

PRICEWATERHOUSECOOPERS 

VAT Survey 2006

Smooth transition, unfinished agenda*

*connectedthinking

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Preface

The Value Added Tax (VAT) that has been introduced in a majority of the Indian States with effect from April 1, 2005, in lieu of the erstwhile Sales Tax, has been the single most significant fiscal reform in the past fifty years. The stated intent of both the Government of India and the Empowered Committee of the State Finance Ministers, in introducing this measure, has been the reduction in aggregate taxes, introduction of a common market and the facilitation of bringing into being of an integrated Goods and Services Tax.

On the eve of completion of one year under the VAT regime, it was felt necessary to take stock of the implications of VAT on trade and industry, as perceived by them. In this background, PricewaterhouseCoopers ('PwC') conducted a comprehensive VAT Survey in order to document the experience of businesses across various industrial sectors, on both the policy and operational aspects of the VAT. The Survey was intended to assess the experience of businesses in switching over to the VAT regime and to identify their continuing concerns with regard thereto.

The Survey was conducted by using a focused and structured questionnaire which was administered to more than a hundred companies having all India operations. We take this opportunity to thank each one of the respondents for having spared their valuable time to provide their viewpoints on the aforesaid aspects of their VAT experience.

We are happy to present this report summarizing the key findings of the Survey. The results provide useful insights on how the VAT has come about and how it has impacted prices in general and business efficiencies in particular. It also highlights the manner in which both industry and the State Governments have handled the transition.

We are confident that the findings of the Survey will enable the State Governments to better understand the issues and concerns of trade and industry, especially in view of the recent introduction of VAT in several additional States, and to consequently further refine the VAT legislation and rules so as to bring about a simplified, uniform and tax payer friendly VAT.

Rathin Datta
Chairman & CEO
PricewaterhouseCoopers Pvt. Ltd.
18th April 2006

Executive Summary

Value Added Tax – This much awaited tax reform finally happened in April 2005. Each of the stakeholders viz. State Governments, Trade and Industry and Consumers had different experiences to share. The survey was designed to document the experience of the respondent companies and to identify the unfinished agenda for making the VAT regime more industry friendly.

It was heartening to note that fully 84% of the respondents believed that the overall experience of transitioning from the sales tax regime to the VAT regime was smooth.

As to the preparedness of the State Governments in addressing the transition, only a small percentage of the respondents felt that the State Governments were fully prepared for the switch over to VAT. The survey respondents also indicated the areas where further improvements in the VAT regime were required. These were as follows:-

- Introduction of uniform product classifications
- Extension of input tax credits to Central Sales Taxes paid on procurement
- Adoption of a practical approach to VAT audits of assesseees
- Introduction of single window assessment processes for all State taxes
- Change in the mindset of VAT administrators

Only 25% of the respondents felt that the VAT had a significant impact on their business model. The impact of VAT on prices was more or less neutral insofar as industry as a whole was concerned. The self assessment system, which is the highlight of the VAT, in contrast to the erstwhile sales tax, has cast a huge responsibility on businesses since 100% compliance with the VAT rules and regulations is a pre-requisite for self assessment.

The results of the survey are expected to be very revealing for the State Governments and other stakeholders to gain an insight as to where we are on VAT implementation today, the further changes that are required in the VAT regime and the manner of realization of the integrated GST, in line with the statement made by the Finance Minister in his Budget Speech.

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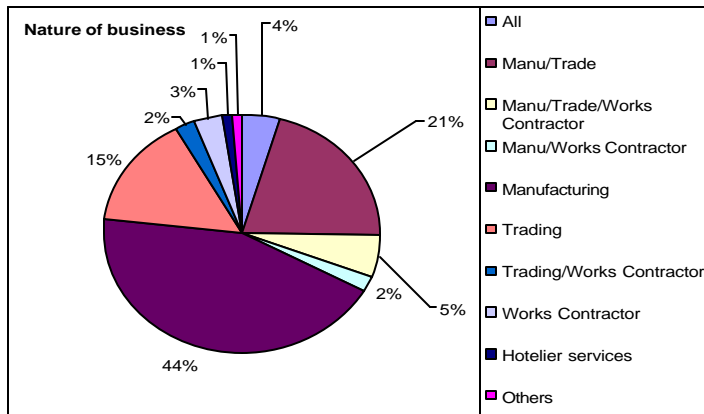
Prashant Deshpande
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Methodology & Respondents' Profile

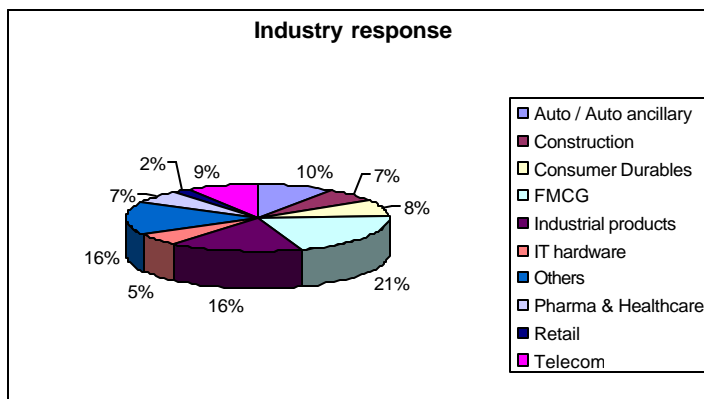
VAT Survey 2006 is a detailed analysis documenting the experiences that Trade and Industry have had in switching over from the erstwhile sales tax to the VAT regime. PricewaterhouseCoopers carried out this survey entirely with regard to companies having all India operations. The survey covers all aspects of VAT, from design to implementation and to further expectations that the Industry has in this regard.

