

## **VAT: Key Questions and their Answers**

The government's decision to introduce Value Added Tax in the country has sent a wave of fear across the business community which has aroused much opposition and resentment. Much of the reaction against VAT seems to be arising from lack of awareness about the basics of this Value Added Tax. This writing answers certain basic questions on VAT and by making a comparison with GST, illustrates the differences between these two tax regimes. What follows is based on draft VAT Acts any of which may change during the legislative process.

### **Why pay the GST or VAT?**

The rationale behind both of these levies is same: both are consumption taxes which discourage consumption and promote savings. The savings lead to investment, capital formation and consequent economic growth. Economic growth provides improved living standards. Thus the VAT and GST both discourage consumption today for a better consumption tomorrow. Both call for a sacrifice now to get the promise of reward in future. Both of these levies also serve a supplementary purpose: both lead to documentation of economy and a shift from import duties to domestic taxes which is a big challenge at least in the developing countries.

### **Who pays GST or VAT**

GST and VAT both travel with price. In a domestic transaction, seller of goods/ services receives the price and the buyer pays it. GST or VAT is paid with price by buyer to the seller. The seller collects the tax and deposits it in the government treasury. The government officials in the tax department just watch that the buyer pays the right amount of tax and seller faithfully deposits the amount so received in the government exchequer. In case of import, importer

incurs the liability of both seller and buyer. He pays the tax and also deposits it in the treasury.

Both GST and VAT however make a provision to shift the liability to pay the tax. Under both GST and VAT, Federal Government may by a notification in the official gazette specify the goods in respect of which the liability to pay tax would be of the buyer of goods/ services. What difference would such a notification make? To the extent of goods so specified, the buyer instead of seller will have to face the consequences of non payment of tax.

### **When GST or VAT becomes payable?**

The question of time of payment is essentially the concept of time of supply. In GST, the tax became payable at the earlier of the following points in time: 1. the time when goods are delivered by seller to the buyer; 2. the time when goods to be supplied are identified/separated and the buyer is given opportunity to lift the goods whether or not the buyer avails the opportunity. In case of services, GST becomes payable at the time service is provided. Supply of goods under a hire purchase agreement makes a departure from the above general rule. In the case of such a supply, GST becomes payable when the seller and buyer enter into such an agreement.

Under VAT, some more points in time are added to the above list at the earlier of which, VAT becomes payable. These additional points in time are: 1. the time when seller issues to the buyer an invoice for the supply; 2. the time when buyer pays to the seller any part of the consideration for the supply.

VAT adds another dimension to the time of supply concept. This is the dimension of periodic supply. When the seller supplies goods not all at one time but breaks up the supply temporally; VAT specifies the following points in time at the earlier of which, the tax becomes payable: 1. if separate invoices are issued for each periodic consignment, the time when an invoice is issued; 2. the time

when payment for the supply becomes due; 3. the time when a part payment for the supply is received by the seller and 4. the first day on which buyer is able to use or enjoy the goods. The word ability to use is notable. It means when seller makes the goods available to buyer, the buyer is able to use them even if he does not out of his own priorities.

### **What amount of GST or VAT to pay?**

The amount of GST or VAT payable is calculated according to the following formula:

$$\text{Amount of tax payable} = \text{Tax Rate} \times \text{Value of supply.}$$

The two ingredients of equation on the right side of equality sign are a bit different in GST and VAT.

*Tax rate in GST* Rate system is more complicated in GST. There is a standard rate of 16% in GST. Besides, there are 11 more GST rates above and below the standard rate, which are payable on certain specified supplies. For example, ship breakers pay GST at the rate of Rs. 4848 per metric ton. GST rate on supply of sugar is 8% and the rate on supply of natural gas to CNG station is 25%. Commercial importers pay GST at the rate of 18% on commercial imports.

*Tax rate in VAT.* VAT has a single standard rate of 15% on any supply/ import.

*Value of supply in GST:* Supplies for GST purposes are divisible into the following two categories in terms of valuation rules: 1. Actual Value Supplies and 2. Market Value Supplies.

In case of Actual Value Supplies, the value is the *actual amount* of money excluding GST which changes hands between seller and buyer. In the case of Market Value Supplies, the value is the *amount* excluding GST which would change hands between seller and buyer in a transaction in the open market.

Actual Value Supplies have one standard value with some deviations around the standard. The standard value is consideration in money for the supply plus all federal duties/ taxes plus all provincial duties/ taxes minus GST. Deviations around this standard apply in the following situations.

