

# A Note on Value Added Tax

Recently the Central Government circulated the draft of the Model Value Added Sales Tax Bill, 2003 for public comments. The Institute submitted a detailed note to Mr. Asim Dasgupta, Chairman, Empowered Committee for implementation of VAT Law. The same is published for the information of members

## General Suggestions:

### 1. *A uniform VAT law*

A uniform VAT law should be evolved to be used by all the States. This will ensure the proper legal evolution of VAT, its uniform judicial interpretation and hassle free application in the case of assesseees having multi-state operations.

### 2. *Harmonisation of commodity rates*

To enable the VAT system operate in harmony with international practices it is necessary that the VAT law should follow the harmonised system of Nomenclature conceived and devised by the CCC (Customs Cooperation Council) headquartered at Belgium.

### 3. *States' role*

The VAT law should be so drafted that the various State governments should not be allowed to tinker with the fundamental provisions which would distort the uniform evolution of the law. To achieve this objective the States' role should be restricted to the prescription of different ceiling limits and the rates of tax applicable to different commodities.

## Specific Suggestions:

### 1. **Availability of Sales Tax Rate Schedules and Rules under the VAT**

Although draft VAT Act is available, till today no sales tax rate schedules and rules are available which are vital for understanding the impact of VAT on different industries.

#### **Suggestion**

Draft sales tax rate schedules and rules should be published immediately so that there can be proper interaction amongst government, various professional bodies such as ICAI, traders and industries at large before any finalisation.

### 2. **Availability of Minutes of Empowered Committee Meetings and Meetings of Commissioners of Sales Tax of different States**

2.1 Lot of seminars are being organised at national and

State level where the general principles of VAT are being discussed and public support is being sought.

2.2 However, no information is given as to what is being discussed at each meeting of Empowered Committee and Commissioners of Sales Tax, which is very vital to understand the views of different States and their representatives.

#### **Suggestion**

2.3 The Central Government should provide minutes of these meetings to ICAI so that members can discuss the subject matter and suggest their considered views which will help to introduce VAT.

### 3. **Expected merger of all separate Sales Tax Laws (such as works contract tax, lease tax and motor spirits tax) under VAT and Existence/Introduction of entry tax.**

3.1 VAT has been successful in other countries as they have only one tax as VAT and they do not have excise, octroi, entry tax, luxury tax, profession tax, etc. Under a pragmatic vision, Central Government representatives should emphasize and try to achieve the same in the long run in all meetings of Empowered Committee at national level.

3.2 It is disheartening to note that inspite of well accepted principle of merger of all taxes on inputs and outputs under the VAT by all the State Governments almost all states are introducing entry tax which will be an additional hindrance in introduction of VAT. It is also surprising to note from the reports available about the proceedings of Empowered Committee Meetings that none of the representatives - either from State or Centre - has discussed on entry tax.

#### **Suggestions**

3.3 The Central Government should instruct all the States that no new entry tax should be introduced and efforts should be made to remove the existing entry tax, octroi and cess and merge the same with the VAT.

### 4. **Sales Tax Incentives and VAT**

4.1 Under the VAT, it is suggested that all exemption incen-

tives should be covered into deferral incentives. It is believed that exemption is not compatible with VAT.

- 4.2 We are enclosing an annexure which gives a detailed note on the above subject giving historical background of incentives explaining when and why exemption option was introduced in various States. We have also explained how exemption option can work under the VAT.

### Suggestion

- 4.3 The Central Government should consider the issue in detail and should address the same at the meetings of the Empowered Committee at the national level.

## 5. Central Sales Tax and VAT

- 5.1 It is universally accepted that Central Sales Tax is one of the hindrances in the introduction of VAT.
- 5.2 It is theoretically suggested that Central Sales Tax should be phased out gradually making it Nil in coming years.
- 5.3 This is neither practical nor viable, because if CST is removed, then by simple planning of purchasing all the raw-materials by way of inter-State purchases and selling final products only by way of inter-State sales, total sales tax incidence can be made Nil. State governments will have virtually no sales tax revenue in this option.
- 5.4 The practical and viable solution is allowance of set-off of Central Sales Tax. All the Central Sales Tax revenue will be collected in the same way as it is done today, but the revenue collected should be deposited with the special purpose vehicle to be created at the national level. In the State of consumption, set-off of CST paid will be given by the State who will get reimbursement of the same from special vehicle created at the national level. A detailed note can be provided if government agrees in principle.

