Input Tax Credit For Capital Goods And Opening Stock Under VAT

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One of the principles of VAT is that the dealer should be entitled to input credit on all his purchases. There cannot be exception in respect of capital goods. However, in the VAT introduced in India, differential treatment in respect of input tax credit is given to capital goods. There is also lack of uniformity on this issue in all states. The input tax credit on capital goods should be streamlined and should be allowed on all such goods barring very few notified items.

In relation to opening stock the attempt should be to allow set off as and when identified stock is sold, irrespective of period of purchase or submission of details within stipulated time.

The talk for introducing Value Added Tax in place of traditional sale tax system was on for last about 10 years. After marathon discussions and efforts of Empowering Committee the system has been implemented in majority of states in India. Some states have still not implemented VAT. The system will be more effective if implemented by all states and if uniform policy is adopted in respect of important aspects of the scheme.

Preview of earlier Sales Tax Scheme

Prior to implementation of VAT, i.e., before 1.4.2005, the States had their own schemes for levy of sales tax. Therefore the levy system differed from state to state. However in general the scheme was single point levy of tax. In this system the tax is levied at first point of sale of goods. The goods are generally sold first time by manufacturers or importers. In certain cases, when the purchases are from unregistered dealers, the dealer becomes liable to first point of tax even if he is not manufacturer on importer. In this system the subsequent transactions are allowed as resale.

Under this system, amongst others, following are the major draw backs:

(a) No uniformity in tax rates. The states adopt their own classification of commodities. The dealers do planning and the dealers, not in position to do planning, suffer.

(b) Cascading effect. The major issue in the old system was about cascading effect. The manufacturers were not allowed full setoff of the tax paid by them on their purchases. For example, in Maharashtra, even if the manufacturer has purchased the goods by paying full tax at about 15.3%, he used to get set off of about 11% and 4.3% he has to bear as burden of tax on his purchases. This burden of tax used to get reflected in sale price of manufactured goods.

When manufactured goods are sold, the manufacturer will charge tax on such inflated price (i.e. including tax component) and thus tax upon tax was attracted. This cascading effect can indirectly push up the prices of goods to a substantial extent, depending upon the stages involved between the original manufacture of raw materials and the finished goods. For sake of brevity the other aspects of cascading effect are not discussed

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here, but this is one of the important issues to be tackled with VAT.

(c) There were other issues involved with single point tax system like, levy of turnover tax, surcharge, high rate of taxes etc.. There were certain advantages from above system. Since the above aspects are not very much relevant with the subject matter of this article nothing more is added for sake of brevity.

Change over to VAT

The new system sought to be adopted i.e. Value Added Tax is certainly a superior system. The system seeks to do away with many draw backs as noticed in relation to earlier system. It will bring uniformity in tax rates. It does away with turnover tax, surcharge, additional tax etc., which are essentially sales tax but collected in different names. The VAT system is expected to be simple and dealer friendly.

Cascading effect

The most crucial issue, the VAT system seeks to tackle, is about cascading effect. As mentioned above, cascading effect is due to fact that tax upon tax is attracted. Under VAT, the ideology is to allow full credit of Input tax credit i.e. set off of taxes paid on purchases. So the manufacturer should not consider any of tax paid on his purchases as part of his purchase price and accordingly while fixing his sale price no component of tax will get included in the same. This will avoid tax upon tax. This can also be referred to as a stage of full VAT. In this article I wish to discuss whether this basic principle of VAT has been fully adopted or not and if not the consequences thereof.

Principle of VAT

As discussed above the system of Value Added Tax is based on the principle that the dealer should be liable to pay tax on all his sales. Correspondingly he should get Input Tax Credit (also referred to as set off) on all his purchases. Thus the VAT is based on principle that dealer should not bear any tax burden. Whatever tax burden is there, it should get passed on to the customer and the dealer should not be made to bear any tax. However, in the VAT laws introduced in majority of the States in India, this principle is not strictly followed. It is noticed that there are provisions for retention or negative lists in VAT Acts. The retention means full set off of tax paid on purchases is not allowed. It is allowed after reducing it by certain percentages, generally 4%. Similarly negative list means on the items mentioned in negative list, no set off is granted. For example, in Maharashtra there are about ten items on which retention/reduction is contemplated and there are about nine items on which set off is totally disallowed.

