VAT

Value Added Tax [IPCC] 2013-14

Complete information relating VAT.

Aman Singhal

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SOURCE OF DATA:

- ***ICAI STUDY MATERIAL***
- ***INCOME TAX SERVICE TAX & VAT- Dr.GIRISH AHUJA***

DISCLAIMER:

Data contained here is correct as best of knowledge of author. All the mistakes are removed and data is reliable. Information contained here is for those who are appearing in Nov12 exams and onwards. Any change in standards or law will be applicable as soon as declared by ICAI after compilation of this.

(Author)

VALUE ADDED TAX [VAT]

HOW THE IDEA OF VAT CAME INTO EXISTENCE?

Ans. A really progressive and well-oriented country should balance the requirements of direct and indirect taxes in a fair manner. Too much dependence on direct taxes will be repressive(दबाने वाला) but at the same time passing heavy burdens to the general public by way of indirect taxes will constitute hardships to the common citizen. This lead the economic administrators throughout the world to find a mid-way which they founded and we call it Value Added Tax [VAT] system.

Note- Excise duty is levied by the manufacturers on the goods produced and sold by them. Excise duty is imposed by Central Government. Also follows the system of VAT.

WHY VAT?

Ans. This can be better understood with the help of an example:
You are a trader. You have purchased goods of Rs 10,000 and paid tax @4% on it. Now you want to sell these goods to suppose X after adding profits of Rs.1,000. Then in that case your billing calculations will be as follows-

<u>Under Old Sales Tax System:-</u>

Your cost price	= Rs.10,000+ 4% tax
	= Rs.10,400
(+)Profit	= Rs.1,000

	Rs.11,400
(+)Sales tax @4%	Rs.456

Sales Price	Rs.11,856

Here point is to note that on selling the goods you have charged tax on tax means 11,400 includes 400 of tax on which you have again charged tax of Rs.16. This is called cascading effect.*

<u>Under Modern VAT System:-</u>

Your cost price (Rs.400-will not be added as you will get input VAT credit of that which will be discussed later on)	= Rs.10,000
(+) Profit	= Rs.1,000

(+) VAT @4%	Rs.440

Selling price	Rs.11,440

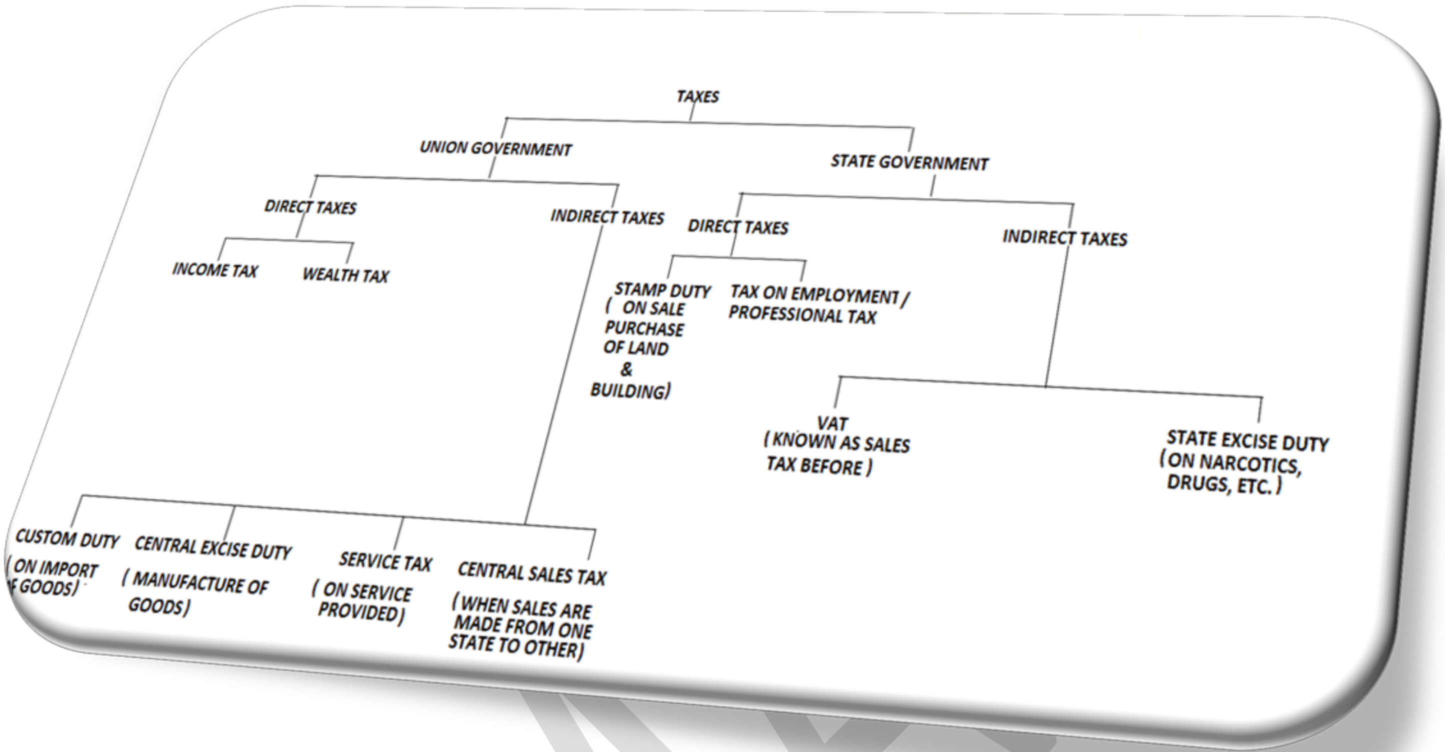
Here you can see that by calculating bill under VAT , consumer had to pay less. There are many other benefits also which will be discussed further.

Before going on further discussion on VAT, let us understood tax system and a little bit about VAT history.

In some countries like India, taxes are imposed separately by Central\Union Government and State Governments. Their rules & structures may be different.

