

# India Takes a Giant Leap With Faceless Audits

by Sean Foley, Justin Donatello, Hasnain Shroff, Ajit Jain, Anuradha Rathod, and Karnik Kansara

Reprinted from *Tax Notes International*, May 3, 2021, p. 627

## India Takes a Giant Leap With Faceless Audits

by Sean Foley, Justin Donatello, Hasnain Shroff, Ajit Jain, Anuradha Rathod, and Karnik Kansara

Sean Foley and Justin Donatello are with the Washington National Tax practice of KPMG LLP, and Hasnain Shroff, Ajit Jain, Anuradha Rathod, and Karnik Kansara are with BSR & Co. LLP, KPMG's member firm in India.

In this article, the authors outline India's recently overhauled audit system and highlight factors that taxpayers operating in India should consider when preparing for an audit.

Over the past several years, the Indian government has taken concrete measures to change its image from an aggressive tax jurisdiction to a taxpayer- and investor-friendly regime. Continuing that effort, the Indian Revenue Authority (IRA) has taken a giant leap forward with the introduction of the Faceless Assessment Scheme (FAS). Intended to make the entire tax system seamless, painless, and faceless, Prime Minister Narendra Modi launched the "Transparent Taxation – Honoring the Honest" platform in August 2020, a major reform that includes the FAS. The IRA carried out a small FAS pilot in 2015 and expanded the program in 2019. Because of the success of the pilots and the challenges created by the COVID-19 pandemic, the IRA decided to proceed with a full-fledged implementation of the FAS and reallocated approximately 68 percent of its manpower to the program.

The FAS is a complete overhaul of the way audits are conducted in India. True to its name, the FAS eliminates human interaction between taxpayers and the IRA by conducting the audit entirely through digital communication; taxpayers do not even know the names of the IRA agents conducting the audit. Although there are obvious advantages, including increased efficiency, the FAS also has many potential drawbacks, including the inability to speak directly with the agent conducting the

examination, which could increase the burden on taxpayers subject to examination. Taxpayers operating in India that are not prepared for an audit under the FAS could find themselves challenging adjustments not based on the relevant facts or law and could even be subject to penalties if they do not respond to the IRA in the required time frame.

This article provides an overview of how the FAS operates. It discusses some of the system's potential advantages and disadvantages and highlights some important factors taxpayers operating in India should consider to prepare for and manage an FAS audit.