It is needless to add that to the extent of retention the tax burden is to be absorbed by dealer. Similarly on items of negative list the whole burden is to be absorbed by the dealer. To above extent the principle of VAT gets defeated and the cascading effect goes on. In this article the position of set off in respect of capital goods and opening stock is discussed keeping in view the above basic principle.

The point being made here is whether in India the VAT is introduced with true spirit. A lot of confusion is prevailing in respect of common commodity classification. Similarly confusion is prevailing in respect of set off on capital goods and business capital assets. The disallowance of such set off will take away the very basic principle of VAT.

Capital Goods

Purchase of Capital goods is one of the important activity of dealer on purchase side. Under VAT Acts, normally the meaning of Capital goods under the Income Tax Act, 1961 is adopted. A dealer has to purchase capital goods which may include plant and machinery, furniture, fixture, electrical installations, vehicles and many others. Similarly a dealer may be creating capital assets himself by purchasing materials for capital assets like, building materials etc. Normally all the above items are taxable and the dealer has to pay sales tax on purchase of above goods. Under VAT it is expected that the dealer should get full credit for tax paid on such purchases, more particularly when the basic principle is to avoid cascading effect. These assets are used for the business and while fixing sale price of the business products the dealer has to include some portion towards cost of acquisition of these assets as part of sale price. In other words, the cost of acquisition of business asset is always a component of sale price. If the input credit is not allowed in full then certainly, to the extent of disallowance, the principle of VAT gets defeated.

For example, a dealer has purchased furniture for his business, costing Rs.1,00,000/-. Assuming that the vendor has charged tax to him @ 12.5%, he will have additional cost of Rs.12,500/- by way of VAT. Now, if the credit for VAT paid is allowed the dealer can consider the cost of acquisition at Rs.1,00,000/-. If the credit of tax paid is not allowed then he has to consider the cost of purchase at Rs.1,12,500/-. While marking up his price on account of

establishment cost he has to consider this cost of furniture as one of the components. If cost remains higher, obviously to that extent the mark up will go up. If the cost is lower i.e. after considering input credit of Rs.12,500/- the cost will be lower and to that extent the mark up will also be lower, resulting in overall lower sale price. When tax paid on purchase is included in cost, the said tax indirectly gets reflected in sale price and hence there is also element of tax upon tax. This cascading effect can very well be imagined from above example. Depending upon the volume of capital goods and the tax component on the same the magnitude of the cascading effect can be imagined. When the tax is collected on sales, indirectly there is collection of tax on the cost of capital goods also which includes tax paid on purchase of such assets. The VAT theory demands that full credit of tax paid on purchases should be allowed under VAT and from above example it is clear that if the full credit is not given there is departure from above theory.

Under VAT, the ideology is to allow full credit of Input tax credit i.e. set off of taxes paid on purchases. So the manufacturer should not consider any of tax paid on his purchases as part of his purchase price and accordingly while fixing his sale price no component of tax will get included in the same. This will avoid tax upon tax. This can also be referred to as a stage of full VAT.

Policy in White paper

The white paper published by Empowering Committee on VAT dated 17.1.2005 duly recognizes the importance of input credit on capital goods. Para 2.4 of said paper says as under:

"2.4 If the tax credit exceeds the tax payable on sales in a month, the excess credit will be carried over to the end of next financial year. If there is any excess unadjusted input tax credit at the end of second year, then the same will be eligible for refund.

Input tax credit on capital goods will also be available for traders and manufacturers. Tax credit on capital goods may be adjusted over a maximum of 36 equal monthly instalments. The States may at their option reduce this number of instalments.

There will be a negative list for capital goods (on the basis of principles already decided by the Empowered Committee) not eligible for input tax credit."

The policy lays down that in relation to capital goods set off will be available to Traders and manufacturers. It also transpires that there is no intention to have any retention in respect of capital goods. The most important factor is that the white paper recognizes the fact that set off is to be given to both traders and manufacturers. It is well known that under traditional sales tax system, partial credit was allowed on capital goods to the manufacturers but no credit was allowed to traders. The white paper, taking into account the very basis of VAT system, laid down policy statement that set off will be allowed to both manufacturers and traders.

