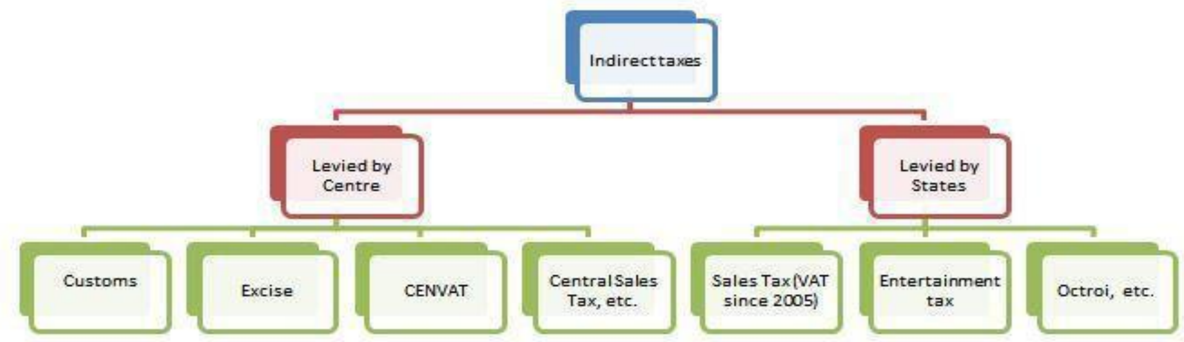
Goods and Services Tax

The Goods and Services tax came into effect from 1st July 2017 after the relevant bills were passed in the Parliament and the State legislatures. This explanation is structured in 3 parts: -

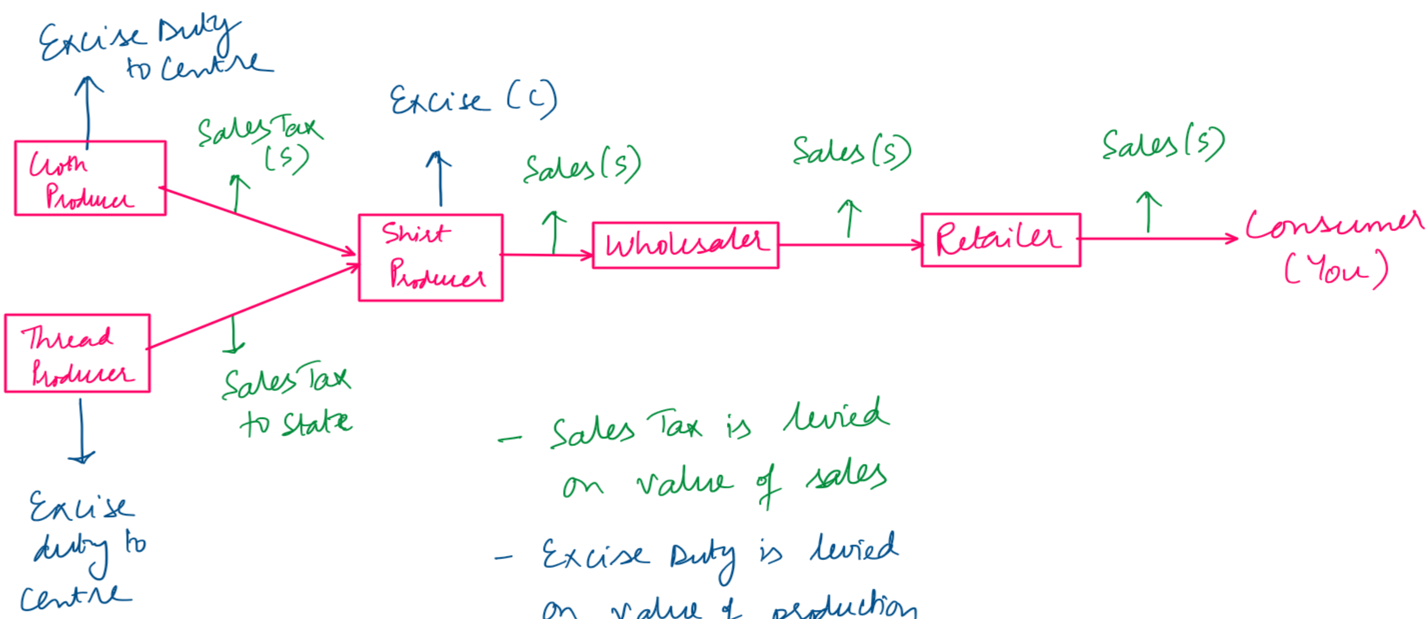
1. We understand the old system of indirect taxation.
2. We look at the problems in that system.
3. See how can those problems be addressed and overhaul the old system into a new one – GST.

Part 1: - The old system of indirect taxes (pre-2005)

Taxes are levied on events. A person responsible for causing that event has the responsibility to pay tax to the levying authority. For example, sale of a good or service, generation of income, change of international boundary, earning of profit by a company, etc. All these are events which are taxed by the government. The responsibility to pay tax i.e., deposit tax with the government, is always of the person on whom tax has been levied. In some cases, though, the person can rightfully collect the tax from someone else. In such cases, the tax is levied on A, and it will be A who will pay this to the government, but A can collect this tax from B, who actually bears the burden. Such taxes are indirect taxes. Centre, State and local bodies levy such indirect taxes, some of which are given below.



