

VAT IN SPECIAL TRANSACTIONS

11.1 VAT AND SALES-TAX INCENTIVES

Traditionally all the State Governments have been using sales-tax incentives as an important developmental tool particularly, for industrial development of an area of the State which is undeveloped or underdeveloped and where no one would like to set up an industry because of several disadvantages such as lack of proper infrastructure, remoteness of the market, unwillingness of the workers to work in the remote and isolated areas etc. The basic philosophy of the incentive schemes is that even if the State does not get revenue from sales tax, the taxpayer will contribute towards the development of the undeveloped area of the State and get rewarded out of more realisation.

Any fiscal exemption from tax or subsidy is against the principles of VAT as it breaks the VAT chain. VAT system works on the basis of tax credit passed at each stage of production and distribution through issuance of tax invoices. Dealers effecting exempted sales are not allowed to avail input tax credit and they also cannot pass on the credit. Therefore, if a transaction in the VAT system passes through an exempted dealer, credit earned from the first point of chain till such dealer gets lost, thereby breaking the VAT chain.

11.1.1 Principles laid down in the White Paper

The White Paper on State-Level Value Added Tax provides that under the VAT system, the existing incentive schemes may be continued in the manner deemed appropriate by the States after ensuring that VAT chain is not affected.

Thus, at the national level, no common policy has been adopted regarding the treatment of incentive schemes. This was due to the reason that different states have offered various kinds of incentives depending on the requirements and the local needs of the States and the relevant tax system in the State. The Empowered Committee while allowing the States to decide their own policy for treatment of Incentives had prescribed certain preconditions:

- (i) the quantum as well as the time period allowed for availing the incentives should not be increased or extended.
- (ii) VAT chain should not be affected.

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11.1.2 Different incentive schemes

By and large the incentives are given in three modes as described below:-

(a) Exemption from tax

Under this mode incentives are given by way of exemption from tax. The eligible industry is not required to pay any sales tax on purchases of raw material as well as on sales of finished product. The advantage of this mode is that the unit is not required to pay any tax and thus its realisation improves. This brings it in a position to stand the competition. The amount of entitlement is to be availed within a specified period. The exemption so allowed, ceases either with the expiry of exemption period or the exemption amount whichever occurs first.

(b) Deferment of tax liability

Under this mode eligible industry is at par with any other normal unit. It collects the tax on sale of finished goods and also pays the tax to its vendors on the purchase of raw materials etc. However, such eligible unit/industry is not required to pay the collected tax to the Government immediately. The tax liability is assessed by applying the normal provisions. However, payment of tax to the Government is deferred for particular period. After that particular period, the liability is required to be paid in prescribed instalments.

(c) Remission of tax

Under this mode an eligible industry is allowed to collect tax at an appropriate rate but is not required to pay the same. The unit is required to file periodical return and show the tax liability. After filing the return the department remits the tax liability in full. Thus, the tax liability as per return is deemed to have been paid. The input tax paid on purchases by the unit is being given as refund immediately after filing the return.

The exemption mode will not be suitable for VAT regime as it would break the VAT chain. The dealers would not be able to issue tax invoices and pass on the credit. However, under deferment and remission mode the VAT invoices showing VAT separately can be issued by the dealer, thereby resulting in continuance of VAT chain. These modes of incentives, therefore appear to be much better option under VAT regime for exempted units as they fulfill the objective of grant of incentives without breaking the VAT chain.

11.1.3 Consideration for schemes under VAT laws

The States implementing VAT have taken a uniform decision to continue the incentives under VAT. However, some States have decided to continue exemption/deferment as per the earlier position while some have decided to change the exemption mode for availing incentives to the deferment mode.

The broad principles, which have been considered by the States while framing various schemes, are:

- (i) The VAT chain should not be disturbed.

