SALES TAX INCENTIVES AND VAT

—Ashok Chandak

A total of 21states have so far adopted Value Added Tax (VAT) in India. Basic philosophy of VAT is that there cannot be only incentives under fiscal laws. There are certain practical difficulties in implementation both to the Government and to industrial units or dealers, which may be solved but only in the time to come.

Traditionally all State Governments are using Sales Tax Incentives as an important developmental tool particularly for industrial development of an area of the State which is undeveloped or underdeveloped and where no one would like to set up an industry because of several disadvantages such as lack of proper infrastructure, remoteness of market, unwillingness of the workers to work in the remote isolated areas etc. Thus, almost all State Governments have started offering Sales Tax incentives for industrial development of backward areas. However, of late, incentives are offered, may be at graded scales, to any new industry in any area. The basic philosophy of the incentive schemes, never mind, even if the State does not get revenue from Sales Tax, is to let taxpayer do the development of undeveloped area of the State and get rewarded out of more realisation as tax incentives are available.

The first preliminary discussion of State level VAT took place in the meeting of Chief Ministers convened in 1995. Since any fiscal exemption from tax or subsidy is against the principles of VAT, Incentive Schemes were considered as major hindrance in the way of introduction of Value Added Tax (VAT). In the latter meeting of Chief Ministers convened by the then Finance Minister on 16.11.1999, an important decision to discontinue Sales Tax related industrial incentives with effect from January 1, 2000 was taken and it was agreed by all the States that no new incentives will be sanctioned after 01.01.2000. However, pending applications for incentives will be considered and the incentives shall be granted.

The White Paper on "State level Value Added Tax" released on 17.01.2005 recorded on this issue as under:

"2.15 Incentives: Under the VAT system, the existing incentive schemes may be continued in the manner deemed appropriate by the States after ensuring that VAT chain is not affected".

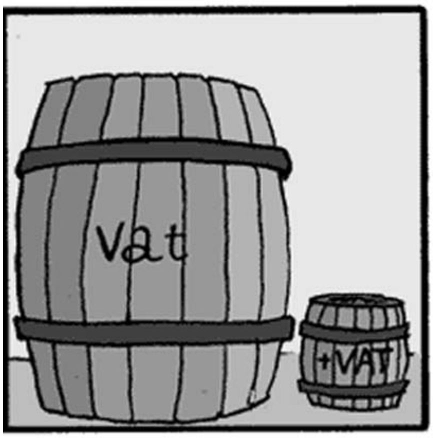
Thus, at national level, no common policy has been adopted in response to treatment of Incentive Schemes. This was due to reason that different States have offered different types of incentives

The author is the Past President of the Institute. He can be reached at achandak_ngp@sancharnet.in

depending upon the requirements and local needs of the State and the relevant tax system in the State. The Empowered Committee, while allowing States to decided their own policy for treatment of incentives, has prescribed the following pre-conditions:

1. The quantum as well as the time period allowed for availing incentives should not be increased or extended.
2. VAT chain is not affected.

A total of 21states have so far adopted VAT regime in India. All States have decided the issue as per the requirement of the State. In this article an attempt is made to discuss some difficulties and modalities adopted by various States in this regard.



Today's Scenario

By and large the incentives are given in two modes as under:

Exemption from Tax: Under this Mode incentives are given by way of exemption from tax. The eligible industry is not required to pay any Sales Tax on purchases of raw material as well as on sales of finished product. The advantage of this mode is that unit is not required to pay any tax thus its realisation improves and is in a position to stand in competition. In most of the States, an exempted unit is given exemption from the payment of tax by fixing its quantum of entitlement depending upon FCI (Fixed Capital Investment) and other relevant factors. The amount of entitlement is to be availed within a specified period. The exemption so allowed ceases either with the expiry of exemption period or the exemption amount whichever occurs first. Under the present position all inputs are allowed to be purchased without payment of tax, in some cases against a particular declaration. These inputs are expected to be used by the eligible unit for manufacture of finished product at exempted unit. The exemption is also allowed on sales made within the State or in the course of inter-State trade or commerce. The sales made within the State of manufactured goods by such unit are treated as tax exempted goods at the first stage of sales and resale of the same by subsequent dealer does not attract tax. When the goods purchased from an exempted unit are further used in the manufacture, the second manufacturer in the State where last point tax is applicable, gets a deduction of turnover of goods purchased from exempted unit and where it is first point tax on these goods, no tax is attracted.