However, as per white paper the State Governments can provide to give set off on staggering basis, at most in 36 instalments. This is subject to policy of individual states. The states, like Maharashtra, have provided set off in one slot and the same is to be claimed immediately on effecting purchase.

Expectation belied

The dealers community was very happy on reading the white paper. They thought that now the incidence of sale tax on business assets and Capital goods will be totally abolished or will be minimum. In other words, they expected full set off on all purchases including capital assets and correspondingly liable to pay tax on sale side.

As per white paper, the negative list is to be based on certain pre agreed principles by empowered committee. The dealers are not aware about said principles. However, it appears that states have taken their own decisions to provide negative list or reduction in set off in respect of capital goods. For example, in Maharashtra there are many instances where set off on capital goods is restricted or is denied. The instances can be noted as under:

(i) It is provided that if the dealer's turnover of sale of goods is less than 50% of gross receipts then set off in relation to capital goods will not be available.

(ii) On passenger motor vehicles the setoff is denied. The set off is denied even in respect of parts, components and accessories of such motor vehicles. For goods vehicle the set off is allowed in full.

(iii) The dealer engaged in job work activity only will not be entitled to set off on capital goods.

(iv) There is no set off on purchases effected by way of Works Contract where such purchases

result in immovable property.

(v) There is no set off on building materials when it is used in construction activity.

(vi) There is also no set off on furniture, fixture, office equipments and electrical installations.

It can be seen that a major portion of capital assets is being kept out of set off net. The building materials are for the purpose of construction of factory building/office building or utilities like staff quarters etc.. The set off on above items would have reduced lot of burden on manufacturers/ traders and this could have reduced the cascading effect in the market.

The restrictions discussed above will also deprive the dealer of the set off on plant and machinery when the same is obtained by way of Works Contract. This is a very harsh effect of negative list. Even under non VAT era, set off was available on plant and machinery but will now get denied under VAT regime because of above negative list.

The immediate effect of such list will be that the dealers may be required to opt for two separate transactions, one for purchase of plant and machinery and the other for installation of the same. If this is the position the set off will be available. However if the contract is composite and hence works contract, set off gets disallowed. This is illogical and making the provisions unnecessarily complicated. When otherwise the dealer is entitled to set off, simply by bifurcating transaction, it is felt that disallowance of set off only because it is by way of works contract, is not correct. This also puts a very heavy burden upon dealer and gives rise to cascading effect. In other states also the position is not above board. The missing factor is lack of uniformity in the negative list.

Diversity in the provisions of States

Different States have provided different schemes for set off on Capital goods. The indicative and prima facie study of VAT Acts of few other states can throw light on the said issue.

Karnataka

In respect of capital assets Karnataka Value Added Tax Act provides for Special Scheme under section 12. The Input Tax Credit on Capital Assets is allowed on assets purchased only after 1.4.2005 for use in business. Deduction is allowed only after commencement of commercial production or sale of taxable goods.

Rule 133 prescribe provisions relating to Input Tax Credit on Capital Goods. Application is required to be made to the VAT officer for the same. Input Tax Credit is to be claimed in 12 monthly instalments as specified in the order passed by the VAT Officer. Where the Capital assets are used for sale of exempted goods (other then when exempted goods are exported), no Input Tax Credit is available. Where the capital goods are used partially for exempted or non-exempted goods, Input Tax Credit would be allowed on proportionate basis. Capital goods has been defined under section 2(7) as Plant, Cold Storage and similar Plant, Machinery, Goods Vehicles, Equipment, Moulds, Tools and Jigs, whose total cost is not less than an amount notified by the Government or Commissioner and used in the course of business other than for sale.

Delhi

Capital goods have been defined under section 2(f) as Plant, Machinery and Equipment used in the process of trade or manufacture. No Input Tax Credit is available on purchase of goods which are to be incorporated into the structure of a building or owned or occupied by a person. No Input Tax Credit is allowed when capital goods are used in the manufacture of tax free goods. Input Tax Credit on Capital goods will be allowed in three equal annual instalments.

