❖ ***Background of VAT***

VAT was initiated first in France in mid-1950's, then in European countries in 1960's and subsequently introduced in about 130 countries, including several federal countries. In Asia, it has been introduced by a large number of countries from China to Sri Lanka.
Even in India, there has been a VAT system introduced by the Government of India for about last ten years in respect of Central excise duties.

Value added tax is an indirect tax charged on sale of goods. Before the implementation of Value Added Tax, Sales tax was charged on sales. Sales tax was levied at first point of sale, and the resellers did not contribute to the Government. Government was losing huge revenue due to this system. Finally Government introduced VAT on 1st April 2005, with the motto of uniformity in tax structure and to reduce the evasion of tax.

❖ ***What are the need for introducing VAT***

Before we understand the concept of VAT, we must know why VAT has been implemented in India, although there was resistance from people. A short glance will explain the need for its implementation.

Demerits of Sales Tax:

1. *Numbers of Rates and Taxes:*
There were huge numbers of rates of taxes depending on the category of goods. There was no uniformity among the rates of taxes and were very high.

2. *Additional taxes:*
Other than sales tax levied on sales, consumer had to pay extra taxes such as Turnover tax on sales along with Surcharge on taxes which were as high as 10%.This extra burden of tax was exploiting the consumers.

3. *Huge formalities:*
Huge formalities were followed in terms of various Forms. Getting such Form from sales tax department was itself a great task. System of Sales tax is most complex in the world and it hampers the mobility of goods. It results in noncompliance and corruption.

4. *Cascading Effect (tax on tax):*
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, inputs 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 as well as tax paid on previous purchases. In the prevailing sales tax structure, there are other taxes also such as turnover tax, surcharge on sales tax, additional surcharge, etc. With introduction of VAT, these other taxes have been abolished.

5. Unhealthy competition among States by giving sales tax incentives to new industries. When one State gave incentives, others also had to give. This reduced State finances.

7. States introduced 'first point sale' to avoid cascading effect of State sales tax. This made tax evasion easy.

Introduced VAT in Sales tax in India

Discussions with State Governments –

Central Government initiated discussions with State Governments in 1995. After lot of arguments by Central Government, all States ultimately agreed to introduce State Level Vat at the conference of Chief Ministers all States at Delhi in November, 1999.

'Empowered Committee' of State Governments –

A high power committee consisting of senior representatives of all 29 States was constituted under Chairmanship of Dr. Asim Dasgupta, Finance Minister, West Bengal.

After deliberations and many meetings, it was announced that all States have agreed to introduce VAT w.e.f. 1-4-2005.

A 'White paper' was released by Dr. Asim Dasgupta, Chairman of Empowered Committee, on 17-1-2005. The White Paper is a policy document indicating basic policies of State Sales Tax VAT. It provides a base for the preparations 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:

- Justification of VAT and Background
- Design of State-Level VAT
- Steps taken by the States

CST is proposed to be abolished –

Vat is consumption based tax while CST is production based tax. Thus, CST is against principles of Vat. CST has been reduced to 3% w.e.f. 1-4-2007. CST rate is proposed to be reduced by 1% every year and made Nil by 1-4-2010.

Revenue loss if CST rate is reduced –

If CST rate is reduced, State finances will suffer, since revenue of Central Sales Tax goes to respective State Government. It is proposed to authorise State Governments to levy tax on some services like medical, legal and education.

State-wise position of VAT

Haryana was the only State to introduce VAT w.e.f. 1-4-2003. 20 States introduced VAT w.e.f. 1-5-2005. These include Assam, Andhra Pradesh, Bihar, Delhi, Goa, Karnataka, Kerala, Maharashtra, Punjab and West Bengal.

States ruled by BJP like Gujarat, Chhatisgarh, Jharkhand, Madhya Pradesh and Rajasthan introduced Vat w.e.f. 1-4-2006. Tamilnadu has introduced Vat on 1-1-2007.

