CHAPTER VI MISCELLANEOUS PROVISIONS

6.1 Input tax credit

The KVAT Act, as it stood prior to 1 July 2006, provided for ITC on the tax paid for purchase of goods from all registered dealers except presumptive tax and compounded tax dealers, subject to certain conditions. The Government amended the Act to limit eligibility for ITC to the registered dealers liable to tax under section 6 (1) from 1 July 2006. Besides, dealer can deduct from the output tax payable, the purchase tax remitted by him on goods purchased from the unregistered dealers and entry tax paid under the Tax on Entry of Goods into Local Areas Act, 1994 as special rebate.

6.1.1 Provisions governing declaration of details of the selling dealers in the returns

The Dealers can avail ITC solely on the basis of the statement of purchases depicting invoice number, date, TIN of dealers effecting sale, nature of goods, value before and after discount, VAT charged and net amount charged etc. The TIN of the supplier entered in the statement serve as the main criteria for determining eligibility of ITC. We analysed the system of allowing ITC and noticed following deficiencies.

- Purchases from the registered dealers not liable to tax and compounded tax dealers, are not eligible for ITC. Since the registration number assigned to these dealers is also TIN, it is impossible to detect availing of inadmissible ITC on purchase from such dealers from the purchase statement.
- Registration certificate of a dealer registered under the KGST Act was valid only upto 30 June 2005. We noticed during local audit that even during 2006-07, dealers were availing ITC on the strength of statements where they enter KGST registration number of some suppliers instead of TIN. Even the department cannot easily ascertain the correctness of ITC in such cases.

6.1.2 System of cross verification of the records of the selling dealers

As per the system in place, the dealers can avail ITC under the KVAT Act merely on the strength of the purchase list attached to the monthly returns filed by the dealers. They need not attach tax invoices in support of ITC. There was no system to cross check purchase with the sale, to ascertain the correctness of ITC claim. Department introduced e-filing of return for major dealers with effect from 1 April 2008. Consequently, the AAs could cross check ITC claim on purchase from such dealers. At present the AAs can do it effectively as e-filing of returns is mandatory from January 2009

onwards for all dealers. **However, the Government is yet to come out with a guideline stipulating the system and percentage of cross verification to be conducted by the AAs while allowing ITCs.**

6.1.3 Results of scrutiny of assessment records conducted by audit

We also scrutinised selected assessment files at Special Circle and CTO (Works Contract), Thiruvananthapuram to ascertain whether the dealers were complying with the conditions and restrictions specified in the Act, in availing of ITC which was newly introduced under the VAT system and to verify whether the AAs were detecting incorrect availing of ITC during departmental scrutiny. It brought out cases of excess availing of ITC/non-assessment of reverse tax, interest and penal interest thereon amounting to Rs. 1 crore as shown below.

(Rupees in lakh)

Sl. No.	Year	Nature of irregularity	Short levy
Special Circle, Thiruvananthapuram			
1.	2006-07	As per the annual return for the year 2006-07, an assessee availed ITC of Rs. 50.12 lakh towards sales return. But aggregate of ITC as per monthly returns from April 2006 to March 2007 amounted to Rs. 38.62 lakh only. The AA failed to detect the excess claim of ITC and demand excess ITC of Rs. 11.50 lakh and interest and penal interest.	20.47
2.	2006-07	An assessee paid tax of Rs. 30.92 lakh on purchases as per purchase statements attached to the monthly returns. Against this, the dealer claimed ITC of Rs. 34.54 lakh. The AA did not demand Rs 3.62 lakh claimed in excess and interest and penal interest due thereon.	6.45
3.	2007-08	An assessee whose local purchase was Rs. 30.77 crore availed ITC on purchase of Rs. 31.34 crore. The AA failed to make good excess ITC of Rs. 3.50 lakh and levy interest and penal interest thereon.	4.96
4.	A dealer should limit the claim of ITC or its refund to the tax paid in excess of the rate specified in section 8(1) of CST Act, i.e., four *per cent* upto 2006-07 and three *per cent* during 2007-08, if he transfers the goods purchased in the State to outside the State otherwise than by interstate sale or sale in the course of export.		
	2005-06 to 2007-08	Two dealers who effected interstate stock transfer of goods valued at Rs. 7.07 crore and Rs 9.13 crore did not limit corresponding ITC/special rebate to four/three *per cent*. The AA failed to detect this and assess the reverse tax and interest and penal interest thereon.	36.49