### Suggestions

- 5.5 It is felt that there is a need for CST which will act a buffer to balance the States' activities in the VAT front. Preferably it should be zero rated.
- 5.6 The Central Government should discuss the proposal mentioned in para 5.4 at the national level in the meetings of Empowered Committee.

## 6. VAT and Set-off of Fuels, Motor Spirits and Capital Assets

- 6.1 It is proposed not to extend VAT to Motor Spirits. At the national level it is estimated that about one-third sales tax revenue comes from sales tax on motor spirits. If VAT is not introduced for motor spirits, it will not be a real VAT when such an important area is kept out of VAT.
- 6.2 Moreover, it should be noted that today HSD is also used as fuel in several industries in addition to furnace

oil, LSHS, etc. There is no reason why set-off should not be given for input tax paid on HSD and other motor spirits if used as fuels, when similar set-off is available for other fuels under the proposed VAT.

- 6.3 It is also proposed in some of the States that set-off on capital assets should be allowed proportionately during the next three years. This is against the principle of VAT. When the seller of capital assets has to deposit full sales tax in the same year and when the government is allowing set-off out of this "received sales tax", there is no reason why set-off should be spread over to next three years.

### Suggestions

- 6.4 Set-off should be made available on motor spirits when consumed in manufacturing of any taxable commodity as this will remove any cascading effect and make final product more competitive internationally.
- 6.5 Set-off on capital asset should be provided in the same year.

## 7. Refund of excess of input tax over output tax

- 7.1 Under the proposed VAT, it is mentioned that if input tax exceeds output tax, i.e., set-off is more than the tax payable, then no refund of such excess set-off will be given in cash. Such excess will be carried forward for future adjustments.
- 7.2 This will not be practical. Because one should understand that such a situation arises only when raw-materials are taxed at very high rates. E.G., petrochemicals, such as naphtha, which are taxed @ 15.8% and final products are taxable at a low rate - say 4% OR majority sale is by way of inter-state sale taxable @ 4% against C-form. Thus, in future there will be no opportunity to adjust such excess set-off in such cases.

### Suggestion

- 7.3. Excess of set-off should be refunded back in the same year. Such carry forward is not heard of anywhere else in the world.

## 8. Goods sold on hire purchase basis

- 8.1 When the goods are sold on hire purchase basis only the hire charges received/ receivable during the year are taxed. Therefore, some States have proposed that the set off of tax paid should be phased out in proportion to hire charges.

### Suggestion

- 8.2 When the seller of assets has sold the goods possibly sales tax is received in the same year and therefore there is no logic in postponing the grant of set off. Thus we recommend that the set off should be provided in the same year.

## Annexure

## SALES TAX INCENTIVES AND VAT

## 1. PREAMBLE

Mainly sales tax incentives are available in two ways:

- A) Exemption
- B) Deferral

By combining or by providing options out of the above two ways, Sales Tax incentives are given by different States in different ways. Mainly in the following ways incentives are given by all States:

- a) Under the option of exemption, on purchase side, Eligible unit issues concessional forms so that no tax is payable (e.g. Maharashtra) or negligible tax is payable (e.g. in Gujarat 0.25%). On the sales side, eligible unit is exempted from payment of tax (e.g. Punjab, Gujarat and Maharashtra), or eligible unit is allowed to charge and collect tax but later on it is remitted fully by the State without any need to pay the same (e.g. West Bengal).
- b) Under the option of deferral incentives, Eligible unit issues different kind of concessional form so that the seller will not charge any tax but tax payable is calculated and deferred by sales tax department. On the sales side, Eligible unit charges and collects the tax and keep the same with it for a certain period and pays back the same in several installments without any interest.

## 2. HISTORY OF SALES TAX INCENTIVES

If we study the history of sales tax incentives it was the pragmatic vision of the Government of Maharashtra which realized as back as year 1963-64 that sales tax can be used as an important developmental tool, particularly for development of areas where no enterprise would like to go in the ordinary circumstances because of several disadvantages, such as lack of proper infrastructure, remoteness to market, unwillingness of the work force to work in the remote isolated areas etc. The Government of Maharashtra realized that if sales tax subsidy is given then many entrepreneurs will go to remote undeveloped backward areas. Thus, the first sales tax incentives scheme was introduced in 1964. After this, every four or five years, the scheme was revised with additional features. Many other States liked such schemes and they also came out with their own

incentives schemes. The resultant development of so many backward areas, in almost all States is now a history.

