

Reforms for a Better Tax Governance in India

S. Mahalingam



FORUM
OF FREE ENTERPRISE

"Free Enterprise was born with man and shall survive as long as man survives".

- A. D. Shroff
Founder-President
Forum of Free Enterprise



SHAILESH KAPADIA



(24-12-1949 – 19-10-1988)

Late Mr. Shailesh Kapadia, FCA, was a Chartered Accountant by profession and was a partner of M/s G.M. Kapadia & Co. and M/s Kapadia Associates, Chartered Accountants, Mumbai.



Shailesh qualified as a Chartered Accountant in 1974 after completing his Articles with M/s Dalal & Shah and M/s G.M. Kapadia & Co., Chartered Accountants, Mumbai. Shailesh had done his schooling at Scindia School, Gwalior and he graduated in Commerce from the Sydenham College of Commerce & Economics, Mumbai, in 1970.

Shailesh enjoyed the confidence of clients, colleagues and friends. He had a charming personality and was able to achieve almost every task allotted to him. In his short but dynamic professional career, spanning over fourteen years, Shailesh held important positions in various professional and public institutions.

Shailesh's leadership qualities came to the fore when he was the President of the Bombay Chartered Accountants' Society in the year 1982-83. During his tenure he successfully organized the Third Regional Conference at Mumbai.

Shailesh was member, Institute of Fiscal Studies, U.K.; member of the Law Committee and Vice-Chairman of the Direct Taxation Committee, Indian Merchants' Chamber. He was also a Director of several public companies in India and Trustee of various public Charitable Trusts.

He regularly contributed papers on diverse subjects of professional interest at refresher courses, seminars and conferences organised by professional bodies.



This booklet is sponsored by
SHAILESH KAPADIA MEMORIAL TRUST

INTRODUCTION

We are, indeed, delighted to publish this extremely relevant, timely and insightful booklet on the crucial subject of “Reforms for a Better Tax Governance in India”. This is the full text of the talk delivered by Mr. S. Mahalingam, the former Chief Finance Officer of Tata Consultancy Services recently in Bangalore.

Every single Finance Minister invariably proclaims in his budget speech that his tax proposals and changes have, among other things, an avowed objective of simplifying and rationalising tax structure and tax administration – and making it an increasingly “tax assessee-friendly”! But come and behold, their complexities continue to intensify more and more with every passing year. We are not sure whether this year’s budget is going to be any different, although the Finance Minister assures us that he is moving towards a simplified tax regime, faster settlement of cases, new Dispute Resolution Scheme and making tax administration accountable.

From time to time, many expert commissions and committees have offered their well-thought out and comprehensive policy recommendations and many of them are supposedly accepted and implemented by the government. Yet, the prevailing tax system – both direct and indirect – continue to baffle and exasperate practically most of the stakeholders in the economy, especially the honest tax payers, honest tax practitioners and tax lawyers, and even those who are engaged in tax administration and resolution of tax related judicial disputes. The common man, however, retains his abiding faith that the system

would reform somehow, some day! In turn, he also believes that his fortunes would eventually improve by the government's adoption and implementation of fair, prudent and efficient tax system, and using its positive outcome through rightful mobilisation of tax revenues for betterment of his future.

In this contextual framework, Mr. Mahalingam has given us the benefit of his vast professional knowledge, experience and insights by authoring this excellent booklet. Also, his involvement as a member of Tax Administration Reform Commission, under the Chairmanship of Dr. Parthasarathi Shome, has enabled him to reflect on the fault-lines of our taxation and governance system from very close quarters, be it the issue of retrospective taxation, target-based approach of tax officials in making tax demands, lack of service focus or a huge pile up of pending tax cases in various courts. What is striking is that right upfront, the author points out that *“as you will see from my talk today, this governance system is the cause of the problem and unless we change the tax governance system, we will continue to have tax terrorism in this country”*.

Having so said, Mr. Mahalingam is not just a mere critique of the system, but has several unique, constructive and practical suggestions to offer. Illustratively, after evaluating extensively the dispute resolution/settlement system and huge backlog of pending cases, he suggests an effective compliance management system by classifying the entire class of taxable entities into four broad categories. These are – compliant; triers; fence sitters; and offenders. He then offers divergent strategies to deal with them from self-compliance approach for those who are compliant;

to help and guidance for triers; to balanced mix of persuasion and enforcement measures for fence sitters and their close monitoring; and finally, a whole range of penal measures, including prosecution, to be applied to offenders or habitual offenders.

At the same time, he has many significant reflections on why disputes arise. Besides providing some glimpse of international best practices in dealing with dispute settlements, he also invites our attention to the National Litigation Policy, 2010, which states: *“Government must cease to be a compulsive litigant. The philosophy that matters should be left to the courts for ultimate decision has to be discarded. The easy approach, “let the Court decide” must be eschewed and condemned”*. The author regrets that this is not a policy that is followed and refers to many examples of needless litigation.

Finally, he refers to the imperatives of improving internal processes and also commends the application of technology and their design for enhancing and implementation capability by the tax administration. He also appreciates how *“e-filing and e-payment systems have brought a great deal of convenience to tax payers. Considerable improvement has been made in taking up cases for scrutiny”*. Before dealing with his suggestions for *“organizational structural reform that is required in the area of Human Resources Management”*, he highlights the importance of expanding the tax base; effective revenue management; credible revenue forecasting, based on realistic assumptions; and formulating tax policies grounded on research.

This text of Mr. Mahalingam's talk is also embellished with apt and eloquent quotes from several eminent

experts, and especially of late Mr. Nani Palkhivala. Hence, we would also like to add our own bit, and conclude this introduction by recalling the following two powerful thoughts of late Mr. Palkhivala, which are so very relevant in the current state of taxation and fiscal scenario of our country: *“The fiscal system must have not merely legality but also legitimacy. It is denuded of all legitimacy when there are breaches of faith on the part of the government in its dealings with taxpayers”*. And finally, *“The health of our economy will not improve until we inject the “S” factor into our fiscal laws, and make them Sane, Simple and Stable”*.