NOTE: Cascading Effect= ***Charging tax on tax.***

IN INDIA:



Note- <u>Impact of tax</u>= Who is paying?

<u>Incidence of tax</u>= Who will ultimately bear the tax?

In direct taxes both impact and incidence of tax is on same person. For example- Income Tax. The person who is paying can't recover it from some other person.
In indirect taxes impact and incidence of tax is different. For example- VAT, paid by seller to the government but ultimately recovered from the consumers who can't recover further.

<u>Some points to be noted down here:</u>

- Union government shares a part of some taxes recovered from public with state government.
  For example- Central Sales Tax [CST] is charged by central government but the amount received from this tax will be kept by state governments.
- If goods are sold within the same state then VAT/Sales tax is applicable. But if the goods are sold in other state then CST is applicable.
- If goods are exported to another country then no tax is applicable, in order to make goods cheaper and able to compete in foreign markets.
- On wine, narcotics, etc. central excise duty is not applicable.
- Taxes are applicable on final price of goods means after including all expenses incurred and profit as well.
- Every state has its own VAT rules
- In Delhi= DVAT [Delhi Value Added Tax]
  UP= UPVAT
  Haryana= HVAT, etc.
- Central sales tax= Inter State Sales Tax.
- Seller pays CST to the state government of the state from which seller is selling goods.

- Input credit is not received for CST paid in case of purchaser as it was received by the government of state from which purchases have been made. But same can be obtained in case of seller if charged.
  [Concept of VAT credit will be discussed further on]
- CST adds to the cost price of the goods in case of purchaser.

HISTORICAL BACKGROUND OF VAT:

- First introduced in France in 1954.
- Today, about 130 countries have adopted this system of taxation.
- Proposed for the first time by Dr.Wilhelm Von Siemens for Germany in 1919 as an improved turnover tax.
- Then by professor Thomas S. Adams in 1921 for the USA in the sales tax system.
- Then by Shoup Mission for the reconstruction of Japanese Economy in 1949.
- Not introduced by any country till 1953 and limited to the boundaries of France until the fifties.
- Spreading rapidly since the sixties.
- Followed by
  - Ivory Cost in 1960
  - Senegal in 1961
  - Brazil and Denmark in 1967.
- 1968, France extended the VAT to the retail level while the Federal Republic of Germany introduced it in tax system.
- In other states-
  - Netherlands and Sweden 1969
  - Luxembourg 1970
  - Belgium 1971
  - Ireland 1972
  - Italy, UK, Austria 1973
    Other member of European union
  - Portugal and Spain 1986
  - Greece 1987
  - Finland 1994
  - Many other European countries and North and South America, Africa and Ocenia have introduced VAT.
- In Asian region:
  - The Republic of Vietnam 1973
    [Abolished soon but re-introduced in 1999]
  - South Korea 1977
  - China 1984
  - Indonesia 1985
  - Taiwan 1986
  - Philippines 1988
  - Japan 1989
  - Pakistan 1990
  - Bangladesh 1991
  - Thailand 1992
  - Singapore 1994
  - Nepal 1997

- Mongolia & Sri Lanka 1998

- In India
  - In the South Asian Association for Regional Cooperation [SAARC] 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].
  - MODVAT was designed to cover manufacturing of goods by giving credit of excise duty paid on inputs.
  - Scope of MODVAT has been extended over the years and has since been renamed as Central Value Added Tax [CENVAT], which covers service also.

VAT IN INDIAN CONTEXT:-

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

DISADVANTAGES OF COLLECTING TAX AT FIRST STAGE:

- The tax rate has to be higher as sales tax was levied and collected at the first stage.
  This encouraged tax evasion and sales tax became a tax on honesty, which means more the honesty, more the tax liability.
- If goods escaped tax at first stage, the goods escaped tax net altogether.
- There was ample scope of under-valuation of the value of the goods at first stage, as there was no tax payable at any subsequent stages. For example-

DISADVANTAGES OF COLLECTING TAX AT LAST STAGE:-

- Tax evasion was maximum since the price charged at the last point of sale increases, which encouraged evasion, even if the tax rates were low.
- It was difficult to track the goods evading tax since there was no record of their earlier movements and after the last point sale, the goods reached in the hands of the consumer.
- This also encouraged under-invoicing and involves generation of black money due to cash dealings at the last point of sale.

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

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 (दस्तावेज़) 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 state governments can exercise their jurisdiction.

Note: Indian constitution contains three lists which tells the powers of Union and State Governments.

- **The Union List-** **Powers of Union Government.**
- **The State List-** **Powers of State Government**
- **The Concurrent List-** **Powers for both, union as well as State Government.**

The power to levy tax on sales transactions in the form of VAT is drawn from entry no.54 in list II of seventh Schedule of the constitution of India by the State Governments.
Income tax, excise duty and custom duty constitute the major sources of tax revenue to the Central Government. The State Government substantially (वास्तव मे) 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 [MODVAT], which is currently in operation as CENVAT. CENVAT applies to goods and services but not to sales tax and State-level VAT.

STRUCTURE OF CENVAT:-

As of now, the central government levies excise duty on all goods manufactured in India or produced in India.
Paid by the manufacturer/producer at the time of removal of goods from the factory at prescribed rates. The prevailing structure of such duties include

- CENVAT
- Special Excise Duty [SED]
- Additional Excise Duty on goods of special importance, AED [GSI]
- Additional duty of excise on textiles and textile articles, AED [T& TA]
- Cesses on specified commodities.

MODVAT was introduced on March1,1986 under the union excise duty as a system of giving credit for excise duty on inputs.
Initially introduced for a selected number of commodities.
MODVAT was extended over years and was finally replaced by CENVAT in the budget 2000-01.
The CENVAT scheme initially allowed instant credit of 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 used to pay excise duty on any final product.

System of Vat was also introduced in Service Tax in 2002.

