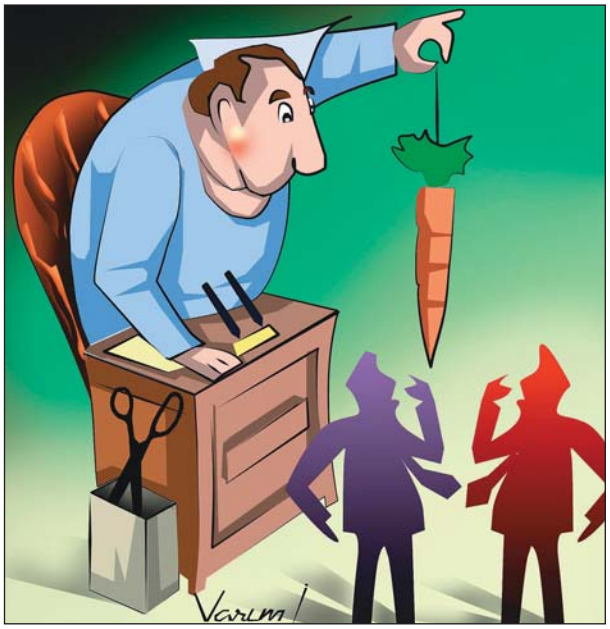
Salient Features of VAT Analysed With Sales Tax Law

The VAT law should be interpreted in its widest amplitude to ensure that its objective is met. The principle of *utres magis valeat quampareat* which means "it is better for a thing to have effect than to make it void" should be kept in mind so far as implementation difficulties pertaining to VAT are concerned. This article highlights the salient features of VAT vis-à-vis Sales Tax Law.



FR Singhvi

S Venkataramani

The journey of sales tax, which has moved towards the Valued Added Tax (VAT) regime, started way back in 1938 in Madhya Pradesh in the form of "Petrol Tax". This was only a selective sales tax. Tamil Nadu was the first State to introduce a multi-point sales tax in 1939.

Close on the heels of Tamil Nadu, many States resorted to this form of taxation during and after the Second World War. As there has been no specific rationale behind a particular form of sales tax structure the models adopted earlier underwent changes. As the States adopted a particular structure of the tax without giving thorough consideration to its economic rationale, difficulties were faced in the administration of the tax. Also, it was overlooked that the economic circumstances of different States were not homogeneous: trade diversion, opposition from trade organisations, problems of inter-State trade and double taxation were experienced by many of the States. While some of the problems were sorted out in the State Finance Minister's Conference held in 1948, the Constituent Assembly incorporated some of these problems in the Constitution.

Each State tried to subject under its law, the same transaction to tax on the nexus doctrine. A contract of sale comprises of various stages or elements, such as agreement to sale, transfer of property in goods, transportation, delivery, payment of consideration, etc. It is possible for any of the elements in a contract of sale to be distributed to more than one State. Each State relied on one or more of such elements as having a territorial nexus and brought the sale to tax. The Supreme Court upheld the levy of taxes by different States on the basis of nexus theory. Subsequently some judgments were reversed causing confusion and warranted refunds from the State (Ref: cases of United Motors, Bengal Immunity, Larsen & Toubro, etc.), ultimately resulting in introduction of Central Sales Tax Act, in 1956. It is during the same time that VAT was born. Had the Government looked into VAT which was by then enacted in France in 1954 rather than Central Sales Tax (CST) the story of businesses, tax evasion, etc., would have been very different.

