



# CHALLENGES *of* INDIAN TAX ADMINISTRATION

Edited by  
Rajiva Ranjan Singh



# TAXPAYER INFORMATION SERVICES

- ANANDITA BAGCHI AND KALYAN CHAND

## EXECUTIVE SUMMARY

---

Every tax administration throughout the world collects taxes from its taxpayers in order to garner resources for the government's public expenditure. Naturally, this process becomes easier for the tax administration if the taxpayers willingly and voluntarily comply with their obligations under the country's tax code. In enhancing taxpayers' level of voluntary compliance, three factors play a very important role – **certainty** about the tax to be paid (it relates to the ability to determine without any ambiguity, the tax payable on any transaction since ambiguity adds to the cost of compliance), the **convenience** to pay it (the means and methods using which the taxpayer can pay his share of tax to the government with minimum compliance cost), and the **attitude** of the tax administration which drives both of these (helpful, unobtrusive and non-adversarial). It is therefore an important responsibility of every country's revenue body to provide relevant and easily understandable information to the taxpayers which would help facilitate paying of taxes, filing of returns and other activities by the taxpayers. As a corollary to this, improving information service delivery also becomes critical to boost the said voluntary compliance. In the realm of information service delivery, revenue bodies have realised that each category or group of taxpayers act or respond differently to their immediate tax environment as well as to the information that is provided by the revenue bodies. There is a need to carry out 'taxpayer segmentation' so that the diverse categories of taxpayers can be catered to accordingly.

In the introductory part of this paper, the authors have captured how the attitude of tax administrations towards taxpayers has been changing over time from the '*Command and Control*' model to the '*Voluntary Compliance*' model and also enumerate a few tax administrations as examples to show how the rights of the taxpayers are secured through taxpayers' charters and bills of rights. '*Development of Strategic Plans by the Tax Administrations of the World*' brings out the necessity for revenue bodies to plan in order for them to achieve decided targets in a number of areas including increased taxpayer satisfaction. The next part of the paper is where most of the focus lies – '*Taxpayer Information Services – analysing various tax administrations*'. This section elaborates the need to understand taxpayer behaviour and compliance attitudes. It also sets out the manner in which some other tax administrations are carrying out taxpayer attitudinal research and tailoring information service delivery accordingly. The authors have then discussed the following traditional and contemporary means of delivering information to the taxpayers: website of the tax administration, educational publications for taxpayer

information, circulars and rulings, call centres and IVRS, written communication, publicity campaigns, social media technologies, and community engagement programmes. Within these, the best practices of other tax administrations have been cited and it has been suggested that India too must adopt those. Currently in India, we see that there is an increased recognition of the necessity to make taxpayers' lives simpler. The Indian tax administration is also taking steps towards that end. However, what we notice is that even though the Indian tax administration is doing many things which other tax administrations are, the manner in which they are done differ greatly and therefore the effectiveness diminishes.

The paper then moves on to discuss a few aspects of the quality of taxpayer information services, the establishment of service delivery standards and performance against them. A very important aspect that is covered is the manner in which a few other tax administrations conduct taxpayer satisfaction/perception surveys and place the results in public domain. These are extremely important in gauging the effectiveness of the information services that are being provided to the taxpayers. Currently, India does not engage in any such research and the authors suggest that this should be started at the earliest. Towards the end, the essential nature of having dedicated, willing and knowledgeable staff and office/unit for dissemination of information to taxpayers is stressed on. The paper concludes with recommendations which the Indian tax administration could consider implementing in order to augment the provision of taxpayer information services to its tax-paying community.

# WIDENING OF TAXPAYER BASE

- RAJIVA RANJAN SINGH AND STUTI MANCHANDA

## EXECUTIVE SUMMARY

---

India with a population of nearly 125 crores has a very low tax payer base of about 4.5 crores. This is less than 4 per cent of the total population but the number of return filers is still lower at 3 per cent. The purpose of this report is to highlight the narrow tax payer base in India in terms of the potential taxpayers who by law, economic and other evidence should be within the tax net. This is not an attempt to predict the exact numbers but gives an idea and an indicative approach for future work in this area. The approach of the report has a non- intrusive technology based focus on procedural, administrative and other changes in the Indian tax administration to widen the tax payer base.

