Value Added Tax

For CA PCC/IPCC

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- Value Added Tax is tax on sale of goods.
- Value Added Tax (VAT) is payable by seller who is termed as dealer.
- Sale of goods can be broadly classified in three categorises.
  - Inter State Sale (i.e. out of state sale) (tax on sale levied by union government under CST Act, powers under 92A of list I, i.e. union list)
  - Sale in case of import (No sales tax)
  - Sale in case of export (No sales tax)
  - Intra state sales (i.e. within state sale) (tax on sale levied by state government under State VAT Act – powers to levy under entry 54 of list III, i.e. state list.

>>WE WILL DISCUSS THE IMPORTANT ASPECTS OF CENTRAL SALES TAX & Value Added Tax SEPRATELY.

>>Whenever sale transaction of goods takes places, we consider whether the sale was ‘within the state’ or ‘in other state’. And according to that we consider which tax to levy on the goods transacted, i.e. ‘CST’ or ‘STATE VAT (local sales tax)’, as these two are levied under different acts.

>>Concepts of levy, assessment and collection.

>>Levy and collection are two different concepts.

>>Levy stands for creating a liability of tax in respect of goods.

>>Then come assessment, which means, that what would be the amount of liability of tax.

>>And then Collection of tax.

IMPORTANT ASPECTS OF CST

- The CST provides for levy on Inter State Sales and also defines what is inter state sales.
- CST is levied by Central Government under CST Act.
- Tax so levied under CST Act, is collected under the same act, in each state & kept by state only.
- CST is payable in the state, from which movement of goods commences. (i.e. from which goods are actually sold)
- The tax collected is retained by the state in which it is collected.
- CST Act "administered" by Sales tax authorities of each state.
- Thus, the state government 'Sales tax officer' who collects & assesses Local(State) sales tax (on intra state sales), also collects & assesses CST.

ASPECTS OF STATE VAT (LOCAL SALES TAX)

- Tax on sale within the state is a state subject.
- State VAT in each state is administered by respective state government of each state.
- Therefore each state makes changes as per their needs.
- Basic concepts are same in VAT acts of all states. But 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 credit', etc. are not uniform.

BASIC CONCEPTS OF VAT

Value Added Tax works on the principle of tax on 'value added' at each manufacturing or distribution stages.

For example, when raw material passes through various manufacturing stages or 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.

VALUE ADDED means difference between selling price and purchase price, VAT avoids cascading effect of a tax.

MEANING OF 'CASCADING EFFECT OF TAX'

In simple cascading effect of tax means 'tax on tax', this should be avoided.

<u>Example:</u>

Let us assume that tax on a product is 10% of selling price. Manufacturer 'A' supplied his output to 'B' at Rs.100. Thus, 'B' gets the material at Rs.110, inclusive of tax [Rs.100 + (Rs.100*10% tax)]

He ('B') carries out further processing and sells his output to 'C' at Rs.150. while calculating his cost 'B' has considered his purchase cost of material as Rs.110 and added Rs.40 as his conversion charges(value added by him). While selling product to 'C', 'B' will charge tax again @10%. Thus, 'C' will get the item at Rs.165 [Rs.150 + (Rs.150*10% tax)].

