

VALUE ADDED TAX

INTRODUCTION

Value Added Tax or VAT is a broad based tax levied at multiple stage with tax on inputs credited against taxes on output. The origin of VAT can be traced as far back as the writing of F V on Siemens, who proposed it in 1919 as a substitute for the then newly established German turnover tax.

Since then numerous economists have recommended it in different contexts. In addition, various committees have examined the tax in detail. However, for its rejuvenation, the tax owes much to Maurice Faure and Carl Shoup. **The recent evolution of VAT can be considered as the most important fiscal innovation of the present century.**

Q.NO.1 WHAT IS VAT?

VAT is a tax, which is charged on the 'increase in value' of goods and services at each stage of production and circulation. It is also chargeable on the value of all imported goods. It is charged by registered VAT businesses/persons/taxpayers. VAT has replaced a number of other taxes and its introduction has not resulted in either increased prices to final consumers or reduced profitability of business. VAT is levied on the difference between the sale price of the goods produced or the services rendered, and the cost thereof -that is, **the difference between the output and the input.**

Q.NO. 2 EXPLAIN THE FEATURES OF VAT ?

FEATURES OF VAT:

1. Tax levied and collected at every point of sale.
2. Tax collected at every point of sale and the tax already paid by the dealer at the time of purchase of goods will be deducted from the amount of tax paid at the next sale.
3. Dealers reselling tax-paid goods will have to collect VAT and file returns and pay VAT at every stage of sale (value addition)
4. It is transparent and easier.
5. VAT dispenses with such forms and sets off all tax paid at the time of purchase from the amount of tax payable on sale.
6. The returns and the challans are filed together in a simple format after self-assessment done by the dealer himself.
7. At the most a few forms are required.
8. Tax on goods and services both.
9. Self-assessments by dealers.
10. Penalties will be stricter.

Q.NO.3 HOW TO CALCULATE VAT? ILLUSTRATIVE WITH AN EXAMPLE.

VAT is calculated by deducting tax credit from tax collected during the payment period

Example 1: (Rate of tax assumed is 10%)

Purchase Price	Rs. 100
Tax paid during purchase	Rs. 10 (input tax)
Selling Price	Rs. 150
Tax collected during resale	Rs. 15 (output tax)
Input tax credit (tax paid during purchase)	Rs. 10
VAT payable (output tax – input tax)	Rs.5
Total tax collected y government	
At the time of purchase by the dealer	Rs.10
At the time of resale by the dealer	Rs.5
Total tax:	Rs. (10+5)=Rs.15

Example 2:

	10% Sales Tax		10% VAT	
	Effect on Prices to final consumer	Proceeds to the government	Effect on Prices to final Consumer	Proceeds to the government
A mines copper and sells it to a manufacture B	100		100	
Sales tax of 10%	10	10	10	10
Total cost B	110		100	
B converts it into a wire with his labour/profit and sells it to C , a wholesaler at 100% margin	220		200	
Sales tax/VAT	22	22	20	20-10=10
Total cost to C	242		200	
C sells to D , a retailer at a 20% mark up	290		240	
Sales tax/VAT	29	29	24	24-20=4
Cost to D	319		240	
D sells it to the consumer at 100% mark-up	638		480	
Sales tax/VAT	64	64	48	48-24=24
Cost to consumer	702		528	
Total Proceeds to government		125		48

The first thing we observe from the above table is that with equal tax rates of 10%, the final price to the consumer is 33% or Rs. 174 (Rs. 702-Rs. 528) higher in the cascading (traditional) sales-tax system. A part of this difference is owing to the Rs. 77 (Rs. 125-Rs. 48) higher tax receipts of the government. The rest of the difference, Rs. 97, is taken by higher profits of the different intermediaries, **B, C & D**.

The second thing we can observe is that almost every time the VAT is charged, it is not an expense to the person who pays it, but just an advance to the government via the supplier. This is true for all except the final customer who cannot claim the VAT deduction. Actually, he is the only one who pays the full amount. The above table assumes that the different intermediaries want to keep a fixed percentage mark-up (perhaps because of capital invested in inventory). As a result, each time there are fewer profits to the business intermediaries who don't take a mark-up on the VAT. This also explains why the VAT is considered a better tax than the sales tax.

We also observe from the last two lines of the above table that the consumer is benefited by Rs. 174 (Rs. 702-Rs. 528) in the VAT system whereas the government loses by Rs. 77 (Rs. 125-Rs.48).