Sunil S. Bhandare

Editor

Reforms for a Better Tax Governance in India

S. Mahalingam*

Palkhivala- the multifaceted personality

It is indeed a great honour for me to address a programme organized in memory of the late Nani Palkhivala. Sucheta Dalal, the well known financial journalist, notes in her book on A.D.Shroff, founder of the Forum of Free Enterprise, that Nani Palkhivala, as a public orator, was a discovery of the Forum. Apparently, Mr. Shroff first heard the thirty seven year old Palkhivala speak at a Forum event on 2nd December 1957 and was very impressed. As noted in the book, he had said to M.R.Pai- "where did you find this young man- you must encourage him". Palkhivala went on to deliver his first post budget analysis soon after. He was a master orator who held his audience to

* *The author was formerly Chief Financial Officer (CFO) and Executive Director, Tata Consultancy Services Ltd.(TCS). The text is based on the lecture delivered by him at Bangalore on 13th January 2016 in memory of the late Mr. Nani A. Palkhivala under the auspices of Nani A. Palkhivala Memorial Trust. The booklet is published with kind permission of the Trust for wide circulation.*

rapt attention. Almost immediately, his budget analysis became a big public event. Those were the days when newspapers were the first to get budget reports on slow ticker tapes; there was no televised speech and certainly no instant analysis by a battery of experts. So the post budget speech became a must-attend annual event for the financial community. Soon the Greens Hotel in Bombay could not accommodate all those who sought entry. In 1965, the Forum shifted the event to the much larger Cowasji Jehangir Hall. The event went from strength to strength and moved in 1966 to the east lawns of the Cricket Club of India(CCI) to accommodate the surging crowds. In the 1980s, Palkhivala's budget speech had arguably become the second most important event after the finance minister's budget speech. The venue was the Brabourne stadium and it used to be crowded to capacity until Palkhivala decided in 1994 to stop delivering the speech.

Mr. Palkhivala spoke on the budget in a number of cities in India, after the first speech in Bombay. I used to be one of the organizers of his budget analysis speech in Madras in the 80s and early 90s. We used to hunt for venues each year, as the crowds used to keep increasing. In the last few occasions, venue was the Madras University Centenary Auditorium in the Marina and we used to keep public address system outside on the grounds for people who could not be accommodated in the large hall.

He also gave other speeches in public meetings and it was educative to hear him talk on a number of different topics. In Madras, he spoke at the theosophical

society on "Man - Past, Present and Future", where the subject was largely philosophical. He gave a Prof.Devanesan lecture on Higher Education. One of the most memorable speeches, which was totally spontaneous, was at the Sankara Netralaya, where he went accompanied by Dr.Badrinath on an impromptu invitation. The speech I heard which he gave to hospital staff who had assembled, was enthralling. In that hospital, I was also witness to his charitable instinct, especially giving to causes without any self publicity.

He was also the Founder Chairman of Tata Consultancy services, which was started as a Division of Tata Sons Ltd in 1968. He continued in that role until 1996, except for a short period between 1977 and 1979 when he went as India's Ambassador to the United States. I have had occasions to interact with him during the period he was Chairman on TCS matters. He was proud of the pioneering steps we were taking in TCS to create the IT industry in India. He always took the ethically correct view in business discussions. Along with Mr.F.C.Kohli, he pioneered the IT industry and laid the foundation for India's largest company by market capitalization.

I can go on about his multi dimensional personality. He was of course the greatest jurist of his time. You should read the book "Nani Palkhivala- the Courtroom Genius" written by my friend Mr.Arvind Datar along with Mr. Soli Sorabjee, both great lawyers. They talk about a number of path breaking cases that he argued and the most famous one was the Kesavananda Bharati case which he argued in the Supreme Court

of India, almost single handedly for 31 days , spread over a few months. As the book notes “whatever the defects and the manner in which the case was heard and judgment delivered, the formulation of the basic structure theory saved democracy and preserved the rule of law”. Justice Khanna who was in the bench which heard the case recalled in his memoirs that “ the height of eloquence to which Palkhivala had risen has seldom been equalled and has never been surpassed in the history of the Supreme Court”. He was a great writer- not just books but also newspaper articles. He was a very effective Ambassador of India in the United States – a post he occupied immediately after the lifting of the Emergency. He was a philosopher- one should read his book “India’s Priceless Heritage” to understand his great regard for the spiritual civilization of India. He was the Managing trustee of Veda Pata Nidhi trust which he took up at the behest of the Sankaracharya of Kanchi. There were very many facets to his personality.

Mr. Palkhivala said profoundly once that we keep tackling breezily fifty year problems with five year plans, staffed by two year officers, working with one year appropriations, fondly hoping that somehow the laws of economics will be suspended because we are Indians. As you will see from my talk today, this governance system is the cause of the problem and unless we change the tax governance system, we will continue to have tax terrorism in this country. We need to keep in mind another of his sayings- To tax and to please is not given to men; but to tax and be fair is.