From 10th September, 2004, inter sectoral credit is also allowed.
Note: Under the inter-sectoral credit system the assesse is allowed to take credit of central excise duty paid on input/capital goods while making the payment of service tax. Similarly, the assesse is allowed to take credit of service tax paid on input services while making the payment of Central Excise Duty.

At present , the CENVAT scheme is governed by CENVAT Credit Rules, 2004.

COMMITTEE OF STATE FINANCE MINISTERS:

VAT was introduced in the area of manufacture and services, and for the sake of uniformity, similar system was proposed to be incorporated in the area of sales there by replacing the existing sales tax system. To materialize this concept, the 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 reforms following the meeting.

The task force known as “Kelkar Committee” observed that presently, “each state levies multiple taxes on the same item in a different names or at different stages e.g. Entry Tax, Luxury Tax,etc.”. however it opined (का मानना है) that “it is necessary that State VAT should be the tax to unify all the state level taxes, i.e., sales tax, purchase tax, turnover tax, works contract tax, entry tax, special additional tax, etc. should all be covered under State VAT.

The 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 (वृद्धि) of transparency. To this end, the committee recommended:

- The adoption of four general floor rates (0,4,8,12) and two special floor rates (1 & 20) in place of the existing multiple rates being levied in different states;
- Keeping the exemptions to a minimum;
- Preparing a list of exempted goods and fixing a target date beyond which no state/union territory should exempt goods other than those mentioned in the list, and;
- Doing away with sales tax incentives for industrialization.

Many efforts have been done in the past to introduce VAT. The committee of States Finance Ministers (in 1995 & 1998, respectively) and of the Chief Ministers (in 1999) have put forth recommendations to replace sales tax by VAT. The in the conference of the Chief Ministers and Finance Ministers, it was scheduled to introduce State VAT in lieu of Sales tax from 1.4.2003.

However the schedule had to be revised in view of agitative (उत्तेजित) trader's community. The Empowered committee of State Finance Ministers agreed upon 1.6.2003 as the revised date of implementation of VAT and it was expected that most of the state and union territories will implement VAT from 1.6.2003, but it did not happen.

Later, the Finance Minister deferred (स्थगित) the implementation of VAT for some more time so that more conducive environment may be created and agitative opposition may be set to peace. Besides consensus (सहमति) of all the states over the model law and introduction of VAT on uniform basis was also necessary. On 30.4.2003 he announced that unless all states conform to model draft law and agreed VAT rates, introducing VAT on 1.6.2003 will not be possible. He stated that VAT should be implemented all over India. Patchwork will not serve the purpose. In this connection, the empowered committee of State Finance Ministers met regularly and brought out a white paper on State level VAT on 17.1.2005.

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

Note: A white paper is an authoritative report or guide that helps solve a problem. White papers are used to educate readers and help people make decisions, and may be a consultation as to the details of new legislation. The publishing of a white paper signifies a clear intention on the part of a government to pass new law.

Part1: In this part , the justification of VAT and its background had been mentioned.
Part2: The main design of State Level VAT. While doing so, it recognized that this VAT is a state subject and therefore the states will have freedom for appropriate variations consistent with the basic design as agreed upon by the empowered committee.
Part3: discussed the other related issues for effective implementation of VAT.

Justification of VAT and Background:

- In the existing sales tax structure, there are problems of double taxation of commodities and multiplicity of taxes, resulting in a cascading tax burden.

- In the prevailing sales tax structure, several States levying multiplicity of taxes, such as turnover tax, surcharge on sales tax, additional surcharge, etc. with introduction of VAT, these other taxes have been abolished. In addition, Central Sales Tax is also to be phased out. As a result, overall tax burden will be rationalized, and prices in general fall.
- In the VAT, a set-off is given for input tax.
- VAT has replaced the existing system of inspection by a system of built-in-self-assessment by the dealers and auditing.
- The tax structure will become simple.

The white paper also specified that registration under State VAT Act shall not be compulsory for small dealers with gross annual turnover not exceeding Rs.5 lakhs.
However, the empowered committee of state finance ministers has subsequently allowed the states to increase the threshold limit for small dealers to Rs.10 lakhs.

Present position:
Finally state level was introduced on 1-4-2005 by majority of states

Discontinuance of Central Sales Tax:
With the introduction of State-Level VAT system, it is proposed to face out the Central sales tax {CST}. However, since the states will stand to loss large revenue on the account of its discontinuance a mechanism is being thought of for compensating the states for such loss of revenue.

ADVANTAGES OF VAT:

The purpose of a tax system is to bring in revenues to the government. Tax revenue can be raised in many ways. However the main characteristics of a good tax system should be-

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

VAT holds the following advantages:

- *Easy to administer and transparent:* It is easy simple and easy to administer. Also reduces the cost of compliance by the dealer and is transparent, as tax is charged in every bill and there will be no local statutory forms.
- *Less litigation(मुकदमा)/Neutrality:* The greatest advantage of the system is that it does not interfere in the choice of decision of purchase. He will also be allowed to purchase any item he requires as raw material for the purpose of manufacturing or packing. As under VAT no items will be specified in the registration certificate of the dealer. How much value is added and at what stage it is added in the system of production/distribution is of no consequence. This system is neutral with regard to choice of production technique, as well as business organization.
- *Tax credit on purchase of capital goods:* In this system dealer will also get input credit of VAT paid by him on purchase of "Capital Goods" for manufacturing purpose. {Note in the cases where capital goods are used for the purchase of exempted goods}.
- *Abolition of statutory forms:* All problems relating to forms automatically get resolved as there are no forms under VAT. Dealers will not have to make visits to department to get these forms issued. It also saves the time and cost of department. Now the time of assessing officers can be utilized for other useful purposes like monitoring of tax collection instead of issuing forms.