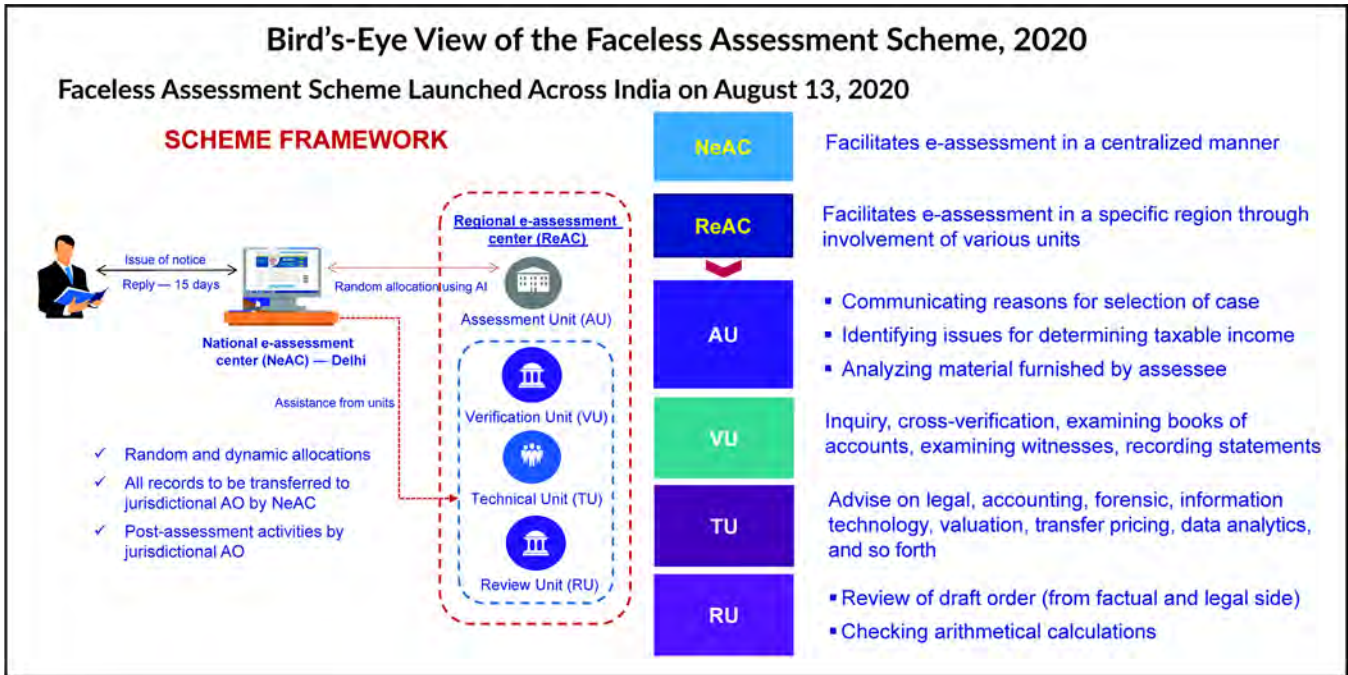
### Overview of the FAS

Detailed guidance on faceless assessments was introduced on August 13, 2020, along with the launch of the transparent taxation platform, encompassing faceless assessments and faceless appeals. Since then, the IRA has set up a national e-assessment center (NeAC), which is the central communication gateway between taxpayers and the IRA. Twenty different regional e-assessment centers (ReAC) have also been set up, each containing various specialized units.

The FAS is a completely digitized approach to conducting audits with almost no human interaction. That kind of approach was virtually unheard of before the FAS, especially in a country like India, which has neither a very technologically equipped taxpayer base nor a tech-savvy tax administration.<sup>1</sup>

There is one stark contrast of the FAS vis-à-vis the current e-assessment/e-audit process. While e-assessment/e-audit is conducted through

<sup>1</sup>The recent Budget 2021-2022 has clarified that India will not stop at faceless assessment or appeals, having also proposed a faceless scheme to conduct proceedings before the Income Tax Appellate Tribunal, which is the second level of appellate forum before the courts.



electronic means, the taxpayer knows the identity of the revenue officer. However, under the FAS, there is no interaction between the taxpayer and the revenue officer except through the NeAC gateway. Further, different officers at locations across the country may be involved in the process at various stages, presumably making the audit free from any single revenue officer's bias.

What is surely apparent is that the FAS is nothing like the approach taken by other revenue authorities. For instance, the U.S. IRS conducts correspondence examinations, which are handled almost exclusively through written communication between the taxpayer and the IRS. Unlike the FAS, correspondence examinations are generally narrowly focused and limited to low-risk issues. Further, with IRS field examinations, taxpayers and the IRS communicate in person or via telephone and provide written responses and data to support the position taken on the tax return. In both correspondence and field examinations, the taxpayer knows the identity of the IRS agent conducting the examination and can generally speak with that individual and her supervisor. It is difficult to imagine a large U.S. taxpayer going through an entire examination without knowing the identity of the agent or being able to speak with the revenue agent about its case, answer questions orally, or otherwise provide context and

explanations about its data. That is, however, the position that many taxpayers will find themselves in when subject to an FAS audit.

**FAS Scope**

The FAS covers all resident taxpayers and tax issues except for cases involving search and investigation matters. Thus, an Indian incorporated entity, including a subsidiary of a multinational enterprise, is subject to the FAS. Nonresident taxpayers and cases involving search and investigation matters will continue to be audited in the traditional manner.

Transfer pricing audits are not covered. However, enabling provisions have been introduced in regulations to apply the FAS to transfer pricing audits. The IRA will be releasing separate guidelines for faceless transfer pricing audits that would be effective no later than March 31, 2022.

**How the FAS Works**

The figure depicts the flow of assessment proceedings under the FAS and the roles of NeAC, as well as ReAC and its specialized units (AU, VU, TU, and RU).