In a State like Maharashtra any manufacturer is entitled for credit (full/partial) of input tax on raw material, etc. However, if the goods are purchased from exempted unit, no Input Tax Credit is available. The quantum of exemption availed is calculated at prevalent rates on the taxable turnover of sales as well as purchases. The unit is compared with any other non-exempted unit and tax saved by the exempted unit as compared with non-exempted unit, is considered as quantum of exemption availed.

Deferment of tax liability: Under this mode, eligible industry is at par with any normal unit. It collects the tax on sales of finished goods so also pays the tax to its vendors on purchases of raw materials, etc. However, it is not required to pay collected tax to the Government immediately. The tax liability is assessed applying normal provisions. However, payment of tax to the Government is deferred for particular period. After that period the liability is required to be paid in prescribed instalments. In some States, raw material is allowed to be purchased free of tax and liability to pay tax which unit would have paid to its vendor, is called upon the eligible unit. This liability is also paid alongwith tax collected on sale in the prescribed method. Advantages of the mode when compared to exemption, includes more cash realisation without attracting Income Tax on additional cash and shorter payment of excise duty. Some States have also allowed prepayment of the deferred tax liability on some basis.

Considerations For Schemes Under VAT Laws

The States implementing VAT have taken uniform decision to continue incentives under VAT. However, some States have decided to continue exemption/ deferment as per present position. Some have decided to change exemption mode for availing incentives to deferment mode only.

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

(i) The VAT chain should not be disturbed.
(ii) Should there be two methods for VAT chain?
(iii) There should not be more rev-

enue loss to the States.

(iv) The Department should be able to track the transactions and should ensure that there is no evasion/avoidance of tax due to the policy.

(v) In addition, wherever exemption/deferment as per old provision is continued additional issues considered are as under:

(a) The units enjoying exemption under old law should not be put to a disadvantageous position under the VAT system.

(b) The units who are purchasing inputs without payment of any tax should be allowed to enjoy the benefit under the new system also.

Having decided to continue industrial incentives, question for consideration is how to continue VAT chain and whether more than one system be followed for calculation of tax? All States have adopted 'Invoice Method' for calculation of VAT. Deferment mode though compatible with Invoice Method, has some difficulties. Exemption mode is definitely not compatible with invoice method.

Exemption Mode, VAT Chain and Method for VAT

If exemption has to be continued then for continuation of VAT chain, subtraction method will have to be adopted for calculation of VAT. This leads to continuation of two methods for calculation of VAT. It is argued that VAT being tax on Value Addition the incidence of tax on final sale price to consumer will remain the same under both the methods. This argument holds good till the time same rate of tax is attracted on all inputs including consumables. However, if rates on input are not common, then final tax by two methods will differ. To illustrate: Inputs are as under:

(Amount in Rs.)

Input	Material Value	Tax Rate	Tax Amount	Total Purchase Value
A	1,000.00	4%	40.00	1,040.00
B	3,000.00	10%	300.00	3,300.00
C (Purchased from exempted dealer)	1,500.00	Tax free	NIL	1,500.00
	5,500.00		340.00	5,840.00

Output Cost to Consumer: 11,000.00 including VAT (Rate of tax assumed @10%). Thus, VAT will be 1000.00. Under invoice method VAT can be shown separately however, in subtraction method it cannot be shown separately. VAT liability under both methods will be as under:

(Amount in Rs.)

Invoice Method		Substraction Method	
VAT on sales Less: Input tax credit	1,000.00 340.00	Sale Price (consumer price) Less: Purchase Value of Input	11,000.00 5,840.00
Net Liability	660.00	Value Addition	5,160.00
		Tax rate by 10% VAT $\frac{5160 \times 10}{100+10}$	469.00
Government Revenue Output Tax Rs.660/- + Input Tax Rs.340/- = Total Rs.1,000/-		Government Revenue Output Tax Rs.469/- + Input Tax Rs.340/- = Total Rs.809/-	

Thus, while consumer pays same price, Government is at loss under substraction method and trade is beneficiary. Therefore, adopting two methods for calculation of VAT is not correct.

