assessing Officer is required to form prima facie opinion based on tangible material which provides the nexus or the link having reason to believe that income has escaped assessment. The Assessing Officer was also required to examine whether the cash deposits were disclosed in the return of income to form an opinion that income has escaped assessment.

The power to reopen an assessment is conditional on the formation of a reason to believe that income chargeable to tax has escaped assessment. The power is not akin to a review. The existence of tangible material is necessary to ensure against an arbitrary exercise of power".

1.5.5. In the case of PCIT v. Paramount Communication P. Ltd. (2017) 392 ITR 444,79 taxmann.com 409 1.5.5. (Delhi) (HC), the Hon'ble high court confirmed reopening based on material outside the record . The relevant paragraphs are reproduced:

"8. As far as AY 2004-05 is concerned, this Court is of the opinion that in the reference to the bogus purchase made by the assessee from M/s. Kashish Impex Pvt. Ltd. and the information received for the period 17.09.2002 to 20.05.2005 and the amount of bogus purchase for the period under consideration amounted to Rs. 1.64 crores was entirely based upon the information received from the

Directorate of Revenue Intelligence (DRI) Regional Unit at Jaipur. This in turn was based upon information given by the Central Excise Department. While it is true that the court is conscious that the reassessment notice should not have been routinely issued, at the same time, the nature of power is wide enough that when there an escapement of income and the Revenue has information ruling that this escapement is also relatable to suppression of material facts (which could include false claims), the power to reopen concluded assessment can validly be exercised. The consideration which ought to weigh with the Revenue and are considered valid are the existence of tangible material or information - in the light of the judgment in CIT v. Kelvinator of India [2010] 320 ITR 561 (SC).

9. Having regard to the contents of the notice for AY 2003-04, the court is unable to agree with the findings of the ITAT. It constitutes reference to tangible material "outside" the record, i.e. information based upon the investigation of the Commissioner of Central Excise with respect to the purchases made by the assesses. However, as far as the second issue is concerned, the Court is of the opinion that even the rectified order does not address the issues squarely. Thus, arguendo such arguments could be validly raised. At the same time, the court notices that for both AYs 2004-05 and 2005-06, the note discloses the source of the information, i.e. DRI Local Unit at Jaipur, sending information based upon the Commissioner of Central Excise's investigations. To require the Revenue to disclose further details regarding the nature of documents or contents thereof would be virtually rewriting the conditions in section 147. After all, Section 147 merely authorises the issuance of notice to reopen with conditions. If the Court were to dictate the manner and contents of what is to be written, the statutory conditions would be added as it were. In this context, it needs to be emphasized that the court would interpret the statute as they stand in their own terms, but at the same time being conscious of the rights of the citizens. So viewed, Kelvinator of India (supra) strikes just balance. To add further conditions to the nature of discussion/reasons that the officer authorising the notice would have to discuss in the note or decision would be beyond the purview of the Courts and would not be justified. For the above reasons, this Court is of the opinion that the impugned order - and the consequential order of 05.01.17 cannot be sustained. They are accordingly set aside.".

1.5.6. It may be noted that SLP against this order was dismissed on 14th July 2017 (84 taxmann.com 300(SC)) .

2. The Assessing Officers may further refer to the following cases (in favour of revenue) for better understanding of reopening based on information from outside the record :

Choksi Vachharaj Makanji & Co. V. ACIT	(2016)	76 taxmann.com 17	(Guj) (HC)
Aravali Infrapower Ltd. v. DCIT	(2017)	390 ITR 456	(Delhi) (HC)
Aradhna Estate Pvt. Ltd. v. DCIT	(2018)	404 ITR 105	(Guj) (HC)
Rajnish Jain. v. CIT	(2018)	402 ITR 12	(All) (HC)
Trans Corporate Advisory Services (P.) Ltd. V ACIT	(2017)	77 taxmann.com 21	(Mad) (HC)
Jayant Security & Finance Ltd. v. ACIT	(2018)	254 Taxman 81	(Guj.) (HC)
Ankit Agrochem (P.) Ltd. v. JCIT	(2018)	253 Taxman 141	(Raj) (HC)
Virbhadra Singh v. Dy. CIT	(2017)	291 CTR 439	(HP) (HC)

3. A thorough analysis of the above case laws and following the standard operating procedure circulated by the CBDT (247/140/2017-A &PC-1 dated 10.01.2018) in the matter of reassessment will go a long way in making the reassessment cases sustainable at least on technical grounds.

Tracing The Powers Of AO To Make Assessment U/S 153A W.R.T Presence Or Absence Of Incriminating Material

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Executive Summary

A view is being frequently propounded by assessees before the courts that the powers of an AO to make assessment u/s 153A are restricted to those issues which emanate from the evidences found in search only. It is being argued that the AO cannot embark upon assessment on any other issue, which either has no relevance or nexus to evidence found during search or is based merely on the re-appreciation/examination of an entry already recorded in books or document already made available to AO or any claim/relief already claimed and allowed by AO prior to search, whether u/s 143(1) or 143(3). There are contradictory decisions of the Courts on the issue. Therefore, it has become necessary to trace the power of AO to make assessment u/s 153A, w.r.t presence or absence of incriminating material.

The following discussion is only an attempt to provide some insight into the various nuances, which could be relevant to understand the controversy and take a view while framing assessments as well as in the pleadings before various judicial forums.

1. After going through various decisions of the courts and the rationale considered by such courts to decide on this issue, it is necessary for the better understanding of the powers of the AO to make assessment u/s 153A to analyze and seek answers to certain pertinent questions/issues:

(i) Why the issue of notice u/s 153A for 6 AYs is automatic in cases where search is initiated without requirement of recording of any satisfaction/reference to seized material unlike section 147?

(ii) When issue of notice u/s 153A is independent of seizure of any material, then can a restriction be inferred in the powers of AO to assess the total income that the addition is to be based on seized evidences only?

(iii) Whether the nexus of seized material is essential for making assessment of total income u/s 153A?

1.1 The language of section 153A makes it very clear that there is no explicit or intended requirement of seizure of incriminating material during the search u/s 132(1) before issuing the notices u/s 153A. The jurisdiction of section 153A is automatic from the moment a search is initiated. There is no requirement of examination of seized material or recording any satisfaction w.r.t availability of seized material before issue of notice u/s 153A. In my opinion, the intention of legislature in allowing so could be that the initiation of search itself is subject to recording of satisfaction u/s 132(1) by the PDIT(Inv) on grounds that:

(i) Upon issue of summons u/s 131(1), the assessee has failed to produce or would not produce the books of accounts or other documents so requisitioned; or

(ii) The assessee is in possession of money, bullion jewellery, article or thing which represents wholly or partly in come has not been or would not be disclosed for the purposes of the Act.

Hence a conjoint reading of section 153A and 132(1) would clearly imply that a satisfaction to issue notice u/s 153A is already deemed to be imported from the satisfaction recorded by PDIT(Inv) at the time of issuing warrants u/s 132(1). The existence of satisfaction recorded by PDIT(Inv) is liable to be challenged before courts. Hence, until such satisfaction for issue of warrants u/s 132(1) are held invalid by any court, the satisfaction recorded by PDIT(Inv) shall continue to hold the fort for purposes of 153A also and it is for this reason there is no further requirement of recording any belief or satisfaction by AO for issue of notice u/s 153A.

As may be noted from the conditions of recording the satisfaction of PDIT(Inv), one of the conditions is regarding books or other documents which were not produced or would not have been produced on issue of summons. Thereby implying that **post search, while the AO is making assessment, it has to examine the correctness of income disclosed not only based on what material has been gathered during search but also based on these books or documents which in the opinion of PDIT(Inv) would not have been produced upon issue of summons, whether or not such books of accounts or documents have been actually found during search.** In fact, there are numerous instances when even the books of accounts as per already filed audit reports are not found at any of the premises during search, more so when the searched entities represent only the shell companies. Similarly, there is a requirement of satisfaction by PDIT(Inv) in respect of income being fully or partly not disclosed for the purposes of the Act. Hence, even if some income/ entry is disclosed in books or audited accounts, the AO is mandated to examine whether such income / entry was disclosed fully or partly and/ or represents its real nature and source for the purposes of the Act. This inter alia would mean that even the entries disclosed in accounts which might represent income fully or partly would in itself be an incriminating material for which a search was initiated. When the non-production of books or other documents can give rise to a belief for initiating search u/s 132(1), then it may be counterproductive to conclude that the power of AO is restricted to assessment based only on incriminating material found in search, irrespective of any other item of income which might have remained fully or partly undisclosed for the purposes of the Act, based upon the entries already appearing in such books, if any.

1.2 It is the 'assessment of total income' which is required to be made u/s 153A. The total income as defined u/s 2(45) would be the total income computed as per section 5 of the Act. The word 'assessment' cannot have a different meaning for different purposes under the same Act, unless restricted by specific provisions. The process of assessment for the purposes of the Act is wide enough to include every kind of enquiry/examination for discovery, quantification and assessment of any income wholly or partly for the purposes of the Act. Hence, the process of 'assessment of total income' u/s 153A can neither be restrictive nor have a different connotation for assessment under section 153A vis a vis 143(3) or 147. As per the scheme under the Act, the satisfaction recorded u/s 132(1) and the results of search are intended to be brought to a logical conclusion by initiating the proceedings u/s 153A without any further act of the AO. Hence it is in the scheme of the Act that after issuance of notice u/s 153A, the next action of the AO must follow the examination of all aspects for which a search has been initiated. Hence, it cannot be said that the AO u/s 153A cannot proceed to examine the books of accounts or documents, entries which were produced before him subsequently, wherein might also represent income wholly or partly, which has not been disclosed for the purposes of the Act. Hence, it may be contrary to the scheme of the provisions of 132(1) r/w 153A, if it were to be held that power of AO is restricted only to make assessment the evidence found during search. The provisions of 153A not only require assessment of undisclosed income but total income also. The expression 'total income' would include the income emanating from disclosed items, income emanating from partly or wrongly disclosed items as well as income emanating from undisclosed items. U/s 153A, no distinction is made for assessment of total income in the cases which were earlier completed u/s 143(1), the cases which were earlier completed u/s 143(3)/147 or the cases where no return was filed prior to search. Thus, in all the three categories, it is as per the scheme of the Act that the total income of the assessee as defined u/s 2(45) needs to be assessed for all the 6 AYs for which the AO is mandated to issue notice u/s 153A.

1.3 Further u/s 153A, there is a provision for abatement of pending assessments whether or not any evidences were found for that year. There can also be a situation where neither any regular assessments were made earlier nor any proceedings were pending, which could be abated. The section also envisages the issue of notice u/s 153A whether or not any evidences were found for that year. It is also implicit that u/s 153A, the items of total income which could be assessed u/s 153A in abated proceedings cannot be different for the cases which could not be abated such as I) where no proceedings were pending; or ii) where earlier assessments were completed u/s 143(3)/147; or iii) where earlier assessments were not made at all. The only caveat could be that before making any addition to the total income, the AO must bring on the record how such items are falling into the category of total income for the purposes of the Act. Thus, if it were to be held that no addition can be made without any incriminating material in respect of the years covered by section 153A, then it would lead to an absurd consequence whereby the powers granted to issue notices u/s 153A would be rendered otiose in cases which got abated for any particular AY. In the absence of any seized material, AO may not be able to proceed to make any assessment of any other item of total income implying that the process of making assessment of total income as envisaged in section 153A fails in abated cases. However, a statute can never be interpreted in a manner to make it redundant.

1.4 Section 153A does not say that additions should be strictly made on the basis of evidence found in the course of search, or on the basis of any other post-search material or information available with the AO though such assessment cannot be arbitrary. The provisions section of 147 and section 153A, though have different conditions to assume jurisdiction but both operate to make the assessment of total income only. The Memorandum explaining the provisions of Finance (No. 2) Bill of 2009 while inserting explanation 3 to section 147 reads as under:

"Some courts have held that the Assessing Officer has to restrict the reassessment proceedings only to issues in respect of which the reasons have been recorded for reopening the assessment. He is not empowered to touch upon any other issue for which no reasons have been recorded. The above interpretation is contrary to the legislative intent.

Therefore to articulate the legislative intent clearly, explanation 3 has been inserted in section 147 to provide that assessing officer may examine, assess or reassess any issue relevant to income which comes to his notice subsequently in the course of proceedings under this section, notwithstanding that the reasons for such issue has not been included in the reasons recorded under subsection(2) of section 148".

Hence, even in absence of any explanation u/s 153A also similar to the explanation 3 u/s 147, the intention of the legislature and the scheme of the Act for making assessment u/s 153A where search u/s 132 is initiated, is same i.e. in order to make assessment of total income, after having assumed the jurisdiction to assess total income, the powers of AO shall not remain restricted to mere those material which were seized during search but shall also include the assessment of income based on any entry already recorded prior to search or any claim/relief allowed prior to search, which has been found to be erroneous during the proceedings u/s 153A.

1.5 There is divergence of judicial opinion on the question of whether assessment u/s 153A can be restricted to only the incriminating material seized during the search or whether the AO can also take a view based on something which might be noticed otherwise during the course of assessment proceedings u/s 153A? Some of the conflicting opinions expressed in judicial verdicts are as under:

(a) Allahabad High Court in **Raj Kumar Arora** 367 ITR

517 has held that there is no requirement of incriminating material for invoking provisions of 153A.

(b) The Delhi High Court in **Kabul Chawla** 380 ITR 573 (Del) held that assessment u/s 153A on an issue could not have been made unless backed by some incriminating material found during the search. The department has not accepted the decision in case of Kabul Chawla and the SLP was filed was subsequently withdrawn due to low tax effect.

© However, the same Delhi High Court in case of **Dayawanti Gupta** Vs CIT 390 ITR 496(Del) in para 16 has observed that:

"Section 153A, which provides for an assessment in case of search, and was introduced by the Finance Act, 2003 with effect from 1-6-2003, does not provide that a search assessment has to be made strictly on the basis of evidence found as a result of search or other documents and such other materials or information as are available with the Assessing Officer and relatable to the evidence found. The earlier section 158BB which is not applicable in case of a search conducted after 31-5-2003, provided that the computation of the undisclosed income can only be on the basis of the evidence found as a result of search or other documents and materials or information as are available with the Assessing Officer, provided they are related to the materials found. Section 153A(1)(b) requires assessment or reassessment of total income of the six assessment years immediately preceding the assessment year relevant to the previous year in which the search took place. This, however, does not mean that the assessment under section 153A can be arbitrary or made without any relevance or nexus with the seized material…..".

(d) Filatex India Ltd Vs CIT-IV 229 Taxman 555 (Delhi)

Whether during assessment under section 153A, additions need not be restricted or limited to incriminating material found during course of search and, hence, argument of assessee that addition under section 115JB was not justified in order under section 153A as no incriminating material was found concerning said addition had to be rejected - Held, yes.

(e) Sunny Jacob jewelers and wedding center Vs DCIT 362 ITR 664 (Ker)

Whether there is no requirement under provisions of Act requiring department to collect information and evidence for each and every year for six previous years in order to initiate proceedings under section 153A – Held, yes

(f) CIT Vs Anil Kumar Bhatia 352 ITR 493(Delhi)

Whether even if assessment order had already been passed in respect of all or any of those six assessment years, either under section 143(1)(a) or section 143(3) prior to initiation of search/requisition, still Assessing Officer is empowered to reopen those proceedings under section 153A without any fetters and reassess total income taking note of undisclosed income, if any, unearthed during search - Held, yes

(g) CIT-II Vs continental warehousing corporation 235 Taxman 568 (SC)

The High Court by impugned order held that no addition can be made in respect of assessments which have become final if no incriminating material is found during search or during 153A proceeding - Whether Special Leave Petition filed against impugned order was to be granted - Held, yes

(h) Principal Commissioner of Income-tax, Delhi-2 v. Best Infrastructure (India) (P.)Ltd. 256 Taxman 63(SC)

High Court by impugned order held that where during search proceeding one of directors of assessee-company surrendered a certain sum as undisclosed income only for assessment year in question and not for each of six assessment years preceding year of search, said submission could not be said to be incriminating material qua each of preceding assessment years and, consequently, assumption of jurisdiction under section 153A and consequent additions made by Assessing Officer on said basis were not justified - Whether SLP against said impugned order was to be allowed - Held, yes.

(i) The dismissal of SLP by supreme court in case of **PCIT vs Meeta Gutgutia** wherein also the same views were expressed as in Kabul Chawla, would also not lead to conclusion that the question decided by Delhi High court against the revenue in Meeta Gutgutia is settled because the SLP has already been admitted by SC for hearing on the same question in several other cases such as Continental warehousing, Best Infrastructure(supra).

(j) Further, Supreme Court in **Sinhgad Tech Edu Society** 397 ITR 344(SC) held that no notice u/s 153C could be invoked unless there was incriminating material is also of no consequence as the provisions of section 153C has been amended w.e.f 1/4/2005 and that the decision of Sinhgad Tech Edu society was for period prior to 1/4/2005.

1.6 The sum and substance of all the decisions above could only indicate that **the question of whether the AO has powers u/s 153A to assess total income as defined u/s 2(45) dehors the incriminating material also, has not at all become final** and the same is yet pending final adjudication before the SC in SLPs admitted. Hence the arguments made in preceding paragraphs can be pitched up to support the revenues' contention before courts.

2. Now next set of questions which are required to be answered are:

(I) What constitutes incriminating material for the purpose of making an assessment of total income u/s 153A?

(ii) Whether the mere fact that an entry has been considered in any earlier proceedings or that the entry/ income is recorded in accounts in the manner which is later found to be different from its true nature and source could take away its character of being incriminating for the purpose of making an assessment u/s 153A?

2.1 The 'incriminating material' can be in any form such as evidence in the nature of i) a document, content of any document; ii) an entry in books of account; iii) an asset; iv) a statement given on oath; v) absence of any fact claimed earlier but coming to notice during search; vi) absence of books being found during search; or vii) absence of the office/ business premises as claimed during returns filed or any other documents, etc. In short, any fact/ evidence which could suggest that the documents/ transactions claimed or submitted in any earlier proceedings were not genuine, being only a device/ make belief based on non-existent facts or suppressed/ misrepresented facts, would constitute an incriminating material sufficient to make assessment for the purposes of the Act. A mere statement u/s 132(4) is an evidence for making an assessment as also held by apex court in **B Kishore Kumar Vs DCIT** 234 Taxman 771(SC) as under:

High Court by impugned order held that since assessee himself had stated in sworn statement during search and seizure about his undisclosed income, tax was to be levied on basis of admission without scrutinizing documents - Whether Special Leave Petition filed against impugned order was to be dismissed - Held, yes

Hence even a statement u/s 132(4) shall also constitute incriminating material to dislodge any earlier finding for the purpose of making an assessment u/s 153A.

2.2 Since the proceedings under the Act are civil in nature, even the circumstantial evidences based on preponderance of probability will constitute incriminating material enough to make an assessment of income and fasten the tax liability as held by in **Sumati Dayal Vs CIT** 214 ITR 801(SC). It will therefore include any circumstantial material also, which directly or indirectly, proves that the earlier evidence submitted was only a make belief and such new material has a bearing on the assessment of total income of any assessee, even if such income was earlier admitted as correct in absence of any such adverse facts available at the time of earlier assessment.

The requirement of incriminating material is not specifically mentioned in the Act. However, w.e.f. 1/4/2005 the provisions of section 153C have been amended so as to allow the invocation of proceedings u/s 153C if any document, an entry or an asset is found in relation or pertaining to a person other than the searched person, **which has a bearing on the assessment of total income as per the provisions of the I T Act. Hence the word “incriminating”, as used by the courts in context of section 153C, needs to be applied in the context of section 153A also which has to be seen as something which can have a bearing on the assessment of correct total income u/s 2(45) as per provisions of the Act.**

2.3 The expression **'have a bearing on determination'** as used u/s 153C also has a wide connotation which implies that the nexus of the seized documents/ assets to income should only be a logical nexus to the ultimate process of determination of total income and that such evidence need not be in the nature of direct hard evidence. Applying the same principles, the incriminating material for the purposes of section 153A also has to be necessarily construed to be in the nature of a prima facie evidence only (including a circumstantial evidence) and not a hard evidence. The use of the expression **'books of accounts'** u/s 153C again suggests that even the entries recorded in the books of accounts, which have not been correctly recorded or camouflaged would also partake the character of incriminating material, if the same has a bearing on the determination of income which has not been already disclosed in the return filed, if any. Hence, the entries in the regular books of accounts would also trigger the assessment u/s 153A/C, if there is some prima facie evidence that the entry recorded therein is camouflaged, or incorrect, wholly or partially, and such entries have a bearing on determination of total income of such person. **The definition under clause (ii) of 271AAB(c) also defines undisclosed income as "any income based on entry in books of accounts wholly or partly false and would not have been found to be so, had the search not been conducted".** This clearly implies that any entry even recorded in the books, which is found to be wholly or partly false along with having a bearing on determination of income based on evidence gathered during search, would also be in the nature of incriminating material. Further, recently introduced section 270A, which is also applicable to search asstt. for AYs other than specified years, mandates to levy penalty even in cases where the expenses had been claimed in the books without any evidence or where the entries recorded in the books were found to be false. **This also supports the contention that mere recording of an entry in the books of accounts does not take away its incriminating character, if such entry was without evidence or had been falsely recorded in the books of accounts.** The same principle will also hold good for the documents submitted earlier in relation to entries recorded in the books but later found that the documents were not genuine or manipulated or camouflaged. **Supreme Court in Sinhgad Tech Edu Society or Delhi High Court in Kabul Chawla never considered the implication of section 270A and 271AAB as explained above while considering as to what material would constitute incriminating for the purposes of assessment of total income under section 153A/C.**

2.4 The provisions of section 153A/153C are not the normal assessment provisions like 143(3); rather they are curative provisions to plug the mischief of evasion of taxable income based on evidences found in pursuance to search. Hence, if on account of search, the facts and circumstances suggest that any entry already appearing in books or accepted in earlier assessments based on documents submitted at that point of time, are camouflaged or manipulated or reflected to be in the nature or from a source which is different from the real nature or source as appearing from the evidences found during a subsequent search, then such material/ facts coming to fore now will definitely constitute an incriminating material. In consequence of the same the earlier recorded entries/earlier admitted documents and evidence shall have no force as genuine evidence. If it were held not to be so, then the purpose of 153A would be defeated as it would fail to prevent the mischief, which it sought to prevent just because the entries were already recoded in the books or some documents had already been accepted. **Hence applying the Hayden's rule of mischief, the mere fact that such entries are recorded in the books of accounts or some fabricated or colourful documents have already been accepted as correct, will not prevent such material or entry from being incriminating, if the circumstances suggest otherwise.** The Hayden's rule of mischief has been judicially accepted and applied by Calcutta High Court in **Reckitt Colman of India Ltd. vs. ACIT** (2001) 252 ITR 550 (Cal).

The incriminating material can be from the search or even from subsequent surveys or any other enquiries. Recently in **CIT Chennai vs Ajit S Kumar** 93 Taxman.com294(SC), the court in the context of section 158BB has upheld the use of information collected in a survey in case of connected person carried along with search in other person for the purpose of making asstt. u/s 158BB. Provisions of 158BB are Pari Materia to section 153A.

*The Delhi High court in **PCIT Vs Kabul Chawla** in para 37(iv) observed as under:*

"iv. Although Section 153 A ***does not say*** *that additions should be strictly made on the basis of evidence found in the course of the search, or other post-search material or information available with the AO which can be related to the evidence found, it does not mean that the assessment "can be arbitrary or made without any relevance or nexus with the seized material. Obviously, an assessment has to be made under this Section only on the basis of seized material."*

The Delhi High court has thus explained the underlying principle that though the assessment may not be based on seized evidence only but the addition cannot be arbitrary. There can be no dispute on this proposition. It has to be based on evidences found during search, or **post search or information available with the AO which can be related to the evidence found.** Thus, any entry already recorded in the books which is not true in its nature or source and any information even coming to the AO post search shall constitute incriminating material for the purpose of making an assessment u/s 153A.

3. Even if it is accepted that the AO does has powers to consider other aspects which were not directly emanating from seized material or that the AO had some basis to disturb earlier findings, it would still be necessary to seek answers to the following questions:

(i) Whether the change of opinion based on material is permissible while making assessment?

(ii) What are the conditions and to what extent the AO can dislodge the claims already accepted/claimed/allowed, etc. in earlier proceedings?

(iii) Whether u/s 153A, the AO can disturb the findings arrived on an issue, whether explicitly or otherwise, in earlier assessments concluded u/s 147/143(3) when it is found that the AO has been misled by placing evidences due to suppression or misrepresentation of facts, which were subsequently found to be doubtful based on evidences gathered?

3.1 There is a distinction between a **mere change of opinion and a change of opinion based on fresh facts.** The latter would imply that the earlier conclusions of the AO were misled by placing evidence on suppression or misrepresentation of material facts. An order passed by the AO relying upon such make belief documents, suppressed or misrepresented facts, which were later found to be not true, shall become void or voidable, as the case may be. **Under such circumstances, the acceptance of any claim, relief etc. in any earlier order shall also have no binding force in any subsequent proceedings and the change of opinion would be permissible.** The Courts have accepted the principle that any fraud practiced on the court is always a ground for vacating the judgment, as where the court is deceived or misled as to material circumstances, or its process is abused, resulting in the rendition of a judgment, which would not have been given if the whole conduct of the case had been fair".

The Madras High Court in case of **L. Mohanam vs Mohamed Idris** on 24 June, 2011 in O.S.A.No.310 of 2010 has observed as under:

19. In support of his contention, the learned senior counsel for the appellant/plaintiff relied on the decision of the Hon'ble Supreme Court in Hamza Haji V. State of Kerala and another reported in (2006) 7 SCC 416, wherein it has been observed that a decision obtained by playing a fraud on Court is liable to be set aside on the basic principle that the party who secured such a decision by fraud cannot be allowed to enjoy its fruits. The learned senior counsel also relied on the observation of the Hon'ble Supreme Court in State of Andhra Pradesh and another Vs. T.Suryachandra Rao reported in (2005) 6 SCC 149 to the effect that the fraud vitiates every solemn Act and fraud and justice never dwell together. In A.V.Papayya Sastry and Others Vs. Govt. Of Andhra Pradesh and others reported in (2007) 4 Supreme Court Cases 221 also, the Hon'ble Supreme Court has observed that fraud vitiates all judicial acts whether in rem or in personam and that a judgment, decree or order obtained by fraud has to be treated as non-est and nullity, whether by the Court of first instance or by the final Court and that the same can be challenged in any Court, at any time, in appeal, revision, writ or even in collateral proceedings. In North Eastern Railway Administration, Gorakhpur Vs. Bhagwan Das (dead) By Lrs reported in (2008) 8 Supreme Court Cases 511, the Hon'ble Supreme Court has again reiterated the point that *a judgment or decree obtained by fraud either in the first court or in the highest Court, is a nullity in the eye of law.*

Section 44 of the Evidence Act also enables a party otherwise bound by a previous adjudication to show that it was not final or binding because it is vitiated by fraud. The provision therefore gives jurisdiction and authority to a Court to consider and decide the question whether a prior adjudication is vitiated by fraud.

Thus, the above propositions of law abundantly make clear that the AO also being a quasi-judicial authority, while functioning under the Act, shall also be bound by similar principles of jurisprudence. **Hence, for the purposes of assessment of total income u/s 153A also, any findings given in respect of any claim/relief in earlier proceedings shall stand vacated by operation of legal principles (as held by the Apex court above), where it is found that in earlier proceedings the AO has been misled by suppression or misrepresentation of material facts or by producing only make belief documents, which were not found to be genuine subsequently based on emergence of new facts during enquiries. Hence the view that the AO cannot rescind from accepting the documents admitted earlier is not a gospel truth which can be applied in each and every circumstance.**

3.2 Further the Apex court in **ITO Vs. Techspan India (P.) Ltd.** 92 taxmann.com 361 (SC) observed as under:

Whether before interfering with proposed re-opening of assessment on ground that same is based only on a change of opinion, Court ought to verify whether assessment earlier made has either expressly or by necessary implication expressed an opinion on a matter which is basis of alleged escapement of income that was taxable; if assessment order is non-speaking, cryptic or perfunctory in nature, it may be difficult to attribute to Assessing Officer any opinion on questions that are raised in proposed re-assessment proceedings - Held, yes - Whether every attempt to bring to tax income that has escaped assessment, cannot be absorbed by judicial intervention on an assumed change of opinion even in cases where order of assessment does not address itself to a given aspect sought to be examined in re-assessment proceedings - Held, yes

In view of the above, applying the same principle in the present context also, it can be safely concluded that in the absence of any categorical finding on the genuineness of a claim in an earlier assessment having being accepted on make belief documents/evidences only, it cannot be said that the A.O. has expressed any opinion on the correctness or otherwise of the items/entries disclosed in the return of income already filed prior to the search. The judicial view is very clear wherein it has been held that the mere submission of some documents proving identity or bank account, affidavits in contrast to the other evidences suggesting the transaction to be suspicious cannot be accepted to have established the genuineness of transaction. **Hence, if any earlier finding has been found to be vitiated or incorrect based on material found subsequently, the AO shall have powers to review such findings based on any tangible material coming to his notice, while exercising power of assessment of total income u/s 153A.**

In view of the above, it is clear that if there is some material noticed subsequently whether found during search or otherwise, the findings of earlier assessments can be dislodged, irrespective of whether such earlier assessment was under 143(1) or 143(3)/147.

The Times They Are A-Changing

Prasenjit Singh
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Sh. Prasenjit Singh is an IRS officer of 1990 batch and is currently posted as Commissioner of Income Tax, TDS, Vadodara. The present article is based on the appellate order passed by him as Commissioner (Appeals). Relevant extracts from this order has been reproduced. However, the name of the assessee has been muted. This order was widely appreciated and the author was awarded the title of 'BEST INNOVATOR' in the charge of Pr. CCIT, Gujarat for the exceptional ideas utilized in the appellate proceedings.

Executive Summary

The present article is based on the appellate order passed by me as Commissioner (Appeals). Relevant extracts from my order have been reproduced. However, the name of the assessee has been muted. This order was widely appreciated and the author was awarded the title of 'BEST INNOVATOR' in the charge of Pr. CCIT, Gujarat for the exceptional ideas utilized in the appellate proceedings.

The above popular number by Bob Dylan has a strong message, not restricted to the music or literature but applicable to the taxation as well. Let us see how.

1. In large number of cases in a South Gujarat district, on behalf of a big group planning a factory, huge parcels of land were acquired and compensation was paid towards land acquisition which included compensation for land and non land component such as structures, wells, farm house, trees, crops etc. The total payment of Rs. 245 crores was made to 529 persons. This payment was made towards land cost but also included the payment of Rs. 90 crores made for non-land component (Construction/ Structures/Well, agriculture crops, trees, etc.) The land acquisition was carried out from 2001 onwards to 2006 and compensation payments were made from F.Y. 2007-09 to 2011-12. In all the cases of compensation payments, reassessment proceedings were initiated. The assessment was completed in more than 250 cases and appeals were filed against the reassessment proceedings. The CIT(A) while dealing with few of these appeals noticed that in some cases the payment for the 'non land component' which included construction/structures/Kaccha Huts/WC/Well, etc., trees, agriculture crops was unusually high vis-à-vis the compensation received for the land. The main challenge was that the cases were being decided in FY 2015-16 while the events of acquisition and financial transactions had taken place several years ago. Whether there existed any structures, trees, crops etc. were not ascertainable. In order to verify the basis and authenticity of these payments made for the 'non land component, a reference was made to National Remote Sensing Centre (NRSC) Hyderabad under ISRO to determine from the analysis of the Satellite Images since 1999 upto 2012 regarding the nature of the crops produced, number of trees existing, and whether any construction/structure existed or not.

2. In one of such cases of land acquisition and receipt of large compensation, the reassessment proceedings were initiated by the AO in an individual case named MSP for AY 2008-09. The assessee had received a large compensation from Land Acquisition Officer. The compensation consisted of price of land (Rs. 30L) and also towards structures on the land (Rs. 170 L). These were not disclosed in return for the said year.

3. The Issue and Challenges:

The payment of compensation by E. Steel Ltd was made under two broad categories:

a. The payment made towards acquisition of land.

b. The payment towards non land component which included payments made under the following heads:

- Construction/structures/Kaccha Huts/WC/Well, etc.
- Trees
- Agriculture Crops

- The majority of the land acquisition was completed by 2004 and the payment for the land acquisition was started from F.Y. 2006-07 onwards. The issue which required investigations was that in some cases the compensation payment for the 'non land component' which included construction/structures/Kaccha Huts/ WC/ Well, etc., Trees and agriculture crops, was unusually high vis-à-vis the compensation received for the land.
- 570 such cases were reopened in u/s 147 of the IT Act in AY 2012-13 i.e. after more than 3 - 6 years of actual transactions had actually taken place. The challenge was how to ascertain the facts of existence of agriculture crops, trees and structures for which huge payments had been made after so many years. The availability of the historical data is always a challenge.

c. Before the AO, the assessee objected to the reopening of case and pleaded that the land in question was agricultural land, not liable to capital gains. The AO after allowing sufficient opportunity and after going through the details in respect of agricultural operations done on said land, rejected the claim of assessee and passed an order by determining the income at Rs. 2,20,83,800/-, a week before the closing of financial year 2012-13 and raising demand of Rs. 1.10 Crore. The AO also rejected the claim of section 54B and initiated penalty u/s 271(1)(c).

d. Similar exercise was undertaken for two more individual cases which are all related to each other. Dissatisfied with the assessment order, an appeal before the Commissioner (Appeals) was preferred challenging the reopening, LTCG not treated exempt, charging interest and initiating penalty for concealment.

e. The appellant was provided with 12 opportunities to defend his case by Commissioner (Appeals), but no compliance was made. The Appellate authority had to explore other options to obtain sufficient information on the case. Some similar cases were already disposed off in the same Appellate office and observations/documents/ decisions in such cases were found relevant for the present appeal also.

f. The acquired land was situated in a Notified Area. The Notification of Industries and Mines Department, Government of Gujarat and Gujarat Municipalities Act, 1963 (GUJ 34 of 1964). This Act, dealing with the Notified Area defines the notified areas as urban area or part thereof specified as notified area to be an Industrial Township Area under the provisions of Clause – I of article 243 Q of the Constitution of India. It has been expressly clarified that the provisions of Gujarat Panchayats Act ceased to apply in respect of notified areas from the date of notification.

g. The assessing officer had formed his `reason to believe` perceiving the corresponding Capital Gains had escaped assessment as the lands acquired was capital assets u/s 2(14) of the Act and corresponding Capital Gains was not offered for tax by the appellant. The AO also referred to the Census register of the area and on the basis of above information, the assessing officers held that total of population of all the villages taken together exceeds 10000 and such total population should be considered for the purpose of section 2 (14)(iii)(a) .

h. MY OBSERVATIONS AS COMMISSIONER (APPEALS)

(a) The land acquired/sold/transferred was not an agricultural and therefore, it was a Capital Asset in view of section 2(14) of the IT Act.

(b) Without prejudice to the above finding that the land sold/transferred/acquired was not an Agricultural Land, the issue of applicability of section 2(14)(iii)(a) and (b) is only of academic interest as it has been held that the land sold/transferred/ acquired was not an agricultural land and therefore, it was a Capital Asset u/s 2(14) of the IT Act.

© As regards the indexed 'cost of acquisition', it has been held that the fair market value of the land would be taken @ 2.05 per sq mtr. as on 01.04.1981 and the indexed 'cost of acquisition' for the purpose of Long Term Capital Gain would be worked out accordingly.

(d) As regards deductions u/s 10(37) of the Income Tax Act and 54B, the issues have been decided against the appellants for the reason that the land itself has not been held to be an 'agricultural land'. Moreover, there has been no evidence of any agricultural activity in the immediate past, in respect of the said land.

(e) As regards compensation/sale consideration for other immovable assets on the land like pakka house, pakka huts, trees, water tank, etc, the said assets are treated as distinct and separate capital assets and he corresponding compensation/consideration has not been treated as compensation/ consideration for the land.

(f) The said compensation/consideration for other immovable assets has been assessed under the head STCG and not under the head 'income from other source' as done by the AO.

(g) On estimate basis, deduction for indexed cost of acquisition has been given @ 50% of the consideration/compensation received, in respect of such other immovable assets

(h) Investment in the immovable assets is to be taxed u/s 69 of the I T Act and the investment value is to be taken as deemed income under the head `Other Sources`. The year of taxability of deemed income will be the year, in which, the investment is detected i.e. the year to which, the appeal pertains to. This means 50% of the compensation received for other assets is assessable under the head ` Other Sources`,

(I) As regards issue of notice u/s 148 of the Act, the validity of notice u/s 148 has been upheld as there has been no scrutiny assessment earlier and the notice u/s 148 was issued within 4 years from the end of relevant to assessment year. Moreover, the assessing officer had duly recorded his/her reasons to believe regarding escapement of income from tax alter considering the material received from the concerned authorities of the State Government regarding consideration paid for acquisition/sale of land/ other properties.

i. During the course of the appellate proceedings, it was noticed that the appellant had received payment for his land survey no. Xxx-Yyy of Rs. 30,00,000/- as compensation for land and Rs. 1,70,00,000/- towards construction/structures/Kaccha Huts/WC/well, etc. In instant case, the payments made by Xxxx Yyyyy Ltd. towards non land component was found to be unusually high vis-à-vis the compensation received for the land. The non land component included payments made towards the:

- Construction/structures/Kaccha Huts/WC/Well, etc.
- Trees
- Agriculture Crops

j. SATELLITE- A TAX GUY IN THE SKY ENTERS THE SCENE

The follow up, so far chained to the earth, rose to **'Stratosphere'** in appellate proceedings. Historic satellite data is the only means to get the past information of different features.

k. Taking into consideration the fact, that payments had been made of large amounts on account of construction, trees, crops, etc., which was unusual, abnormal and uncommon as normally the quality of construction, etc. in rural areas is of inferior quality, it was decided that further enquiries need to be done in these cases. In order to verify the basis and authenticity of these payments made for the 'non land component, **a reference was made u/s 250(4) of the I T Act, 1961 to National Remote Sensing Centre (NRSC) Hyderabad under ISRO to determine from the analysis of the Satellite Images since 1999 upto 2012 regarding the nature of the crops produced, number of trees existing, whether any construction/structure existing on the 61 parcel of land for which the compensation had been paid.**

l. This reference made to NRSC, Hyderabad included as the initial measure, an exercise for the collection of basic data before making a request to NRSC, Hyderabad. As a first step, a reference was made to Bhaskaracharya Institute for Space Applications and Geo-Informatics, Gandhinagar, Gujarat, also known as 'BISAG'. This institute is a State Level Nodal Agency established by Government of Gujarat, to facilitate the use of spatial and geo-spatial technologies for the planning and developmental activities pertaining to Agriculture, Land and Water Resource Management, Wasteland/Watershed Development, Forestry, Disaster Management, Infrastructure and Education. The list of 61 Survey Numbers of the land acquired by E. Steel Ltd in the H. Notified Area was provided to 'BISAG' in June 2015 to locate these 61 survey numbers and get it marked it on the maps of Gujarat with the size and shape of the land as per the survey number. The required data was provided by BISAG. This data provided by BISAG was having background satellite data with shape file and scanned cadastral map for the useful interpretation by National Remote Sensing Centre(NRSC), Hyderabad under ISRO.

land 15 multi-spectral LISS-IV of Resourcesat-1/2 images were used in the analysis.

