CHAPTER – I

INTRODUCTION

WHAT IS TAX?

The word tax is derived from the Latin word ‘taxare’ meaning ‘to estimate’. “A tax is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority” and is any contribution imposed by government whether under the name of toll, tribute, impost, duty, custom, excise, subsidy, aid, supply, or other name.” (Black’s Law Dictionary)

Funds provided by taxation have been used by states and their functional equivalents throughout history to carry out many functions. Some of these include expenditures on war, the enforcement of law and public order, protection of property, economic infrastructure (roads, legal tender, enforcement of contracts, etc.), public works, social engineering, and the operation of government itself. Most modern governments also use taxes to fund welfare and public services. These services can include education systems, health care systems, and pensions for the elderly, unemployment benefits, and public transportation. Energy, water and waste management systems are also common public utilities. Governments use different kinds of taxes and vary the tax rates. This is done to distribute the tax burden among individuals or classes of the population involved in taxable activities, such as business, or to redistribute resources between individuals or classes in the population. Taxation has four main purposes or effects: Revenue, Redistribution, Re-pricing, and Representation.
The main purpose is revenue: taxes raise funds to spend on roads, schools, hospitals, and on other indirect government functions like market regulation or legal systems.

The second purpose is redistribution, which means transferring wealth from the richer sections of society to poorer sections.

A third purpose of taxation is re-pricing of certain goods to increase or decreases their consumption. Taxes are levied to discourage consumption of certain items like say tobacco.

A fourth effect of taxation has been representation, where the citizens by paying taxes demand accountability in return from the rulers or governments. Several studies have shown that direct taxation (such as income taxes) generates the greatest degree of accountability and better governance, while indirect taxation tends to have smaller effects.

HISTORY OF TAXATION

The first known system of taxation was in Ancient Egypt around 3000 BC - 2800 BC in the first dynasty of the Old Kingdom. Records from that time show that the pharaoh would conduct a biennial tour of the kingdom, collecting tax revenues from the people. Other records are granary receipts on limestone flakes and papyrus. Early taxation is also described in the Bible. In Genesis (chapter 47, verse 24 - the New International Version), it states "But when the crop comes in, give a fifth of it to Pharaoh. The other four-fifths you may keep as seed for the fields and as food for yourselves and your households and your children." Joseph was
telling the people of Egypt how to divide their crop, providing a portion to the Pharaoh. A share (20%) of the crop was the tax.

The history of taxation can be briefly described country wise as follows:

i. Egyptian Taxes

The first known taxation system was in ancient Egypt. The Pharaoh would collect taxes twice a year from the Egyptians. One of the most commonly taxed items in the ancient world was cooking oil, which was actually taxed throughout Egyptian history because of shortages. Egyptian taxes eventually became so widely known that they were even mentioned in the bible, "When the crop comes in, give a fifth of it to Pharaoh."

ii. Athens, Greece

To the Athenians in Greece, war was a lifestyle, and a pricey one at that. As such, Athenians taxed their citizens for war costs with a tax they called "eisphora." The most historic factor of this tax was that it exempted no one, which many consider the first democratic taxation system, as after the wars the money was often refunded to the people. There is also some documentation of a tax put on foreigners (or any individual without an Athenian mother and father), called "metoikion."

iii. Salt Tax in India

Salt has been taxed in India for centuries. However, in 1835 the British East India Company raised the import taxes drastically after they began to impose rule over Indian
provinces. The salt tax was raised and lowered by multiple leaders and events, and was not
repealed until 1946.

iv. Rome and Caesar

Taxes called "portoria" were first levied in Rome on imports and exports to the
city. Caesar Augustus, who is now considered a genius tax strategist of his time, gave individual
cities the job of collecting taxes. He also raised sales taxes on slaves from 1% to 4%, and
created a tax to raise retirement funds for soldiers of the army.

v. Great Britain

The occupation of the Roman Empire may have sparked the flame for first taxes in
England. During the 11th century Lady Godiva's husband, Leofric, Earl of Mercia, said he
would lower taxes were she to ride through the streets naked on a horse. Lady Godiva
made the now famous ride and lowered taxes for her people.