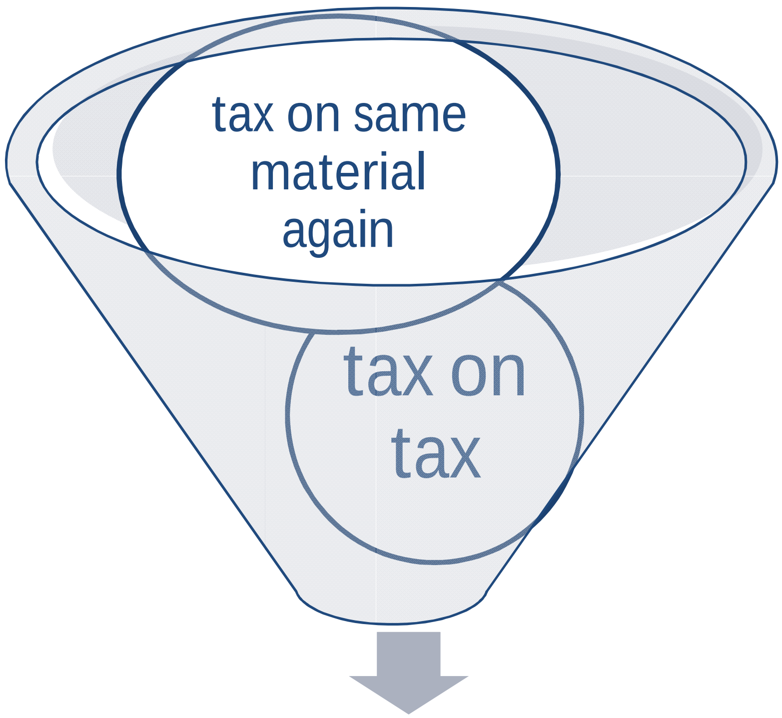
In fact value added by 'B' is only Rs.40 (150-110), tax on which would have been only Rs.4, while tax paid was Rs.15. As stages of production/distribution (sales) continue, each subsequent purchaser has to pay tax again and again on the material which has already suffered tax.

TAX IS ALSO PAID ON TAX. THIS IS CALLED '*CASCADING EFFECT*'.

There are two CAUSES of CASCADING EFFECT OF TAX.

1. Tax on same material again and again

2. Tax on tax of previous stage



CASCADING EFFECT OF TAX

VAT AVOIDS CASCADING EFFECT OF TAX

To avoid cascading effect of tax we have to work out a method, which eliminates both the above mentioned effect of cascading, i.e.

1. Same material should not get taxed again
2. Tax levied on previous stage should not get taxed on subsequent stage.

Value Added Tax is the method. HOW??

to answer this, we will take the both aspects of cascading separately.

- TAX LEVIED ON PREVIOUS STAGE SHOULD NOT GET TAXED ON SUBSEQUENT STAGE.
  This is very simple and I am sure that u can answer it.
  ?????
  Alright I tell u..
  Don't include the tax paid on inputs in your cost and subsequently in your sale price, as simple as it is.
  Okay, in the above example, 'A' levied the tax on Rs.100 and sold it to 'B' for Rs.110 (100+10 tax), now for 'B', though he paid Rs.110 for the material but the actual cost of 'inputs' for charging tax on subsequent sale by him would be Rs.100 and not Rs.110 as extra Rs.10 paid is the amount of tax levied by 'A'.
  Therefore if we do not include the tax paid on inputs purchased, in our sale price after some value addition in inputs, we can overcome with the one of the effect of CASCADING, i.e. we can save the extra tax on 'tax paid earlier on purchase of inputs'.

  - NOW THE QUESTION ARISES THAT WHY NOT TO INCLUDE TAX PAID ON INPUTS WHILE SELLING THE OUTPUT??
    Answer to this question is that VAT works on the tax credit method.
    As we'll get the 'credit' of tax paid on purchase of inputs, while calculating our output tax liability.

Therefore as we'll get the credit of tax paid on inputs, though in future, we should not consider it (tax paid on inputs) as our cost, while selling our output to some buyer and therefore ELIMINATING ONE OF THE CAUSES OF *CASCADING EFFECT OF TAX.*

- SAME MATERIAL SHOULD NOT GET TAXED AGAIN AND AGAIN

  This is very simple as well.

  VAT works on 'tax credit' method. What is tax credit method ??