- *Self-assessment:* Dealers are not required to appear before the assessing authority for their yearly assessments, as under VAT there is provision for self assessment. All the cases will be accepted by the department as correct and only a few will be selected for audit as is being done by Income tax department and Excise Department at present.
- *Deterrent (निवारक) against tax avoidance:* Under the old sales tax system tax was charged either on first stage or last stage. Hence the chances of tax evasion is high because the dealer can saves the whole amount of tax due on such transactions. Under the VAT dealer can only steal the amount of tax only to the extent that he is liable to pay. Also the dealer has to register himself if he wants to get the benefit of input VAT credit.
- *No cascading effect:* It does not have cascading effect due to system of deduction or credit mechanism. Since VAT does away with cascading, it avoids distorting business decisions.
- *Effective enforcement and audit strategies:* Under this system details of invoices are kept which lead to effective audits.
- *Minimum exemptions:* The system will be more effective because of minimum exemptions.
- *Removal of anomaly (अवैधता, कमिया) of Single point taxation.*
- *Competitiveness of exports:* Exports can be freed from domestic trade taxes in real sense.
- *Instrument to tax consignment of goods:* Instrument of taxing consignment of goods and services as in the case of consignment transfer and stock transfer, the input tax credit is given after deducting 2 %. Such 2% tax is retained by the state government.
- *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.
- *Transparency:* Under this system the buyer knows that what he is paying as tax out of total consideration. This transparency enables the state government to know as to what is the exact amount of tax coming at each stage. It is a great aid to the Government while taking decisions with regard to rate of tax etc.

DISADVANTAGES OF VAT:

Inherently there are certain limitations of VAT due to which it being opposed by some of the trade associations. Moreover VAT undoubtedly has many advantages but without taking note of the limitation of VAT, one is just looking only at one side of the coin. The limitations of VAT are discussed hereunder.

- *Detailed Records:* Like any other system VAT is also not free from all evils. Though on record it is said to be the simplest method, however, it is more complicated than a simple first point tax. Many small dealers maintain only primitive accounts and it is very difficult for them to keep proper and detailed records required for VAT purposes. It will also be difficult to administer the tax systems at wholesale and retail stage as they usually deal in numerous products and commodities, which carry different rate. Thus matching of input and output taxes is difficult. Ideally VAT should have very few rates which does not seems to be possible in India due to varying and diverse fiscal and social requirements. In case matching requirement is waved off there is a possibility of tax evasion as explained hereunder:-

Amount in Rs.

	1%	4%	8%	20%	TOTAL
Purchases made by a dealer	1,000	1,000	1,000	1,000	4,000
Tax Paid	10	40	80	200	330
Sales shown by Dealer					
Case A	**I**	**II**	**III**	**IV**	**TOTAL**
	1,200	1,200	1,200	1,200	4,800
Tax Charged	12	48	96	240	396
Tax Liability (Rs.396-Rs.330)= Rs.66					
Case B	**I**	**II**	**III**	**IV**	**TOTAL**
	1,400	1,200	1,200	1,000	4,800
Tax Charged	14	48	96	200	358
Tax Liability (Rs.358-Rs.330)= Rs.28					

- *Causes Inflation:* It's impact will depend on various factors such as inventory holding period, demand supply position of that product, number of intermediaries etc. investment in stock is bound is increase as tax will be paid at the time of purchase, hence will have to carry tax paid stock.
- *Refund of Tax:* VAT credit is not available if no tax is payable on final product being exempt or taxable at lower rate. Hence a mechanism is needed for early refund of tax paid on inputs/capital goods in case of dealers/manufacturers of exempted goods or exporters.
- *Increase in Investment:* Dealer will be making purchases after paying tax , therefore investment in stock will go up the extent of tax paid. Under old system the dealer was making purchases against statuory forms, hence was not liable to pay tax on purchases.
- *No credit for tax paid on Inter State Purchase:* the biggest problem of introduction of VAT is the non-availability of credit of tax paid on inter-state purchases in initial years. It will also result in some cascading effect, which goes against the basic spirit of VAT.
- *Composition Scheme:* Introduction of composition scheme will obstruct the flow of audit trail and this scheme can be misutilised by unscrupulous dealer.
- The rate of VAT is not same for all the commodities.
- For complying with the VAT provisions the accounting costs will increase.
- As a result of introduction of VAT, the administrative costs to the state can increase as the number of dealers to be administered will go up significantly.

WHAT IS VAT AND HOW IT IS DIFFERENT FROM EARLIER SALES TAX SYSTEM?

Ans. VAT is a system of charging tax, which is charged on the increase in value of goods and services at each stage of production and circulation.

- Also chargeable on the value of imported goods.
- Charged by registered VAT businesses/persons/taxpayers.
- Replaced a number of taxes
- Not resulted in increased prices to final consumers or reduced profitability of business.
- Charged on the difference between output and input.
- It's a multi point sales tax system.
- Tax paid by the dealer is deducted from the tax collected at every point of sale and the tax already paid.

DIFFERENCE BETWEEN VAT AND EARLIER SALES TAX SYSTEM:

- Earlier tax was levied either at first stage or last stage (single point tax system). Under VAT tax is levied and collected at every stage (multi-point tax system).
- No cascading effect under VAT but was present in earlier system.
- Earlier computation of tax liability is complex but it is transparent and easier under VAT.
- Use of statuory forms for tax evasion under old system but there are no such forms under VAT system.
- Returns and challans were filed separately and the dealers have to give numerous details under old system but in VAT, returns and challans are filed together in a simple format after self assessment done by seller himself.
- Under old system tax was levied on goods only but under VAT tax is levied on both, goods as well as services.
- Assessment was done by departments but under VAT dealers do self-assessment.
- Penalties are stricter in VAT system.

EARLIER SALES TAX SYSTEM:

FIRST POINT TAX:

Suppose you are a manufacturer producing goods costing Rs.80 and you add a profit of Rs.20 in that, then the final selling price is Rs.100. If the tax % is 20 (usually higher in first point system as the tax is charged only once in starting) then the tax total tax charged on this good is Rs.20 as no further tax will be levied on this good.