- (ii) There should not be any further revenue loss to the States.
- (iii) The Department should be able to track the transactions and should ensure that there is no evasion/avoidance of tax due to the policy.
- (iv) In addition, wherever exemption/deferment as per old provision is continued additional issues considered are as under:
 - (a) the units enjoying exemption under the old law should not be put to disadvantageous position under the VAT system.
 - (b) the units who are purchasing inputs without payment of any tax should be allowed to enjoy the benefit under the new system also.

11.2 VAT AND WORKS CONTRACT

The works contract is a deemed sale, which involves the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract. Under State VAT laws works contract transactions too shall be subjected to VAT within the purview of Entry 54 of the List II of the Seventh Schedule of the Constitution.

Earlier the judicial decisions took a view that in the case of composite contracts involving sale of goods and execution of works, no sales tax could be levied at all. However, in order to make the law clear, the 46th amendment to the Constitution provided for the taxation of transfer of materials used in the execution of a works contract as deemed sale. Clause 29A was added to Article 366 of the Constitution of India to cover 'transfer of property in goods involved in execution of works contract'.

11.2.1 Constitutional authority

The power of the States to levy VAT on sales and purchases of goods is derived from Entry 54 of List II (State List) of Schedule VII to the Constitution of India which reads as under:

Entry 54. "Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of entry 92-A of List I".

Clause (29A) of the Article 366 of the Constitution defines the term "tax on sale or purchase of goods" as under:

- (29A) "tax on the sale or purchase of goods" includes-
- (a) a tax on the transfer, otherwise than in pursuance of a contract, of property in any goods for cash, deferred payment or other valuable consideration;
 - (b) a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract;
 - (c) a tax on the delivery of goods on hire-purchase or any system of payment by instalments;

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- (d) a tax on the transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration;
- (e) a tax on the supply of goods by any unincorporated association or body of persons to a member thereof for cash, deferred payment or other valuable consideration;
- (f) a tax on the supply, by way of or as part of any service or in any other manner whatsoever, of goods, being food or any other article for human consumption or any drink (whether or not intoxicating), where such supply or service is for cash, deferred payment or other valuable consideration,

and such transfer, delivery or supply of any goods shall be deemed to be a sale of those goods by the person making the transfer, delivery or supply and a purchase of those goods by the person to whom such transfer, delivery or supply is made.

Thus, sub-clause (b) of clause (29A) of Article 366 provides for charging of tax on works contract.

11.2.2 Definition of works contract

The Finance Act, 2005 had inserted clause 2(ja) in the Central Sales-tax Act, 1956 which reads as under:

'(ja) "works contract" means a contract for carrying out any work which, includes assembling, construction, building, altering, manufacturing, processing, fabricating, erection, installation, fitting out, improvement, repair or commissioning of any movable or immovable property".

Majority of the States have adopted this definition for works contract in their VAT legislations.

11.2.3 Guidelines to ascertain works contract

To ascertain whether a transaction is a works contract as contemplated in Article 366 (29A)(b), the following points should be kept in mind:

1. There must exist an individual works contract; divisible contracts are out side the scope.
2. Goods must be involved in the execution of the works. Transfer of property in goods does qualify as works contract when it is incorporated in the works.
3. Transfer of property in goods must pass as goods or in some other form. Form of goods has no relevance (may have a relevance for determination of rate of tax).
4. Property in goods must pass during the execution of works not before or after the execution of works.
5. Some work has to be done on the property of the contractee by the contractor.
6. In the works contract, transfer of property must be an integral part of its execution.
7. Pure labour contracts or service contracts are out side the purview of the sales tax/VAT law.

8. If during the execution of works contract goods are consumed and their identity is lost then no transfer of property occurs in those goods.
9. There must be a dominant intention to effect the transfer of property in goods in execution of works contract. However, even if the dominant intention of the contract is rendering of a service, and in that process if there is a transfer of property in goods, the contract will amount to a works contract.