Andhra Pradesh

No Input Tax Credit would be allowed on the items like, Automobiles including commercial vehicles, air-conditioners (unless used in Plant, Laboratory, restaurant or eating establishment) which could be used for providing facility to the employees, Inputs used in construction or maintenance of any buildings, including factory buildings or office buildings (unless the dealer is a works contractor), earth moving equipment, generators. Also where capital goods are used in exempted and non-exempted goods, the same would be allowed on proportionate basis.

West Bengal

Capital goods are defined under section 2(6) as goods meant for use in manufacture or for execution of works contracts or goods required by a reseller to keep the goods in saleable condition or to effect sale properly, as may be notified.

Input Tax Credit is available on purchases of taxable goods for use in manufacture, for resale of taxable goods or execution of works contract. When the goods are used partially for specified purpose and for other purposes, Input Tax Credit will be available only to the extent to which they are used for specified purposes. No Input Tax Credit will be available on Air-conditioners, Automobiles, Building Materials, Office Equipment, Furniture & Fixture, Electrical Fittings, goods

used for providing facilities to employees etc. Also no Input Tax Credit is available when Capital Assets are used in the manufacture of exempted goods. Input Tax Credit will be allowed in one or more instalment based on the purchase price of capital assets.

From indicative study of above few VAT Acts it is very clearly apparent that there is lack of uniformity. The mention of pre agreed negative list of capital goods in white paper appears to be non starter. It is utmost necessary that the uniformity should be achieved, else the issue sought to be simplified by VAT will remain as it is.

Rate of tax on Capital Goods

The effect of non allowability of set off would not have been felt much, had there been lesser incidence of tax on Capital goods. It is seen that there is no entry for lower rate of 4% on capital goods as such. The normal rate therefore will be 12.5%. The higher incidence increases the burden. Coupled with non availability of set off it certainly pushes up the cost of acquisition of capital goods. The resultant effect is thus a high burden on dealer, which should not be there as per principles of VAT.

True spirit of VAT

The point being made here is whether in India the VAT is introduced with true spirit. A lot of confusion is prevailing in respect of common commodity classification. Similarly confusion is prevailing in respect of set off on capital goods and business capital assets. The disallowance of such set off will take away the very basic principle of VAT.

Effect on deemed sale transactions

The consequential effect of above disallowance is also directly on the deemed sale categories viz: the Works Contracts and transfer of right to use goods (lease transactions). For example, if the dealer is leasing Capital goods and even if he is paying vat on lease rentals, being sale under VAT Act, no set off will be available in respect of its purchases if it is in negative list. For example, a dealer is in leasing activity of furniture and fixtures. In Maharashtra even if he pays VAT on lease rentals of furniture he will not get set off on the purchase of furniture. This will totally jeopardize the leasing activity and will result in high inflation.

The Expectation

It is true that the VAT System is in formative stage. The State Governments/Empowering Committee is in procedure of bringing uniformity in various aspects, one being to bring uniformity in respect of set off on capital goods. However, the confusion should be clarified at the earliest. Keeping into mind the principles of VAT, set off should be allowed in full on all capital assets barring very few items like, passenger motor vehicle. An early improvement in situation is better.

Procedural requirements for claim of set off

Barring the items covered by negative list and subject to retention rules, the dealers are entitled to set off on capital goods like any other purchases. Thus the dealer will have to bifurcate their purchase in eligible capital goods for set off and non-eligible capital goods. In respect of eligible capital goods the dealer will be required to follow procedural requirements for claiming set off successfully. For example, dealers will be required to support purchase of capital goods with tax invoice. In absence of such tax invoice set off will be disallowed.

Once the dealer is entitled to set off he has to further see the state provisions in respect of allowability. If it is subject to certain instalments, the dealer will be required to claim set off accordingly in his returns. If the set off is subject to prior permission, the requirement will be required to be fulfilled. The allowable of set off on capital goods will be, of course, part of normal set off. The dealer will be able to adjust this set off against his other sales tax liability. For example, dealer can adjust his set off as per following illustration.

