PERSPECTIVE

Goods and Services Tax Unscrambled
– Understanding the new proposed tax regime in India

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Abstract

A lot has been said and written about the proposed Goods and Services Tax (GST). In fact, this new proposed tax reform is touted as one of the biggest taxation reforms in India. Its impact will be widespread and in this paper, we attempt to understand the existing tax regime, challenges with the existing regime, the new proposed GST tax, its impact, pitfalls and roadblocks in its enactment.

Introduction

It has been 15 years since the roadmap for implementing the most ambitious constitutional amendment related to indirect taxes in India was conceived, aptly named Goods and Services Tax (GST). Regimes, ideologies and much of the Indian business landscape has changed during this long 15 year period. In fact, GST will go down in history as an expensively long implementation of any reform for a developing nation, much less a long impending tax reform. While the delay can be attributed to many reasons, it clearly shows the narrow and short sighted outlook of the political class, distorted vision of our legislators, and the self-seeking defensive posture of our state governments in the garb of protecting its citizens.

I am not sure when or if GST in its proposed, or any other form, will see the light of an Indian morning but I consider it important to keep the optimism and the spirit alive. After all, despite a sub-functional system, India has shown an impressive growth – annual GDP of close to 8% for the last 10 years making it one amongst the fastest growing economies across the globe. With this perspective, here is an attempt to present a comprehensive analysis of this highly complicated proposed GST bill.

Comprehend your indirect taxes as they exist today

Let us first enumerate all (well almost!) the indirect taxes that we currently pay to our governments, both to the state and center (central taxes) for the transactions that we undertake on a regular and not so regular basis. This list does not include income tax as it is a direct tax and continues to be governed by separate laws as are corporate taxes.

Indirect taxes are charges that are levied on goods and services and not on income or individuals. Indirect tax, though recovered from the consumer, is collected and submitted by the dealers in the chain of the transaction.

CENTRAL TAXES (broad categories)	STATE TAXES
Excise duty	Value Added Tax / Sales tax
Customs duty	Entry tax - Octroi
Interstate sales (Central sales tax or CST)	State cess and surcharge
Service tax	Entertainment tax
Education cess	Stamp duty and land revenue
Surcharges	

Here's a simple **illustration** of how the various indirect taxes are levied:

'A' is a manufacturer who sells finished goods to 'B', a wholesaler. 'B' further sells the goods to 'C', the retailer in a different state. 'C' sells the goods to the final consumer 'Me'. Each transaction in this cycle will attract taxes, duties or levies.

Tax Incident 1

Manufacturer of the finished goods, 'A' will attract central excise duty. In case the goods were imported, customs duty will also be levied on 'A'. Further, there is a possibility of additional excise duty levy, additional customs duty levy, commonly known as CVD, depending on the kind of input or import.

- ***Excise duty***

  Central excise duty is an indirect tax levied on those goods which are manufactured in India and are meant for home consumption. The taxable event is 'manufacture' and the liability of central excise duty arises as soon as the goods are manufactured. It is a tax on manufacturing, which is paid by a manufacturer, who passes its incidence on to the customers. Excise duty in India is a federal subject except for certain item like liquor which is a state subject and the duty is collected by the state, not by the center.[1]

- ***Customs duty***

  Customs duty is a type of indirect tax levied on goods imported into India and exported from India. Taxable event is import into or export from India. Import of goods means bringing goods into India from a place outside the country.[2]

Tax Incident 2

Intrastate sale from 'A' to 'B' will attract state sales tax or VAT.

- ***Sales tax***

  Sales Tax is a levy on the purchase and sale of goods in India, levied under the authority of both central legislation (Central Sales Tax) and state government legislations (sales tax). The state government levies sales tax principally on intrastate sale of goods and the central government levies central sales tax on interstate sale of goods.

1. http://www.archive.india.gov.in/business/taxation/excise_duty.php
2. http://www.archive.india.gov.in/business/taxation/custom_duty.php

VAT

VAT is a multipoint destination-based system of taxation, with tax being levied on value addition at each stage of transaction in the production / distribution chain. The term 'value addition' implies the increase in value of goods and services at each stage of production or transfer of goods and services. VAT is a tax on the final consumption of goods or services and is ultimately borne by the consumer.3 VAT is essentially a state subject.

Tax Incident 3

Interstate sale from 'B' to 'C' will attract central sales tax (CST). The sale may also attract entry tax.

CST

Central Sales Tax is a tax levied on interstate sale by the center but collected by the state.

Octroi

Octroi is charged at the point of entry of goods into a local area for consumption, use, or sale. It is generally applicable to goods entering urban areas, i.e., areas serviced by municipalities or corporations. It is a check post-based levy collected by the local tax administration and has a broad tax base covering all goods brought into a local jurisdiction.