The survey questionnaire was distributed to the participating companies. This was followed up by telephonic calls to the CFOs in these companies to bring about seriousness to the entire effort. Special care was taken to ensure that all types of industries and all types of businesses were appropriately represented in the survey so that the results emerging out of it were representative.

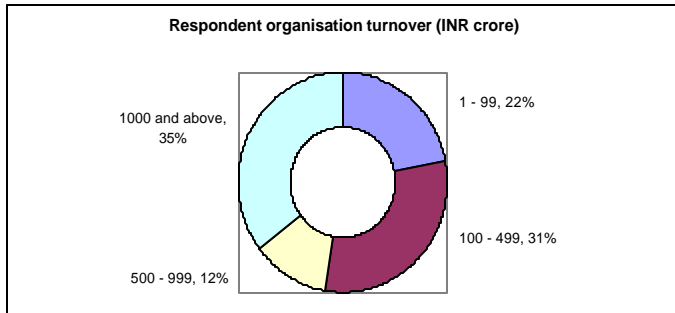
The survey process was completed in a record time of two months and the response rate was very encouraging. The survey response covered all sectors of business from manufacturing to trading. The survey also evoked goods response from all industry segments.



Most of the respondents were from the manufacturing sector. As to the industrial segments who have responded, the main respondents were from FMCG, Auto/Auto ancillary and telecom sectors.



There was adequate representation from big, medium and low sized companies to this survey. The profile of the participating companies is depicted below:



More than 75% of the respondents were companies with turnover of over Rs 100 crores per annum.

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Survey Findings

Structure of VAT

Internationally, VAT is levied on both goods and services. In India, the VAT on manufacture of goods (CENVAT) and the tax on services are levied by the Central Government whereas the States levy VAT on sale of goods. The co-existence of the powers of taxation between the Central and State Governments is typical in a federal country such as India.

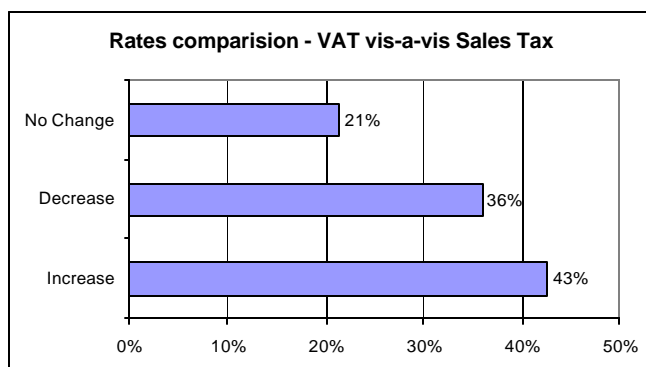
The CENVAT regime has stabilized over a period of time. The broad principles adopted by the Centre in the CENVAT Scheme have been followed while formulating the design of the State level VAT as well. The major highlights of the White Paper on VAT issued by the Empowered Committee of State Finance Ministers in January 2005 on the design of the State level VAT were:-

- Availability of input tax credit of tax paid on purchases
- Zero-rating of exports
- Uniformity in tax rates across the States
- Two basic rates of VAT viz. 4% & 12.5 %
- Gradual phase out of CST

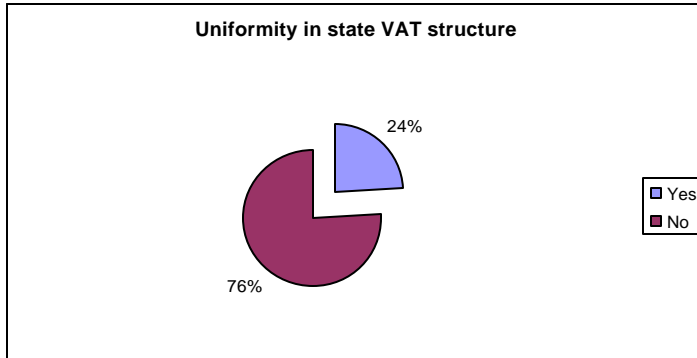
VAT Rates

Under the sales tax regime, the States were operating the following base rates – 4%, 8% and 12%. Whereas the commodities under the erstwhile 4% and 12% rates have been classified under the 4% and 12.5% rates respectively under the VAT regime, the commodities under the 8% category have been classified either under the 4% or the 12.5% rate under VAT.

It was thus expected that post VAT implementation, the rates of most commodities would change. 79% of the respondents have confirmed that the rates had indeed changed with regard to their products due to the switch over to VAT.



The Empowered Committee of State Finance Ministers had endeavoured to bring in uniformity in the VAT structure of the States. As VAT is a State subject, the States have the liberty to prescribe the rates of sales tax for a particular commodity. As high as 76 % of the respondents felt that the States have not been successful in bringing about uniformity in the structure of VAT. The Empowered Committee needs to take note of this very important fact as one of the main objectives of VAT implementation does not seem to have been met.

