

CHAPTER 24

VAT — Concepts and General Principles

24.1 Historical Background

Value Added Tax or VAT is a broad based tax levied at multiple stage with tax on inputs credited against taxes on output. The origin of VAT can be traced as far back as the writings of F Von Siemens, who proposed it in 1919 as a substitute for the then newly established German turnover tax.

Since then numerous economists have recommended it in different contexts. In addition, various committees have examined the tax in detail. However, for its rejuvenation, the tax owes much to Maurice Faure and Carl Shoup. **The recent evolution of VAT can be considered as the most important fiscal innovation of the present century.**

VAT was firstly introduced in the 1950's but it remained confined to handful number of countries till the 1980's. The rise of VAT is unparalleled and its history reveals that no other form of taxation had transformed from theory to practise in such a manner. Today even by those countries which initially rejected it have adopted this form of taxation for generating revenues.

The development of VAT in other countries suggests that although it was not adopted by many countries until the sixties, over the years the tax has come to occupy an important place in the fiscal armory of nearly all industrialized countries and in a large number of Latin American, Asian and African countries. As many as 30 countries have switched over to VAT since 1980 and the total number of countries who have adopted VAT presently reached to more than 130. Thus, the augmentation of interest in VAT has been the most remarkable event in the evolution of commodity taxes in the present century. In addition, as of today, VAT is evenly distributed throughout the world, though it is particularly predominant in Europe and Latin America.

VAT was first introduced in France in 1954. With this imposition, France became the first European country to implement VAT on an extensive scale.

It was not, however, at first a complete system of VAT, since it applied only to transactions entered into by manufacturers and wholesalers. It was supplemented by a separate tax on services. In addition, there were special excises, which were levied on services and distribution.

The tax was thus a full-blown consumption-type VAT on the industrial sector where all investment expenditures were fully deducted. However, retailers and agriculturists were not included in the coverage of VAT.

A further reform measure which was initiated in January 1968, consisted essentially of an extension in the coverage of VAT. Several activities were now included as VAT was extended to all transactions formerly subject to the local tax and to the tax on services, which were then abolished. In addition, VAT was imposed on goods transport and other transactions formerly subject to a *special excise*.

In accordance with the Sixth Directive of the European Economic Commission (of May 17, 1977), the French law was amended on December 29, 1978 and the scope of the tax was expanded to include services under VAT. The tax base was finally broadened to

include agriculture in its ambit in 1984. Agriculturists were, however, given the option to pay VAT; those who opted for VAT were required to remain under VAT for at least three years. The experience shows that about one-third of the agriculturists opt for VAT.

In spite of all these measures taking place in relation to VAT, two of the most populous countries of the world India and USA have been without VAT being federal nations having strong presence of the state level administrators in its levy.

Now a major beginning has been made in India. Most of the States including Union Territories have implemented VAT w.e.f. 1st April, 2005 which has substituted local sales tax laws and various other local levies. It will not be out of the context to mention that VAT had already been introduced under the Excise Law way back in 1986 and in Service Tax since 2002. Inter sectoral credit is also allowed since 10th September, 2004.

In common business parlance, VAT in India is not comparable with that of in other countries because it is replacement of State level sales tax and not entire indirect tax structure. The Government of India introduced VAT system ten years ago in respect of Central Excise Duties in the form of MODVAT which was later on renamed as CENVAT. The States Governments of Madhya Pradesh and Maharashtra had incorporated the concept of tax on value addition in their respective Sales Tax Legislations during the mid 90's, but could not succeed in implementing the same in the desired manner. With the joint efforts of the Central Government and the State Governments, it was implemented by a majority of the States with effect from 1st April 2005.

VAT has replaced the general sales tax structure with the only difference in the manner of its levy. The power to levy tax on sales transactions in the form of VAT is drawn from entry 54 in List II of Seventh Schedule of the Constitution of India by the State Governments. Under VAT, every sale transaction taking place in the course of business is taxed enabling the Government to collect revenue on value addition at every stage. The *cascading effect* of VAT being collected at every stage on the cost of goods is reduced by *providing set off of tax paid on the purchases*.

24.2 Evolution of VAT in India

India already had a system of tax collection wherein the tax was collected at one point from the transactions involving the sale of goods. The single point tax was collected either at the first stage or at the last stage.

The system of *collecting tax at first stage* had the following disadvantages:

- (a) Since sales tax was levied and collected at the first stage (*i.e.*, at the stage of the wholesale), the tax rate had to be higher. This encouraged tax evasion and sales tax became a tax on honesty, which means the honesty, more the tax liability.
- (b) In case somehow the goods escaped the tax at the first stage, the goods escaped tax net altogether since there was no way by which it could be caught at any subsequent stage.
- (c) There was ample scope for under-valuation of the value of the goods at first stage, since there was no tax payable at any subsequent stages, even if the goods were subsequently sold at much higher prices.

In the system of *collection of tax at the last stage* also, several weaknesses were witnessed:

- (a) The tax evasion was maximum since the price level at the last point of sale increases, which encouraged evasion, even if the tax rates were low;

- (b) It was difficult to track the goods evading tax since there was no record of their earlier movements and after the last point sale, the goods reached in the hands of the consumers;
- (c) This also encouraged under-invoicing and involves generation of black money due to cash dealings at the last point of sale.

Since VAT is collected at various stages, all the above disadvantages and weaknesses have been overcome, the cascading effect of taxes is eliminated. More transparent structure is made up and compliance are improved.

India has been slow in adoption of VAT. In domestic trade taxes, it adopted excise duty at the central level and sales tax at the state level for this purpose.

