Chapter 4

VAT in India

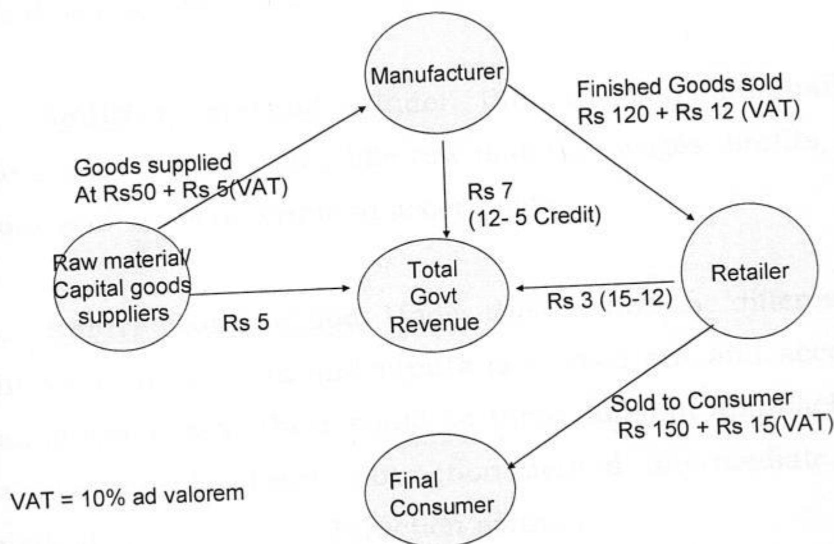
1. The idea of taxation through VAT can be attributed to Mr F Von Siemens, who in 1918, proposed this as a substitute for German turnover tax. Since then the proposal was examined by many economist and the current popularity of VAT can be attributed to Mr Mouris Laure and Mr Carl Shoup. France was the first country to have introduced VAT in 1954. Initially it was applicable only on the transactions entered into by the manufacturers and the wholesalers. Later on, it was supplemented by separate tax on services, which was in addition to the special excises on services and distributions. Retailers and agriculturalist were not included in the ambit of VAT. However, during the period 1954 to 1968, VAT was extended to cover all industrial, agricultural and commercial activities. In accordance with the sixth Directive of the European Economics Commission, French law was also amended whereby the scope for tax was expanded to include services under VAT. Since then the development of the on VAT in other countries had been phenomenal.

2. To fully appreciate utility of VAT, it would be desirable to discuss in brief various basic concepts relating to it. VAT can be defied as multipoint sales tax with set off for tax paid on purchases. It is collected on the value addition done in the every process of supply chain of goods from the manufacturers to the ultimate buyer. Under this taxation system, cascading effect of the taxes is avoided due to the system of deduction or credit mechanism. The tax is mere pass through. VAT is a tax on consumption and the total burden of the tax is borne by the consumer of goods and services. The study undertaken by US GAO[22] found that VAT may be less expensive to administer them the income tax. The tax Administration agency in the United Kingdom measured the administrative cost of VAT to be

[22] US Government Accountability Office Report(2008)

0.55% of revenue collected compared to 1.27% of income tax. Officials of New Zealand Inland Revenue department informed that the administering their VAT was easier than administering some of other taxes.

The system of taxation is best demonstrated by the diagram given below.



3. There could be following three specific variants of VAT:

a) **Gross Product Variant**: This method allows deductions for all purchase, raw material and components but no deduction is permitted for business inputs (like capital goods such as plant and machinery). It may be treated as equivalent to gross national product, and under this system of VAT, capital goods are taxed twice.

b) **Income variant**: Under this system deductions are allowed for purchases of raw materials and components as well as depreciation on capital goods. As such, the net investment i.e. gross investment minus depreciation is taxed

c) **Consumption variant**: Under the system, all deduction of business including capital assets are allowed. The system does not

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differentiate between the capital and the current expenditure and does not specify the life of asset etc. This variant of the VAT is used in most of the countries as it is tax neutral in respect of techniques of production i.e. Labour capital intensive. This form of taxation is simple and easy to implement.

Method of computation of VAT:

There are three types of methods adopted for calculating VAT. These are discussed as below:

a. **Addition method**: Under this method, summation of all elements of value added like raw material, wages, profits, rent, etc is done and tax is determined accordingly.

b. **Subtraction method**: Under this method the difference between the value of outputs and inputs is worked out and accordingly the tax is calculated. There could be three different approach under the system, namely, direct subtraction method, intermediate subtraction method and indirect subtraction method.

c. **Tax credit method**: Under this method, deduction of tax on inputs from tax on sales for each text period is allowed. Most of the countries use this method of computation of VAT which is also known as **invoice method**.