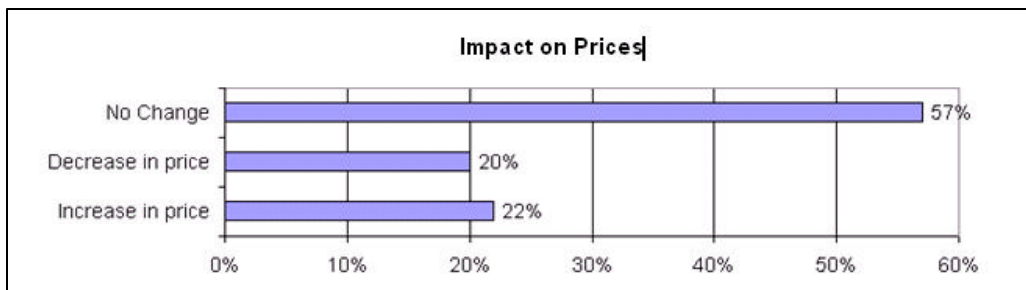


Non uniformity in the VAT rates across the States has adversely impacted companies with all India operations as they have had to reckon with varying rates in different States.

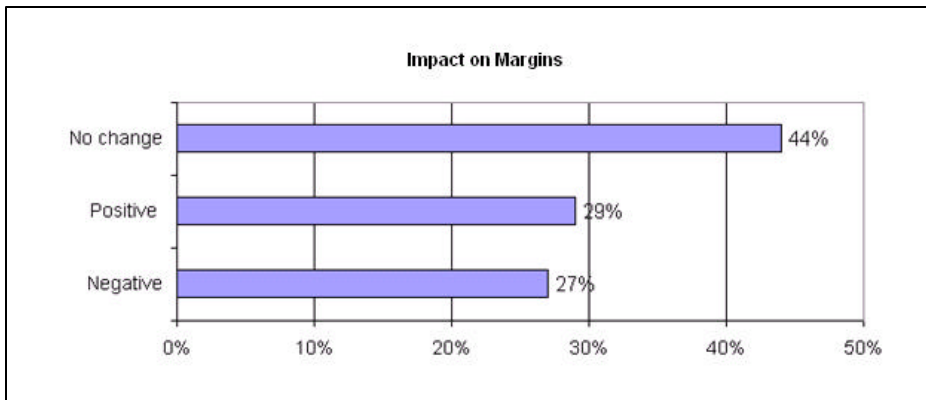
Impact on prices and margins

The survey indicates that 57% of the respondents did not feel the impact of VAT on their product prices. However, 22% of the respondents indicated an increase in the product prices while the balance respondents indicated a decrease in the prices.

Further, an analysis of the responses shows that the auto and auto ancillary as also the consumer durable sectors together comprise a significant proportion of the respondents who had indicated that the introduction of the VAT did not impact prices. As regards respondents indicating a decrease in prices, post introduction of VAT, the industrial goods and construction sectors formed a significant percentage. Finally, the telecom and FMCG sectors were adversely impacted as a result of the VAT, in that they have reported an increase in prices, post its introduction. These findings are interesting and contrary to popular perception that the VAT has contributed to a price rise in most manufacturing sectors. This appears not to be the case.

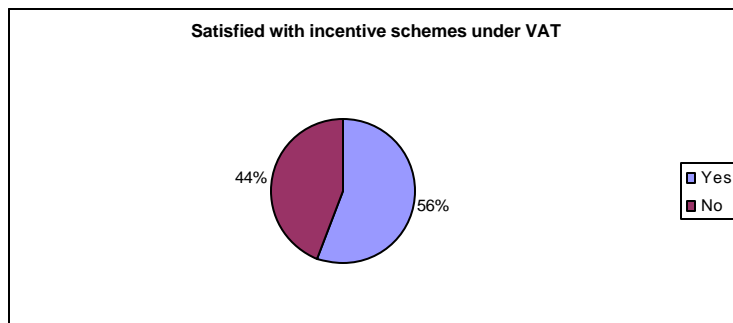


As regards the corollary implications on margins, 44% of the respondents had indicated no impact on the margins while 29% of the respondent indicated a positive impact on the margins. The balance 27% indicated a negative impact. Further on analysis it is seen that the IT hardware, telecom and construction sectors have reported a nil impact on margins as a result of the switchover. This would mean that for the telecom sector for instance, where there has been a price increase as a result of VAT, the impact has been passed on through price increase and margins have consequently been protected. On the other hand, the industrial and pharma sectors appear to have gained as they have reported a positive impact on margins as a result of the switchover. Finally, as commonly and correctly understood, the FMCG and retail sectors have reported a negative impact on margins as a result of the VAT, thereby indicating an inability to pass on the increased tax cost through price increases.



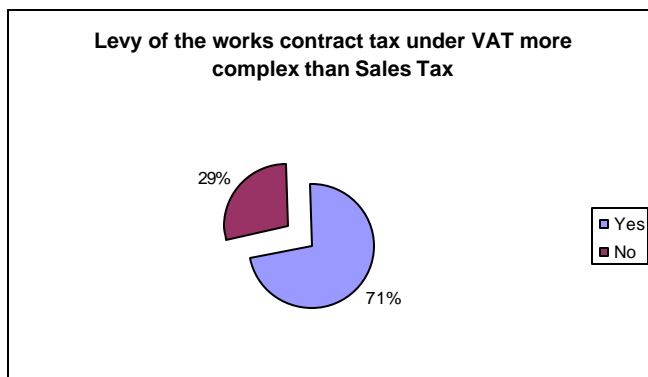
Benefits under Incentive Schemes

The White Paper on VAT had indicated that the States would continue the benefits granted to units in backward areas, provided the VAT chain was not affected. The options available to these units post VAT implementation were therefore limited. The States have followed different practices. While some States have converted the exemption schemes to deferrals others have chose to continue the exemption schemes for the balance period, although not in conformity with the White Paper. 56% of the participating companies were satisfied with the manner in which benefits under the incentive schemes have been continued in the VAT regime.