The Central Government attempted reforms in the central excise duty by introducing the principles of VAT in 1986 through the introduction of MODVAT. Over the period the rates have been rationalized, exemptions have been reduced and the coverage has been extended to almost all the commodities commencing. MODVAT has now been converted into a central VAT, coined and called CENVAT.

The state governments had been indifferent in undertaking any reforms in their sales tax system, although it accounts for approximately 60% of the state's own tax revenue. The existing sales tax system of the states was confronted with many drawbacks and weaknesses.

The Task Force known as Kelkar Committee observed that presently, "each State levies multiple taxes on the same item in different names or at different stages *e.g.* Entry Tax, Luxury Tax, etc." However, it opined that "it is necessary that State VAT should be the tax to unify all the State-level taxes *i.e.* Sales Tax, Purchase Tax, Turnover tax, Works Contract Tax, Entry Tax, Special Additional Tax, etc. should all be covered under State VAT.

The efforts were initiated towards introduction of VAT since last many years. The Committees of States' Finance Ministers (in 1995 and 1998, respectively) and of the Chief Ministers (in 1999) have put forth recommendations to replace sales tax by VAT. This was ratified by the Conference of the Chief Ministers and Finance Ministers held on November 16, 1999 and introduction of State VAT in lieu of Sales Tax was finally scheduled to be made with effect from 1-4-2003.

However, the schedule had to be revised in view of agitative traders' community. The Empowered Committee of State Finance Ministers agreed upon 1-6-2003 as the revised date of implementation of VAT and it was expected that most of the State and Union Territories will implement VAT from 1-6-2003, but it did not happen.

Later, the Finance Minister deferred the implementation of VAT for some more time so that more conducive environment may be created and agitative opposition may be set to peace. Besides consensus of all the states over the model law and introduction of VAT on uniform basis was also necessary. On 30-4-2003 he announced that unless all States conform to model draft law and agreed VAT rates, introducing VAT on 1-6-2003 will not be possible. He stated that VAT should be implemented all over India. Patchwork will not serve the purpose. In this connection, the Empowered Committee of State Finance Ministers met regularly and brought out a White Paper on State level VAT on 17-1-2005.

This White Paper on State-level Value Added Tax (VAT) was presented in three parts:

Part 1: In this part, the justification of VAT and its background had been mentioned

Part 2: The main design of VAT. While doing so, it recognized that this VAT is a State subject and therefore the States will have freedom for appropriate variations consistent with the basic design as agreed upon by the Empowered Committee.

Part 3: Part 3 discussed the other related issues for effective implementation of VAT.

Justification of VAT and Background

- In the existing sales tax structure, there are problems of double taxation of commodities and multiplicity of taxes, resulting in a cascading tax burden.
- For instance, in the existing structure, before a commodity is produced, puts are first taxed, and then after the commodity is produced with input tax load, output is taxed again. This causes an unfair double taxation with cascading effects.
- In the VAT, a set-off is given for input tax.

In the prevailing sales tax structure, several States levying multiplicity of taxes, such as turnover tax, surcharge on sales tax, additional surcharge, etc. With introduction of VAT, these other taxes will be abolished. In addition, Central sales tax is also to be phased out. As a result, overall tax burden will be rationalized, and prices in general fall.

Further, VAT will replace the existing system of inspection by a system of built-in self-assessment by the dealers and auditing.

- The tax structure will become simple. That will improve tax compliance and also augment revenue growth.

The VAT will therefore help common people, traders, industrialists and also the Government. It is indeed a move towards more efficiency, equal competition and fairness in the taxation system.

CHAPTER 25

Design of State Level VAT

25.1 What is VAT

VAT is a tax, which is charged on the 'increase in value' of goods and services at each stage of production and circulation. It is also chargeable on the value of all imported goods. It is charged by registered VAT businesses/persons/taxpayers. VAT has replaced a number of other taxes and its introduction has not resulted in either increased prices to final consumers or reduced profitability of business. VAT is levied on the difference between the sale price of the goods produced or the services rendered, and the cost thereof — that is, *the difference between the output and the input*.

In other words

- It is nothing but multi-point Sales Tax.
- It is collected on value addition only at each stage.
- Tax paid by the dealer is deducted from the tax payable collected at every point of sale and the tax already paid.

25.2 How is VAT different from the current Sales Tax?

<i>Current Sales Tax</i>	<i>Under VAT</i>
1. Tax levied at the stage of the first sale or at the final stage	1. Tax levied and collected at every point of sale
2. Successive sales (resale) of goods on which tax is already paid do not attract tax	2. Tax collected at every point of sale and the tax already paid by the dealer at the time of purchase of goods will be deducted from the amount of tax paid at the next sale
3. Dealers reselling tax paid goods do not collect any tax on resale and file NIL returns	3. Dealers reselling tax-paid goods will have to collect VAT and file returns and pay VAT at every stage of sale (value addition)
4. Computation of tax liability is complex	4. It is transparent and easier
5. Sales Tax is not levied at the time of purchases against statutory forms but there is misuse of such forms resulting in tax evasion.	5. VAT dispenses with such forms and sets off all tax paid at the time of purchase from the amount of tax payable on sale
6. Returns and challans are filed separately and the dealers have to give numerous details	6. The returns and the challans are filed together in a simple format after self-assessment done by the dealer himself
7. A large number of forms are required	7. At the most a few forms are required
8. Tax on goods only	8. Tax on goods and services both.
9. Assessment done by the department	9. Self-assessments by dealers
10. Penalty for defaulters/evaders not strict	10. Penalties will be stricter

25.3 How to calculate VAT?

VAT is calculated by deducting tax credit from tax collected during the payment period.