In addition, two methods will also have certain practical difficulties for reseller. They will have to keep separate accounts for goods purchased from exempted and non-exempted person and its disposal. This is practically impossible. If a purchaser is dealing only in exempted goods or purchasing particular commodity only from exempted unit, it may be possible to maintain separate accounts. Otherwise, it will be difficult to maintain such accounts. Theoretically, one may be in a position to say there is no difficulty in maintaining such accounts or if such accounts are not maintained pro-rata method should be followed. But in practice, this is possible only if very highly sophisticated software and accounting system is employed, which will have a huge cost implication and possibly reseller i.e. traders may not be in a position to maintain such accounts. Take for example a Grocery Shop, which deals in thousands of commodities deals in biscuits. The turnover of biscuits may not justify maintenance of separate account. The biscuits do not reach to the grocer directly. In normal trade chain it changes 2 to 3 hands from manufacturer to grocer viz. Manufacturer, Distributor (who may be handling biscuit manufactured by various manufacturer), City Wholesaler (who may be dealing not only in biscuits but also in number of other products and may be selling along with biscuits a number of other products), Area Wholesaler (who may be selling a number of other products to the grocer). The Distributor may purchase the biscuits from more than one sources viz. (1) purchases from outside the State (2) purchases within the State from non-exempted manufacturers (3) purchases from exempted manufacturer. Here again some difficulties are likely to be faced. Following illustration will make the position clear.

Distributor in the month of May, have purchased the goods as under:

Source of Purchases	Quantity	Price Per unit (Rs.)	Value (Rs.)	Tax (Rs.)	Total purchase value
Out of State	500	10	5,000	200(C.S.T.)	5,200
Within State From Non-exempted unit	700	12	8,400	840 (VAT)	9,240
From exempted unit	600	13	7,800	—	7,800
Total	1800		21,200	1,040	22,240

In the month of May, out of above purchases he had sold say 1500 units under 10 invoices. Now the C&F Agent is in a fix as to how to charge tax to customer, say to customer 'A' to whom 180 units @20/- per unit + VAT are sold. It is difficult to identify the product with reference to source. Thus one way is to charge tax on pro-rata basis. Question arises as to which pro-rata whether based on value or quantity? Secondly, at the time of sale one may not be knowing as to how much quantity will be purchased during the month from various sources. There may be opening stock also. Thus, it will be difficult for him to collect the taxes. Even if he is very efficient and decides to charge tax on the basis of moving average, his sales invoice may be as under:

(Amount in Rs.)

	Units	Rate	Value	Tax	Total
Sale out of import/out of State	50 units	20	1,000/-	100	1,100/-
Sale out of non-exempted	70 units	20	1,400/-	140	1,540/-
Sale out of exempted pro-rata	60 units	20	1,200/-	42 *	1,242/-
Total	180 units	20	3,600/-	282	3,882/-

*60 Units sales price 1200 <u>less</u> purchase price Rs.780/- = Value Addition 420/- VAT rate 10% = VAT Rs.42/-. If the invoice is made in the manner, purchaser will come to know that on 60 units value addition at the hands of Distributor is Rs.420/-.

Success of continuation of exemption module is dependent upon the system of trading from the stage of manufacture to the stage of consumption by applying subtraction method, which is practically impossible. Theoretically, it can be said that this chain can be tracked by incorporating further certificate on the invoices. However, it is practically very difficult. Take above invoice only. Question is how the Distributor should give certificate on the invoice. Thus, there is always a danger of State Government loosing VAT or trader paying more tax.

The other issue in this scheme is that as explained above the purchaser will know the margin of seller because under the subtraction method the tax can be charged only on value addition. In a practical situation no seller would like to tell the purchaser his profit margin/value addition. A manufacturer purchasing inputs from eligible unit is not entitled to set-off of tax on such purchases since the sale is exempted. Thus, the manufacturer within the State would not like to purchase from exempted unit or the exempted unit would not be in a position to realise more price than the normal unit.

(Amount in Rs.)

	Inputs purchased	
Particulars	**From Normal Unit**	**From Exempted Unit**
Input purchased	10,000/-	10,000/-
VAT	1,000/-	NIL
	11,000/-	10,000/-
Less: Input Tax Credit	1,000/-	—
Net Cost	10,000/-	10,000/-

Thus, there is no added advantage to exempted unit.

Deferment–VAT chain– Method for VAT

The Unit is treated at par with any normal unit and is subject to all provisions of tax laws applicable to the normal unit. Thus, while purchaser is entitled for Input Tax Credit the unit is not required to pay tax for particular period and thereafter also in prescribed instalments. This leads to grant of Input Tax Credit of tax, which is not received in Government Treasury.

