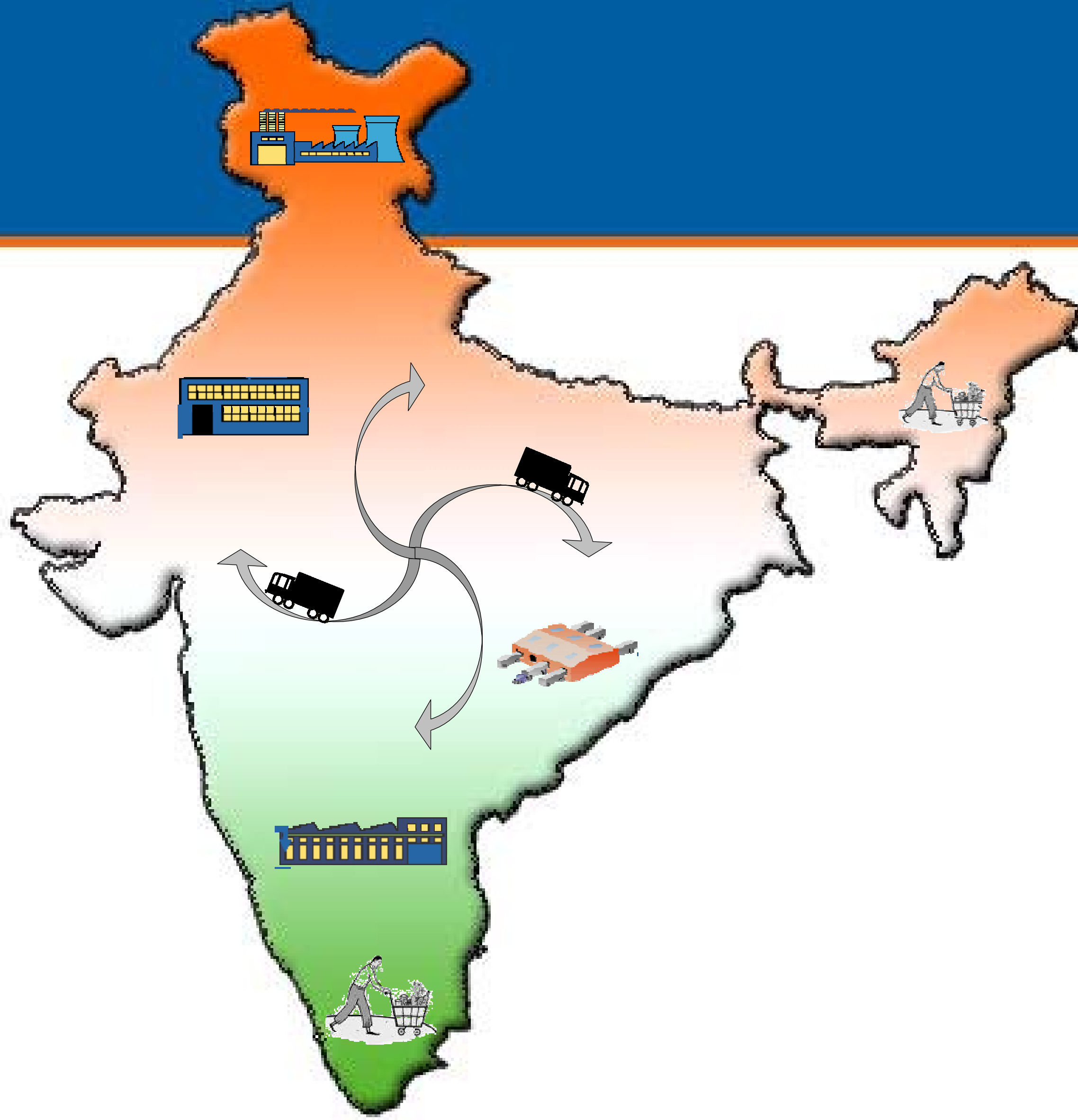
ENAM Securities
India Research

GST: A Primer



Creating a borderless domestic market

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Executive summary

- **GST is the most ambitious indirect tax reform in India attempted ever and will create one "borderless domestic market". It will tax "consumption" as against "production"** which is the current norm**.** A **uniform rate will be imposed on a product only once, at the point of its supply, thus reducing the cost for consumers**

- **Key benefits: If GST is implemented sans too many exemptions and with a single rate:**
  - **Macro**: Successful pan-India implementation **will add ~1-1.7% to the GDP and will boost Tax/ GDP ratio**
  - **Micro** : **On Consumer**: **Incidence of tax will come down in case of manufactured goods**. However, in case of **services the incidence** and coverage **of tax may rise resulting in higher prices**
  - **Industry**: Volume growth will accrue as incidence of taxation is minimized. Also, supply chain efficiencies will accrue as there will be no need for multiple depots and warehouses
  - **Likely beneficiaries**: **Auto, FMCG, Logistics**

- **Roll-out of GST: Apr 2011 seems more likely as the current dithering owes to :**
  - **Clarity on rate of GST**: 12-18?
  - **Revenue Neutral Rate**: States need to be compensated for revenues of at least ~Rs 2.9 trn while centre needs ~ Rs 2.3 trn
  - **States losing their sovereign right to tax goods** despite getting the right to tax services
  - **Lack of enabling constitutional amendments and backbone IT infra** for a simultaneous nation-wide launch

- **GST is not just VAT + Service tax, but an improvement over the previous VAT and disjointed services tax:**
  - **Will remove cascading effect of taxes** and include comprehensively more indirect Central taxes and integrate goods and services taxes for set-off relief, but also capture certain value addition in the distributive trade
  - A continuous chain of set-off from the original producer's point and service provider's point up to the retailer's level would be established which would eliminate the burden of all cascading effects, including the burden of CENVAT and service tax

Manufacturing prices to come down but services to get costlier

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Dual GST
e.g. 8% - State GST
8% - Central GST

Manufactured Goods	Services
Existing Rate: 20%+	Existing Rate: 10.2%
GST: 12-16 %?	GST: 12-16 %?