- (i)** When the seller makes supplies on a discounted price, the discount is deducted from the standard subject to the condition that the discount is in conformity with the normal business practices.
- (ii)** When goods are imported, the actual value is the Customs value plus Customs Duties plus Federal Excise Duties.
- (iii)** When the value declared in an invoice is doubtful, the actual value is the value as determined by a Valuation Committee.

Market Value Supplies are valued at a consideration in money which the goods would generally fetch in the open market. Sales Tax Act provides the following situations in which market value applies.

- (i)** When the consideration for a supply is in kind or is partly in kind and partly in money, the value of supply shall be the open market price of supply excluding the amount of Sales Tax chargeable thereon.
- (ii)** When the seller and buyer are associated persons and the supply is made for no consideration or for a consideration which is lower than the open market price, the value of supply shall be the open market price excluding Sales Tax chargeable thereon.
- (iii)** When the supply includes a markup and its price is higher than open market price, the value of supply shall be the open market price excluding Sales Tax chargeable thereon.

*Value of supply in VAT:* For purposes of valuation, VAT divides goods/ services into two categories: 1. imports and 2. domestic supplies. For imports, valuation rules are the same under GST and VAT except that under VAT, cost of services treated under provincial VAT law as part of the imported goods will be added to the value determined under GST. For domestic supplies, there are Actual Value Supplies and Market Value Supplies. Actual value of a supply is the consideration for the supply excluding an amount equal to the consideration multiplied by the tax fraction (tax fraction means the amount worked out according to the formula  $R/100+R$  where R is the value added tax rate). VAT applies market value in the following situation: 1, supply between associated persons for no consideration or for a consideration lower than the open market price and 2, the associated buyer would not be entitled to a full input tax credit on his purchase. In such a situation, value of supply shall be the open market price reduced by an amount equal to the tax fraction of that price.

### **Where and how GST or VAT is paid?**

GST on imports is paid alongwith Customs Duties at the same time and in the same manner as the chargeable Custom Duties. The same rule applies under VAT. For domestic supplies, a record of monthly purchases and sales is maintained under GST and the amount of Sales Tax chargeable on the value of purchases and sales is calculated. The amount calculated as chargeable on purchases is paid to the preceding seller in supply chain. The amount calculated as chargeable on sales is collected from the buyer next in supply chain. The amount of Sales Tax paid to the preceding seller is deducted from Sales Tax collected from the succeeding buyer and the differential amount is paid in a designated branch of National Bank every month alongwith Return.

Under VAT, Sales Tax Return will be filed every month with Federal Board of Revenue in manual or, where so required, in an electronic format. The concept of

tax adjustment has been given a broader scope under VAT. Apart from deduction of Input Tax from Output Tax as in GST, VAT has introduced the concept of a series of increasing and decreasing adjustments to the amount of tax payable. An increasing adjustment increases the net amount payable. A decreasing adjustment decreases the net amount payable. The concept of increasing and decreasing adjustments has brought the provisions of VAT in line with the business practices.

**Who Collects GST or VAT:** GST is collected by the Federal Board of Revenue under the Sales Tax Act. VAT will be collected by the Federal Board of Revenue under Federal VAT Act and Provincial VAT Acts.

**Which goods/ services subjected to GST or VAT:** Federal VAT Act levies VAT on the import and domestic supply of all goods except a few exemptions and zero ratings. The Federal VAT Act also levies VAT on transportation of goods and passengers through railway, sea or air. Provincial VAT Acts levy VAT on services. All services excluding those exempted and specified in first schedule to the Provincial VAT Acts are chargeable to Value Added Tax. The services exempted from VAT include services provided by religious institutions, educational institutions, charitable institutions, certain specified financial services and the funeral/ burial services. Certain supplies relating to immovable property have also been exempted from VAT. These include supply of vacant land, supply of land to be used for agricultural purposes, supply of hotel accommodation for continuous period of more than 45 days and the lease/ hiring of residential immovable properties.

From the above answers to the basic questions about GST and VAT, it may have become apparent by now that VAT is nothing new. It is already in force in the country in the form of GST. Introduction of VAT is just a change of name

accompanied by a broader scope. VAT is in fact GST minus aberrations from the concept of value addition. GST incorporated these aberrations in the form of numerous exemptions and zero ratings. VAT is left with only a few non avoidable exemptions and zero ratings. Not only have the aberrations been removed from GST to change it into VAT, the mechanism of subordinate legislation through SROs which brought about many of these deviations has also been eliminated. Under VAT, any exemptions or zero ratings can be granted only by the statute. Answers to the basic questions under the GST and VAT do not involve substantial differences. Where the VAT does involve deviations from GST, most of these are to the advantage for the existing GST payers.