Note: In the above illustration, it is observed that in the VAT regime the effect on price to B is only Rs. 100. This is because the tax paid on purchase by B is allowed to be setoff/credited against the tax (output tax) payable by C on sale of the goods. Similarly, intermediaries C and D too will be allowed input tax credit until the goods reaches the final consumer (who cannot claim the VAT deduction).

Q.NO. 4 WHAT ARE THE VARIANTS OF VAT?

Variant	Description
Gross Product Variant	Principle: The gross product variant allows deductions for taxes on all purchase of raw materials and components. No deduction is allowed for taxes on capital inputs Limitation: - Capital goods are taxed twice i.e., at the time of purchase and at the time of sale of goods produced using those capital goods. - Modernization and upgrading of plant and machinery is delayed due to this double tax treatment.
Income Variant	Principle: - The income variant of VAT allows for deductions on purchase of raw materials and components as well as depreciation on capital goods. (i.e.) Credit on Capital purchases are allowed in the ratio of Depreciation over the life of the capital asset. - This method provides incentives to classify purchase as current expenditure to claim set off. Limitation: There are difficulties connected with the specification of any method of measuring depreciation, which basically depends on the life of an asset as well as on the rate of inflation.
Consumption Variant	Principle: - Consumption variant of VAT allows for deduction on all business purchases including capital assets. - Gross investment is deductive in calculating value added. - It neither distinguishes between capital and current expenditures nor specifies the life of assets or depreciation allowances for different assets. Merits: - It does not affect decisions regarding investment because the tax on capital goods is also set off against the VAT liability. Hence, the system is tax neutral in respect of techniques of production (labour or capital intensive). - Convenient from the point of administrative expediency as it simplifies tax administration by obviating the need to distinguish between purchases of intermediate and capital goods on the one hand and consumption goods on the other hand. Limitation: The system is tax neutral from the view point of Government as it leads to loss of revenues to the Government.

Q.NO. 5 WHAT ARE THE GENERAL REQUIREMENTS FOR VAT SYSTEM?

General Requirements for VAT System:

- Compulsory issue of tax invoice and retail invoice:** Tax invoice is issued to a dealer/consumer who has to take input VAT Credit whereas retail invoice is meant for inter state sales or sale to a consumer who does not require input credit of VAT.
- Registration:** There is a compulsory registration of the dealer if the aggregate turnover exceeds a certain specified limit.
- Composition scheme:** A small dealer whose turnover does not exceed a specified limit (say in Delhi Rs. 50 lakhs) can opt for composition scheme where he shall have to pay tax himself at a small percentage of gross turnover and in this case buyer of goods with not get input VAT Credit.

4. **Tax payer identification Number (TIN):** There will be a taxpayer's identification number of 11 digit numericals which will be unique to each dealer.
5. Simplified returns of VAT are to be filed monthly or quarterly as specified by each state.
6. Self-assessment by dealers.
7. Audit under VAT has been made compulsory by various States.
8. No requirement of any declaration form as bill will be raised for each sale and VAT shall be levied.
9. Comprehensive coverage as only few commodities have been exempted from VAT.

Q.NO. 6 WHAT ARE THE METHODS FOR COMPUTATION OF VAT?

The various methods of computation of VAT are:

Method	Description
Addition Method	1. Suitability: This method is mainly used with income variant of VAT. 2. Demerits: a. This method does not easily accommodate exemptions of intermediate dealers. b. It does not facilitate matching of invoices for detecting evasion. 3. Computation: a. Step 1: Aggregate all the factor payments including profits to arrive at the total value addition. b. Step 2: Apply the rate on Step 1 to calculate the tax.
Invoice Method	1. Suitability: Under Central Excise Law, this method is followed. 2. Salient features: a. The most important aspect of this method is that at each stage, tax is to be charged separately in the invoice. b. This method is also called the "Tax Credit Method" or "Voucher Method". 3. Merits: a. In this method the beneficiary is the trade and Industry because the tax collection at all stages is very much lesser than the tax received by the State because of the availability of set-off of tax paid. b. The possibility of tax evasion is reduced to minimum, because credit can be claimed only when purchase invoice is produced. 4. Computation: Step 1: Compute the tax to be imposed at each stage of sales on the entire sale value. Step 2: Set-off the tax paid at the earlier stage. (i.e., at the stage of purchases in set-off). Step 3: The differential tax is paid.
Subtraction Method	1. Suitability: This method is normally applied where the tax is not charged separately. 2. Salient Features: a. Tax is charged only on the value added at each stage of the sale of goods b. There is no tax credit as the total value of goods sold is not taken into account. 3. Methods of determination of value added: a. Direct Subtraction method: Value added = Total value of sales exclusive of tax Less: Total value of purchases exclusive of tax. b. Intermediate subtraction method: Value added = Total value of sales inclusive of tax. Less: Total value of purchases inclusive of tax. c. Indirect Subtraction Method 4. Computation: Step 1: Compute the value added under either of the above methods. Step 2: Apply the rate of tax on the amount calculated in step 1.