Fault Lines in the Indian Tax System

What are the fault lines in the Indian Tax System? Retrospective taxation squandered the image of India as a safe place for running a business. Tax officials will say that through the demands in the famous case of Vodofone, they were merely plugging a loophole . The question asked by them is how anyone can escape taxation after a large amount is made as profit as a result of value addition in India. All of us in companies have been subjected to infructuous tax demands. The Income Tax official, after making this unjustified tax demand , will helpfully advice you – off the record of course- to seek remedy in the legal system. You will then pay part of this demand and over the next ten years or so spend considerable money and time in fighting this case in various courts. These demands are made because every officer has a target to be met- we have the impression that the Government of India lacks business orientation. However the tax officials have targets and their performance on this front is monitored by the Finance Minister himself. This process of setting targets at various levels and rigorously and regularly monitoring are better than what most highly efficient companies have! Revenue officials are very creative and send tax demands on companies on notional capital gains when foreign companies add to the equity investment in their fully owned subsidiaries in India, ostensibly because the fair valuation of the shares are higher than what they are subscribing at! Tax officials, who have worked only in the Revenue Department, have little grounding in business models, which leads them to think of these novel methods. All of us have experienced delays in

getting refunds because the government wants to reduce the fiscal deficits by not giving refunds. This tells you something about the antiquated accounting system that the government follows. There is a term called "Protective Demands" in their armor. If the revenue authorities have made a demand due to an interpretation of the act, even if another officer finds this interpretation far fetched, he is forced to levy the same demand on another party. Therefore a Rs.10 crore demand on one company can trigger a Rs.100 crore demand on another company, until the original case is decided. No tax officer accepts any adverse verdict, whether from the Commissioner (Appeals) or from Tribunal or from High Court. He will fight on upto Supreme Court. They will do that because they are risk averse. We know about the moral hazard issues , commonly called corruption and it pervades the system. Above all, the Revenue Department has no service focus. Most of the times, you get treated shabbily. They ask you to produce voluminous data of no relevance to the income and tax papers on hand . A senior tax official once told me that the revenue departments of the Government do not discriminate on how they treat tax payers or their own officers. When an officer is treated shabbily by his Department, do you expect him to be nice to taxpayers? Many people ask me what is tax terrorism. The issues I have described above define tax terrorism, as the tax payer experiences it.

Tax Administration Reform Commission (TARC)

Based on the public outcry, Government realized that the time for considering a wholesale transformation

of the tax governance system had come. Sometime back, the Government had established a tax forum, under the chairmanship of Dr.Parthasarathi Shome, Adviser to the Finance Minister, with the rank of Minister of State, where Taxpayers could bring their difficulties and also air issues with tax policies. However, the Government felt the need for involving more experts in reviewing the changes that are required in the Tax Administration system. In 2013, they constituted a Commission called Tax Administration Reform Commission or TARC for short, under the Chairmanship of Dr.Parthasarathi Shome, to review the application of Tax Policies and Tax Laws in the context of global best practices and recommend measures for reforms required in tax administration to enhance its effectiveness and efficiency. There were 12 items in the Terms of Reference. Besides Dr.Shome, six members were appointed. Mr.Zutshi and Mr.Moorthy were former Chairmen of CBEC and CBDT respectively. Mrs. Sunita Kaila and Mr.Y.G.Parande were former members of CBDT and CBEC respectively. These four people brought considerable experience and expertise on Revenue Administration. From the Private sector, the members were Mr.Diwakar, former head of Taxation for Murugappa Group and myself. Secretary of the Commission was a senior Revenue Department official Mr.Sanjay Kumar. This was a highly accomplished set of personnel with considerable experience in Government and Private sector and it was led by Dr.Shome who has worked in IMF, who has taught in US Universities and been a consultant to a number of countries on tax administration reforms.

TARC, in its 18 months of existence, produced four reports over 1370 pages. TARC consulted a large number of experts and had meetings with the Department Officials across India and with Industry Associations. This was truly a collaborative effort. I had experienced Tax Department as an executive in a company. During the course of my membership of this Commission, I learnt a lot about the mandate of the Tax Departments and their structure and these interactions enabled me to develop a better view of the Governance system. This talk is based on the work the Commission did and the recommendations that were made.

Current State-Disputes and Resolution Mechanisms

When one talks of reform in the tax administration, immediately people think of improved ways of dispute management. There are too many pending disputes. When we asked for data from CBDT for the previous year, which was Financial year 2012-13, they told us that 199,390 cases were pending before Commissioner(Appeals), 31015 at Appellate Tribunal, 31,230 at the High Courts and 5808 at the Supreme Court. Of these, the cases pending for over 10 years was 565 at Appellate Tribunal, 733 in High Courts and 148 in Supreme Court. When we asked for the same information from CBEC, we were told that there were 33,225 cases at the level of Commissioner(Appeals), 62163 with CESTAT, 15113 with various High Courts and 3081 at Supreme Court. When asked to give data of cases over three years old. They told us that 20,076 cases were pending

with Commissioner(appeals), 6869 with High Courts and 1390 with Supreme Court. In the words of Mr.Palkhivala, you experience eternity in the Courts of Law in India!

It is not that the Government did not bother about a better process for bringing in certainty to the tax regime. They had felt the need for resorting to Alternate Dispute Resolution approach and had created alternate avenues for Dispute Prevention and Dispute Settlement. If you are a Non Resident taxpayer or belong to a certain category of residents , you can file applications with the Authority for Advanced Ruling or AAR as it is called, to obtain binding rulings on income tax issues or issues under indirect tax laws arising out of a transaction or proposed transaction. There is Settlement Commission which can be approached once in a lifetime for making a true and complete disclosure of their duty liability or additions to your income, over and above what has already been disclosed before the respective departments. There is Advance Pricing Agreement which was formed to provide the much needed certainty to multinational enterprises operating in India. In addition, Dispute Resolution Panel was introduced in 2009 as a step between the AO and the appellate forum to address the concerns of non resident tax payers and issues relating to Transfer Pricing. However, in spite of having all these mechanisms which can either prevent a dispute from arising or help in its settlement, the number of pending disputes have continued to go up. I would say that the Department had no will to either prevent or speed up the resolution process.

Compliance Management

If people normally comply with the law, the number of disputes will come down. Therefore, the right approach is to work on a trust based compliance framework. If tax payers clearly understand their obligations under different tax laws, most of them will tend to comply. Taxpayers can be classified under four different categories, based on analyzing their track record. These are – compliant, Triers, Fence Sitters and Offenders. Let me explain each of them.

