

## VAT Implementation & its Consequences

**Objective:** The article seeks to provide an insight of the transition to the VAT regime from the sales tax regime. The basic purpose is to examine how the implementation of VAT would change the rules of game for business in India. It is also attempted to bring forth the key strengths and fallacies of the new system.

Beginning 1<sup>st</sup> April 2005 a new concept in the Indian indirect taxation system, VAT is being introduced. Value added tax or VAT is a destination based taxation system where the tax is levied at multiple points on the value addition at each stage. It removes the cascading effect of taxes by introduction of a system of Input tax credit.

### Transitional Phase

As the new system takes fold, businesses will have to gear themselves for meeting out the requirement of the VAT regime. The key things required to comply with the new legislation are:

- ❑ **Registration:** All dealers covered under the respective VAT laws will have to get themselves registered under the new VAT Act. Most state VAT laws provide for automatic registration of dealers already covered under the previous state sales tax rates, provided a declaration form in the prescribed praforma is submitted. The security given under the existing sales tax laws would suffice for VAT purpose. However dealers below the threshold limit of turnover and those opting for composition scheme need not get themselves registered under VAT.
- ❑ **Composition scheme:** Those dealers adopting for composition scheme will have to exercise the option within the specified days of VAT enactment, by furnishing an application in the specified format. The tax on such dealers would be charged @ 1% of turnover. They will not require to maintain detailed books of accounts but at the same time can neither claim input tax credit, nor issue tax invoice.
- ❑ **Input credit on opening stock:** Most state VAT laws have provisions for providing credit on the stock on 01-04-2005. For this the dealer will have to prepare an invoice wise list of the stock in hand and will also need a certificate from a CA (in certain cases) verifying the same. The dealer should have purchased the same from a registered dealer and should have the invoice for the same.
- ❑ **Invoice:** Invoice is a crucial document under VAT as it becomes the basis of input tax credit, just as in case of excise. Hence it is absolutely essential that the invoice issued comply with the VAT law requirements. For instance it should contain the Tax Identification Number (TIN) of both the purchaser and the seller, the name and address of the printer. It should be serially numbered beginning every financial year. Every VAT dealer would be required to issue an invoice for every credit sale and cash sale in excess of Rs 100 (as per Delhi VAT).
- ❑ **Accounts and audit:** The dealers will need to keep detailed books of account under VAT regime. For instance item wise details of purchases, sales and inventory. The details of the purchasing dealer such as TIN will also be maintained. Every dealer whose turnover exceeds Rs 40 lacs will have to get its accounts audited by a CA and submit the same along with annual return. The details of purchases and sales are required to be submitted along with the VAT returns in the prescribed praforma.
- ❑ **Free Samples:** No input tax will be available on goods distributed as free samples or gifts as these are not sales (being without consideration). To avoid this free items to be billed at a nominal price say Re 1.

### Discrepancy among Different State VAT bills

Tax on local sales is a state matter and thus each state has enacted / proposed to enact a different VAT law. The white paper issued by the empowered committee on VAT intended to harmonise all state VAT laws. However there are numerous differences in the various state VAT laws and corresponding rules. Some of the areas of differences are mentioned below.

- ❑ **Threshold limit:** The turnover limit below which a dealer is not required to get himself registered under VAT differs under various state VAT laws (ranges from 200,000 to 500,000).
- ❑ **Composition scheme:** The turnover limit for opting for composition scheme is 25 lacs in some states and 50 lacs in some other. Further under Delhi VAT a dealer is not eligible for the scheme if he is registered under the CST act or if he at any time during the year in which he opts for this scheme purchases goods from an unregistered dealer or procures or sells goods from / to outside Delhi.
- ❑ **Input tax credit on opening stock:** A few states like Kerala do not have any such facility. While even for states that provide this concession, the rules differ considerably. In some states no credit will be allowed for stocks older than one year like Punjab and Delhi while others give a corresponding time of only three months. Further in some states the credit will be based on the actual tax paid, while others give a maximum limit of 12.5%, still further some mention of providing credit at a rate lower of the actual tax paid and the new VAT rate. This credit will be provided instantly in some states while other states like Punjab provide the same in monthly installments over a defined period.
- ❑ **Return:** Various states prescribe different criteria for determining whether VAT return has to be filed monthly or quarterly. For instance in Delhi, if the turnover of the dealer in the previous year exceeds Rs 5 crores then the return has to be filed every month, other wise only quarterly return is required to be filed.
- ❑ **Bad Debts:** Some states (like Delhi) allow credit for genuine business bad debts actually written off in the books of accounts. While other like Haryana do not allow any such liberation.
- ❑ **Tax credit on stock transfers:** Even though the white paper suggests credit of input tax paid in excess of 4% to be provided on stock transfers outside the state, not all states provide the same.
- ❑ **Capital goods:** The definition of capital goods is different in each state. Furthermore the period over which the credit on capital goods would be provided differs. Some provide instant credit while others specify monthly installments over a given period.

Hence there are a lot of discrepancies in the VAT bills / Act of different states. The Central Government must in the interest of business seek actively to harmonise these. A uniform VAT legislation through out the country would lead to tremendous amount of clarity and ease of operation.