Entry tax is levied on the sale of goods brought into a municipal area from other jurisdictions. It is an account-based levy collected by sales tax administration for the local governments and is applicable to goods sold by sales tax dealers only. Octroi or entry tax, as the case may be, is applicable to foreign as well as domestic goods, with no set-off provisions.[4]

Tax Incident 4

Intrastate sale from 'C' to 'Me' will further attract state sales tax or VAT.

In case of a transaction involving 'services' within the meaning of central board of excise and customs, instead of goods, the service provider would be levied service tax (central tax).

Service tax

Service Tax is a tax levied on services rendered by a person and the responsibility of tax payment is on the service provider. It is an indirect tax as it can be recovered from the service receiver by the service provider in course of his business transactions.[5]

Complexities in this tax regime

- **Multiplicity of taxes:** From the previous illustration, it is evident that a simple movement of goods from one hand to another attracts multiple taxes. This multiplicity of taxes has rendered the indirect taxation landscape in India excessively complex that mandates each dealer in the chain of transaction to maintain multiple forms, receipts and records of each transaction. The return filing is nothing short of a hair pulling exercise, with cumbersome tax calculations while accounting for all the credits to be deducted on each transaction.
- **Ambiguity, at times:** Indirect tax is imposed and collected by either the center or the state and sometimes, both. There are times when the two overlap leading to chaos and often unnecessary litigations resulting in increase in compliance and administrative cost to businesses.
- **Double taxation or cascading effect of taxes:** Also referred as taxes on taxes, this can be illustrated by using the above example. A sells to B at X price and pays Y% as tax on it, B adds value of P and re-sells to C. Now C has to pay Y% tax, this time on X*(1+Y)+P, instead of having to pay only on P, the added value thereby resulting in taxes on taxes or double taxation.
- **Cross utilization of tax credit:** Claiming tax credit requires meticulous filing of prescribed documents in the required format, even then no central and state tax credit can be claimed against each other. Hence, the tax credits under center and state are incompatible! Additionally, no tax credit would be available in respect of certain levies such as basic Customs duty, CST, entry tax or Octroi, which then becomes a cost to business thereby increasing the cost burden on the end consumer.
- **Non uniform tax rate structure:** In a developing nation such as India, states which offer lower indirect taxes attract more investments resulting in greater development compared to states with higher indirect taxes. These states are able to manipulate taxes since they have higher consumption which helps in minimizing the impact on the state's revenue. A uniform tax structure will give all the states a level playing field.

The case for another tax system

In a quest to simplify payment and collection of taxes, regime after regime has tried to introduce several mechanisms and reforms, depleting much of the government's coffers in initiating and organizing committees to study, research and recommend how simplification can be effected and implemented. VAT was introduced in April 2005 to replace the then existing general sales tax. Under VAT, widespread reforms were introduced but were not sufficient. Thereafter a committee

3. http://www.archive.india.gov.in/business/taxation/vat.php
4. http://www.nipfp.org.in/media/pdf/books/BK_60/Chapters/2.%20Structure%20Of%20Domestic%20Trade%20Taxes%20%26%20Customs%20Duties.pdf
5. http://www.archive.india.gov.in/business/taxation/service_tax.php

was appointed, the Finance Ministry's Joint Working Group, which researched and monitored the indirect tax mechanisms in several European nations and formulated a proposal which formed the foundation for the current proposed GST.

The proposed GST bill: Salient features

- **Dual GST model:** Under the dual GST system, both central goods and services tax, and state goods and services tax will be levied on all transactions except interstate sales, which shall be governed by the Integrated Goods and Services Tax.
- **Subsumed categories:** GST recommends collapsing the above mentioned taxes and duties, and surcharges under three broad categories:

  1. Central Goods and Services Tax CGST
  2. State Goods and Services Tax - SGST
  3. Integrated Goods and Services Tax - IGST (this is proposed to be the sum of the applicable CGST and SGST)

Levy of these taxes will be driven by the kind of transaction that takes place. But before coming to the procedural and application aspect, let us first rearrange the current taxes under these broad categories, "subsumed" as the intelligentsia refers!

CGST	SGST	IGST
Excise duty	Value Added Tax / sales tax	Interstate sales tax
Customs duty including countervailing duty (SVD), special additional duty (SAD)	State excise duty	
Service tax	Octroi entry tax in lieu of Octroi	
Education cess	Entertainment tax	
Surcharges	State cess and surcharge	

- **Taxable event will be place of sale and not place of origin:** The GST model has taken a 180 degree turn on the 'taxable event'. Under the current system, indirect taxes are collected at the place of origin, whereas the GST bill proposes the taxable event to be the place of consumption instead of the place of origin. This is a major shift from the prevalent model and has been a source of anxiety, understandably so, among some states that are more manufacture- or production-centric. The concern stems from the apprehension of loss to the exchequer on interstate transactions / sale.