11.2.4 Taxable turnover for works contract

The entire contract price cannot be subjected to VAT but only value of the goods in which the property would pass during execution of works contract can be taxed. Therefore, turnover for imposition of VAT in relation to the transfer of property in goods (whether as goods or in some other form) involved in execution of a works contract, shall mean sale price of goods in which there is transfer of property. The amount representing labour and other service charges incurred for such execution should be excluded.

Where such labour and other service charges are not quantifiable, the sale price shall be the cost of acquisition of the goods and the margin of profit on them prevalent in the trade plus the cost of transferring the property in the goods and all other expenses in relation thereto till the property in them, whether as such or in any other form, passes to the contractee and where the property passes in a different form, the sale price shall include the cost of conversion.

11.2.5 Tax rates

The principle schemes of levy of sales tax on works contracts have been retained in the VAT regime as well. The VAT legislations provide the following two broad schemes for levy of VAT on transfer of property involved in the execution of the works contract:

(a) Schedule Rate

As a basic feature, tax is chargeable on the transfer of property in the goods involved in the execution of a works contract at the rates prescribed for the concerned goods in the schedules of the concerned State VAT legislation. Where the value of each item of material transferred in the course of execution of a works contract is identifiable, tax is charged on the value of individual items of materials as provided under the schedules to the concerned State VAT legislation. On inputs the contractor is entitled to avail input tax credit.

(b) Composition Rate

The VAT Legislations have provided for composition rates to be applied on the entire contract value of the works contract. In such cases, generally the contractor is not entitled to avail of input tax credit on goods procured from within the State. However, in some States (e.g. Maharashtra) partial input tax credit is granted.

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11.2.6 Composition scheme

Under works contract the scheme of composition is a mechanism provided to collect the tax in a simple manner. The object of such a mechanism is to minimise the inconvenience caused to the assessee and also to the department in computing the figures. However, it must be noted that in the composition scheme input tax credit is not allowed.

Provisions for compounding levy are only enabling provisions where an option is given to the assessee either to opt for composition or to file the returns. Therefore, before opting for the composition scheme the contractor must analyse the expenditure components like labour charges, hire charges for machinery and tools, cost of consumables, cost of establishment, profit element, value of local tax-suffered goods, turnover of sub-contractors, value of exempted goods etc. because all these are included in the total contract value which is subjected to composition fee.

Since the composition amount is worked out on the basis of the total value of the contract, whether composition scheme is to be preferred or not depends upon the nature and scope of the contract. The composition scheme has both merits and demerits, so before opting for this scheme the contractor should see whether it is economical for him or not.

11.2.7 Input tax credit on capital goods

Several kinds of works contracts do not involve any manufacturing or processing of goods e.g. contracts for construction of roads, bridges, etc., and yet we find that capital goods of substantial amount are used in the execution of such contracts. Majority of the VAT legislations provide for availing of input tax credit on capital goods **only** where such goods are used in manufacturing or processing of goods.

11.3 VAT AND LEASE TRANSACTIONS

A lease is a special type of transaction, under which a party owning the asset (called the 'lessor') provides that asset for use over a certain period of time to another party (called the 'lessee') for consideration (called 'rentals'). The legal ownership of the asset remains with the lessor, but the lessee retains the possession and uses the asset over the period of the lease.

Therefore, the characteristics of a lease are:

- (a) there must be a lessor and a lessee both competent to contract;
- (b) there must be an asset to be leased;
- (c) actual possession and control on the asset must be transferred;
- (d) there must be an acceptance of the lease property;
- (e) there must be transfer of right of enjoyment by the lessor to the lessee;
- (f) there must be a consideration.

11.3.1 Lease as per AS 19

Accounting Standard (AS 19) issued by the Institute of Chartered Accountants of India defines lease as “an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.”

Generally, there are two different types of leases:

Finance lease : Here the lessor provides finance to the lessee for the purchase of necessary equipments. Machinery and tools, intended to be purchased are purchased in the name of the lessor, but the right to select the assets rests with the lessee. Lessor's interest in the equipment is that of ownership and the rent received or receivable against such lease. After the end of lease period the lessee has an option to purchase the leased asset. As per the Accounting Standard (AS 19) on leases issued by the ICAI, a finance lease is a lease that transfers substantially all the risks and rewards incident to the ownership of an asset.