It may be mentioned here that the set off under VAT Acts are subject to one very important condition. It is generally provided in VAT Acts that the set off on any goods should not exceed the tax received on same goods in Government Treasury. For example, section 48(5) of Maharashtra VAT Act provides that the dealer will not be entitled to setoff

Example of tax credit and set off on Capital goods under VAT	
(i) Tax paid on procurement of inputs/supplies worth Rs.1 lakh @ 4%.	Rs. 4,000
(ii) Tax paid on procurement of capital goods of Rs.10 lakhs @ 4%.	Rs.40,000
(iii) Tax credit available in the month.	Rs.44,000
(iv) Tax on Sales of Rs.10,00,000 during the month.	Rs.40,000
(v) Tax payable during the month.	Nil
(vi) Carry over of tax credit for set off during the next month.	Rs.4,000

more then the amount received in treasury. Therefore, if the vendor fails to make payment of tax to Government, the purchaser's claim of set off will be denied. If at any earlier stage some tax has got paid, to that extent the set off can be claimed.

If the vendor fails to make payment of tax to Government, then the claimant dealer will lose the setoff, inspite of fact that he has paid tax to his vendor. Therefore the purchasing dealer, desirous of claiming setoff, should also look into the credentials of the vendor so as to be sure that he will get the set off of tax paid to him.

Purchase from unregistered dealers

The availability of set off on Capital goods is subject to the fact that such taxable goods are purchased from registered dealers who have issued Tax invoice. The same is subject to negative list and other factors as discussed above. Compared to same, the purchases from unregistered dealers may be more advantageous. In most of the VAT Acts there are no provisions to levy purchase tax. In Maharashtra VAT Act, 2002, there is no proviso for levy of purchase tax. The effect is that if the purchase is from unregistered dealer no tax is attracted on the same. In such case there is burden on account of disallowability of set off, being an item of negative list. The above aspect can be explained with small example.

The passenger motor vehicle is in negative list. If a VAT dealer purchases motor vehicle from registered dealer the vendor will charge tax. However, purchasing dealer will not be entitled to set off, the motor vehicle being in negative list. Thus the dealer will be required to bear the tax paid to vendor as his cost of purchase.

On the other hand if the said motor vehicle is purchased from unregistered dealer he will not be required to pay tax to his vendor, since he is unregistered dealer. There being no provision for levy of purchase tax, no tax will be attracted in hands of purchaser. Of course, there is no question of any set off also. However, it will be seen that there being no tax incidence, the dealer will be saving his cost to the extent of tax on such purchase. This can happen in all the cases where reduction is contemplated or the goods are in negative list. In all such cases, the purchases from unregistered dealers will bring down the effective acquisition cost. However the above position is subject to the provisions in respective state VAT Acts about levy of purchase tax. If such provision is there then the above position will not be possible. Since the turnover limits for registration are two low, there are very rare chances of capital goods being sold by any unregistered dealer and hence the above situation will take place only in certain contingences.

However, the more possibility can arise in respect of smaller purchases from which the capital assets are created. For example, there may be purchase of building materials from unregistered dealers, where without attracting any tax burden the dealer may construct the factory building. Thus there is possibility that the set off provisions may get by passed, more particularly in case of small traders and dealers.

Set off on Opening Stock

VAT has replaced the earlier sales tax laws. There is fundamental change in taxation system. Under earlier laws, the normal system of taxation was single point tax system. After the tax is levied in the hands of importer or manufacturer, the subsequent sales in respect of same goods were allowed as resale. There was no tax to be levied on same. In other words the resale dealers were most probably not liable to any tax or at the most to the extent of meager tax like, resale tax etc., as in Maharashtra.

VAT has replaced the earlier sales tax laws. There is fundamental change in taxation system. Under earlier laws, the normal system of taxation was single point tax system. After the tax is levied in the hands of importer or manufacturer, the subsequent sales in respect of same goods were allowed as resale. There was no tax to be levied on same.

However, under VAT the principles for levy of tax are different. Every dealer has to pay tax on his sales except the dealers opting for composition. Thus, after introduction of VAT from 1.4.2005, all dealers will be liable to tax. The sale will include the sale from opening stock. The sales tax authorities have two options. They can allow resale system to be operative in respect of sale/purchase of goods from opening stock. However, this is difficult to operate practically for dealers. For sales tax authorities also it will be difficult to have effective control over such provision. So the only other way is to levy tax on all sales taking place after 1.4.2005.