Sl. No.	Year	Nature of irregularity	Short levy
5.	Dealer should avail ITC on sales return in the year in which sale is made.		
	2006-07	A dealer claimed ITC of Rs. 38.62 lakh on sales return. This included a credit of Rs. 2.70 lakh pertaining to sales return of vehicles sold during March 2006 (2005-06). The AA failed to detect this and reject the ITC claim and levy interest and penal interest thereon.	4.80
6.	ITC under the KVAT Act shall not be allowed on any tax illegally collected. Collection of tax at a rate exceeding the rate at which a dealer is liable to tax is illegal.		
	2006-07 and 2007-08	ITC availed of by a dealer on purchase of four *per cent* taxable raw materials and capital goods exceeded that computed on the basis of conceded turnover by Rs. 1.06 lakh. The AA failed to detect this and assess the reverse tax, interest and penal interest thereon.	1.78
7.	Input tax availed in respect of goods shall be reversed, if such goods are subsequently used fully or partly for purposes in relation to which no ITC is allowable.		
	2006-07	A dealer who consumed/issued, 12.5 *per cent* taxable goods valued at Rs. 1.13 crore, assessed reverse tax of Rs. 2.63 lakh only against Rs. 14.08 lakh which escaped the notice of the AA.	11.45
	2006-07	A dealer purchased 20 *per cent* taxable goods for Rs. 30.36 lakh and availed ITC of Rs. 6.07 lakh. He did not assess reverse tax on it though he neither sold it nor held it as closing stock which escaped the notice of the AA.	6.07
	CTO (Works Contract), Thiruvananthapuram		
	2007-08	A contractor switched over to compounded tax during 2007-08. But he did not reverse the ITC availed of on material valued Rs. 91.56 lakh, held as closing stock during 2006-07.	7.55

After we pointed out the mistakes, the Government stated that rectification of short levy pointed out in audit is in progress in all cases. We are yet to receive further information on the matter (June 2010)

6.2 Provision for grant of exemption to certain class of dealers

As per the KGST Act, apart from commodities included in the schedule III to that Act, the Government can grant, tax exemption based on the category of purchasers/sellers, turnover, etc., through notifications issued from time to time. The Government rescinded all those notifications on introduction of VAT from 1 April 2005. The KVAT Act limits the exemption

to the goods listed in Schedule I to the Act. Besides, exemption is applicable to turnover of medicine purchased from the manufacturers and first sellers in the State who have opted for payment of the compounded tax on MRP, those dealing exclusively on rationed articles under the Kerala Rationing Order, 1966, sale of goods to developers/industrial units or establishments in the Special Economic Zone in the state (subject to certain conditions) and turnover on sale or purchase made by a dealer through his agent in respect of which tax has been paid by the agent and *vice versa*.

6.2.1 Deficiencies in the provision for exemption on goods taxable at the first point

Goods taxable only at the point of first sale in the state are outside the purview of the KVAT Act and are still governed by the KGST Act. However, medicine for which compounded tax on MRP is paid by the first seller is in effect a first point taxable item.

In the case of medicines, payment of compounded tax by importers and first sellers based on MRP is optional. But, in practice all second and subsequent sellers of medicine are availing exemption on entire turnover of medicines, which was possible only if all the first sellers of medicines in the state exercised option for compounding. But we have come across instances of first sellers not opting for compounded tax. Examples: The Pharmaceutical Corporation Kerala Ltd. (Oushadi), Thrissur (TIN 32080236592), Arya Vaidya Sala, (Kottakal) (TIN 32100224275).

We are of the opinion that the department should publish in their website list of importers/manufacturers in the State who have opted to pay compounded tax on medicines every year to enable the AAs to verify the claims of exemption of subsequent dealers effectively.

6.2.2 Forms for claiming exemption on sale of goods on which tax was paid on MRP

The dealer claiming exemption on medicines subjected to tax on the MRP at the point of first sale should obtain an invoice in form 8H from the selling dealer, which should be kept by the dealer himself for production, if demanded by the AA.

As pointed out in the previous paragraph, all the subsequent dealers in medicines claim exemption showing the entire sales as goods on which tax was paid on MRP. Since it is not mandatory to furnish the copy of form 8H alongwith the returns, there is no scope for the AAs to verify the correctness of the claims without calling for the documents from the dealers.

Returns under KVAT Act are to be treated as deemed to be assessed unless selected for detailed audit (the percentage of which is limited). **Hence department may make it mandatory for the dealers claiming**

exemption to furnish copy of the form 8H alongwith the returns which would make the returns self sufficient and enable cross-verification of such claims, if required subsequently.

6.2.3 Deficiencies in system governing grant of exemption

Works contractors can opt to pay compounded tax based on the whole amount of contract. Under the Act, whole amount of contract shall not include the amount paid to sub-contractors for execution of a portion of works contract provided the latter is a registered dealer liable to tax under the Act and the former filing a certificate in form 20 H[17].