Uttaranchal has not introduced Vat till November, 2007. UP has introduced Vat w.e.f. 1-1-2008. J&K is not in the picture due to constitutional issues.

- ***Value Added Tax:***

Basic Concepts / Features

☛ It is a simplified Sales tax system:

VAT is same as Sales tax but it is being levied in a different manner.VAT works on the principle that when raw material passes through various manufacturing stages and manufactured product passes through various distribution stages, tax should be levied on the 'Value Added' at each stage and not on the gross sales price.

☛ It is a consumption tax because it is borne ultimately by the final consumer and not by companies. It is charged as a percentage of prices, which means that the actual tax burden is visible at each stage in the production and distribution chain.

- This ensures that same commodity does not get taxed again and again and there is no cascading effect. In simple terms, 'value added' means difference between selling price and purchase price. VAT avoids cascading effect of a tax.
- It is collected fractionally, via a system of deductions whereby taxable persons can deduct from their VAT liability the amount of tax they have paid to other taxable persons on purchases for their business activities. This mechanism ensures that the tax is neutral regardless of how many transactions are involved.
- Basically, VAT is multi-point tax, with provision for granting set off (credit) of the tax paid at the earlier stage. Thus, tax burden is passed on when goods are sold. This process continues till goods are finally consumed. Hence, VAT is termed as 'consumption based' tax. VAT works on the principle of 'tax credit system'.
- Vat system not same in all States –

The VAT system as introduced is result of deliberations of committee of representatives from 29 States. Each State has its own views and peculiarities. Hence, having uniform nationwide VAT is very difficult and some compromises/adjustments are inevitable.

Vat law not uniform in all States –

- Each State has made changes as per their needs. Though basic concepts are same in VAT Acts of all States, provisions in respect of credit allowable, credit of tax on Capital goods, credit when goods are sold inter-state are not uniform. Even definitions of terms like business', 'sale', 'sale price', 'goods', 'dealer', 'turnover', 'input tax' etc. are not uniform. Schedules indicating tax rates on various articles are also not uniform, though broadly, the schedules are expected to be same.

Advantages of VAT

1. Coverage:

It offers all the economic advantage of a tax that includes the entire retail price within its scope. Direct payment of tax is spread out over a large number of firms instead of being concentrated on particular groups such as wholesalers and retailers.

If retailers do evade tax, tax will be lost only on their margins. One particular advantage is that of the widening of the tax base by bringing all transactions into tax net.

2. Revenue Security:

VAT represents an important tool against tax evasion and is superior to a business tax or a sales tax from the point of view of revenue security.

If payment of tax is successfully avoided, at any particular stage of production and distribute on cycle nothing will be lost if the tax is picked up at a later stage. And even if it is not picked up subsequently, the Government would have at least collected the VAT paid at stage previous to that at which the tax is avoided.

On the other hand if evasion takes place under sales tax, the Government looses all the taxes due on the product.

A significant advantage of the value added tax in any country is the cross audit feature. Tax charged by one firm is reported as a deduction by the firms buying from it.

3. Selectivity:

VAT may be selectively applied to specific goods or business entities. In addition, VAT does not burden capital goods because the consumption type VAT provides a full credit for the tax included in purchase of capital goods. The credit does not subsidize the purchase of capital goods it simply eliminates the tax that has been imposed on them.

4. Co-ordination of VAT with direct taxes.

Most tax payers cheat on their sales, not to evade VAT but to evade personal and corporate income tax. Thus operations of an effective VAT, in implementation greatly help income tax administration and revenue collection.

Other important advantages of VAT are:

1. Uniform rates of VAT will boost trade activities and will create a favorable atmosphere for the expansion and economy.

2. VAT Helps amassing tax revenues to finance the fund necessary for socio-economic growth of the economy. It has the in-built capacity to raise more tax revenues without altering the existing tax structure and is yet able to expand the tax-base.