However, prices may rise in the services segment as the rising tax burden will be a pass through

Sectoral impact

Industry	Impact and points for consideration
Manufacturing	Overall likely to be positive – rate reduction and supply chain gains (*see slides 18-20 for details*)
❑ Auto, Logistics ➡	**Positive.** Overall incidence of tax will come down enabling volume gains
❑ FMCG, Retail, Media ➡	Significant reduction in tax rates, supply chain gains over a period of time
Real estate	❑ Sale/ Transfer may be kept outside the purview of GST ❑ Commercial leasing should attract GST
Hospitality	Would attract GST, luxury tax to be subsumed
Aviation	Would attract GST, additional cost if ATF kept outside the purview of GST
Infrastructure	❑ No discussions yet on existing exemptions for roads, power projects, etc. ❑ Output (e.g. toll collections, power charges, etc.) likely to remain outside the GST net, at least to begin with

What's in it?

- **Consumer:**
  - Reduction in incidence of tax on manufactured goods
  - But services may become costlier
- **Government:**
  - Increased tax collections due to wider tax base and tax/ GDP ratio
  - Efficient administration: Reduction in number of taxes at Central and State level
- **Business:**
  - Reduction in cascading effect of multiple taxes will lead to volume gains
  - Decrease in effective tax rate of many goods
  - Supply chain efficiencies: No need for multiple warehouses/ depots
- **Will GST impact shareholder value? Should be neutral for businesses but:**
  - Administrative burden for management of regulatory changes
  - Non-deductible GST
  - Non-tax payers
  - Pre-financing

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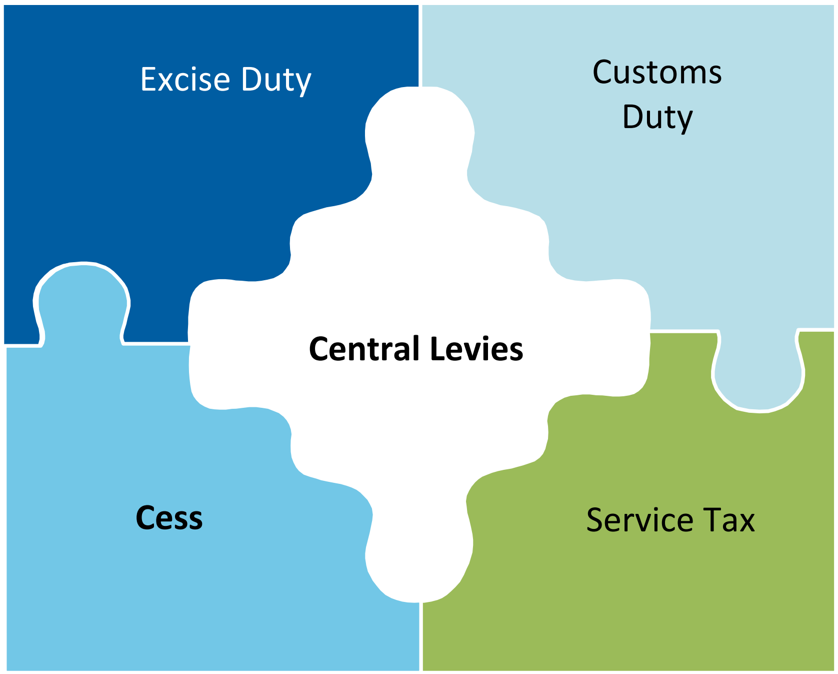
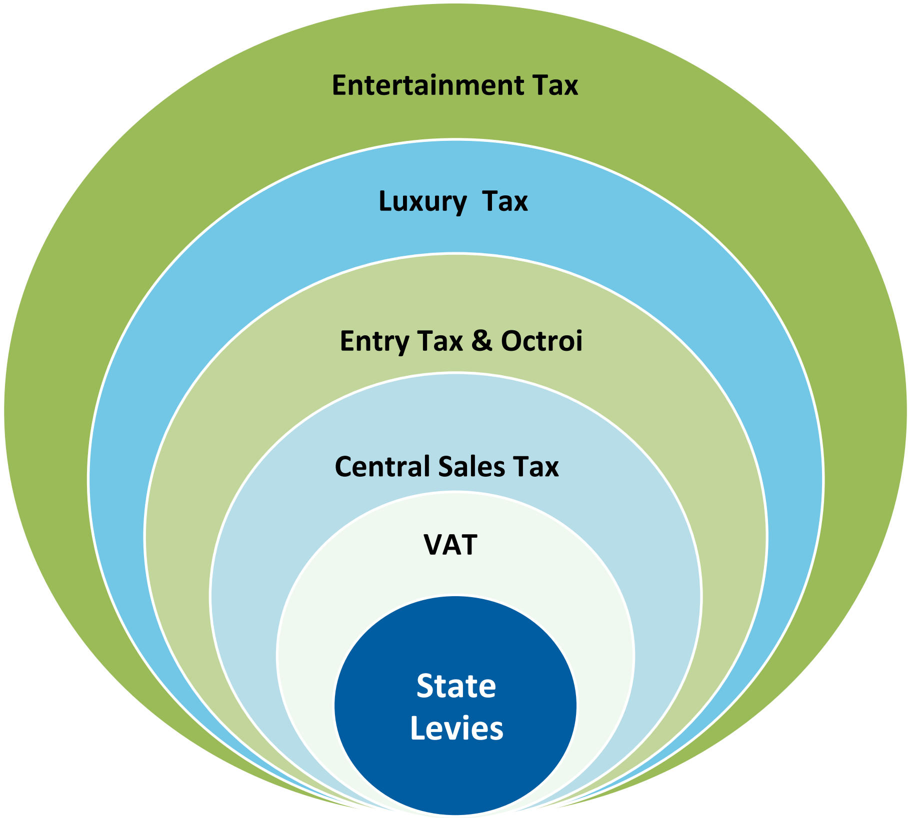
Slide No.