How tax evasion is possible in this system?

Tax evasion is very simple in this system as the tax is levied only once in starting. Suppose you are the owner of two different firms one of your firm is producing a good costing Rs.850 and wants to earn a profit of Rs.150 on it and the tax rate is 20% then on such good you have to pay tax of Rs.200. But if you sell that product to your second firm at Rs.900 then tax liability will only be of Rs.180. and after that you can sell that product by adding any profit through second firm as no tax will be charged further and you have simply fooled government by Rs.20.

LAST POINT TAX:

Suppose you are a manufacturer producing a good and selling the same for Rs.100 to a trader who sells it to a retailer for Rs.150 who ultimately sells that to a consumer for Rs.180 then the levy of tax on such goods will be at the last stage i.e., when the goods reached in the hands of consumer. In this case if the tax rate is 10%, the tax levied will be Rs.18. Before this no tax will be charged on that good.

How tax evasion is possible in such system?

Here the tax is levied when the goods reach in the hands of ultimate consumer. Before that no tax is levied. As a result there is no record that from where goods come in transmission and where transmission comes to an end. So it becomes difficult to trace goods.

Under invoicing of goods is also a method to evade tax. Suppose a good cost to retailer for Rs.100 and he sells it for Rs.150 and tax % is 10 then the original tax liability will be Rs.15. but to evade tax retailer prepares invoice for Rs.110 and Rs.40 taken without invoice. Then the tax liability remained of Rs.11 and there is a tax evasion of Rs.4 on Rs.40 taken without invoice.

Liability of tax under old sakes tax system and VAT if charged at each stage:-

In order to stop tax evasion, the state government had desired that instead of levying the sales tax either at first stage or last stage, it should be levied at each stage.

Levying the tax at each stage would have resulted into the following two anomalies under old system:

- Tax charged more than once on same items.
- There is cascading effect.

To overcome this problem VAT was introduced so that VAT is calculated is calculated by deducting input tax credit from the tax collected during the payment period.

INPUT TAX CREDIT:

The tax paid by the dealer on its purchases of inputs and capital goods is eligible for credit while making payment of VAT on the sale of such goods. Such credit is known as input tax credit. Such input tax credit is allowed as set off from the output tax payable by the dealers on its sale.

Suppose you are a dealer dealing in specific goods which you purchase from a manufacturer at Rs.100 with a tax of Rs.10, means a total of Rs.110. Here you want to earn a profit of Rs.20 on it. So here your cost price will be Rs.100 and selling price will be Rs.120 and tax @10% will be charged on Rs.120 i.e., Rs.12. now you don't need to pay government Rs.12 as tax. You just need to pay Rs.2 because you have already paid Rs.10 at the time of purchase what we call input tax credit. The tax paid by you will be deducted from the tax you have collected from your customers and only the balance has to be deposited with the government.

Note: A dealer can't claim the input tax credit if the purchases of goods and capital goods are not meant for business.

Illustration to understand till done concept:

Suppose you are a owner of a coal mine and selling coal to A at Rs.1000 per quintal and charging tax @5%. A after adding a profit of Rs.200 sells it to B and charged tax @5%. B sells the same to a customer after adding a profit of Rs.100 and charging tax @5%. Calculate the tax liability if:

- Tax is charged following earlier sales tax system.
- Under VAT.

Comment also.

<u>*Solution:*</u>

Under old system:

Selling price of coal	Rs.1000		
Tax charged @5%	Rs.50		
Total invoice value		Rs.1,050	
Cost to A	Rs.1050		
Profit	Rs.200		
Selling price		Rs.1250	
Tax @5%		Rs.62.5	
Total invoice value			Rs.1312.5
Cost to B	Rs.1312.5		
Profit	Rs.100		
Selling price		Rs.1412.5	
Tax @5%		Rs.70.6	
Total invoice value			Rs.1483.1
Cost to customer	Rs.1483.1		

Under VAT:

Selling price	Rs.1000	
VAT @5%	Rs.50	
Total invoice value		Rs.1050
Cost to A	Rs.1000 (Input credit of Rs.50 is available)	
Profit	Rs.200	

Selling price	Rs.1200	
VAT @5%	Rs.60	
Total invoice value		Rs.1260

Tax liability = Rs.60-Rs.50 = Rs.10

Cost to B	Rs.1200 (input credit of Rs.60 is available)		
Profit	Rs.100		
Selling price		Rs.1300	
VAT@%5		Rs.65	
Total invoice value			Rs.1365

Tax liability =Rs.65-Rs.60 =Rs.5

Cost to customer	Rs.1365 (customer doesn't gets benefit of input tax credit)

Comments:
As here we can clearly see that under old system the tax paid by us becomes the part of cost but in VAT it doesn't. Under VAT, the amount of tax paid by us is available as input tax credit which we can subtract from the tax collected on sale. But consumer who consumes such good will not get such input. Also under old system total tax paid on one commodity is Rs.183.10 (50+62.5+70.6) whereas under VAT total tax paid is Rs.65 (50+10+5). If you analyze then you can see that it is just the tax charged from final customer but government receive that in parts. Cascading effect is also present in old system whereas not in VAT. Also under VAT goods are cheaper for consumer.

ELIGIBLE PURCHASES FOR AVAILING INPUT TAX CREDIT:

Available only when **taxable goods** are purchased for the following purposes:

- For sale/resale within the state.
- For inter-state trade or commerce.
- To be used as
    - Containers or packing material.
    - Raw materials
    - Consumables store.

  For the goods which will be sold according to first two points and if exported.
- Used in the execution of works contract.
- Capital goods used in the manufacture of taxable goods.

Input tax credit is available on each item which is used in the production of taxable goods in the case of manufacturing concern and all purchases in case of trading concern except such purchases are made from other states or territories. Input tax credit is available only when purchase is made within state but you can sell it anywhere.