Here is an example of taxation in the old regime: -

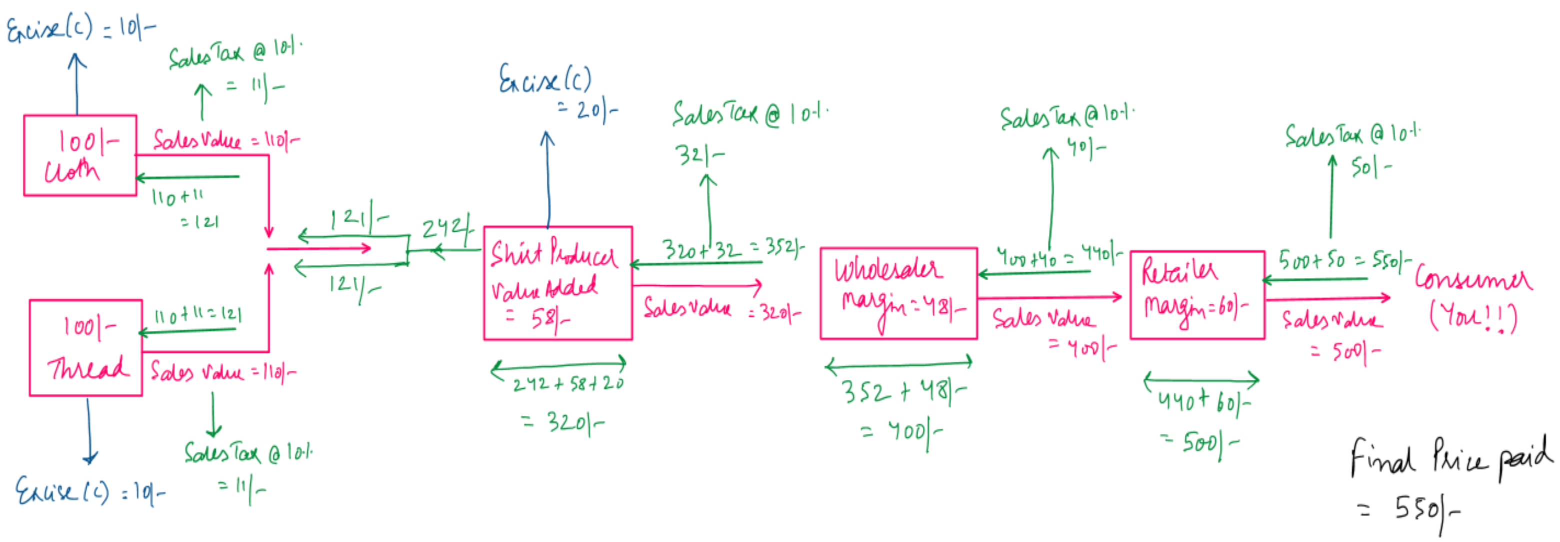


- Sales Tax is levied on value of sales
- Excise Duty is levied on value of production or at a flat rate i.e. specific duty.

Every producer pays excise duty to the Centre on production. On every sale, a sales tax is levied by the state government (it was later changed to VAT, more on that later). The wholesaler adds his margin (profit) and sells to the retailer, who in turn adds his own margin before selling it to the consumer. Again, a sales tax is levied at every sale instance. Also, if the sale is an inter-state sale, the State government cannot levy a sales tax, rather it is the Centre that levies a Central Sales Tax (CST*). Since all these are indirect taxes, they are ultimately borne by the consumer.

*CST - If the sale is from one state to another, the state government cannot levy a sales tax as this will distort the free movement of goods in course of inter-state trade. This is a constitutional requirement (Art 301-307). In order to compensate the selling state for loss of sales tax, the central government levies a Central Sales tax and transfers the entire amount to the selling state. In the following illustration, the taxation in old regime is explained through the production and sale of a shirt. A shirt producer buys 2 inputs, cloth and thread. Sale takes through the wholesaler and retailer, who add their own margins.

Example with numbers



Part 2: - The problem with the old system

If we observe the above flow chart closely, we will notice that the consumer is paying a very high price as compared to the cost of production. The total value added at different stages of production is Rs. 366 (100/- by cloth producer, 100/- by thread producer, 58/- by shirt producer, 48/- by Wholesaler, 60/- by the retailer). Whereas, the final value paid by the consumer is Rs. 550/-, which amounts to an effective tax of 33.5% (184/550). No wonder that no one would be ready to pay taxes by asking for bills from the seller. The problem is compounding of taxes – double taxation of the same value and a tax on tax. This is also referred to as cascading of taxes.

Let's see the tax paid at the stage of sale from Producer to Wholesaler. The sales value is Rs. 320/-, and at the rate of 10% Sales Tax, a Rs. 32/- tax is levied, which is collected by the producer from the wholesaler, taking the total amount paid by wholesaler to Rs. 352/-. Let's break it down-

$Tax = 10\%\ of\ 320$
32 = 10 % of (300 + 20 (Excise duty paid to Centre))
32 = 10% of (242 (cost of inputs) + 58 (value added by producer) + 20 (Excise duty))
32 = 10% of (121 (cost paid to cloth producer) + 121 (cost paid to cloth producer) + 58 + 20)
32 = 10% of (110(value of sale) + 11 (sales tax) + 121 + 58 + 20)
32 = 10% of (100 (value recd. by Cloth producer) + 10 (Excise Duty) + 11 + 121 + 58 + 20)
32 = 10% of (100 + 10 + 11 + 100 + 10 + 11 + 58 + 20)
32 = (10 + 1 + 1.1) + (10 + 1 + 1.1) + (5.8) +(2)

So, the tax of Rs. 32 paid by the wholesaler to the producer consists of the following: -

1. A tax of Rs. 5.8 paid on the value added by the producer
2. A tax of Rs. 2 paid on the excise duty, itself a tax, on the excise duty paid by producer to Centre – A tax on tax.
3. A tax of Rs. 10 paid on value added by the cloth producer, which is a value that has already been taxed during the sale from cloth producer to the shirt producer. Similarly, Rs. 10/- on value added by the thread producer – A tax on value already taxed.
4. A tax of Rs. 1/- each paid on the excise duty of Rs. 10/- each paid by the cloth & thread producer to the Centre – A tax on tax.
5. A tax of Rs. 1.1/- each on the sales tax of Rs. 11/- levied on the sale transaction between cloth & thread producer and the shirt producer – A tax on tax.