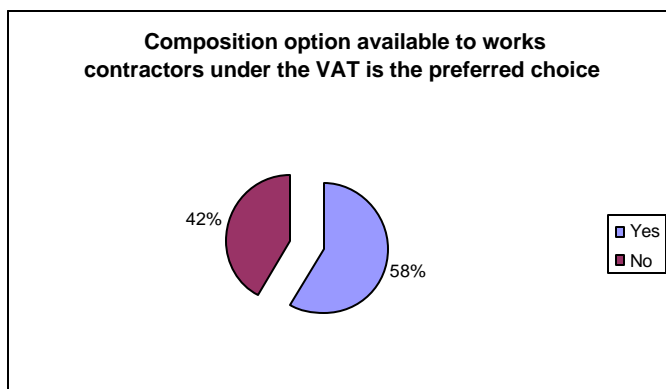


Works Contracts

The 46th amendment to the Constitution continues to be a complex area for sales taxation and post introduction of VAT, the tax treatment of works contracts remains a complicated area. Most respondents believe that the levy of tax on works contracts under VAT is more complex than under the sales tax regime. A unified GST could be one of the solutions for taxation of works contracts involving both material and labour. This is an important implication of the findings.

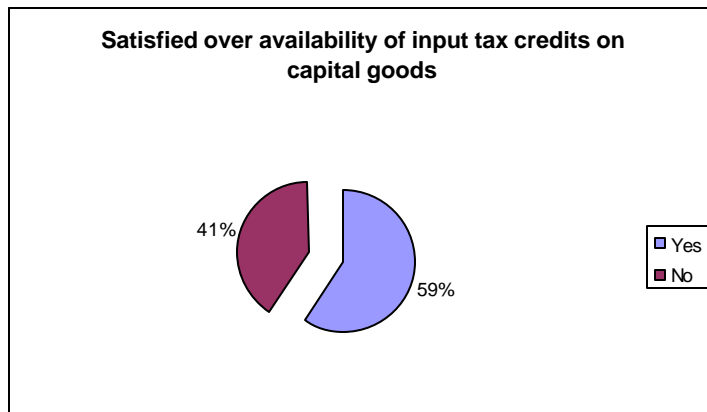


Further, only 42 % believed that the composition option available to works contractors under the VAT system was simpler and therefore the preferred choice.



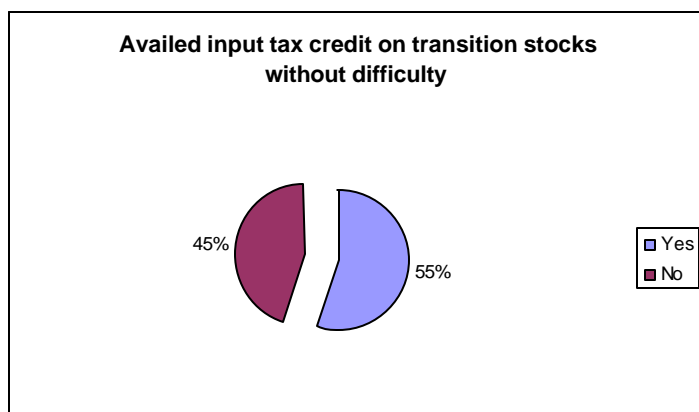
Input tax credits

One highlight of the VAT system is the availability of input tax credit to the dealer on inputs and capital goods purchased within the State. There has been no uniformity in the definition of the term 'Capital Goods' and therefore only 59 % of the participating companies were satisfied with the manner in which input tax credits have been made available on capital goods. The differing periods over which the States have permitted availment of capital goods credit and the variations in procedural formalities for claiming the credit have only added to the dissatisfaction.



A very significant proportion of the auto, auto ancillary, construction, pharma and healthcare and consumer durable sectors express satisfaction at the manner of availability of input tax credits on capital goods. However, respondents in the telecom, retail, IT hardware and FMCG sectors were equally split in their assessment of ease of eligibility to such tax credits.

As regards availment of credit on transition stocks, only 55 % of the participating companies were able to avail the input tax credit on the transition stocks without difficulty. Once again, the procedural formalities, which has differed from State to State, and the lack of clarity on the transition date seem to have played a part in their inability to avail credits without trouble.



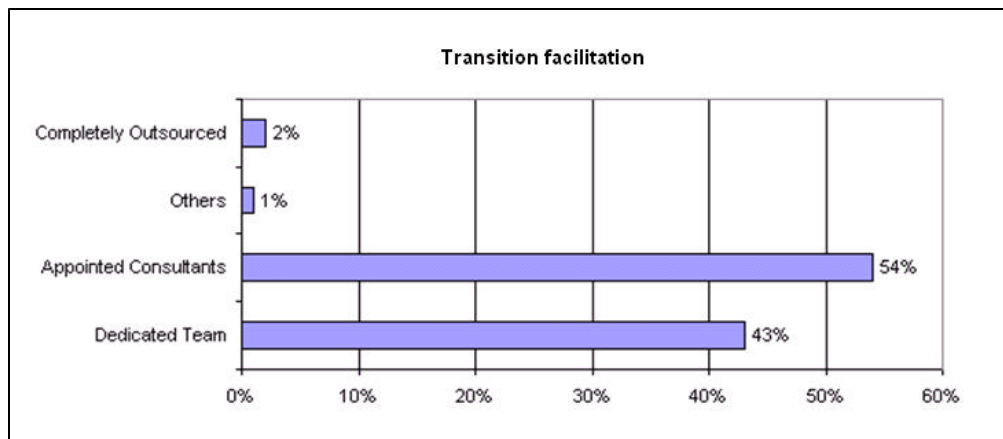
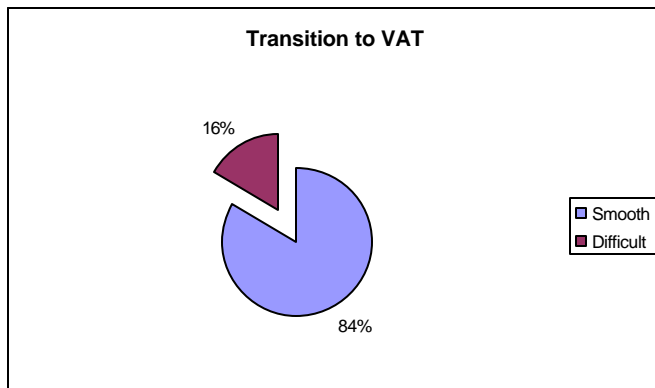
Almost all of the participating companies felt that the co-existence of Entry Tax & Special Entry Tax together with VAT was unnecessary and a cumbersome reality.