In the State of Maharashtra, the first incentive scheme was Cash Refund Scheme introduced in GR No. IDL 7064/IND.I dated 25th September, 1964 which allowed incentives by way of Cash Refund of the Sales Tax paid by the eligible unit. This scheme lasted for about 5 years.

However, in practice it was found that there were several administrative issues coming in the way of getting refund of sales tax. Hence, the deferral scheme was introduced, in which the eligible unit was allowed to collect tax and pay to the government after the particular period. Such scheme was introduced in the year 1969, which was Deferral Scheme in GR No. IDL 7069/IND.I dated 2nd April, 1969. In this scheme new units were allowed to collect Sales Tax for 6 years which was payable after 18 years in 3 annual installments. Along with this modified Cash Refund Scheme for existing units, investing in backward area also continued. The Deferral Schemes continued for next 10 years with some intermediate modified schemes till the 1979 scheme was introduced.

## 3. PRACTICAL DIFFICULTIES ENCOUNTERED IN THE OPERATION OF DEFERRAL SCHEME

However, before the introduction of 1979 scheme, in the course of operation of earlier schemes, both the governments as well as eligible units realized that there are inherent difficulties in the operation of deferral schemes. Eligible units realized that in effect they cannot get sales tax extra over and above the basic price because of competitiveness, increased transport cost and other increased production costs due to backward area. Hence, they represented to the government that as sales tax deferral is not to their advantage, option of sales tax exemption should be given so that their competitiveness and hence the viability of the unit can be achieved.

Government also realized that many fraudulent units had come up who had collected tax under the deferral scheme and then closed and ran away after some period. This had brought real revenue losses to the State Exchequer. Hence, government also favoured sales tax exemption option. For the first time,

Government of Maharashtra introduced exemption option in the 1979 Incentive Scheme introduced in GR No. IDL 7079(2043)/IND.8 dated 5th January, 1980. **Gujarat and other States also adopted similar option.**

For last more than two decades exemption option has worked without any problem in all the States. However, during this period in the deferral option, there have been so many litigations, lots of issues of recovery, chasing of run-away deferral units, issue of closure of units immediately after the deferral period, keeping of too many administrative records for almost 15-20 years, tedious follow up for several years involving change of almost all persons in the government as well as eligible units, etc.

Thus, on all counts exemption option has proved to be better both for governments as well as eligible units.

#### 4. PROPOSED PROVISIONS UNDER THE VAT

It is surprising to note that under the VAT, it is proposed to convert all exemption incentives into deferral incentives. Perhaps, this suggestion has come from persons who have not operated these incentive schemes or they are not having sufficient experience in the field of incentives. It is believed that exemption option is not compatible with the system of VAT. The proposals envisage operation of deferral incentives for all eligible units in following manner:

- a) On purchase side, there will not be any concessional form available to eligible units. Hence, they will be required to pay full tax on purchase side.
- B) On sales side eligible units will be required to collect tax and collected tax will be deferred for a longer period.

#### 5. EFFECTS OF SUCH PROVISIONS ON ELIGIBLE UNITS AND GOVERNMENT

At present, both types of eligible units under deferral as well as exemption are permitted to buy their inputs against concessional forms without involving immediate cash-flow. If these concessional forms are withdrawn, both types of units will have to bear immediate cash outflow, affecting their working capital. In case of some of the units, purchase incentives

may be more than sales incentives, particularly when raw-materials includes high taxed products such as naphtha, natural gas, industrial alcohol, etc. Also in the case of Mega Plants where because of huge capacity, CST sales (@ 4%) are far more than Local sales, purchase incentives can be more than sales incentives. In such cases, even viability of units comes into question. In case of normal manufacture also, purchase incentives always form 30-40% out of total incentives. Thus, on purchase side, there is adverse effect for both types of units - deferral as well as exemption - under the new proposals of VAT, by way of increased cash out-flow for sales tax payment.