The report is organized in six broad sections. The first section '*Is the Number of taxpayers adequate*' looks at some national and cross country statistics to indicate that even though the number of taxpayers in the country has increased over the years but it still lies below its potential level. Data on cash transactions, black economy, number of professionals and Micro, Small and Medium Enterprises (MSMEs) indicates the scope to fill the gap in the base. Based on a number of estimates of middle class in India and their income brackets, it has been pointed that a large no. of individuals who are seen as potential tax filers are actually non-compliant. The second section '*Measures taken to widen the taxpayer base*' looks to acknowledge the initiatives that have been undertaken or are in the pipeline by the Income Tax Department (ITD). This includes presumptive taxation, TDS, TCS, AIR, STT, BCTT and a host of other initiatives including some of the latest steps taken by the incumbent government. However, despite these steps, there are certain loose ends that remain to be addressed. The third section '*Problems of the present system*' throws light on the problems that exist with the current initiatives and practices of the department including the PAN system and why they are not working effectively. Lack of comprehensive list of reportable transactions under AIR and CIB, lack of capacity in collection and utilization of data, lack of tax payer awareness, lack of uniformity in Rules relating to use of PAN especially for third party reporting and various administrative problems are discussed. The fourth section '*Good practices followed by other tax administrations*' looks to address the problems discussed in the previous section in order to fill the prevailing gaps by learning from global best practices of other tax administrations and comparing to Indian administration. This includes 1) taxpayer registration system as it is the foundation for any other initiative, 2) third party reporting, 3) data collation, matching and business analytics and 4) use of electronic cash registers. The fifth section '*Possible solutions*' discusses some possible solutions that can be applied to the Indian context given its current standing.

The idea is to importantly address the gaps in taxpayer information and database and use of technology, that is, the practices that can be adopted to create a comprehensive taxpayer database which is the foundation for any non-intrusive initiative to widen or deepen the tax base. The final section '*Conclusion and recommendations*' sums up the whole issue on account of prevailing tax administrative and tax payer situation, gaps in the Indian tax administration and recommends initiatives based on best practices from successful tax administrations.

# RISK-BASED AUDIT FOR IMPROVED COMPLIANCE

- SANJAY KUMAR

## EXECUTIVE SUMMARY

---

Ensuring higher tax compliance has been, and continues to be, one of the key objectives of the tax administrations, and to achieve that they usually employ detailed enforcement mechanisms. But of late, there is a change in that emphasis. Modern tax administrations are beginning to recognize the importance of self-assessment and voluntary compliance, and tax enforcement are beginning to be based on risk identification and its management. Two reasons for that – one, it is impossible for any revenue administration to control and check every single taxpayer and second, it is wasteful to routinely examine low-risk, compliant taxpayers. All these are part of a holistic and co-operative approach to enhance taxpayers' compliance by addressing compliance risks in a structured manner as part of multi-year strategic planning.

Indian tax administration (direct taxes) moved on that path sometime ago, *albeit* in a very cautious manner, as part of its many incremental reforms, and has set up a risk-based audit system, called a computer-aided scrutiny system (CASS). But what is of note is that despite setting up CASS some years ago, manual selection of tax audits has not stopped. This paper explores the merits of moving to a full-fledged risk-based audit system, and also outlines the institutional uncertainties over such changeovers. The author, being an ex-IRS officer, understands the general fear of the CBDT – the biggest fear of the CBDT in moving fully to the risk-based compliance system is risk to the likely tax collection. To that, the paper states that these risks and perceived fears can often derail any reform programme and suggests that it is imperative that all such debatable, grey areas are properly considered and steps to mitigate these challenges are properly delineated so that the uncertainty and institutional risks can be minimised. To provide a well-structured and delineated path, the paper also presents a SWOT analysis of institutional risk, and suggests that such analyses can help come over the perceived risks.