Plethora of central & state levies…





… problems with Cenvat & revenue leakages prompted the need for GST

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- **Several indirect taxes at Central and State level, multiple taxes leading to cascading effect and complexity in compliance. The introduction of Central VAT (CENVAT) removed the cascading burden of "tax on tax" to an extent by providing a mechanism of "set off" for tax paid on inputs and services up to the stage of production**
- **Similarly, the introduction of VAT in the States removed the cascading effect by giving set-off for tax paid on inputs as well as tax paid on previous purchases**
- **But both the CENVAT and the State VAT have certain problems:**
  - Tax on tax in current Central Excise and State VAT mechanism
  - No harmony in VAT rates on similar commodities from one State to another
  - CENVAT credit & VAT input tax set-off not comprehensive due to restrictive provisions
  - Break in credit chain in Inter-State transactions

CENVAT
- Value addition below the stage of production was excluded
- Several taxes like addl Excise and Customs Duty, Surcharges etc were not included

State VAT
- CENVAT load on goods has not been removed, resulting in a cascading effect
- Taxes such as Luxury tax, Entertainment tax etc have not been subsumed

Plethora of problems kept the benefits of comprehensive input tax service tax set-off out of the reach of manufacturers/ dealers and led to complexity in compliance due to multiple taxes

I: How will it work?

A host of taxes to be subsumed in GST

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GST

Central Levies	**State Levies**
Central Excise, Addl Excise duty	Value Added Tax
Service Tax	Entry Tax (not in lieu of Octroi)
Additional Customs Duties	Entertainment Tax
Central Sales Tax	Luxury Tax
Addl Customs Duty, or CVD	Tax on lottery, gambling etc.
Special Addl Customs duty (SAD)- 4%	Cesses and surcharges
Surcharges	
Cesses	

Toll Tax, stamp duty, passenger tax, road tax Royalty, Electricity Duty, Purchase Tax and local are not included in GST. Currently there are 330 exemptions in the CENVAT and 99 by states in their VAT list. The govt may still have a list of 50 despite pruning down

Features of Proposed Structure

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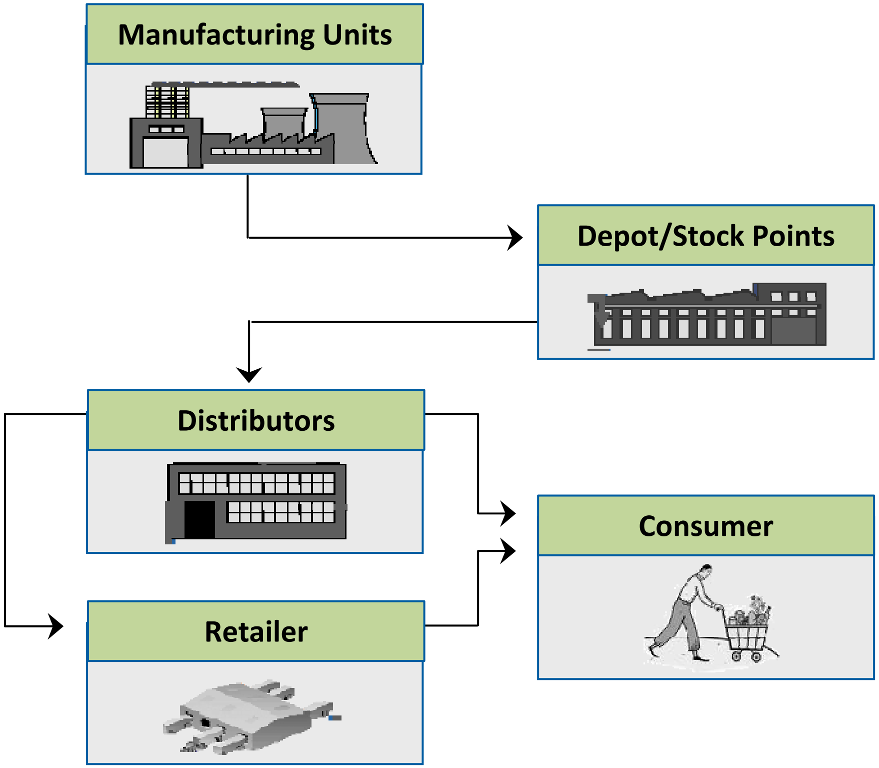
- **Basic Structure**
  - Dual GST comprising Central GST (CGST) and State GST (SGST) to operate concurrently on supply of goods and services for consideration
  - Taxable event of 'supply' as against manufacture (Excise) and sales (VAT)
- **Coverage**
  - Identified taxes to be subsumed in GST
  - Alcohol and most Petroleum products to be outside GST
  - Tobacco products to be part of GST with non-creditable levy besides GST
  - Imports would be subjected to GST on destination principle
  - SGST on import to be levied by the State where goods & services get consumed
- **Thresholds**
  - SGST: INR 1 mn for goods and services
  - CGST: INR 15 mn for goods and 'to be' decided for services
  - For dealers with annual turnover of goods & services not exceeding INR 5 million, option of concessional tax rate of 0.5% or more under composition scheme
  - Rates: Still uncertain
  - Lower rate on necessary items & goods of basic importance
  - Aggregate standard rate of SGST and CGST could be between 12 and 18%