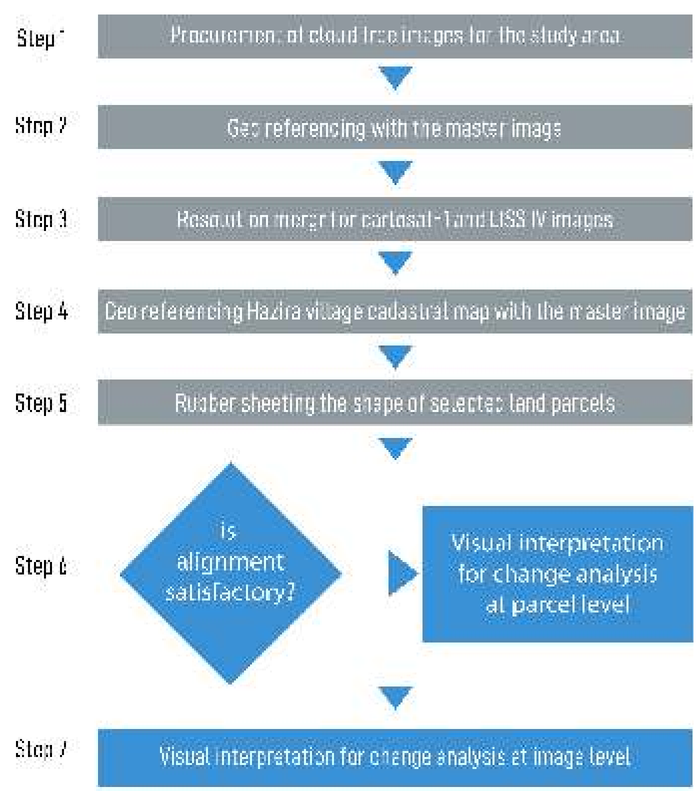
m. This mapped survey numbers with size and shape was sent to NRSC, Hyderabad, for obtaining the images of land as per the survey numbers alongwith the crops, trees, constructed structures (tube well, house, shades, etc.) to determine whether the kharif, rabi or summer crop was produced on these lands or not; whether any construction/ structure was existing on these land during the period 1999 to 2006.

n. **The mapped survey numbers with size and shape was used by NRSC vis-à-vis the remote sensing technology which has historic data base on the study area, to derive information on land use features like the crops, trees, water bodies, settlements and structures and the changes in the land parcel that has taken place over the years.** The remote sensing technology advantage is that each feature on earth has different pattern, shape, texture, tone, etc. These different land covers are distinctly manifested in the satellite data in the form of different image elements viz., the tone, the texture, the pattern, the shape and the association, etc. The analysis of these elements provided information with respect to the identification of these land cover features. Satellite data is amenable to geo-referencing, by which the coordinates of the image could be matched to that of the real world. This enabled NRSC to map different features on the Earth's surface. **Further, analysis of the multi-temporal data enabled NRSC to detect the changes the different features are undergoing, either naturally or through man-made activities.** In addition, historic satellite data is the only means to get the past information of different features. In light of these advantages, NRSC used the remote sensing satellite data by employing appropriate geospatial analytical techniques.

o. The NRSC for the analysis of period from 1999 to 2012, the corresponding cloud-free high resolution imagery of Indian Remote Sensing Satellites were selected. For the years 1999 to 2003 the analysis was carried out using the then available panchromatic data of IRS-1C / ID with 5.8 m resolution and subsequently multi-spectral LISS-IV data of Resourcesat-1/2 with 5.8 m resolution were used. Since 2006 the Cartosat-1 Panchromatic data with a spatial resolution of 2.5m was used in the analysis. Seven imageries of and IRS-1C/D PAN, six imageries of Cartosat-land 15 multi-spectral LISS-IV of Resourcesat-1/2 images were used in the analysis.

p. An amount of Rs.2,50,000/- was paid to NRSC, Hyderabad for obtaining the Satellite Data from the various satellites. In some cases, where the data was not available with the Indian Satellites due to clouds, etc., the data was obtained from the International Satellites by NRSC, Hyderabad for the same.

q. The study used (i) master reference satellite data, (ii) satellite data for the reference period, (iii) cadastral map of the H. village along with shape file. Soft copy of the cadastral map in JPEG format, shape file of the selected parcels with revenue/survey number as well as the paper-print hard copy were provided by this office. The methodology employed essentially comprised of two broad steps viz., (1) geo-referencing the satellite data and the shape file and (2) interpretation of the images. The methodology followed in this study is presented in Fig. v



r. In the report of the NRSC, Hyderabad which was received in September 2016, i**t was found that no agriculture activity or evidence of any crops have been found on the various parcels of land including the appellant's land (Survey No. Xxx-Yyy from the period 1999 to 2012. Only scrubs were found with no signs of any crops or vegetables on the said parcel of lands. It was also pointed out that no construction/structure was found on the said land till 2006.** Subsequently a show cause notice was issued to the assessee on 08.02.2017 which is as following :-

"During the course of appellate proceedings, it was noticed that you had received compensation from M/s Xxxx Yyyy Limited during the A.Y. 2008-09 for **'acquisition of land'** for **Survey** No. Abc-xyz. The records show that you had received the following amount of compensation for acquisition of land.

In order to verify the genuineness of the above payments received by you on account of crops, trees and construction, an inquiry was conducted by this office u/s 250(4) of the Income Tax Act, 1961. The details of your land alongwith survey number was communicated to the **National Remote Sensing Centre,(NRSC) Hyderabad,** so as to determine after analyzing the satellite images the following issues:

a) Whether kharif, rabi or any other summer crops were/ was produced on this piece of land or not or any agriculture produce had been produced since year 1999?

b) The number of trees existing on this piece of land since year 1999?

c) Whether any construction/structure was existing on this land, since year 1999?

The NRSC, Hyderabad in its report has informed the following facts in regards to your land:

i) **No agricultural activity or evidence of any crops** have been found on this piece of land at **Survey No.** abc from the period 1999 to 2012.

ii) The **number of trees** on your land have been estimated at ______, to be existing on this survey number. While as per the report of the Forest Department who had conducted the survey for determination of the types of trees, during the pre- acquisition period had reported that only 2 types of trees were found therein, which are namely (i) ______________ (ii) ___________________. The report dated of Forest Department

iii) The reports of the NRSC, Hyderabad points out that very small area of construction **(less than 5% construction was found)** on the land bearing **Survey Number** abc for which payment to the extent of Rs. 1,70,00,000/- has been made to you .

The relevant portion of the report (Satellite Images) of the NRSC, Hyderabad pertaining to your land is enclosed with this show cause letter. In view of the findings of the NRSC, Hyderabad, you are hereby directed to furnish your reply / clarification on this issue, with documentary evidence, **by 27/02/2017** to this office, failing which, it will be assumed that you had nothing to submit on this aspect and the appeal will be decided on the details available on record."

s. This show cause notice was issued on the address given by the appellant in Appeal Memo(Form No.35) and was duly served on the appellant on 10.02.2017 as per the Speed Post on line tracking. **In response to the show cause notice, no compliance was made by the appellant and no clarification was submitted. The appellant sought adjournments only and no reply was filed. The finding by the NRSC, Hyderabad which was confronted to the appellant proves that there existed no construction/ structure, etc of any kind on the said land. It was also pointed out that no construction was found on Survey No. Xyz-abc. By no stretch of imagination the payment for this no construction can be made of Rs.1,70,00,000/- while the total payment for the land is only Rs. 30,00,000/- which itself proves that the payment made for the no construction can be thousand times more than the land cost. The compensation received by the appellant cannot be considered to have been paid towards construction/ structure, etc. and therefore the amount of compensation of Rs. 1,70,00,000/- received will be treated as income from other sources as held by the AO in the assessment order.**

The copy of the Satellite Imaging Report by NRSC, Hyderabad is enclosed as Annexure A of this appellate order.

t. Keeping in view, the above findings of the CIT(A) while adjudicating the various appeals on the various similar issues raised in the grounds of appeal in this appeal, the various grounds of appeals are being decided accordingly as following:

Ground No. 1	**Dismissed**- The reassessment proceedings are valid
Ground No. 2	**Dismissed** as the land has been held to be capital asset.
Ground No. 3	**Dismissed**- The compensation for other assets of Rs. 1,70,00,000/- is to be assessed under the head Income from other sources as it has been proved vide NRSC, Hyderabad report discussed from para 7.1.2 to 7.1.10 of the appellate order.
Ground No. 4	**Dismissed**- The charging of interest is mandatory as per the provisions of the Act. The order of the AO for charging of interest in order and is upheld.
Ground No. 5	This ground is premature at this stage. The initiation of penalty proceedings by the AO has been correctly done as per the provisions of the Act and therefore the **ground of appeal is dismissed.**

In the result, the appeal was dismissed.

The appeal was dismissed as the satellite imagery from 1999 to 2012 proved that there existed no structures on the said parcel of land for which the huge payment was made. The present appeal as well as several other similar appeals are pending before ITAT for adjudication.

u. ARE NOT THE END RESULTS FACISNATING!

When it comes to tax assessment, huge sets data can be gathered from a vast array of resources. Tax authorities can use vast public records ranging from the driving licenses to voter registration including satellite imaging.

By combining this data with aerial imagery and geographic information systems, tax authorities can spot irregularities and inconsistencies in property matters in a whole new way. However, the entire exercise needs understanding the technology, transparency, going through the legal approvals, obtaining the precise data and its proper interpretation. Ne may be careful in drawing the correct inference, so that the entire exercise may not end up in putting the ball in one's own goal post.

v. IMAGING SATELLITES AND THEIR RESOLUTION

The use of aerial imagery is not new. It started around by Joseph N Nicepce, for military use in 1827 but abandoned due to lack of equipments. However, it developed rapidly with the invention of photographic camera. First recorded use was made through a balloon in 1858 by Gaspad Felix Tournachon over Bievre valley. Photography using kites was done by M Arthur Bahut in late 1880s' in France. In 1922, it was used in Newark, New Jersey successfully, discovering more than 1500 buildings not on the tax rolls using ariel photography and maps.

One must understand that there is much difference between the aerial photography and satellite imaging. The later came to existence only around one hundred years later than the aerial photography. Though both are used to study the earth from a height, the techniques and cost may differ a lot. There are four types of resolution when discussing satellite imagery in remote sensing: spatial, spectral, temporal, and radiometric. Additionally, geometric resolution refers to the satellite sensor's ability to effectively image a portion of the Earth's surface in a single pixel.

A satellite's image resolution also depends on several factors, including the instrument used and the altitude of the satellite's orbit. Satellite imagery can be supplemented with aerial photography, which has higher resolution but is more expensive. With all this technology, because the land area of the country is so large and satellite databases are huge, creating useful data from the raw images is a very challenging professional work and also time-consuming. For this reason, publicly available satellite image datasets are usually processed for visual or scientific commercial use by third parties- usually experts on such matters. Satellites are used to estimate crop sizes, coupled with an algorithm or two could also give us the value of a crop and the expected income also and taxes on it, if taxable.

w. Applicability of the Satellite Imaging Technology:

This technology can be used for detection of tax evasion in other areas also where historical data is required:

- Mining
- Construction Activities
- Installation of big Machineries/Industrial Structures
- Tracking movement of Vehicles
- Agriculture/ Horticulture/Animal Husbandry

The latest avatar (incarnation) is the use of drones better known as UAS (Unmanned aerial systems) for commercial as well as for the tax assessments. Specific software can be prepared and uploaded for this purpose. It solves the many great challenges facing tax appraisers, for example:

- Getting physical access to the property to make a proper appraisal, which otherwise would involve taking permission from the taxpayer/court.
- Having enough field assessors to cover all the properties spread across a vast area on the tax rolls.
- The cost of aerial photography is reduced considerably with remotely controlled drones.
- Drones have an advantage over quality of image that satellite imagery cannot compete with.
- This allows appraisers to observe and document a property in real-time on the date of inspection and will undoubtedly change the way many properties are viewed going forward.
- Drone imagery can be time stamped and conducted largely at will. This allows a running record of improvements and depreciations to be maintained, and offers a completely current picture to meet protests by owners at a later date in a court at the time of trial.
- However, the follow up of local/State/Union laws on its use is required. An assessor may be required to follow not only his own law but the aviation laws and privacy/civil laws etc. while collecting such data for official uses.

In one assignment to a marketing consultant, a struggling retailer located directly across the street another profitable retail chain wanted to know why it was not getting enough customers, where as the store opposite too it was doing a roaring business. During the inspection, the drone captured the unintended information on traffic flow; the appraiser was able to easily identify that the retailer had only right in/right out ingress and egress. It was virtually impossible to leave the property and traverse the four lanes and to pass the traffic light in front of the competitor store to return in the opposite direction. The client was able to change their marketing strategy to suit the conditions.

In yet another case, a large property was saved from the damage after studying the images of the roof showing numerous areas of pooling water which could potentially be harmful to the structure. The drone was able to identify a problem before it developed into something much worse.

I recently came across interesting news that the wine makers in the Fronton region of Southern France are flying sophisticated drones laden with customized software that let them monitor fields of sick plants, predict output and map vineyard to the basic size of a grape or even less than it. The drones take only a minute to fly over a square mile to capture the finest details. Such photographs are assembled by the software and turn them into a 3D realistic looking video.

By studying it minutely, winemakers can decide to spray the exact quantity of fertilizer/pesticide to optimise the quality, keeping the cost to a minimum. The output of the produce as well as the desired quality/output can be maintained to the wine makers' satisfaction.

How does that old song go? - The times they are a-changing- and we all have to agree.

(My sincere thanks to Sri C.P. Bhatia, IRS, Jt. CIT, Ahmedabad, for his help in drafting the article- Prasenjit Singh, IRS)

S No-XX 17 Mar 1999 | S No-XX 1 Mar 2000 | S No-XX 14 Feb 2001 | S No-XX 30 Jan 2002 | S No-XX 27 Mar 2003 | S No-XX 27 Dec 2003 | S No-XX 07 Nov 2004 | S No-XX 25 Mar 2005 | S No-XX 04 Dec 2006

Year	1999	2000	2001	2002	2003	2004	2005	2006
Vegetation	scrub	scrub	scrub	scrub	scrub	scrub	scrub	scrub
Trees	many	many	many	many	many	many	many	many
Construction	no	no	no	no	no	no	no	no

Authority for Advance Rulings and Settlement of Tax Disputes

Justice Arijit Pasayat
Retd. Supreme Court Judge

Justice Arijit Pasayat completed his graduation with Honours in English & obtained LL.B. from M.S. Law College, Cuttack securing First Rank. As an advocate, he had practiced in Constitutional, Taxation and almost all other branches of Law. He was appointed as an Additional Judge of the Orissa High Court on 20.3.1989 and a permanent Judge of that Court on 20.9.1990. He was appointed as Acting Chief Justice of Orissa High Court on 2.4.1999. He was elevated as Chief Justice of Kerala High Court on 20.9.1999. &Transferred as Chief Justice, Delhi High Court on 10.5.2000. He was then elevated as Judge of the Supreme Court on 19.10.2001. He Retired on 9.5.2009 after delivering more than 2500 judgments. He was Awarded Doctorate in Law by Utkal University, Bhubneshwar and Degree of LL.D. (Honoris Causa) by Fakir Mohan University, Balasore. He is the Vice-Chairman of Special Investigation Team on Black money.

Executive Summary

The concept of Advance Rulings has global background and perspectives. The system is in vogue in several countries though procedurally there may be dissimilarities. The first document which shed light on this important concept is the International Bureau of Fiscal Documentation (IBFD) which was published in 1997-2000. It contained articles by authors of various countries on the fundamentals of Advance Rulings. The first conference i.e. 1999 IFA Congress is a milestone in the journey of forums for Advance Rulings. A large number of participating countries reported on the Advance Rulings System prevalent in their countries.

1) The concept of Advance Rulings has global background and perspectives. The system is in vogue in several countries though procedurally there may be dissimilarities. The first document which shed light on this important concept is the International Bureau of Fiscal Documentation (IBFD) which was published in 1997-2000. It contained articles by authors of various countries on the fundamentals of Advance Rulings. The first conference i.e. 1999 IFA Congress is a milestone in the journey of forums for Advance Rulings. A large number of participating countries reported on the Advance Rulings System prevalent in their countries. The importance for Advance Rulings has been stated by Professor Maarten J. Ellies in the following words:-

"A more or less binding statement from the revenue authorities upon the voluntary request of a private person, concerning the treatment and consequences of one or a series of contemplated future actions or transactions".

Though Advance Rulings facility serves almost similar purposes in all countries, significant differences can be noticed in the procedures adopted. Some countries provide for highly developed systems statutorily prescribed, in case of some others, very informal and almost adhoc procedures are provided. The first report relating to establishment of a formal ruling system was recommended by the Carter Commission in its 1967 Report. In India, the scheme was first recommended by the Wanchoo Committee in mid 70s and was formally introduced by Finance Act, 1993. Chapter XIX-B of the Income Tax Act, 1961 (in short "the Act") was introduced with effect from 01.06.1993. Under the provision, the scheme empowering the giving of Advance Rulings was entrusted to an adjudicatory body.

Advance Rulings is the written opinion or the authoritative adjudication by an Authority empowered to render it with regard to the tax consequences of a transaction or proposed transaction or an assessment in regard thereto.

The salient features are:

1. It relates to a transaction entered into or proposed to be

entered into by the Applicant (the Advance Rulings is to be given on questions specified in relation to such a transaction by the Applicant);

2. Questions on which Rulings can be sought are:

- Questions of law or facts pertaining to the income-tax liability of the Applicant qua the transaction undertaken or proposed to be undertaken;
- The questions may be on questions of law or fact and, therefore, mixed questions of fact and law can be included;
- As each question needs to be answered, there is a requirement of breaking of complex questions into two or more simple questions;
- No ruling can be given on a purely hypothecated question and it / they should arise out of the statement of facts given with the application;
- Subject to certain limitations, the question may relate to any aspect of the Applicant's liability including international aspects and aspects governed by Double Tax Agreement. It may even cover aspects of allied laws that may have a bearing on tax liability such as the Law of Contracts, the Law of Trusts and the like. But the question must have a direct bearing on and nexus with the interpretation of the Indian Income Tax Act;
- (These relate to non-residents only)
- Advance Rulings can be obtained to determine whether an arrangement which is proposed to be undertaken by any person being a resident or a non-resident is an impermissible avoidance arrangement as referred to in Chapter X-A or not (General Anti Avoidance Rules) [GAAR].

Under Section 245-R of the Income Tax Act, certain restrictions have been imposed on the admissibility of an application, if the question concerned is pending before other authorities.

An Advance Rulings cannot be sought where, as noted above, (a) in the case of a non-residents applicant the matter is pending before any Income Tax Authority, the Appellate Tribunal or any Court; (b) it involves determination of fair market value of any property, or relates to a transaction which is designed prima facie for avoidance of income tax.

An Advance Rulings pronounced by the Authority is binding in respect of the transactions in relation to which ruling has been sought; (a) on the Commissioner and the Income Tax Authorities subordinate to him in respect of the applicant and (b) on the applicant who has sought it. The Advance Rulings is in the nature of a policy guide to the applicant as well as tax authorities. It is significant that under Section 245-N of the Income Tax Act, an Advance Ruling can be obtained by the following persons:

- a non-resident;
- a resident-undertaking proposing to undertake a transaction with a non-resident can obtain advance ruling in respect of any question of law or fact in relation to the tax liability of the non-resident arising out of such transaction;
- a resident who has undertaken or propose to undertake one or more transactions of value of Rs.100 crore or more in total [vide Notification No.73, dated 28.11.2014];
- a notified public sector company;
- any person, being a resident or non-resident, can obtain an advance ruling to decide whether an arrangement proposed to be undertaken by him is an impermissible avoidance arrangements and may be subjected to General Anti Avoidance Rules or not;
- an applicant as defined in Section 28E(c) of the Customs Act, 1961;
- an applicant as defined in Section 23A(c) of the Central Excise Act, 1944;
- an applicant as defined in Section 96A(b) of the Finance Act, 1994.

After noticing the utility of the Advance Rulings mechanism under the Income Tax Act, similar provisions have been made under the CGST / SGST Act and UTGST Act. As per Section 95 of CGST / SGST Act and Section 12 of UTGST Act, “Advance Ruling” means a decision provided by the Authority or the Appellate Authority to an applicant on matters or on questions specified in Section 97(2) or Section 100(1) of CGST / SGST Act as the case may be, in relation to the supply of goods and / or services proposed to be undertaken or being undertaken by the applicant, (Unlike the Income Tax Act, the CGST / SGST Act and UTGST Act provide for an appeal before the AAAR) the provisions of appeal before AAAR dealt with in Sections 100 and 101 of CGST / SGST Act or Section 14 of the UTGST Act. For each state, there is one AAR and AAAR. The AAAR constituted under the SGST Act or UTGST Act is deemed to be the AAAR under the CGST Act in respect of the respective state or union territory. The broad features and objectives for setting up the mechanism of Advance Rulings is to: (1) to provide certainty in tax liability in relation to an activity proposed to be undertaken by the applicant; (2) to attract Foreign Direct Investment (FDI); (3) to reduce litigation; (4) pronounce rulings expeditiously and in inexpensive manner. The objective for Advance Ruling both under the Income Tax regime and the Goods & Services Tax are in pari materia.

The large number of applications that have been filed is a happy indication that tax payers intend to have clarity and certainty so far as their tax liabilities are concerned and in the process avoid litigation which is not only expensive but also time consuming.

Advances need to be made in the field of 'Advance Rulings'

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Executive Summary

Valuable resources of the nation get wasted in pursuing the litigation in various courts of law before a final or conclusive view emerges out. Since, conventional methods of appeal and further appeals have proven to be time consuming and costly better way to manage disputes would be to have clarity in advance in which context the institution of 'Advance Ruling', needs to be fine tuned and strengthened on the above suggested lines which if done will go a long way in improving the dispute management.

Introduction:

Most ideal situation which one can contemplate is to ensure that there are absolutely no disputes. Disputes always block the smooth evolution and hence dispute management had always been the priority of any Administration. Conventional methods of dispute resolution of having Consensus or Adjudication have failed to ensure smooth dispute management. Most ideal situation in any dispute management is to ensure removal of the possibilities which give rise to disputes. India which is just a budding economy can hardly afford to have time consuming and protracted litigations because it just frustrates the efforts made to uplift the growth of the economy. Thus, like other countries India has also tried to introduce faster and conclusive methods to manage disputes and creation of Authority for Advance Ruling(for short 'the Authority) under the Income Tax Act way back in the year 1993 is a step in that very direction. The Finance Act, 1993 inserted s new Chapter XIX-B to the Income Tax Act, 1961 titled as 'Advance Rulings'. The object to be achieved, as explained by the Finance Minister in his Budget Speech for 1992-93, is to avoid needless litigation and promote better tax payer relations. The procedure for any tax payer in seeking advance ruling, in short, is to have formal confirmation from the tax authorities in advance of entering into specific transactions, of the tax related consequences.

2. **Appraisal of the functioning of the Authority:**

2.1 Authority for Advance Ruling has been in existence for the last 25 years. Initially, the Authority started with one Bench at Delhi with the constitution of a Chairman who had been a Judge of the Supreme Court and two other members drawn from the Indian Revenue Service and Indian Legal Service. Thereafter, two additional Benches have been created one at Mumbai and another additional Bench known as NCR Bench at New Delhi. As on date there are three Benches i.e. one Principal Bench and two additional Benches.

2.2 Though the Authority has been in existence for the last 25 years now, as a mechanism of dispute management it has yet to establish itself. Below mentioned statistics will show that potential of the Authority has either not been exploited by the tax payers or that it has not enthused the confidence of the tax payers as a conclusive forum of dispute management.

Year	No of applications filed	Nos. of Rulings pronounced	Nos. of Withdrawal/rejection
2018	18	17	11
2017	22	09	29
2016	31	129	45
2015	19	05	39
2014	55	22	05

Filing of fewer applications in the Authority as well as very few pronouncements of the Rulings coupled with the disproportionate withdrawal of applications indicates that there are definitely issues which are impacting the performance of the Authority adversely. In the subsequent discussion that follows few of such issues are discussed.

3.0 **Issues impacting the performance:**

3.1 **Delay in disposal:**

Above extracted data goes to show that the potential of the Authority as a forum for dispute management, is not getting fully exploited. One of the reasons for very few tax payers approaching the Authority for advance rulings is clearly the delayed recruitment of Members in the Authority because of which it goes non-functional for a substantial period. Unfortunately, since its inception the Authority has never functioned to its full strength. To ensure that there is not much gap in between the occurance of the vacancy in the cadre of Members of the Authority and deployment of the new Members, it will only be a good idea for the Government to be pro-active and to draw an approved panel of four or five persons at a time so that whenever the vacancy occurs there are persons in advance to be deployed. In this very context, it will be relevant to ensure that the person being selected as a Member should, irrespective of the age, have a full tenure of 02 years. It is believed that such a step would also stabilize the uninterrupted working of the Authority.

3.2 Issue of pendency:

3.2.1 Clause (i) of the Proviso to sub-section (a) of Section 245R of the I.T. Act, 1961 acts as a bar on the Authority to not to allow the application where the question raised in the application is already pending before any Income-tax Authority or Appellate Tribunal or any Court. However, the Act does not specify as to what is the import of the phrase 'pending before any income-tax authority'. As a matter of fact this is one of the most litigated points in the context of the Authority for Advance Rulings which is in a way acting as an impediment for the Taxpayers especially the Non-Residents to seek redressal through the Authority.

3.2.2 View of the Authority had been that if in the case of the applicant notice u/s 143(2) of the Income Tax Act has been issued the proceedings should be treated to be pending before the Income Tax Authority because while undertaking scrutiny of a return of income the Income-tax authority gets the authority to have look at the global affairs of the taxpayers which may inter alia include the issue agitated in the application. However, this view of the Authority has been challenged by the applicants repeatedly before the High Court by filing Writ under Article 226 of the Constitution. Repeated view of the Delhi High Court (refer for illustration Hyosung Corporation reported in 382 ITR 376) has been that in the absence of an issue specifically raised mere issuance of notice u/s 143(2) by the Assessing Officer will not make the issue pending. Since, this issue is of vast importance and especially when there is no clarity in the provisions of law, it is felt that Legislature should immediately undertake fine-tuning of the provisions so as to specifically provide, may be by way of Explanation, as to under what circumstances issue involved can be said to be pending. By way of Explanation it can very well be provided that if the proceedings i.r.to the period relevant to the year in which the transaction is already undertaken is pending before the Assessing Officer whether or not the transaction has been made part of the return of income already filed all issues will be deemed to be pending irrespective of whether or not the AO has specifically raised a specific question to be answered by the taxpayer.

3.2.3 **Delay on the part of the Authority in giving Rulings:**

Though sub-section (6) of section 245 provides that "the authority shall pronounce its advance ruling in writing within 6 months of the receipt of application" yet in practice it is seen that this limitation is hardly adhered to and in most of the cases Authority takes years to pronounce its rulings. At times, it happens that by the time application matures for pronouncement of the Ruling the circumstances change like the transaction is already undertaken etc. as a result of which the application itself becomes infructuous. It has been observed that because of the delay on the part of the Authority in pronouncing its Rulings applicants in a big number get forced to withdraw their applications. Under the circumstances, it is suggested that in cases where the Authority decides to permit withdrawal of the application, fee deposited by the applicants should also be ordered to be refunded in very deserving cases. Such a provision will prompt the Authority as well as all others concerned to be diligent and prompt in disposal. Such a provision would otherwise also get justified on the basis of the principles of equity.

3.2.4 **Need to expand the scope of the application before the Authority:**

3.2.4.1 Right now under the existing law scope of the Authority for its Rulings is very limited. Because of the limited scope only a few applicants can approach the Authority for its advance Rulings. Resultantly, the institution of **'Advance Ruling'** is not getting fully exploited so as to manage or reduce disputes. As already indicated most ideal situation is to visualize and do away with the possibilities of dispute itself. Though applicants can visualize the possible future litigation yet they are not able to plug these possibilities through the medium of 'advance Rulings'. Because of the very restricted scope of advance Rulings, purpose of having disputes free tax regime get frustrated. As already above, on an average not even more than 100 applicants approach the Authority for obtaining 'advance rulings' which reflects very poorly in the context of the huge mountain of litigation confronting the taxpayers including the Income tax Department.

3.2.4.2 In the light of the discussion made above, to exploit full potential of the Authority as a medium of pre-empting the possible litigation, there is a need to expand the jurisdiction for 'advance Rulings'. To begin with, in addition to the existing provisions, it will only be proper if irrespective of the residential status, an applicant is allowed to approach the Authority for a ruling in respect of a transaction proposed to be undertaken or a transaction already been undertaken but return of income in respect of which has not become due or filed and the time for filing the return of income u/s 139(1) has not yet expired. To ensure that the Authority is not burdened with the insignificant or frivolous transactions it can be thought to put in a cap (say of 50 crores or more) on the amount of the transaction which alone can be made subject matter of application.

3.2.5 **Absence of Notification for the Resident applicants:**

3.2.5.1 In exercise of the powers conferrd by sub-clause (iia) of clause (b) of section 245N of the Act, a Notification bearing No.73/2014/F.No.142/6/2014-TPL dated 28-11-2014 had been issued enabling the Resident Applicants to approach the Authority for advance Ruling if value of one or more transactions undertaken or proposed to be undertaken exceeds 100 crores or more. However, it is seen that law as contained u/s 245N(b) has undergone material change w.e.f 01-04-2017 whereby clause and sub-clauses have been renamed/renumbered in the sense that there is no sub-clause (iia) of clause (b) on the Statute Book now as a result of which the Notification of 28-11-2014 has become a dead letter. Because of the change in the law objections are being taken in the Authority to argue that by virtue of the old Notification the Authority post 01-04-2017 cannot be approached by the Resident applicants which otherwise now get covered u/s 245(A)(III). The matter very recently got flagged even in Newspapers (Times of India of 12-04-2019). Absence of new Notification has created an atmosphere of uncertainty in the minds of the Resident applicants as well as all others and it has impacted adversely the admission and Rulings in respect of all those applications which are filed post the year 2017. It is hoped the Central Board of Direct Taxes takes a call early to issue Notification afresh so that Resident applicants start approaching Authority for Rulings.

4. **Summation:**

Valuable resources of the nation get wasted in pursuing the litigation in various courts of law before a final or conclusive view emerges out. Since, conventional methods of appeal and further appeals have proven to be time consuming and costly better way to manage disputes would be to have clarity in advance in which context the institution of 'Advance Ruling', needs to be fine tuned and strengthened on the above suggested lines which if done will go a long way in improving the dispute management.

[The author is Commissioner of Income Tax (Authority for Advanced Rulings), Delhi and views are personal.]

Advance Pricing Agreement Programme in India

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Executive Summary

A separate code on transfer pricing under sections 92 to 92F of the Income Tax Act, 1961 (hereafter, the ITA) covering intra-group cross-border transactions became applicable from 1 April 2001. The regulations are based on the arm's length principle and provided for determination of arm's length price of international transactions between associated enterprises. The Rules 10A to 10 E of the Income Tax Rules, 1962 (hereafter, the Rules) deals with procedural aspects regarding the implementation of transfer pricing law.

1. Introduction[1]

A separate code on transfer pricing under sections 92 to 92F of the Income Tax Act, 1961 (hereafter, the ITA) covering intra-group cross-border transactions became applicable from 1 April 2001. The regulations are based on the arm's length principle and provided for determination of arm's length price of international transactions between associated enterprises. The Rules 10A to 10 E of the Income Tax Rules, 1962 (hereafter, the Rules) deals with procedural aspects regarding the implementation of transfer pricing law.

Years of audits had resulted in a large number of transfer pricing disputes. The decisions by various administrative and judicial authorities were not helping proper resolution of these disputes which most of the times were of repetitive in nature and more of issues of facts than questions of law. A need for an alternate and effective dispute resolution mechanism was felt to bring about certainty and uniformity of approach on the transfer pricing issues.

In this background, the advance pricing agreement (APA) programme was introduced in the year 2012 in the ITA. The provisions regarding rollback of the APA were added later in the year 2015. The APA process is voluntary, and supplements appeal and other dispute resolution measures provided in the ITA and the Double Taxation Avoidance Agreements for resolving transfer pricing disputes.

Six years have elapsed since the APA programme was introduced in India. Commenting on the APA programme, the Chairman of the Central Board of Direct Taxes (CBDT) in the second APA Annual Report stated that, "The APA Programme is a major initiative of the Government towards fostering a non-adversarial tax regime. By concluding 219

1- This article is written by Sanjeev Sharma, Commissioner APA, Delhi

Agreements till 31 March 2018, we have shown our intent and commitment towards establishing such a regime. Let me assure all stakeholders that every possible step would be taken to strengthen the APA Programme."

Sections 2 and 3 describe the legal and administrative framework for the APA programme. APA process is summarised in Section 4. Section 5 provides information on applications filed and agreements signed. Conclusion is available in Section 6.

2. The APA Programme- Legal Framework

An APA is an agreement between the CBDT and any person, which determines, in advance, the arm's length price (hereafter, ALP) or specifies the manner of the determination of ALP (or both), in relation to an international transaction.

The primary objective of an APA is to provide certainty and comfort to taxpayers so that predictable and foreseeable conditions and outcomes can be expected regarding transfer pricing practices. The benefits of an APA are many. The risk of double taxation is eliminated in the bilateral APA. The APA also provides for an agreement on maintenance of documentation, so that the burden of record keeping is reduced. Further, there is no full-scale transfer pricing audit and only a compliance audit to check the adherence to the agreed terms and conditions.

India has created a legal framework providing for a legally binding agreement between the taxpayer and the CBDT. The Finance Act, 2012, inserted sections 92CC and 92 CD in the ITA to provide the legal basis for APA in India. These statutory provisions, effective from 1 July 2012, empowered the CBDT to enter an agreement with any person, with the approval of Central Government, determining the ALP or specifying the manner of determination of ALP in relation to an international transaction to be entered into by that person.

The rules regarding the implementation aspects of the APA Scheme were notified later on 30 August 2012 in the form of rules 10F to 10T and rule 44GA of the Rules. These provisions lay down the detailed procedures for the filing of pre-filing consultation application, pre-filing consultation, fees, the filing of APA application, processing of the application, amendment of application, withdrawal of application, terms and conditions, filing of Annual Compliance Report, Compliance Audit, revision, cancellation and renewal of the APA.

The CBDT issued a "Guidance with FAQs" on the APA scheme in the form of a Tax Payer Information Series[2]. A taxpayer can request an APA for a maximum period of five years. A shorter period is not prohibited.

Rollback provisions in the APA Scheme were introduced through the insertion of sub-section (9A) in section 92CC by the Finance (No.2) Act, 2014. The relevant rules (10MA and 10RA) for the rollback of the APA were notified on 14 March 2015, and a FAQ[3] through Circular No. 10/2015 was issued explaining the provisions of the rollback of the APA. The primary condition for the rollback of the APA is that the international transaction in the rollback period shall be the same as in the APA period. The FAR analysis of the rollback year shall not differ materially from the FAR analysis validated for the APA years. The rollback provisions are applicable for four years prior to the first year of the APA period, and the applicant does not have the option to pick and choose the years for which it wants to apply for rollback. The applicant must apply the rollback of the APA for all four years or not apply at all. For example, if the applicant's transfer price has been accepted to be at arm's length in the transfer pricing audit for any of the four previous years or a year is not in the transfer pricing audit, these years cannot be left out, and rollback of the APA would apply to these years also.

A taxpayer would be able to have certainty in matters of transfer pricing for a maximum period of 9 years (prospective five years and four rollback years) by applying for an APA along with an application for the rollback of the APA.

Transfer pricing regulation[4] has introduced provisions regarding secondary adjustment and these also apply to primary adjustment arising out of the APA.

The APA remains in force for the period covered in the APA and is binding on the requesting person and the Commissioner of Income Tax (and his subordinate income tax authorities) having jurisdiction over such person.

2- Guidance and FAQs available at: http://www.incometaxindia.gov.in/booklets%20%20pamphlets/advance-pricing-agreement-guidance-with-faqs-(tpi-43).pdf (accessed 15.02.2019).

3 - Circular No.10/2015 dated 10th June, 2015 is available at: http://www.incometaxindia.gov.in/communications/circular/circular_no_10_2015.pdf (last accessed 15.02.2019).