The law of CST which is a origin based tax, took India away from

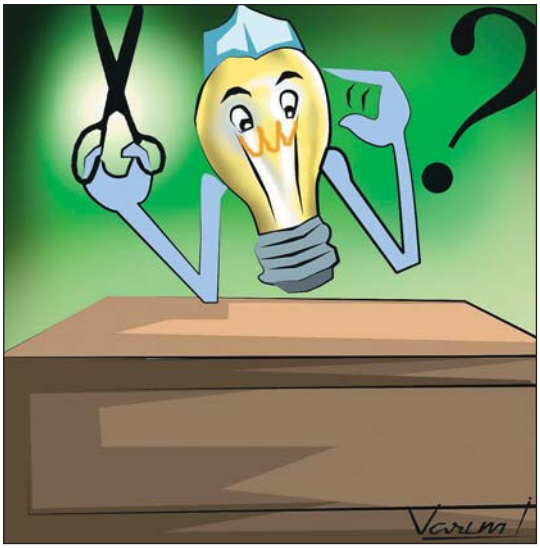
The authors are Members of the Institute. They can be reached at frsinghvi@sduca.com and venkat@sduca.com respectively

VAT which ideally must be destination based. The Government had proposed CST Act only as a regulatory law with zero tax rates to ensure that inter-State sales are not taxed by the Origin State. This is the basis of VAT, which got defeated by the CST Act.

Till early 1980's sales tax was a multipoint levy with no set off and this in turn, drove up the prices of goods on account of cascading effect of taxes. The States found it difficult to justify multipoint tax at the high rates of tax and secondly found it difficult to manage the increasing numbeer of assessees. It therefore, resorted to single point tax system at higher rates of tax to generate the required revenue. This was the second major step which created further distance/difficulty for introducing VAT in our country. Had the government introduced the concept of setoff to the existing multipoint tax system rather than going in for single point tax system, we would have had a major concept of VAT into our Sales Tax Law much earlier.

The government has emphasised the need for buoyant revenues to satisfy the State's requirements of funds for its developmental activities. The system of sales tax is highly saturated, addresses only limited resource mobilisation capabilities and does not lead to tax buoyancy except when tax rates are enhanced. In the event, the tax rates are enhanced the industry is adversely affected leading to flight of trade, evasion, suppression and unhealthy competition among States. States studied the impact of sales tax system and felt the need for reform to the sales tax system of taxation. Therefore, VAT was the answer.

The present framework of the Constitution empowers both the State and the Centre to levy indirect taxes on trades and services. This dichotomy gives room for varied taxes and tax structures. Such variety invariably brings with it the difficulties in administration and gives room for tax evasion. Over the years, Tax Reform Committees have recommended a comprehensive VAT that could tax all commodities and services replace central excise duty, sales tax, and other domestic trade taxes. However, due to this dichotomy of authority under the Constitution, India has been rather slow in the adoption of VAT and has created an obstacle in introducing the European-style VAT in India.



The interim report of Dr.Raja J. Chelliah Committee in December 1991, stated:

A comprehensive value added tax (VAT) covering sales of most goods (except those by agriculturists) and many services, should be levied at a single rate or at a few rates. Tax theory and international experience indicate that this constitutes the best "neutral" way of raising the bulk of the indirect tax revenue. A single – rate tax is the easiest to administer; a tax with two or three rates would be manageable. The VAT will apply to domestic products as well as imports, but exports will be exempt.

The federal form of Government, single point tax system, CST rate at 4% kept the above recommendation in cold storage till 1999. The formation of Empowered Committee of State Chief Ministers in 1999 opened up the subject of implementing VAT. Although a single VAT covering both the Centre and States will be an answer, we headed for a State based VAT regime wherein CST Act will continue to regulate and levy tax on inter-state movement of goods.

The continuance of CST, which approximately generates Rs.15000 to Rs.17500 crore (Rs.13590 crore for 2000-2001 Source: RBI Bulletin, March 2002), will hinder and stunt growth. While the European Union is talking of set-off provisions across countries, we fail to understand why the Central and State Government cannot take a bold initiative of abolition of CST or at least think of set-off provisions for inter-State movement of goods. Assuming that abolition of CST will result in loss of revenue of approximately Rs.15,000 crore one has to bear in mind the buoyancy that VAT regime will bring in, which will offset the loss. Therefore, CST is a small price to pay to make India globally competitive. It is for these reasons that the trade, industry and academicians firmly believe that CST law should not be continued in the VAT regime and allow free movement of goods without having a cascading effect of tax on cost of goods.

