



Implementation of Value Added Tax in India – Lessons for transition to Goods and Services Tax – *A Study Report*



Comptroller and Auditor General of India

New Delhi, June 2010

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Preface

Transition from sales tax regime to Value Added Tax (VAT) system was a major reform in tax administration. This is due to be followed shortly by the Goods and Services Tax (GST) which will subsume VAT and Service Tax. In that context, it was felt by us that a performance audit conducted all over India of the transition from sales tax to VAT would be of help in highlighting the deficiencies to be avoided while introducing GST.

This study report is the compilation of the findings of the performance audit conducted between April 2009 and November 2009 by the Accountants General of 23 States covering the post-VAT periods ranging between April 2005 and March 2009. Deficiencies noticed in other compliance audit exercises have also been included in this report. The work leading to this report was conducted by a core team led by Shri H K Dharmadarshi, Principal Director, State Receipts Audit, office of the Comptroller and Auditor General of India.



Executive Summary

Context

With a view to bring more efficiency in the tax administration and equal competition and fairness in the taxation system, the Union Government decided in the year 1995 to introduce a taxation structure based on the Value Added Tax (VAT) in the country in place of the existing General Sales Tax Acts in force since the year 1957. By doing so, multiple points of taxation were proposed to be done away with and the overall tax burden was sought to be rationalised. The objectives of implementation of VAT were *interalia*, to help common people, traders, industrialists and also the Government as the tax structure would be simpler and more transparent. The revised taxation system was to replace the existing system of annual assessment by the assessing authority by a system of self-assessment by the dealers subject to scrutiny/audit by the Commercial Taxes Department.

This report

We reviewed the transitional process from sales tax regime to VAT system across 23 States. The objective of the review was to evaluate that planning for implementation and the transition from the sales tax regime to VAT system was effected timely and properly, the organisational set up and the provisions of the State VAT Acts and Rules made thereunder were adequate and effective to prevent leakage of revenue and the system which has been in place for four/five years was functioning satisfactorily.

This report synthesises the findings of the audit reviews on 'transition from sales tax to VAT' conducted by the Accountants General of 23 States and lessons for transition to Goods and Services Taxation (GST) which is under active consideration of the Union Government. The report is divided into four parts, executive summary, background, our assessment and lessons for transition to GST.

Audit findings

We found deficiencies in the planning, strategies and in the transitional process besides lacunae in the VAT Acts and Rules across the States. Though the various issues requiring attention before implementation of the VAT in the country was analysed and mentioned in the White Paper of the Empowered Committee, other pending issues requiring attention before switching over to VAT were neither foreseen nor planned. At the time of bringing out the White Paper in January 2005, it was envisaged that the VAT system would be implemented by April 2005. The time frame of three months and the presumption of readiness were both unrealistic and scores of pending issues still haunt the State Governments. Besides, there was lack of monitoring at the apex level on the developments in the States regarding implementation of VAT due to which there were wide scale differences between the basic design proposed in the White Paper and the corresponding provisions included in the different State VAT Acts and Rules. Further, all the states have agreed for uniformity in the rates of taxes. Instances of deviation in these rates prescribed by the Empowered Committee and those implemented by the States have been noticed.

We feel that these vital issues should have been adequately dealt with before switching over to VAT for its proper and effective implementation.

The deficiencies in the planning and the transitional process and the summary of results of our audit are pointed out in the succeeding paragraphs.

Automation

Our study revealed that there were shortcomings in the automation process like non-mapping of the business rules, partial usage of the modules, manual intervention etc., coupled with the non-completion of the computerisation of the check gates and failure to interlink these with the Commissionerate/unit level offices. Due to these, the full benefits of computerisation could not be harnessed nor could the assessing officers get the information while scrutinising/assessing the dealers.

Scrutiny of returns

The white paper envisaged *cent percent* scrutiny of the returns to detect mistakes and recovery of any short payment of taxes from the dealer. We noticed that the processes of scrutiny of returns and tax audit were yet to be streamlined in almost all the States reviewed and consequently abnormally low percentage of scrutiny of the returns assessments left enough scope for leakage of revenue.

Also, we have found that the formats of the returns were deficient coupled with absence of provisions for furnishing supporting documents alongwith the returns which led to insufficiency of information due to which no meaningful scrutiny of the returns could be conducted. We found tax evasion of Rs. 873 crore from 2614 returns in 15 States. Besides, seven dealers in a State were granted tax exemption of Rs. 1026 crore on turnover of Rs. 25650 crore from sale of tax paid goods, without any documentation.

Tax audit

Unlike cent percent assessment in the repealed act, in the VAT system only a percentage of dealers, scientifically selected, are to be taken up for tax audits which is to be done by an audit wing independent of the tax collecting wing. Tax audit is crucial in the VAT system as this is when the records including books of accounts of the dealers are examined in detail by the AOs. Our study found that while some states have prescribed the criteria for selection of the dealers, other states left the selection at the discretion of the department. Further, time limit for completion of tax audit has not been prescribed by seven states.

Our analysis across States showed that one out of two dealers tried to evade tax as the departments detected 56,000 cases of evasion out of one lakh dealers taken up for tax audits and additional demands totaling Rs. 783 crore was raised.

Input tax credit mechanism

Though the white paper envisaged allowance of input tax credit (ITC) only based on documentation of tax invoice. We found that in none of the States the provisions for claiming ITC was foolproof and the States deviated from the basic design and allowed ITC without any checks. Some States have not prescribed the documents to be furnished in support of the claims of ITC while in other cases the return formats were deficient. Due to these deficiencies there was in fact no control on the ITC claims and we feel that in the

present scenario these were being allowed purely on an *ad hoc* basis. We noticed allowance of inadmissible ITC of Rs. 829 crore in 53170 cases across 16 States.

Cross verification

Cross verification of the records of the other dealers/departments like Central Excise, Customs and Income Tax Departments has not been prescribed by any of the States though this issue was flagged to be of utmost importance in the White Paper. Besides, the States have not made it mandatory to verify the information available at the TINXSYS website before allowing concessional rates/exemptions on interstate trade.

These aspects of cross verification should have been accorded topmost priority and completed within a prescribed timeframe to plug the scope of evasion of tax as only a meagre percentage of cases are being taken up for tax audit. Cross verification with the records of other tax departments conducted by us in 5 States pointed out evasion of tax of Rs. 56 crore in 160 cases. Our reviews also revealed 201 cases of submission of fake/invalid declaration forms leading to tax evasion of Rs. 16.68 crore in four States.

Deterrence

Though penalty provisions existed in the VAT Acts/Rules in all the states for various categories of default, yet it was observed in seven states that there was no provision for a minimum penalty for each and every nature of offence based on the magnitude of the offences. It was further observed in these states that the penal provisions were left to the discretion of the tax authorities. There was no specific distinction between the amount of penalty leviable for first offence and subsequent offences as well as wilful default. Our study revealed that in nine States, penalty amounting to Rs. 485 crore on non-compliance was not levied.

Since VAT relies more on the dealers and the control of the executives are diluted, the control mechanism should have been stringent to act as a deterrent for the tax evading dealers.

Incentive schemes

Continuation of the incentive schemes under the VAT was against the spirit of the original schemes and resulted in undue enrichment to the incentive holders at the cost of general public, besides payment of ITC to these units from the State coffers leading to excess outgo of taxpayer's money. We found that manufacturers covered under the tax exemption schemes in three States collected and did not remit tax of Rs. 6400 crore (Reliance group of industries contributing more than 90 *per cent*). Tax was not remitted yet ITC was refunded by the Government from its coffers to the purchasing dealers.