Features of Proposed Structure Contd…

- **Input tax Credits (ITC)**
  - Credit of tax paid under CGST, SGST and Integrated GST (IGST)
  - Cross utilization of CGST and SGST credit not permitted except under IGST
  - Refund of unutilized accumulated ITC expected in situations of exports, purchase of capital goods and where input tax rate is higher than out put tax rate
- **Exemptions/ benefits**
  - Tax exemptions under Special Industrial Area scheme to continue by way of ‘refund’ mechanism
  - Exports and supplies to SEZ processing area to be zero rated
  - List of exemptions likely to get truncated
  - Limited flexibility to States to exempt goods of local importance
- **Inter-state transactions to be covered under Integrated GST (IGST) model**
  - IGST would be aggregate of CGST and SGST
  - Centre would levy IGST on all inter-state transactions
  - Inter-State seller will pay IGST on its value addition after adjusting credit of CGST, SGST and IGST on inputs
  - The inter-State purchaser may use the credit of the IGST paid on his purchases to discharge the liability of output tax i.e. CGST / SGST / IGST

Fiscal costs: Key determinant of supply chains



Investments in Tax Havens

- Sales Tax / VAT Exemptions
- Sales Tax / VAT Deferrals
- Income Tax Exemptions

Differential Tax Considerations

- CST VAT tradeoff
- Low /Negligible VAT
- Partial Set offs for Input
- Multiple tax costs for movement of goods

The entire supply chain strategy of corporates currently is geared to gain fiscal benefits/ avoid taxes instead of efficiencies. This is set to change and the need for multiple warehouses/ depots will be eliminated

Grey Areas

- **Operational glitches**
  - Necessary items chargeable to lower rate and exempted items
  - Treatment of Stock transfers & 'job work'
- **Tax on services:**
  - Elaborate 'Rules of Supply' for inter-State services detailing time and place
  - Having a negative list of services which are not taxed
  - Determination of 'base' for computing CGST & SGST - Valuation in case of 'MRP'/ 'tariff value' products
  - Removal of Concessional Forms
  - Common Approach – Common law, common assessment procedure and a common return
- **Formulating transitional provisions with a Uniform tax dispute settlement system Harmonize Central and State machineries**
- **Integration and IT enablement to check revenue leakage & improve compliance level**
- **Dealing with accumulated tax credits under existing law**

#Sec II : Impact – macro & micro

Revenues foregone by govt may flow back gradually

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Tax & Revenues

Indirect tax

- A singular tax rate will raise centre's revenues by ~1%
- Leakages will be plugged
- Overall price levels will come down in the LT. However, prices tend to rise in the ST
- Could dramatically enhance volume growth for corporates

Direct Tax

Direct Tax Code

- Will bring about simplicity and stability to the tax regime and shield it from annual tinkering
- Will weed plethora of exemptions etc (Ref revenues forgone table below)
- Buoy overall revenues

Revenues forgone: Direct tax code and GST could enable huge savings

(Rs bn)	2007-08	% of total taxes	2008-09	% of total taxes
Corporate tax	622	11	689	11
Income-tax	381	6	396	7
Excise	875	15	1,283	21
Customs	1,536	26	2,258	37
Total	**3,413**	**58**	**4,625**	**76**

Source: Various IMF and MoF reports

GST implementation to add ~ 1-1.7% to GDP

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Impact on macro variables

(USD mn)	2008-2009	Lower band	Higher band
GDP	10,907	95	186
Export	1,687	54	107
Import	2,878	69	136
Net Export	(1,191)	(10)	(19)

Source: NCAER, Task Force papers

Segmental impact

% chg	Lower band	Higher band
GDP	0.87	1.7
Export	3.22	6.34
Import	2.39	4.71
Net Export	0.83	1.63
Output	0.32	0.64
Real Returns to Land	0.42	0.82
Real Returns to Labour	0.68	1.33
Real Returns to Capital	0.37	0.74

Agri & Services sector prices may go up

Manufacturing: Tax paid by consumer to come down

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	Under VAT (Rs)	Under GST (Rs)
Cost of production	**2,000**	**2,000**
Add: production margin profit	150	150
Manufacturer basic price	2,150	2,150
Add: Central Excise Duty @ 8%	172	0
Add: Central Sales Tax @ 2%	43	0
Add: Central GST @ 8%	0	172
Add: State GST @ 8%	0	172
add: VAT	295	0
Total Price of the Manufacturer	**2,660**	**2,494**
Invoice Raised by the Manufacturer	2,660	2,494
(B) Dealer to Final Consumer		
Cost of goods to the Dealer	2,660	2,494
Add: profit margin @ 20%	532	499
Dealer basic price	3,192	2,993
Add: Value Added Tax @ 12.5%	399	0
Add: Central GST @ 8%	0	240
Add: State GST @ 8%	0	240
less: VAT credit	295	
less: GST credit		344
Invoice Raised by the Dealer	3,296	3,128
Total tax incidence on consumer	**614**	**479**
Paid by:		
Manufacturer	510	344
Dealer basic price	104	135
	614	**479**

Automobiles: Favourable impact

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- **Total indirect taxes currently at 22-23%, hence likely to see a 4-6% saving**
  - With GST there is a likelihood of 4-6% savings for the final consumers.
  - We expect OEMs to pass on the benefit of lower taxes (at least partially) to induce higher volumes.
- **Will also result in lower warehousing costs for OEMs, thereby reducing the inventory days in the system**
- **However, impact on companies with Excise free plants remains unclear**
  - Hero Honda, Bajaj, Ashok Leyland, Tata Motors have a sizeable portion of total production from tax free locations.