Operating lease : Here the lessor selects the machinery and equipment required to be purchased and then leases out the same to the customer. The ownership is retained by the lessor but the use of the assets by the lessee is made for a limited period of time. The AS 19 on Leases defines an operating lease as a lease other than a finance lease.

11.3.2 Constitutional authority

Lease is chargeable to tax by virtue of sub-clause (d) of clause (29A) of Article 366 of the Constitution of India (refer clause (29A) in para 11.2.1). Sub-clause (d) provides that tax on sale or purchase includes “a tax on the transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration.” In common parlance, these transactions are known as lease of goods and are also referred to as “deemed sales”. The tax on these sales is referred to as “lease tax”. Such transfer of right to use the goods could be for any purpose and the period may or may not be fixed.

11.3.3 Taxable event

Taxable event is the transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration. Thus, a transfer which is gratuitous is not taxable. Also, transfer of the right to use *immovable property*, like renting a house or factory is not taxable.

11.3.4 Taxable turnover

Normally, the sale price means the amount of valuable consideration paid or payable for any sale made during the given period. It also includes some other charges before delivery thereof. However, certain States have provided for the deduction of interest or finance charges for the purpose of determination of sale price/taxable turnover.

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11.3.5 Inter-state leasing

Lease of an asset that is in the course of inter-State or import trade cannot be taxed under a State VAT law. It can be taxed under the Central Sales-tax Act, 1956.

As the definition of "sale" in the Central Sales-tax Act, 1956 has been amended to cover 'deemed sale', therefore deemed sales in the course of inter-State trade will attract tax under the Central Sales Tax Act.

11.3.6 Sub-lease

Transfer of the right to use goods does not require that the goods should be owned by the person effecting such transfer. Accordingly, sub-lease of an asset too can be taxed, unless the State Value Added Tax law has provided for the levy of tax only at one stage.

11.3.7 Sale of leased asset after lease period

Sale of a leased asset after the lease period is over is taxable in the same manner in which normal sale of such asset would have been taxed. Normally, such sale is effected to the same lessee and hence such sale would be a local one exigible to tax under the VAT laws of the State in which the asset is located.

11.3.8 Maintenance of leased asset

The maintenance of the leased asset involving supply of materials for maintenance/repair by the lessor would not amount to works contract, as there would be no transfer of property in such materials to the lessee. Thus, there would be no VAT on the value of the materials supplied during maintenance/repair of the asset. In case of computers, generally the lessor undertakes the maintenance and repair of the leased computers. However, the materials required during such maintenance /repair would be input for sale and input tax credit will be available.

11.3.9 Input tax credit

(a) Input tax credit allowed on purchase of the leased asset

Under the VAT legislations tax is to be charged on each stage of sale with the availing of input tax credit of the tax charged on the earlier stages. The tenure of the lease agreements is generally spread over a long period of time and lease rentals are collected over such lease periods. The lessor would pay VAT at the time of procurement of goods. However, liability to pay VAT on lease rentals will be spread over the tenure of the lease. Therefore, some States have provided for utilization of input credit for paying output tax only over the entire period of lease.

This would result in accumulation of input tax credit in the hands of the lessor for a long period of time. Since the tax would eventually be payable by the lessor, he may opt to carry forward the excess input tax credit instead of claiming a refund from the tax authorities. Consequently, the lessor would have to manage his working capital in order to ensure that

carrying of excess input tax credit does not affect his business adversely. However, States like Maharashtra have provided for immediate utilization of such input tax credit against payment of any tax.

(b) Input tax credit as capital goods

The assets given on lease will be generally capitalized by the lessor in his books and will be treated as capital assets. Thus, provision relating to input tax credit on capital goods will apply, e.g. if VAT law provides to give input tax credit on capital goods in 36 months then irrespective of period of lease, input tax credit will be available only for 36 months.