4 - See section 92CE of the Act

The APA program provides for unilateral, bilateral, and multilateral APAs. The applicant has the option of choosing a particular type of APA. A unilateral APA[5] is an agreement between the CBDT and the applicant and protects the applicant from transfer pricing adjustments under the ITA. In the bilateral APA, the applicant is required to make an application with the Indian competent authority, and another request is needed to be made by the applicant or its AE to the competent authority of its country of residence. In multilateral APA, the applicant is required to make an application with the Indian competent authority, and simultaneously the applicant or its AEs should apply to the competent authority of the other countries relevant to the international transactions. The bilateral and multilateral APAs protect the taxpayers and their associated enterprises from the potential double taxation of the income from the same international transaction.

The provisions of mutual agreement procedure (Art.25 or equivalent) and associated enterprises (Art.9) of relevant tax treaty are used to negotiate and agree at the bilateral and multilateral APAs with the tax authority of other countries. The applicant must accept the terms of an agreement before a bilateral or multilateral APA is entered with other competent authorities.

Some of Indian tax treaties with major trading partners did not contain paragraph 2 in Article 9 (or equivalent Article) providing for 'Corresponding Adjustment,' and this prevented the CBDT from accepting an application for bilateral APA involving these countries. The CBDT, keeping with the spirit of the Report on BEPS Action 14[6] effective 27 November 2017, has decided to accept bilateral APA applications regardless of the availability of paragraph 2 in Article 9 of the tax treaty. The CBDT accepts a request for bilateral or multilateral APA only when the other country also has a corresponding APA program.

Presently, any taxpayer having international transactions can request an APA. There are no restrictions of any type like minimum threshold on the annual value of related party transactions or nature of transactions for taxpayers seeking an APA. The international transactions under transfer pricing audit or are pending for decision with any judicial authority can also be covered in the APA.

There are some restrictions regarding granting the benefit of the rollback of the APA. One such limitation[7] is in regard to non-availability of the rollback in respect of an international transaction for a rollback year if the determination of arm's length price of the said international transaction for the said year has been the subject matter of an appeal before the Appellate Tribunal, and the Appellate Tribunal has passed an order disposing of such appeal at any time before signing of the agreement.

The rules do not provide for suspension of ongoing transfer pricing audit or investigation during the application process and till signing of the agreement. The taxpayer is protected from the transfer pricing audit in respect of the covered transactions after signing the agreement.

3. Administrative framework

The CBDT has created special teams tasked exclusively for APA. The APA program started in 2013 with one APA Team headed by a Commissioner located in New Delhi and a total of four additional/joint commissioners based in New Delhi, Mumbai, and Bangalore. Eight Deputy/Assistant Commissioners assisted them. Considering a large number of applications filed and for fast-tracking the finalisation of the APA, the CBDT has lately added three more commissioners to the program. However, the officers at lower level not increased. The APA Teams work under the control and supervision of Principal Chief Commissioner of Income Tax (International Tax and Transfer Pricing) based in New Delhi. The APA Teams are responsible for processing both unilateral and bilateral applications and submit the Position Papers to the CBDT. After approval of the CBDT, the APA Team negotiates the terms and conditions with the taxpayer in case of unilateral APA.

In case of applications for bilateral/multilateral APAs, the Competent Authority of India carries out negotiations with the competent authorities of other countries.

4. APA Process

4.1 Request for an APA

An APA is a taxpayer motivated agreement. The APA

5 - In unilateral APAs, the risk of potential double taxation remains given that the methodology agreed by the taxpayer with the tax administration of a country may not necessarily be accepted by the counter party tax administration. This risk may increase after the unilateral APAs are exchanged with the tax administration of counter party based on the minimum agreed standards in relation to Action 5 of the G20/OECD BEPS Project.

6 - OECD/G20, Making Dispute Resolution Mechanisms More Effective: Action 14 Final Report

process starts with the filing of an application[8] by the taxpayer in the prescribed form (Form 3CED). There are no monetary limits specified for being eligible to file an APA application. A taxpayer may also request a pre-filing consultation meeting with the APA authorities before submitting a formal APA application. Pre-filing consultation can be also sought on an anonymous basis. Pre-filing consultation is now optional. The pre-filing consultation process is non-binding on both the parties.

The formal application must contain the specified information. The application needs to state the multinational group structure, organisation arrangement, mention covered transactions explicitly, provide FAR analysis of the applicant and all relevant entities for the covered transactions, economic analysis, a copy of inter-company agreements for all covered transactions; audited accounts, and the proposed terms and conditions. A taxpayer is free to cover all or select only some international transactions for the APA. The application can be made for continuing transactions and proposed transactions.

An applicant needs to pay a graded fee[9] based on the value of related party transactions proposed to be covered in the APA. An application requesting rollback of the APA requires payment of a fixed fee of INR 500,000. The fee paid is non-refundable except when the application is not allowed to be proceeded with under rule 10 K.

An application requesting a unilateral APA is filed with the Principal Chief Commissioner of Income Tax (International Tax and Transfer Pricing), New Delhi. The application for bilateral/multilateral APA is required to be filed with the competent authority of India. In the case of bilateral/multilateral APA, the associated enterprise must initiate the procedure for entering into APA with the competent authority of other country and evidence of the same shall be furnished to the competent authority.

4.2 Acceptance/rejection of an APA application

The APA application, relevant information, and documents attached to the application are subject to preliminary processing by the APA Team to determine the completeness of the application under the provisions of rule 10K. In case the application is defective due to the absence of information or relevant document is not attached or the requisite fee is not paid, the taxpayer is given an opportunity to remove the defects. The non-removal of defects may lead to rejection of the application after providing an opportunity of being heard to the applicant.

An applicant may request in writing for an amendment to its application at any times before the finalisation of terms of the applicant. Such an amendment application shall be filed with the same authority with whom APA request application was submitted. The applicant is allowed to convert an application for unilateral APA to bilateral/multilateral APA and vice-versa and such a request is not considered to have the effect of altering the nature of the original application. The taxpayer can withdraw an APA application at any stage before the finalisation of the APA.

4.3 Examination and analysis of an APA application

A visit to the applicant's business premises, taking into account the convenience of the taxpayer, is undertaken to understand the FAR submitted by the taxpayer. The visit provides the APA Team with firsthand information on the underlying business activities concerning the covered transactions and helps it to better understand the facts of the transactions, business model and business realities of the taxpayer. The visit to the business premises also helps the taxpayer and the APA Team to understand each other's perspectives, concerns and agree on a time frame for completion of the APA process. The visit allows discussion of the issues directly with the responsible officials of the applicant. The focus of the office visit depends on the nature of the business and business model adopted by the applicant.

In case of taxpayers applying bilateral APA, a joint site visit along with the representatives of the other competent authority is also possible. The applicant is expected to give full cooperation for this purpose.

During analysis and detailed evaluation of the application additional information or documentation may be requested. The APA Team is required to do detailed functional analysis and examines the APA application in a reasonable and fair

8 - Application must be filed in prescribed Form No.3CED available at https://www.incometaxindia.gov.in/Forms/Income-Tax%20Rules/103120000000007772.pdf (accessed 4 March, 2019)

9 - Fee is INR one million for value of international transactions, proposed during the proposed period of agreement, up to INR 1000 million. If the value of international transactions exceeds INR 2000 million, the fee is INR two million. The fee is INR one and a half million for value of transactions between INR 1000 million and INR 2000 million

manner taking into consideration all the pieces of evidence and information furnished by the applicant or collected by it. On completion of the analysis and evaluation, the APA Team prepares a position paper (draft report) for submission to the CBDT. In case of unilateral APA, the CBDT directs the APA Team to carry out negotiations on the terms and conditions approved by it. In the case of the bilateral APA, all the process after the receipt of the position paper from the APA Team is handled by the competent authority.

4.4 Entering into an APA

The procedure of negotiations, approval, and signing of the APA is different for unilateral and bilateral APA.

The negotiations with the applicant in case of unilateral APA are carried out by the APA Team.

These negotiations are focussed on the appropriate transfer pricing method, the basis of arriving at arm's length price or arm's length results, terms and conditions, critical assumptions, nature of documents to be maintained by the applicant and to be filed along with the Annual Compliance Report.

After completion of the negotiations, a mutually agreed draft agreement is sent to the CBDT by the APA Team for seeking approval of the Central Government. The CBDT signs the agreement with the applicant after obtaining approval of the Central Government.

In case of a bilateral APA, the negotiations are carried out by the competent authority with the other competent authority and the applicant is not a part of the negotiation between two competent authorities, but it may be consulted for this purpose by the Indian competent authority. The provisions of MAP apply regarding the process.

4.5 Taxpayer's obligations after the signing of the agreement

The applicant is obliged to file a modified return of income, based on the terms and conditions of the agreement, for the completed years of the APA period including rollback years and pay additional tax and interest as per provisions of the ITA.

The applicant is also required to withdraw an appeal pending with the administrative or judicial authorities concerning the covered transactions and for the period covered in the APA.

The taxpayer is also obligated to file an annual compliance report in Form 3CF to the Principal Chief Commissioner of Income Tax (International Taxation) for each year covered in the agreement.

4.6 Revenue's obligations after the signing of the agreement

The modified return of income filed by the taxpayer is deemed to be a return of income filed under section 139 and all provisions of the ITA apply accordingly. The APA years including rollback years covered in the agreement are not subject to the transfer pricing audit. However, there is no protection from the regular transfer pricing audit of international transactions not included in the agreement. The ongoing transfer pricing audit will be stopped.

The Revenue will withdraw all appeals filed by it before the Income Tax Appellate Tribunal, High Court, and Supreme Court. The jurisdictional transfer pricing officer is required to carry out a compliance audit to ensure compliance with the terms of the APA, including satisfaction of the critical assumptions and consistency of the application of the transfer pricing method.

4.7 Cancellation of an agreement[10]

The CBDT can cancel an existing agreement unilaterally after providing an opportunity of being heard to the taxpayer in the following circumstances:

- the taxpayer has failed to comply with the terms of the agreement;
- the taxpayer has failed to file the annual compliance report in time;
- the annual compliance report furnished by the taxpayer contains a material error; or
- the taxpayer does not agree with the revision of existing agreement proposed by the CBDT.

The cancellation order must be a reasoned order in writing and must specify the effective date of cancellation of the agreement. The agreement can also be cancelled from the very beginning of the effective date for the reason of fraud or misrepresentation of facts by the taxpayer, and the order of cancellation must be in writing detailing the reasons for such a declaration.

10 - See rule 10 R of the Rules

4.8 Legal effect of the APA

An APA is binding on the taxpayer and the Commissioner of Income-Tax in relation to the covered transactions. If the taxpayer complies with the terms and conditions of the agreement, the tax administration shall accept the ALP or the application of transfer pricing methodology regarding the covered transactions and period covered in the APA.

The agreement shall not be binding on the tax administration if the taxpayer has obtained the agreement by fraud or misrepresentation of facts.

5. Applications filed and progress made

The tax administration for the first-time accepted applications for APA in the year 2012-2013. Till now, seven cycles of filing applications are over. The applications submitted in a year apply to APA period of five years starting from the 1 April of the next financial year. For example, if an applicant desires that APA should be effective 1 April 2018, the application must be filed by 31 March 2018.

The information in this section is based on the Second Annual APA Report issued by the CBDT.

5.1 APA Applications filed

The first batch of APA applications were submitted in the financial year ending March 2013. The information on the year-wise filing of unilateral and bilateral applications is given below:

Financial Year	Unilateral Applications	Bilateral Applications	Total APA Applications
2012-13	117	29	146
2013-14	206	26	232
2014-15	192	14	206
2015-16	113	19	132
2016-17	78	23	101
2017-18	115	53	168
Total	821	164	985

The CBDT has not received any application for multilateral APA till 31 March 2018. In the case of bilateral APA, the taxpayers prefer bilateral APA with the country of the AE with whom significant transactions take place and transactions with the AEs located in other countries are covered through unilateral APA. The table indicates that the majority of the applications filed (84%) are for unilateral APA.

During FY 2018-2019, a total of 123 application for unilateral APA which included 56 for renewal of the APA are filed. Another 46 applications for bilateral APA are also filed.

5.2 Progress on the signing of APA

Only nine unilateral agreements were signed during the first two years of the program. This slow start is for apparent reasons of the program being new, and it takes time to process the application and negotiate an agreement with the taxpayer. The program picked-up pace in later years and this progress is reflected from the year-wise figures of agreements signed till 31 March 2018 as given in the below table.

Financial Year	Unilateral	Bilateral	Total APA
2013- 2014	5	0	5
2014- 2015	3	1	4
2015- 2016	53	2	55
2016- 2017	80	8	88
2017- 2018	58	9	67
Total	199	20	219

The above information is for concluded agreements. There would be a large number of cases at various stages of the processing like cases under negotiations of agreements and cases in the approval process in the CBDT.

In addition to 219 agreements signed, 82 applications did not require processing or processing was abandoned at the various stage for varied reasons including withdrawal of applications by the applicants and merger of multiple applications in taxpayer groups.

The applications received during the initial years of the program mainly belonged to taxpayers having a history of transfer pricing disputes or with multiple types and complex intra-group transactions.

A total of 52 agreements are signed in the year 2018-2019 taking the tally of signed agreements until 31 March 2019 to 271.

5.3 Transfer Pricing Methods Used

Transfer pricing law does not give priority to any of the six transfer pricing methods. The nature of the transaction and availability of reliable information on the comparable or other data help in deciding the selection of the most appropriate transfer pricing method for the APA. The analysis of agreements signed in the year 2017-2018 shows that the Transactional Net Margin Method (TNMM) was used for benchmarking 133 out of 182 transactions. Twenty-one transactions used the Comparable Uncontrolled Price Method. 24 transactions have used the Other Method. Cost-Plus Method[11] is used in 3 cases while Internal Resale Price Method is used in one case.

The 'Other Method' is not a method prescribed in the OECD TP Guidelines[12].This method is increasingly being used in the concluded APAs in India for cases in which application of five established methods become difficult for various reasons for example cases involving complex transactions, or transactions for which comparable data is not available or financial information on independent enterprises is not available.

In the controlled transactions involving the provision of services to the associated enterprises, the TNMM has generally been used as the transfer pricing method, and the operating profit margin (mark up on cost) is the most common profit level indicator used to benchmark results and agreed in the agreements signed.

The significant focus of the evaluation of the APA applications has been on determining the proper operating cost in the captive service providers' cases wherein TNMM is proposed as the TP method. The cost of the employee stock option plan, restricted stock unit, or a similar incentive provided to the employees of the taxpayer by the parent group entity has been included in the cost base. Similarly, the effect of the use of free of cost assets or assets on loan provided to and used by the taxpayer forms part of the operating cost. The recoveries made from the associated enterprises which are integral to the business operations has been added in the cost base, and mark-up applied. The captive service providers sometimes use the software that is licensed by the service recipient entity from third parties and for which cost is not charged to the applicant. The non-allocation of cost results in a narrow cost base and this becomes different from the cost base of independent enterprises whose cost base include all expenses. Comparability adjustments are made to account for differing amounts of receivable, payable, and inventory. In the case of captive service providers, such an adjustment can be implemented in terms of credit period allowed for the realisation of invoices raised.

There are many other issues that were generally disputed by the taxpayers in transfer pricing audits but settled in the APA. These are for example intra-group services, royalty, and AMP expense.

5.4 Compliance Audit

The taxpayers who have entered APAs with the government are required to furnish an Annual Compliance Report (ACR) for each year covered in the agreement in the prescribed Form 3CEF (Rule 10-O). The transfer pricing officer having jurisdiction over the taxpayer carries out the compliance audit of the agreement for each year covered in the agreement (Rule 10P). Non-compliance of the terms and conditions including Critical Assumption may lead to cancellation of the APA. It is heartening to note that a large number of compliance audits concerning the signed agreements are finalised and no material deviation from the agreed terms and conditions have been pointed out in any case. The CBDT is liberal in accepting minor deviations not having a material effect on the transactions and concluded APA.

The regular transfer pricing audit will not be undertaken for

11- The CBDT effective 1 April 2012 had prescribed sixth method for computation of arm's length price under Section 92C of the ITA and Rule 10B of the IT Rules (other five methods are: Comparable Uncontrolled Price Method, Resale Price Method, Cost-Plus Method, Profit-Split Method, and Transactional Net Margin Method).

12 - OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators 2017

the international transactions covered in the APA. The regular transfer pricing audit would be restricted to the international transactions not included in the APA. Therefore, it is advisable to cover all the international transactions in the APA to avoid separate transfer pricing audit for the same year.

6. Conclusion

The intra-group trade accounts for approximately 50% of global transactions[13]. The developing countries like India are likely to have a far more significant proportion of cross border transactions within the MNE groups and subject to transfer pricing regulations. The developing countries have greater exposure to BEPS risks due to being capital and technology importing countries. This requirement potentially increases the usefulness of an effective TP dispute resolution mechanism like APA.

Intensive examination of APA applications and in-depth analysis of international transactions and documents enable a better appreciation of transfer price set by the applicant and their compliance with the arm's length principle. The 360 degree view of the taxpayer position enables a proper understanding of the transaction and proper determination of arm's length pricing methodology. A proper APA agreement help collect fair amount of taxes without any dispute.

Filing of a large number of applications by the taxpayers is a testimony of their confidence in the APA Program. The experience suggests that applicants have, by and large, provided full cooperation in the APA process leading to the logical conclusion of the process and signing of agreements. The APA Teams could not process some applications due to non-cooperation from the taxpayers.

The APA Teams have had a good experience in dealing with the applicants and tax intermediaries. There are some issues regarding the non-furnishing of information but this is being looked into. The taxpayers do share information that they may obtain from their associated enterprises. The APA process is very open and transparent, and success depends on the mutual faith amongst the stakeholders. The quality of information filed, FAR, and economic analysis submitted in the applications has improved over the years.

There is a genuine concern about the pendency of a large number of applications for disposal.

A large number of applications have been filed, but processing takes time. The APA Teams will be able to dispose of applications with speed after they gain experience on all types of cases and the taxpayers furnish comprehensive and quality economic analysis along with the application.

There were concerns regarding the confidentiality of the information disclosed in the APA application or furnished during the processing of the application, but in these six years of the APA Program or since the inception of transfer pricing law in India, there have not been any practical problems in this regard.

The APA programme has so far been successful in resolving pending transfer pricing disputes and providing a realistic solution to the potential problems. Many types of difficult issues and complex cases have been solved. The program has provided a desired certainty to the taxpayer on transfer pricing issues and at the same time collected the much needed revenue for the exchequer. The Program is making a noticeable change in the taxpayer's perception of tax system and tax administration in India. Signing of one agreement resolves 9 potential transfer pricing cases. Signing of more and more APAs will reduce pendency of cases with the administrative and judicial authorities.

The government and the CBDT are committed to effective implementation of the APA Program and have adopted a solution-oriented approach for providing certainty to the taxpayers as far as the issues regarding transfer pricing are concerned.

It is hoped that by providing an efficient, effective and transparent dispute resolution mechanism in the form of APA, the investment climate in the country will certainly improve which in turn help improving India's ranking in the World Bank ranking of 'Ease of Doing Business'.

13 - OECD Work on Taxation (2018-19) available at http://www.oecd.org/tax/centre-for-tax-policy-and-administration-brochure.pdf (accessed 4 March, 2019)

Reduction of Income Tax Litigation

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Executive Summary

Stability and certainty is important for a good tax policy. Of late, litigation under the Income-tax Act has reached alarming proportions leading to uncertainty in the minds of both taxpayers and budget making authorities. Litigation involves enormous administrative and legal cost. One effective step of reducing litigation is to amend Section 253(2) of the Income-tax Act, 1961, which gives power to the Principal Commissioner of Income Tax to file appeal against the order of Commissioner of Income Tax (Appeals). Once the case has been decided by the Commissioner of Income Tax (Appeals), who is a senior officer of the Department, there is no valid reason for filing further appeal by the Revenue. If the provision is omitted from the Income Tax Act, the litigation would be reduced by approximately in 80% or more cases, as in majority of the cases, it is the Department who files appeal in such cases. The suggested amendment in the Income-tax Act that would go a long way in overhauling tax administration, mobilizing more revenue, improvement of economy, reduction in administrative cost of the Income Tax Department & compliance cost of the tax payers.

1. The litigation under the Income Tax Act has reached alarming proportions leading to uncertainty in the minds of Corporate and Non- Corporate taxpayers regarding their final tax liability leading to indecisions about investment decisions and huge compliance cost, uncertainty about final tax collectible in the minds of Budget making authorities and enormous administrative and legal cost.

2. One amendment in the Income-tax Act that would go a long way in overhauling the entire tax administration and increased collection of revenue, improvement of Indian Economy, reduction in administrative cost of the Income Tax Department & compliance cost of the tax payers, besides reducing frivolous litigation, is to omit the provision regarding filing of appeal by Principal Commissioner of Income Tax (PCIT) against the appellate orders of Commissioner of Income Tax (Appeals) i.e. CIT (A). To overcome the cases of bad and perverse order of the CIT (A), the power of revision u/s 263 of the Income Tax Act, 1961, in such cases may be extended to the Chief Commissioner of Income Tax, as was earlier available to Commissioner of Income-tax (CIT) to revise the order of DCIT/IAC (Appeals).

The provision that provides for appeal filing power and duty to CIT is sub-section (2) of section 253 of the Income-tax Act, 1961. Section 253(2) reads as:

"The Commissioner may, if he objects to any order passed by a [Deputy Commissioner (Appeals)] [before the 1st day of October, 1998] [or, as the case may be, a Commissioner (Appeals)] under [section 154 or] section 250, direct the [Assessing] Officer to appeal to the Appellate Tribunal against the order."

3. Deletion of the provisions of Sub Section (2) of Section 253 of the Income-tax Act (and the corresponding provisions of other Direct Tax Laws) is extremely desirable on account of many benefits and reasons as discussed in subsequent pages.

4. The litigation Structure of the Direct Taxes Laws is as under

Assessing Officer – Income Tax Officer / Assistant Commissioner of Income Tax / Deputy Commissioner of Income Tax /Joint Commissioner of Income Tax / Additional Commissioner of Income Tax

↓

Commissioner of Income Tax (Appeal)

↓

Income Tax Appellant Tribunal (ITAT)

↓

High Court

↓

Supreme Court

5. The numbers of appeals pending and amount disputed (as on December, 2018) are:

Cases pending before	**No. of pending cases**	**Amount disputed** (Rs. crores)
Income Tax Appellant Tribunal	40879	2,89,837
High Court	39652	2,68,212
Supreme Court	6052	10,658
Total	86583	5,68,707

The success rate of the Departmental Appeals at ITAT, High Court and Supreme Court is extremely low and is possibly less than 10%. It is interesting to note that no such data is readily available with respect to success rate of departmental appeal filed under the Direct Tax laws. But the success rate of departmental litigation for Indirect taxes in Courts and Tribunal during the last four Financial Years has been as under

Year	Supreme Court	High Court	CESTAT
2008-09	9.81%	29.6%	10.0%
2009-10	7.85%	35.10%	18.2%
2010-11	5.5%	27.8%	17.2%
2011-12	10.64%	29.85%	19.7%

The success rate of a department appeal at Tribunal level, in Indirect-tax cases, in the past 4 years, has varied from 10 to 20 percent.

6. When the success rate of departmental appeal is extremely low no gainful purpose is served in filling departmental appeal against the order of CIT(A), especially when the administrative and other costs of filing departmental appeal far exceeds the revenue collected.

7. In the study covering the period 2006-09, CAG (the topic was also suggested by the Central Board of Direct Taxes during consultations on areas of concern in the Department) observed as under :-

a. The success rate of the Department at various levels of appeals is low and appeals go decidedly in favour of the tax payers.

b. One of the biggest concerns is the lack of credible and reliable data on the volume and impact of appeals. Widely divergent data is compiled by different sources which have not been subjected to reconciliation. Records to monitor filing of appeals and implementation of appellate orders were not maintained properly in the assessment units. Inadequate controls led to time barring of appeals and delays in implementation of appellate orders. AO's work on appeals is not subjected to internal audit, denying the process an independent appraisal.

8. The Bombay High Court in the case of CIT-2, Mumbai vs. L&T Ltd. order passed on 10 July 2014, the Bench of Justices BP Colabawalla and SC Dharmadhikari, said –

a. The Revenue Officers must realize that just like other powers an executive power conferred in them is in the nature of a Trust. They hold officer as trustees of the public at large. They deal with public revenue and public money and that cannot be wasted in such frivolous litigation. We, therefore, dismiss these appeals with costs quantified at Rs. 1 lakh each.

b. We do not understand why higher officials do not have the courage to take bold decisions particularly of not pursuing such matters up to this court or higher. Because the Assessee is a leading Public Limited Company should not act as a deterrent for them to take an informed, rational decision and sub serving larger Public Interest. The biggest litigant, namely, the State ought to be aware of the Pendency of cases in High Courts of Bombay, Madras, Calcutta and Allahabad; for example. If it is their policies particularly on litigations, then, the least that can be said is that the State has failed to act for public good and in Public Interest, the High Court added.

9. The benefits of omission of sub-section (2) of section 253 are discussed hereunder.

9.1. The compliance cost of tax payers in dealing with the litigation at ITAT, High Court and Supreme Court is massive in terms of huge payments to Chartered Accountants and lawyers and the same for entire economy of India would be at least a thousand crores by a conservative estimation.

9.2. The administrative cost to the Income Tax Department is huge in terms of-

(a) Payments to Departmental Counsel at High Courts and Supreme Court,

(b) Deployment of manpower of the level of Commissioner of Income Tax (CIT) and Additional/joint Commissioner of Income-tax (Add/JCIT) as Departmental Representatives at ITAT. At present 50 out of 635 Commissioners of Income Tax and about 100 out of 1575 ADDL/JCIT are deployed at ITAT. With the omission of section 253(2) of the Income Tax Act, 90% of such officers may be more gainfully deployed for the work relating to tax evasion detection and curbing of black money.

(c) Major time & efforts of Administrative CITs, Add/JCITs and Assessing Officers is consumed in studying the orders of CIT, ITAT, High Courts and writing notes as to why further appeals are required to be filed and preparing petitions for further appeals. The Administrative wing officers do not get much time to deal with the assessment, investigation, collection of tax and other important work relating to current cases.

(d) Prime office space is required to keep the assessment records and other documents relating to litigation and if Department accepts the decisions of its own Commissioner of Income Tax (Appeals), much office space may be freed to be utilized in a better manner. As things stands today, most of the AOs up to the rank of Deputy Commissioner of Income Tax in metropolitan cities, shares a room with fellow AOs and is sitting in a room full with files all around him, constantly being disturbed by the voices coming from the other side of the room. The assessment work requires careful study of accounts and law and most AOs are working in a very difficult working environment. The cost of keeping records of most frivolous appeal is enormous.

10. Once the case has been decided by Commissioner of Income tax in favour of a tax payer, there is no valid reason to for filing further appeal by the Income Tax Department as discussed below—

(a) As a matter of stated policy, 99% Returns of income are not scrutinized and the Government has decided to bear the revenue loss to concentrate in 1 % of the cases, which means the decision of 99% of tax payers to pay taxes are accepted.

(b) Though Administrative Commissioners have powers to revise the orders of AOs, not more than 1 to 2 percent of orders of AOs are revised, which means the decisions in 99% assessment orders of Assessing Officers are accepted.

(c) In large number of cases, the amount of tax involved exceeds monetary limit fixed by CBDT, second appeal is generally filed. The AO defends his/ his predecessor's order and recommends further appeal; the Add/JCIT plays it safe and agrees with his AO and the Commissioners, generally agrees with his recommendations of his subordinates and authorizes appeal to ITAT. It is pertinent to note that in more than 90% cases, the ITAT has been agreeing with the orders of CIT (A), yet the practice of filing appeal goes on as the Income-tax Act enables the Commissioner to file appeal and most officers feels safe in filing appeal rather than in not filing appeal, due to complex legal positions on various issues and to avoid the perception about the officer's decision in not filing appeals "favours" the tax payers. When 99% Returns of the taxpayers and Assessment orders of AOs which happen to be much junior to CIT (A) are accepted, what is the harm in accepting Orders of CIT (A), who generally after more than 20 years of service, and after vigilance clearance and on the basis of excellent performance annual reports are promoted as Commissioner by the DPC held by UPSC?

(d) The entire situation looks paradoxical from the Department's point of view, where decisions of AOs, Add/JCIT, Administrative Commissioners, Chief Commissioner are acceptable to the Department, it is the decision of CIT (A) only which is a matter of scrutiny by his juniors- AOs and Add/JCIT (who send scrutiny report on CIT (A)'s order to the CIT) and subject of litigation by the Department, a Department whose very senior officer, the CIT (A) happens to be.

(e) The entire situation looks paradoxical from the Taxpayer's point of view, for whom the AOs, is an arm of Government and when he appeals to CIT(A), another arm of Government, and even if he gets relief at the level of CIT(A), another arm of Government, i.e. CIT, files appeal to ITAT. Many such departmental appeals are further litigated at High Courts and Supreme Court and generally it takes more than 10 to 15 years for cases of one assessment year to be finalized and by that time many more cases of dispute of subsequent assessment years starts getting unresolved at various appellate stages and the taxpayers is saddled with large number of pending disputes to be finalized.

If the provision authorizing the CIT to file appeal against the order of CIT (Appeals) is omitted from the Income Tax Act, the pendency of cases could come down to less than 20% of the cases in which the taxpayers file appeals, as approximately in 80% or more cases, it is the Department who files appeal against the order of CIT (Appeals). Moreover, CBDT has time and again reiterated its stand that the orders of CIT (Appeals) on question of fact should be accepted by the Principal Commissioners unless the findings are perverse. Vide various Circulars and Instructions, the Board has directed that Principal Commissioners should adopt a selective approach on filing appeals before the Income Tax Appellate Tribunal and that such appeals should be authorized after careful scrutiny, so that frivolous appeals are not filed and litigation is minimised.

11. The revenue collection in the Departmental appeal cases is extremely low. No data in this regard is readily available but it can be safely stated that the revenue collection in the cases filed by the Department and decided in favour of the Department by the ITAT, High Court and Supreme Court is less than the actual money paid as court fees and fees paid to departmental advocates. As the practice of filling appeal against the order of CIT (A) by the Department is not yielding any significant revenue and the cost of litigation to the department is possibly more than the revenue collection, there is a strong case to omit the provisions of section 253(2) of the Income-tax Act, 1961, giving power & duty to the CIT to file appeal against the order of CIT (A).

12. Stability and certainty is important for a good tax policy and uncertainly over final tax liability greatly discourages important investment decisions and slows down the economic progress. Large numbers of extremely educated and talented Indian citizens both in the department and as tax practitioners are involved in this fruitless litigation works. It is high time the department should accept the decision of its own very senior officer could happen to be Commissioner of Income Tax (Appeals).

[The author is Principal Director General of Income Tax (Legal & Research) and views are personal]

Disallowance for Violation of Section 13(1)(c) R.w.s.13(2)(b) of the Act-Denial of Entire Exemption, or Limited only to the Amount Diverted-Judicial Decisions

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Executive Summary

The article attempts to examine whether violation of the conditions laid u/s 13(1)(c), r.w.s 13(3) and 13(2)(b) would lead to only disallowance of monetary value of the benefit given to the prohibited person(s), or would result in denial of the entire exemption claimed by the assessee u/s 11 and 12 of the I.T. Act.

1. Charitable entities can claim exemptions from tax as per sections 11 and 12 of the Income Tax Act. Section 13 of the Income Tax Act contains conditions, violation of which, can affect claim of such exemption u/s 11 and 12. Section 13(1)(c) prohibits use of trust property or income for direct or indirect benefit of the prohibited person(s).

2. Prohibited person(s) have been specified in section 13(3) of the Act, which include the author of the trust or founder of the institution, person who has made a substantial contribution to the trust, any trustee of the trust or manager, any relative of such author, founder or trustee or manager, or any concern in which any of these persons have substantial interest.

3. The main objective of section 13(1)(c) read with section 13(3) is to prevent the exploitation of the charitable institution by persons who are in a position to exercise control over the management of the institution. Section 13(2) enumerates the situations where it would be deemed that the income or property of the trust or institution has been used or applied for the benefit of a person referred to in section13(3) of the Act.

4. While the conditions stipulated in these provisions and restrictions are clear and unambiguous, its application has raised controversies, i.e. whether violation of the conditions would lead to only disallowance of monetary value of the benefit to the prohibited person(s), or would it lead to denial of the entire exemption claimed by the assessee u/s 11 and 12 of the Act.

5. The Hon'ble Supreme Court decision in the case of 'DIT vs. Bharat Diamond Bourse' (259 ITR 280) (2003) and the Karnataka High Court decision in the case of 'CIT vs. Fr. Mullers Charitable Institution' (2014) (Kar)(363 ITR 230) are the two important decisions on this issue. While 'DIT vs. Bharat Diamond Bourse' decision calls for denial of complete exemption, the Karnataka High Court in the case of CIT Vs. Fr. Mullers prescribes a softer approach by disallowance of only the extent the income is diverted.

6. Recently, vide decision dated 18.12.2018 in the case of CIT(E), Pune Vs. Audyogik Shikshan Mandal, Pune (101 taxmann.com 247) (Bom)(2019) the Hon'ble Bombay High Court has followed the decision in the case of Fr. Mullers Charitable Institutions, by observing that on a plain reading of sections 11 and 13 of the Act, it is clear that the legislature did not contemplate denial of entire benefit under section 11 of the Act to the trust. The Bombay High Court has held that the interpretation advanced by the Department would lead to grave injustice as any minor mistake involving small amount would lead to denial of benefit of the entire exemption claimed. The Hon'ble High Court further noted that SLP filed by the department against the decision of Karnataka High Court was dismissed. It is worth mentioning that while dismissing the SLP in the case of 'CIT vs. Father Mullers Charitable Institutions', the Hon'ble Supreme Court kept the question of law open (SLP(C) No. 15907/2014).

7. However, Department has not accepted the decision of the Hon'ble Bombay High Court and has filed SLP against this decision. The facts of the case 'CIT(E), Pune Vs. Audyogik Shikshan Mandal, Pune' and issue involved are discussed hereinafter.

7.1 M/s Audyogik Shikshan Mandal, Pune, the assessee trust had purchased a Skoda car for Rs. 11.38 lakh in the name of trustee, that is it had applied its income/property for the benefit of a person referred to in sub-section (3) of section 13 of the Act. The Assessing Officer held that the assessee trust was not entitled to any exemption u/s 11 of the Act and he brought the entire income of the assessee trust to tax, including the amount spent for purchase of the car. The CIT(A) upheld the action of the A.O.

7.2 Revenue's appeal before the ITAT took an interesting turn. The Hon'ble Accountant Member relied on the decision of Supreme Court in 'Bharat Diamond Bourse' (259 ITR 280) and following the ratio (Para 7 and Para 20 of the Hon'ble Supreme Court Decision) held that the assessee would lose the benefit of Section 11 and 12 of the Act. The Judicial member gave a dissenting order by holding that deeming provision of Section 13(2)(b) has been invoked beyond its scope, and that merely a property being made available to a person does not deem that it was also used by such person. Further, he held that the A.O. has erred in taxing the entire income of the trust by denying the benefit of section 11 in totality, even in respect of portion of income which was undisputedly applied towards the objects of the trust.

7.3 The matter was referred to Third Member. The Third Member observed that the car had been purchased in the exclusive name of the trustee, who had complete control over the car and had no personal car of his own, and that there was no resolution passed by the trust in writing. He held that there was violation of provisions of section 13(2)(b) r.w.s. 13(3) of the Act. With regard to quantum of exemption, he noted that the 'Bharat Diamond Bourse' case fell within ambit of section 13(a) r.w.s. 13(1)(c) of the Act. He also noted that in Fr. Mullers case (363 ITR 378), the Hon'ble Supreme Court rejected SLP by affirming the view of Hon'ble Karnataka High Court wherein it was said that in the event of violation of section 13(1)(d), it was only the income or investment or deposit which has been made in violation of section 11(5), that will be liable to tax. The Third Member relied on Fr. Mullers case, as it was a latter judgment of the Apex Court, and held that denial of exemption under section 11 should be limited to the amount which was diverted (i.e. car purchased in the name of prohibited person in violation of section 13(2)(b) of the Act).

7.4 On appeal filed by the department, the Hon'ble Bombay High Court has noted that the Apex Court decision in Bharat Diamond Bourse is not clear whether it is only to the extent of income diverted or the entire income that is to be denied exemption. The Court further noted that the decision of Karnataka High Court in Fr. Mullers case deals with the very issue and held that benefit of section 11 will not be available only in respect of the amount of diverted income. The Hon'ble High Court also noted that the Karnataka High Court in Fr. Mullers case had placed reliance on decision of Mumbai High Court in Sheth Mafatlal Gaganbhai Foundation (249 ITR 533), and Delhi High Court decision in Agrim Charan Foundation (253 ITR 593). The Hon'ble High Court observed that if the interpretation sought to be advanced by the Revenue is accepted, it would lead to grave injustice as for any mistake, however minor, the consequence would be denial of benefit of exemption to entire income.

8. Thus the legal issue involved is whether the AO is correct in denying entire exemption claimed u/s 11 of the Act, or, should the disallowance be restricted only to that income of the Trust which was used/applied directly or indirectly for the benefit of the prohibited persons. The issue involved is quite significant and has huge tax implications. In several cases, appeals are pending before High Courts and the Supreme Court.

9. There is a general perception that the Hon'ble Supreme Court has held different views in the two judgments. It is perceived that while Bharat Diamond Bourse case has been decided in favour of the revenue, by dismissing the SLP filed by the department against the Karnataka High Court decision in Fr. Mullers case, which is a subsequent decision, the Apex Court apparently reversed its stand. However, this perception is not correct and the facts of both the cases and the provision of the Act involved are different. Moreover, even in the latter case the Apex Court while dismissing the SLP filed by the department kept the question of law open. This cannot be construed as reversing its earlier stand involved in the Bharat Diamond Bourse case, or that the issue has been adjudicated and reached finality.