We found that there is no system to ascertain whether the contractor issuing certificate in form 20 H has included the contract receipt of the relevant work in his return and paid tax or whether the sub-contract is for labour element alone which is not liable to tax. For instance, a builder in CTO (Works Contract), Thiruvananthapuram, claimed exemption aggregating Rs. 47.62 crore from the contract receipts during 2005-06 to 2007-08 towards payment to the sub-contractors on the strength of list of payments alone and without form 20 H. The lists included many items of work which were in the nature of labour contract that was not liable to tax under KVAT Act.

The department stated that the assessee had produced form 20 H for a turnover of Rs 10.20 crore for 2005-06. However, forms 20E[18] to prove that tax has actually been paid by the sub-contractor has not been furnished.

We recommend that

- **The Government may consider amending the Act to give more clarity to the provisions on exemptions to avoid evasion of tax.**
- **The Department may ensure before allowing the exemption that dealers strictly comply with conditions prescribed in the Act and Rules.**

6.3 Provisions for cross verification

6.3.1 Deficiencies in the provisions for cross verification

We observed that there was no fool proof mechanism for cross verification of the details of turnover of the dealers with that disclosed by others.

17 Form to be issued by the sub-contractor to the main contractor to prove that a portion of the work is being executed by him on which the main contractor has no liability to pay tax.

18 Form to be issued by the AA of the sub-contractor to the main contractor absolving him of the liability of deducting tax at source from the bills of the sub-contractors and to ensure that tax has been assessed and paid by the sub-contractor in the circle where he is registered.

Though the introduction of compulsory e-filing from January 2009 has opened the scope for cross verification, **the department is yet to come out with a comprehensive mechanism prescribing the modalities for carrying out cross verification during the scrutiny of the returns.**

6.3.2 Absence/deficiencies in the provisions for cross verification of records of other departments/sources like Central Excise & Income Tax Departments, TINXSYS etc.

We noticed that the Act or Rules do not include any provision to cross verify the correctness of turnover with the records of Income Tax (IT) and Central Excise (CE) Departments, etc., though the white paper of the EPC specifically stressed upon this aspect. Also, the Department has not issued any instruction in this regard so far. However, dealers having total turnover exceeding Rs. 40 lakh are required to furnish certified copy of P&L account and balance sheet. But we have noticed largescale non-furnishing of these mandatory documents leaving no room for carrying out any cross verification.

Government stated that Intelligence wing during the course of their investigation routinely check declarations available with revenue department of the Central Government.

We recommend that the Government may insert provisions in the KVAT Act/Rules making verification of records of IT/CE Departments and TINXSYS advisable, while conducting audit assessments/ assessment of escaped turnover. In other cases, Government may prescribe percentage check while scrutinising the returns.

6.3.3 Deficiencies in uploading data in TINXSYS

Tax Information Exchange System (TINXSYS) is a centralised exchange of all interstate dealers spread across various States and Union territories. Apart from the dealer verification, the commercial tax officers can also use the TINXSYS for verification of statutory forms issued under the CST Act by other State Commercial Tax Departments and filed by the dealers in support of the claim for the concessional rate/exemption of tax.

In reply to one of our queries, the department stated that they were directly uploading details of forms under the CST Act to TINXSYS server from headquarters and that they last updated the data on C, F, H forms on 14 August 2009 and that of E 1 and E 2 forms on 8 April 2009.

We made an effort to ascertain the effectiveness of the system by using data collected from C/F forms issued during 2007-08 in Special Circle, Thiruvananthapuram. We could gather the details of the dealers by either entering the CST number or the TIN in the relevant box of the TINXSYS website. However, in the case of form search, when the details of forms

were entered, it displayed a message 'form not found in the field entered form number'.

Besides, we found that the department has not issued any instruction to the AAs to verify the details of the TINXSYS website while finalising the assessments/scrutiny of returns both under the CST Act and the KVAT Act.

The Government stated that online downloading of form is mandatory from January 2010 and downloaded forms get automatically updated in the TINXSYS. Software had been developed and integrated with KVATIS to capture manual statutory form issue details also.

The Department may ensure that the data stated to be uploaded to the TINXSYS is accessible to the users. Also, the Government may issue instructions to the AAs to consult the website while finalising assessments/scrutiny of the returns.

6.4 Tax deduction at source

Any person who awards any works contract to a contractor for execution is an awarder under the KVAT Act. Every awarder shall deduct from every payment, including advance payment made to the works contractors, the tax payable by the contractor on the works contract and remit it to Government on or before fifth day of the month succeeding the month in which they make the deduction. If any awarder effects any payment without deduction of the tax or after making such deduction fails to remit it to the Government account, the awarder shall be liable for the payment of such amount to the Government as if it is the tax due from him.