People who fall under the compliance segment exhibit both high commitment and capacity to comply. These would be individuals and businesses that believe in doing the right thing and take concrete steps to ensure that they comply. They would include firms with a strong record in corporate governance and ethics, those employing reliable professionals to ensure maintenance of compliance and ensuring adequate diligence to maintain systems that are configured to ensure compliance. While these people should be left to self compliance and given due recognition, there would be occasional checks to monitor continuing compliance.

Triers are those who are basically law abiding in attitude but who may lack the capacity, either by reason of limited resources or limited knowledge of law, for full compliance. They do make the effort to comply, but may fall short due to their limited capacity. They need to be assisted to comply through help and guidance. Of course, they would need higher monitoring than the compliant.

In the third category are fence sitters who have no basic commitment to compliance but would like to avoid the risk of consequences if, in their perception, there is a high probability of their non compliance being detected. They need to be dealt with a balanced mix of persuasion and enforcement measures. The key to ensuring compliance on their part will be to create and maintain the perception that the probability of their being caught is high. They need to be monitored closely and penalized where serious or persistent non compliance is noticed.

In the last category are offenders or habitual offenders who may not be amenable to persuasion and who make tax evasion their business strategy. It is to this category that the whole range of penal measures, including prosecution, which should be applied. If we are able to do a proper segmentation, the revenue department can put in place strategies to get high levels of compliance at a much reduced effort. This segmentation can be done through analysis of the data that the department already has and the properly verified data that is obtained from external sources.

Dispute Management

Let us come back to the question as to why disputes arise? The law maker is the Ministry of Finance and they also amend the laws. The two Boards issue notifications/circulars on a need basis to supplement the primary legislation. We know that currently there is a high degree of uncertainty in the application of tax laws as the interpretation is largely left to the assessing officers in the field, with little guidance provided and they make differing interpretations. Section 37B of

the Central Excise Act, 1944 for central excise and service tax, section 151A of the Customs act , 1962 for Customs and Section 119 of the Income tax, 1961 enable the two Boards to issue clarifications that bind the tax officers , in order to ensure consistency and nip avoidable disputes in the bud. Unfortunately, this facility has not been used effectively. Between 2006 and 2014, 18 circulars were issued under section 119 of the IT Act, 2 circulars were issued under Section 37B of the Central excise act and none was issued in this eight year period under Section 161A of the Customs act. A number of disputes arise because of the failure of the two Boards to issue clarifications in a proactive and timely manner. What is worse is that sometimes litigation is persisted by the departments despite a clarification by the Board and in a number of cases, officers in the field fail to follow the Board's instructions. I will give you an example. CBEC in a circular in 1999 provided a clarification. It had been brought to the notice of CBEC that field formations were demanding duty on the compound preparation arising during the course of manufacture of Agarbatti classifying them under heading 3302.90 of the Central Excise Tariff as odoriferous compound. CBEC examined the process and issued clarification that it is not an excisable product. Following this circular, Karnataka Soaps and Detergents Ltd, who were paying duty on stock transfer of certain odoriferous compounds to their own unit, stopped payment of duty with effect from April 2000. This was accepted by the Department for sometime , but in November 2005, some wise officers felt that the Board had gone wrong and so issued show cause notices to Karnataka Soaps. As usual the

Adjudicating Authorities confirmed the demand with odoriferous penalties. The tribunal observed "In our considered view, the board has taken a view which is applicable to the entire length and breadth of India. It cannot be so brushed away by the departmental officers.... In our considered view the Board Circular will apply in its full force to the case in hand before us at least to the agarbatti perfumery compounds wherein revenue has not produced any evidence of they being bought and sold". The revenue, in spite of this, has continued the litigation and taken it to the Supreme Court where it is pending. The Board has also made a flipflop as new wisdom seems to have dawned in the dark corridors of power and has now clarified that the earlier circular is only applicable to such intermediate or odoriferous compounds as are not capable of being bought and sold. There are many questions that come up- Why did the Board wait for 15 years to give further clarification? How much money are they going to get from the agarbatti manufacturers as excise duty on the secret odoriferous compounds? It is difficult to conceive where the accountability lies, leave alone action taken- whether at the level of the officer who ignores the Board's guidance or at the level of the Commissioner or Chief Commissioner, who ignore the actions of the officer or the Board itself. There is total uncertainty about the treatment of anything under the Revenue administration.

The drafting at times is bad and the clarifications quite often take a narrow and many times inconsistent view. Why should the Finance Ministry not make the proposed tax legislation public so that potential areas of ambiguity can be identified early. The

global practices are very different. For example, Her Majesty's Revenue and Customs (HMRC) in the UK publishes detailed tax manuals putting out their views on almost every aspect of taxation. While tax manuals are intended for use by HMRC officers, they are published for the public too and are referred to even by the courts. Currently there does not appear to be a Standard Operating Procedure in India for drafting tax laws. Dr. Atul Gawande, the renowned surgeon in the US and whose books usually feature among the Best Sellers list of New York Times, wrote a highly popular book on how the use of check lists can improve the success rate in surgeries and care. It is a brilliant book and I recommend it to everyone. He describes how some hospitals in the US have a higher success rate than others in treatment of complex cases. Similarly can we not have a check list for preparing tax legislation? There should be defined standards for why the legislation is initiated, what are the statement of objects and reasons, how can we make the drafting clear and precise and what sort of public consultation should be had. There can be secrecy on rates of taxation, but not on the laws.

Another reason for disputes is the lack of accountability for quality of decisions. You would be surprised to know that the quality of decisions delivered by tax officers is not a specific parameter in their performance assessment. Targets given for Commissioners (Appeals) are only in terms of the number of cases to be disposed in a month. Actually, it was found that if the officers were to pass well considered and good quality orders, they would not be able to achieve the prescribed number of disposals.