The continuation of the CST levy defeats the very objective of VAT law. Among others, the following advantages are likely to accrue on abolition of CST in a VAT regime:

- Free movement of goods in the course of inter-State trade or commerce
- Cascading effect of taxes will be curtailed.
- Will reduce tax induced distortion on account of vertical / horizontal integration
- Will give way to transparency in tax while introduction of VAT in its pure form
- Decreases incentive for evasion of taxes due to its self-policing nature
- Generates buoyant revenues due to levy of tax on value addition at each stage
- Will reduce a lot of paper work like issue / receipt of forms, etc. The invoice itself can act as a document for claiming setoff / proof of inter-State purchase, etc., ensuring smooth and speedy administration.

The Central Government has announced abolition of CST over a period of 3 years with no change in rate in the first year. However, had the Government reduced the CST rate to 2% immediately and thereafter abolished in the subsequent year we would have witnessed:

✓ Better compliance as trade and industry will not look at tax planning avenues such as branch / stock transfers and consignment sales. This will ensure buoyancy in revenue.

✓ The loss of revenue to the exchequer on account of reduction in rate of tax from 4% to 2% will be offset by higher compliance and it will improve the confidence of taxpayers towards the proposed reforms.

In case the above options are not acceptable to the Government, then the CST paid on purchase must be allowed to be set-off in a VAT regime in the destination State. It will not be a burden on the States to absorb this 2% set-off considering the buoyancy in taxes that a VAT regime will generate and the transparency that it will create.

VAT vs. Sales Tax

VAT an abbreviated form for Value Added Tax is to be understood as "the value that a producer (whether a manufacturer, distributor or advertising agent) adds to his raw materials or purchases before selling the new or improved product or service. VAT in simple terms could be defined "as a tax on the value addition at different stages of manufacturing and distribution of goods and services". It is a broad based form of indirect tax, in the nature of a multi-point sales tax (exports being zero rated) with a set off or credit for tax paid on purchases/services. Each transaction of goods sold in the course of business is taxed, thus providing revenue to the government on value addition at each stage. On account of set off being provided on preceding purchase, cascading effect on the cost of goods is avoided. It is a self-policing and transparent system of taxation reducing the scope for tax evasion wherein the administration will be highly automated.

Sales Tax is narrow based single point taxation system with no setoff benefits. IT Requires intensive check / control by the Department and is not transparent as the tax gets added to the cost of goods. It is not neutral and the incidence of tax increases in a horizontal form of business. Cost of goods exported includes element of sales tax paid on purchases. In this system the administration is highly manual.

1. Registration:

In each State there is a threshold limit varying between Rs.1 lakh to Rs. 5 lakhs for all dealers. Certain classes of dealers or contractors whose taxable turnover exceeds the prescribed limit in a month and dealers involved in interstate trade, import or export taxable goods, commission agents, casual traders, non resident dealers are required to mandatorily register without any threshold limits. Voluntarily registration is permissible.

In the sales tax regime the threshold limits are lower and registration formalities were almost similar to the VAT laws.

I. Incidence, levy and collection of taxes under VAT law

Every registered dealer or a dealer liable for registration is required to pay tax under the VAT Act on sale of goods at the specified rates. A registered dealer is also liable to pay tax on goods purchased by him from an unregistered dealer for use by him in the course of business. The multipoint levy is on a transaction of sale of taxable goods governed by the relevant schedule. Taxability of Agency transactions is more or less similar to taxability of such transactions under the existing sales tax laws.

Sale of goods, which are exempt from payment of tax under the Act, will either be notified or stated separately in the relevant schedule to the Act.

Export sales are "Zero rated". This means that export sales are exempt from payment of tax and input tax paid in respect of such exports is permitted to be set-off.