Out of Rs. 32/- tax levied at this stage, only Rs. 5.8/- was on that value that had yet not been taxed. Rest, Rs. 26.2/- was either a tax on tax or a tax on value already taxed.

Part 3: - Correcting the old system

3.1 Introduction of VAT (2005)

Since 2005, sales tax in the states is levied on the Value added and not the entire value of sales transaction. This new way of levying sales tax was itself called VAT (Value added tax).

In case of Excise duty (Central Tax), the VATting system (levying a tax on value added and not on entire value) was already implemented in the 1980s. That tax was called CENVAT/MODVAT. Let us understand this VATting system.

Under the VAT system, only the value added at any stage is taxed, rather than the total value. The objective is to decrease the tax burden by making the taxation system fair, and thus increase compliance. In the above example, it would be a tax on Rs. 58/- only (=Rs. 5.8/-) during the sale from producer to wholesaler.

How would VAT be levied? For that we need to understand something called as Input Tax Credit (ITC). This system is based on taxable value at the previous (input) stage and the proof of tax paid on it, i.e., the bill, which is *offset* against the tax *to be paid* at the later (output) stage.

In the above example, the producer has already deposited a sales tax (called the VAT after 2005) on the value of his inputs, i.e., Rs. 11/- each to the cloth and thread producer. This 11/- is a proof that a tax on value of 110/- has already been paid, and as such, the tax that he has paid to the state government is reflected in his record with the government. If, and when, he sells the good in future, he would have to charge from buyer and pay to the government his VAT liability. From whatever tax liability on account of a sale transaction that arises for him in future (i.e., VAT), his account shows that he has paid Rs. 22/- already, and thus needs to pay only the additional amount, i.e., tax on the additional value only. This Rs. 22/- is the Input tax credit that he has received in his account, which he will use to offset the tax liability on his output.

Two very important points to keep in mind are: -

1. Tax is always charged on the entire value of transaction, not on the value added. How will the government know what is your value added? For all we know, the thread and cloth sellers may not have even deposited the tax collected with the government. Taxing the value added is the objective. It is achieved through the system of ITC. A tax will always be levied on entire value. We will levy it in such a manner that effectively only the value added is taxed.
2. The system of ITC and offsetting is available only for a tax against the same tax, not any other tax. ITC can be offset for VAT only against VAT, and not any other tax- neither Excise duty, which is a central tax, nor taxes like entertainment, luxury, octroi, etc. which are state taxes.

The government would always and always collect tax on the entire value of transaction. Only if the seller has ITC in his account with the government, would he be able to use it to offset. To achieve this, the seller would prepare a bill in which the value of transaction would be that of his inputs and value added only, and charge the customer according to that. Here is the comparison: -

Bills of Transaction between
Producer and wholesaler

Old Regime
(pre-2005)

Value of Sale = 320
Sales Tax @10% = 32/-
Total paid = 352/-

New Regime
(2005-2017)

Value of Input = 110 + 110
= 220/-
Tax already paid = 22/-
Value Added = 58/-
Excise paid = 20/-

∴ Value of Sale = 220
58
20
298 ← Value charged by producer

Sales Tax @ 10% = 29.8/-

Total paid = 327.8/- ← Value paid by wholesaler

Tax paid by producer = 29.8 − 22 (ITC)
= 7.8/-
= 5.8 + 2
(10% of 58) (10% of 20)
Value Added Excise Duty

From the above illustration, both the benefits and shortcomings should be clear. To summarize: -

- The tax burden is substantially reducing as the taxable value is now much less than before.
- Entire cascading effect (tax on tax) is not eliminated because a VAT is being levied on Excise duty as well.

GST addresses this problem of cascading completely. It does so by removing all other events of taxation other than sale, so that they can be offset against each other.