  - In tax credit method of Value Added Tax, the tax is levied on full sale price (of course 'tax paid on inputs' are excluded) but credit is given of tax paid on purchases. Thus, effectively, tax is levied only on 'Value Added'.
  - >When a dealer sells his output,
>he charges tax on sale price of the output,
>which includes "the value of 'inputs' purchased" and "the value added by him", but excludes the amount of tax paid on inputs.
>now the cascading arises in respect of the input material purchased, on which the seller has already levied tax and had paid the same to government
>such input material should not get levied to tax again.
  - To overcome such a situation, tax credit method of Value Added Tax is used.
  - Tax is calculated on the whole selling price of output and then tax credit of 'tax paid on inputs' is given while paying the output tax to government.
  - Tax credit basically is a 'set off' of "tax paid on inputs" against "tax to be paid on sale of output".

ILLUSTRATION OF TAX CREDIT METHOD TO AVOID CASCADING EFFECT

	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 ‘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’ or Rs. 40 to the product.

Simply, ‘value added’ is the difference between selling price and the purchase price in case of traded goods, and difference between selling price of final product and purchase price of inputs, in case of manufactured goods.

RULES OF TAX CREDIT OF VAT

- Input tax credit is allowed for the entire VAT paid within the state on purchase of taxable goods meant for resale.
- In the following cases no credit for input tax in available.
  - Goods which have been purchased from unregistered dealers.
  - Goods which have been purchased from a dealer situated in some other state.
  - Goods which have been imported into India.
  - Goods which have been used in the production of EXEMPTED GOODS.
  - Capital goods.
  - Purchase of goods to be dispatched as branch transfer outside states.
  - Purchase of goods in cases where the dealer does not have invoices showing amounts of tax charged separately by the selling dealer.

  In all the above cases tax paid on purchases/inputs shall be considered as cost of purchase/inputs and shall be included in the selling price.

- CARRY FORWARD OF TAX CREDIT

  Sometimes input tax credit exceeds output tax credit during a tax period. Such excess shall be carry forward to next tax period and if it remains unadjusted even at the end of the financial then such excess shall be refunded by the Government.

  For the goods exported out of India, VAT paid within a state shall be refunded by the Government within a period of 3 months. Similarly units located in Special Economic Zones and 100% Export Oriented Units shall be either exempt from paying input VAT or there will be refund of input tax within 3 months.

- GOLDEN RULE FOR TAX CREDIT OF VAT

  When tax credit of VAT for certain transaction is not available, any tax paid on purchases/inputs, shall have to be consider as cost of purchases/inputs.

  For example: when we purchase from any other state, tax paid as CST will not be available for tax credit and the same should be consider as cost of purchases.

This is the biggest limitation of Value Added Tax that *CASCADING EFFECT* is not fully eliminated. As tax is paid on tax in case of Inter-State purchases because full value is considered as cost of purchases.

Features of VAT

- Vat is tax on sale of goods
- there are only four rates of VAT,i.e.0%,1%,4%,12.50%
- Sales tax is levied at every stage of the sale transaction
- the sales reffered under VAT is intra state sales and not inter state slaes
- sales tax is calculated on the difference b/w sales value and purchase value and not on sale value.
- VAT is implemented by giving set-off the tax suffered by the purchases(called input tax credit) against tax payable on the sales.
- sales tax is calculated on the sales price which is ex-sales tax price and not cum-sales tax price.
- VAT is not implemented to tall goods. Goods such as Petrol,Liquor etc whose price is not wholly determined by the market and government plays a role in price fixation are not governed by VAT.

Need For VAT in India

- Avoids distortion in the economy due to ununiformity all accross the channel.
- prevents cascading effect (multiple taxation) by providing credit of input taxation.
- VAT is just and logical way of taxing all dealers in equitable mannerwherby all dealers share burden of tax.
- this tax leads to easy computation and compliance.
- Credit of input taxation leads to cost efficiency.
- In this system every dealer will like to have benefit of input tax credit so there will be better compliance through self policing.
- VAT is the most transparent procedure of taxation of goods and service.

