4

VAT – CONCEPTS AND GENERAL PRINCIPLES

Learning objectives
After reading this chapter you will be able to understand:
¨ the basic concepts of VAT in relation to manufacture of and trading in goods and services.
¨ a brief historical background of VAT.
¨ calculation of VAT liability.
¨ merits and demerits of VAT.
¨ development of VAT in the Indian context.
¨ a brief overview of State-Level VAT in India.

1. Introduction

A really progressive and welfare oriented country should balance the requirements of direct and indirect taxes in a fair manner. Too much dependence on direct taxes will be repressive but at the same time passing heavy burdens to the general public by way of indirect taxes will constitute hardships to the common citizen. Therefore, economic administrators throughout the world have been constantly engaged in the exercise of lightening the burden of indirect taxes on the ultimate consumers.

Suppose, for manufacturing a product A, the manufacturer has to purchase four types of commodities B, C, D and E on which he pays excise duty[1]. When ultimately he sells his manufactured product A on which he has to discharge his liability towards excise, the excise duty leviable on such product will be on a tax base which will include excise duties paid by the manufacturer on products B, C, D and E. Thus, the final excise duty is a duty on duty, which will increase the cost of production as well as the price of the final product.

[1] Excise duty is levied on the manufacture of goods. The concepts relating to excise duty shall be taken up in Paper – 8: Indirect Tax Laws at the Final level.

Suppose, we find a method by which the excise duties paid on commodities B, C, D and E are allowed to be set-off from the final duty liability on product A, it is obvious that the manufacturer will not only be able to avoid payment of duty on duty but the cost of the product will also be reduced leading to a benefit to the consumer. This is the origin of Value added tax (VAT).

In simple words, the tax will be levied and collected at each stage of manufacture only on the value added by the manufacturer represented by the purchase value and the value of the work performed on such purchased commodities. This will not only result in cost reduction but will also ensure equity. What we have talked about is a value added tax on manufacture. In the same way, there can be a value added tax in respect of trading in commodities also.

In other words, the various taxes paid on inputs purchased will be allowed as a credit and will be allowed to be set off against the tax liability on the value of sales of the commodity. Thus, there can be a system of VAT in respect of manufacture and in respect of sales. In the same way, one can think of a system of VAT in dealing with input and output services. When the individual systems of manufacturing, sales and services VAT are ultimately combined to form a grand system of VAT on goods and services, such a VAT system will be applicable throughout the country as a common market.

2. Historical background

Ever since 1954, when the tax on value added was introduced in France it has spread to a large number of countries. This tax was proposed for the first time by Dr. Wilhelm Von Siemens for Germany in 1919 as an improved turnover tax. In 1921, VAT was suggested by Professor Thomas S. Adams for the United States of America who recommended "sales-tax with a credit or refund for taxes paid by the producer or dealer (as purchaser) on goods bought for resale or for necessary use in the production of goods for sales." VAT was also recommended by the Shoup Mission for the reconstruction of the Japanese Economy in 1949. However, the tax was not introduced by any country till 1953. France led the way in 1954 by adopting a VAT that covered the industrial sector alone and the tax was limited up to the wholesale level. The tax was limited to the boundaries of France until the fifties.

VAT has, however, been spreading rapidly since the sixties. The Ivory Coast followed France by adopting VAT in 1960. The tax was introduced by Senegal in 1961 and by Brazil and Denmark in 1967. The tax has gathered further momentum as it was made a standard form of sales-tax required for the countries of the European Union (then European Economic Community). In 1968, France extended VAT to the retail level while the Federal Republic of Germany introduced it in its tax system. The Netherlands and Sweden imposed this tax in 1969 while Luxembourg adopted it in 1970, Belgium in 1971, Ireland in 1972, and Italy, the United Kingdom, and Austria in 1973. Of the other members of the European Union, Portugal and Spain introduced VAT in 1986, Greece in 1987, while this tax was adopted by Finland in 1994. Many other European countries have adopted VAT. Similarly, many countries in the North and South America, Africa and Oceania have introduced VAT.

VAT has been spreading in the Asian region as well. The Republic of Vietnam adopted VAT briefly in 1973. (VAT was abolished soon but it was reintroduced in 1999 in Vietnam.) South Korea introduced VAT in 1977, China in 1984, Indonesia in 1985, Taiwan in 1986, Philippines in 1988, Japan in 1989, Thailand in 1992, and Singapore in 1994 while Mongolia has been implementing this tax since 1998.