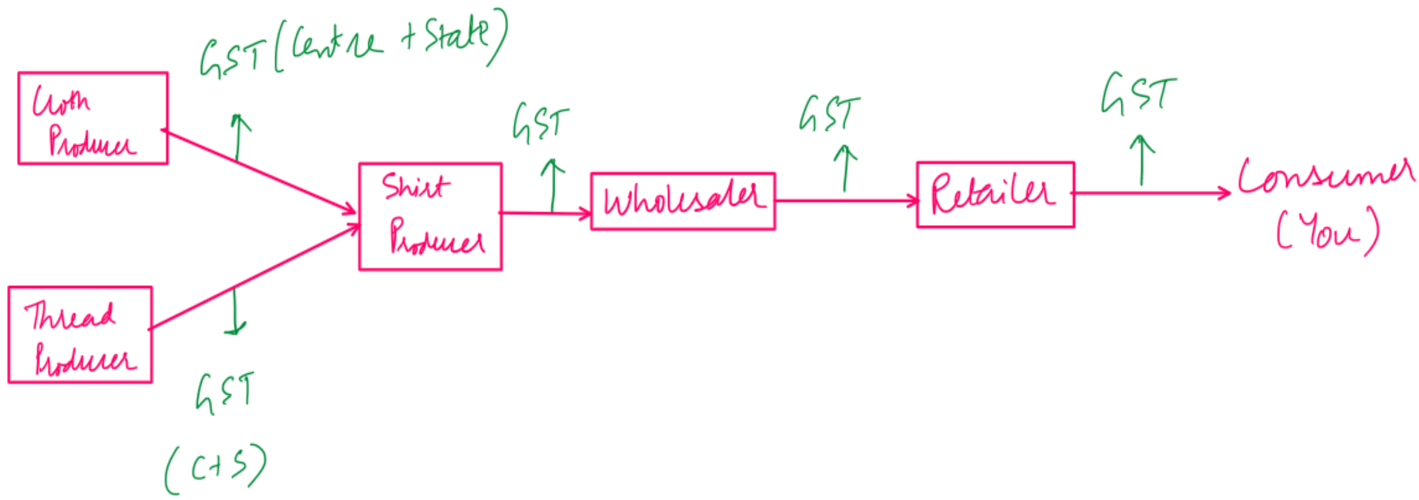
3.2 The GST system

If the above example seems complex, try adding other taxes in between. In case of inter-state sale, a Central Sales Tax (CST) is levied. Upon entry into a state, district or municipal bodies, various entry taxes/octroi are levied. There would hardly be a business in the country that is completely based out of one state. The supply chains run through various states, and thereby, are subject to multiple taxes. VAT of one state is not the same as other state and more importantly, is not offsetable against VAT paid in another state. Even VAT paid is not offsetable against other indirect taxes in the same state. Of course, a central indirect tax (such as excise) is not offsetable against a state tax or vice-versa. The VATting system of 2005 was merely a start. GST is the culmination of that process of integration of taxes to develop a fair, compliance incentivizing taxation system.

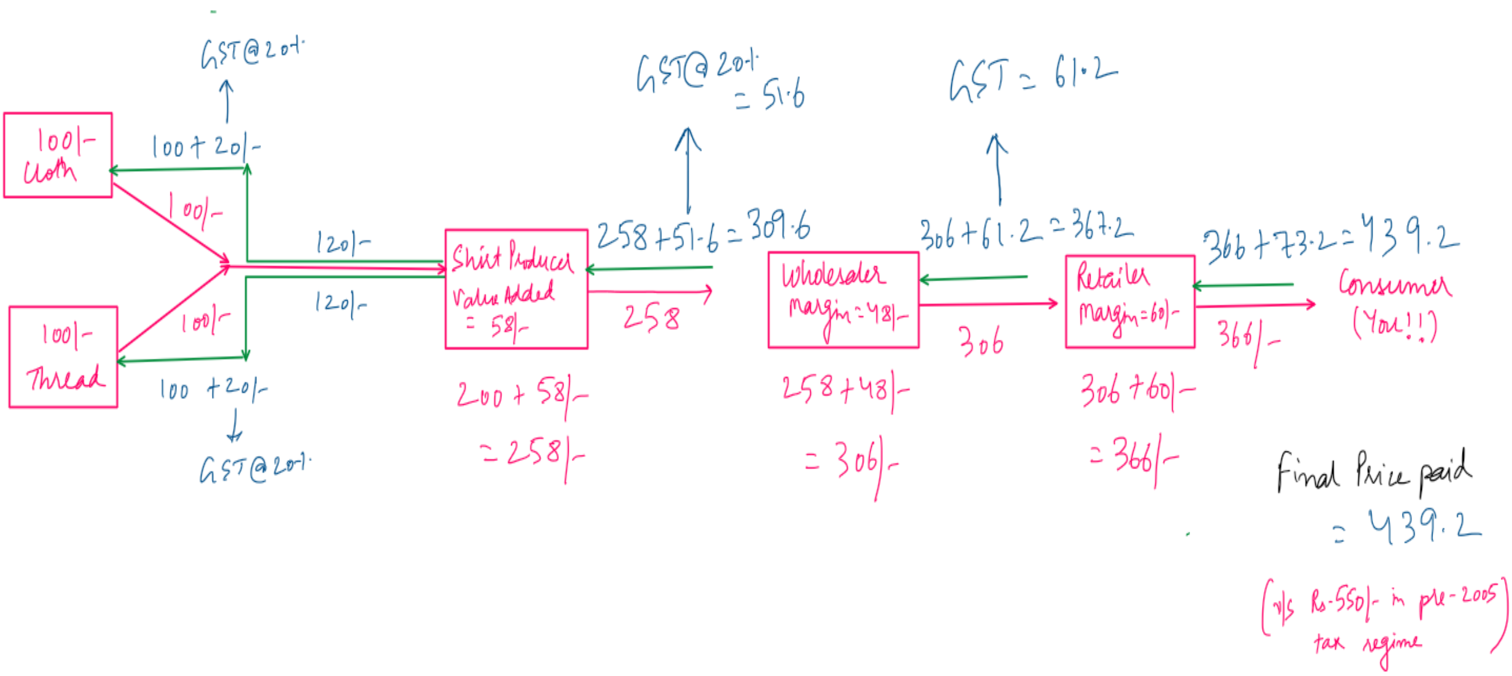
*__*A note on compliance__* – Any law is only as good as it is complied with. A tax law needs to have low cost of compliance and a high cost of non-compliance in order to encourage and force people to comply with tax laws. Multiple events of taxation and multiple authorities associated with them create a complex system with high monetary and human costs of compliance. Further, such a complex system will have inherent coordination problem and therefore, catching a tax evader becomes systemically impossible. It is only a tax officer – the person, who catches the evader, not the system. As such, the cost of compliance is extremely high, and that of non-compliance is a low probability of getting caught and even then, the cost is usually the bribe paid to a person. It is the person who can be bribed, not the system. Since one is caught by the person, a tax officer, it is relatively 'cheap' to get away. I hope now you realize what is actually meant by the common rant that you come across- 'Bribes have only gone up since the new system came into place'. Well, now it is the system that is catching the evader, not the person. So, the costs of non-compliance are naturally reaching the level of legal penalty, much more than the bribe paid in earlier times.

What is GST?

If you understood the VAT system above, understanding GST is very simple. GST is simply the wider application of the VAT system. It **__removes all other events of indirect taxes__** (**except Customs) and combines them into one single event – the sale of a Good or a service. Whenever a good is sold from one person to another, GST is levied, which is simply the VAT of the old system, i.e., sales tax levied in a Value-added manner. There is no other tax like the excise duty, central sales tax or entry/octroi, etc. A produces and sells a good to B, only GST is paid. B sells it to C and charges a tax on value added in the same manner as was described above.



