Taxation of Inter-state transactions: Issues and Options

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Present system

- State VATs, and an assortment of stand alone taxes on services assigned to the states,
  - result is considerable degree of tax exportation among states, both directly through central sales tax and indirectly through unrebated input taxes for goods traded across state borders.
  - fragments the economy into smaller markets, with associated costs of moving across these markets.
  - Competitiveness of the domestic enterprises in exports as well as in the domestic market undermined

Objective of GST

- Establish a rational tax system and integrate the states of India into a common market.
- dual VAT, incorporating subnational taxes
  - Needs to define a mechanism for dealing with inter-state transactions in
    - goods : sales from one state to another
    - Services: services spanning more than one state

Desirable features of a system

- Preserve and protect provisions for claiming input tax credit
- Minimise costs of compliance and costs of administration
  - High compliance costs would discourage inter-state transactions
    - Differences between taxes on local sales and inter-state sales
    - Reporting requirements to more than one tax administration
- Preferably generates minimal inter-dependence between jurisdictions in revenue flows
- A system that does not rely on checkposts is considered more desirable

Alternative models: zero-rating

- Normally used for exports – imports face a CVD
- No tax on outputs and full refund of input taxes for the exporting dealer
  - Importing dealer pays tax on imports when those goods are sold
- System has to rely on transaction wise or a dealer wise information system
- Potential difficulties
  - Large difference between tax on local sales and inter-state sales – arbitrage opportunities – carousel trade EU
  - A dealer might prefer to import a goods rather than buy it locally
  - Breaks the chain of invoices

Alternative models: With central VAT

- Zero-rating with a central VAT maintains a chain of invoices
  - Dealer might still prefer to purchase inter-state
  - Differences between rates of tax on local and inter-state transactions persists
- CVAT: exporter collects tax on all sales at the same rate, remits taxes on inter-state sales to central government
  - Tax credit offered by central government to importer
  - Exporting state continues to zero-rate
  - No differences in tax rates but compliance costs of two regimes persists

Alternative models:Clearing House

- Exporter collects the same tax on all transactions – remits on local sales to the state government and taxes on inter-state sales to a clearing house
  - Importer claims credit through the clearing house
  - If all taxes go through the state governments – inter-dependence on revenue
  - If separately credited as in a CVAT – some compliance costs
  - Doesn't explicitly rely on a central VAT
  - In the absence of checkposts – importer might prefer to buy as local sales in exporting state and evade taxes in the importing state

Alternative models: pairwise

- Exporter collects tax all transactions
  - Remits tax to relevant state governments through banking channels
  - High compliance costs: need to remit taxes to multiple state authorities
  - If tax rates are different – arbitrage possibilities
  - Administration – exporter outside purview of audit for importing states
- All these systems require transaction wise or dealer wise information
  - Single coordinated system for timely cross verification
- Important to define –
  - Liability of proof/tax if there is a mismatch
  - what happens to revenue let unclaimed

Pre-payment system

- Also called reverse charge
- Zero-rating by the exporting state – pre-payment of taxes in importing state
  - on receipt of goods or in first return thereafter
  - Mimics the treatment of inter country imports more closely
  - Distinction between local purchases and imports reduced for importer
  - Compliance cost for exporter remains as in pure zero-rating
  - Arbitrage possibility reduced
  - Depends on transaction wise information
  - No explicit revenue flows across jurisdictions

Table : Reform of Inter-state transactions: Comparison of Alternatives				
	Pure Zero rating	**Pre-payment system**	**Pair wise clearing**	**Clearing House**
Comparison with local sales	High benefits from evasion	High benefits from evasion	No benefits	No benefits
Comparison with local purchases	Inter-state purchase cheaper	No difference	No difference	No difference
Dependence on other states for revenue	None	None	On all inter-state transactions	On all inter-state transactions
Dependence on transaction wise information	Complete	Complete	Complete	Alternative redistribution mechanism may be devised
Compliance costs	Exporter: Consolidated filing of information Importer: neutral	Exporter: Consolidated filing of information Importers: higher costs if pre-payment is to be made consignment wise; neutral if payment with return	Compliance cost intensive – separate tax remit for each importing state as well as to exporting state Importer: neutral	Separate filing of return for local and inter-state sales – associated tax admin Importer: Neutral

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Possible Mechanism for fraud	Exporter can set up a fake dealer in the importing state and record the receipt of transactions. The importer can then disappear. If the department is not vigilant, then this can be a source of major revenue loss. If the department is vigilant, these transactions cannot be sustained over long periods.	Provisions have to allow for the importer to reallocate the pre-paid tax, in the event of the goods being lost/ damaged in transit or the value of the goods being lower than when the tax was paid. If this provision is made, there are issues of valuation and verification of the receipt of goods to authenticate the transactions, without which there can emerge the scope for tax evasion.	Exporting state and exporting dealer have no incentive to document inter-state sales. Exporting dealer can record the transaction as a local sale to an unregistered person, when a transaction involves inter-state sales. This reduces the transaction costs for the seller and buyer can pass of these goods without paying tax in the importing state. The exporting state can afford to ignore such transactions since there is a revenue gain from ignoring them. In other words, this system may require a strong set of check posts too, to monitor inflow of goods.	Same as in the pair-wise clearing case.
Administrative costs	Reflected in the forms of potential fraud and in the information intensity of the regime.			

Some final issues

- Choice of system would depend on the extent of revenue risk the states would like to bear
  - Risk averse decisions would limit any overlap between the tax payers in one state and the tax administration in the other
    - Prepayment emerges ahead of the others on this count
- If reducing compliance cost is the primary goal
  - Clearing house or CVAT would be a viable option
- In sale of goods, special provisions kick in for B to B sales alone. Same principle for services can create some difficulties
  - Service provider in one state providing services to final consumers in multiple states
  - If services span more than one state –telecom, transport
  - Need to reconsider place of supply rules
- Related question – how to define a taxable entity in the case of services – each branch of a bank is a separate entity? Each billing office of a courier company?