



Kelkar on Indirect Taxes

The Task Force headed by Shri Vijay Kelkar on implementation of the Fiscal Responsibility and Budget Management Act, 2003, has submitted its report, which will have far reaching consequences. The report contains proposals for integration of goods and services taxation as well as the sharing of service tax revenues with States.

The preface to the Vijay Kelkar report hints at an ambitious bargain between the Central government and States towards rationalizing all the State taxes on goods and services. A majority of proposals will most likely be resisted by the States. Further, when the emphasis has been on a state-level VAT, the Task Force headed by Shri Kelkar recommends a state-level goods and service tax (GST) as well as a Central GST.



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Goods and Services Tax

The report states that independent taxation of goods and services under different laws create the same kind of problems as selective taxation of services and that the line between goods and services is getting blurred with disputes landing up in the Supreme Court. Since there is a strong inter-dependence of goods and services in the production and distribution activities, the report recommends that tax on services should be fully integrated with the existing central VAT (Cenvat) on goods by a modern VAT type levy on all goods and services to be imposed by the Central Government hereinafter called the Central GST.

Features of Central GST

- (i) Value addition in the post manufacture stage being in the nature of services can be taxed by the Centre.
- (ii) The practice of allowing abatement on MRP in respect of goods covered under Standards of Weights and Measurement Act should be discontinued.

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- (iii) concept of removal as it exists in Central Excise should be discarded and the tax should go to the extent of the retail price thereby avoiding the necessity of distinguishing goods and services.
- (iv) The tax base must be comprehensively extended to cover all goods and services going up to the final consumer reflecting the tax base of a typical consumption VAT.
- (v) The Central GST liability computation should be based on an invoice credit method, whereby credit for the tax paid on all intermediate goods or services would be granted, based on the invoice issued by the supplier.
- (vi) The tax should be structured on destination principle and the base will shift from production to consumption whereby imports would be liable to tax and export will be relieved of the burden of goods and services tax.

Tax rates in Central GST

The report recommends a lower rate of 6% on necessities like matches and processed food, 12% for most commodities and services and higher rate of 20% on items like automobiles, air-conditioners, aerated water, polyester filament yarn, etc. The Task Force has recommended that exports must be zero-rated and the exclusion from tax should be only on the ground of significant externalities, merit goods and administrative feasibility. Further the new law must have a well-defined negative list of goods and services.



Proposed negative list:

- (a) Commodities with negative externalities whose consumption has to be checked.
- (b) Public services of Government, Municipality, Panchayat, Defence, Civil Administration, Paramilitary, Police, Intelligence but excluding Railways, Post and Telegraph, other commercial departments, public sector enterprises, banks and insurance.

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- (c) Medical services which will be defined in consultation with Health Ministry.
- (d) All school and college education.
- (e) Service transaction between an employer and employee as a service provider or recipient.
- (f) Unprocessed food articles
- (g) Life saving drugs and equipment
- (h) Equipment used in national security functions.

Petroleum: The grand plan of integration of Central Excise and Service Tax Law and the concept of a Central GST as proposed falters when it comes to petroleum products.

The Task Force has recommended that commodities like petroleum crude and products, natural gas and tobacco should be subjected to a Central GST at higher rate and that input tax credit should not be granted to the purchasers of these commodities on administrative consideration. The Task Force has recommended the imposition of specific rates. In other words, an 'island of isolation' is once again created and petroleum products will attract higher duty without credit for the purchaser, thereby creating a break in the chain.

Tax Payer Base: The report recommends that since only a small number of firms account for large proportion of revenues, the resources for collection must con-

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concentrate on the largest taxpayers as a part of risk management. Small dealers, including service providers and manufacturers, should be exempted from the purview of the tax by up to a threshold limit of up to Rs.25 lakhs in annual turnover. However, those below the limit can be voluntarily registered to enable them to sell to registered manufacturers.

A compounded levy of 2% can be levied on small dealers with annual turnover of up to Rs.40 lakhs without any input tax credit. The limit of 40 lakhs has been fixed taking into account the tax audit provisions under the Income Tax Act.