Example with numbers :- Let GST be @20% (double the Sales Tax rate)



Net Tax Paid :

1. By Cloth & Thread producer = 20 − 0 = 20/- = 20% of 100/-
2. By Shirt producer = 51.6 − 40 = 11.6/- = 20% of 58/-
3. By Wholesaler = 61.2 − 51.6 = 9.6/- = 20% of 48/-
4. By Retailer = 73.2 − 61.2 = 12/- = 20% of 60/-
5. By Customer = 73.2 = 20% of Entire Value Added
   = 20% of (100 + 100 + 58 + 48 + 60)
   = 20% of 366/-

Statutory definition: - GST has been defined as any tax on supply of goods and services other than on alcohol for human consumption. It has three important properties:

- It has a one nation-one tax structure. This means it will subsume many indirect taxes like VAT, CST, Excise, Service tax, etc.
- It is a destination-based tax. This means the taxing authority is the place where goods are supplied to and not where the sale originates.
- It has a VAT like structure. This means that taxes paid at previous stages will be available as setoff at the subsequent stage.

Normally when you (the consumer) buy something, you will see two components of GST – Central and State. This is because when a sale is made within a State (say Tamil Nadu), GST will be shared between Center and the State. In case the sale takes place across two States, IGST (Integrated GST) will be levied. The revenue collected under CGST is for the Centre, while that collected under SGST is of the destination state. In order to ensure smooth operations, the goods & services to be taxed as well as other essential design features of the GST would have to be common between the Center and the States.

GST and its administration

GST will be administered by the **GST council**. It will be the apex policy making body consisting of Central and State ministers in charge of Finance. The Council will make recommendations on model GST laws, its rates, place of supply rules and any other matters relating to GST. Some commentators say that GST has led to surrender of financial sovereignty of States to the Center. This became visible during Covid times when States could not raise taxes by way of increasing their indirect taxes as they used to do earlier by raising rates of VAT on various items. Well, this is not just misrepresentation of truth but also a cunning reasoning to go back to the old, inefficient, tax-evasive, bribe-heavy, tax-terrorism days of a rent-seeking state. Yes, the states, earlier, had the right to tax transactions in their territory. Now it is both center and the states, *together,* through the GST council which will levy taxes. They have not surrendered their sovereignty, rather both the center and states have **'pooled their sovereign rights'** to streamline and better manage the taxation of goods and services in India. A streamlined administration, an easy compliance, a unified system of taxation throughout the country has truly created a better environment for doing business, paying taxes and led to reduction of tax burden on the consumer while increasing tax revenues for the government by widening tax base.

As yet (March 2022), petroleum and petroleum products, i.e., crude, high speed diesel, motor spirit, aviation turbine fuel and natural gas, are not subject to GST and shall be subject to it from a date to be notified by the GST Council. They continue to be under the earlier system. VAT and other input taxes paid on them cannot be offset against GST. It has also been decided that the area up to 12 nautical miles will be under Central administration. However, States can collect tax on economic activities carried therein. Stamp duties which are levied on legal agreements by states, will continue to be levied separately.

Benefits of GST?

The main benefit is that it is a simple to administer and thus, an efficient taxation system. In 2017, it was merely an expectation, in 2022, it is a reality that it has substantially increased compliance. The much wider and still growing tax base (users registered with GST) is a proof of this. In the low compliance system of the past, the honest tax payer was not only paying his own share, but also that of the evader.

As has been illustrated above, elimination of multiple events of taxation and their cascading effects has led to a reduction in price (*Refer anti-profiteering clause below). The system of input tax credit (ITC) which allows for offsetting of all indirect taxes paid at earlier stage is the biggest reform. Earlier, since central and state taxes were completely isolated from each other and were administered separately, there was no scope of offsetting taxes paid to the center or state against the other. Harmonization of center and state tax administrations would also reduce duplication of efforts and cut red-tape. Additionally, the new automated system of GSTN would reduce errors and ease up the return filing procedure.

Challenges in the GST system

Most important one is the multiple slabs of GST rates. In the current model, there are 5 rates of 0%, 5%, 12%, 18% and 28%. Besides, there are number of items such as raw agricultural produce which is zero rated and some luxury goods and those with negative externalities which attract a cess over and above the rate of 28%. This has made the system highly complicated. It is, though, important to see this complication in context.

In the earlier system, in order to comply with tax laws, a firm would have to do numerous filings with different departments of governments at all three levels (Centre, State, local). This meant not just higher overall monetary costs to simply remain compliant (i.e., not the tax cost, but filing cost), but also dedicating time and resources for compliance.

Imagine someone standing over your head and asking to simply submit a signed document every day. It won't take long for you to get fed up. The costs were so prohibitive that almost everyone chose *complete non-compliance*. In a system where not collecting and depositing tax with government could only be found out through random raids by tax officials, a businessman would take the chances of not being caught. And if, due to bad luck or sheer visibility of his business, was caught, then may choose to resort to bribe the inspector and even earn impunity for some time.

The new system is based on Input tax credit, which requires submitting an invoice. The total number of filings (GST Return filings such as GSTR-3B) a business would have to do have come down drastically, but anything is still more than Zero- the number of filings that a business was practically doing earlier. This is the reason for a random rant that you see by lazy commentators about GST- 'Oh the idea was good but implementation was shoddy'. Shoddy? Really? This is a below average disgruntled journalist trying to couch his/her mediocre sophistry.

A more ponderance worthy drawback of the system is lobbying and politicization. Many producers or service providers, especially in the food processing sector would want their products to be zero rated or so. This may give rise to unscrupulous classifications in order to escape taxation. The central government with its majority in GST council has been accused of enabling reduction of GST rates on items with an eye on elections.