One may be in a position to plan a transaction in such a way that it gains from the State. Take for an example 'A' unit is under deferral scheme. It is purchasing inputs within the State and selling the manufactured product in the course of inter-State trade or commerce. If such unit sells the goods on Form 'C' it pays only 4% CST. Exports are otherwise exempt. ITC Credit will be available on inputs. Such unit under VAT may be in a position to introduce one more agency before the goods are actually sold in the course of inter-State trade or commerce or exported and then the other agency would be in a position to gain substantial cash. The issue is explained below:

'A' is a unit under deferment. It purchased inputs say of Rs.1,000/- on payment of VAT tax say @10% i.e. Rs.100/-. Inputs are converted into finished product which are sold at Rs.2,000/- plus VAT/CST.

Presently 'A' is making a direct sale in the course of inter-State trade or commerce and therefore collect 4% tax on sale value of Rs.2,000/- i.e. Rs.80/- and pays the same. Thus, State gets Rs.80/- as tax. Under VAT 'A' had already paid Input Tax of Rs.100/-. Since C.S.T. liability of Rs.80/- is depressed 'A' will claim refund of Rs.100/- on account of input tax and Rs.80/- will be debited to his limit. There is no loss to Government as Government has refunded the tax, which is collected and will get Rs.80/- in prescribed manner.

Under VAT 'A' may introduces an agency 'B' and sells the finished goods within State to 'B' to Rs.1,900/- on which tax is collected @10% i.e. Rs.190/- payment of deferred and 'A' will claim refund of input tax Rs.100/-. There is no loss to Government till this stage.

Now 'B' would sell the goods in the course of inter-State trade at Rs.2,000/- + 4% CST i.e. Rs.80/-. Thus the purchaser in other State will get the goods at the same value. However, 'B' would be entitled for an ITC of Rs.190/- as 'A' has charged the same to 'B'. 'B' would be able to adjust his tax liability of Rs.80/- from the ITC of Rs.190/- and will lodge a claim for refund of Rs.110/-. Thus, the State will have to grant the refund of Rs.110/- to 'B'. 'A's limit will be debited by Rs.190/-.This refund would be a cash flow issue for Government. No doubt, as against this refund of Rs.110/-, the Government will get Rs.190/- after deferred period or much lesser amount on net present value (in Maharashtra only Rs.51/- on NPV basis).

There is an apprehension that with the introduction of VAT this kind of planning would be rampant and the State will have to give a large refund.

Haryana Model

The State of Haryana adopted VAT w.e.f. 01.04.2003. Haryana has followed a model for treatment of exemption unit, which is highlighted as under:

- All exempted units were converted into deferred units compulsorily.
- The amount of deferred tax could be either paid after five years or 50% of the deferred tax was allowed to be paid upfront alongwith the returns. This ensured NPV of 50% of the deferred tax for the Department.
- There is no provision for refund of tax paid on inputs by the exempted/deferred units under H-VAT Act. Thus, ITC is required to be reduced from amount of tax to be deferred.
- This system was challenged before the High Court of Punjab & Haryana High Court upheld the validity of such amendment by its judgment dated 26.05.2003 and decided the issue in favour of the Department of Excise & Taxation, Government of Haryana (136 STC 359)

This model for treatment of exemption units is also followed by some Southern States.

Maharashtra Model

Maharashtra has decided to continue the present scheme for grant of Sales Tax Incentives under exemption mode or deferment mode. Sections 88 to 94 (chapter XIV) of the Maharashtra Act and Rules 55(f), 57(2) and Rules 77 to 84 deal with this subject. Union Territory of Daman and Dieu also follows Maharashtra model.

Exemption Units: The salient features of Maharashtra model for treatment of exemption units are as under:

- The exemption shall be restricted till monetary ceiling granted to the unit is exhausted or till the last date of period up to which the deferment has been granted (whichever is earlier).
- The units will have to pay VAT for the purchase of inputs.
- At the time of filing of return, claim for refund of tax on input has to be filed with the Department by the dealer.
- Application for refund shall be filed by the dealer within 30 days of the filing of return.
- The Assessing Officer has to grant the refund within three months from the end of return period.
- The units will not be allowed any ITC/set-off on raw materials, etc.
- This model introduces the subtraction method for calculation of tax liability of the subsequent reseller who has purchased goods from an exempted unit.
- Manufacturer purchasing goods from exempted unit will not be entitled for any ITC/Set-off or benefit of substraction method.