3. Since VAT is mostly based on 100% self-assessment, it will reduce the taxpayers' hazards to visit tax offices frequently and lead to better tax compliance.

4. It became easier to give tax concessions to goods used by common man or goods used for manufacture of capital goods or exported goods.

5. Since there is no tax on tax, price escalation is avoided and will make prices more competitive with the foreign counterparts. This matter is very important in present era of globalization and economic liberalization.

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

Disadvantages of VAT

It will be a virtual crime not to look for the other side of the coin of the Indian VAT System. Main disadvantages that have been identified in connection with VAT are as follows:

1. VAT is regressive.

It is claimed that tax is regressive i.e. its burden falls disproportionately on the poor since the poor are likely to spend more of their income than a relatively richer person.

2. VAT is inflationary.

VAT is too difficult to operate from the position of both the administration and business. Some businessmen seize almost any opportunity to raise prices and the introduction of VAT certainly offers such an opportunity. However, temporary price controls are a result of the careful setting of the rates of VAT.

3. VAT favors the capital intensive firm.

It is argued that VAT has a direct impact on the tax of the labour-intensive firms compared to the capital-intensive firms. Since the ratio of value added to selling price is greater for the former, this is a real problem for labour intensive economies and industries.

4. Powers given to Sales tax inspectors:

In order to give effect to the various provisions of the VAT legislation more powers have been given to sales tax inspectors. This may cause harassment to the assesses of VAT. This may even lead to return of "Inspector Raj" which will play havoc and might lead to corruption in the system.

5. Central Sales Tax:

Central Sales tax is a major issue connected with the implementation of Value Added Tax in our country. There is a need to phase out CST and move to completely destination-based tax system. It is a very difficult task as it is an important source of revenue for government.

Scope of VAT

Who are covered under VAT:

1. All dealers may be registered under VAT.

2. All dealers with an annual turnover as prescribed in the respective State VAT legislation shall be included under the regime of VAT.

3. Dealers with turnover less than the specified turnover may register voluntarily.

4. Dealers having annual turnover between the limits specified in respective State VAT legislation may opt for composition scheme, where in they have to pay a lower rate of VAT, and no setoff facility is provided to such dealers

Set-off of Tax Credit under VAT

Manufacturer will be entitled to credit of tax paid on inputs used by him in manufacture. A trader (dealer) will be entitled to get credit of tax on goods which he has purchased for re-sale *[para 2.3 of White Paper on State-Level VAT].*

Essentials for Set-off of Tax Credit

There are certain requirements which have to be completed for claiming Set-off.

1. Set-off to be allowed only to a Registered Dealer.

On purchase for manufacturing /Trading/ Works contract/Lease, set-off can be claimed by Registered Dealers.

A Registered dealer can avail set off on purchases of the following:

a) Raw materials, parts, Components, Spares.

b) Fuel

c) Trading goods
d) Packing Material
e) Capital asset

2. A valid TAX INVOICE is must to claim set-off.
A registered dealer, selling any goods, must issue to the purchaser a TAX INVOICE containing following particulars, and retain a copy there of for three years from the end of the year in which sale is booked.

a) The word Tax Invoice in bold letter at the top or prominent place.

b) Name, Address and Registration Number of Selling Dealer.

c) Name and Address of the Purchasing Dealer.

d) Serial Number and Date

e) Description, Quantity and Price of the goods sold.

f) The amount of Tax charged, to be shown separately.

g) Signed by the selling dealer or a person authorized by him.