The KVAT Rule requires that the awarder of work should file a quarterly return in form 10C showing the details of the work awarded every quarter. The Central/State Government departments and Union Territories, local authority and autonomous bodies are required to file quarterly return in form 10F, showing the details of sales, local purchase from registered dealers, interstate purchase, works contract executed, etc.

We found that the department has not installed a mechanism to monitor the receipt of periodic returns from the awarders of works. Also, non-registration of the departments under Central/State Governments have been pointed out earlier. We also found that the department is yet to install a system in the circles to periodically ascertain the number of awarders under them. Due to these deficiencies the department could not effectively monitor the deduction of tax at source and remittance thereof into the Government accounts.

The Government stated that the awarders have to e-file the return with details of works awarded by them and AAs can cross check it with the e-return filed by the contactors. But the fact remains that the awarder

can e-file the return only if they are registered and there is a need for monitoring the e-filing of returns.

We are of the opinion that the Department may install a system of carrying out periodic surveys to detect awarders of work who are not registered and a monitoring mechanism to watch filing of the returns by those who are registered.

6.5 Acceptance and disposal of appeal cases

The DC (Appeals) is the first appellate authority under the KVAT Act whereas it was Appellate Assistant Commissioner under the KGST Act. There were eight DCs (Appeals)[19] during the period of review. Persons aggrieved by the orders issued or proceedings recorded by an authority not above the rank of ACs may appeal against such order to the DC (Appeals).

6.5.1 Deficiency in the provision

The KVAT Act, as it stood prior to 30 March 2007, provided that a dealer should pay entire tax assessed to entertain appeal against best judgment assessment. However, the Government dispensed with this provision thereafter.

We are of the opinion that the Government should review the decision of dispensing the provision. This would ensure registration of the genuine appeal cases only and lessen the scope for evasion/run away cases.

Government stated that in this matter they have to look into hazards faced by dealers in case of huge demands because of arbitrary assessments. We feel that the Government can issue suitable instructions to its officers to be careful while finalising assessments and revive the earlier system of payment of the dues in dispute to safeguard revenue of the Government.

6.5.2 Deficiency in compliance

We called for the details of the disposal of the appeal cases under the KVAT Act. However, only DC (Appeals), Ernakulam provided us the information. On analysis of the data, the following deficiencies were noticed.

- Time limit fixed in the Act for disposal of appeal or revision is one year, after excluding periods of stay. The appellate authority did not dispose within one year 2,098 out of 3,381 appeals filed in that office during 2005-06 to 2007-08.

[19] One at Thiruvananthapuram, two each at Kozhikode and Kollam and three at Ernakulam.

- The CCT in August 2005 had directed that stay petitions should be disposed of within three weeks of their receipt and if stay is granted the appeal should be disposed of within two months from the date of stay order.
- The DC (Appeals), Ernakulam did not dispose of 1,285 out of 1,596 stay petitions filed between 2006-07 and 2007-08 within the time frame of three weeks and did not dispose of 238 out of 311 cases (in which stay orders were passed during the above period) within two months from the date of stay order.

We feel that the Department may install a control mechanism for watching disposal of pending appeal cases and monitor their pace of disposal.

6.6 Deterrent measures

The KVAT Act provides for levy of penalty for commission of offence under the Act and interest and penal interest for short remittance of tax.

6.6.1 Deficiencies in the provisions

We analysed the provisions relating to deterrent measures and found the following deficiencies.

6.6.1.1 Comparison of the figures furnished in the P&L account and balance sheet filed alongwith the certified audit report with those disclosed in the return is the main source for detection of evasion/short levy of tax. We noticed that the dealers (mainly under CTO, III circle, Kannur) having total turnover of Rs. 40 lakh and above for whom filing of audit certificate and P&L account was mandatory, were not filing the same. They remitted the maximum penalty of Rs. 10,000 (due for cases where evasion cannot be quantified), if imposed, and continued the offence of non-submission of the statutory reports. Since the Act is silent about further deterrent measures, the AAs did not take any further action against these dealers.

6.6.1.2 Under the KVAT Rules, if the dealer himself detects omission before initial scrutiny and submits a revised return and if the tax liability increases, he is liable to pay in addition to the balance tax, interest and twice the same as penal interest. But if the AAs reject such return during initial scrutiny and the dealer files a fresh return, the dealer is liable to pay interest only. In every other case where a dealer submits a revised return, rectifying omissions, in response to notices or otherwise, payment of twice or thrice the interest as penalty/penal interest/settlement fee is mandatory. Similar mandatory payment of minimum penalty is not prescribed in the case of best judgment assessments.