An ideal GST system may be one that has just one flat rate on all items traded. But that would be a regressive taxation regime. The current multiple tax rates reflect progressive element in GST system with items of lesser value and necessity taxed at a 0 or 5% tax rate and items of higher value, luxury and demerit goods taxed at 18%, 28%, including Cess. A reform in the tax slabs is still desirable.

GST compensation to states

The states put a condition before agreeing to pool their constitutional rights together. They asked for compensation in the event of a shortfall. Whatever was a state's total revenue from indirect taxes pre-2017 was taken and an average nominal growth rate of 14% was decided, i.e., it was assumed that it would grow at the rate of 14% every year for next 5 years. Against this assumed collection in future, there would have been some actual collection once GST comes into force. The Centre agreed that if there would be any shortfall in State's revenues on account of implementation of GST, then the Centre would compensate the State to that extent till the next 5 years (i.e. till 2022). Mark the words – it is on account of shortfall *due to GST implementation* – if for e.g., the state itself is unable to do it, or if there is a pandemic, then Central government is not responsible for a compensation arising out of general shortfall. The GST compensation cess levied on luxury and demerit goods is for purpose of compensation. It was originally meant to go away in 2022. Thanks to Covid, it seems it's not yet going away.

Concept of Revenue Neutral rate

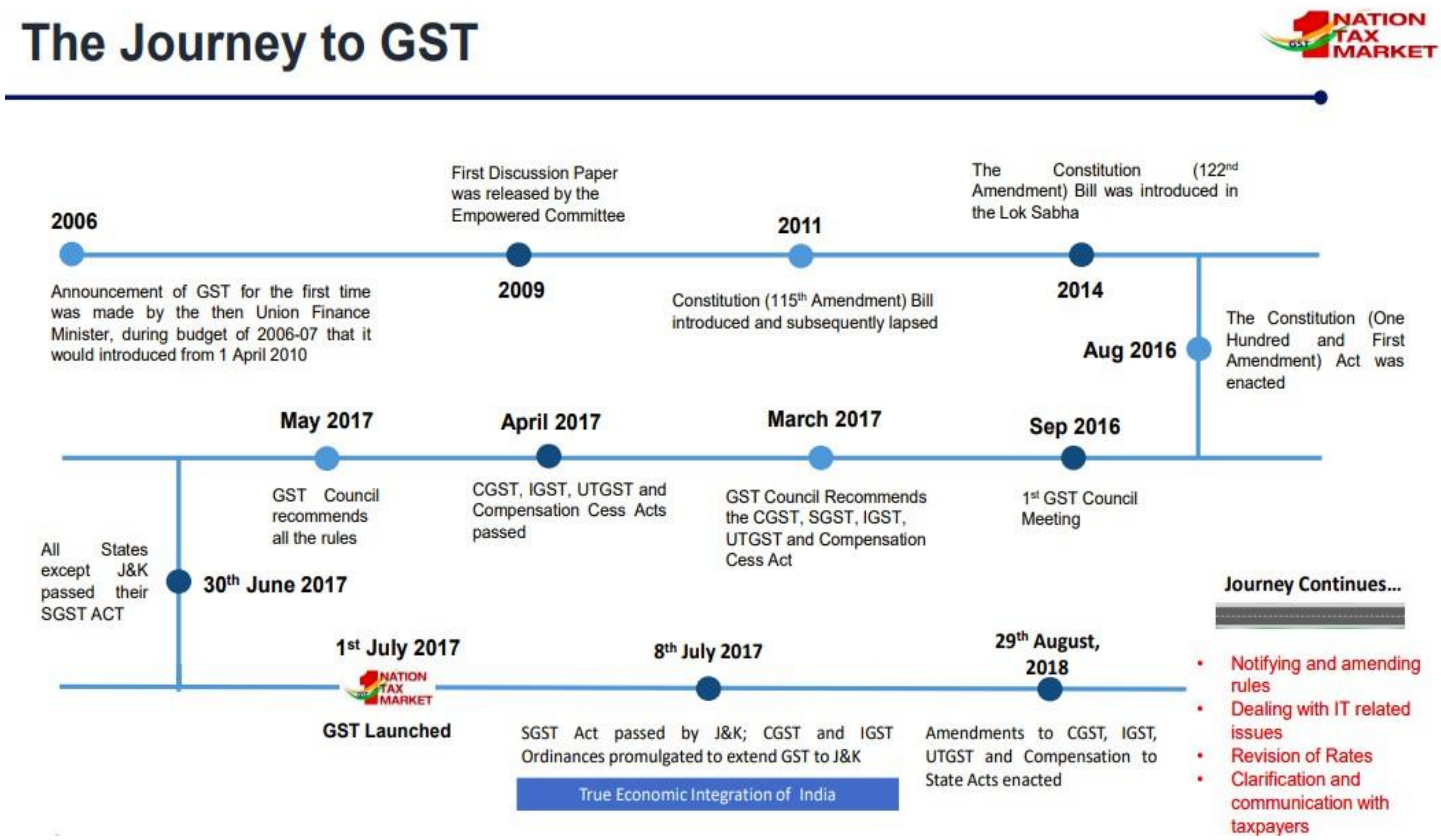
It is the tax rate that allows the government to *receive the same amount of revenue despite the change in tax laws*. In Pre-GST era, the total incidence of indirect tax in most of the states was about 30% (12% excise, 14% VAT and other taxes, depending on the good). Under the GST regime, if the average incidence of taxation comes out to be, say 20%, the government will lose out on revenue. However, the government also expects an increase in tax base, and thus, an increase in revenue on account of that. Therefore, pre-GST, the effort was to make sure that new tax rates are such that revenue of the government does not decrease. The average GST rate which ensures this is called revenue neutral rate. It is the rate at which tax revenue will remain the same, despite allowing input credits, exemptions, etc.