Monitoring of post implementation issues

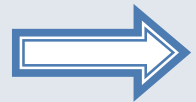
As there was no mechanism at the apex level (Central Government) to oversee the progresses made by the respective State Governments in view of the fact that VAT was completely a new subject and needed close watch, the aforesaid deficiencies and the fulfilment of the issues highlighted in the White Paper could not be effectively monitored. This was also evident from the different tax structure and rates adopted by the States.

Besides, weak monitoring also hampered ensuring that the reduction in rates of taxes showed up in the prices of the commodities and the benefit reached the desired

beneficiaries (common man). Our study found that 13 manufacturers did not reduce the maximum retail price of the goods despite sharp decline in the rate of tax. Consequently, the benefit of Rs. 40 crore was illegally retained by these manufacturers and the dealers in the VAT chain instead of passing on to the consumers.

Lessons for transition

As highlighted in the paragraphs above, the loose-ends across the VAT system have created a situation rife with opportunities for tax evasion in the States. We recommend that resolution of issues from the legacy system requires particular attention. Automation including standardisation of the processes across the country, integration of all the units, streamlining the entire gamut of processes of assessment including timeframe for scrutiny; periodicity of filing the returns, cross verification of the details and risk based selection of dealers for tax audit are the areas which need to be addressed properly before switching over to the GST. Further, appropriate measures need to be taken for capacity building of the staff, standardisation of the departmental manuals and minimising the discretion in penalty clauses. Lastly, an efficient mechanism is needed to oversee and guide in case of any deviation in the GST that may distort the basic structure of the GST. The detailed recommendations may be seen in Chapter III of the study report.





CHAPTER 1

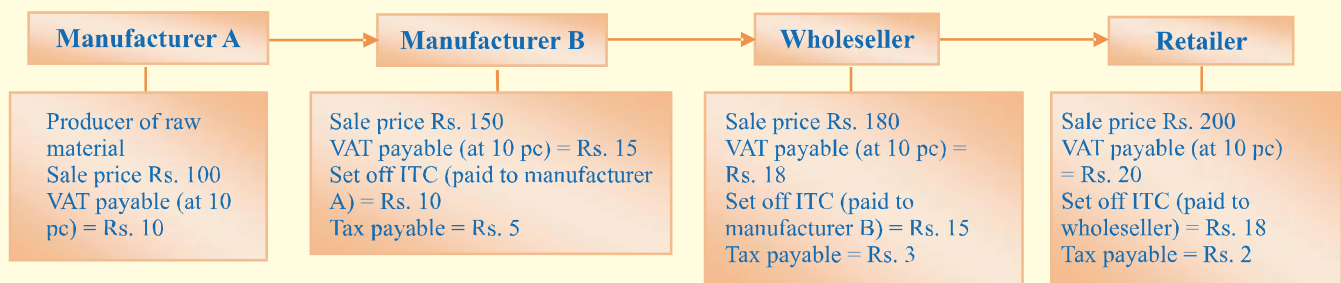
Background

The Concept

1.1 Introduction of Value added tax (VAT) was viewed as a major step towards reform in tax administration and as a stepping stone for implementation of an integrated administration of State and Central taxes in the future.

1.2 Goods pass through various stages in the manufacturing and the distribution chain till they reach the consumer. At each stage, some value is added. VAT is a multipoint tax with provision for granting setoff or credit for the tax paid on the purchases against the tax payable on sales. A registered dealer collects VAT from the purchasing dealer during sale of taxable goods within the state of registration. The purchasing dealer becomes eligible for credit for the tax already paid (called **Input Tax Credit-ITC¹**), with this facility available on purchases down the chain of sales till the goods reaches the consumer. The ITC can be set-off against the total tax liability on sales during the relevant tax period².

Flow chart for ITC



1.3 The multiple benefits of VAT over the existing Sales Tax were:

- The dealers would be incentivised to tax compliance in order to avail the benefit of ITC.
- The facility of set-off of tax removes the problem of multiple taxation and together with rationalised tax rate, would eventually lead to fall in price of goods.
- The system would be built on trust as dealers will deposit the tax on the basis of self-assessment. Few dealers, selected on the basis of risk assessment, will be subjected to tax audits by tax authorities.

¹ The ITC is given for both the manufacturers as well as traders for purchase of inputs/supplies from within the State irrespective of when ITC will be utilised. Tax paid on inputs procured from outside the state is not eligible for credit.

² The unadjusted ITC can be carried forward for two years and thereafter, will be refunded to the dealer.

- **With automation providing the backbone for implementation, it would be possible to track transactions and conduct non-intrusive and more effective scrutiny of returns to detect evasion.**
- **Differential rates of taxation across the States, can lead to unintended diversion of trade and creation of “safe havens” for tax evasion. VAT presupposes a uniform floor rate of tax to obviate such risk.**

Preparation for the shift

1.4 Tax on sales is a State subject under the Constitution of India. The Government of India (GOI) set up an Empowered Committee of State Finance Ministers (referred as Empowered Committee) in 1999 to formulate the basic design of VAT through consensus. Deliberations over six years bore fruit in a White Paper in January 2005. While laying down the basic design (salient features illustrated at Annexure), the White Paper provided space for “federal flexibility” by permitting State Governments to adopt appropriate variations. These variations were reflected in the VAT Acts and Rules enacted by the State Governments.

1.5 In the meanwhile, Haryana introduced VAT in April 2003 and the remaining States gradually shifted from Sales Tax to VAT from April 2005 onwards, the last being Uttar Pradesh which implemented VAT from 2008. At present, VAT is in place in all the States across the country.

Our study

1.6 We conducted a study on the transition from the sales tax regime and implementation of VAT system across 23 States³ to seek an assurance that:

- **the States planned well for the transition;**
- **the transition was accompanied by a re-jig of the organisation and the processes;**
- **the legislative provisions were adequate and enforced;**
- **internal controls were in place and were effective in preventing leakage of revenue; and**
- **the systems have stabilised and are functioning effectively.**

Acknowledgment

1.7 Indian Audit and Accounts Department acknowledges the cooperation of the Taxation Departments of all the 23 States in providing the necessary information and records for audit. Our reports were prepared after discussions with the departments/

³ Andhra Pradesh, Assam, Bihar, Chhattisgarh, Delhi, Gujarat, Himachal Pradesh, Jammu and Kashmir, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Manipur, Meghalaya, Mizoram, Nagaland, Orissa, Rajasthan, Sikkim, Tamil Nadu, Tripura and West Bengal. These reports are available on the CAG’s website, www.cag.gov.in

State Governments. We are happy to report that the State Governments have accepted most of our findings/recommendations and assured us of remedial action.



CHAPTER 2 Our assessment

Planning

2.1 There was a sense of urgency in the Government of India to bring the States into the VAT fold, which left the State Governments little time to prepare the edifice to build the VAT superstructure. The architecture of VAT was undoubtedly a complete shift from the existing sales tax; it engendered different business processes as also augmented infrastructure for successful implementation. The States agreed to implement VAT within three months (i.e., by April 2005) of finalising the design structure in the White Paper, partly on the assumption that much preparatory work was already underway in the States. The time frame of three months and the presumption of readiness were both unrealistic and the inadequate focus on planning has come to haunt the State Governments. Most states had their VAT Acts in place before the basic design was laid down in the White Paper; this led to wide disparity in the processes adopted across the States. For instance, Chattisgarh VAT Act prescribed *100 per cent* tax audit and *no scrutiny* of tax returns⁴ which was a significant deviation from the basic design that laid down that all returns will be scrutinised and only a prescribed percentage will be audited.