4. Today, more than 160 countries have implemented VAT system for taxation and the global experience indicates that the VAT system is the most effective mechanism to raise revenue with efficiency. The consumption tax on goods and services on the basis of value addition is known as VAT or GST. Different countries have different forms of GST which arise because of Constitution of the country, objective reality of history and politic of the member countries. GST model followed in Singapore, Australia, Denmark and New Zealand has a

single rate with broad base. The single rate structure is generally considered to be an ideal system and mostly recommended by the experts due to its simplicity, administration, transparency, fairness. However, single rate of taxation may not protect and ensure the interest of some select group like economically weaker section of society or certain basic commodities like food and medicine, etc., Most of the EU countries have a standard rate with certain exemptions. In EU about one third of the tax base is subjected to constant rates including zero rates.

5. India has been rather slow in the adoption of VAT due to federal features of its indirect tax system. While the Union government has the authority to impose a broad spectrum of excise duties on production or manufacture, the States are assigned the power to levy sales tax on consumption. In addition, States are empowered to levy tax on many other goods and services in the form of entry tax, octroi, entertainment tax, electricity duty, motor vehicles tax, passengers and goods tax, and so on. This dichotomy of authority under the Constitution has created an obstacle in introducing European-style VAT in India, although over the years, tax reform committees[23] have recommended that union excise duty, sales tax, and other domestic trade taxes be replaced by a comprehensive VAT that could tax all commodities and services. Currently, a system of dual VAT exists: Cenvat at the central level, and state-VAT at the state level which are existing independently.

6. Cenvat

(a) In 1986, for the first time, reforms were initiated in the basic excise duty through the introduction of modified value added tax (Modvat). This provided for set-off for taxes on inputs. Initially, it was introduced for a selected number of commodities. The coverage was

[23] Tax Reform Committee (2002), and, Report of Task Force on implementation of the FRVM(2004)

limited to 37 chapters out of a total of 91. This form of VAT was not fully called as VAT and some critics have said " The so-called Indian MODVAT is not VAT at all, but rather a form of modified excise duty. The MODVAT is essentially manufacturing excise tax with credit allowed for excise duty and customs in a limited number of industries, introduced mainly with a view to eliminating cascading effect of multipoint excise levies"[24]. Over time, Modvat was extended to some additional commodities. Finally, it was extended to almost all commodities except light diesel oil, high-speed diesel, motor spirit (gasoline-as input only) and matches (as final product. MODVAT was replaced by Central VAT (known as Cenvat) through the Budget 2000-01. The existing rate under Cenvat is 12%.

(b) The Cenvat Scheme allows instant credit for basic excise duty (BED), special excise duty (SED), Additional Duty of Excise (ADE) and countervailing duty (CVD) paid on inputs and capital goods received in a factory for the manufacture of any dutiable final products. The credit could be utilized to pay excise duty on any final product. That is, all raw materials or inputs are covered except light diesel oil, high-speed diesel and motor spirit (gasoline). Similarly, credit could be availed on capital goods including pollution control equipment, components, spares, accessories, moulds and dyes and paints, packaging material, greases/coolants and fuels. Through the introduction of Cenvat, credit can be taken by the manufacturer immediately on receipt of eligible and duty-paid goods in the factory. There is no need for the manufacturer to file any declaration or obtain any permission. For capital goods, however, only 50% of the duty paid on the goods can be availed of in a financial year; the remaining credit can be claimed in the next financial year, provided the goods are still in use (except for spares and components, refectories, moulds and dies). Further, no depreciation should be claimed by the manufacturer under Section 32 of the Income Tax Act,

[24] Tait, Alan, (1988)

1961 on that part of the value of these capital goods that represents the amount of duty paid on such goods. A manufacturer who manufactures only tax-exempt final products is not allowed to take this credit. However, a manufacturer producing both dutiable and exempted final products in the same factory is eligible to avail of its benefits subject to certain conditions *viz.*, maintenance of separate records in respect of inputs used for manufacture exempted products or payment of 8% of the total price (excluding all taxes) of the exempted final products or in the case of a few specified items, on reversal of the credit availed. Similarly, credit can be availed of on capital goods, if not used exclusively for the manufacture of exempted final products.

