



## STUDY NOTE -12

### STATE LEVEL VAT

#### This Study Note includes

- Background of State VAT
- Basic Principle of VAT
- Disadvantages and Pitfalls in VAT
- Overview of State VAT
- Procedural Provisions relating to VAT
- Impact of VAT on CST

### 12.1 BACKGROUND OF STATE VAT

Tax on sale within the State is a State subject. Over the period, many distortions had come in taxation. Following were some of the problems -

- Unhealthy competition among States by giving sales tax incentives to new industries. When one State gave incentives, others also had to give. This ruined State finances.
- 'Tax rate war' started to attract more revenue to State. Often, goods from the State were sent to another State on stock transfer basis and brought back in the same State to show as Inter-State Sale.
- States introduced 'first point sale' to avoid cascading effect of State sales tax. This made tax evasion easy.
- Cascading effect of tax due to Central Sales Tax.

**Discussions with State Governments** - Central Government initiated discussions with State Governments in 1995. After lot of persuasion 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.

**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.

### 12.1.1 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.

**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.*

### 12.1.2 State Vat is diluted version of VAT

The Vat as introduced, is a diluted version of Vat and some compromises have been made. There is no credit of Central Sales Tax paid on inter-state purchases. This problem will not arise if CST rate is reduced to 0% on 1-4-2010, as planned and inter-state sale is made 'zero rated'.

If goods are sent outside State on stock transfer basis, credit (set off) of tax paid on inputs is available only to the extent of tax paid in excess of 4%. Thus, credit (set off) to the extent of 4% tax on inputs is lost. It is not clear what will be position when CST rate is brought down to Nil. Thus, the VAT as introduced is State Vat and not a national Vat.

### 12.1.3 World scenario in respect of Development of 'VAT'

Concept of VAT was developed to avoid cascading effect of taxes. VAT was found to be a very good and transparent tax collection system, which reduces tax evasion, ensures better tax compliance and increases tax revenue.

***First introduced in France*** - Concept of VAT was first conceived by Mr. Maurice Laure, Joint Director of French Tax Authority. Vat (termed as TVA in France) was introduced for the first time in France on 10-4-1954.

***Vat in Europe*** - Vat system got real impetus when European Union (EU) made adopting VAT regime as condition precedent to joining European Common Market. Members of EU (that



time it was European Common Market) were required to introduce common system of Vat *vide* Sixth Council Directive No. 77/388/EEC dated 17-5-1977. This is most important document so far as Vat in Europe is concerned.

Vat is imposed in Europe on both goods and services. Vat rate varies in various member countries of European Union. Minimum is 15% and maximum is 25%. General Vat rate in UK is 17.5%, but there is lower rate of 5% in case of some goods and some goods are exempt.

General Vat rate in some other countries is as follows – Sweden – 25%, Germany – 19%, France – 19.6%.

If goods or services are exported to another EU member country or other country, Vat is not imposed. Vat paid on inputs is granted as refund.

European Union was formed on 1-11-1993. Many countries joined EU later. As in July 2007, 27 countries are part of EU.

**Development in other countries** - Many countries in Asia, Central America and other parts of Europe have introduced Vat. So far, about 135 countries have introduced Vat.

**Vat in China** - China introduced Vat on 24 items in 1984. Later, regulations for VAT Tax were made effective on 1-1-1994 and Vat was extended to all goods and services. The general Vat rate is 17%. Vat rate is reduced to 13% in some cases. There is no Vat on exports.

**Consumption tax in Japan** – Japan has system of consumption tax, which is levied @ 5%.

**No Vat in USA** - USA has not introduced Vat. In USA, tax is levied by State Governments on retail sale. The rate varies between 0% to 8.8%. There is no tax on services in USA.

**Development in India** - In India, Vat was introduced at manufacturing stage under Central Excise in 1986, termed as Modvat (modified value added tax). Modvat was re-named as Cenvat w.e.f. 1-4-2000. System of Vat was introduced in service tax w.e.f. 16-8-2002. Credit of excise duty and service tax was made inter-changeable w.e.f. 10-9-2004. Thus, partial integration of goods and service tax has been achieved. Presently, full integration is not possible since power to levy sales tax is with State Government.

## **12.2 BASIC PRINCIPLE OF VAT**

VAT (Value Added Tax) is a tax on final consumption of goods and services.

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. 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.

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. It is tax on consumption of goods and services. VAT works on the principle of ‘tax credit system’.