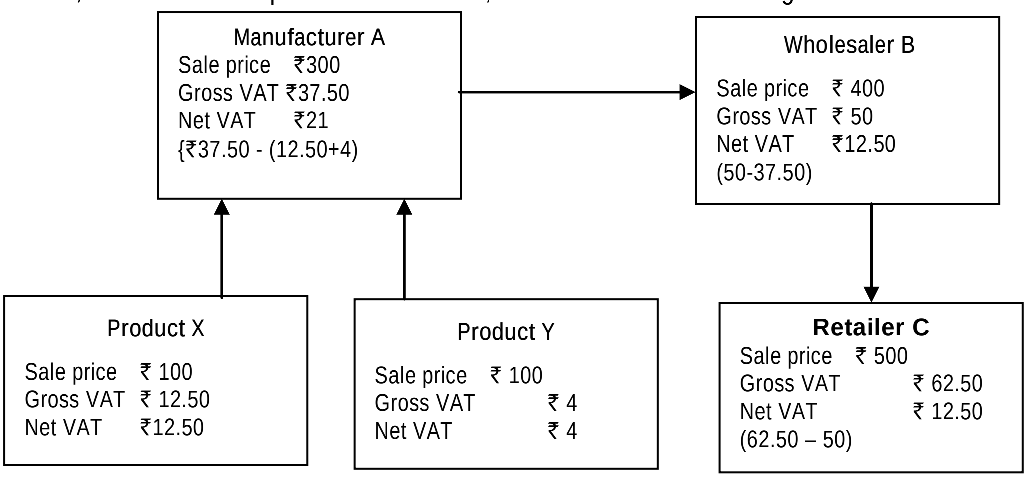
In the South Asian Association for Regional Cooperation (SMRC) region, VAT has been considered in great depth in India. In 1986, India introduced VAT in a different way under the name of Modified Value Added Tax (MODVAT). Unlike the VAT system of other countries, the Indian MODVAT system was designed to cover manufacturing of goods by giving credit of excise duty paid on inputs. The scope of MODVAT has been extended over the years and has since been renamed as Central Value Added Tax (CENVAT), which covers services also.

Pakistan adopted VAT in 1990, Bangladesh in 1991, and Nepal in 1997 while Sri Lanka introduced VAT in 1998.

As VAT is less distortive and more revenue-productive, it has been spreading all over the world. As on today, about 130 countries have adopted the same.

3. Calculation of VAT liability

3.1 Different stages of VAT : The Value Added Tax (VAT) is a multistage tax levied as a proportion of the value added (i.e. sales minus purchase) which is equivalent to wages plus interest, other costs and profits. To illustrate, a chart of transactions is given below:



Inputs for manufacturer

Note: The rate of tax is assumed to be 12.5% on the transactions relating to goods manufactured by A.

For a manufacturer A, inputs are product X and product Y which are purchased from a primary producer. In practice, even these producers use inputs. For example, a farmer would use seeds, feeds, fertilizer, pesticides, etc. However, for this example their VAT impact is not considered. B is a wholesaler and C is a retailer.

The inputs X and Y are purchased at ₹ 100 each on which tax is paid @12.5 % and 4% respectively. The manufacturer A would, therefore, take the credit for tax paid by him for the use of such inputs. The input price of ₹ 200 plus tax would include wages, salaries and other manufacturing expenses. To all this, he would also add his own profit. Assuming that after the addition of all these costs his sale price is ₹ 300, the gross tax (at the rate of 12.5 per cent) would be ₹ 37.50. As manufacturer A has already paid tax on ₹ 200, he would get credit for this tax (i.e. 12.50+4=16.50). Therefore, his net VAT liability would be ₹ 37.50 minus ₹ 16.50. Thus, manufacturer A would pay ₹ 21 only (because of this he would take the cost of his inputs to be only ₹ 200)

Similarly, the sale price of ₹ 400 fixed by wholesaler B would have net VAT liability of ₹ 12.50 (₹ 50-37.50= ₹ 12.50) and the sales price of ₹500 by Retailer C would also have net VAT liability of ₹ 12.50 (₹ 62.50 - 50 = ₹ 12.50). Thus, VAT is collected at each stage of production and distribution process, and in principle, its entire burden falls on the final consumer, who does not get any tax credit. Thus, VAT is a broad-based tax covering the value added to each commodity by parties during the various stages of production and distribution.

3.2 How VAT operates : The operation of VAT can be further appreciated from the following illustrations:

Illustration

A is a trader selling raw materials to a manufacturer of finished products. He imports his stock-in-trade as well as purchases the same in the local markets and sells the entire product to B. If the rate of VAT is assumed to be 12.50 per cent ad valorem, he will pay VAT as under:

Sl. No.	*Particulars*	*₹*
(i)	*A's cost of imported materials (from other State)*	*10,000*
	(A will deposit ₹1250 duty on the above. Since, this is not a State VAT it will form cost of the input)	*1,250*
(ii)	*A's cost of local materials*	*20,000*
	(VAT charged by local suppliers ₹2,500. Since the credit of this would be available, it will not be included in cost of input)	
(iii)	*Other expenditure (such as for storage, transport, interest, etc.) incurred and profit earned by A* *[Interest is assumed to be a manufacturing expense]*	*8,750*
(iv)	*Sales price of goods*	*40,000*
(v)	*VAT on the above @ 12.50% (Approx.)*	*5,000*
(vi)	*Invoice value charged by A to the manufacturer, B*	*45,000*

I. A's liability for VAT

			₹
	Tax on the sales price		5,000

	Less: Set-off of VAT paid on purchases		
	On imported goods	Nil	
	On local goods	2,500	2,500
	Net Tax Payable		2,500

In the above illustration (as well as in illustrations that follows) it is assumed that set off of VAT paid on imported goods from outside countries or other States is not allowed.