**Audit Process Flow and Review Process**

The IRA uses artificial intelligence and machine learning to identify tax returns for

examination. The case is then assigned to a ReAC using an automated allocation system. All communication between a taxpayer and the ReAC and its specialized units flows through the NeAC. The NeAC is responsible for automated allocation of cases to the ReAC, which then allocates the cases in the same manner to an assessment unit (AU). If there is a need to verify or examine the books and records, or for technical support in areas such as accounting and valuation, the AU approaches the NeAC, which then assigns the case to a verification unit (VU) or technical unit (TU), as appropriate. The AU gathers input from the various units and prepares a draft assessment order based on the available information (or observations on the tax return).

The NeAC examines the draft orders and takes one of three approaches:

1. If no modification to income is proposed, the NeAC finalizes the draft order and serves a copy to the taxpayer.
2. If a modification to income is proposed, the NeAC serves a notice to the taxpayer to show cause why the assessment in the draft order is incorrect.
3. If the NeAC determines that the draft order should undergo an additional level of review, the NeAC will assign the draft order to a ReAC review unit (RU) through the automated allocation system. The RU may concur with the draft order or suggest further modifications, then forward the draft order to the NeAC. If it concurs, the NeAC follows steps 1 or 2, as appropriate. If the RU proposes modifications, the NeAC assigns the case to an AU other than the one that performed the initial analysis.

Only after considering comments from the RU and AU, as well as the taxpayer's response to the show-cause notice, does the NeAC finalize the assessment.

At any stage during the audit, the NeAC, if it considers it necessary, can transfer the case to an identified jurisdictional officer. To date, the IRA has not provided any guidance on what circumstances would warrant that kind of transfer.

### **Taxpayer Response**

On receiving a show-cause notice, the taxpayer must respond to the NeAC within 15

days, and no more than a 15-day extension is permitted. The NeAC then forwards the taxpayer's response to the AU, which considers the taxpayer's response and revises the order, if necessary. If the taxpayer fails to respond in the specified period, the AU finalizes the assessment and the NeAC will issue the final order to the taxpayer.

If a modification to income is proposed in the draft order, the taxpayer may request a personal hearing to present its case before the IRA. Those requests are subject to the approval of the chief commissioner or director general of the ReAC involved. The grant of a personal hearing is not automatic and is at the discretion of the IRA — it is expected that personal hearings will rarely be granted. If the request is approved, the hearing is conducted exclusively through videoconference. Moreover, because the legislation is meant to keep the interaction faceless, it is presumed that even during the video hearing, revenue officers' identities might not be disclosed to the taxpayer.

One of the most unique, and perhaps concerning, features of the FAS is that the individuals conducting the audit can change throughout the examination. Thus, the RU agent who performed the first review of the draft order might not be the same one reviewing the revised draft order. Consequently, when responding to inquiries at any stage of an audit, taxpayers must ensure that their responses tell the whole story because the IRA officer reviewing the response might not have any context or historical knowledge of the issue.

### **Transferring the Case to an Identified Officer**

On completion of the assessment and after the issuance of the final order, the NeAC transfers all the electronic records to the taxpayer's jurisdictional officer, who takes over other procedural requirements such as imposing penalties, recovering additional tax, rectifying any mistakes, and giving effect to appellate orders.

### **Advantages and Disadvantages of the FAS**

#### **Advantages**

There are multiple benefits of the FAS, including the ability to track progress of audits online and shorter audit cycles because of strict

response-time requirements. Because all communications are digital, the time spent on travel and waiting at the tax office is eliminated. Plus, taxpayers can cost-effectively make submissions online.

The standardization of issues raised, and adjustments to income declared by similar classes of taxpayers or taxpayers belonging to the same industry or sector, reduces the possibility of an agent's raising ad hoc issues and adjustments to income. That was a prevalent problem under the prior audit regime because decisions were made by individual assessing officers in consultation with their superiors. Despite those consultations, taxpayers were still subject to the views of one or two individuals, resulting in inconsistent treatment of similar issues. Now it is possible to have more visibility of the IRA's view on some issues, increasing the likelihood of a consistent approach. Also, personal biases can be eliminated because of the allocation of cases to separate units through the automated allocation system and because there is no direct interaction between taxpayers and tax officers. Further, taxpayers based in any city or region can be examined by an AU in any other city or region, which can bring consistency to issues raised because taxpayers are not subject to the whims of local revenue officers.

