

# 1

## CHAPTER

# INDIRECT TAXES IN INDIA: PRE-GST ERA

### LEARNING OBJECTIVES

**After studying this chapter, you shall be able to understand the following:**

- Types of taxes in India
- Features of Indirect Taxes
- Provisions in Constitution regarding taxation
- VAT; Concept and Features
- Variants of VAT
- Defects in structure of Indirect Taxes prior to GST

### 1.1 INTRODUCTION

India is a Socialist, democratic and republic country. The federal structure of India comprises central and state level Government. Both the Governments, share the prime responsibilities including meeting out the increasing development needs of the country. The primary source of revenue is the levy of taxes only. In fact, in order to stimulate economic growth and to fulfil socio-economic objectives, the tax is considered to be the most important source of revenue for the Government.

A tax is a compulsory contribution from a person to the expenses incurred by the state in common interest of all without reference to specific benefits conferred on any individual. The tax cannot be regarded as voluntary payment or donation. Rather, it is enforced contribution which is exacted through legislative authority. The word tax has been derived from the Latin word "Taxo" which means touch sharply or charge.

As per Wikipedia, "*A tax is a mandatory financial charge or some other type of levy imposed upon a tax payer (an individual or other legal entity) by the Government in order to fund various public expenditure*". It may be noted that the tax is a mandatory payment because a failure to pay or evasion of or resistance of taxation, is punishable by law.

### 1.2 TYPES OF TAXES

The taxes are generally classified into direct tax and indirect tax.

1. **Direct Tax :** A direct tax is paid directly by an individual or organization to an imposing entity. The direct tax is a type of tax where the incidence and impact of taxation falls on the same entity. It means brunt

of direct tax cannot be shifted by the taxpayer to someone else. The significant direct tax imposed in India is Income Tax.

2. **Indirect Tax :** The indirect taxes are imposed on goods/services. The immediate liability to pay indirect taxes lies on the manufacturer/service provider/seller, etc. but the burden is ultimately transferred to the consumers. Since this tax is indirectly borne by the consumer, it is called as indirect tax. Hence, an indirect tax is collected by an intermediary from the person who bears the ultimate economic burden of the tax. It may be noted that the burden of indirect tax is transferred not in the form of taxes but as a part of the price of such goods/services.

### 1.3 FEATURES OF INDIRECT TAXES

The following are the basic features of indirect taxes:

1. **Taxable Event:** The indirect taxes are levied on purchase/sale/manufacture of goods and provision of services.
2. **Incidence & Impact:** In case of indirect taxes, the incidence and impact fall on two different persons. It means the tax burden is shifted by the supplier to the buyer or recipient of goods or services.
3. **Regressive Taxation:** The indirect taxes do not depend on paying capacity as tax payable on commodity is same whether it is purchased by a poor man or rich person. Therefore, indirect taxes are regressive in nature. There are exceptions to this argument as higher taxes may be imposed on luxury goods.
4. **Impact of Indirect Tax:** The indirect tax on goods and services increases its price. This leads to inflationary trend.
5. **Promotes Welfare:** The harmful or sin products like alcohol, tobacco, etc. may be taxed at higher rate. This practice not only discourages consumption of such goods but also increases the revenue of the State.
6. **Major Source of Revenue:** In India, the contribution of indirect taxes to total tax revenue is more than 50%. Therefore, it is a major source of tax revenue for the Government.

### 1.4 TAXATION POWERS OF UNION & STATE GOVERNMENT

In India, the constitution is Supreme and all laws and actions of the Government are sub-ordinate to it. The constitution provides that no tax shall be levied or collected except by authority of law. The Structure of Government in India is federal in nature. As per article 1(1) of constitution, India shall be union of States. There is a bifurcation of powers between union and states. Government of India (Central Government) has certain powers in respect of whole country. Each state (and union territory) has certain powers in respect of that particular state (Union territory).

#### 1.4.1 Indian constitution

India has a three-tier federal structure, comprising the following:-

- (a) The Union Government
- (b) The State Government
- (c) The Local Government

The power to levy taxes and duties is distributed among the three tiers of Government, in accordance with the provisions of Indian Constitution. The constitution consists of a preamble, 25 parts containing 448 articles and 12 Schedules.

## 1.4.2 Provisions of constitution regarding taxation

The power to levy and collect taxes emerges from the constitution of India. The following are the significant provisions of the constitution regarding taxation:

1. **Article 265:** It states that no tax shall be levied or collected except by authority of law. In fact, it prohibits arbitrary collection of tax.
2. **Article 246:** The authority to enact law and levy taxes and duties is given by constitution vide Article 246. The Parliament may make laws for the whole of India or any part of the territory of India, the State legislature may make laws for whole or part of the State.
3. **Seventh Schedule (to Article 246):** The Seventh Schedule contains three lists which enumerate the matters under which the union and the State Governments have the authority to make laws.
  - (a) **List I (Union List):** The **Central Government** has the exclusive right to make laws in respect of any matter covered in this list. Parliament makes law in this regard. Some of the items in List I are defense of India, naval, military and air forces, atomic energy and mineral resources, central bureau of intelligence and investigation, railways, highways, currency, RBI, post office saving bank, taxes on income other than agricultural income, duties of customs, corporation tax, etc.
  - (b) **List II (State List):** It contains the matters in respect of which the State Government has the exclusive right to make laws. These matters include public order, police, local government, public health and sanitation, hospital, burials and burial grounds, cremation ground, libraries, water, fisheries, betting and gambling, etc.
  - (c) **List III (Concurrent List):** It contains the matters in respect of which both Central & State Governments have powers to make laws. This list includes criminal laws, criminal procedure, marriage and divorce, contracts including partnership, agency, bankruptcy and insolvency, trust and trustees, trade unions, industrial and labour disputes, etc.

### Power to Levy GST

The power to levy Goods and Services Tax (GST) has been conferred by Article 246A of the Constitution which was introduced by the Constitution (101<sup>st</sup> Amendment) Act, 2016. The **significant provisions of Constitution (101<sup>st</sup> Amendment) Act, 2016** have been discussed in detail in Chapter 2 :“GST in India : An introduction.”

## 1.5 CONCEPT OF VALUE ADDED TAX (VAT)<sup>1</sup>

The value added tax (VAT) was introduced in India in 2005. It is a multi point system of taxation on sale of goods wherein a mechanism is provided to grant credit for tax paid on inputs. Under VAT, the tax is collected in Stages an transactions involving sale of goods. The input tax (*i.e.* paid on purchases) is rebated against output tax (*i.e.* tax payable on sales).

Under the VAT system, the net tax payable is calculated in the following manner:

$$\text{VAT} = \text{Tax collected on sales} - \text{Tax paid on purchases}$$

### 1.5.1 What is Cascading Effect

The cascading effect implies charging tax on tax. In other words, at the time of levy of tax, the total value is considered which is inclusive of all taxes paid up to that point. In this manner, if the tax is always charged on the selling price of the product, the burden of tax keeps on increasing at each point of sales. In this process, the effect of taxation magnifies as at each level tax is calculated on

1. The VAT was state level tax, prevailing in Pre-GST era. At present, it has been subsumed in GST. It has been discussed here, as this topic forms part of B.Com. (Hons.) Syllabus.

value, which includes taxes already levied and paid. The charging of tax on tax is called as 'Cascading Effect of tax'.

### 1.5.2 VAT has eliminated cascading effect

VAT has been developed to avoid cascading effect of taxes. This has become possible as tax is effectively charged only on value addition at each stage and not on the entire sale price. The cascading effect has been prevented through tax credit system, called as Input Tax Credit.

### 1.5.3 Input Tax Credit

If any registered dealer is purchasing goods within a particular state and has paid value added tax and subsequently the goods were sold in the same state, in that case such registered dealer shall be allowed to take credit for input tax, subject to certain conditions. In other words, the tax is imposed at each stage on the entire Sales value and the tax paid at the earlier stage is allowed as set off. This credit availability is called as "Input Tax Credit". **For example:** Mr. Bhuvan is a registered dealer and has purchased inputs worth ₹ 5,00,000 (plus VAT @ 4%). The actual sales in the month were ₹ 9,00,000 (plus VAT @ 10%). It means

**VAT paid on purchases** = ₹ 20,000 [Calculated as ₹ 5,00,000 × 4%]

**Output VAT payable** = ₹ 90,000 [Calculated as ₹ 9,00,000 × 10%]

Since, VAT paid on purchases can be adjusted against output VAT payable; the net VAT payable for the month shall be ₹ 90,000 minus ₹ 20,000. It means after adjusting ITC, the net VAT liability is ₹ 70,000.

### 1.5.4 Scope of input tax credit under VAT

In Pre-GST era, the concept of ITC was prevailing in VAT, Excise and Service Tax. The following important points may be noted about the entitlement of ITC under VAT:

- (a) It is allowed to a registered dealer.
- (b) It is also allowed in respect at VAT paid on purchase of capital goods.
- (c) The Central Sales Tax (CST) paid on purchases made from outside state is not allowed as ITC.
- (d) It is allowed only if the purchases are made from a registered dealer.
- (e) The ITC is not available in respect of purchases from a dealer who has opted for composition scheme.
- (f) If goods have been used to manufacture the exempted goods, ITC is not available.

## 1.6 VARIANTS OF VAT<sup>2</sup>

The various possibilities of credit for VAT paid on purchase is called as variants of VAT. The VAT has three variants:

- (a) Gross Product Variant
  - (b) Income Variant
  - (c) Consumption Variant
- (a) **Gross Product Variant:** Under this variant, VAT credit is allowed only of VAT paid on raw materials other than capital Goods. The merit of Gross Product variant is the prevention of cascading effect due to allowance of VAT credit on non-capital goods.

2. VAT has been subsumed in GST. The variants of VAT have been discussed as it forms part of B.Com. (Hons.) Syllabus