2.2 In our opinion, the basic pre-requisites for operationalising VAT would be that the tax administration would:

- Lay down the road map for clearance of issues from the legacy system to facilitate a clean switch to VAT;
- Harmonise tax rates to meet the desired goals of uniform floor rate of tax across the States;
- Automate the processes, complete with end-to-end integration of assessment units with check-posts and the Commissionerates. The process would also generate a database of registered dealers complete with 11-digit Taxpayer Identification Number (TIN);
- Prescribe tax returns that would provide the data necessary for non-intrusive scrutiny of the returns. Such data would also provide the template for drawing a scientific sample of high-risk returns for detailed tax audit; and
- Prepare manuals and upgrade the skills of the staff to meet the new challenges.

⁴ Tax returns are scrutinised by the assessing officers (AOs) without calling for additional data/documents or requiring the presence of the assessee. Subsequently, returns will be selected for a detailed tax audit, for which the AO can examine additional documents in the presence of the assessee.

2.3 Our evaluation of implementation is structured on the above pre-requisites and the findings are highlighted in the succeeding paragraphs.

Clearance of legacy issues

2.4 The White Paper looked ahead at the post-VAT scenario only and did not prescribe methods for clearance of assessments in the legacy systems. This was an issue that clearly missed the attention of the State Governments also as they stood poised for introducing VAT. **On the date of transition, 15 States together had more than 58 lakh assessments pending under the repealed Acts.** The uncollected tax under these repealed Acts in five States alone stood at around Rs. 12,000 crore.

2.5 **This inventory of pending assessments was a drag on the system** and even after 4 years of transition, no innovative solution has been found for this vexed issue. Recently, some States took a decision to ease the backlog by declaring assessments upto a particular amount as deemed to be assessed while one State opted for fast track assessments⁵, thus accepting the attendant risks of tax evasion. **After 4 years, the pending assessments and arrears of taxes under the repealed Acts are still staggeringly high: over 28 lakh in 15 States and uncollected tax demand of Rs. 40,600 crore in 7 States.**

2.6 Inability to start with a clean slate has impinged on the ability of the tax administration to lay down the foundation for VAT firmly. The backlog has effectively tied the AOs down as well.

Harmonisation of tax rates

2.7 The White Paper envisaged that VAT will cover 550 goods, of which:

- 46 goods, comprising natural and unprocessed products in the unorganised sector, will be exempted;
- 270 goods to be taxed at four *per cent* will be common for all the States and;
- The remaining commodities, common for all the States will fall under the general VAT rate of 12.5 *per cent*.

2.8 Uniform tax rates across the States was an important feature of the basic design of VAT meant to check diversion of trade and unfair trade practices as well as to promote a co-operative spirit among States in taxation. We found that there were significant variations between the tax rates of same commodities across the States and even after lapse of 4 years, the issue still remains unresolved. **The States are tweaking the rates on their whims thus creating distortions.**

Mahe is a Union Territory with an area of about 9 sq. km and population of 36,823 (2001 census) located inside the territory of Kerala. We found that tax arbitrage derived from lower tax rates in Mahe, has become a drain to the exchequer in Kerala.

⁵ All assessments were completed by accepting the returns of the dealers without seeking any further records from the dealer.

Our analysis across few select commodities⁶ for one year showed that Mahe imported goods worth Rs. 374 crore (which would have fetched tax of Rs. 119 crore to Kerala). For a population so low, the imports are abnormally high. Evidently, due to differences in tax rates, Mahe has emerged as a pocket for tax evasion.

2.9 It was hoped that the Empowered Committee would provide an overarching control on adherence to the basic design and correct mid-course anomalies. But distortions in the basic design went largely untrammelled. In addition to differential tax rates, these distortions included:

- **Additional levies:** The advantage of removal of cascading effect of taxes in VAT was that it would lower the prices of goods. Therefore, the White Paper prescribed that the States may not impose any additional levies that will compromise this goal. States which impose entry tax were to subsume it under VAT. We found that Karnataka continued with entry tax but did not make it VAT-able. Other States like Bihar and Gujarat introduced additional taxes subsequent to the implementation of VAT, thus compromising the VAT structure;
- **Wide disparity in the format of tax returns** which is discussed in detail in paragraph 2.20. Common structures would have paved way for greater ease in the shift to GST;
- **Substantial difference in processes** relating to submission of returns and supporting documents, scrutiny of returns, tax audits, penalties etc., between the provisions of the State VAT Acts and those prescribed in the basic design. Also, there was no uniformity between the provisions relating to the above processes among the State VAT Acts.

Automation

2.10 The White Paper reported that the States had initiated, and in many cases also completed, steps for computerisation upto the levels of AO and also at the check posts. The number of registered dealers increased substantially post-VAT; instead of assessment of annual returns under Sales Tax, VAT prescribed monthly or quarterly submission of returns; together the quantum of work in the assessment units increased many-fold under VAT. The States did not re-engineer their processes or augment the staff, in which situation, automation was only way forward. Automation was the bedrock on which the success of VAT rested upon as tax evasion cannot be checked without cross-verification (illustrative list) of:

- **Purchase and sales by cross-linking the declarations of one dealer with the others he transacted with;**
- **Tax actually paid on the previous points along the chain of sales before allowing set-off of ITC or grant exemptions, as the case may be;**

⁶ Goods included petrol, diesel, India made foreign liquor, chicken, ghee and tiles.

- **Establish trail of transactions to detect dealers either not registered in the system or not submitting tax returns and thus evading tax;**
- **Cross-link VAT returns with that of Central Excise and Income Tax in collaboration with the relevant tax authorities.**

2.11 We found that automation was in a nascent stage in all States except Kerala. **The scrutiny of returns is not automated** and the networking with the Commissionerates is an unfinished agenda in all States except Kerala. The check posts were either not computerised or the data from the check posts was not available online to the AO. **Only Kerala had prescribed e-filing of returns for all dealers.** In the other States, e-filing of returns is in various stages of implementation.

Jharkhand and Bihar use web-based VAT application software named VICTORY (VAT Information Computerisation to Optimise Revenue Yields) for registration of dealers, processing of returns and create MIS for monitoring. The software is yet to provide an integrated platform for IT-enabled processing of returns. Other States also developed their own software: VAT information systems in Andhra Pradesh and Orissa, Delhi-VAT in Delhi, TN-VATIS in Tamil Nadu, KVAT information systems in Kerala, VAT and CST systems Management system in the North Eastern States, RAJVISTA in Rajasthan and so on. These attempts at automation are yet to stabilise.

2.12 It was known that VAT will eventually lead to the GST and common software developed on a common platform across the States would be a precursor for this shift. We feel that the GOI could have stepped in to meet this need rather than leave it to the individual States to co-ordinate. **Disparate efforts in automation** led to multiplicity of efforts and resource allocation but more importantly, the outputs generated from these silos **have not evolved a common platform for integration.**

Manuals

2.13 A manual maps the processes and provides a reference point to navigate the VAT as well as for organising training on the new Act. It also lays down a framework of internal controls for effective monitoring. **We found that most of the States were yet to prepare manuals.**

Registration of dealers

2.14 A dealer registered under the repealed Sales Tax Acts and liable to pay tax under VAT⁷, was deemed to be registered under the VAT Act. But the Taxpayers Identification Number (TIN) was allotted to dealers who sought registration separately under VAT. In the process, a database of dealers under VAT was created. However, the