**Distinction between sales tax and Vat** - Basic distinction between Vat and sales tax is that sales tax is payable on total value of goods while Vat is payable only on ‘value addition’ at each stage.

### 12.2.1 Cascading effect of tax

Generally, any tax is related to selling price of product. In modern production technology, raw material passes through various stages and processes till it reaches the ultimate stage e.g., steel ingots are made in a steel mill. These are rolled into plates by a re-rolling unit, while third manufacturer makes furniture from these plates. Thus, output of the first manufacturer becomes input for second manufacturer, who carries out further processing and supply it to third manufacturer. This process continues till a final product emerges.

This product then goes to distributor / wholesaler, who sells it to retailer and then it reaches the ultimate consumer. If a tax is based on selling price of a product, the tax burden goes on increasing as raw material and final product passes from one stage to other, as illustrated below, where A sales to B and B sales to C.

| Details            | A   | B   | C   |
|--------------------|-----|-----|-----|
| <b>Purchases</b>   | -   | 110 | 165 |
| <b>Value Added</b> | 100 | 40  | 35  |
| <b>Sub – Total</b> | 100 | 150 | 200 |
| <b>Add Tax 10%</b> | 10  | 15  | 20  |
| <b>Total</b>       | 110 | 165 | 220 |

You will find that B is paying tax not only on his contribution of Rs 40 but also on Rs 100 and Rs 10. Thus, same material gets taxed again and again and there is also tax on tax. As stages of production and / or sales continue, each subsequent purchaser has to pay tax again and again on the material which has already suffered tax. Tax is also paid on tax. This is called *cascading effect*.

### 12.2.2 Disadvantages of cascading effect of taxes

A tax purely based on selling price of a product has cascading effect, which has the following disadvantages :

- Real tax content in the price of a product cannot be known, as a product passes through various stages and tax is levied at each stage.



- Tax burden on any commodity will vary widely depending on the number of stages through which it passes in the chain from first producer to the ultimate consumer.
- Ancillarisation is discouraged and manufacturer tries to manufacture all parts and do all processes in his plant itself. This increases manufacturing costs.
- End use based exemptions and concessions (e.g. exports or goods consumed by poor) cannot be given since it is not known what were taxes paid in earlier states.
- Exports cannot be made fully tax free.

### 12.2.3 VAT avoids cascading effect of tax

System of VAT works on tax credit method. In Tax Credit Method of VAT, the tax is levied on full sale price, but credit is given of tax paid on purchases. Thus, effectively, tax is levied only on 'Value Added'. Most of the countries have adopted 'tax credit' method for implementation of VAT.

The aforesaid illustration will work out as follows under VAT system.

'B' will purchase goods from 'A' @ Rs. 110, which is inclusive of duty of Rs. 10. Since 'B' is going to get credit of duty of Rs. 10, he will not consider this amount for his costing. He will charge conversion charges of Rs. 40.00 and sell his goods at Rs. 140. Following example will illustrate the tax credit method of VAT.

|             | Transaction without VAT |     | Transaction With VAT |     |
|-------------|-------------------------|-----|----------------------|-----|
| Details     | A                       | B   | A                    | B   |
| Purchases   | -                       | 110 | -                    | 100 |
| Value Added | 100                     | 40  | 100                  | 40  |
| Sub – Total | 100                     | 150 | 100                  | 140 |
| Add Tax 10% | 10                      | 15  | 10                   | 14  |
| Total       | 110                     | 165 | 110                  | 154 |

**Note** - 'B' is purchasing goods from 'A'. In second case, his purchase price is Rs 100/- as he is entitled to VAT credit of Rs 10/- i.e. tax paid on purchases. His invoice shows tax paid as Rs 14. However, since he has got credit of Rs 10/-, effectively is paying only Rs 4/- as tax, which is 10% of Rs 40/-, i.e. 10% of 'value added' by him.

**Meaning of 'Value added'** - *In the above illustration, the 'value' of inputs is Rs 110, while 'value' of output is Rs 150. Thus, the manufacturer has made 'value addition' of Rs 40 to the product. Simply put,*

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'value added' is the difference between selling price and the purchase price.

#### **12.2.4 Revenue Neutral Rate**

Government was earlier getting tax revenue of Rs 25. In above example, Government gets revenue of only Rs 14. To avoid loss of revenue, rate of tax will have to be suitably increased such that Government gets same revenue as per previous system. This is termed as 'RNR' (Revenue Neutral Rate'). In aforesaid example, RNR will be high i.e. 17.86%.

