

# Financial Liberalisation with Reference to Value Added Tax (VAT)

Author : CA A. K. Jain

## 1. Introduction

Value Added Tax is emerging as an effective tool of taxation in the hands of Governments internationally. In fact more than 100 countries around the world have accepted this as a way of taxation on commercial activities. Our neighboring countries like Bangladesh, Bhutan, Nepal and Pakistan have already recognized VAT. Developed countries including Australia, United States, USSR, UK have already introduced VAT successfully.

## 2. Indian Scenario

In Indian context of indirect tax system, the Central Government has the legislative powers to impose excise duties (CENVAT) on production and the states are empowered to levy sales tax on consumption. In addition, states are also authorized to levy tax on goods and services in the form of entry tax, entertainment tax etc.

With the acceptance of VAT by the central and state governments, India would have a system of dual VAT; a CENVAT levied by the Union and a state VAT by the states. Successful implementation programme of VAT will replace sales tax at state level and excise and central sales tax at central level.

## 3. VAT & Its Necessity

VAT is a multi-point tax system but without the effect of double taxation. Tax is chargeable at rate prescribed at each point of sale. In Valued Added Taxation system, the tax is calculated at different points of production and distribution of a commodity. It is collected in installment on the basis of value added at each point of production and distribution. Since an input is taxed only once VAT avoids the cascading effect, which is the chief demerit of a generalized system of taxation i.e. excise and sales tax.

There are several objectives associated with VAT, foremost being its revenue raising quality, due to inclusion of items such as wages, interest, profits etc. in its base. It shall also bring in more discipline in the indirect tax regime. It is also imperative that VAT will take care of the demerits of the existing system.

## 4. Calculation of Tax

For the calculation of tax payable on a service or commodity under this system, it is necessary to measure value added at each stage of manufacture and distribution. Three methods are generally prevalent to determine the differential values at each stage.

A. Addition Method: This method is based on the identification of value-added, which is arrived by summation of all the elements of value (i.e. wages, profits, rent and interest).

B. Subtraction method: The subtraction method estimates value-added by means of difference between outputs and inputs.

C. Indirect Subtraction Method: The indirect subtraction method entails deduction of tax on inputs from tax on sales for each tax period. This method is also known as tax credit method or invoice method. In practice, most countries use this method and employ net-consumption VAT. Tax Credit Method to avail VAT has been accepted by the Committee of the State Finance Ministers. Under this method, credit is allowed for tax paid on all the purchases and inputs made and adjusted to extent permissible against tax charged on sales.

#### 5. Merits of VAT

Application of VAT is expected to reduce harassments and corrupt practices. Since, it is expected that the provisions of VAT will reduce multiple taxation it will make our domestic industry more competitive at international level. This will also help better tax compliance and increase in net revenue collections. Even the lower rate of taxation is expected to bring higher revenue due to large base. The transparency in the system of collection will further help the government and the industry in their day to day working.

#### 6. Problems During Switch Over

In the initial years of change to this system the states have the fear that their revenues are likely to suffer due to lower rates, probably this is the main reason for their reluctance to accept VAT. Now its being agreed by the central government that it will compensate the states for the revenue loss suffered on account of implementations of VAT. However, it is quite likely that some of the economically weaker states offering Sales Tax based incentives to attract investment may suffer by implementation of VAT as exemptions will be withdrawn. While the manufactures appear to be happy with this change but, how far VAT Regime gets endorsement from the trader community is a question mark. Some of their apprehensions are genuine and ought to be addressed. It is essential that uniformity in rates in the schedules / classification of commodities / nomenclatures on all India basis is introduced. Disparity shall encourage cross border smuggling of goods between neighboring States. Piecemeal implementation of VAT i.e. in some States first and in others later will not render full benefits of VAT. The target should be to cover the whole country so as to include credit for inter-state purchases and tax on services.

#### 7. Special Additional Tax

Some states have proposed to make good the loss of revenue due to implementation of VAT by creating Special Additional Tax on certain selected items. Such provision shall permit the States to exercise discretion to include any particular item under SAT, which shall give rise to non-transparency. Moreover rates of such items in various states shall not be uniform. Therefore, it shall defeat broader principle of uniformity of rates in Sales Tax.

#### 8. Necessity of Computerisation

For the smooth and successful adoption it is utmost important that all governments revenue records and business accounts are effectively and efficiently computerized. Government will also implement a scheme of PAN No. for every business.