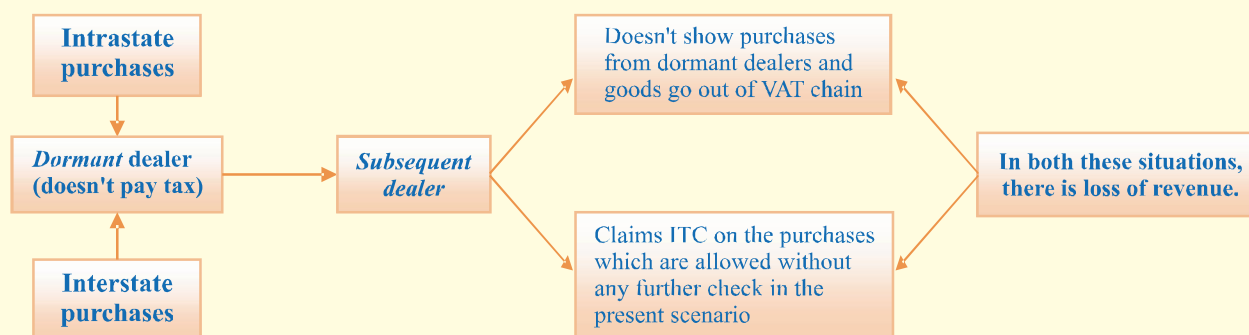
⁷ Dealers with turnover below Rs. 5 lakh were not liable for payment of VAT. Dealers with annual gross turnover not exceeding Rs. 50 lakh, were allowed the option for a composition scheme under which VAT will be collected at a flat rate of tax. The White Paper allowed the states the flexibility to fix these thresholds according to their need. However, dealers opting for composition scheme were not entitled to ITC.

States have not correlated the two, to identify the dealers who were earlier registered under the repealed Acts but had opted not to register under the VAT Acts. Such dealers who are out of the VAT database may not only evade tax, but participate in the VAT chain undetected and those who purchase from such dealers may claim and receive ITC.

2.15 A dealer with an annual turnover of less than the initial thresholds need not register under the VAT. A dealer (with annual turnover of less than Rs. 50 lakh) would be registered but could opt to remain out of the VAT chain and pay tax at a flat rate on his turnover (under the composition scheme). Once out of the VAT chain, these dealers are secured from the in-built mechanism of scrutiny in the system⁸. This necessitated that periodic checks of the books of accounts of such dealers, is in-built into the system. This need was over-looked and remained unaddressed till we raised this issue.

2.16 Dormant TINs who either do not submit the tax returns or active in submitting claims, would need to be put under the scanner for the reasons for dormancy. The States do not have a mechanism for detection of non-filers. A “non-filing” dealer can misutilise the declaration forms⁹, evade tax, disrupt the ITC chain and yet remain undetected in this scenario. Chart illustrates the impact of dormant TINs.

Chart showing effect of dormant TIN



2.17 The State VAT Acts provided for periodic surveys for identification of unregistered dealers. Surveys were an integral part of the Sales Tax regime too but the framework for such surveys - prescribing the periodicity, the methods for survey and the monitoring of results - was unchartered and they remain so in the VAT regime as well. We found that the surveys in VAT were sporadic and the results unimpressive. Our analysis in four States showed that **on an average, it took two surveys to add one dealer into the tax net.**

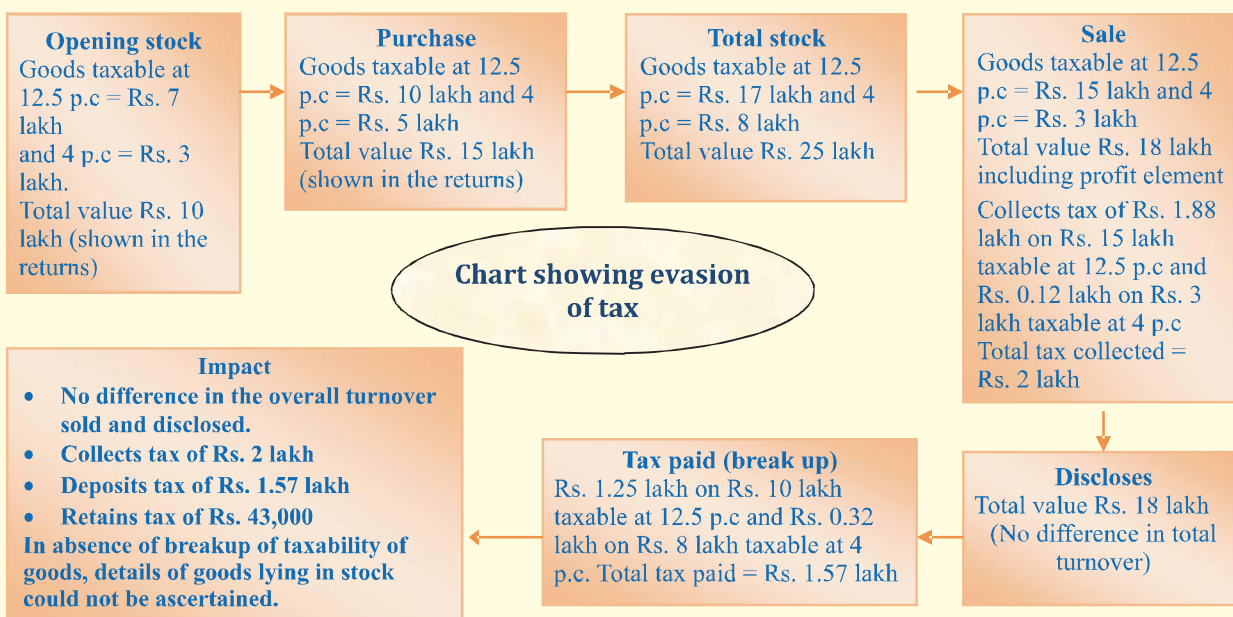
⁸ The ITC is claimed and allowed across a chain of purchase. Such a chain would bring the spotlight on a dealer who opts out or under-reports his turnover in the cross-referencing that VAT makes possible. A composite dealer or a dealer below the initial threshold may, however, not claim ITC and remain out of such scrutiny.

⁹ As at present, e-filing is not mandatory in most of the States which is fraught with the risk of issue of declaration forms without a check on the status of submission of the returns.

We cross-checked the sales declared by dealers under the VAT and detected 86 unregistered dealers who together had a turnover of Rs 22 crore. Though each of these dealers had a turnover of more than Rs. 5 lakh, they were not registered under VAT and the tax evasion of Rs 4 crore, remained undetected. These transactions remained out of the VAT chain causing loss of revenue which cannot be quantified.

Filing of Tax returns

2.18 The State VAT Acts require submission of periodic (quarterly/monthly) tax returns by the dealers failing which the AOs can conclude assessments on best judgement basis¹⁰. In order to affect a meaningful scrutiny and cross-verification, it was necessary that the tax returns were so prescribed that they would capture all the essential data¹¹. We found a wide variation in the forms of tax returns across the States. In two States, the returns were not prescribed. The documents to be appended to the return in support of the particulars mentioned in the returns were also not prescribed. Besides, two States did not prescribe for submission of annual returns alongwith the annual audit reports¹². **Though VAT is a commodity based tax, the returns in ten States did not prescribe details like name and description of the commodity purchased and sold, exemption/reduction in rates of tax; details of opening and closing stock etc., without which verification was rendered impossible.** Chart illustrates the scope of evasion in the absence of such details. It also illustrates the perils of multiple rates of taxation.



¹⁰ After providing the dealer an opportunity of being heard.

¹¹ The ITC claim will be primarily based on the invoice details of each purchase. Every selling dealer will issue a serially numbered and signed tax invoice showing tax charged separately and keep a counterfoil or duplicate of such invoice. These details are required to be appended to the tax return in support of the claim for ITC.