© The scheme of Cenvat, *inter alia,* provides the following facilities:

i. removal of inputs or capital goods as such on payment of an amount equal to the credit availed in respect of such inputs or capital goods;

ii. removal of goods to job-workers for processing, testing, reconditioning or for any other purpose provided that the goods are received back within 180 days or are removed from the premises of the job-worker;

iii. refund of credit accumulated due to export under bond of the final products is also permissible;

iv. unutilized Cenvat credit can be transferred on account of shifting of a factory to another site or due to change in ownership by sale, merger, amalgamation, lease or transfer to a joint venture wherein liabilities are also transferred; and

v. a special dispensation has been made in the case of goods manufactured in specified areas of the North-East, Kutch district of Gujarat, state of Jammu & Kashmir and State of Sikkim. The manufacturer should take reasonable steps to ensure that the appropriate duty has been paid on inputs

or capital goods on which credit is availed, as indicated in the documents accompanying the goods.

(d) Administrative Controls under Cenvat

The administrative controls under Cenvat is described below:

a. ***Self-Assessment Procedure:*** Under this procedure, earlier known as self removal procedure, the assessee assesses the duty liability himself and pays it to the account of the government on monthly basis.

b. ***Physical Control System:*** This is the oldest form of procedure under the Union excise duty. Under this system, there is an assessment of tax by the Central Excise Officer posted at the factory, before the removal of goods. This system is now restricted to cigarettes only.

c. ***Compounded Levy Scheme:*** This procedure is meant for small-scale decentralized sector and till recently covered stainless steel and *Pattis/Pattas* and aluminium circles. Now it has been introduced on Pan Masala Under this scheme the duty for a specified period is fixed on the basis of the number and type machines. Payment of tax under this procedure absolves the manufacturer from observing day-to-day formalities of Cenvat regarding maintenance of accounts and removal of goods etc.

(e) Obligations under Cenvat

Since a significant volume of manufactured goods are covered under the self removal procedure and the benefit of Cenvat has been extended to all of them, the procedure provided for certain obligations on the part of manufacturers and dealers. These are:

Declarative Obligations:

The administration of Cenvat requires various declarative obligations as given below:

i. ***Tax Payer Registration:*** Every manufacturer of excisable goods (except small-scale manufacturer) is required to get him registered before the commencement of production. Registration is valid for the premises it is granted. If a manufacturer desires to start production of a new product he should get his registration duly endorsed to this effect. Since 1994, wholesalers *(i.e.,* dealers who intend to pass Cenvat credit to its buyers), are required to be registered.

ii. ***Issue of Invoices:*** An invoice must accompany the consignment, each time the goods are transported from the factory to the godown of the manufacturer. To keep track of the clearance of goods from the factory, each page of the invoice book should be pre-authenticated by the owner or working partner or the Managing Director or Company Secretary or any other authorized officer of the assessee and be serially numbered in the book and the numbers intimated to the Superintendent of Central Excise in advance. It is provided that the Cenvat credit could be taken through the invoices issued by the first and the second stage dealers of excisable goods only. The credit cannot be taken on the basis of the invoices that are issued by the third and the subsequent stage dealers.

iii. ***Monthly Return:*** The manufacturer is required to pay Cenvat on a monthly basis and submit a monthly return (ER1) to the Superintendent of Central Excise by the 10th of the month following the month during which duty was paid. Manufacturers availing of the small-scale exemption, based on

value or quantity of clearances during a financial year, need to file their returns only on a quarterly basis.

Accounting Obligations :

With the introduction of Cenvat, maintenance of statutory accounts has been done away with. However, the manufacturer is required to maintain his records regarding receipt, disposal, consumption and inventory of goods containing relevant information. If Cenvat credit is taken or utilized wrongly, the same, along with interest, will be recovered and, if the same involves fraud, willful mis-statement, collusion, suppression of facts or contravention of the provisions of the Act or the Rules, mandatory penalty and interest will also be attracted. Manufacturers who are to pay duty on the final products cleared by them can pay duty in cash or through the Cenvat credit.

(f) Audit and Special Audit: The central excise department carries out audit of all the units engaged in the manufacturing activities and required to pay the Cenvat. During the course of audit, the team members look into the various records maintained by the manufacturers or dealers. If during the course of audit, discrepancies are found the unit, they are required to make the payment of the duty evaded.