  However, it is believed that this model will increase the tax base and consequently, result in more collection for the state governments.

- **No cross-utilization of input tax credit (ITC):** The GST bill prohibits cross-utilization of ITC between SGST and CGST.

  – **Input tax credit:** Input tax credit is simply the credit for tax that a dealer accrues while paying taxes on input. For instance, the tax paid by a wholesaler on purchase of goods from the manufacturer will entitle the wholesaler to claim credit of tax on sale of those goods to a dealer / retailer. So under the GST, the assesse will not be able to claim credit of input tax which was paid to the state to be offset against the tax liability to the center and vice versa.

- **Service tax:** Under the proposed GST, not just the center but also the states have been granted the right to levy and collect service tax and the same can be utilized for input credit against payment of tax on both goods and services. It is also proposed to have a uniform tax rate for both goods and services. This will potentially streamline the process to a great extent and help in bringing uniformity. The definition of service tax has also been changed to include everything other than goods.
- **GST council:** A GST council chaired by the Union Finance Minister and ministers nominated by each state government as members will be constituted. The decisions of the GST council will be made by three-fourth

majority votes of the council, one-third of the center, and two-third of the state. The GST will inter-alia recommend on the GST rates, exemptions under the GST, and taxes, cesses and surcharges to be subsumed under the GST. The council may also function as a dispute resolution body.

- **GST rate:** Although the GST rate has not been specifically mentioned in the draft bill, it is being speculated to be anywhere in the range of 18% to 24%. The critics of the draft bill are demanding an upper cap to be specified lest the executive have undue powers to make changes to the rates.
- **Taxes not under the purview of GST:** Certain taxes and duties have not been subsumed under any of the above three categories and are proposed to continue to be governed as per the prevalent laws and rules. These are stamp duty, vehicle tax, road and passenger tax, property tax, electricity duty, and basic customs and export duty.
- **GST threshold:** In the interest of the small-scale industries and small traders, a uniform state GST threshold across states is proposed. The threshold has been set at gross annual turnover of INR 10 lakh, both for goods and services. Under consideration is providing adequate compensation for the lower threshold states under the VAT regime such as North-Eastern states and special category states.
- **Exemptions:** Alcohol for human consumption has been exempted, as of now, from the levy of GST in the draft bill. This may get included at a later date upon GST council's recommendation. There are other categories of goods that are being considered for exemption such as petroleum products and tobacco, however, under the original bill, they are included under GST.

Understanding the GST operation

Let us understand the workings of the GST with an illustration:

X is a manufacturer in the state of Maharashtra and sells their goods for INR 10,000 to Y, a wholesaler in the same state. Y sells the goods to Z, a retailer in the state of Karnataka for INR 11,000. Z resells the goods to C, consumer for INR 12,000 in the same state of Karnataka.

Let's break this whole cycle in the following individual transactions and work the GST payable, assuming the CGST rate to be 12% and SGST rate to be 10%. IGST will work out to be 22% (CGST+SGST).

1

- X to Y – Intrastate sale
- Sale price – INR 10,000
- CGST @12% – 1200
- SGST @ 10% – 1000
- Total GST – 2200
- X will deposit the tax collected (INR 2200) in the state of Maharashtra.

2

- Y to Z – Interstate sale
- Sale Price – INR 11,000
- IGST @ 22% - INR 2,420
- Y to claim Input Tax Credit (ITC) of INR 2,200 paid at the purchase from X (above)
- Y's tax liability INR 2420-2200 = INR 220 as IGST
- Maharashtra to transfer the SGST collected on the first transaction to the centre since the SGST input has been used to set-off the IGST.
- Tax collected by centre is CGST+SGST+IGST= 200+1000+220= 2420

3

- Z to C – Intrastate sale
- Sale price INR 12,000
- CGST @ 12% - INR 1440
- SGST @ 10% - INR 1200
- Total GST – INR 2640
- Z to claim input tax credit of INR 2420 (CGST ITC = 1320 and SGST ITC = 1100)
- Z's Tax liability INR 2640-2420 = INR 220
- Z will deposit INR 120 as CGST and INR 100 as SGST
- Centre to transfer INR 1100 IGST input to the state of Karnataka to set-off SGST in the same state transaction

4

- Total tax collected by:
- Center – INR 1540 (2200+220+220-1100)
- State of Karnataka – INR 1200 (1100+100)
- State of Maharashtra - INR 0