Our analysis of the data received from 13 DCs[20] during 2005-06 to 2007-08 indicated that even though the tax liability due to the revised return increased in 5,753 cases after initial scrutiny of the returns, the AAs levied penalty only in 2,775 cases (48.24 *per cent*). Thus, it is evident that the AAs had not levied penalty/penal interest/settlement fee in all the cases in which tax liability had increased consequent to filing of revised returns.

6.6.2 Deficiencies in compliance

An AA can initiate best judgment assessment within five years if short levy of tax has occurred due to escape of turnover from the assessment or on assessment at a lower rate or by availing of irregular ITC/special rebate; the dealer can avoid further proceedings if he pays the balance tax alongwith the interest and thrice the same as settlement fee.

On analysis of the data received from 11 DCs[21], we noticed the following deficiencies.

- Though the AAs issued notice for the best judgment assessment of the escaped turnover in 1,044 cases involving Rs. 27.68 crore during 2005-06 to 2007-08, 736 dealers did not submit revised return. Of these, the AAs completed best judgment assessment in 550 cases, but penalty was levied only in 37 cases. Thus, though the AAs assessed balance tax in 550 cases they levied penalty only in 6.73 *per cent* of the cases, which proved that in majority of cases AAs did not use the discretionary provisions in favour of revenue.
- The KVAT Act as amended with effect from 1 April 2007 stipulates that, if the dealer detects any omission or mistake in the annual return with reference to the audited figures, he could file a revised annual return and if the tax liability increases, he should pay the balance tax, interest and twice the interest as penal interest. We noticed that even in cases where the dealers filed revised return and remitted differential tax and interest, they did not remit the penal interest; neither did the AAs detect the mistake and demanded the balance dues.

We recommend that the Government may rectify inconsistency in invoking penal measures by making specific provision to fix a minimum penalty for first and subsequent offences instead of leaving it to the discretion of the AAs.

Government stated that there cannot be mandatory penalty as it would encourage mechanical levy of penalty. We are of the view that, by making

[20] Idukki, Kannur, Kasargod, Kollam, Kottayam, Kozhikode, Mattanchery, Malappuram, Palakkad, Pathanamthitta, Thiruvananthapuram, Thrissur and Wayanad

[21] Alappuzha, Idukki, Kannur, Kasargod, Kollam, Malappuram, Palakkad, Pathanamthitta, Thiruvananthapuram, Thrissur and Wayanad

the levy of penalty discretionary, the Government is not only making voluntary correction of omissions by dealers less attractive, but also allowing scope for arbitrary levy of penalty by the AAs as pointed out above which is generally not subjected to any further scrutiny.

6.7 Refund

Under the KVAT Act, dealers can obtain as refund, the input tax paid in respect of the purchase of goods sold in the course of export or interstate trade or stock transfer or used in the manufacture of goods for sale/ transfer. But in the case of stock transfer, it is limited to the input tax paid in excess of four *per cent* upto 2006-07 and in excess of three *per cent* during 2007-08. Similarly, if a dealer cannot fully adjust the excess ITC carried over in each return period during the last return period of that year, it should be refunded. Refund under the KVAT Act effected to dealers during 2005-06, 2006-07 and 2007-08 amounted to Rs. 18.45 crore, Rs. 103.69 crore and Rs. 148.61 crore respectively.

Our analysis of the refund process brought out the following deficiencies.

6.7.1 Deficiencies in provisions

Under the KVAT Act, dealers claiming refund of ITC on goods sold/ transferred interstate and goods exported have to furnish proof of interstate sale/export as well as declarations on tax collection from the dealers who collected tax, in addition to other details. However, the corresponding rules for refund of the ITC remaining unadjusted at the end of the year do not prescribe such declaration/proof for payment of tax.

6.7.2 Deficiencies in compliance

During local audit we noticed instances where dealers carried over the ITC remaining unadjusted during the last return period of the year to the next financial year. In CTO, Changanacherry we noticed that though a dealer had obtained refund of Rs. 2.10 lakh for the year 2005-06, he had carried forward credit for the same amount in the annual return of 2006-07 and availed ITC. This mistake was not detected by the AA.

Our effort to verify the refund files of Special Circle, Thiruvananthapuram did not materialise as none of the files of the dealers who had availed of refunds contained monthly/quarterly returns, annual returns and form 13 A/ P & L account.

We recommend that the Government may amend the KVAT Rules to ensure that while sanctioning refund of the ITC, AAs confirm genuineness of the claim by cross checking the purchase invoices.

6.7.3 Refund to the dealers having total turnover less than Rs. 10 lakh

ITC can be allowed only against output tax payable and, no output tax is payable by the dealers having turnover upto Rs. 10 lakh (unless they are importers or casual traders or dealers in gold, silver and platinum group of metals). Such dealers are not eligible for the ITC unless they opt to collect tax and remit the same to the Government. Dealer should exercise such an option by filing an application in form 1F before the AA.