vi. The French Revolution

Before the French Revolution, civil unrest laid heavily on the shoulders of high
taxes for lower classes. While clergymen and nobles were exempt to taxes, peasants and
regular wage earning workers were not. The tax gap also left lower class citizens unable to pay
court fees, making justice unaffordable except by those wealthy enough to afford it. While
the true cause of the French Revolution is still being debated today, many Historians feel these
high and unfair taxes were a large contributing factor to the civil unrest.
vii. United States

The history of taxation in the United States began when it was composed of colonies ruled by the British Empire, French Empire, and Spanish Empire. After independence from Europe the United States collected poll taxes, tariffs, and excise taxes. The United States imposed income taxes intermittently until 1895 when unapportioned taxes on interest, dividends and rents were ruled unconstitutional. The advent of the 16th Amendment to the United States Constitution modified the apportionment requirement in 1913, and since then the income tax has become one of the means of funding the Federal Government.

viii. India

In India, the tradition of taxation has been in force from ancient times. It finds its references in many ancient books like 'Manu Smriti' and 'Arthasastra'. There was a perfect admixture of direct taxes with indirect taxes and they were varied in nature.

India's history of taxation suggests existence of a large and composite taxable population. With the advent of the moguls in India the country witnessed a sea of change in the taxation system of India. Although, they also practiced the same norm of taxation but it was more homogeneous in structure and collection. The Islamic rulers imposed Jizya. It was later on abolished by Akbar. However, Aurangzeb, the last prominent Mughal Emperor, levied Jizya on his mostly Hindu subjects in 1679. Reasons for this are cited to be financial stringency and personal inclination on the part of the emperor, and a petition by the ulama. His subjects were taxed in accordance with the property they owned. Government servants were exempt, as were the blind, the paralyzed, and the indigent. Its introduction
encountered much opposition, which was, however, abolished. Jizya is a per capita tax levied on a section of an Islamic state's non-Muslim citizens, who meet certain criteria. From the point of view of the Muslim rulers, Jizya was a material proof of the non-Muslims' acceptance of subjection to the state and its laws, "just as for the inhabitants it was a concrete continuation of the taxes paid to earlier regimes." In return, non-Muslim citizens were permitted to practice their faith, to enjoy a measure of communal autonomy, to be entitled to Muslim state's protection from outside aggression, to be exempted from military service and the Zakat as obligatory upon Muslim citizens. The period of British rule in India witnessed some remarkable change in the whole taxation system of India. Although, it was highly in favor of the British government and its exchequer but it incorporated modern and scientific method of taxation tools and systems. In 1922, the country witnessed a paradigm shift in the overall Indian taxation system. Setting up of administrative system and taxation system was first done by the Britishers.

The **GST** is a broad based, single, comprehensive tax levied on goods and services at each point of sale of goods or provision of service, in which, the seller or the service provider may claim the input credit of tax which he has paid while purchasing the goods or availing the service; the final consumer will thus bear only the GST charged by the last dealer in the supply chain. With the introduction of GST at the state level, the additional burden of CENVAT and service tax would be comprehensively removed and major Central and State tax will get subsumed into GST which will reduced the multiplicity of the taxes. Thus it marks a measure improvement over the previous system of VAT. Again, the transparent and complete chain of set-offs, GST will hell
winding the coverage of tax base and improve tax compliance. This may lead to higher revenue which further results in lowering of tax burden.

GST is a tax on goods and services with the benefit of continuous chain of set off from the level of manufacturers and service providers right up to the retailer’s level. Thus it is essentially a tax only on value addition at each stage, and thus a supplier of goods and/or services is permitted to set off the GST paid at the previous stage through an input tax credit mechanism. GST has been envisaged to give relief of the cascading burden of “tax on tax”.