Illustration 25.1

Example: (Rate of tax assumed is 10%)

Purchase Price	Rs. 1,00,000
Tax paid during purchase	Rs. 10,000 (input tax)
Selling Price	Rs. 1,50,000
Tax collected during resale	Rs. 15,000 (output tax)
Input tax credit (Tax paid during purchase)	Rs. 10,000
VAT payable (output tax – input tax)	Rs. 5,000
Total tax collected by government	
At the time of purchase by the dealer	Rs. 10,000
At the time of resale by the dealer	Rs. 5,000
Total tax:	Rs. (10,000+5,000) =Rs. 15,000

Illustration 25.2

	10% Sales tax		10% VAT	
	Effect on Prices to final consumer	Proceeds to the government	Effect on Prices to final consumer	Proceeds to the government
A mines copper and sells it to a manufacturer B	100		100	
Sales tax of 10%.	10	10	10	10
Total Cost to B	110		100	
B converts it into a wire with his labour/profit and sells it to C , a wholesaler at 100% margin	220		200	
Sales tax/VAT	22	22	20	20 - 10 = 10
Total cost to C	242		200	
C sells to D , a retailer at a 20% mark-up	290		240	
Sales Tax/VAT	29	29	24	24 - 20 = 4
Cost to D	319		240	
D sells it to the consumer at 100% mark-up	638		480	
Sales tax/VAT	64	64	48	48 - 24 = 24
Cost to consumer	702		528	
Total Proceeds to government		125		48

The first thing we observe from the above table is that with equal tax rates of 10%, the final price to the consumer is 33% or Rs. 174 (Rs.702 - Rs. 528) higher in the cascading (traditional) sales-tax system. A part of this difference is owing to the Rs. 77 (Rs. 125 - Rs. 48) higher tax receipts of the government. The rest of the difference, Rs. 97, is taken by higher profits of the different intermediaries **B**, **C** & **D**.

The second thing we can observe is that almost every time the VAT is charged, it is not an expense to the person who pays it, but just an advance to the government via the supplier. This is true for all except the final customer who cannot claim the VAT deduction. Actually, he is the only one who pays the full amount. The above table assumes that the different intermediaries want to

keep a fixed percentage mark-up (perhaps because of capital invested in inventory). As a result, each time there are fewer profits to the business intermediaries who don't take a mark-up on the VAT. This also explains why the VAT is considered a better tax than the sales tax.

We also observe from the last two lines of the above table that the consumer is benefited by Rs. 174 (Rs. 702 - Rs. 528) in the VAT system whereas the government loses by Rs. 77 (Rs. 125 - Rs. 48).

Note.—In the above illustration, it is observed that in the VAT regime the effect on price to B is only Rs. 100. This is because the tax paid on purchase by B is allowed to be setoff/credited against the tax (output tax) payable by C on sale of the goods. Similarly, intermediaries C and D too will be allowed input tax credit until the goods reaches the final consumer (who cannot claim the VAT deduction).

Incidence of tax where more than one raw-material is used for production

The incidence of tax involving more than one transaction can be explained by the following illustration:

Illustration 25.3

1. R is the manufacturer of two raw-materials viz., X & Y. These two raw-materials have been manufactured by taking the basic produce of mines on which Vat has not been allowed. The selling cost of raw-material X is Rs. 100 per kg. and the rate of VAT is 4% whereas selling cost of raw-material Y is Rs. 120 per kg and the rate of Vat is 12.5%.
2. S has used 1 kg each of both the above raw-materials by purchasing it from R and manufactured product Z. The quantity manufactured after allowing for loss in manufacturing is 1.8 kg. The aggregate of wages, conversion cost and profit on the sale of produce Z is Rs. 500. Thus product Z has been sold for Rs. 720 and VAT has been charged @ 12.5%.
3. T who has purchased the above product Z from S has sold the same to U for Rs. 1000 and VAT has been charged @ 12.5%.
4. U sold the product Z to the customer W for Rs. 1500 and charged VAT @ 12.5%

Manufacturer S		
	Rs.	VAT charged Rs.
Sale price	720 @ 12.5%	90
Less: VAT credit		
100 × 4 %	4	
120 × 12.5%	15	19
Net VAT paid		71
↓		
Whole seller T		
	Rs.	VAT charged Rs.
Sale price	1000 @ 12.5%	125
Less: VAT credit		
720 × 12.5%		90
Net VAT paid		35
↓		

Retailer U		
	Rs.	VAT charged Rs.
Sale price	1500 @ 12.5%	187.5
Less: VAT credit		
1000 × 12.5%		125
Net VAT paid		62.5

Total VAT earned by the State Government Rs. 19 + 71 + 35 + 62.5 = 187.5

25.4 Eligible purchases for availing input tax credit

The input tax credit is available only when the taxable goods are purchased for the following purposes—

- (1) For sale/resale within the State;
- (2) For sale in the course of inter State trade or commerce; *i.e.* Goods are sold to any other State or Union Territory of India;
- (3) To be used as—
 - (i) Containers or packing materials;
 - (ii) Raw materials; or
 - (iii) Consumable stores,
 and the goods so manufactured by the use of the above raw-materials, packing materials are sold within the State or in the course of inter State trade commerce;
- (4) For being used in the execution of a works contract;
- (5) To be used as **capital goods** required for the purpose of manufacture of taxable goods;
- (6) To be used as—
 - (a) Raw materials;
 - (b) Capital goods;
 - (c) Consumable stores; and
 - (d) Packing materials/containers
 and goods so manufactured by the use of above items are sold in the course of export out of the territory of India.