Now B manufactures finished products from the raw materials purchased from A and other materials purchased from other suppliers. His liability would be as under:

			(₹)
(i)	B's cost of raw materials		40,000
	(VAT recovered by *A* ₹5,000)		
(ii)	B's cost of other materials		
	Local Purchases		20,000
	(VAT charged on the above ₹2,500)		
	Inter- State Purchases*		10,400
	(CST paid ₹400)		
(iii)	Manufacturing and other expenses incurred and profit earned by B		29,600
(iv)	Sale price of finished product		1,00,000
(v)	VAT on the above		12,500
(vi)	Invoice value charged by B to the wholesaler, C		1,12,500
II.	B's liability for VAT		
	Tax on the sales price		12,500
	Less: Set-off of VAT on Purchases		
	To A	5,000	
	To other suppliers	2,500	7,500
	Net Tax Payable		5,000

*Credit / set off for tax paid on inter-State purchases (inputs) is not allowed.

When C, after repacking the goods into other packing, sells the finished product to a retailer. The following would be the position:

		(₹)
(i)	C's cost of goods	1,00,000
	(VAT recovered by B ₹12, 500)	
(ii)	Cost of packing material	2,000
	(VAT charged on the above ₹ 250)	
(iii)	Expenses incurred and profit earned by C	18,000
(iv)	Sale price of goods	1,20,000

(v)	VAT on the above		15,000
(vi)	Invoice value charged by C to D, a retailer		1,35,000
III.	C's liability for VAT		
	Tax on the sales price		15,000
	Less: set-off of VAT paid		
	To B	12,500	
	To other suppliers	250	12,750
	Net Tax payable		2,250

When D sells the goods to the consumers, the position would be as under:

		₹
(i)	D's cost of goods	1,20,000
	(VAT recovered by C ₹15,000)	
(iii)	Expenses incurred and profit earned by D	20,000
(iv)	Sale price of goods	1,40,000
(v)	VAT on the above	17,500
(vi)	Invoice value charged by D to the consumers	1,57,500
IV.	D's liability for VAT	
	Tax on the sale price	17,500
	Less: Set-off of VAT paid to C	15,000
	Net Tax Payable	2,500

Total recovery

It would be seen that in the above illustrations, at the successive stages which the raw materials and other goods pass till they are sold to the ultimate consumers, VAT would be collected as under:

		(₹)
(i)	Paid by suppliers selling raw materials to A	2,500
(ii)	Net tax paid by A on his sales to B	2,500
(iii)	Paid by suppliers selling other materials to B	2,500
(iv)	Net tax paid by B	5,000
(v)	Paid by suppliers selling packing materials to C	250
(vii)	Net tax paid by C	2,250
(viii)	Net tax paid by D	2,500
	Total recovery of revenue	17,500

Now, if tax was leviable under a sales-tax law at the last stage in a series of successive sales (when the finished product is sold to consumers) the authorities in the above case would have recovered the entire tax of ₹17, 500 from D at 12.50 per cent on his sale price of ₹1,40,000 and all earlier stages are to be exempted.

4. Variants of VAT

VAT has three variants, viz., (a) gross product variant, (b) income variant, and (c) consumption variant. These variants are presented in a schematic diagram given below:

Different variants of VAT

Gross product variant	Income variant	Consumption variant
Tax is levied on all sales and deduction for tax paid on inputs excluding capital inputs is allowed.	Tax is levied on all sales with set-off for tax paid on inputs and only depreciation on capital goods.	Tax is levied on all sales with deduction for tax paid on all business inputs (including capital goods).

The gross product variant allows deductions for taxes on all purchases of raw materials and components, but no deduction is allowed for taxes on capital inputs. That is, taxes on capital goods such as plant and machinery are not deductible from the tax base in the year of purchase and tax on the depreciated part of the plant and machinery is not deductible in the subsequent years. Capital goods carry a heavier tax burden as they are taxed twice. Modernization and upgrading of plant and machinery is delayed due to this double tax treatment.

The income variant of VAT on the other hand allows for deductions on purchases of raw materials and components as well as depreciation on capital goods. This method provides incentives to classify purchases as current expenditure to claim set-off. In practice, however, there are many difficulties connected with the specification of any method of measuring depreciation, which basically depends on the life of an asset as well as on the rate of inflation.

Consumption variant of VAT allows for deduction on all business purchases including capital assets. Thus, gross investment is deductible in calculating value added. It neither distinguishes between capital and current expenditures nor specifies the life of assets or depreciation allowances for different assets. This form is neutral between the methods of production; there will be no effect on tax liability due to the method of production (i.e. substituting capital for labour or vice versa). The tax is also neutral between the decision to save or consume.