At the effective rate of 30% on 100/- rupees of actual value of output produced, if we were collecting only Rs. 10/- of tax, that would mean that we were able to tax only 33 rupees of the total value produced, i.e., 1/3rd of GDP (30% of 33 = 10). In the new regime, if we are able to tax double the value, i.e., 2/3rd of GDP, then, even if we levy a 15% tax, our tax revenue would not change (15% of 66 = 10). This is RNR.

Anti-profiteering clause

Look at the illustration above again. The buyer will only benefit if the seller charges a tax on him only on the value, not on the tax that he has paid. The GST system, with a much lower RNR (or average tax rates than earlier), should definitely make goods cheaper for the consumer. However, whether the consumer actually receives this benefit or not depends on the seller, who may try to profit off the consumer behaviour. The consumer is already paying a higher price. The seller may increase his own profit by increasing the price of good by the amount of reduction in taxes that the consumer would see. He may, not pass on the benefits. This is profiteering off the changes in tax system. GST law makes it illegal.

GST on international trade- Imports and Exports: - Since GST is a destination-based tax, exports would be zero-rated as the sale is not made in India. Zero rated does not mean exempt. They will be eligible for full duty drawback. Please note **customs duty is not part of GST**. Imports would attract tax in the same manner as domestic goods and services. They will be subjected to a basic customs duty when they enter the territory of India. After that, they will be subjected to IGST.



GST Law from a Constitutional Perspective (1/2)

Definition of GST

Article 366(12A)

"Goods and services tax" means any tax on supply of goods, or services or both except taxes on the supply of the alcoholic liquor for human consumption

Sl No	Definition	Article	Definition
1.	Goods	366(12)	Includes all materials, commodities, and articles [Pre Existing Definition]
2.	Service	366 (26A)	Anything other than goods [Introduced vide 101st Constitutional Amendment Act]
3.	State	366(26B)	With reference to articles 246A, 268, 269,269A and Article 279A includes a Union territory with Legislature. [Introduced vide 101st Constitutional Amendment Act]

"Goods and Services tax" law while having unique principles, has significant elements of prior Central and State laws; and is also inspired by VAT/GST legislation of EU, Australia, Malaysia etc. along with International VAT/GST guidelines of OECD

- Notified as Constitution (101st Amendment) Act, 2016 on 08.09.2016
- Key Features:
  - Concurrent jurisdiction for levy & collection of GST by the Centre & the States – Article 246A
  - Centre to levy & collect IGST on supplies in the course of inter-State trade or commerce including imports – Article 269A
  - Compensation for loss of revenue to States for five years on recommendation of GSTC – Clause 19
  - GST on petroleum crude, high speed diesel, motor spirit (commonly known as petrol), natural gas & aviation turbine fuel to be levied from a later date on recommendations of GSTC

GST Council – Constitution (Article 279A of the Constitution)

Chairperson – Union FM
Vice Chairperson - to be chosen amongst the Ministers of State Government
Members - MOS (Finance) and all Ministers of Finance / Taxation of each
State Quorum is 50% of total members
Decision by 75% majority
States - 2/3 weightage and Centre - 1/3 weightage
Council to make recommendations on everything related to GST including laws, rules and rates etc.

Main Features of the GST Act

- Concurrent jurisdiction for levy & collection of GST by the Centre (CGST) and the States (SGST)
- Centre to levy and collect IGST on supplies in the course of inter-State supplies & on imports Compensation for loss of revenue to States for five years
- All transactions and processes only through electronic mode – Nonintrusive administration
- PAN Based Registration

- Registration only if turnover more than Rs. 20 lac (Rs. 10 lac for special category States except J&K)
- Option of Voluntary Registration
- Composition threshold shall be Rs. 100 lac
  - Composition scheme shall not be available to inter-State suppliers, service providers (except restaurant service) and specified category of manufacturers
- Deemed Registration in three working days
- Input Tax Credit available on taxes paid on all procurements (except few specified items)

  -The e-way bill system has been introduced nation-wide for all inter-State movement of goods with effect from 01.04.2018. As on 16.06.2018, all States and Union Territories have introduced e-way bill system for intra-state movement of goods

- Anti-Profiteering provision – National Anti-Profiteering Authority already set up
  - Standing Committee on Anti-Profiteering already set up
- State level Screening Committee already set up

What is composition levy under GST?

The composition levy is an alternative method of levy of tax designed for small taxpayers

whose turnover is up to Rs. 75 lakhs (Rs. 50 lakhs in case of few States). The objective of composition scheme is to bring simplicity and to reduce the compliance cost for the small taxpayers. Moreover, it is optional and the eligible person opting to pay tax under this scheme can pay tax at a prescribed percentage of his turnover every quarter, instead of paying tax at normal rate.

Such persons need to electronically file **quarterly returns** in Form GSTR-4 on the GSTN common portal by the 18th of the month succeeding the quarter. For example return in respect of supplies made during July, 2017 to September, 2017 is required to be filed by 18th October, 2017.

Goods and Service Tax Network

- Incorporated in March 2013 as Section 25 private limited company with paid up capital of Rs. 10 crore

- Equity Holders – Earlier Centre, State and private sector. Now completely government owned.