COVERAGE OF INPUT TAX CREDIT AND ITS SET-OFF

- *Instant credit of input tax:* input tax credit is available to all manufacturers and dealers for their purchases which are meant for sale/resale irrespective of the place of utilization.
- *Carry forward of VAT credit:* If the input VAT credit exceeds the tax payable on sales made within the state in a month, the excess credit will be adjusted against CST payable on inter-state sales but if still excess remains in hand then it will be carried forward to subsequent month(s) and the unadjusted VAT credit at the end of period is eligible for refund.

- *No input credit on CST paid on purchases from other states:* For example if a dealer of Delhi purchased goods from Mumbai costing Rs.100000 and paid CST Rs.2000 then that dealer of Delhi will not get credit of Rs.2000 paid as CST and it's cost will become Rs.102000,
- *Input credit on stock transfer to other states:* Stock transfer to branches or on consignment basis does not amount to sale. But if goods are sent outside the state then input credit will be available only to the extent of excess of 2% i.e., 2% will be deducted from total. For example if VAT paid is 5% and goods are transferred to a branch outside state then input will be 3% (5%-2%).
- *Treatment of input tax in case of export sales:* Export sales are zero tax rated. Therefore exporters are granted refund of input taxes paid by them or can be adjusted against domestic sales. The refund has to granted within a period of three months from the end of the period in which the transaction for export took place.

PURCHASES NOT ELIGIBLE FOR INPUT TAX CREDIT:

- Purchase from unregistered dealer.
- Purchase from dealer under composition scheme.
- Purchases of goods as notified by government.
- Where invoice is not available or invoice does not show the amount of tax separately.
- Purchase of goods utilized in the manufacture of exempted goods.
- Purchase of goods for personal use or provided free of charge as gifts.
- Imported from outside India or purchased from other states
- Given away as free samples or stolen or lost.
- Goods received on consignment sale or on stock transfer from other states.
- Goods purchased or returned within the specified period.
- Purchase of automobile and its spare parts and accessories by a person other than a dealer.

INPUT TAX CREDIT ON CAPITAL GOODS:

- Input tax credit also available on capital goods for manufacturers and traders.
- Such credit will be adjusted over a maximum period of 36 equal monthly installments.
- States can reduce the number of months if they desire to.
- There is a negative list of capital goods which is not eligible for input tax credit.

CENVAT CREDIT OF EXCISE AND SERVICE TAX:

- Excise duty and service tax are levied by Central government. VAT is levied by state government.
- Assessee is allowed CENVAT credit of excise and service tax on input goods/services while making payment of same.
- CENVAT credit is allowed only when buyer is also manufacturer of goods.
- Input tax credit of VAT is allowed to every dealer against the VAT payable/CST payable under the state VAT Law.

Central sales tax is charged by a dealer when goods are sold to other states i.e., inter-state sales.
VAT is charged when intra-state sales are made.

CST is levied by the central government but collected and retained by state government from where the movement of goods started.
VAT is levied by state governments and collected and retained by same state government.
On **Inter-state purchase CST** is applicable but not eligible for input tax credit as that CST has been received by government of other state.
CST charged on inter-state sale can be deducted from input tax credit available as the goods which are sold to other states are eligible for input tax credit and CST so charged is collected by your state government.

RATE OF CST:

- If goods are sold to a registered dealer in some other sate then maximum rate of CST to be charged is 2%.
- If goods are sold to any other person in some other state then CST equal to the rate of VAT in the state from where the movement of goods started is applicable.

VAT Rate in the state	Sale to a registered dealer in another state	Sale to any other person in another state
1%	1%	1%
2%	2%	2%
4%	2%	4%
12.5%	2%	12.5%

COVERAGE OF GOODS UNDER VAT:

- All the goods including declared goods will be covered under VAT and will get benefit on input tax credit.
- Few goods including liquor, lottery tickets, petrol, diesel, aviation turbine fuel and other motor spirit are outside VAT as their prices are not fully market determined. Continued to be taxed under any other sate act or under any special provision in VAT.

VAT RATES:

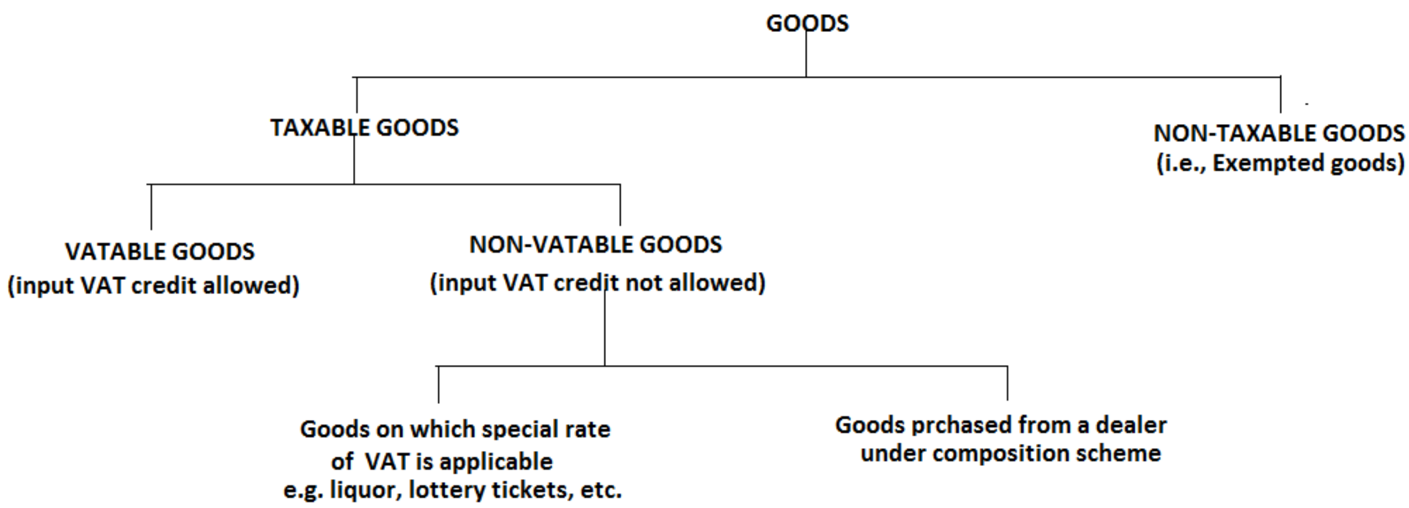
- VAT covers about 550 goods.
- There are 2 basic rates i.e., 4% & 12.5%.
- A specific category of tax-exempted goods.
- A special VAT rate of 1% only for gold and silver ornaments.