10. In the case of Bharat Diamond Bourse,(259 ITR 280), the assessee had advanced a sum to one of its members, being a prohibited person within the meaning of Section 13(3)(a) r.w.s 13(1)(c)(ii) of the Act. There was contravention of Section 13(2)(a), and therefore, the Hon'ble High Court held that the assessee is not entitled to exemption u/s 11. In para 7 of the judgement, the Hon'ble Apex Court has approved complete denial of exemption u/s 11 and has reiterated the same view in Para 20 of the judgement. On the other hand, in Fr. Muller case, before the Karnataka High Court, the fact involved was advancing of huge amount by the assessee trust to other parties as loans in violation of Section 11(5) of the Act, and thereby attracted Section 13(1)(d) of the Act. The question was whether the entire income of the trust was taxable, and secondly whether maximum marginal rate of tax was leviable u/s 164 of the Act on the entire income. The Karnataka High Court decided in favour of the assessee, and SLP filed against this decision has been dismissed by the Supreme Court, without adjudicating on the questions raised, and keeping the question of law open.

CONCLUSION

11. Section 13 of the I.T. Act stipulates restrictions, subject to which the trust should function; and violation of which would affect the exemption claimed by the assessee. These conditions/restrictions guarantee safeguards against misuse of trust property/income by the trustees or other persons who are in a position to misuse their power. Therefore, violation of any of such conditions may result in denial of the complete exemption and also attracts maximum marginal rate of tax u/s 164(2) of the Act.

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Policy For Taxation Of Digital Economy

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Executive Summary

Taxation of the digital economy is perhaps the most daunting challenge in the Direct Tax Policy domain. The defining characteristic of digital economy is mobility: comprising mobility of intangibles (which constitute the significant asset base of digital economy), mobility of user base and mobility of business functions. With little dependency on local personnel to carry out business functions and greater flexibility in choosing location of servers and other resources digital economy is often unencumbered by specific territorial nexuses. Tax jurisdictions are defined based on the physical nexus between the income sought to be taxed and the territorial boundaries of a country. But digital economy stretches seamlessly across national borders making it difficult to capture and quantify its profits within the physical confines of specific jurisdictions.

INTRODUCTION

Taxation of the digital economy is perhaps the most daunting challenge in the Direct Tax Policy domain. The defining characteristic of digital economy is mobility: comprising mobility of intangibles (which constitute the significant asset base of digital economy), mobility of user base and mobility of business functions. With little dependency on local personnel to carry out business functions and greater flexibility in choosing location of servers and other resources digital economy is often unencumbered by specific territorial nexuses. **Tax jurisdictions are defined based on the physical nexus between the income sought to be taxed and the territorial boundaries of a country. But digital economy stretches seamlessly across national borders making it difficult to capture and quantify its profits within the physical confines of specific jurisdictions.**

It is to be remembered that rules governing assignment of taxing rights among host jurisdictions were made in the 1920s before the new business models were even conceptualized. The current framework of laws comprising domestic laws and tax-treaties recognize a "Permanent Establishment" (defined as a fixed place of business) as the threshold for taxation rights on business income. A digital business model on the other hand can have significant economic presence in a country without a physical establishment and consequently avoid tax liability. **Failure to enforce adequate taxation of digital economy leads to revenue loss impairing financing of public goods. In addition to this, unequal distribution of tax burden on digital enterprises and brick and mortar industry violates one of the fundamental principles of tax policy, viz. neutrality, causing economic distortions.** As digital economy already occupies substantial economic space and is on a growth trajectory these issues need to be addressed on a priority basis.

SIZE OF DIGITAL ECONOMY

A 2010 report of the Boston Consultancy Group had postulated that the digital economy in G20 countries would grow from USD 2.3 Trillion in 2010 to USD 4.2 Trillion by 2016. **A 2018 report of the Ministry of Electronics & Information Technology, Government of India values**

India's digital economy at about USD 200 Billion or about 8% of the GDP. Predicting a steep growth, the Ministry's Report pegs the value anywhere between USD 800 Billion to 1 Trillion in nominal terms by 2025 or at 18% to 23% of the GDP. This economic value of USD 800 Billion to USD 1 Trillion is estimated to give rise to digital revenues ranging between USD 1.4 Trillion to USD 1.8 Trillion. We are talking about a significant tax base.

FUNDAMENTAL PRINCIPLES OF TAX POLICY

Raising revenue for financing public goods is the primary purpose of taxation. The means and quantum of revenue to be raised depend on the policy priorities of governments. However, taxation itself is governed by certain basic policy parameters which have emerged and been recognized over the years. These include:

1. **Neutrality:** Taxation should seek to be neutral between diverse business activities with minimal bias in favor of or against any economic option. A neutral taxation is expected to lead to optimal allocation of resources thereby promoting economic efficiency minimizing economic distortions and corresponding deadweight losses. This entails equal and neutral application of tax policy on all types of business while addressing specific issues pertaining to any form of economic activity standing in the way of such equal application.

2. **Efficiency:** Efficiency in the context of tax policy implies minimizing costs- cost of compliance to the taxpayer and costs of administration for the governments- as far as possible.

3. **Certainty & Simplicity:** Tax policy should strive for a stable tax regime with tax rules clear and simple which enables the taxpayer to understand his entitlements and obligations. A complex tax system often leads to aggressive tax planning and excessive litigation.

4. **Effectiveness & Fairness:** Practical enforceability is the hallmark of sound tax policy. If a tax administration is unable to collect legitimate taxes from an enterprise technically liable to tax, tax system is not efficient. It will also be perceived as unfair by those who actually pay taxes.

5. **Flexibility:** A taxation system should be flexible enough to adapt to changing needs of revenue on an ongoing basis. It should keep pace with commercial and technological developments. This requires both structural durability and the dynamic ability to respond to the ever-changing economic environment.

6. **Equity:** Equity as a policy consideration comprises horizontal and vertical equity. Horizontal equity demands that taxpayers in similar circumstances should share the same tax burden. Vertical equity requires that taxpayers in better circumstance should higher tax burden. In a cross-border context, equity involves inter nation equity also. In other words, each country should receive an equitable share of revenues raised from cross border transactions.

DIGITAL ECONOMY

The term Digital Technology perhaps first appeared in the title of the eponymous 1995 bestseller by Don Tapscott though Oxford Dictionary traces its first use to the year 1990. Since then, exponential growth of Information and Communication Technologies has made technologies accessible and affordable. Digital devices have become cheaper and internet connectivity faster, reliable and reasonably priced. **Growing at the rate of 10% per annum digital economy is outpacing global economy. By no means a peripheral segment of economy, it is no longer possible to ring-fence digital economy for the purpose of taxation**. Instead tax policy has to be re-conceptualized to suit its economic models.

The most defining feature of digital economy is its mobility which enables enterprises to relocate at minimal cost, choose optimal location for its functions and assets and access remote markets. Mobility comprises mobility of intangibles, recognized as the key business assets of digital economy, mobility of customer base and mobility of business functions. And this mobility makes it most challenging to tax.

DIGITAL ECONOMY & CROSS BORDER TAXATION

LEGAL CHALLENGES

The major legal challenges raised by digital economy include the following:

1. **Absence of territorial nexus:** The defining feature of digital economy is the fact that it can have significant economic presence in any domain without any physical establishment or personnel located. However, rules of international taxation recognize the existence of a permanent establishment as the basic threshold for

taxation. **A case in point will be the rendering of technical or business services via an online platform without the physical presence of personnel in the source jurisdiction.** At present, the courts are holding that no income has accrued or arisen in India and no tax liability attracted.

2. **Valuation of Data:** Value creation in digital economy is often in the field of data which is the key business asset. At present, there are no defined rules to evaluate the data in quantitative terms for the purpose of taxation. **Though we are all aware of the economic value of such data and its income potential, this remains largely an unexplored territory in the absence of explicit legislation.**

3. **Characterization of Income:** Assignment of taxing rights hinges upon the characterization of income (business profits, royalty etc). Income generated by digital economy often defies such categorization. For example, passive incomes such as royalty attracts withholding taxes in the source jurisdiction, business income gets taxable only with the physical presence in the form of a permanent establishment in the source domain. Consideration paid for utilization of online advertisement facilities could be amenable to characterization either as royalty or business income.

ADMINISTRATIVE CHALLENGES

The major administrative challenges are discussed below:

1. **Identification:** In the absence of physical presence, the most crucial challenge is to locate and identify the digital economic activities and players in a jurisdiction

2. **Determining the Extent of Activities:** Next task is to determine the extent of such digital economic activities

3. **Information Collection & Verification:** The third task is to collect information and verify the same to quantify income generation, if any.

4. **Enforcement:** The final and most crucial task is the enforcement of tax law on digital enterprises

These challenges may not look important at the policy making level, but are really daunting at the field level. While the jurisdictional officer may not even be cognisant of the first issue of identification, quantification and verification poses a very real problem. And completion of assessment of digital income and enforcement of tax collection in the absence of physical defaulters and physical assets are almost impossible.

DOUBLE TAXATION & UNINTENTED NON-TAXATION

The rules governing cross border taxation are based on exhaustive studies of business processes of the brick and mortar era when double taxation of international trade was a burning issue. Such rules do not take into account business process flowing in a seamless continuum across transnational supply chains. The income generated out of these operations cannot be segmented to discrete jurisdictions enabling countries to enforce their tax laws. As such it is not the double taxation which is the issue now, but unintended non-taxation. **The question here is not just that of a few enterprises avoiding tax leading to erosion of tax bases. This avoidance naturally increases the tax burden on other enterprises leading to economic distortions and violation of fundamental principles of tax policy.** Therefore, there is a need to rethink on tax policy for digital economy

The international community is seized of this widening tax gap and Tax Challenges of Digital Economy is the First Action Plan of the BEPS (Base Erosion and Profit Shifting) Reports accepted by G-20 countries including India and OECD. In 2016 India introduced Equalization Levy on Business to Business Transactions exceeding a specified limit. Other countries are following suit.

However, these initiatives have so far touched only the tip of the iceberg and our legal and policy framework sweats to keep pace with current business models, which get outdated and replaced by newer models at lightning speed. **We have to take a call whether we want to play safe and stick to presumptive taxation or want to go further and evolve a whole new taxation model.** With digital economy, expanding and filling up the whole economic space crowding out brick and mortar models, may be time is running out.

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Challenges Of Framing New International Taxation Rules In Digital Economy - Determining Value Creation

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Executive Summary

The world is now divided as to how to frame the rules of international taxation in digital economy. No consensus has been reached as yet. In this article opinion has been expressed as how one may go about framing new international taxation rules, taking into account global value creation through global value chains. One should consider value of capturing the behavioral pattern of users in algorithms, network effect creation, how critical mass of end users are reached for global sustenance and monetization of globalized data. A simultaneous approach through the laws of Physics being universal in nature as well as economic pattern unique to a country has been taken into account.

1. INTRODUCTION

1.1 The top 20 economy countries of the world, forming the group **G20, decided in summit meeting that taxation of Multi National Enterprises (MNEs)** operating in digital economy platform should be made on the cardinal principle of 'where **economic activities occur and value is created'.** OECD has been assigned the task of framing new International Taxation Rules keeping this principle in mind. The report of OECD is to be submitted before next G20 summit meeting for ratification by the global leaders. **This poses a serious challenge to determine how the 'value is created' in Digital Economy which is different from Brick and Mortar model.** This also reveals the shortcomings of the existing International Rules in dealing with this aspect.

1.2 How India fits in this global scenario? [1] Amongst

1 - Harvard Business Review. 2017. Digital Evolution Index. In December 2017, China accounted for almost a fifth of the world's internet users. However, the internet space is tightly controlled in China and the domestic market is dominated by Chinese tech giants Alibaba and Tencent. Global players in China are disproportionately low. For instance, Facebook users were just 1.8 million or 0.08% of the global share.

countries with market access in digital economy, India has emerged as the world's largest global marketplace with its 462 million internet users (11 percent of world-wide users) in 2017, followed by the European Union with 433 million internet users (10 percent of worldwide users). The number of internet users in India is expected to increase rapidly from 462 million in 2017 to 650 million in 2020[2]. With rising internet penetration and greater digital maturity of users in India, the e-commerce is likely to increase from $45 billion in 2017 to $100 billion by 2020[3].

2. THE NEED FOR A PARADIGM SHIFT

2.1 OECD calls for a paradigm shift4 in framing the rules in International Tax. It observes that ' the advent of e-commerce and the internet has had a dramatic impact on intellectual supplies. Intellectual content can now be readily digitized. Direct provision of intellectual supplies is available. Basic ingredients like speed, bandwidth, software and hardware applications have achieved appropriate and workable levels. It requires little infrastructure to operate from their original jurisdiction and easily shift to locations of low tax jurisdictions.' It adds **'Digitalization** is pervasive, and hence does not pose unique issues, but exacerbates the challenges for international taxation. In particular, **it has further increased the opportunities for multinational enterprises (MNEs) to exploit the fundamental flaw in international tax rules: the independent entity principle.** This requires tax authorities to start from the accounts in each country of the various affiliates of MNEs; and, although they have powers (though without adequate resources) to adjust those accounts, they are expected to do so on the basis that such affiliates are independent entities, dealing at 'arm's length' with each other. This independent entity fiction runs counter to the economic reality that MNEs operate as unitary firms under centralized control and direction. It also allows, indeed encourages, MNEs to create complex corporate groups, with often hundreds of affiliates, many located in tax havens, enabling them to achieve low overall effective tax rates on their global profits. Such strategies have become easier for all MNEs due to digitalization of business models, even those which involve supplying physical commodities (e.g. Apple, Amazon). This clearly requires a paradigm shift in international tax. It was implicit in the call from the G20 leaders for reform of the rules to ensure that MNEs could be taxed 'where economic activities occur and value is created'.

2.2 In the said input BMG has also suggested to create a Digital PE for digital economy instead of the conventional PE for brick and mortar model. For the test of the digital PE the criteria of the following should be met.

- Significant economic presence.
- Withholding tax on digital transactions
- Digital Equalising Levy

This can be measured through allocation keys involving users.

2.3 'Simplified Allocation Keys: For the combined profits of this common business model, two equally weighted allocation keys are defined as follows:

USERS: Using users as an allocation key reflects the importance of each market and the value of users to the global business of MNE from fee-paying third-party customers seeking advertising services. The country is determined by the location of the user and not the legal terms of any contracts, licenses, or other documents with either users or the third-parties that pay the MNE for advertising, aggregate user data, etc.

Operating Expenses: This allocation key recognizes all operational inputs.

- As such, it covers all research and development, website maintenance, sales, marketing, distribution, management, support functions, etc. This key would include categories of expenses such as: Salaries and bonuses of all operations personnel (allocated by location of personnel).
- All other direct and allocated operating expenses (allocated by location of personnel or facility to which the expenses relate).
- Commissions and service fees paid to other parties for all operational functions (allocated by location where the other party provides the services) (These payments economically include all personnel costs, office and

2 - BCG. 2016. Digital Influence Study. This study forecast that India with its 650 million internet users, will cross the expected combined populations of the G7 countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States)

3 - Boston Consulting Group. February 2018. Digital Consumer Spending in India: a $100 billion Opportunity. This is a conservative estimate compared to the estimates made by the Bank of America/ Merill Lynch which project the digital economy in India to touch $120 billion in 2020.

manufacturing costs, etc. of the legal entity performing the relevant operational functions for the taxpayer. Payments to any related parties whose profits are included in the combined profits for the profit split would of course be excluded.)'

2.4 **OECD Reports**[4] : The Interim Report identifies three characteristics that are frequently observed in highly digitalized business models (HDBM):

2.4.1 Cross jurisdictional scale without mass

- Digitalisation has made business functions more mobile;
- digital businesses can interact with global customer bases without substantial increases in physical presence

2.4.2 Importance of intangible assets and intellectual property rights (IPRs)

- **Algorithms, patents** and other intangibles are becoming more relevant in production processes
- These are thus affecting many different sectors; crucial for some business models (e.g., platform-based businesses) which would not exist in their current form without intense use of intangibles

2.4.3 Role of data and user participation, including network effects

- Data collection increased in quality, quantity and speed
- Data and user-generated content (UGC) are used in all phases of value creation
- There are important synergies between knowledge creation from data and IPRs
- **Reliance on intangibles also reinforces the contribution of data to value creation**
- Data often a key driver of firms' profitability and competitive advantage
- **Economic gains can be leveraged through data value cycles:**
- Collection big databases analytics knowledge bases data-driven decisions
- Businesses are able to improve products, operations, marketing and decision making through increased reliance on data value cycles
- Productivity increase imply gains in market share, competitiveness, profitability
- **Data and user-generated content is a significant source of value creation**

Member countries agreed to undertake a coherent and concurrent review of the rules governing

- **nexus**
- **profit allocation**

with respect to the fundamental concepts relating to the allocation of taxing rights between jurisdictions and the determination of the relevant share of the multinational enterprise's profits that will be subject to taxation in a given jurisdiction. However, while giving their decisions the opinions varied among countries and different stake holders.

2.5 The **European Union** (European Commission) in its communication on [5]"Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence" dated 21.03.2018 held that,

"The fundamental principle for profit allocation should remain that taxation takes place in the jurisdiction where value is created. Considering that in the digital economy, a significant part of the value of a business is created where the users are based and data is collected and processed, the directive would set out criteria specifically targeted at attributing profit to a digital permanent establishment."

For example, these criteria could be based on criteria such as:

- the users' engagements and contributions to the development of a platform;
- the data collected from users in a Member State through a digital platform;
- number of users; and/or
- user-generated content.

3. Stakeholders' view - Digital Economy Group (DEG)

3.1 **Digital Economy Group (DEG)** consisting of 10 top

4 - OECD -Chapter-II,Digitalisation, Business models & Value creation, Note by the Secretariat,11-13 December, 2017

5 - Proposal for the council directive laying down rules relating to the corporate taxation of a significant digital presence Brussels, dated 21.03.2018 COM(2018) 147 final.

6 - OECD- Tax challenges of the digitalization- comments received on request for input, PART I pages 137 to 150, dated 25.10.2017

companies of the world operating in the digital platform viz., **Amazon, Expedia, Google, Facebook, Netflix, Microsoft, Twitter,** etc. submitted before OECD[6] in their Request for Input (RFI) dated October, 2017 that 'the digital economy is becoming the economy itself, and that **it is not possible to "ring fence" the "digital economy".** 'Any proposal which applies only to a certain segment of the digitalized economy would constitute a clear **violation of the neutrality principle.** This would include any proposal which applies only to "highly digitalized business models". Digitalization derives innovation and growth and has enhanced the business efficiency of virtually every sector of the economy.'

3.2.1 **Value-creation:** DEG has stated that **this topic has not been discussed transparently** earlier. They have strongly objected that value is being created simply by the existence of market and hence under international tax policy market should attract some part of the tax. These arguments would be a substantial departure from existing policy with possibly far reaching consequences for all business engaged in cross-border trade.

3.2.2 Secondly, **DEG** states 'we believe that an enterprise creates its success through its deployment of personnel and capital resources. **Innovation and production create value, consumption does not.** A commercial transaction between a supplier and a purchaser is an exchange of value for value. (whether for goods or services) but that transaction creates no new value. Digital companies compete with each other worldwide to attract the best talent, in order to design the business models, features, platforms, and analytical tools that drive their businesses these businesses, the capital investment necessary to fund them, and the risks innovators take on them with no guarantee of success. These businesses certainly utilize the internet, but using this means of connectivity does not discount the value of the personal skill needed to create. The capital investment necessary to fund or attract the best talent, in order to design the business model, features, platforms, and analytical tools drive their businesses. It depends on the risks innovators take with no guaranty of success. **Endorsing the policy notion that value is created by consumption rather than production would be a fundamental shift of rights to a tax base from the country of production to the country of consumption.** This conclusion cannot be limited in application to the digitalized economy, or indeed some subsect of the digitalized economy. If the OECD were to endorse this shift for some subset of ordinary business transactions, it is hard to see a principled reason how to limit the expansion of this theory to apply to other export sales into a market.'

3.2.3 The **DEG** in its RFI on the role of the data emphasized that: **"Data itself does not create value.** Rather, the value is created through those processes which structure, aggregate, and analyze, and present the data in a manner responsive to the users' objectives. Data has always existed; what is new is the ability of many enterprises (not just the "highly digitalized" ones) to structure data in ways that allow the application of analytical tools against that aggregated data. That value is created through application of the enterprise's investments in advanced computer processing and software tools. Users and consumers of digital services are in no way involved in these structuring and analysis functions. We understand that arguments have been made that a direct income tax is appropriate for those enterprises which obtain access to a market through digital means. This market access theory is essentially a tariff on imports. We would be surprised if the OECD were to endorse this theory of taxation."

3.3 The **DEG** further argued that "We also understand that arguments have been made that tax should be imposed on a theory that users constitute a natural resource that is mined by enterprises. This is a novel analogy but **it certainly fails to justify an extraordinary allocation of taxation rights to the jurisdiction where users reside**, any more than would be the case for purchasers of luxury goods, high performance automobiles, or any other item. We also understand that arguments have been made that sales made by digitalized economy enterprises benefit from the infrastructure of the consumer's jurisdiction. Again, this theory does not distinguish the cases of luxury goods, which are bought by educated and sophisticated consumers, or luxury cars, which are driven on roads financed by residents of the market jurisdiction. In fact, the capital investment in the hardware which supports digital connectivity has been financed, built and operated in large part by the enterprises which provide the digital services."

3.4 "The main feature at the core of all three options is the ability for an enterprise to access a market remotely. That commercial reach is possible due to the widely available internet and cloud infrastructure, not necessarily due to the IP of the enterprise selling remotely. Those infrastructure resources are essential to all remote sales models. They also are available to all enterprises. Thus, the technology which provides the highways for remote sales and the other benefits of digitalization are available to all enterprises, large and small, without distinction of geographic origin. Every innovator may capitalize on these resources at relatively low cost, enabling start-ups and SMEs in developing markets to compete in the global market. IP does not arise spontaneously; it is the result of substantial human effort and investment risk. Statutorily protected IP such as patents, copyrights, and trademarks protect the innovative work of employees or individual entrepreneurs. To the extent that IP is viewed as especially significant to value creation in the digitalized economy, its role should be seen as emphasizing the value contributed by the human innovators whose work the law protects."

3.5 The DEG concluded that "Despite the review of business models conducted for the 2015 Action 1 Final Report, we believe that in some quarters there is still an assumption that highly digitalized enterprises "operate in the cloud". Enterprises which have managed to grow in these highly competitive sectors have done so only through heavy investment in very substantial workforces, and multi-billion-dollar yearly investment in infrastructure to enable the cloud's operation (e.g., data centers, services, network architecture, etc.). "

4. DIGITAL ECONOMY TAXATION THINK TANK (DET 3) –SPAIN[7]

4.1 The DET-3 in contrast has the following views, "This brings a need to evaluate impact of A.I. and Data analytics role in the significant people functions BEPS analysis. But the key game changes in our view is that in the new world of client centricity, a relevant part of the interaction with client or potential client has moved to the digital space and brands in any segment/industry and market level, are re-designing their customer touch-points strategies to adapt to the new digital channels, that will co-exist with other channels. Omni-channel management is what companies are forced to do to play in most markets, especially in some industries. That has a significant cost, and many times the cost of related resources managing that budget and activity is away of the market country where consumer is based.

4.2 A new intangible asset class is in our opinion strongly emerging and required to be identified due to its relevance: the **"data rights"**. Unprecedented and scaling at a pace whose growing curve was not seen before in human history. This fact makes it necessary for most companies to invest efforts and resources (functions) in organizing and curating that vast amount of data collected as a first step, and second, to develop a culture that enable the business to think about **extracting value from that data**, which takes time. Some digital native companies created only in the last 15 years are already mastering the use of **algorithm driven business models working predominantly with data** and being completely relying on it for every turn of the key in their business model (see the case of some Live Stream content value propositions or E-Market places). But most other companies, in any industry, will be soon reaping the benefits of the last part of the data journey, which is the exploitation and use of the data to produce value.

4.3 Data is used for almost anything in **HDBMs (Highly Digitalized Business Models),** but this is not just a digital companies pattern, it is changing now the status quo in most industries. Global value chains depend on seamless, dynamic, continuous information/data flows across the legal entities and the different functions/departments. We go to a multinational company type where data is used real time everywhere across the value chain. That is why we talk about knowledge base capital, that is not in the balance sheet but is indeed a key element of any Transfer Pricing analysis and likely a unique and valuable tax asset. Data ownership across the value chain needs to be mapped, but at the right level of effort/detail.

4.4 In our view, trying to list the types of data that will be generated is an endless exercise because the data touch points that most companies will generate across their business model is vast. But we can nonetheless make 3 general categories to simplify any analysis:

1. **Class C:** Data that enhance MNE operations
2. **Class B:** Data that enhance customer relations
3. **Class A:** Data enabling New Products/Business models

While there could be some unavoidable intra-categories overlap, this type of general conceptualization, would allow at least an initial approximation to the subsequent topic of

7 - OECD - Tax challenges of the digitalisation- comments received on request for input– PART I pages117 to 136, dated 25/10/2017

how much data could be worth. Let us also have a look at how raw data is creating a value chain for the experiments in physics of global importance."

4.5 The **OECD in the Interim report in March 2018 summed up all the countries' views on User participation as 2 broadly differing views as follows:**

- Role of user participation is a unique and important driver of value creation – Allows HDBMs to collect a great deal of information and monetise it in various ways (e.g., pricing, advertisement)
- The action by HDBMs to source data from users is NOT an activity to which profit should be attributed – User's contributed data, content and other information similar to any other input sourced from an independent, third party.

5 APPLICATION OF ECONOPHYSICS

5.1 In view of these contrasting views from economic angles, let us take the help of the Laws of Physics, which is more universal in nature cutting across countries, jurisdictions, administrations etc. to ascertain the role of user participation and value of user's data. The branch of Physics which explains economic phenomenon is known as Econophysics.

5.2 HOW BIG DATA ADVANCES PHYSICS[8]

5.2.1 The World Science Festival and Annals of Physics join forces at an event at Columbia University and has been opined in that conference that: "In the era of big data, every scientific discipline must find a way to tackle challenges in storing, handling and **interpreting large amounts of raw information.** Earlier this month, experts examined how to address that issue in the physical sciences. The panel, titled **Big Data and the Future of Physics,** was part of the **World Science Festival** in New York City".

8 How Big Data Advances Physics –The World Science Festival & Annals of Physics- Columbia University- Marc Chahin- June 27,2017- Elsevier

5.2.2 "As scholarly research is becoming increasingly digitized and data science is taking over many domains, **the importance of managing and sharing data is being felt throughout the scientific community**", explained panelist Anita de Waard, Elsevier's VP Research Data Collaborations, who develops cross-disciplinary frameworks to store, share and search experimental outputs, in collaboration with academic and government groups. "**As data, software and ideas become available to everyone, science can take advantage of the network effect to radically accelerate**." Prof. Michael Tuts, the current Chair of the Columbia University Physics Department and an experimental particle physicist, shared his experiences with **the ATLAS Experiment at the Large Hadron Collider (LHC) accelerator at CERN in Geneva[5]**. At the LHC, two beams of 100 billion subatomic particles are collided at high speeds in the hopes of finding evidence of new physics. In 2012, the Higgs boson was found at the LHC, leading a year later to the Nobel Prize.

5.2.3 One of the main **challenges** in running the LHC is **handling the vast amounts of data** it produces. Prof. Tuts compared the LHC to a 100-megapixel digital camera that takes 40 million electronic "pictures" of the colliding proton bunches per second. **The raw data has to be turned into data that can be used for physics analysis, resulting in various separate sets of data** that need to be saved on disks and tapes for posterity. **All these data are being put on the Worldwide LHC Computing Grid (WLCG), consisting of 167 computing sites located in 42 countries and holding over 200PB (200,000TB) in 1 billion files.**

5.2.4 How the "Network Effect" is accelerating science

Anita de Ward pointed out different ways that sharing is taking place, leading to **networked knowledge.** De Ward summarized the three presentations as describing **shared data (on particles and stars), shared software** (preserved and "dockized" or wrapped up in preservable containers) and **shared ideas.** As science thus becomes "deconstructed" in its component parts, it allows the "**network effect**," meaning that many more connections become possible between nodes in a network than in the traditional linear stream, where a scientist creates his or her own data, software and ideas in relative isolation. **This enables scientific progress to accelerate at an exponential rate: not only can data created by one team be used by the whole world, but new parties can contribute to software and ideas."**

8 - How Big Data Advances Physics –The World Science Festival & Annals of Physics- Columbia University- Marc Chahin- June 27,2017- Elsevier.

5.3 CRITICAL REVIEW AND COMMENTS

Let us examine some of the arguments for and against these views critically.

5.3.1 In the very beginning of this chapter through an example of the value creation of an orange hanging in the tree in California, it has been clearly determined through the basic principle of Economic Allegiance Doctrine (EAD) that the value is not created until it is consumed by the consumer. This proposition laid down the basis of international taxation. Hence, the argument put forward by Digital Economic Group (DEG), the largest group to be affected when OECD calls for a paradigm shift in approach in international tax, that "consumption does not create value" is in complete contrast to the fundamentals of EAD. This also fundamentally opposes the summary of the G 20 summit call "where economic activities occur and value is created".

5.3.2 Regarding the issues raised by the Digital Economy Group (DEG) that the value is created not from the data itself, but the value is created through those processes which structure, aggregate, and analyse, and present the data in a manner responsive to the users' objectives has to be looked deeper from a different angle to understand the entire process. One has to look into the processes by which the Digital Economy Multinational Enterprises (MNE) function-

- **Internet of things, (IoT)**
- **Machine Learning (ML)**
- **Artificial Intelligence (AI)**
- **Algorithm(Alg)**

5.3.3 **Internet of things (IoT):** It is the network of physical devices, vehicles, home appliances and other items , software, sensors, actuators, and connectivity which enables these objects to connect and exchange data. Each thing is uniquely identifiable through its embedded computing system but is able to inter-operate within the existing Internet infrastructure. The figure of **online capable devices** increased to **8.4 billion in 2017.** Experts estimate that the IoT will consist of about **30 billion objects by 2020. It is also estimated that the global market value of IoT will reach $7.1 trillion by 2020.**

5.3.4 **Machine Learning (ML):** It is a field of computer science that gives computer systems the ability to "learn" (i.e., progressively improve performance on a specific task) with data, without being explicitly programmed. The name Machine learning was coined in 1959 by Arthur Samuel. Evolved from the study of pattern recognition and computational learning theory in artificial intelligence, machine learning explores the study and construction of algorithms that can learn from and make predictions on data , such algorithms overcome strictly static program instructions by making data-driven predictions or decisions, through building a model from sample inputs. The computers are fed millions of user's data to understand the behavioural attribute of a particular user from its experience of learning from the other millions of data and build the process itself.

5.3.5 **Artificial Intelligence (AI):** Wherein the machines which becomes accustomed on being fed with millions of data can build any **user preference of choice likings, dis-likings and can suitably suggest** how the **particular user will respond to a particular type** of situation. Businesses today view AI as systems that can learn instead of systems that are programmed. The pace of The pace of deep neural network innovation means companies can now solve an entirely new set of problems. As of February 2018, there are 2,117 AI start-ups, segmented into 13 categories that collectively raised $29 billion in funding, according to Venture Scanner.

5.3.6 **Algorithms(Alg):** The characteristics and all the tell-tale details of the users are captured through millions of algorithms done simultaneously. So **when 2 users chat among themselves in a social networking site viz. Facebook or WhatsApp,** they provide a huge amount of **unstructured data** to the machines which captures the **personal preferences of the user and suggest how the user be approached from the point of customised advertising.** The power to evaluate, and influence the choices of the captive user base, is the USP of the big digital companies. These often leads to monopolistic trade practices and even can break the barrier of ethical trade practices. **The European Union has levied a penalty of $ 2.99 billion on Google for showing only their own products at the top of the search list** bypassing all products of other enterprises.

5.3.7 Whatever be the investment made in Human Resources and otherwise in developing new artificial intelligence, algorithm, neuron networks, this will have no real value if these are not based on the real time data of millions and millions of users to know their preference or choice. Thus, **capturing the behavioral attributes** in the algorithm is the actual value that determines its value creation or value base.

5.3.8 **Value Chains, Value Networks and Value Shops:** The OECD report highlights the three concepts of creating of value or profit as above. In the Global Value Chains apt for the digital economies wherein value creation begins with raw materials and proceeds to a finished product as per Stabell and Fjeldesad (1998), two alternative models that of value networks and value shops have been described. The concept of the value network model depends on where value is created by linking users, suppliers or customers i.e. creating network relationship using a mediating technology. This covers all types of multisided platforms. The value shops models are where value is created to resolve customers' problems, grievances by marshalling of resources viz. Cloud Computing. (pg.19)

6 NETWORK EFFECT & CRITICAL MASS

6.1 **Network Effect:** This issue is also highlighted in the interim report of the OECD dated 11-13, December, 2017. This report illustrates that the success of the business models depends on "network" only whether being a direct network or indirect network. In direct network the value increases as the number of users increases. The Direct network uses the digital platform and benefits from the group of end users. (pg.8). The OECD report also highlights that the digital markets are not competitive and single firms become large enough to influence market prices and it becomes difficult for new firms to gain significant market shares. Here digital products and services disseminate faster, markets clear faster, idea circulate faster and it becomes much easier for businesses to identify, engage and develop their customer base. (pg.10)

6.2 **Critical Mass:** 'Critical Mass' term is derived from **Nuclear Physics** and it is to measure the minimum amount of a given fissile material necessary to achieve a self-sustaining fission chain reaction under stated conditions. Critical mass refers to the level of users that are required to help create a set of network effects that are so strong, that they build a moat for that particular business. Sometimes there is no second place in a market when network effects are that strong. In **Digital Economy** this term can be used to measure the number of users to start the chain reaction of multiplying the user reach which has **a multiplier effect and is the USP for Digital MNEs in maximizing profit.**

6.3 Research by European School of Management and Technology(ESMT), Berlin, Germany[9] shows that the common definition of critical mass in business would be when "diffusion becomes self-sustaining" (Rogers 2003: 243). **Critical mass phenomena** rely on a rapidly evolving endogenous process over time, e.g. installed base effects driving diffusion even in the absence of price decreases. The link between technology diffusion and installed base effects is well-established (Cabral 1990, 2006; Rohlfs 1974; Kretschmer 2008; Granovetter 1978; Markus 1987), and research identifying multiple stable equilibria separated by an unstable one (Evans and Schmalensee 2010; Economides and Himmelberg 1995; Katz and Shapiro 1985) characterizes the transition from one equilibrium to the other as critical mass. By using the logic of multiple equilibria and endogenous diffusion shows that critical mass – a self-sustaining diffusion process – will only emerge if boundary conditions on the strength of installed base effects, the size of the installed base, and the current market price, are met. The research found that these three parameters are substitutes in terms of reaching critical mass.

6.4 WILLINGNESS TO PAY AND NETWORK EFFECTS

6.4.1 Suppose that at each time, t, consumers decide, depending on the net benefit, whether or not to subscribe to a service. The service displays network effects such that the installed base of adopters (subscribers) affects consumer willingness to pay. There is a measure one of infinitely lived consumers with unit demand for the service influenced by consumer type and the installed base of users. Consumer v's preferences are represented by the willingness-to-pay function $u(v,x_{t-\delta})$, where v is the individual preference parameter, $x_{t-\delta}$ is lagged network size at time t, and the

9 - Identifying Critical Mass in the Global Cellular Telephony Market, Michał Grajek , European School of Management and Technology, , Schlossplatz 1, 10178 Berlin,

6.4.2 **Short-Run and Long-Run Subscription Demand of Critical Mass:**

At time t consumer v decides whether to subscribe by considering the net utility from joining

$$u(v, x_{t-\delta}) - p_t$$

where δ is lag length & u is willingness to-pay function.

There is one market price, If (1) is non-negative, the consumer will join, otherwise not. The consumer indifferent between joining or staying out at time *t* (v^*_t)is given by the following equation.

$$u(v_t^*, x_{t-\delta}) = p_t \quad (2)$$

All consumers with *v* will join. Define

$$H(v_t^*) \equiv 1 - F(v_t^*) \quad (3)$$

$$x_t = H(v_t^*) \quad (4)$$

such that H(.) equals the number of consumers in the network at time t. The state equation describing network size at time t, that is, short-run demand, is given by:

In steady state, no consumer can increase utility by joining or leaving; the network stays constant over time, which gives the following long-run demand condition:

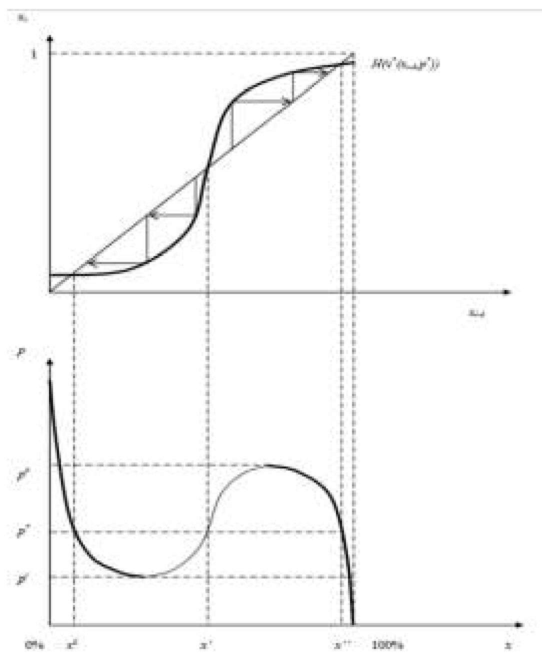
$$x_t = x_{t-\delta} \quad (5)$$

Long-run demand is reached when the market is saturated and there are no more consumers to fuel further diffusion. However, long-run demand can also fall short of full saturation depending on prices and consumer preferences.

6.4.3 **NETWORK DYNAMICS: CRITICAL MASS AND DIFFUSION TAKEOFF**

(1990) analysis of the equilibrium network size path shows that for sufficiently strong network effects and lag length δ approaching zero, the equilibrium adoption path is unique and discontinuous as described by equation (4). Because H(.) maps the change in network size from time $t-\delta$ to t, it is convenient to think of it as of a function of lagged network size $x_{t-\delta}$. To see how network externalities and price affect diffusion, we calculate the derivatives of H(.) with respect to lagged network size $x_{t-\delta}$. and price p as below. The slope of H(.) increases in the strength of network effects measured by $\eta = \frac{\partial u(v_t^*, x_{t-\delta})}{\partial x_{t-\delta}}$, as shown in figure 1 below:

Figure 1. Stable vs. unstable equilibria



(I) H is non-decreasing if and only if network effects are non-negative,

(ii) the slope of H equals zero if there are no network effects, and

(iii) the slope of H increases with network effects whenever the density of types is strictly positive.