Among the three variants of VAT, the consumption variant is widely used. Several countries of Europe and other continents have adopted this variant. The reasons for preference of this variant are:

Firstly, it does not affect decisions regarding investment because the tax on capital goods is also set-off against the VAT liability. Hence, the system is tax neutral in respect of techniques of production (labour or capital-intensive).

Secondly, the consumption variant is convenient from the point of administrative expediency as it simplifies tax administration by obviating the need to distinguish between purchases of intermediate and capital goods on the one hand and consumption goods on the other hand.

In practice, therefore, most countries use the consumption variant. Also, most VAT countries include many services in the tax base. Since the business gets set-off for the tax on services, it does not cause any cascading effect.

5. Methods for computation of tax

There are several methods to calculate the ‘value added’ to the goods for levy of tax. The three commonly used methods are:

(a) addition method,

(b) invoice method and

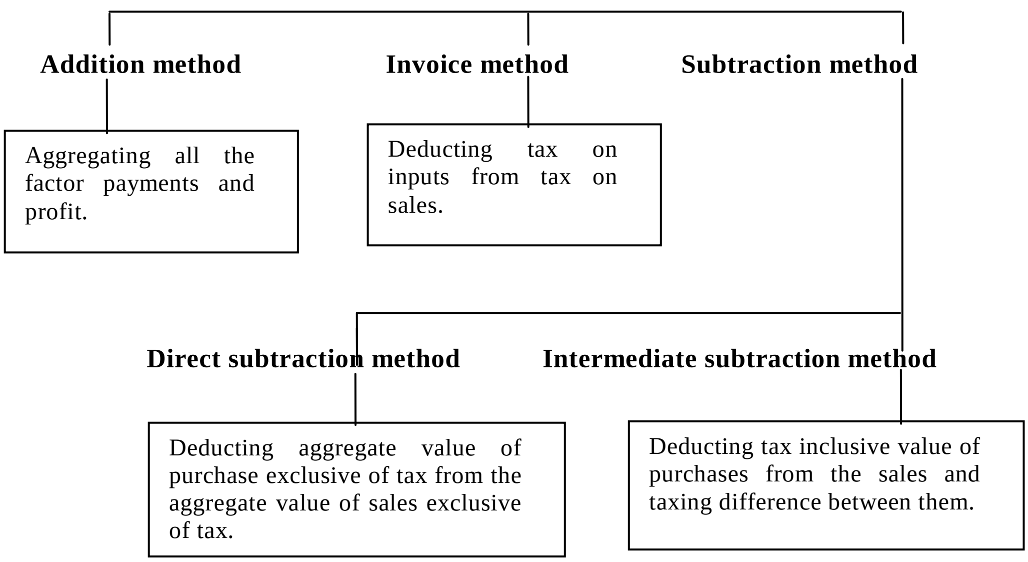
(c) subtraction method.

The subtraction method can be further divided into:

(a) direct subtraction method

(b) intermediate subtraction method

Methods of computation of VAT



5.1 Addition Method : This method aggregates all the factor payments including profits to arrive at the total value addition on which the rate is applied to calculate the tax. This type of calculation is mainly used with income variant of VAT. Addition method does not easily accommodate exemptions of intermediate dealers. A drawback of this method is that it does not facilitate matching of invoices for detecting evasion.

5.2 Invoice Method : This is the most common and popular method for computing the tax liability under 'VAT' system. Under this method, tax is imposed at each stage of sales on the entire sale value and the tax paid at the earlier stage is allowed as set-off. In other words, out of tax so calculated, tax paid at the earlier stage i.e., at the stage of purchases is set-off, and at every stage the differential tax is being paid. The most important aspect of this method is that at each stage, tax is to be charged separately in the invoice. This method is very popular in western countries. In India also, under the VAT law as introduced in several States and under the Central Excise Law this method is followed. This method is also called the 'Tax Credit Method' or 'Voucher Method'. From the following illustration, the mode of calculation of tax under this method will become clear:

Stage	Particulars	VAT Liability	Less VAT Credit	Tax to Government
1.	Manufacturer/first seller in the State sells the goods to distributor for ₹1000. Rate of tax is 12.50%. Therefore, his tax liability will be ₹125. He will not get any VAT credit, being the first seller.	125	-	125
2.	Distributor sells the goods to a wholesale dealer for say ₹ 1200 @ 12.50% and will get set-off of tax paid at earlier stage at ₹ 125. His tax liability will be ₹ 25.	150	125	25
3.	Wholesale dealer sells the goods to a retailer at say ₹ 1500. Here again he will have to pay the tax on ₹ 1500. He will get credit of tax paid at earlier stage of ₹ 150. His tax liability will be ₹ 37.50.	187.50	150	37.50
4.	Retailer sells the goods to consumers at say ₹ 2000. Here again he will have to pay tax on ₹ 2000. He will get credit for tax paid earlier at. ₹ 187.50. His tax liability will be ₹62.50.	250	187.50	62.50
	Total	712.50	462.50	250

Thus, the Government will get tax on the final retail sale price of ₹ 2,000. However, the tax will be paid in instalments 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 gets 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 all the stages is ₹712.50 whereas tax received by the State is only ₹ 250. 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.