(g) Weaknesses of the System under Cenvat

Though VAT, in one form or another, has been in operation at the centre of last 22 years, yet there are certain flaws in the system which still has the cascading effect of taxation:

i. Non inclusion of several central taxes on the overall framework of Cenvat, such as, additional customs duty, surcharge, etc

ii. no serious steps have been taken to capture the value

added chain in the distribution trade for the majority of goods below the manufacturing level in the existing scheme of Cenvat

iii. un-organized sector, which contribute significantly to the GDP of the country, continued to remain out of the Cenvat
iv. Cenvat has not been extended to all commodities and there are some goods which are outside Cenvat scheme
v. misuse of Cenvat scheme because the absence of cross verification
vi. lack of computerization of data relating to invoice in the central excise offices
vii. misuse of facility of deemed credit

7. State VAT

(a) A variety of taxes on commodities and services are levied by the State Governments under the authority available to them under the State List. The most important of these are sales tax, state excise, motor vehicles tax, passengers & goods tax, entertainment tax, electricity duty and octroi. Until recently, sales tax was the most important tax on commodities levied by the States. Most of the States used to levy sales tax on the first point of sale, which is on the sale made by the manufacturer or the wholesaler. Some of the States levied tax on the last registered dealer (known as the last-point sales tax) who sold commodities to the consumer or to the unregistered dealer. The state taxation system also suffered from much deficiency. The foremost deficiency was related to its cascading effect. The sales tax was levied on the gross value without allowing any credit or set-off for the taxes paid on inputs (i.e., tax is levied on gross value at the successive stages). Besides, there was multiplicity of rates, some having as many as 17 categories.

(b) The Committees of States' Finance Ministers (in 1995 and 1998, respectively) and of the Chief Ministers (in 1999) have put forth

recommendations to replace sales lax by VAT. The Conference of Chief Ministers and Finance Ministers ratified this on November 16, 1999. In this Conference, the Chief Ministers and Finance Ministers have resolved to recommend some major reforms that have already been implemented. Also, to oversee that the reforms recommended by the Conference are implemented, the Central Government appointed a Committee of States Finance Ministers. This Committee has played an important role in implementing the reforms and in introducing VAT at the sub-national level. The first reform related to the adoption of a four-rate structure (i.e. zero, 4, 8 and 12 percent) in the then existing sales tax. In addition, there were two special rates of 1 percent and 20 percent for a few specified items. The recommended rates were floor rates - the States had the freedom to adopt higher rate on any of the commodities from the list. This checked the rate war and prevented diversion of trade.

(c) The recommendation of Empowered Committee has been implemented by the States in the country replacing their sales tax with VAT. Haryana was the first State to replace its sales tax by value added tax (VAT) on 1st April 2003 and Uttar Pradesh was the last state to have implemented from 1st January 2008. The system of state-VAT, as implemented in the states, follows three-rate structure: 0%, 4% and a standard rate of 12.5% with some exceptions. Gold, silver, precious and semiprecious stones have a VAT rate of 1% and liquor has a higher rate of 20%. Zero rate is applied to a large number of commodities. A perusal of the items falling in this category indicates that it includes:

i) natural and unprocessed products - which are in the un-organized sector (such as betel leaves, earthen pot etc.);
ii) items which are barred from taxation on sale (such as newspaper, national flag etc.); and
iii) items which have social implications (such as books, periodicals, slate, slate-pencils etc.).

Four percent is applicable to a very long list of items. This category includes items falling in the category of:

i) essential commodities (such as branded bread, bulk drugs, paper etc.),

ii) declared goods (such as iron & steel, hide & skins etc.),

iii) industrial and agricultural basic inputs (such as printing ink, coir, *beedi* leaves, fibres, seeds etc.), and ;

iv) capital goods.

8. The experience in governance of State-VAT

It is about three years that the VAT had been in operation in States and the experience gained so far is summarised below:

i. At present, information of VAT of an individual assessee is dealt separately and it may not be possible to effectively compile and process the data for an effective monitoring. It is required to operate State-VAT through a single master file, based on unique tax identification number (TIN). The TIN should bear an economic activity code based on International Standard Industrial Classification (ISIC). In addition, the TIN must have feasibility for comparison among different taxes such as State-VAT, Cenvat, and income tax (including tax on corporate income). The TIN would also aid in drawing a comparison of tax statistics with the national accounts. This would facilitate proper use of the database of various systems.

ii. To have an effective and efficient governance of State-VAT, a prerequisite is to adopt suitable computational technology. It is absolutely necessary that a requisite system, suitable to the structure and administrative requirements of each State be selected and implemented.

iii. Proper co-ordination among the States to adapt according to their requirement of software. Pooling their resources for

developing requisite software programs could be cost effective.

iv. In most States training of the personnel needs prioritization. The staff to administer existing sales tax is not adequately trained. The training is all the more crucial when it comes to administering VAT.

v. Assessment is an important function in the overall functioning of the taxation department. At present all the dealers are called into the office of the sales tax with books of accounts. This procedure is not cost-effective. One should switch over to a system of selective assessment. Selection of cases for assessment has to it made in accordance with various criteria, such as, size, turnover, and risk evaluation.

vi. Dealers especially dealing mainly in exports requiring refund should be properly scrutinized.

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