

Taxonomy of VAT

Question 1

Briefly explain the three commonly used methods for computation of VAT.

Answer

The three commonly used methods for computation of VAT are briefly explained below:

- (A) **Addition Method:** This method aggregates all the factor payments including profit to arrive at the total value addition on which the rate is applied to calculate the tax. This type of calculation is mainly used with income variant of VAT. Further, this method does not easily accommodate exemptions of intermediate dealers. The main drawback of this method is that it does not facilitate matching of invoices for detecting evasion.
- (B) **Invoice Method:** Under invoice method, at each stage of sales, VAT is imposed on the full sales value and VAT paid at the earlier stage is allowed as set off. Hence, at every stage the difference between the VAT payable at the time of sales and VAT paid at the time of purchases is required to be paid.

Under this method, at each stage, VAT is charged separately in the invoice. It is the most common and popular method of computing VAT. In India also this method is followed for computation of State-Level VAT and CENVAT. It is also known as the 'Tax Credit Method' or 'Voucher Method'.

- (C) **Subtraction Method:** Under this method, the tax is charged only on the value added at each stage of sale of goods. Since the total value of goods sold is not taken into account, the question of grant of claim for set-off or tax credit does not arise. This method is normally applied where the tax is not charged separately.

Question 2

Briefly discuss the different variants of VAT.

Answer

The different variants of VAT are briefly discussed below:

- **Gross Product Variant:** Tax is levied on all sales and deduction for tax paid on inputs excluding capital inputs is allowed.
- **Income Variant:** Tax is levied on all sales with set-off for tax paid on inputs and only depreciation on capital goods. This variant provides incentives to classify purchases as current expenditure to claim set-off.

- **Consumption Variant:** Tax is levied on all sales with deduction for tax paid on all business inputs [including capital goods]. Thus, gross investment is deductible in calculating value added. It neither distinguishes between capital and current expenditures nor specifies the life of assets or depreciations allowances for different assets. This variant is neutral between the methods of production [i.e. substitution capital for labour or vice versa]. The tax is also neutral between the decision to save or consume.

Among the above-mentioned three variants of VAT, Consumption Variant is widely used.

Question 3

Discuss any four merits of VAT.

Answer

Following are the merits of VAT:

- (i) **No Tax Evasion:** It is said that VAT is a logical beauty. Under VAT, credit of duty paid is allowed against the liability on the final product manufactured or sold. Therefore, unless proper records are kept in respect of various inputs, it is not possible to claim credit. Hence suppression of purchases or production will be difficult because it will lead to loss of revenue. A perfect system of VAT will be a perfect chain where tax evasion is difficult.
- (ii) **Neutrality:** The greatest advantage of the system is that it does not interfere in the choice of decision for purchases because it has anti-cascading effect.
- (iii) **Certainty:** The VAT system is based simply on transactions. Thus, there is no need to go through complicated definitions like sales, sales price, turnover of purchases and turnover of sales. The tax is also broad-based and applicable to all sales in business leaving little room for different interpretations. Thus, this system brings certainty to a great extent.
- (iv) **Transparency:** Under a VAT system, the buyer knows, out of the total consideration paid for purchase of material, what is tax component. Thus, the system ensures transparency also. This transparency enables the State Governments to know as to what is the exact amount of tax coming at each stage. Thus, it is a great aid to the Government while taking decisions with regard to rate of tax etc.
- (v) **Better revenue collection and stability:** The Government will receive its due tax on the final consumer/retail sale price. There will be a minimum possibility of revenue leakage, since the tax credit will be given only if the proof of tax paid at an earlier stage is produced. This means that if the tax is evaded at one stage, full tax will be recoverable from the person at the subsequent stage or from a person unable to produce proof of such tax payment. Thus, in particular, an invoice of VAT will be self enforcing and will induce business to demand invoices from the suppliers. Another attribute of VAT is that it is an exceptionally stable and flexible source of government revenue.

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- (vi) **Better accounting systems:** Since the tax paid on earlier stage is received back, the system will promote better accounting systems.
- (vii) **Effect on retail price:** A persistent criticism of the VAT form has been that since the tax is payable on the final sale price, the VAT usually increases the prices of the goods. However, VAT does not have any inflationary impact as it merely replaces the existing equal sales tax. It is also pertinent to add here that with the introduction of VAT, the tax impact on the raw material is to be totally eliminated. Therefore, there may not be any increase in the prices.
- (viii) **Exports become cheaper:** The exports would be cheaper as taxes paid at earlier stages could be availed as credit or refunded in cash.

[Note: Students may give any four merits out of the above total eight merits given hereinabove]

Question 4

Discuss any four demerit of VAT System.

Answer

VAT System has the following demerits:

- (i) **Existence of several concessions:** The merits of VAT will accrue only under a situation where there is only one rate of VAT and VAT applies to all commodities without any question of exemptions whatsoever. Once concessions like differential rates of VAT, Composition Schemes, Exemption Schemes, Exempted Category of Goods etc. are built into the system, distortions are bound to occur.
- (ii) **Integration of Central VAT with State VAT:** In the federal structure of India in the context of sales-tax, so long as Central VAT is not integrated with the State VAT, it will be difficult to put the purchases from other states at par with the state purchases. Therefore, the advantage of neutrality will be confined only by purchases within the State.
- (iii) **Increased Accounting Cost:** For complying with the VAT provisions, the accounting cost will increase. The burden of this increase may not be commensurate with the benefit to traders and small firms.
- (iv) **Increased Working Capital Requirements:** Since under VAT System tax is to be imposed or paid at various stages and not on last stage, it would increase the working capital requirements and the interest burden on the same. In this way, it is considered to be non-beneficial as compared to the single stage last point taxation system.
- (v) **Increased Administration Cost:** The administration cost to the State has increased under VAT because of significant increase in the no. of dealers to be administered.

(vi) **Regressive in nature:** It is claimed that VAT is regressive in nature because its burden falls disproportionately on the poor as the poor are likely to spend more of their income than the rich.

[Note: Students may give any four demerits out of the above total six demerits given hereinabove]

Exercise

1. *Briefly explain the different stages of VAT.*
2. *Briefly explain the mechanism of operation of VAT with the help of an illustration.*
3. *Describe the invoice method of calculation of VAT.*