Consumer v's willingness-to-pay function is specified as follows:

$$u(v, X_{i,t-1}) = v + cX_{i,t-1} + dX^2_{i,t-1} \quad (6)$$

where c and d are parameters that determine the extent of installed base effects (this is called **Network Effects parameters**), with the square term capturing possible non-linearities. Installed base $X_{i,t-1}$ is defined as the number of subscribers normalized by population size in a given geographic market (i.e. country) in period t-1 $(X_{i,t-1} = x_{i,t-1}/POP_{i,t-1})$.

Thus, specification (6) ass$(-\infty, a_{i,t}]$hat network ε $b_{i,t} > 0$. ıre a function of relative rather than absolute number of subscribers facilitate analysis of multiple differently-sized markets. It is assumed that the preference parameter v to be uniformly distributed over with density

$$\text{Where } a_{i,t} = a_{0i} + a_1(GDP/POP)_{i,t} \quad (7)$$

$$b_{i,t} = bPOP_{i,t} \quad (8)$$

The highest consumer type in the population depends on a country's GDP per head and the unobserved heterogeneity across countries; the extent to which demand reacts to price changes depends on the country's overall population.

Diffusion Equation (4) becomes:

$$X_{i,t} = a_{0i}b + a_1 b(GDP/POP)_{i,t} - bp_{i,t} + bcX_{t-1} + bdX_{t-1}^2 \quad (9)$$

The structural parameters of this model can be recovered from the following estimation equation:

$$X_{i,t} = \alpha_{0i} + \alpha_1(GDP/POP)_{i,t} + \beta p_{i,t} + \gamma_1 X_{i,t-1} + \gamma_2 X_{i,t-1}^2 + \varepsilon_{i,t} \quad (10)$$

where $\varepsilon_{i,t}$ denotes the error term, which is heteroscedastic and correlated across time t, but not across markets i. The error term captures the effects of variables that affect subscriptions, but are not observed in data set, e.g. marketing effort of operators, or the degree of non-price competition more generally, in each geographic market. Equation (10) simplifies to a multi-market version of the original Bass model if β=0 (i.e., price does not matter for network diffusion). To see this, rearrange the terms to obtain:

$$X_{i,t} - X_{i,t-1} = \alpha_0 + \alpha_1(GDP/POP)_{i,t} + \beta p_{i,t} + (\gamma_1 - 1)X_{i,t-1} + \gamma_2 X_{i,t-1}^2 + \varepsilon_{i,t} \quad (11)$$

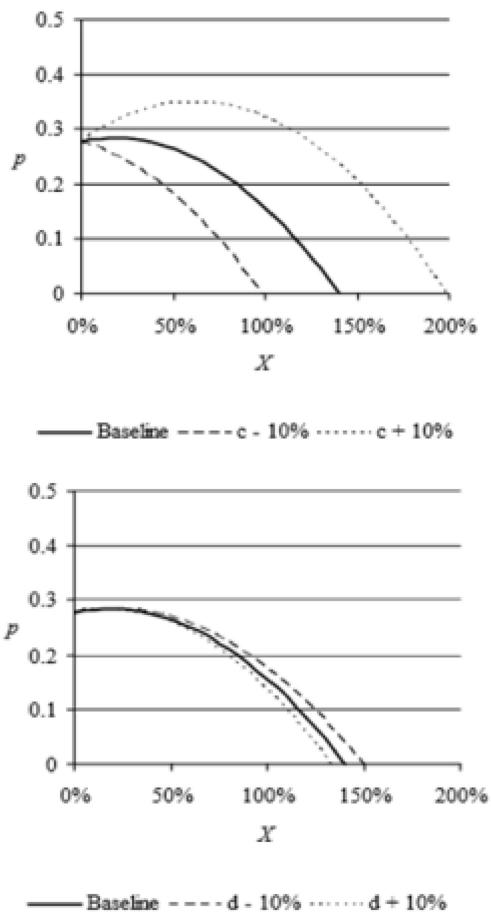
The left-hand side of (11) corresponds to subscription sales at t and the right-hand side is a square function of cumulative sales through period t-1 with a market-specific intercept, which is a straightforward extension of the Bass model to a multi-market context. In fact, a single market version of (11) matches exactly the discrete analog of the Bass (1969) diffusion equation, as shown below:

$$\frac{\partial}{\partial x_{t-\delta}} H(v_t^*) = f(v_t^*).\left(\frac{\partial u(v_t^*, x_{t-\delta})}{\partial v_t^*}\right)^{-1}.\frac{\partial u(v_t^*, x_{t-\delta})}{\partial x_{t-\delta}} \quad (12)$$

The estimates of coefficient in equation (10) identify the structural model parameters as follows: the highest consumer type in the population is identified via two parameters, $a_0 = -\alpha_0/\beta$ and $a_1 = -\alpha_1/\beta$, and the density of the distribution of types is given by the price parameter,

$b = -\beta$. The network effects parameters c and d are identified via-γ1/βand-γ2/β, respectively. Thus, the **network effects** in this model are identified by separating the impact of installed base on current subscriptions from the impact of price. More generally, the **installed base effect** could also be due to **other social contagion effects including social learning under uncertainty and social-normative pressures**, as has been pointed out for aggregate diffusion models (Van den Bulte and Lilien, 2001; Van den Bulte and Stremersch, 2004). The focus, however, is less on the source of the installed base effect than on its implications for critical mass, and the installed base parameters are estimated to gain insights about critical mass by simulating counterfactual steady states of the diffusion process.

Figure 2 sensitivity of long-run demand to changes in the net effect parameters



6.5 RESULTANT APPLICATION IN DIGITAL ECONOMY

The research as above56 shows the importance of the critical mass of end users and the value of network effects based on social networking irrespective of prices for a globally operating digital MNE to be profitable in the global perspective. The installed base of interactive users plays a pivotal role in garnering profit for the MNE after it reaches a stage of diffusion attaining critical mass of users similar to happenings in a nuclear chain reaction. a slight variation of 10% in network effect parameter c results in the long run demand to appreciate by more than 60%, thus creating a multiplier effect after reaching diffusion stage.

7. RESEARCH BY G20 YOUNG ENTREPRENEURS ALLIANCE

7.1 Research by G20 Young Entrepreneurs Alliance10, published by Accenture shows that to Create a dynamic platform ecosystem that enables Digital Businesses to achieve critical mass, the following five distinctive capabilities has to be achieved. One may call it five Ps:

- a differentiated value proposition,
- service personalization,
- market responsive pricing,
- effective cyber protection,
- scalability power of ecosystem partners.

7.2 This depends on fostering a supportive enabling environment: There are factors and conditions within the broader economy that are required for platforms to emerge and grow and include

- digital user size and savviness,
- public policies.

7.3 It has been observed by OECD that the economic success of the digital business model relies on a critical mass of end users, wherein many of the end users benefit from "free" access to a specific service and the operators of digital platform compensate for this by leveraging data on users and transactions e.g. by selling targeted advertisements to customers on the other side of the markets, advertisers. (pg.12)

7.3.1 Customer data and user generated content contribute hugely to value creation. Without user participation and User Generated Content(UGC) the digital business as it is, cease to exist. A user whether active or passive is contributing in the value creation since the digital platform is capturing his preference and behaviors which can directly be monetized. The target of a digital MNE is to reach a critical mass of users, thus giving it the major competitive advantage and hence, the source of profitability. (pg.45-46)

7.3.2 Conclusion on Critical Mass So, for instance, when a continuously loss making WhatsApp is purchased by Facebook for a whopping price of $ 14 Billion , this amount is paid not only for the machines on which WhatsApp works or the Human Resource of software engineers acquired, or for the tangible assets reflected in the balance sheet, but for capturing the behavioral attributes of billions of WhatsApp users over a long period of time , whose value is not mentioned anywhere, which can be used effectively for future revenue generations by Facebook since WhatsApp possessed huge critical mass of users on real time basis through capturing the behavioral attributes of end users in algorithms.

7.4 Data Monetization "Rather than just being an e-Commerce platform, Alibaba is an infrastructure and data company—which is our strength and also our future. By focusing on big data capabilities, we gain a full, clear picture of buyers and sellers on the Alibaba platforms, and we are able to offer additional services to them." - Cheng Ouyang, Executive Senior Advisor - Alibaba Group, China

7.4.1 The research by G20 Young Entrepreneur's Alliance57 shows that Data generated by platforms proliferates—whether from analysis of user experience, behaviors, service consumption or productivity measures. In turn, this creates a multiplier loop, where the value of data multiplies with the number of users and partners in the ecosystem. Platforms enable the gathering of data and the generation of real-time insights on customers, market trends and operations. Indeed, the rich volumes of data and the speed of intelligent service enhancement that is feasible on platforms are possibly beyond reach of the traditional business model.

7.4.2 The largest data-driven opportunity is the ability of a platform to capture value by creating new products and services, improving user experiences, managing risk and increasing productivity. These are avenues of internal monetization where data-driven enhancements are generated within the company. The impact is difficult to measure and the opportunity is often not maximized. Data monetization can also be achieved by providing data-based services to third-parties—which can be a high-margin business for platform players.

7.4.3 Although the largest opportunity will be internal monetization, the potential for external monetization is high if the platform holds unique data and has the capability to package innovative services around that data for third parties While some platforms are primarily transaction oriented and others are strongly data oriented, the opportunity from data monetization is undeniable for all platforms.

7.4.4 Alibaba's asset-light model means China's biggest online e-Commerce company can invest in next-generation technologies and services, such as cloud computing and big data, to maintain its competitive edge. Data—and better understanding of it—is integral to the company's operations. More than 37 percent of Alibaba's workforce is science, technology, engineering and mathematics (STEM) talent, mainly employed in database management, machine learning and artificial intelligence. The data insights gained are being monetized in a number of different ways. For instance, Alibaba uses data to derive 49 percent of its group revenue from advertising services, including third-party advertisers. “Super-ID” under the Dharma Sword initiative tracks the preferences of 630 million users, the vast majority of China's internet population. Sellers pay a monthly fee for Alibaba software that they use to analyse relevant data and personalize services for customers. Smart logistics data predicts supply and demand and guides platform sellers to pre-transfer merchandise to designated warehouses where there is strong demand. Finally, Alibaba is developing a unique enterprise credit system by bringing together data on sellers' financial records, including affiliate Ant Financials' records, past transactions and information from partners, such as banks. Unique data can be of immense value to businesses and societies outside the platform business."

7.4.5 The OECD Report highlights that Consumers provide data when they interact with the company's website or app. The interaction may be active, such as when users create a profile, save items of interest for future reference or make a purchase. It may also be passive, such as when users browse the website or authorize the company to access their browser histories or geolocation data. It may also be possible for the company to access information via other websites or apps open at the same time. Such data collection, and the value that can be extracted from it through data analysis, is an important aspect of the reseller business model.

7.4.6 A reseller extracts value from consumer data in two main ways. First, it may use personalized data such as demographic information as well as data about the consumers' behavior and product use to understand consumer preferences and, based on these preferences, improve their products and target their marketing at the individual user level. Online stores or apps may be tailored to each individual consumer. Second, a reseller may also use data to engage in differential pricing, charging consumers different prices based on their personal information.

7.4.7 Little is publicly known about resellers' potential differential pricing strategies. While some companies have denied that they change prices based on personal information, however, anecdotal evidence is nevertheless plentiful (Mohammed, 2017). In a summary of evidence of price differentiation by US retailers, a 2015 Council of Economic Advisors report also outlined three categories of price differentiation strategies:

(i) exploring the demand curve, i.e. conducting online experiments to learn about demand elasticities.

(ii) steering and differential pricing based on demographics, and

(iii) behavioral targeting and personalized pricing (CEA, 2015). To the extent that such strategies are employed, resellers are able to capture consumer surplus for themselves by using data, thereby maximizing profits. (pg. 52-53)

7.4.8 In another example in the ride for hire companies like Uber, Bla Bla, wherein the core of the company's operations is connecting passengers and drivers using internet connectivity and running the algorithms by which, the company sets prices. Whereas it has computer hardware, servers, knowledge based capital, and intellectual property components but the service depends upon the data describing the precise locations of drivers and passengers. The company collects and stores user data including ride history, user profile details and payment and bank information which leads to product developments and ability to maintain the quality. User data is the input to the sophisticated price setting algorithm. Unlike, the traditional taxi business model where fares are fixed, here fares are fixed by the digital MNEs. This also relies on surge pricing depending upon the demand of the user at a given time on real time basis. "(pg.63)

7.4.9 This point has been highlighted by submission of DET3, wherein they have mentioned that global value chains depend on seamless, dynamic, continuous, information data flow, across the legal entities. So, real time data is the life line of any digital operation and data used for almost everything in Highly Digitalized Business Models (HDBM). Three kinds of data can be used where-

- Data that enhance MNE operations
- Data that enhance customer relations
- Data enabling New Products/Business models

7.4.10 Even for an experiment of world-wide ramification in Large Hadron Collider (LHC) which ultimately detected the existence of Higgs- Boson particle, popularly known as God's particle, the success depended on collection of billions of raw data and analyzing them across countries, through network effect, as duly acknowledged in the World Science Festival. This once again proves the fundamental principle of the chain of value creation in Science through

- Experiment,
- Observation,
- Inference.

This fundamental principle of science is ruling the thinking of the humanity over ages, cutting across all countries and responsible for human progress. So, it follows logically that, without experiment there can be no observation and without observation there can be no inference. Taking a corollary in the present instance of digital economy it can be inferred that:

- without experiment, i.e. collection of real time raw data,
- there can be no observation, i.e. processing the data in Artificial Intelligence and
- no inference i.e. drawing of algorithm depicting the specific behavioral attributes of a particular user on real time basis.

7.4.11 Any denial to the access of the data source in any country tantamount to denial of experiment, that renders the process of observation and inference i.e. building artificial Intelligence and algorithm, useless. This happened in the case of China which blocked the entry of non-resident MNEs in Digital Economy. So, the non-resident digital MNEs could not draw any algorithm based on data of Chinese population irrespective of their vast access to high end technology. Thus, the argument of the Digital Economy Group that raw data has got no value and only the process of creation with that data has got value, is not acceptable as per global standard of science as well as in economic reality. So, there can be no doubt that data has got enormous value.

7.4.12 Thus, the value is created wherein real time user data is collected, processed and used by various digital companies providing different kind of services with value additions. In this regard the comments made by the BEPS monitoring group on the need for a paradigm shift in approach from the brick and mortar model to the digital model in taxing the digital economy cannot be over stated that the country of taxation is determined by the location of users and not by other standards. Taking the stand taken by BEPS group it can be further stated that the maximum value is created by the collection of raw data or to the access of the raw data source which is consonant with a successful experiment in science and has the maximum value in creating the value chain as observation and inference follows subsequently. Thus, the arguments put forward by the Digital Economy Group and the countries supporting this view cannot be accepted in view of the Principles of

Science laid down over ages.

8. Profit Attribution on the basis of Fractional Apportionment

8.1 The concept of fractional apportionment has originally been proposed by the four economists in their report to the League of Nations. Wherein it is difficult to quantify taxable profits correctly within a specific jurisdiction due to economic complexity, then this approach would be very useful.

8.2 Methods based on Fractional Apportionment

Another approach considered would be to apportion the profits of the whole enterprise to the digital presence either on the basis of a predetermined formula, or on the basis of variable allocation factors determined on a case-by-case basis. In the context of a significant economic presence, the implementation of a method based on fractional apportionment would require the performance of three successive steps:

(1) the definition of the tax base to be divided,

(2) the determination of the allocation keys to divide that tax base, and

(3) the weighting of these allocation keys. (Para 287)

It is important to note that the domestic laws of most countries use profit attribution methods based on the separate accounts of the PE, rather than fractional apportionment. In addition, fractional apportionment methods would be a departure from current international standards of taxation.

8.3 In view of the discussions on fractional apportionment as above one may think of the Massachusetts formula wherein equal weightage were given to the following 3 factors for profit attribution -

- Property factor
- Pay role factor
- Sales factor

8.4 It is observed that European Union (EU) in their communique dated 25.10.2016 on Common Consolidated Corporate Tax Base (CCCTB) the same apportionment formula with equal weightage but slightly different nomenclature:

- Assets- Company has in an EU Member Country
- Labour- (number of employees and employment costs): - the company has in that EU Country
- Sale - The company made in that EU Country.

Since, this fractional apportionment formula finds wider acceptance in international circles, one may think about the same in Indian perspective also.

8.5 In this respect it may be considered as to why the costs on labour expenditure in the case of an MNE doing business in a digital economy is much lesser than the labour cost incurred by a brick and mortar model MNE of same proportion, the reason being that the users of the digital economy functions as employees in a real sense. So, the difference in the labour cost of a brick and mortar MNE and the MNE doing digital business gives one a fair idea of the user's contribution by way of reduced cost and increase in profit in the hands of the digital company. So, while attributing profits, a portion of the 1/3rd attributable to labour cost in a brick and mortar MNE would actually come for user contribution.

8.6 Similarly, in the case of assets which in a conventional brick and mortar model relates to only physical and tangible assets but in the case of digital economy MNE, the real value of these assets forms a larger part in intangible assets viz intellectual property rights. The assets of the company also consist of using these assets in an unfettered manner in a country like India which guaranty by law the user of this intellectual property rights and prevents it from getting copied or unlawful uses. These guaranty by the Government of India carries a lot of value which would be understood from the benefit doctrine discussed earlier. So, while understanding the scenario of doing the fractional apportionment, while taking users contribution as a sizeable portion of the 1/3 weightage allocated to Labour costs, the spending done in public domain to build up the infrastructure and the law guaranteeing unfettered use of the IP rights should form part of the 1/3 weightage to Asset.

9. VIEW OF UN , IMF AND LOOKING BEYOND

Is consensus at OECD the only way, even at the cost of sacrificing national interest? It will be important to understand the view of the Chief of International Tax in UN in this regard.

10 "Is a consensus the holy grail?"[11]

10.1 It seems that a full debate on this issue of limiting consideration to the supply side would probably not lead to a consensus by 2020. And, in fact, to revert to Schön's

analogy, the siren song for developing countries (among others) might be the push for consensus by 2020. Caution and a degree of scepticism are warranted, and developing countries may need to show a willingness to prefer no deal in 2020 over a bad deal that may effectively constrain policy space for decades. Moving from the more readily accepted activities excluded by the term "value creation" to the more contested issues, it should be borne in mind that attempts to achieve a consensus in so large a body of countries as the Inclusive Framework, especially one composed of developing, emerging and developed economies, are unlikely to exhibit complete coherence in either legal or economic terms."

10.2 IMF in its press release[12] observed in this regard, "Directors welcomed the discussion on tax challenges associated with digitalization. They recognized that this is a difficult issue, technically and politically, and that views on whether special treatment is needed, and if so in what form, continue to differ widely.

They noted that the Platform for Collaboration on Tax provides a useful framework for bringing together the IMF, OECD, UN, and World Bank, and could continue to play an active role in supporting international tax coordination."

10.3 Since India has been the pioneer in championing the cause of the developing world and the entire developing world looks up to what India is deciding, time has come for India to assert its rightful place in the global scenario to get a justifiable deal in the Platform for Collaboration on Tax, not only for itself but for the entire developing world.

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Disclaimer: The opinions expressed in this article is that of the author only. This should not be construed as representing the view of the Ministry of Finance, Government of India.

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1 Chief, International Tax Cooperation Unit, financing for Sustainable Development Office, United Nations. This paper was written while on sabbatical at the Oxford University Centre for Business Taxation. The comments of Professor Michael Devereux of the Centre on an earlier version of this paper are especially acknowledged; however, the paper reflects only the personal views of the author.

12 The IMF Press Release No. 19/69 ; March 10, 2019;
IMF Executive Board Reviews Corporate Taxation in the Global Economy

Taxation of Cloud Computing Services – An Analysis

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Executive Summary

In today's technology world, businesses require access to high end technology equipment like servers in order to host various services online. Due to this, requirement for these kinds of servers have increased tremendously among the e-commerce businesses. Owning/maintaining such servers and upkeep requires skilled manpower, which is a costly affair. So many e-commerce start-up companies are availing cloud computing services from Amazon, Google, etc.

1.1 In today's technology world, businesses require access to high end technology equipment like servers in order to host various services online. Due to this, requirement for these kinds of servers have increased tremendously among the e-commerce businesses. Owning/maintaining such servers and upkeep requires skilled manpower, which is a costly affair. So many e-commerce start-up companies are availing cloud computing services from Amazon, Google, etc.

Understanding Cloud Computing

1.2 Cloud computing is the provision of standardised, configurable, on-demand, online computer services, which can include computing, storage, software, and data management, using shared physical and virtual resources (including networks, servers, and applications). Since the services are provided online using the provider's hardware, users can typically access the service using various types of devices wherever they are located, provided they have a suitable Internet connection.

1.3 There are three major models of delivering 'clouding computing' services to businesses and they are as follows:

A. Infrastructure as a Service (IaaS) Model - Under this model, typically utilized by large multinational businesses, IT infrastructure in the form of data centers, virtual servers, network infrastructure, equipment, etc. are sourced as a service from third party service providers.

B. Platform as a Service (PaaS) Model - PaaS is a category of cloud computing services that provides a computing platform and programming tools as a service for customers.

C. Software as a Service (SaaS) Model - Under this model the service provider hosts several software applications for consumers to use as and when required thereby eliminating the need to install and run the software application on the consumer's own infrastructure. It can be provided either to business customers (B2B) or to individual customers (B2C).

1.4 Under the Cloud Computing arrangement, it is found that the customers are only allowed to store their data and process the same, with no control over the location where the same will be stored. Service Provider will have control over the data and right to transfer the same to any country. Customer is merely using a standard storage and processing facility provided by the service provider and consideration paid is only to use such facility and does not extend to any right or property or information.

1.5 Customer is only allowed to use services to store, retrieve, query, serve, and execute content which is owned, licensed or lawfully obtained by it. The customer will have no control over any other data stored in the server. Service provider also allows use of certain software as part of the services. Such software can neither be sold nor distributed to the customer and can only be used as part of service offerings. The recipient of services is only allowed to store or run a query on the content or data which are owned by them. Customer is merely allowed to use the standard facility offered with certain sophisticated software embedded in it.

Taxability under the Income Tax Act

2.1 Income would be chargeable to tax in India if the same falls within the scope of section 4 read with section 5 of the Act. Section 4 is the charging provision under the Act. The charge is in respect of the total income for any year. The scope of total income chargeable to tax in India is outlined by Section 5. This scope of total income depends upon whether the assessee concerned is a resident or non-resident in India. Place of accrual assumes importance especially for non-resident taxation, since a non-resident is liable to pay tax only on income, which accrues or arises in India.

2.2 If the service provider do not carry out any business activity (CIT V R.D. Aggarwal & Co. (1956) 56 ITR 20) in India, then there will be no 'business connection' in terms section 9(1)(i) of the Act. Generally, cloud service providers do not have offices, IT infrastructures and servers in outside India and all their services are provided from outside India. In such circumstances, it cannot be said that the income of non-resident accrues or arises in India or is from business connection in India.

Payment for Cloud Services whether Royalty:

2.3 Section 9(1)(vi) of the Act deals with taxation of Royalty. Section 9(1)(vi)(b) of the Act provides that any royalty payable by a person resident in India would deem to accrue or arise in India, except where the royalty is payable in respect of any right, property or information used or utilised for the purpose of business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India. If the payment made for Cloud Computing Services is regarded as in the nature of "Royalty" then it would be covered under section 9(1)(vi) of the Act and hence would accrue or arise in India.

2.4 The term 'royalty' is defined in Explanation 2 to section 9(1)(vi). The scope of definition is further expanded by Explanations 4, 5 and 6 to section 9 (1) (vi). The same are extracted below:

Explanation 2. For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for—

(i) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;

(ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property ;

(iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;

(iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(iva) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;

(v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or

(vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v).

Explanation 4.- For the removal of doubts, it is hereby clarified that the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred.

Explanation 5.- For the removal of doubts, it is hereby clarified that the royalty includes and has always included consideration in respect of any right, property or information, whether or not-

(a) the possession or control of such right, property or information is with the payer;

(b) such right, property or information is used directly by the payer;

(C) the location of such right, property or information is in India.

Explanation 6.- For the removal of doubts, it is hereby clarified that the expression "process" includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret;

2.5 The term Royalty is defined in Article 12(3) of India – USA is as follows:

12(3) The term "royalties" as used in this Article means

(a) payments of any kind received as a consideration for the **use of, or the right to use, any copyright of a literary, artistic, or scientific work,** including cinematograph films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof

(b) payments of any kind received as consideration for the use of, or **the right to use, any industrial, commercial, or scientific equipment,** other than payments derived by an enterprise described in paragraph 1 of Article 8 (Shipping and Air Transport) from activities described in paragraph 2(c) or 3 of Article 8.

Whether access to server constitutes Royalty for use of Software

2.6 Copyright is a bundle of rights including, inter alia, rights of reproduction, communication to the public, adaptation and translation of any work. Copyright ensures certain safeguards of the rights of authors over their creations. A comprehensive legislation is enacted to monitor the Copyright laws in India. It is the Copyright Act, 1957 ("CRA"). The various rights in a Copyright are transferred individually or in the aggregate or in combination thereof.

2.7 Royalties means consideration for 'transfer' of any of these rights. Unless any of these rights move from the recipient to the payer for consideration, the consideration would not constitute royalties. In other words, there has to be a transfer of a copyright right. If what is secured is only a product which is an embodiment of the rights, the same would be regarded as a transfer of a copyrighted article. Payments for copyrighted article do not constitute 'royalties'. It is only payments for copyright right that constitute royalties. With respect to characterisation of software license, as to whether it constitutes royalty or business profits under DTAA, the High Court of various states in India having taken conflicting views.

2.8 The Delhi High Court in the case of **DIT v Ericsson AB [2012] 246 CTR 422** held that payment towards copyrighted software does not partake the character of 'royalty' under the Act and the Treaty. Similar view is taken in Bombay High Court in the case of **Mahyco Mosanto Biotech (India) (P) Ltd vs UOI (2016 74 taxmann.com 92(Bom)** and by Madras High Court in the case of **Vinzas Solutions India Pvt. Ltd. (392ITR155).**

2.9 However, the Karnataka High Court in the case of **CIT vs. Samsung Electronics Co Ltd 345 ITR 494** has taken a contrary view, wherein it was held that the amount paid to foreign supplier for supply of the "shrink-wrapped" software is not the price of the CD alone nor software alone nor the price of license granted. It is a combination of all. In substance unless a license was granted permitting the end user to copy and download the software, the CD would not be helpful to the end user. Further, **Explanation 4 to section 9(1)(vi)** clarifies that the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a license) irrespective of the medium through which such right is transferred.

2.10 While availing the cloud services the e-commerce companies are provided with limited access to the server and software functionality available on Service Provider's IT infrastructure and not allowed to download any software. These companies do not download the software license and install on their systems. The payment is for bundle of services – storage space, software, 24/7 access etc. Therefore, the payment for cloud services is not only for software but for host of other services. In that context, the applicability of above decisions which are with reference to software royalty will have to be tested at higher forums. Further, whether the purchase of shrink wrap software constitutes royalty or not is pending before the Honourable Supreme Court and decision in that case will also have a bearing on the taxability of payment made for software services.

Whether access to server constitutes an Equipment Royalty

2.11 The question that needs to be answered is whether 'server' can be treated as equipment. The Hon'ble Madras High Court in **Poompuhar Shipping Corporation Ltd.v ITO [2013] 38 taxmann.com 150 (Madras)** highlighted the need for construing 'equipment' widely, so as to embrace every article employed by the employer for the purposes of his business. 'Equipment', in whatever name called either as an apparatus or as plant or machinery, so long as they are employed for the purposes of one's income, the same shall stand covered by Clause (iva). Drawing inference from the above one can state that 'server' is equipment. The next aspect that needs to be addressed is whether e-commerce companies have 'right to use' the server. The meaning of the term 'right to use' is therefore of significance. In this regard, following judicial precedents may be referred.

2.12 The Hon'ble Delhi High Court in the case of **Asia Satellite Telecommunications Co. Ltd v DIT [2011] 197 Taxman 263 (Delhi)** has held the transponder and the process therein are actually utilized for the satellite owner for rendering the services to the customer and further that it cannot be said that the transponder or process employed therein are used by the customer.

2.13 The Mumbai Tribunal **DDIT v Savvis Communication Corporation [2016] 69 taxmann.com 106 (Mumbai - Trib.)** has held that payment received for providing web hosting services though involving use of certain scientific equipment cannot be treated as 'consideration for use of, or right to use of, scientific equipment' which is a sine qua non for taxability under section 9(1)(vi), read with Explanation 2 (iva) thereto as also article 12 of Indo-US DTAA.

2.14 The Chennai Tribunal **ACIT v Vishwak Solutions Pvt. Ltd ITA No. 1935 & 1936/Mds/2010 dated 30.01.2015** has observed and held that the assessee was only using the storage space provided by non-resident in US namely INETU, in the machines owned by INETU situated outside India. The assessee had no right over the equipment in which data was stored. The charges were based on the volume of data stored in the machines. The charges paid to them were not for the payment of or right to use any industrial, commercial or scientific equipment and hence payment is not royalty under Article 12 of Indo-USA DTAA. It is a service rendered by the non-resident promoting connectivity to the assessee for hosting of website and not for usage of any machines. It is only for the use of server outside India and is not taxable in India and hence tax need not be deducted at source.

2.15 Recently, the Pune Tribunal **EPRSS Prepaid Recharge Services India P. Ltd v ITO [TS-623-ITAT-2018(PUN)]** evaluated the taxability on cloud computing services provided by Amazon and held that payment made towards web hosting charges for hiring servers from Amazon in its cloud units did not amount to Royalty under the Act and India - USA Treaty. It was observed by the Tribunal that the assessee did not use or acquire any right to use any industrial, commercial or scientific equipment while using the technology services provided by Amazon. The assessee did not possess or have any control over the server space deployed by Amazon while providing e-services and no rights in technology / IPRs were obtained from Amazon under the agreement. The Tribunal also held that retrospective amendment to 'royalty' definition under the Income-tax Act vide Finance Act, 2012 will not override Treaty provisions.

2.16 In this context, it is important to refer to Explanation 5 to section 9(1)(vi) of the Act. Explanation 5 specifically provides that for determination as to what constitutes royalty, the possession or control of right/property/information or direct use of such right/property/information by the payer or location of such right/property/information in India are not relevant consideration. Therefore, it appears that the Legislature has made its view very clear that even a remote use of right/property/information would also constitute royalty for the purpose of the Income tax Act. Viewed in this context, the companies in India availing cloud services would be remotely using the right/property/information and the possession or location of the server is not relevant consideration for determination as to whether payment for cloud services constitutes royalty.

2.17 However, the interpretation of Explanation 5 to section 9(1)(vi) will not be applicable in the context of tax treaties. As held by various judicial pronouncements, the 2012 amendment to the Income tax Act will not be applicable in the context of tax treaty. With these conflicting positions, it would be interesting to see the future development in this space. Without amendment to tax treaties, the full effect of Explanation 5 to section 9(1)(vi) cannot be achieved.

Claim Of Deduction Of Expenses On Payments To Non-residents : A User's Guide.

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Sri Som has contributed to the booklet on Royalty and Fees for Technical Services in the Taxpayer Information Series Booklet brought out by the Directorate of Income Tax (PR, PP&OL) in the year 2013 alongwith Sri SanjayKumar, IRS (Retired), who was the then Director of International Taxation , Kolkata .He has also contributed to several of the pamphlets developed by the Directorate in the matter of non-resident taxation.

His area of interest are reading, writing and social networking .

Executive Summary

Executive Summary: By Nilay Baran Som, Addl.CIT: This article tries to develop a working guide to the officers on the issue of payment to non-residents. The fundamental point to be examined by the Assessing Officers in connection with disallowance under section 40(a)(i) of the Income Tax Act of any payment to a non-resident is whether the sum is taxable under the provisions of the Income Tax Act or not. The next point is whether the non-resident is entitled to treaty benefit to escape source-country taxation or not. With quick reference to the relevant sections of the Income Tax Act and the relevant articles of a typical treaty, two particular expenses, viz, software payments and export commission are picked up for further analysis. A check list is also prepared for guidance of the Assessing Officers. The need for co-ordination between the Assessing Unit and the TDS Unit of International Taxation is also highlighted.

1.1. There are a few books available in the market on the topic, 'Finance for non-Finance Executives.' There is also a need for similar literature on the topic, " international taxation for non- international taxation officers" . The reason is simple, as detailed below.

1.2. The International Taxation Division, even within the Department, still today is looked at, with mixed feeling of awe and nonchalance. Across the board, it is often felt that knowledge and skill in this area of taxation, is necessary for the officers posted in the International Taxation Commissionerates only and those not posted there, can do without an iota of knowledge about International Taxation.

1.3. However, the above deep-rooted prevalent opinion is far from being true, particularly, in the context of today's globalised world, where there is continuous cross-border flow of labour, capital and technology, almost throughout the year.

1.4. An immediate ramification of the cross-border flow referred to above is that the scrutiny or audit of the cases of resident assessees in India , have more cross border issues than before, apart from the transfer pricing issues. While the Transfer Pricing Officer takes care of transfer pricing issues , other issues, like examination of deductibility of an expenditure claim of a resident taxpayer, claim of a foreign tax credit by a taxpayer, will have to be taken up by the jurisdictional Assessing Officer only. Another recent development is the requirement of enhanced cooperation at the bilateral and multilateral levels, because of several action agenda of the OECD in the context of Base Erosion and Profit Splitting (BEPS). In this scenario, officers willy nilly will require some knowledge about Exchange of Information (EOI) mechanism. Although EOI as such is not a part of international taxation, attending EOI related work requires some idea about the tax treaties and international tax practices. Several information leaks which have come to the public domain also have repercussions on the bucket list of work of a few officers at the operations level.

1.5. This article will focus on the limited issue of allowance /disallowance of expenses under section 40(a) (i) of the Income Tax Act, 1961 (hereafter, referred to as the Act, wherever considered appropriate) and how the Assessing Officers may address the issue correctly, which is discussed at length next.

1.6. Payment to Non-residents

1.6.1. The Assessing Officers dealing with the corporate as well as non-corporate business cases often come across cases where payments are made to non-residents without deduction of tax at source. While sometimes, officers do justice to such cases by looking at both the legality of the non-deduction as well as genuineness of such payments, in many cases, these aspects either are not investigated at all or position of the taxpayer accepted without proper examination. Sometimes, the position of the taxpayer is summarily dismissed with much bravado, by simply disallowing such claim u/s 40(a)(i) of the Income Tax Act, 1961, 'since tax is not deducted at source.'

1.6.2. None of the above positions as mentioned in preceding paragraph is an aid to fair examination of the issue involved. Rather, it is necessary that the Assessing Officer examine the issues from both aspects, factual details as well as legal perspective; so that any addition made in this regard is sustainable. For this, a proper understanding of section 195 and section 40(a)(i) of the Income Tax Act, 1961, is necessary. This apart, it will be of help if the officer develops the confidence to look at relevant provisions of Double Taxation Avoidance Agreement, if any argument is advanced by the taxpayer in support of the remittance/ booking of expenditure without deduction of tax.

1.6.3. In this context, it may be mentioned that section 195 of the Income Tax Act as amended by Finance Act, 2012 makes it obligatory on the part of persons making payment to non residents to deduct tax at source, if such payment constitutes income of the non-resident. To elaborate further, explanation 2 below section 195 of the Act stipulates the obligation to deduct tax **at source from any payment comprising sum chargeable under the provisions of the Income Tax Act, 1961,** whether or not the non-resident has any residence or place of business or business connection in India or has any other business, in any manner whatsoever in India. While the background for inserting this amendment cannot be discussed within the limited scope of this article, it is necessary to appreciate that the above explanation does not call for deduction of tax at source from each and every payment made to a non-resident. It is important to note that the obligation to deduct tax at source from the payment to a non-resident arises only if the payment is otherwise **'a sum chargeable to tax under Income Tax Act, 1961'.** Interested readers may refer to the ruling of the Honourbale Supreme Court in the case of GE India Technology Centre Private Limited versus CIT [2010] 327ITR 56, to appreciate full implications of the obligation under section195.

1.6.4. At this juncture, it is pertinent to consider the rules of taxation of various categories of income that are generally encountered, as per the provisions of the Act. Generally speaking, out of the various possible payments that a non-resident can receive from a resident taxpayer, i.e., interest, royalty, fees for technical services are tax deductible at source. The applicable rate of deduction is the rate specified by the Act or the Treaty, whichever is beneficial to the non-resident.

1.6.5. Payments on account of transfer of immovable property are generally tax deductible at source at the state where the property is located. However, such payments on capital account will not figure in any claim for deduction under section 40(a) (i) of the Act.

1.6.6. On the other hand, payments in the nature of business income in the hands of non-resident cannot be taxed unless the non-resident assessee has a business connection in

India. The idea of business connection appears in section 9(1) (i) of the Income Tax Act. Existence of business connection is a sine qua non for the business of the non-resident to be taxable in India. Further, even if it is possible to establish a business connection, the non-resident may take shelter of the treaty that no business income can be brought to tax in India, since in treaty terms, there is no 'Permanent Establishment' of the non-resident in India.

1.6.7. While the above assertions may appear to be aphoristic statements, they are not so really. The basis of the above statement is discussed in the following sub-paragraphs.