On the sales side, it is proposed that exemption units will have to collect tax like deferral units. The very fact that the unit has opted for exemption option shows that the unit cannot collect extra money by way of charging sales tax in addition to basic price because of competitiveness and other factors in the market. If extra money can be collected by any unit by way of sales tax then no unit will go for exemption option. By forcing all exemption units to go for deferral option, government should realize that the brunt of sales tax will have to be borne by eligible units themselves, i.e. they will continue to realize the same total price; they will have to bear the burden of sales tax from the same money which used to come under exemption. In the present times of recession, many units will not remain viable and will have to be closed down which will add further fuel to present recession.

On government side, they will have to face all the problems in respect of deferral scheme as enumerated in para no. 3 under the head "Practical difficulties encountered in the operation of Deferral Scheme".

Legally, it is doubtful whether government can force such change over. On the ground of promissory estoppel and natural justice, there will be innumerable litigation in all the States.

Apart from legality, it will be unethical. If responsible governments break promises given under government policies, industries and traders will not have any faith in any of the future government policies.

**6. PRACTICAL OPTIONS**

We give below several options, which can be adopted for incentive schemes. Under these options, hardships of eligible units will be much mitigated although not eliminated.

**a) OPTIONS FOR INCENTIVES ON PURCHASE SIDE**

**(i) OPTION - 1**

On purchase side, concessional form must continue. Because, under the VAT also all forms under the CST Act such as form-C, form-H, form-F, etc. are going to be continued. Again this is not going to be a “Full-fledged VAT” as understood internationally. In the present “so called VAT” there will be several features which are against the principles of “ideal VAT”. Other input tax such as entry tax, octroi, cess, works contract tax, lease tax etc. are not going to be merged with the VAT. Central Sales Tax is not going to be abolished. Set off of CST is also not being provided. Various Sales Tax Forms under the CST Act are going to continue. In such scenario if some concessional forms continue for the incentive schemes under the VAT, every eligible unit will welcome it with no corresponding additional disadvantage to the Government.

**(ii) OPTION - 2**

On purchase side, if the concessional forms have to be removed, then the government must refund the taxes paid on purchases to eligible units within one month of the purchases (today 100% export oriented units are getting such refund). Here the government is not at a loss because the government was not getting any income on the purchase side under the exemption or deferral when there was use of concessional forms. Now, the government will pay such refund from the amount deposited by vendors in the government treasury by way of payment of their liability. Legally this is possible and Government of Maharashtra had already operated this scheme for 5 years during the operation of the 1964 Scheme. We reproduce below para 5 of the 1964 Scheme:

“(5) Sales Tax - In order to help a new industry to compete with an established industry during the ini-

tial period of its production, the Government shall give a cash refund of the sales tax paid by the industry on raw materials purchased by it and on the finished products, for the first 13 years after the date of License or Registration.....”

Such sales tax refund can be renamed as subsidy to avoid any legal hassle (if any).

**b) (i) OPTIONS FOR INCENTIVES ON SALES SIDE**

It is misconception that exemption incentives cannot work under the VAT. In Maharashtra, during the VAT period 1/10/1995 to 31/3/1999, exemption incentives have worked very well. Provisions under the Maharashtra VAT existing at that time should be introduced in the proposed VAT laws. There were two options available. In case of purchases from normal dealers (i.e. tax paid purchasers), the reseller was entitled to claim set-off of taxes on his purchases under Rule 42H while calculating sales tax on his sales. The reseller also had the option to pay tax on reduced sale price (i.e. sale price - purchase price) under Rule 46B particularly if such purchases are from exempted units.

**ii) OPTION - 2**

On the sales side, if deferral option is made compulsory, the tax collected should be allowed to be deferred perpetually. Legally this is possible, if suitable amendment is made to the Sales Tax Act. In the past, to solve the problem of allowance of deferred sales tax under section 43-B of the Income-tax, almost all States have carried out amendments to their Sales Tax Act providing that whenever any eligible unit has opted for “deferral loan scheme” and loan liability has been raised by the relevant government corporation/institution such as SICOM, GIC, etc. then as far as Sales Tax Department is concerned, “sales tax is deemed to have been paid in public interest”.

**(iii) OPTION - 3**

If by any chance the collected tax cannot be deferred perpetually because of any legal hitch, it should be allowed to be deferred for a very long period say 30 years for exemption units (which will be converted into deferral units). ■