The paper also suggests that the tax administration should move towards a compliance management approach and must work with the taxpayers for improving the compliance – an approach adopted by many developed tax administrations. This is particularly important from the sustainability point of view of the reform process, and in that effort has suggested making use of the vast amounts of data the CBDT already has concerning a large number of taxpayers. The data will allow differentiated taxpayer services to different risk-segments of the taxpayers, and will help the tax administration build up a truly risk-based workflows for processing the registration, filing, reporting and payment transactions that the taxpayers make or should make. A comprehensive risk rating, based on data mining

modeling, can be applied to each transaction so that all available relevant data are utilized. As a result, high-risk transactions and the taxpayers can be flagged for case-specific treatment while low-risk transactions can move on to routine attention. The emphasis in this above approach is on managing tax compliance, and developing a more consultative and collaborative relationship with the taxpayer. This will help the tax administration better understand business and its environment. A dialogue between the tax administration and taxpayers (may be, large businesses only) can reduce incidence of tax shortfalls and administrative penalties, and promote good corporate governance.

To achieve that, the paper suggests, that proper staff training would be required on two issues – one, change in attitude, from just an enforcement agency role to a consultative and collaborative relationship with the taxpayers and two, enhanced capability for working on the digital medium. Since a fully-operational risk-based compliance system will eventually require moving fully to digital auditing, it may require change in the business process, demanding, perhaps, the creation of new audit procedures to conduct the tax compliance audit. It will thus be important for the CBDT to identify the required capabilities for audit roles, along with identifying capability gaps and so that a suitable development training programme can be set up.

The paper suggests that risk identification tend to be transaction-led, based on limited information, and so it is important to put in place a system which aggregates the taxpayer information within the organisation, and not work in silos, so that an analytical approach, based on strong IT infrastructure with improved data management, could be put in place. The paper also mentions that recently announced BEPS actions is likely to throw up new challenges, as more and more data are going to be there in the system through master file and CbC reporting. How the new data is managed and harnessed for risk identification and audit selection will be a challenge that would require enhanced capability of the staff and officers, including the ability to carry out audit on the digital platform, away from the existing paper environment.



# **TRANSFER PRICING DOCUMENTATION REQUIREMENT**

- K.R. SEKAR, GAUTAM MALLICK, MANISHA GUPTA

## **EXECUTIVE SUMMARY**

---

The transfer pricing regulations (TPR) were introduced in India in the year 2001. India was among the very few countries which required the taxpayers to report all the related party transactions to the tax authorities. Indian TPR also required the taxpayer to maintain contemporaneous documentation. Though the regulations were in line with the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines), there were some notable deviations. The notable deviations were use of arithmetic mean and the requirement to demonstrate that the previous two years of data have a bearing on the current year of analysis for use of previous two years of data. The TPR prescribed stringent penalties for non-maintenance as well as non-submission of documents by taxpayers.

The importance of transfer pricing documentation has been emphasised by numerous court decision and a well maintained documentation has enabled taxpayer avoid any transfer pricing adjustment. Though the Indian TPR prescribes the documentation to be maintained, no specific guidelines have been prescribed for typical transactions like management services or companies incurring sustainably losses during start-up phase or for companies adopting marginal cost pricing.

Indian tax authorities during audits have been proposing adjustment to the transfer price of the taxpayer in case the taxpayer has incurred losses and has entered into related party transactions without analysing the reasons for such losses. Similarly, payment of management charges have been challenged by the authorities and have summarily determined the arm's length price to be nil. On the other hand the appellate have considered and appreciated the documentation maintained by taxpayer and have in most of the cases ruled in favour of the taxpayer.

Given this background, in order to avoid litigation, the tax authorities may consider issuing guidelines on the transfer pricing documentation that needs to be maintained by the taxpayer for specific transactions. This chapter analyses the transfer pricing documentation guidelines issued by various countries and provides guidance on the type of documentation that could help both the taxpayers and the tax authorities mitigate transfer pricing litigation.