5.3 Subtraction Method: While the above-stated invoice or tax-credit method is the most common method of VAT, another method to determine the liability of a taxable person is the cost subtraction method, which is also a simple method. Under this method, the tax is charged only on the value added at each stage of the sale of goods. Since, the total value of goods sold is not taken into account, the question of grant of claim for set-off or tax credit does not arise. This method is normally applied where the tax is not charged separately. Under this method for imposing tax, 'value added' is simply taken as the difference between sales and purchases. The following illustration will make the working of this system clear:

Stage No.	Particulars	Turnover for tax under VAT (₹)	Tax @ 12.50% (₹)
1.	First seller sells the goods to a distributor at say, ₹ 1125 inclusive of tax	1,125	125 $\left[\frac{(1125 \times 12.50)}{100+12.50}\right]$
2.	Distributor sells the goods to a whole-seller at say, ₹1,350. Here taxable turnover will be ₹1,350 - ₹1,125	225	25 $\left[\frac{(225 \times 12.50)}{100+12.50}\right]$
3.	Wholesaler sells the goods to a retailer at say, ₹ 1,687.50. Here taxable turnover will be ₹ 1,687.50 - ₹ 1,350	337.50	37.50 $\left[\frac{(337.50 \times 12.50)}{100+12.50}\right]$

4.	Retailer selling the goods at say, ₹ 2250. Taxable turnover will be' ₹2250 - ₹ 1687.50	562.50	62.50 $\left[\frac{(562.50 \times 12.50)}{100+12.50}\right]$
		2,250	250

Tax is calculated by the formula $\frac{T \times R}{100+R}$

T = Taxable turnover, R = Rate of Tax

Thus, under this system also, the incidence of tax is at each stage and the incidence of tax on the final sale price to the consumer will remain the same as in the earlier method. However, this holds good till the time the same rate of tax is attracted on all inputs, including consumables and services, added at all the stages of production/distribution. If the rates are not common, then the final tax by the two methods may differ. This is explained in tables given below:

Invoice Method (All inputs taxable under ONE rate)

Particulars	Invoice	Material Value	VAT	Input tax credit	NET
Inputs for A					
Product X(@12.50%)	260	231	29	--	29
Product Y(@12.50%)	450	400	50	--	50
	------	-------	-------	--------	--------
'A' sales goods to 'B'	710	631	79	--	79
'B' sales goods to 'C'	1125	1000	125	79	46
'C' sales goods to 'D'	1800	1600	200	125	75
'D' sales goods to 'E'	2250	2000	250	200	50
	2700	2400	300	250	50
FINAL	2700	2400	300	--	300

Subtraction Method (All inputs taxable under ONE rate)

Particulars	Invoice	Purchase Price	Value Added	VAT @ 12.50%
Inputs for A				
On Input	710	--	--	79
'A' to 'B'	1125	710	415	46
'B' to 'C'	1800	1125	675	75
'C' to 'D'	2250	1800	450	50
'D' to 'E'	2700	2250	450	50
FINAL	2700	--	--	300

Invoice Method (Inputs taxable at different rates)

Particulars	Invoice	Material Value	VAT	Input tax credit	NET
Inputs for A					
Product X(@12.50%)	450	400	50	--	50
Product Y(@ 4%)	260	250	10	--	10
	------	-------	-------	--------	--------
‘A’ sales goods to ‘B’	710	650	60	--	60
‘B’ sales goods to ‘C’	1125	1000	125	60	65
‘C’ sales goods to ‘D’	1800	1600	200	125	75
‘D’ sales goods to ‘E’	2250	2000	250	200	50
	2700	2400	300	250	50
FINAL	2700	2400	300	--	300

Subtraction Method (Inputs taxable at different rates)

Particulars	Invoice	Purchase Price	Value Added	VAT @ 12.50%
Inputs for A				
On Input	710	--	--	60
‘A’ to ‘B’	1125	710	415	46
‘B’ to ‘C’	1800	1125	675	75
‘C’ to ‘D’	2250	1800	450	50
‘D’ to ‘E’	2700	2250	450	50
FINAL	2700	--	--	281

Thus, on the same consumer price of ₹ 2700 under invoice method VAT works out to be ₹300 where as under the subtraction method it works out to be ₹ 281. Therefore, the method is not considered as a good method. The method is being objected to on the ground that under this method, tax is levied on income. The value addition at each stage may not be only due to profit but may be partly due to freight/transportation and other services. The incidence of tax is on the sale of goods. However, the mode of calculation of taxable turnover is value added. Therefore, the method cannot be said to be imposing tax on income/profit.