Illustration: Automobiles

A) Manufacturer to dealer	Under VAT (Rs)	Under GST (Rs)
Cost of production	1000	1000
Add: production margin profit	120	120
Manufacturer basic price	1120	1120
Add: Central Excise Duty @ 8%	89.6	0
Add: Central Sales Tax @ 2%	24	0
Add: VAT @ 12.5%	140	
Add: Central GST @ 8%	0	90
Add: State GST @ 8%	0	90
Total Price of the Manufacturer	**1374**	**1299**
Tax Component in Price to Final Consumer	**254**	**179**
Tax as a % of final price	**18%**	**14%**
Tax a % of Manufacturer's basic price	**23%**	**16%**

FMCG: Lot of positives

- **Tax rate (includes excise, VAT, entry tax) for most FMCG companies at 23% - 28% on Ex factory price**
- **GST regime has 2 benefits – Potential price reduction and Supply Chain cost reduction**
  - In a 16% GST Scenario, retail consumer prices could be reduced by 6%. This does not include the saving on 4% VAT levied on input cost
  - Companies had extensive warehouse network to avoid CST. Thus a consolidation of supply chain could yield 2% savings
- **Grey Area: Companies that gain from manufacturing in excise free zone, may have to pay higher taxes under the new GST regime**
  - Thus companies paying low excise tax (e.g. Dabur & Marico) will have minimal benefit from moving into GST regime. However there are proposals to protect such incentives though cash refunds
  - Cigarette prices could increase by 3-5%, as excise duty is unlikely to be subsumed

	Current Scenario		GST Scenario I		GST Scenario II	
		Rs		Rs		Rs
Ex Factory Price		**100**	-	**100**	-	**100**
CENVAT (or Excise duty)	8%	8	14%	14	16%	16
Entry Tax	3%	3	-		-	-
Landed Cost to C&F		**111**	-	**114**	-	**116**
Value added (i.e. margin)	3%	3	3%	3	3%	3
VAT	12.5%	14	14%	2	16%	3
Landed Cost of Distributor		**129**	-	**120**	-	**123**
Value added (i.e. margin)	5%	6	5%	6	5%	6
VAT (net of credit)	12.5%	3	14%	1	16%	1
Landed cost for Retailer		**138**		**127**		**130**
Value added (i.e. margin)	12%	17	12%	15	12%	16
VAT (net of credit)	12.5%	2	14%	2	16%	3
MRP to Consumer		**157**	-	**145**	-	**149**
MRP price could fall by		**-**	-	**9%**	-	**6%**

Note: Assuming the product is manufactures in one state and sold in another state through the company Depots

Excise % of gross sales (FY09)

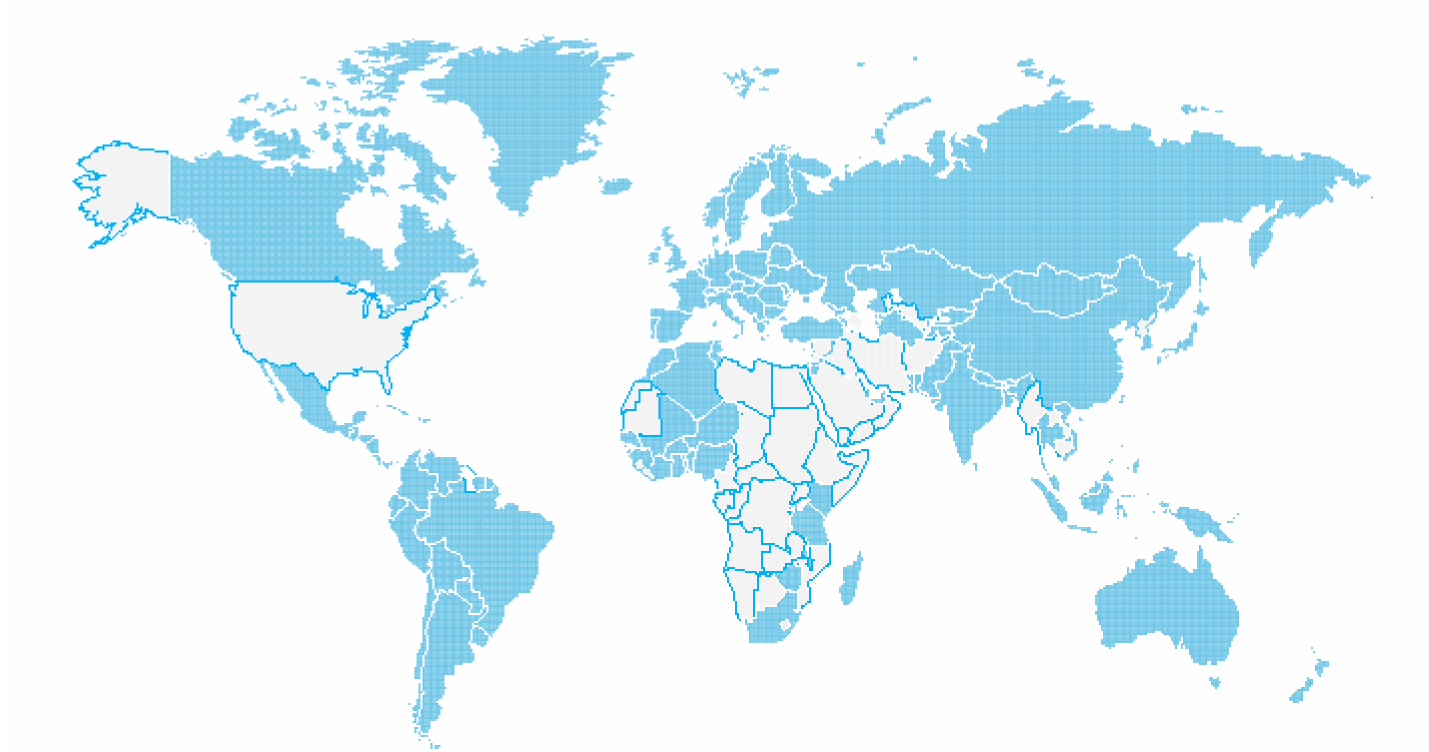
ITC	36%
Glaxo Cons.	9%
Asian paints	9%
HUL	7%
Colgate	3%
Nestle	3%
Jyothy	3%
Godrej Cons.	3%
Dabur India	1%
Britannia	1%
Marico	0%
Tata Tea	0%