# **TRANSFER PRICING METHODS AND COMPARABILITY ADJUSTMENTS**

- K.R. SEKAR, GAUTAM MALLICK, MANISHA GUPTA

## **EXECUTIVE SUMMARY**

---

The Indian transfer pricing regulations (TPR) prescribes six methods for determining the arm's length price of the related party transactions. The taxpayer is required to select the most appropriate method among the prescribed six methods to arrive at the arm's length price of transactions. In applying a method selected for arriving at the arm's length price, the taxpayer needs to consider the specific characteristics of the property transferred or services provided in the two transactions, the functions performed, assets employed or to be employed and the risks assumed by the respective parties, the contractual terms transactions, conditions prevailing in the markets in which the respective parties to the transactions operate.

The India TPR also provides for adjustment to the transfer price if there are differences between the transactions being compared, or between the enterprises entering into such transactions.

The India tax authorities recently notified rules on use of multiple year data and the range concept. Prior to the issue of these rules, data of the year in which the transaction has taken place was used for arriving at the arm's length price. The taxpayer was allowed to use prior two years of data if it was able to demonstrate that the prior two years of data has a bearing on the year on which the transaction has taken place. The use of multiple years of data has been restricted to profit based methods (Cost plus method, resale price method and transaction net margin method).

The rules have also introduced the range concept. Though the inter-quartile range was not adopted by the India tax authorities, the 35<sup>th</sup> and 65<sup>th</sup> percentile has been adopted. The percentile range could only be applied only if six or more comparable enterprises have been selected for determining the arm's length price of the related party transaction. In case there are less than six comparable enterprises, the average of such price would be applied for determining the arm's length price.

The changes proposed by the Indian tax authorities would have a long term impact in reduce transfer pricing litigation. This chapter outlines the transfer pricing method adopted in India and other active transfer pricing regulations countries and new rules notified by the Indian tax authorities.

# TAX DISPUTE RESOLUTION

- MUKESH BUTANI

## EXECUTIVE SUMMARY

---

A lot has changed since India began embracing economic liberalization more than two decades ago. Successive governments have rolled out measures to improve India's attractiveness as preferred investment destination. Over these years India's fiscal statutes have undergone comprehensive reforms too, although the pace of reforms has been rather tardy and often trailed in keeping up with rapidly emerging business landscape.

Effective tax administration and efficient dispute resolution are two elements at the core of ease of doing business in any jurisdiction. Ease of tax compliance features prominently in the list of relevant parameters for determining global 'ease of doing business' rankings published by the World Bank. The latest World Bank report (of 2015) puts India at 130 place, twelve notches higher than the previous rating (142 place); albeit, we as a country continue to fare poorly on certain key indices including ease of tax compliance and dispute resolution. The process of tax compliance in India has been historically cumbersome. At last count, there are 33 tax payments that a business is required to comply with, and it takes close to 250 hours a year towards ensuring mere compliance. Onerous tax litigation procedure and frivolous tax demands in some cases add to taxpayers' plight. A majority of reasons can be ascribed to the present state of tax administration and disappointing pace of dispute resolution across different forums.

This Chapter, further divided into five sub-chapters, is premised on the research undertaken to understand functioning of tax administration and dispute resolution forums in India, and select international practices across the globe.

Our research in this Chapter is duly supplemented by experiences in dealing with administration, dispute resolution forums, and useful precedences emerging from understanding best practices. Each of the sub-chapter culminates into a broad range of recommendations on measures which could be considered towards enhancing the efficacy of 'service delivery' to taxpayers.

The broad architecture of this chapter is, thus, summarized below:

Subchapter 1 presents statistical highlights for tax-to-gross domestic production data, which underlines the significance of tax revenues for Government exchequer. The Chapter also traces the evolution of Indian tax system, providing insights on nuances of tax policy

making in India, along with an overview of dispute resolution forums for tax matters. Another section in this subchapter reasons the sub optimal performance of administration and how shortcomings of dispute resolution system has adversely impacted investment flows into the country, though in recent past the government tax policies have attempted to salvage the situation.

Subchapter 2 focuses on reasons contributing to rising instances of tax disputes in India. The significance of 3C's (Certainty, Clarity and Consistency) in tax policy landscape needs to be absorbed by both administration and judiciary, for creating a positive investment climate. In this subchapter, we have also summarized ideas to drawn upon global best practices in addressing challenges of Indian tax administration and tax dispute forums.