1.6.8. Payments in the nature of interest, royalty and fees for technical services are guided by the source rule. Sections 9(1) (v); 9 (1) (vi) and 9(1) (vii) of the Income Tax Act, 1961,respectively provide that interest, royalty and fees from technical services are taxable in India if the payment is made from India (source country). Generally, the treaties also provide the source country the right to tax such payments albeit at a concessional rate. Interest, Royalty and Fees for technical services generally are covered under Articles 11 and 12 of a typical treaty.

1.6.9. As already stated, for business income the requirement of the section 9(1)(i) of the Act, is that there should be a business connection of the non-resident in India. The treaty requirement as per Article-7 of most of the treaties is that income of the non-resident in the source country can be held as taxable if there is a Permanent Establishment (PE) of the non-resident assessee in that country. The simplest form of PE, as defined in Article 5 of a typical tax treaty, is a fixed place of business in the source country from which the business of the non-resident is carried on.

1.7. The sum and substance of the above discussion is that, it is comparatively easy to deal with cases of interest, royalty and fees from technical services, if the payment can be identified to be of the above category. Even for the purpose of identification or categorisation of income, the Assessing Officer should collect all factual details, such as, particulars of the non -resident parties involved, copies of agreements, if any, copy of invoices etc.

1.8. Even within the boundary of such easier transactions, difficulties may arise sometimes. A typical example may be given in respect of Fees for Technical Services (FTS).The payment to non-resident may be within the realm of the definition of FTS as per the Domestic Act. However, the assessee may advance an argument that the payment is not so as the 'technology has not been 'made available' to it by the non -resident assessee.

1.9. To understand what is meant by 'technology made available', as a thumb's rule , it may be stated that technology is made available when, after the service is provided by the non-resident, the recipient party can in future apply the technology on its own, without external help from the provider. If such a problem is encountered, the Assessing Officer has to carefully examine both the legal and factual aspects of the issue and the judicial precedence, before allowing such claim of the taxpayer. To further appreciate the phrase 'make available' interested readers may go through the text of the protocol to the India -USA DTAA, where the concept has been explained with illustrations.

1.10. It is similarly difficult to make a disallowance of a payment to a non-resident if the sum payable is in the nature of business income of the non-resident and the assessee claims that the non -resident does not have a permanent establishment in India . However, it is also imperative on the part of the Assessing Officer to carefully examine the transaction and find out whether it is really business income of the assessee or the income falls within any other category like royalty or FTS. In addition, the Assessing Officer should also examine whether the contention of the assessee is in line with the stated stand of the department in respect of similar transactions.

2.0. With this background, two items of expenditure claims are discussed below which may be of help to the Assessing Officers.

2.1.1. Software related payments: The Income Tax Act, section 9(1) (vi) , Explanation 2 and 4 squarely deal with the issue in as much as any payment by a resident taxpayer to a non resident as software license fee and the like is categorised as royalty. The assessees, on the other hand, claim that such payments are nothing but business income of the non- resident and therefore, not tax deductible in absence of a permanent establishment of the non-resident and further that, the payment does not fit in to the treaty definition of royalty.

2.1.2. Be that may as it, it is first to be acknowledged that the issue is a debatable one. There are a few cases in support of the stand that the payment is nature of royalty while there are contrary rulings also. While the issue is pending before the Honourble Supreme Court for adjudication, a few rulings for and against the department is juxtaposed below.

2.1.3. Therefore, before accepting any submissions based on plethora of judgments in favour of the assessee on the issue of software, the Assessing Officers must take note the views of the Honourable Karnataka High Court in the below cases.

2.1.4. The Assessing Officers should also be on guard before being swayed by the submissions made by the taxpayer quoting from the OECD commentary. The OECD commentary on Article 12 highlights that software license payments have nothing to do with transfer of copyright and it is just a sale of a copyrighted article. It is to be remembered that the concepts of copyright vis a vis copyrighted article is alien to the Income Tax Act, 1961, the Double Taxation Avoidance Agreements and the Indian Copyright Act, 1957. The above concept has only been floated by the OECD commentary which is not binding on the Indian Tax Authorities. Moreover, India has officially expressed its reservation on many a position on the OECD commentary on royalty including the view on royalty (2017 Update to the OECD Model Tax Convention,pp 639).

SI No	Rulings holding such payment as royalty	Rulings holding such payment as not royalty
1	CIT vs Samsung Electronic Company Ltd & Others [2012] 345 ITR 494(Kar)	Commissioner of Income Tax Vs. Dynamic Vertical Software India (P) ltd. [2011]332 ITR 222 (Del)
2	Synopsis International Old Ltd. [2012](212 Taxman 454) (Kar)	Director of Income tax vs. Infrasoft Ltd. [2014] 220 Taxman 273 (Del)

2.2.1. Export Commission: This is an area where the Assessing Officer has to tread very carefully.

2.2.2. The Central Board of Direct Taxes, (CBDT) had issued a circular (Circular No 786 dated, the 7th February 2000) regarding taxability of export commission and liability of TDS thereon under section 195 of the Act. In that circular, it was generally held that no tax is required to be deducted from such commission. However, subsequently, the Board has withdrawn the above circular by issuing another Circular, viz, Circular no 7 dated, the 20th July 2009. The reason cited for the withdrawal of the earlier circular was its misuse by some taxpayers.

2.2.3. Now, the question is what is the implication of the withdrawal of the earlier circular of 2000. Does it imply that the Board is of the view that such commission is always tax deductible? The answer is an emphatic 'no'. One has to remember that in the first place, for tax to be deductible, the sum must be an income of the non-resident accruing/arising in India or deemed to have accruing and arising in India, In many cases , it will be seen that such commission is merely a business income of the export agent and he does not have any Permanent Establishment in India for that business income to be taxable.

2.2.4. In some of the cases however, based on facts and circumstances, the Assessing Officer may find that the commission agent has rendered technical, managerial or consultancy services and the commission is actually in the nature of fees for technical services. However, for arriving at such a conclusion, the Assessing Officer has to gather sufficient evidences such as , the copy of agreement between the exporter and the agent, documentation regarding how the services were rendered, copy of invoices and nature of services mentioned therein, e-mail correspondences etc. If the export agent is a tax resident of a DTAA Country, again it has to be tested, whether the definition of FTS as per the Act also fits in, to the definition of FTS as per the DTAA. The decision of the Delhi High Court in the case of Havel's India Ltd reported in (2013) 352ITR 376 may be of help to the officers.

2.2.5. The above discussion is made with the presumption that the commission incurred is a genuine one. However, if the finding of fact leads to an inference that the commission is bogus one, the issue of tax deduction under section 40(a)(i) of the Act will take a back seat and the officer will investigate the case from the angle of section 37(1) of the Act.

3.0. Further complications may arise when the taxpayer, in support of non-deduction of tax at source under section 195, may cite existence of 'Most Favoured Nation (MFN) clause of the treaty and pleads for its automatic application in the case of the assessee. It may also site a few case laws in its support Discussion on such claims based on the MFN Clause is outside the scope of this otherwise basic article. Still in a nutshell, it may be stated that the MFN Clause is present in some of the Double Taxation Avoidance

Agreements of India. The MFN Clause tries to ensure that if one of the treaty partners, enters into an agreement with some other state where, in that agreement, under similar circumstances, the other state enjoys some benefits not available in the treaty between the first two states, the other treaty partner of the first treaty, will automatically be eligible to the similar treatment . In this context, it may be mentioned that the revenue favourable ruling of the AAR denying automatic application of the MFN Clause has been reversed by the Honourable Delhi High Court. In other words, decision in the case of Steria (India) Limited reported in 364 ITR 381 (AAR) has been overruled in the Writ case filed against the ruling. The judgement of the Delhi High Court [Steria India Limited versus DCIT reported in [2016] 386 ITR 390 (Delhi) is in favour of the assessee. Many tribunals are following the Delhi High Court Ruling. However, if any Assessing Officer comes across any such claim, alarm bells should ring and he should remember that the issue is pending before the Honourable Apex Court.

4.0. Before winding up this article, it may be reiterated that even after thorough legal and factual analysis of the case, the Assessing Officer may find that the assessee is really entitled to a benefit under the treaty, either on the point of taxability or on the point of rates. For establishing entitlement of treaty benefit, the payer assessee must demonstrate that it is in possession of the tax residency certificate of the non-resident. However, before conferring any benefit the Assessing Officer should be prudent enough to find out how the issue had been dealt with in the earlier years and at what forum the same is pending.

5.0. Further, the Assessing Officer should also check, whether tax can be correctly deducted, where the same has been treated as taxable by the assessee itself. In this connection, it will of help to the Assessing Officer if he prepares a flow -chart based on the following points or tests, as given below :

I. Whether the amount comprise sum chargeable to tax;

ii. If answer is yes, is the non-resident from a state which is a treaty partner?

iii. If yes, whether non-resident has tax residency certificate?

iv. If the answer is yes, whether the non-resident has obtained PAN?

v. If the answer is yes, the tax rate as per the treaty or as per the Act, whichever is less, is the applicable rate.

vi. If the answer to the question no (iv) above is no, whether the sum is in the nature of interest, royalty or FTS?

vii. If the answer is yes, whether the payer is in possession of details as specified Rule 37BC of the Income Tax Rules, 1962?

viii. If the answer is yes, the tax rate as per the treaty or as per the Act, whichever is less, is the applicable rate.

ix. If the answer is no, the maximum marginal rate as per the provisions of section 206AA of the Income Tax Act is the applicable rate.

x. If the answer to the question no (ii) is no, the provisions of the Act will follow and the tax rate will depend on whether the payee has PAN or not.

6.0. To conclude, the Assessing Officers are advised to share any instance of non -deduction of tax where the same was deductible to the notice of the officer in charge of non-resident TDS in the International Taxation Commissionerate. On the basis of such inputs, the Assessing Officer (TDS), International Taxation may initiate proceedings under section 201of the Act. It is expected that in near future, there will be system- driven protocols to share such data between the Assessing Officer and the TDS officer so that appropriate and timely action from all possible angles can be taken by the department timely.

References:

1. Web reference: 2017 Update to the OECD Model Tax Convention [www.oecd.org/ctp/treches/2017-update-model-tax–convention.pdf accessed on 28.04.2019]

2 Taxpayer Information Series Booklet Series 44 :Royalty and Fees for Technical Services, Published by Directorate of Income Tax [PR,PP&OL] Authors : Shri Sanjay Kumar ,Former DIT, International Taxation Kolkata and Shri Nilay Baran Som , Former DDIT(Trg), D.T.R.T.I, Kolkata .

[Sections of the Income Tax Act:9 (1)(i); 9 (1)(v); 9 (1)(vi); 9 (1)(vii); Section 40(a)(i), Section 195, Section 201 and Section 206AA of the Income Tax Act,1961]

New Penalty Provisions Under Section 270A

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Executive Summary

Penalty provisions have been substantially amended from A.Y.2017-18 onwards. This article discusses the amended provisions. In the light of various judicial pronouncements, it shows the correct way of initiating penalties under sections 271(1)(c), 270A and 271AAC of Income Tax Act

Penalty u/s 271(1)(c) is leviable only upto A.Y. 2016-17

Penalty u/s 270A is required to be levied from A.Y. 2017-18 onwards

Penalty u/s 270A is leviable for:

1	Under-reporting of income	Penalty @ 50% of amount of tax payable on under-reported income
2	Under-reported income is in consequence of any misreporting thereof	Penalty @ 200% of amount of tax payable on under-reported income

Under Reporting of income is defined in Section 270A(2) of Income Tax Act as follows:

"(2) A person shall be considered to have under-reported his income, if

(a) the income assessed is greater than the income determined in the return processed under clause (a) of sub-section (1) of section 143;

(b) the income assessed is greater than the maximum amount not chargeable to tax, where no return of income has been furnished;

(c) the income reassessed is greater than the income assessed or reassessed immediately before such reassessment;

(d) the amount of deemed total income assessed or reassessed as per the provisions of section 115JB or section 115JC, as the case may be, is greater than the deemed total income determined in the return processed under clause (a) of sub-section (1) of section 143;

(e) the amount of deemed total income assessed as per the provisions of section 115JB or section 115JC is greater than the maximum amount not chargeable to tax, where no return of income has been filed;

(f) the amount of deemed total income reassessed as per the provisions of section 115JB or section 115JC, as the case may be, is greater than the deemed total income assessed or reassessed immediately before such reassessment;

(g) the income assessed or reassessed has the effect of reducing the loss or converting such loss into income."

Exceptions to under reporting of income are laid down in Section 270A(6) of Income Tax Act as follows:

"(6) The under-reported income, for the purposes of this section, shall not include the following, namely:

(a) the amount of income in respect of which the assessee offers an explanation and the Assessing Officer or the

Commissioner (Appeals) or the Commissioner or the Principal Commissioner, as the case may be, is satisfied that the explanation is bona fide and the assessee has disclosed all the material facts to substantiate the explanation offered;

(b) the amount of under-reported income determined on the basis of an estimate, if the accounts are correct and complete to the satisfaction of the Assessing Officer or the Commissioner (Appeals) or the Commissioner or the Principal Commissioner, as the case may be, but the method employed is such that the income cannot properly be deduced therefrom;

(c) the amount of under-reported income determined on the basis of an estimate, if the assessee has, on his own, estimated a lower amount of addition or disallowance on the same issue, has included such amount in the computation of his income and has disclosed all the facts material to the addition or disallowance;

(d) the amount of under-reported income represented by any addition made in conformity with the arm's length price determined by the Transfer Pricing Officer, where the assessee had maintained information and documents as prescribed under section 92D, declared the international transaction under Chapter X, and, disclosed all the material facts relating to the transaction; and

(e) the amount of undisclosed income referred to in section 271AAB."

Section 270A(8) of Income Tax Act is reproduced below:

"(8) Notwithstanding anything contained in sub-section (6) or sub-section **(7), where under-reported income is in consequence of any misreporting thereof by any person,** the penalty referred to in sub-section (1) shall be equal to two hundred per cent of the amount of tax payable on under-reported income."

A perusal of above clause shows that penalty is 200% where under-reported income is in consequence of any misreporting thereof by any person.

Misreporting of income is defined in Section 270A(9) as follows:

"(9) The cases of misreporting of income referred to in sub-section (8) shall be the following, namely:

(a) misrepresentation or suppression of facts;

(b) failure to record investments in the books of account;

© claim of expenditure not substantiated by any evidence;

(d) recording of any false entry in the books of account;

(e) failure to record any receipt in books of account having a bearing on total income; and

(f) failure to report any international transaction or any transaction deemed to be an international transaction or any specified domestic transaction, to which the provisions of Chapter X apply."

An important question for the Assessing Officers is how to correctly initiate penalty proceedings u/s 270A.

Hon'ble Karnataka High Court in the case of CIT Vs Manjunatha Cotton And Ginning Factory (2013)(359 ITR 565) held as follows:

"63. In the light of what is stated above, what emerges is as under:

(a) …..

(b) …..

(p) Notice under Section 274 of the Act should specifically state the grounds mentioned in Section 271(l)(c), i.e., whether it is for concealment of income or for furnishing of incorrect particulars of income

(q) Sending printed form where all the ground mentioned in Section 271 are mentioned would not satisfy requirement of law.

(r) The assessee should know the grounds which he has to meet specifically. Otherwise, principles of natural justice is offended. On the basis of such proceedings, no penalty could be imposed to the assessee.

(s) Taking up of penalty proceedings on one limb and finding the assessee guilty of another limb is bad in law.

(t) The penalty proceedings are distinct from the assessment proceedings. The proceedings for imposition of penalty though emanate from proceedings of assessment, it is independent and separate aspect of the proceedings.

(u) The findings recorded in the assessment proceedings insofar as "concealment of income" and "furnishing of incorrect particulars" would not operate as res judicata in the penalty proceedings. It is open to the assessee to contest the said proceedings on merits. However, the validity of the assessment or reassessment in pursuance of which penalty is levied, cannot be the subject matter of penalty proceedings. The assessment or reassessment cannot be declared as invalid in the penalty proceedings."

Relying upon the above decision, Hon'ble Karnataka High Court in the case of CIT Vs SSA'S Emerald Meadows [2016] 73 taxmann.com 241 (Karnataka) dismissed appeal of the Department in which substantial question of law was as follows:

"(1) Whether, omission if assessing officer to explicitly mention that penalty proceedings are being initiated for furnishing of inaccurate particulars or that for concealment of income makes the penalty order liable for cancellation even when it has been proved beyond reasonable doubt that the assessee had concealed income in the facts and circumstances of the case?”

Hon'ble Supreme Court dismissed SLP of the department in the above case of CIT Vs SSA'S Emerald Meadows [2016] 73 taxmann.com 248 (SC)/[2016] 242 Taxman 180 (SC).

In view of the above decisions, the assessing officers must be very careful so as to initiate penalty proceedings u/s 270A correctly. Two different rates of penalty i.e. 50% & 200% are required to be levied u/s 270A. Hence, after each addition, it must be clearly specified whether penalty is being initiated for:

(i) under-reporting of income or

(ii) under-reporting income which is in consequence of misreporting thereof.

Taking into consideration above case laws and provisions of section 270A, penalty u/s 270A may be initiated as follows:

1. Penalty proceedings u/s 270A of Income Tax Act are hereby initiated for under-reporting of income

2. Penalty proceedings u/s 270A of Income Tax Act are hereby initiated for under-reporting of income which is in consequence of misreporting thereof

Section 270A has clearly defined under-reporting of income in Section 270A(2) and misreporting of income in Section 270A(9). In comparison, 'furnishing inaccurate particulars of income' and 'concealed particulars of income' were not defined in section 271(1)(c). Hence, as far as possible, while recording satisfaction for initiation of penalty, the assessing officer should try to identify in which clause or sub-clause of Section 270A(2) or Section 270A(9) that particular addition falls. Similarly, in the penalty order also the relevant clause or sub-clause of Section 270A(2) or Section 270A(9) should be specified. Moreover, if the assessing officer has specified the clause or sub-clause in assessment order, it is essential that in the penalty order also, same clause or sub-clause has to be relied upon.

Courts have consistently held that at the time of initiation of penalty, charge should be clearly specified. Understanding of this basic concept by the assessing officers will go a long way in correct initiating of penalty and passing of sustainable penalty orders. Each and every word in the sentence for initiation of penalty is crucial. Hence, the assessing officers must stop, think and ponder before recording satisfaction for initiation of penalty.

As reproduced above, Hon'ble Karnataka High Court in the case of CIT Vs Manjunatha Cotton & Ginning Factory held that notice under Section 274 of the Act should specifically state the grounds mentioned in Section 271(l)(c), i.e., whether it is for concealment of income or for furnishing of incorrect particulars of income. Similarly, in the printed notice u/s 274 r.w.s 270A, it is essential to tick the applicable part in printed penalty notice and strike off inapplicable part in printed penalty notice. Thus, if penalty is initiated only for under reporting of income, the printed notice must not contain mention of misreporting of income. In such a case, misreporting of income is required to be essentially struck off.

Section 270AA provides for immunity from imposition of penalty u/s 270A. The section is reproduced below:

“Immunity from imposition of penalty, etc.

270AA. (1) An assessee may make an application to the Assessing Officer to grant immunity from imposition of penalty under section 270A and initiation of proceedings under section 276C or section 276CC, if he fulfils the following conditions, namely:

(a) the tax and interest payable as per the order of assessment or reassessment under sub-section (3) of section 143 or section 147, as the case may be, has been paid within the period specified in such notice of demand; and

(b) no appeal against the order referred to in clause (a) has been filed.

(2) An application referred to in sub-section (1) shall be made within one month from the end of the month in which the order referred to in clause (a) of sub-section (1) has been received and shall be made in such form and verified in such manner as may be prescribed.

(3) The Assessing Officer shall, subject to fulfilment of the conditions specified in sub-section (1) and after the expiry of the period of filing the appeal as specified in clause (b) of

sub-section (2) of section 249, grant immunity from imposition of penalty under section 270A and initiation of proceedings under section 276C or section 276CC, where the proceedings for penalty under section 270A has not been initiated under the circumstances referred to in sub-section (9) of the said section 270A.

(4) The Assessing Officer shall, within a period of one month from the end of the month in which the application under sub-section (1) is received, pass an order accepting or rejecting such application"

In view of the above provision, penalty u/s 270A is required to be waived by the assessing officer if the assessee pays entire tax and interest within the time specified in notice of demand and does not file appeal against the order. However, it may be noted that in view of provisions of section 270AA(3), immunity is not provided for cases of misreporting of income refer to in section 270A(9).

Penalty proceedings u/s 271(1)(c) are required to be initiated in assessments upto A.Y. 2016-17. In view of various case laws discussed above, as far as possible, penalty u/s 271(1)(c) for a particular addition should be initiated either for furnishing inaccurate particulars of income or concealment of income, not both limbs. Penalty u/s 271(1)(c) may be initiated as follows:

(i) Penalty proceedings u/s 271(1)(c) of Income Tax Act are initiated for furnishing inaccurate particulars of income

(ii) Penalty proceedings u/s 271(1)(c) of Income Tax Act are initiated for concealing particulars of income

Penalty proceedings u/s 271(1)(c) initiated in the following manner may not stand the test of appeal:

(i) Penalty proceedings u/s 271(1)(c) are initiated for furnishing inaccurate particulars of income and concealing particulars of income

(ii) Penalty proceedings u/s 271(1)(c) are initiated for furnishing inaccurate particulars of income or concealing particulars of income

(iii) Penalty proceedings u/s 271(1)(c) are initiated for furnishing inaccurate particulars of income and/or concealing particulars of income

Thereafter, inapplicable part in printed penalty notice is required to be struck off

Thus, correct initiation of penalty is the foundation upon which entire penalty order stands. Correct initiation of penalty after due application of mind will go a long way in penalty orders being sustained.

Penalty in Cash Deposit Cases

Assessing Officers are making addition u/s 68 or section 69A of Income Tax Act on account of unexplained cash deposits.

In many cases, Assessing Officers have initiated penalty u/s 271(1)(c) or 270A.

In this regard, attention is drawn to provisions of section 271AAC of Income Tax Act applicable from A.Y. 2017-18 onwards. Penalty is required to be levied under this section where addition has been made u/s section 68, section 69, section 69A, section 69B, section 69C or section 69D and tax is payable u/s 115BBE of IT Act.

Section 271AAC is reproduced below:

Penalty in respect of certain income.

271AAC. (1) The Assessing Officer may, notwithstanding anything contained in this Act other than the provisions of section 271AAB, direct that, in a case where the income determined includes any income referred to in section 68, section 69, section 69A, section 69B, section 69C or section 69D for any previous year, the assessee shall pay by way of penalty, in addition to tax payable under section 115BBE, a sum computed at the rate of ten per cent of the tax payable under clause (i) of sub-section (1) of section 115BBE:

Provided that no penalty shall be levied in respect of income referred to in section 68, section 69, section 69A, section 69B, section 69C or section 69D to the extent such income has been included by the assessee in the return of income furnished under section 139 and the tax in accordance with the provisions of clause (i) of sub-section (1) of section 115BBE has been paid on or before the end of the relevant previous year.

(2) No penalty under the provisions of section 270A shall be imposed upon the assessee in respect of the income referred to in sub-section (1).

(3) The provisions of sections 274 and 275 shall, as far as may be, apply in relation to the penalty referred to in this section.

From A.Y. 2017-18 onwards, Assessing Officers must initiate penalty only u/s 271AAC where tax is payable u/s 115BBE of IT Act.

Rt. Hon'ble James Wilson-Architect Of Modern Indian Budgeting System

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Chandra Prakash Bhatia, IRS, has collected historical facts and compiled a book titled 'The First Budget of India and the Birth of Income Tax' in 2015, published by Radiance, Kolkata. He has recently published a brief collection of citations of Income Tax judgments of Hon'ble Gujarat High Court in favour of Revenue delivered during past 25 years, titled as “The Tributum”

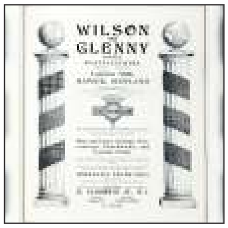
Executive Summary

The Royal proclamation on November 1, 1858 in grand Darbar held at Allahabad was a major event in modern Indian financial history. Lord Canning announced that the Queen had assumed the governance of India. This proclamation declared the future policy of the British Rule in India. This action also opened doors for the modern system of annual budgeting, revenue forecast and revenue accounting by the Union government as well as sharing it with the Provincial governments. Experience of the East India Company in governance made it clear that the government cannot depend upon the land revenue alone and other alternatives must be explored. At the same time modern banking, shipping and commercial agriculture also received public and private patronage. Introduction of railways and postage system gave a boost to the business. Many financial reforms like introduction of English system of judiciary and paper currency were introduced in India much ahead of the other Asian countries. The architect of such reforms was Right Hon'ble James Wilson, a financier, who was chosen due to his academic stature and apolitical approach to resolve the unprecedented crisis being faced by the new Indian Government, headed by Lord Canning. One of such measures was the introduction of the first direct self taxation in India, where the taxpayer had to assess his own income and to file his return of income and to pay the corresponding taxes on his own. It was by no means an easy task in a country where taxation was presumed undesirable and literacy was very low. However, such an experiment paved way for the diminishing the general resistance and for taking steps in the public welfare in future. We all must read his life story and the story of introduction of the Income tax in India of that time.

The Right Hon'ble James Wilson, the architect of modern system of budget and revenue accounting in India, was born on the 3rd June 1805 in a small border town of Scotland called Hawick. His father Mr. William was running a textile mill. He joined a hat factory, when he was 16 but continued his studies. This business proved successful and he soon set up his business in London along with his brother. He was an admirer of Adam Smith and believed in his theory of 'laissez-faire'. He was married to Ms. Elizabeth Preston of New Castle-upon-Tyne.

He dreamt of setting up a news paper specializing in financial matters covering all aspects of trade and commerce, including business/financial statistics. 'The Economist' magazine was started by him on the 2nd Sep 1843. In early days of the magazine, he used to write many columns himself. Later-on, it was handled by Mr. Walter

Bagehot, husband of his eldest daughter Eliza. It is not under family ownership at present. It's columns are circulated in many news papers across the world



Mr. James Wilson had six daughters. A daughter, Sophie, was married to Mr. William Stirling Halsey, who later joined the Indian Civil Service. He also served as Private Secretary to Mr. Wilson. One of his daughters, Ms. Emile Isabel Wilson was later known as **Mrs. Russell** Barrington. Mr. Wilson had other daughters named Julia, Joe and Matilda[1].

He was elected to British Parliament in 1847 from Westbury and was nominated for the post of Joint Secretary to the Board of Control for India, looking after Indian financial affairs from London. He could foresee the need for a new bank for International Business for the growing business needs. He set up the 'Chartered Bank of India, Australia and China' on the 9th October 1852. This bank had a branch in Calcutta as well. This venture grew up and later merged with 'The Standard Bank of British South Africa'. Later-on it was named the Standard Chartered Bank, which has a global presence today.

In early 1859, Lord Stanley, the first secretary of State for India, recommended to appoint a financier from England to fill the vacancy caused by appointment of Sir Barnes Peacock, the Legal Member as the Chief Justice of the Supreme Court at Calcutta. Lord Palmerston, the British Prime Minister in 1859 had put a great faith in him and offered him the post of Finance Member to the Viceroy of India Council, akin to the post of Chancellor of Indian Exchequer. After the great mutiny, finances in India were in total chaos. The treasury was nearly empty and cost of governance was very high. It was perceived by some to be situation more dangerous than the mutiny itself.

Mr. Wilson took up the challenge and set sails for India the 20th October 1859 for India. He arrived on 28th November 1858. A letter dated 22nd November 1858 written by Lord Canning to him suggests that he may fix his residence in any of the government accommodations at the Park, Barrackpore, Calcutta[2]. However, the official papers disclose that at the time of his death, he was staying at 9, Middleton Street, Calcutta[3] in the house of his physician, Dr. Macrae. This locality has been renumbered by KMC. At 9 & 9/1, a building has come up called the Middleton Mansion. Mr. James Wilson took over his seat as the Finance Member of the Governor General in Council on the 3rd December 1859. He introduced a Bill on the 18the February 1860 in the Indian Legislature, aimed at amending the tariff laws. Mr. James Wilson's financial statements of 1860 marked the commencement of a new chapter in the financial history of the country. He introduced the system of budget, paper currency and was best known for introduction of Income Tax in India.

At the time of presenting his budget, Mr. Wilson delivered a forceful speech in the Indian Legislature[4]. He observed that the suppression of the mutiny had entailed a great expenditure and had resulted in large public debt. He surveyed the prevailing economic condition of India and outlined the steps he desired to take to put it in order. He proposed two new taxes- one was called the 'License tax' – to be imposed on trade and commerce and the other was imposition of 'Income tax, which was to be imposed on people in general irrespective of their nature of work. In his opinion, the two supplemented each other and targeted different classes of people. Income tax was supposed to be levied upon annual income exceeding Rs. 200 annually. He defended such a low basic limit observing that it will ensure greater justice[5]. He called upon people to contribute for the cost of governance. The tax proposed was a progressive one, the rich supposed to pay more.

He also introduced better system of accounting for the tax collection. A separate account was to be kept for one percent duty. The tax so collected was to be utilized by the Provincial Govt. for construction of roads, canals and other public utilities. Proper documentation ensured that such statistics was to be utilized by successive governments for determining the proper course of actions and to study whether such steps were yielding results or not. Provincial governments were authorized to notify and exempt the properties utilized for religious and charitable purposes. He had to face opposition from many quarters, particularly

1.Life of Walter Bagehot- Mrs. Russell Barrington-1914
2.Life of Walter Bagehot- Mrs. Russell Barrington-1914
3.The Calcutta Gazette-1860
4.Proceedings of the Legislative Council of India-1860.

from the European community. As traders, they were likely to be affected. So far they were enjoying special privileges. However, he termed his measures as just, equitable and based upon intelligent principles.

At that time several members of the Council expressed hope that imposition of Income tax will not be a permanent measure and it would be taken resort to only in emergency. They believed that it will be given up as soon as the situation improved.

The Income Tax Bill was passed on the 24th July 1860. It was known as Act XXXII of 1860. Mr. Wilson expressed his satisfaction that such a large Bill was passed without much change in its basic form. It received the assent of the Governor General in Council on the same day. It was to be imposed for five years.

The Bill was again partly amended due to some deficiencies pointed out. It came into force in the month of September 1860[6]. This session was sponsored by Sir Bartle Frere, in the absence of Mr. James Wilson. It was numbered as the Act XXXIX of 1860. However, some taxes were already collected in some parts of the country, particularly in Oudh Province owing to the financial crunch faced by the Government. The government had to issue an order to legalize the collections already made.

The yield of tax was rather small in the very first year. Mr. Charles Canning was the Viceroy during that period. Other important works during this period was, setting up of a university each in Calcutta, Bombay and Madras, passing of the Indian Penal Code 1860, Indian Councils Act 1861 and Indian Police Act 1861, creation of Indian Police Service, reorganization of the Customs Department and setting up of Archeological Survey of India.

After its expiry in 1865, Income Tax was not renewed immediately. The period from 1860 to 1886 was a period of experiment in which 23 Acts were passed for charging the direct tax. The income-tax of 1860, by any standard, be it implementation, operation or collection, cannot be termed successful. The procedure experiment of levy and collection of tax was continued under different nomenclatures like. 'License tax' (introduced in 1867 and abandoned next year), 'Certificate tax' (introduced in 1868 and abandoned next year), 'General Income Tax' (introduced in 1869 and abolished in the year 1873) and a License tax on trades and professions (introduced in 1878). However, such sustained efforts by the Government softened the resistance of the public at large and sent a message that direct taxes could not be wished away. The Government machinery and the tax payers found a balance in consequential statute, known as the Income Tax 1886, which still exists despite several changes. Learning from the past mistakes, income from agriculture was exempt from Income Tax in India under this Act. From 1886 onwards, Income Tax has been an important part of the annual Budget presented before the Indian Parliament.

He died on 11th August 1860 at the young age of 55 years after suffering from dysentery. A Gazette notification shows that he was buried in Calcutta on the 12th August 1860. Flags were unfurled at half mast and guns were ordered to be fired for 15 minutes from the ramparts of Fort William at the time of his burial.

(Gazette- Courtesy- 'The National Library', Kolkata.)

Rt. Hon'ble James Wilson could not bear the hot and humid summer of Calcutta. Frequent travel and hard work took a heavy toll on his health. He died on the 3rd August 1860 and was buried in Calcutta. His tomb at Cemetery at Lower Circular Road, Kolkata has been discovered after much effort by the author of this article. It has been restored by the author with the permission of the Christian Burial Board. The photographs (after restoration) of his tomb and the epitaph inscribed on it are shown above.

The 24th day of July has been declared as the Income Tax day by the Government. We all are the proud inheritors of this legacy, now almost 160 years old.

5.The History of Taxation in India- P Banerjea-1930

6.The speech of James Wilson along with the correspondence for preparation of the budget in 1860 has been published in a book titled 'India's First Budget and the Birth of Income Tax' written by me and published by Radiance, Kolkata in 2015.

Post-Liberalisation Direct Tax Reforms in India

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Executive Summary

This thesis was written in 2009 and subsequently, Government has brought in many changes in Tax administration. Brief of the paper, duly updated, has been reproduced here The thesis titled "Post-liberalization Direct Tax Reforms in India" was submitted in 2009 by the author for the award of M. Phil. Degree from Defence and Strategic Studies under the University of Madras. Statistics appearing in the present article have been updated for the benefit of the readers. Full text (84 pages) of this paper, under the same heading is available on the departmental website at the following link-https://www.irsofficersonline.gov.in/AchieverPavilionProfessionalDetails.aspx?AID=38

In 1991, in reaction to a severe macro economic crisis involving high fiscal deficit and depleted foreign exchange reserve, India approached the World Bank for a 'structural adjustment' loan. The structural adjustment programmes supported by the World Bank institutions, while disbursing loans, began by encouraging reform in trade policy. The emphasis gradually shifted to fiscal issues, in response to growing recognition that inappropriate and unsustainable expenditure and revenue policies are, in many instances, the major cause of disappointing economic performance. Polak's Model[1], followed by IMF, asserted that the external gap (current account balance) is a reflection of the internal gap between revenue and expenditure. Structural adjustment programmes, therefore, became more concerned with mobilising revenue through improved taxation and better pricing of public services. Tax reform became an essential component of strategy of structural adjustment in developing countries, as it was felt that **"existing tax systems of many developing countries are distortionary and contribute to a host of economic problems, including production inefficiency, capital flight, and fiscal and balance of payments disequilibria".**[2]

The trend of tax reforms in the developed world in the eighties began to be reflected in Bank-Fund advice on tax reforms, placing emphasis on uniform taxation through an **"explicit recognition that gains in economic efficiency, horizontal equity, and administrative simplicity that stem from uniform taxation outweigh any vertical equity losses."**[3]

Let us first look into the background situations existing in the decade, 1990-2000. **Indian Economic Crisis**: Faced with rising inflation (12.1%), huge fiscal deficit and balance of payment crisis in mid-1991, India's new government introduced a fairly comprehensive policy reform package-with currency devaluation as its centre piece. A sudden drying up of inward remittances, higher oil import bill due

1 - Named after Jacques J Polak, an IMF economist, it is a macroeconomic monetary model developed in the IMF. It is the basis of conditionalities applied by IMF while giving credits.

2 - Shirazi and Shah, Tax Policy in Developing Countries, World Bank, Washington,1991,page xv.

3 - Ibid, page xvi.

to the Gulf-war, collapse of the Soviet economy (then India's largest trading partner) and rapidly advancing Chinese economy with a greater use of market co-ordination formed the international background for initiating these policy changes. On the domestic front, the political instability (India had three Prime Ministers from three different political parties in the preceding 18-month period) had accentuated the economic troubles as critical decisions got postponed and fiscal discipline loosened. In dire need for funds, the Finance Minister, in letter dated 11.11.1991, highlighted some of the reform measures taken and wrote to the President, World Bank that **"the effectiveness of these measures in bringing about the desired structural adjustments in the economy while maintaining the momentum of growth depends critically on the availability of adequate external finance. Accordingly, we are requesting a Structural Adjustment Loan / Credit from the World Bank".**[4] Key ingredients of economic policy followed by India in pre-1991 period were:

- Central planning, to direct investments into essential/ priority channels
- Dominant public sector, to undertake major infrastructural investments
- Private sector's role in agriculture, consumer goods, and capital goods
- Licensing system to avoid monopolies
- direct investments in specified channels and Import substitution
- High tariff wall to protect nascent industry
- Price and quantity controls- rationing, foreign exchange controls, quotas
- Subsidy, to keep prices affordable for poor and incentives to producers.

Some of these key ingredients were shelved or revised when economy was opened-up and liberalized, as part of structural adjustment programme, in the period 1991 onwards. It included loosening of quota-permit raj, shrinking of public sector, lowering tariff barriers, policy of emphasis on export generation rather than import substitution, current account convertibility and 'managed' float of rupee. Tax reforms were part of these changes.

The Indian reforms tried to consciously fashion the new policy as close to the **'Washington consensus'**[5] as permitted by domestic conditions and advocated by the International Monetary Fund and the World Bank, shown below:-

- Balanced budget, with deficit of a few percent of GDP,
- Spending controls, and
- Broad based taxation with low marginal rates ;
- Sound macro-economic policy with some limited social safety nets;
- Trade and investment liberalisation ;
- Privatisation of state-owned enterprises ; and
- De-regulation of markets, including the labour market.

More efficient revenue mobilisation can fund needed public goods and services and help cut fiscal imbalances as well as promote investment and growth by reducing the adverse allocational effects of the tax system.

WORLD BANK'S ADVICE ON DIRECT TAXES

- Revenue should be generated from company income taxes with a single statutory rate comparable to the maximum personal income tax rate, and tax preferences linked to investments and profits should be reduced.
- Efficiency should be addressed in two ways. To avoid inter-sectoral distortions, deductions, allowances, and credits should be distributed more evenly across sectors and assets; to avoid distortions across periods, depreciation, inflation-adjusted interest deductions, and related indexing provisions should be improved.
- Tax preferences should be limited in coverage and duration to cases in which market imperfections cannot be addressed more directly.
- Revenue should be generated by personal income taxes with wide bases and maximum marginal rates of between 30 and 50 percent.
- Equity would be improved by setting household income exemption levels high enough (for example, at the minimum wage or up to two times per capita GDP for low income countries with limited administrative capacity) to exclude very small taxpayers and by introducing a structure of gradually increasing marginal

4 - From the text of Finance Minister's letter to the President, World Bank, reproduced in Uma Kapila, ed., Recent Developments in Indian Economy With Special Reference to Structural Reforms, Academic Foundation, Delhi, 1992, page 338.