Every registered dealer effecting sales of taxable goods is required to collect taxes separately in the Tax Invoice and reflect such taxes collected separately in the books of accounts.

The Central or State Government, Local Authority or a Statutory Body is required to collect and remit taxes as prescribed under the Act and issue Tax Invoices / Sale bill as the case may be on effecting such sale.

Sales tax is generally single point in nature with no setoff facility and was generally payable on sale by a first dealer in the State and in some cases payable by the last dealer in the State. The rate of tax were governed by schedules / notifications. Collection of taxes on sale was optional. Though the exports sales exempt the tax on the inputs are refunded or set-off as in case of VAT.

Composite dealers are registered dealers under the VAT law who have opted to pay tax on their sales at flat rate as provided in the respective State VAT Acts, provided their turnover do not exceed the specified limits. Such dealers are neither permitted to issue Tax Invoice (tax collection denied) nor can the buyers avail set-off on such tax-suffered purchases.

II Input tax, Output tax, Net tax and Input tax restrictions

VAT is based on the premise that where the output is taxable or is 'zero' rated, taxes paid on related inputs will be set-off. If the sale of a particular commodity is exempt from payment of VAT, set-off benefit of taxes paid on inputs is denied. In this context it is relevant to understand what Input tax, Output tax and Net tax mean.

- **Input tax** is the tax paid by a Dealer on purchase, from a VAT-registered dealer in the same State (CST paid on inter-state purchase is not reckoned as input tax), of goods that are normally used for manufacture or processing or resale. It also includes tax paid on capital goods purchased (subject to the prescribed conditions) and on stock / inventory (subject to the conditions prescribed) held on the date of commencement of the VAT Act. Input tax also includes the tax paid by an Agent on purchases effected on behalf of a Principal subject to certain conditions. Some States consider the tax paid by a VAT dealer on purchases effected from unregistered dealers as input tax. However, the said tax paid on such unregistered dealer purchases are permitted to be set-off only when such goods are either traded or are used in the manufacture or processing of goods and thereafter sold locally / in the course of interstate trade or exported.
- **Output tax** is the tax payable by a Dealer in respect of sale of goods. It includes the tax payable on taxable sales effected by a Commission Agent on behalf of his Principal subject to the condition that such Agent issues the relevant declaration to his Principal.
- **Net tax** is the amount of tax payable by a Dealer after setting off the Input tax with Output tax in the manner specified / prescribed.
- The input tax credit will be available for set-off on tax payable against local and inter-State sales. Input tax paid on purchases will be eligible for refund in case such goods are either exported or the goods manufactured out of such purchases are exported outside the Country or the rate of tax on final product is lower than that of rate of tax on its inputs.
- Tax paid on purchase of notified/specified capital goods which are used in the business is eligible for input tax setoff as prescribed or immediately and from the date on which such capital goods are put to use, depending on the value of Capital Goods, to be notified by the States.
- In respect of goods that are manufactured and stock transferred outside the State, input tax paid will be eligible for set-off in excess of 4%. Some States have denied input tax setoff fully on stock transfer of traded goods.
- If dealer is engaged in the business of sale of taxable goods and exempted goods, proportionate set-off of input tax relating to taxable sale will be permitted. Some States have evolved suitable formulas to compute such proportionate tax.
- Tax paid on opening stock of goods held on the date of commencement of the VAT Act will be eligible for set-off subject to the conditions stipulated in the transitional provisions of the Act/Rules. It is understood that such set-off will be allowed to dealers after a 3 months freeze

over a period of subsequent six months.

- Input tax credit can be availed by a dealer provided, he has in his possession the relevant Tax Invoice/Debit Note/Credit Note. In respect of tax paid on unregistered dealer purchases the dealer is required to have in his possession the relevant proof of payment of such taxes.
- The Net tax payable is to be remitted each month after appropriate set-off. However, where the Input tax exceeds Output tax, the dealer would be entitled to a refund/carry forward as prescribed.

