Value Added Tax (VAT) and its implications

"The king should collect his taxes without hurting his subjects, even as a bee collects honey without harming the flowers." -Vidur Niti

The Value Added Ta x (VAT) system i s considered by many experts to be superior than the conventional sales tax system. Over 120 countries accounting for 70 percent of world's population have VAT system in place. VAT is supposed to usher in a brave new world of higher tax collections, simplified procedures, less corruption, greater federalism and above all, lower prices for consumers.

The present sales tax system in India

Since the taxation of sales of goods is a State subject under the Constitution of India, different States have different sales tax regimes based on their own understanding of their self-interest. Even in respect of Central Sales Tax (CST) Act, the CST is implemented by respective State Governments and revenue of CST goes to State from which movement of goods commenced. Due to these peculiar features many deficiencies crept into the structure of sales tax. Some of these deficiencies are discussed below:

Competition among States

Some States and Union Territories made abnormal reduction in the rates of tax for attracting business from other States, giving way to unhealthy competition between States.Business tended to be diverted where sales tax rates were low as buyers found it economica l to purchase goods from neighboring State.

Sales Tax Incentive

Sales tax incentives also distorted the tax structure. When one State started giving sales tax incentives, other States had no option but to grant similar incentives. Many undesirable practices started and the purpose of granting incentives got defeated.

Steps taken to solve the problems arising in the present sales tax system

Luckily, the problems were realised and all the States agreed to take necessary steps. In the conference of Chief Ministers of States held on 16.11.1999, it was decided to implement uniform minimum rates of sales tax for the entire country. States could charge sales tax higher than the minimum but not lower. So, it was also decided to phase out present local sales tax system and implement VAT.

The new system was to be put in place with effect from April 1, 2002, but there were still several issues and problems which needed to be sorted out to the satisfaction of all the concerned parties, so the introduction of the proposed VAT system was postponed by one year till April 1, 2003. Again, now the implementation of VAT has been put off till June 1, 2003.

Discussion papers on VAT has already been issued by many States. Some State Governments have even published draft VAT Bill.

Reforms in Central Sales Tax :

It has been realised that the proposed reforms related to sales taxation cannot be complete without reforms of the Central Sales Tax. To start with, some amendments have been made in Central Sales Tax Act in May 2002 vide Finance Act, 2002 to facilitate implementation of VAT.The Central Sales Tax rate has been proposed to be reduced from present 4% to 2%. However, this is contingent upon the implementation of the VAT.

What is Value Added Tax (VAT)?

VAT is a form of sales tax only. 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 Rs. 100. Thus, ‘B’ gets the material at Rs. 110, inclusive of tax @ 10%. He carries out further processing and sells his output to ‘C’ at Rs. 150.

Under Present System, C will get the item at Rs. 150.00 + 10% tax = Rs.165.00

However, ‘value added’ by B is only Rs. 40 (150-110), tax on which would have been only Rs. 4, while the tax paid was Rs. 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 been taxed. This is called cascading effect.

In the VAT system, B will have to pay tax on the value addition done by him only i.e. Rs. 40 only and C will get the item at Rs. 150 + 10% of Rs.40 tax = Rs. 154.00

This concept of VAT is developed particularly in West European countries where they have a common market of all Western Europe. Due to advantages of VAT, presently VAT has been introduced in over 120 countries, including countries in Africa, Asia, Europe, Middle East, South America, North America and even China. However, USA has not gone into VAT yet.

Applicability of VAT

In order to achieve uniformity all over India, the States have attempted to define the important terms uniform all over India such as the definitions of ‘Dealer’, ‘Sale’, ‘Business’, ‘Sale Price’ etc. Following details are provided from the Draft Delhi Sales Tax Act, 2003(hereinafter termed as the Draft Act).

As per the definition of Dealer provided in the Draft Act, 'Dealer' means any person who carries on business. It also includes a club, association, society, trust or co-operative society, whether incorporated or not, which buys goods from or sells goods to its members for price, fees or subscription, whether or not in the course of business. The term “Business” includes any trade, commerce or manufacture and any adventure or concern or any transaction in connection with, or incidental or ancillary to such trade, commerce or manufacture. It does not matter, whether “sale” is their primary activity or not or it has been effected with a motive to gain or profit.

The Draft Act requires all the dealers who carry on any business to apply for registration and pay tax under this Act if the turnover exceeds the taxable quantum.

The turnover means the aggregate of the amounts of sales price received or receivable by the dealer.

The taxable quantum prescribed by States varies from one to another. In some States dealers with up to Rs. 5 lakh annual turnover are outside the ambit of VAT, this limit is lower in certain States – as low as Rs.1 lakh in Haryana, the only state to implement VAT from April 1, 2003.

Also, it has been provided that these provisions would not be applicable in case of inter-state sale or in the course of export or import outside India.

In the Draft Act, the special position of NGO's with respect to VAT has not been considere d separately. However, in our opinion any NGO carrying on any trade activity will come under the purview of this Act.

Rates of Taxes

Uniform minimum rates would be adopted by all the States and Union Territories and if this happens, then undesirable competition between States would be eliminated to a large extent. As per the proposed scheme a State would have the liberty to take a decision to levy tax at a higher rate. Four main minimum VAT rates, namely, 0, 4, 8 and 12 percent are proposed. Apart from this, for some special commodities the proposed VAT rates are 1 percent and 20 percent.

Some Legal Requirements for VAT

Book Keeping

The Draft Act requires every dealer to prepare and retain sufficient records to readily ascertain the amount of tax due under this Draft Act. Also, every dealer is required to preserve a copy of all tax invoices issued by him and the original of tax invoices received by him.

The Draft Act also requires the registered dealers making a sale liable to tax under this Draft Act, to provide the purchaser at the time of purchase with a tax invoice containing the particulars as prescribed in the Draft Act.

Accounts to be audited in certain cases

If in any particular year, the gross turnover of a dealer exceeds forty lakh rupees or such amount as may be prescribed, then such dealer shall get its accounts in respect of such year audited by a certified accountant as per the provisions of the Draft Act.

It is inevitable that the prices of a wide range of commonly used commodities and products would rise in the short term even if the new tax system would, in the long term, eventually bring down costs along the entire production and distribution chain. However, people are hopeful that the VAT would aim to bring reduction in prices, simplicity, and transparency in the system and eliminate cascading effect of the tax.

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