CHAPTER III

VALUE ADDED TAX AND ITS IMPACT - AN OVER VIEW

3.1 Introduction

In the economic reforms of India, indirect tax reforms have become an integral part of the liberalization process since 1991. In the first phase of reforms, the Government of India has been steadily concentrating upon a tax structure that leads to a simple, moderate, rational and easy system. At the central level, an initiative has been taken to bring down both the excise and customs tariffs, reduce the number of rates, correct anomalies and get rid of the complexities in the system. In addition to indirect taxes levied by the centre, the states are empowered to levy certain indirect taxes and Sales Tax, which forms major part of revenue for almost all States. There was wide variation in erstwhile Sales Tax rates of the same commodity in different states. In many states both inputs as well as outputs were taxed creating a cascading effect. With a view to removing this shortcoming of erstwhile Sales Tax system, the viable solution found was to shift to destination based Value Added Tax (VAT).

The Value Added Tax aims to radically reform the conventional system of Sales Tax laws that was mingled with the horrible effects of double taxation. VAT is the most diversified and simple as well as transparent indirect tax system with in-built capacity to raise more tax revenue without distorting the existing tax structure and is yet able to widen the tax base. VAT system has the unique feature of preventing the scope of tax avoidance. VAT is more taxpayer-friendly than the conventional Sales Tax system. It does not exert any undue pressure of shouldering additional tax burden. For the socio-economic growth and prosperity of an economy, introduction of VAT is a boon and not a baneful act.
VAT is not just a replacement of conventional sales tax regime. It is a change in business strategies. It affects every walk of life in business models; say procurement policy, suppliers’ chain, distribution policy, selling and marketing strategies and finally the bottom line.²

3.2 Historical Background

Going into the historical background of VAT, it can be stated that the concept of VAT, which was the brainchild of F. Vans Siemens first originated in 1918 as an alternative to turnover tax in Germany. France was the first country to adopt it in 1954 and this largely paved the way for it being accepted as instrument for harmonization of tax. In 1967 the Council of European Economic Community (EEC) issued directives for widespread adoption of Value Added Tax to replace existing turnover taxes and link EEC members with a common tax system. The Council also hoped the new system would increase foreign trade, which was hindered by the complex regulatory practices of the turnover tax system. After the directive, countries outside the EEC such as Austria, Sweden, Brazil, Greece, and Peru also adopted some variation of the VAT, either in addition to or as a replacement for their own national tax structures. Subsequently, about 160 countries including Pakistan in 1990, Bangladesh in 1991, Sri Lanka in 1995, China in 1994 and Nepal in 2000 have adopted VAT. Developed countries like Australia, Canada, the European Union, Spain, Japan, United Kingdom etc. have also adopted this system. Alongside, the US has not implemented VAT. They believe that A VAT ultimately penalizes consumption and encourages savings. Let us have a look at some countries throughout the world that have adopted VAT system in Table 7.
<table>
<thead>
<tr>
<th>Country</th>
<th>Year in which VAT Introduced</th>
<th>Country</th>
<th>Year in which VAT Introduced</th>
<th>Country</th>
<th>Year in which VAT Introduced</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>January 1973</td>
<td>Hungary</td>
<td>January 1988</td>
<td>Morocco</td>
<td>April 1986</td>
</tr>
<tr>
<td>Australia</td>
<td>July 2000</td>
<td>Ireland</td>
<td>November 1972</td>
<td>Mozambique</td>
<td>April 1999</td>
</tr>
<tr>
<td>Argentina</td>
<td>January 1975</td>
<td>Italy</td>
<td>January 1973</td>
<td>Netherlands</td>
<td>January 1969</td>
</tr>
<tr>
<td>Algeria</td>
<td>April 1992</td>
<td>Indonesia</td>
<td>April 1985</td>
<td>Nicaragua</td>
<td>January 1975</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>April 1994</td>
<td>Israel</td>
<td>July 1976</td>
<td>Namibia</td>
<td>October 1999</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>July 1991</td>
<td>India</td>
<td>April 2005</td>
<td>New Zealand</td>
<td>May 1986</td>
</tr>
<tr>
<td>Chile</td>
<td>March 1975</td>
<td>Korea</td>
<td>July 1977</td>
<td>Poland</td>
<td>July 1993</td>
</tr>
<tr>
<td>Fiji</td>
<td>July 1992</td>
<td>Mongolia</td>
<td>May 1993</td>
<td>Panama</td>
<td>March 1977</td>
</tr>
<tr>
<td>Switzerland</td>
<td>January 1995</td>
<td>Turkey</td>
<td>January 1985</td>
<td>Uruguay</td>
<td>January 1968</td>
</tr>
<tr>
<td>Taiwan</td>
<td>April 1986</td>
<td>United Kingdom</td>
<td>April 1973</td>
<td>Venezuela</td>
<td>October 1993</td>
</tr>
</tbody>
</table>


The Indirect Taxation Committee so formed in July 1976 under the chairmanship of L. K. Jha extensively reviewed the Indian Indirect Tax structures where it was found that there were multiplicity in tax rates and exemptions. The tax base was narrow thus making the tax system less effective and less robust in regard to tax mobilization. To overcome the impasse, the Committee recommended both long-term as well as short-term measures for reforming the indirect tax system and advocated to introduce ad valorem tax as far possible to boost the economy on to its growth trajectory with less of departure from the cherished path of success and growth so as to compete with the global standards and prosperity. As a refinement
of *ad valorem tax*, the Government latter introduced MODVAT with effect from March 1986.³

The Tax Reforms Committee set up under the chairmanship of Raja J Chelliah in 1991 recommended reforms in the taxes and duties administered by the Centre and States. Consequently, the system of Modified Value Added Tax was implemented in the matter of central and excise duty with great success. Prompted by the efficiency of the MODVAT system, Central Government replaced MODVAT with Central VAT (CENVAT) Scheme since 2000-01.

The concept of VAT is not totally new to India as the Centre had introduced a VAT system for about last twenty years in respect of Central Excise duties. The first preliminary discussion on State level VAT was held in a meeting of Chief Ministers convened by Manmohan Singh, the then Union Finance Minister in 1995. The main theme of this meeting was to discuss the basic issues on VAT and this was followed up by periodic interactions of State Finance Ministers. Subsequently, three important decisions were taken in a meeting of all the Chief Ministers of India convened by Yashwant Sinha, the Union Finance Minister in 1999. The important decisions were: (a) there will not be any Sales Tax rate war among the States and uniformity of Sales Tax rates should be made for different categories of commodities with effect from January 1, 2000, (b) in the interest of harmonization of incidence of Sales Tax, the sales-tax-related industrial incentive schemes would also have to be discontinued with effect from January 1, 2000, (c) on the basis of achievement of the first two objectives, steps would be taken by the States for introduction of State level VAT after adequate preparation. However, an Empowered Committee of State Finance Ministers was set up in implementing
these decisions and for the purpose of arriving at a consensus and implementing a nationwide State level VAT.\(^4\)

The Empowered Committee of State Finance Ministers headed by the Finance Minister of West Bengal, Asim Kumar Dasgupta and comprising the finance ministers of Assam, Delhi, Gujarat, Jammu & Kashmir, Jharkhand, Karnataka, Madhya Pradesh, Maharashtra, Meghalaya, Punjab, Tamil Nadu and Uttar Pradesh, endorsed the suggestion that every State law on VAT should have a minimum set of common features. At the conference of the State Finance Ministers held on January 23, 2002, it was agreed that all the 28 States as well as the Union Territories would introduce VAT with effect from April 1, 2003. At this stage, there were certain developments which delayed the introduction of VAT. Finally, it was announced that all states have agreed to introduce VAT w.e.f. 1\(^{st}\) April 2005. A ‘White Paper’ was released by Asim Dasgupta, the Chairman of Empowered Committee, on 17\(^{th}\) January 2005. The White Paper is a policy document indicating basic policies of Value Added Tax. Haryana was the only State to introduce VAT w.e.f. 1\(^{st}\) April 2003. 21 States have introduced VAT (though in diluted form) w.e.f. 1\(^{st}\) April 2005. These include Assam, Andhra Pradesh, Bihar, Delhi, Goa, Karnataka, Kerala, Maharashtra, Punjab and West Bengal. Chhattisgarh, Jharkhand, Madhya Pradesh, Rajasthan, and Gujarat have introduced VAT to replace the Sales Tax in April 1 2006. Tamil Nadu adopted VAT in the year 2007 and Uttar Pradesh in the year 2008.

The Value Added Tax Act, 2003 came into force with effect from 1\(^{st}\) April 2005 on the assurance that the loss of revenue to the State of Kerala, if any, will be reimbursed by the Central Government during the initial years. The Kerala Value Added Tax Bill, 2003 was passed in the State Assembly and it received the assent of the President on 10.12.2004, published in the Gazette in K. G Ext .No 2705 dated

3.3 Concept and Genesis of VAT

According to the Economics Dictionary, VAT is a "tax on the value added to a product at each stage of its production, from raw materials to finished product. Widely employed in Europe, Value-Added Taxes have the advantage (for Governments) of raising revenue 'invisibly,' that is, without appearing as taxes on the bill paid by the consumer." \(^5\)

The term ‘value added’ refers to increase in value of goods and services at each stage of production/ transfer of goods or commodities/ services. Thus VAT basically means the tax likely to be levied on the value added by an organization at each stage of its rendering services or producing goods.\(^6\)

VAT is a consumption tax because it is borne ultimately by the final consumer. It is not a charge on companies. It is collected fractionally through a system of deductions whereby taxable persons can deduct from their VAT liability the amount of tax they have paid to other taxable persons on purchases for their business activities. VAT, therefore, is levied at every point in the series of sales by the registered dealers with the provision of credit of input tax paid at the previous point of purchase thereof.\(^7\)

The essence of VAT is in providing set-off for the tax paid earlier, and this is given effect through the concept of input tax credit/rebate. This input tax credit in relation to any period means setting off the amount of input tax by a registered dealer against the amount of his output tax. The Value Added Tax is based on the value addition to the goods, and the related VAT liability of the dealer is calculated by deducting input tax credit from tax collected on sales during the payment period (say a month).\(^8\)
Each commodity passes through different stages of production and distribution before it finally reaches the consumer. Some value is added at each stage of the production and distribution chain. Value Added Tax is tax on value addition at each stage. Under VAT system, a dealer collects tax on his sales, retains the tax paid on his purchase and pays balance to the Government Treasury. It is a consumption tax because it is borne ultimately by the final consumer. The tax paid by the dealer is passed on to the buyer. It is not a charge on the dealer. Hence, VAT is a multipoint tax system with provision for set off of tax paid on purchases at each point of sale. In brief, VAT can be defined as “a multi point system of taxation on sale of goods where in a mechanism is provided to grant credit for tax paid on inputs (purchased goods).”