GST is abbreviation for Goods and Service Tax. GST would be levied on all the transactions of goods and services made of a consideration. This new levy would replace almost all of the indirect taxes. In particular, it would replace the following indirect taxes:

**At Federal Level**

- Central Excise Duty
- Service Tax
- Additional Excise Duties
- CVD (Levied on imports in lieu of Excise duty)
- SAD (Levied on imports in lieu of VAT)
- Excise Duty levied on Medicinal and Toiletries preparations,
- Surcharges and cesses
At State Level

- VAT/ Sales tax
- Entertainment tax (Unless it is levied by the local bodies)
- Luxury Tax
- Taxes on lottery, betting and gambling
- Entry tax not in lieu of Octroi
- Cesses and Surcharges

The government plans to introduce dual GST structure in India. Under dual GST, a Central Goods and Services Tax (CGST) and a State Goods and Services Tax (SGST) will be levied on the taxable value of a transaction. This dual structure will ensure a higher involvement from the states, and consequently their buy-in into the GST regime, thus facilitating smoother implementation. Both the tax components will be charged on the manufacturing cost. The government is deliberating on fixing the value of combined GST rate at the moment, which is expected to be between 14-16 per cent. After the combined GST rate is decided, the centre and the states will finalise the CGST and SGST rates. All kinds of goods and services, barring some exceptions, would be under the GST purview.

**WHAT IS GST?**

**Goods and Service Tax** is a tax on goods and services, which is leviable at each point of sale or provision of service, in which at the time of sale of goods or providing the services the seller or service provider can claim the input credit of tax which he has paid while purchasing the goods
or procuring the service. On most of the goods and services the rate of tax remains the same but as per the necessity of the nation some goods or services can be declared as “exempted” or “Zero rated”. The whole system is developed in such a way that it avoids the cascading effect and the final consumer bears the burden of all the tax. Generally, in such a system Exports are zero rated and all the taxes paid while purchasing and manufacturing the goods including the taxes paid on raw material and services are returned to the exporter to make the exports competitive. The sellers or service providers collect the tax from their customer, who may or may not be the ultimate customer, and before depositing the same to the exchequer, they deduct the tax they have already paid. This is simply very similar to VAT which is at present applicable in most of the states and can be termed as National level VAT on Goods and Services with only one difference that in this system not only goods but also services are involved and the rate of tax on goods and services are generally the same.

The **Goods and Services Tax (GST)** is a value added tax to be implemented in India by April 2012. It will replace all indirect taxes levied on goods and services by the Indian Central and State governments. It is aimed at being comprehensive for most goods and services with few tax exemption.

India is a federal republic, and the GST will thus be implemented concurrently by the central and state governments as the Central GST and the State GST respectively. Exports will be zero-rated and imports will be levied the same taxes as domestic goods and services adhering to the destination principle.115th Constitutional Amendment Bill, 2011 (“Bill”) was put before the Parliament by the Finance Minister on 22 March 2011. In its current state, the Constitution of India does not provide concurrent powers of taxation to the Union and the States. The Bill
proposes to amend the Constitution to empower the Union and States to frame laws for levying goods and service tax (“GST”) on transactions involving the supply of goods and services. The Bill is thus a crucial step by the United Progressive Alliance Government to ensure introduction of the GST regime by 2012 in India. If this is considered to be a major improvement over the pre-existing central excise duty at the national level and the sales tax system at the state level, the new tax will be a further significant breakthrough and the next logical step towards a comprehensive indirect tax reform in the country. Keeping this overall objective in view, an announcement was made by Shri Palaniappan Chidambaram, the Union Finance Minister, during the central budget of 2007–2008 that it would be introduced from April 1, 2010 and that the Empowered Committee of State Finance Ministers, on his request, would work with the Central Government to prepare a road map for introduction of GST in India.

GST elsewhere: More than 140 countries have introduced GST in some form. It has been a part of the tax landscape in Europe for the past 50 years and is fast becoming the preferred form of indirect tax in the Asia Pacific region. It is interesting to note that there are over 40 models of GST currently in force, each with its own peculiarities. While countries such as Singapore and New Zealand tax virtually everything at a single rate, Indonesia has five positive rates, a zero rate and over 30 categories of exemptions. In China, GST applies only to goods and the provision of repairs, replacement and processing services. It is only recoverable on goods used in the production process, and GST on fixed assets is not recoverable. There is a separate business tax in the form of VAT. For example, when the GST was introduced in New Zealand in 1987, it yielded revenues that were 45 per cent higher than anticipated, in large part due to improved compliance. It is more neutral and efficient structure could yield significant dividends to the economy in increased output and productivity. The GST in Canada replaced the federal
manufacturers’ sales tax which was then levied at the rate of 13 per cent and was similar in design and structure as the CENVAT in India. It is estimated that this replacement resulted in an increase in potential GDP by 1.4 per cent, consisting of 0.9 per cent increase in national income from higher factor productivity and 0.5 per cent increase from a larger capital stock (due to elimination of tax cascading). The Canadian experience is suggestive of the potential benefits to the Indian economy. This means gains of about US$ 15 billion annually. Discounting these flows at a modest 3 per cent per annum, the present value of the GST works out to about half a trillion dollars. This is indeed a staggering sum and suggests the need for energetic action to usher the GST regime at an early date. GST rates of some countries are given below. Country Rate of GST Australia 10%, Canada 5%, Germany 19%, Japan 5%, Singapore 7%, Sweden 25% and UK 17.5% (20% w.e.f. 4 Jan 2011).