6. Merits and demerits of VAT

6.1 Merits

1. No tax evasion : It is said that VAT is a logical beauty. Under VAT, credit of duty paid is allowed against the liability on the final product manufactured or sold. Therefore, unless proper records are kept in respect of various inputs, it is not possible to claim credit. Hence, suppression of purchases or production will be difficult because it will lead to loss of revenue. A perfect system of VAT will be a perfect chain where tax evasion is difficult.

2. Neutrality : The greatest advantage of the system is that it does not interfere in the choice of

decision for purchases. This is because the system has anti-cascading effect. How much value is added and at what stage it is added in the system of production/distribution is of no consequence. The system is neutral with regard to choice of production technique, as well as business organisation. All other things remaining the same, the issue of tax liability does not vary the decision about the source of purchase. VAT facilitates precise identification and rebate of the tax on purchases and thus ensures that there is no cascading effect of tax. In short, the allocation of resources is left to be decided by the free play of market forces and competition.

3. Certainty : The VAT is a system based simply on transactions. Thus there is no need to go through complicated definitions like sales, sales price, turnover of purchases and turnover of sales. The tax is also broad-based and applicable to all sales in business leaving little room for different interpretations. Thus, this system brings certainty to a great extent.

4. Transparency : Under a VAT system, the buyer knows, out of the total consideration paid for purchase of material, what is tax component. Thus, the system ensures transparency also. This transparency enables the State Governments to know as to what is the exact amount of tax coming at each stage. Thus, it is a great aid to the Government while taking decisions with regard to rate of tax etc.

5. Better revenue collection and stability : The Government will receive its due tax on the final consumer/retail sale price. There will be a minimum possibility of revenue leakage, since the tax credit will be given only if the proof of tax paid at an earlier stage is produced. This means that if the tax is evaded at one stage, full tax will be recoverable from the person at the subsequent stage or from a person unable to produce proof of such tax payment. Thus, in particular, an invoice of VAT will be self enforcing and will induce business to demand invoices from the suppliers. Another attribute of VAT is that it is an exceptionally stable and flexible source of Government revenue.

6. Better accounting systems : Since the tax paid on an earlier stage is to be received back, the system will promote better accounting systems.

7. Effect on retail price : A persistent criticism of the VAT form has been that since the tax is payable on the final sale price, the VAT usually increases the prices of the goods. However, VAT does not have any inflationary impact as it merely replaces the existing equal sales tax. It may also be pointed out that with the introduction of VAT; the tax impact on raw material is to be totally eliminated. Therefore, there may not be any increase in the prices.

6.2 Demerits

1. The merits accrue in full measure only under a situation where there is only one rate of VAT and VAT applies to all commodities without any question of exemptions whatsoever. Once concessions like differential rates of VAT, composition schemes, exemption schemes, exempted category of goods etc. are built into the system, distortions are bound to occur and the fundamental principle that VAT will totally eliminate cascading effects of taxes will also be subject to qualifications.
2. In the federal structure of India in the context of sales-tax, so long as Central VAT is not integrated with the State VAT, it will be difficult to put the purchases from other States at par with the State purchases. Therefore, the advantage of neutrality will be confined only

for purchases within the State.

3. For complying with the VAT provisions, the accounting cost will increase. The burden of this increase may not be commensurate with the benefit to traders and small firms.
4. Another possible weak point in the introduction of VAT, which will have an adverse impact on it is that, since the tax is to be imposed or paid at various stages and not on last stage, it would increase the working capital requirements and the interest burden on the same. In this way it is considered to be non-beneficial as compared to the single stage-last point taxation system.
5. VAT is a form of consumption tax. Since, the proportion of income spent on consumption is larger for the poor than for the rich, VAT tends to be regressive. However, this weakness is inherent in all the forms of consumption tax. While it may be possible to moderate the distribution impact of VAT by taxing necessities at a lower rate, it is always advisable to moderate the distribution considerations through other programmes rather than concessions or exemptions, which create complications for administration.
6. As a result of introduction of VAT, the administration cost to the State can increase as the number of dealers to be administered will go up significantly.

7. VAT in Indian context

The Indian Union is a federal structure under the Constitution of India. The Central Government and the State Governments derive their powers through the instrumentality of the Union List, the State List and the Concurrent List. So far as powers of taxation are concerned there are clearly specified areas over which the Central Government and the States can exercise their jurisdiction.

While Income-tax, excise duty and customs duty[2] constitute the major sources of tax revenue to the Central Government, the State Governments substantially depend on sales-tax as the main source of revenue. The Central Government undertook a series of reforms in indirect taxes, the major among which was the introduction of Modified VAT, which is currently in operation as CENVAT. However, in view of the constitutional constraints, CENVAT applies to goods and services but not to sales tax and State- Level VAT.