In subchapter 3, we have attempted to analyze functioning of traditional forums available for tax dispute resolution [i.e. Commissioner (Appeals), Appellate Tribunals, High Court, Supreme Court] and come up with a set of recommendations towards evolving a more effective approach to tax dispute resolution. There is a strong case for evaluating best practices emerging from review of tax policies/ administration of select economies and draw upon some of these best practices. This subchapter also touches upon the relevance of National Tax Tribunal as an alternate forum for efficacious resolution of tax disputes, particularly in wake of staggering statistics of tax disputes, even though the constitutionality of NTT (in its proposed format) is no longer an open debate following the Apex Court's ruling.

In subchapter 4, focus is on policy and practices towards evolving effective Alternate Dispute Resolution ("ADR") forums. Many countries, such as the US, Australia, UK, have successfully implemented ADR mechanism to deal with tax disputes, and it is important for dispute-ridden country like India to leverage learnings of such countries and evolve a more robust dispute resolution machinery.

Lastly, subchapter 5 presents a snapshot on emerging tax policy landscape – both in international and Indian context. While embracing progressive era of tax policies, it is inescapable for policymakers to take into account challenges of such transition and adequately equip tax administration and taxpayers to enable the shift at administrative level.

# TAX DEBT RECOVERY – A CHALLENGE

- HARISH KUMAR WITH INPUTS FROM SANJAY KUMAR

## EXECUTIVE SUMMARY

---

Recovery of taxes is one of the most important functions of tax administrations, to a large extent the *sine qua non* for efficiency and efficacy of the tax administration. The aim of tax administration is to attain high rates of voluntary on-time payment and low incidence of tax arrears. Achieving this requires a high level of on-time filing to establish amounts owed and quick follow-up when payment is overdue. An effective arrears management system would identify and report all tax dues, provide a consolidated picture of the taxpayer's total tax arrears, prioritize arrears cases based on risk criteria (e.g., size of arrears, age of arrears, number of taxes involved, taxpayer's payment history), and apply taxpayer' profiling analytics which would predict the most effective action to achieve payment of the debt based on known circumstances and behavior. The desired outcome is likely to be achieved when the collection system reduces the incidence of unpaid taxes, reduce the size of the tax administration's total tax arrears inventory relative to annual core tax collections, and also reduce the extent of old core tax arrears (a high percentage may indicate poor debt collection practices and performance). Tax administrators need to make tax payment part of the normal system of doing business and as close to the event creating the liability as possible, in order to eliminate or reduce the risk of non- or late-payment.

Indian direct tax administration has not shown a particularly healthy trend on recovery of taxes, despite registering impressive year-on-year growth in overall collection of the taxes over the last decade, and this should be a cause for concern for the Central Board of Direct Taxes (CBDT). Relevant data, as shown in the Chapter, shows that the tax department is increasing the tax debt stock year-after-year: percentage of actual tax collections to the tax debt stock (total pending demand) has gone down from FY 2009-10 to 2013-14. This is not a sign of a modernizing tax administration and more importantly, it puts undue pressure on fiscal deficit. No government can afford to bring new tax instruments to augment its tax revenue, and not collect the tax debt on time. It defeats the basic principle of public finance principle. Such a lackadaisical approach calls for a paradigm shift in the tax debt management. The recent Tax Administration Reforms Commission (TARC) report also suggested a change in the tax collection approach and recommended that the present approach to tax collections of identifying debts should be changed to an approach based on identifying debtors and understanding their behaviour. To do that, the TARC also recommended that there should be a separate vertical focusing only on tax collections.

This chapter discusses various systemic limitations which hinder the desired results, namely, lengthy and tortuous legal process for recovery spread over many years and thereby making the recovery process ineffectual, archaic assessment process which emphasizes revenue-oriented or cautious approach rather than a judicious and matter-of-fact approach, inaccurate database making recovery without proper risk assessment and finally, inadequate staff allocation for recovery – even the Public Accounts Committee (2013-14) in its 87<sup>th</sup> report on tax administration pointed out that the “*Tax Recovery Wing in the Department has been functioning with depleted staff strength*”.