3. Maintenance of Account:
Every Registered dealer shall keep and maintain true and correct account of daily transaction showing goods produced, manufactured, bought and sold, value thereon together with invoice and bills.
Along with all these details all VAT dealers are required to keep following records.

a) VAT account:

This can be maintained manually or computerized. VAT account should contain details of Input and Output tax, Debit note and credit note issued/ received during the period.

b) Purchase Records:

Proper accounting of all purchases in a chronological order stating therein the date on which the goods so purchased, the name and registration number of the selling dealer, tax invoice number and date, the amount of purchase price and amount of tax paid separately should be maintained.

c) Sales Register:

Sales register should contain Tax Invoice number, name and address thereof, Total sale value, exempted sales- such as consignment sales/ sock transfer, etc. All copies of invoice should be retained in serial number.

d) Debit Notes and Credit Notes Register:

Copies of the Debit note and Credit note issued / received are to be recorded in a book and should be filed separately under different rates of tax in the same manner as that ofpurchase/sales register. The end result of debit/ credit note accounts are to be taken into account while adjusting monthly tax payable.

e) Period of Retention of Accounts:

All books and records shown above shall be retained by a dealer until the expiration of 5 years after the end of the year to which it relates or for such other period as may be prescribed.

Set-Off of Input Tax Credit –

Credit will be available of tax paid on inputs purchased within the State. Credit will *not be* available of certain goods purchased like petroleum products, liquor, petrol, diesel, motor spirit (position of furnace oil is not clear in white paper, but many States do not give credit).
No credit is available in case of Inter-State purchases.

Set-Off of tax paid on capital goods –

Credit will be available of tax paid on capital goods purchased within the State. Credit will be available only in respect of capital goods used in manufacture or processing. The credit will be spread over three financial years and not in first year itself. There will be a negative list of capital goods *[para 2.4 of White Paper on State-Level VAT]*
States has deviated from these provisions. In West Bengal and Kerala, it is available in 36 monthly instalments. In Karnataka, it is available in 12 monthly instalments, but value of capital goods should be minimum Rs 10 lakhs. Capital goods of value less than Rs 10 lakhs will be 'inputs' and immediate credit will be available. In Maharashtra, entire credit is available immediately.

Instant credit –

Credit will be available as soon as inputs are purchased. It is not necessary to wait till these are utilised or sold *[para* 2.3 *of White Paper on State-Level VAT].*
No credit of CST paid - Credit of Central Sales Tax (CST) paid on inputs and capital goods purchased from other States will not be available *[para 2.6 of White Paper on State-Level VAT].* This appears to be discriminatory and violative of Articles 303 and 304(a) of Constitution.

Set-Off of Tax on opening stock as on 1st April 2005 –

Input tax as already paid on goods lying in stock as on the day when Vat was introduced (which are purchased within one year prior to that date) was available to dealer. For example, if Vat was introduced on 1-4-2005, credit of tax paid on stock lying as on 31-3-2005 was allowed if the goods were purchased on or after 1-4-2004.
Detailed stock statement were required to be submitted to sales tax authorities. This credit will be available over a period of six months after an interval of 3 months need for verification *[para 2.7 of White Paper on State-Level VAT].*
States have deviated from these provisions.

Very few sales tax forms –

Most of present sales tax forms will disappear, *{para* 2.14 of White *Paper on State-Level VAT]*
However, forms relating to EOU/SEZ may continue. Forms under CST Act will continue.

One to one correlation not required –

VAT does not require one to one i.e. Bill to Bill correlation between input and output. Credit is available as soon as inputs /capital goods are purchased.
The credit can be utilised for payment of VAT on any final product. It is not necessary to wait till the input is actually consumed/sold.

When Credit cannot be Availed:
Credit of tax paid on inputs will be denied in following situations –

1. *No credit if final product is exempt –*

Credit of tax paid on inputs is available only if tax is paid on final products. Thus, when final product is exempt from tax, credit will not be availed. If availed, it will have to be reversed on *pro-rata* basis.