Practically, since most State Governments had single point sales tax at first level, RNR is not high. In fact, RNR is lower than the earlier sales tax rate since under Vat, tax is realised on final selling price and not the price at the first level.

For example, if earlier sales tax rate was 15% on wholesale price of Rs 100; under VAT system, tax will be collected at consumption stage i.e. on retail price of (say) Rs 140.

***It has been decided to levy sales tax at RNR of 12.5% for most of commodities.***

***What is meant by consumption Types of 'VAT'?*** - 'Consumption based tax' means tax is actually levied only when goods are finally consumed / utilised. Till then, the tax burden is passed on to next buyer.

#### **12.2.5 Advantages of VAT over conventional system of taxation**

**Advantages of VAT are as follows :**

- Tax burden is only at the last i.e. consumption stage. This is useful for taxation structure based on 'destination principle'.
- It becomes easier to give tax concessions to goods used by common man or goods used for manufacture of capital goods or exported goods.
- Exports can be freed from domestic trade taxes.
- It provides an instrument of taxing consumption of goods and services.
- Interference in market forces is minimum.
- Simplicity and transparency.
- Aids tax enforcement by providing audit trail through different stages of production and trade.
- Thus, it acts as a self-policing mechanism resulting in lower tax evasion.
- Tax rates can be lower as tax is levied on retail price and not on wholesale price.



## 12.3 DISADVANTAGES AND PITFALLS IN VAT

One major disadvantage of Vat is tremendous paper work and record keeping. Vat system can work only if record keeping is proper and reliable. The elaborate record keeping is not possible to small businesses. Hence, exemption is granted to tiny businesses whose turnover is below prescribed limits. In case of small businesses, a composition scheme is provided where tax is paid on gross value of sales at a fixed rate.

Some major problems in Vat are –

- Bogus Invoices on which tax credit is availed, i.e. invoice without actual purchase of goods.
- Acquisition fraud (missing trader fraud).
- Carousel Fraud (missing trader fraud).

**Acquisition fraud** - The acquisition fraud is based on the fact that goods imported are tax free. A dealer imports goods and makes sale within the country. The dealer either has his own Vat registration number or he hijacks other's Vat number. He collects the tax from buyer and then disappears without paying the collected tax to Government. The buyer is usually innocent and is not aware that the seller is not going to pay tax to Government. This is 'missing trader fraud' of one type.

In Indian context, this fraud is possible when CST rate is Nil or is reduced to 1%. A dealer can purchase goods inter-state and make sale within the State. He will collect tax and then disappear. He may use someone else's vat number in his invoices or may himself get registered with address of some temporary rented premises.

### 12.3.1 'Carousel fraud' in VAT

'Carousel' means 'merry-go-around' or 'roundabout' (Concise Oxford Dictionary). This is 'missing trader fraud' of another type. It is much more involved and difficult to trace. The fraud works as follows –

One dealer 'A' imports goods without tax. He sells goods to 'B' and charges Vat. 'B' avails credit of tax shown by 'A' in his Invoice. 'B' sells the goods to 'C' and charges Vat. Actually, 'B' has to pay only differential amount as tax. 'C' avails credit of tax shown by 'B' in his Invoice. 'C' sells goods to 'D' by charging Vat. Since 'C' has availed credit of Vat paid by 'B', he has to pay only differential amount, which is small. 'D' exports the goods and claims refund of input tax i.e. entire tax shown by 'C' in his Invoice.

This is a legitimate transaction. The missing link is that 'A' actually does not deposit tax to Government. 'A' either has his own Vat registration number or he hijacks other's Vat number. He collects tax and then disappears. Thus, 'D' gets refund of tax which is actually not paid by 'A'. By the time Government traces the transaction to 'A', he i.e. 'A' has disappeared.

The same goods are used again and again for 'imports' and 'exports'. That is why the fraud is termed as 'carousel' fraud. The high value goods like microchips and mobile phones are generally used for such deals.

UK is said to be main victim of such fraud. It is reported that UK has lost 12.6 billion Euro in such frauds. It is said that fraudsters prefer UK since it has weak and time consuming legal system!

In UK, reverse charge has been introduced in 2006 on tax payable on wholesale sales of mobile phones and microchips to combat the fraud. In 'reverse charge', buyer himself is liable to pay Vat on goods purchased.