VARIENTS OF VAT

CONSUMPTION VARIANT | GROSS PRODUCT VARIANT | INCOME VARIANT

CONSUMPTION VARIANT

- Here deduction is available to tax paid on inputs as well as capital goods.
- This is easy to operate.
- It does not discriminate between labour intensive industries and capital intensive industries.
- The method is tax neutral between methods of production, i.e. whether capital intensive or labour intensive.
- It is administratively convenient as disputes about nature of purchases, life of capital goods, depreciation, etc are avoided.
- Consumption method is the most popular method all over world. It is adopted by almost all countries (including India) who have introduced Value Added Tax system.

GROSS PRODUCT VARIANT

- Credit of tax on inputs is allowed but credit of tax paid on capital goods is not allowed. This discourages investment in capital goods.
- In this method, cascading effect of taxes still exists as indirectly, capital goods are taxed twice (as its cost is included in cost of production, through depreciation).
- This variant also raises disputes between ‘inputs’ and ‘capital goods’ and hence not used in any country.

INCOME VARIANT

- here deduction is allowed of value of inputs and depreciation on capital, from value of sales.
- This method encourages tendency to classify purchases as current expenditure since full set off is immediately available.
- If the purchases is classified as capital goods, set-off of tax paid gets spread over number of years.
- Since deduction of depreciation is allowable, tax cannot be calculated on individual invoice.
- This method is suitable when tax is not charged separately in Invoice.
- However, disadvantage of this variant is that direct passing of burden of tax on purchaser is no possible.
- This variant is no where in actual use.

mEtHODS OF VAT

i. INVOICE mEtHOD

- The tax credit system of Value Added Tax is called invoice method or 'tax credit method'.
- This is the most common and popular method for computing the tax liability under 'VAT' system.
- Under this method, tax is imposed at each stage of sales on the entire sale value and the tax paid at the earlier stage is allowed as set-off.
- Out of tax calculated on sales, tax paid at the stage of purchase is set-off and at every stage the differential tax is being paid.
- The most important aspect of this method is that at each stage, tax is to be charged separately in the invoice.
- Illustration: invoice of ABC will be Rs.100 plus VAT Rs.10. Total Value Rs.110.
  Invoice of XYZ Co. will be Rs.150 plus VAT Rs.15 i.e. totals Rs.165.
  XYZ Co. will utilise tax credit of Rs.10 (VAT paid by ABC) and pay Rs.5 as Value Added Tax by cash.

ii. <u>SUBTRACTION mEtHOD</u>

- In 'subtraction method' value of purchases are deducted from sale price and tax in paid on the difference.
- 'Value Added' is calculated as difference between sales and purchases.
- In this method, tax cannot be shown separately in invoice and hence burden cannot be directly passed on to consumer.
- Tax liability can be calculated only periodically (say monthly or quarterly).
- Burden of tax cannot be directly passed on to buyer.
- This method is suitable when VAT rate is uniform on all commodities.
- If VAT rates are different on intermediate products, the cascading effect of taxes cannot be fully eliminated.
- This method is suitable for Gross Product Variant where purchases of capital goods are ignored.
- <u>Illustration:</u> Invoice of ABC will be Rs.110 (without any breakup, inclusive of VAT). Invoice of XYZ Co. will be Rs.165 (without any breakup, inclusive of VAT). By subtracting purchase price from sales price, the amount on which VAT payable is Rs.55 (Rs.165-Rs.110). Treating this amount as inclusive of VAT, the net VAT payable (by back calculation) is Rs.5.
  [BACK CALCULATION = VALUE*RATE OF VAT/(100+VAT RATE)]

iii. <u>Addition mEtHOD</u>

- In addition method, tax is calculated on all factor payments including profits, but excluding value of material.
- This method is not at all suitable for consumption method of VAT.
- It can be used with income variant of VAT.
- Tax payable is calculated periodically and not invoice wise.
- Thus, burden of tax cannot be directly passed on to buyer.
- <u>Illustration:</u> expenses of XYZ Co. plus plus its profit are Rs.50.
  VAT on this amount @10% will be Rs. 5. Invoice of AB will be for Rs.110 and invoice of XYZ Co. will be for Rs.165 without any breakup.