**THE ADVENT OF GST**

GST will bring about a change on the tax firmament by redistributing the burden of taxation equitably between manufacturing and services. It will lower the tax rate by broadening the tax base and minimising exemptions. It will reduce distortions by completely switching to the destination principle. It will foster a common market across the country and reduce compliance costs. It will facilitate investment decisions being made on purely economic concerns, independent of tax considerations. It will promote exports. GST will also promote employment. Most importantly, it will spur growth. The following represents the movement of goods after GST.

1. Taxes which cannot be set off will reduce

2. All India tax will be based on value added
3. No value added implies no tax to be paid to the government

4. Creation of a tax neutral supply chain.

5. You follow any route; the tax given to the government will remain the same.

6. Entry tax, Octroi etc. Will be there, but as is evident, these are also being slowly removed. This will make the supply chain perfectly neutral to taxes

7. Efficiency of SCM will depend on the cost minimization of the following costs.
   
   a) Logistics cost
   
   b) Carrying and forwarding agency costs
   
   c) Warehouse fixed and variable costs d. Depot fixed and variable costs

8. The selection should be based on the following trades off which must be taken into consideration while designing the supply chain.
   
   a. Meshed design Vs Hub and spoke Vs combination
   
   b. Warehouse capacity and depot capacity
   
   c. No of warehouse and no of depots
   
   d. Mode of transport on road(9 ton Vs 15 ton Vs 20 ton) and rail (Half rake, full rake, 2point rake)
   
   e. Replacement cycle
   
   f. Safety stock
   
   g. Milk runs
IMPACT OF GST ON VARIOUS SECTORS

Introduction of GST will greatly improve the quality of the indirect tax system and, therefore, make it possible to have higher resources on a sustainable basis, which will make the fiscal situation more sustainable. This reform will solve many critical issues in the long run. According to a recent study on the impact of GST, India could gain as much as $15 billion annually once the GST is in place. Discounting these flows at a modest 3 per cent per annum, the present value of the GST will work out to about half a trillion dollars. GST will give more relief to industry, trade and agriculture through a more comprehensive and wider coverage of input tax set-off and service tax set-off, subsuming of several Central and State taxes in the GST and phasing out of CST. The transparent and complete chain of set-offs which will result in widening of tax base and better tax compliance may also lead to lowering of tax burden on an average dealer in industry, trade and agriculture.

The subsuming of major Central and State taxes in GST, complete and comprehensive setoff of input goods and services and phasing out of Central Sales Tax (CST) would reduce the cost of locally manufactured goods and services. This will increase the competitiveness of Indian goods and services in the international market and give boost to Indian exports. The impact of Goods and Services Tax on certain sectors are discussed hereunder.
Food Industry

The application of GST to food items will have a significant impact on those living under subsistence levels. It would have a major impact on the poor. But at the same time, a complete exemption for food items would drastically shrink the tax base. Food includes a variety of items, including grains and cereals, meat, fish, and poultry, milk and dairy products, fruits and vegetables, candy and confectionary, snacks, prepared meals for home consumption, restaurant meals, and beverages. In India while food as such is exempt from the CENVAT, many of the food items including food grains and cereals attract the state VAT at the rate of 4%. Exemption under the state VAT is restricted to unprocessed food, e.g., fresh fruits and vegetables, meat and eggs, and coarse grains. Beverages are generally taxable, with the exception of milk. Even if food is within the scope of GST, such sales would largely remain exempt due to small business registration threshold. Given the exemption of food from CENVAT and 4% VAT on food items, the GST under a single rate would lead to a doubling of tax burden on food. Hence certain measures need to be taken in this regard.