7.1 Central value added tax (CENVAT) : At the Central level, at the time of Independence, India inherited a system of commodity taxes in which excise duties were levied on about a dozen articles yielding a small proportion of total tax revenue to the Centre. Following Independence, the rates were raised, the base was enlarged, and more and more items were brought into its net. Over time, there was a speedy extension of excise duties. It was not only levied on finished goods but also covered raw materials, intermediate goods and capital goods.

7.1.1 Structure of CENVAT : As of now, the Central Government levies excise duties on all goods manufactured or produced in the country. Such duty is paid by the manufacturer / producer at the time of removal of goods from the factory at prescribed rates. The prevailing

[2] Customs duty is levied on import and export of goods. The concepts relating to customs duty shall be taken up in Paper – 8: Indirect Tax Laws at the Final level.

structure of such duties includes (i) CENVAT, (ii) special excise duty (SED), (iii) additional excise duty on goods of special importance, AED (GSI) (iv) additional duty of excise on textiles and textile articles, AED (T&TA), and (v) cesses on specified commodities.

With effect from March 1, 1986, MODVAT was introduced under the union excise duty as a system of giving credit for excise duty on inputs. Initially, it was introduced for a selected number of commodities. Over time, MODVAT was extended and was finally replaced by Central VAT, known as CENVAT in the Budget 2000-01. The CENVAT scheme initially allowed instant credit for specified excise duties paid on inputs and capital goods received in a factory for the manufacture of any dutiable final products . The credit could be utilised to pay excise duty on any final product.

The Finance Act, 2004 marked a beginning for an integrated goods and service tax system wherein the duties of excise paid on inputs / capital goods and service tax paid on input services could be adjusted against a manufacturer's excise duty liability or a service provider's service tax liability. At present, the CENVAT scheme is governed by CENVAT Credit Rules, 2004.

7.2 **Committee of State Finance Ministers:** After the introduction of VAT in the area of manufacture and services, a need for uniformity arose wherein similar system was proposed to be incorporated in the area of sales thereby replacing the existing sales tax system. To materialize this concept, the then Union Finance Minister called a meeting of the State Finance Ministers in May 1994 and a Committee of State Finance Ministers was constituted on sales tax reform following this meeting. The Committee had to examine all aspects of sales tax reform, including the introduction of VAT.

The Committee recommended several measures to rationalize the existing sales tax with the ultimate aim of introducing VAT at the State level. The major recommendations included simplification of the rate structure, minimization of the exemptions and enhancement of transparency. To this end, the Committee recommended:

(i) The adoption of four general floor rates (0, 4, 8, 12) and two special floor rates (1 and 20) in place of the existing multiple rates being levied in different States;

(ii) Keeping the exemptions to a minimum;

(iii) Preparing a list of exempt goods and fixing a target date beyond which no State/Union Territory should exempt goods other than those mentioned in the list, and;

(iv) Doing away with sales tax incentives for industrialization. No new tax incentives should be given after 1 April, 1997, and the existing ones should be allowed to lapse in due course.

The Committee also recommended several preparatory steps to be taken for the implementation of a full-fledged State-Level VAT. This included a massive taxpayers education programme, computerization of sales tax administration, and preparation of model VAT legislation. For implementing the above decisions, an Empowered Committee of State Finance Ministers was set up.

7.3 **White Paper on State-Level VAT in India :** The Empowered Committee of State Finance Ministers met regularly and with the repetitive discussions and collective efforts brought out a White paper on 17.01.2005, which provided a base for the preparation of various

State VAT legislations. It has been recognized that VAT is a State subject and therefore, the States will have freedom for appropriate variations consistent with the basic design as agreed upon at the Empowered Committee. Broadly, the White Paper consists of the following:

(a) Justification of VAT and Background

(b) Design of State-Level VAT.

(c) Steps taken by the States.

8. Present position

Finally State-Level VAT was introduced on 01.04.2005 by majority of the States. The States have passed State-Level VAT legislations which are modeled on the draft model VAT law, prescribed by the Central Government. The legislations also incorporate the various principles of State-Level VAT as contained in the White Paper released by the Empowered Committee. However, such State Legislations contain provisions to cater to the specific needs of the State finances.

8.1 Discontinuance of central sales tax : With the introduction of State-Level VAT system, it is proposed to phase out the Central sales tax (CST). However, since the states will stand to lose large revenue on account of its discontinuance a mechanism is being thought of for compensating the States for such loss of revenue.

9. Audit provisions under VAT

Like majority of the developing economies our country is also facing the problem of lack of education and awareness about tax laws, more particularly amongst the trading community. Further, the VAT system of taxation is new to them. Since the trading community is not educated enough and equipped to understand the implications of the VAT system of taxation immediately, there is every possibility that they may not be in a position to arrange their business affairs to fall in line with the requirements of the State-Level VAT and calculate and discharge their exact tax liability under the VAT laws. On the other hand, the tax administrator i.e. the authorities in the taxation department also find themselves devoid of sufficient resources to educate the tax payers and inform them about the procedural and accounting changes that are necessitated by the implementation of VAT system.