The report does not address the reason why there are only a few number of firms accounting for revenues. The problem is that there are a number of firms which carry out activities attracting taxes but are blissfully evading taxes. The enforcement mechanism has not been able to increase the number of new assessees. Instead, the entire energy and resources is directed towards creating new demands on existing assessees who are complying with the law. This methodology is blessed and the report is absolutely silent on the 'parallel economy.'

Assessee/Administration: The unit of taxation under the Central GST as per the report should be the person defined under the Income Tax Act, 1961 and not the production unit/branches. This is a sweeping tax reform which, if implemented, would result in loss of work for a

number of excise officials. Under the current law, each factory requires registration, filing of monthly returns, periodic visits and audit and there is a significant activity in the Taxation Range. In Income Tax, it is only a central assessment based on the filing of a return. Once this proposal is accepted and the unit of taxation becomes the person then the necessity for having range officers near the factory would disappear and all of them would have to be relocated at the central office in the city or region, etc.

The administration is expected to ride on the newly developed OLTRAS of the Income Tax Department to collect information regarding payment of taxes from banks. All registered tax payers are required to file a monthly information return along the lines of the TDS annual information return detailing all transactions relating to sales and purchases of goods and services.

Date of implementation: The fully integrated goods and services tax outlined above should be implemented as the Indian Goods and Services Act, w.e.f. 1.4.2005 in order to replace the Central Excise Act, 1944 and service tax levied under Finance Act, 1994. Further, this legal framework should be consistent with the best international practices.

Small Scale Industries: The Task Force has recommended that the small-scale exemption should be reduced from Rs.1 crore to Rs.40 lakhs. Further, for clearances between Rs.40 lakhs to Rs.1 crore, the assessee should have an option to pay duty at the rate of 4% without any credit for the integrated GST paid on inputs or at a standard GST rate, and claim credit. This limit is based on value of total clearances including exempted items but excluding export clearances.

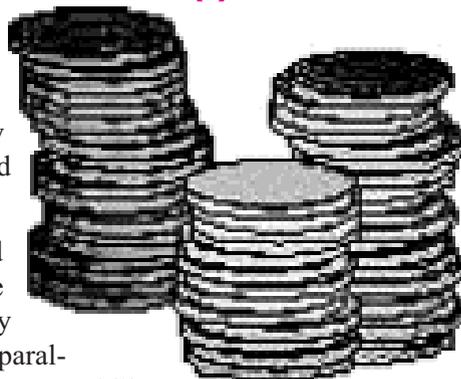
This will create more confusion since there is an exemption up to Rs.40 lakhs and after Rs.40 lakhs there is an option of 4% without credit or normal rate with credit. This would create a number of issues such as date of purchase, availability of credit, transition, exercise of



option, subsequent periods, etc.

Immovable property: The Task Force has recommended the following:

- (i) Existing stamp duty system should be abolished.
- (ii) Central GST should apply to all the newly constructed, residential or commercial property. Where it is self-used, the tax should be on the cost of construction.
- (iii) Where it is sold or transferred, the Central GST should be on the consideration received at first transfer or sale. Credit would be available for the Central GST embedded in the raw material used in the construction.
- (iv) Rental charges in respect of lease of immovable property for commercial purposes would be liable to central GST. However, rental for residential properties would be exempted.
- (v) All secondary market transactions in immovable property would attract GST on the difference between the sale proceeds and purchase price and the payment would be borne by the purchaser of immovable property and the proceeds from the levy of Central GST should form part of the divisible pool.
- (vi) States can continue to levy registration fee at a specific rate not exceeding Rs.200 per transaction in immovable property, which is merely a user charge for the IT systems used in property registration.



This proposal is unlikely to find acceptance, since the premise behind the proposal is the prevalence of black money in the real estate sector in a big way. The parallel economy exists in every sector and a proposal like this would only affect the organized sector, which is already complying with existing tax laws at Central, State and Municipal levels. It is not as if that this proposal would immediately bring to an end the parallel economy in real estate. The whole purpose is defeated since the Central GST is on the purchaser. The tax is proposed on both residential and commercial, whereas

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a purchaser of a residential unit will not be able to take a credit in the absence of any Central GST. Even though there are discussions on this issue, the recommendations do not reflect any benefit for the person who gets a residential property constructed.