Housing and Construction industry

In some countries in Europe, supply of land and real property are excluded from the scope of tax whereas in Australia, New Zealand, Canada and South Africa, housing and construction services are treated like any other commodity. When a real estate developer builds and sells a home, it is subject to VAT on the full selling price, which would include the cost of land, building materials, and construction services. Commercial buildings and factory sales are also taxable in the same way, as are rental charges for leasing of industrial and commercial buildings. There are only two exceptions:
Resale of used homes and private dwellings, and Rental of dwellings.

A sale of used homes and dwellings is exempted because the tax is already collected at the time of their first purchase. Residential rentals are also exempted for the same reason. If rents were to be made taxable, then credit would need to be allowed on the purchase of the dwelling and on repairs and maintenance. In India the construction and housing sector need to be included in the GST tax base because the construction sector is a significant contributor to the national economy.

FMCG sector

Despite the economic slowdown, India’s Fast Moving Consumer Goods (FMCG) sector has grown consistently during the past three to four years, reaching a size of $25 billion (Rs 120,000 crore) at retail sales in 2008. Implementation of the proposed Goods and Services Tax (GST) and opening of Foreign Direct Investment (FDI) are expected to fuel growth further and raise the industry’s size to $47 billion (Rs 225,000 crore) by 2013 and $95 billion (Rs 456,000 crore) by 2018, according to a new FICCI-Technopak report. The FMCG sector is also one of the major contributors to the exchequer with $6.5 billion (Rs 31,000 crore) paid through direct and indirect taxes. Implementation of GST will have several benefits for the FMCG sector including uniform, simplified and single point taxation and thereby reduced prices.
Rail sector

There have been suggestions for including the rail sector under the GST umbrella to bring about significant tax gains and widen the tax net so as to keep the overall GST rate low. The inclusion of the rail sector in the tax regime which will do away with most of the indirect taxes should be done if the government wants to provide a level playing field to road and air transportation sector. This will have the added benefit of ensuring that all inter-state transportation of goods can be tracked through the proposed information technology (IT) network.

Financial services

In most of the countries Goods and Services Tax is not charged on financial services. For example in New Zealand, almost all goods and services are covered under the GST except that of financial services. The reason behind this is that the charge for services provided by financial intermediaries like banks and insurance companies is generally not precise, i.e. the fee is taken as a margin that is hidden in interest, dividends, annuity payments or such other financial flows from the transactions. If the fee was not a hidden one, then it would be easy to charge the service to tax.

In China, financial services are taxable under their business tax, which is a tax on turnover with no tax credits allowed on inputs. Because it is a turnover tax, it can be applied to the total spread for margin services, with no need to allocate the spread between borrowers and depositors. Israel and Korea also apply tax in such alternative forms.
Under the Service Tax, India has followed the approach of bringing virtually all financial services within the ambit of tax where the consideration for them is in the form of an explicit fee. It has gone beyond this by bringing selected margin services (where the consideration is the spread between two financial inflows and outflows) within the Service Tax net. The following are principal examples of such taxable margin services: Merchant discounts on credit/debit card transactions are taxable as a consideration for credit card services, as are any explicit fees or late payment charges collected from the card member. In foreign currency conversion transactions without an explicit fee, tax applies to a deemed amount of consideration equal to 2% of the amount converted. The tax applies to that portion of life insurance premiums that represents a cover for risks.

In some countries, transactions in gold, silver and other precious metals are also treated as part of the financial sector, given that these metals are often bought as investments, and not for consumption and hence they are exempted from tax.

As there are no compelling reasons to exempt financial services from the purview of GST, it would be advisable to continue the same approach as followed under the Service Tax provisions.

**Information Technology Enabled Services**

For the purpose of taxing e-commerce or software, it is essential to define the kind of property. Intangible property means property that can be moved but cannot be touched and felt. It can be further divided into Intellectual Property Rights and Others like Goodwill, Interest, and Receivables. The medium through which the software is transmitted determines the
nature of goods. If it is through electronic form, then it is considered as intangible property, but if it is any other type of medium, then it would be tangible property. Depending on the type of goods and their place of supply, the tax implications vary in the countries that already have GST. E-commerce and other such transactions are the toughest to tax and need the highest probability of tax planning.