Thus there are 4 rates of VAT as per white paper.

(i) 0%
(ii) 1%
(iii) 4% (lower rate)
(iv) 12.5% (Standard rate)

NON-AVAILABILITY OF INPUT CREDIT IN CERTAIN CASES:

- *Where final product is exempt:* In such case no input tax credit will be received on that goods and if availed, it will have to be reversed on pro rata basis.
- *No credit if input lost/damaged/stolen before use.*
- *No credit on purchase of automobiles and fuel.* However, some states are allowing input credit for the same.



Exempted Goods:

- Under exempted goods category, empowered committee has listed about 50 commodities consisting
  - Natural products
  - Unprocessed products
  - Items which are legally barred from taxation
  - Items which have social implications.
- In addition to these commodities, state governments can flexibly choose a set of maximum 10 commodities which are of local importance to the states.
- Examples of few exempted categories of commodities are given below.
  - Blood including blood components
  - Fresh vegetables and fruits
  - Electricity energy
  - Course grain other than paddy, rice and wheat.
  - Kum-kum, bindi, sindur, etc.
  - All bangles except made of precious metals.
  - Curd, lassi, butter milk, etc.

Principles of VAT:-

The following two principles are relevant for implementation of VAT-

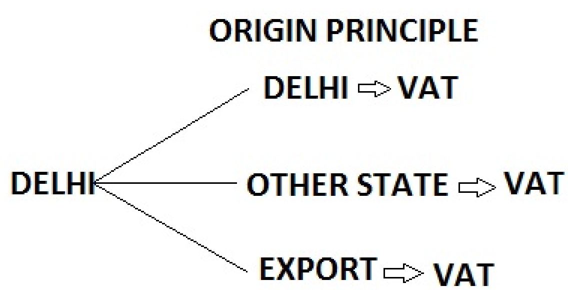
- Origin principle
- Destination principle

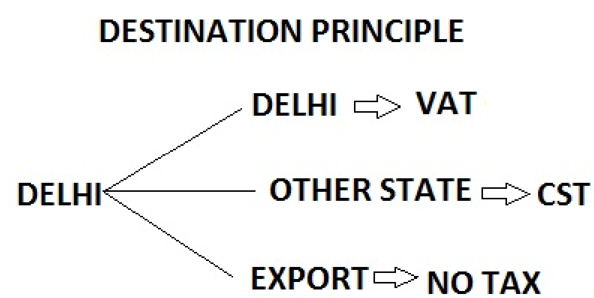
Origin principle:

- Under this principle tax is levied on the basis of origin of goods.
- All goods are subject to tax whether they are domestically consumed or they are exported. Technically, value added on all goods whether they are meant for exporters or to be consumed in India is subjected to tax.
- Limits VAT to goods originating in the country of consumption.
- Exports are taxable but imports are exempt in this principle as imported goods are not originated in consumption country whereas exported goods are.
- Under this principle imported goods are not taxable and hence it gives preference to goods produced abroad.

Destination principle:

- Under this principle tax is levied on the basis of destination of goods not on the basis of origin.
- All goods are taxed if they are consumed within the country.
- Exports are exempt whereas imports are subject to tax.
- An important feature of this principle is that under this principle imported goods are treated at par with domestic products.
- In the EEC (European Economic Community) countries, origin principle was once considered for eliminating border controls and problem of valuation, but was subsequently given up as being impractical. Now destination principle is being followed in those countries.
- In India we are following Destination principle.





VARIANTS AND METHODS OF COMPUTATION OF VAT:

Variants:

Gross product variant

- Tax is levied on all sales.
- Deduction (input tax credit) is allowed only on all purchases of raw materials and components not on capital goods.

Income variant

- Tax is levied on all sales .
- Input tax credit is allowed on purchase of raw material as well as tax on depreciation of capital goods.
- Credit of tax on capital goods is allowed in the ratio of depreciation over the life of the asset.

- ➢ Depreciation is dependent on life of asset as well as rate of inflation, therefore there are many difficulties connected with the variant in measuring input tax credit.

CONSUMPTION VARIANT

- ➢ Tax is levied on all sales.
- ➢ Input tax credit is allowed on both inputs as well as capital goods
- ➢ Input tax credit on capital goods is allowed by the states in 24/36 installments.
- ➢ Does not distinguish between capital and current expenditure.

Q. Why Consumption Variant is most popular and widely used among all three variants?

Ans. Following are the reasons:

- It is tax neutral. Does not affect investment decision as tax on capital goods is also set-off against VAT liability.
- Simplifies tax administration.
- Does not cause any cascading effect.

METHODS:

ADDITION METHOD-

Tax is levied only on value additions made at each stage. Such additions include profit, expenses on manufacturing (either direct on indirect), etc. For example- A manufacturer purchased goods for Rs.1 lakh and paid VAT @ 4%. He incurred expenses worth Rs.5000 on further processing and added profit of Rs.1000. Depreciation on machinery used is Rs.4000. Then in this case VAT will be calculated on Rs.10,000 i.e., value added (5000+1000+4000). Therefore VAT will be Rs.400.

In this method we need not to calculate input tax credit as we are calculating directly on value added.

INVOICE METHOD-

This is the method which we commonly use. Under this method tax is calculated on invoice value and then input credit is subtracted in order to calculate tax liability.