Presently, tax on sales or purchase of goods is levied by virtue of entry 54 in List II of VII schedule of the Constitution of India. VAT is also leviable with respect to this entry. VAT is simply a form of the Sales Tax. The only difference is that it is collected at every point in the series of sales by a registered dealer with the provision of credit for input tax paid at the previous point of purchase thereof. Thus, a dealer is required to pay the difference of what tax he has paid at the earlier stage. The basic requirement for this purpose is that the tax amount should be invariably shown in the invoice. The tax charged or collected and shown separately would not form part of the turnover.

3.4 VAT Computation

Value Added Taxation works under chain system and creates incentives for each participant from production to sale and clearly identifies his role, because he is only taxable for paying on VAT on addition in value generation. It is a multipoint tax system with input tax credit available for tax paid on corresponding purchases. Full tax is charged at each transaction, but tax is paid to Government after
considering input tax credit. Thus indirectly tax is charged on value addition only. Therefore, it is called Value Added Tax or VAT.

Since VAT is a very versatile tax, it offers several methods to calculate the quantum of tax payable. The commonly used methods of calculation are addition, subtraction and tax credit.

(a) Addition Method
In ‘addition method’, all factor payments including profits are aggregated to arrive at the total value addition. This type of computation is used mainly with income VAT. Addition method cannot easily accommodate exemptions of intermediate firms. It is also difficult to exempt exports and do correct valuation of imported goods. Another drawback is that it does not facilitate matching of invoices for detecting tax evasion.

(b) Subtraction Method
This is the simplest method for computing tax liability. The value added by a firm is calculated by subtracting total purchases from sales. Tax is easily ascertained by applying the rate on the value addition. Under the subtraction method, value added is measured as the difference between an enterprise's taxable sales and its purchases of taxable goods and services from other enterprises. At the end of the reporting period, the VAT rate is applied to this difference to determine the tax liability. The subtraction method differs from the credit invoice method principally in that the tax rate is applied to a net amount of value added (sales less purchases), rather than to the gross sales, with credits for tax paid on gross purchases.

(c) Tax credit or Invoice Method
VAT operating countries mostly employ the tax credit or invoice method for computing the actual tax payable. It is widely used in conjunction with comprehensive VAT. In this method, deduction of taxes paid on inputs is
allowed from the taxes payable on sales on the basis of the aggregates of the
taxes indicated on all invoices. The invoices received for the purchase of inputs
and sale of value added commodities give correct indication of the actual tax
liability. It eliminates the distortion caused by a differential rate structure.

3.5. Rationale for Introducing VAT

In the Sales Tax system, before a commodity is produced, inputs are first
taxed, and then after the commodity is produced with input tax load, output is taxed
again. This causes an unfair double taxation with cascading effects. In the VAT, a
set-off is given for input tax as well as tax paid on previous purchases. Also, there is
a multiplicity of taxes in several states, and such taxes include turnover tax,
surcharge on sales tax, additional surcharge, etc. With the introduction of VAT
these other taxes are abolished. CST is also going to be abolished in a phased
manner. As a result, overall tax burden will be rationalized and the prices in general
will tend to fall. The trading community in India had exploited the Governments by
misusing the conventional Sales Tax system in adopting loopholes in the system
administered by the Centre or State. If a well administered system comes in, it will
close avenues for traders and businessmen to evade paying taxes. They will also be
compelled to keep proper records of their sales and purchases.11

The general perception of the conventional Single Point Sales Tax system
is that it is highly complex with multiplicity of rates, plethora of explanations, many
rates in some group of items, extensive use of statutory forms, high and unrealistic
quota of assessment, loss of revenue on value additions, ‘tax rate war’ between the
States. The consensus was that a new system is needed and Value Added Tax has
emerged as a principal instrument of taxing domestic consumption worldwide
during last four decades. It is now in operation in more than 160 Countries. The
basic advantages of Value Added Tax can be stated as its neutrality, transparency,
certainty and self-policing mechanism. Figures in table 8 give a comprehensive picture of the rate slab of single point Sales Tax in different states.

<table>
<thead>
<tr>
<th>States</th>
<th>Rate Slabs</th>
<th>No. of Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra Pradesh</td>
<td>0%,1%,4%,8%,10%,12%,16%,9.33%,20%,30%</td>
<td>10</td>
</tr>
<tr>
<td>Assam</td>
<td>0%,1%,4%,8%,12%,20%</td>
<td>6</td>
</tr>
<tr>
<td>Delhi</td>
<td>0%,1%,4%,6%,8%,12,20%</td>
<td>7</td>
</tr>
<tr>
<td>Gujarat</td>
<td>0%,1%,2%,4%,6%,8%,12%,14%,15%,20%,25%,54%</td>
<td>12</td>
</tr>
<tr>
<td>Haryana</td>
<td>0%,1%,2%,4%,5%,8%,10%,12%,20%</td>
<td>9</td>
</tr>
<tr>
<td>Himachal Pradesh</td>
<td>0%,1%,1.5%,3%,3.5%,4%,8%,10%,12%,15%,30%</td>
<td>11</td>
</tr>
<tr>
<td>Jammu &amp; Kashmir</td>
<td>0%,1%,4%,8%,12%,20%,30%</td>
<td>7</td>
</tr>
<tr>
<td>Karnataka</td>
<td>0%,1%,2%,4%,8%,10%,12%,15%,20%,60%</td>
<td>10</td>
</tr>
<tr>
<td>Kerala</td>
<td>0%,1%,4%,8%,12%,17%,20%,24%,25%,27,30%,37,55,85%</td>
<td>14</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>0%,1%,2%,4%,8%,12%,20%,25%</td>
<td>8</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>0%,5%,2%,4%,8%,10%,12%,13%,20%,24%,25%,27,30%,33%</td>
<td>14</td>
</tr>
<tr>
<td>Meghalaya</td>
<td>0%,1%,4%,8%,12%,20%,25%</td>
<td>7</td>
</tr>
<tr>
<td>Nagaland</td>
<td>0%,1%,4%,8%,12%,20%</td>
<td>6</td>
</tr>
<tr>
<td>Orissa</td>
<td>0%,1%,2%,4%,6%,8%,10%,12%16%,18%,20%</td>
<td>11</td>
</tr>
<tr>
<td>Punjab</td>
<td>0%,1%,3%,4%,8%,12%,20%</td>
<td>7</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>0%,2%,4%,6%,8%,10%,12%,16%,18%,20%,23%,25%,40%,43%</td>
<td>14</td>
</tr>
<tr>
<td>Sikkim</td>
<td>0%,1%,4%,8%,10%,12%,20%</td>
<td>7</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>0%,1%,2%,4%,8%,10%,11%,12%,16%,18%,20%,30%,40%,50%,70%</td>
<td>15</td>
</tr>
<tr>
<td>Tripura</td>
<td>0%,2%,4%,5%,6%,7%,8%,10%,12%,13%,14%,15%,20%</td>
<td>13</td>
</tr>
<tr>
<td>Uttar Pradesh</td>
<td>0%,1%,2%,2.5%,4%,5%,6.5%,7.5%,8%,10%,12%,12.5%,16%,20%,32.5%</td>
<td>15</td>
</tr>
<tr>
<td>West Bengal</td>
<td>0%,1%,2%,3%,4%,5.5%,5%,7%,7.5%,8%,10%,12%,15%,17%,20%</td>
<td>15</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance, Department of Revenue, Government of India.

From the above table, it is clear that, there existed 15 rates in the States of Uttar Pradesh and West Bengal. The State of Kerala had 14 rates under Sales Tax system.
VAT is necessary because of the following reasons:

✎ VAT is based on the best international practices, characterized by trust, transparency, stability, simplicity, efficiency and a dealer friendly tax administration.

✎ There is no tax on inputs. VAT is the only solution to remove cascading and pyramiding effect to achieve economic efficiency.

✎ VAT reduces scope for undervaluation and tax evasion.

✎ In VAT system, invoice is a must for claiming set off. This enables the authority to crosscheck declared transactions between taxpayers.

✎ VAT, with its audit trail improves compliance.

✎ VAT encourages self-policing mechanism.

✎ VAT would give the big-push for a macro-jump in the economy.

✎ VAT removes multiple taxes like surcharge, turn over tax etc. on goods.

✎ VAT provides efficient resource allocation, it ensures removal of various taxes and levies.

✎ VAT enhances tax neutrality in the international trade.

✎ VAT minimizes litigation because of less rate slabs.

✎ VAT ensures that there is no tax ‘War Between the States’.

✎ VAT promotes development of ancillary industries.

✎ VAT ensures that all barriers to inter-state trade and commerce and export out of the territory of India should be removed.

✎ VAT provides broad tax base.

✎ VAT ensures few tax exemptions.

✎ VAT makes the law sensible to demand and price.

✎ VAT encourages self-regulated mechanism. Similarly it provides an effectively enforceable penalty system.
VAT assures a reliable information technology support to achieve automated E-filing or returns.

VAT ensures to promptly address taxpayer’s queries in order to firmly establish that the taxman is a facilitator.

VAT increases the competitiveness of Indian industry by removing the cascading effect of the erstwhile Sales Tax system.

VAT avoids the problem of undervaluing, as all stages of production and distribution are subject to a tax.