Transition to VAT

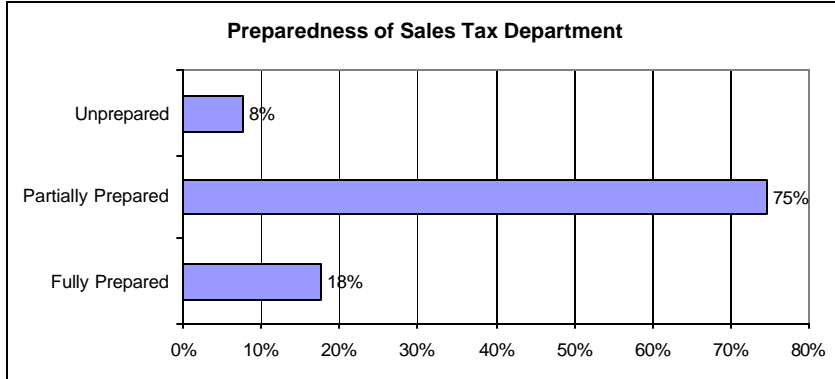
The transition to VAT was a challenging task for both, the State Governments as well as Trade & Industry. Both stakeholders were required to do a significant amount of preparatory work so as to

ensure, a smooth transition from the erstwhile sales tax regime to the fundamentally different VAT.

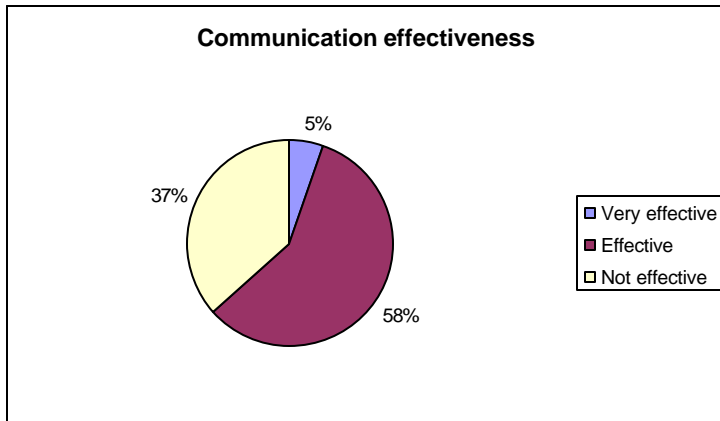
However, fully 84 % of the participating companies felt that the overall transition to VAT was nevertheless smooth. This was probably due to the fact that most of the participating companies (97%) had either dedicated teams or had appointed consultants to assist them in the transition phase. This finding is very encouraging but is also due to the fact that the VAT has been a long time coming and hence companies have been preparing for it for quite a while.



Further, the States that had implemented VAT had also done preparatory work for the switch over to VAT. This included not only extensive communication campaigns run both by the Central Government as well as the State Governments but also reorganisation of the tax administration, extensive computerisation of processes etc. However, 75% of the respondents felt that the State Governments were only partly prepared in meeting the transitional requirements.



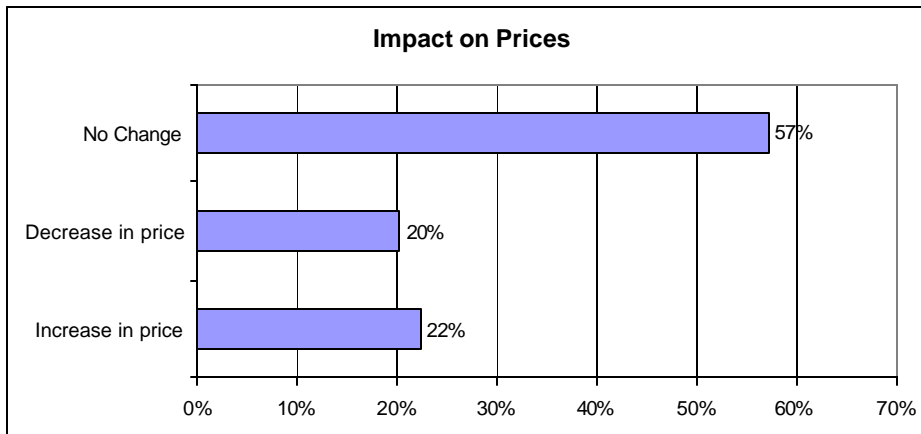
As regards the effectiveness of the communications campaigns run by the State Sales Tax Departments, 63 % felt that the campaigns were effective.