**Can the fraud work in Indian context?** – In Indian context, the fraud can work in inter-state purchases and sales in the same way in which it works in European countries in imports / exports. The person finally selling the goods outside the State can either claim refund of tax paid on his purchases or can adjust the credit for paying taxes on sales made within the States.

In fact, it is possible that actually, goods may not move. Only documents may move from one State to another!.

**What happens if 'D' is innocent and had entered into genuine transaction?** - If 'D' is innocent, he cannot be penalised for default of 'A'. One such case has been decided by Court of Justice of European Communities, which is the highest Court of European Union. In *Optigen Ltd v. Commissioners of Customs and Excise* 2006 EUECJ C-354/03 (decided on 12-1-2006), it has been held that Government cannot refuse refund in such cases.

In India also, Tribunal has held that a buyer cannot be penalised for default of the seller.

In *Prachi Poly Products v. CCE* 2005 (186) ELT 100 (CESTAT SMB), it was held that a genuine buyer is eligible for Cenvat credit, even if the seller-manufacturer did not pay duty.

In *R S Industries v. CCE* 2003(153) ELT 114 (CEGAT), the manufacturer supplied goods to buyer on duty paying document. The manufacturer had availed Cenvat credit on inputs fraudulently. It was held that the buyer is not responsible for fraud of supplier and he is entitled to Cenvat credit on basis of a valid duty paying document.

**Precautions being taken by State Governments under Vat** - State Governments have put up or are in process of putting up check posts at State borders to ensure that all goods entering and leaving State are properly recorded. Though the purpose is sound, it is experience everywhere that such physical barriers increase harassment of honest tax payers while dishonest taxpayers can devise their own ways to hoodwink the system.

## 12.4 OVERVIEW OF STATE VAT

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.

The white paper gives background of problems in present system of sales tax, principles of Vat and its advantages. It also gives basic design of State level Vat proposed to be implemented. States have generally followed the principles as given in the White Paper. Of course, there are variations.



Highlights of policy regarding State Vat as contained in White Paper are given below.

**Tax Credit** - 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].

**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.*

**Credit 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.

**Transitional Credit of stock as at the beginning of Vat Act** - 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.

**Entry tax/Octroi will continue** - There is no proposal to extend VAT to entry tax (in lieu of octroi) or Octroi levied by local authorities. These will continue.

#### **12.4.1 Purchase tax in VAT or 'reverse charge'**

Though white paper makes no mention of purchase tax, some States like Kerala and Andhra Pradesh have made provision for imposition of purchase tax when purchase is from unregistered dealers. Its credit will be available where vat credit on purchases is available. Thus, in effect, in respect of purchases where Vat credit is not available, purchase tax will be payable.

This is termed as 'reverse charge'.

In UK, reverse charge has been introduced in 2006, on tax payable on sale of mobile phones and microchips.

**Reverse charge** - Normally, Vat is payable by seller of goods. However, in some cases, the liability is cast on the purchaser of goods. This is termed as 'reverse charge'.

This concept is used in service tax also. In reverse charge, the service receiver also acts as service provider. He pays tax on services received by him. He can avail Cenvat credit of tax paid by him, since the service is actually his 'input service'.

There is provision of 'tax collection at source' under section 206C of Income Tax Act. Here, seller of liquor is liable to pay tax at source. The buyer has no liability. Tax deduction at source (TDS) under Income tax is really not 'reverse charge', since basic responsibility of payment of income tax continues to be that of person earning income.

Mode of 'reverse charge' is used when it is administratively difficult to collect tax from seller of goods or service provider or income earner.

#### **12.4.2 Tax rates 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] .

### **12.4.3 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.

#### **12.4.4 Where input credit will not be available**

Credit of tax paid on inputs will be denied in following situations -

**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.

**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).

**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.

**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.

#### **12.4.5 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 re-



versed. 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’.

#### **12.4.6 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.

#### **12.4.7 Exemptions and incentives to new industries already granted to continue**

All State Governments were offering sales tax incentives to new industries set up in the State. The incentives were broadly of three types - (a) Exemption - Don’t charge tax and don’t pay (b) Deferral - Charge sales tax in invoice but pay after long period of (say) 12 to 18 years (c) Remission - Charge in the invoice but retain and do not pay to Government. - - State Governments have stopped giving incentives to new industries after January, 2000. However, there are commitments in respect of industries set up prior to January, 2000. State Governments to continue with the incentives which were already granted [*para 2.15 of White Paper on State-Level VAT*]. [Some States may allow industries under exemption scheme to convert to deferral scheme so that such industries can pass on benefit of VAT to their buyers].