The combined incidence of Central and State taxes is more than 32 per cent in India, whereas the burden of taxes in other countries is around 18 per cent. This burden needs to be brought down since we are integrating our economy with the global economy.\textsuperscript{13} Other than implementing VAT at States level our potions for tax reforms are now fully exhausted. Kelkar Committee has taken care of that. Our direct taxes are at peak level as compared to that of neighbours and competitors. The organized industry is miserably over-taxsed and we have already forfeited its growth potential for more revenue. This change can come only with VAT which can definitely raise the tax ratio from the current 13 per cent to a decent level of 20 per cent or more. VAT is not only the best; it is the only choice if we want to enter the domain of developed economies.\textsuperscript{14}

3.6 VAT and States

“The introduction of VAT has posed a problem in federal economies, developed or developing. The issue is more complicated in India as commodity taxation is levied at two levels-excise duty by the Centre and Sales Tax by the States. While such a system has no parallel elsewhere, the Centre and State must resolve quickly the compensation issue so that VAT implementation is on course.”\textsuperscript{15}
Introduction of State level VAT is the most significant tax reform measure at State level. The State level VAT being implemented presently has replaced the erstwhile Sales Tax system of the States. Under Entry 54 of List II (State List) in the Seventh Schedule to the Constitution of India, “tax on sale or purchase of goods within a State” is a State subject. The decision to implement State level VAT was taken in the meeting of the Empowered Committee (EC) of State Finance Ministers held on June 18, 2004, where a board consensus was arrived at amongst the States to introduce VAT from April 1, 2005.

3.6.1 Separate Law for Each States

The Empowered Committee of State Finance Ministers - headed by West Bengal Finance Minister, Asim Kumar Dasgupta and comprising the finance ministers of Assam, Delhi, Gujarat, Jammu & Kashmir, Jharkhand, Karnataka, Madhya Pradesh, Maharashtra, Meghalaya, Punjab, Tamil Nadu and Uttar Pradesh - endorsed the suggestion that every State law on VAT should have a minimum set of common features. The Empowered Committee, though its deliberation over the years, finalized a design of VAT to be adopted by the States, which seeks to retain certain essential features commonly across States while, at the same time, providing a measure of flexibility to the States to enable them to meet their local requirements. Though basic concepts are same in VAT Acts of all States, provisions in respect of credit allowable, credit of tax on capital goods, credit when goods are sold inter-state are not uniform. Even definitions of terms like ‘business’, ‘sale’, ‘sale price’, ‘goods’, ‘dealer’, ‘turnover’, ‘input tax’ etc. are not uniform. Schedules indicating tax rates on various articles are also not uniform, though broadly, the schedules are expected to be same. Nevertheless, after a delay of over four years, all the States in the country have agreed to replace the existing Sales Tax regime with the much-debated VAT from April 1, 2005. The following table brings out the VAT implementation schedule of various States.
TABLE 9
VAT Implementation Schedule of Various States

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>States</th>
<th>Date of Implementation of VAT</th>
<th>Number of States</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Haryana</td>
<td>1-04-2003</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>Andhra Pradesh, West Bengal, Kerala, Karnataka, Orissa, NCT Delhi, Tripura, Bihar, Arunachal Pradesh, Sikkim, Panjab, Goa, Mizoram, Nagaland, Jammu and Kashmir, Manipur, Maharashtra, Himachal Pradesh, Assam, and Meghalaya</td>
<td>1-04-2005</td>
<td>20</td>
</tr>
<tr>
<td>3</td>
<td>Uttarakhand</td>
<td>1-10-2005</td>
<td>1</td>
</tr>
<tr>
<td>4</td>
<td>Rajasthan, Gujarat, Madhya Pradesh, Chhatisgarh, Jharkhand</td>
<td>1-04-2006</td>
<td>5</td>
</tr>
<tr>
<td>5</td>
<td>Tamil Nadu</td>
<td>1-01-2007</td>
<td>1</td>
</tr>
<tr>
<td>6</td>
<td>Uttar Pradesh</td>
<td>1-01-2008</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance, Department of Revenue, Government of India.

3.6.2 Compensation to States

One of the major constraints that has prevented introduction of a full fledged VAT in India is the federal structure wherein the States do not want to forego their revenue as there is an apprehension that revenue collections will come down when VAT is implemented. In this regard, a major initiative has been undertaken in the Union Budget, 2003-04, to facilitate the implementation of the VAT as a part of State-level fiscal reforms. The Central Government has agreed to compensate 100 per cent of the possible revenue loss in the first year of the introduction of the VAT, 75 per cent in the second year and 50 per cent in the third year. Formula for compensation has been finalised and provision has been made in Finance Budget of Union Government for 2005-06. To estimate these losses, the potential growth rate of sales tax for 2005-06, 2006-07 and 2007-08 will be based
on the average of the three highest annual growth rates during the previous 5 years, that is, 2000-05. This average buoyancy will be applied on the Sales Tax base of 2004-05 to estimate the expected Sales Tax revenue for 2005-06. Any shortfall in the actual revenue will be compensated on the basis of this formula. Central Government has received claims totaling ₹ 13167.3 crore during 2005-06, 2006-07 and 2007-08 (January 31, 2008). It has already released ₹ 9247.6 crore (Table-10)

### TABLE 10

**Release of Funds under VAT Compensation Package (₹ Crore)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Claim Received</th>
<th>No. of States</th>
<th>Released in 2005-06</th>
<th>Released in 2006-07</th>
<th>Released in 2007-08</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005-06</td>
<td>6942.9</td>
<td>10</td>
<td>2471.3</td>
<td>3696.2</td>
<td>597.9</td>
<td>177.5</td>
</tr>
<tr>
<td>2006-07</td>
<td>4334.1</td>
<td>9</td>
<td>-</td>
<td>395.9</td>
<td>896.3</td>
<td>3041.9</td>
</tr>
<tr>
<td>2007-08</td>
<td>1890.3</td>
<td>2</td>
<td>-</td>
<td>-</td>
<td>1190.0</td>
<td>700.3</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance, Department of Revenue, Government of India.

### 3.7 Highlights of State VAT

The following are the major highlights of State Level VAT:

#### 3.7.1 Simple and Transparent

There is no other tax that can be as transparent and simple like VAT. VAT is simple in the sense that the point of levy is shifted to the sale point unlike our present sales taxation where the levy is at the first sale point, first purchase point or at the last purchase point. Also tax administration will be simpler as there will not be any exemption or concession as in the present system. At every stage of transaction, VAT indicates the quantum of tax payable after adjusting tax credits. The taxpayer, the ultimate consumer and the administration are all fully aware of all the details of tax payment. The transparency improves compliance as it becomes difficult to evade taxes successfully at every transaction stage. The certainty and transparency of tax structure will be an attractive incentive for investment.
3.7.2 Input Tax and Output Tax

Input tax is the tax paid or payable in the course of business, on purchases of any goods made from a registered dealer of the State, and shall also include purchase tax, if any, paid by the purchasing registered dealer. Output tax means the tax charged or chargeable under the Act, by a registered dealer for the sale of goods in the course of business.

3.7.2.1 Input Tax Credit (ITC)

Tax paid on the earlier point is called input tax. This amount will be adjusted or rebated against the tax payable by the purchasing dealer on his sales. This credit availability is called input tax credit. The essence of VAT is in providing set-off for the tax paid earlier, and this is given effect through the concept of input tax credit/rebate. This input tax credit in relation to any period means setting off the amount of input tax by a registered dealer against the amount of his output tax. This input tax credit will be given for both manufactures and traders for purchase of input/supplies meant for both sales within the state as well as to other states, irrespective of when these will be utilized /sold. This also reduces immediate tax liability.

Any registered dealer, paying tax under section 6(1), who makes purchases of taxable goods from a registered dealer within the state, is eligible for input tax credit. Sub-section (3) provides that input tax credit shall be allowed to a registered dealer for a return period against output tax payable for the same period if the dealer is not otherwise made ineligible under the provisions of sub-section (4) to (13).

3.7.2.2 Input Tax Credit on Capital Goods.

Purchase of capital goods is one of the important activities of the 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 the 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 the 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.

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 the said paper say as “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 installments. The States may at their option reduce this number of installments. 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 the policy statement that set off will be allowed to both manufacturers and traders.

However, as per the White Paper, the State Governments can provide to give set off on staggering basis, at most in 36 installments. 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.

In respect of capital goods purchased by a dealer, the value of which exceeds ₹ 5 lakhs, input tax credit shall be allowed over a period of 3 years from the date of commencement of commercial production or from the date from which capital goods are put to use, whichever is later. The dealer shall claim the input tax credit in 36 installments in the monthly return. Where the value of such goods is ₹5 lakhs or less they will be termed as normal input and input tax credit will be allowable under sub-section (3) of section 11 i.e. in a single installment.\(^{18}\)

3.7.2.3 Instant credit

Credit will be available as soon as inputs are purchased. It is not necessary to wait till these are utilized or sold. The input tax credit will be given for both manufacturers and traders for purchase of input/ supplies meant for both sales
within the state as well as to other states, irrespective of when these will be utilized/sold. Even for stock transfer/consignment sale of goods out of the State, input tax paid in excess of 4% will be eligible for tax credit.\(^{19}\)

VAT is a procedure whereby a dealer can utilise credit for tax paid on inputs/supplies against tax payable on sales. Under the VAT, credit in respect of purchases made during a period can be set-off against the tax payable on sales during that period, irrespective of when the supplies/inputs purchased are utilised/sold. This implies that VAT credit is a credit on purchase of inputs/supplies and a dealer becomes entitled to it immediately upon making a purchase. This implies that the dealer does not have to wait for the sales to be made or the purchased goods to be used for production to claim VAT credit.\(^{20}\)

### 3.7.2.4 No Credit of CST

Central Sales Tax, by whatever name it is called is collected by the selling States and it is also the part of the state revenue. Central Sales Tax was introduced in our country in 1957 specially to monitor the movement of goods from one State to another in the course of Interstate Sales. In 2005, the rate of CST is 4 per cent against C-form. But this rate was not the original or initially introduced rate. Let us have a look at the rate of CST varied from it’s inception in the table given below:

<table>
<thead>
<tr>
<th>Year</th>
<th>CST Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1957</td>
<td>1%</td>
</tr>
<tr>
<td>1963</td>
<td>2%</td>
</tr>
<tr>
<td>1966</td>
<td>3%</td>
</tr>
<tr>
<td>1975</td>
<td>4%</td>
</tr>
<tr>
<td>2007</td>
<td>3%</td>
</tr>
<tr>
<td>2008</td>
<td>2%</td>
</tr>
</tbody>
</table>

Source: RBI

In his budget speech of Budget 2003-04 the erstwhile Finance Minister Jaswant Singh has declared the following on the floor of house: “With the
introduction of VAT, there is need to now phased out the CST, and move to a completely destination–based system. This cannot be done in one step. We must let stabilize VAT; but also recognize that these two – VAT and CST – cannot remain in tandem, in perpetuity. Therefore, in the first instance, the ceiling rate of CST for the inter-state sale between registered dealers will be reduced to 2 percent during 2003-2004, with effect from date to be notified. The Government of India will compensate the States for loss of revenue from this reduction of the CST. This will be done, as all these steps have been undertaken, only after arriving at a consensus with the Empowered Committee of State Finance Ministers.”