Illustration 2

The benefits

- It is anticipated that with the introduction of GST, the tax liability will be reduced since the taxes on taxes or double taxation will be completely eliminated, thus bringing down the cost of the goods and services, benefitting the consumers.
- Streamlining the process - Since under the proposed GST, a whole lot of taxes are subsumed, there would be lesser paperwork required resulting in lower administrative cost to businesses.
- Will allow seamless utilization of input tax credit.
- Will levy a uniform rate for both goods and services across states in India, helping streamline and align tax calculations and processes.
- Potential to stem corruption and black marketeering, since the authorities will have a better handle and can perform efficient monitoring of tax due to the sheer simplicity of the structure and process.
- The introduction of GST will not only include comprehensively more indirect central taxes and integrate goods and services taxes for set-off relief, but also capture certain value addition in the distributive trade.
- Will allow cross-utilization of input tax credit between goods and services.
- No refund claims would be required due to end-to-end seamless credit mechanism.
- It is anticipated that with the simplification of the process and elimination of double taxation, Indian goods will be available at more competitive prices which should boost Indian exports and increase our foreign reserves.

Roadblocks to enactment

- Although at a concept level, all the major political parties have demonstrated their assent to GST implementation, they disagree on specific issues. And since the ruling party at the center does not enjoy a majority in the Upper House, the GST as proposed in the current form will struggle to pass. For the bill to pass in the Rajya Sabha, it will need two-third votes.
- The bill can be enacted only if 50% of the states in India ratify the passage of the bill. This in itself is an enormous task not just because of the differing political ideologies but as the bill does not enjoy support from some states who fear loss of revenue due to the change in the tax collection and levy model.
- There are states that are demanding protection from the center for as long as 10 years in the form of compensation for drop in revenue due to GST implementation. There is a proposal to allow levy of additional 1% tax for the state of origin on interstate transaction for a period of at least 2 years. It is however, feared that this may further have a cascading effect resulting in higher liability for the end consumer.
- The implementation itself will be a humongous exercise as all the IT systems and processes will need to be synchronized.
- There are too many open questions for which the center has not provided convincing answers such as the exemptions available under the new regime, the limit for the small scale industry, the percentage of the rate of tax itself, and more.
- Consensus of the states and center over revenue neutral rate (RNR) is also one of the impediments in the implementation of GST.

RNR can be defined as the optimum rate of tax which will ensure similar revenue generation for the states and the center under the proposed GST compared to what is being generated under the current regime from the various tax levies. In essence, the new tax structure should have no negative revenue impact.

- The speculated GST rate is 20-26%. Much of the developed world that has adopted this model has capped the rate at 12-18%. However, due to the dual structure and simultaneous CGST and SGST, states will get to collect less than half of the proposed GST, which would work out to 8%-12% of SGST assuming the range of GST to be 20-26%. Therefore, any further lowering of the tax rate may not find favor with many states.

Is a Constitutional amendment necessary?

India has a federal structure with clear delineation of power to tax between the center and the states. While the center is empowered to impose certain taxes such as excise, customs and service, the states have been empowered under the constitution to impose and collect sales tax, octroi, purchase tax (in certain states), luxury tax, and property tax, among others. The rights of the center and states are mutually exclusive and sacrosanct. Therefore, a constitutional amendment is essential for empowering the center to levy tax on sale of goods and the states to levy service tax, tax on imports, and other consequential taxes.

The not so good about it

- The new system can potentially increase the gap between the more developed and less developed states since the tax will be on consumption.
- Although the total tax on the product may decrease only slightly, the states may lose their revenues to the center in this center-state divide of taxes. The problem may get compounded in states which are governed by different political parties than that present in the center, especially if the state loses under the GST model compared to the current one. With lesser revenue collections, they may have to perpetually play in the hands of the center. Consequently, the center may eventually influence how the state utilizes the money.
- The GST model based on the taxation event being "sale", may harm the manufacturing environment in the country. Since the state will not gain as much from the manufacturing activity, they may not grant the much needed incentives and subsidies to the manufacturing industry.
- Services will also be taxed at the same rate as goods, which may be much higher than the current system, although its benefits cannot be denied.
- There are other proposals being considered for adoption such as the multiple tax slabs for different items, and 'sin' tax which is another unknown category demanded by certain quarters. The center is deviating and compromising on a lot of issues which were part of the original bill.
- Dealers may face a huge challenge in maintaining processes and systems of both the regimes in cases of interstate transactions between states that opt out of the GST and states that implement the GST.

Conclusion

There are some valid points and concerns being raised by the opposition in the Parliament and several economists and scholars, which should be addressed. It is important to establish broad consensus, more so as the states need to ratify the bill. While there can never be a perfect system, it is imperative that all the parties arrive at an agreement to build a robust system which addresses the many lacunae in the current system of indirect taxes. The implementation process for both governments (states and center) and businesses will be time consuming, so even if the bill were to be passed today, it would be some years before the economy can start reaping its true benefits. Even after the bill is passed, the enacted law will evolve and undergo several iterations and amendments.

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