It has also been pointed out in the chapter that many advanced and fast modernizing tax administrations have of late been developing strategies and approaches to improve the tax collection and recovery processes, resulting in some spectacular improvements in performance in tax collection and recovery. These tax administrations are accurately targeting tax debtors using advanced analytics and other information so that there is right intervention at the right time, ranging from soft measures designed to prevent taxpayers from falling into debt in the first place through to tough enforcement measures and thereby eliminating ineffective interventions and improving revenue flow. Studying debtor behaviour is another important aspect of improving tax collection, ensuring that the tax administration is responsive to changes and often, ahead of the debtor to accomplish the task at hand, i.e., collecting the taxes. This shift in tax compliance strategy is towards prevention through different approaches.

While all these steps are towards making a paradigm shift in the approach and focus on tax recovery, what is important worth emphasizing is that the government needs to take its first step, with a willingness to tackle the problem in right spirit, backed by right action, based on a well-considered debt management strategy, aimed at increasing the likelihood of debt recovery, improving the speed of collection and reducing the cost of recovery. Without such approach, we will witness accretion of tax debt stock, and a lackadaisical tax administration which will further dither into an abyss with point of almost no return.

# TAX DATA ANALYSIS

- RAJIVA RANJAN SINGH AND STUTI MANCHANDA

## EXECUTIVE SUMMARY

---

Importance of data has been discussed in various domains. It is acknowledged as the foremost step before formulating any model, theory, policy and legislation. This report is an attempt to highlight the importance of data and fundamental role of research and analysis for tax administration and policy in India. This is a cross country study where data used by various tax administrations, research and analysis carried out by them and the various statistics brought out by them are presented. The purpose is to highlight the usefulness of data and research in tax administration by showcasing their extensive and widespread presence in some of the successful tax administrations around the world.

It has been organized in six sections. The first section '*Tax Statistics*' is an insight into the various kind of data compiled and analysis done to bring out a large variety of tax statistics. India's efforts are presented first followed by the practices of some successful tax administrations which provides a roadmap for Indian tax Research and Analysis wing to undertake such initiatives. It broadly discusses annual statistics, historical statistics and other detailed statistics. The second section '*Research and Analysis*' discusses the types of research that is being undertaken by various tax administrations whether in-house or outsourced, and an idea of various research topics is also given. Tax Gap is an important area that deserves considerable attention. Other kinds include market research, perception surveys and other reports and working papers. In the case of India, some research is carried out by the department as well as private research bodies but very little is available in public domain and there is still a long way to go. The third section '*Regulatory Impact Analysis (RIA)*' discusses about what RIA is and how the tool is being used effectively across administrations for assessing the costs and benefits of various legislative and policy changes, schemes, programs and projects. The use of this tool by various tax administrations is discussed with the intention to stress the importance of bringing such processes in public domain in order to maintain a transparent and an effective system.

The fourth section '*problems of lack of proper utilization of data*' shows that there are mechanisms to collect information/data and that such data is being collected by way of various tax and information returns. But the data is not yet compiled and maintained in the desirable manner which acts as an information constraint for various actions. Indian tax administration can learn from the practices of various tax administrations the importance of initiating such a practice to maintain a comprehensive database. This would help in

generating statistics and trends and help in policy action. The fifth section '*Tax statistics, Tax Data Analysis and Research set-up*' gives a view of the organizational set up of the research and analysis units of the tax administrations of advanced countries and recommends a structure for the Indian set up. This includes a multi-disciplinary body of economists, statisticians, operational researchers, social scientists and IT and general professionals. The last section '*Conclusions and way-forward*' sums up the entire study putting forth its purpose and suggests the way forward for adopting a strategy of Tax Data Analysis by adapting to Indian context. This report, to the best knowledge, is the first kind of an attempt to provide a fundamental ready-made guide of 'how to do' and 'what to do' in the area of tax Analysis and Research.