Ramesh Chandra, Member Secretary of Empowered Committee of State finance ministers remarked on VAT at a conference organized by FICCI in November 2004: “We have been saying from the very beginning that CST and VAT are not compatible. CST has been introduced years ago due to certain reasons and those reasons persist even now. So merely making CST 4% into zero percent was not the solution. The Empowered Committee felt that time has not come to do anything on the Sales Tax front. Also the States had collected ₹1 crore as the sales tax. This constitutes 80 percent of the revenue. So CST would continue from April 2005 and the position would be reviewed in October 2005.”

Finally in White Paper it was declared that initially there would be no change in CST and VAT will be introduced without any change in CST and according to this VAT was introduced as such in the month of April 2005 by 20 states along with the CST without any change. Ramesh Chandra, at a conference organized by CII at New Delhi in April 2005, declared that CST will start phasing out from 2006 and will be completely abolished in the forthcoming years: “CST is a biggest barrier and the Empowered Committee of State Finance Ministers is
working to remove it. We have determined that the rate of CST will come down to 2% from the April 1, 2006, before being ultimately phased out from 1st April 2007.\(^{22}\)

However, CST and VAT are not compatible. CST has not been made VATable. That is, CST paid cannot be claimed for credit under present VAT system. Today, all the business units need to find a local sourcing of materials for a temporary period of two years, which would not be possible for many traders who have been dealing on inter-state purchases for the last several years. The additional tax burden has to be ultimately borne by the final consumer. Until CST is abolished, the main objective of VAT will be lost and will seriously undermine the benefits of VAT in rationalizing the supply chain management and removing distortions in inter-state movement of goods.

CST paid on inputs procured from other States through inter-state sale and stock transfer will not be eligible for credit. However, a decision has been taken for duly phasing out of inter-state sales tax or Central Sales Tax.\(^{23}\)

The provisions in respect of Central Sales Tax are summarised below:

- Present CST rate of 4 per cent will continue for some time. CST may go after decision in respect of loss of revenue to States is taken and Comprehensive Taxation Information System is put in place.
- Present CST forms i.e. C, D, E-I/E-II, F, H and I will also continue.
- There will be no credit of CST paid on inter-state purchases.
- If goods are sent on stock transfer outside the State, input tax paid in excess of 4 per cent will be allowed as credit. In other words, input tax to the extent of 4 per cent will not be allowed as credit if goods are sent inter-state.

### 3.7.2.5 Non-Availability of Input Tax Credit

Credit of tax paid on inputs will be denied in following situations:
No credit if final product is exempt: Credit of tax paid on inputs is available only if tax is paid on final products. Thus, when final product is exempt from tax, credit will not be availed. If availed, it will have to be reversed on pro-rata basis.

No credit if output goods are stock transferred to another State: If the final products are transferred to another State as stock transfer or branch transfer, input credit availed will have to be reversed on pro-rata basis, which is in excess of 4%. In other words, in case of goods sent on stock transfer / branch transfer out of the State, 4% tax on inputs will become payable e.g. if tax paid on inputs is 12.5%, credit of 8.5% is available. If tax paid on inputs is 4%, no credit is available. Thus, the VAT as introduced is State VAT and not a national VAT.

No input credit in certain cases: In following cases, the dealer is not entitled to input credit: (a) Inputs used in exempted final products (b) Final product not sold but given as free sample (c) Inputs lost/damaged/ stolen before use. If credit is availed, it will have to be reversed.

No credit on certain purchases: Generally, in following cases, credit is not available: (a) Purchase of automobiles (except in case of purchase of automobiles by automobile dealers for resale) (b) fuel. There are variations between provisions of various states.

3.7.2.6 Mechanism of Set Off

The process of deducting of input tax from output tax is called input tax credit. When a registered dealer purchases any material for input after paying VAT, he can avail the credit of input tax paid and deduct the amount paid as input tax from tax liability on goods sold.

Notes:

☞ You don’t have to wait for sale to materialize to get the credit
☞ You have to get a tax invoice from the registered seller to avail credit
You don’t require anybody’s permission to get credit
No restriction on what you purchase

When Credit Cannot Availed:

Input tax credit cannot be availed in following cases:

- Credit on input tax cannot be claimed if purchased from unregistered dealer
- Purchase of goods used for manufacture of exempted goods
- Inter-state purchases (however entry tax credit can be availed in such cases)
- If seller does not provide you a tax invoice

3.7.2.7 Carrying Over of Tax Credit

If the credit exceeds the tax payable on sales in a month, the excess credit will be carried over to the end of the next financial year. If there is excess unadjusted input tax credit at the end of second year, then the same will be eligible for refund.24

If the input tax of a dealer for a return period is more than the out put tax of that return period, the difference between the input tax and the output shall be first adjusted against any interest, tax or any other amount due or demanded under this Act., from the dealer for any return period and then to the tax payable by a dealer on the deals in the course of inter-state trade and the balance, if any, shall be carried forward to the next return period for the purpose of allowing input tax in the succeeding return period, provided that where the excess input tax credit so carried forward cannot be fully adjusted during the last return period of that year, the excess input tax credit so remaining unadjusted, shall be refunded to the dealer as if it were a refund accrued under section 13.25
3.7.3 VAT Avoids Cascading Effect of Tax

The system of VAT works on tax credit method. In tax credit method of VAT, the tax is levied on full sale price, but credit is given for tax paid on purchases. Thus, effectively, tax is levied only on ‘value added’. Most of the countries have adopted ‘tax credit’ method for implementation of VAT. VAT works on the principle that when raw material passes through various manufacturing stages and manufactured product passes through various distribution stages, tax should be levied on the ‘value added’ at each stage and not on the gross sales price. This ensures that same commodity does not get taxed again and again and there is no cascading effect. In simple terms, ‘value added’ means difference between selling price and purchase price. VAT avoids cascading effect of a tax.

3.7.3.1 Meaning of ‘Cascading Effect of Tax’

Generally, any tax is related to the selling price of a product. In modern production technology, raw material passes through various stages and processes till it reaches the ultimate stage. If a tax is based on selling price of a product, the tax burden goes on increasing as raw material and final product passes from one stage to other. For example, let us assume that tax on a product is 10% of selling price. Manufacturer ‘A’ supplies his output to ‘B’ at ₹ 100. Thus, ‘B’ gets the material at ₹ 110, inclusive of tax @ 10%. He carries out further processing and sells his output to ‘C’ at ₹ 150. While calculating his cost, ‘B’ has considered his purchase cost of materials as ₹ 110 and added ₹ 40 as his conversion charges. While selling product to C, B will charge tax again @ 10%. Thus C will get the item at ₹ 165 (150+10% tax). In fact, ‘value added’ by B is only ₹ 40 (150–110), tax on which would have been only ₹ 4, while the tax paid was ₹ 15. As stages of production and/or sales continue, each subsequent purchaser has to pay tax again and again on
the material which has already suffered tax. Tax is also paid on tax. This is called cascading effect.

3.7.3.2 Disadvantages of Cascading Effect of Taxes:

A tax purely based on selling price of a product has a cascading effect, which has the following disadvantages:

**Computation of Exact Tax Content is Difficult:**

It becomes very difficult to know the real tax content in the price of a product, as a product passes through various stages and tax is levied at each stage. This is particularly important for granting export incentives or for fixing regulatory prices. Varying tax burden on any commodity will vary widely depending on the number of stages through which it passes in the chain from first producer to the ultimate consumer.

**Discourages Ancillarisation:**

Ancillarisation means getting most of the parts/components manufactured from outside and making final assembly. It is common for large manufacturers (like automobile, machinery etc.) to get the parts manufactured from outside and make final assembly in their plant. If a component is purchased from outside, tax is payable. However, if the same component is manufactured inside the factory, no tax would be payable. Thus, manufacturers are tempted to manufacture parts themselves instead of developing ancillary units for supply of the same. This is against the national policy, because it discourages growth of Small Scale Industry and increases concentration of economic power.

**Concessions on Basis of END use are not Possible:**

The same article may be used for various purposes e.g. copper may be used for making utensils, electric cables or air conditioners. The Government would naturally like to vary tax burden depending on use. However, this is not possible because when copper is cleared from factory, its final use cannot be known. Exports cannot be made tax free – though final products which are exported, are exempt
from tax, there is no mechanism to grant rebate of tax paid at the earlier stages on the inputs. It may be noted that as per WTO (World Trade Organization) stipulations, exports can be made free of domestic taxes, but export incentives as such cannot be given.