Another issue that was noticed was that the reviews of orders by the Assessing Officers do not address the dimensions of quality and instead focus on whether the orders were in favour of the revenue department or the tax payer. I presume the thought process is not to fairly administer the law. If an assessment is in favour of tax payers, it is considered as a bad quality order. There is an adversarial relationship with the tax payers and in fact, tax payers do not have confidence that they would get justice at the hands of departmental officers. A trust based tax payer service oriented system does not exist.

A major component of disputes in both CBDT and CBEC is demands pursuant to audit objections raised either by internal audit or by the Comptroller and Auditor General (CAG). Field formations may not be in agreement with the CAG's audit objections. But the resolution of the matter with CAG often takes a long time. To take care of that, the CBEC has issued circulars instructing that protective demands be raised in such cases. The logic for the prescription is that such protective demands would ensure that the matter is not time barred. Cases having similar issues are referred to as "Call Book". When we asked CBEC for figures for 2012-13, we were informed that 33,128 cases amounting to demand of Rs.54056 crores were the pending call book cases. It appears that this extreme risk aversion is of a recent origin. Mr.Zutshi, Member of our Commission who was the Chairman of CBEC in 2001-02 was aghast at the practice of call book. He felt that the CBEC, unlike in the old times, was not being courageous enough to take a stand.

National Litigation Policy, 2010, states that “Government must cease to be a compulsive litigant. The philosophy that matters should be left to the courts for ultimate decision has to be discarded. The easy approach, “let the Court decide” must be eschewed and condemned.” This is not a policy that is followed. There are many examples of needless litigation. In M/s RGL enterprises Vs. Commissioner of Central Excise Delhi -1, the Tribunal, while upholding the tax payer’s appeal, awarded costs to the appellant and directed that a copy of the order be sent to the CBEC and Secretary (Revenue). This was a case involving failure of judicial discipline on the part of original and appellate officers of the department in not following a judicial precedent binding on them and the Tribunal used strong words in its order to express its consternation. There are many examples we can give to show describe cases of purposeless litigation.

Tax administration cannot be reformed only by addressing individual cases. The whole system has to be remedied. New processes need to be designed. We need to change the structure so that there is attention to quality and accountability and we need to work on the attitudes of officers and others working for Revenue Administration. In the areas of process improvement, TARC report has suggested processes to ensure that litigation arises only if all the remedies are exhausted. It has suggested an Early Dispute Resolution(EDR) mechanism and also suggested resorting to Alternate Dispute Resolution (ADR) methodology. This will work only if we create a mechanism for guiding the assessee on how to navigate the system. A Taxpayer Dispute Resolution

Centre(TDRC) will be a useful point for guiding the assesses on how disputes can be prevented from escalating. TDRC will act as a single point of contact for tax payers guiding them on whether they should opt for EDR or the ADR channel. TDRC will communicate with the taxpayer and narrow down and determine the issues involved in the dispute. Rectification of mistakes by the assesses and resolution of disputes through an improved Dispute Resolution Panel are the mechanisms for early dispute resolution. The ADR channel comprises conciliation and arbitration. Ideally disputes involving simple questions of fact should be referred for conciliation while those involving a mixed question of law and fact should be referred for arbitration. Substantial questions of law, however, would not be fit for resolution through these methods and the taxpayer would then be advised by TDRC to opt for litigation for the resolution of such disputes.

I have gone into Dispute Resolution in some detail since litigation shows how unfriendly the system is. Recently Mr.Arun Jaitley, the Finance Minister, said that Retrospective Legislation gave India a bad name and has been of no benefit to the Government as it has not been able to collect any revenue. The success rate for the Department has been very poor. For the year 2012-13, in the case of Income Tax, the Department won only 62 of the 536 cases disposed off by the Supreme Court that year. The position was not different in the case of Indirect taxes. Out of 239 cases disposed off by the Supreme Court that year, only 29 went in favour of the Department. A Commissioner explained to me that even when they have a sound case, the manner in which they manage the disputes points to

National Litigation Policy, 2010, states that "Government must cease to be a compulsive litigant. The philosophy that matters should be left to the courts for ultimate decision has to be discarded. The easy approach, "let the Court decide" must be eschewed and condemned." This is not a policy that is followed. There are many examples of needless litigation. In M/s RGL enterprises Vs. Commissioner of Central Excise Delhi -1, the Tribunal, while upholding the tax payer's appeal, awarded costs to the appellant and directed that a copy of the order be sent to the CBEC and Secretary (Revenue). This was a case involving failure of judicial discipline on the part of original and appellate officers of the department in not following a judicial precedent binding on them and the Tribunal used strong words in its order to express its consternation. There are many examples we can give to show describe cases of purposeless litigation.

Tax administration cannot be reformed only by addressing individual cases. The whole system has to be remedied. New processes need to be designed. We need to change the structure so that there is attention to quality and accountability and we need to work on the attitudes of officers and others working for Revenue Administration. In the areas of process improvement, TARC report has suggested processes to ensure that litigation arises only if all the remedies are exhausted. It has suggested an Early Dispute Resolution(EDR) mechanism and also suggested resorting to Alternate Dispute Resolution (ADR) methodology. This will work only if we create a mechanism for guiding the assessee on how to navigate the system. A Taxpayer Dispute Resolution

Centre(TDRC) will be a useful point for guiding the assesses on how disputes can be prevented from escalating. TDRC will act as a single point of contact for tax payers guiding them on whether they should opt for EDR or the ADR channel. TDRC will communicate with the taxpayer and narrow down and determine the issues involved in the dispute. Rectification of mistakes by the assesses and resolution of disputes through an improved Dispute Resolution Panel are the mechanisms for early dispute resolution. The ADR channel comprises conciliation and arbitration. Ideally disputes involving simple questions of fact should be referred for conciliation while those involving a mixed question of law and fact should be referred for arbitration. Substantial questions of law, however, would not be fit for resolution through these methods and the taxpayer would then be advised by TDRC to opt for litigation for the resolution of such disputes.