¹² Dealers having turnover more than Rs. 40 lakh are to submit an annual audit report certified by chartered accountants.

e-filing of tax returns becomes an essential pre-requisite for deriving the benefits of automation. The tax returns must be simple to reduce the cost of compliance to the assessee but they must also provide the basic data for scrutiny to establish the trail of transactions leading to ITC claims.

We feel that there is need for software built on a common platform that can be scaled for GST subsequently. The software may provide drop-down lists that will reduce the scope for data input errors. The classification of goods can be uniform across the States (in harmony with HSN in Central excise) regardless of difference in rates of taxation. The need for enclosing a *challan* as proof for deposit of tax can also be circumvented if the Treasuries were to generate a unique *challan* identification number, which the taxpayer can quote in his return.

2.19 The mechanism to monitor filing of returns was particularly inadequate in six states. The departments in these States did not maintain any records/registers for recording receipt of returns, which left the department little scope for exercising controls. **Our analysis in seven other States showed compliance to filing of 86 per cent; what was worrisome was that no action had been taken by the departments for the remaining 1.3 lakh returns that were not filed.** Besides the tax evasion by the errant dealers, the omission would break the VAT chain hampering cross-verification before allowing input tax credits or deduction on account of tax paid sales.

Scrutiny of tax returns

2.20 The White Paper envisaged that **all** tax returns will be scrutinised¹³ within a prescribed time limit from the date of filing the return. The scrutiny will be the basis for raising additional demand, if any. It also envisaged that the ITC claim will be admitted on documentation of tax invoices.

2.21 We found that in a few States, the Acts did not contain a provision for scrutiny or prescribed check of select sample. Eight states did not prescribe any time limit for the scrutiny. **Most of the States had not laid down a check list of points to serve as a ready reckoner for the AOs for such scrutiny.**

Clearly, the system of scrutiny of returns is yet to crystallise and tax evasion remained undetected. **Our audit sample threw up 2614 cases of evasion of tax aggregating Rs. 873 crore¹⁴.**

2.22 Besides, the States are clearly unable to cope with the work and our analysis across 10 states showed that **only 34 per cent of the returns were scrutinised, leaving a balance of 80 lakh returns that were yet to be scrutinised.** In five States the shortfall was as high as 80 per cent and in three States, no records were maintained to check whether scrutiny was conducted or not.

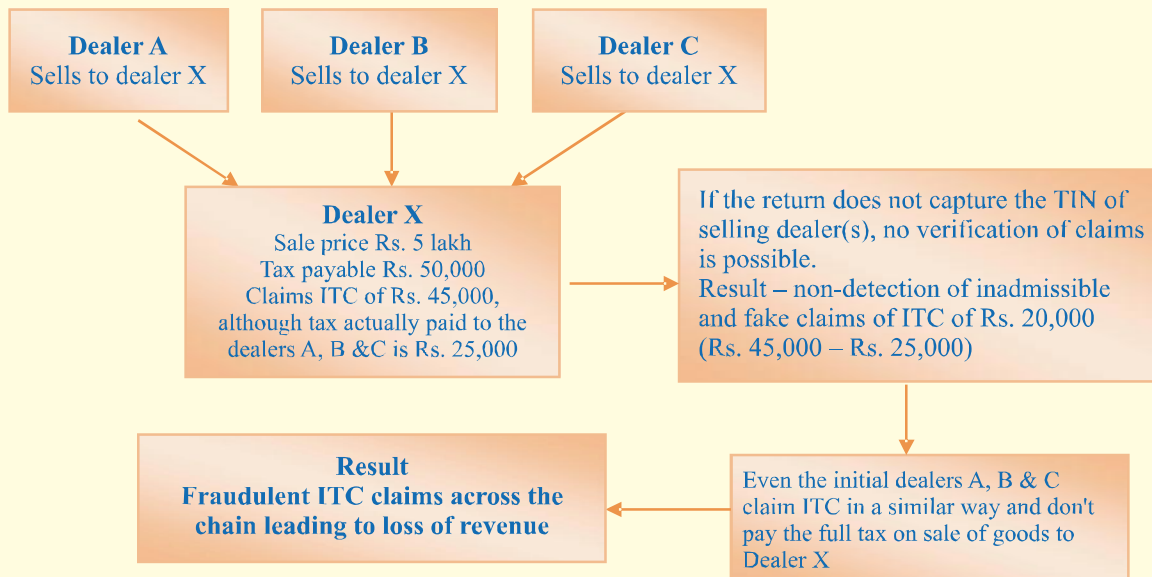
2.23 None of the States made cross-verification¹⁵ mandatory except in Bihar. However, Bihar also withdrew this provision in July 2007. **The States are facing**

¹³ Such scrutiny will be conducted on the basis of the information contained in the tax returns without calling for additional documents or requiring the presence of the dealer.

¹⁴ This includes penalty and interest which is mandatorily payable on short payment of tax.

pressure from the traders unnerved by the potential of such checks; this pressure is the reason why the States are chary of laying down a transparent and integrated system of cross-verification.

2.24 We are of the opinion that the return should capture TIN-wise aggregate data of sales/purchases segregated goods-wise. This would assist in cross-verification of sales/purchases across TINs before admitting an ITC claim. In the absence of such data, it becomes impossible to detect fake ITC claims as illustrated in the chart below.



Our analysis in 16 States brought out 53,000 cases of inadmissible claims of ITC amounting to Rs. 829.16 crore.

Tax audit

2.25 The White Paper envisaged tax audit of sample of dealers, based on a scientific risk analysis, by an audit wing that will be independent of the tax collection wing. The audit will be initiated and completed within prescribed time limits.

2.26 Five states had prescribed the criteria for selection of dealers for tax audit; in the remaining states, the selection was left largely to the discretion of the team. Seven states did not prescribe a time limit for completion of the tax audit. A monitoring mechanism to watch the progress of tax audit was missing in most states.

2.27 The challenge that is yet to be surmounted was completion of selected audits. **Only 33 per cent of the selected dealers could actually be audited in the seven States that we analysed.** In the last 4 years, 1.4 lakh dealers were covered in these States; the inventory of the remaining 4.7 lakh tax audits will alone take four years to cover at the current pace of disposal. This must be viewed with the fact that the departments were conducting 100 per cent tax audit (detailed assessments) in the

¹⁵ Cross-verification of claims of a dealer with the returns of the preceding dealer.

Sales Tax regime. Under the VAT system, the number of dealers increased at least two times¹⁶ but the same system is unable to even cover 5 *per cent* of the dealers in tax audit. **We feel that the system is unable to adjust to the separate peer review mechanism of tax audit in VAT.** It is partly due to the logistical difficulties of access to records that normally resides in the tax collection units; the mindsets and the culture of collusion is yet to be unshackled.

2.28 Our analysis across five States showed that on an average, **concealment of turnover was detected in one in every two cases audited by the department.** One lakh tax audits conducted by the departments across States raised additional demand of Rs 783 crore on more than 56,000 dealers. Non-conduct of tax audit even of the selected dealers is fraught with the risk of these cases becoming time barred causing loss of revenue to the States.

The percentage of tax audits must be benchmarked to the results of 100 *per cent* scrutiny of assessments. The extent of evasion flagged by such scrutiny should be the basis for fixing the percentage.

Alternatively, the departments may also consider setting up a database of dubious dealers on the basis of past history of the dealers, which will form one of the bases for selection of audit sample. This database should be made online in the department's website for view by all concerned.

Cross verification with other sources

2.29 Automation in other tax departments like income tax, central excise departments, provide an opportunity to the VAT administrators to cross-link the VAT returns to the income/production reported to the other tax departments. However, such cross-linking has not yet got established in the States and is a lacuna that must be plugged.