### 3.7.3.3 Computation Procedure of VAT

VAT is certainly a more transparent and accurate system of taxation. The Sales Tax structure allowed for double taxation thereby cascading the tax burden. For example, before producing a commodity, inputs are first taxed, the produced commodity is then taxed and finally at the time of sale, the entire commodity is taxed once again. By taxing the commodity multiple times, it increases the cost of the goods and therefore the price the end consumer has to pay for it. Indigenous production suffers from cost disadvantage between 8 to 20% as a result of the cascading effect of taxes, points out industry body of ASSOCHAM. Value Added Taxation creates an incentive for each participant in the chain from production to sale. A trader at the end of a month or a quarter needs to produce all his purchase invoices and all the sale invoices. The trader gets a tax credit for all his purchases (since those are goods and services for which their producers have already been taxed), and is liable for taxation only on the difference between his purchase and sales invoices.

The computation procedure of VAT is explained with the help of a hypothetical case as given in Table12. The following transaction chain under VAT regime assumes that CST rate is 4% and VAT rate is 12.5%.
TABLE 12
Computation Procedure of VAT

<table>
<thead>
<tr>
<th><code>X</code> of</th>
<th><code>Y</code> of</th>
<th>SALE@</th>
<th><code>Z</code> of</th>
</tr>
</thead>
<tbody>
<tr>
<td>DELHI</td>
<td>→ KOLKATA</td>
<td>₹154 → KOLKATA</td>
<td></td>
</tr>
<tr>
<td></td>
<td>SALE@</td>
<td>₹184/- → KOLKATA</td>
<td>₹194/- → KOLKATA</td>
</tr>
</tbody>
</table>

(i) Raw material producer ↦ `X`
(ii) Manufacturer ↦ `Y`
(iii) Whole seller ↦ `Z`
(iv) Retailer ↦ `R`

The above hypothetical case is elaborately presented at a glance in computing VAT in Table 13.

TABLE 13
Computation Procedure of Tax under VAT Regime

<table>
<thead>
<tr>
<th>Seller To Buyer</th>
<th>Cost Price</th>
<th>Value addition (VA) Including Profit (₹)</th>
<th>Selling Price (₹) (Excluding Tax)</th>
<th>Tax Rate</th>
<th>Invoice Value (₹) (Including Tax)</th>
<th>Tax Payable (₹)</th>
<th>Tax Credit (₹)</th>
<th>Net CST outflow (i.e. seller will deposit in Govt. treasury) (₹)</th>
<th>Net VAT outflow (i.e. seller will deposit in Govt. treasury) (₹)</th>
<th>Total net tax outflow (i.e. seller will deposit in Govt. treasury) (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X to Y</td>
<td>0</td>
<td>100(VA) + 4(CST)</td>
<td>100</td>
<td>4% CST</td>
<td>104</td>
<td>4</td>
<td>0</td>
<td>4.00</td>
<td>0</td>
<td>4.00</td>
</tr>
<tr>
<td>Y to Z</td>
<td>104</td>
<td>50</td>
<td>154</td>
<td>12.5% VAT</td>
<td>173.25</td>
<td>19.25</td>
<td>0</td>
<td>19.25</td>
<td>3.75</td>
<td>19.25</td>
</tr>
<tr>
<td>Z to R</td>
<td>154</td>
<td>30</td>
<td>184</td>
<td>12.5% VAT</td>
<td>207.00</td>
<td>23.00</td>
<td>19.25</td>
<td>23.00</td>
<td>3.75</td>
<td>23.00</td>
</tr>
<tr>
<td>R to consumer</td>
<td>184</td>
<td>10</td>
<td>194</td>
<td>12.5% VAT</td>
<td>218.25</td>
<td>24.25</td>
<td>23.00</td>
<td>23.00</td>
<td>0</td>
<td>1.25</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total tax to the Government (CST + VAT)</strong></td>
<td><strong>4.00</strong></td>
<td><strong>24.25</strong></td>
<td><strong>28.25</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

From the above table it is clear that though real value addition should be ₹190 [i.e. (₹100 + ₹50 + ₹30 + ₹10)], total value addition (including CST) in all
stages calculated is ₹ 194 [i.e. ( ₹100 + ₹4) + ₹50 + ₹30 + ₹10] as CST paid cannot be claimed for credit under the present VAT system. Therefore, total VAT collected at different stages is ₹24.25 (i.e. 12.5% of ₹194). Here it is important to note that until CST is totally phased out, the main objective of VAT will be lost. Because the amount of VAT calculated is ₹24.25 (i.e. 12.5% of ₹194) in lieu of the actual amount of VAT which is ₹23.75 (i.e. 12.5% of ₹190), in the sense that manufacturer will have to bear an additional tax burden ₹0.05 (i.e. 12.5% of ₹4, which is CST) under the present VAT system. Truly speaking, VAT rate should not be charged on ₹4 (i.e. 4% of ₹100 as inter-state trade). However, the final price, which the consumer has to pay under present VAT regime, is ₹218.25 (i.e. ₹194 + ₹24.25). That is, ultimately the consumer will have to pay additional tax burden until CST system is entirely abolished.

3.7.4 VAT and IT

An important requirement for the successful implementation of VAT is efficient and expeditious processing of information. For this purpose, an advanced computer system using the latest available software is absolutely essential. Manual system cannot process voluminous information with the accuracy and speed of the computer.

In the present context of VAT system, there is an urgent need to give effective and simple business solution with the help of computer software package. At present, a full-fledged Accounting Package will fetch more than ₹10, 000/- which cannot be afforded by a small businessman. It is proposed to develop and market application software as Accounting Package including VAT solution for a price-ranging between ₹1500/- to ₹2000/- which can be marketed to all the business segments.27
3.7.4.1 E-Filing in Kerala

As per the modernization programme of the Commercial Taxes Department, computerization is progressing in a fast pace. From 1\textsuperscript{st} January 2009 onwards the Government has introduce e-filing of VAT returns of all registered VAT dealers utilizing the Information Technology. The dealers having Internet facility can file the VAT returns using online facilities. But dealers having no internet facility can utilize the service of ‘Akshaya Centre’ for e-filing VAT returns at free of cost. The simplified system of e-filing VAT return enables the Department to capture up to date details on trade and which will also augment revenue collection.\textsuperscript{28}

Kerala is the first State in India to facilitate electronic filing of returns to all dealers having VAT registration in the State. Dealers can e-file periodical returns from any place at any time through the internet. For those dealers who cannot utilize this option, a facility is being introduced to e-file their returns through the selected ‘Akshaya Centers’ in Kerala at free of cost. The State has a full-fledged Data Center at Trivandrum, where the business transaction details of dealers could be stored. From the data so received, various analytical data could be generated and the possible ways of tax evasion could be reduced to the maximum possible extent. In the VAT scenario for every value addition at each selling point, tax has to be levied and credit has to be paid for the tax on the previous purchase point. Now, it has become very simple to execute this complicated task. The verification of the business transactions of all the registered dealers in the State is possible as the data is highly transparent in the electronic media. This also helps the department to check the bogus input tax claims and unaccounted transaction then by enhancing the revenue collection to a larger extent.\textsuperscript{29}
Dealers having an internet connection can do e-filing, in the internet explorer screen by opening www.keralataxes.in in the address column. Click **E-File** link, enter the username and password. The username is TIN / PIN of the Registered Dealer. Passwords shall have to be collected from the respective Deputy Commissioner’s Office. Option is provided to modify the Password later by the dealers. After entering the TIN and Password, the return particulars can be entered. Detailed User Manual and Latest e-filing Circulars can be viewed or downloaded from the e-filing home page.

In case the dealer does not have internet connectivity in their offices, they can file monthly / quarterly returns through the selected Akshaya Centers near to their premises on free of cost. Permission has been given to the selected Akshaya Centers by Kerala Commercial Taxes Department to file the dealer’s return and for that Akshaya User Ids and Passwords have been issued. Selected Akshaya Centers have to connect to the website www.keralataxes.in, on clicking the E-File; the login page will be displayed. Log in using the Akshaya User Id and Password to the e-Filing system. After confirming the same, enter TIN and Password to reach the dealer’s e-Filing Home Page.

The dealer can use the following links,

- **Enter Return** -- to enter the return details.
- **Latest e-Filing Circulars** -- to download the latest information on e-Filing.
- **Download User Manual** -- to download the detailed user manual on e-Filing procedures.
- **Download Invoice Format** --to download the invoice format (excel sheet) related to sales and purchase bills.
- **Upload Sales / Purchase Invoices** --to upload the Sales / Purchase text files.
**Print Return** -- To know the current status of the return. The completed return can be submitted to generate Return Print Outs, which has to be submitted at the respective VAT Circle along with the instrument. 30

### 3.7.4.1 E-Payments in Kerala

Commercial Tax Department, Government of Kerala has introduced e-filing facility of VAT returns to all VAT dealers, from January 2009. Thus Kerala has become the first state in India to introduce electronic filing of tax returns. Yet another milestone, ‘e-payment’ started from September 2009 onwards.

The e-payment facility uses the modern technique of computerization to transfer the monthly tax amount due, directly from the Account of the Dealer or Dealer Authorized Account to the Government Account. This is a simple and transparent facility which ensures online transaction on safe and secure mode.

In order to facilitate e-payment, the Commercial Tax Department has made a tie-up with SBI and SBT. This facility is achieved through the integration of websites of The Commercial Tax Department and the respective banks. For ensuring security of the website of the Commercial Tax Department, site authority has been completed by STQC, a Government of India agency. Besides this, the VeriSign SSL Certification ensures the safety of the monetary transactions.

E-payment is mandatory for all the TIN dealers from September 2009. The submission of e-returns is completed only if the monthly tax amount due has been paid through the e-payment facility.
For availing the facility of e-payment, Internet Banking Account is mandatory for all the TIN Registered Dealers. The required User Id and password would be issued by the bank, to those dealers who possess Internet Banking Account. Those dealers who already have an account with the State Bank of India or the State Bank of Travancore need not open a new account, in order to avail the facility of e-payment. The facility to open Zero Balance Account is available with the SBI and SBT.