2. *Restricted credit if output goods are transferred to another State –*

If the final products are Transferred to another State as stock transfer or branch transfer, input credit availed will have to be reversed on *pro-rata* basis, which is in excess of 3%. In other words, in case of goods sent on stock transfer/branch transfer out of State, 3% tax on inputs will become payable e.g. if tax paid on inputs is 12.5%, credit of *9.5%* is available. If tax paid on inputs is 3%, no credit is available (This is termed as 'retention'). Thus, the VAT as introduced is State Vat and not a national Vat (In case of some States, even if CST is reduced to 3%, retention has been kept @ 4% only).

3. No input credit in certain cases –

In following cases, the dealer is not entitled to input credit –
(a) Inputs used in exempted final products
(b) Final product not sold but given as free sample
(c) Inputs lost/damaged/stolen before use. If credit was availed, it will have to be reversed.

4. *No credit on certain purchases –*

Generally, in following cases, credit is not available –
(a) Purchase of automobiles (except in case of purchase of automobiles by automobile dealers for re-sale)
(b) fuel.
There are variations between provisions of different States.

Tax relief Under VAT:
There are two methods mentioned for lowering the tax burden.
a) Exemptions:
It is a partial relief provided to the trader, for eg. in case of exemptions, traders need not charge any VAT on the goods sold. But the trader cannot claim set-off or credit for the input tax paid by him on purchases.
b) Zero Rating:
It is complete relief provided to the trader, there is no tax charged on Sales and trader can avail Input tax credit for purchases made.

Distinction between 'Zero rated sale' and 'exempt sale'
Certain sales are 'zero rated' i.e. tax is not payable on final product in certain specified circumstances. In such cases, credit will be available on the inputs i.e. credit will not have to be reversed.

Distinction between 'zero rated sale' and 'exempt sale' is that in case of 'zero rated sale', credit is available on tax paid on inputs, while in case of exempt goods, credit of tax paid on inputs is not available.
As per para 2.5 of White Paper on State-Level VAT, export sales are zero rated, i.e. though sales tax is not payable on export sales, credit will be available of tax paid on inputs.
In respect of sale to EOU/SEZ, there will be either exemption of input tax or tax paid will be refunded to them within three months. If supplies to EOU/SEZ are exempt from sales tax, then the question will arise whether these are 'zero rated' or 'exempt goods'.
In case of stock transfer to another State, CST is not payable, but input credit will have to be reversed to the extent of 3%. Thus, stock transfer of goods to another State is 'exempt' and not 'zero rated'.
It is not clear what will be the policy after CST is reduced to 2% or when CST is reduced to zero. As per basic concept of Vat, inter-state transactions should be 'zero rated' and not 'exempt'.

Refund if VAT credit of input tax available cannot be utilised for any reason
Entire input tax will be refundable within three months, when final product is exported. In respect of sale to EOU/SEZ, there will be either exemption of input tax or tax paid will be refunded within three months *[para 2.5 of White Paper on State-Level VAT].*
If tax credit exceeds tax payable on sales, the excess credit will be carried to end of next financial year. Excess unadjusted credit at end of second year will be eligible for refund *[para 2.4 of White Paper on State-Level VAT]*
Such excess credit can arise when purchases of inputs are made locally, but final product is mainly exported or stock transferred to another State.

Rates of taxes under VAT-
Ideally, VAT should have only one rate. Though this is not possible, it is certain that there should be minimum varieties of rates. Broadly, following VAT rates are proposed *[para 2.18 and 2.19 of White Paper on State-Level VAT] –*

❖ 0% on natural and un-processed produces in unorganised sector, goods having social implications and items which are legally barred from taxation (e.g. newspapers, national flag). This will contain 46 commodities, out of which 10 will be chosen by individual States which are of local or social importance. Other commodities will be common for all States. Certain specified life saving medicines have been exempted from VAT tax.

❖ No VAT on Additional Excise Duty items (textile, sugar and tobacco) in first year. Position will be reviewed later. Vat has been imposed by State Governments @ 12.5% on tobacco products w.e.f. 1-4-2007.