Each State has restricted set-off of input tax in certain circumstances. Some instances in certain States where corresponding input tax cannot be set-off in computing Net tax are:

- If the sale (output) other than exports is exempt from tax;
- When traded stocks are transferred to a branch or to an Agent outside the state;
- On capital goods and other goods which are notified / specified specifically;
- On purchase of petroleum products for use as fuel for motor vehicles;
- If the Input goods are lost or destroyed or their usage is changed the reversal of set-off shall be at the prevailing market price;
- On goods purchased from a dealer who is liable to register but has failed to register;
- Free supplies / barter etc., will not attract any tax since there is no sale involved.
- Input tax, in excess of 4%, paid on petroleum products (for use other than as fuel for motor vehicles) can be set-off in computing Net tax.

Certain goods are kept outside the purview of VAT regime viz., Petrol / Diesel etc., which is likely to suffer tax under the general sales tax laws of the appropriate State. VAT laws do not envisage that taxes paid under the appropriate general sales tax laws for the purpose of set-off.

Apart from what has been discussed above each State has enacted provisions restricting the input tax set-off in a number of circumstances. One has to peruse such Acts carefully prior to claiming set-off / rebate. For instance the draft VAT Act of Tamil Nadu does not provide of input tax set-off on purchases in case of a works contractor although deduction is permissible (on purchase value) while computing the taxable turnover in respect of purchases effected from local registered dealers.

The Central Government has announced abolition of Central Sales Tax (CST) over a period of three years with no change in rate in the first year. However, had the Government reduced the CST rate to 2% immediately and thereafter abolished in the subsequent year would have witnessed better compliance.

Sales tax is a single point taxation system with tax on sale to be paid by a first dealer in the State. Some States had a system of setoff facility of tax paid in respect of certain raw materials that are used in manufacture of goods. Goods exempt from payment of taxes were generally governed by notifications or separate schedules.

III. Rates of taxes

In VAT there are 4 schedules with four rates namely 0, 1, 4 & 20 percent with a revenue neutral rate of 12.5% payable on sales. These rates and schedules are common to all States, thereby substantially reducing the litigation with regard to rate of tax and classification and also reducing the imbalance in different States on similar goods on account of tax rates. Specified / notified industrial are taxable at 4% with setoff facility.

Sales tax law - the point for levy of tax and the rate are specified in the schedules (up to 8 Schedules) to the Act. There are over 10 rates taxable at different point (more than 3). These rates, the point of sale and the description of goods vary from State to State. Specified/notified industrial inputs were taxable at rates varying between 2% to 4% with a setoff facility in certain States.

IV. Composite dealers

Composite dealers are registered dealers under the VAT law who have opted to pay tax on their sales at a flat rate as provided in the respective State VAT Acts, provided their turnovers do not exceed the specified limits. Such dealers are neither permitted to issue Tax Invoice (tax collection denied) nor can the buyers avail set-off on such tax-suffered purchases. Dealers in liquor are not permitted to opt for payment of tax under the composite scheme. In case, their turnovers exceed the specified limits they may have to get into the regular VAT scheme prospectively. Works contractors, Hoteliers, Caterers and small dealers permitted to opt for composite method of payment of tax.

In Sales Tax law the provisions relating to the Composition dealer are similar to that of VAT laws.

V. Setoff of tax paid on Capital Goods

Capital goods are defined under the respective State VAT Acts and all capital goods barring the capital goods speicified in the schedule V are eligible for setoff of tax paid, provided such goods are used in business other than for re-sale. Setoff is allowed only after commencement of commercial production on filing of the specified Form within the prescribed time. Units are engaged in manufacture and export wholly or partially, are eligible for setoff in first month when export is made and in other cases where the value of the capital goods exceed the specified limit the tax paid will be set-off over a period of 1 to 3 years as provided in the VAT law of the different States. If capital goods are sold within the specified period VAT is payable sale and unexpired portion of input credit lapses.