The communications strategy adopted by the States have obviously helped in the process of transition and this needs to be vigoursly pursued in the future as well.

Impact on prices

One of the key apprehensions raised by certain stakeholders was the likely increase in prices of products as a result of the introduction of VAT.

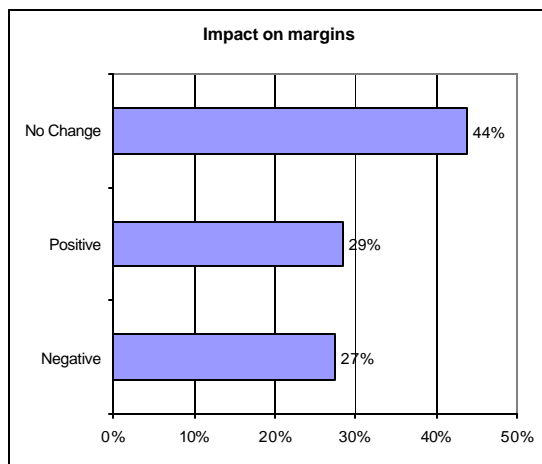


The results indicate that there was no change in prices, due to VAT, in the case of 56% of the participants. It is interesting to note that 22% of the respondents increased the prices of their products while 20% decreased prices. It would therefore be reasonable to conclude that the introduction of VAT has been largely price neutral on an overall basis.

Impact on Margins

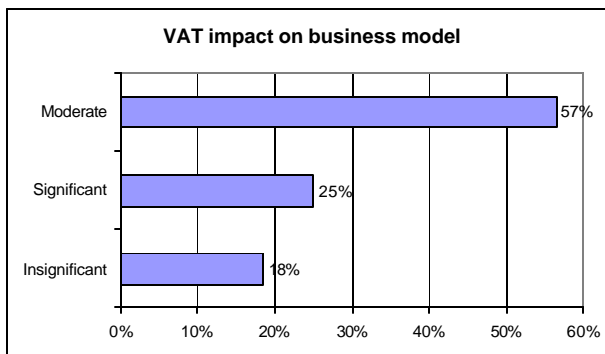
44% of the respondents indicated that they maintained margins post VAT whereas 28% experienced a positive impact thereon.

For those industries that experienced a positive impact on margins, the input tax credit optimisation seems to have played a major part.



Effect on business model

Only 25 % of the participating companies felt that the introduction of VAT had significantly impacted their business models.

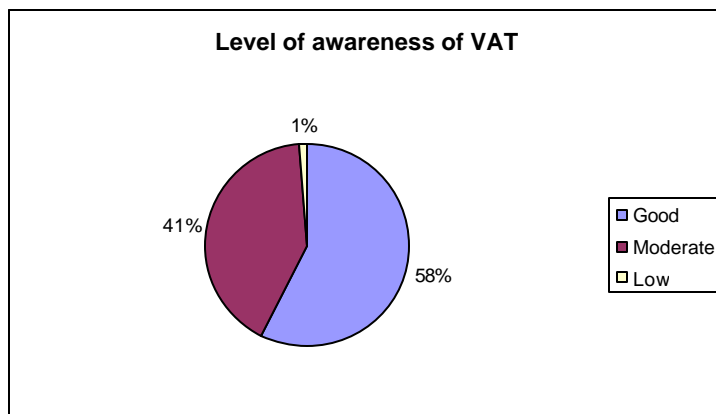


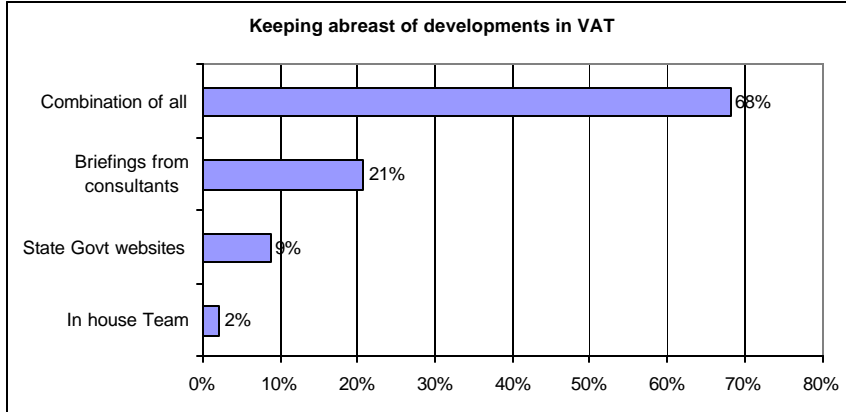
This important question as to the impact on business models has had a variety of differing responses. The telecom, consumer durables, auto and auto ancillary, construction and IT hardware sectors have all indicated that there has been an insignificant impact of the switchover to the VAT on their business models. On the other hand, respondents in the retail, industrial products, FMCG, pharma and healthcare sectors have reported a significant impact on their business models as a result of the introduction of the VAT. There has thus been a varied and uneven impact of the VAT across different industrial sectors, perhaps unintended but a reality nevertheless. As a result, businesses have had to adopt differing responses in order to cope with these implications.