25.5 Coverage of Set-Off/Input Tax Credit

(1) Instant credit of input tax

This input tax credit will be given both to the manufacturers and traders for purchase of inputs/supplies meant for both sales within the State as well as to other States, irrespective of when these will be utilized/sold. This also reduces immediate tax liability.

(2) No input credit on central sales tax paid on purchases from other States

At present, there is no credit of CST if inputs are purchased from outside the State. For example if the goods are purchased by Delhi dealer from Mumbai for Rs. 1,02,000 which includes CST of Rs. 2,000, Delhi dealer will not get input tax credit of Rs. 2,000. If goods are sent outside State on stock transfer basis, credit (set off) of tax paid on inputs purchased within the State is available only to the extent of tax paid in excess of 2% *e.g.* if tax paid on inputs is 12.5%, input credit of 10.5% is available.

(3) Input credit on stock transfer to other States

When CST rate is reduced to Nil, full credit of tax paid on inputs will be available i.e. inter-state sales and dispatches will be 'zero rated' and not 'exempt'.

25.6 Purchases not eligible for input tax credit

Input credit is not be allowed in the following circumstances:

1. Purchasing from unregistered dealers;
2. Purchases from registered dealer who opt for **composition scheme** under the provisions of the Act;
3. Purchases of goods as may be notified by the State Government;
4. Purchase of goods where invoice does not show the amount of tax separately;
5. Purchase of goods, which are utilized in the manufacture of exempted goods;
6. Purchase of goods used for personal use/consumption or provided free of charge as gifts (partial credit is available in the State of Maharashtra);
7. Goods imported from outside the territory of India or goods purchased before it reaches the custom frontiers of India;
8. Goods purchased from other States viz. inter-State purchases.

25.7 Input tax credit on capital goods

Input tax credit on capital goods will also be available for traders and manufacturers. Tax credit on capital goods may be adjusted over a maximum of 36 equal monthly instalments. The States may at their option reduce this number of instalments.

There is a negative list for capital goods (on the basis of principles already decided by the Empowered Committee) which is not eligible for input tax credit.

25.8 Coverage of Goods under VAT

In general, all the goods, including declared goods will be covered under VAT and will get the benefit of input tax credit.

The only few goods which will be **outside VAT** will be **liquor, lottery tickets, petrol, diesel, aviation turbine fuel and other motor spirit** since their prices are not fully market determined. These will continue to be taxed under the any other State Act or even by making special provisions in the VAT Act itself, and with uniform floor rates decided by the Empowered Committee.

25.9 VAT Rates and Classification of Commodities

- Under the VAT system covering about 550 goods, there will be only two basic VAT rates of 4% and 12.5%, plus
- a specific category of tax-exempted goods and
- a special VAT rate of 1% only for gold and silver ornaments.

25.10 Non-availability of input credit in certain cases

In the following cases credit of tax paid on inputs shall not be allowed:

1. *Where final product is exempt* — Credit of tax paid on inputs is available only if tax is paid on final products. When final product is exempt from tax, credit will not be allowed. If credit was availed, it will have to be reversed on pro rata basis.
2. *No credit if input lost/damaged/stolen before use* — Where the inputs have been lost or damaged or stolen before these have been used, credit of tax paid on such input shall not be allowed. If credit was availed, it will have to be reversed.
3. *No credit on certain purchase* — Generally, in following cases, credit is not available—
 - (a) Purchase of automobiles
 - (b) Fuel. However, some States are allowing input credit for the same.

25.11 Origin/destination principle

The following two principles are relevant for implementation of VAT—

- (a) Origin principle.
- (b) Destination principle.

(a) Origin principle: Under 'origin principle', value added domestically on all goods whether they are meant for exports or to be consumed in India is subjected to tax. Hence, if there is value added abroad tax cannot be levied on such value added in India. This principle confines VAT only to goods originating in the country of consumption. Whereas exports are taxable under this principle but imports are exempt. It is mostly used in conjunction with income VAT and is unpopular for obvious reasons.

(b) Destination principle: Under this principle, value added irrespective of the place of origin is taxable. All goods are taxed if they are consumed within the country. Consequently, exports are exempt while imports are subjected to tax. Destination principle is normally used along with consumption VAT. In a federal set-up like India, destination principle is preferred for taxation of products consumed within the various States of the country. A very important feature of this principle is that imported goods are treated at par with domestic products whereas in the origin principle imported goods are not taxable and hence it gives preference to goods produced abroad. In the EEC countries, origin principle was once considered for eliminating border controls and problems of valuation, but was subsequently given up as being impractical. Thus the destination principle is now being followed in those countries.

25.12 Variants and Methods of Computation of VAT**(1) Variants of VAT**

VAT has three variants namely,—

- (a) gross product variant,
- (b) income variant, and
- (c) consumption variant.

These variants can be further distinguished according to their methods of calculation,—

- (i) addition method,
- (ii) invoice method and
- (iii) subtraction method.

The subtraction method could be further divided into:

- (a) direct subtraction method,
- (b) intermediate subtraction method, and
- (c) indirect subtraction method.

(a) Gross Product Variant

In case of Gross Product Variant, tax is levied on all sales but deductions for taxes on all purchases of raw materials and components (*i.e.* inputs) are allowed. However, no deduction is allowed for taxes paid on capital inputs with the result that in this variant of VAT, capital goods carry a heavier tax burden as they are taxed twice.