During local audit we noticed instances of the AAs granting the refund of the excess of input over the output tax to the dealers, whose total turnover was less than Rs. 10 lakh and who had not submitted option in form 1F, in few cases. In CTO Nedumangad, the AA granted such refunds aggregating Rs. 1.37 lakh to two dealers who had not even collected tax.

After we pointed out the mistake, the Government stated that the dealers who had opted for collection of tax failed to file option in form 1F due to ignorance, resulting in short levy and that department was taking action to withdraw the amount illegally refunded. The reply is not correct as in these cases the question of option doesn't arise because the dealers had not colleted any tax and hence not eligible for ITC.

We recommend that the Department may ensure that dealers below the assessable limit, who have not filed option to collect tax, do not collect tax and that AA's do not refund ITC to them.

6.8 Claim for compensation of loss of revenue due to introduction of VAT

The Government of India (GOI) agreed to compensate the State Government for the loss of revenue consequent to the implementation of VAT from 1 April 2005 and issued guidelines in July 2005 on the modalities for the calculation of the compensation claims. The compensation allowable was 100 *per cent*, 75 *per cent* and *50 per cent of* such loss during the years 2005-06, 2006-07 and 2007-08 respectively. As per the guidelines, the department should compare the VAT receipts with the revenue of the pre-VAT period; suitably extrapolate it on the basis of average growth rate of revenue of the previous five years. They should deduct, from the total revenue collection for the respective years, tax receipts from the commodities under KGST Act and ITC under VAT adjusted against central sales tax (CST). The resultant net revenue was to be compared with the projected tax revenue for the year to arrive at the loss due to the introduction of VAT. The State Government preferred compensation claim of Rs. 1,000.16 crore, Rs. 396.45 crore and Rs. 218.81 crore for the years 2005-06, 2006-07 and 2007-08 respectively against which the GOI sanctioned Rs. 895.89 crore for 2005-06, Rs. 233.66 crore

for 2006-07 and Rs. 119.78 crore for 2007-08 respectively upto August 2009.

The Report of the Comptroller and Auditor General of India (Revenue Receipts) for the year ended 31 March 2008 contained important audit findings in relation to the VAT compensation claim for 2005-06 and 2006-07. Our analysis of the VAT compensation claim pertaining to 2007-08 revealed the following discrepancies.

Kerala Financial Code, Volume I stipulates that, the department should compare the figures compiled by the controlling officers with the accounts received from the Accountant General and reconcile the difference before the accounts of the year were closed.

The GOI allowed VAT compensation on the basis of figures certified by the Accountant General. The department had booked figures of Rs. 1,016.21 crore and Rs. 3,334.96 crore under CST and KGST for the year 2007-08. However, as per the figures collected by the CCT from the field offices the total CST collection for the year was Rs. 222.62 crore and in respect of seven dealers[22] of KGST the collection was Rs. 3,995.73 crore. This proves that the department was aware of the fact that the figures booked were unrealistic. In spite of this, the department did not undertake any effort to reconcile the differences. As stated in paragraph 2.5, we have detected misclassification resulting in excess accounting of Rs. 753.27 crore and Rs. 187.39 crore under CST and KVAT respectively and short accounting of Rs. 932.31 crore under KGST for the year. Excess accounting of KVAT of Rs. 187.39 crore resulted in short demand of VAT compensation from Central Government by Rs. 93.69 crore (50 *per cent* of Rs. 187.39 crore).

Scrutiny of the figures booked under various Minor Heads of Account 0040, revealed that the Forest Divisions were remitting the KVAT collected by them under the KGST resulting in reduction in figures of the VAT collection. Amount incorrectly remitted by 48 Forest Divisions aggregated Rs. 3.57 crore resulting in excess claim of compensation of Rs. 1.78 crore.

Payment of VAT compensation shall be contingent upon the States complying with the designs of the VAT as finalised by the EPC as per GOI's notification governing the VAT compensation. Measures adopted during 2005-06, 2006-07 and 2007-08 which had the effect of depressing VAT revenue during those years shall not be considered for the purpose of compensation.

Depression in revenue occurred due to the deviations from the VAT design indicated in Sl. Nos. 1 and 4 in the tables under paragraph 6.9.1 viz., reduction of rate of tax on used vehicle to 0.5 *per cent* and one *per cent* excess grant of ITC on the consignment sale/stock transfer of the goods

[22] Bharath Petroleum Corporation, Hindustan Petroleum, Indian Oil Corporation, Indo Burmese Petroleum, Kerala State Beverages Corporation, Kerala State Co-operative Consumer Federation and Reliance Industries Limited.

outside the State respectively. The department did not include the above deviation and consequent depression of VAT revenue in the list of deviations enclosed to VAT compensation claim. As the actual shortfall in revenue on this account was not available, even we could not quantify the excess demand of VAT compensation.