VAT Compliance

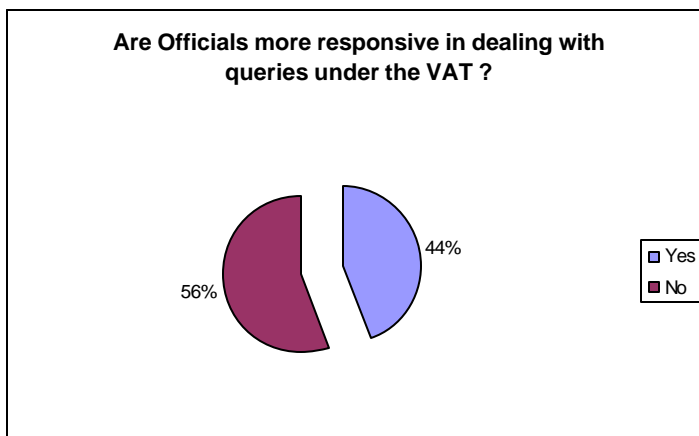
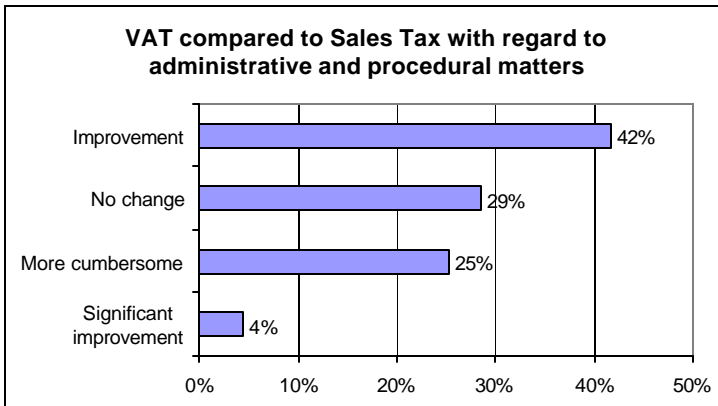
Since the VAT envisages a self assessment process, it requires the highest level of compliance. The dealers are expected to be fully compliant with the VAT laws and procedures. Further, the VAT system envisages a trail of transactions to be recorded and consequently maintenance of proper books and accounts becomes an essential business imperative.

The self assessment system has its own advantages. The dealers are relieved of the burden of getting the assessments done while the tax administrators concentrate only on major dealers on an exception basis. In order to achieve 100 % tax compliance, awareness of VAT in an organisation is a pre requisite. Further, the organisation needs to keep abreast of the frequent changes that are announced by the State Governments in relation to VAT. These changes are expected to be high in the initial years of VAT implementation as it will take time for the new system to stabilise.

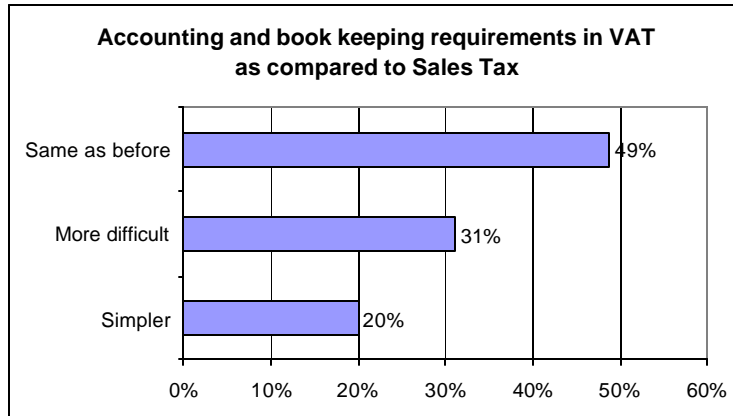




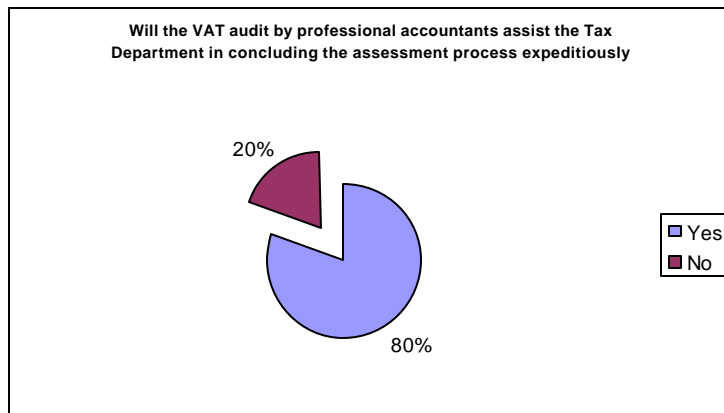
The introduction of VAT is expected to bring about a change in the tax administration as assessments will now need to be audited as an exception rather than as a rule, as was the case in the erstwhile sales tax regime. This paradigm shift is expected to result in large scale changes in procedures and processes. The tax authorities are now expected to play a consultative role and guide the tax payers in complying with the VAT rules and regulations.



The recording and accounting of transactions is of utmost importance in the VAT regime and organisations will now be required to be vigilant in maintaining full and complete books of accounts with comprehensive documentation.



80 % of the participating companies were of the opinion that the introduction of VAT Audit by professional accountants was a helpful measure and could assist the Sales Tax / Commercial Tax Departments to expedite their validation and verification processes and procedures.