I have gone into Dispute Resolution in some detail since litigation shows how unfriendly the system is. Recently Mr.Arun Jaitley, the Finance Minister, said that Retrospective Legislation gave India a bad name and has been of no benefit to the Government as it has not been able to collect any revenue. The success rate for the Department has been very poor. For the year 2012-13, in the case of Income Tax, the Department won only 62 of the 536 cases disposed off by the Supreme Court that year. The position was not different in the case of Indirect taxes. Out of 239 cases disposed off by the Supreme Court that year, only 29 went in favour of the Department. A Commissioner explained to me that even when they have a sound case, the manner in which they manage the disputes points to

the lack of drive and competence in the Department. The officer gets changed every three years and the briefing to the Departmental representative and to the lawyers take place at the last minute. Compare this with the position of the assessee who prepares his case diligently and who employ well briefed top lawyers. It is not possible for the Department to focus on succeeding in larger number of cases, given the high volume of litigation that they are responsible for starting. The only way is to prune down the number of pending cases and for this, they need to have a target of withdrawing from litigation half of the pending cases. This is not a difficult task, as many of the pending cases are due to protective demands and if the interpretation of the law is objectively checked in one of the cases, it will result in eliminating a number of cases falling under this point. At the same time, the Revenue needs to have a target of winning in 75% of the cases they fight. This type of target will make sure that they have a good "gating" system whereby a good scrutiny of the issues is done before the cases are approved for litigation. Both the Boards need to give far greater importance to Dispute Management. At present, neither of the Boards has a member whose sole responsibility is to manage disputes. We need to have Dispute Management as a specific position of a member in the Board.

Improving Internal Processes

Any organization needs to reengineer its internal processes periodically. Both the Boards have been using computers for a long time. One would even say that they have been pioneers in automation in the Government. I have personally met some of the

officers and have been very impressed with their grasp of technology and their design and implementation capability. However they are not career IT professionals as the advancement in service takes place as a result of being in the areas connected with assessment. After some time, I will deal with the necessary organizational structural reform that is required in the area of Human Resources Management.

E filing and e payment systems have brought a great deal of convenience to tax payers. Considerable improvement has been made in taking up cases for scrutiny. The cases that are picked up for scrutiny are through two channels-(a) risk based assessment carried out in an automated manner using computer software; and (b) manual picking up of cases that fall under specified categories of cases that qualify for "compulsory scrutiny". There are instances of taxpayers being selected for scrutiny even when there no substantial issues. These lead to harassment. The only way is to strengthen the automated process of selection through quantitative and qualitative filters.

Revenue Management

In spite of aggressive collection mechanism adopted by the department and the disputes foisted, the tax to GDP ratio is poor and is not enough for the economy to be on the path of inclusive growth and sustainable development. In 2012-13, the tax-GDP ratio stood at 5.58% for direct taxes and 4.7% for indirect taxes. At about 16% for central plus state taxes, India has one of the lowest tax-GDP ratios among comparable countries. Even some lower middle income countries reported tax-GDP ratios of 18%. The Finance Minister

has talked about going towards a 25% tax rate for companies and simultaneously working towards elimination of exemptions granted. My only career has been in the Software export industry, which is deemed to have received considerable tax exemption. That is only in name, as this industry comes under MAT. The Finance Ministry will tell you that the MAT can be adjusted towards taxes payable in future years. But the calculation of income for application of MAT includes profit from SEZ, which is exempted from tax. Since the industry had invested a lot in creating large sized campuses classified as SEZ, tax exemption will be only in name, as there will not be enough tax accruing to set off the MAT already paid on an expanded base of income. I had discussed this anomaly with the tax officials once, only to be told that the Government's main revenue comes from MAT payment!

Expanding the Tax Base

One of the ways for the tax collection to improve to the appropriate level is to enhance the tax payer base. Permanent Account Number or PAN as it is called had been introduced a number of years back and the Department has allotted PAN to about 17 crore entities. However IT returns had been filed in 2012-13 by only 3.5 crore entities. The gap between PAN Card holders and number of tax payers is growing over time. While the number of PAN card holders increased by 175 percent during 2005-06 to 2010-11, the number of tax payers during the same period rose only by 17%. To a significant extent, the difference reflects the use of PAN card as a proof of identity for various stipulated economic functions that have no

relation to tax. Nevertheless, the gap must have a bearing on the efforts to widen the tax base as also the efficacy of PAN card distribution system. While the effort has to be continued on increasing the tax payer base through a detailed analysis of this disparity, we also need to see if PAN can serve as the Common Business Identification Number, similar to the standing of Social Security Number in the US.

There is no denying that the tax payer base has to go up in India and for that, there is a need to control the cash economy. Large scale transactions take place in cash, especially in land dealings. There is a great deal of cross referencing and analysis that is required in order to catch those who conduct their businesses or professions under the radar and go largely undetected. We need to accomplish this through analysis based segmentation of tax payer community and efficient targeting of non filers rather than good and habitual tax payers.

Information and Communication Technology

As I have pointed out earlier, Revenue department has been a leader in automation when compared with other government departments. While being a pioneer is good, it brings with it its own problems, especially when technologies change. Both Direct Tax and Indirect Tax departments have, over the last 20 years, developed a number of systems which are not interconnected, as they were developed at different points in time. Even when there are successful systems, the data quality is poor. For example, while income tax returns are captured electronically, the assessment details in cases where they have been taken for scrutiny are

not fed back and therefore the data base cannot be used for analytics. The departments have focused on improving the processes through automation, rather than in the use of data for management. The departments are now working on creating data warehouses and developing the analytical capability.