Under the KVAT Act, the AAs can adjust refund due under the KVAT against arrears due under the KGST and CST Acts. Such adjustments would have impact of boosting the actual collection under the KVAT. The department failed to deduct the total amount so adjusted, from the collection under the KVAT to arrive at the figures for the VAT compensation. As the amount so adjusted was not readily available, ascertaining the short demand of VAT compensation on this account was not possible.

6.9 Other points of interest

6.9.1 Deviation from VAT design approved by the EPC

The prime objective of the VAT design in 'the white paper on state level value added tax' issued by the EPC was implementation of a uniform floor rate of tax across the country. Under VAT system covering about 550 goods, about 46 commodities comprising natural and unprocessed products in unorganised sector which are legally barred from taxation and items which have social implications were listed under exempted category. Of these, 36 commodities were to be common for all the States and individual States were allowed the flexibility to choose a maximum of 10 commodities from a list of goods finalised by the EPC. Under four *per cent* VAT rate category, 270 commodities were included to be common for all the States comprising of items of basic necessities such as medicines and drugs, all agricultural and industrial inputs, capital goods and declared goods. Remaining commodities common for all states were to fall under general VAT rate of 12.5 *per cent*. The white paper stipulated that whenever a deviation is reported from the uniform floor rate, the EPC should take up the matter with the concerned State and Government of India for rectification.

We found that the State deviated from the VAT design and fixed tax on 53 commodities at a rate lower than uniform floor rate prescribed by the EPC. The State included three 12.5 *per cent* and 15 four *per cent* taxable commodities in the exempted category. In one case each, the State fixed tax at 0.5 *per cent* and one *per cent* for a 12.5 *per cent* and four *per cent* taxable commodity. In the remaining cases they included, 12.5 *per cent* commodities in Schedule III pertaining to four *per cent* taxable items. We have included details in Annexure - II.

Following are some instances where unintended loss/short levy of tax occurred due to deviation from the VAT design. The KVAT specified, tax

rate of four *per cent* against floor rate of 12.5 *per cent* in VAT design for items at serial number 1 and 2.

Sl. No.	Commodity	Nature of deficiency
1.	Used motor vehicles	With effect from 24 April 2007, the tax on used motor vehicle was reduced from four *per cent* to 0.5 *per cent* without concurrence of the EPC. The Act does not exclude even used vehicles that have not suffered any tax in the state earlier such as those purchased from other States and delivery vehicles (Tax paid availed as ITC). Tax forgone during 2007-08 in respect of a dealer in Special Circle, Thiruvananthapuram alone amounted to Rs. 44.30 lakh.
2.	Bakery products, sweet, confectionery, etc., if sold in unregistered brand name	Large manufacturers having branded products are availing the benefit of reduction by not registering some of their products or resorting even to cancellation of existing registration. A dealer in Special Circle, Thrissur cancelled the brand name registration and avoided tax of Rs. 82.04 lakh during 2005-06 and 2006-07.
	Government stated that they would examine the case. We are yet to receive further information on the matter (June 2010).	
3.	On stock transfer/consignment sale of goods outside the State, the KVAT Act allowed input tax paid in excess of three *per cent* as ITC during 2007-08 instead of four *per cent* stipulated in VAT design. i.e., input credit of one *per cent* in excess of that fixed by the EPC. Consequently revenue may decrease substantially. Revenue forgone in respect of two cases mentioned in Sl. No. 4 of the table under paragraph 6.1.3 worked out to Rs. 3.58 lakh.	
4.	The VAT design provided for abolition of other taxes such as turnover tax, surcharge, additional salestax, etc. But Kerala Finance Act 2008 introduced the following tax proposals with effect from 1 April 2008 on commodities covered by the KVAT Act. (1) Social security cess at one *per cent* of the tax payable under the KVAT Act on goods other than the declared goods. (2) Surcharge at the rate of 10 *per cent* of tax, in the case of national and multinational companies functioning in the State as retail chains or direct marketing chains, who import not less than 50 *per cent* of their stock from outside the state or country and not less than 75 *per cent* of whose sale are retail business and total turnover exceeds Rs. 5 crore per annum, on goods other than declared goods.	