Cross-verification by audit with records of other tax departments in five States revealed evasion of tax of Rs. 56 crore in 160 cases.

2.30 Tax Information Exchange System (TINXSYS) spread across the States was conceived to help the State Governments to monitor inter-state trade as also for verification of Statutory Forms¹⁷ submitted by the dealers. The State Governments were required to upload details of all statutory forms issued by them for inter-state trade and commerce to the TINXSYS.

2.31 Five states confirmed to us that they were not uploading data on TINXSYS; seven other States provided us no confirmation. **None of the States have issued instructions to AOs to access the TINXSYS while scrutinising returns or for tax audit.**

¹⁶ Thus conservatively, the department should be able to cover at least half of the dealers, given its capacity to cover 100% of the dealers in the Sales Tax regime.

¹⁷ Issued by other States Commercial Tax Departments where the purchaser/transferee resides. The forms will be submitted by the seller/transferor in his State along with his tax returns.

2.32 Besides, the TINXSYS in its present form allows only uploading of information by the issuing authorities of declaration forms. But it doesn't allow uploading the information by the States in which the forms are utilised. Such a system would facilitate cross verification and prevent usage of fake or invalid forms.

We have been repeatedly pointing out instances of tax evasion that could have been detected through co-operative efforts between States. **This year, our cross-verification detected 201 cases in four States of submission of fake/invalid declaration forms leading to tax evasion of Rs. 16.68 crore.**

Where the States conducted such cross-verification, the results supplement our assessment on evasion. In two assessment units in Kerala, we found that cross verification conducted by the department unearthed evasion of tax of Rs. 97 crore by use of fake declaration forms. However, the efforts came to naught when the State buckled under pressure from the dealers and waived the additional demand.

Factoring additionalities

Incentive schemes

2.33 After much deliberation amidst divergent views¹⁸, the States agreed to continue the existing incentive schemes under the VAT with the caveat that the VAT chain must not be affected by the exemptions. Most States continued with the exemptions with minor changes.

2.34 Three States allowed the exempted manufacturer to collect tax from the purchaser but also retain the tax without remitting it to the State. The idea being that this will in effect be an exemption to the manufacturer and the VAT chain will also not be broken. The result: the manufacturers were being enriched and the purchaser claimed ITC on tax paid, which was an additional outgo for the State Governments.

We found that manufacturers in these three States collected and did not remit tax of Rs. 6400 crore in four years, with Reliance Group of Companies accounting for more than 90 per cent of it. Besides, two manufacturers in one State were allowed ITC of Rs. 8 crore; since no output tax was paid by the preceding dealers, this amount was paid from the Government coffers. Subsequent to our intervention, the provision was withdrawn but with prospective effect.

Tax collected at the first-point of sale

2.35 Two States collected the entire tax on certain category of goods at the first point of sale; the purchaser would then claim exemption from tax on subsequent sales. But there was no mechanism to check the claim of the purchaser for exemption by cross verification of the purchase and sale of tax paid goods. In fact, the dealers were required to submit a detailed statement on such purchases under the Sales tax regime to claim exemption but this requirement was curiously removed under VAT.

¹⁸ In the initial meeting of the empowered committee in November 1999, one of the issues on which consensus was attained was discontinuance of the sale-tax-related industrial incentive schemes with effect from January 2000 in the interest of harmonisation of incidence of sales tax.

We found that seven dealers in a State claimed tax exemption of Rs 1026 crore on turnover of Rs. 25,650 crore from sale of tax paid goods. The State Government allowed the claim without any proof.

2.36 In another State that allowed an option for first-point collection¹⁹ of tax to dealers of medicines, we found that all second/subsequent dealers availed of exemption on their entire turnover of sale of medicine. This presupposes that all first dealers had opted for the compounding scheme. But we found that there were “first sellers” who did not opt for the compounded tax. The tax leakage could have been avoided if the list of such dealers who had opted for first-point collection was published on the departmental web-site and the system required all the subsequent dealers to furnish all details of purchases for which they claimed such exemption.

Tax deducted at source

2.37 The VAT system envisages deduction of tax while releasing payments to suppliers or works contractors. The deductors are required to submit periodic returns for the TDS collected. In some States, the Acts did not specify the requirement for sending TDS returns; in other States, the submission of the returns was tardy. In all, the mechanism to assure the department that tax was deducted where deductible, and the entire amount deducted was deposited into the Government account, did not exist, except Kerala. The State Governments do not have an automated system to process TDS returns and in most of the States the deductors are not identified by a unique number to facilitate reconciliation of the returns with the tax amount deposited²⁰. In fact, the main defaulters in submission of returns are the Public Works departments; the Governments are unable to rein in their own executing departments. Only Kerala has instituted a system by which the tax liability is assessed by the AO and a certificate provided to the executing agency for deductions from the final payment. The penalty imposed for non-compliance is high (100 *per cent*) and automation has increased the probability of detection of non-compliance.

Our study shows that non-deduction of TDS is wide-spread. Cross-verification with the records of executing agencies in five states showed that tax amounting to Rs. 185 crore, was not deducted. This was not detected by the State Governments either.

Tax on the maximum retail price (MRP)

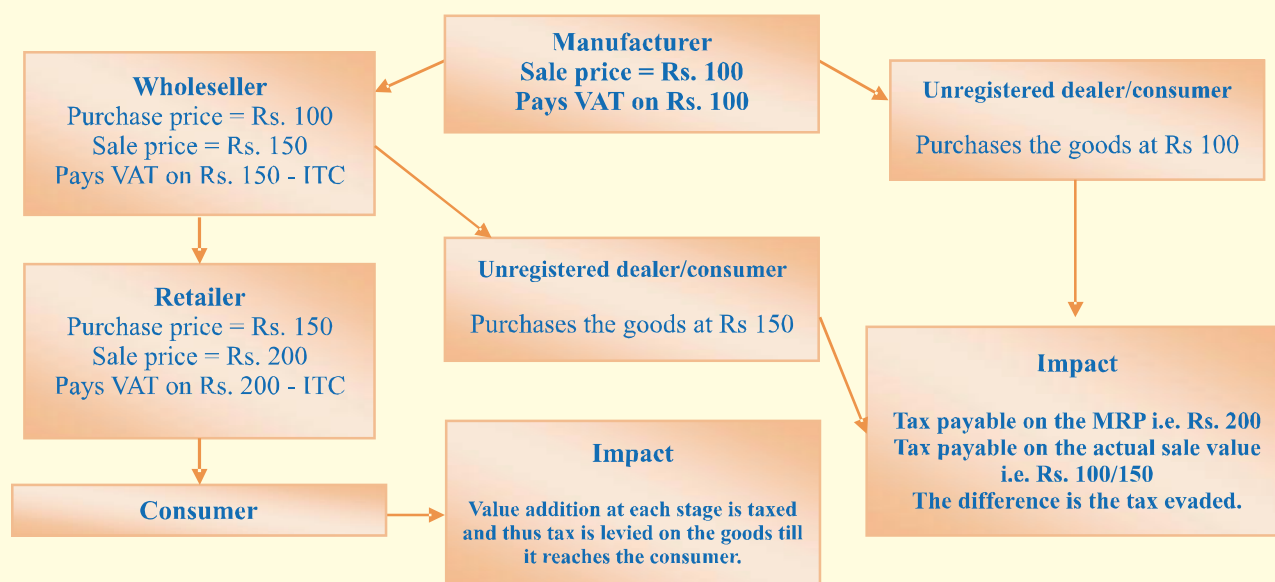
2.38 While defining the sale price in its VAT Act, one State stipulated that in the event of sale of goods to a person other than a registered dealer, the sale price shall be deemed to be the MRP if such price is declared on the package of the commodity, otherwise the price in which the goods are generally sold at the retail level. This provision highlights the avenue for tax evasion by over-stating direct sales to the consumers/unregistered dealers and pay tax on the actual sale price (instead of MRP, which will be higher). By this mode, the subsequent value addition will also elude the VAT chain and lead to

¹⁹ This option was available to the dealers opting for payment of compounded tax on maximum retail price paid tax.