5 - The term was coined by Williamson, 1989 to denote the package of policies advocated by the IMF and World Bank.

tax rates.

- The tax would improve both equity and administration by extending the use of withholding taxes on wage and interest incomes and by introducing fair, presumptive taxation of hard-to-tax groups.
- At 10 to 15 percent border withholding tax on profits, dividends, and other repatriations should be introduced where it is not already in use.

The Bank-Fund advice on income tax reforms reflected the world trend. The tax rates have reduced globally. The peak Personal Income Tax rate in OECD countries reduced from average of 54.9% in 1986 to 37.6% in 2002[6]. Studies on tax reforms in Chile and Uruguay (Harberger, 1989), Colombia (McLure, 1989), Indonesia (Gillis, 1989) and Jamaica (Bahl, 1989), amongst others see a trend of 'base broadening and rate flattening". Abed (1998:21) notes lowering of top marginal income/corporate tax rates in reforms carried out in the 1990s in Bangladesh, Benin, Bolivia, Kenya and Uganda.

TAXATION OF INCOME: SOME CONCEPTS

In The Wealth of the Nations (1776), Adam Smith proposed that a good tax system:

- Should reflect a person's ability to pay
- Should be certain
- Should be convenient
- Should be administratively efficient and not cause economic distortion.

These principles still hold good. Taxation fulfils many of these characteristics. High rate of taxes generally discourage saving and investment. "The discouragement of investment, however, is less severe than may appear because the tax often reduces the net loss suffered on an unsuccessful investment as well as the net profit realised on a successful one.[7] **Overall, income taxes have much less distortionary effect than most excise, import and sales taxes.**

Adequacy and yield-

Taxes on income yields adequate and substantial revenue in many developed countries. In India, it is an important source of revenue.

Ability to Pay- In majority of countries, individual income taxes are generally levied under 'global' system. It is also followed in India.the poor are kept out by a threshold limit. Most Economists view income tax as best form of taxation because it reflects the taxpayers' ability to pay, as income is universally regarded as the best single index of economic power. Horizontal equity implies that those placed in similar economic circumstances should be treated the same. Vertical equity concept relates to use of progressively higher rates of taxes (tax the richer heavily than the poor) to attain goal of reduction of income equality. However, companies are taxed at uniform rate, as equity is concerned with people and not with organizations.

Economic Neutrality and Resource Allocation Decisions- The economic neutrality or efficiency is a measure of effect of a tax on relative prices and economic decisions made by consumers and producers. An economically neutral or efficient tax should not upset the pattern of production, trade, consumption, savings and investments. Individual income taxes have relatively little effect on economic choices.

Visibility: Income tax is highly visible. Its visibility can be reduced by provision of tax deduction at source (TDS) or pay-as-you-earn (PAYE). Most of the tax is actually collected and therefore, its visibility is effectively reduced.

Collection cost: By keeping threshold higher the cost of collection can be kept low. In India, the cost of collection of IT is presently only 0.54% of total tax collected.

Political acceptability: Income tax, in some form or the other, has been in existence for more than 150 years and has gained political acceptability. However, there is no tax on agricultural income in India and attempts to bring it have faced severe resistance indicating its poor political acceptability.

Administrative Capacity: A complex but well settled income tax law, with judicially interpreted phraseology, is in place in India. A system of TDS and advance tax payment is in place. However, weaknesses in administrative capacity are reflected by:

- Computerisation is not fully implemented
- Narrow tax base: In F.Y. 2018-19, only 6.85 crore (all entities) out of a population of nearly 130 crores filed

6 - Howell H Zee, Personal Income Tax Reform: Concepts, Issues, and Comparative Country Development, IMF Working Paper WP/05/87, International Monetary Fund, April, 2005, page 48.

7 - Evsey D. Domar and Richard A. Musgrave, Proportional Income Taxation and Risk Taking, Quaterly Journal of Economics, vol. 58 (1944), pp. 388-422, quoted in Goode, R. (1984:116).

income tax return

- Slow appellate procedure
- Corruption and tax evasion is rampant.

Relationship between Domestic and Foreign Tax Bases and Rates: A country is able to attract foreign capital and to retain domestic capital if it has a transparent, efficient, stable and moderate tax system. Large differences in tax rates between countries may lead to capital flight and transfer of profits from high-tax-rate to low-tax-rate country. While designing its tax system, a capital-importing country, like India, must take into account the tax regimes of capital-exporting countries as well as the advantages of its competitors, vying for the same foreign capital. Some countries have entered the competition for capital by lowering tax rates or by giving more promotional incentives than their competitors.

Tackling Influence of Inflation: Inflation is an implicit tax, as people with equivalent incomes, are left with lesser purchasing power. The government should attempt to insulate explicit taxes from the consequences of high inflation rates. In the case of personal income taxes, inflation can lead to bracket creep (people with lesser purchasing power are asked to pay taxes at the same rate) and to erosion of threshold allowances and deductions. The remedy is to link the nominal tax base with some inflation index (e.g., consumer price index), as has been attempted in Mexico and Turkey. In Chile, a comprehensive system of inflation indexation has been developed with a view to reduce such distortions. It is suggested that instead of 'patches' or parts of tax system indexed to inflation, the entire tax system should be indexed to inflation.

SIMPLIFICATION OF TAX LAWS

A number of changes were introduced to simplify some of the calculations attendant to filing of return:

- The calculation of **depreciation**[8] on business assets was simplified by introducing 'block of assets' system,
- Limits imposed on business expenditure in the nature of **entertainment, hospitality and advertisements** were removed or rationalised in keeping with the current business practices.
- The method for computation of **long-term-capital-gains** was changed by allowing for indexation for inflation and a lower flat rate of tax[9] instead of progressive exemptions.
- Government notified **accounting standards** that required tax payers to follow uniform accounting year and mainly mercantile system of accounting.
- Dividends became tax-free in the hands of recipients by introduction of Dividend Distribution Tax.

The donor-based Gift Tax Act was withdrawn but gifts from non-relatives were made taxable in the hands of the donees in the Income Tax Act (s 56 (vi)) wef 30.09.98. Business re-organisation was made tax-neutral wef 1999-00. This helped in unleashing of mergers and demergers making business more efficient.

EFFECT OF REFORMS ON REVENUE COLLECTION

The study examines the effect of reforms on tax collections, savings and investments in the period 1991 to 2009.

Normally revenue collection should go down with lowering of tax rates. The share of direct taxes in gross tax revenue has gone up from 23% to 55% in the period 1991-92 to 2008-09. In the corresponding period, the share of indirect taxes in gross tax revenue went down from 77% to 45%, indicating structural shift in the composition of revenue. This was a reflection of maturing of Indian economy, as economists prefer direct taxes - as they are more equitable and are linked to the tax payers' ability to pay. The brunt of indirect taxes is also borne by the poor when they buy consumable products.

The all round improvement in direct tax collection with lowering of tax rates in India led to the conclusion that India is providing a textbook illustration of the 'Laffer curve'[10]. India's gamble of reducing tax rates, at a time when additional resources were required, has apparently paid off

The lowering of tax rate appears to have a positive correlation with revenue collection, domestic savings and domestic capital formation. It has also brought in a virtuous cycle of compliance, as more and more tax payers are joining the rosters of ITD. **The number of taxpayers has risen more than five times from 70 lakhs in 1992-93**[11]

8 - Normally, in taxation of business income, an allowance has to be provided for recovery of capital costs representing use of capital assets in the production process. This recovery has to be spread over number of years representing gradual depreciation in value of assets due to normal wear and tear and due to obsolescence.

9 - A lower flat rate was prescribed as under declaration of value of asset at the time of sale was leading to loss of revenue for the state and local government in the form of lower stamp duty and municipal taxes, respectively.

to 3.67 crores in 2007-08[12] and it has gone up to 6.92 crores in 2016-17 and expected at 7.41 crores in 2017-18, with Direct tax to GDP ratio at 5.98. (Source administrative Handbook 2019)

SHORTCOMINGS IN THE DIRECT TAX REFORMS AND THE WAY AHEAD

The World Bank publication, 'Lessons in Tax Reform' advises that tax preferences should be 'limited in coverage and duration to cases in which market imperfections cannot be addressed more directly'[13]. The IMF also advises for 'minimum recourse to tax incentive schemes'[14]. Chelliah Committee on Tax Reforms had advised Government of India that with lowering of tax rates, 'several of the incentive provisions (should) be withdrawn'[15]. The TRC pointed out that "the use of the tax system for promoting such (non-revenue) objectives undermines the equity of the system, creates complication in administration and leads to all kinds of distortions and anomalies. For a thorough reform of the tax system towards simplicity and equity and substantial reduction of rates, it is absolutely necessary to eliminate all such incentives/concessions in the tax system except for the essential few." Despite clear advice on the issue of reduction of tax preferences, Government of India did nothing to curtail tax preferences. In fact, tax preferences have increased over the years. The income tax law presently provides for exemptions and concessions for every conceivable activity with social appeal, ranging from sports to family planning, from exports to poultry farming, and so on. Many of these incentives are distributed as political largesse rather than for any sound economic reason. Sometimes it is also a manifestation of rent-seeking activity of 'pressure groups'.

Most of the incentives were introduced in the Income Tax Act during high-tax-rate-regime to promote activities which were considered beneficial to social and economic development of the nation. Incentives to promote export and foreign exchange earnings were introduced to assist Indian companies to compete in global market. Incentives for investment in backward areas were introduced to promote balanced regional development. While these non-revenue goals are laudable in themselves, it is time to carry out a study to identify incentives which are effective and have actually led to achievement of these non-revenue objectives, and those which are not. The latter can be considered for curtailment/elimination. "Thus, in devising tax policies to meet economic and social objectives, potential gains must be weighed against the revenue and potential losses in efficiency that might be associated with these measures."[16] Curtailment of tax incentives has been part of tax reforms of Indonesia, Columbia and Jamaica[17].

Once tax incentives are withdrawn substantially, Government can think of withdrawing minimum alternate tax, thus reducing the administrative burden of implementing this complex provision.

Taxation of agricultural income

Taxation of agricultural income is a state subject under the federal constitution of India and therefore the central government is not able to levy any tax on it. The state governments do not have the machinery to levy income tax on one activity alone. Thus, agricultural income largely goes untaxed. Non-levy of tax on agricultural sector is leading to following negative effects:

(a) Government is losing revenue,

(b) it is causing horizontal inequity and

(c) a number of non-agriculturists are showing agricultural income and avoiding payment of taxes.

Showing agricultural income has become an easy route for conversion of unaccounted business income to declared income without any tax burden.

During 1960's and 1970's, a number of committees were appointed, both at the Centre and State levels, to examine the issue of agricultural income taxation. This tax could not be imposed due to:

a) Political reason[18]

b) Difficulties in assessment of agricultural income. They arise from the nature of agricultural operations and the conceptual problems involved in distinguishing current from capital costs[19].

c) Agriculture was generally considered as a subsistence activity.

10 - Refers to a supposed relationship between economic activity and the rate of taxation which suggests that there is an optimum tax rate which maximizes revenue. Named after the American economist Arthur Laffer.

11 - Budget speech of Finance Minister for 1992-93, available at www.finmin.nic.in

12 - Administrative Handbook of ITD, 2009, page296

13 - World Bank, Lessons of Tax Reform,1991, page 58.

14 - Abed op cit page 10.

15 - Raja Chelliah, TRC Final Report, Part I, Ministry of Finance, New Delhi, page 11

16 - Shirazi and Shah, op cit, page xviii.

17 - World Bank, Lessons of Tax Reform, 1991, page 37.

For political reasons, agricultural sector could not be imposed with any substantial additional tax burden. This issue was altogether abandoned by both the governments and the researchers. The new Direct Taxes Code also does not propose to tax agricultural income.

Anti avoidance provision

The line between tax evasion and tax avoidance is getting thinner . A tax avoidance scheme is generally understood to be the one where "steps having no commercial purpose apart from the avoidance of a tax are inserted in a composite transaction made up of a pre-ordained series of transactions."[20] Tax laws of many countries like Singapore, Australia, New Zealand, UK, Malaysia, etc. now have anti-avoidance provisions. Similar law based on section 33 of the Singapore Income Tax Act, have already been adopted in India.

Reform of State and Local taxes

The Central Government has carried out co-ordinated reform of taxes falling in its jurisdiction. The State and Local governments still lag behind in the reform of taxes falling in their jurisdiction. This has indirectly effected collection of central taxes, e.g. high stamp duty (a local tax) on transfer of property still entices people to under-declare the cost of consideration of the property at the time of its sale, thus reducing capital gains payable on it. Similarly, high sales tax rates (a State level tax), lead to unaccounted sale which lead to under-declared profits and which in turn leads to lower collection of income tax. It is, therefore, imperative that a regime of moderate central taxes be accompanied by a regime of moderate state and local taxes. GST reforms have been subsequently introduced.

Reform of Tax Administration and Procedure

- **Computerisation programme:** Income Tax Department has gone for extensive computerisation, but proper training to staff was not provided resulting in under-utilisation of facilities. Tanzi and Pellechio (1997:281) suggest that 'the purchase of computers must follow, not precede, the development of a specific strategy'. Similarly, focused computer training should precede placement of expensive computers (with tax software). The department still prescribes that all registers and records be maintained in manual form. Thus, staff has to prepare records both manually and on computers, which leads to duplication of work and causes resentment in staff. Much of this has been corrected subsequently.
- **Reduction of limitation period:** The Income Tax Act prescribes a limitation period of two years and nine months, from the end of accounting period, for completion of assessments. As with the bureaucracy elsewhere, the general tendency is to complete assessment towards the end of the limitation period. Thus, for an assessee whose case comes up for scrutiny, the tax liability is finalised nearly three years after the end of the accounting period, an unusually long period of uncertainty. With improvement in means of communication and office automation, there is need to curtail the period of limitation. This shall also help in prompt recovery of taxes due to the Government and shall reduce losses due to inflation. It has also been introduced in the Income Tax Act recently.
- **Sharing of information between tax departments:** The activity of running a business involves interaction with many tax and economic departments like sales tax, central excise, customs, etc. A proper system of sharing of information between these departments is desirable, as offence committed under one Act leads to consequences under the other Acts. At times it is noticed that a person caught making unaccounted sales by the sales tax department escapes payment of income tax on the profit made on such sales due to lack of communication between these departments. The Government may consider making it statutory duty of the investigating officer of one tax/economic department to inform the other tax department if he feels that information in his possession indicates evasion of the tax.
- **Reform of tax administration:** Any successful tax reform programme should integrate strategy of change in tax laws with the tax department's human resource plan.

(a) Incentives facing tax administrators

The First CIAT general assembly in Panama in 1967 had declared that "tax administration is the key to tax policy". Over the period of time it has been recognised that the way taxes are administered can make a difference between

18 - DN Dwivedi, op cit, page 47
19 - KN Raj, "Direct Taxation of Agriculture", in Ed. Dwivedi, D.N., Readings in Indian Public Finance, Wiley Eastern Limited, New Delhi, 1973, page 51.
20 - Expert Group, Report to Simplify Income Tax Law, Taxmann, New Delhi, 1997,41.

'statutory' and 'effective' taxation[21]. This led Jantscher (1990) to declare that "tax administration is tax policy".

The tax department, being part of larger bureaucracy, is often required to conform to broader government policies in hiring, firing, compensation, and promotion. Tax economists and HR consultants, after study of tax administration in different countries[22], have stressed the role of proper financial compensation to tax administrators for success of any tax reform programme. Some countries, like Ghana, Uganda and Zambia have set up autonomous Revenue Boards, separate from the Civil Services, to overcome this problem. They had met with 'considerable success'[23]. If tax administration is to be made effective, its wage policy must be revised. The IMF advises to have 'fewer but better paid civil servants'[24]. Higher salaries for tax administrators, within civil service, have been provided in many countries, including Argentina and Peru. While role of monetary reward in motivating an employee cannot be denied, it should not be over stressed. One should be able to recognise non-monetary rewards which can be offered to staff, like putting up photograph of the best employee, introducing best inspector to the Chief Commissioner, giving challenging job of 'audit' to better performers, etc.[25]

An effective reward should fulfil following three characteristics:

- Saliency (visibility and immediacy)
- Valence (employees value it)
- Contingency (contingent on desired behaviour)

Differential treatment, whether in monetary or non-monetary terms, between good and bad performer does motivate and reinforce good performance. India's present reform programme has totally overlooked this aspect of global trend of tax reform. If tax reforms are to have any sustained impact, incentives facing the tax administrators have to improve.

(b) Identification of 'dead wood' and 'corrupt wood'

It is essential to identify the inefficient and corrupt officials and to suitably punish them. Punishment to bad performer should be as visible as reward to good performer. Tanzi and Pellechio (1997:277) advocate "higher salaries but less secure jobs for tax administrators". The Tax Reform Committee has suggested three pronged strategy to deal with corruption :

- Identification of corrupt officers and vigilance action against them
- Removing corrupt officers by use of service rule FR56J
- Identification of sensitive posts (where scope for corruption is large) and appointment of honest officers on these posts.

(c) Reallocation of resources

"Traditional tax administrations generally use their personnel and resources poorly. Often, a large share of personnel is occupied with trivial, mechanical, and highly unproductive tasks, while useful tasks are starved for resources. The reason for such misallocation is that today's allocation may reflect yesterday's needs."[26] Some steps to free workforce from routine low productivity jobs are: mechanisation; tax collection through banks; setting appropriate threshold to take out cost-ineffective small cases; use of deterrent penalties to encourage voluntary compliance; self assessment; audit selection strategy and its secrecy[27]; presumptive tax on small taxpayers to take them out of procedurally long regular taxation, etc. The manpower so freed can then be redeployed in more productive areas, like audit, big taxpayers cell, 'hunting' for new assessees, etc. Similar attention should be paid for reallocation of financial resources.

(d) Privatisation of some functions of the tax department

Enforcement of tax laws and collection of taxes is a function which has to be performed by the state itself. However, Acuna (1992) suggests that some routine functions of the tax department can be considered for privatisation[28]. As part of the reforms in India, work relating to Taxpayer Information Network (TIN) has been outsourced to National Securities Depository Limited (NSDL) and for PAN to UTI Limited.

(e) Allocation of adequate funds and their fungibility

Government has given more than necessary emphasis on reducing the cost of collection of direct taxes. The cost of

21 - Vito Tanzi and A. Pellechio op cit, An 'effective' description of taxation is the one "based on economic reality, taking into account all the distortions brought about by tax evasion, tax avoidance, misapplication of laws, abuses on the part of tax officials, and so forth." Page 274.

22 - Silvani and Baer (1997), Tanzi and Pellechio (1997), Schlemenson (1992), Chand and Moene (1997)

23 - Silvani and Baer, Designing a Tax Adninistration Reform Strategy, in Tax Notes International, 1997, page392

24 - A. Tait, IMF Advice on Fiscal Policy, Finance and Development, March 1990.

25 - According to World Development Report, 1994, such rewards in kind have been very successful in reform of state owned enterprises in Korea.

collection was only 0.54% in FY 2007-08. One major reason is allocation of inadequate funds to run the tax office. The tax office is always short of such essential items as paper, printed stationary, etc. The visitors to tax office are not even provided with facility to sit while they wait for 'hearing' of their tax cases. The allocation of funds for upkeep of tax offices should improve. Further, the departmental heads should be allowed greater flexibility to use allocated funds. Subsequently, Aaykar Seva Kendras, ASK- have been set up all over the country.

(f) Training of staff

While quite adequate network exists for training of staff in tax matters, extension of training facilities in use of computers and in investigation of tax evasion cases is desirable. The Tax Reform Committee has suggested that senior officers of the tax departments should be given training in broader social aspects and economic consequences of taxation.

Tax Research Bureau and other pan-organisational facilities: The Tax Reform Committee and the Expert Group have both noticed lack of basic data for analysis of impact of existing and alternative tax provisions. The Expert Group (para 17, page 5) noticed that "No reliable information, even relating to the allowances claimed by large companies or by taxpayers according to their income range, the tax effect of various incentive provisions, like reliefs and savings in specified assets, the impact of depreciation rates or cause-wise analysis of appeals, is available." In absence of such details, the reforms and changes in tax laws are more based on conjectures than sound analytical reasoning. The Tax Reform Committee had suggested setting up of a Tax Research Bureau consisting of economists, revenue officers, and tax practitioners and assisted by research assistants, to conduct research in matters of tax policy on a regular basis. Subsequently, it has been set up under DOR

Establishment of such a bureau within or outside the tax department is imperative to ensure that changes to tax laws are made on sound analytical basis and not on perceived notions of bureaucrats/politicians. Similar pan-organisational institutions should be set up to support field staff in audit, investigation, legal representation of cases or to study practices relating to evasion of taxes.

A continuation of present efforts to simplify tax laws; to expand TDS coverage; to widen tax base and to increase scope of presumptive taxation, along with implementation of suggestions given in this chapter is likely to lead to improvement in both tax compliance and increase in revenue.

CONCLUSION

There is a need for adoption of a differential performance-based pay structure for tax administrators, with visible reward to performers and punishment to non-performers. It is suggested that some routine functions of tax department may be considered for privatisation to introduce a feeling of competition. The tax department should continuously analyse its utilisation of available human and financial resources, so as to put them to maximum use. This paper suggests some steps to free the workforce from routine low productivity tasks and their redeployment in more productive areas. The tax department should consider setting up of Tax Research Bureau and other pan-organisational facilities to continuously improve its working.

Tax reform does not happen on its own but has to be brought about. Tax reform has to be a continuous process. Collection from direct taxes in India has grown steadily. From 2008, direct tax collection has, overtaken collection from indirect taxes. However, there is scope for further improvement.

26 - Tanzi and Pellechio, op cit 1997, page 279.

27 - " It is important that taxpayers believe that a larger percentage of taxpayers is audited than is actually the case (Tanzi and Pellechio, op cit 1997) . However, in India, Government routinely announces the crieria for selection of cases to prevent misuse by the tax administrators.

28 - LFR Acuna, Privatisation of Tax Administration, in Bird, R.M. and Jantscher, M.C.(ed.), Improving Tax Administration in Developing Countries, IMF, Washington, 1992

Designing Trust for Indian Tax System

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He is author of the bestselling books, Loophole Games: A Treatise on Tax Avoidance Strategies, followed by (among others) departmental officers working in investigation and corporate assessment roles, and Tangible Guide to Intangibles: Identification, Valuation, Taxation & Transfer Pricing, followed by Transfer Pricing Officers across the country.

Executive Summary

Significant academic research has been conducted to establish factors that lead to voluntary tax compliance. A plain and pessimistic conclusion of some redoubtable research is that taxpayers have an inherent selfish motive to evade taxes; hence they have to be forced by deterrence and procedure to pay tax. But most works of research have demonstrated that taxpayers comply due to a mixture of power and trust. Power is of two kinds – coercive power and legitimate power.

This essay concentrates on the other factor that affects taxpayer behaviour: trust. Trust is critical for voluntary and cheap compliance. A simple illustration is a business that does not involve trust. If there is no trust between two parties, they have to hire advocates to draw lengthy contract. This increases the cost of doing business for both the parties. Whereas, if there was trust, they can save the money spent on advocates and advisors.

Every time there is trust, society benefits.Breach of trust leads towasteful expenses. Trust between the government and citizens makes tax compliance smooth and effortless. But how does trust lead to tax compliance? And what are the challenges in developing trust between public and public institutions like the I-T department?

The public goods game

The public goods game is a basic game in experimental economics[1]. In this game, all members of public are asked to contribute money to a public pot in the morning. The money collected in the pot gets multiplied n times by evening. Then the money is distributed equally among the public. Say 10 people participate in the game. Each contributes Rs. 10/- to the public pot. So the sum total in the pot is Rs. 100/-. It gets multiplied by 5 times by evening and becomes Rs. 500/-. Each of the participants gets Rs. 50/- in the evening.

The game is continued daily. The participants do the same thing daily. Each contributes Rs. 10/- in the morning and gets Rs. 50/- in the evening. This state can be called Equilibrium 1.

One fine day, one of the participants (let us call them Evader E) decides not to contribute to the public pot. He keeps his Rs. 10/- in his pocket. The money collected in the pot in the morning is Rs. 90/- only (Rs. 10/- times 9 participants). By

1- See: https://en.wikipedia.org/wiki/Public_goods_game evening it becomes Rs. 450/-. Each participant gets Rs. 45/- in the evening. But E now has Rs. 55/-.

Others end up getting Rs. 45/- instead of Rs. 50/-. E ends up getting Rs. 55/-. What happens the next day? None of the participants puts money into the pot. None gets any money from the pot in the evening. This is Equilibrium 2.

In this game, there are only two equilibriums. Equilibrium 1 is a state in which participants trust other participants. Everyone benefits. Equilibrium 2 is a state in which there is no trust. Everyone loses out on the produce from public trust. It is, in effect, a variant of the prisoners' dilemma. There is no other equilibrium. It is easier to move from Equilibrium 1 to Equilibrium 2; but difficult to move back from the second to first equilibrium (i.e. it is difficult to regain trust in the game).

This game tells us how citizens rationalise evasive behaviour. High Networth Individuals (HNIs) and business managers allege that the government does not properly utilise tax collected in welfare and public amenities. They perceive a high degree of corruption in application of their tax money to public good. This helps them rationalise tax evasion. The salaried class feels that HNIs and corporates have many avenues of evading taxes, but they don't. They see episodes of tax evasion and feel a sense of relative deprivation. They rue that tax is deducted from their salary as TDS. Whenever given a chance, salaried individuals are eager to dodge tax. They tend to evade tax on capital gains (from sale of property), house rent, and miscellaneous income.

The problem here is two-pronged:

a. Develop trust between taxpayers and tax department, and

b. Develop trust among taxpayers about compliance of HNIs and corporates

A proper quantitative study has not been conducted in India yet to gauge the trust that taxpayers have on the taxation system in India. Results of a survey conducted by the Azim Premji University and Lokniti are indicative of the trust reposed by citizens on various government institutions:

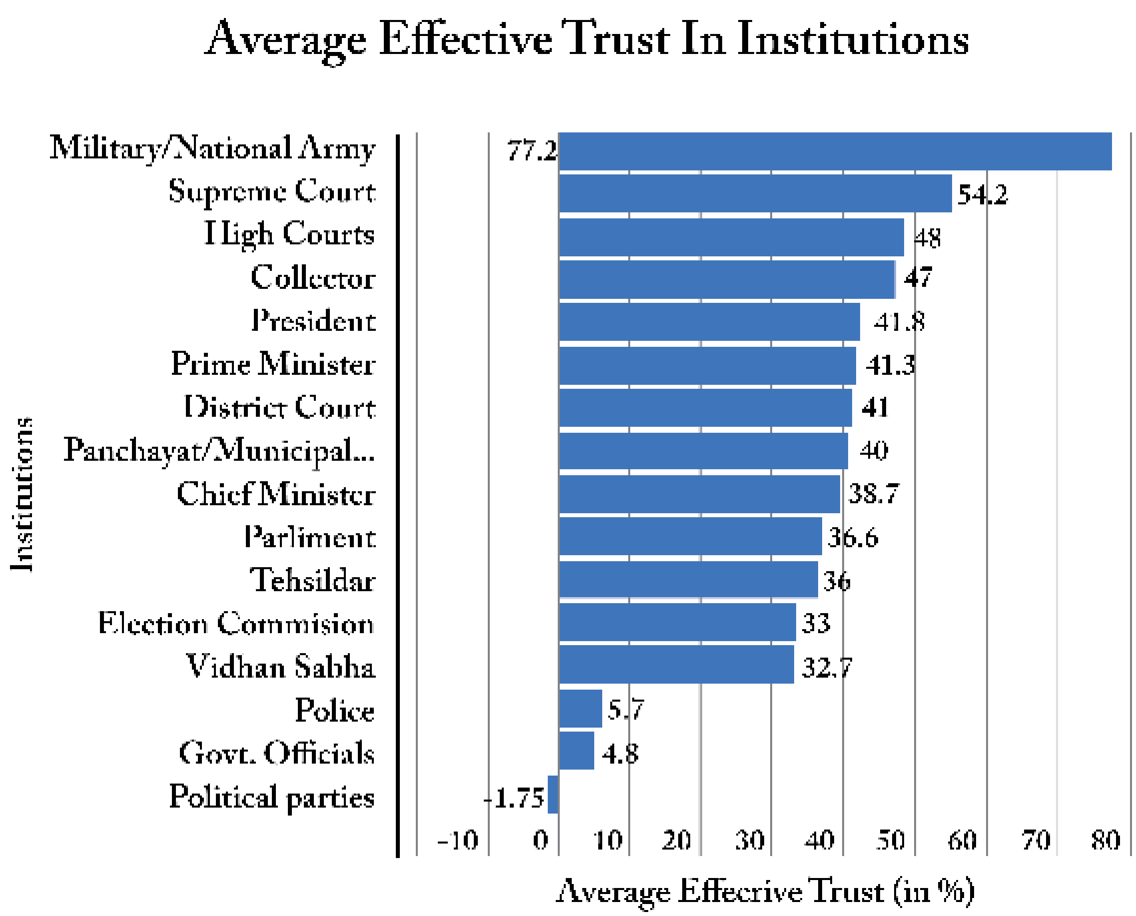

Figure Source: Politics And Society Between Elections, 2018, by Azim Premji University and Lokniti (CSDS)

It is risky to draw any conclusion on trust in tax systems from above study. Not all citizens are taxpayers. Different class of taxpayers have different level of trust on the taxation system. Further, the study does not throw light on public trust on central government institutions. But above study does indicate a general lack of trust in government institutions and government officials.

Notwithstanding indicative data on trust levels of taxpayers, how do we design a system to develop the two kinds of trust mentioned above? Prof. Dan Ariely, a professor of psychology and behavioural economics at Duke University, hints at a possible solution[2]. He reasons that **trust between two parties can be improved by bringing in a third party whom both trust.** He gives the example of individuals subscribing to an insurance company. Generally, distrust between individuals and insurance company leads to the following situation:

- Individuals subscribe to insurance plans
- A customer makes excessive claims with the insurance company when damage happens
- The insurance company loses trust on its customers. It feels that customers make excessive claims. It devises rules for detailed inspection and lower disbursement than claim made.
- Other customers feel that if they make a genuine claim, the insurance company will reimburse much lower amount. The insurance company wants to maximise its profits. Hence, there is a conflict of interest between the insurance company's profit motive and damage reimbursements. So they also start making excessive claims.

This process becomes a vicious self-reinforcing system that lacks trust. Expenses of the insurance company increase due to higher investigation expenses. Customers also suffer due to delay in reimbursement and longer litigation.

Prof. Ariely analysed an insurance company that brought in a third party into the equation. This insurance company said that after paying all damage claims, and after accounting for its expenses, it will give whatever is left to a reputed charity. Few days after this offer was made by the insurance company, it got call from a customer who had lost his laptop and had been reimbursed. The customer reported that he found his laptop in his colleague's office chambers; and offered to return the damage claim he had made. This was followed by similar behaviour by other customers.

Designing trust for Indian tax system

A simple approach for designing trust for Indian tax system is to either involve a third party or to make the taxpayer a participant in the application of revenue collected. The present taxation system in India is mired by conflict between taxpayers and government. An ideal environment to promote voluntary compliance is one that has both conflict and cooperation. Cooperation can come when the taxpayer is involved in the application of revenue collected by the tax department.

A simple proposal for doing this is to give points/credits to taxpayers. Similar to the way shopping complexes give credits on certain purchases to customers, the tax department can give credit to taxpayers. Illustratively, for every Rs. 1 Lakh paid, the taxpayer gets a credit of 10 points. Those who pay more than Rs. 50 Lakhs in any year get additional credits. The credits are added to the taxpayer's smartcard (which will double up as a PAN identification). The credits can be used for availing of VIP or privileged services, such as:

- Donating to the armed forces
- Sponsoring scholarship of a poor student
- An Evening tea with the Finance Minister
- Premier VIP seat during Independence Day and Republic day celebrations

More the credits an HNI accumulates, more will be their status in society: because credits are linked to philanthropy and status symbols. Philanthropic HNIs would be assured that their money is spent in funding a poor student's

2 - See: http://danariely.com/

education. Other HNIs would get to tweet their tea party with the finance minister.

Such pro-social behaviour will build trust in the middle class. They will gain trust in pro-social behaviour. Too many news items about cash seizures and I-T raids erodes their trust on the system. Too many tweets and public display of taxpayer credits by HNIs and corporates will build their trust. Many of them will start paying tax on their rental income and capital gains.

IP Migration, Equalisation Levy, and Trust

New business models arising out of digital commerce enable a firm to do business in India without having a permanent establishment in India. Indian taxmen have no jurisdiction over such firms. In late 1990s, many foreign e-commerce firms started doing business in India without having a base in India. This led to tax base erosion in India. Typically, they would be based out of a tax haven, and would maintain a subsidiary in India to provide routine support.

Their blatant act of tax avoidance encouraged many Indian firms to resort to externalisation. Externalisation is a process in which Indian firms open a parent company in a tax haven and migrate their Intellectual Properties (and other intangibles) to the parent company. IP is the only valuable asset of e-commerce companies, and income is primarily attributed to IPs. Once IP is migrated out of India, they too stop paying tax in India.

Indian tech companies felt a sense of relative deprivation on seeing foreign MNCs not paying tax while they have to pay tax. They resorted to externalisation to dodge the taxmen. India lost out on many valuable IPs that were incubated in tech hubs like Bangalore, Mumbai, and Gurgaon.

The CBDT constituted a committee, the Akhilesh Ranjan Committee on taxation of e-commerce, to investigate ways of taxing the digital economy. While the committee could not propose an easy way to tax digital economy, it proposed imposing of an indirect tax (equalisation levy) on overseas digital companies' payments from India. An indirect tax as substitute for direct tax is never good economics. The committee too realised this and proposed equalisation levy as a stop gap measure till a final solution can be arrived at.

Equalisation levy was a game changer. Many tech start-ups who were contemplating IP migration to Singapore or Ireland changed their plans. Unfortunately, there is no detailed research on the impact of equalisation levy on taxpayer behaviour. Neither is there a quantitative research on IP migration after advent of equalisation levy, nor is there any qualitative research on business restructuring strategy after advent of equalisation levy.

In the absence of research results, we cannot be sure if equalisation levy increased the level of trust in domestic e-commerce companies. However, anti-abuse measures are generally associated with higher level of trust among taxpayers.

Conclusion

In conclusion, this essay does not delve into the effectiveness of deterrence measures such as penalty, prosecution, arrest, or naming-and-shaming on taxpaying behaviour. It analyses the impact of trust on voluntary tax compliance. It goes on to analyse ways and means of designing trust in tax system of India. One way is to convert the 'conflict' relationship between taxpayers and government into a 'conflict and cooperation' relationship. Taxpayers be given a say on the application of some part of tax paid for welfare. Credits can be given in return for tax payment, which could become a matter of vanity and prestige in society. Lastly, prompt anti-abuse provisions can improve the trust of taxpayers on efficacy of taxation system.

A word of caution is that policy design should be evidence-driven. The tax department or government think-tanks should sponsor studies and research to gauge the effect of pilot projects on trust quotient of HNI and small taxpayers.

Efficacy of Tax breaks

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Executive Summary

A Tax break is a saving on a tax payer's liability and provides savings to tax deductions and exemptions. Tax breaks are an essential component of any taxing statute. However, as a result of the tax breaks, a chunk of revenue otherwise available to the exchequer is lost. Tax breaks are based on the theory that the government is compensated for the loss of revenue by relief from financial burden which would otherwise have to be met by appropriation from public funds and by the benefit resulting from the promotion of general welfare. In view of these principles, tax breaks are factored in a taxing statute to achieve socio-economic justice.

1. A Tax break is a saving on a tax payer's liability and provides savings to tax deductions and exemptions. Tax breaks are an essential component of any taxing statute. However, as a result of the tax breaks, a chunk of revenue otherwise available to the exchequer is lost. Tax breaks are based on the theory that the government is compensated for the loss of revenue by relief from financial burden which would otherwise have to be met by appropriation from public funds and by the benefit resulting from the promotion of general welfare. In view of these principles, tax breaks are factored in a taxing statute to achieve socio-economic justice.

2. The use of tax incentives to attract investments is prevalent around the world. However, there is no definitive data on the global magnitude of incentives granted because not all countries collect and publicly report such data and there is no common methodology for reporting across all countries. Rough estimate by Action Aid (2013) pegs the incentives granted by developing countries from corporate income tax (CIT) at $138 billion. For selected Asian countries, UN Economic and Social Commission for Asia and the Pacific (2014) estimates that tax breaks granted ranges from 0 per cent to 0.6 per cent and 0.1 per cent to 8.1 per cent of GDP from CIT breaks and customs duty.

3. The immediate and direct effect of tax incentives is loss of potential revenues for governments, and a significant burden to developing countries. Tax incentives undermine government's efforts to raise adequate domestic resources to finance the delivery of essential services and social protection at the scale and quality necessary to ensure that their citizens are able to fulfil unrealized rights, address inequality and meet sustainable development goals for all. Widespread use of tax incentives is also linked to problems of corruption and poor governance.

4. Tax incentives essentially constitute a set of fiscal policy tools that governments use to achieve desired economic and social policy outcomes. It is an exercise of the state's taxing power but with negative effect on public revenues. While imposing taxes increases public revenues, granting tax incentives involves calibrating the design and scope of the tax system to favour certain groups by partially waiving the collection of taxes otherwise due to encourage undertaking of certain behaviours, decisions or activities.