When we pointed out these cases, the department stated in respect of Sl. No. 3, that white paper was not a binding document as far as the financial autonomy of the State is concerned and that the Central Government would compensate the revenue loss. The reply is not tenable as loss occurred due to retention of words "in excess of the rate specified under subsection (i) of section 8 of Central Sales Tax Act, 1956" instead of "in excess of four *per cent*" in relevant provisos of KVAT Act during 2007-08. Department could not produce any evidence to prove that it was a conscious decision and not an omission. Also, it is evident from the reply of the department that the State was claiming VAT compensation from Central Government

even for depression in VAT revenue due to deviation from VAT design, in contravention of condition for VAT compensation.

We recommend that the Government may analyse the above deviations and make amendments to ensure that dealers do not misuse the lacuna therein at the cost of the State/Central Government.

6.9.2 Compounding of gold

The KVAT Act permits dealers in ornaments or wares or articles of gold, silver and platinum group of metals to opt for the payment of compounded tax from 1 July 2006, under which, the tax payable during the first year of option was 200 *per cent* of the highest tax payable during any of the preceding three years. But compounded tax for those who commenced business after 1 April 2006 was 150 *per cent* of the average monthly tax payable, from the commencement of business. Thus, while the former is required to pay compounded tax at 200 *per cent* of the highest tax payable the latter has to pay compounded tax based on 150 *per cent* of tax collected during the initial period of business when sales turnover will be normally low.

6.9.3 Other deficiencies in the Rules

6.9.3.1 Dealers can avail credit of the input tax paid on the goods involved in export, interstate sale/stock transfer either as ITC or as refund. In the case of refund of the ITC, the AAs are required to conduct thorough scrutiny of the records to confirm the genuineness of the transaction before refund. But these dealers could avail of ITC which do not call for thorough scrutiny. Hence, the above category of the dealers who have output tax on intrastate trade can escape thorough scrutiny if the claim is within the limit of his output tax liability.

After we pointed out the anomally, the Government stated that prescription of thorough scrutiny before grant of refund due to probable loss of revenue does not mean that other files should escape process of scrutiny. However, we noticed that due to non-prescription of checks to be done in the latter case, most of the AAs are admitting ITC claim on self assessment returns of such dealers without any scrutiny.

6.9.3.2 KVAT Act stipulates that the sale price is inclusive of any sum charged for anything done by the dealer in respect of the goods or services at the time or delivery thereof. In the case of works contract, the Supreme Court held[23] that since the taxable event is the transfer of property in goods involved in the execution of a works contract and the said transfer of property in such goods takes place when the goods are incorporated in the work, the value of the goods which can constitute the measure for the

[23] Gannon Dunkerly & Co. and others Vs State of Rajasthan and others ((1993) 88 STC 204) (SC).

levy of the tax has to be the value of the goods at the time of incorporation of the goods in the work. Provisions relating to works contract under KVAT Rules inserted with effect from 24 April 2007 do not restrict deduction towards labour charge to that incurred during or after incorporation to work. This is against the spirit of the Act and decision of the Apex Court.

We recommend that the Government may examine these provisions and amend the Act/Rules to rectify the deficiencies pointed out.

6.9.4 Clarification by the CCT

Rules of Interpretation of the Schedules stipulate that those commodities which are given with HSN number should be given the same meaning as in the Customs Tariff Act, 1975. If any inconsistency is observed between the meaning of a commodity without HSN number and the meaning of a commodity with HSN number, the commodity should be interpreted by including it in that entry which is having the HSN number. The KVAT Act empowers the Commissioner to issue clarification if any dispute arises regarding the rate of tax of a commodity.

We found that the following clarification issued by the CCT were not consistent with the Rules of Interpretation of the Schedules.

- PVC doors and windows and their frames, threshold (HSN 3925.20.00), shutters, blinds and similar article and part thereof (HSN 3925.30.00) are taxable at 12.5 *per cent* under Sl. No. 29 (1) (a) & (b), PVC profiles (channels) with or without hole is taxable at four *per cent* under Sl. No. 99 (1) (l0) (iii). The CCT in May 2007 had clarified that PVC panels, sections and frames, door panel and ceiling panels without fabrication are PVC profiles of the latter category. The clarification was incorrect as Sl. No. 99 relates to pipe and pipe fittings and the Act specifically include parts of doors and windows in former category, taxable at 12.5 *per cent*.

After we pointed out the anomally, the Department stated that the clarification is applicable only to the sample products produced by the applicant. But we found that those selling PVC doors and windows in unassembled form availed the benefit of this clarification, instance of which have been included in paragraph 2.4.11 item 3 of the Audit Report (Revenue Receipts) (Volume I) of the Comptroller and Auditor General of India for the year ended 31 March 2009, Government of Kerala.

The Government may review CCT's instruction and issue orders with retrospective effect, so that cases where lower rates were applied in view of the instruction can be reopened.