PROBLEM 1: Methods of Computation VAT – Inputs taxable at different rates

Inputs used for the production of Output 'M' are 'X' and 'Y' respectively. The following are details of inputs-

Input	VAT Rate	Invoice Price (inclusive of vat)
Product X	12.5%	45,000
Product Y	45	26,000

The following are the details of Sales and the rate of VAT applicable for the Output 'M' is 12.5 %-

Description	A to B	B to C	C to D	D to E	E to Consumer
Invoice Price	Rs. 76,500	Rs.1,12,500	Rs. 1,80,000	Rs. 2,25,00	Rs. 2,70,000

From the above details, Calculate the VAT collected at each stage and the VAT finally remitted using the two different methods i.e. (a) Invoice Method. And (b) subtraction Method.

Solution:

A. INVOICE METHOD

(Amount in Rs.)

Particulars (1)	Invoice (2)	Material Value (3)	Vat (4)	Input Tax Credit (5)	Net (6)
Inputs for A					
Product X (@ 12.50%)	45,000	40,000	5,000	-	5,000
Product Y (@ 4%)	26,000	25,000	1,000	-	1,000
Sale by A to B	76,500	68,000	8,500	6,000	2,500
Sale by B to C	1,12,500	1,00,000	12,500	8,500	4,000
Sale by C to D	1,80,000	1,60,000	20,000	12,500	7,500
Sale by D to E	2,25,000	2,00,000	25,000	20,000	5,000
Sale by E to Consumer	2,70,000	2,40,000	30,000	25,000	5,000
Final	2,70,00	2,40,000	30,000	-	30,000

B. SUBTRACTION METHOD

(Amount in Rs.)

Particulars	Invoice	Material Value	Vat	Input Tax Credit
1	2	3	4	5= 4 X 12.50/112.50
On Input	71,000	-	-	6,000
Sale by A to B	76,000	71,000	5,500	610
Sale by B to C	1,12,500	76,500	36,000	4,000
Sale by C to D	1,80,000	1,12,500	67,500	7,500
Sale by D to E	2,25,000	1,80,000	45,000	5,000
Sale by E to Consumer	2,70,000	2,25,000	45,000	5,000
Final	2,70,000	-	-	28,110

Inference: In the above illustration, total collections under Invoice Method and Subtraction Method differs due to differences in rates of VAT on inputs and outputs.

PROBLEM 2: Compute the invoice value to be charged and amount of tax payable under VAT by a dealer who had purchased goods for Rs. 1,20,000 and after adding for expenses of Rs. 10,000 and of profit Rs. 15,000 had sold out the same. The rate of VAT on Purchases and sales is 12.5%.

Solution:**1. Computation of Invoice Value**

Particulars	Rs.
Cost of goods Purchased	1,20,000
Add: Additional expenses	10,000
Add: Profit Share	15,000
Total Invoice Value	1,45,000

2. Computation of Tax payable

Particulars	Rs.
VAT on Invoice Value @ 125%	18,125
Less: Input Tax Credit – VAT on purchases @ 12.5% (1,20,000 X 12.5%)	(15,000)
VAT Payable	3,125

Q.NO. 7 WHAT ARE THE ADVANTAGES OF VAT?**Advantages of VAT:**

VAT being a broad based tax levied at multiple stage is generally perceived as an explicit replacement of State sales tax for raising additional revenue for the Government. The purpose of a tax system is to bring in revenues to the Government. Tax revenues can be raised in many ways. However, the main characteristic of good tax system should be –

1. The tax system should be fair or equitable;
2. It should cause the least possible harmful effects to the economy and to the extent possible; it should promote growth to the economy.
3. It should be simple both for its compliance by the payer and for its administration by the Government.
4. It should be income elastic.