11.3.10 On going leases

In case of the lease agreements entered prior to the introduction of VAT, the lessor would have paid sales tax at the time of procuring the goods. Further, if the lease agreement related to first point goods, the lessor would not have been required to pay any tax on the lease rentals received by him in the sales tax regime.

However, in the VAT regime, the lessor would be required to pay tax on the lease rentals received post introduction of VAT with availability of input tax credit of sales tax paid at the time of procurement of such goods. The availing of input tax credit would be subject to the provisions of the concerned VAT legislations.

11.4 VAT AND HIRE-PURCHASE TRANSACTIONS

Hire purchase is a type of instalment credit under which the hire purchaser, called the hirer, agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase. Under this transaction, the hirer acquires the property (goods) immediately on signing the hire purchase agreement but the ownership or title of the same is transferred only when the last instalment is paid. The hire purchase system is regulated by the Hire Purchase Act 1972. This Act defines a hire purchase as “an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:

- (i) The owner delivers possession of goods thereof to a person on condition that such person pays the agreed amount in periodic instalments.
- (ii) The property in the goods is to pass to such person on the payment of the last of such instalments, and
- (iii) Such person has a right to terminate the agreement at any time before the property so passes”.

Hire purchase should be distinguished from instalment sale wherein property passes to the purchaser with the payment of the first instalment. However, in case of hire purchase

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(ownership remains with the seller until the last instalment is paid) buyer gets ownership after paying the last instalment.

11.4.1 Constitutional authority

Sub-clause (c) of clause (29A) of Article 366 of the Constitution of India provides for "a tax on the delivery of goods on hire-purchase or any system of payment by installments." By virtue of this sub-clause, State legislations have been able to deem that a sale takes place on the date of delivery of the goods on hire purchase notwithstanding the fact that the option to purchase is exercised only at the end when the title of the goods as per the terms stands transferred from the dealer to the hirer.

Pure financial transactions

The transactions which are purely of a financial nature between the financier and the hirer are not covered by sub-clause (c) of clause (29A) of Article 366. The Supreme Court in the case of *Sundaram Finance Ltd. vs State of Kerala (17 STC 489)* held that in the given case the transaction though termed as hire purchase was merely a financial transaction involving no sale. In this case, Sundaram Finance Limited was carrying on the business of financing. The customer who purchased motor vehicles from the dealer directly, applied to the company for a loan, which was paid by the company directly to the dealer. The company as a security for repayment got executed a promissory note, a sale letter, receipt for the amount paid, an undertaking to keep the vehicle insured and an agreement called 'hire purchase agreement' in which the company was shown as "owner" to let the vehicle to the customer as "hirer." On interpretation of the total documents, the Supreme Court held that intention of the company in obtaining hire purchase and other agreement was to secure return of loan advanced to the customer and there was no real sale of vehicle intended to the customer by the company. The Court therefore held that there was no sale of the vehicle by Sundaram Finance Ltd. to the hirer and so it was outside the purview of sales-tax law.

11.4.2 Physical delivery

Delivery of goods under hire-purchase or installment sale has to be a physical or actual delivery of goods in contradistinction to constructive or symbolic delivery of goods as the goods are intended to be delivered for use by the hirer/customer. Consequently, the taxable event takes place in the State in which the goods are actually delivered and hence subject to tax under the VAT law of such State.

However, if there is movement of goods from one State to another in pursuance of a contract the position may change. In such a case, it would be an inter-State sale and tax should be imposed under the Central Sale-tax Act 1956.

Under VAT laws of different States hire-purchase and installment sales are at par with normal sales and hence the provisions of the State VAT laws as applicable to normal sales are equally applicable to hire-purchase and installment sales.