The Registered TIN Dealers can login to the website of the Department ‘www. Keralataxes.gov.in’ by using the User Id and password which can be obtaining from the Department of Commercial Tax and file their e-return using the ‘File Return’ link available in the Home Page. If the dealer has the liability to pay tax, he/she will have to click on the ‘e-payment’ link in the Home Page itself.31

3.7.5 Tax Rates and Classification of Commodities

The VAT system can operate efficiently either with a single rate or with multiple rates. Zero rates can be used for exempting goods and low rates can give various kinds of tax concessions. Preferential treatment can be given to certain essential commodities, sensitive sectors and loss making firms by allowing tax refunds. In many instances, higher than normal rates are applied for curbing luxury or harmful consumption.

Under the VAT system covering about 550 goods, there will be only two basic VAT rates of 4% and 12.5%, plus a specific category of tax-exempted goods and a special VAT rate of 1% only for gold and silver ornaments. Thus the multiplicity of rates in the Sales Tax structure will be done away with under the VAT system. The following VAT rates are existing.32

- 0% on natural and un-processed products in unorganized sector, goods having social implications and items which are legally barred from taxation (e.g. newspapers, national flag). This will contain 46 commodities, out of
which 10 will be chosen by individual States which are of local social importance. Other commodities will be common for all states.

- No VAT on AED items (textile, sugar and tobacco) in the first year. This position will be reviewed later.
- 1% floor rate for gold and silver ornaments, precious and semi-precious stones.
- 4% for goods of basic necessities (including medicines and drugs), all industrial and agricultural inputs, declared goods and capital goods. This will consist of about 270 commodities.
- 12.5% RNR (Revenue Neutral Rate) on other goods.
- Aviation turbine fuel (ATF) and petroleum products (petrol, diesel and motor spirit) will be out of VAT regime. Liquor, cigarettes and lottery tickets will also be taxed at a higher rate. These will have uniform floor rates for all states. Tax paid on these will not be eligible for input tax credit.

There are four schedules in the KVAT Act. The schedules attached to the Act provide for description of goods, the point of levy and rate of tax of the goods coming under each schedule.

(a) First Schedule: - contains goods which are exempted from tax. No tax can be levied on goods coming under this schedule.

(b) Second Schedule: - covers goods in respect of which tax is leviable at all points of sale at the rate of 1%.

(c) Third Schedule: - deals with goods in respect of which tax is leviable at all points of sale at the rate of 4%.

(d) Fourth Schedule: - deals with goods which are outside the purview of VAT and taxable as per the provisions of the KGST Act. Petrol, High speed diesel, Aviation turbine fuel, Motor spirit including light diesel oil, foreign liquor, Ganja and Opium are included in this schedule.
(e) Goods taxable @ 20%:- There is no separate schedule for goods taxable @ 20%. But goods specifically mentioned in section 6 (1) (a) are liable to be taxed @ 20% at all points of sale. Aerated branded soft drinks excluding soda is the only item taxable at the rate of 20%.

(f) Residuary goods:- Goods which are not included in any of the entries of the First, Second, Third and Fourth Schedules are liable to be taxed at the rate of 12.5% at all points of sale within the State.

3.7.6 Concessions and Incentives under VAT

With the decision to implement the VAT, all the State Governments have put the incentive schemes aside. All the businesses, which were granted the benefits of various incentive schemes, need to find a way out to sustain and survive, as all their financial projections need to be adjusted so as to suit the requirements of the current legislations across various states. As the basic idea of VAT is to ensure uniformity across various sections, it is imperative that there should not be any schemes permitting exemptions for specific dealers. This would result in a situation where the VAT chain breaks in between in case there are dealer specific exemptions, as they exist today.

3.7.6.1 Sales Tax Incentives and VAT

Since any fiscal exemption from tax or subsidy is against the principles of VAT, Incentive Schemes are considered as a major hindrance to the introduction of Value Added Tax. In the meeting of Chief Ministers convened by the then Finance Minister on 16.11.1999, it was decided to discontinue Sales Tax related industrial incentives with effect from January 1, 2000. All the States agreed that no new incentives will be sanctioned after 01.01.2000. However, it was also decided that pending applications for incentives will be considered and the incentives shall be granted.
The White Paper on “State Level Value Added Tax” released on 17.01.2005 recorded that the existing incentive schemes may be continued in the manner deemed appropriate by the states after ensuring that VAT chain is not affected. Thus, at national level, no common policy has been adopted in response to the treatment of Incentive Schemes. This was due to the reason that different states have offered different types of incentives depending upon the requirements and local needs of the state and the relevant tax system in the State. The Empowered Committee, while allowing the states to decide their own policy for treatment of incentives, has prescribed the following pre-conditions:

1. The quantum as well as the time period allowed for availing incentives should not be increased or extended.

2. VAT chain is not affected.

### 3.7.6.2 Concession for Small Dealers

Registration for dealers with gross annual turnover above ₹ 5 lakhs will be compulsory. There is provision for voluntary registration. All existing dealers will be automatically registered under the VAT Act. Small dealers with gross annual turnover not exceeding ₹ 5 lakhs will not be liable to pay VAT. States will have flexibility to fix the threshold limit within ₹ 5 lakhs. Small dealers with annual gross turnover not exceeding ₹ 50 lakhs who are otherwise liable to pay VAT, shall however have the option for a composition scheme with payment of tax at a small percentage of gross turnover. The dealers opting for this composition scheme will not be entitled to input tax credit.\(^{33}\)

In Kerala, the Value Added Tax legislation also provides for a simplified tax payment at the rate of 1% of the total turnover (presently at the rate of 0.25%)
for small dealers whose turnover for a year is between 5 lakhs rupees and 50 lakhs rupees (Presently between 10 lakhs rupees and 50 lakhs rupees). This will release small dealers from cumbersome procedures of detailed maintenance of books of accounts. Certain categories of dealers are entitled for compounding under the Value Added Tax Act. They are works contractors, dealers in mechanical crushing units producing granite metals, dealers in cooked food and dealers who transfer right to use of video cassettes and CDs. The Legislation on Value Added Tax also addresses the transitional issues, while moving towards a VAT regime. At present, many S S I Units are enjoying exemptions which are granted to them under the KGST Act. Since exemptions are not possible under VAT, the Government intends to provide a “deferral scheme” for such units.34

3.7.6.3 Tax Relief under VAT

There are two methods for lowering the tax burden.

a) Exemptions:

It is a partial relief provided to the trader. For e.g. in case of exemptions, traders need not charge any VAT on the goods sold. But the trader cannot claim set-off or credit for the input tax paid by him on purchases.

b) Zero Rating:

It is a complete relief provided to the trader, there is no tax charged on sales and the trader can avail Input tax credit for purchases made. If the transaction is to be fully relieved of tax, then it should be zero rated, such as exports.

The distinction between ‘zero rated sale’ and ‘exempt sale’ is that in case of ‘zero rated sale’, credit is available on tax paid on inputs, while in case of exempt goods, credit of tax paid on inputs is not available. As per paragraph 2.5 of the White Paper on State-Level VAT, export sales are zero rated. That is though Sales Tax is not payable on export sales, credit will be available of tax paid on inputs. In
respect of sale to EOU/SEZ, there will be either exemption of input tax or tax paid will be refunded to them within three months. If supplies to EOU/SEZ are exempt from Sales Tax, then the question will arise whether these are ‘zero rated’ or ‘exempt goods.’

3.7.6.4 Special Rebating

The exponents of VAT are of the view that whatever tax merges with the price of the goods should be given rebating. Accordingly special rebating has been provided for the tax paid at the time of purchase under section 6(2) of the Kerala Value Added Tax Act, 2003 and Entry Tax paid under Section 3 of the Entry Tax Act, at the time of entry of goods into the State.

3.7.7 Procedural Provisions

VAT is not just a replacement of conventional Sales Tax regime. It is a change in business strategies. It affects every walk of life in business models; say procurement policy, suppliers’ chain, distribution policy, selling and marketing strategies and finally the bottom line. General procedural provisions are given below:

3.7.7.1 Tax Payer’s Identification Number

Under VAT system, TIN is issued to all the registered dealers on the line of PAN, which is being issued by the Income Tax Department. It is a code to identify a taxpayer. Each taxpayer will be having a single unique TIN.

The Tax Payer’s Identification Number will consist of 11 digit numerals throughout the country. First two characters will represent the State Code as used by the Union Ministry of Home Affairs. The set-up of the next 9 characters may, however, be different in different states.
The following are the in objectives of the TIN:

- To facilitate computer applications, such as detecting stop filers and delinquent accounts.
- To help crosscheck information on taxpayer compliance, for example the selective crosschecking of sales and purchases among VAT taxpayers.

3.7.7.2 Tax Invoice

The entire design of VAT with input tax credit is mainly based on documentation of tax invoice, cash memo or bill. Every registered dealer, having turnover in excess of the amount specified, issues to the purchaser, serially numbered tax invoice with the prescribed particulars. This tax invoice is required to be signed and dated by the dealer or his regular employee, showing the required particulars. The dealer is required to keep a counterfoil or duplicate of the tax invoice duly signed and dated. Failure to comply with the above invites penalty.\(^{36}\)

VAT invoice forms the cornerstone for administration in a VAT regime and are issued by a registered dealer in respect of taxable sales in the same state. A valid Tax Invoice is a must to claim set-off. A registered dealer, selling any goods, must issue to the purchaser a Tax Invoice containing following particulars, and retain a copy there of for three years from the end of the year in which sale is booked.

a) The word Tax Invoice in bold letter at the top or prominent place.
b) Name, Address and Registration Number of Selling Dealer.
c) Name and Address of the Purchasing Dealer.
d) Serial Number and Date.
e) Description, Quantity and Price of the goods sold.
f) The amount of Tax charged, to be shown separately.
g) Signed by the selling dealer or a person authorized by him.