Impact on industry

Sourcing	Procurement patterns may have to change
Distribution	Multi-level GST may need restructuring of distribution levels
Warehousing	Move towards efficiency based Regional warehousing
Accounting	Documentation & record keeping requirements would increase
Pricing	Pricing strategies may have to tweaked in Auto, FMCG, Retail, Media etc
Inventory Control	Cash flow impact would need to be examined
Systems	IT/ ERP systems need to be updated

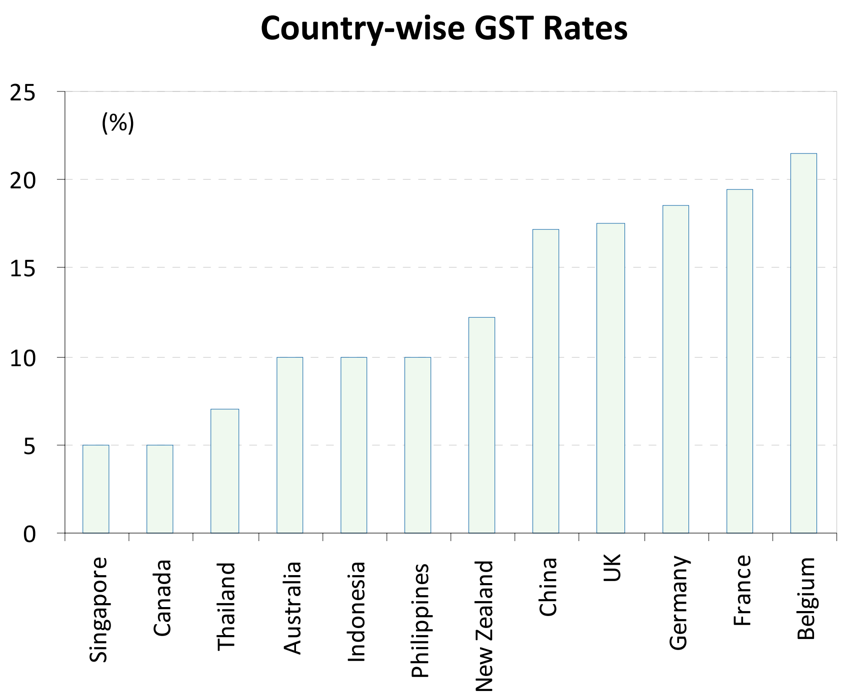
#Sec III: Global experience

VAT & GST footprint

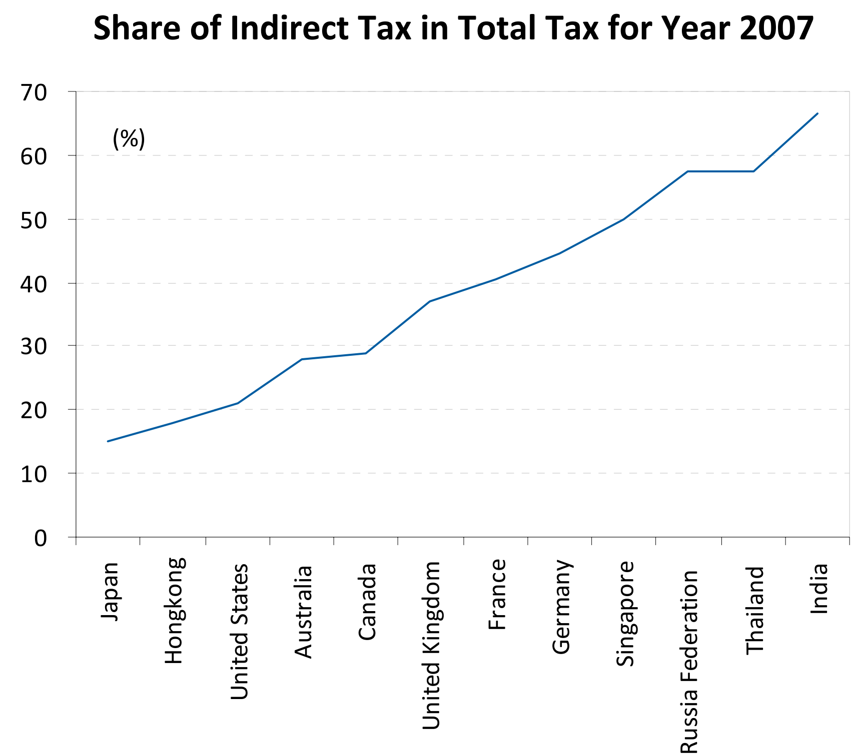


- VAT & GST are levied in > 90 countries
- Very established in Europe, relatively young in Asia & developing world
- Large part of government tax revenue in G20, particularly around Asia
- India’s GST experiment will be unique as no country has levied it on banking & financial services as of yet