It may be noted here that in such transactions the word 'purchase' is of primary significance while 'hire' is an adjunct. In a contract of hire-purchase the contract is for 'purchase' with the attributes of hire and not 'hire' with the attributes of a purchase. As a corollary of it, the hirer or the customer under the installment sale effects deemed purchase of the goods delivered to him in respect of which he can claim the same concessions as the dealer effecting normal purchase of the goods.

11.4.3 Taxable event

The definition of sale under value added tax laws of various States provides that the taxable event will be the delivery of goods on hire purchase or any system of payment by installments. It is implicit that such transaction should be for monetary consideration.

In the case of hire-purchase, property passes in the goods when the hirer exercises his option to purchase the goods subject to the fulfillment of the terms of the agreement and then the transaction fructifies into a concluded (normal) sale.

In the case of delivery of goods on a system of payment by installments, property in the goods passes only where all the installments are paid, which the customer is under an obligation to pay. Such a sale is called 'an installment sale'. Such a transaction is distinct from a credit sale of goods as in the credit sale, the property in the goods immediately passes on delivery of the goods and the buyer is allowed to pay the price by installment or otherwise.

The basic difference in taxation of hire-purchase transaction is that the taxable event has been made the delivery of the goods and not the completed sale on payment of the last installment.

11.4.4 Point of tax

A debatable question which arises is whether in case of hire-purchase or installment sale VAT will have to be paid again at the time when transaction fructifies into a concluded sale, inspite of tax having been deposited on installment (payable as and when due, whether or not recovered). Answer to this problem depends mostly upon the provisions of the VAT laws of the States in which the goods are located when the transaction fructifies into a concluded sale.

One view is that when the transaction fructifies into a concluded sale, tax will not be payable as tax has already been paid on installment. However the other view is that, earlier tax was a tax on delivery of the goods on hire-purchase or installment. Therefore, at that time only the consideration received for hire-purchase or installment was taxed and the consideration receivable at the time of concluded sale does not get taxed. Hence, tax is payable again on the fructified sale on the depreciated value of the asset or its market value. The second view appears to be logical. However, if no consideration is payable on fructified sale then tax is not attracted.

11.4.5 Input tax credit

The hire purchase transaction is at par with normal sale transaction. Therefore normal provisions relating to input tax credit will apply. However, some States have provided for pro-

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rata credit.

11.4.6 Finance charges/interest

It is common knowledge that the installment fixed for payment in the case of a hire-purchase arrangement involves an element of interest or finance charges in addition to the price of the goods sold. While some of the State VAT legislations have provided for deduction of such interest or finance charges in arriving at the sale price to be treated as turnover in a hire purchase transaction, some States have not done so.

11.4.7 Goods returned

The VAT is payable on the date of delivery of the goods. If for any reason the goods are returned, then refund of tax will have to be claimed as per the provisions of respective State VAT laws. Many States provide the time limit for granting the claim of goods returned. Therefore, if the goods are not returned during that specified period, no benefit will be available.

11.4.8 Unpaid installments/ forfeited installments

If for any reason, the transaction of hire purchase fails, then the vendor takes possession of the goods. In substance, this is a sales return. Thus, the provisions of local VAT Act relating to sales return will apply. Normally in such cases the installment received for the intervening period are forfeited.

Self-examination questions

1. Explain how sales tax incentives cause problems for VAT system?
2. What are the different incentive schemes? Explain.
3. Does the White Paper provide any guideline in respect of sales-tax incentives? If yes, then explain the guideline.
4. Describe the broad principles considered by the States while framing various sales-tax incentive schemes in VAT regime.
5. What is a works contract? Is it a sale? Explain with reference to the constitutional authority providing for the same.
6. Enlist the guidelines to ascertain whether a transaction is a works contract.
7. What is the taxable turnover for works contract? Also mention the types of tax rates specified under various VAT laws.
8. What is a lease? Is it liable to tax under VAT laws? Explain.
9. How can the input tax credit be claimed in case of lease transactions?
10. Explain the concept of hire-purchase transactions. Comment upon their exigibility to VAT.