3.7.7.3 Debit Note and Credit Note

If the sale price is increased /reduced subsequent to sale, the transaction will be recorded through proper debit/credit note. The buyer will adjust the input credit available to him accordingly. A VAT dealer is required to issue a credit/ debit note drawing nexus to a sale or purchase in case of return by a customer on return to a supplier, additional discount and change in prices. The contents of a credit/ debit note are similar to that of a Tax Invoice. The credit note and debit note specified in section 41 shall bear separate consecutive serial numbers and shall contain the following details:

* Nature of the document (whether debit note/credit note)
* Date of issue
* Name and address of the selling dealer (with registration number)
* Name and address of the buying dealer (with registration number)
* Number and date of the invoice in relation to which the credit note or debit not is issued
* Amount credited or debited
* Tax due on the amount credited or debited

3.7.7.4 Registration and Tax Liability

In each state there is a threshold limit for registration of dealers. Every dealer whose total turnover in any year is not less than five lakhs rupees shall, and any other dealer may, get himself registered under this Act\(^{37}\). Voluntary registration is permissible. At the same time, certain categories of dealers have to take registration irrespective of their total turnover. They are:
(i) Casual traders;
(ii) Dealers registered under the KGST Act, 1963 as on 31.3.2005 if their total turnover during 2004-05 was not less than five lakhs.
(iii) Dealers registered under section 7 (3) of the Central Sales Tax Act, 1956.
(iv) Dealers who obtain or bring goods from outside the State or those who effect export of goods outside the territory of India.
(v) Dealers in bullion or specie or in jewellery of gold, silver or platinum group metals.
(vi) Non resident dealers and their agents.
(vii) Every commission agent, broker, delcredere agent, auctioneer or any other mercantile agent.
(viii) Every contractor
(ix) Every State Government, Central Government or Government of every union Territory or every Department of Government or any Autonomous body or Local authority and
(x) Every hallmarking unit.

Every registered dealer or a dealer liable for registration is required to pay tax under the VAT Act on sale of goods. A registered dealer is also liable to pay VAT for goods purchased by him from an unregistered dealer. Every registered dealer effecting sales of taxable goods is required to collect taxes separately in the Tax Invoice and reflect such taxes collected separately in the books of accounts.

3.7.7.5 Return Filing

The return filing procedures are designed with the objective of reducing the compliance costs incurred by business when completing and filing their returns. They are intended to encourage businesses to comply with their obligations to file returns and pay VAT through the application of penalties in case of late payment of
VAT and late filing of returns. They also aim at a registered dealer would be required to file a quarterly/annual return along with requisite details such as output tax liability, value of input tax credit and payment of VAT. There would be a single page return form common for both VAT and CST liabilities.

3.7.7.6 Destination Principle

The destination principle allows computation of value addition irrespective of the origin. The principle is that all goods consumed in a country should pay tax. In this regime, exports are exempt while imports are invariably taxed. It is normally used with consumption VAT and is preferred particularly in a federal form of government.\(^{38}\)

3.7.8 Provision of Assessment

The basic simplicity in VAT is that VAT liability will be self-assessed by the dealers themselves in terms of submission on return upon setting off the tax credit. Return forms as well as other procedures will be simple in all states. There will no longer be compulsory assessment at the end of each year as it existed under Sales Tax system. If no specific notice is issued proposing departmental audit of the books of account of the dealer within the time limit specified in the Act, the dealer will be deemed to have been self-assessed on the basis of returns submitted by him.\(^{39}\)

Deemed Assessment concept is a major feature of the VAT. Tax liability will be self-assessed by the dealer in terms of submission of returns up to setting off the tax on inputs/supplies by himself. Correctness of self-assessment may be checked through a system of audit, where a certain percentage of dealers may be
taken for audit on a scientific basis. The Kerala Value Added Tax Act, 2003 contains provision for self-assessment under section 21 of the Act. There is no formal assessment order, in the Value Added Tax system. Only in the cases where an assessee is not filing a return or files a defective return, will lead to ‘Best Judgment Assessment’. The assessing authority may complete the assessment under Best of Judgment Assessment in the following cases; - (a) if no return is filed (b) filed incorrect return (c) failed to file fresh return.

3.7.9 Refunding Practices

Excess credit will be carried forward to next the year. In case the credit is not utilized for a certain period, it is refunded to the dealer. On account of set-off provisions the refund of tax is a normal feature of the law and is expected to be paid within the prescribed time from the end of the month in which return is filed. In a Sales Tax regime, refund instances are by way of exceptions and are generally not paid by the Government in time.

For all exports made out of the country, tax paid within the states will be refunded in full and this refund will be made within three months. Units located in SEZ and EOU will be granted either exemption from payment of input tax or refund of the input tax paid within three months.

3.7.10 Accounting Treatment under VAT

ICAI has issued Guidance Note on Accounting for State Level VAT on 15th April 2005. The Guidance Note is based on the principles of VAT as contained in White Paper released on 17th January 2005. However, there are variations in respect of each state. Hence, accounting policies will have to be adapted to suit provisions
of VAT law of the particular state. The following broad principles should be kept in mind.

- As per AS-2, cost of purchase for purpose of inventory valuation should not include tax, if credit of tax paid is available.
- For the purpose of income tax, inventory valuation should be inclusive of taxes, even if its credit is available, as per section 145A of Income Tax Act.
- Purchase account should be debited with net amount. VAT credit receivable on purchases should go to ‘VAT Credit Receivable (Input) Account’.
- Accounts of each rate i.e. 0%, 1%, 4%, 12.5% is required to be kept separately.
- In case of capital goods, as per AS-10, the cost of fixed assets should include only non-refundable duties or taxes.
- If the entire credit of tax on capital goods is not available immediately, the credit that is available immediately should be debited to VAT Credit Receivable (Capital Goods) Account and credit which is not available immediately should be taken to ‘VAT Credit Deferred (Capital Goods) Account.’
- In case of sales, the sales account should be credited only with the net amount (i.e. exclusive of VAT). Tax payable should be credited to separate account ‘VAT Payable Account’ (This is ‘exclusion method’. Interestingly, in case of excise duty paid on final product, ‘inclusive method’ is permitted, i.e. sale account is credited inclusive of excise duty on the final product).
- If any VAT is payable at the end of period (after adjusting VAT credit available), the balance is to be shown as ‘current liability.’

3.7.10.1 Maintenance of Accounts

Implementation of VAT system does not mean that now a dealer has to adopt a new system of accounts but he has to simply keep records for claiming
adjustments or set off of previous tax paid. How to make the entries relating to taxes is an important aspect. Presently, dealers enter sales tax payable but as per the provisions of the VAT Act, they will have to make two more entries — input tax (tax paid on purchases) and output tax (tax charged on sales), as the same are mandatory.

Every Registered dealer shall keep and maintain true and correct account of daily transaction showing goods produced, manufactured, bought and sold and value thereon together with invoice and bills. Along with all these details all VAT dealers are required to keep following records.

a) **Cash Book**
A daily cash book, that is to say, a record of all cash receipts and payments, kept and maintained from day to day indicating the cash balance in hand at the end of each day.

b) **Journal**
A journal, if the accounts are maintained according to the mercantile system of accounting.

c) **VAT account**
This can be maintained manually or electronically. VAT account should contain details of input and output tax, debit note and credit note issued/received during the period.

d) **Purchase Records**
Proper accounting of all purchases in the chronological order stating the date on which the goods so purchased, the name and registration number of the selling dealer, tax invoice number and date, the amount of purchase price and the amount of tax paid separately should be maintained.

e) **Sales Register**
Sales register showing date wise details of the sales effected to be registered indicating the registration number of the purchasing dealer, quantity and value of
each class of goods sold, freight, delivery charges or cost of installation which are separately charged, other charges, if any, received, and output tax for such sales.

**f) Stock Register**
A stock register showing date wise details of in-out- balance position of goods indicating opening stock, goods purchased, goods received otherwise than by way of purchase, goods received on stock transfer, goods sold or used for manufacturing, goods disposed of otherwise than by way of sale or manufacturing, consignment or stock transfer, goods bought or sold in the course of inter-state trade or commerce or in the course of export out of or import into the territory of India, and the closing stock.

**g) Debit Notes and Credit Notes Register**
Copies of the debit note and credit note issued / received are to be recorded in a book and should be filed separately under different rates of tax in the same manner as that of purchase/sales register. The end result of debit/ credit note accounts are to be taken into account while adjusting monthly tax payable.

**h) Period of Retention of Accounts**
Accounts and other records maintained by a dealer shall be preserved by them for a period of five years from the expiry of the year to which the assessment relates or from the date of disposal of the appeal or revision arising out of such assessment or from the date of completion of any other proceeding under the Act connected with such assessment or appeal or revision whichever is later and shall be kept at the place of business mentioned in the certificate of registration. Every dealer who maintains accounts by electronic means shall intimate the concerned assessing authority in advance along with the password. Such dealers shall also retain them in the electronically readable format for the retention period specified in this sub-rule.

**i) Accounts and Documents**
Every dealer shall keep separate purchase and sales accounts for different goods liable to tax at different rates of tax.
Every dealer liable to pay turnover tax shall maintain separate accounts for the goods liable to turnover tax.

Every dealer shall keep separate accounts in respect of sales or purchases in the course of export or import and in respect of inter-state sales or purchases.

Every commission agent, broker, del credere agent, auctioneer or any other mercantile agent shall maintain accounts showing:

1. Particulars of authorization received by him to purchase or sell goods on behalf of each principal separately and the date on which a copy of such authorization in each case was sent to the assessing authority.
2. Particulars of goods purchased, or of goods received for sale on behalf of each principal each day.
3. Details of purchases or sales effected on behalf of each principal each day.
4. Details of accounts furnished to each principal each day.
5. The tax paid on purchases or on sales affected on behalf of each principal and the Chalan No. and date of remittance of the tax to treasury.

Every wholesale dealer, importer and manufacturer shall maintain day-to-day stock accounts of each class of goods dealt in by him. The stock account shall contain particulars of purchases or receipts, sales or deliveries and balance stock.

### 3.7.10.2 Accounting Treatment for VAT Credit on Input – Tax/Supplies

With a view to recommending appropriate accounting treatment for VAT credit, it would be useful to note the requirements of paragraphs 6 and 7 of Accounting Standard (AS) 2, ‘Valuation of Inventories’, issued by the Institute of Chartered Accountants of India, dealing with ‘cost of inventories’ and ‘costs of purchase’, which are as below:
“The cost of inventories should comprise all costs of purchases, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.”