However, if tax is levied on sales, then it is necessary that set off is granted on opening stock. This is very much necessary, else it will result into double taxation. This will be unfair as also inflationary.The white paper has duly recognized

this fact and has stated as under in relation to set off on opening stock.

"2.7 All tax-paid goods purchased on or after April 1, 2004 and still in stock as on April 1, 2005 will be eligible to receive input tax credit, subject to submission of requisite documents. Resellers holding tax-paid goods on April 1, 2005 will also be eligible. VAT will be levied on the goods when sold on and after April 1, 2005 and input tax credit will be given for the sales tax already paid in the previous year. This tax credit will be available over a period of 6 months after an interval of 3 months needed for verification."

The mode of allowing set off

The white paper has outlined the mode of allowing set off. It is mentioned that the stock out of purchasers after 1.4.2004 will be eligible for set off. The set off is subject to submission of requisite documents. It is also stated that the same will be allowed in 6 months instalments after lapse of first 3 months. But above is a suggestive method. The set off depends upon the actual provisions in this regard in respective VAT Acts.

For example, under Maharashtra VAT Act the provisions are on different footing. The set off is allowed only in respect of trading stocks. The manufacturers have to take set off on their purchases in respective year of purchase. There is also no limitation about date of purchase and even stock purchased prior to 1.4.2004 are eligible for set off. However, in respect of capital goods the set off will be allowable in respect of the purchases effected after 1.4.2003. Similarly set off is not required to be claimed in instalments. The entire set off on trading goods can be claimed in return for April,2005. However, in respect of Capital goods set off will be allowable in month in which the sale of such capital asset is effected. There is one more important condition that the goods, on which set off is claimed, are to be sold before 31.12.2005. If not so resold, the set off is to be reversed. There is one more requirement of filing statement of stock before stipulated date i.e. latest by 15th June, 2005.

Thus the set off on opening stocks is treated separately in different state VAT Acts. The dealers will have to comply with respective conditions, to be eligible for set off. The practical difficulties which the dealers will find is about the submission of requisite details and documents. In case of many of resellers and small traders, no detailed stock records are kept. It is therefore possible that for many stock items corresponding purchase invoices may not be available.

In absences of such details, dealer will lose set off though he will be liable to pay tax on sale side. This will affect the trading community very hard, particularly in small towns and villages, where accounts of stocks are not kept in methodical way.

The condition for resale of stock within the given time may also pose practical difficulties. There may be slow moving goods in stock which may not be sold by given date. Thus the dealer will lose set off in respect of such stocks also.

Some suggestions

Thought, the scheme for set off on opening stock is well recognized and required to be implemented with the possible reasonable control, a small suggestion can be made here.

The uncertainty about implementation of VAT zoomed large till 1st April, 2005. It is only when authoritative statements started coming in media, that the VAT has been implemented, the trading community took it seriously. Thereafter, for longtime confusion prevailed because of on going protests by the trading community. The provisions also came late in the hands of VAT consultants and the traders. Under above circumstances it cannot be said that there was clarity amongst traders about the set off. The traders are now in process of understanding and preparing requisite details of stock. It is possible that in the short time allowed for submission of details the traders may commit certain mistakes or may omit to mention the stocks in the stock statements. However, fair play requires that when the dealer is made to pay sales tax and is in position to establish the identity of purchase supported by purchase bill, he should be allowed set off irrespective of fact whether the stock statements is correctly filed or not. The white paper recognizes this fact and has only recommended for submission of requisite details but not specified about time limit for same. Also there should not be restriction of time limit for resale of stock items.

Adjustment of Set off

The set off available on capital goods as well as on opening stock is, of course, available for adjustment against liability on sale side. The excess set off can be carried forward to next month and adjusted in return for next month. However, at the end of financial year the dealers will be required to claim such excess as refund and such excess may not be entitled for adjustment in next financial year. The position depends upon the provisions in respective state VAT Acts.

Conclusion

The VAT system is, as stated above, most welcome and progressive system. However, the differential treatment given to capital goods is required to be streamlined in near future so as to say that the VAT is made applicable in its true sense. ■