A single point of communication through the NeAC and a repository of information also ensures the confidentiality of business information shared by taxpayers.

It is possible for the AU to seek input from other specialized units like the VUs and TUs. That will improve the quality of audits and should result in well-reasoned assessment orders. And improvement in the quality of orders and explanations eases the litigation process and enables the government to address loopholes in the law and enhance tax collections.

### Disadvantages

The FAS is not without its drawbacks, however. First, there is no consistency in the team members conducting the examination. Because the revenue officers and specialists change during the examination, there is a possibility that a new team member might change course and pursue a different or additional issue that was not considered by the first revenue officer. That could

lead to protracted examinations and multiple requests for information. Also, because new team members might not have historical knowledge, they might request information that has already been provided or is irrelevant.

That lack of consistency could also lead to an increase in disputes: Cases being reviewed and verified by several different units and officers may lead to disparate thoughts and several viewpoints. That could lead to the IRA taking the most conservative — that is, government-favorable — position.

Responding to requests for information will likely become more burdensome. Because there is no opportunity to speak with the examiner to provide a walk-through of the data, the information submitted must be complete and easy to follow. Taxpayers may need to prepare lengthy written explanations to accompany their data so the individuals conducting the examination can understand what has been provided and how it reconciles with the tax return.

Denying the taxpayer's request for a personal hearing, and thus the opportunity to present its case to any identified decision-making authority, could result in denial of its rights to natural justice.<sup>2</sup> Also, it is unclear who in the chain of review has the final say on the adjustment or modification to taxpayer income.

It is yet to be seen whether the IRA will recruit subject matter experts for VUs and TUs, positions currently being filled by reallocating existing officers. The effectiveness of the FAS is highly dependent on the performance of those units, so a lack of expertise in any of the required fields may result in incorrect and unjust adjustments to income, which in turn may result in protracted litigation.

Finally, while standardization of issues may have its advantages, it could result in the IRA making adjustments to similarly situated taxpayers without fully understanding the fact pattern of each case or taxpayer. That could result in incorrect positions, unfair adjustments to income, and protracted litigation.

<sup>2</sup>The principle of natural justice in India is akin to due process rights in the United States.

Many of those identified disadvantages are similar to problems faced by taxpayers under audit in other jurisdictions. However, those taxpayers often have some ability to engage with the person conducting the examination, which can mitigate many concerns. Under the FAS there is no such ability. Consequently, taxpayers need to be mindful of the risks presented by the regime and prepare for an audit even before being contacted by the IRA.

### Points for MNEs to Consider

While the IRA leads India into its next phase of digitalization, it is important for taxpayers to be cognizant of several aspects of the FAS, including:

- Gear-up: Taxpayers will have to evaluate and update or upgrade their recordkeeping systems and be ready to furnish data to the NeAC in the limited time frame provided under the FAS. Failure to do so will result in penalties and the closure of assessments based on the best (ex parte) judgment of the tax officers. That may lead to penalties and litigation if not handled appropriately.
- Taxpayers also need to know where relevant documents are stored. Key documents are often not in the tax or finance department's possession. Given the required response time, taxpayers must be able to quickly access and analyze data and key documents.
- Limited opportunity for a face-to-face discussion (personal hearing) will require

taxpayers to meticulously assemble the information and documents to make technically sound and complete submissions. Taxpayers will need to have processes in place to gather and present raw data in a clear and convincing fashion.

- Using statistical tools and tables to represent data, hyperlinking related sections, and summarizing and indexing the information is recommended because those kinds of visualizations can help the auditor better understand the data.

### Conclusion

The FAS is a huge transformation of the Indian taxation regime. It will bring a sea change in the way the tax world looks at India, although some growing pains can be expected. Given the regime's one-of-a-kind nature, taxpayers operating in India must assess their processes and systems to ensure they are prepared for audit under the FAS.<sup>3</sup> ■

---

<sup>3</sup>The information in this article is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG LLP.