Keeping in view the above objectives, VAT is being implemented in various states in place of the local sales tax payable by the seller. VAT is also expected to be more effective and efficient for every person including Government, manufactures, traders and consumers and hold the following advantages:

1. **Easy to Administer & Transparent:** This system of charging tax is easy to administer because of its simplicity. It also reduces the cost of compliance by the dealers and is transparent, as tax is to be charged in every bill and there will be no local statutory forms.
2. **Less Litigation:** There will be no litigation with respect to allowability of items, as under VAT no items will be specified in the registration certificate of the dealer. The dealer will be allowed to purchase any of the items of his choice in which he intends to deal. He will also be allowed to purchase any item he requires as raw material for the purpose of manufacturing or for packing.
3. **Tax Credit on purchase of Capital Goods:** The dealer will be allowed to purchase capital goods for manufacturing after paying sale tax and will be entitled to get set off sales tax paid on such purchases from his sales tax liability, which will arise on the sales made by him.
4. **Abolition of Statutory Forms:** There are no forms under VAT. Therefore, all problems related to forms automatically get resolved.
5. **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.
6. **Deterrent against Tax Avoidance:** It will act as deterrent against tax avoidance. Under the present system, tax is charged either on first point basis or at last point basis hence the incentive to evade tax is high because the dealer saves the whole amount of tax due on such transaction, whereas under VAT the incentive to evade tax is low because the dealer saves only a part of tax i.e. (tax amount which he is liable to pay less the amount of tax he has already paid on his purchases).
7. **No Cascading Effect:** It does not have cascading (tax on tax) effect due to system of deduction or credit mechanism. Since VAT does away with cascading, it avoids distorting business decisions; the need for vertical integration is dictated only by the market forces or technical considerations, and not by the tax structure.

8. **Effective Audit & Enforcement Strategies:** The input credit method by generating a trail of invoices is argued to be system that encourages better compliance since the purchaser seeks an invoice to get input tax credit. Further, this trail of invoices supports effective audit and enforcement strategies.
9. **Minimum Exemptions:** The system will be more effective because of minimum exemptions.
10. **Removal of Anomaly of First Point Taxation:** VAT eliminates the limitations of single point tax either at first point or last point. In the case of last point goods, the temptation to evade tax is high. Firstly, the quantum of tax at one point is high. Secondly, as the exemption is available against statutory forms, possibility of misuse of forms cannot be ruled out. Similarly, under first point tax system, tax avoidance by way of selling the goods at first point to their sister concerns at lower rates and thereafter increasing the price of the goods because subsequent sales being exempt as tax paid. This anomaly is also being taken care of under VAT, without introducing cascading.

Since the dealer gets a set off for taxes paid at the earlier stages these are not treated as part of costs and this is expected to reduce that component of cost as well as the associated financing requirement. Further, the problem of enhanced cascading via the markup rule too is also ruled out under the system

Q.NO. 8 WHAT ARE THE LIMITATIONS OF VAT?

Limitations of VAT:

India being a Federal Republic country has state level administration of the local sales tax which is being replaced by VAT and had been the reason for deferment of its implementation time and again. 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.

1. **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.
2. **Cause Inflation:** It is also argued that VAT causes inflation. It's impact will depend on various factors such as inventory holding period, demand supply position of that particular product, number of intermediaries etc. Investment in stock is bound to increase as tax will be paid at the time of purchase, hence one will have to carry tax paid stock.
3. **Refund of Tax:** Credit of tax paid on inputs/capital goods is available to be utilized against tax liability which will be calculated on the sale of final product. VAT credit can not be availed if no tax is payable on final product being exempt or taxable at lower rate.
4. **Functional Problems:** The functional problem of VAT is that input tax credit is allowed on the basis of the invoices issued by the dealer. In respect of invoices where tax at the earlier stage is charged and collected, but not remitted to the State by the concerned dealer, the dealer who has paid the tax and who is entitle to take credit for the tax paid should not be made to suffer. Provisions to protect the interest of the dealers who have paid the tax should be made.
5. **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 statutory forms, hence was not liable to pay tax on it's purchases.
6. **Not Credit for Tax paid on Inter-state Purchases:** The biggest problem of introduction of VAT is the non-availability of credit for tax paid on interstate purchases in initial years. It will also result in some cascading effect, which goes against the basic spirit of VAT.
7. **Audit under VAT:** Most of the states introduced VAT on 1.4.2005 and they have incorporated audit provisions in the Legislation itself. Audit under VAT is important for better and effective implementation of the VAT system.

The End