“The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.”

Attention is invited to the paragraph related to ‘costs of purchase’, according to which, only those taxes have to be included as costs of purchase which are not subsequently recoverable by the enterprise from the taxing authorities. Since the tax paid on inputs is available for set-off against the tax payable on sales or is refundable, it is of the nature of taxes recoverable from taxing authorities and accordingly, input tax paid should not be included in the costs of purchase.

In view of the above, the amount of tax paid on purchase of inputs/supplies and available for VAT credit should be debited to a separate account, VAT Credit Receivable (Inputs) Account. Hence, the following would be the entry for purchases:

- Purchase Account…………………………………………Dr
- VAT Credit Receivable (Inputs) Account……………… Dr
- To Suppliers / Bank Account

As and when VAT credit is actually utilised against VAT payable on sales, appropriate accounting entries will be required to record the adjustment, i.e., VAT Credit Receivable (Inputs) Account should be credited with a corresponding debit to the account maintained for tax payable on sales. The debit balance in VAT Credit
Receivable (Inputs) Account, at the year-end, should be shown on the ‘Assets’ side of the balance sheet under the head ‘Loans and Advances.’

A dealer may purchase certain common inputs which are to be used for making taxable sales as well as for making exempt sales. In such cases, the dealer, on the date of purchase, should estimate inputs expected to be used for making taxable sales and for making exempt sales. The dealer should recognise VAT credit only in respect of those inputs which are expected to be used for making taxable sales and no VAT credit should be recognized in respect of inputs expected to be used for making exempt sales. Subsequently, in case the actual use is different from the estimated use, the dealer should pass an appropriate adjustment entry for the same. Similarly, in the case of stock transfer/consignment sale of goods out of the State where VAT credit is available only to the extent of a certain portion of input tax paid, the dealer should make an estimate of the expected stock transfers/consignment sales and account for accordingly.

3.7.10.3 Accounting Treatment for VAT on Sales/Output Tax

The Value Added Tax is collected from the customers on behalf of the VAT authorities and, therefore, its collection from the customers is not an economic benefit for the enterprise and it does not result in any increase in the equity of the enterprise. Accordingly, it should not be recognised as an income of the enterprise. Moreover, the payment of VAT should not be treated as an expense in the financial statements of the enterprise.

In view of the above, it is recommended that the amount of tax collected from customers on sale of goods should be credited to an appropriate account, ‘VAT Payable Account.’ Where the enterprise has not charged VAT separately but has made a composite charge, it should segregate the portion of sales which is attributable to tax and should credit the same to ‘VAT Payable Account’ at periodic
intervals. The amounts of VAT payable adjusted against the VAT Credit Receivable (Inputs) Account or VAT Credit Receivable (Capital Goods) Account and amounts paid in cash will be debited to this account.

The following would be the entry for sales:

Bank/ Customers Account……………………Dr.
   To Sales Account
   To VAT Payable Account

Adjustment Entry-

As and when VAT credit is actually utilized against VAT payable on sales, the following entry would be passed:

VAT Payable Account……………………Dr.
   To VAT Credit Receivable (Input) Account

The debit balance in VAT Credit Receivable Account at the year end is shown on the Asset side of the Balance-Sheet under the head "Loans and Advances." On the other hand, the credit balance of the VAT Payable Account is shown on the Liabilities side under the head "Current Liabilities."  

3.7.10.4. Accounting Treatment for VAT Credit in Case of Capital goods

The accounting treatment recommended in the following paragraphs applies only to those capital goods which are eligible for the credit.

Paragraph 9.1 of the Accounting Standard (AS) 10, Accounting for Fixed Assets, issued by the Institute of Chartered Accountants of India, inter-alia, provides as below:

“The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of
bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price....”

VAT credit is considered to be of the nature of a refundable tax. Therefore, the tax paid on purchase of capital goods should not be included in the cost of such capital goods.

VAT credit on capital goods may or may not be available immediately. To the extent VAT credit is available immediately, the amount in respect thereof should be debited to an appropriate account, ‘VAT Credit Receivable (Capital Goods) Account’ and the balance which is not available immediately, should be debited to another appropriate account, ‘VAT Credit Deferred (Capital Goods) Account.’ Subsequently, when the balance credit or a part thereof becomes available, the appropriate adjustment for the same should be made, i.e., the amount of credit becoming available should be credited to ‘VAT Credit Deferred (Capital Goods) Account’ with a corresponding debit to ‘VAT Credit Receivable (Capital Goods) Account.’ Depreciation should be charged on the original cost of fixed asset excluding VAT credit.\(^{44}\)

3.7.10.5 Accounting Treatment for Refund of Input Tax

Input tax which cannot be adjusted against the VAT payable over the specified period of time and input tax paid on purchases made for exports out of the country are eligible for refund. Any refund of input tax received in this manner should be credited to the VAT Credit Receivable (Inputs) Account or VAT Credit Receivable (Capital Goods) Account, as appropriate.\(^{45}\)

3.7.11 VAT Audit

One major simplification proposed under VAT regime is that unlike the Sales Tax system there will be no compulsory scrutiny of returns. If no specific notice is issued by the VAT department proposing departmental audit of the books
of accounts of the dealer within the time limit specified in the Act, the dealer will be
deemed to have been self-assessed on the basis of returns submitted by him.
Correctness of self-assessment should be checked through a system of departmental
audit. A certain percentage of the dealers will be taken up for audit every year on a
scientific basis. If, however, evasion is detected on audit, the concerned dealer may
be taken up for audit for previous periods. The audit team will conduct its work in a
time-bound manner and audit must be completed within six months. The audit
report will be transparently sent to the dealer also.46

Correctness of self-assessment will be checked through the system of
Departmental Audit. A certain percentage of the dealers will be taken up for audit
every year on a scientific basis. If however, evasion is detected on audit, the
concerned dealer may be taken up for audit for previous period. This audit wing
will remain delinked from tax collection wing to remove any bias. The audit team
will conduct its work in a time bound manner and audit will be completed within 6
months. The audit report will be transparently sent to the dealer also.47

The State Legislatures providing for VAT Audit by Chartered Accountants
have reaffirmed the faith and confidence reposed by the society in Chartered
Accountants. Even the Hon’ble Supreme Court in TD Venkatarao Vs. Union of
India (1999) 237 ITR 315 (SC) has recognised the supremacy and competence of
the Chartered Accountants in the matter of Audits under tax laws in following
words:

“Chartered Accountants, by reason of their training have special aptitude in the
matter of Audit. It is reasonable that they, who form a class by themselves, should
be required to audit the accounts of business, whose income exceeds...”
The Audit approach of the tax auditor under the Value Added Tax System will be more or less similar to the approach which is adopted by the auditor while conducting the tax audit under the provisions of Section 44AB of the Income Tax Act, 1961. However, the reporting requirements vary to a considerable extent. While the auditor has to apply the basic principles of audit in all the audits, yet the requirements of VAT Audit are different and accordingly the tax auditor under the VAT Law is expected to design his audit programme.48

VAT audit is an onerous duty cast on the auditor to certify the correctness of return, quantify the tax liability, verify the correct rate of VAT, and verify the deductions and forms. Unlike Income Tax Audit Report which is filed along with the return, the VAT Audit Report is provided after the returns are filed. VAT Audit Report may result in the auditor advising the assessee to file revised return.

The first thing, the auditor should do is to obtain the copies of the return and verify the correctness of the same. Form No.704 itself starts with certification about correctness and completeness of the Sales Tax returns. If copies of the returns filed are not available the same can be obtained from Sales Tax Department on request, or else the auditor should give appropriate disclosure that in the absence of the return in the dealer's possession the report is based on the statement of accounts and registers provided. The Audit Report is in form of certification subject to the observations and comments about non compliance, short comings and deficiencies in the returns filed by the dealer as given in part 2 of the audit report. This certificate presumes existence of non-compliance, shortcomings and deficiencies. Any shortcoming and deficiency which have a direct impact on Tax and Compliance of the Act and Rules should be reported. For example, if a person signing a 'C' Form is not authorised to sign the 'C' Form or for that matter even the return, the auditor will have to comment upon that and also advise the dealer to file the prescribed form for authorizing the said person.49
Every dealer whose total turnover in a year exceeds rupees forty lakhs shall get his accounts audited annually by a Chartered Accountant or Cost Accountant and shall submit a copy of the audited statement of accounts and certificate, in the manner prescribed.\(^{50}\)

### 3.7.13 Penal Provisions

There is a fear in the mind of trading community regarding the powers given to the tax authorities. Delhi VAT Bill, 2004 contains chapter-XIII (Section 86 to Section 94), which provides for wide powers to the tax authorities to impose fine, penalty and other stringent measures. In the VAT Bill, Section 78 provides that the burden of proof is upon the traders and not upon the persons alleging tax evasion. Due to these provisions, the trading community fears harassment in the hands of tax authorities.

### 3.8 Conclusion

VAT is one of the most radical reforms that has been implemented for the Indian economy after years of political and economic debate. In implementing VAT, the biggest benefit perhaps is that it could unite India into a large common market. This will lead to better business policy as each producer will have a big common market before him. VAT would change the nature of trade in the coming years, but the medium level of traders that is C&F agents, distributors, stockiest etc. would face problems as the companies would reduce the tier of marketing. Similarly small retail dealers would be required to maintain more accounts or pay composition money which cannot be collected from the customers. The present provision of CST and VAT cannot go together. After the abolition of CST the direct marketing concept may gain ground and the necessity of having warehouse and godowns in all states may decrease or come to an end. It would adversely affect the trade and employment of the states. America which has similar federal and state laws \ Constitution has not implemented VAT.
NOTES

5 www.CA in INDIA.org, e-bible for chartered accountant.
15 S. Sridharan, “Countdown to VAT: Impact on Centre-State Finances,”


37 The Kerala Value added Tax (Amendment) Act, 2005: 10.


The Kerala Finance Act, 2007: 15.