Wide range of rates, but higher importance



Source: various web sites



Source: Government Finance Statistics, IMF, September 2009

Global lessons?: It's a WIP everywhere

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- **European Union (1967 to date):**
  - Constant evolution of rules
  - Companies applied lessons learnt in countries with VAT, to those that introduced VAT anew
  - Cross border reporting continues to be problematic
- **Canada (last 10 years): Closest to India**
  - Like India, history of federal tax collection alongside state tax collection
  - Moving slowly from dual GST to harmonized/single GST
  - Effective use of technology benefits taxpayers and tax authorities
  - Changes raised transition challenges – the early preparers came off best
- **Australia in 2000:**
  - Like India – move from many Indirect Taxes to GST
  - Transition/grandfathering rules caught many businesses out
  - Early preparers came off best
  - Nearly 10 years on – settled system; many taxability/credit entitlement issues remain
- **China:**
  - Top-down introduction for taxpayers to VAT – legislation published 10 days before go-live date, chaotic
  - Compliance plagued by inefficiency, continues to be transformed by technology
  - Moving towards unified VAT system (currently separate VAT on goods, Business Tax on services)

… global lessons?

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- **Malaysia:**
  - GST on the table since 2005, put off several times
  - In lieu of Sales Tax and Service tax system
  - Industry groups negotiating treatments/processes on behalf of all businesses affected
- **Singapore from 1994:**
  - Culture developed of good compliance being the norm
  - Strong incentives for export companies
  - Real focus on simplifying compliance (no reverse charge even though legislative framework allows for it)
  - Moving towards internal controls framework – rewards those that use technology and have good GST management processes

Appendix

Revenues to be subsumed in GST

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Revenues from central taxes to be subsumed in CGST

Nature of tax (Rs bn)	Non-SIN goods	POL	Tobacco	Total
CVD	535	52	0	587
Union Excise duties	529	602	103	1,234
Service tax	513	0	0	513
Total	**1,577**	**654**	**103**	**2,334**

Revenues from State taxes to be subsumed in SGST

(Rs bn)	Total
Stamp Duty	385
Taxes on Vehicles	155
Taxes on Goods & passengers	67
Taxes on Duties and Electricity	92
Sales Tax/ Vat (Incl. CST and Purchase tax)	1,817
Entertainment Tax	11
Entry taxes not lieu of Octroi	39
Other Tax and duties*	26
Total	**2,592**

Source: NCAER, Task Force papers

** This includes taxes on lottery , betting, luxury tax, cesses and surcharges by states*

Exemptions

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- **Purchase tax: Being discussed by GoI**
- **Tax on items containing Alcohol: Exempt**
- **Tax on Tobacco products: Tobacco products would be subjected to GST with ITC. Centre may be allowed to levy excise duty on tobacco products over and above GST with ITC.**
- **Tax on Petroleum Products: Exempt**
- **Threshold limits**

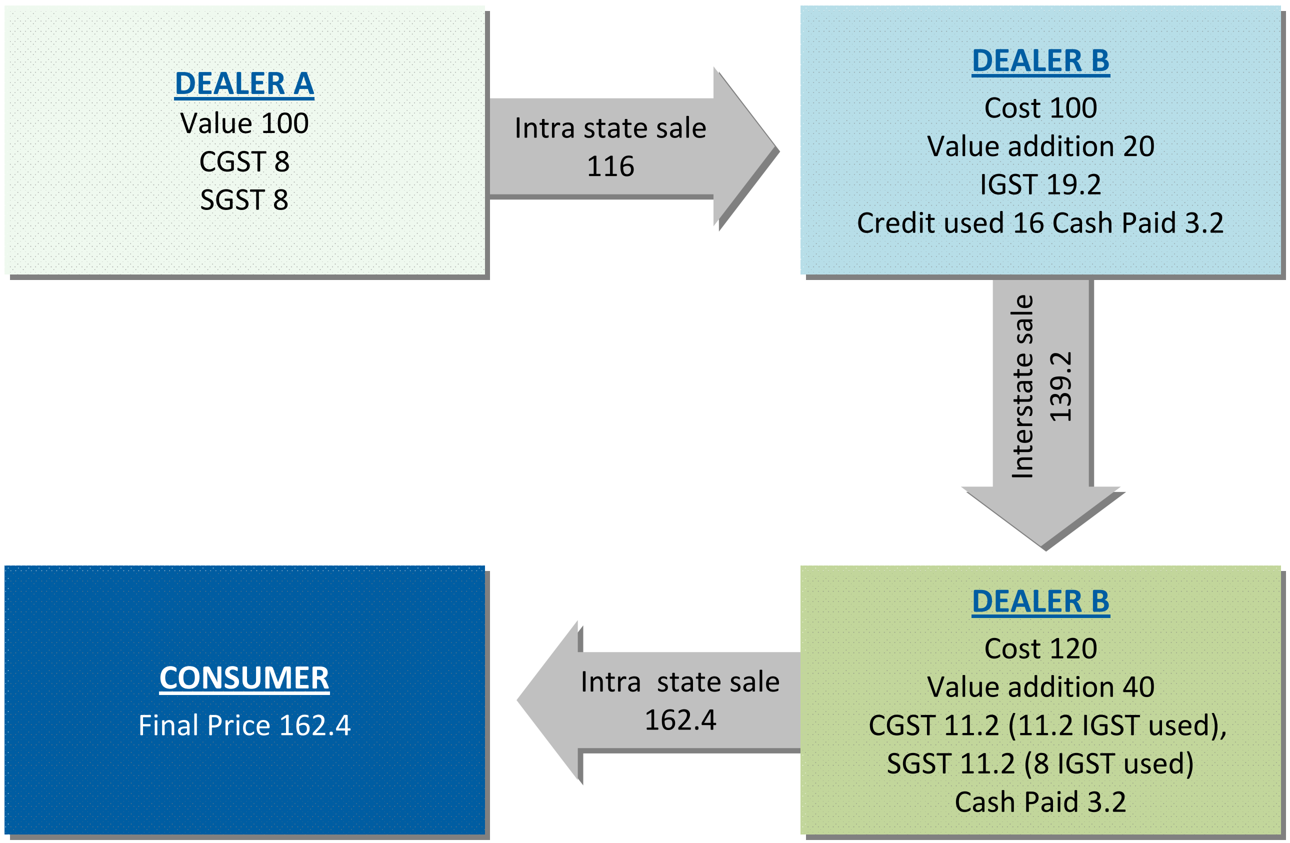
Tax	Goods	Services
CGST	Rs 15 mn	Yet to be decided
SGST	Rs 1 mn	Rs 1 million