Units Entitled for Deferment: Maharashtra VAT Act permits to the eligible units continue availment of incentives under deferment mode. Salient features are as under:

- The deferment shall be restricted till monetary ceiling granted to the unit is exhausted or till the last date of period up to which the deferment has been granted (whichever is earlier).
- The units will have to pay VAT for the purchase of inputs.
- At the time of filing of return, claim for refund of tax on

input has to be filed with the Department by the dealer.

- Application for refund shall be filed by the dealer within 30 days of the filing of return.
- The Assessing Officer has to grant the refund within three month from end of return period.
- The units will not be allowed any ITC/set-off on raw materials, etc.
- Tax liability will be calculated under invoice method. Therefore, subsequent reseller who has purchased goods from such unit will get ITC/Set-off.

viii. Manufacturer purchasing goods from exempted unit will also be entitled for ITC/Set-off.

Punjab Model

The Punjab model for treatment of exempted and deferred unit is under separate notification. The salient features of this model are as under:

Exempted Units:

- Under PGST Act, the inputs purchased by exempted and deferred units were not subjected to taxation. These were purchased against RD/declarations. To continue with this concession, the input tax, which has been paid by the exempted unit is refunded back. Thus, the tax, which has been collected by the Department in the complete chain upto the exempted unit, would be refunded making inputs tax-free.
- Since, refund is to be granted to the exempted units in respect of tax paid on inputs, such units would not be entitled to any ITC against it.
- For the purpose of calculating tax for deduction from the entitlement limit the normal tax rate applicable to the commodity would apply.
- For the calculation of notional output tax (i.e. exemption availed), the normal rate applicable to the commodity would apply.
- The exempted unit would issue an invoice stating thereon that ITC would be available @ 4% against this invoice even if the VAT rate is higher than 4%.
- Subsequent person (dealer) will be entitled for the notional inputs tax credit at the rate of 4% only.
- In case subsequent person sells these goods to a person other than a VAT dealer (taxable person) within the State (i.e. to a TOT dealer or a consumer), he would be allowed to deduct from his taxable turnover, the purchase value of goods purchased from the exempted unit and thus pay tax on value addition only. Notional ITC of 4% shall not be available in such transaction. In all other cases, subsequent person, while calculating out tax, will claim ITC @ 4% and deposit the balance amount with the Government treasury.
- In case of intra-State sales by a taxable person, notional tax of 4% would be available only on goods, which are purchased directly from an exempted unit. In case of inter-State sales, the notional ITC would be capped to the extent of liability under the CST Act. In case of sales to a registered person or to a consumer, notional ITC would not be available.
- In case the goods manufactured are tax free, notional tax credit shall not be allowed.
- A taxable person purchasing goods directly from an exempt unit would not be entitled for any refund attributable to notional credit of 4%.
- However, subsequent taxable person in a chain would be entitled for full credit of ITC irrespective of the nature of transaction, subject to the restrictions prescribed in the VAT Act.

Deferment Units: No change is made in the Scheme.

Remission Model:

This is an alternative mechanism to replace the exemption and bring all transactions in the VAT Chain. Before the Sales Tax Incentives Scheme, the incentives were given in the Form of grant and not as exemption of tax/deferment of tax. Thus the dealers were require to charge the tax, pay the same to Government and wait for a considerable period to get a refund. The exemption mode of incentive was introduced to overcome this difficulty only. The difficulty can also be solved under the remission model. The sailent features of the model are as under:

- An eligible manufacturer (the dealer) is allowed to collect the tax at an appropriate rate but is not require to pay the same.
- The dealer is required to file periodical return and show the tax liability.
- After filing the return the department remits the tax liability in full. Thus the tax liability as per return is deemed to have been paid.
- The VAT invoices showing VAT separately are issued by the dealer. Therefore VAT chain is continued.
- The input tax paid on purchased by the dealer is being given as refund immediately after filing the return.

This model appears to be much better option under VAT Regim for exemption units, as it fulfills the objective of grant of incentives, the industry is not require to wait for a long period for getting the incentives and the VAT chain is being maintained.

Conclusion

Basic philosophy of VAT is that there cannot be only incentives under fiscal laws. There are certain practical difficulties in implementation both to the Government and to industrial units/dealers, which may be solved only in time to come. ■