Under the sales tax laws no such setoff facility was permissible in respect of sales tax paid on capital goods.

VI. Tax Invoice/Sale Bill and Debit/Credit notes

VAT Invoices form the cornerstone for administration in a VAT regime and is issued by a registered dealer in respect of taxable sales in the same State. VAT rate and VAT amount is to be mandatorily specified in such Tax Invoice. A dealer opting for payment of tax by way of composition on selling only non-taxable goods is not permitted to issue a Tax Invoice. This document containing the prescribed particulars entitles the buyer to claim input tax setoff.

A registered dealer is required to issue a Sale Bill containing the prescribed particulars in the following circumstances:

- When he effects a sale of non-taxable goods;
- When he effects an inter-State or export sale;
- When he has opted for payment of tax under composition scheme;

Under the sales tax laws a Sale Bill is to be issued on sale of goods. Collection of sales tax need not be specified separately as no set-off is provided in the law.

VII. Credit and Debit Notes

A VAT dealer is required to issue a Credit / Debit note drawing a nexus to the sale or purchases in any of the following circumstances among others:

- When goods sold or purchased are returned to the supplier or customer;
- When an additional discount is offered;
- When the sale or purchase price requires an amendment / change;
- When a Tax Invoice is required to be cancelled for any reason after its issue;
- When the tax charged in the invoice exceeds the amounts of tax payable;
- When there is a mistake apparent in the Tax Invoice necessitating the issue of Credit or Debit note.

The contents of a Credit or Debit note are similar to that of Tax Invoice. Only one copy of the relevant Credit / Debit note marked "Original" shall be issued.

VIII. Books and Records

Every registered dealer liable to pay tax is required to maintain true and correct accounts in any of the languages notified by the Government for a period of five years (in Karnataka, or as specified in the relevant State Act) after the end of the year to which they relate. A registered dealer shall maintain commodity-wise stock, purchase and sales accounts. The said accounts (registers) serially numbered shall reflect commodity-wise, quantity-wise and value-wise details of receipts, sales, deliveries, issues and balance. A manufacturer shall maintain production records showing quantity-wise details of various raw materialsocomponent parts/inputs/packing materials and consumables used in such manufacture and the relevant details of the goods so manufactured and the by-products/waste products arising thereon.

A works contractor is required to maintain books and records among others indicating the following details:

- Copies of the relevant agreements / contracts together with the particulars of names / addresses of persons on whose behalf he is carrying out the works contract;
- The particulars of goods purchased / received and utilized in respect of such works contracts with details of payments received / running bills raised;
- The relevant purchase register must contain the details of commodity-wise/quantity-wise and value-wise purchases/receipts and their utilization.

A registered dealer who is engaged in the transfer of right to use goods is required to maintain among others the following books and records:

- Copies of the relevant agreements;
- The particulars of names and addresses of the persons to

whom he has delivered the goods for use;

- The particulars of goods purchased / received and transferred;
- The details of payments received / receivable in respect of such agreements / contracts.

Every dealer is required to maintain the books and records / documents indicated above together with Tax invoices / Sale bills / Debit & Credit notes relating to his business till the retention period specified in the respective State Acts. In the event the said dealer maintains his accounts electronically, such dealer must retain such documents and records in an electronically readable format. In case, such books are maintained electronically the dealer is required to maintain copies of such registers duly printed in the manner prescribed under the respective Acts/ Rules.

The VAT provisions with regard books and records are similar to the sales tax law.

IX. Audit

The VAT laws of most States provide for Audit of accounts by Chartered Accountants / Sales Tax Practitioners if the taxable turnover exceeds the prescribed limits. Say for instance in Karnataka Audit of accounts is mandatory if the taxable turnover exceeds Rs.25 lakhs per annum. Non corporates can be audited by a CA or STP. Corporates to be audited only by CA and the relevant report as prescribed is to be filed within 6 months from close of the year.