²⁰ Such a system exists in the Income Tax department where the deductors are identified by the TAN and the e-TDS module facilitates reconciliation.

leakage of revenue as illustrated in the chart. **Under pressure from the dealers, the State withdrew the provision.**

Our study in the above State revealed that 12 manufacturing dealers had a turnover aggregating Rs. 128 crore, of which 47 *per cent* was declared as direct sales. Since the provision in the Act was repealed, the department was constrained to accept the actual sale price as the base for calculating tax.



Deterrence in the system

Penalties

2.39 It was accepted that the penal provisions in the VAT Acts should not be more stringent than that in the existing sales tax Acts. We found that the VAT Acts did contain penalty clauses but the deterrence was effete. Seven states did not prescribe the quantum of penalty, which was left largely to the discretion of the AO. In four States, the amount was so low that that the dealers continued to pay the penalty and default in submission of annual audited accounts. Where prescribed, penalty was not imposed. **Our study revealed that in nine States, penalty amounting to Rs. 485 crore on non-compliance was not levied.** The tax returns of large taxpayers are required to be certified by a chartered accountant (CA). **But there is no deterrence in the State VAT Acts against the respective CAs when tax evasion is detected in the accounts certified by them.**

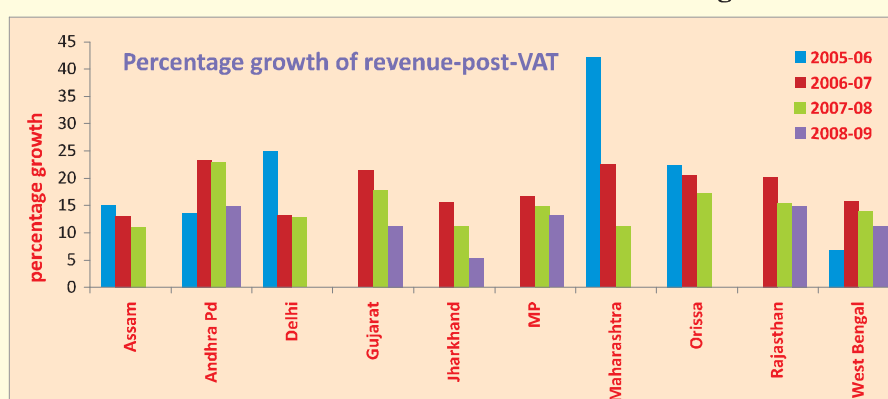
Trends in revenue collection: extent of evasion

2.40 The trends in revenue collection also point to leakages in tax collection. Other things being equal, VAT must lead to mopping up of revenue simply because the base of VAT is invariably broader than that of the taxes, which it replaces. VAT has a self-regulatory mechanism that would incentivise the dealers to compliance because of taxation of goods at all the points of VAT chain till consumption.

2.41 Of the 23 States in our study, we found that ten States have registered a dip in the average growth of revenue during the post-VAT regime against those relating to the pre-VAT periods. These included few of the major states like Gujarat and Tamil Nadu²². Since there has been a quantum increase in tax base in all the states after implementation of VAT, the deceleration can mainly be attributed to tax evasion.

State	Growth in collection ²¹ (in per cent)	
	Pre-VAT	Post-VAT
Assam	22.7	13.0
Chhattisgarh	28.0	22.7
Gujarat	19.2	16.8
Jharkhand	17.4	10.7
Madhya Pradesh	15.8	14.9
Rajasthan	17.6	16.8
Sikkim	11.9	8.7
Tamil Nadu	16.8	8.2

2.42 There has been a downturn in the growth rate of collection post-implementation of VAT in 12 out of 23 States; in three States it registered an increase and in the remaining eight states the growth rate was inconsistent. The matrices of two States are illustrated below to show that the fall in growth rate was despite an expansion in the tax net and in GSDP²³ of the States:



Growth of GSDP (in percentage)		
Year	Andhra Pradesh	Rajasthan ²⁴
05-06	12.2	9.7
06-07	11.38	15.7
07-08	11.59	14.2
08-09	11.80	13.0
Growth in Number of dealers registered (in lakh)		
05-06	1.6	2.6
06-07	2.0	3.0
07-08	2.4	3.1
08-09	2.7	3.4
Growth in VAT collection (in percentage)		
05-06	13.6	16.6
06-07	23.3	20.2
07-08	23.0	15.3
08-09	14.9	14.8

²¹ Equal number of years before and after the date of implementation of VAT has been considered.

²² The growth rate has picked up in 2008-09 to 13.9 per cent.

²³ Gross State Domestic Product.

²⁴ VAT implemented from April 2006.

Impact of VAT on prices

2.43 The White Paper was sanguine that implementation of VAT will bring down the prices of goods due to rationalisation of tax rates and abolition of cascading tax effects in the legacy systems. But there was no system to monitor this impact and ensure that the benefits were indeed being passed on to the common man.

2.44 We selected a basket of goods²⁵ and checked the records of 13 manufacturers in a State in three initial months of implementation of VAT, to check its impact on prices. **We found that the manufacturers did not reduce the maximum retail prices (MRP)²⁶ after introduction of VAT though there was substantial reduction of tax rates.** The benefit of Rs 40 crore which should have been passed on to the consumer was consumed by the manufacturers and the dealers across the VAT chain. The dealers have undoubtedly enriched themselves at the cost of the common man.

²⁵ The goods included cosmetics, aerated drinks, pharmaceutical products, paints, bakery and food preparations.

²⁶ The MRP listed by the manufacturer includes the tax element.



*Lessons for
transition to GST*





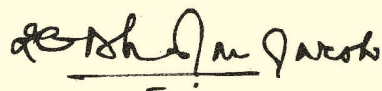
CHAPTER 3 Lessons for transition to GST

We recommend that:

- A road map for resolution of issues from the legacy system may be drawn up before the switch to GST.
- Place automation high on priority. To begin with, e-filing may be made mandatory. The tax returns must be simple to reduce the cost of compliance to the assessee but they must also provide the basic data for scrutiny to establish the trail of transactions leading to ITC claims.
- The Government of India may steer the development of software which will standardise the processes across the country. The software must enable non-intrusive and system-based scrutiny of returns; detect non-filers or dormant dealers; and selection of sample for tax audit.
- Due priority must be placed for integrating all units (including check gates) within the States as also inter-State.
- The Act should specify timeframe for scrutiny of tax returns (and process ITC claim and refunds) that will bind the tax administration for efficient service delivery which in turn will enhance taxpayer confidence in the new system.
- Ensure that departmental manuals are prepared for standardising the entire gamut of processes and align the internal controls with the GST.
- Training of staff, with due emphasis on advocacy, is central to the success of GST.
- The periodicity for filing the returns may be fixed in accordance with the turnover of the respective dealers. This will reduce the burden on the department and ease monitoring on the dealers.
- Refine the risk-based selection of dealers for tax audit to generate a sample that is both viable and effective in detection of evasion.
- Prescribe a comprehensive mechanism for cross verification of the returns of the dealers with other records like returns of other dealers, Income Tax/Customs/Central Excise Departments and TINXSYS website. The States may be incentivised for timely uploading of data in the TINXSYS. TINXSYS

should provide an option for the user states to upload the utilisation of declaration forms as also for the States to upload list of dubious TINs.