5. The most common use of tax incentives is to promote investments. They serve to attract flow of capital in preferred locations and sectors of the economy or to undertake specific investment activities (e.g. financing

infrastructure projects, research and development). Tax breaks are provided for various reasons such as

a. Charitable activities

b. Encouraging personal savings

c. Providing boost to exports thru SEZs

d. Encouraging infra. development

e. Balanced regional growth.

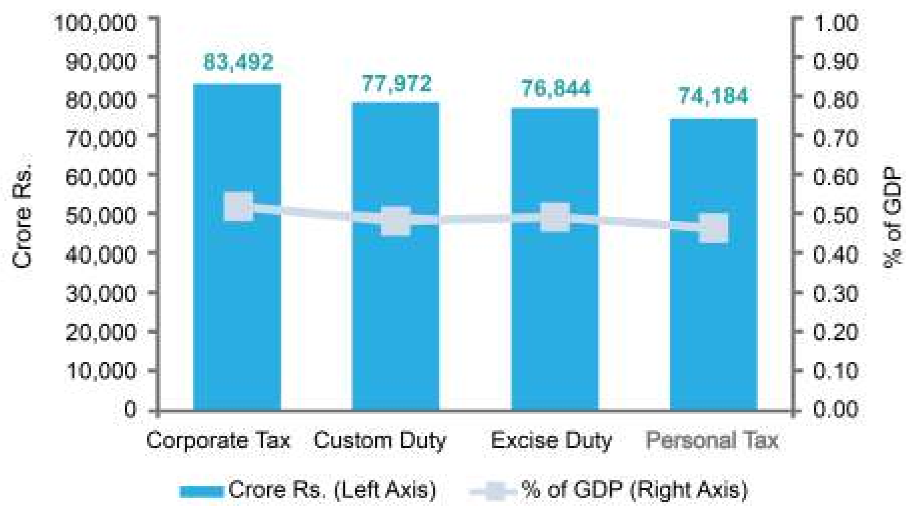
f. Environmental activities

g. Accelerated depreciation etc………

The tax breaks are provided in the direct taxes as well as indirect taxes. The following table gives the revenue foregone estimate, its percentage to GDP and percentage of CT revenue foregone in INDIA for the years 09-10 to 12-13.

F.Y.	REVENUE FOREGONE(CR.)	AS % OF GDP	%OF CT REVENUE FOREGONE
09-10	482432	7.4	1.1
10-11	459075	6.1	0.8
11-12	533583	5.9	0.7
12-13	573630	5.7	0.7

The following graphic depicts the revenue foregone under various heads and their ratio to GDP for F.Y. 16-17.



6. The composition of tax breaks in the above chart is also very interesting. The total revenue foregone consists of % on account of custom duty, 24.5% on account of excise, 27% on account of CT and 23.7% on account of IT. There is a need to re-examine the tax breaks looking at such substantial volume. This is because absence of tax breaks would result in so much additional tax revenue for the government. The question which needs to be looked into is whether the tax breaks provided are contributing to the purpose for which they have been made and whether these tax breaks can be suitably modified and minimized.

7. Several committees like the Shome Committee, Kelkar Committee have studied the relevance and efficacy of tax breaks. Dr. Amreesh Bagchi has done extensive work on this area. From the studies the following conclusions emerge: -

7.1 There is a widespread perception that frequent changes in the tax code have been akin to substituting the erstwhile license raj with an exemption raj.

7.2 Tax policy and Tax administration are interlinked. A complex tax policy involving many deductions and exemptions leads to a complex tax legislation.

7.3 This inevitably leads to cumbersome administration through a cascading effect on filing, compliance procedure and enforcement measures.

7.4 The series to adhoc exemptions has only served to clutter the culture of compliance.

7.5 Every exemption has a constituency and since democratic systems tend to respond to constituencies, a tax break to one constituency inevitably spawns similar demand by other constituency.

7.6 Tax codes have become replete with exemptions, allowances, deductions and incentives. What started as sectoral and specific relief from his taxes was soon extended to facilitate and accommodate social or developmental goals.

7.7 It has been rarely analysed whether such tax exemptions have achieved the desired objectives.

7.8 The tax breaks have developed life of their own and inevitably multiplied over time being driven by interest of specific power groups at different points of time.

8. In addition to the above inferences, the research also brings about the following observations about tax breaks.

8.1 There is hardly any evidence to prove that the tax incentives have, per se, increased investment or saving for which the incentives were devised.

8.2 It has been proved very often that scaling back of tax breaks have almost always had a positive effect on tax policy, tax revenue, tax compliance and tax administration.

8.3 An important implication of the exemption tax regime is the loss of effective parliamentary oversight as resultant tax expenditures are not transparent and not amenable to C & AG audit: a clear loss to democratic government.

8.4 Tax incentives create antagonist tension between the Tax administrator and the assessees thus becoming a major source of litigation.

8.5 Fewer the tax incentives, less is the discretionary space available to the tax administrators.

8.6 The control over provision of tax incentives by Govt. officials often results in unwarranted discretion in the hands of the officials.

9. Though the tax breaks provide a suitable outlet for promoting and enhancing social welfare, they come with several hidden costs. The cost of tax breaks can be summarized as under:

9.1 There is a clear distortion between investments which have granted incentives and those without incentives.

9.2 The revenue foregone would have to be compensated from alternative distortive taxes.

9.3 Administrative resources are required for proper implementation of the exemptions.

9.4 The social cause of corruption and rent seeking activities connected with the abuse of tax breaks are quite substantial.

While these costs would have a substantial volume, the benefits to the economy that could be attributed solely to tax breaks are less clear and not easily quantifiable. The cost effectiveness of the tax incentives is therefore often questionable.

10. In view of the above lacunae, it can be easily inferred that the tax breaks are:

a. Inefficient and iniquitous,

b. Impose greater tax payers compliance and administrative burden,

c. Result in revenue loss and the complexity of the tax breaks encourage tax avoidance and rent seeking behavior.

d. The tax breaks have been greatly misused by the tax payers resulting in substantial diminishing of their efficacy.

11. In view of the above inferences, it can easily be seen that though the tax breaks have been promoted and provided as instruments of achieving socio economic goals, they have failed to achieve the objectives for which they have been designed. The tax breaks therefore need to be seriously re-visited. The following action points are suggested for the same:

a. A joint committee should be set up by both CBDT and CBEC to examine effectiveness and efficacy of the existing tax breaks.

b. The committee should regularly examine and set a place of mechanism for regular review of tax breaks.

c. The tax structure should be designed in such a way that it will have smaller basket of rates, will be broad based and have minimum exemptions and incentives.

d. Unwarranted exemptions should be phased out resulting in reduction of tax expenditure and a more transparent administration..

The Missing Link: The Collaboration between GSTN and TDS

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On Central deputation, he worked as Director (School Education), Ministry of HRD, Govt. of India where he played important role in implementation of Sarva Siksha Abhiyan (SSA) and operationalisation Mid-Day Meal Schemes in schools throughout the country.

He was selected as Liaison Officer by Ministry of External Affairs, GoI and Indian Army and he successfully led a team of 60 pilgrims to a month long Himalayan High Altitude trekking of Kailash Manasarovar Yatra to Tibet, China.

Executive Summary

Unprecedented pace of changes happening in the field of Information and Communication Technology (ICT) offers both unfamiliar challenges as well as new vistas for effective tax administration. This article demonstrates as to how the GSTN offers huge possibility, as a real time collaborative tool, for TDS wing of ITD to have an effective compliance verification system without much additional cost or manpower. It also spells out a scheme to harness the potential of GSTN data base for empowering the TDS administrators by which they can have speed and precision in detecting TDS defaults. Hence, it is imperative for the ITD to collaborate with GSTN on real time basis for generation of business intelligence and analytics for effective implementation of the TDS provisions.

1. Introduction

The best win in a war is winning the war without fighting. TDS provision is a knight in shining armour in the Income Tax Department's war against tax evasion and its endeavour of revenue mobilisation. It plays a significant role in tax collection in India as it accounts for 40% of total collection of Direct Taxes. It is a cost effective and non-intrusive tool of tax collection. It lightens the tax burden as the tax payer pays the tax, through TDS, in instalments as and when the income is earned. At the same time, TDS ensures regular flow of revenues to the State exchequer. Thus, it is a win-win situation for both the Tax Payer and the Government.

Collaboration between TDS and GSTN (Goods and Service Tax Network) will force multiply the capability of TDS wing without any additional cost or manpower and enhance the capability of TDS Officers to effectively enforce TDS provisions.

2. Why such a proposal?

Implementation of TDS provisions in the Income Tax Act, 1961 differs from that of other provisions under the Act, like assessment, investigation, transfer pricing etc., in which the reporting by the tax payer and examination by the Income Tax Department (ITD) takes place on post-mortem basis, that is, long after occurrence of the transactions. But, under the scheme of TDS, the tax payers are required to report the transactions and comply with the TDS provisions more frequently on monthly and quarterly basis and at a closer intervals from the time of occurrence of transactions. Hence, **the main challenge for effective implementation of TDS provisions is that it requires closer and almost 'live' (real time) basis monitoring of transaction of the tax payers and TDS compliance thereon.** In this regard, the advancement in information technology and data analytics provides viable solutions to the tax administrators to face this challenge.

In this regard, the operationalization of GSTN (Goods and Service Tax Network) is an important mile stone in e-governance and more particularly in the dynamically unfolding digital world, it brings a paradigm shift in tax administration. **It is estimated that the GSTN is going to process almost 300 crore invoices each month from a total of 112 Lakh users. This represents a massive digitization at all levels of the Indian economy. In the GST system, invoices are required to be matched between supplier and buyer of goods and services. Hence, the GSTN virtually is going to maintain the books of account of the tax payers on real time basis, capturing almost all income and expenses.**

In such situation, GSTN offers huge possibility, as a real time collaborative tool, for TDS wing of ITD to have an effective compliance and verification system for implementation of TDS provisions under Income Tax Act which very much requires such real time data. Harnessing the potential of GSTN data base will empower the TDS administrators by bringing in precision and speed into the administrative and monitoring processes. Therefore, it is imperative for the ITD to collaborate with GSTN on real time basis for generation of business intelligence and analytics for effective implementation of the TDS provisions. Establishing a platform for seamless exchange of data between GSTN and TDS Wing is an urgent need of the hour as GSTN is in the process of firming up its architecture after initial field trials. Moreover, a robust data mining mechanism thereon will provide cost effective and non-intrusive tool for successful enforcement of TDS collections. It will also significantly contribute towards widening the tax base, promotion of voluntary compliance and thus, checking tax evasion.

3. GST at a glance:

Introduction of GST is one of the most ambitious initiatives in the arena of tax reform in India. It is expected to change the Indian tax structure and pave way for modernization of tax administration. GST is a destination based consumption tax. The introduction of GST has subsumed around 17 different indirect taxes in India, viz., Excise duty, Service tax, Central Sales tax, Value added tax, Entertainment tax, Luxury tax, Entry tax, etc.

There are three models of GST

A) Central GST - Levied by Centre

B) State GST and - Levied by State

C) Integrated GST - Levied on Inter-State supplies.

Every person whose supplies (turn over) under GST exceeds Rs.20 lakhs in a year, is compulsorily required to get themselves registered under GST. Certain assessees are required to compulsorily register even though the supplies does not exceed Rs.20 lakhs. For e.g., supplier through e-commerce, person making inter-state supply etc.

Every registered person under the GST is required to file the following returns.

FORM	DESCRIPTION	DUE DATE
GSTR 1	Outward Supplies (Sales or Services rendered)	10th of the next month
GSTR 2	Inward Supplies (Purchases or Services received) (Based on GSTR 2A, which in turn based on GSTR 1 of the supplier of goods or services)	15th of the next month
GSTR 3	Monthly return (Consolidated Revenue & Expenses)	20th of the next month
GSTR 4	Returns by Compounding tax payers (Whose turnover less than Rs.1.5 crores) (Similar to presumptive basis)	18thday of the month next to the quarter
GSTR 9	Annual Return (Final P&L Account)	31st December Next F.Y.

3.1 Forward Charge and Reverse Charge:

Generally the Service Provider or the Supplier of goods is liable to pay GST (Forward Charge). Whereas in some cases the GST is required to be discharged by the recipient of the service. This is called Reverse Charge.

For example, in case of legal fees, the lawyer (being Service provider) is exempted from paying GST and hence, he raises the bill without GST on the Client (Service receiver). Alternatively, the Client (Service receiver) shall pay the relevant GST under Reverse Charge Mechanism (RCM). In addition to this, the Client is required to deduct TDS under Income Tax for the same.

3.2 GST Network (GSTN):

The entire IT infrastructure for implementation of GST is entrusted to GSTN, a strong IT Infrastructure and Service back bone, which enables capture, processing and exchange of information amongst the stakeholders (including tax payers, States and Central Governments, Accounting Offices, Banks and RBI). The common GST Portal developed by GSTN will function as the front-end of the overall GST IT eco-system. The IT systems of CBIC and State Tax Departments will function as back-ends that would handle tax administration functions such as registration approval, assessment, audit, adjudication etc.

3.3 Unlike the earlier tax regime, GSTN captures complete trail of transactions from the first originator but also with the final recipient across the supply chain. Hence, drawing the transaction details from the GSTN and cross verifying the same with the Income Tax would help the TDS administrators to generate business intelligence on suppression / misrepresentation of facts as well as non-compliance of tax provisions. The GST registration number is a PAN based registration and hence, it would be easy for such cross verification.

4. Scope for collaboration between GSTN and TDS:

4.1 Eco system of GSTN is designed mainly to facilitate the GST administrators who are keen on monitoring the Service Providers/ Goods Suppliers on their outward supplies (Sales/Turnover)and to implement the provisions of the GST Act. They mainly deal with the credit side of the P&L a/c.

Whereas, the TDS administrators are generally interested in keeping a watch on the Service Receivers on inward supplies, i.e., their expenditures made towards services received on which whether TDS has been deducted or not. That is, they mainly deal with the items on the debit side of the P&L a/c.

4.1 (a) This dichotomy is successfully resolved by the Returns of GST-R2/GST-R2A of a person which mainly gets auto populated from the information contained in the GST-R1 which is filed by his Service

Provider/Supplier of goods. Thus, this information from the GST-R2/GST-R2A can successfully be used by the TDS administrators after cross verification with TRACES (Conso Files)/ Form 26AS to verify and generate actionable intelligence as to

(a) whether TDS has been deducted or not?

(b) If deducted, has it been deducted within the prescribed time or not?

(c) If deducted, has it been deducted at the prescribed rate or not?

GSTN	Recipient Name	State	Invoice Num	date	Invoice Value	Taxable Value	IGST
08ABBPB9034H1ZX	ABC Ltd	RAJASTHAN	3690	12/03/2018	77,647.50	73,950.00	3,697.50
08ABBPB9034H1ZX	ABC Ltd	RAJASTHAN	3691	12/03/2018	10,48,320.00	9,98,400.00	49,920.00
08ABBPB9034H1ZX	ABC Ltd	RAJASTHAN	3697	18/03/2018	11,08,800.00	10,56,000.00	52,800.00
08ABBPB9034H1ZX	ABC Ltd	RAJASTHAN	3698	19/03/2018	9,87,840.00	9,40,800.00	47,040.00
08ABBPB9034H1ZX	ABC Ltd	RAJASTHAN	3700	24/03/2018	9,67,680.00	9,21,600.00	46,080.00

4.1 (b) Present challenge:

Though the Invoice-wise data downloaded from the Return GST-R2 / GST-R2A is a goldmine for TDS verification, the limitation is that Return GST-R2 / GST-R2A does not have a marker to distinguish as to whether the particular Voucher record is either for supply of Goods or for rendering Services in the GST-R1. Once this marker is introduced in the Return GST-R2 / GST-R2A, then it will be easy to segregate only the invoices related to provision of services and data therein can be subjected for data analytics and cross verification with TRACES/Form 26 AS to generate business intelligence.

4.1 (c). Recommendation for solution:

The marker could be in the form of internationally followed standard coding systems such as HSN Code and SAC code.

- **HSN Code stands for Harmonious System of Nomenclature and it is an eight digit code used for describing every unique goods.**
- **SAC Code stands for Service Accounting Code and it is a six digit code used for describing every unique services.**

Extracts of SAC code downloaded is as under:-

Group 99546		Installation Services
	995461	Electrical Installation Services including Electrical wiring & Fitting services. Fire Alarm Installattion Services, Burglar Alarm System Installattion Services
	995462	Water Plumbing And Drain Laying Services
	995463	Heating, Ventilation And Air Conditioning Equipment Installation Services
	995464	Gas Fitting Installation Services
	995465	Insulation Services

If this SAC code is incorporated invoice wise in the Return Form GSTR 1, then it would enable the TDS administrator to identify and segregate only those invoice records pertaining to TDS application and map them against the relevant sections under the Income Tax Act for cross verification. Under the GST Act it is mandatory for all assesses making supplies (Turnover) more than INR 1.50 cores to state the HSN / SAC in their invoice to the recipient. The invoice issued under the GST is said to be proper only if the same contains the unique HSN and SAC. Hence the system already makes it mandatory to state HSN/ SAC for every line item issued in the invoice. Hence making the same available in the GSTR 1/ GSTR 2A does not add any additional burden to the tax payers.

4.2 Items under Reverse Charge Mechanism (RCM):-

As has been discussed in para 3.1, in the of RCM cases, there is no liability for the Service provide to pay GST. Alternatively, it is the Client (Receiver of the service) who fulfills the responsibilities under GST as well as TDS. **Since there are no two parties involved in these cases consequently, there are no checks and balances which are present in Forward charge cases, and hence there is more likelihood of TDS defaults in these cases.**

4.2 (a) In respect of domestic transactions, the relevant data in RCM cases could be extracted from Item no 4 of GST-R2/Item no 4(A)(3) of GST-R3B which is in vogue at present and compliance to the TDS provisions could be examined.

4.2 (b) Similarly, in respect of Import of Goods and Services, the same is deemed as Inter State Supply of goods and services under GST. In these cases, Integrated Tax (IGST) is required to be paid by the importer in India under Reverse Charge Mechanism (RCM). This information relating to the same also required to be disclosed in the Return GSTR 2 / GSTR-3B Item 4(A)(2).

Based on the above, the TDS compliance with reference to Section 195 of the Income Tax Act can be verified and necessary corrective action can be taken.

4.2 (c) Further, as per sec 9(4) of the CGST Act, if the dealer avails Goods or Services from the unregistered GST dealer (whose Turnover is less than INR 20 lakhs), that dealer being the service recipient shall pay the GST under reverse charge. This provision in GST Act is suspended for the time being. When it is made operational in future, expenses like contracts, security service provider for whom TDS u/s 194C may get covered and compliance can be enforced under TDS provisions in respect of those payments. **This will widen the tax base as well as augment TDS collections.**

4.3 E-Commerce Operators:

In recent times, there is a proliferation of e-commerce operators in the market. With their unconventional style of operation and uncommon business models, they pose new challenges for tax administrators especially to the TDS administrators. **In such situation, col 4C and 5B of GSTR-1 captures supplies of Goods/services through e-commerce operations or by e-commerce operators. The commission income accrues to the e-commerce operators can be collected and analyzed to examine compliance to TDS provisions.**

5. Conclusion:

The GSTN eco system is a gold mine for data analytics as it captures the information on the transactions carried out by the businesses on a real time basis in a comprehensive way. Collaboration with GSTN will empower the TDS administrators to enforce TDS provisions in a cost effective and non-intrusive manner with speed and precision. Building a robust platform for seamless exchange of data will go a long way to promote voluntary compliance, widen the tax base, increase TDS collections, arrest tax evasion and thus better tax administration.

6. Recommendations:

In the light of the above discussion, the following recommendations are submitted for the consideration of CBDT for collaboration with GSTN, to leverage the comprehensive e-governance initiative of GSTN, in order to improve the implementation of TDS provisions and to maximize TDS collections:-

- **To recommend to GST Network Pvt Ltd to include a marker in the form of HSN or SAC code (which is being followed by the tax payers in their paper invoice) in their digital return form GSTR-1;**
- **To create a digital platform in Income Tax Department to receive GSTN data, do data mining and to generate actionable intelligence for use by the field formation;**
- **To sensitise officers of ITD about the utilisation of GSTN database.**

Transfer Pricing in India

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Sh.S.C. Mishra is a Chief Commissioner of Income Tax (Retd.).He had authored two books, namely, 'Transfer Pricing Manual' published by Law Publishing House in 2001 and 'Transfer Pricing in India' published by Wolters Kluwer in 2016 (First edition) and2019(Second edition).

Executive Summary

A substantial volume of global trade comprises transactions between related enterprises within groups of multinational enterprises (MNEs). The transactions between such related or associated enterprises may take place under conditions different from those taking place between independent enterprises. Transfer pricing is a term used for pricing of such cross-border, intra-group transactions in goods, intangibles or services including financial services. The prices of such transactions between associated enterprises should, however, for tax purposes be in conformity with those which would be charged between independent enterprises, usually, referred to as arm's length pricing. Arm's length simply means 'at a distance, not on familiar or friendly terms'. Arm's length pricing is an international standard that compares the transfer prices charged between associated enterprises with the prices carried out between independent entities. Arm's length transaction is one negotiated by related parties, each acting in its own interest and it is the basis for a fair market value determination. Arm's length pricing has been defined in Article 7 of the OECD Guidelines on Transfer Pricing in the permanent establishment context and in Article 9 in the associated enterprise context.

Introduction

A substantial volume of global trade comprises transactions between related enterprises within groups of multinational enterprises (MNEs). The transactions between such related or associated enterprises may take place under conditions different from those taking place between independent enterprises. Transfer pricing is a term used for pricing of such cross-border, intra-group transactions in goods, intangibles or services including financial services. The prices of such transactions between associated enterprises should, however, for tax purposes be in conformity with those which would be charged between independent enterprises, usually, referred to as arm's length pricing. Arm's length simply means 'at a distance, not on familiar or friendly terms'. Arm's length pricing is an international standard that compares the transfer prices charged between associated enterprises with the prices carried out between independent entities. Arm's length transaction is one negotiated by related parties, each acting in its own interest and it is the basis for a fair market value determination. Arm's length pricing has been defined in Article 7 of the OECD Guidelines on Transfer Pricing in the permanent establishment context and in Article 9 in the associated enterprise context.

Object of Transfer Pricing Regulations

In India, transfer pricing regulations date back to 1939 which were adopted in the 1961 Act. In view of the increasing participation of MNEs in the economic life of India, particularly, after the liberalisation of the Indian economy in 1991, a need was felt to provide a detailed statutory framework which can lead to a reasonable, fair and equitable profit allocation and tax to India. Accordingly, sections 92 to 92F were introduced with effect from 01.04.2002 along with rules 10A to 10E notified on 21.08.2002. These provisions covered the meaning of the terms *'international transaction'* and *'associated enterprises'* besides providing methods for computation of arm's length price and documentation requirements. The provisions also created an authority named as Transfer Pricing Officer for the specialised role of determining arm's length price after the assessing officer has made a reference of an international transaction to the above authority. This process was completed after extensive consultations and feedback from all the stakeholders.

The basic intention underlying these transfer pricing regulations was to prevent shifting out of profits from India by manipulating prices charged in international transactions, thereby eroding the country's tax base.

Associated Enterprise

This concept adopted from the OECD guidelines was primarily based on the participation, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise. The deeming provision extended the meaning to control of the other enterprise through shareholding or voting right or by advancing loan or providing guarantee or the use of know-how patents, trademark etc., or the manufacturing being wholly dependent or by being a major supplier of raw materials or consumables or being in a position to influence the pricing or other such influences. It is the reality of control rather than the form or mode of its exercise that is decisive in the presumption of control.

International Transaction

It means a transaction between two or more associated enterprises, either or both of whom are non-residents by way of transfer of tangible or intangible property or advancing of loans or providing services having a bearing on income or assets. Certain specified domestic transactions prone to price manipulations were also included. The scope of the term *'international transactions'* was expanded by providing a clarificatory amendment to include various modes of transactions, particularly, relating to intangible property, capital financing, provision of technical, managerial or consultancy services and business restructuring.

Arm's Length Methods

In conformity with the OECD guidelines, the methods provided are direct and indirect. **The direct methods** are the comparable uncontrolled price method, the resale price method and the cost plus method. These direct methods compare the prices or the normal gross profit margins or the normal gross profit mark-ups respectively. **The indirect methods** are the profit split method that splits the combined net profit and the transactional net margin method that compares the net profit margin or the operating profit relating to an appropriate base such as cost, sales or assets. In India, in most of the cases, the transactional net margin method is applied followed by the resale price method and cost plus method. The profit split method is applied in very few cases. There is also a **residuary method** as may be prescribed by the CBDT.

Most Appropriate Method

The most appropriate method is selected having regard to the nature of transaction, the method that provides the **most reliable measure of an arm's length price** in relation to the international transaction and the functions performed taking into account assets employed and risks assumed. The function performed may relate to market or product development or procurement or inventory management or quality control or selling and marketing. The assets employed may be tangible like product distribution activity or computer systems or general office facilities or intangible including trademarks, patents, know-how etc. The risks assumed include those relative to the market, product liability, credit, inventory obsolescence, foreign currency, R&D, financing and country/regional risks.

Besides the above, the selection of the most appropriate method depends upon the degree of comparability between the international transaction and that of the selected comparables. Another factor is the availability and reliability of data and assumptions necessary or application of the method along with the extent to which reliable and accurate adjustment can be made to account for the differences with the comparable transaction.

Arm's Length Range

Since transfer pricing is not an exact science, quite often, the application of the most appropriate method produces a range of figure all of which are equally reliable. In India, the earlier mode based on arithmetical mean has been substituted partly by the arm's length range applicable only where the resale price method or the cost plus method or the transactional net margin method is being applied. The application is based on the dataset consisting of six or more entries and the arm's length range beginning from the 35th percentile of the dataset and ending on 65th percentile. The range concept is not applicable where methods other than these are being applied.

Comparability

For determining the arm's length price by the most appropriate method, comparability is at the heart of the matter. The factors for comparability are the specific characteristics of the property transferred or services provided in the transaction under review and comparable transaction, the functions performed, taking into account assets employed, the risks assumed by the respective parties to the transactions and the contractual terms and conditions prevailing in the relevant markets. The other factors are geographical location and size of the market, the laws and Government orders in force, cost of labour and capital in the respective markets, overall economic development and level of competition and whether the markets are wholesale or retail. In India, the adjustments for differences between comparable transaction and the transaction under review that could materially affect the prices, the gross profit margin or profit mark-up or net profit has proved to be the most litigation prone area.

Special Considerations for certain transactions

For transactions involving transfer of intangible property, provision of intra-group services, intra-group financing, cost contribution arrangements and business restructuring, there are special considerations.

In the transactions involving transfer of intangible property, the critical aspects to be considered are the identification of the specific intangibles, its legal and beneficial ownership, the contribution of each enterprise to their development, enhancement, maintenance, protection and exploitation in addition to the manner in which it contributes to the creation of value. In India, there have been a large number of disputes relating to the arm's length compensation to be made to the Indian enterprise for its contribution to the advertisement, marketing and promotion expenses enhancing the value of the foreign brand.

The compensation for contract research and manufacturing services provided by the Indian enterprise to its overseas parent or associate has been another litigation prone area. In transfer pricing analysis, the initial factor is whether services have, in fact, been rendered and if so, what is the economic or commercial value of such services and, finally, whether the amount of service charge conforms to arm's length standard.

The emerging markets like China and India are becoming sources of foreign investments. The factors for determining arm's length interest rate for such investments are the principal amount, the duration of the loan, the security involved, the credit standing of the borrower and the interest rate prevailing at the situs of the lender for comparable loans between unrelated parties.

In cases of cost contribution arrangements, in any allocation of interest or cost or expense between the participants, arm's length standard has to be applied. This is to be done after determining the participants, the expected benefits to each participant from the arrangement and the value of its contribution.

There have been cases of intentional profit shifting through restructuring by shifting of functions, assets and risks within the enterprises belonging to MNE groups. In transfer pricing analysis, it has to be seen whether the conduct of the enterprises conforms to the contractual allocation of risks and whether they are at arm's length. The actual transaction undertaken including role of contractual terms and the economic substance of the transaction have to be examined.

Safe Harbour Rules

India, like Australia and Mexico, has adopted safe harbour rules that are consistent with arm's length standard. These rules were introduced in 2013 and were liberalised in 2017. They are intended to reduce the administrative burden of Revenue by exempting low-value adding intra-group services from audit for simplified compliance and to provide certainty. The assessees eligible for opting these rules are those engaged in providing software development services or IT-enabled services or knowledge process outsourcing services with insignificant risks to the non-resident associated enterprise. Assessees engaged in contract research and development services relating to manufacture and export of core auto components apart from generic pharmaceutical drugs and those who have made intra-groups loans or provided corporate guarantee may also opt for safe harbour subject to specified conditions.

Burden of Proof

It is mandated that a taxpayer while furnishing the return of income shall compute any income or expense rising from international transaction having regard to the arm's length price. He has to establish this by maintaining the prescribed documents. Thus, the primary onus is on the taxpayer to determine an arm's length price and to substantiate the same with prescribed documentation. The underlying logic for this burden is that he being a party to the transaction, he has full knowledge of the same and the profits earned by him. In case of failure on the part of taxpayer to establish that the declared price conforms to arm's length standard, it is for the tax authority to determine such price. In case an arm's length price declared by the assessee is rejected, the burden shifts to the tax authority to re-compute the price as per the rules.

Documentation

The documentation requirement is guided by the burden of proof. The documentation requirements are intended to ensure that taxpayers give appropriate consideration in establishing prices of transactions with associated enterprises. Secondly, to provide tax administration with the information necessary to conduct an informed transfer pricing risk assessment. Finally, to provide tax administration with useful information to be employed in conducting a thorough audit.

In keeping with India's commitment to implement the recommendation of BEPS Action 13 report on documentation and country-by-country reporting, enabling amendments were introduced in 2016. Pursuant to these amendments, as per notification dated 31.10.2017, the rules and forms thereunder were introduced. **Accordingly, India adopted a three- tiered approach** by envisaging a master file, a local file and a country-by-country report. This, in fact, is a landmark development and fulfils a long felt need of the tax administrations particularly, of the developing countries for access to the required information for transfer pricing analysis.

The **master file** is to be furnished by a constituent entity of an international group having consolidated group revenue exceeding 500 crore rupees and the aggregate value of international transaction exceeding 50 crore rupees. The master file provides a blueprint of the international group with the information in respect of ownership structure and the nature of businesses. The next item is the important drivers of profit of such businesses, particularly, overall strategy of the international group for the development, ownership and exploitation of intangible property, including location of principal research and development facilities and their management besides all the important intangible property owned by the group. It includes a brief description of important service arrangements made among members of the international group, details about transfer pricing policy or allocating service costs and determining prices paid for services. The next is the details about intra-group funding including central financing functions.

In contrast to the master file providing a blueprint of the MNE group, the **local file** provides more detailed information relating to the specific intercompany transactions supplementing the master file. The local file provides the local organisation chart and each material category of international transactions in which the entity is involved.

The **country-by-country report** is to be furnished by a parent entity or an alternate reporting entity or any other constituent entity resident in India. It furnishes location-wise indicators of economic activities like the revenue from transactions with unrelated and related parties, the profit (loss) before income tax, income tax accrued and paid on cash basis, stated capital, accumulated earnings, number of employees and tangible assets other than cash. It also provides the main business activities and particulars of R&D and intangibles, services and financial services by each constituent entity.

Penalties

The object of penalty provisions is to provide a disincentive against non-compliance of taxation laws and to encourage compliance. Hence, penalties have been stipulated for failure to keep and maintain the required documents, for failure to furnish the prescribed report from an accountant as also for concealing the particulars of income or furnishing inaccurate particulars thereof. The defence against penalty is existence of reasonable cause or taxpayer's good faith and due diligence.

Dispute Resolution Mechanisms

An early finalisation of tax liability is a prerequisite for any effective tax system enabling early collection of revenues legally due. The dispute resolution mechanisms applicable to the taxes on income relating to cross-border transactions comprise **domestic mechanisms** and the **mutual agreement procedures** under the tax treaties. The domestic mechanism consists of appeals and judicial reviews. The mutual agreement procedure to resolve the issues arising under the tax treaties is the other limb of the mechanism. It is for the taxpayer to choose the forum which will be the most effective, depending upon the facts and circumstances of his case.

The first appellate authority is the CIT(A). However, any person in whose case there is variation in the income or loss returned as per the order proposed by the assessing officer, on the basis of the computation by the TPO of the arm's length price as also a foreign company, the draft of the order of assessment which is prejudicial to the interest of the assessee and the variation is not acceptable to the taxpayer, he can file his objections to the **Dispute Resolution Panels** (DRP) based in Delhi and Mumbai. This Panel comprises three Commissioners who are its full time members. The powers of the DRP are coterminous with those of the assessing officer. The DRP is empowered to issue such directions as he thinks fit after considering the draft order, the objections by the assessee and the evidence furnished or collected. An order passed by an assessing officer pursuant to the directions of the DRP is appealable before the Tribunal which is the final fact finding authority. An appeal lies to the High Court from any order of Tribunal involving a substantial question of law. An appeal is provided to the Supreme Court from any judgement of High Court subject to certificate of fitness by the High Court certifying that the case involves a substantial question of law of general importance. India has developed a sophisticated body of case laws.

Article 25 of Model Double Taxation Convention provides an alternative mechanism in the form of **Mutual Agreement Procedure** (MAP) irrespective of the remedies provided by the domestic law of the respective States. It is the responsibility of tax administrations who are parties to tax Conventions to ensure that the taxpayers are not subjected to double taxation, do not avail of unintended double non-taxation and are not subjected to taxation not in accordance with the provisions of a tax Convention. MAP is intended to resolve disputes in respect of these issues. A large number of cases under MAP are in the context of transfer pricing problems and the issue of the existence of PE.

Advance Pricing Agreement (APA) is an arrangement in respect of certain specified transactions that determines in advance for a specified period, the appropriate criteria for determining the arm's length price of an international transaction or specifies the manner in which such price is to be determined. This is a dispute prevention mechanism. The main purpose of an APA is to supplement traditional administrative, judicial and treaty mechanisms for resolving transfer pricing issues in an environment of co-operative and non-adversarial negotiation for resolution of transfer pricing issues.

There are **three types of APAs,** namely, unilateral, bilateral and multilateral. This process is initiated with pre-filing consultation followed by furnishing of an APA application, due diligence, analysis of the terms of application by the APA team, negotiation between the competent authorities in the cases of bilateral or multilateral APA, acceptance or rejection of an APA application, entering into APA, its implementation, filing of annual compliance report by the taxpayer and compliance audit by the tax authorities concerned. This may result on renewal, revocation, revision or cancellation of the APA.

Capacity Building

The negotiation of APAs and the analysis of the country-by-country reporting are critical for the capacity building of Revenue by having access to the required information for transfer pricing analysis. This will address the problem of asymmetry of information between the taxpayer and the tax administration contributing to reduction in tax disputes.

Mission of Taxalogue

To provide a platform and build a network amongst tax officers, tax practitioners, eminent personalities, tax payers etc., for sharing and discussing matters related to tax issues, administrative best practices, such other matters as deemed to be of educational/professional value etc., with a view to promote effective and litigation-free tax administration, voluntary compliance and tax payer service.

Represents

- Sun, the giver of light dispelling darkness and Life sustenance /
- Government /
- Core of Lotus (Wisdom) /
- Discussion Table in which the Round table signifies equality of participants.

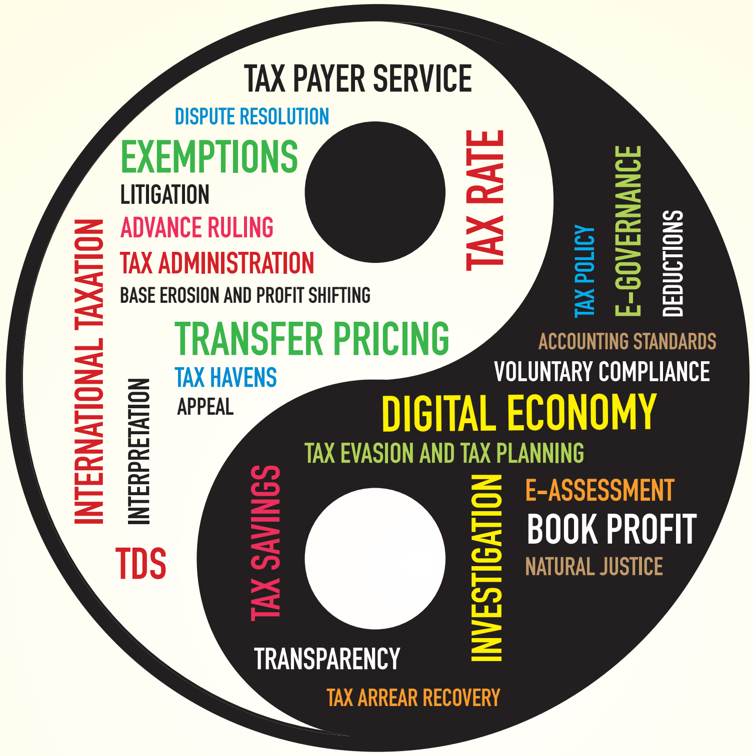
TAXALOGUE

Represents

- Lotus petals (Wisdom) /
- Sun rays (Disemination of knowledge) /
- Multiple stakeholders such as Tax payer, Tax Advisors and Tax men etc, coming together to share and discuss.

Represents

- Open book (Knowledge, transparency) /
- Sea waves (Fluidity, Infinity) /
- Bird in flight (freedom)



The Yin-Yang literally means "dark-bright"/ "negative-positive". This concept of dualism describes as to how seemingly opposite or contrary forces may actually be complementary, interconnected, and interdependent in the natural world, and how they may give rise to each other as they interrelate to one another.

Yin and yang can be thought of as complementary (rather than opposing) forces that interact to form a dynamic system in which the whole is greater than the assembled parts.

The Income Tax Department endeavours to achieve this synergy among tax officers, tax practitioners and tax payers to make tax compliance in India a pleasant experience.

An Initiative by
Directorate of Legal & Research
Central Board of Direct Taxes
Income Tax Department
Goverment of India