I would like to give you an interesting example of what can be achieved if data quality is improved and data is shared across departments. Central Economic Intelligence Bureau (CEIB) is the nodal agency for economic intelligence and is responsible for coordinating and strengthening economic intelligence and enforcement activities of agencies under the Ministry of Finance. CEIB shared information received from the sales tax department, Mumbai, with the IT department regarding bogus sales bills. This information was based on a data mismatch between the VAT credit being claimed on purchases and VAT payments being shown on sales. Based on this information, the I-T department at Mumbai detected bogus purchases worth Rs.8,100 crore and undisclosed income of Rs.1,995 crores. The encouraging outcome of the success in detecting evasion prompted the CEIB to urge all state governments to carry out such matches of the data on VAT credit claimed and VAT payments made.

I have already talked about the prevalence of multiple computerized applications in both the Departments which cannot automatically work together. This is the usual picture in any organization which have a number of legacy application systems. For both the departments and the taxpayers, ease of doing

business improves when one can use the technology to interact with each taxpayer, handle the required processes, easily implement new pieces of legislation and perform detailed analytical calculations for management as well as studying impacts and trends. Inland Revenue Department in the United States has adopted a slogan - Digital by Default. Every activity concerning the Tax System has to be capable of being operated through computers. If a legal provision is too complex and cannot be reduced to algorithms, they do not accept it. We need to move to such a system. We have seen many instances of long lead times to implement new provisions, especially in Excise and Customs area. This is in many instances due to complexity in law. For us to adopt Digital by Default as a principle and to facilitate Information Sharing across departments, we need to work on creating a common architecture and developing specialization in the Computer Departments. The current practice of assigning officers on a short tenure to computer section will need to change in favour of career officers in this department and also to have a mechanism for bringing talent from outside. This can only work if we can make Computer Department as an independent entity with its own financial and personnel policies.

Revenue Forecasting

A single minded focus on targets is a major reason for aggressive assessments. We need to move to a system of using forecasts and not making them into targets. Over-estimated tax forecasts often leaves the CBDT and CBEC dissatisfied with the overall budget making process, and the government with

an inaccurate tax revenue forecasts. This leads to attempts to impose unjustified tax demands on assesseees. Credible revenue estimates, based on realistic assumptions, are thus required on a regular basis to achieve a tax environment characterized by better accountability to taxpayers.

Revenue forecast, revenue potential and revenue target are three distinct , although closely related, concepts. Revenue forecast is the forecast tax revenue for a given tax policy structure. Revenue target can be equal to or more than the revenue forecast as it may aim to cover partially the tax gap, which could be due to compliance, policy and administrative efficiency gaps. Revenue potential is usually higher than both the revenue forecast and the revenue target as it estimates potential tax revenue after fully closing the tax gap, i.e., with 100% compliance, policy parameters (rates, exemptions, etc) suitably benchmarked against other comparable systems(countries or states) and administrative efficiency kept at the highest attainable.

This is an activity requiring considerable expertise in using different forecasting models, reviewing and reporting forecasts and monitoring taxes, accessing relevant and quality data in sufficient detail, partnering non governmental bodies and research institutions and integrating revenue forecasting with policy. This requires a different organizational competence in the two Boards. We need to have specialists working on large data identifying patterns and exceptions and helping the Board to come up with credible forecasts,

which can then be used as expectations from Commissioners.

Formulation of Tax Policies

Budget exercise should not merely reflect the wishes of the Finance Minister and of the Political Leadership. Besides collecting revenue for the Government, it is used for directing economic activity to newer areas and modifying the behavioural patterns. We need to use techniques for predicting the behavior before formulating tax policies. The primary object of predictive analysis is to use the information resources available to the tax administration to move from a reactive approach to non compliance, including frauds, to a proactive approach that deters and prevents frauds. Predictive analysis also enables the administration to anticipate and address emerging risks by guiding and enabling it to develop and deploy other appropriate interventions such as improved customer services, sharply targeted scrutiny and audits.

Tax policies should also be grounded on research. Tax departments employ strategy on three fronts - defining tax base and imposing tax rates, setting up tax compliance procedures, and employing enforcement measures based on risk identification. The tax payer has two types of strategies at his disposal- lobbying (for tax shelters or lower taxes) and choosing the level of compliance. An ideal tax governance process will bring about convergence in attaining the expectations of the tax department as well as the tax payer. Research has an important role to play in the process of attaining that equilibrium.

Tax department's pursuit of its policy strategies has to be guided by research that provides answers to questions like: will the strategy increase or decrease compliance?; will it widen or shrink the tax base?; will it increase or decrease compliance costs?; will it increase or decrease the effectiveness and credibility of its enforcement?; and does the tax department have the capacity to implement the strategy?

Competency and Structure

Ultimately it is the employees of the tax department who carry out the tasks. Highly accomplished individuals are selected as direct entry officers through civil service competitive examination. However there is very little effort made to develop the competency and career of a person. I have talked to persons who have acted as Departmental Representatives for arguing the matter in front of the Appellate Tribunals. There was no formal training given and they learn on the job, with consequences to the manner in which they present the cases. Indian businesses have also altered and there are a number of India headquartered multinationals, similar to Tata Consultancy Services where I served. I asked an officer in charge of assessing complex international transfer pricing issues on how he was trained and the answer was the same - he learnt on the job, with consequences which the assessee company has to bear. In the year 2014, there were four Chairpersons of CBDT, which meant that the person with about 3 months left before retirement becomes the leader. We can imagine how effective they will be.

It is necessary that we radically change the system, While the recruitment process could be still be

continued through direct entry method administered by UPSC and through promotions in the department, there is a need to build specialization based on aptitude and performance and leaders have to be identified early. Given the complexity of the business and economic environment, there is a need for inducting experienced people from industry. This calls for a radically different Human Resources Development process.