### Call on future strategies

The VAT is a totally different system from the existing single point taxation system and as such a lot of business decisions will have to be revisited. Some of them are discussed below:

- ❑ **Purchase locally or centrally:** Any thing purchased from outside the state suffers CST, which is not vatable. Thus maximum benefit would be received by having raw material and capital good sources in the state of manufacture. This will impact decisions regarding set up of OEMs and in selection of vendors.  
Another possibility could be the vendors having their depots in the state of manufacture. They will stock transfer to the depots and then make local sale to the manufacturer. Thus the manufacturer will get input tax credit though the vendor would lose that on his inputs.
- ❑ **Refund of VAT to trade partners:** The tax rates differ from state to state. Most companies maintain a uniform all India price at which they sell to their distributors so as not to give any advantage to the distributors of the states having low rates of taxes. After VAT all the trade chain from distributors to wholesalers and retailers will have to pay tax. In order to secure the trade margins the companies will have to rationalise them.
- ❑ **Stock transfers:** As discussed earlier some states do not provide credit of input tax paid in excess of 4% on stock transfers outside the state. Thus in such states no input credit will be allowed on stock transfers (neither in the state of manufacture nor in the state of sale). It will have to be identified for which products it is beneficial to make sale by paying CST @ 4% and obtaining input tax credit than making stock transfers without paying CST and without taking any input tax credit. This will affect decisions on stock transfers from the state of manufacture to the state of consumption. It will also influence the decisions of the location of the manufacturing sites.
- ❑ **Location of CFA:** Once CST is removed (as proposed by FM) the whole logic of having a Carrying & Forwarding Agent in every State (as employed by most big corporate) will break. This will require a fresh analysis of the CFA operating cost in small states vis-à-vis the extra logistics cost of serving them from nearby prominent states.
- ❑ **Increase in competition:** National players will face increased price competition from local players as local purchase & local sale avoids any cascading of taxes.

The new VAT regime will require the re-designing of the entire supply chain of the companies. It is therefore very important that all states go for the VAT simultaneously with full clarity as to the future roadmap.

### Benefits of VAT

VAT is a globally acclaimed indirect tax system with innumerable benefits for all. Some of the key benefits of the new regime are highlighted below.

- ❑ **Prevent cascading of taxes:** VAT being a multi point taxation system with provision for allowing credit on inputs and capital goods, there is no cascading of taxes. In the earlier system there was double taxation to the extent that both the finished product and the raw materials used to suffer sales tax.
- ❑ **Ease of Administration:** There will be uniform classification of goods across states thus easing tax administration (HSN nomenclature). There will not be various types of concessional purchases as in normal sales tax, as whatever is paid would be allowed as input credit.

- ❑ **Self-assessment:** Each assessee will file returns in prescribed format. Only selected returns will be chosen for scrutiny. This will replace the existing system of inspection. Hence there is no regular assessment in VAT but strict controls & investigation provisions in case of suspicion.
- ❑ **Fewer Taxes:** It seeks to abolish the burden of some of the earlier taxes like turnover tax, surcharge on sales tax, additional surcharge, special additional tax etc. In addition CST is also to be phased out. Entry tax levied otherwise than in lieu of Octroi will either be abolished or made vatable.
- ❑ **Curb tax evasion:** The multi point tax will help check tax evasion and curb black money. The government is also planning to implement a comprehensive cross checking system by coordination between the authorities of the State Govt. and the authorities of Central Excise and Income Tax. This will help organised sector that is a loyal taxpayer.
- ❑ **Equitable:** Under VAT system, there would not be given any tax concession to new industries. These concessions distorted the investment decisions and gave unfair tax advantage to some. Now, all these would be over. The new taxation system would be equitable and fair to all.  
Probably, a harmonised VAT rate of 12.5% / 4% across major product categories in all States will create a level playing field across States, and eliminate inter State ramping.
- ❑ **Less litigation:** Under VAT system there would be only two main tax rates. So, VAT would be much easier to administer and comply with. Further, as there would be only two main rates of tax, disputes relating to classification of goods, a main source of litigation today, would practically disappear. At present, tax is collected either at the first stage of sale or purchase or at the last. The disputes relating to stage of tax is another major area of litigation today, as tax would be collected at each stage under VAT system such litigation would naturally come to an end.

VAT will bring simplicity and transparency in the tax structure. It is expected that the level of compliance will increase and the prices of goods in general will go down. The successful implementation of VAT in Haryana should allay all fears.

### **Gaps / Shortcomings in the proposed VAT structure:**

VAT will require huge improvement in the level of documentation and their preservation. The businesses will have to devote huge amount of resources initially to gear themselves for complying with the new requirements. But apart from this the proposed VAT structure is beset with structural problems as well.

- ❑ **Benefits large consumption states:** Under VAT credit on inputs is available only to VAT dealers on purchases from a VAT dealer within the same state on tax invoice for the purpose of:
  - Sale within the same state, inter state sale from that state or export out of India
  - Use in the manufacture of goods other than exempted goods meant for resale as above.
  - Use in the same state as capital goods.
 This would tilt the decision on location of manufacturing units in favor of highest consumption states. Thus will increase regional imbalance.

- ❑ **Inter – state Credit:** Since input credit is available only of the tax paid in the state in which sale is made, this would bring skewness into business decisions. As it is more beneficial (from VAT angle) to have self-sustaining manufacturing units in each state producing only for the requirement of that state. The true potential of Vat would be realised when there is input credit on purchases made from anywhere in India with no CST. This would make India as one whole market and encourage interstate trade and commerce. This will also stop unhealthy tax-rate “war” and trade diversion among the states.
- ❑ **Imports:** It is also essential to bring imports into the VAT chain. This is must for the protection of land-locked states. Similarly services should also be included in VAT. Infact the Kelkar committee report on Indirect taxes talks about a national level Goods and Services Tax system. This would really be the next big leap into tax reforms.

Thus the VAT system being implemented is not free of fallacies. Though most of them can be expected to weed out as the vision of fully integrated national goods and service tax is realised over a period of time.

VAT is the biggest tax reform measure in India since independence. Let us hope that the transition would be successful and will pave the way for a more efficient and competitive business environment in India.

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