Further, under the VAT system a major thrust is to be laid on the ‘self assessment’ i.e., the tax liability, calculated and paid by the tax payers through their periodical returns, will be accepted by and large and the tax payers will not be called to substantiate the tax liability 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 when the particulars furnished by the tax payers are verified by an independent auditor in minute details by:

- going through the books of account and

- analysing and interpret the provisions of the State-Level VAT laws and
- reporting the under-assessment, if any, made by the dealer requiring additional payment or
- reporting any excess payment of tax warranting refund to the tax payer.

In most of the countries tax evasion is rampant under the existing tax systems. In India too, evasion of excise and sales-tax is estimated to be very high. If no audit is prescribed under VAT law, the chances of evasion of VAT tax will increase causing revenue leakage for the Government. It is, therefore, essential that the audit of the proposed VAT system is attempted 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.

The concept of audit is popular even in foreign countries where the system of VAT is in practice since long in the field of indirect taxation. In countries like France and Korea the audit has proved to be an effective tool to check the evasion of tax, which was mostly done by producing fake invoices etc.

Since VAT is a new concept, some of the States want to keep the procedural formalities to the minimum. Hence, at the initial stage their law makers refrain from keeping any audit provisions in their Act and rules. Perhaps, this may be due to the initial stage of introduction of VAT. But most of the States, keeping in mind the importance of audit, have incorporated the audit provisions since inception.

Some States like the State of Maharashtra and State of Kerala have provided detailed particulars to be furnished by various dealers in respect of their VAT assessments.

10. ICAI's role in VAT

The ICAI has rendered pioneering service in evolving the necessary accounting guidelines both for CENVAT as well as State Level VAT. It has brought out Guidance Notes for accounting for CENVAT as well as State-Level VAT. These Guidance Notes address all the accounting issues in regard to CENVAT and State-Level VAT. Further, the Institute has brought out a comprehensive study on State-Level VAT in India. It contains an elaborate discussion of the various general principles of VAT and State Level VAT. These general principles have been incorporated in the various State-Level VAT legislations. However, there are special provisions contained in the respective State level legislations to cater to the specific needs of the States. Various State governments have issued detailed clarification on different practical issues arising on implementation of the State-Level VAT.

11. Role of Chartered Accountant in VAT

Chartered Accountants have a key role to play in proper implementation of VAT.

(i) **Record keeping** : VAT requires proper record keeping and accounting. Systematic records of input credit and its proper utilisation is necessary for the success of VAT. Chartered Accountants are well equipped to perform such tasks

(ii) Tax planning : In order to establish an efficient plan for purchases and sales, a careful study of VAT is required. A Chartered Accountant is competent to analyze the impact of various alternatives and choose the most optimum method of purchases and sales in order to minimize the tax impact.

(iii) Negotiations with suppliers to reduce price : VAT credit alters cost structure of goods supplied as inputs. A Chartered Accountant will ensure that the benefit of such cost reduction is passed on by the suppliers to his company. However, if the buyers of his company make the similar demand, he must be ready with full data to resist the claims.

(iv) Handling the audit by departmental officers : There will be audit wing in department and certain percentage of dealers will be taken up for audit every year on scientific basis. Chartered Accountant can ensure proper record keeping so as to satisfy the departmental auditors. The professional expertise of a Chartered Accountant will help him in effectively replying audit queries and sorting out audit objections.

(v) External audit of VAT records : Under VAT system, trust has been reposed on tax payers as there will be no regular assessment of all VAT returns but only few returns will be scrutinized. In other cases, return filed by dealer will be accepted. Thus, a check on compliance becomes necessary. Chartered Accountants can play a very vital role in ensuring tax compliance by audit of VAT accounts.

VAT laws of some States provide for audit by outside agencies. In Karnataka, audit report is required if turnover exceeds ₹25 lakhs. Andhra Pradesh VAT Act provides for audit by Chartered Accountant, if audit is ordered by Commissioner. Maharashtra VAT laws provide for audit by Chartered Accountant if turnover exceeds ₹40 lakhs. Other States may also prescribe external audit, once they see the utility of audit reports furnished by Chartered Accountant in ensuring tax compliance.

12. Goods and Service Tax

Goods and Service Tax is India's most ambitious indirect tax reform aimed at attaining a comprehensive and harmonized tax structure. The then Finance minister, Mr. P. Chidambaram, in Union Budget 2006-07, had proposed the roll out of GST. In a federal State like India, GST is aimed at accomplishing a common domestic market, removing multiplicity of taxes, eliminating the cascading effect of tax on tax, making the prices of the Indian products competitive and, above all, benefiting the end consumers. In this regard, First Discussion Paper on Goods and Services Tax in India was proposed by the Empowered Committee of State Finance Ministers on November 10, 2009. The Thirteenth Finance Commission for gave its Task Force Recommendations on GST on December 12, 2009. The GST model is expected to be dual so that both Central and State Governments can collect taxes to raise resources to fulfill their sovereign obligations/ duties. It will subsume most of the indirect taxes being levied in India.