India has been struggling with the taxation of e-commerce. In spite of various judicial Pronouncements and laws, the tax implications are still not very clear. Presently, the packaged and customized software is taxed on the basis of the intent of the parties. To be in sync with the best international practices, domestic supply of software should also attract GST on the basis of mode of transaction. Hence, if the software is transferred though electronic form, it should be considered as Intellectual Property and regarded as a service. If the software is transferred on media or any other tangible property, then it should be treated as goods and subject to GST.

Impact on small enterprises

The impact of GST on small enterprises is of great concern. There will be three categories of small enterprises in the GST regime. Those below the threshold need not register for the GST. Those between the threshold and composition turnovers will have the option to pay a turnover based tax or opt to join the GST regime. Given the possibilities of input tax credit, not all small enterprise may seek the turnover tax option. The third category of small enterprises above the turnover threshold will need to be within the GST framework. Possible downward changes in the threshold in some States consequent to the introduction of
GST may result in obligations being created for some dealers. In such cases suitable provisions could be made to provide direct assistance to the affected small enterprises if considered desirable. In respect of Central GST, the position is slightly more complex. Small scale units manufacturing specified goods are allowed exemption of excise up to a turnover of Rs 1.5 crores. These units, which may be required to register for payment of GST, may see this as an additional cost.

**Complexity**

In spite of the improvements made in the tax design and administration over the past few years, the systems at both central and state levels remain complex. Their administration leaves a lot to be desired. They are subject to disputes and court challenges, and the process for resolution of disputes is slow and expensive. At the same time, the systems suffer from substantial compliance gaps, except in the highly organized sectors of the economy. There are several factors contributing to this unsatisfactory state of affairs. The most significant cause of complexity is, of course, policy related and is due to the existence of exemptions and multiple rates, and the irrational structure of the levies. These deficiencies are the most glaring in the case of the CENVAT and the Service Tax.

The starting base for the CENVAT is narrow, and is being further eroded by a variety of area-specific, and conditional and unconditional exemptions. A few years ago the Government attempted to rationalize the CENVAT rates by reducing their multiplicity but has not adhered to this policy and has reintroduced concessions for several sectors/products.
The key problem with the service tax is the basic approach of levying it on specified services, each of which generates an extensive debate as to what is included in the base. Ideally, the tax base should be defined to include all services, with a limited list of exclusions (the so-called “negative list”). The Government has been reluctant to adopt this approach for the fear that it could bring into the tax net many services that are politically sensitive.

The complexities under the State VAT relate primarily to classification of goods to different tax rate schedules. Theoretically, one might expect that the lower tax rates would be applied to basic necessities that are consumed largely by the poor. This is not the case under the State VAT. The lowest rate of 1% applies to precious metals and jewellery, and related products—hardly likely to be ranked highly from the distributional perspective. The middle rate of 4% applies to selected basic necessities and also a range of industrial inputs and IT products. In fact, basic necessities fall into three categories – exempted from tax, taxable at 4%, and taxable at the standard rate of 12.5%. The classification would appear to be arbitrary, with no well accepted theoretical underpinning. Whatever the political merits of this approach, it is not conducive to lower compliance costs. Most retailers find it difficult to determine the tax rate applicable to a given item without referring to the legislative schedules. Consumers are even less aware of the tax applicable to various items. This gives rise to leakages and rent seeking.

Another source of complexity under the State VAT is determining whether a particular transaction constitutes a sale of goods. This problem is most acute in the case of software
products and intangibles such as the right to distribute/exhibit movies or time slots for broadcasting advertisements.

Compounding the structural or design deficiencies of each of the taxes is the poor or archaic infrastructure for their administration. Taxpayer services, which are a lynchpin of a successful self-assessment system, are virtually nonexistent or grossly inadequate under both central and state administrations. Many of the administrative processes are still manual, not benefiting from the efficiencies of automation. All this not only increase the costs of compliance, but also undermines revenue collection.