❖ 1% floor rate for gold and silver ornaments, precious and semi-precious stones.

❖ 4% for goods of basic necessities (including medicines and drugs), all industrial and agricultural inputs, declared goods & capital goods. This will consist of about 270 commodities.

❖ 12.5% RNR (Revenue Neutral Rate) on other goods.

Aviation turbine fuel (ATF) and petroleum products (petrol, diesel and motor spirit) will be out of VAT regime. Liquor, cigarettes, lottery tickets, will also be taxed at a higher rate. These will have

uniform floor rates for all States (generally 20%). Tax paid on these will not be eligible for input tax credit.
Broadly, VAT rates of all States follow this pattern, but still there are many variations.
For example, in some States, Vat rate on gold and silver ornaments has been reduced to 0.25%, as traders were facing competition from neighboring States. Kerala State has imposed tax @ 20% on some luxury goods, though tax on such goods should be @ 12.5% as per the white paper.
In some States, hand tools are taxed at 4%, while in some States, these are taxed at 12.5%.
Policy about turnover tax, surcharge, additional tax etc. imposed by State Governments - States were levying turnover tax, surcharge etc. on sales tax,. Those taxes on sale will go. However, Octroi and Entry tax (which is in lieu of octroi) will continue. Other type of Entry Tax will either be discontinued or will be made Vatable *[para 2.16 of White Paper on State-Level VAT] .*

Concessions for Small Dealers

VAT tax will be payable only by those dealers whose turnover exceeds Rs five lakhs per annum. The dealers whose turnover is less than Rs five lakhs can register on optional basis. Dealers having turnover exceeding 5 lakhs should register within 30 days from date of liability to get registered *[para 2.9 of White Paper on State-Level VAT]*
In case of Karnataka, the limit is only Rs two lakhs. Most of States have kept the limit as Rs five lakhs.

Composition scheme for dealers with turnover upto Rs 50 lakhs –

Small dealers having gross turnover exceeding Rs five lakhs but less than Rs 50 lakhs have option of composition scheme. They will have to pay a small percentage of gross turnover. They will not be entitled to any input tax credit *[para 2.9 of White Paper on State-Level VAT]*
The percentage has not been announced in white paper, but earlier, it was announced as 1%. This rate has been prescribed in West Bengal VAT Act, AP VAT Act, Delhi VAT Act, Kerala VAT Act and Karnataka VAT Act.
In case of Karnataka, composition scheme is available only to a dealer whose turnover in a period of four consecutive quarters does not exceed Rs 15 lakhs.
In Maharashtra, tax payable under composition scheme is 8% of difference between value of turnover of sales less value of turnover of purchases including tax (other than excluded goods) (in short, it is 8% of gross margin of trader). Second hand car dealer is required to pay sales tax @ 4%. In case of works contract, tax can be paid @ 8% of total contract value after deducting amount payable towards sub-contracts to the sub-contractors.

Dealers who make inter-

State purchases are not eligible for the composition scheme. This provision applies to VAT law of almost all States.
The scheme is optional. They can opt to pay normal VAT tax and avail credit of input tax. Composition scheme is a practical scheme considering ground realities, though it dilutes the basic concept of vat that tax is payable at consumption stage. Of course, such schemes are provided in almost all Vat regimes prevailing in Europe and elsewhere, considering practical difficulties in assessing and collecting tax from small traders.

Variants of VAT

VAT could be levied with three specific Variants,
(a) Gross Product Variant,
(b) Income Variant,
(c) Consumption Variants

These variants could be further distinguished their methods of calculation,
(i) Additional Method; (a) Direct Subtraction method
(ii) Subtraction Method (b) Intermediate Subtraction method

(c) Indirect Subtraction method

Gross Product Variant

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.