(b) Income Variant

In case of Income Variant, tax is levied on all sales but deductions towards purchases of raw materials and components (*i.e.* inputs) as well as depreciation on capital goods are allowed. Those following this variant of VAT hold incentives by classifying purchases as current expenditure to claim set-off. In this variant, gross investment minus depreciation *i.e.* net investment is taxed. The depreciation to be provided is dependent on the life of an

asset as well as on the rate of inflation, therefore there are many difficulties connected with the variant in measuring depreciation.

(c) Consumption Variant

In case of Consumption Variant, tax is levied as all sales but deduction on all business purchases including capital assets is allowed. Thus, gross investment is deductible in calculating value added. The economic base of the tax, under Consumption Variant of VAT is equal to the total private consumption. This variant of VAT does not distinguish between capital and current expenditures hence there is no need to specify the life of assets or depreciation allowances for different assets. This form is neutral between the methods of production; there will be net effect on tax liability due to the method of production (*i.e.* substitution capital for labour or *vice versa*). The tax is also neutral between the decision to save or consume.

The consumption variant of VAT is most popular and widely used variant among the three variants of VAT. The reasons behind the preference of this variant over the other are as under:

- (a) This variant is tax neutral as it does not affect decisions regarding investment because the tax on capital goods is also set-off against the VAT liability.
- (b) This variant relieves all exports from taxation while imports are taxed which is harmonious with the destination principle *i.e.* if the destination of goods is foreign country, it should not be taxed in India.
- (c) The consumption variant is convenient from the point of administrative expediency as it simplifies tax administration as it distinguishes between purchases of intermediate and capital goods on the one hand and consumption goods on the other hand.
- (d) It does not cause any cascading effect.

(2) Method for Computation of tax

There are several methods to calculate the 'Value Added' to the goods for levy of tax. The two commonly used methods are as under:

- (A) Invoice method/tax credit method, and
- (B) Subtraction method.

(A) Invoice method/Tax credit method

Tax credit method involves payment of tax by the seller *i.e.* manufacturer or dealer at full selling price and credit of tax is allowed, which he has paid at the time of purchase. Thus, the tax is levied on full sale price, but credit is given of tax paid on purchases and effectively, tax is levied only on 'Value Added' only.

It's an easy and simple way to ensure that tax is paid. It helps elimination of cascading effect of tax on consumers.

Example

	Under Present System		Under VAT Tax	
	Manufacturer	Trader	Manufacturer	Trader
<i>Seller</i>				
Purchase Price	Trader	Consumer	Trader	Consumer
Purchase price	—	220	—	200
Value Addition (Rs.)	200	80	200	80
Selling Price (Rs.)	200	300	200	280
Tax Rate applicable (%)	10%	10%	10%	10%
Tax charged by seller (Rs.)	20	30	20	28

	Under Present System		Under VAT Tax	
	Manufacturer	Trader	Manufacturer	Trader
Tax credit available to seller (Rs.)	-	-	-	20
Total tax payable by seller (Rs.)	20	30	20	8
Total Cost to Buyer (Rs.)	220	330	220	308

Thus, under existing tax system, the consumer gets the product at Rs. 330, while when VAT system is there he gets the same product at Rs. 308; thus a saving Rs. 22.

Thus, the Government will get tax on the final retail sale price of Rs. 280. However, the tax will be paid in installments at different stages. At each stage, tax liability is worked out on the sale price and credit is also given on the basis of tax charged in the purchase invoice.

If the first seller is a manufacturer, he will get the credit of tax paid on raw materials, etc. which are used in the manufacturing. From the above illustration, it is clear that under this method tax credit cannot be claimed unless and until the purchase invoice is produced. As a result, in a chain, if at any stage the transaction is kept out of the books, still there is no loss of revenue. The department will be in a position to recover the full tax at the next stage. Thus, the possibility of tax evasion, if not entirely ruled out, will be reduced to a minimum. However, proper measures should be implemented to prevent the production of fake invoices to claim the credit of tax at an earlier stage.

It is said that in this method the beneficiary is the trade and industry because in the above example, the total tax collection at the two stages is Rs. 48 whereas tax received by the State is only Rs. 28. The set-off available is also tax paid. If the profit margin is to be kept at the Constant level then the set-off will have to be considered to avoid cascading effects of taxes.

Illustration 25.4

Manufacturer A sold product X to B of Delhi @ Rs. 1000 per unit. He has charged CST @ 2% on the said product and paid Rs. 80 as freight.

B of Delhi sold goods to C of Delhi @ Rs. 1250 per unit and charged VAT @ 12.5%.

C of Delhi sold goods to D, a consumer @ Rs. 1500 per unit and charged VAT @ 12.5%

B Liability of VAT

	Rs.
Cost of product X purchased from Mumbai	
Rs. 1000 + 20 (CST) + Rs. 80	1,100
(Credit of CST shall not be allowed under VAT)	
Sale price	1,250
VAT payable	156.25

C Liability of VAT

Purchase price exclusive of VAT	1,250
VAT credit to be taken	156.25
Sale price	1,500
VAT payable @ 12.5%	187.50
VAT credit allowed	156.25
Net VAT payable	31.25

(B) Subtraction method

Under subtraction method, the purchase price is deducted from selling price and tax is paid on the net amount only *i.e.* value added. Thus, when the tax is paid on net amount, dealer's margin is disclosed.