## **12.5 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 indeed been paid (b) There is no double credit on basis of same invoice. TIN will have to be indicated on each in-



voice 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 rampant.

**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.

### 12.5.1 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 eight 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.



### 12.5.2 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 *plus* (b) Reversal of Credit (On exempted goods, stock transfers, free samples, lost inputs) - *Less* - (c) Input tax credit available.

This net amount is required to be paid through prescribed challan on or before due date.

### 12.5.3 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 -

- As per AS-2, cost of purchase for purpose of inventory valuation should not include tax, if credit of tax paid is available.
- 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.
- Purchase account should be debited with net amount. VAT credit receivable on purchases should go to 'VAT Credit receivable (Input) Account'.
- Account of each rate i.e. 0%, 1%, 4%, 12.5% etc. is required to be kept separately.
- In case of capital goods, as per AS-10, cost of fixed assets should include only non-refundable duties or taxes.
- 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'.
- 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].
- If any VAT is payable at the end of period (after adjusting VAT credit available), the balance is to be shown as 'current liability'.

### 12.5.4 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.

## 12.6 IMPACT OF VAT ON CST

The provisions in respect of Central Sales Tax are summarised below –

- Para 4.3 of White Paper on State-Level VAT had stated that present CST rate (that time it was 4%) will continue for some time. CST may go after decision in respect of loss of revenue to States is taken and comprehensive Taxation information System is put in place. Accordingly, CST rate has been reduced to 3% w.e.f. 1-4-2007.
- Present CST forms i.e. C, D, E-I / E-II, F, H, I and J will also continue.
- There will be no credit of CST paid on inter-state purchases [para 2.6 of White Paper on State-Level VAT].
- If goods are sent on stock transfer outside the State, input tax paid in excess of 4% will be allowed as credit. In other words, input tax to the extent of 4% will not be allowed as credit



if goods are sent inter-state (The CST rates has been reduced to 3% w.e.f. 1-4-2007. The dis-allowance should also be reduced to 3%. It is not known whether all State Governments are reducing the dis-allowance i.e. 'retention').

Unfortunately, the way sales tax VAT is to be implemented by States, it is only local (i.e. State) VAT and not national VAT. This is because –

- (a) If goods are purchased from another State, credit (set off) of CST paid in other State will not be granted by the State where the goods are consumed / used / sold.
- (b) If goods are sent to another State on stock transfer basis, only restricted input credit will be given, i.e. there will be no credit on first 4% tax paid on inputs.

Obviously, this is against basic concept of VAT. Thus, the State Level VAT is a truncated version of VAT. It can at the most be termed as 'Local Sales Tax VAT' and not 'National Sales Tax VAT'.

### **12.6.1 Discriminatory treatment to CST**

Provision of not granting credit of CST seems discriminatory. Article 303 of Constitution of India provides as follows, 'Neither Parliament nor the Legislature of State shall have power to make any law giving any preference to one State over another, or making any discrimination between one State and another'.

As per Article 304(a), State Government can impose tax on goods imported from other States, but cannot discriminate between goods imported from other States and goods manufactured within the State.

Kelkar Committee in para 7.2 of its final report submitted in December 2002, has expressed apprehensions about legal implications of Article 304(a) in State Level VAT. The Kelkar Committee has expressed apprehension that investment decisions will tend towards States where the market within the State is larger than outside.

Giving credit only for locally purchased goods appears to be discriminatory and it appears that this will discourage inter-state purchases.

**States indirectly taxing inter-state transaction** - If goods sent on stock transfer basis, credit will be granted only in excess of 4% tax paid on inputs. Thus, indirectly, tax will be levied on stock transfers.

As per Article 286, State Government cannot impose tax on sale or purchase during imports or exports; or tax on sale outside the State. It means that State Government can impose sales tax only on sale within the State.

### **12.6.2 Will inter-state sale be zero rated?**

The Vat system will be Vat compliant if inter-state sale or stock transfer is 'zero rated' i.e. no tax will be payable on inter-state sale or stock transfers, but entire credit of taxes paid on inputs and capital goods is available. If CST is reduced to Nil, but restricted credit of tax paid inputs is available, then the inter-state sales will be 'exempt' and not 'zero rated'. Then the Vat system will not be as per principles of Vat.

The intention seems to be to make inter-state sales 'zero rated' and not merely 'exempt'. However, white paper issued by Empowered Committee does not categorically say so.