A composition scheme with a floor rate of 0.5% to be available for taxpayers having annual turnover below Rs 5 million. This is to protect the interests of small business's

Inter State Goods & Services Tax (IGST)

- **The Empowered Committee has accepted the recommendation for adoption of IGST model for taxation of inter-State transaction of Goods and Services. The scope of IGST Model is that Centre would levy IGST which would be CGST plus SGST on all inter-State transactions of taxable goods and services. IGST will be payable only on value addition. A Central Agency will act as a clearing house, verify the claims and inform the respective governments to transfer the funds.**
- **The major advantages of IGST Model are:**
- **Maintenance of uninterrupted ITC chain on inter-State transactions.**
- **No upfront payment of tax or substantial blockage of funds for the inter-State seller or buyer.**
- **No refund claim in exporting State, as ITC is used up while paying the tax.**
- **Self monitoring model.**
- **Level of computerization is limited to inter-State dealers and Central and State Governments should be able to computerise their processes expeditiously.**
- **As all inter-State dealers will be e-registered and correspondence with them will be by e-mail, the compliance level will improve substantially.**
- **Model can take 'Business to Business' as well as 'Business**

IGST Mechanism



Transfers

State 1 to Centre - 8 of SGST towards payments of IGST

Centre to State 2 - 8 of IGST towards payment of GST

Exim & inter state supply of services

- **Exports would be zero-rated**
- **Exports to SEZ's will also be zero rated**
  - No benefit would be allowed for the sales from SEZ to domestic tariff area
- **Imports would be subject to CGST & SGST based on the destination principle**
  - SGST revenue will accrue to the state where the imports are consumed
  - Both CGST and SGST paid on imports will be available as credit for set-off
- **Taxation of inter-state supply of services: Rules may be formulated based on**
  - Place of location of immovable property
  - Place of performance of services
  - Location of service recipient (e.g. telecom & e-commerce)
  - Others (e.g. point of origin – for travel/logistics)

The Proposed Model of C-GST & S GST

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- **On all the supplies of Goods & Services uniform C-GST & S-GST would be applicable (e.g. 8% C-GST + 8% S-GST) except for Exports and Exempted goods.**
- **On imports, the importer would be liable to pay both C-GST + SGST. However, such GST on imports would be available as GST Credit / Setoff against output GST. (The Custom Duty would continue as a separate levy, it would not be the part of the GST system)**
- **On Interstate supplies of Goods & Services, IGST (Integrated GST) would be applicable which would be equal to C - GST + S - GST. Full Credit of input IGST would be available to the exporting / dispatching state against output IGST. The Exports would be zero rated**
- **On within the sate supplies of Goods & Services, the local supplier would charge C-GST + S-GST, the full credit of which would be available against output C-GST & S- GST, respectively**
- **Central Agency, appointed by the Central Government would do the transfers of funds between the States & Central, States & States and cross verification of transactions**
- **Single , Common Returns for I GST , C-GST & S-GST , Common Procedures**
- **The Dealers would make Net GST Payments to the Central & State Governments**

Estimates of the GST base

Consumption method

Description (bn)	Amount
Aggregate pvt final consumption expenditure	226
Pvt final consumption expenditure relating to purchase form unregistered dealers(unorganized sector)	125
Pvt final consumption expenditure (organized sector)	101
Govt. final consumption expenditure on goods and svcs	42
Gross fixed capital formation in household sector (excl labour)	38
Intermediate input from unregistered dealers	171
Gross total	353
Exemption for food, health, education , and svcs	63
Estimated non land GST base in 2006-07	290
GDP at factor cost in 2006-07	3,779
Non-land GST bases as proportion of GDP(%)	76.69
GDP at factor cost in 2007-08	432
Estimated non land GST base in 2007-08	331
GST base relating to land for 2007-08	43
Estimated GST Base 2007-08	374

Source: Task Force on GST

NCAER Estimates of the GST Base

Description	Amount (bn)
Estmated GST base (excl land and the threshold exemption (2003-04)	24,500
Impact of threshold exemption (purchase from unorganized sector)	8,942
Non-land GST base in 2003-04 adj. for threshold exemption	15,559
GDP of factor cost 2003-04	25,382
Estimated Non-land GST base in 2003-04 (%)	61
GDP at factor cost 2007-08	43,209
Estimated Non-land GST base in 2007-08 (%)	26,487
GST base relating to land for 2007-08	4,293
Estimated GST base in 2007-08	30,780

Source: NCAER

Estimated of GST base : Revenue model

NON POL (Existing Base)	Amnts (bn)	
Countervailing duty	535	
Public ledger account (paid to Govt.)	531	
Revenue foregone	875	
Cenvat	1,474	
Output tax	3,415	
Output tax base	20,724	
Input tax base	8,947	
Existing GST base (Goods)		**11,777**
Services (Existing base)		**4,137**
Additional base		
Financial base	668	
Rail	208	
Land	4,293	
Trade	5,181	
Petro. Power& tobacco	1,915	
Construction	1,319	
Sub-total		**13,583**
GST Base		**29,497**

Source: Task Force on GST

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