This method is unpopular and cumbersome. It is practically impossible when various inputs are used in the manufacture of numerous outputs. It is also not preferred by dealers as their margin gets disclosed.

Subtraction method, which is also simple method is another method to determine the liability of taxable person.

Example

Suppose a manufacturer sells goods to a trader for Rs. 220 which includes tax charged @ 10%. The trader sells the same goods to a consumer for Rs. 388 which also includes tax charged @ 10%. The tax in this case shall be worked as under:

Manufacturer sells the goods to trader	Turnover	VAT @ 10%
	220	20
		$[220 \times 10/110]$
Trader sells the goods to consumer		
Taxable turnover shall be		8
$308 - 220 = 88$	88	$[88 \times 10/110]$

Total tax Rs. 20 + 8 = Rs. 28.

In the above system also, the incidence of tax is at each stage.

25.13 Advantages of VAT

VAT being a broad based tax levied at multiple stages is generally perceived as an explicit replacement of State sales tax for raising additional revenue for the Government. The purpose of a tax system is to bring in revenues to the Government. Tax revenues can be raised in many ways. However, the main characteristic of good tax system should be—

- The tax system should be fair or equitable;
- It should cause the least possible harmful effects to the economy and to the extent possible, it should promote growth to the economy;
- It should be simple both for its compliance by the payer and for its administration by the Government;
- It should be income elastic.

Keeping in view the above objectives, VAT is being implemented in various states in place of the local sales tax payable by the seller. VAT is also expected to be more effective and efficient for every person including Government, manufacturers, traders and consumers and hold the following advantages:—

(i) Easy to Administer & Transparent

This system of charging tax is easy to administer because of its simplicity. It also reduces the cost of compliance by the dealers and is transparent, as tax is to be charged in every bill and there will be no local statutory forms.

(ii) Less Litigation

There will be no litigation with respect to allowability of items, as under VAT no items will be specified in the registration certificate of the dealer. The dealer will be allowed to purchase any of the items of his choice in which he intends to deal. He will

also be allowed to purchase any item he requires as raw material for the purpose of manufacturing or for packing.

(iii) Tax Credit on purchase of Capital Goods

The dealer will be allowed to purchase capital goods for manufacturing after paying sale tax and will be entitled to get set off sales tax paid on such purchases from his sales tax liability, which will arise on the sales made by him.

(iv) Abolition of Statutory Forms

There are no forms under VAT. Therefore, all problems related to forms automatically get resolved. Dealer will not have to make visits to department to get these forms issued. Similarly, there will be saving to the department both in terms of cost and in terms of time. Assessing Officers will be saving lot of time which otherwise was being wasted in issuance of statutory forms, and now this can be utilised for other useful purposes including monitoring of tax collection and better administration. Tax collection cost of the department will go down. There will be a direct reduction and the amount spent on the cost of paper and printing of statutory forms will become NIL. Secondly, the department will also be able to serve more dealers with existing staff and that too more efficiently.

(v) Self-Assessment

Dealers are not required to appear before the Assessing Authority for their yearly assessments, as under VAT there is provision for self-assessment. All the cases will be accepted by the department as correct and only a few will be selected for audit as is being done by Income Tax Department and Excise Department at present.

(vi) Deterrent against Tax Avoidance

It will act as deterrent against tax avoidance. Under the present system, tax is charged either on first point basis or at last point basis hence the incentive to evade tax is high because the dealer saves the whole amount of tax due on such transaction, whereas under VAT the incentive to evade tax is low because the dealer saves only a part of tax *i.e.* (tax amount which he is liable to pay less the amount of tax he has already paid on his purchases). Even otherwise the chances of not seeking sales invoice by the subsequent purchaser is less (unless otherwise he is a consumer and not registered with the department) as he will not be entitled to claim tax benefit for the tax paid by him unless he is in possession of the tax invoice.

(vii) No Cascading Effect

It does not have cascading (tax on tax) effect due to system of deduction or credit mechanism. Since VAT does away with cascading, it avoids distorting business decisions; the need for vertical integration is dictated only by the market forces or technical considerations, and not by the tax structure.

(viii) Effective Audit & Enforcement Strategies

The input credit method by generating a trail of invoices is argued to be system that encourages better compliance since the purchaser seeks an invoice to get input tax credit. Further, this trail of invoices supports effective audit and enforcement strategies.

(ix) Minimum Exemptions

The system will be more effective because of minimum exemptions.

(x) Removal of Anomaly of First Point Taxation

VAT eliminates the limitations of single point tax either at first point or last point. In the case of last point goods, the temptation to evade tax is high. Firstly, the quantum of tax at one point is very high. Secondly, as the exemption is available against statutory

forms, possibility of misuse of forms cannot be ruled out. Similarly, under first point tax system, tax avoidance by way of selling the goods at first point to their sister concerns at lower rates and thereafter increasing the price of the goods because subsequent sales being exempt as tax paid. This anomaly is also being taken care of under VAT, without introducing cascading.

Since the dealer gets a set off for taxes paid at the earlier stages these are not treated as part of costs and this is expected to reduce that component of cost as well as the associated financing requirement. Further, the problem of enhanced cascading via the markup rule too is also ruled out under the system.

(xi) Discourages Ancillarisation

Ancillarisation means getting most of the parts/components manufactured from outside and making final assembly. It is common for large manufacture (like automobile machinery, etc.) to get the parts manufactured from outside and make final assembly in its plant. If a component is purchased from outside tax is payable, however if the same is manufactured inside the factory no Tax would be payable. Thus, manufactures are tempted to manufacture parts themselves instead of developing ancillary units for supply of the same. This is against the national policy because it encourages growth of Small Scale industry and increases concentration of economic power. If a manufacture decides to reduce ancillarisation, it increases cost of production and waste of scarce national resources as the large manufacture may not be in a position to fully utilize the production capacity of the machinery.