- To function as a Common Pass-through portal for taxpayers
  - submit registration application
  - file returns
  - make tax payments
  - Infosys appointed as Managed Service Provider (MSP)
  - Appointed 73 GST Suvidha Providers (GSPs)

Pre-GST Indirect Tax Structure in India

Central Taxes

- Central Excise duty
- Additional duties of excise
- Excise duty levied under Medicinal & Toilet Preparation Act
- Additional duties of customs (CVD & SAD)
- Service Tax
- Surcharges & Cesses

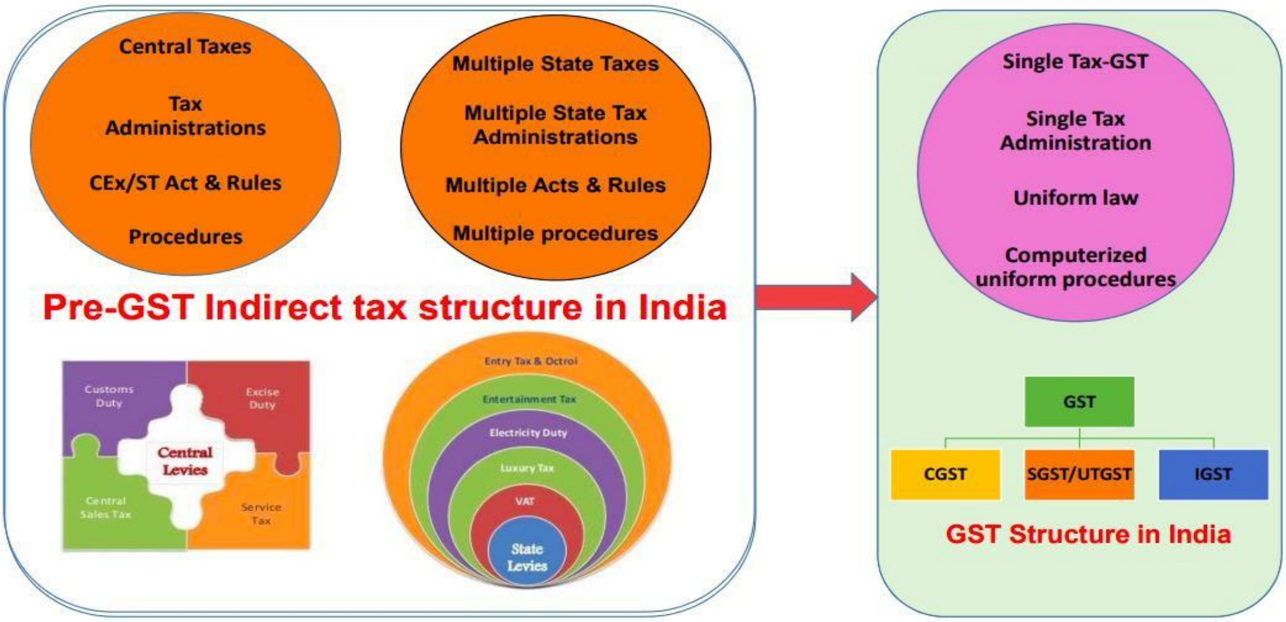
State Taxes

- State VAT / Sales Tax
- Central Sales Tax
- Purchase Tax
- Entertainment Tax (other than those levied by local bodies)
- Luxury Tax
- Entry Tax (All forms)
- Taxes on lottery, betting & gambling
- Surcharges & Cesses

+ *13 Cesses*

GST

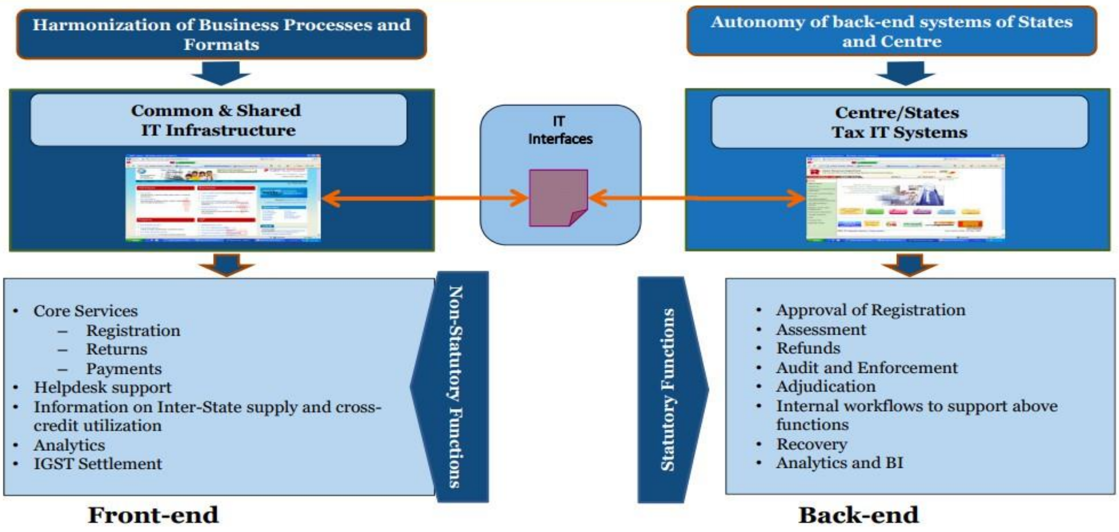
Constitution amended to provide concurrent powers to both Centre & States to levy GST (Centre to tax sale of goods and States to tax provision of services)



Outside GST !

	Alcohol for human consumption	Power to tax remains with the State
	Five petroleum products – crude oil , diesel, petrol, natural gas and ATF	GST Council to decide the date from which GST will be applicable
	Tobacco	Part of GST but power to levy additional excise duty with Central Government
	Entertainment tax levied by local bodies	Power to tax remains with local bodies

Goods and Service Tax Network (3/4)



Benefits of GST (1/2)

1. Reduction in Cascading of Taxes
2. Overall Reduction in Prices
3. Common National Market
4. Benefits to Small Taxpayers
5. Self-Regulating Tax System
6. Non-Intrusive Electronic Tax System

- Decrease in Inflation
- Ease of Doing Business
- Decrease in "Black" Transactions

Benefits of GST (2/2)

7. Simplified Tax Regime
8. Reduction in Multiplicity of Taxes
9. Consumption Based Tax
10. Abolition of CST
11. Exports to be Zero Rated
12. Protection of Domestic Ind. - IGST

- More informed consumer
- Poorer States to Gain
- Make in India