- Minimise discretion in clauses relating to penalty across different types of offence.
- Install a mechanism to monitor any deviations in the GST that distort the GST.



(H K Dharmadarshi)

Principal Director (State Receipts Audit)

New Delhi

Date :

Countersigned

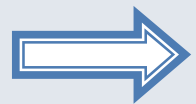


(Vinod Rai)

Comptroller and Auditor General of India

New Delhi

Date :



Annexure

Salient features of Value Added Tax

The major designs put forth in the White Paper were as follows.

- The manufacturers and traders (dealers) will be given input tax credit for purchase of inputs - including that on capital goods - meant for use in manufacture or resale.
- Input tax credit, remaining unadjusted till the end of second year; and also on exports will be refunded to the dealers.
- The dealers will submit self assessment returns declaring their tax liability under state level VAT. The Government will consider these self assessment returns as deemed assessment, except where the notice for audit of books of accounts of the dealer was issued within prescribed period.
- Audit of books of accounts of the dealer will be de-linked from tax collection wing to remove any bias.
- The existing incentive schemes will be continued in a manner deemed appropriate by the State, after ensuring that VAT chain is not affected.
- Taxes such as turnover tax, surcharge, additional surcharge and special additional tax would be abolished.

Besides the above, the White Paper also envisaged the following:

Opening stock: All tax paid goods purchased on or after April 1, 2004, and still in stock as on April 1, 2005 was eligible for input tax credit, subject to submission of requisite documents.

Compulsory issue of tax invoice: Since the entire design of VAT with input tax credit was crucially based on documentation of tax invoice, cash memo or bill, every registered dealer was required to issue serially numbered tax invoice.

Rates of taxes: The White Paper envisaged that in the VAT system, 550 goods will be covered and there will be two basic rates of four *per cent* and 12.5 *per cent*, plus a specific category of tax exempted goods and a special VAT rate of one *per cent* only for gold and silver ornaments etc.

It stated that under the exempted category, there would be about 46 commodities comprising of natural and unprocessed products in unorganized sector, items which were legally barred from taxation and items which have social implications. The States were allowed the flexibility to choose a maximum of 10 items from the list. The rest of the commodities were to be common for all the States. Under four *per cent* category, largest number of goods i.e. 270 goods, were to be listed which were to be common for all the States. These goods comprised of items of basic necessities such as medicines and drugs, all agricultural and industrial inputs, capital goods and declared goods. The remaining commodities, common for all the States were to fall under the general VAT rate of 12.5 *per cent*.

Taxpayers identification number: The taxpayer's identification number (TIN) consisting of 11 digits was to be issued to the dealers.

Return: Simplified forms of returns were to be notified by the respective States, which are to be filed monthly/quarterly and accompanied by *challans*.

Scrutiny of returns: Each and every return were to be scrutinised expeditiously within a prescribed time limit from the date of filing and in case of any mistake detected, the dealer was required to pay the deficit tax appropriately.

Audit: Correctness of self assessment was to be checked through a system of departmental audit. A certain percentage of the dealers were to be taken up for audit every year on a scientific basis. However, if any evasion was detected on audit, the concerned dealer was to be taken up for audit of all the previous periods.

Cross verification: The White Paper envisaged a computerised system of cross checking on the basis of co-ordination between the tax authorities of the State Governments and the authorities of Central Excise and Income Tax to compare constantly the tax returns to check tax evasion.

Incentives: Under the VAT system, the existing incentives schemes were allowed to be continued.

Penal provisions: Penal provisions in the VAT Acts should not be more stringent than in the existing sales tax Acts.

Central sales tax: With implementation of the VAT system, the central sales tax was also to be phased out gradually. The White Paper envisaged that there was a critical need for putting in place a regulatory frame work in terms of taxation information exchange system to give a comprehensive picture of interstate trade of all commodities. Accordingly, a website named 'TINXSYS' was introduced by the Union Government to serve as a centralised exchange of all interstate dealers spread across the various States. It is a repository of interstate transactions taking place among various states. It helps the commercial tax departments of various states to effectively monitor interstate trade.

Glossary of terms and abbreviations

Assessing officers (AO): means any officer of the Commercial Tax Department authorised by the Commissioner to make any assessment in such area or areas of the whole of the State.

Basic design: means the common points worked out by the empowered committee of Finance Ministers of the States for implementation of State-level Value Added Tax in the country.

Best judgment assessments: means assessment of tax payable made on the basis of the analysis made by the assessing officer in absence of the returns furnished by the dealers or in the absence of the books of accounts of the dealer.

CA: Chartered accountants.

Declaration forms: means forms prescribed under the Central Sales Tax Act, 1956 to facilitate inter-state trade and commerce.

Dormant TIN: means the dealers who carry on business but do not submit return/do not carry on any business for considerable periods but retain registration.

Empowered committee: means the committee of the State Finance Ministers set-up by the Government of India for formulation of the basic design facilitating implementation of Value Added Tax system in India.

GOI: Government of India.

GSDP: Gross State Domestic Product.

GST: Goods and Services Tax.

HSN: Harmonised system nomenclature.

Input tax credit (ITC): means the deduction from the output tax payable on account of tax paid on the purchases.

Incentive schemes: means the schemes for promoting industries in which tax exemptions and other benefits are extended to the manufacturers for setting up industries in the State.

ITC chain: means the chain in which a number of dealers claim deduction of tax paid at earlier stages from the output tax payable.

MRP: maximum retail price.

Repealed Act: means the Acts which have been discontinued on introduction of the Value Added Tax like the General Sales Tax Acts, Entry Tax Acts, etc.

Self assessment: means assessments of tax payable made by the respective dealers in their returns and if no specific notice is issued proposing departmental audit of the books of accounts, the dealer is treated as self assessed on the basis of returns submitted by him.

Scrutiny of returns: means the process in which the correctness of the returns of the dealers are analysed by the officers of the Commercial Tax Department.

Survey: means the exercises conducted to unearth/detect unregistered dealers.

TDS: Tax deducted at source.

Tax audits: means selection of certain percentage of the dealers for detailed verification of the returns submitted with the books of accounts for assessing the tax payable by them.

Taxable goods: means the goods which are taxable under the State Value Added Tax Acts.

Tax invoices: means the document to be issued by the registered dealers having turnover above a specific amount to a purchaser which shall be serially numbered having prescribed particulars. It should be signed by the dealer and the counterfoil duly signed should be kept with him as a proof of sales made during a particular period.

Tax-paid goods: means the goods/class of goods on which tax is payable only on the first point of sale and all subsequent sales are exempt of tax.

Tax returns: means a return showing the particulars of sales and purchases, tax payable minus input tax credits and other particulars as required to be submitted by a dealer.

Taxpayer's identification number (TIN): means 11 digit unique number to be allotted to each dealer of which the first two digits represent the State code as used by the Union Ministry of Home Affairs while the next nine characters may, however, be different in different States.

Tax information exchange system (TINXSYS): is a website launched by the Government of India to serve as a repository of information on inter-state trade and commerce. Declaration forms issued to the dealers by respective States are to be uploaded in this site which facilitates subsequent verifications by any State, if required.

Uniform floor rate of tax: Tax rates of similar types of goods to be same across the States which ensures fair trade practices and arrests diversion of trade.

VAT: Value Added Tax.

White Paper: is a paper brought out by the empowered committee outlining the various issues relating to implementation and the basic design of the State-level Value Added Tax.



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