Only when a radical transformation takes place in the People development function, we can expect a responsive tax administration. The pressure to meet exogenously imposed revenue targets, irrespective of the condition or prospects of the market economy, has not only made it tough for tax payers to make business decisions, it has also led to significant worsening in the officers' work environment. Also the tax administration subjects its staff to an irrational practice of vigilance in which anonymous complaints against them are given equal status to direct evidence. Vigilance emanates from external agencies, which is not common practice in many tax administrations. The outcome of the vigilance process can linger for years, truncating the possibility of success of many careers. This fear starts from entry to termination of a career. The result is extreme risk aversion. Thus an AO is likely to issue an order despite knowing it would not stand judicial scrutiny, and higher tax officials are unlikely to modify it for fear of vigilance. At the same time, accusations of moral hazard and demand for bribes cannot be ignored. On the one hand, this could be partially explained through the administration operating as a subservient entity to another public service stream so that, despite evidentiary slide in the morals of the

institution, management does not feel responsible for it. On the other hand, given that the ultimate sufferer from corruption is the tax payer- while recognizing that he has to necessarily be at least a passive participant - there is no gainsaying the fact that there is need for the tax administration's management to take extraordinary steps to contain and obviate this institutional disease since it has a direct impact on society, its productivity and on the economy's measured GDP.

It is therefore essential to develop an institution with highly competent and efficient officers. There is a need to infuse spirit back into the employees, give them a sense of purpose and empower them to meet the goals of the organization. Currently both CBDT and CBEC report to the Revenue Secretary who comes from Indian Administrative Service(IAS). He is likely to have little experience or background with tax administration at the national level and little familiarity with tax, including international tax, issues that are increasingly assuming centre stage in emerging global challenges in taxation. Yet he is the final signatory on decisions on tax policy and administration matters prior to their arrival for the Finance Minister's consideration. This has translated to the Indian tax administration's attention and concerns - in the form of Revenue Secretary's control over CBDT and CBEC- to mainly represent the Revenue Secretary's area of familiarity, i.e., general administration, in which he may be highly competent but which is likely to possess thin links to the most challenging matters of tax policy making or modernizing the tax administration in the light of current global practices. In a sense, this peculiar practice has assigned the ultimate responsibility for

administration and financial control lying with the Revenue Secretary - Department of Revenue- rather than to the CBDT or CBEC. TARC report is not the first report to call for removal of control of tax administration from Revenue Secretary. Tax Reforms Committee 1992 chaired by Prof.Raja J. Chelliah recommended abolition of the post of Revenue Secretary. Wanchoo Committee, 1971, had earlier recommended making the Board an autonomous body , independent of the Ministry of Finance, with the Chairman enjoying the status of Secretary to Government of India. Estimates Committee of Parliament, in its 10th report(1991-92) voiced similar views.

Another important change that has to be made is to separate revenue administration from creating tax policies and legislation. This is the practice followed in many countries like the UK. A Tax Council, headed by the Chief Economic Advisor (CEA) at the Ministry of Finance, will bring the rigour of economic analysis and high precision in legislative drafting to tax laws so that the tax laws are not only of assured quality, but are also coherent across tax types. There would be inputs from the Boards and Tax Council will also have Chairman of CBDT and of CBEC as its members. It will also have representation from Ministry of Finance at senior level.

We need to unify the two Boards. In most countries, Direct and Indirect Tax Administration work as unified entity. There is need for companies to deal with Business Taxes in a unified manner. It is difficult to get the level of sharing required unless they operate as a single entity, a position that used to exist until the early

60s. We have proposed a transition to Central Board of Direct and Indirect Taxes.

Conclusion

Mr. Nani Palkhivala said once *"The radiating potencies of taxes go far beyond the mere raising of revenue. They propel tendencies which can obstruct effort, deflect enterprise and constrict growth. Bad economics may temporarily be good politics; but politics should be behind a fiscal law, and not in front of it."*

There can be no better explanation of the impact of fiscal policies and revenue administration on the growth and development agenda of the government than these words of Nani Palkhivala. The changes we have recommended in the report are transformative ones. We have also indicated the need for setting up a Change Office in the Ministry of Finance reporting directly to the Finance Minister. We have indicated a time period of five years to effect this transformation.

The TARC report begins the Executive summary with the following quotation from Robin Sharma's book *"The Monk who sold his Ferrari"* *"to liberate the potential ... you must first expand your imagination... Things are always created twice: first in the workshop of the mind and only then, in reality. When you ...take control ... and imagine... in a state of total expectancy, dormant forces will awaken... to unlock the true potential... to create a kind of magic...forget about the past. Dare to dream that you are more than the sum of your current circumstances. Expect the best. You will be astonished at the results."*

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

- Eugene Black
Former President,
World Bank

FORUM

OF FREE ENTERPRISE

The Forum of Free Enterprise is a non-political and non-partisan organisation started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems through booklets, meetings, and other means as befit a democratic society.

In recent years the Forum has also been focusing on the youth with a view to developing good and well-informed citizenship. A number of youth activities including essay and elocution contests and leadership training camps are organised every year towards this goal.

Membership of the Forum : Annual Membership fee is Rs.250/- (entrance fee Rs. 100/-). Associate Membership fee Rs. 150/- (entrance fee Rs. 40/-). Students (Graduate and Master's degree course students, full time Management students, students pursuing Chartered Accountancy, Company Secretaries, Cost and Management Accountants, Cost and Works Accountants and Banking courses) may enrol as Student Associates on payment of Rs. 50/- per year. Please write for details to : Forum of Free Enterprise, Peninsula House, 2nd Floor, 235, Dr. D. N. Road, Mumbai 400 001. Tel.: 022-22614253, E-mail: ffe@vsnl.net

Published by S. S. Bhandare for the Forum of Free Enterprise, Peninsula House, 2nd Floor, 235, Dr. D. N. Road, Mumbai 400001, and printed by S. V. Limaye at India Printing Works, India Printing House, 42 G. D. Ambekar Marg, Wadala, Mumbai 400 031.

2.5/March/2016