Financial Services:

- (i) All regulated finance companies registered with RBI, IRDA, PFRDA, FMC and Stock exchanges registered with SEBI, banks, brokerage firms, insurance companies, primary dealers, pension fund managers, etc. will have to separately register with Central Excise Department.

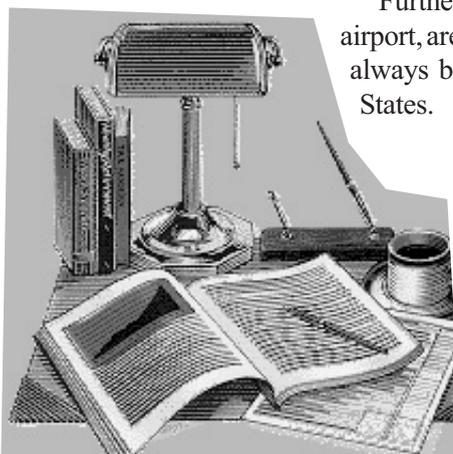
- (ii) Value will be calculated by subtracting allowable purchases (purchases of revenue or capital nature on which integrated GST has been paid or deemed to be paid and eligible for credit) from the net revenues. (All receipts in the nature of income including receipts from sale of assets as reduced by the amount of service tax deemed to be included therein.)

- (iii) Net revenue shall not include farm loans, home loans, loans to non-profit organisations, student loans, and commercial loans to all registered GST tax payers.

Neither the States had been a party to the crucial “Task Force” headed by Shri Vijay Kelkar nor has their point of view been considered in the matter even though the tax reforms involve a major participation by the States.

- (iv)** The purchaser of the financial services can claim credit in respect of services received from a registered financial service provider.

The computation mechanism called ‘subtraction method’ is in reality a tax on the profit made on the transaction. The report while dealing with direct taxes does not refer to any abolition of income tax on banks and other financial service providers. The report, thus, on proper translation, indicates an Income Tax on the profits, a Central GST on the profits as well as a State GST on profits.



Imports: **(i)** The counter vailing duty is to be replaced by two-part levy, the first being a reflection of the proposed Central GST and the second being a State level GST. This indicates that services, which are imported, are also likely to be taxed.

(ii) The collections under both parts should be separately accounted and all imports should be taxed at the same rate under Central GST and State GST as applicable to consumption of domestic goods.

(iii) Where the imported goods and services are used as intermediate inputs in production or distribution, credit for the proposed Central GST and State GST shall be allowed against Central GST and State GST on final

products respectively. The report is silent on credit against services under Central GST.

(iv) The revenues collected from Central GST should form part of a divisible pool that would be shared between Centre and State at the appropriate rate. The revenue collected from State VAT on imports would be assigned to the State of import destination.

States are not likely to be very enthusiastic about this proposal, since very few States have ports and airports and only some States have significant traffic in the form of imports.

It is not clear that as to what is meant by assignment of the revenue to the State of import destination.

Import happens at the port, which is within the control of the Customs Department. If the plan of the Central Government is to collect the State GST on import and assign it to the State, the same would not be acceptable to the States.

Further, the States, which don't have any port or airport, are unlikely to agree. Sharing of revenues has always been a sore point between the Centre and States.