SUBTRACTION METHOD-

Under this method purchase price is deducted from sale price and VAT is calculated on the difference. This method is unpopular because while doing so dealers margin is disclosed. Also not possible when different inputs are used to manufacture a product.

This method can be divided into two categories:

- Direct Subtraction Method= Sale price – Purchase price. Both Exclusive of VAT.
- Intermediate Subtraction Method= Sale price – Purchase Price. Both Inclusive of VAT.

Example-

Purchase price = Rs.104 including VAT @ 4%

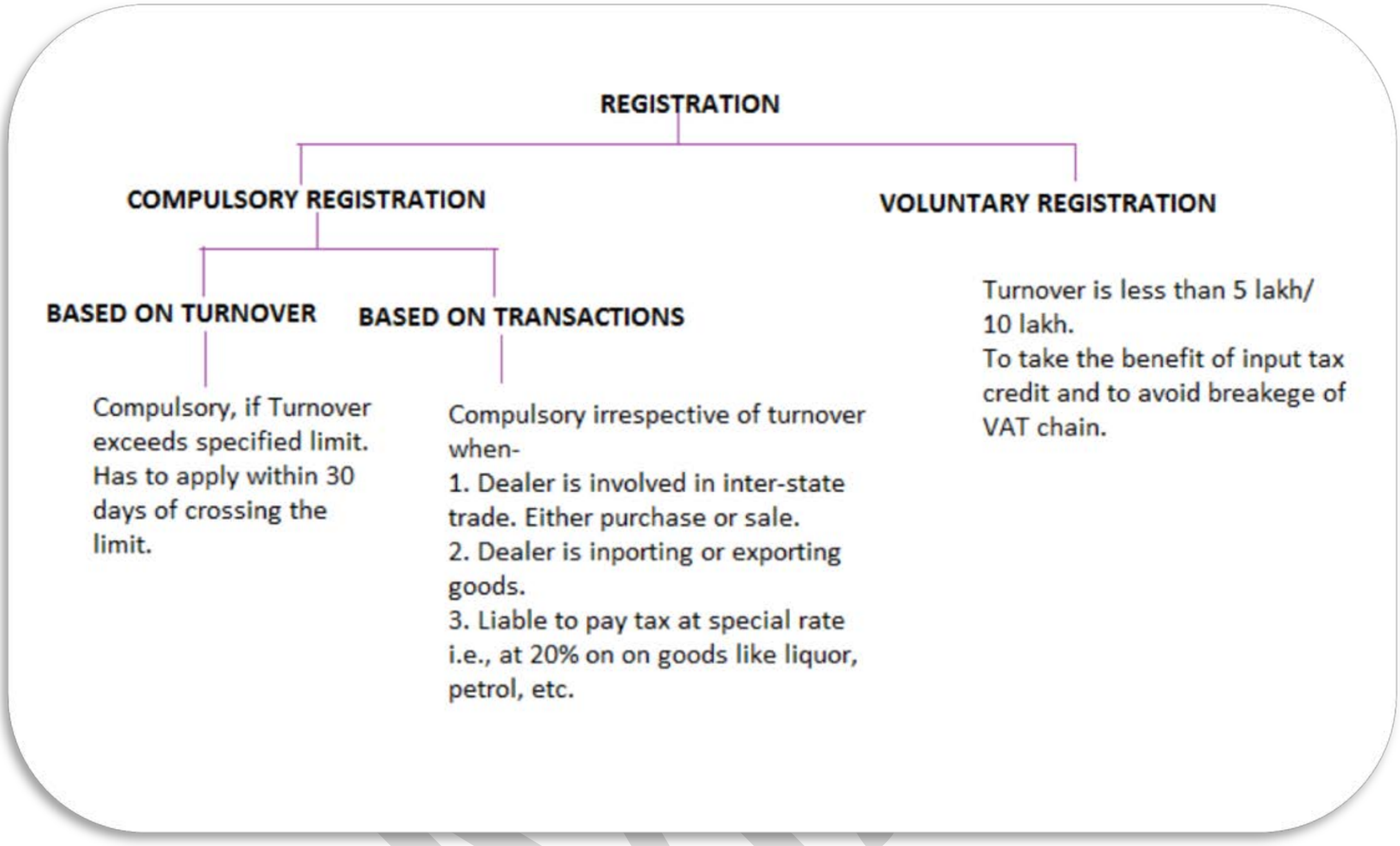
Sale Price = Rs.156 including VAT @ 4%

Direct Subtraction Method = (150-100)*4/100 = Rs.2

Intermediate Subtraction Method = (156-104)*4/104 = Rs.2

REGISTRATION UNDER VAT:-

Every dealer whose annual turnover exceeds Rs.5,00,000 has to register himself under State VAT laws. In some states this threshold limit is upto Rs.10,00,000.



Registration can be cancelled on-

- Discontinuance of business.
- Dealer become insolvent
- Dealer has sold entire business.

COMPOSITION SCHEME:

Small dealers whose annual gross turnover is less than 25lakhs/50lakhs can opt for composition scheme. Under this scheme they just need to pay tax as a lump sum payment. Ordinarily it is a percentage of gross annual turnover like 0.5%. Dealer need to calculate input tax credit and can't issue tax invoice. This breaks the VAT chain.

Advantages:

- Simplifies tax calculation.
- Return can be filled for a longer period.
- Not required to maintain detailed records.

Disadvantages:

- Can't avail benefit of input tax credit.
- No input credit available also to dealer who has purchased goods from a dealer under composition scheme.

TAX PAYER IDENTIFICATION NUMBER (TIN):

- 11 digit numerical.
- First 2 character represents state code used by Ministry of Home Affairs.
- Next 9 digits differ from state to state.

RECORDS TO BE MAINTAINED:

- Purchase records.
- Sales records
- Complete details of VAT accounts
- Bank records
- Cash book
- Annual accounts
- Tax audit report

RETURN OF VAT:

Monthly or quarterly as specified by each State Law.