(xii) Competitiveness of Exports

Export can be freed from domestic trade taxes in real sense.

(xiii) Instrument to tax consignment of goods

Instrument of taxing consignment of goods and services.

(xiv) Economic Advantages

- (a) Buoyant Revenue,
- (b) Efficient tax collection,
- (c) Neutrality with minimum dist,
- (d) Interference in market forces is minimum.

Looking at the advantages of VAT, it appears that the amount of benefits which the society will be reaping from its implementation will be enormous.

25.14 Limitations of VAT

India being a Federal Republic country has state level administration of the local sales tax which is being replaced by VAT and had been the reason for deferment of its implementation time and again. Inherently there are certain limitations of VAT due to which it being opposed by some of the trade associations. Moreover VAT undoubtedly has many advantages but without taking note of the limitation of VAT, one is just looking only at one side of the coin. The limitations of VAT are discussed hereunder:

(i) Detailed Records

Like any other system VAT is also not free from all evils. Though on record it is said to be the simplest method, however, it is more complicated than a simple first point tax. Many small dealers maintain only primitive accounts and it is very difficult for them to keep proper and detailed records required for VAT purposes. It will also be difficult to administer the tax systems at wholesale and retail stage as they usually deal in numerous products and commodities, which carry different rate. Thus matching of output and input

taxes is difficult. Ideally VAT should have very few rates which does not seem to be possible in India due to varying and diverse fiscal and social requirements. In case matching requirement is waved off there is a possibility of tax evasion as explained hereunder:—

Purchases made by a Dealer

	Amount (In Rs.)			
1%	4%	8%	20%	Total
1,000	1,000	1,000	1,000	4,000
Tax Paid				
10	40	80	200	330

Sales Shown by Dealer

Case A

I	II	III	IV	Total
1,200	1,200	1,200	1,200	4,800
12	48	96	240	396

Tax Liability (Rs. 396 - Rs. 330) = Rs. 66

Case B

I	II	III	IV	Total
1,400	1,200	1,200	1,000	4,800
14	48	96	200	358

Tax Liability (Rs. 358 - Rs. 330) = Rs. 28.

(ii) Causes Inflation

It is also argued that VAT causes inflation. Its impact will depend on various factors such as inventory holding period, demand supply position of that particular product, number of intermediaries etc. Investment in stock is bound to increase as tax will be paid at the time of purchase, hence one will have to carry tax paid stock.

(iii) Refund of Tax

Credit of tax paid on inputs/capital goods is available to be utilised against tax liability which will be calculated on the sale of final product. VAT credit can not be availed if no tax is payable on final product being exempt or taxable at lower rate. Similar situation will arise in the case of exporters also. Hence a mechanism is needed for the early refund of tax paid on input/capital goods in the case of dealer/manufacturer of exempted goods or exporters. Similarly refunds will also arise on sales made to diplomats/diplomatic missions and to other organisations who are exempted from the levy of sales tax.

(iv) Functional Problems

The functional problem of VAT is that input tax credit is allowed on the basis of the invoices issued by the dealer. In respect of invoices where tax at the earlier stage is charged and collected, but not remitted to the State by the concerned dealer, the dealer who has paid the tax and who is entitle to take credit for the tax paid should not be made to suffer. Provisions to protect the interest of the dealers who have paid the tax should be made.

(v) Increase in investment

Dealer will be making purchases after paying tax, therefore investment in stock will go up the extent of tax paid. Under old system the dealer was making purchases against statutory forms, hence was not liable to pay tax on its purchases.

(vi) No Credit for Tax paid on Inter-state Purchases

The biggest problem of introduction of VAT is the non-availability of credit for tax paid on interstate purchases in initial years. It will also result in some cascading effect, which goes against the basic spirit of VAT.

(vii) Composition Scheme

Introduction of composition scheme will obstruct the flow of audit trail and this scheme can be misutilised by unscrupulous dealer.

(viii) Financial planning by Department

VAT will require comprehensive financial planning on the part of State Government to calculate the value of retainable tax because there is an involvement of refunds under VAT as discussed hereinabove.

(ix) Audit under VAT

Most of the States introduced VAT on 1.4.2005 and they have incorporated audit provisions in the Legislation itself. Audit under VAT is important for better and effective implementation of the VAT system

25.15 Requirement of Audit under VAT**(A) Lack of Education among Traders Community**

In our country the trading community is not educated enough therefore they face problem in understanding the requirements of tax laws. Moreover the VAT system of taxation is new to the trading community.

Due lack of knowledge and unawareness, the traders are not well equipped to understand the implications of the VAT system of taxation. Keeping these factors in view the State Government in order to arrange their business affairs to fall in line with the requirements of the State – Level VAT, calculate and discharge their exact tax liability under the VAT Law have incorporated audit provisions in VAT Acts.

(B) Lack of Resources with Taxation Authorities

The taxation authorities do not sufficient resources to educate the tax payers and inform them about the procedural requirements and accounting changes that are required under VAT system. Due to lack of resources, the taxation authorities are also not in a position to ensure that all the requirements of VAT are being fulfilled and there is no loss of Government revenue. Therefore, it is desirable to prescribe for an audit under VAT by a qualified professional so that the taxation authorities may the procedural requirements.