Agreement between Centre & States

The Task Force seeks that Centre and States reach an agreement for a comprehensive tax on goods and services comprising the following:

- Centre and States should exercise concurrent but independent jurisdiction over common tax bases.
- Centre and States have to replace existing octroi, CST, State level sales tax, entry tax, stamp duty, telecom license fee based on revenue sharing, turnover taxes, tax on consumption and sale of electricity, tax on transportation of goods and services and passengers, excise taxes and all other cascading type levies and replace with two separate laws viz. Indian Goods Services Tax Act and State Goods and Services Tax Act.
- Both tax jurisdictions will exclude the tax paid to the other jurisdiction from the assessment of value bases.
- Centre and State should have independent power to fix tax rates. However, there must be co-ordination between the levels of the Government.
- The Central GST should be at 6%, 12% and 20%

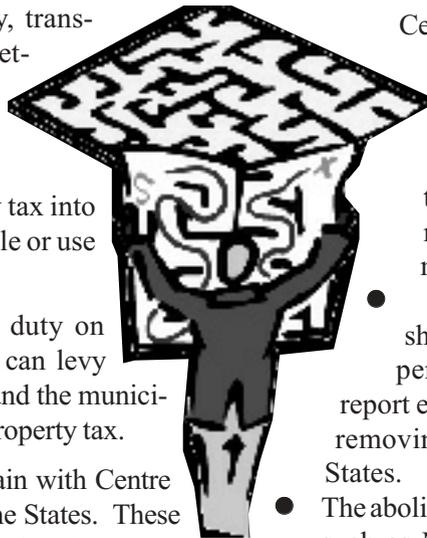
and the State GST should be 4%, 8% and 14%.

The grand plan therefore clearly depends upon the agreement to be arrived at between the Centre and all the States. In a federal structure with fierce independence being exercised by States, it is difficult to imagine that such an agreement is likely to surface immediately.

Mandate for the States

The Task Force report suggests that:

- States should allow the Centre to levy tax on land and building, electricity, transport, luxuries, waterways, betting, gambling, etc. in exchange for the right to levy tax for all services.
- States should abolish all entry tax into local area for consumption, sale or use therein.
- States should abolish stamp duty on lands and buildings but they can levy VAT on immovable property and the municipalities will continue to levy property tax.
- Right to tax tobacco will remain with Centre and right to tax alcohol with the States. These 'sin taxes' will be in the nature of excise.



Conclusion

It is no doubt true that sincere efforts have been put in by the Task Force in creating a report and giving new ideas for tax reforms as well as for eliminating the budget deficit. However, the following problems are inevitable:

- When States have geared themselves for VAT on commodities, the proposals which talk about an integration of goods and services at the Centre and State level is likely to derail VAT.
- A number of meetings amongst States have still not resulted in the finalisation of the list of exempted commodities. This report recommends that the Centre and the States must agree upon a common list of exempted commodities both under the Central GST and State GST.
- The report recommends that the penalty and related provisions in the State Law should be the same as in

The ultimate raison d'être of competition is the interest of the consumer. Consumer's right to free and fair competition can't be denied by any other consideration. There is also a need for supportive institutions to strengthen a competitive society.

Central Law. This is likely to be opposed by the States.

- States are not going to be enthusiastic about the tax on imports specifically when the revenue is to be assigned. Further, the report recommends rates at 5% to 10%, which would mean significant lower collections.
- States have been demanding that they should be allowed to tax services as a compensation for bringing VAT, whereas the report expands the scope of tax for the Centre by removing the existing areas of domain of the States.
- The abolition of CST is likely to be resisted by States such as Maharashtra, Gujarat, Haryana, Andhra Pradesh, Tamil Nadu, Karnataka, Madhya Pradesh, Kerala, Uttar Pradesh and West Bengal for revenue reasons as the CST collections for the year ending 31.03.2004 is Rs.2130 cr., Rs.1200 cr., Rs.1147 cr., Rs.1106 cr., Rs.976 cr., Rs.884 cr., Rs.749 cr., Rs.546 cr., Rs.485 cr. and Rs.384 cr. respectively.
- The Central Government collection of service taxes for the year 2003-2004 is Rs.8,300 crore and the budget estimate for the year 2004-2005 is Rs.14,150 crore. The proposal envisages a continuation of the tax on service by the Centre through the Central GST as well as allowing the States to tax the services through the local GST. Even assuming the same revenues are possible, the revenue would be for all the States put together. To get this, the States are required to abolish all existing revenue streams such as electricity, registration, stamp duty, gambling, betting, CST, sales tax, entry tax, etc. and provide a credit mechanism for both services and commodities.