The sales tax laws of many States provided for Audit of accounts on turnovers exceeding the prescribed limits although the provisions were not strictly enforced in some States. However, States like Kerala/ Andhra Pradesh etc., strictly enforced the relevant audit provisions. Not strictly enforced in Karnataka.

Certain goods are kept outside the purview of VAT regime viz. Petrol/Diesel, etc. which are likely to suffer tax under the general sales tax laws of the appropriate states. VAT laws do not envisage that taxes paid under the appropriate general sales tax laws for the purpose of set-off.

X. Returns & Assessments

Every dealer is required to file a monthly return under the VAT Act in the prescribed manner and in the prescribed form for the prescribed period. Such return shall be accompanied by the tax due after taking rebate/set-off as provided in the Act/Rules. Most States provide for revision of such returns within a prescribed time limit in the event of any incorrect statements/details/ short or excess payment of tax/omission etc. Generally annual returns are not prescribed in VAT Acts of most States.

All the States have provided for payment of interest in the respective Acts / Rules at specified rates on short payment of taxes under certain circumstances.

The VAT Act / Rules provide for summary assessment in case of all dealers wherein the monthly / annual return filed by the dealer is deemed to be correct and complete and the prescribed Authority is not required to pass an order of assessment.

If the prescribed Authority has reason to believe that the return filed by the dealer is incorrect or incomplete or if such dealer fails to file a return, the prescribed Authority is empowered to assess such dealer based on the information available to the best of his judgment. Issue of a notice shall precede such best judgment assessment.

However the Commissioner of Commercial Taxes of respective States are empowered to notify – specific dealers/class of dealers/ class of goods or in any of the said combination to undergo an assessment in the regular course. In the case of mandatory assessments the prescribed Authority is empowered to scrutinize the books and records and seek such information from the dealer as he deems fit for the purpose of conclusion of assessments. After production of books and records by the dealer the prescribed Authority is empowered to accept the return or pass such order that he may deem fit to the best of his judgment (after providing a reasonable opportunity to the dealer of being heard).

The VAT Act/Rules provide for conclusion of assessments indicated above within a prescribed time frame. Most States have provided a time limit of 5 years for the purpose of assessment/re-assessment/revision/re-opening of assessment etc. The re-assessment/ revision/re-opening of assessments is also governed by the time frame stipulated in the Act/Rules.

The prescribed Authority is empowered to rectify an order of assessment / re-assessment with a view to correct any mistake apparent on the face of the record in so far as it is erroneous or pre-judicial to the interest of the revenue. Rectification is also possible in cases and circumstances where judicial authorities have passed orders. However, such rectification is governed by a time frame stipulated in the Act / Rules. The provisions of interest / penalties are equally applicable in such cases

where rectification is carried out by the prescribed Authority.

In the sales tax law it was mandatory for filing of annual returns forms and consequence annual assessment. In most cases the assessees by the department with the books of accounts for verifications and completion of assessment. This was a very major activity for all the assessees/dealers and the department officials which is totally done away with in the VAT law thereby reducing the interactions with the department officials and the dealers substantially.

XI. Refund

On account of setoff provisions the refund of tax is a normal feature of law and is expected to be paid within the prescribed time from the end of the month in which return is filed.

In a sales tax regime refund instances are by way of exceptions and are generally not paid by the Government in time.

XII. Penalties

In a VAT regime most of the penalty provisions are non-discretionary and are to be levied automatically.

In a sales tax regime most of the penalty provisions are discretionary.

Conclusion

We would like to state that the VAT law should be interpreted in its widest amplitude to ensure that its objective end is met. Further, the chartered accountants should ensure independence, objectivity, quality of work and observance of professional codes in the area of their practice or work.

We are witnessing the evolution and implementation of VAT law and we would like to impress upon each one including ourselves that the onus of proper understanding of the VAT law and giving it a proper direction to comply with law to a large extent lies with our fraternity. ■