Income Variant

The income variant of VAT on the other hand allows for deductions on purchases of raw materials and components as well as on depreciation on capital goods. This method provides incentives to classify purchases as current expenditure to claim set-off. However in practice, 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

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 capita] 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. In our Country generally income variant is adopted.
The reasons for preference of Consumption variant are:

- 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.

- 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.

Different Modes of Computation of VAT

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) Tax Credit Method / Invoice Method
(c) Subtraction Method (Direct , Intermediate and Indirect)

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.
A drawback of this method is that it does not facilitate matching of invoices for detecting evasion.

Tax Credit /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, under 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:

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.

Procedural Provisions Relating to VAT

A system of audit checks will have to be established to keep check on bogus invoices. One essential requirement is to give TIN (Tax Identification Number) to all registered dealers, so that a check is maintained that
(a) The tax as shown in the invoice has really been paid
(b) There is no double credit on basis of same invoice.
TIN will have to be indicated on each invoice issued. It will be a 11 digit numerical code. First two digits will indicate State Code *[para 2.10 of White Paper on State-Level VAT].*

Thus, State level computer network with check based on TIN will be established. Otherwise, misuse will be uncontrolled.

Documentation required to avail credit of tax paid on inputs and capital goods –

Tax credit will be given on basis of document, which will be a 'Tax Invoice', cash memo or bill. Such invoice can be issued only by a registered dealer, who is liable to pay sales tax. The invoice should be serially numbered and duly signed, containing prescribed details. The tax payable should be shown separately in the Invoice. The dealer should keep counterfoil/duplicate of such invoice duly signed and dated *[para 2.8 of White Paper on State-Level VAT]*
In case of manufacturer, Invoice issued under Central Excise Rules should serve purpose of VAT also, if the invoice contains required particulars.
Dealers availing composition scheme shall not show any tax in their invoice. They are not entitled to any credit of tax paid on their purchases.

Debit note and credit note –

If sale price is increased/reduced subsequent to sale, the transaction will be recorded through proper debit/credit note. The buyer will adjust the input credit available to him accordingly.

Records and Accounts

Each State has prescribed records to be maintained. Broadly, following records will be required.

- Records of purchases of Inputs.
- Record of debit notes and credit notes.
- Quantity record of inputs.
- Record of credit notes received from supplier.
- Record of capital goods.
- Sale register and tax charged on sales.

Record of Tax credit available –

Monthly/quarterly totals of the following should be taken - (a) Input credit available (b) Credit available on capital goods (c) Credit notes from suppliers.

Carry forward/refund of tax credit –

If input tax credit cannot be utilised in a particular month/ Year, the credit can be carried forward and used in subsequent months/year. Refund of such excess credit is permitted only if goods were exported out of India. If credit is not utilised in two years, refund will be granted.

Preservation of records –

Since assessment can be opened for prescribed period (usually five to right years), it is necessary to preserve all relevant records for prescribed period from close of the financial year. The records can be audited by departmental audit party.

Payment of VAT Tax and filing of returns

Every dealer is required to file returns on monthly/quarterly basis. If the records are kept properly, filing the return will be very easy and mistakes will be minimum.

Net Tax payable –

Net tax payable will have to be calculated as follows –
(a) Output tax XXX
plus
(b) Reversal of Credit
(On exempted goods, stock transfers, free samples, lost inputs) XXX
Less –
(c) Input tax credit available (XX)
Net Tax Payable
This net amount is required to be paid through prescribed challan on or before due date.

Accounting treatment of VAT

ICAI has issued Guidance Note on Accounting for State level VAT on 15-4-2005. The guidance note is based on principles of VAT as contained in White paper released on 17-1-2005. However, there are variations in respect of each State. Hence, accounting policies will have to be adopted to suit provisions of VAT law of the particular State. Following broad principles should be kept in mind:-
(a) As per AS-2, cost of purchase for purpose of inventory valuation should not include tax, if credit of tax paid is available.

(b) For purpose of income tax, inventory valuation should be inclusive of taxes, even if its credit is available, as per section 145A of Income Tax Act.