## 9. DELHI VALUE ADDED TAX

### 9.1 Similarities to the Present System

Presently, Delhi is levying Last Point Sales Tax or Retail Sales Tax on many items, and as per economics, it is nothing but another form of Value Added Tax. Under the present system, an Inter-State Seller or Exporter is allowed to purchase his inventory, without payment of tax, against ST-1 or ST-35 Form. In VAT system, he has to purchase after paying local tax, but this tax paid on purchases is fully set off from his Central Sales Tax Liability. In case his CST liability is less than the local tax already paid, the net can be adjusted against his other VAT liability or can be claimed as Refund.

Similar is the case of Manufacturers - rather than purchasing without payment of tax against ST-1 / ST-35 Form, Local Tax is levied on purchases, and an equal amount is allowed to be set off against the Sales Tax liability on finished goods.

Therefore, changeover to VAT system is change in local sales tax collection procedure only. From the point of view of the seller, present arrangement of "not subjecting certain transaction to tax (like RD sale, sale of raw material to manufacturer, sale to inter-State seller etc.)" will change to "Subject all transactions to tax, but refund / adjust the tax so levied to the purchasing dealer". In other words, from the point of view of the purchase, he will not be able to "purchase tax free against forms", but an "purchase tax paid and take set-off." Although, it does not make any difference to the tax-payer, but the beauty of this system is that since all local sales are subject to tax, there are non Local Statutory Forms.

In the present system, many traders dealing in goods that are distributed from Delhi are facing problem of double taxation because of withdrawal of footnote facility. VAT solves their problem too. The entire local sales tax levied on the purchases of an Inter-State Exporter is allowed to be set off against the Central liability. Hence, no double taxation. In VAT, like in present system, no Local Sales Tax/VAT is levied on Inter-State Sales or Exports. Similarly, in case of inter-State purchase or imports, no set off is given because no local tax has been paid on such transactions. Manufacturers of exempted goods are presently not allowed to purchase their raw materials against forms. Similar would be the case under VAT. They will not be allowed to take tax credit for goods purchased for use in manufacture of exempted commodities.

### 9.2 Differences as compared to the present system

In VAT system, all local sales will attract VAT liability. There would be no difference whether one is selling to another dealer or to the consumer. The same tax, equal to the rate of tax applied on the sale price, is to be charged. In present system, whatever tax charged is to be paid to the department, however, in VAT system, from this tax charged from the customer, he deducts the tax already paid on the purchase, and pays the rest to the Department. Present system does not allow Capital Goods, such as machinery, to be purchased against local forms. However, in VAT system, tax paid even on machinery is allowed to be set off.

### 9.3 Book Keeping, Forms & Returns

The present system requires the dealers to maintain account of Sales and Purchases. Calculation of VAT also requires maintenance of such accounts and nothing more. There are no local statutory forms under VAT. However the central statutory forms will remain as it is. There would be a single - page return form, common for Local & Central Acts. The return would be required to be filed quarterly, as is being done today. It is proposed that following documents will be required to be filed with return:

- A. Proof of payment (C portion of challans),
- B. Dealer wise statement of Central RD sales, against C/D/F/H Forms.
- C. Dealer wise statement of purchases during the quarter, for which tax credit has been availed.
- D. Pre-utilisation account of C/E/F/H Forms with the last quarter return.

### 10. Conclusion

Effective management of VAT will do away with multiple levies like Entry Tax, Turnover Tax, Additional Sales Tax, Surcharge, CESS, Octroi etc. There is no place for any other kind of taxation. One window tax reduces the collection cost to the States with easy compliance by taxpayers. In view of the anticipated advantages over a period of time all states and Union Territories including special category states have in principle agreed to shift to VAT from April 1, 2003. However, some of the states are still attempting to push forward the deadline as this will allow all states to effect the transition to VAT at the same time. This will also provide some more time to the central government to amend central sales tax act, bring legislative changes for implementation, taxation of services at state level and settlement of procedure for compensation to states on account of losses in revenue collection due to implementation of VAT. The delay would also give the states more time to put administrative arrangement into place and training employees for the new system.

Clearly, there is a need to popularise the scheme of VAT through persuasion, allaying the genuine fears of all the parties. New regime will be theoretically superior to the existing regime known to all. If effectively implemented, it will ensure greater transparency. It will also have the great merit of being simpler to monitor. Even from the revenue angle, it should increase the revenue in the hands of the State Governments. However, it is feared that in the first few years of VAT, the State Governments might face shortfall in revenue.

Author : CA A. K. Jain

**Tapuriah Jain & Associates**

Chartered Accountants

21., Skipper House, 9, Pusa Road, New Delhi - 110 005

Tele : 91-11-28754012 & 13, Mobile : 91-98-100-46108, E-Mail : [caindia@hotmail.com](mailto:caindia@hotmail.com)