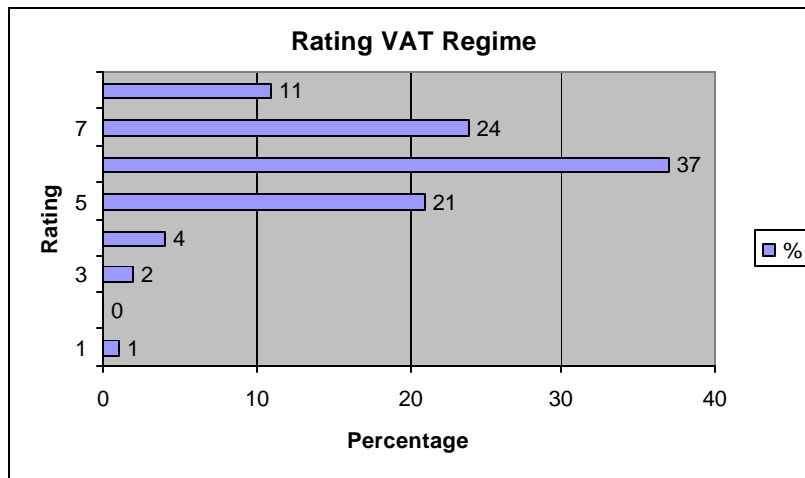


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Conclusions and Expectations

The VAT system is in force for a year now. Apart from its initial resistance, Trade and Industry has welcomed the implementation of VAT as the pros clearly outnumber the cons. However, there are still some areas where businesses feel that much needs to be done.

The respondents were asked to rate the VAT regime, on a scale of 1-10 (1 being Poor and 10 being Excellent), the VAT regime on parameters such as simplicity, transparency and effectiveness.



The participating companies were also asked to identify the areas where they wished to see improvements / changes so as to make the VAT more industry friendly. They were also asked to give suggestions. The broad areas identified for improvement were: -

- Rates of taxes
- Classification of Industrial inputs
- Compliance Procedures
- Refund Procedures

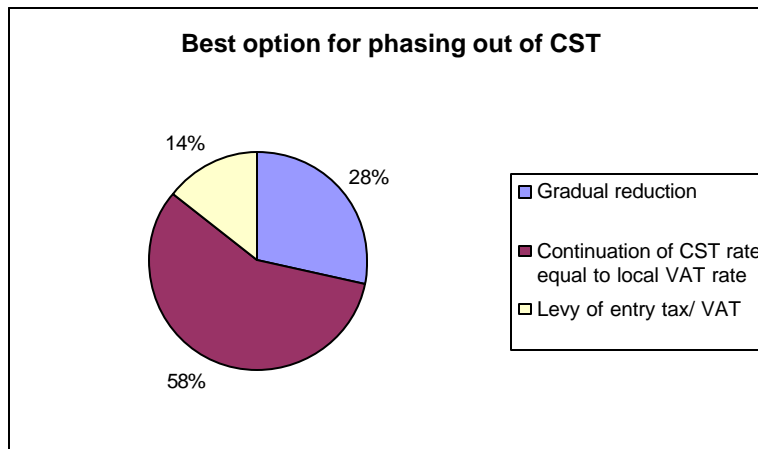
Some of the suggestions received were:-

- Introduction of uniform product classifications
- Extension of input tax credits to Central Sales Taxes paid on procurement
- Adoption of a practical approach to VAT audits of assesseees
- Introduction of single window assessment processes for all State taxes

- Change in the mindset of VAT administrators

Phasing out of CST

28 % of the participating Companies were of the view that the CST should be gradually reduced to nil with continuation of statutory forms such as C, F etc. However, 58 % chose to opt for CST rate being equal to local VAT rate coupled with abolition of all statutory forms and full input tax credit of CST paid to the eligible purchasers. Only 14 % of the participating companies opted for the option of levy of entry tax / VAT by the importing State at the point of entry of goods into the State.



Interestingly, the respondents in the consumer durable and retail sectors were in favour of entry tax in lieu of CST, whereas a significant proportion of respondents in the pharma, telecom, FMCG, auto, auto ancillary and construction sectors favoured a continuation of CST, equivalent to the local VAT rate.

Switch over to GST

All the participating Companies were unanimous that it was time for India to begin the process of switch over to a unified Goods and Services Tax. Most of them were of the view that it should happen in the next five years. This seems to be entirely in line with the Government of India's intention to introduce the GST with effect from April 1, 2010.

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Abbreviations

CENVAT	Central Value Added Tax
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CST	Central Sales Tax
FMCG	Fast Moving Consumer Goods
GST	Goods and Services Tax
LTU	Large Taxpayer Unit
PwC	PricewaterhouseCoopers
TIN	Taxpayer Identification Number
VAT	Value Added Tax

PwC Indirect Tax Services

Indirect Taxes pervade every area of a company's business across various industry sectors. Their impact on material & product costs, prices, cash flow, profitability and, ultimately on shareholder value is being increasingly recognised as an important element in national and global competitiveness. However, unlike their corporate tax sibling, indirect taxes are often poorly understood and rarely actively managed or even measured. Typically, responsibility for indirect taxes falls between diverse departments such as operations, finance, procurement, tax and legal, with no central co-ordination or overall strategy. Yet, indirect taxes often represent the biggest element of a company's tax costs.

PwC's Indirect Tax Practice addresses the above challenge through the core value proposition of the strategic management of indirect taxes. We offer comprehensive advice and assistance in all areas of indirect taxes from customs to central excise from service tax to works contract tax and sales tax and, now, the VAT. All this is backed by litigation support at every stage. We also offer expertise on all aspects of trade policy, including on free trade agreements, anti dumping duties and cross border supply chains.

The practice is an all India one and is represented in seven India cities viz. New Delhi, Mumbai, Kolkatta, Chennai, Bangalore, Hyderabad and Pune. The Indirect tax teams in each of these locations consist of well qualified and experienced professionals with expertise in all areas of indirect tax law. We also have industry specialists who are able to synthesise their industry and tax knowledge so as to offer optimal and tax efficient solutions to our clients.

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