(c) Purchase account should be debited with net amount. VAT credit receivable on purchases should go to 'VAT Credit receivable (Input) Account.
(d) Account of each rate i.e. 0%, 1%, 4%, 12.5% etc. is required to be kept separately.

(e) In case of capital goods, as per AS-10, cost of fixed assets should include only non-refundable duties or taxes.

(f) If entire credit of tax on capital goods is not available immediately, the credit that is available immediately should be debited to VAT Credit Receivable (Capital Goods) Account and credit which is not available immediately should be taken to 'VAT Credit Deferred Account'.

(g) In case of sales, the sales account should be credited only with net amount (i.e. exclusive of VAT). Tax payable should be credited to separate account 'VAT Payable Account' [This is 'exclusion method'. Interestingly, in case of excise duty paid on final product, 'inclusive method' is permitted, i.e. sale account is credited inclusive of excise duty on final product].

(h) If any VAT is payable at the end of period (after adjusting VAT credit available), the **bal-**ance is to be shown as 'current liability'.

Assessment of TAX

Dealer is required to assess his tax and pay himself. It will be basically self-assessment. There will be no compulsory assessment at end of the year. If notice is not issued within prescribed time, dealer will be deemed to have been self-assessed *[para 2.12 of White Paper on State-Level VAT]*
Returns will be filed monthly/quarterly, as prescribed, along with challans. Returns will be scrutinised and if there is technical mistake, it will have to be rectified by dealer *[para 2.11 of White Paper on State-Level VAT]*

As per West Bengal VAT Act, if dealer does not receive any intimation within two years from end of the accounting year, it is deemed that his return has been accepted by sales tax authority. In case of Andhra Pradesh, the time limit is four years from date of filing of return.

Audit of records - There will be audit wing in department and certain percentage of dealers will be taken up for audit every year on scientific basis. The audit wing will be independent of tax collection wing, to remove bias. There will be cross verification with Central Excise and Income Tax also, *[para 2.13 of White Paper on State-Level VAT]*

Audit by outside Agencies - VAT laws of some States provide for audit by outside agencies. AP Vat Act provides for audit by CA, cost Auditor or Sales tax Practitioner (STP), if audit is ordered by Commissioner. In Karnataka, audit report is required if turnover exceeds Rs 25 lakhs.
In Delhi, the dealer is required to submit copy of audit report u/s 44AB of Income Tax Act (This report is required when turnover exceeds Rs 40 lakhs per annum) No separate audit is prescribed, unless special audit is ordered by department.
In Maharashtra, audit report from Chartered Accountant or Cost Accountant is required if sales turnover exceeds Rs 40 lakhs.

Question: 1:
Compute the invoice value to be charged and amount of tax payable under VAT by a dealer who had purchased goods for Rs. 1,20,0000 and after adding for expenses of Rs.10,000 and of profit Rs. 15,000 had sold out the same. The rate of VAT on purchases and sales is 12.5%. compute the VAT payable.
Solution:
Invoice value to be charged
Purchase price of goods 1,20,000
Add: Expenses 10,000
Add: Profit margin 15,000
Amount to be billed 1,45,000
Add: VAT @ 12.5% 18,125
Total invoice value 1,63,125
VAT to be paid
VAT charged in the invoice 18,125
Less: VAT credit on input 12.5% of Rs. 1,20,000 (15,000)
Balance VAT payable 3,125

Question: 2:
Manufacturer A sold product X to B of Delhi @ Rs. 1000 per unit. He has charged CST @ 4% on the said product and paid Rs. 60 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%.

Compute the VAT payable by B and C.
B Liability of VAT Rs.
Cost of product X purchased from Mumbai
Rs. 1000 + 40 (CST) + Rs. 60 1,100
(Credit of CST shall not be allowed under VAT)
Sale price 1,250
VAT payable 156.25