(C) Self-Assessment under VAT regime

Another reason for prescribing an audit under the VAT by a Chartered Accountant, is that under the VAT system a major thrust is to be laid on the 'self assessment'. The dealer/assessee calculates its tax liability himself and thereafter pays the same. The tax payers through their periodical returns inform the Department about its business affairs. These periodic returns are accepted by and large and the tax payers are not to be called for substantiating their tax liability as shown by them in the returns by producing books of account and other relevant material. The assessments with books of account will be an exception. Therefore there is a strong need to see that the tax payers discharge their tax liability properly while filing the returns. This can be ensured only where the particulars furnished by the tax payers are verified by an independent auditor in minute details by going not only through the books of account but also by analyzing and interpreting the provisions of the State – Level VAT Laws and reporting, whether any under-assessment was made by the dealer requiring additional payment or whether there was any excess payment of tax warranting refund to the tax payer.

Due to these factors and requirements audit under VAT become essential and shall be performed on a regular basis. However, it is not possible to conduct the audit of all the VAT dealers. Therefore, the criteria for audit can be the amount of turnover or the class of dealer dealing in specified commodities.

25.16 General requirement for VAT System

(a) *Compulsory issue of tax invoice and Retail Invoice:* The entire design of VAT with input tax credit is crucially based on tax invoice, or retail invoice.

Tax invoice: Every registered dealer, having turnover of sales above an amount specified, shall issue to the purchaser serially numbered **tax invoice** with the prescribed particulars.

This tax invoice will be signed and dated by the dealer or his regular employee, showing the required particulars.

The dealer shall keep a counterfoil or duplicate of such tax invoice duly signed and dated. Failure to comply with the above will attract penalty.

The purchaser will get input credit on the basis of the said tax invoice.

Retail invoice: Where sales are made to a consumer or in the course of inter-State trade and commerce, the dealer shall issue retail invoice. No input credit is available to purchaser on the basis of this retail invoice.

(b) *Registration:* There is a compulsory registration of the dealer if the aggregate turnover exceeds a certain specified limit. It is Rs. 5,00,000 in most of the States whereas in Delhi it is Rs. 10 lakhs. Small dealers whose gross turnover does not exceed Rs. 5 lakh/10 lakh shall not be liable to pay VAT. These small dealers will not be allowed input tax credit on their purchases. Small dealers may also get voluntary registration and come under the purview of VAT provisions.

(c) *Composition scheme:* A small dealer whose turnover does not exceed a specified limit (say in Delhi Rs. 50 lakhs) can opt for composition scheme where he shall have to pay tax himself at a small percentage of gross turnover and in this case buyer of goods **with not be entitled to input VAT Credit.**

(d) *Tax Payer Identification Number (TIN):* There will be a taxpayers identification number of 11 digit numerals which will be unique to each dealer. First two characters will represent the State Code as used by the Union Ministry of Home affairs. The set up of the next nine characters may, however, be different in different States.

(e) Simplified return of VAT are to filed monthly or quarterly as specified by each State.

Every return furnished by dealers will be scrutinized expeditiously within prescribed time limit from the date of filing the return. If any technical mistake is detected on scrutiny, the dealer will be required to pay the deficit appropriately.

(f) Self-assessment by dealers.

Procedure of Self-Assessment of VAT Liability

- The basic simplification in VAT is that VAT liability will be self-assessed by the dealers themselves in terms of submission of returns upon setting off the tax credit.
- Return forms as well as other procedures are simple in all States.
- There will not longer be compulsory assessment at the end of each year as is existing now. If no specific notice is issued proposing departmental audit of the books of accounts of the dealer within the time limit specified in the Act the

dealer will be deemed to have been self-assessed on the basis of returns submitted by him.

(g) Audit under VAT has been made compulsory by various States.

- Correctness of self-assessment will be checked through a system of Departmental Audit.
- A certain percentage of the dealers will be taken up for audit every year on a scientific basis. If, however, evasion is detected on audit, the concerned dealer may be taken up for audit for previous periods.
- This Audit Wing will remain delinked from tax collection wing to remove any bias.
- The audit team will conduct its work in a time bound manner and audit will be completed within six months. The audit report will be transparently sent to the dealer also.
- Simultaneously, a cross-checking, computerized system is being worked out on the basis of coordination between the tax authorities of the State Government and the authorities of Central Excise and Income Tax to compare constantly the tax returns and set-off documents of VAT system of the States and those of Central Excise and Income Tax.
- This comprehensive cross-checking system will help reduce tax evasion and also lead to significant growth of tax revenue.

(h) No requirement of any declaration form as bill will be raised for each sale and VAT shall be levied.

(i) Comprehensive coverage as only few commodities have been exempted from VAT.

MULTIPLE CHOICE QUESTIONS

- 1 Tax is levied under VAT at
 (A) Last stage of sale
 (B) Multistage
 (C) First stage of sale
 (D) First and last stage of sale

Write True or False

- 1 Input credit under VAT is available on account of Central Sales Tax paid on the purchases
- 2 Input credit is available on account of import duty paid on goods purchased from a country outside India
- 3 Input credit is payable on account of VAT paid on capital goods
- 4 Input credit is available only if the purchaser has obtained proper tax in voice
- 5 VAT avoids cascading effect
- 6 Vat is easy to administer and transparent

Answers to multiple choice questions

1. (B)

Answers to True or False

- | | | | | | |
|---|-----|---|-----|---|-----|
| 1 | (F) | 3 | (T) | 5 | (T) |
| 2 | (F) | 4 | (T) | 6 | (T) |